

MEMBERS' REPORT

The Members present their annual report together with the audited financial statements for the year ended 31 March 2007.

Accounting requirements

The financial statements have been prepared in a form directed by Scottish Ministers in accordance with section 45(2) of the Water Industry (Scotland) Act 2002.

Principal activities

Scottish Water's principal activities during the year were the supply of water and waste water services to around 5 million customers in homes and businesses across Scotland covering an area of 30,410 square miles.

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.

Scottish Water also performed a number of related but non-regulated operating activities, which fall outside the range of services that it is legally obliged to provide.

A review of the business and future developments for Scottish Water are presented in the Chair's Statement on page [] and in the Business and Financial Review on pages [] to [].

Members

The Chair and other Non Executive Members are appointed by Scottish Ministers. Executive Members are appointed by Scottish Water after receiving consent to the appointment from Scottish Ministers. The Members as at the date of the Annual Report and their biographies are set out on pages [] to [].

Members and their interests

All Members have declared that they had no material interests in any contracts awarded during the year by Scottish Water. A register of Members' interests is maintained at Scottish Water's head office and is open for inspection during normal office hours.

Results

The surplus for the year after taxation amounted to £158.3 million. Details of the financial results and associated accounting policies are set out on pages [] to [].

Research and development

To ensure that Scottish Water derives benefit from the most up-to-date research being undertaken within the industry, research expenditure is targeted towards collaborative research with other water operators and regulators within the UK. This ensures that access is gained to high value, widely based research programmes in the Environmental, Quality, Engineering, Operational and Regulatory fields. Research into issues common to the UK water industry is procured through membership of the UK Water Industry Research Centre and the Foundation of Water Research.

Political and charitable contributions

No political or charitable contributions were made during the year. Scottish Water supports WaterAid, a charity founded by the UK water industry which raises funds for water related projects overseas. Employees represent Scottish Water on regional fundraising committees, which are periodically provided with facilities and other support.

Employee relations and involvement

Scottish Water employed an average of 3,587 staff during the year. Details of the costs incurred in relation to these staff can be found in note 5 to the financial statements on page []. Scottish Water is committed to a policy of equal opportunities for all employees irrespective of race, religion, sex, disability or age and uses a number of forums to encourage employee involvement. Employees are kept involved through a process of regular team meetings, employee newsletters and representation on the Scottish Water and Business Unit Councils. These forums facilitate a partnership approach to the development of Scottish Water and the associated employee relations issues.

Scottish Water is committed to continually improving its performance in relation to Health and Safety. Through an extensive safety awareness campaign, safety briefings and ongoing training, awareness of health and safety issues is being encouraged and increased among employees.

Payment of suppliers

Scottish Water agrees terms and conditions with suppliers before business takes place. Provided that all trading terms and conditions have been complied with, it is Scottish Water's policy and practice to pay agreed invoices in accordance with the terms of payment. At 31 March 2007, the amount owed to trade creditors was equivalent to 36 days of purchases from suppliers.

Auditors

PricewaterhouseCoopers LLP chartered accountants and registered auditor were appointed as auditors by the Auditor General for Scotland in accordance with the Public Finance and Accountability (Scotland) Act 2000.

CORPORATE GOVERNANCE

Scottish Water is committed to the principles of good governance and the code of best practice with regard to corporate governance. The members of Scottish Water's Board are accountable to the Scottish Executive through the Scottish Water (Corporate Governance) etc. Directions 2002. This statement describes how the members comply with the requirements of the above Direction and the provisions set out in the revised Combined Code (section 1) of the listing rules of the Financial Services Authority introduced in July 2003.

Compliance

The Members confirm that throughout the year and up to the date of approval of the Annual Report and Accounts Scottish Water complied with:-

- (a) The relevant sections of the Combined Code of Corporate Governance as set out in the listing rules of the Financial Services Authority; and
- (b) The Scottish Water (Corporate Governance) etc. Directions 2002 and other Directions, requirements and guidance issued by the Scottish Ministers (other than the Cryptosporidium (Scottish Water) Directions 2003) in so far as such matters relate to the functions of Scottish Water.

The Members confirm that throughout the year and up to the date of approval of the Annual Report and Accounts, Scottish Water complied substantially with the requirements of the Cryptosporidium (Scottish Water) Directions 2003. Scottish Water has delivered on the vast majority of the commitments given to the Drinking Water Quality Regulator for Scotland to ensure compliance with those elements of the Directions required by June 2006. A few key elements are taking longer to implement but a programme of investment for the period 2006-10 to address longer term elements of the Directions has been agreed with the Drinking Water Quality Regulator for Scotland.

The Members of the Board

The Board of Scottish Water comprises 11 members, 7 non-executive board members and 4 executive Board members (see members' biographies on page xx). The Board has a formal schedule of matters specifically reserved to it for decision making. Reporting to the Board are the Chief Executive and the Executive Members who have responsibility for the management of Scottish Water, and the Board Committees detailed below.

In accordance with the best practice recommended by the Cadbury Committee, there is a clear division of responsibilities between the Chair and the Chief Executive. Scottish Water also benefits from the expertise of its non-executive members whose range of experience brings independent judgement on issues of strategy and performance, which are vital to the success of Scottish Water.

During the year, the Board met on 10 occasions to review Scottish Water's operational and financial performance, business strategy and risk management.

Board Committees

Attendance at the Board and the three principal Board committees is shown in the table below.

Name	Board		Audit		Commercial		Remuneration	
	Held	Attended	Held	Attended	Held	Attended	Held	Attended
Ronnie Mercer	10	10	-	-	-	-	-	-
David Gray	10	8	4	4	1	1	-	-
Graeme Crombie	10	10	4	4	-	-	4	4
Professor Paul Jowitt	10	5 *	4	4	-	-	4	1
Ian McMillan	10	10	4	3	1	1	-	-
Rita Theil	10	7*	-	-	-	-	4	3
Pat Kelly	10	10	4	4	1	1	4	4
Jon Hargreaves	10	10	-	-	-	-	-	-
Douglas Millican	10	9	-	-	-	-	-	-
Chris Banks	10	9	-	-	-	-	-	-
Geoff Aitkenhead	10	10	-	-	-	-	-	-
Cheryl Black (until Nov 06)	6	6	-	-	-	-	-	-

* Note: one attended by telephone conference.

Remuneration Committee

The Remuneration Committee, which is chaired by a non-executive member, Mr Graeme Crombie, comprises three other non-executive members: Professor Paul Jowitt, Mr Pat Kelly and Mrs Rita Theil.

The Committee, in accordance with requirements of the Corporate Governance Direction, monitors the contract terms, remuneration and other benefits for each of the executive members including performance related bonus schemes. The committee met on 4 occasions during the year.

The committee has access to external independent advice as it sees fit.

Audit Committee

The Audit Committee, which is chaired by a non-executive member with a financial background, Mr David Gray, comprises four other non-executive Members: Mr Graeme Crombie, Professor Paul Jowitt, Mr Pat Kelly and Mr Ian McMillan. The Committee met on 4 occasions during the year.

The Committee reviews the financial reports of Scottish Water and considers the results of the Auditors examination and review of the financial statements. It meets with management and with internal and external auditors to review the effectiveness of internal controls and business risk management. The Chair of the Audit Committee reports to the Board on internal control and risk management matters following each Audit Committee meeting.

Commercial Committee

The Commercial Committee was chaired by a non-executive member, Mr Ian McMillan, and comprised 2 other non-executive members: Mr David Gray and Mrs Rita Theil.

The Committee met on 1 occasion during the year to review commercial and property proposals and monitor performance thereon and reported to the Board on specific proposals. The Committee was disbanded on 28 June 2006 and its work is now addressed by the Board or Business Management Team as appropriate.

Business Management Team

The Chief Executive is responsible for the management and operation of Scottish Water within the strategy determined by the Board and is supported by a Business Management Team which he Chairs. Its other members are:

Geoff Aitkenhead	Asset Management Director
Christopher Banks	Commercial Director
Cheryl Black	Customer Service Director (until 26 November 2006)
Douglas Millican	Finance and Regulation Director
Mark Adderley	Human Resources and Business Services Director (until 8 February 2007)

Internal Control

Scottish Water operates within a broad strategic framework set by Scottish Ministers. The targets and milestones that Scottish Water has agreed to meet are set out in its Delivery Plan for the 2006-2010 period. The Delivery Plan also sets out the resources required and proposals for meeting and out-performing the regulatory targets.

The members of the Board recognise their responsibility for establishing, maintaining and reviewing the systems of internal control and risk management from a financial and operational perspective. These systems are designed to manage, rather than eliminate, the risk of failure to achieve business and operational objectives and to provide reasonable, but not absolute, assurance against material misstatement or loss.

The systems of internal control are compliant with the relevant sections of the Combined Code and the Scottish Water (Corporate Governance) etc. Directions 2002. They are based on an ongoing process designed to identify those risks material to the achievement of Scottish Water's policies, aims and objectives, to evaluate those risks and to manage them effectively in accordance with good risk management practices. The risk management process has been in place for the full year under review and up to the date of approval of the Annual Report and financial statements.

Scottish Water recognises the importance of fulfilling its social responsibilities. To this aim the Board has a Sustainable Development Policy that includes social, economic and environmental aspects and has set up a Sustainable Development Advisory Group who report directly to the Board. This is led by a member of the Board (Professor Paul Jowitt) and includes the Asset Management Director and is attended by a range of external advisers. The group provides a forum for discussion on sustainable development issues relating to the water industry and, as well as advising the Board, challenges the implementation of the sustainable development policy and strategy.

The Board is committed to providing an active but appropriate level of support to community projects. This is detailed further in the Corporate Social Responsibility section on pages [] to [].

Risk Management

Scottish Water has established a Risk Policy that defines risk appetite and sets out a consistent approach to the management of risk. The business identifies key risks at corporate and functional levels. Risks are evaluated by considering their consequences, in terms of impact and likelihood, on the achievement of service delivery and business objectives. Existing arrangements for managing the risks are

considered and, where these are not perceived to be effective, action plans are drawn up which aim to achieve the right balance between risk and control.

Key risks in relation to monitoring water quality and planning for and managing water quality incidents are being managed in a reasonable and prudent manner, having regard to the current regulatory framework and available resources.

Risk Management is integral to the Business and Financial Planning process in Scottish Water and this continues to develop in line with business needs. Escalation procedures are in place.

The risk register and risk management processes are reviewed annually by the Board, twice a year by the Audit Committee and quarterly by the Business Management Team. In addition, each quarter, the Board reviews the status of the most significant business risks.

Control Activities

Scottish Water's Internal Control Framework incorporates:

- Policy-making and strategic direction at Board level. There is a formal schedule of matters reserved for decision by board members.
- An organisational structure which clearly defines lines of authority and accountability.
- A statement of general principles pertaining to rules and procedures for the regulation of the business.
- Financial authority limits governing delegation of authority by the Board.
- Regular review by the Board and management of service, quality and financial performance compared to plan.
- Development of procedure manuals for staff instruction and guidance.
- Project approval, monitoring and control processes specifically developed for capital expenditure.
- High profile given by the Board and management to Health & Safety issues.

High quality personnel are viewed as an essential part of the control environment. Ethical behaviour is incorporated into staff conditions of service and demanding recruitment criteria, and a policy for the development and training of staff supports ethical standards.

Control Effectiveness Review

Reviewing control effectiveness is a continuous process throughout the year. The Board gains assurance as to the effectiveness of internal control through a collaborative approach, based on the work of internal and external audit, other internal and external review agencies, and executive members' reports. The controls assurance process is co-ordinated by internal audit and incorporates self-assessment by management, independent assessment by audit, and annual statements of assurance from senior management.

Information and Communication

Scottish Water has developed an annual budgeting and financial and performance reporting system that compares results with budget on a monthly basis, providing information for internal and external reporting. Key Performance Targets have been

agreed with Regulators and the Scottish Executive. Performance against these targets is reported monthly to the Board and quarterly to the Regulators and the Scottish Executive.

Scottish Water has an ongoing programme of developing systems to assist customer service and decision making in financial and operational areas of the business. The overall aim is to produce relevant, reliable and timely operational, financial, and compliance related information, consistent with the objectives of the business, to enable management to exercise effective control and direction.

Scottish Water has, following widespread consultation, introduced a Consultation Code setting out how it consults external stakeholders in relation to proposals for, and the undertaking of, significant core business activities.

Board and Committee Performance

A formal review of performance was carried out by the Board and Committees and actions arising from it are being implemented. Formal annual evaluation processes are in place for all members including the Chair. Induction and ongoing training is provided for members with specific emphasis on finance, regulation and risk analysis.

Independence of Auditors

The Auditor General for Scotland is responsible to the Scottish Parliament for securing the audit of the financial statements of Scottish Water. For 2006/07 to 2010/11, the Auditor General appointed PricewaterhouseCoopers LLP as the auditors of Scottish Water.

Under the terms of PricewaterhouseCoopers LLP's appointment, they may not carry out any non-audit work for Scottish Water without the prior approval of Audit Scotland.

Going Concern

Scottish Water operates under an annual external financial limit (EFL) set by the Scottish Executive. 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 changes are approved annually by the Water Industry Commission for Scotland.

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 accounts are therefore prepared on a going concern basis.