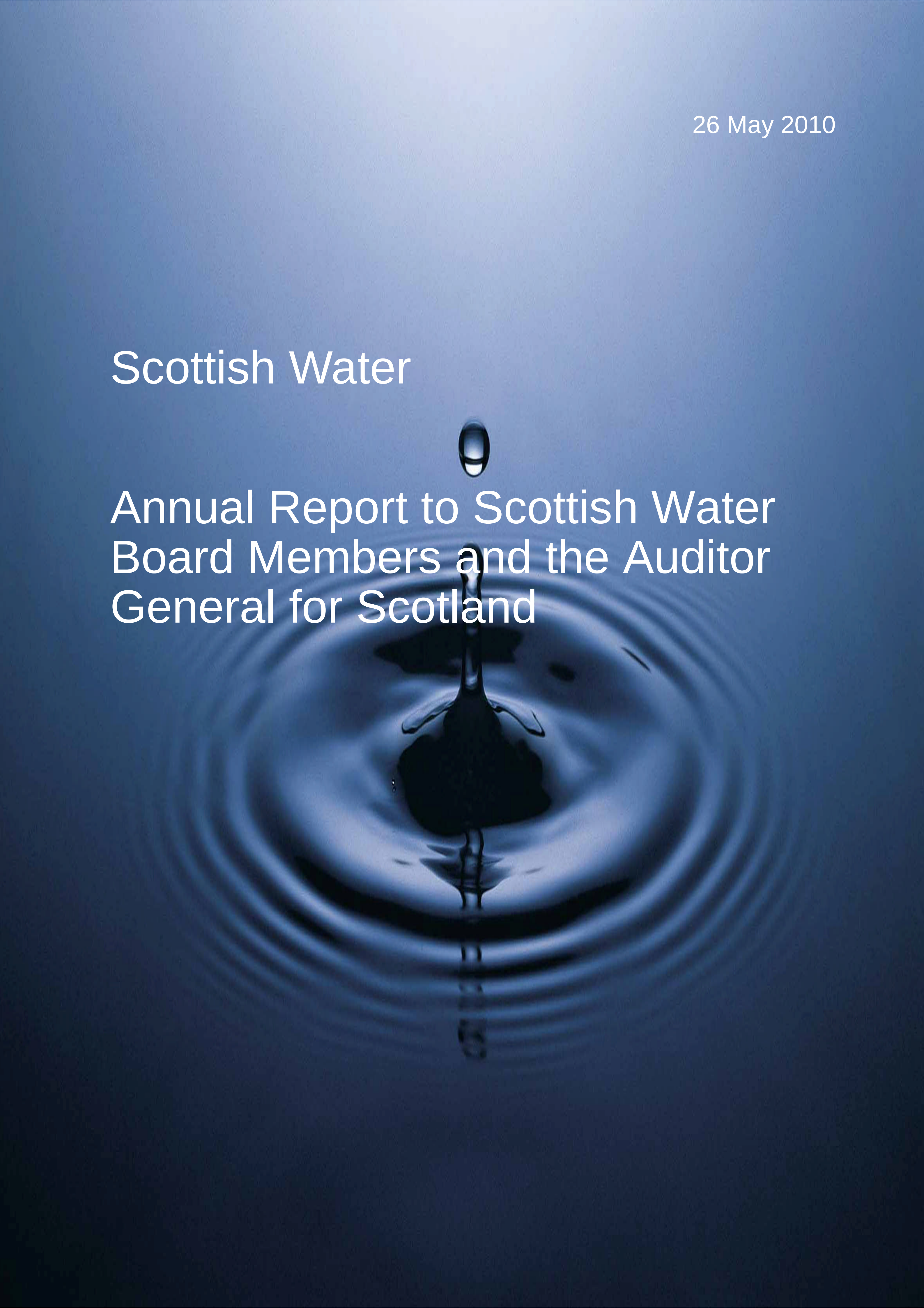
26 May 2010

Scottish Water

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



Contents

Abbreviations used throughout our report:

IAS	International Auditing Standards
IFRS	International Financial Reporting Standards
SWBS	Scottish Water Business Stream
SWBSH	Scottish Water Business Stream Holdings
SWS	Scottish Water Solutions
SWH	Scottish Water Horizons
SWHH	Scottish Water Horizons Holdings
WICS	Water Industry Commission for Scotland
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 auditor 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 2010 have been prepared to comply with the Water Industry (Scotland) Act 2002 and IFRS.

The overall quality of the working papers and the 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.

We are pleased to report that our **true and fair opinion** and **regularity opinion** on the financial statements for the year ended 31 March 2010 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 four subsidiary companies of Scottish Water and the joint venture (SWS) produce separate statutory accounts, under the requirements of the Companies Act, and are therefore subject to separate external audits. Our audit opinions on the financial statements of each of these companies are **unqualified**, with the exception of SWS which will not finalise its accounts until September this year due to outstanding legal and accounting treatment matters. This has not affected our audit opinion for Scottish Water.

Accounting Issues – Section 3

International Financial Reporting Standards

The interim results to 30 September 2009 were the first consolidated interim financial statements presented under IFRS. We provided a review opinion on these financial statements in November 2009 which did not note any significant issues. The financial statements for the year ended 31 March 2010 are the first full set of IFRS financial statements and as such we have reviewed relevant accounting treatments and disclosures.

Based on the work we carried out, both on the interim financial statements and on the full financial statements for the year ended 31 March 2010, we believe that the process of IFRS conversion has been well managed.

Large Balances Containing Judgements by Management

The financial statements contain a number of sizeable balances which required an element of judgement by management, including a Household Bad Debt Provision of £296.9 million, a Household Credit Note Provision of £21.1 million and a Restructuring Provision of £7.9 million for Scottish Water (£8.3 million at Group level).

For each of these balances, we have examined the judgements that management has applied to arrive at the figure included in the 2009/10 financial statements. In each case, we are satisfied that management has applied reasonable judgements that reflect prevailing economic circumstances

Wholesale Income Uncertainty Provision

Within the 2009/10 financial statements is a provision for £7.1 million (2008/09: £10.2 million) for "wholesale income uncertainty". This provision is considered necessary by management due to issues concerning the accuracy and completeness of CMA data, arising from incorrect calculations, estimated usages and vacant properties. It also provides for as yet unknown issues that may require Scottish Water to refund some of the wholesale income it has already billed.

We recognise that management has made significant efforts to collate appropriate supporting information for the provision. Of the total balance of £7.1 million, management has been able to provide specific examples and calculations to support a balance of around £4.0 million. However, the remaining balance of £3.1 million appears to be based on judgements around uncertain future events. Therefore, it is not possible to conclude with any degree of certainty whether this element of the provision will prove to be over or understated.

Whilst recognising that management has made best efforts to provide reasonable estimates for a significant portion of the total provision, we believe that the remaining uncertain balance should more appropriately be disclosed as a contingent liability within the financial statements. Management do not intend making any adjustment in the 2009/10 financial statements. However, the balance is below our overall materiality level and does not result in a qualification to our audit opinion.

Financial Performance 2009/10 – Section 4

From management information (which is not prepared on an IFRS basis), we are aware that Scottish Water's actual financial outturn for 2009/10 was materially in line with the budget. Total income was £1,066.2 million against a budget of £1,062.7 million and total expenditure was £736.9 million against a budget of £738.6 million.

The Scottish Water Group statutory surplus before tax for the year ended 31 March 2010 was £145.3 million compared to a surplus of £203.8 million for the year ended 31 March 2009.

The additional costs in 2009/10 contributing to much of the £58.5 million reduction in surplus on ordinary activities before tax are chiefly the result of:

- An increase in the depreciation charge of £33.5 million. This has been caused by the additional fixed assets that have been brought onto the Balance Sheet in the year; and
- An increase of £28.0 million in repairs and maintenance costs arising from a treatment required by IAS 16. These costs have been reclassified from assets under construction in the year and charged directly to the Statement of Comprehensive Income.

Quality and Standards (Q&S) capital programmes 2 and 3 incurred gross expenditure of £611.3 million in 2009/10 against a budget of £625.8 million. The total investment in the four years to March 2010 was £2,360 million.

Scottish Water acknowledges that there are inherent challenges in delivering a large and complex capital programme and usually anticipates a certain level of completion costs may need to be incurred in subsequent years. This may occur for a number of reasons including slippage, changes to scope or delays in achieving third party consents or agreements. Cumulative Q&S3 completion costs of £236 million from the 2006 – 2010 regulatory period will need to be delivered during the 2010–2015 regulatory period.

The overall cash position at the 2009/10 year end for Scottish Water was higher than budgeted by £151.4 million. This was affected by (variance from budgeted position in brackets):

- Cumulative slippage / lower than expected capital expenditure (£33.9 million);
- An increase in creditor accruals (£42.7 million);
- Lower debtors at year end (£13.3 million); and
- An increase in the drawdown on loans from the Scottish Government (£37.0 million) associated with out-performance in previous years of the 2006-2010 regulatory contract.

Financial Forecast 2010/11 and Financial Pressures – Section 5

The approved Scottish Water budget for the period 2010-2015 which includes the regulated business activities only is summarised below:

			£million		
	2010/11	2011/12	2012/13	2013/14	2014/15
Total turnover	1,061	1,035	1,051	1,067	1,083
Surplus after Tax	99	65	67	66	66

The 2011 – 2015 forecasts incorporate a number of particular challenges, including:

- The challenging Price Determination will create significant revenue pressure throughout the full duration of the forthcoming regulatory period

- The economic downturn may lead to a deterioration in collection rates or an increase in discounts and benefits

- The Final Determination assumes costs will rise by the RPI rate each year. However, recent evidence suggests that certain of Scottish Water's actual costs have been rising faster than the RPI rate

- In 2009/10, total capital expenditure (both Q&S and non-Q&S work) was £648 million. Net borrowing of £218.8 million was required to achieve this level of capital expenditure. However, future borrowing limits set by the Scottish Government have reduced borrowing to £140 million per annum for the next five year regulatory period

The restrictions on income and borrowing, taken with likely cost pressures, confirm that Scottish Water will require to reduce costs and utilise cash balances to meet key WIC targets.

Key Performance Indicators

Management present KPIs 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.

Tier One and Two indicators are monitored by the Board on a monthly basis, with actions agreed where necessary to ensure Scottish Water stays on track to deliver the agreed targets.

A key target is Scottish Water's OPA score. 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.

Scottish Water achieved an OPA target of 291 in 2009/10, exceeding the stretch target of 271.

Scottish Water is required to report the OPA scores to Scottish Ministers. The Ministers' Direction for the 2010-2015 regulatory period is as follows:

'Improve services to customers, such that by 2013-14, standards are comparable with the upper quartile performance achieved by the industry in England and Wales in 2007-08 as measured by the Overall Performance Assessment. Thereafter [Scottish Water] shall maintain that level of performance.'

In the Final Determination, the WIC confirmed that Scottish Water should achieve an OPA score in the range of 380-400 by 2013/14, and that performance should be maintained above 380 in 2014/15 and subsequent years. Against an actual OPA score of 291 in 2009/10, the achievement of this Ministerial target will require significant action and effort by Scottish Water.

Another key target relates to the delivery of the capital investment programme. In this regard, £236 million of investment to the 2006-2010 regulatory period will need to be carried forward to the 2010-2015 regulatory period.

This carry forward arises from slippage, changes in scope and delays in obtaining consents or agreements. Original funding for the carry forward should be maintained and not be used to fund other projects.

Governance and Control

We have reviewed Scottish Water's overall governance arrangements including a review of Board and key Committee structures and minutes, financial reporting to the Board, risk management and internal audit arrangements. Appropriate arrangements and reporting were noted.

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP
26 May 2010

1. Introduction

1.01 Our overall responsibility as external auditor 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.

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

1.03 Scottish Water, as a publicly owned organisation, is directly answerable to the Scottish Government. In undertaking our audit, we aim to take account of this wider perspective, the regulated environment in which Scottish Water operates and the requirements of the WIC; in particular, the role the WIC plays in terms of assessing Scottish Water's performance against key service delivery targets and setting customer prices.

1.04 Set out below is a summary of the responsibilities of Scottish Water Board Members and the Chief Executive and our responsibilities as your external auditor.

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 IFRS.	• Issuing an audit report (opinion) on whether the financial statements give a true and fair view of the financial position and income and expenditure 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 income and expenditure.

1.05 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 2010 have been prepared to comply with the Water Industry (Scotland) Act 2002 and IFRS.

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 26 May 2010 and will be approved by the Board on 2 June 2010.

Audit Adjustments

2.05 During the course of our audit, no material misstatements with an impact on our audit opinion were identified.

2.06 Under IAS 260 – “Communication of audit matters to those charged with Governance” we are required to report all unadjusted errors (over a de minimis level set by us) to members of the Audit Committee. No such matters need to be brought to your attention.

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 2010 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 (100% owned)
• Scottish Water Business Stream Holdings (SWBSH)
• Scottish Water Business Stream (SWBS) – held through SWBSH
• Scottish Water Horizons Holdings (SWHH)
• Scottish Water Horizons (SWH) – held through SWHH
Joint Venture
• Scottish Water Solutions (SWS)

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. Each subsidiary venture is equity accounted within the Scottish Water Group financial statements.

2.12 The nature of the contractual agreement between Scottish Water and the other shareholders in SWS is such that the parties are engaged in joint activities that do not constitute an entity carrying on a trade or business in its own right. Consequently, SWS Limited has been accounted for under IAS 31 'Interests in joint ventures', as a jointly-controlled operation. On this basis Scottish Water accounts directly for its own gross assets, liabilities and cash flows in the joint operation.

2.13 Our audit opinions on the financial statements of each of these companies are **unqualified**, with the exception of SWS which will not finalise its accounts until September this year (see paragraphs 3.21 and 3.22). This is due to outstanding legal and accounting treatment matters which have not affected our audit opinion for Scottish Water.

Water Industry Commission for Scotland – Regulatory Accounts

2.14 On an annual basis, the WICS requires Scottish Water to produce Regulatory Accounts. As the external auditor of Scottish Water, we provide an audit opinion on certain elements of the Regulatory Accounts. Our work in respect of the Regulatory Accounts is ongoing and will be completed in time for the return to be made to the WICS on 11 June 2010.

3. Accounting Issues

Introduction

3.01 During the year, we have reviewed and management has discussed with us a number of accounting treatments, including changes which have resulted from the transition to IFRS. This approach allowed us to work closely with management to agree appropriate accounting treatments at an early stage.

International Financial Reporting Standards

3.02 The interim results to 30 September 2009 were the first consolidated interim financial statements presented under IFRS. We provided a review opinion on these financial statements in November 2009 which did not note any significant issues. The financial statements for the year ended 31 March 2010 are the first full set of IFRS financial statements and as such we have reviewed relevant accounting treatments and disclosures.

3.03 Based on the work we carried out, both on the interim financial statements and on the full financial statements for the year ended 31 March 2010, we believe that the process of IFRS conversion has been well managed.

Large Balances Containing Judgements by Management

3.04 The financial statements contain a number of sizeable balances, including a Household Bad Debt Provision of £296.9 million, a Household Credit Note Provision of £21.1 million and a Restructuring Provision of £7.9 million for Scottish Water (£8.3 million at Group level).

3.05 For each of these balances, we have examined the judgements that management has applied to arrive at the figure included in the 2009/10 financial statements. In each case, we are satisfied that management has applied reasonable judgements that reflect prevailing economic circumstances.

3.06 In addition, we note that the balances included within the financial statements for the pension asset and liability are sensitive to underlying assumptions. We have considered the assumptions provided by Scottish Water's actuary in the context of the overall financial statements and have no matters which we need to bring to Members' attention.

Wholesale Income Uncertainty Provision (£7.1 million)

3.07 In addition to the balances discussed above, the financial statements also include a Wholesale Income Uncertainty Provision. This balance is inherently difficult to quantify and has therefore been subject to detailed assessment, consistent with our approach in previous years.

3.08 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 this water to their customers.

3.09 When the market was opened up the CMA was established. The CMA is responsible for maintaining the underlying data that is used to calculate water charges levied by Scottish Water on service providers.

3.10 The wholesale income uncertainty provision has been estimated at £7.1 million for 2009/10 (2008/09:

£10.2 million). 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 providers.

3.11 As in 2008/09, management considers a wholesale income provision necessary due to a number of factors:

- Scottish Water bills SWBS in accordance with schedules received from the CMA. During 2008/09 and 2009/10, certain 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 as a result of, for example, inaccurate discounts being applied. This resulted in Scottish Water receiving more income than it was entitled to.

- Based on CMA billing schedules, Scottish Water invoices SWBS on a monthly basis. However, there is a time lag of up to 18 months from when estimated meter readings (the basis for monthly forecast billings) become actual meter readings which are used to determine actual charges. This information is reconciled by the CMA and necessary adjustments then need to be 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. At present, this information is submitted to the CMA by the licensed providers without any independent verification of completeness and therefore income currently being received by Scottish Water could potentially be overstated.

3.12 Furthermore, unlike the detailed trend data available to support the household bad debt provision and credit note provision, detailed historic information is not available for all elements of the wholesale income uncertainty provision. This is principally due to the CMA only being in existence from 1 April 2008, thereby limiting the trend analysis that can be performed.

Ongoing Data Quality Work

3.13 Discussions are ongoing between the CMA and Scottish Water to resolve the potential lack of reliability of data provided to Scottish Water by the CMA. However, this continues to be 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.

3.14 SWBS has also experienced challenges as a result of the accuracy of CMA data. Concerns over the accuracy of amounts billed by Scottish Water (on the basis of CMA data) have led SWBS to set up a prepayment of £4.9 million in its financial statements in anticipation of receiving a refund from Scottish Water.

3.15 In order to enhance the accuracy of the prepayment amount, SWBS has established a Data Quality Team with the role of reducing the data gaps between the CMA, Scottish Water and SWBS customer information. Work on vacant property data has already commenced and going forward, the team's priorities are to identify and investigate systematic problems with individual accounts and deal with corrections and settlement queries relating to the wholesale charges between SWBS and Scottish Water.

Accounting Treatment

3.16 In accounting terms, in order to include a balance as a provision within the financial statements, the balance needs to meet three key criteria set out within IAS 37 *'Provisions, Contingent Liabilities and Contingent Assets'*:

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 probable that Scottish Water will need to refund SWBS relating to income received in 2009/10.
3. Reliable estimate	×	Given the limited historic information available to Scottish Water, it is difficult for management to determine a wholly reliable estimate, based on supporting data or trends available.

3.17 We recognise that management has made significant efforts to collate appropriate supporting information for the provision. Of the total balance of £7.1 million, management has been able to provide specific examples and calculations to support a balance of around £4.0 million. However, the remaining balance of £3.1 million appears to be based on judgements around uncertain future events. Therefore, it is not possible to conclude with any degree of certainty whether this element of the provision will prove to be over or understated.

3.18 In light of continuing uncertainty over a portion of the balance, we suggest that Scottish Water should continue to address its concerns to the CMA, seeking their resolution of the underlying data quality and reliability issues. While we recognise that there will always be issues to resolve in any billing system, improving the quality of underlying data should help minimise the number of issues that require a provision.

3.19 The difficulties experienced by Scottish Water will become significant should more of the non-domestic market choose to receive their water from a licensed provider other than SWBS. SWBS is a wholly-owned subsidiary of Scottish Water with profits and results being consolidated into the Scottish Water Group financial statements; this would not be the case for other providers. ***(See Action 1 in Appendix 1)***

3.20 Whilst recognising that management has made best efforts to provide reasonable estimates for a significant portion of the total provision, we believe that the remaining uncertain balance should more appropriately be disclosed as a contingent liability within the financial statements. Management do not intend making any adjustment in the 2009/10 financial statements. However, the balance is below our overall materiality level and does not result in a qualification to our audit opinion.

Subsidiaries

3.21 A number of subsidiaries are consolidated within the Scottish Water Group financial statements. Certain of these subsidiaries have given rise to accounting issues with significance at a Group level.

Scottish Water Solutions

3.22 Management of SWS has decided that it would not be possible to finalise the 2009/10 financial statements in accordance with the planned timetable, which was intended to fit with Group reporting deadlines. Instead, SWS plans to finalise its financial statements in September 2010. This is because of concerns arising from uncertainties over a particular legal case and the determination of certain accounting treatment matters.

3.23 We are also external auditor for SWS and have completed our year end audit work in accordance with the original plan. From a Group auditor point of view, our principal uncertainty concerns the potential crystallisation and treatment of legal liabilities in light of ongoing litigation. We are aware of the potential exposure at Group level but have not disclosed this within this report to ensure we do not prejudice any negotiations or further discussions. In our view, this is unlikely to be material to the Group financial statements and no other matters of Group significance have arisen.

Scottish Water Horizons

3.24 SWH has experienced particular trading challenges during 2009/10 which have predominantly affected the Contracting and Developer Services business segments.

3.25 Although SWH has been profitable in 2009/10, SWH management has taken the opportunity to consider the future strategic direction that the business should take, with a specific focus on consolidation and potential divestment in certain segments.

3.26 We also act as external auditor to SWH and in this capacity have reviewed the Business Plan and forecast financial position covering the period to 2014/2015. On the basis of this review, it is clear that management plans to take action in relation to the company's future and profitability. As a result, from a Group perspective, we have been able to conclude that SWH will continue as a Going Concern for at least the next 12 months.

4. Financial Performance 2009/10

Revenue

4.01 From management information (which is not prepared on an IFRS basis), Scottish Water's actual financial outturn for 2009/10 was materially in line with the budget. Total income was £1,066.2 million against a budget of £1,062.7 million and total expenditure was £736.9 million against a budget of £738.6 million.

4.02 The statutory financial performance for the Scottish Water Group, as set out in the Consolidated Income Statement for the year ended 31 March 2010, is set out below:

	2010 £million	2009 £million
Revenue	1,124.1	1,094.6
Cost of sales	(674.3)	(609.2)
Gross surplus	**449.8**	**485.4**
Administrative expenses	(104.5)	(101.8)
Operating Surplus	**345.3**	**383.6**
Finance Income	38.9	56.4
Finance Costs	(238.9)	(236.2)
Surplus on ordinary activities before tax	**145.3**	**203.8**
Taxation	(37.7)	(76.8)
Surplus for the year	**107.6**	**127.0**

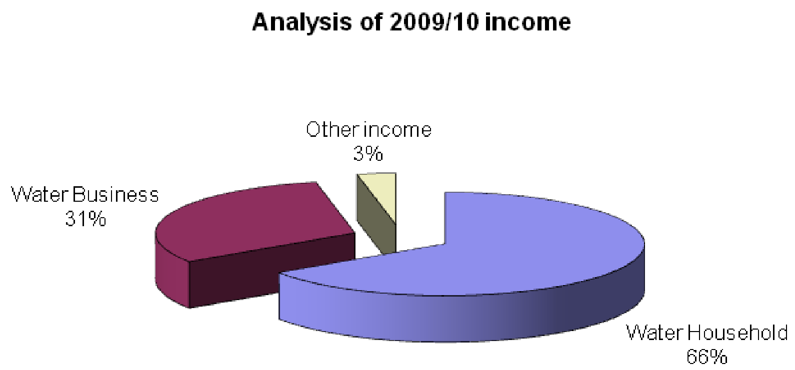
4.03 The additional costs in 2009/10 contributing to much of the £58.5 million reduction in surplus on ordinary activities before tax in the statutory results are chiefly the result of:

- An increase in the depreciation charge of £33.5 million. This has been caused by the additional fixed assets that have been brought onto the Balance Sheet in the year; and
- An increase of £28.0 million in repairs and maintenance costs arising from an accounting treatment required by IAS 16. These costs have been reclassified from assets under construction in the year and charged directly to the Statement of Comprehensive Income.

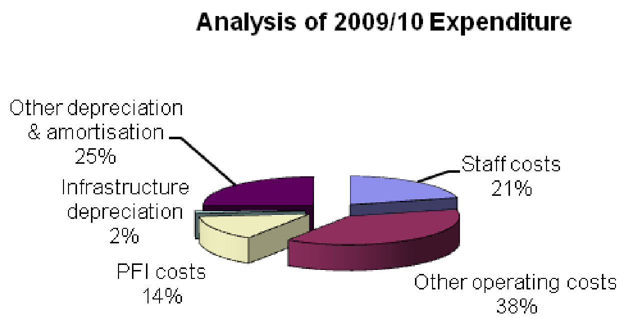
4.04 Scottish Water's underlying regulated operating costs for the year were actually £15.7 million under budget. However, we note that this cost saving was largely offset by additional one-off costs in the year, including:

- Additional voluntary redundancy costs of £8.1 million;
- Unbudgeted costs arising from the severe weather conditions through the winter of £3.1 million; and
- Unbudgeted restructuring costs of £2.3 million.

4.05 The split of Group income from the statutory accounts for the year is shown in the graph below. This demonstrates that the bulk of Scottish Water's income is derived from households but that a sizeable proportion also arises from the Business market:



4.06 The split of Group operating expenditure for the year is shown in the graph below, based on our analysis of underlying financial records. This shows that PFI costs, depreciation and amortisation make up a significant proportion at 40% of total expenditure, illustrating the asset-intensive nature of Scottish Water's business:



Capital

4.07 Quality and Standards (Q&S) capital programmes 2 and 3 incurred gross expenditure of £611.3 million in 2009/10 against a budget of £625.8 million. The total investment in the four years to March 2010 was £2,360 million.

4.08 Scottish Water acknowledges that there are inherent challenges in delivering a large and complex capital programme and usually anticipates a certain level of completion costs may need to be incurred in subsequent years. This may occur for a number of reasons including slippage, changes to scope or delays in achieving third party consents or agreements. Cumulative Q&S3 completion costs of £236 million from the 2006 – 2010 regulatory period will need to be delivered during the 2010–2015 regulatory period.

Cash Balances

4.09 The closing cash balance for the Scottish Water Group, as at 31 March 2010 was £218.5 million (31 March 2009: £75.2 million). This cash balance is split across the Scottish Water Group as follows:

	2009/10 £ million	2008/09 £ million
Scottish Water	153.5	15.9
Scottish Water Horizons	2.5	7.0
Scottish Water Horizons Holdings	3.1	3.1
Scottish Water Business Stream	20.8	11.0
Scottish Water Business Stream Holdings	38.6	38.2
Total Group Cash Balance	**218.5**	**75.2**

4.10 The overall cash position at the 2009/10 year end for Scottish Water was higher than budgeted by £151.4 million. This was affected by (variance from budgeted position in brackets):

- Cumulative slippage / lower than expected capital expenditure (£33.9 million);
- An increase in creditor accruals (£42.7 million);
- Lower debtors at year end (£13.3 million); and
- An increase in the drawdown on loans from the Scottish Government (£37.0 million) associated with out-performance in previous years of the 2006-2010 regulatory contract.

5. Financial Forecast 2010 - 2015

5.01 The approved Scottish Water budget for the period 2010-2015 which includes the regulated business activities only is summarised below:

	2010/11	2011/12	2012/13	2013/14	2014/15
	£million	£million	£million	£million	£million
Total turnover	1,061	1,035	1,051	1,067	1,083
Operating expenditure	(308)	(312)	(312)	(316)	(321)
Other expenditure e.g. PFI costs, depreciation	(452)	(463)	(472)	(480)	(486)
Operating profit /surplus	**301**	**260**	**267**	**271**	**276**
Interest payable	164	169	174	179	184
Profit/ surplus before Tax	**137**	**91**	**93**	**92**	**92**
Taxation	38	26	26	26	26
Profit/ surplus after Tax	**99**	**65**	**67**	**66**	**66**

5.02 The 2010-2015 forecasts incorporate a number of assumptions and particular challenges as follows:

Turnover

5.03 The price determination issued by the WICS in December 2009 states that water charges will rise by 5% below the rate of inflation over the five-year period 2010-15. Households will enjoy a price freeze in the first year (2010/2011) and, subject to inflation, there is the prospect of a further price freeze in 2011/12. Household charges will then increase by less than inflation between 2012 and 2015. This challenging Price Determination will create significant revenue pressure throughout the full duration of the forthcoming regulatory period.

5.04 Collection rates for household debt have displayed a broadly steady trend in recent years. However, if the economic downturn has a negative impact on actual collection rates or leads to increases in discounts and benefits, Scottish Water will need to close the gap through additional savings rather than price increases (see point above relating to Price Determination). Management has been taking a range of initiatives to address this risk of deterioration, including working closely with local authorities and the Department for Work and Pensions, targeting its recovery actions on specific market segments and assessing alternative debt collection options, such as third party debt management companies.

Costs

5.05 Scottish Water's Final Determination assumes costs will rise by the RPI rate each year. However, based on trends observed during 2009/10, we can see that actual costs in certain areas (e.g. power and chemicals in particular) have been rising faster than the RPI rate, meaning that should this continue into 2010/11, any additional adverse cost gap will need to be closed through additional savings.

5.06 Forecast operating costs reflect those set out in the Final Determination issued by the WIC in November 2009. As a result, operating costs do not include the adverse impacts arising from the 2010 rates revaluation (announced in February 2010) or from the review of the Billing and Collection order in 2012. These factors may apply additional cost pressure over and above that identified in the forecasts.

Profits/Surpluses

5.07 In overall terms, the Final Determination issued by the WICS anticipates a reduction in the level of future profits/surpluses previously returned by Scottish Water.

Capital and Borrowing

5.08 In 2010/11, Scottish Water's total capital expenditure is budgeted at £484 million, supported by new net borrowing of £140 million.

5.09 In 2009/10, total capital expenditure (both Q&S and non-Q&S work) was £648 million. Net borrowing of £218.8 million was required to achieve this level of capital expenditure. Going forward, future borrowing limits set in agreement with Scottish Government will result in a lower borrowing limit of £140 million per annum for the next five year regulatory period, reflecting Scottish Water's target capital investment levels.

Overall

5.10 The restrictions on income and reduced borrowing, taken with potential cost pressures, confirm that Scottish Water will require to reduce costs and utilise cash balances to meet key WIC targets. ***(See Action 2 in Appendix 1)***

6. Key Performance Indicators

6.01 Management present key performance indicators (KPIs) 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 and Tier Two indicators are monitored by the Board on a monthly basis, with actions agreed where necessary to ensure Scottish Water stays on track to deliver the agreed targets.

6.03 For the purposes of this Report, we only note and comment upon Tier One Indicators.

	2009/10			2010/11	
Key Performance Indicator	**Delivery Plan Target**	**Internal Stretch Target**	**Actual Year-end**	**Delivery Plan Target**	**Internal Stretch Target**
OPA score (YTD = 12 month rolling average)[1]	241	271	291	302	322
OPEX spend against target profile	£304.1m	£296.0m	£301.9m	£335.3m	£330.3m
Scottish Water Profit before Tax (excluding depreciation)	£463.4m	£478.4m	£475.5m	£421.5m	£436.5m
Capital Spend on Q&S2 and Q&S3 programmes	£625.9m	£625.9m	£611.3m	N/A	N/A
Number of Q&S2 & Q&S3 projects remaining to be delivered	N/A	N/A	N/A	65	50
Cumulative % output delivery on Q&S2	99.89%	99.89%	99.88%	N/A	N/A
Cumulative % output delivery on Q&S3	95.77%	97.07%	95.80%	N/A	N/A
Compliance with WIC leakage (ML/d) [2]	750	710	704	720	700
Health and Safety – number of reportable incidents	N/A	29	34	N/A	26
Customer satisfaction survey - % satisfied.	80%	84%	82%	N/A	N/A
Q&S IIIb delivery (OMD measure)	N/A	N/A	N/A	N/A	more than 100% of yr 1 target
Revenue for Core DP	£1,062.7m	£1,062.7m	£1,066.2m	£1,060.7m	£1,065.7m
Total Capital Expenditure	£690.0m	N/A	£648.0m	£484.1m	N/A
Household customers - Collection performance %	N/A	94.10%	94.25%	N/A	94.30%

[1] *Note different basis of measurement will be used in 2010/11.*

[2] *Note different basis of measurement will be used in 2010/11.*

OPA Score

6.04 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.

6.05 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.

6.06 Scottish Water is required to report the OPA scores to Scottish Ministers. The Ministers' Direction for the 2010-2015 regulatory period is as follows:

'Improve services to customers, such that by 2013-14, standards are comparable with the upper quartile performance achieved by the industry in England and Wales in 2007-08 as measured by the Overall Performance Assessment. Thereafter [Scottish Water] shall maintain that level of performance.'

6.07 In the Final Determination, the WIC confirmed that Scottish Water should achieve an OPA score in the range of 380-400 by 2013/14, and that performance should be maintained above 380 in 2014/15 and subsequent years.

6.08 Against an actual OPA score of 291 in 2009/10, the achievement of this Ministerial target will require significant action and effort by Scottish Water. ***(See Action 3 in Appendix 1)***

Operating Expenditure (OPEX)

6.09 Scottish Water has a history of achieving its OPEX target and this successful performance will need to continue against a potential backdrop of reducing revenue and cost increases in certain areas above the RPI rate (see Section 5).

Capital Expenditure (CAPEX)

6.10 Throughout the regulatory period 2006-2010, Scottish Water progressed its Q&S Capital Investment Programme 3, seeking to achieve the targets set out and agreed with the WIC in the Delivery Plan.

6.11 The particular challenges in this area relate to the avoidance of delivery slippage and the restrictions on borrowing to fund capital work.

6.12 Due to the scale and complexity of the programme, a total £236 million of investment relating to Q&S3 was not delivered during the 2006-2010 regulatory period and will now need to be carried over into the 2010-2015 regulatory period. The level of completion costs that will need to be met in the subsequent regulatory period is consistent with the expectation management developed over the course of the programme and is smaller than the Q&S2 programme completion costs (£311 million) that were carried forward into the 2006-2010 regulatory period from the previous period. This carry forward arises from slippage, changes in scope and delays in obtaining necessary consents or agreements. Original funding for the carry forward should be maintained and not used to fund other projects.

6.13 The total budgeted capital investment for the 2010/11 year is £484 million of which £183m relates to the Q&S2/3a completion costs carried forward from the 2006–2010 regulatory period. This recognises that a concerted effort will be made to close out a significant portion of these projects during 2010/11.

6.14 We do note, however, that around £53 million of Q&S3 is forecast to be carried over into 2011/12, notwithstanding any as of yet unforeseen delays that may occur in 2010/11. ***(See Action 4 in Appendix 1)***

Leakage Targets

6.15 The 2009/10 target for leakage was to achieve an average of 750 million litres of leakage per day. The actual results for the year show an average of 704 million litres a day, despite the severe weather conditions that led to a significant increase in burst pipes.

6.16 In achieving this performance, it was necessary for Scottish Water to incur significant targetted expenditure during the year of £14.5 million (2008/09: £20.8 million).

6.17 Leakage targets for 2010/11 have now been set, with Scottish Water having put in place a Delivery Plan target of 720Mld and a stretch target of 700Mld.

Scottish Water Annual Outperformance Incentives Plan (AOIP)

6.18 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 have broadly remained consistent with prior years.

6.19 Annual outperformance incentive payments for 2009/10 were calculated based on Scottish Water's performance during 2009/10 in respect of:

Measure	Target	Stretch Target	Actual Performance	Outperformance allocation %
Profit before tax excluding depreciation in comparison with the targets in the Final Price Determination	£463.4m	£478.4m	£475.5m	30%
Outperformance in respect of the Final Determination Overall Performance Assessment Target	241	271	291	40%
Investments: • Output delivered • Q&S2/3a investment	 • 85% • £121.4m	 • 110% • £108.5m	 • 86.5% • £129.4m	15%
Leakage (measured in mega litres per day)	750Mld	710Mld	704Mld	15%
TOTAL				**100%**

6.20 On an annual basis, Internal Audit review the incentive calculations by tracing the performance statistics to the base data e.g. OPA score for 2009/10 to third party evidence such as those formal reports issued by the WIC.

6.21 As part of our normal audit procedures, we have reviewed the work undertaken by Internal Audit and re-performed certain of the calculations to confirm the calculation of the incentive payments. We emphasise that we do not express a specific opinion on the appropriateness or accuracy of the AOIP. 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.

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 and undertake our audit. We only evaluate and test those core systems and related internal controls on which we plan to rely during our audit and which are required in relation to our Code of Audit responsibilities.

7.02 In 2009/10, we considered certain governance arrangements in place within Scottish Water, as set out in the paragraphs which follow.

Overall Governance Arrangements

7.03 We have reviewed Scottish Water's overall governance arrangements including a review of Board and key Committee structures and minutes, financial reporting to the Board and Standing Financial Instructions. Appropriate arrangements and reporting were noted.

7.04 In March 2009, four non-executive directors were replaced when their terms of appointment ended. Despite these changes to the Board structure, we did not identify any significant issues or areas for improvement as a result of the changes.

Review of key financial processes and controls

7.05 Over the term of our external audit appointment, we review those key financial processes and controls which could have a direct impact on the fair statement of balances within the financial statements. During 2009/10, we have documented and evaluated the key financial processes and controls to determine whether there had been any changes in key controls. Our audit testing included individual walkthroughs of the specific financial processes in place. In addition, on a rotational basis every three years, we undertake more detailed testing of certain key financial controls to ensure that these controls continue to operate as expected.

7.06 During the course of our 2009/10 audit, we reviewed and tested a range of key controls within the following key systems and processes:

- Main Accounting System;
- Bank and Cash;
- Revenue and Receivables;
- Purchases and Payables;
- Payroll; and
- Asset Management.

7.07 Minor control weaknesses were identified but these were not deemed to be material and mitigating controls were identified where appropriate. Scottish Water continues to have in place an appropriate control environment for our audit purposes.

Risk Management

7.08 The corporate risk register was last approved by the Board in April 2010. The identified corporate risks were scored on the basis of consequence to the Board (very serious, serious, material or insignificant) and likelihood of impact (inconceivable, conceivable but highly unlikely, possible, probable, almost certain). Consequences are defined in one of four contexts – reputational, financial, operational or external. Any risks which are scored in excess of 250 are classified as major risks which need to be addressed by Management immediately.

7.09 When we reviewed the Risk Register as at April 2010, there were two “red” risks facing Scottish Water with a total score of 850 (compared to five risks with a total score of 1,550 at September 2009). The two significant risks related to:

- Risk of delivery of water into customers' premises which is not fit to drink due to contamination; and
- Risk of adverse changes to the current Billing & Collection Order due to increased pressure by COSLA and individual local authorities;

7.10 Although the number of “red” risks has decreased since September 2009, there has been a general increase in the number of “amber” risks facing the business. This represents a general deterioration in the risk environment i.e. although less “red” risks exist, Scottish Water is facing serious risks on more fronts.

7.11 Management has identified a range of specific actions to mitigate the risks identified in the risk register and has set timeframes and allocated ownership for the actions. The effectiveness of the mitigating actions is also assessed to demonstrate how management is controlling the risks.

7.12 In addition, risk management appears regularly on the Senior Management Team’s and Audit Committee’s agenda with this key activity featuring as an integral part of Scottish Water’s areas of development and delivery.

7.13 As a result, we have not identified any particular areas for improvement.

Internal Audit

7.14 In addition, as part of our controls work, we also considered Scottish Water’s Internal Audit Function, in particular Internal Audit staffing and work undertaken during 2009/10. In addition to its normal quarterly reporting to the Audit Committee, Internal Audit also reports on relevant Audit Scotland publications and national report findings.

7.15 We did not note any significant issues in relation to the work undertaken by Internal Audit and are therefore pleased to report that we have placed reliance on certain elements of the work they undertook in 2009/10.

7.16 In undertaking its audit plan, Internal Audit has encountered certain difficulties in completing all planned work in relation to Information Technology controls. These difficulties have been caused by long term staff absence and we are pleased to report that the Head of Internal Audit is in the process of putting in place alternative arrangements in relation to this area of importance.

7.17 While the scope of Internal Audit’s Information Technology work goes beyond the financial systems that we are primarily concerned with for our external audit, we reviewed all relevant reports to inform our judgement on the overall control environment. This included review of the following reports:

- Optimum customer connections system;
- Security and administration of the PeopleSoft Financial Management System; and
- Controls and procedures governing the security, administration and implementation of the Advanced Scheduler System

7.18 We note that the above Internal Audit reports identified a number of risks. These issues were followed up as part of our year end audit work to assess if there was any impact on our audit.

7.19 Our work did not identify any weaknesses with significance for our financial statements audit opinion and we therefore believe Scottish Water continues to have in place an appropriate control environment.

Audit Scotland National Reports

7.20 Audit Scotland National Reports are brought to the attention of the Audit Committee by the Head of Internal Audit and considered by Members where relevant.

Prevention and Detection of Fraud and Corruption

7.21 Our approach has been determined through consideration of certain incentives, pressures, opportunities, and attitudes relevant to the prevention of fraud.

7.22 As part of our rotational audit plan, we reviewed certain elements of Scottish Water's fraud and corruption policies, in particular relating to members and staff conduct.

7.23 We have also discussed these matters with senior management as well as reviewing work undertaken by Internal Audit.

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

7.25 Internal audit has identified two cases of alleged fraud that arose during 2009/10. These cases related to contractor relationships but were not specific to any staff member or contractor. The allegations were not anticipated to be significant by Internal Audit and were not investigated further.

Appendix 1: Higher Risk Challenges for Board Attention

Reference	Agreed Recommendation
Action 1 – Quality of CMA Data (paragraph 3.19)	Scottish Water should continue to address their concerns to the CMA regarding underlying data quality and should work closely with the CMA to resolve and improve the quality of the data. This should be designed to improve accuracy of billing and reduce the number of issues which require provisioning.
Action 2 – Financial Outlook 2010-2015 (paragraph 5.11)	Scottish Water faces a number of significant challenges as a result of restrictions to its income / pricing, borrowing and possible cost pressures in relation to the RPI assumptions contained in the Final Determination. As a result, Scottish Water will need to reduce its cost base and utilise cash balances to meet key WIC targets.
Action 3 – Achieving OPA Targets (paragraph 6.08)	Scottish Water achieved an OPA target of 291 in 2009/10, exceeding the stretch target of 271. However, we note that the WIC has set Scottish Water the challenge of achieving an OPA score of 380 – 400 by 2013/14. This will require concerted action and effort by Scottish Water over the next four years, across a range of business areas.
Action 4 – Capital Infrastructure Programme (paragraph 6.14)	Scottish Water is undertaking an ambitious capital investment programme in 2010/11 which includes an overhang of uncompleted work carried forward from the 2006-2010 regulatory period. Further Q&S3 work is forecast to be carried over into 2011/12, notwithstanding any further slippage or delays that may occur in 2010/11. Scottish Water will need to make significant efforts to deliver the forecast level of investment in 2010/11 and minimise any further slippage to 2011/12 or beyond.

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 2009/10 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 2009 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 2009).
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 2009)
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	To be signed by Management 2 June 2010.
Material Weaknesses in Internal Control	Internal Controls findings reported separately in our External Audit Status Update (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 (November 2009) and 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 2009/10 Financial Statements.
Audit Materiality	Audit Planning document – presented to Audit Committee in November 2009
Fair Value Measurement and Disclosure	Included in representation letter, to be signed by management dated 2 June 2010
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 2009/10

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 2009/10 are summarised below:

Formal Output	Timing
Audit Plan	November 2009
Interim Accounts – Audit Opinion	November 2009
Detailed Timetable for 2009/10 Financial Audit	November 2009
External Audit Status Update (including follow up of prior year recommendations)	March 2009
Annual Report to Board Members and the Auditor General for Scotland	May 2010
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 Business Stream Holdings ✓ 6. Scottish Water Horizons Holdings ✓ 7. Scottish Water Regulatory Accounts ✓ Unqualified Audit Opinions	June 2010

Freedom of Information (Scotland) Act 2002

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