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Scottish Water

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

Year ended 31 March 2015

5 June 2015

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Introduction

Scope and objectives

We are pleased to present to you the key matters arising from our audit for the year ending 31 March 2015.

Our audit was performed in accordance with the principles contained in Audit Scotland's Code of Audit Practice ("the Code") and the scope and proposed focus of our work as set out in our Audit plan. Following the completion of our audit procedures, we confirm that the initial assessment of risk and scope remain appropriate. We have therefore made no significant changes to the audit plan previously presented.

Status

At the date of preparing this report, we have completed our audit work over the Scottish Water and subsidiary companies, to the extent necessary to support the consolidated financial statements. The audit opinion for the consolidated financial statements was signed on 29 May 2015. A copy of the financial statements has been provided to Audit Scotland.

Clearance meetings were held for the Group and subsidiary companies in April and May. Mark Hoskyns-Abrahall attended the Business Stream clearance meeting as a Group representative due to its financial significance within the Group results. We also held clearance meetings with the PwC component auditor for all subsidiary audits to ensure that we have considered any matters arising that would have an impact on the Group results.

The Group structure chart is included in appendix 1. At the time of writing unqualified audit opinions have been issued for the five subsidiaries and one jointly controlled operation.

Materiality

We have conducted our work in accordance with the overall materiality and de-minimis posting level previously communicated in our Audit Plan. The materiality levels used in the consolidated Scottish Water Group financial statements is outlined below:

- Overall materiality - £10.8m (£10.5m as communicated in December 2014). This is the amount that we used in assessing the overall impact on the financial statements of any potential adjustments and in reaching our audit opinion and is based on 1% of total expenses (including interest) in the consolidated income statement.

- Performance materiality - £8.1m (£7.9m as communicated in December 2014). Performance materiality is used to plan the amount of work we perform, for example in determining sample sizes, and is calculated as 75% of overall materiality.

- De-minimis posting level - £200k (£200k as communicated in December 2014). Under ISA 450 (UK&I), we are required to report to the Audit Committee on all unadjusted misstatements in excess of a 'de-minimis' level or 'clearly trivial' amount. This is has been set at the pre-agreed level as confirmed with the Audit Committee in December 2014.

The levels outlined above have been used in our audit of the Consolidated financial statements, however lower statutory materiality levels have been used for the subsidiary statutory audits. These levels are detailed below:

Subsidiary	Overall Materiality	Performance materiality	SUM posting level (Group)
Scottish Water Group company	£10.2m	£7.7m	£0.2m
Scottish Water Business Stream Ltd	£3m	£2.3m	£0.2m
Scottish Water Horizons Holdings Ltd	£1.4m	£1m	£0.2m
Scottish Water Horizons Ltd	£0.2m	£0.15m	£0.2m
Scottish Water Business Stream Holdings Ltd	£1.3m	£1m	£0.2m
Scottish Water International Ltd	£0.05	£0.04	£0.2m
Scottish Water Solutions 2 Ltd	£1.5m	£1.1m	£0.2m

There are no unadjusted items to report in respect of the Scottish Water Group or subsidiaries in excess of £0.2m.

Significant audit and accounting matters

Significant and elevated audit risks

In our audit plan presented in December 2014 the following areas were identified as having a significant or elevated risk of material misstatement in the Group financial statements:

Risk	**Significant / Elevated**	**Fraud**	**Error**	**Judgement**
Management override of control	Significant	◉	○	○
Risk of fraud in revenue recognition	Significant	◉	○	○
Risk of fraud in expenditure and capital additions	Significant	◉	○	◉
Household bad debt provision	Elevated	○	○	◉
Pension assumptions	Elevated	○	○	◉

The audit procedures performed and conclusions reached in response to these significant and elevated risks are detailed within this report. We have also included below other areas which we have determined to have a higher level of judgement.

Areas of particular audit focus

Consistent with FY14, we will include a section in our audit report detailing those areas that were of a particular focus to the audit. These are the areas where the audit risk had the most significant impact on our audit strategy, allocation of resources and direction of efforts of the engagement team.

It is expected the 'significant issues' identified by the audit committee, and therefore communicated in the annual report, will be aligned with the areas of particular focus identified by us. The audit committee has identified the following areas in their risk assessment:

- Household bad debt provision and the sensitivities on future household collection rates;
- Delivery costs associated with Scottish Water capital investment programmes and the associated expenditure classification; and
- Key assumptions associated with determining the actuarial valuation of pension obligations.

These areas are consistent with the risk assessment included within our audit opinion.

Management override of controls

As stipulated in our audit plan, the risk of management override of control is assumed to be present on all engagements. As management remuneration incorporates an element of financial measures, we conclude that the key incentive for management relates to improving the performance of the profit and loss account through overstating revenue or inappropriately capitalising expenses. We have performed the following procedures to address the risk of management override:

- We held discussions with management and internal audit on the assessment and consideration of fraud risk;
- We re-performed control account reconciliations over key balance sheet accounts;
- We performed manual journal testing using fraud risk criteria across the Scottish Water Group. These criteria included a bespoke test to identify material manual journals which had impacted both expenditure and fixed asset account codes. As part of our testing we used our Data Assurance specialists to run interrogation tools over the complete population of journals posted. The results show that 53% (2014:43%) of all journal entries posted in the Group Company are manual journals, however there have been no journals posted by senior finance members. We provided management with the key statistics gathered through the data interrogation tools and they will review this as part of their regular finance meetings.
- We have reviewed areas of significant estimate and key judgement such as accruals, bad debt provisions and credit note provisions; and
- We have incorporated an element of unpredictability into our audit procedures for example, through selecting a sample of executive members' expenses and ensuring that they were adequately supported.

No issues have arisen from our testing.

Risk of fraud in revenue recognition

As outlined in our risk assessment, the risk of fraud in revenue recognition has been identified as a significant risk for the wholesale and other non-regulatory income streams, as these income streams could be manipulated by management. The risk of fraud in household income is not deemed to be a significant risk as both the collection of the household billings (controlled by local councils) and the price is not within the control of Scottish Water management. We also circulated confirmations directly to the local councils and confirmed closing debtor positions and total household billings in the year. We received confirmations from 31 of the 32 councils, covering 99% of the revenue and there were no significant reconciling items arising.

Revenue is recognised once services have been provided to customers and there is a risk that management may overstate this revenue to improve financial performance. We have performed the following procedures to address the risk of fraud in revenue recognition:

- We have reviewed the revenue recognition policy and confirmed that there have been no changes and that the policy remains appropriate;
- We have performed substantive testing over revenue transactions recognised in 2014/15 and agreed a sample of transactions to invoice and cash receipt; and
- We have reviewed and substantively tested the credit notes and invoices recognised at the period end and agreed the service date associated with the invoices to ensure that these have been recognised in the appropriate period.

No issues have arisen from our testing.

Risk of fraud in expenditure and capital additions

There is a risk that due to the capital investment programme and profit targets in place, management may feel pressure to manipulate expenditure recognition by inappropriately capitalising expenses to achieve planned capital investment targets, or to reduce expenses recognised in the income statement to achieve profitability targets. We have performed the following procedures to address this risk:

- We have evaluated and tested the controls and processes established by management to ensure that income statement expenditure and capital expenditure was recorded and classified correctly within the financial statements, in particular if assets capitalised have been authorised by appropriate individuals;
- We tested a sample of expenditure by agreeing transactions to invoices and by testing the appropriateness of expenses capitalised;
- We tested assets under the course of construction additions transferred to fixed asset categories around the period end for appropriateness of asset completion and categorisation; and
- We identified material manual journals posted to both fixed assets and expenditure accounts and understood the rationale for the adjustments by obtaining appropriate evidence such as invoices or contracts.

No issues have arisen from our testing.

Household bad debt provision

As at 31 March 2015, the Scottish Water balance sheet includes a household income debtor of £439.4 million and a corresponding bad debt provision of £418.6 million, leaving a net debtor position of £20.8 million (2013: £33.5 million). Scottish Water is not permitted to write off any of its outstanding debt and therefore this total outstanding debt includes all years dating back to 1996/97.

The provision is established by applying an average forecast collection rate to the total household billing, and by deducting the forecast recoverable amount from the outstanding receivable. This is demonstrated in the table below:

	1996 - 2011	**2011/2012**	**2012/2013**	**2013/2014**	**2014/2015**	**Total**
Total billings (£m)	7,716	749	755	783	804	10.807
Cash collected (£m)	7,429	719	723	747	750	10,368
Forecast total collection (£m)	7,430	720	724	749	766	10,389
Outstanding debtor (£m)	287	30	32	36	54	439
Provision (£m)	286	29	31	33	39	418
Net debtor (£m)	1	1	1	3	15	21

The key components of the bad debt provision are the total household billings, cash collected to date and the forecast collection rate. The household billing amounts and cash collected are communicated by the councils and these figures cannot be influenced by Scottish Water. As part of our audit procedures we have agreed the total billings and cash collected in 2014/15 to confirmations issued directly to the councils. Historic billings and cash collection included in the provision calculation were agreed to prior year audit work papers where these amounts were previously confirmed.

The table also illustrates that the majority of the outstanding receivable relate to historic periods (65% pre 2011) and these are substantially provided for. If Scottish Water adopted the working practices of most 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 this older aged debt.

The most sensitive assumption is the forecast collection rate, and the level at which this is estimated could have a significant impact on the bad debt provision. The forecast collection rate is estimated individually for each financial year with reference to the actual cash that has been collected for each year to date, and consideration for relevant circumstances which will impact future collection levels.

The actual cash collection rates and forecast total cash collection rates for the past five years are detailed below:

	2010/2011	**2011/2012**	**2012/2013**	**2013/2014**	**2014/2015**
Actual collection to date %	96.05%	96.02%	95.81%	95.40%	93.24%
Forecast total collection %	96.10%	96.09%	95.90%	95.77%	95.15%

As expected, the actual cash collection rates for earlier years is close to the forecast collection rate as, given the passage of time, it is not anticipated that a significant amount of the outstanding debtor position for these years will be recovered. 2013/14 and 2014/15 financial years show both the largest difference between actual and forecast collection rates and also the largest outstanding debtor balances. These years therefore carry the greatest level of estimation and also have the most significant impact on the bad debt provision level. The total average forecast collection rate across all years is 96.13% (2013/2014: 96.02%).

Both the in year cash collection (93.24%) and the historic cumulative collection, ignoring the first year of collection (95.88%), have reached the highest rates in 2014/15 and in response to this the 2014/15 forecast collection rate has been increased to 95.15% (previously held at 95%). Although these forecast rates have been increased, they remain lower than the actual average cash collection for financial years up to 2011/12 of 96.21% (2013: 96.12%) and lower than the average cash collected as a percentage of total billings for all years to date of 95.93% (2013: 95.68%). Management have confirmed that the reason for the lower forecast collection levels is due to the following matters:

- Collection years 2003 – 2008 are higher than the other financial years (average 96.5%) due to specific collection programmes and incentives run by Scottish Water with the councils at that time;
- Management have concerns in regard to the impact of the welfare reforms and council tax benefit changes which are yet to be realised in Scotland due to the Scottish Government and Scottish local authorities jointly funding the 10% reduction in central government funding of the Council Tax Reduction Scheme for 2013/14 and 2014/15;
- Management have discussed the impact of the welfare reform with English and Welsh water companies and they have communicated a decrease in overall collection rates and a direct correlation between the impact of welfare reform and water company collections; and
- The Council tax freeze is now in its seventh year and councils have improved their controls covering exemptions and discounts to maximise the collection of cash. However management consider that a further step change in collection performance is unlikely.

There is limited published data available to estimate the impact that changes in welfare reform will have on future cash collection rates. We have obtained the observed council tax collection rates for England from the government statistics website which show that while collection rates in England are generally higher than in Scotland, there has been an average 0.4% reduction in 2013/14. The collection graph has been included in appendix 2 and shows that although the average reduction was 0.4%, the range for each of the geographical areas was a reduction between 0.2% and 0.8%.

In considering the appropriateness of the forecast cash collection rates, we have performed sensitivity analysis as to what impact a change in the assumptions used would have on the overall provision level. The sensitivity has been performed over the 2013/14 and 2014/15 forecast collection rates, as these are the years with the largest difference between actual and forecast collection rates and therefore subject to the greatest level of estimation.

The upper range of sensitivity applied assumed that the current cash collection rates of 96.21% will hold has been applied to the 2013/14 and 2014/15 years. A mid-range has been included using the 0.4% reduction experienced in English council tax collection rates and forecast rate of 95.8% has been applied to 2013/14 and 2014/15.

	13/14 forecast collection rate	**14/15 forecast collection rate**	**Bad debt charge (£m)**	**Bad debt provision (£m)**
Actual historic rate applied (max)	96.21%	96.21%	10.8	409.6
0.4% reduction (mid)	95.81%	95.81%	17.3	416
Current position (low)	95.77%	95.15%	19.8	418.6
Range (current to max)	0.44%	1.06%	9	9

The above sensitivities demonstrate that were forecast collection rates increased to historic highs of 96.21% the year end provision would fall by £9m. We believe that this is an unlikely scenario, but note that this remains below our overall materiality level. If an allowance of 0.4% below the historic high's is made, which is in line with the trend reported in England for Council Tax collection over the past year, and collection rates were increased to 95.81%, this would result in a £2.5m reduction in the year end bad debt provision, which is clearly not material.

While we have, therefore, been able to conclude that the household bad debt provision is not materially misstated, we do believe that it is at the cautious end of a range. Given the sensitivity of the provision to small changes in the collection rate assumption, we have asked management to disclose the sensitivity information in the notes to the accounts, in line with the disclosures make elsewhere on pension scheme assumptions. We note that the forecast cash collection assumptions are highly sensitive and given the magnitude of outstanding receivables and provision, the Board must ensure that these assumptions are appropriate and represent the best estimate. This will be included in the letter of representation.

Pension assumptions

Employees of Scottish Water participate in three pensions funds; North East Scotland pension fund, the Lothian pension fund and the Strathclyde pension fund which are all part of Local Government defined benefit pension schemes. A full actuarial triannual valuation was carried out at 31 March 2014 for all three funds and has been updated at 31 March 2015 by Hymans Robertsons (independent actuary).

We have independently confirmed the pension assets and accuracy of the census data held by the pension funds as part of our audit procedures. We have also reviewed the key assumptions applied to the pension schemes valuations and compared these with our own actuarial specialists' expectations, which included benchmarking the assumptions against a range of other schemes with March year ends.

The key assumptions are included below:

Assumption	2014	2015
Rate of increase in pensionable salaries	2.3%	2.3%
Rate of increase in pensions payment	2.6%	2.3%
Discount rate	4.3%	3.3%
Inflation rate	2.6%	2.3%

Mortality	North East years		Lothian years		Strathclyde years	
	2014	2015	2014	2015	2014	2015
Male – retired	22.4	22.0	20.7	22.2	21.3	22.3
Female – retired	24.7	24.6	23.1	23.8	23.6	23.7
Male – retiring in 20 years	25.2	24.2	22.7	24.3	23.3	24.9
Female – retiring in 20 years	27.6	27.5	25.0	26.4	25.0	26.3

Overall these assumptions are in line with an expected assumption range. We have provided a benchmark analysis over the key pension assumptions within appendix 3 and these show that the Scottish Water assumptions are at the prudent to median range in comparison with other companies assumptions at 31/03/2015. This is consistent with the positioning of the assumptions at 31/03/2014 and there has therefore been no significant change in approach or position against benchmarks in respect of the pension assumptions.

We note that the assumptions used are highly sensitive and given the magnitude of the pension deficit the Board must ensure that the assumptions used are appropriate and represent the best estimate. This will be included in the letter of representation.

Other areas of judgement and provisioning

In addition to the significant and elevated audit risks outlined above, we have provided an overview of the work performed and findings over other judgemental areas, which could have a significant impact on the quality of earnings for the year or the financial position at March 2015.

Income uncertainty provision

In the 2014/15 financial statements the income uncertainty provision in the Company balance sheet is £14m. This provision is £12.4m in respect of Scottish Water Business stream and £1.6m for other licenced providers. Management consider a provision necessary due to issues regarding the accuracy of the Central Marketing Agency's (CMA) data arising from incorrect calculations, estimated usages and vacant properties. A proportion of revenue recognised in the year may therefore be required to be refunded to the licensed providers.

The income uncertainty level has been agreed between Scottish Water and Scottish Water Business Stream and the same adjustment recognised in the Scottish Water wholesale revenue and Scottish Water Business Stream cost of sales. The PwC audit teams have reviewed the adjustments made in both Scottish Water and Scottish Water Business Stream with no issues or intercompany differences noted. The income uncertainty provision in the Scottish Water Group balance sheet is immaterial as the intercompany position with Scottish Water Business Stream is removed on consolidation.

We note that Scottish Water and Scottish Water Business Stream management have agreed the out turns for 2010/11, 2011/12 and 2012/13, however these recalculations have not been processed by the CMA prior to the year end and £7.9m of the provision relates to these years. Progress will be made in 2015/16 on finalising the out turn for the 2013/14 period.

Accrual for credit note adjustments

The credit note accrual of £31.0m (2014: £30.5m) has been recognised to account for future issue of credit adjustments to customers for balances previously paid.

The provision is calculated by applying a historic accrual rate of 1.032% (2013/14: 1.057%) to total billings up to 31 March 2015, less the total credits raised to March 2015. This historic accrual rate represents the average percentage of credit adjustments issued to customers after the close of the financial year over the period from 1996/97 to 2008/09. Management will also make additional adjustments for any periods where they consider there to have been unexpected lower levels of credits issued, or if the future rate of credits is expected to increase. In 2014/15 an additional accrual of £0.8m has been created (2013/14: £1.1m). This methodology is consistent with the approach adopted in previous years.

The key areas of judgement in the credit note accrual are the historic accrual percentage rate applied, and any additional adjustments made by management. We have verified the inputs to the historic accrual percentage rate including billings and credit adjustments with no issues noted. The calculation does not incorporate the percentage of credit notes received on years after 2008/09, which we concur with, as there is less data on which to base a reliable long term run rate.

No issues have arisen from our testing.

IFRS 10

Scottish Water adopted IFRS 10 'Consolidated financial statements' with effect from 1 April 2014. IFRS 10 requires that an entity that controls one or more entities should present consolidated financial statements. The standard notes that an investor has control over an entity if and only if the investor has all of the following:

- Power over the investee;
- Exposure, or rights, to variable returns from its involvement with the investee; and
- The ability to use its power over the investee to affect the amount of the investor's returns.

We have considered the appropriateness of consolidation for all subsidiaries with reference to the criteria above. In particular we have considered if the governance arrangements in respect of Scottish Water Business Stream are sufficient to support consolidation. The following matters have been considered:

- The responsibilities of the Scottish Water Business Stream Holdings Board and common members with the Scottish Water Group board. The responsibilities include approval of dividend payments from Scottish Water business stream, approval of business plans, review of financial performance and approval of key management personnel, for example the Business Stream CEO;
- The chair appointed to Scottish Water Group and Scottish Water Business Stream is consistent;
- Dividends paid from Scottish Water Business Stream in 2014/15 have been used elsewhere within the Scottish Water Group, but cannot be used within the regulatory business; and
- The Scottish Water Group Finance Director was on the interview panel for the appointment of the new Finance Director for Scottish Water Business Stream.

We conclude that the consolidation of Scottish Water Business Stream for 2014/15 is appropriate, however the Board will be required to revisit and reconfirm that consolidation is appropriate each year.

Financial performance

2014/15 financial performance

The financial performance for 2014/15 as reported in the Consolidated Income Statement is included below:

	2014/15 £ Million	2013/14 £ Million
Revenue	1,187.4	1,179.7
Cost of sales	(754.6)	(742.6)
Gross surplus	**432.8**	**437.1**
Administrative expenses	(135.5)	(145.4)
Operating Surplus	**297.3**	**291.7**
Finance Income	2.0	1.1
Finance Costs	(188.6)	(191.8)
Surplus on ordinary activities before tax	**110.7**	**101.0**
Taxation	(19.7)	64.5
Surplus for the year	**91.0**	**165.5**

The results show an overall increase at the revenue and profit before tax level from 2013/14. The gross margin percentage of 36% has decreased by 1% from 37% in 2013/14, however the margin on profit before tax has remained consistent with 2013/14 at 9%. The primary factors in these movements are set out in the sections below.

Revenue

The split of revenue in the Group by entity has remained in line with previous years being 71% (2014: 67%) from Scottish Water, 27% (2014: 31%) from Business Stream and 2% (2014: 2%) from Horizons and International. There has been an overall £7.7m increase in revenue due the following factors:

- Increase of £21.9m in household revenue due to a 1.6% increase in household charges and a net increase of 16,044 properties being connected in the year.
- Increase of £4.5m in other non-regulated revenue primarily due to increase in Horizons of £2.9m and 100% growth in International to £2.4m.
- Decrease in business revenue of £18.7m. There was a decrease in Business Stream revenue of £44.2m reflecting the increased market activity of new entrants with 18 companies now licensed to operate in the retail market, and this was partially offset by an increase in Scottish Water's sales to other licensed providers of £25.5m

The increase in revenue is in line with our testing performed over the Group.

Operating costs

Total cost of sales and operating expenses have increased by £2.1m to £890.1m and margins have remained relatively consistent with gross margin at 36% (2014: 37%) and operating profit margin at 25% (2014: 24.7%). The increase has arisen due to:

- Increase of £6.1m in depreciation and amortisation costs due to the profile of capital investment in the year;
- Increase in Horizons and International operating costs of £2.2m reflecting the increased activity in these companies;
- Increase of £3m in Scottish Water PFI operating costs;
- Increase of £8.4m in IFRS and consolidation adjustments;
- Decrease of £11.9m in Scottish Water regulatory operating costs and £5.7m in business stream operating costs. The decrease in Scottish Water regulatory costs is primarily due to a £14.5m reduction in local authority rates charges and release of £5.5m land fill tax accrual which is no longer required. These are offset by increases in energy prices, carbon reduction charges and operating costs associated with new capital investment.

The movement in operating costs is in line with our testing performed.

2015 – 2021 regulatory period and business plan

Final agreement of the Scottish Water business plan for the 2015 – 21 period was reached with the Customer Forum in January 2014 and the Final Determination of the charges that will apply for water and waste water services was issued by the WICs in November 2014.

The WIC's Final Determination has endorsed a nominal increase in household charges of 1.6% per annum for the years 2015/16 – 2017/18, and that Scottish Water charges must increase by no more than 1.8% below the CPI rate of inflation for subsequent years.

The overall forecast finance requirements for delivering the 2015 – 21 business plan is £8 billion. The budget assumes that £7 billion will be received from customer revenue and £720 million from Government borrowing. Additional financing will be received from disposal of non-core capital assets, and from opening cash balances.

The significant elements of the delivery plan for the 2015 – 21 regulatory period are detailed in the table below:

Outturn prices	**2015-16**	**2016-17**	**2017-18**	**2018-19**	**2019-20**	**2020-21**
Total capital expenditure (£m)	509	584	585	614	632	642
Total operating expenditure (£m)	504	520	534	547	560	573
Total revenue (£m)	1,098	1,121	1,160	1,183	1,208	1,233
Closing cash balance (£m)	247	207	185	143	93	40

The table above demonstrates that the cash balances will decrease to £40m by 2021 if the current delivery plan is met. An outperformance plan has been prepared to ensure that cash balances remain higher than the £40m forecast. The primary areas identified for potential out-performance include; energy management (including self-generation opportunities), fleet management, capital project design, scoping and construction, rationalisation of IT platforms/applications and driving a "right-first-time" culture across the business.

Governance and Internal Control Arrangements

Overall Governance Arrangements

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

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. We test controls over significant risk cycles every year and on a rotational basis (every three years), we undertake more detailed testing other financial controls over non-significant risk areas. We also consider Scottish Water's Information Technology (IT) general control environment, as it relates to the financial statements.

In the 2014/15 audit plan, the test of controls included the following key areas:

- Authorisation for changes to supplier details and ensuring appropriate support was in place to approve the changes;
- Authorisation for changes to employee details, new joiners and leavers; and
- Authorisation and approval of fixed asset additions at various stages of capitalisation.

There were no control recommendations identified which would have a significant impact on the financial statements.

Risk Management

On an annual basis the corporate risk register is approved by the Board. 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.

We reviewed the Risk Register as at March 2015, and at that date there were five "red" risks facing Scottish Water. These risks related to:

- Risk of delivery of water into customer premises which is not fit to drink due to contamination;
- Risk arising from the failure of a critical asset or assets;
- Operational, reputational and financial risk arising from a contractor engaged to deliver water infrastructure improvements not fulfilling their obligations/liabilities;
- Financial and operational risk arising from failure of a PFI project to remain financially sustainable; and
- Risk of reduction in value of Scottish Water Business Stream arising from increasing number of competitors in the wholesale market.

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.

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

Internal Audit

As part of the planning for the 2014/15 audit, we also considered Scottish Water's Internal Audit function, in particular work undertaken during 2014/15. In addition to its normal quarterly reporting to the Audit Committee, Internal Audit also reports on relevant Audit Scotland publications and national report findings. Action plans are put in place by management for any control weaknesses identified by Internal Audit. These will be followed up by Internal Audit and reported to the Audit Committee.

The Head of Internal Audit presents a quarterly report to the Audit Committee and an Internal Audit annual report at the May Audit Committee prior to approval of the Annual Report and Accounts. The Head of Internal Audit has also performed a "fair, balanced and understandable" review of the Annual Report and Accounts.

Fraud

Fraud risk assessment, anti-fraud governance and the tone at the top in respect of fraud risk has been a focus for the Senior Management team during 2014/15.

An Ethics Committee was established to govern the anti-fraud strategy and related proactive and reactive investigations. The committee is chaired by Geoff Aitkenhead (Executive Director Capital Investment) and comprises the leadership team and senior management representatives from a range of departments. The Committee meets at least four times a year and is responsible for a number of activities including oversight, development and implementation of appropriate counter-fraud strategies across Scottish Water and the review of investigation reports and corrective action plans.

An external whistleblowing hotline was established in June 2014 with any activity reported to and monitored by the head of Internal Audit. The launch of the whistleblowing hotline was communicated to all employees through letters directly to employees at home, promotion in the company magazine and posters across all main sites. An interactive session was included at the SW One events for all managers and team leaders, to discuss the risk of fraudulent actions and how to recognise potential fraud risks.

National Fraud Initiative

The National Fraud Initiative (NFI) 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.

Scottish Water are participating in the 2014/15 NFI exercise and provided Audit Scotland with payroll and supplier payments data. We understand that 495 recommended matches have been communicated to Scottish Water and Internal Audit have begun investigating the returns.

Other reporting matters

Relationships and Independence

We confirm that, as at the date of this document, in our professional judgement, we comply with UK regulatory and professional requirements, including the Ethical Standards issued by the Auditing Practices Board, and that the firm is independent of Scottish Water and its subsidiaries. In order to be able to report this to you, we have made enquiries of all PwC team members providing services to the Group.

Non audit services

Before the firm takes on any engagement for other services with the Group, we have, and will continue give full consideration as to whether the service would conflict with our role as auditors or impair our independence. We are also required to obtain pre approval from Audit Scotland for any non-audit services provided to Scottish Water. We have considered the threats and safeguards in respect to all services and considered no issues which would have prevented us from performing the non-audit services.

The services provided in 2014/15 were to Scottish Water Business Stream only and comprised the provision of a VAT and HRS helpline, advice in relation to auto-enrolment compliance and implementation, corporation tax services and employee tax services. These were previously communicated to the Audit Committee as part of our audit plan in December 2014.

Fraud

Based upon discussions with management and internal audit we are aware of a number of instances of alleged fraud in the period. These matters have been brought to the Audit Committees attention by internal audit. Any confirmed instances of fraud will be reported to Audit Scotland in the fraud reports to be issued in May 2015. No instances of material fraud have been brought to our attention and we ask the Audit Committee to confirm if they are aware of any suspected or actual fraud having been conducted during the year.

Related parties

We have not identified any significant matters in relation to related parties or related party transactions. The disclosure of related party transactions in the consolidated financial statements is reasonable.

In March 2015 we requested all Non-Executive and Executive Directors to confirm any transactions they were aware of between Scottish Water companies and close family members, or other companies over which they had control or influence over. This list along with the register of declared interests has been included within the representation letter and we will request that the Directors re-confirm that this listing is complete prior to signing.

Uncorrected misstatements

No uncorrected misstatements in excess of £200k have been identified through our audit procedures.

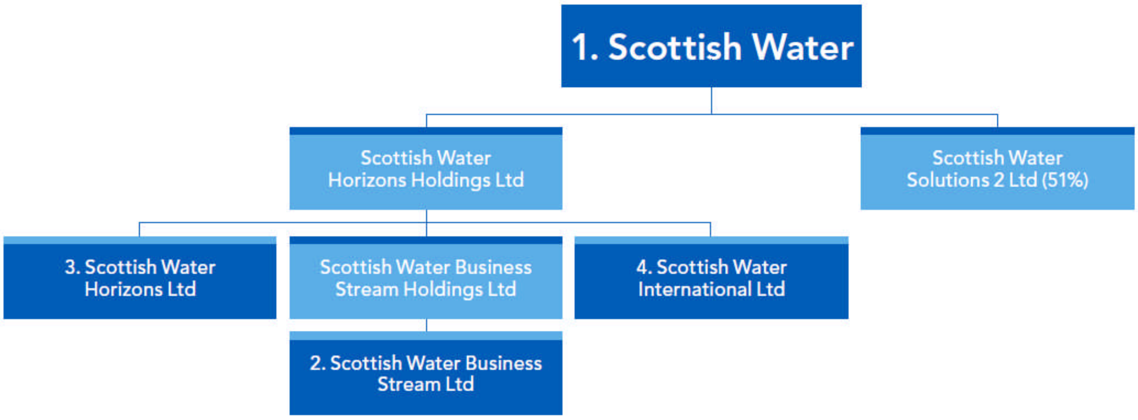
Going concern

We are not aware of any events or conditions which would cast doubt over the Groups ability to continue as a going concern. We have obtained and reviewed the going concern assessment and note no issues. As a result we consider that the Board's adoption of the going concern basis of preparation is appropriate.

Appendices

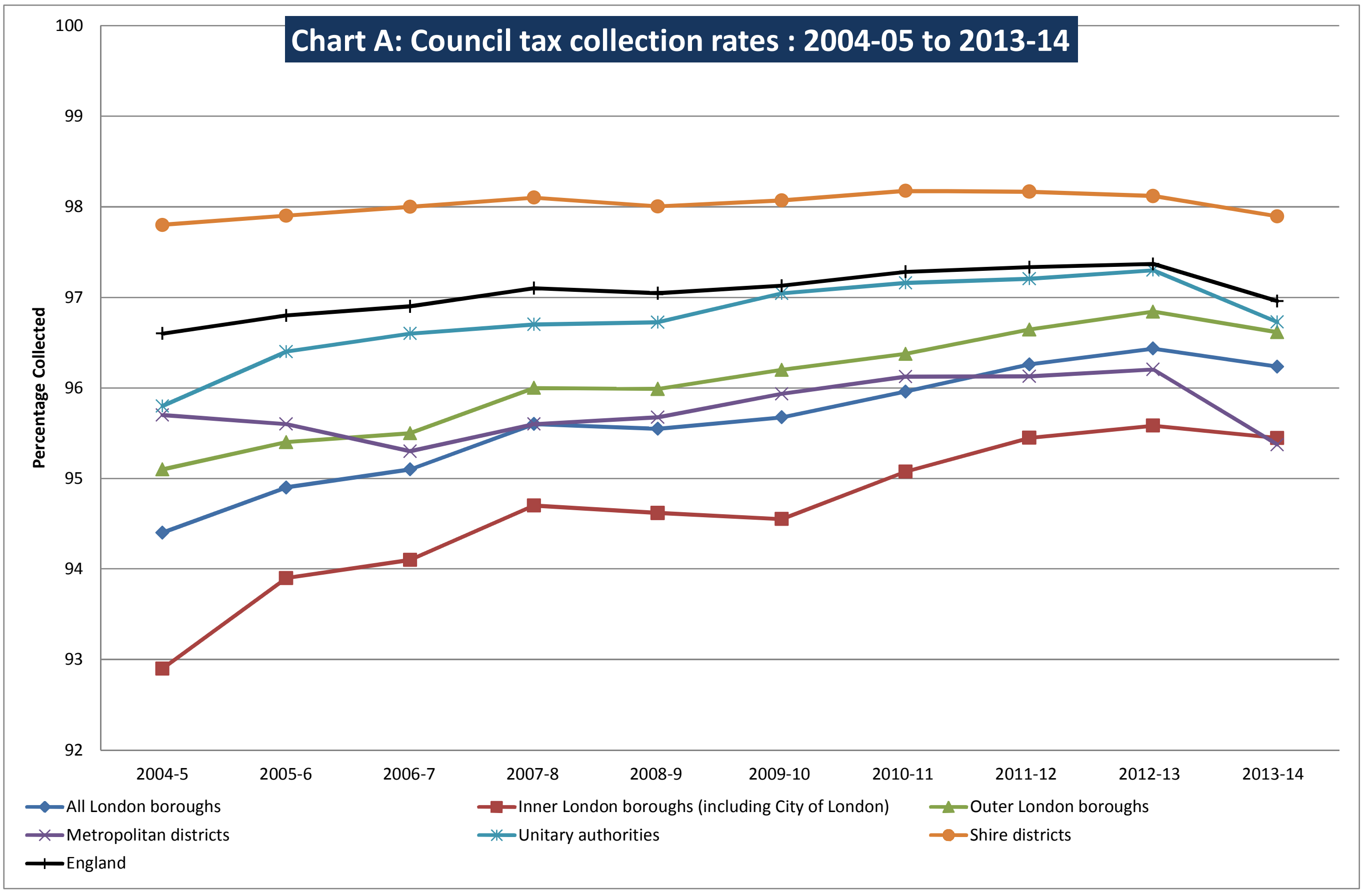
Scottish Water Group Structure Chart

In addition to our appointment as auditors for Scottish Water under our Audit Scotland appointment, we are also the statutory auditors for each of the Group subsidiaries. The companies below are 100% owned, with the exception of Scottish Water Solutions 2 Ltd which is 51% owned and accounted for as a jointly operation.



English council tax collection rates

The graph below has been obtained from the Government statistics website and shows the movement in council tax cash collection rates from 2004 – 2014.



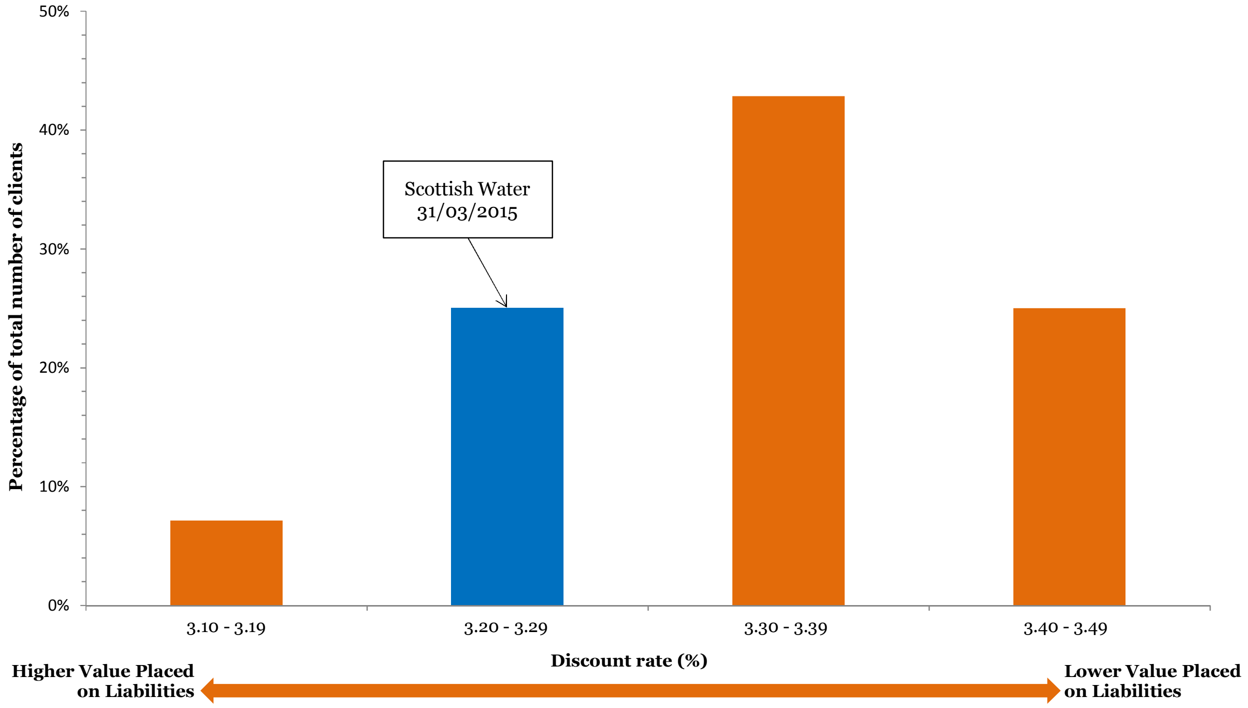
Pensions benchmarking

We have benchmarked the key pension assumptions included in the Scottish Water financial statements with a range of other clients reporting at 31/03/2015. The assumptions we have benchmarked are:

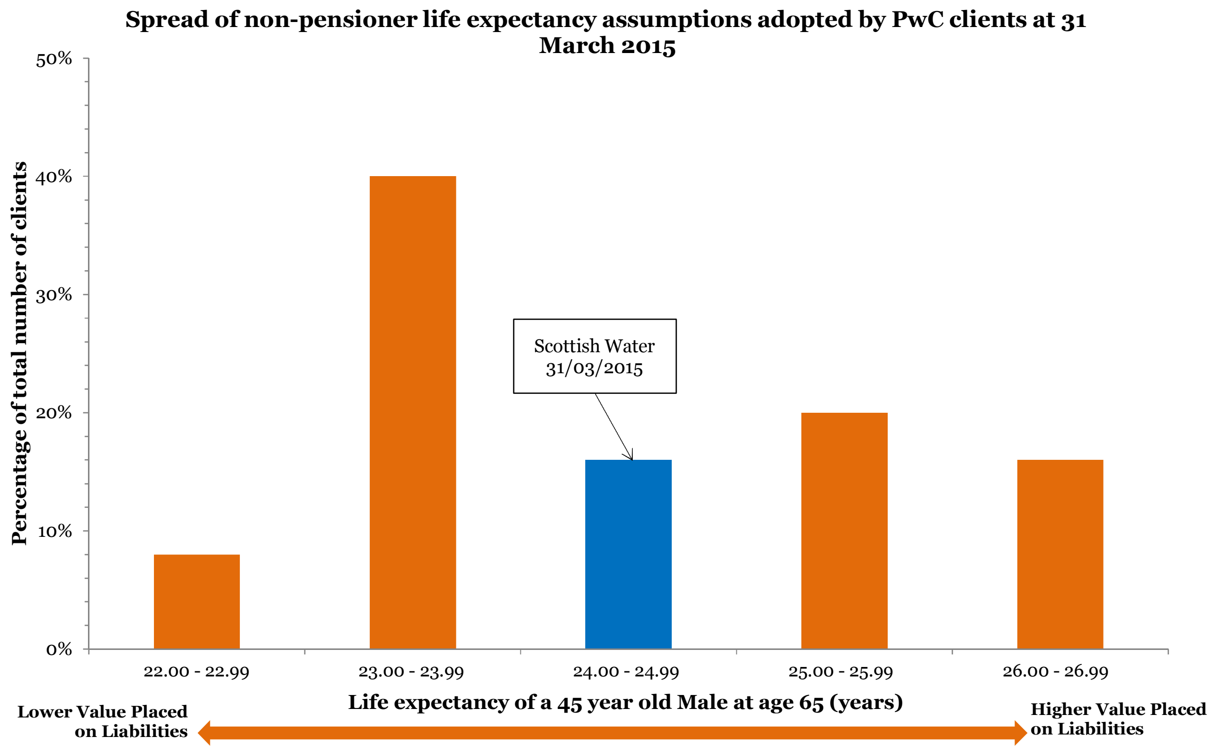
- Discount rate; and
- Mortality assumptions.

The results are included within the following graphs:

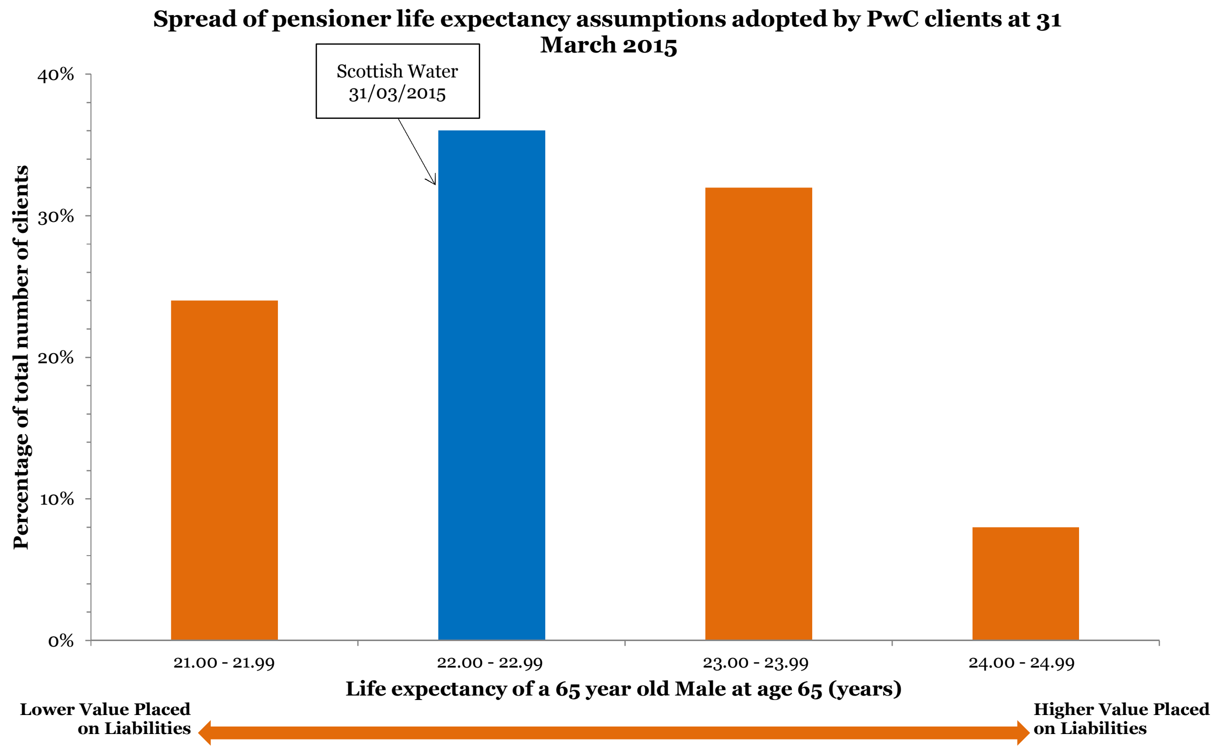
Spread of discount rate assumptions adopted by PwC clients at 31 March 2015



Number of clients: 28 (including draft assumptions)
Reporting Date: 31/03/2015



Number of clients: 25 (including draft assumptions)
Reporting Date: 31/03/2015



Number of clients: 25 (including draft assumptions)
Reporting Date: 31/03/2015

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 2014/15 or comments as appropriate.

Communication Required under ISA 260		Reference/Comment
Copy of engagement letter to those charged with governance	✓	Signed Engagements Letter with Audit Scotland at the start of our 5 year appointment and updated annually.
Independence and objectivity confirmation	✓	Audit planning document reported to Audit Committee in December 2014 confirmed there are no matters which we perceive may impact our independence and objectivity of the audit team. This has been reconfirmed within this report.
Details of all non-audit work performed by the firm and related fees	✓	Details of non-audit work have been included within this report.
Nature and scope of work together with timing of expected reports	✓	Audit planning document reported to Audit Committee in December 2014 confirmed the nature and scope of work and expected timings of reports.
Uncorrected misstatements	✓	There are no uncorrected misstatements to report. This has been confirmed within this report.
Expected modifications to audit report	✓	No modifications expected. Final audit opinion issued in financial statements reviewed by Audit Committee in May 2015.
Materiality	✓	Materiality has been confirmed with the Audit Committee in our audit plan from December 2014 and final levels re-confirmed within this report.
Views about the qualitative aspects of the entity's accounting practices and financial reporting	✓	Significant matters and qualitative aspects of accounting practices and financial reporting are included 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 in May 2015.
Final draft of representation letter	✓	Final draft of the representation letter has been included within the joint accounting paper issued to Audit Committee in May 2015.
Any other audit matters of governance interest	✓	None identified.
Related Parties	✓	Other than those transactions disclosed in the Financial Statements we have not identified any further transactions requiring disclosure. This is confirmed within this report.
Fraud	✓	Discussed fraud arrangements with the Audit Committee members, review of internal audit findings and management throughout audit process.
Significant deficiencies in internal control identified during the audit	✓	Internal Controls findings are discussed within this report. No material weaknesses were identified that would impact adversely on our audit approach or opinion.