
Scottish Water

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

23 May 2012

For the financial year
ended 31 March 2012

Contents

<i>Executive Summary</i>	3
<i>Section 1: Introduction</i>	4
<i>Section 2: Financial Statements and Audit Opinions</i>	5
<i>Section 3: 2011/12 Financial Performance</i>	9
<i>Section 4: 2012/13 Financial Forecast and Beyond</i>	11
<i>Section 5: Key Performance Indicators (KPIs)</i>	13
<i>Section 6: Governance and Internal Control Arrangements</i>	15
<i>Appendices</i>	18
<i>Appendix 1: Action Plan</i>	19
<i>Appendix 2: Key Performance Indicators</i>	21
<i>Appendix 3: Communication to those Charged With Governance</i>	22

Executive Summary

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

The financial statements of Scottish Water for the year ended 31 March 2012 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).

Section 2

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 2012 are **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**.

We have also highlighted certain accounting treatments within the financial statements, specifically the need for management to take action in relation to the ongoing accuracy issues with data supplied by the Central Market Agency (CMA) and its impact on the wholesale income uncertainty provision.

Section 3

The overall group position for Scottish Water was a surplus of £98.5 million achieved against a backdrop of a household income price freeze and a cost increase of around 7%.

Section 4

Scottish Water’s regulatory (rather than the group) forecast for 2012/13 is for a reduced surplus after tax of £34 million for 2012/13 based on its agreed delivery plan. Looking ahead Scottish Water is facing a number of challenges including: a continued freeze on household water charges, impact of the economic downturn and the need to complete the existing capital programme.

Section 5

As part of Scottish Water’s regulatory contract, a number of key performance indicators are set and agreed. Overall for 2011/12, Scottish Water has reported that it has exceeded the targets set within the delivery plan.

Section 6

Section 6 summarises our work in relation to the going concern of Scottish Water, internal financial controls, risk management, the work of internal audit and Audit Scotland National Reports.

Section 1: Introduction

Purpose of this report

- 1.01 The Annual Audit Report which follows is designed to set out the scope, nature and extent of our audit, and to summarise our opinion and conclusions on issues arising. Specifically it is designed to direct your attention to matters of significance from our 2011/12 external audit and to confirm what action is planned by management to address the more significant matters that require action.

Scope, nature and extent of our audit

- 1.02 Our overall responsibility as external auditor of Scottish Water is to undertake our audit in accordance with the principles contained in the Code of Audit Practice issued by Audit Scotland in March 2011. In this regard, the Code sets out the need for public sector audits to be planned and undertaken from a wider perspective than in the private sector involving not only assurance on the financial statements but also consideration of areas such as regularity, propriety, performance and the use of resources. It also sets out the need to recognise that the overall audit process is a co-ordinated approach involving the “appointed auditor”, PwC, and the Auditor General for Scotland’s central performance teams. Our audit has been planned and conducted to take account of these wider perspectives where applicable to our responsibilities as “appointed auditor”.
- 1.03 In addition, Scottish Water, as a publicly owned organisation, is directly answerable to the Scottish Government. In undertaking our audit, our understanding also takes account of this wider perspective, in particular the regulated environment in which Scottish Water operates and its relationship with the Water Industry Commission for Scotland (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 Under the requirements of International Standard on Auditing (UK and Ireland) (‘ISA’) 260: “*Communication of audit matters to those charged with governance*”, we are required to communicate audit matters arising from the audit of financial statements to those charged with governance. This Annual Audit Report to Board Members, together with previous reports to the Audit Committee throughout the year, as summarised at Appendix 3, discharges the requirements of ISA 260.
- 1.05 We would like to formally extend our thanks to those Scottish Water directors, managers and staff who have assisted us during the audit process.

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP
Appointed Auditor
Glasgow
23 May 2012

Section 2: Financial Statements and Audit Opinions

Financial Reporting

- 2.01 The financial statements of Scottish Water for the year ended 31 March 2012 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 members remuneration. Recognising Scottish Water's public sector accountability, continued developments in this regard are commended.

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 fieldwork within the agreed timescales. The quality of the draft 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 directors, 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 23 May 2012 and will be approved by the Board on 30 May 2012.

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. We are pleased to report that all adjustments have been processed by management.

Scottish Water - Audit Opinion

- 2.07 Our **true and fair opinion** and **regularity opinion** on the financial statements for the year ended 31 March 2012 are **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

2.10 We are also the external auditor for:

Subsidiaries (100% owned)
<ul style="list-style-type: none"> • Scottish Water Business Stream Holdings (SWBSH) – held through SWHH • Scottish Water Business Stream (SWBS) – held through SWBSH • Scottish Water Horizons Holdings (SWHH) • Scottish Water Horizons (SWH) – held through SWHH • Scottish Water International (SWI) – held through SWHH
Joint Venture
<ul style="list-style-type: none"> • Scottish Water Solutions 1 (SWS1) • Scottish Water Solutions 2 (SWS2)

2.11 Six of the seven organisations noted above have produced separate statutory accounts for the year ended 31 March 2012, under the requirements of the Companies Act, and are subject to separate external audits. Each subsidiary is accounted for within the Scottish Water Group financial statements. SWI was established in January 2012 and will prepare 15 month accounts to the period 31 March 2013. The transactions incurred by SWI during the period January 2012 to March 2012 are immaterial to the Scottish Water Group financial statements.

2.12 The nature of the contractual agreement between Scottish Water and the other shareholders in SWS 1 and 2 are such that the parties are engaged in joint activities that do not constitute entities carrying out a trade or business in their own right. Consequently, SWS 1 and SWS 2 have been accounted for under IAS 31 'Interests in joint ventures', as jointly-controlled operations. On this basis Scottish Water only accounts for its own gross assets, liabilities and cash flows in the joint operations.

2.13 Our audit opinions on the financial statements of each of the six companies are **unqualified**, with the exception of SWS 1 and SWS 2 which will not finalise preparation of their financial statements until later this year. We have completed our group responsibilities for both of these entities and this does not affect our audit opinion on the Scottish Water Group.

Water Industry Commission for Scotland

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 by the WICS Deadline of 14 June 2012.

Audit independence

2.15 We confirm that, in our professional judgment, as at the date of this document, we are independent auditors with respect to Scottish Water and its related entities, within the meaning of UK regulatory and professional requirements and that the objectivity of the audit engagement leader and the audit staff is not impaired.

Accounting Issues

2.16 During the year, we have reviewed and management has discussed with us a number of accounting treatments which are discussed below. This approach allowed us to work closely with management to agree appropriate accounting treatments at an early stage, thereby minimising the need for end of the year reporting of matters previously resolved.

Large Balances Containing Judgement by Management

- 2.17 The financial statements contain a number of sizeable balances, including a Household Bad Debt Provision of £344.9 million, a Household Credit Note accrual of £24.8 million and a Restructuring Provision of £0.9 million for Scottish Water (£1.2 million at Group level).
- 2.18 For each of these balances, we have examined the judgements that management has applied to arrive at the figures included in the 2011/12 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 the prior year.

Wholesale Income Uncertainty

Scottish Water Group Financial Statements

- 2.19 The Scottish Water Group financial statements include a Provision of £4.8 million (2010/11: £3.4 million) in respect of income uncertainty to licensed providers. This equates to c1% of business sales.

Scottish Water (the company) Financial Statements

- 2.20 In addition to the £4.8 million IUP, Scottish Water's financial statements also include an accrual of £5.4 million anticipating that it will be required to repay £10.2 million to Licensed Providers in respect of overcharges reflected in settlement runs to date received from the Central Market Agency (CMA). The CMA is the body set up by regulation to provide data concerning wholesale income.
- 2.21 The accrual and provision partly arises from the delays in the 18 month reconciliation process it takes to calculate and determine the water and wastewater service charges levied by Scottish Water on service providers. However, final reconciliation reports are still outstanding in respect of 2008/09 and 2009/10., In addition, there are continuing quality issues relating to data produced by the CMA, including the accuracy of data in relation to vacant properties.
- 2.22 We are sympathetic with the position Scottish Water finds itself in and acknowledge that the £10.2 million has been based on analysis and detailed calculations, and reflects Scottish Water's best estimate – management has also provided specific representation on this balance.
- 2.23 We are aware that the WICS initiated a project in 2009/10 to resolve these issues and to provide assurance on the integrity of all data produced by the CMA going back to 2008/09. However, there are still ongoing problems and hence the provision for wholesale income uncertainty remains in the 2011/12 financial statements, covering the period 2008/09 to 2011/12.
- 2.24 Recently, the WICS has written to all relevant parties to express its concern with the ongoing issues with data quality and has set an expectation that these issues will be resolved.
- 2.25 We also hold similar concerns and have obtained specific management representation on this matter in terms of early resolution.
- 2.26 The vast majority of the £10.2 million set aside to pay licensed providers in respect of overcharges relates to SWBS. As was the case last year SW has been able to agree a balance of £5.4 million as likely being due to SWBS. This has been reflected in both sets of accounts.
- 2.27 However, the £4.8 million provision, the vast majority of which relates to SWBS, is not reflected in SWBS's financial statements as it has taken a different view than Scottish Water in terms of this balance. Resolution of the £4.8 million difference has not been possible as the Water Services (Intra-Group Regulation) Direction does not permit the sharing of the detailed data between SW and SWBS.

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- 2.28 If this continues to grow in size, particularly relative to our materiality level, it is imperative that Scottish Water works with all parties to resolve the issues concerning the integrity of the data, to remove or reduce the level of provisioning necessary.

Action 1

Section 3: 2011/12 Financial Performance

Financial Performance for the year 2011/12

- 3.01 The financial performance for the Scottish Water Group, as set out in the Consolidated Income Statement for the year ended 31 March 2012, is set out below:

	2011/12
	£
	Million
Revenue	1,138.5
Cost of sales	<u>(718.7)</u>
Gross surplus	419.8
Administrative expenses	<u>(125.5)</u>
Operating Surplus	294.3
Finance Income	64.9
Finance Costs	<u>(252.2)</u>
Surplus on ordinary activities before tax	107.0
Taxation	<u>(8.5)</u>
Surplus for the year	<u>98.5</u>

Revenue

- 3.02 Total revenue increased year-on-year by £11.4 million to £1,138.5 million, principally as a result of new household properties being connected and an increase in business income. Unlike business customers, household customers benefited from a price freeze at a time when RPI was around 4.5%

Expenditure

- 3.03 Total group costs (costs of sales and administrative costs), before exceptional items, increased by around £55.1 million year on year. This was mainly driven by a £20.7 million increase in Scottish Water's operating costs (including PFI costs), a £12.2m increase in Business Stream's operating costs and a £14.9 million increase in depreciation and amortisation costs (before IFRS adjustments), predominantly as a consequence of the capital investment programme.
- 3.04 With expenditure increasing by 7% and with a household income price freeze, it is worth noting that Scottish Water has closed the gap with efficiency and cost reduction actions that have not adversely impacted on reported customer or staff feedback results.

Capital and Borrowing

- 3.08 Capital investment for Scottish Water under IFRS was £353.9 million for the year (2011: £369.9 million).
- 3.09 During the year, net debt increased by £34.2 million to £2,872.6 million (being loans less cash balances). The main driver being a £50.0 million increase in borrowing from the Scottish Government.

Cash Balance

- 3.10 The closing cash balance for the Scottish Water Group, as at 31 March 2012 was £355.2 million (31 March 2011: £339.4 million). This cash balance is split across the Scottish Water Group as follows:

	2011/12 £ million
Scottish Water	241.0
Scottish Water Horizons	1.0
Scottish Water Horizons Holdings	2.1
Scottish Water Business Stream	69.3
Scottish Water International	0.7
Scottish Water Business Stream Holdings	<u>41.1</u>
Total Group Cash Balance	355.2

- 3.11 This represents a year on year increase in cash balances of £15.8 million. Scottish Water intends utilising much of these cash balances to deliver its future capital investment programme, invest over the next three years in renewable energy initiatives and to possibly accelerate loan repayments to the Scottish Government associated with SWBSH.

Section 4: 2012/13 Financial Forecast and Beyond

2012/13 Regulatory Budget

- 4.01 During December 2011 Scottish Water updated its Delivery Plan and internally utilised Business Plan. As part of this process, the Delivery Plan, budget and business targets for 2012/13 were reviewed and challenged by management and the Board.
- 4.02 A summary of the resulting 2012/13 regulatory budget is provided below:

	2012/13 £ million
Revenue	
- Household Income	750
- Wholesale Income	289
- Other Income	<u>5</u>
	1,044
Expenditure	
Regulated Operating Costs	(357)
Other Expenditure (PFI costs, depreciation & other costs)	<u>(477)</u>
	(834)
Regulated Profit Before Interest and Tax	210
Interest	<u>(165)</u>
Regulated Profit Before Tax	45
Taxation	<u>11</u>
Profit after Tax	34

Revenue Forecast 2012/13

- 4.03 Budgeted household revenue reflects the fact that prices have been frozen for the third year in succession. Wholesale income for 2012/13 is budgeted at a similar level to 2011/12, with higher prices being offset by lower volumes due to the ongoing economic situation.
- 4.04 Should the Scottish Government continue to hold household income pricing at current levels, Scottish Water would need to consider whether current capital plans (contained within the regulatory contract) are still achievable. The regulatory contract assumed year on year increases in household income.
- Action 2**
- 4.05 In addition, Scottish Water will continue to face economic recession related risks in the areas of revenue, customer base, contractors and suppliers. While the impact to date on revenue slowdown and bad debt has been limited, management are still keeping close attention on any potential time lag in terms of seeing the full economic impact on these matters.

Expenditure Forecast for 2012/13

- 4.06 Scottish Water has forecasted a total expenditure budget for 2012/13 of £834 million. This operating budget includes a £6.4 million real efficiency improvement compared with the budget set in 2011/12.
- 4.07 Scottish Water has also identified additional costs of £12.4 million in 2012/13 that were not incurred in 2011/12:
- New operating expenditure of £4.0 million as a result of the capital investment programme;
 - £3.5 million relating to additional IT costs;
 - £1.4 million of increases in power costs;
 - Business rate increases of £1.9 million; and
 - Other increases of £1.6 million.
- 4.08 The operating budget has also reflected additional costs in 2012/13 of £8.1 million based on an inflation rate estimate of 2.5%. Current UK inflation is running at 3.5% which means Scottish Water could be exposed to additional costs of approximately £3.2 million.

Action 3

Capital and Borrowing

- 4.09 Budgeted gross capital investment in 2012/13 totals £502m, including £19m for a new Operations Centre.
- 4.11 Scottish Water relies heavily on operational cash to further invest in its capital programme and as discussed previously, continued price freezes may directly impact on levels of capital investment.

Going Concern

- 4.12 Note 1 to the financial statements states that the financial statements have been prepared on a going concern basis. This is reinforced within the Corporate Governance section of the Annual Report.
- 4.13 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.
- 4.12 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.
- 4.13 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 financial statements are therefore prepared on a going concern basis.
- 4.14 Overall, we are satisfied that it is appropriate for the financial statements to have been prepared on a going concern basis.

Section 5: Key Performance Indicators (KPIs)

5.01 As part of Scottish Water’s regulatory contract, a number of key performance indicators are set and agreed. Management present key performance 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 performance assessment (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.

5.02 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. Set out in Appendix 2 is Scottish Water’s performance against key targets for 2011/12 and agreed targets for 2012/13. We express no formal view on these results as they are outwith the scope of our audit.

5.03 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. We note that Scottish Water has taken the initiative to appoint Black and Veatch to undertake an independent review of these reported statistics.

5.04 As well as the agreed performance indicators within the Delivery Plan, Scottish Water also sets itself internal stretch targets. Overall, for 2011/12 Scottish Water has reported that it exceeded the targets set within its Delivery Plan, with the exception of the level of capital expenditure. As in previous years OPA customer scores continue to increase and the benefits of further investment in leakage are identifiable from the reported achievement of the leakage target set.

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

5.05 Scottish Water’s overall performance against KPI’s is directly linked to director and staff incentive schemes. Scottish Water operates an annual incentive scheme (AOIP) and a long term incentive scheme (LTIP) reflecting performance over the 5 year Regulatory Contract period. These incentives are built into the individual staff employment contracts and pay awards of directors and staff.

5.06 The outperformance schemes in place have been approved by the Remuneration Committee and have broadly remained consistent with prior years.

5.07 Annual outperformance incentive payments for 2011/12 were calculated based on Scottish Water’s performance during 2011/12 in respect of:

Measure	Target	Stretch Target	Actual Performance reported
Profit before tax excluding depreciation in comparison with the targets in the Final Price Determination	£385.0m	£400.0m	£402.8m
Outperformance in respect of the Final Determination Overall Performance Assessment Target	317	337	355
Investment delivery			
• Q&S2/3a completion projects outstanding	38	29	29
• Q&S3b overall measure of delivery score	131	>131	160

5.08 On an annual basis, Scottish Water Internal Audit review the incentive calculations by tracing the performance statistics to the base data e.g. OPA score for 2011/12 to third party evidence such as formal reports issued by the WICS. Internal Audit’s report in relation to the 2011/12 bonus calculations stated that **“The Internal Audit work confirmed the relevant figures to appropriate documentation, and they can therefore be considered reliable for AOIP calculation purposes”**

5.09 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.

5.10 We do not express an opinion on the appropriateness or accuracy of the AOIP or LTIP as this is outwith the scope of our audit responsibilities.

Section 6: Governance and Internal Control Arrangements

Overall Governance Arrangements

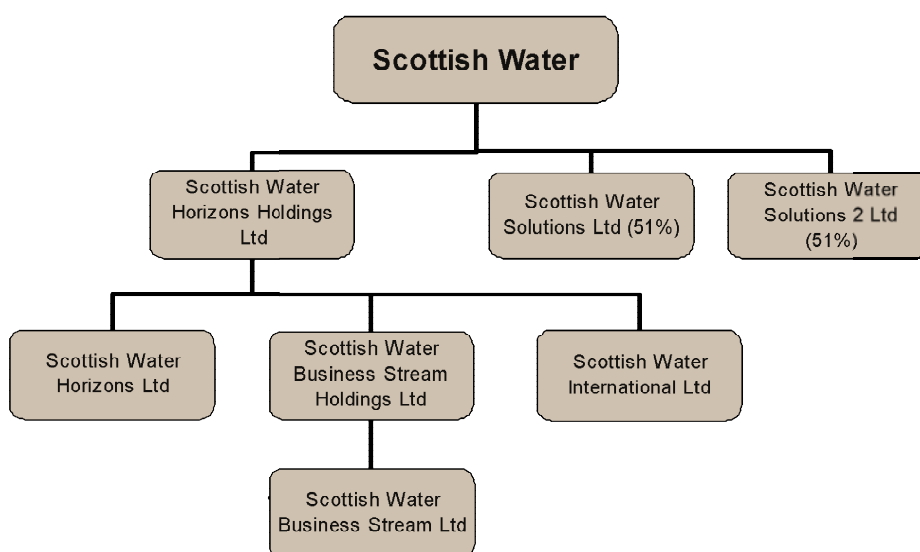
- 6.01 We have updated our understanding of Scottish Water’s overall governance arrangements, including a review of the key Committee structures and composition, internal audit and risk management. An appropriate governance framework is in place.

Systems of Internal Control

- 6.02 Over the term of our external audit appointment, we review those key financial processes and controls which could have a direct impact on the 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. We also consider Scottish water’s IT general control environment, as it relates to the financial statements.
- 6.03 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.

Group Restructure

- 6.04 During 2011/12 the group was restructured to facilitate the financing of growth opportunities in the non regulated areas of the business. Scottish Water’s interest in Scottish Water Business Stream Holdings Ltd (SWBSH) (and its subsidiary Scottish Water Business Stream Ltd (SWBS)) was transferred to its other wholly owned subsidiary, Scottish Water Horizons Holdings Ltd (SWHH). In addition, a new company was set up – Scottish Water International Ltd. Its purpose is to export Scottish Water’s skills, experience and knowledge around the globe primarily by means of consultancy services. The revised structure is summarised in the diagram below:



- 6.05 To complete this restructure SWHH issued £34.6 million of ordinary shares to Scottish Water in exchange for the £34.6 million share capital of SWBS Holdings previously held by Scottish Water.

Risk Management

- 6.06 The corporate risk register is approved on an annual basis by the Board, with the most recent approval to April 2012. In addition, quarterly risk updates are provided to the Board and on an annual basis to the Audit Committee. The identified corporate risks are 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.
- 6.07 When we reviewed the Risk Register as at April 2012, there were 4 “red” risks facing Scottish Water. These 4 significant risks related to:
- Risk arising from revenue tariff freeze for 2013/14 and 2014/15;
 - Risk of deteriorating financial strength limiting the ability to raise market capital in the longer term;
 - Risk of delivery of water quality unfit for human consumption; and
 - Risk of changes to the current Billing and Collection.
- 6.08 Management has recorded a range of specific actions to mitigate the risks identified in the risk register and has set timeframes and allocated ownership for the actions.
- 6.09 Overall, risk management appears regularly on the Senior Management Team’s agenda.

Internal Audit

- 6.10 As part of our controls work, we also considered Scottish Water’s Internal Audit function, in particular Internal Audit staffing and work undertaken during 2011/12. In addition to its normal quarterly reporting to the Audit Committee, Internal Audit also reports on relevant Audit Scotland publications and national report findings.
- 6.11 The Head of Internal Audit presented the annual report on Scottish Water’s control environment at the 23 May 2012 Audit Committee. The overall internal audit opinion for 2011/12 was:

“ The control framework provides substantial assurance that all material risks and issues identified during the year were actively and adequately managed. There are no qualifications to this opinion and there are no significant issues that the Audit Committee should consider in preparing its Annual Report to the Board. ”

(extracted from Internal Audit Annual Report May 2012)

- 6.12 These IT 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 a direct impact on our financial statements audit opinion.

National Fraud Initiative

- 6.13 The 2010/11 / 2011/12 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.
- 6.14 Scottish Water participated in the NFI exercise for the first time. Scottish Water investigated all 63 matches. No significant issues have been identified and all work has been reported to the Audit Committee.

Action 4

Fraud Investigation

- 6.15 During the 2011/12 financial year, Audit Scotland asked us to review Scottish Water's investigation of alleged fraudulent procurement activities at Scottish Water Contracting (SWC) (part of Scottish Water Horizons Ltd). This included PwC reviewing work undertaken by the Scottish Water Internal Audit function and an additional report prepared for Scottish Water's by Dundas and Wilson LLP.
- 6.16 Based on the work we performed we did not identify any evidence that contradicted the conclusions drawn by Scottish Water with regard to the two investigations completed by Internal Audit and Dundas and Wilson LLP, noting that restrictions existing for both due to missing or incomplete evidence.
- 6.17 During meetings in December 2011 Scottish Water management confirmed that the two investigations confirmed pre-existing concerns they had surrounding the control processes within SWC and that the cessation of SWC within SWH had addressed the findings identified in both investigations.
- 6.18 Management stated that it had assured itself that similar issues did not exist elsewhere through the completion further risk based internal audit reviews completed across the SW Group. However, during our review we were unable to identify any formally recorded evidence of specific actions taken by Scottish Water to address the recommendations made for the SW Group made by Dundas and Wilson LLP.
- 6.19 Helpfully, at our request, Scottish Water performed a retrospective review of all Internal Audit reviews completed following the fraud investigation, to identify if there was any further evidence that might indicate that the control weaknesses identified in the investigations might exist elsewhere in the organisation.
- 6.20 During January 2012 Scottish Water considered all Internal Audit reports issued since November 2009. This exercise did not identify any significant issues that would indicate that the weaknesses identified by Internal Audit or Dundas and Wilson LLP were systemic throughout Scottish Water. However, a more recent Internal Audit review on the management of SWH did identify an issue regarding weaknesses in the procurement process. Specifically, it identified that financial controls within SWH were less robust than elsewhere within the SW Group. An action plan to address this matter is in place
- 6.21 In addition, during 2011/12 a number of changes to improve governance were made to SWH, including the appointment of SW's previous Audit Committee Chairman and the current SW Chief Executive to the SWH Board and the appointment of a new Managing Director for SWH.
- 6.22 We are satisfied with the actions taken by Scottish Water management to assure itself that the weaknesses identified were not systemic throughout the organisation. As part of our final audit visit we also confirmed by inquiry that progress has been made by SWH to implement improved control arrangements.

Action 5

Appendices

Appendix 1: Action Plan

To assist management in assessing each recommendation, we have assessed the risk to the organisation for each recommendation according to the criteria shown below:

- High** Significant business matter requiring immediate and continued attention by management
- Moderate** Matter which needs to be rectified but where there is unlikely to be a material impact on the achievement of business objectives
- Low** Minor business impact

The following recommendations have been raised within the body of this report:

Ref	Recommendation and Risk Rating	Management Response, Responsible Officer and Implementation Date
1	<p>Action</p> <p>It is imperative that Scottish Water works with all parties to resolve the issues concerning the integrity of the data, to remove or reduce the level of income uncertainty provisioning necessary.</p> <p>Risk Rating - High</p>	<p>Management Response:</p> <p>We confirm that we will work with our partner organisations to address the data integrity issues regarding the CMA in line with those timescales set out by the Water Industry Commission for Scotland.</p> <p>Responsible Officer: Head of Wholesale Revenue Management</p> <p>Implementation Date: Ongoing</p>
2	<p>Action</p> <p>Should the Scottish Government continue to hold household income pricing at current levels, Scottish Water must ensure that appropriate plans are in place to consider whether current capital plans (contained within the regulatory contract) are still achievable.</p> <p>Risk Rating - High</p>	<p>Management Response:</p> <p>We update the Delivery Plan annually to reflect income streams and borrowing requirement. In addition, we regularly model the impact on the capital investment programme of various financing scenarios.</p> <p>Responsible Officer: Financial Controller</p> <p>Implementation Date: Ongoing</p>

Ref	Recommendation and Risk Rating	Management Response, Responsible Officer and Implementation Date
3	<p>Action</p> <p>Scottish Water should assure itself that the budget assumptions it has made for inflation reflect current market conditions and that appropriate flexibility exists within the budget to respond to any increased costs should inflation be higher than 2.5%.</p> <p>Risk Rating - Moderate</p>	<p>Management Response:</p> <p>The Opex budget for 2012/13 contains an unallocated contingency of c£9 million that will be available to address any additional costs relating to inflation.</p> <p>Responsible Officer: Financial Controller</p> <p>Implementation Date: Ongoing</p>
4	<p>Action</p> <p>Scottish Water should consider the submission of any risk-based datasets in conjunction with its external auditors as part of the 2012/13 NFI exercise.</p> <p>In addition, Scottish Water should consider the need to investigate all NFI matches as some of these matches might be low risk.</p> <p>Risk Rating - Low</p>	<p>Management Response:</p> <p>Agreed. We will discuss the submission of possible additional information for the 2012/13 NFI exercise with the external auditors.</p> <p>Also, in the event of the number of matches significantly increasing the investigation will be prioritised based on the risk rating of the matches.</p> <p>Responsible Officer: Head of Internal Audit</p> <p>Implementation Date: As part of the Next NFI Exercise</p>
5	<p>Action</p> <p>Scottish Water should ensure that best practice is followed in the awarding of subcontracts to all existing and any new suppliers.</p> <p>Risk Rating - Moderate</p>	<p>Management Response:</p> <p>We already implement a robust framework and tendering process and this area will continue to be subject to several audits by our internal audit function as part of its future Internal Audit programme.</p> <p>Responsible Officer: Head of Procurement / Head of Internal Audit</p> <p>Implementation Date: Ongoing</p>

Appendix 2: Key Performance Indicators

The tier 1 Key Performance Indicators (KPIs) for 2012/13 focus on a number of outcomes, including overall customer service (OPA), overall measure of Delivery (OMD) for the Q&S IIIb enhancement programme and completion of Q&S II and IIIa projects. They also include leakage, customer satisfaction and health & safety aspects.

The proposed targets for 2012/13 are below and the following points should be noted:

- All 2012/13 targets are consistent with the February 2012 Delivery Plan Update.
- The OPA business target score for 2012/13 is 358, 20 points higher than the regulatory target.
- The profit target has been set at £15m greater than the regulatory target.
- The Leakage business target for 2012/13 is in the range 600-610 Ml/d, 25 - 35Ml/d below the regulatory target.
- Health and Safety targets will be confirmed once the implications of revised HSE reporting classifications have been fully assessed and once the year-end figure is known.

Tier 1 Performance Indicators	2011/12 Out-turn	Business Target 2011/12	Delivery Plan Target 2011/12	Business Target 2012/13	Delivery Plan Update 2012/13
OPA Score (YTD = 12 month rolling average)	355	337	317	358	338
Q&S IIIb delivery (OMD measure)	160	>131	131	>192	192
Q&S IIIa and Q&S II completion (Number of projects remaining to be delivered)	29	29	38	8	12
Compliance with WIC leakage target (Ml/d)	629.2	655	670	610-600	635
SW Profit before tax excluding depreciation and amortisation	£403m	£400m	£385m	£390m	£375m
Health & Safety – number of reportable incidents to HSE	13	28	n/a	TBC	n/a
Customer Experience Score	83.1%	83%	81%	82-84%	>78%
OPEX spend against target profit £m (core DP)	£340.2m	£334m	£346m	£348m	£357m
Revenue for Core DP (£m)	£1045.8m	£1048m	£1041m	£1050m	£1044m
Total Capital Expenditure (£m)	£491m	£485m- £505m	£485m- £505m	£490- £520m	£505m
Household Customer collection performance (2 year fig) %DP	94.53%	94.3%	94.1%	93.46%	93.31%

Appendix 3: Communication to those Charged With Governance

International Standards on Auditing (“ISA”) (UK&I) 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 Panel during the year. Summarised below are the requirements set out within ISA 260 together with reference to the relevant communication with you during 2011/12 or comments as appropriate.

Communication Required under ISA 260 Reference/Comment

Engagement Letters	✓	Signed Engagements Letter with Audit Scotland at the start of our 5 year appointment and updated annually.
Independence	✓	Audit Planning document reported to Audit Committee in November 2011 confirmed there are no matters which we perceive may impact our independence and objectivity of the audit team.
Audit Approach and Scope	✓	Audit Planning document reported to Audit Committee in November 2011.
Materiality	✓	Audit Planning document reported to Audit Committee in November 2011.
Form and Timing of Communications	✓	Audit Planning document reported to Audit Committee in November 2011.
Accounting Policies/Estimates/Disclosures	✓	Significant matters are considered within this report.
Correspondence with management on significant matters	✓	Discussed and resolved matters arising with management throughout audit process and reporting in our interim management letter, follow up report and the presentation on the financial audit to the Audit Committee in May 2012.
Letter of Representation	✓	Signed by the Director of Finance on behalf of the Board on 30 May 2012.
Financial Statements Audit Opinion	✓	Financial Statement Audit Opinion is included within this report.
Other matters significant to the oversight of financial reporting process	✓	None identified.
Related Parties	✓	Other than those transactions disclosed in the financial statements we have not identified any further transactions requiring disclosure.
Fraud	✓	Discussed fraud arrangements with the Audit Committee members, review of internal audit findings and management throughout audit process.
Material Weaknesses in Internal Controls	✓	Internal Controls findings were discussed with Internal Audit to investigate further through their internal audit reviews.

This report has been prepared for and only for Scottish Water in accordance with the terms of our engagement letter dated and for no other purpose. We do not accept or assume any liability or duty of care for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

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