

Independent Auditors' report to the Water Industry Commission for Scotland and the Board Members of Scottish Water

We have audited the Regulatory Accounts of Scottish Water for the year ended 31 March 2007, which comprise:

- the historic cost financial statements, comprising the historical cost income and expenditure account, statement of total recognised gains and losses, historical cost balance sheet, and related notes to the historical cost financial statements in tables 3 and 14, and
- the current cost financial information, comprising the current cost income and expenditure account, current cost balance sheet, current cost cash flow statement and related notes to the current cost financial information in tables 7, 8, 11, 12, 13, 16, 17, 18w and 18ww; and
- the Statement of Accounting Policies.

The Regulatory Accounts do not include tables 15, 18Wb, 18WWb and 20 – 28. This report is made, on terms that have been agreed, solely to Scottish Water and the Water Industry Commission for Scotland ("the WICS") in order to meet the requirements of regulatory accounting rules issued by the WICS under the Water Industry (Scotland) Act 2002. Our audit work has been undertaken so that we might state to Scottish Water and the WICS those matters that we have agreed to state to them in our report, in order (a) to assist the Scottish Water to meet its obligations under the regulatory accounting rules issued by the WICS and (b) to facilitate the carrying out by the WICS of its regulatory functions and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than Scottish Water and the WICS, for our audit work, for our report, or for the opinions we have formed.

Basis of preparation

The Regulatory Accounts have been prepared in accordance with the Regulatory Accounting Rules 1 to 4 issued by the WICS, the accounting policies set out in the Statement of Accounting Policies and, in the case of the regulatory historical cost financial statements, under the historical cost convention.

The regulatory financial statements are separate from the statutory financial statements of Scottish Water and have not been prepared under the basis of Generally Accepted Accounting Principles in the United Kingdom ("UK GAAP") as the Regulatory Accounting Rules specify alternative disclosures in certain respects. Where the Regulatory Accounting Rules do not specifically address an accounting issue, then they require UK GAAP to be followed. Financial information other than that prepared wholly on the basis of UK GAAP does not necessarily represent a true and fair view of the financial performance or financial position of an entity as shown in financial statements prepared in accordance with the Water Industry (Scotland) Act 2002.

Respective responsibilities of the WICS, the Board Members, Accountable Officer and Auditors

The WICS determines the nature, form and content of the Regulatory Accounts. It is not appropriate for us to assess whether the nature of the information being reported upon is suitable or appropriate for the WICS's purposes. Accordingly, we make no such assessment.

The Board and Accountable Officer responsibilities for preparing the Regulatory Accounts in accordance with the Regulatory Accounting Rules 1 to 4 are set out in the Statement of Board Members' Responsibilities for Regulatory Information.

Our responsibility is to audit the regulatory financial statements in accordance with International Standards on Auditing issued by the Auditing Practices Board, except as stated in the 'Basis of audit opinion' below and having regard to the guidance contained in Audit 05/03 'Reporting to Regulators of Regulated Entities'.

We report to you our opinion as to whether the regulatory historical cost financial statements present fairly, under the historical cost convention, the revenues and costs, assets and liabilities of Scottish Water in accordance with Regulatory Accounting Rule 2 (Classification of expenditure), Regulatory Accounting Rule 3 (Contents of regulatory accounts) and Regulatory Accounting Rule 4 (The analysis of operating costs and assets); and whether the regulatory current cost financial information has been properly prepared in accordance with Regulatory Accounting Rule 1 (Accounting for current costs and regulatory capital values), Regulatory Accounting Rule 3 and Regulatory Accounting Rule 4. We also report to you if, in our opinion, Scottish Water has not kept proper accounting records as required by the Water Industry (Scotland) Act 2002; whether the information is in agreement with Scottish Water's accounting records and has been properly prepared in accordance with the requirements of, as appropriate, Regulatory Accounting Rule 1, Regulatory Accounting Rule 2, Regulatory Accounting Rule 3 and Regulatory Accounting Rule 4; or if we have not received all the information and explanations we require for our audit.

We read the other information contained in the Regulatory Accounts, including any supplementary schedules on which we do not express an audit opinion, and consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the Regulatory Accounts. The other information comprises the M Tables - Regulatory Accounts Commentary; itself comprising General Comments, Results & Reconciliations, Assumptions, Detailed Commentary - M Tables 18w and 18ww and Sundry Points and the Report on the Regulatory Tables for the year ended 31 March 2007.

Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board, except as noted below. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the Regulatory Accounts. It also includes an assessment of the significant estimates and judgements made by the members in the preparation of the Regulatory Accounts, and of whether the accounting policies are appropriate to the Organisation's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the Regulatory Accounts are free from material misstatement, whether caused by fraud or other irregularity or error. However, as the nature, form and content of Regulatory Accounts are determined by the WICS, we did not evaluate the overall adequacy of the presentation of the information, which would have been required if we were to express an audit opinion under International Standards on Auditing (UK and Ireland).

Our opinion on the Regulatory Accounts is separate from our opinion on the statutory financial statements of Scottish Water on which we report, which are prepared for a different purpose. Our audit report in relation to the statutory accounts of Scottish Water (our "Statutory" audit) was made solely to the members of the Board of Scottish Water as a body, the Scottish Parliament and the Auditor General for Scotland in accordance with the Public Finance and Accountability (Scotland) Act 2000. Our Statutory audit work was undertaken so that we might state to the members of the Board of Scottish Water, the Scottish Parliament and the Auditor General for Scotland those matters that we are required to state to them in a Statutory auditor's report and for no other purpose. In these circumstances, to the fullest extent permitted by law, we do not accept or assume any responsibility to anyone other than Scottish Water, the members of the Board of Scottish Water as a body, the Scottish Parliament and the Auditor General for Scotland, for our Statutory audit work, for our Statutory audit report, or for the opinions we have formed in respect of that Statutory audit.

The regulatory historical cost financial statements comprising the historical cost income and expenditure account, statement of total recognised gains and losses, historical cost balance sheet, and related notes to the historical cost financial statements in tables 3 and 14, have been drawn up in accordance with Regulatory Accounting Rule 3 in that infrastructure renewals accounting should

be applied and accordingly that the relevant sections of Financial Reporting Standards 12 and 15 be disapplied.

Opinion

In our opinion, the Regulatory Accounts of Scottish Water for the year ended 31 March 2007 fairly present in accordance with the Regulatory Accounting Rules issued by the WICS, and the accounting policies set out in the Statement of Accounting Policies, the state of Scottish Water's affairs at 31 March 2007 on an historical cost and current cost basis, the historical cost and current cost surplus for the year then ended and current cost cash flow for the year and have been properly prepared in accordance with those conditions, rules and accounting policies.

In respect of this information, we report that in our opinion:

- a) proper accounting records have been kept by Scottish Water as required by the Water Industry (Scotland) Act 2002;
- b) the information is in agreement with Scottish Water's accounting records and has been properly prepared in accordance with, as appropriate, Regulatory Accounting Rules 1 to 4 issued by the WICS;
- c) the regulatory historical cost financial statements comprising the historical cost income and expenditure account, statement of total recognised gains and losses, historical cost balance sheet, and related notes to the historical cost financial statements in tables 3 and 14, present fairly, under the historical cost convention, the revenues and costs, assets and liabilities of Scottish Water and its Core Retail and Core Wholesale Businesses in accordance with Regulatory Accounting Rule 2, Regulatory Accounting Rule 3 and Regulatory Accounting Rule 4 issued in April 2007 by the WICS; and
- d) the regulatory current cost financial information, comprising the current cost income and expenditure account, current cost balance sheet, current cost cash flow statement and related notes to the current cost financial information in tables 7, 8, 11, 12, 13, 16, 17, 18w and 18ww has been properly prepared in accordance with Regulatory Accounting Rule 1, Regulatory Accounting Rule 3 and Regulatory Accounting Rule 4, issued in April 2007 by the WICS.

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP
Chartered Accountants

25 October 2007

Notes:

1. The maintenance and integrity of the Scottish Water web site is the responsibility of the Board Members and the maintenance and integrity of the Water Industry Commission for Scotland's web site is the responsibility of the Water Industry Commission for Scotland; the work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the Regulatory Accounts since they were initially presented on the web sites.
2. Legislation in the United Kingdom governing the preparation and dissemination of financial statements and Regulatory Accounts may differ from legislation in other jurisdictions.