Financial and Business Review

Financial Framework

Scottish Water is subject to incentive-based regulation by the Water Industry Commission for Scotland (the Commission).

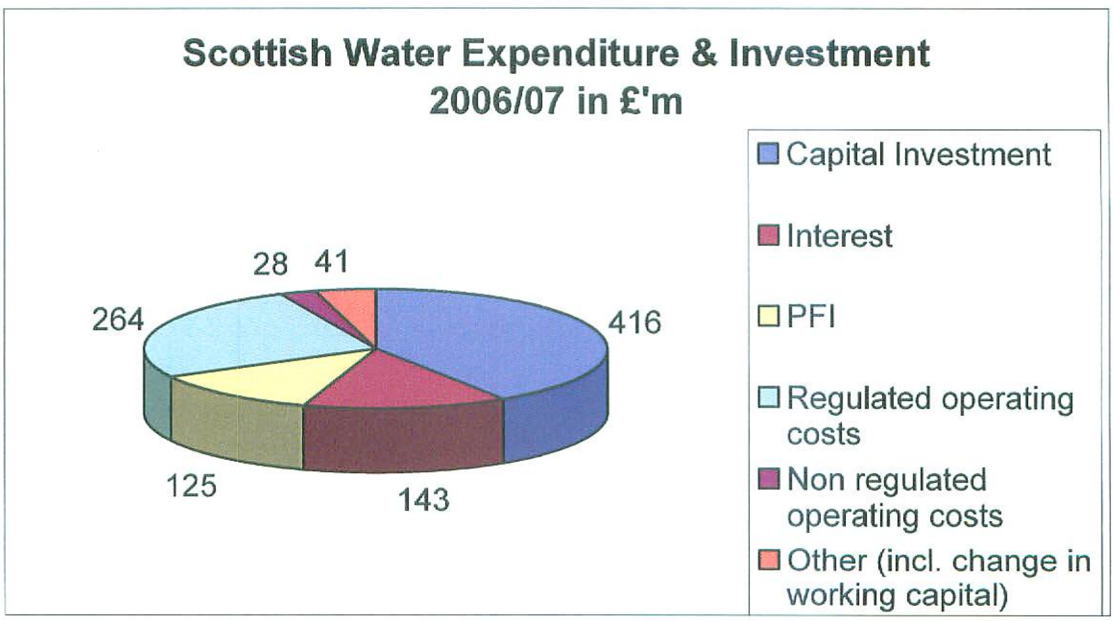
The Commission carries out four year price reviews and caps the prices that Scottish Water charge for water and wastewater services. The combination of regulated price caps and firm constraints on borrowing from the Scottish Executive creates a clearly defined limit on the financing available to Scottish Water.

Within this financial framework Scottish Water has an agreed Delivery Plan with Scottish Ministers that sets out Scottish Water's planned level of investment to deliver the required improvements and the expenditure to run its operation. Scottish Water's aim is to out-perform the targets set out in the Delivery Plan, and thereby out-perform the regulatory contract. The current Regulatory Periods runs from 1 April 2006 until 31 March 2010.

During the year Scottish Water set up a 100% owned subsidiary company, Scottish Water Business Stream Limited, in preparation for the opening of the non-household market to competition which is planned to occur on 1 April, 2008. The subsidiary commenced trading on 1 November, 2006 and all non-household customers were transferred to Scottish Water Business Stream Limited on that date.

Financial Performance

The chart below highlights how the revenue raised during the year was used to finance Scottish Water's operational activities and capital investment programme. The surplus before tax of £228.9 million was fully reinvested in the business to enable the delivery of the capital investment programme.



Turnover

Total turnover for the year decreased by £2.0m to £1,017.0 million. Turnover from regulated water and wastewater services supplied to household customers increased by 2.2% to £642.2 million driven mainly by the tariff increase effective from 1 April 2006. Turnover from services supplied to business customers increased by £2.5 million to £333.7 million.

Turnover from the provision of non-regulated services reduced by £15.9 million or 34.5% to £30.1 million due to the reduction in the sale of contracting services to Scottish Water Solutions Ltd relating principally to mains rehabilitation work. In 2006/07 this work was undertaken internally for Scottish Water's own in-house capital delivery arm and not for Scottish Water Solutions Limited, hence the reduction in turnover.

An analysis of turnover by category is summarised below and reflects the licensed water and waste water services provided to commercial customers that commenced under Scottish Water Business Stream Limited from 1 November 2006:

	2006/07	2005/06	Change
	£m	£m	£m
Household	642.2	628.3	13.9
Commercial	333.7	331.2	2.5
Other	11.0	13.5	-2.5
Total Regulated Turnover	**986.9**	**973.0**	**13.9**
Non regulated trading activities	30.1	46.0	-15.9
Total Turnover	**1,017.0**	**1,019.0**	**-2.0**

Operating costs

Total reported costs of £647.6 million were £26.6 million lower than in 2005/06, a reduction of £32.0million in cost of sales offset by a £5.4million increase in administration costs. This reduction was due mainly to lower non regulated operating costs of £16.2 million reflecting primarily the reduction in turnover highlighted above, lower bad debt costs of £9.7million due to improved cash collection performance and lower depreciation charges of £25.1million. However, these reductions were partially offset by costs associated with new activities: £5.5million for the leakage reduction programme, £1.5million for start-up costs of the Central Market Authority and £1.4million for business separation costs, reduced gains on asset sales of £2.5million, a higher FRS17 pension charge of £2.8 million and increased power costs of £5.8million.

The cost of the PFI schemes in the year was £125.6 million, £5.5 million higher than in 2005/06 due primarily to the impact of additional works required at Stonehaven.

Depreciation, including infrastructure depreciation, reduced by £25.1 million to £225.4 million primarily because of a reduction in the assessed long term annual cost of maintaining the infrastructure assets which reduced by £22.0million to £88.0 million.

Finance costs

During the year, net debt reduced by £12.1 million to £2,424.1 million. The reduction was driven by a £12.1 million increase in cash balances.

At 31 March 2007, the weighted average interest cost of the £2,436.9 million outstanding debt was 5.92% (2006 - 6.00%). Net interest payable during the year was £143.3 million, £0.5 million higher than in 2005/06.

Taxation

The tax charge on the income and expenditure account was £70.6 million, (2006 - £61.3 million). The effective rate was 30.8%, (2006 - 31.3%) in respect of deferred taxation. This is higher than the UK Corporation tax rate of 30% due to adjustments associated with timing differences and disallowed costs.

Performance compared to the Delivery Plan

Scottish Water accepted the Final Determination of charges for 2006-2010 set by the Water Industry Commission for Scotland in November 2005. Following this Scottish Water agreed a Delivery Plan with Scottish Ministers in May 2006 that reflects the commitments required under the Final Determination.

During 2006/07, Scottish Water out-performed the income and expenditure target set out in the Delivery Plan by £23.9 million, as set out below:

Regulatory income and expenditure out-performance	**2006/07 Performance £m**	**2006/07 Delivery Plan £m**	**Variance £m**
Profit before tax per financial statements	**228.9**		
Less non regulated profit	-1.8		
Add back regulated depreciation /amortisation	226.0		
Add back impact of FRS 17	2.8		
Like-for-like profit before tax excluding depreciation and amortisation	**455.9**	**432.0**	**23.9**
Elements of out-performance:			
Income	986.9	981.2	5.7
Operating costs	-263.5	-280.0	16.5
PFI	-125.6	-123.4	-2.2
Gain on sale	1.4	3.0	-1.6
Interest	-143.3	-148.8	5.5
Profit before tax excluding depreciation/amortisation	**455.9**	**432.0**	**23.9**

Capital expenditure

In the first year of the 2006-10 regulatory period Scottish Water successfully delivered £413.3 million of Quality and Standards (Q&S) investment in 2006/07. The

2006-07 outputs target of 98% for Q&SII has been met and outputs out-performance has been achieved on the Q&SIII year 1 Programme compared to our Delivery Plan.

The planned target for investment in 2007/08 presented in the revised Delivery Plan, approved by Scottish Ministers, is £610-650m.

Pension arrangements

Scottish Water is a participating employer in three Local Government Pension Schemes (LGPS) - Strathclyde Pension Fund, the Aberdeen Pension Fund and the Lothian Pension Fund. These funds are administered by Glasgow City Council, Aberdeen City Council and Edinburgh City Council respectively.

The administering authority for each scheme is required to conduct a triennial valuation of the assets and liabilities of the scheme in line with LGPS regulations. This must be conducted by a qualified actuary. The purpose of the valuation is to review the financial position of the fund and specify the employer contribution rates for the next 3 year period. The last valuation was carried out as at 31 March 2005.

The actuarial funding position at 31 March 2005 of Scottish Water's share of each pension fund is shown in the table below.

Scheme	Value of assets £m	Total Accrued Liabilities £m	Deficit £m	Funding Level (%)
Strathclyde	264.6	273.3	8.7	97%
Aberdeen	139.2	165.1	25.9	84%
Lothian	156.2	187.9	31.7	83%

In recognition of the net deficiency in the pension funds, the agreed actuarial employer contribution rates for Scottish Water, expressed as a % of pay, for 2006/07 to 2008/09 are detailed in the table below.

Scheme	2006/07 Contribution Rate %	2007/08 Contribution Rate %	2008/09 Contribution Rate %
Strathclyde	15.9%	17.7%	19.5%
Aberdeen	16.5%	17.1%	18.0%
Lothian	20.1%	21.3%	22.2%

Under FRS 17, *Retirement Benefits,* a snapshot is taken of pension fund assets and liabilities at a specific point in time. Movements in equity markets and discount rates create volatility in the calculation of scheme assets and liabilities. At 31 March 2007, after taking account of deferred taxation, there was a shortfall of assets over respective liabilities of £104.9 million. This was a reduction in the FRS 17 pension liability of £60.1 million from 2005/06 and was due mainly to the actuarial gain of £75.8 million, reflecting the higher discount rate of 5.4% (2006 – 4.9%) applied to scheme liabilities. The higher discount rate reflects the higher bond yields now being experienced in the market place.

International Accounting Standards

All European Union listed companies were required to adopt International Accounting Standards (IAS) for their financial statements from 2005. Scottish Water has now been informed by Scottish Ministers to adopt IAS for the accounting period ending 31 March 2009. The main areas of impact will be: the abolition of renewals accounting currently permitted under Financial Reporting Standard 15 *Tangible Fixed Assets,* which will impact on depreciation charges for infrastructure assets; and a possible impact on the accounting for PFI contracts and taxation.

Compliance with Government Financial Targets

Sufficiency of revenue

Scottish Water is required to cover costs with revenue one year with another. Scottish Water reported a surplus before tax of £228.9 million for the year.

Borrowing Limit

Scottish Ministers set Scottish Water's maximum net new borrowing limit at £20.0 million for 2006/07. Actual net new borrowings in 2006/07 were nil.