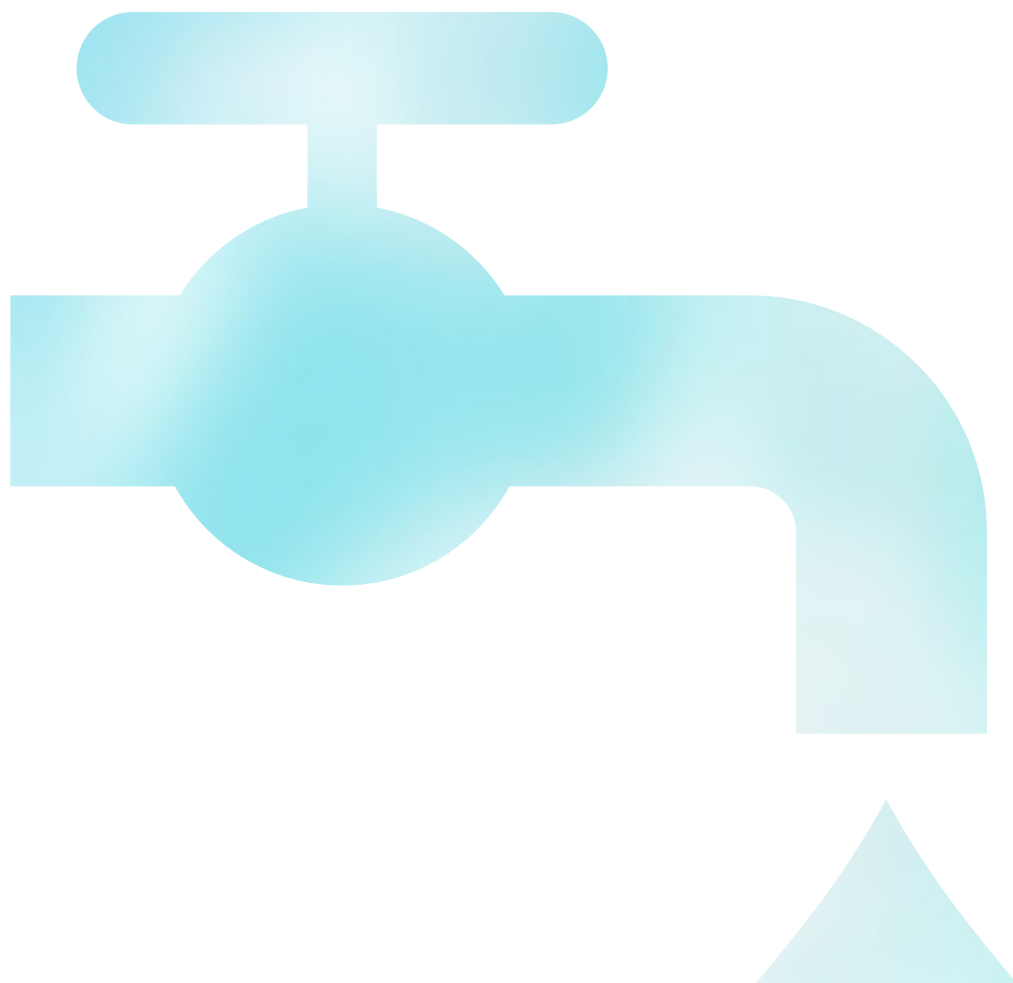


# The 2019/20 audit of Scottish Water



AUDITOR GENERAL 

Prepared for the Public Audit and Post-Legislative Scrutiny Committee by the Auditor General for Scotland  
Made under section 22 of the Public Finance and Accountability (Scotland) Act 2000  
December 2020

# Auditor General for Scotland

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- examine how public bodies spend public money
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- check whether they achieve value for money.

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- NHS bodies
- further education colleges
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# The 2019/20 audit of Scottish Water

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## Introduction

**1.** I have received the audited annual report and accounts and the independent auditor's report for Scottish Water for 2019/20. I am submitting these financial statements and the auditor's report under section 22(4) of the Public Finance and Accountability (Scotland) Act 2000, together with this report that I have prepared under section 22(3) of the Act.

**2.** The auditor issued an unqualified opinion on Scottish Water's financial statements for 2019/20. I have prepared this report to draw the Scottish Parliament's attention to the financial support which is likely to be needed to be provided to Scottish Water Business Stream, a subsidiary of Scottish Water, as a result of disruption caused by the Covid-19 pandemic.

## Background

**3.** Scottish Water was formed in 2002 as a public corporation, answerable to the Scottish Parliament through Scottish ministers. Scottish ministers set high-level objectives for the water industry, approve Scottish Water's business plan and appoint its chair and board members. The Scottish Government's Energy and Climate Change Directorate monitors Scottish Water's performance through receipt of board and other papers, and also attends board and other meetings, including those of the Delivery Assurance Group. The Group is responsible for monitoring delivery of ministers' objectives for the water industry. It comprises officials from the Scottish Government and Scottish Water, together with the Drinking Water Quality Regulator and representatives from the Water Industry Commission for Scotland, the Scottish Environment Protection Agency, Citizens Advice Scotland and the Scottish Public Services Ombudsman.

**4.** Scottish Water is subject to economic regulation by the independent Water Industry Commission for Scotland (the Commission), intended to encourage the water industry in Scotland to provide a high-quality service and value for money to customers. A key part of this is a six-yearly review of charges, which ultimately sets Scottish Water's price limits based on the lowest overall reasonable cost of achieving ministers' objectives for the water industry. The Commission's final determination in respect of its strategic review of charges for the six years 2015/16 to 2020/21 was published in November 2014. Under the Water Services etc. (Scotland) Act 2005, the Commission is also responsible for facilitating competition in the retail water market. This allows non-household business customers to choose who provides their water services, with the Commission licensing all market participants.

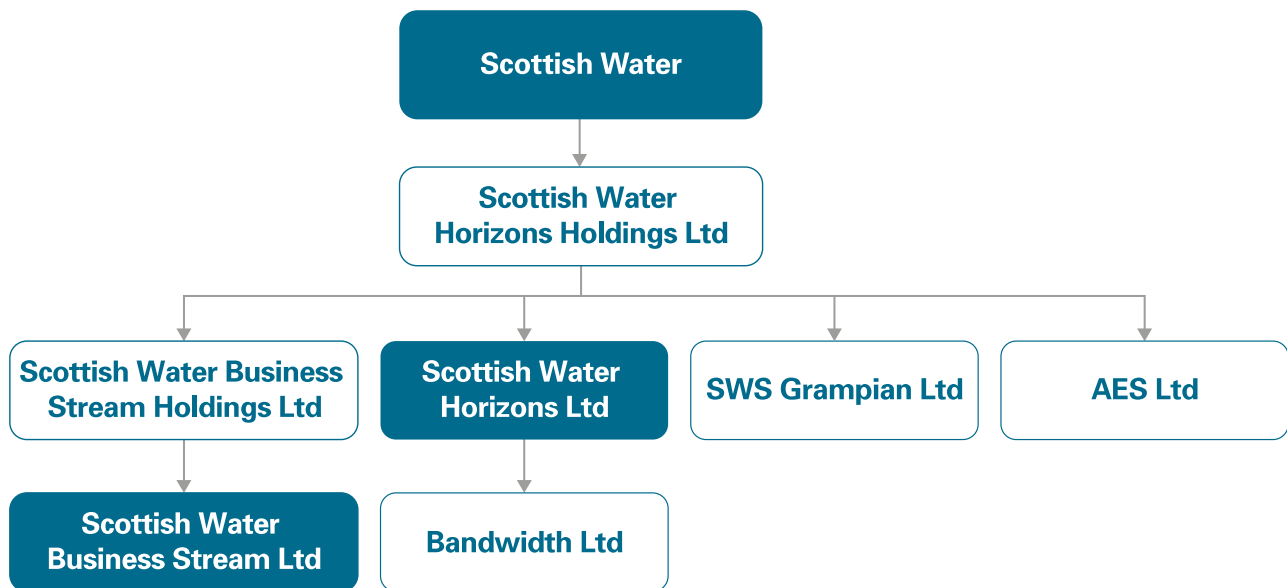
**5.** Scottish Water's principal activities are the supply of water and waste-water services to around 2.6 million households and 153,000 businesses across Scotland. It is the fourth-largest water services provider in the UK and one of the 20 largest businesses in Scotland. During 2019/20, the Scottish Water group's turnover was £1.6 billion, it reported pre-tax profits of £86 million, incurred capital expenditure of £513 million and had total net assets of £5.7 billion.

6. Scottish Water operates a group structure comprising three main trading arms (Exhibit 1):

- **Scottish Water:** supplies households and wholesale licensed providers with regulated water and waste-water services. It is the only supplier of domestic water services in Scotland.
- **Scottish Water Business Stream:** licensed retail subsidiary which supplies water and waste-water services to business customers. Scottish Water Business Stream is now one of 29 companies licensed to provide water services in Scotland. In 2019/20, it expanded further into the English retail market for business customers, through the purchase of the non-household customer book of Yorkshire Water Business Services and Three-Sixty from Kelda Group.<sup>1</sup>
- **Scottish Water Horizons:** provides non-regulated services to customers, such as the treatment and disposal of liquid wastes, including organic sludges, landfill leachates and septic from a range of commercial and industrial processes.

## Exhibit 1 Scottish Water group structure

Scottish Water has three main trading arms.



Note: Bandwidth Energy Ltd was established to develop innovative heat from waste-water projects. Scottish Water Services Grampian Ltd and Aberdeen Environmental Services Ltd are two companies that form the Grampian waste-water treatment services PFI project.

Source: Scottish Water

## Strategic review of charges 2015-21

7. As a public corporation of a trading nature, Scottish Water is expected to operate as a commercial enterprise and cover its costs from charges levied. The Scottish Government wholly owns Scottish Water and any surplus generated is reinvested in the provision of services to its customers and not issued as a dividend. It is

<sup>1</sup> Scottish Water Business Stream also acquired Southern Water’s non-domestic customer book in 2016.

funded largely from charges to customers, and from government loans approved by the Scottish ministers.

**8.** Scottish Water aims to maintain a level of financial strength that ensures its income is sufficient to meet its expenditure, while achieving its objectives at the lowest reasonable cost.<sup>2</sup> Scottish Water aims to ensure its services are affordable while being financially sustainable itself. In setting charges, the Commission does not have regard to the profits or any deficit of Scottish Water Business Stream or Horizons or property sales. These are for the Scottish Water board to manage.

**9.** The Commission's final determination in respect of its strategic review of charges 2015/16 to 2020/21, resulted in Scottish Water preparing a business plan which outlined a forecast finance need of £8.1 billion in order for it to deliver its planned services over the period. Scottish Water assumed that £7.135 billion would be generated from charges levied on customers, with a further £720 million coming from new Scottish Government borrowing. The remaining balance was to be generated from miscellaneous sources, such as infrastructure charges and use of existing cash balances.

**10.** The Commission published its draft determination for the strategic review of charges 2021-27 in October 2020 ([paragraph 22](#)). The draft determination allows Scottish Water to deliver £4.5 billion in investment, an increase of more than £1 billion (30 per cent) from the investment allowed in the current 2015-21 regulatory period. It proposes that the increase in the maximum amount of charges that Scottish Water can levy on its customers each year is set at 2 per cent above inflation on average over the period. The final determination is expected to be published in December 2020.

## The impact of Covid-19 on Scottish Water Business Stream

**11.** The financial impact of the Covid-19 pandemic on the domestic market of Scottish Water has to date been limited, with collection rates for household charges affected to only a limited degree. However, the impact on the non-domestic market in both Scotland and England, within which Scottish Water Business Streams operates, has been more significant. The breadth of its customer base, including a strong public sector customer base, has mitigated the impact to some extent. But certain elements of the customer base, in particular retail, hospitality and the Small and Medium Enterprise sectors, have experienced reduced water consumption and delays to customer payments.

**12.** In 2018/19, Scottish Water Business Stream reported income of £372.0 million and operating costs of £371.7 million, resulting in an operating profit of £0.3 million. In comparison, the corresponding figures for 2019/20 were income of £477.5 million and operating costs of £491.5 million, leading to an operating deficit of £14.0 million. The increase in income and costs in 2019/20 is largely a consequence of Scottish Water Business Stream's expansion into the English retail market ([paragraph 6](#)). While Scottish Water Business Stream expected to report a profit in 2019/20, its costs also include a provision of £13.2 million for doubtful debts arising from Covid-19. Scottish Water considers that the full effect of Covid-19 on its finances will not materialise until 2020/21 and beyond.

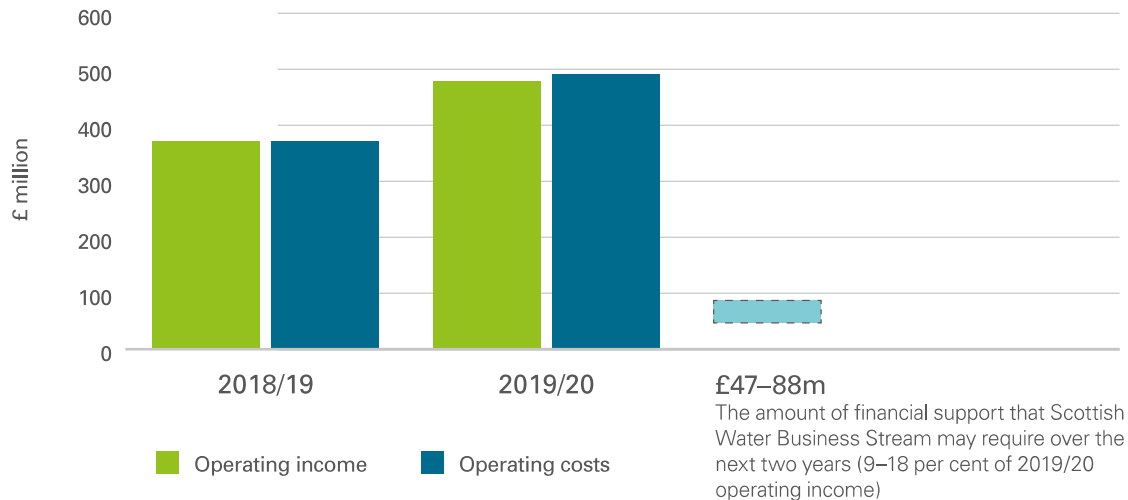
**13.** As part of the response to Covid-19, the Commission has approved a temporary relaxation in the requirement for licensed providers to prepay two months of wholesale charges. Scottish Water calculates this has resulted in a short-term cash impact of approximately £60 million on its regulated business, which it expects will reverse fully by mid-2021. Scottish Water Business Stream is also supporting smaller businesses by not demanding payments of amounts due on normal terms. While there is no commitment to waive charges, Scottish Water Business Stream is exposed to a greater risk of bad debt should elements of the customer base fail to recover from the economic impact of Covid-19. As a result, it has conducted modelling of the possible financial impact of Covid-19 on it, using

<sup>2</sup> In line with the requirements of the Water Industry (Scotland) Act 2002.

low, mid and worse case scenarios. These indicate that Scottish Water Business Stream could require additional support of between £47 million and £88 million over the next 24 months ([Exhibit 2](#)).

## Exhibit 2 Scottish Water Business Stream finances

Scottish Water Business Stream may require additional financial support of between £47 and £88 million over the next two years.



Source: Audit Scotland

**14.** Officers and board members in the Scottish Water group of companies have been fully engaged in establishing the funding facilities required by Scottish Water Business Stream and in discharging their obligations. This has included:

- An assessment of the governance and legal framework between Scottish Water and Scottish Water Business Stream to ascertain the requirements to be met to allow financial support to be provided.
- Discussions between, and approvals obtained from, the Commission and the Scottish Government.
- Consideration of the requirements of State Aid legislation to ensure the funding facility would meet those requirements, with appropriate input from independent advisors.
- An assessment of the robustness of the forecasts and the timescale within which any financial support given will be capable of being repaid.

**15.** The Scottish Water board has now agreed the steps required to provide Scottish Water Business Stream with the financial support required via Scottish Water Business Stream Holdings Ltd. This includes a contingency allowance of £30 million on the estimates of financial support that Scottish Water Business Stream may require; an additional equity injection of £10 million; and a loan facility sufficient to meet the level of financial support forecast. The board has also approved processes to monitor the level of funding drawn-down and Scottish Water Business Stream's ability to repay the funding over the five-year period currently planned. The external auditors commented in their annual audit report on Scottish Water's 2019/20 financial statements that they are satisfied that the process of considering Scottish Water Business Stream's financing requirements and

agreeing next steps has been sufficiently robust and carried out in a diligent and professional manner.

**16.** It should be emphasised that there is no certainty at the moment that financial support to Scottish Water Business Stream will be required. The loan facility will only be drawn down if it is required. What loan support is provided will come from Scottish Water's group cash holdings. Funding will initially be drawn from the intermediate holding companies, Scottish Water Business Stream Holdings and Scottish Water Horizons Holdings, prior to any drawdown from Scottish Water.

**17.** Scottish Water's 2019/20 financial statements indicate that it had a cash balance of £391 million as at 31 March 2020.<sup>3</sup> The Commission's 2014 final determination forecast that Scottish Water would have £70 million cash at this stage of the regulatory period. In accepting the 2014 determination, Scottish Water set out a plan to out-perform the Commission's forecasts to boost its cash balances to align them with its risk appetite to always have cash available of around £100 million to protect against unexpected cost and other shocks.

**18.** Around £216 million of the cash balance in excess of the estimated levels contained in the 2014 final determination was generated in prior years, meaning Scottish Water generated additional cash of £105.2 million in 2019/20. After taking account of timing differences due to the phasing of work under the long-term capital investment programme, this provided Scottish Water with a further £82.9 million as at 31 March 2020. This extra cash was mainly attributable to a project to maximise wholesale revenue collection and lower interest costs than those assumed in the 2014 final determination.

**19.** Covid-19 had limited impact on delivery of the infrastructure investment programme up to 31 March 2020, but Scottish Water recognises the pandemic may impact on its future ability to complete all capital works planned during the current regulatory period. Scottish Water plans that it will use its cash balance, excluding those timing differences, to support the infrastructure investment programme and to address other challenges arising from the consequences of Covid-19, including Scottish Water Business Stream's funding requirements. It is confident that, while Covid-19 may impact on the final cost of the infrastructure investment programme as a result of social distancing and other measures, delivery of the programme will not be affected by the need to support Scottish Water Business Stream.

## Conclusions

**20.** Scottish Water Business Stream has generated cumulative profits of £153 million since it was set up in 2008. This has allowed it to return £65 million to Scottish Water Business Stream Holdings by way of dividends and repay £79 million of debt which was made available in order to establish its business. This is the first time it has required financial support of this kind and Scottish Water is able to do so without additional Scottish Government funding.

**21.** The overall financial and economic impact of the Covid-19 pandemic is currently unknown but is likely to be with us for a number of years. It will be vitally important for Scottish Water to continue to monitor the financial performance of its subsidiaries and debtors, including the payment of customer charges, and to adjust its business plans as appropriate.

**22.** The Commission's draft determination in respect of its strategic review of charges 2021-27 sets out what will be expected of Scottish Water over the coming years to deliver the objectives set for it by ministers. Delivering the efficiencies and performance demanded by the Commission will be challenging for Scottish Water in normal times, but even more so in the current circumstances. I shall continue to monitor Scottish Water's financial performance going forward.

<sup>3</sup> The Scottish Water Business Streams and Horizons groups of companies also had combined cash holdings of £140 million as at 31 March 2020.




# The 2019/20 audit of Scottish Water

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