www.pwc.co.uk

Scottish Water

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

29 May 2013

For the financial year ended 31 March 2013

Contents

Executive Summary

Introduction

The Annual Audit Report which follows is designed to set out the scope, nature and extent of our audit, and to summarise our conclusions arising. Specifically it is designed to direct your attention to those matters of significance from our 2012/13 external audit and to confirm what, if any, related action is planned by management.

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 2013 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 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. During the course of our audit, no material misstatements with an impact on our audit opinion were identified.

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

Our ***true and fair* opinion** and ***regularity opinion*** on the financial statements for the year ended 31 March 2013 are ***unqualified***. Our opinion on the relevant parts of the ***Remuneration Report is unqualified***.

At the time of writing, our audit opinions on the financial statements of each of the six companies are unqualified.

Section 3

We have highlighted certain accounting treatments within the financial statements, specifically the level of provisioning against household bad debt and the accounting treatment of the Group's Income Uncertainty provision.

Wholesale Income Uncertainty Provision

We are pleased to report Scottish Water has worked with relevant parties to resolve many of the areas of disagreement concerning the wholesale data, and that this has lead to a reduced level of income uncertainty provisioning and no difference in expectation between Scottish Water and Scottish Water Business Stream.

Household Bad Debt Provision

It is clear that the level of provision for household debt will always be a matter of judgement within a range of calculations and assumptions from less to more prudent. In this regard, although on the more prudent side, the provision level set by Scottish Water is within the range parameters we would expect.

Section 4

The overall group position for Scottish Water was a surplus of £89.2 million achieved against a backdrop of a household income price freeze and a cost increase of around 3.35%.

This steady decline in profit is consistent with Scottish Water's projections. This trend reflects the three years of household freezes in 2010/11, 2011/12 and 2012/13, whilst Scottish Water has had to absorb steadily increasing costs of sale and administration expenditure in line with RPI.

It is notable that Scottish Water's dependency on non regulated business has increased in terms of profit generation. In 2009/10 the non regulated business contributed c10% of profits for the group compared with 33% in 2012/13 (36% excluding the Scottish Water Horizons loss). Although this in line with Scottish Water's delivery plan, this demonstrates a changing risk profile for Scottish Water whereby the Group is becoming more reliant on the market driven non-regulatory side of the business to generate profits.

Section 5

Scottish Water is forecasting a regulatory profit before tax of £55 million (on a UK GAAP basis). This represents a reduction in profit of £13.3 million from 2012/13 and £19 million from 2011/12. This is despite Scottish Water being able to increase household charges by 2.8% in 2013/14 for the first time in four years.

Although in line with Scottish Water's delivery plan and regulatory requirement, this reinforces the changing risk profile of Scottish Water's business whereby the business is becoming more reliant on the market driven non-regulatory business to generate profits and that going forward the profit levels available to the business for re-investment are diminishing.

Section 6

As part of Scottish Water's regulatory contract, a number of key performance indicators are set and agreed. Overall, for 2012/13 Scottish Water has reported that it exceeded the targets set within its Delivery Plan, with the exception of the level of capital expenditure in the Q&S2/3a investment programme.

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 7

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.

Scottish Water continues to have in place an appropriate control environment for our audit purposes.

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 conclusions arising. Specifically it is designed to direct your attention to those matters of significance from our 2012/13 external audit and to confirm what, if any, related action is planned by management.

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 involving not only the financial statements but also consideration of areas such as regularity and propriety. It also sets out the need to recognise that the overall audit process is a co-ordinated approach involving PwC (the "appointed auditor") and the Auditor General for Scotland's central performance teams. Our audit has been planned and conducted to take account of 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 approach 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
29 May 2013

Section 2: Financial Statements and Audit Opinions

Financial Reporting

2.01 The financial statements for the year ended 31 March 2013 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).

Audit Process

2.02 The draft financial statements and supporting schedules were made available to us at the start of our audit allowing us to progress and complete the audit 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 PwC and your directors, managers and staff and that an efficient audit process was achieved throughout the year.

Accounts Approval

2.03 The consolidated financial statements were presented to the Audit Committee on 22 May 2013 and will be approved by the Board on 29 May 2013.

Audit Adjustments

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

2.05 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 and as a result we have no matters to report in this regard.

Going Concern

2.06 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.

2.07 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.

2.08 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.

2.09 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.

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

Scottish Water - Audit Opinion

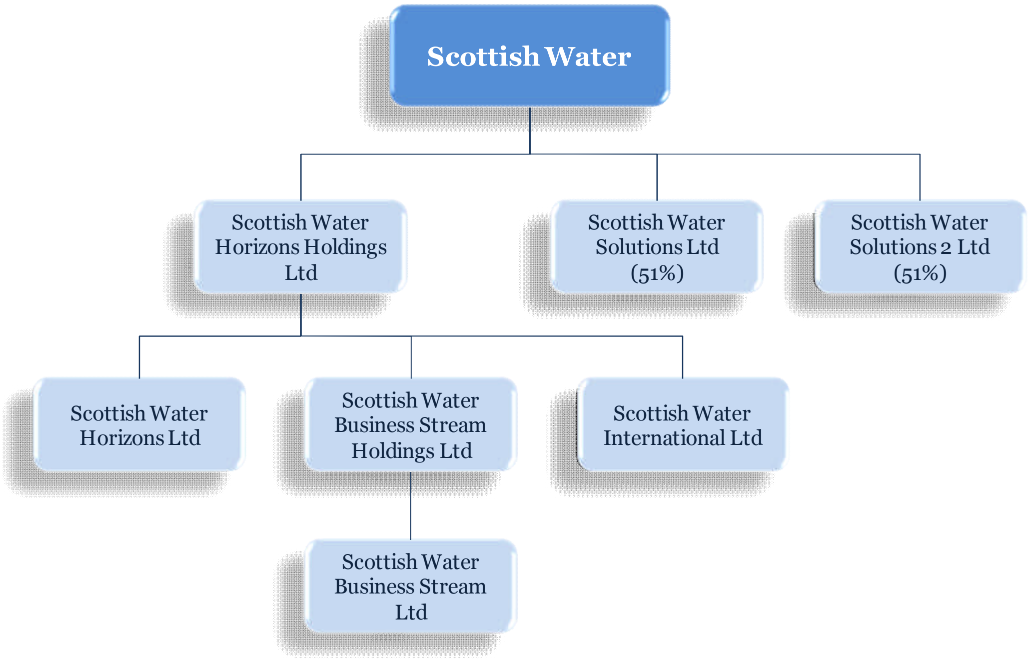
2.11 Our ***true and fair* opinion** and ***regularity opinion*** on the financial statements for the year ended 31 March 2013 are ***unqualified***.

2.12 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***.

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

Scottish Water Subsidiaries

2.14 We are also the external auditor for each of the group entities. All 100% owned unless indicated otherwise.



2.15 Each of the organisations noted above have produced separate statutory accounts for the year ended 31 March 2013, 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. Scottish Water International Ltd was established in January 2012 and has prepared 14 month accounts for to the period to 31 March 2013.

2.16 The nature of the contractual agreement between Scottish Water and the other shareholders in Scottish Water Solutions Ltd (SWS1) and Scottish Water Solutions 2 Ltd (SWS2) 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.

2.17 At the time of writing, our audit opinions on the financial statements of each of the six companies are unqualified.

Water Industry Commission for Scotland

2.18 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 2013.

Audit independence (See Appendix 4)

2.19 As the External Auditors of Scottish Water we are required to follow both the International Standard on Auditing (UK and Ireland) 260 (Revised) "*Communication with those charged with governance*", UK Ethical Standard 1 (Revised) *"Integrity, objectivity and independence*" and UK Ethical Standard 5 (Revised) *"Non-audit services provided to audited entities"* issued by the UK Auditing Practices Board.

2.20 We confirm that in our professional judgement, as at the date of this report:

- we comply with UK regulatory and professional requirements, including the Ethical Standards issued by the Auditing Practices Board; and
- our objectivity is not compromised.

Section 3: Significant Accounting Matters

Significant Accounting Matters

3.01 During the year, we have reviewed and management has discussed with us a number of accounting treatments. These early discussions have 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.

Wholesale Income Uncertainty

3.02 During 2011/12 we highlighted that the Water Industry Commission for Scotland (WICS) had written to all relevant parties to express its concern with ongoing issues with data quality pertaining to wholesale income and had set an expectation that these issues would be resolved. These data quality issues resulted in a difference between the Scottish Water and Scottish Water Business Stream (SWBS) financial statements with regard to the Income Uncertainty Provision.

3.03 In our Annual Report last year Scottish Water committed to working with all parties to resolve the issues concerning the integrity of the data and to remove or reduce the level of income uncertainty provisioning necessary, including the need for SW and SWBS to arrive at a mutually agreed approach to SW provisioning and SWBS income recognition. The progress made by Scottish Water and Scottish Water Business Stream is discussed in the section below.

Scottish Water Group Financial Statements

3.04 The Scottish Water Group financial statements include an accrual of only £0.1 million for other Licensed Providers not in the Scottish Water Group (2011/12: £4.8 million) in respect of income uncertainty. We are pleased to report Scottish Water has worked with relevant parties to resolve many of the areas of disagreement concerning the wholesale data, and that this has lead to a reduced level of income uncertainty provisioning and no difference in expectation between Scottish Water and Scottish Water Business Stream.

Scottish Water Financial Statements

3.05 SW currently holds a £15.5 million provision at the balance sheet date. This represents the agreed intercompany settlement positions for cost of sales in SWBS cost of sales and wholesale revenue within SW, except for the other licensed Providers £0.1 million noted above.

3.06 The £15.5 million provision (excluding the £0.1 million) is reflected in full within SWBS's financial statements as it has not taken a different view than Scottish Water in terms of the balance, resolving the disagreement which existed in previous years.

3.07 We also note that SW has now resolved the reconciliation adjustments concerning 2008/09 and 2009/10 and intends to resolve the similar issue concerning 2010/11, 2011/12 during the next twelve months.

Action 1

Household Bad Debt Provision

3.08 As at 31 March 2013 Scottish Water is reporting a household income debtor of £409.6 million and a corresponding bad debt provision (BDP) of £372.8 million, leaving a net debt position of £36.8 million. This total debt includes all years dating back to 1996/97 and with the bad debt provision being calculated based on historical debt collection rates.

3.09 This bad debt provision reflects an average forecast collection rate of 95.96% for the £9.228 billion Scottish Water has billed in the period 1996/97 to 2012/13.

3.10 In 2012/13 Scottish Water has forecast its collection rate for its 2012/13 billings (£758.3 million) at 95%. This is consistent with the 95% initial assumption made in 2011/12 for the 2011/12 debt. Although we recognise this as an area of judgement we note that this initial forecast collection rate is 0.67% lower than the actual collection rate performance over the past 5 years of 95.67%.

3.11 In considering the appropriateness of the provision applied to the 2012/13 billing we have performed a sensitivity analysis as to what impact a change in the assumptions used would have on the 2012/13 element of the provision.

Assumption Used	Impact on 2012/13 element of the Provision
95%	**£37.915 million**
+/- 0.25%	+/- £1.896 million
+/- 0.5%	+/- £3.792 million
+/- 0.75%	+/- £5.687 million
+/- 1.00%	+/- £7.583 million

3.12 If Scottish Water reduced its 2012/13 element of the provision by 0.67% to reflect the actual average collection rate for the previous five years it would reduce the overall provision by £5.081 million and correspondingly increase its net debt and surplus outturn by the same amount.

3.13 However, in considering this matter, it is worth noting that Scottish Water does not fully provide for any of its outstanding debt, even although some of this dates back some fifteen years. If Scottish Water adopted the working practices of certain Public Limited Companies, or indeed some of the organisations in the Local Authority sector, it would fully provide for or write off a significant amount of its older aged debt. By way of example, if Scottish Water fully provided for all of its pre 2008/09 debt, it would need to increase its household bad debt provision by £4.145 million.

3.14 It is clear that the level of provision for household debt will always be a matter of judgement within a range of calculations and assumptions from less to more prudent. In this regard, although on the more prudent side, the provision level set by Scottish Water is within the range parameters we would expect.

3.15 In addition future consideration should be given to the potential impact of the recent Welfare Reform Act. On 8th March 2012 the Welfare Reform Act 2012 received Royal Assent. The Act introduces a wide range of reforms aimed at making the benefits and tax credits system "fairer and simpler".

3.16 Around 15% of Scottish Water's household income is impacted by full or partial benefits. This is an area of collection risk for Scottish Water as such future welfare payments for water charges will be made directly to claimants rather than directly to public bodies i.e. the claimant will need to then make a payment to Scottish Water via the relevant local authority. Certain data from local authorities suggests that in-year collection of this type of debt could be as low as 72%.

3.17 Therefore, even although arrangements exist for direct payments to public bodies in the case of persistent non payers, Scottish Water will need to monitor closely the impact of Welfare Reform and will likely require to review the appropriateness of the assumptions it uses when calculating the Household Bad Debt Provision at 31 March 2014.

Action 2

Credit Note Accrual

3.18 The credit note accrual relates to adjustments to accounts already paid by customers.

3.19 The calculation basis for the household credit note accrual of £28.3 million (2012: £24.8 million) is consistent with the approach adopted in 2011/12 whereby Scottish Water has applied a historic rate of accrual of 1.064%, being, based on an average percentage movement in billings.

3.20 We have reviewed the judgements that management has applied to arrive at the figures included in the 2012/13 financial statements. Management has demonstrated a consistent methodology in setting the credit note accrual when compared with the prior year.

3.21 During our review of SWs working papers we initially identified that inconsistent rounding practices were used when calculating the credit note accrual Management resolved this matter immediately.

Section 4: 2012/13 Financial Performance

Financial Performance for the year 2012/13

4.01 The financial performance for the Scottish Water Group, as set out in the Consolidated Income Statement for the year ended 31 March 2013, is set out below:

	2012/13 £ Million
Revenue	1,145.7
Cost of sales	(721.9)
Gross surplus	**423.8**
Administrative expenses	(144.1)
Operating Surplus	**279.7**
Finance Income	53.3
Finance Costs	(237.9)
Surplus on ordinary activities before tax	**95.1**
Taxation	(5.9)
Surplus for the year	**89.2**

4.02 This is broken down further in the financial statements in the following segmental analysis:

	Revenue 2012/13 £million	Costs & Expenses 2012/13 £million	Operating Surplus 2012/13 £million
Regulated Water and Waste Water Services	1053.0	(805.5)	247.5
Business Stream	361.5	(324.9)	36.6
Other Trading Activities	20.2	(25.8)	(5.6)
Less Intercompany Elimination	(289.0)	290.2	1.2
Revenue	**1,145.7**	**(866.0)**	**279.7**

Revenue

4.03 Total revenue increased year-on-year by £13.5 million to £1,145.7 million.

	March 2013 (£m)	March 2012 (£m)	Variance (£m)
Household income	750.9	745.6	5.3
Business income	359.3	350.7	8.6
Other regulated income	5.4	5.5	-0.1
Other income	30.1	30.4	-0.3
	1,145.7	**1,132.2**	**13.5**

4.04 As there was no price increase, the £5.3 million increase in household income is principally the result of a net increase of 12,494 new household properties during the year.

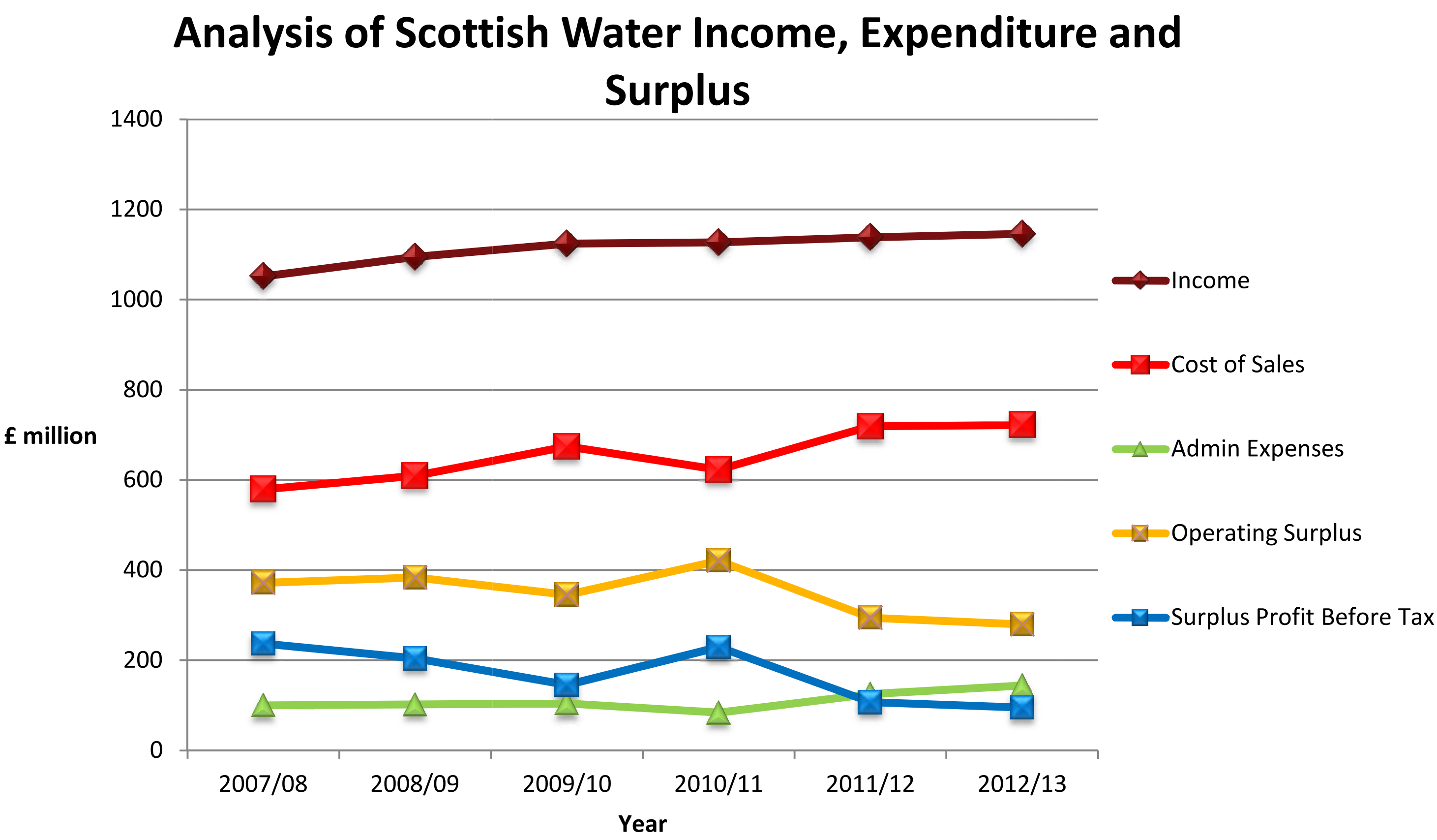
4.05 The £8.6 million increase in business income resulted from additional wholesale charges of c£3.9 million and the recognition of the £4.7 million Income Uncertainty Provision not previously recognised within Scottish Water Business Stream during 2011/12 **(See Income Uncertainty Provision in Section 3).**

Expenditure

4.06 Total group costs (costs of sales and administrative costs), before exceptional items, increased by around £28.1 million year on year. This was mainly driven by a £12.5 million increase in Scottish Water's operating costs (including PFI costs), a £1.7 million increase in Business Stream's operating costs and a £3.1 million increase in depreciation and amortisation costs (before IFRS adjustments), predominantly as a consequence of the capital investment programme. SW International's costs increased £1.0 million to £1.4 million reflecting its first full year of operation and growth in the business.

4.07 With expenditure increasing year on year by 3.35% and with a household income price freeze during 2012/13, it is worth noting that Scottish Water closed the gap with efficiency and cost reduction actions that have not adversely impacted on reported customer or staff feedback results.

4.08 The chart below shows Scottish Water Group performance over the previous six years.



4.09 It should be noted that the 2007/08 accounts were prepared under UK GAAP and 2008/09 was the transition year to International Financial Reporting Standards. The 2010/11 financial statements included a pension related exceptional item which increased the surplus by £83 million (through reduced Cost of Sales of £52 million and reduced Administration Expenses of £31 million).

4.10 As illustrated in the graph above, over the previous 6 years Scottish Water's Group surplus before tax has fallen from £236 million to £95 million. The surplus profit before tax (on an IFRS basis) for the last two years has been analysed further in the table below reflecting the individual performance of Scottish Water and its primary profit generating subsidiaries:

	March 2013 £m	March 2012 £m	Variance £m
Scottish Water	63.6	74.0	-10.4
Scottish Water Horizons	-6.0	1.8	-7.8
Business Stream & SWBSH	36.3	33.9	2.4
SW International	-	-0.3	0.3
Consolidation adjustment	1.2	-2.4	3.6
Total surplus before tax	**95.1**	**107.0**	**-11.9**

4.11 This steady decline in profit is consistent with Scottish Water's projections. This trend reflects the three years of household freezes in 2010/11, 2011/12 and 2012/13, whilst Scottish Water has had to absorb steadily increasing costs of sale and administration expenditure in line with RPI.

4.12 It is notable that Scottish Water's dependency on non regulated business has increased in terms of profit generation. In 2009/10 the non regulated business contributed c10% of profits for the group compared with 33% in 2012/13 (36% excluding the Scottish Water Horizons loss). Although this in line with Scottish Water's delivery plan, this demonstrates a changing risk profile for Scottish Water whereby the Group is becoming more reliant on the market driven non-regulatory side of the business to generate profits.

Scottish Water Horizons – Loss for the Year

4.13 Scottish Water Horizons incurred a loss after tax for 2012/13 of £6.0 million. This loss was predominantly driven by a write down in fixed asset value of £4.3 million. This write down arose following the decision to withdraw from receiving and treating green waste (£3.7 million write down) and withdrawing from ongoing projects that were deemed by management to not be financially viable (£0.6 million write down).

4.14 Taking into account these events, there is still an underlying loss for 2012/13 of £1.64 million. Notwithstanding, Scottish Water Horizons is forecasting a profit after tax £0.3 million for 2013/14.

Action 3

Capital and Borrowing

4.15 Capital investment for Scottish Water under IFRS reporting was £390.7 million for the year (2012: £353.9 million).

4.16 During the year, consolidated net debt increased by £39.6 million to £2,912.2 million (being loans of £3,327.8 million less cash balances of £415.6 million). This increase was driven by additional borrowings from the Scottish Government of £100.0 million partially offset by a £60.4 million increase in consolidated cash balances.

Cash Balances

4.17 The closing cash balance for the Scottish Water Group, as at 31 March 2013 was £415.6 million (31 March 2012: £355.2 million). This cash balance is split across the Scottish Water Group as follows:

	2012/13 £ million
Scottish Water	245.5
Scottish Water Horizons Group	10.3
Scottish Water Business Stream	110.6
Scottish Water International	1.4
Scottish Water Business Stream Holdings	47.8
Total Group Cash Balance	**415.6**

4.18 This represents a year on year increase in cash balances of £60.4 million. However, since the year end a total of £245 million of short term borrowing has been repaid, being £217 million by SW and £28 million by SWBSH. In addition, SWBSH is due to repay a remaining loan of £30.5 million out of cash balances to the Scottish Government in the summer of 2013.

Section 5: 2013/14 Financial Forecast

2013/14 Regulated Budget

5.01 During January / February 2013, Scottish Water updated its Delivery Plan and related Business Plan. As part of this process, the Delivery Plan, budget and business targets for 2013/14 were challenged and approved by the Board.

5.02 Scottish Water prepares its regulated budget on a UK GAAP basis rather than under IFRS, the basis which is used for the preparation of the annual financial statements. The resulting 2013/14 regulated budget for Scottish Water (the Company) is provided below:

	2013/14 £ million
Revenue	
- Household Income	775
- Wholesale Income	282
- Other Income	6
	1,063
Expenditure	
Regulated Operating Costs	(365)
Other Expenditure (PFI costs, depreciation & other costs)	(482)
	(847)
Regulated Profit Before Interest and Tax	**216**
Interest	(161)
Regulated Profit Before Tax	**55**
Taxation	13
Profit after Tax	**42**

Revenue Forecast 2013/14

5.03 The income budget is in line with the Delivery Plan refresh. As agreed with the WICS and the Scottish Government, household income charges have been increased by 2.8%. This is the first time Scottish Water has applied a price increase for four years.

5.04 The budget for household revenue this year is £775 million. £119 million of this revenue is impacted by customers who receive benefits. This is a major risk area for Scottish Water. Data from the local authority sector suggests that in-year collection of this type of debt is currently around 72%, substantially less than Scottish Water's current 95% to 96% collection rate. Scottish Water will be required to monitor closely the impact of Welfare Reform as the year progresses and work with local authorities and Department of Works and Pensions to maximise cash collections. **(See Section 2 – Key Accounting Issues concerning Household Bad Debt Provision)**.

Action 2

5.05 In addition, Scottish Water will continue to face more general economic recession related risks in the areas of revenue, customer base, contractors and suppliers.

5.06 Wholesale income for 2013/14 is budgeted at a lower level than 2012/13 forecast allowing for a potential net reduction in charges and anticipated reduction in volumes. Within the Scottish market, Scottish Water Business Stream holds a market share of 98.4%. However, the market has seen a shift as existing and potential customers move towards tendering for contracts and with some customers looking for significant discounts even when signing up to short term contracts. Where discounts are awarded these need to be applied in line with the discount matrix as required by the WICS.

5.07 Business Stream also expects to see increased competition impacted by the English market moving towards open market status, with competitors using the Scottish market to test strategies and pricing models.

Expenditure Forecast for 2013/14

5.08 Scottish Water has forecast a total expenditure budget for 2013/14 of £847 million.

5.09 Scottish Water has identified additional costs of £12 million in 2013/14 that were not incurred in 2012/13:

- Further operating expenditure of £2.7 million as a result of the capital investment programme;
- £1.8 million relating to additional IT costs;
- a £5.0 million increases in power costs;
- Pension Auto Enrolment costs of £0.8 million
- Facilities compliance cost increases of £0.8 million; and
- Other miscellaneous increases of £0.9 million.

Surplus Before Tax

5.10 As noted in the table at 5.02, Scottish Water is forecasting a regulatory profit before tax of £55 million (on a UK GAAP basis). This represents a reduction in profit of £13.3 million from 2012/13 and £19 million from 2011/12. This is despite Scottish Water being able to increase household charges by 2.8% in 2013/14 for the first time in four years. Although in line with Scottish Water's delivery plan and regulatory requirement, this reinforces the changing risk profile of Scottish Water's business whereby the business is becoming more reliant on the market driven non-regulatory business to generate profits and that going forward the profit levels available to the business for re-investment are diminishing.

Capital and Borrowing

5.11 Budgeted gross capital investment in 2013/14 totals £495 million within the forecast range for investment in the year of £475 million to £520 million. This will be partly delivered through Scottish Water Solutions 2.

5.12 Scottish Water relies heavily on operational cash to further invest in its capital programme and is forecasting that net new borrowing of £85 million will be required in 2013/14.

Section 6: Key Performance Indicators (KPIs)

6.01 As part of Scottish Water's regulatory contract, a number of key performance indicators are set and agreed. Management present and report the key performance indicators in two tiers both within Scottish Water and to the regulator:

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

6.02 Tier one and Tier two indicators are monitored by the Board on a monthly basis, with actions agreed where necessary to ensure Scottish Water stays on track to deliver the agreed targets. Set out in Appendix 2 is Scottish Water's reported performance against key targets for 2012/13 and the agreed targets for 2013/14. We express no formal view on these results as they are outwith the scope of our audit.

6.03 Particular indicators of performance for Scottish Water include customer service scores (OPA), performance against set leakage targets, total operating costs, surplus before tax and depreciation and capital investment levels. We note that Scottish Water has taken the initiative to appoint a third party, Black and Veatch, to undertake an independent review of these reported statistics.

6.04 As well as the agreed performance indicators within the Delivery Plan, Scottish Water also sets itself internal stretch targets. Overall, for 2012/13 Scottish Water has reported that it exceeded the targets set within its Delivery Plan, with the exception of the level of capital expenditure in the Q&S2/3a investment programme. 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)

6.05 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) which reflects performance over the 5 year Regulatory Contract period. These incentives are built into individual staff employment contracts and the pay awards of directors and staff.

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

6.07 Annual outperformance incentive payments for 2012/13 were calculated based on Scottish Water's performance during 2012/13 in respect of the following:

Measure	Target	Stretch Target	Actual Performance reported
Profit before tax excluding depreciation in comparison with the targets in the Final Price Determination	£375.0m	£390.0m	£401.4m
Outperformance in respect of the Final Determination - Overall Performance Assessment Target	338	358	368
Investment delivery • Q&S2/3a completion projects outstanding • Q&S3b overall measure of delivery score	 12 192	 12 >192	 9 205

6.08 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 2012/13 to third party evidence such as formal reports issued by the WICS. Internal Audit's report in relation to the 2012/13 calculations states that

"The Internal Audit work confirmed the relevant figures to appropriate documentation, and they can therefore be considered reliable for AOIP calculation purposes"

6.09 The £401.4 million Profit before Tax disclosed in the table above is the "Regulated Profit before Tax" adjusted for depreciation and amortisation of PFI.

6.10 This performance cannot be readily reconciled to the face of the financial statements summarised in section **Section 4** of our report and this calculation is outwith the scope of our audit and related opinion. This calculation has been subject to review by Scottish Water's Internal Auditors.

6.11 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.

6.12 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 7: Governance and Internal Control Arrangements

Overall Governance Arrangements

7.01 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.

7.02 Following the untimely death of the Chief Executive in October 2012 the Finance Director assumed the role of interim Chief Executive before being formally appointed as the new Chief Executive on 1 February 2013.

7.03 Scottish Water is currently recruiting for a new Finance Director and hopes to be in a position to confirm appointment at the end of May / early June 2013 with the intention that the new Finance Director will join the team no later than by October 2013. This will be dependent on the successful candidates notice period.

Systems of Internal Control

7.04 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 includes individual "walkthrough" testing 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. We also consider Scottish Water's Information Technology (IT) general control environment, as it relates to the financial statements.

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

Risk Management

7.06 On an annual basis the corporate risk register is approved by the Board, with the most recent approval in April 2013. 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.

7.07 When we reviewed the Risk Register as at April 2013, there were 3 "red" risks facing Scottish Water. These 3 significant risks related to:

- Risk of delivery of water into customer premises which is not fit to drink due to contamination;
- Risk of failure of a PFI project to remain financially viable;
- Risk of increased water quality failures and non compliance with regulatory criteria as a result of the loss of the current supply chain for spiral maintenance systems.

7.08 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.

7.09 Overall, risk management appears regularly on the Senior Management Team's agenda.

Internal Audit

7.10 As part of our controls work, we also considered Scottish Water's Internal Audit function, in particular Internal Audit staffing and work undertaken during 2012/13. 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 at the 22 May 2013 Audit Committee. The overall internal audit opinion for 2012/13 states that:

"....The control framework provides substantial assurance that all material risks and issues identified during the year were being actively 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."

7.12 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).

7.13 Although no evidence of fraud was identified by Scottish Water, we nevertheless agreed with the body procurement would be subject to suitable internal audit scrutiny as part of the future Internal Audit programme.

7.14 A number of Internal Audit procurement reviews have now been undertaken across the Group during 2012/13.

7.15 Although a number of control weaknesses have been identified by internal audit, action plans have been put in place by management and these will be followed up by Internal Audit and reported to Audit Committee.

National Fraud Initiative

7.16 The 2012/13 and 2013/14 National Fraud Initiative exercise commenced in October 2012 and is being carried out under new powers for data matching which were 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.

7.17 Last year Scottish Water committed to discussing it's NFI submission with the external auditors as part of the 2012/13 National Fraud Initiative. We can confirm that these discussions have taken place and Scottish Water has put in place arrangements to investigate it's matches.

7.18 In that regard Scottish Water submitted payroll and trade creditor data and is currently investigating 400 high risk matches and will report on the findings in August 2013.

Action 4

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	Scottish Water should continue to work with Scottish Water Business Stream to finalise the 2010/11 and the 2011/12 wholesale income reconciliations. **Risk Rating: Moderate**	**Management Response** Completion of the final settlement runs (RF) in respect of the previous years is part of the ongoing work of process improvements. **Responsible Officer** Financial Controller / Head of Wholesale Revenue Management **Implementation Date** CMA and Wholesale RF Timetable
2	Scottish Water will be required to monitor closely the impact Welfare Reform will have on the collectability of its debt and to ensure arrangements are in place to maximise cash collection. Scottish Water will also need to consider the suitability of the assumptions it uses in setting its Household Bad Debt Provision for 2013/14. **Risk Rating: High**	**Management Response** The monitoring of cash collection performance is part of the regular monthly performance reviews and reporting. Relevant factors and their impact are regularly considered and updated in respect of the bad debt provision calculations. In addition, the potential negative impact of the welfare reform changes will be closely monitored over the coming months. **Responsible Officer** Financial Controller **Implementation Date** March 2014

Ref	Recommendation and Risk Rating	Management Response, Responsible Officer and Implementation Date
3	Scottish Water should continue to monitor closely the financial performance and sustainability of Scottish Water Horizons following the decision to withdraw from receiving and treating green waste and withdraw from ongoing projects that were now deemed not to be financially viable, resulting in a £6 million loss during 2012/13. **Risk Rating: High**	**Management Response** The performance of SWH continues to be monitored closely and regularly by both the SWH Board and the Board of Scottish Water per the standard monthly reporting. In addition, the Finance Director of SWH will present a profitability statement by business segment to the SWH Board each month. **Responsible Officer** SWH Commercial Director **Implementation Date** Continuous Review
4	Scottish Water should continue to ensure that sufficient resource is made available to investigate the 400 high risk National Fraud Initiative Matches before the deadline set by Audit Scotland **Risk Rating: Moderate**	**Management Response** This work is ongoing. A report is being prepared for the August Audit Committee meeting. **Responsible Officer** Head of Internal Audit **Implementation Date** August 2013

Appendix 2: Key Performance Indicators

Scottish Water's Tier 1 Key Performance Indicators (KPIs) for 2013/14 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 2013/14 are below and the following points should be noted:

- All 2013/4 targets are consistent with the February 2013 Delivery Plan Update.
- The OPA business target score for 2013/4 is 394, 14 points higher than the regulatory target.
- The profit target has been set at £20 million greater than the regulatory target.
- OMD targets are based upon the 2011/12 Delivery Plan update and do not reflect the Q&S3b+ programme changes.
- Health and Safety targets will be confirmed once the implications of revised Health & Safety Executive reporting classifications have been fully assessed and once the year-end figure is known.

Tier 1 Performance Indicators	2012/13 Out-turn	Business Target 2012/13	Delivery Plan Target 2012/13	Internal Business Target 2013/14	Regulatory Delivery Plan Target 2013/14
OPA Score (YTD = 12 month rolling average)	368	358	338	394	380
Q&S IIIb delivery (OMD measure)	205	>192	192	>226	226
Q&S IIIa and Q&S II completion (Number of projects remaining to be delivered)	9	12	12	0	0
Compliance with WIC leakage target (Ml/d)	575.2	600-610	635.0	600	600
SW Profit before tax excluding depreciation and amortisation	£401m	£390m	£375.0m	£405m	£385m
Health & Safety – number of reportable incidents to HSE	5	13	n/a	n/a	n/a
Lost time accidents*	21	22	n/a	20	n/a
Customer Experience Score	88%	82% - 84%	>78%	86-89%	>78%
OPEX spend against target profit £m (core DP)	£349m	£350.0m	£359m	£357m	£365m
Revenue for Core DP (£m)	£1053m	£1050.0m	£1044m	£1071m	£1063m
Total Capital Expenditure (£m)	£487m	£490m-£520m	£505m	£475-£520m	£495m

* Lost time accidents replace HSE Target from prior year.

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 Committee during the year. Summarised below are the requirements set out within ISA 260 together with reference to the relevant communication with you during 2012/13 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 December 2012 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 December 2012.
Materiality	✓	Audit Planning document reported to Audit Committee in December 2012.
Form and Timing of Communications	✓	Audit Planning document reported to Audit Committee in December 2012.
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 the presentation on the audit to the Audit Committee on 22 May 2013.
Letter of Representation	✓	Signed by the Chief Executive on behalf of the Board on 29 May 2013.
Financial Statements Audit Opinion	✓	Financial Statement Audit Opinion is included within the Financial Statements.
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 based on our testing no material weaknesses were identified that would impact adversely on our audit approach or opinion.

Appendix 4: Audit Independence

As the External Auditors of Scottish Water we are required to follow both the International Standard on Auditing (UK and Ireland) 260 (Revised) "*Communication with those charged with governance*", UK Ethical Standard 1 (Revised) *"Integrity, objectivity and independence*" and UK Ethical Standard 5 (Revised) *"Non-audit services provided to audited entities"* issued by the UK Auditing Practices Board.

Together these require that we communicate at least annually with you regarding all relationships between PricewaterhouseCoopers LLP in the UK and other PricewaterhouseCoopers' firms and associated entities ("PwC") and Scottish Water, its directors and senior management and its affiliates ("the Group") that, in our professional judgement, may reasonably be thought to bear on our independence and objectivity.

Relationships and Investments

We have not identified any potential issues in respect of personal relationships with the Group or investments in the Group held by individuals.

Employment of PricewaterhouseCoopers staff by the Group

We are not aware of any former PwC partners or staff being employed, or holding discussions in respect of employment, by the Group as a director or in a senior management position covering financial, accounting or control related areas

Business relationships

We have not identified any business relationships between PwC and the Group.

Services provided to the Group

The audit of the consolidated financial statements is undertaken in accordance with the UK Firm's internal policies. The audit engagement is subject to an independent partner review of all significant judgements taken, including our reporting to the Audit Committee and a review of the annual report. The audit is also subject to other internal PwC quality control procedures.

Services to Directors and Senior Management

PwC does not provide any services e.g. personal tax services, directly to directors or senior management.

Gifts and hospitality

We have not identified any significant gifts or hospitality provided to, or received from, a member of Group's board, senior management or staff.