

1 June 2011

Scottish Water

A high-speed photograph of a single water droplet falling into a pool of water. The droplet is captured mid-fall, just above the surface, with a small splash of water below it. The impact has created a series of concentric ripples that spread outwards from the center. The water is a deep, dark blue color, and the lighting is dramatic, highlighting the droplet and the ripples against a darker background.

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

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Abbreviations used throughout our report:

CAPEX	Capital Expenditure
CMA	Central Market Agency
CPI	Consumer Price Index
FREM	Financial Reporting Manual (HM Treasury)
IFRS	International Financial Reporting Standards
ISA	International Standards of Auditing
OPA	Overall Performance Assessment
OPEX	Operating Expenditure
RPI	Retail Price Index
SWBS	Scottish Water Business Stream
SWBSH	Scottish Water Business Stream Holdings
SWH	Scottish Water Horizons
SWHH	Scottish Water Horizons Holdings
SWS1	Scottish Water Solutions 1
SWS2	Scottish Water Solutions 2
WICS	Water Industry Commission for Scotland

Executive Commentary

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

The financial statements of Scottish Water for the year ended 31 March 2011 have been prepared to comply with the Water Industry (Scotland) Act 2002, the UK HM Treasury Financial Reporting Manual (FREM) and International Financial Reporting Standards (IFRS).

The overall quality of the financial statements and working papers produced by management were of a high standard, particularly given the short time period between closing the ledger and presenting the final financial statements to the Audit Committee.

We are pleased to report that our **true and fair opinion** and **regularity opinion** on the financial statements for the year ended 31 March 2011 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 specific elements of the **Remuneration Report is also unqualified**.

Section 3 Accounting Issues highlights certain accounting treatments within the financial statements – areas of particular note relate to the wholesale income uncertainty provision, treatment of pension changes and deferred taxation.

Section 4 Financial Position 2010/11 outlines that the overall group position for Scottish Water was a surplus of £184 million, after exceptional items (pensions) and taxation. Commentary is included for Income, expenditure, borrowing and capita.

Section 5 Financial Forecast 2011/12 - Scottish Water (company) is forecasting a reduced surplus after tax of £43 million for 2011/12 based on the agreed delivery plan.

Looking ahead Scottish Water is facing a number of potential challenges including: setting water charges, economic downturn, borrowing and funding of the capital programme, against the removal of its borrowing capacity in 2011/12.

Scottish Water has met or exceeded the targets set between itself and the WICS. Targets including for example customer satisfaction (OPA), surplus before tax, operating costs and leakage are noted in Section 6 and Appendix 2. In line with contractual obligations this has resulted in certain annual incentivisation payments (AOIP) for 2010/11, in addition to long term payments (LTIP) for the period 2006-2010.

Section 7 summarises our work in relation to internal financial controls, risk management, the work of internal audit and Audit Scotland National Reports.

Overall, we are satisfied that it is appropriate for the accounts to have been prepared on a going concern basis.

PricewaterhouseCoopers LLP
25 May 2011

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. Therefore, aspects of this report are directed more to the Auditor General for Scotland to inform his understanding of Scottish Water’s performance and wider business challenges.
- 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, in particular the regulated environment in which Scottish Water operates and also the requirements of the WICS; for example, the role the WICS 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.

Responsibilities of Scottish Water Board Members and the Chief Executive	Responsibilities of External Audit
<ul style="list-style-type: none"> • 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. 	<ul style="list-style-type: none"> • 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 2011 have been prepared to comply with the Water Industry (Scotland) Act 2002, the UK HM Treasury Financial Reporting Manual (FREM) and International Financial Reporting Standards (IFRS).
- 2.02 Much of Scottish Water's reporting follows the requirements set out in the FREM, which in many cases follows Companies Act requirements. Each year Scottish Water seeks to develop its reporting to meet best practice standards in a range of areas including wider disclosure concerning financial and wider business performance, capital investment and member's remuneration. Recognising Scottish Water's public sector accountability, continued developments in this regard are recommended.

Action Point 1

Audit Process

- 2.03 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.
- 2.04 The overall quality of the financial statements and working papers produced by management were of a high standard, particularly given the short time period between closing the ledger and presenting the final financial statements to the Audit Committee. 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

- 2.05 The consolidated financial statements were presented to the Audit Committee on 25 May 2011 and will be approved by the Board on 1 June 2011.

Audit Adjustments

- 2.06 During the course of our audit, no material misstatements with an impact on our audit opinion were identified.
- 2.07 Under ISA 260 – "Communication of audit matters to those charged with Governance" we are required to report any adjustments proposed by us to the financial statements, over a de minimis level set by us, which management have not processed. Only one proposed audit adjustment was not processed by management. This related to a proposed reduction of £3.4 million to the wholesale income provision (See Section 3 – Accounting Issues for further information)

Scottish Water

- 2.08 We are pleased to report that our **true and fair opinion** and **regularity opinion** on the financial statements for the year ended 31 March 2011 is **unqualified**.
- 2.09 We also provide a view as to whether those parts of the Remuneration Report subject to audit have been properly prepared. Our opinion on specific elements of the **Remuneration Report is also unqualified**.

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

Scottish Water Subsidiaries and Joint Ventures (also see Appendix 3)

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

Subsidiaries (100% owned)
<ul style="list-style-type: none">• 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 Ventures
<ul style="list-style-type: none">• Scottish Water Solutions 1 (SWS1)• Scottish Water Solutions 2 (SWS2)

2.12 The six organisations noted above produce separate statutory accounts under the requirements of the Companies Act and are therefore subject to separate external audits. The financial results of each organisation are accounted for within the Scottish Water Group financial statements.

2.13 Our audit opinions on the financial statements of each of the above organisations are **unqualified**, with the exception of SWS 1 which is unlikely to finalise its accounts until September 2011. This is because of concerns arising from uncertainties over a particular legal case and the determination of certain accounting matters. This approach is consistent with that adopted in 2009/10.

2.14 We are the external auditor for SWS 1 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.

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 has now commenced and will be completed by the deadline agreed with Scottish Water to meet the WICS deadline of 17 June 2011.

3. Accounting Issues

Introduction

- 3.01 During the year, we have reviewed and discussed with management a number of emerging matters concerning accounting treatment. This approach has allowed us to work closely with management to agree appropriate accounting treatments at an early stage.

Large Balances Containing Judgements by Management

- 3.02 The financial statements contain a number of sizeable balances, including a Household Bad Debt Provision of £320.9 million, a Household Credit Note accrual of £21.9 million and a Restructuring Provision of £7.1 million for Scottish Water (£7.8 million at Group level).
- 3.03 For each of these balances, we have examined the judgements that management has applied to arrive at the figures included in the 2010/11 financial statements. In each case, we are satisfied that management has applied reasonable judgements that reflect prevailing economic circumstances and that judgements have been applied consistently compared with prior years.

Group Income Uncertainty Provision (£3.4 million provision)

- 3.04 Within the Scottish Water Group Accounts, Management are recognising a provision of £3.4 million in respect of income uncertainty (compared with a provision of £7.1 million in 2009/10). Management feel it appropriate to include a provision within the financial statement to reflect that further adjustments to income received from Scottish Water Business Stream may need to be made to business customers, as has been the case in previous years.
- 3.05 Management considers that the income provision of £3.4 million is necessary due to the quality and reliability of the data held and provided by the CMA, a time lag of up to 18 months from when estimated meter readings (the basis for monthly billings) become actual meter readings, which in turn are used to determine actual charges, and service providers notifying the CMA of vacant properties, without any independent verification of completeness.
- 3.06 In accounting terms, in order to include a balance as a provision, the balance needs to meet three key criteria set out within IAS 37 'Provisions, Contingent Liabilities and Contingent Assets': Present obligation of a past event; probable outflow; and reliable estimate. We recognise the £3.4 million provision is supported by a number of working papers based on available information and judgements have been made by management to derive an estimated value.
- 3.07 In addition, it is recognised certain of these balances have more supporting information than others, given the nature of the issue. In order to fully meet the definitions in IAS 37 a reliable estimate needs to be made. However, given the nature of the issues emerging and the number of judgements required it is difficult to determine a reliable estimate and therefore conclude with any degree of reliability whether the provision will prove to be over or understated (as required under accounting standards).

- 3.08 As a result, we have proposed that the provision of £3.4 million could be removed from the financial statements with a resultant increase in income of £3.4 million and an additional disclosure outlining the balance as a potential contingent liability. Management consider this provision reasonable and therefore have not processed the proposed adjustment through the financial statements. Overall, the provision of £3.4 million is not material to the financial statements and does not impact on our overall financial statement opinion.
- 3.09 Scottish Water has been able to agree specific individual balances with Scottish Water Business Stream (SWBS) that has resulted in Scottish Water owing SWBS an agreed balance of £4.1 million. This balance has been accounted for as an accrual within the 2010/11 financial statements.

Pension assets and liabilities

- 3.10 On 8 July 2010 the Minister for Pensions announced the UK Government's intention to use the Consumer Prices Index (CPI) rather than Retail Prices Index (RPI) as the inflationary measure for determining the pension increases to be applied to the index-linked features of retirement benefits. In general terms, CPI increases have been lower than RPI and therefore the change has led to a reduction in Scottish Water's pension scheme liabilities.
- 3.11 In accordance with Abstract 48 from the Financial Reporting Council (Urgent Issues Task Force 48) *"Accounting Implications of the replacement of the retail prices index with the consumer prices index for retirement benefits"*, management has determined that Scottish Water had a contractual obligation to pay pensions based on RPI. Therefore, this constitutes a change in contractual obligation (and resultant benefit) which should be processed as a one off credit to the consolidated income account.
- 3.12 Given the size and one off nature of the credit, Scottish Water has appropriately disclosed this as an exceptional item.
- 3.13 In addition, we note that the balances included within the financial statements for the pension assets and liabilities 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 consulted with the PwC Actuarial team in relation to the assumptions adopted. These assumptions are in line with our expected assumption range and we therefore have no matters which we need to bring to Members' attention.

Deferred Taxation

- 3.14 During 2009/10, Scottish Water transitioned its financial reporting from UKGAAP to IFRS. The Finance Act 2008 introduced certain changes in respect of Industrial Building Allowances (IBA) and the resultant accounting treatment of deferred taxation charged under IFRS treatment. To reflect this IFRS change, Scottish Water has restated its' deferred taxation balance at 1 April 2009, reflecting the fact that 2009/10 was the IFRS transition year.
- 3.15 This has resulted in a £91 million restatement of deferred taxation balances in the Statement of Changes in Equity and in the Balance Sheet and in the disclosure in Note 15 to the Financial Statements. There has been no impact on the Consolidated Income Statement.
- 3.16 It is worth recognising that this liability has arisen from an IFRS accounting adjustment to reflect timing differences rather than it being as a result of a tax liability that is likely to crystallise.

4. Financial Performance 2010/11

4.01 The statutory financial performance for the Scottish Water Group, as set out in the Consolidated Income Statement for the year ended 31 March 2011, is set out below:

	2011 Before Exception al Item	Exception al Item	2011	2010
	(£M)	(£M)	(£M)	(£M)
Revenue	1,127.1	-	1,127.1	1,124.1
Cost of sales	(674.4)	52.0	(622.4)	(674.3)
Gross surplus	452.7	52.0	504.7	449.8
Administrative expenses	(114.7)	31.0	(83.7)	(104.5)
Operating Surplus	338.0	83.0	421.0	345.3
Finance Income	62.0	-	62.0	38.9
Finance Costs	(253.8)	-	(253.8)	(238.9)
Surplus on ordinary activities before tax	146.2	83.0	229.2	145.3
Taxation	(22.0)	(23.2)	(45.2)	(37.7)
Surplus for the year	124.2	59.8	184.0	107.6

Revenue

4.02 Total income has increased by £3.0 million due to an increase in household income in year as summarised below:

	2011 £million	2010 £million	Variance £million
Household Income	743.5	737.4	6.1
Business Income	350.9	351.4	(0.5)
Other Income	13.0	14.1	(1.1)
Non-regulated Income	19.7	21.2	(1.5)
Total Income	1,127.1	1,124.1	3.0

4.03 Business income reduced by £0.5 million to £350.9 million, with other income decreasing to £13.0 million, primarily due to lower business water connections than forecast by SWBS. Income from non-regulated trading activities (Scottish Water Horizons) decreased by £1.5 million to £19.7 million, reflecting the restructuring and refocus of SWH activities and a declining utilities market.

Expenditure

- 4.04 Total group operating costs, before exceptional items, increased by £10.3 million to £789.1 million. This was driven mainly by a £25.9 million increase in Scottish Water's operating costs, a £7.1 million increase in SWBS's operating costs and a £13.1 million increase in depreciation and amortisation costs (before IFRS adjustments), predominantly as a consequence of the capital investment programme. These increases were offset by a reduction of £46.2 million in infrastructure maintenance costs.
- 4.05 Scottish Water also benefited by £83.0 million as a result of the Minister for Pensions announcement that the Consumer Prices Index (CPI) rather than Retail Prices Index (RPI) would be the inflationary measure for determining the minimum pension increases to be applied to the statutory index-linked features of retirement benefits.

Capital

- 4.06 Capital investment for Scottish Water under IFRS was £367.6 million for the years (2010: £443.5 million). However capital investment, as measured on a regulatory accounting basis, was £443.4 million (2010: £648.3 million) as IFRS adjustments for example for PFI additions and infrastructure maintenance are removed.

Borrowing

- 4.07 During the year, Scottish Water borrowed the remaining £106 million available from the Scottish Government, and this has contributed to the increase in cash balance as at 31 March 2011.

Cash Balances

- 4.08 The closing cash balance for the Scottish Water Group, as at 31 March 2011 was £339.4 million (2010: £218.5 million).
- 4.09 This higher cash balance reflects the drawdown of the full £106 million Scottish Government lending allocation in 2010/11 as no new net borrowing will be available in 2011/12. However, much of this balance will be utilised during 2011/12 to fund the 2011/12 Capital Investment Programme.

5. Financial Forecast 2011/12 and Beyond

5.01 During February 2011 Scottish Water updated its Delivery Plan and internal Business Plan. As part of this process, the Delivery Plan, budget and business targets for 2011/12 were reviewed and challenged.

5.02 A summary of the 2011/12 regulatory budget is provided below:

		2010/11 £ million
Revenue		
• Household Income	747	
• Wholesale Income	290	
• Other Income	<u>4</u>	
Total Revenue		<u>1,041</u>
Expenditure		
Regulated Operating Costs	(346)	
Other Expenditure (PFI costs, depreciation & other costs)	<u>(473)</u>	
Total Expenditure		<u>(819)</u>
Regulated Profit Before Interest and Tax		222
Interest		<u>(163)</u>
Regulated Profit Before Tax		59
Taxation		<u>(16)</u>
Profit after Tax		<u>43</u>

Revenue forecast for 2011/12

5.03 The income budget is in line with the Delivery Plan update, but is £14 million lower than set out in the final determination. In order to take account of this income reduction, Scottish Water has forecast lower than anticipated operating costs.

Revenue Challenges going forward

- 5.04 Local authorities have held council tax charges at the same value since 2008/09 (zero percent increase) and this appears to be a continuing trend under the Government elected in May 2011. In comparison, water charges have previously been increased annually in line with the price review and agreed regulatory contract, although Scottish Water agreed to hold household water charges at the 209/10 level for this financial year (2010/11) and also 2011/12 after discussions. Initial indications based on election manifestos were that the SNP Government intended to freeze water charges in line with Council tax charges for the next two years. This is something Scottish Water will continue to discuss with the Scottish Government over 2011/12 and going forward. By increasing prices Scottish Water are able to further invest in the capital programme. Should this additional source of income not be available over the 5 year regulatory contract, Scottish Water would need to consider whether capital plans (within the regulatory contract) are still achievable.
- 5.05 In addition, Scottish Water continues to face recession related risks in the areas of revenue, customer base impact, contractors and suppliers. While the impact to date on revenue slowdown and bad debt has been limited, management are still highlighting a potential time lag in terms of seeing the full economic impact and a resultant reduction in associated cash and revenue from 2011/12 onwards as the customer base declines.

Expenditure forecast for 2011/12

- 5.06 Scottish Water has forecasted a total expenditure budget for 2011/12 of £345.8 million. This operating budget represents a £12 million real efficiency improvement compared with the expenditure budget set in 2010/11.
- 5.07 Certain elements of this budget are ring fenced to take into account the anticipated additional rates charges for 2011/12 (£24.6 million), introduction of carbon tax costs which commencing during 2011/12 (£2.5 million) and certain balances earmarked towards the continued restructuring costs (£12.4 million).

Expenditure challenges

- 5.08 The current employee pay deal is due to expire in June 2011. The UK Government has announced a wide spread public sector pay freeze. As a result, and following communication with relevant parties Scottish Water has determined that there will be no pay increases for 2011/12, despite the fact that inflation continues to increase. The pay freeze does not impact on any staff performance related pay as this is determined within the regulatory contract. Scottish Water management recognise the potential impact of a pay freeze on their workforce, particularly in relation to motivation, morale and staff retention.
- 5.09 In addition, there is the possibility of increased budgetary pressure from 2011/12 onwards due to the fall in the Construction Outputs Price Index (COPI), as well as increasing energy costs.

Capital and Borrowing

- 5.10 The budgeted gross Q&S capital investment in 2011/12 totals £500 million. The forecast range for investment in the year is £490 million to £530 million, as set out in the final determination.
- 5.11 Scottish Water relies heavily on operational cash to further invest in the capital programme. As discussed above, initial indications based on election manifestos were that the SNP Government intended to freeze water charges in line with Council tax charges. Should this additional source of income not be available, Scottish Water would need to consider whether capital plans (within the regulatory contract) are still achievable.

Cash Flow

- 5.12 In the 2011/12 Scottish Budget (one year only) the Government announced zero borrowing ability for Scottish Water for the 2011/12 financial year. However, a letter has been received from the Scottish Government reaffirming its commitment to provide the previously committed level of external borrowing over the 2010-2015 regulatory period. Therefore, the removal of borrowing capacity in 2011/12 will potentially only have a one year impact. The Scottish Water Board have accepted the Government's 2011/12 position, noting a further review is planned to take place in September 2011 and that Scottish Water has options, if required, to reduce the capital programme.
- 5.13 In particular, it is noted that around 70% of the capital programme is financed out of operational cash flow and that work is ongoing within Scottish Water to review the capital programme and determine which projects should cease, if and when necessary.
- 5.14 As a result of the borrowing restrictions, Scottish Water (company) is forecasting that its cash balances will decrease to £48 million during 2011/12.

Action Point 2

Going Concern

- 5.15 In note 1 to the financial statements it is clearly stated that the accounts have been prepared on a going concern basis. This is reinforced within the Corporate Governance section of the Annual Report.
- 5.16 The core principles behind the going concern basis are captured in International Accounting Standard 1 and interpreted further for the public sector by HM Treasury's FREM. This interpretation introduces the consideration of whether an entity's services will continue to be provided even if the entity itself ceases to exist in its current form. This is relevant to Scottish Water, given that its principal function to provide water services would still need to be delivered, even if the business ceased to exist in its current form.
- 5.17 Scottish Water operates under an annual external financing limit (EFL) set by the Scottish Government. The annual EFL controls the amount by which Scottish Water can increase its externally sourced finance, including borrowings. In addition, Scottish Water's charging structure is reviewed through a regulatory process and charges are approved annually by the Water Industry Commission for Scotland.
- 5.18 The Members, taking all relevant factors into account, consider that Scottish Water will have adequate resources to continue in operational existence for the foreseeable future. The accounts are therefore prepared on a going concern basis.
- 5.19 Overall, we are satisfied that it is appropriate for the accounts to have been prepared on a going concern basis.

6. Key Performance targets

6.01 As part of Scottish Water’s regulatory contract, a number of key performance targets are agreed and built into the contract. Management present key performance targets/ indicators in two tiers within Scottish Water and to the regulator:

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 targets/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. Set out in Appendix 2 is Scottish Water’s performance against key targets for 2010/11 and agreed targets for 2011/12.

6.03 Key indicators of performance for Scottish Water include customer service scores (OPA), performance against set leakage targets, total operating costs, surplus before tax and capital investment levels for each of the 5 years. Whilst we have no audit responsibility for these key performance indicators, we note that Scottish Water has taken the initiative to appoint Black and Veatch to undertake an independent review of these reported statistics.

6.04 As well as the set performance target within the Delivery Plan agreed with the Regulator, Scottish Water sets itself internal stretch targets, over and above those agreed with the regulator. Overall, for 2010/11 Scottish Water has reported that it exceeded the targets set within the Delivery Plan, with the exception of capital expenditure. This reflects the re-profiling of capital expenditure and the fact that Scottish Water is in year 1 of the new 5 year Regulatory Contract, and capital projects are often slow to start, including the impact of the severe winter weather. As in previous years OPA customer scores continue to increase and the benefits of further investment in leakage are identifiable in the reported achievement of the target leakage set.

Scottish Water Annual Outperformance Incentives Plan (AOIP) and Long Term Incentive Plan (LTIP)

6.05 Scottish Water’s overall performance against KPI’s is directly linked to the payment of incentive schemes. Scottish Water operate an annual incentive scheme (AOIP) and a long term incentive scheme (LTIP) reflecting if Scottish Water achieve outperformance of the 5 year Regulatory Contract. These awards are built into individual staff members’ employment contracts and pay award.

6.05 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.

6.06 Annual outperformance incentive payments for 2010/11 were calculated based on Scottish Water's performance during 2010/11 in respect of:

Measure	Target	Stretch Target	Actual Performance Reported	Outperformance allocation %
Profit before tax excluding depreciation in comparison with the targets in the Final Price Determination	£425.0m	£440.0m	£433.5m	40%
Outperformance in respect of the Final Determination Overall Performance Assessment Target	302	322	330	40%
Investment delivery				
<ul style="list-style-type: none"> • Q&S2/3a completion projects outstanding 	66	50	62	20%
<ul style="list-style-type: none"> • Q&S3b overall measure of delivery score 	63	>63	82	
				100%

6.07 On an annual basis, Internal Audit review the incentive calculations by tracing the performance statistics to the base data e.g. OPA score for 2010/11 to third party evidence such as those formal reports issued by the WICS. Internal Audit's report in relation to the 2010/11 bonus calculations stated *"The Internal Audit work confirmed the relevant figures to appropriate documentation, and they can therefore be considered reliable for bonus calculation purposes"*

6.08 In addition to the annual outperformance incentive plan, The Long Term Incentive Plan (LTIP) was agreed with the Scottish Government that provided targets for the out-performance of the Water Industry Commission's Final Determination for the 2006-10 period. The 2006-2010 regulatory period LTIP payment was paid to staff during 2010/11 and payments are reflected in salary costs and separately disclosed for senior management in the remuneration report.

6.09 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.

6.10 We emphasise that we do not express an opinion on the appropriateness or accuracy of the AOIP or LTIP.

7. Governance and Internal Control Arrangements

Overall Governance Arrangements

- 7.01 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 and structured arrangements were noted.

Review of key financial processes and controls

- 7.02 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. 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. For 2010/11 this included:

- Sales and Receivables;
- Purchasing and Payables;
- Treasury and Cash Management;
- Payroll; and
- Financial Accounting for Property, Plant and Equipment.

- 7.03 In addition, we reviewed Scottish Water's IT general control environment, as it relates to the core financial systems.

- 7.04 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

- 7.05 The corporate risk register is approved on an annual basis by the Board, with the most recent approval in April 2011. In addition, quarterly risk updates are provided to the Board and on an annual basis the Audit Committee. 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.

- 7.06 When we reviewed the Risk Register as at April 2011, there were two "red" risks facing Scottish Water with a total score of 700. The two significant risks are the same as prior year and 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;

- 7.07 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.

- 7.08 During 2010/11 the Board has continued to define its risk appetite across the 4 categories of risk: financial, operational, reputational and external. In addition, work has been undertaken to also consider the potential future opportunities arising (the upside of risks) and how these are captured and monitored within the organisation.
- 7.09 Overall, 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.

Internal Audit

- 7.10 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 2010/11. In addition to its normal quarterly reporting to the Audit Committee, Internal Audit also reports on relevant Audit Scotland publications and national report findings.
- 7.11 The Head of Internal Audit presented the annual report on Scottish Water's control environment to the 25 May 2011 Audit Committee. The overall internal audit opinion for 2010/11 was:
- "The control framework within Scottish Water was Adequate during 2010/11; this opinion is not subject to any qualifications. All material risks and issues identified during the year were adequately managed, including challenges relating to information technology and the management of contractors in various areas of the business"* (extracted from Internal Audit Annual Report May 2011)
- 7.12 In particular a number of concerns have been raised around IT access controls, systems development, disaster recovery and IT contractor management. These areas clearly need to be addressed promptly and were and will continue to be the subject of Audit Committee attention now and in the near future.
- 7.13 Scottish Water management need to put in place a detailed action plans to address the findings of internal audit and we understand that a number of actions have already commenced.

Action Point 3

- 7.14 These higher risk issues were followed up as part of our year end audit work to assess if there was any impact on our financial statements audit. Our work did not identify any reported weaknesses with significant direct impact on our financial statements audit opinion.

National Fraud Initiative (NFI)

- 7.15 The 2010/11 National Fraud Initiative exercise commenced in October 2010 and is being carried out under new powers for data matching included in the Criminal Justice and Licensing (Scotland) Act. The aim of this exercise is to identify potential inconsistencies or circumstances that could indicate fraud or error.
- 7.16 As a result of the new Act, Scottish Water is participating in the NFI exercise for the first time in 2010/11. Payroll data was submitted for matching purposes in November 2010 and the resulting matching records were provided to Scottish Water in January 2011.
- 7.17 A total of 63 matches have been reported for further investigation and work is currently ongoing to investigate all reported matches; with future Audit Committee reporting planned to feedback the outcomes.
- 7.18 Should any possible cases of fraudulent activity impacting on Scottish Water be identified this will be investigated further by Internal Audit where appropriate.

Action Point 4

Audit Scotland National Reports

- 7.19 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.
- 7.20 During the 2010/11 financial year, Audit Scotland published a number of national reports of relevance to Scottish Water. Reports included:
- Review of Major Capital Projects in Scotland;
 - Improving Energy Efficiency;
 - Improving Public Sector Purchasing;
 - Protecting & Improving Scotland's Environment;
 - Improving Public Sector Efficiency; and
 - The Role of Boards.
- 7.21 The relevant reports have been circulated within Scottish Water, with staff and management producing a self assessment comparing Scottish Water's arrangements with the final report recommendations. Where applicable action plans have been developed, which are monitored by Internal Audit with progress updates being presented at the Audit Committee on a routine basis.
- 7.22 In addition, we undertook two specific follow up exercises during 2010/11 on behalf of Audit Scotland:
- Improving public sector purchasing; and
 - Use of consultancy services
- 7.23 The follow up work consists of Scottish Water completing short questionnaires issued by Audit Scotland and PwC reviewing the evidence provided to support the progress being made in relation to the various recommendations. This work is being finalised during May 2011 and will be reported to the Audit Committee in due course. Based on our work to date, there are no matters arising that we need to highlight within this annual report.

Appendix 1 – Action Plan

Reference	Agreed Recommendation
Action Point 1 Page 3, paragraph 2.02	Management should continue to review its overall reporting within the financial statements to ensure compliance with recommended disclosure practices.
Action Point 2 Page 11, paragraph 5.15	Management should continue to monitor closely the cash position during 2011/12 and capital programme progress and commitments, to ensure that the intended programme can still be delivered in line with regulatory requirements or amended accordingly with the WICS agreement.
Action Point 3 Page 15, paragraph 7.13	Management should continue to develop detailed action plans to address Internal Audit's IT recommendations, updating the Audit Committee as and when appropriate.
Action Point 4 Page 15, paragraph 7.18	Internal Audit should continue to investigate the potential data matches, ensuring responses are uploaded onto the NFI database and reported to the Audit Committee as necessary.

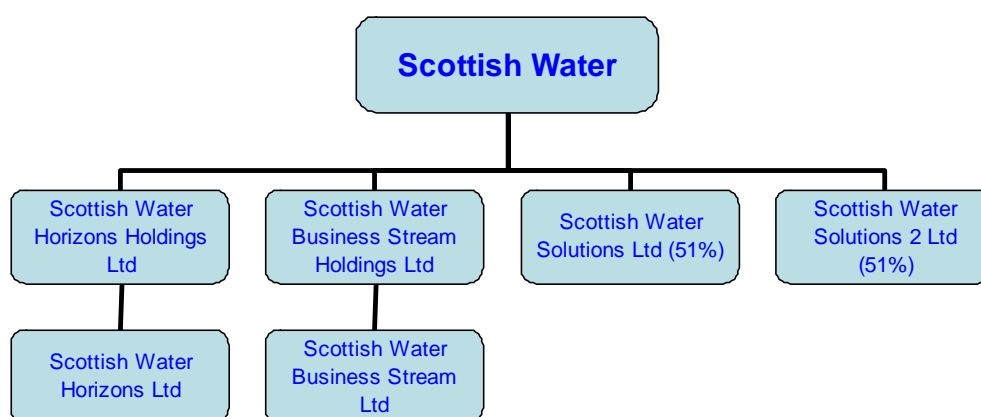
Appendix 2 – Key Performance Indicators

Set out below, as reported to the Scottish Water Board, is a Summary of Scottish Water's 2010/11 performance against key performance indicators (Tier one) and the agreed targets for 2011/12:

Key Performance Indicator	2010/11			2011/12	
	Delivery Plan Target	Internal Stretch Target	Actual Year-end	Delivery Plan Target	Internal Stretch Target
Customer Service - OPA score (rolling four quarters)	302	322	330	317	337
Operating and PFI Costs (£m)	£471m	£467m	£467m	£495m	£482m
Profit Before Tax (excluding Depreciation & Amortisation)	£425m	£440m	£434m	£385m	£400m
Investment – completion of Q&SII/IIIa (No. of remaining projects requiring regulatory sign-off)	66	50	62	38	29
Leakage (Ml/d) (rolling four quarters)	720	700	699	670	655
Reportable incidents to Health and Safety Executive	31	31	31	n/a	28
Investment – Delivery of Q&SIIIb Outputs (OMD Measure)	63	>63	82	131	>131
Q&S Capital Expenditure (£m)	£483m	£484m	£443m	£500m	£500m

Appendix 3 – Scottish Water Group – Financial Position and Key Issues

We are also external auditor to the Scottish Water Subsidiaries and Joint Ventures:



Set out in this appendix is a summary of the financial performance for the Subsidiaries and Joint and certain elements highlighted within the individual Audit Reports, which are considered relevant to Scottish Water. Given the nature of the “Holdings” companies no additional commentary is considered necessary.

Financial Performance Summary

Entity	Turnover £million	Expenditure £ Million	Interest £ Million	Profit before Tax £ Million
Scottish Water Horizons Ltd	17.748	(17.267)	0.012	0.493
Scottish Water Business Stream Ltd	356.8	(331.8)	(1.9)	23.1
Scottish Water Solutions Ltd	88.4	(88.4)	Nil	Nil
Scottish Water Solution 2 Ltd	77.6	(77.6)	Nil	Nil
Scottish Water Horizons Holdings Ltd	Nil	(0.003)	0.02	0.017
Scottish Water Business Stream Holdings Ltd	Nil	Nil	4.2*	4.2

* This balance includes a £3.3 million dividend payment from Scottish Water Business Stream

Scottish Water Horizons Ltd

Financial Performance 2010/11

Horizons' turnover has reduced by £1.6 million year-on-year. Cost of sales has also fallen by £2 million. The cost of sales has reduced in line with the decreased activity in the Utilities and Consultancy division. However, due to a more profitable shipping contract Horizons has improved its gross profit margin to 26% (22% prior year).

Summary of Future Business Issues

The focus for the Horizons business going forward should assist Scottish Water in achieving its non regulated strategic aims of a 'greener' and 'wealthier' Scotland while providing a lower risk operating environment.

Going forward the business will face several key challenges. One of the most pressing is the ability to alleviate the on-going engine problems at the Anaerobic Digestion plant and produce electrical output in line with budgets. In response to this challenge, management (AD) has set realistic and prudent forecasts for income in the forthcoming year and has delayed acceptance of the plant until the appropriate standards are met.

Given the level of new activities that will be targeted by Horizons in the forthcoming years, significant investment will be required. Commercial debt funding continues to be difficult and expensive to secure. While capital grants can alleviate a proportion of the investment cost the key funding for these capital projects is likely to have to be provided by fellow Scottish Water companies.

For 2011/12, a £2.9 million internal loan has been approved by Scottish Water Board and will be provided by Scottish Water Horizons Holdings to Scottish Water Horizons. The loan has been agreed to bridge the gap between what the Government wants Horizons to achieve and the current funding it has provided. The funding is for Horizons capital investment programme which will include feasibility and design of another AD plant in Johnstone and investment in Hydro and Solar panel energy.

Scottish Water Business Stream Ltd

Financial Performance 2010/11

Business Stream reported a £13.3 million profit for the year ended 31 March 2011, £1.3 million greater than budget.

Turnover (excluding customer discounts and Business Solutions revenues) in the period was £352.7 million, £9.8 million above budget, driven principally as a result of vacant property billing. Cost of sales increased in line with turnover.

An adverse variance against budget, of £1.3 million was recorded in respect of operating expenditure. This was principally attributable to a large volume of legacy debt being written off in the year and significant investment in improving data quality, growing the customer base and transforming business processes.

Summary of Future Business Issues

Data Quality

While the quality of data the business holds in respect of its customers has been subject to significant investment and improvement since the company's inception, the challenge to hold reliable and robust data, whilst developing processes capable of maintaining this position, remains an area of management focus.

Development of wholly independent IT Infrastructure

Plans are in place for Business Stream to separate the final elements of its IT infrastructure from Scottish Water. As well as fulfilling a WICS licensing requirement, management estimates that the one-off expenditure required to complete this transition will be paid back within 2-3 years, leading to a recurring saving of between £200-£300,000 per annum.

Cash Management

A key outcome of the shift towards advanced billing and the additional revenues being generated as a result of the 'Cerebrus' project is the significant increase in cash held within the business at any point in time. This can be evidenced by the fact £41.5m was held at 31 March 2011, as opposed to £20.7m at 31 March 2010.

The present and forecast cash position is such that Business Stream should consider utilising the surplus cash balances for generating greater levels of return than are currently being gained through short-term deposits. Management is aware of this issue and is presently devising a strategy as to how best to maximise the returns on the surplus cash balances.

Scottish Water Solutions Ltd

Financial Performance 2010/11

SWS1's retained loss for the year ended 31 March 2011 was £12,000, representing the 2010/11 tax charge. Total income received during the year was £88.4m, compared with cost of sales of £86.4m and administrative expenditure of £2m. Turnover, cost of sales and administration expenditure have fallen in line with expectation as the Q&SII and III programmes approach completion.

Management took the decision not to recognise an efficiency position at 31 March 2011 in respect of Q&SIII. Although the programme is drawing to a close there are a number of projects still to be delivered and where outcomes cannot be reliably estimated.

Summary of Future Business Issues

Going Concern

SWS 1 was set up to manage and deliver Scottish Water's Quality and Standards II Programme (Q&SII) and in subsequent year's part of the Q&S III programme. The contract between Scottish Water and SWS 1 was for the delivery of the programmes of work by 31 March 2010.

Although the contract between SWS1 and Scottish Water has ended there are a number of projects still to be delivered. The last project is forecast to complete on site in December 2011. However, at the end of March 2012 there will be over 200 projects still in their warranty period. As a consequence the Directors believe that SWS1 will continue as a business for at least 12 months from the date of these accounts.

Wind Down of SWS 1

SWS1 is in the process of winding down its operations upon successful delivery of its Q&SII/III Capital Investment Programmes. This wind down will create a number of challenges as follows:

- SWS1 may pursue a course of negotiations to sell to Scottish Water the two-year warranties which exist on recent projects to allow SWS1 to divest of its liabilities and allow the company to be wound up.

- SWS1 will need to monitor the situation in order to make the correct decisions regarding the correct accounting treatment regarding the recognition efficiencies and the company's likelihood of continuing as a going concern.

Scottish Water Solutions 2 Ltd

Financial Performance 2010/11

Scottish Water Solutions 2's retained loss for the year ended 31 March 2011 was £1,000, representing the 2010/11 tax charge. Total income received during the year was £77.6 million compared with cost of sales of £72.2 million and administrative expenses of £5.4m.

Under the contractual agreement, Scottish Water and Thistle Water Services Limited share cost efficiencies or cost overspends arising on projects. Recognition of such gains and losses, in the Profit and Loss Account, occurs where the outcome can be foreseen with reasonable certainty.

Currently an overall forecast inefficiency position of £10 million is being reported by management and a net provision of £5 million, being the Thistle Water Services Limited share of the inefficiency, has been recognised within the period.

Summary of Future Business Issues

Delivery of Scheduled Projects

SWS 2 was set up to manage and deliver Scottish Water's Quality and Standards IIIb Programme (Q&SIIIb). The contract between Scottish Water and SWS 2 was for the delivery of the programmes of work by 31 March 2015.

Activity in respect of Q&SIIIb is scheduled to increase during 2011/12 and 2012/13 with projects moving from the design to construction phase. Management faces a challenge ensuring these projects are delivered to timetable.

In addition, given that the overall project is currently behind budget, management faces a significant challenge in identifying individual project design efficiencies that both meet SW approval and flow through to project efficiencies.

Appendix 4 – External Audit Formal Reporting 2010/11

Formal Reporting to Management during 2010/11

During the year we have presented a number of formal reports to Management and the Audit Committee and produced certain other outputs. Our principal outputs during 2010/11 are summarised below:

Formal Output	Timing																				
Audit Plan	November 2010																				
Interim Accounts – Audit Opinion	November 2010																				
Detailed Timetable for 2009/10 Financial Audit	November 2010																				
External Audit Status Update (including follow up of prior year recommendations)	March 2011																				
Annual Report to Board Members and the Auditor General for Scotland	May 2011																				
<p>Audit Opinions</p> <table border="0" style="width: 100%;"> <tr> <td style="width: 45%;">1. Scottish Water (true and fair and regularity)</td> <td style="width: 5%;">✓</td> <td rowspan="7" style="width: 10%; text-align: center;">}</td> <td rowspan="7" style="width: 30%; vertical-align: middle;">Unqualified Audit Opinions</td> </tr> <tr> <td>2. Remuneration Report (elements only)</td> <td>✓</td> </tr> <tr> <td>3. Scottish Water Business Stream</td> <td>✓</td> </tr> <tr> <td>4. Scottish Water Solutions 2</td> <td>✓</td> </tr> <tr> <td>5. Scottish Water Horizons</td> <td>✓</td> </tr> <tr> <td>6. Scottish Water Business Stream Holdings</td> <td>✓</td> </tr> <tr> <td>7. Scottish Water Horizons Holdings</td> <td>✓</td> </tr> <tr> <td>8. Scottish Water Regulatory Accounts</td> <td>Work Ongoing</td> <td></td> <td></td> </tr> </table>	1. Scottish Water (true and fair and regularity)	✓	}	Unqualified Audit Opinions	2. Remuneration Report (elements only)	✓	3. Scottish Water Business Stream	✓	4. Scottish Water Solutions 2	✓	5. Scottish Water Horizons	✓	6. Scottish Water Business Stream Holdings	✓	7. Scottish Water Horizons Holdings	✓	8. Scottish Water Regulatory Accounts	Work Ongoing			June 2011
1. Scottish Water (true and fair and regularity)	✓	}			Unqualified Audit Opinions																
2. Remuneration Report (elements only)	✓																				
3. Scottish Water Business Stream	✓																				
4. Scottish Water Solutions 2	✓																				
5. Scottish Water Horizons	✓																				
6. Scottish Water Business Stream Holdings	✓																				
7. Scottish Water Horizons Holdings	✓																				
8. Scottish Water Regulatory Accounts	Work Ongoing																				

Freedom of Information (Scotland) Act 2002

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