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 Government 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 Period runs from 1 April 2006 until 31 March 2010.

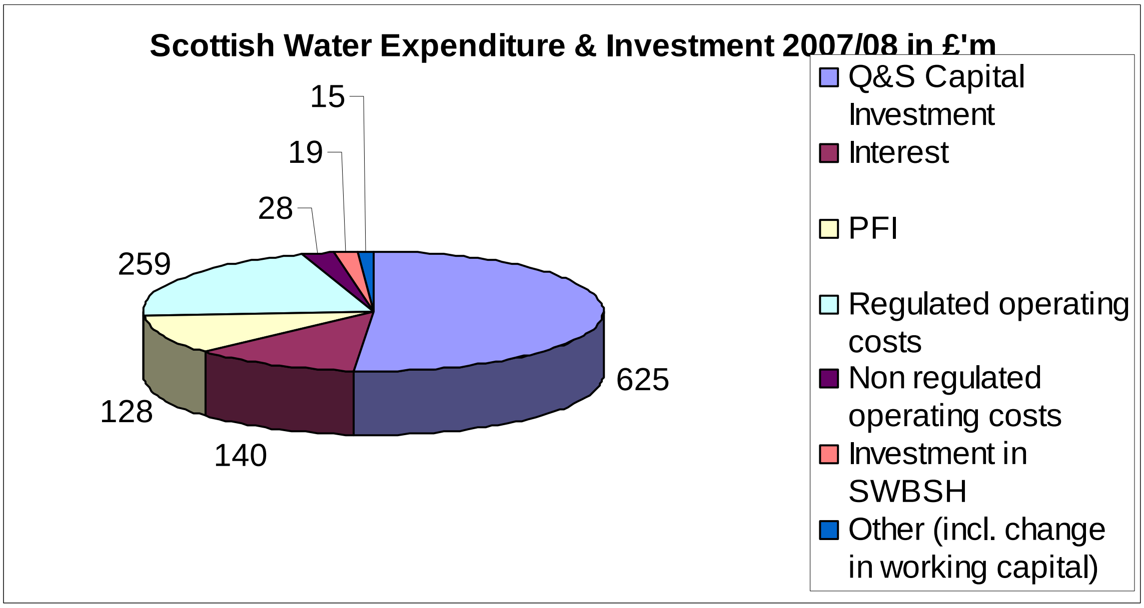
During the year Scottish Water set up a 100% owned subsidiary company, Scottish Water Business Stream Holdings Limited (SWBSH). Scottish Water's investment in Scottish Water Business Stream Limited was transferred to SWBSH to enable sufficient separation between the wholesale and retail businesses in preparation for the opening of the non-household market to competition which occurred on 1 April 2008. SWBSH commenced trading on 1 November 2007.

Financial Performance

In 2007/08 Scottish Water (excluding Business Stream and SWBS Holdings) out-performed the Final Determination by £16.3m bringing total out-performance to 31 March 2008 to £43.7 million. We reported a surplus before tax of £222.2 million for the year, on the historical cost accounting basis.

Scottish Ministers set our maximum net new borrowing limit at £196.4 million for 2007/08. Actual net new borrowings in 2007/08 were £196.3 million.

The chart below highlights how the £1,017.4 million of revenue and the £196.3 million net new government borrowing during the year, for Scottish Water, were used to finance Scottish Water's operational activities and capital investment programme.



Turnover

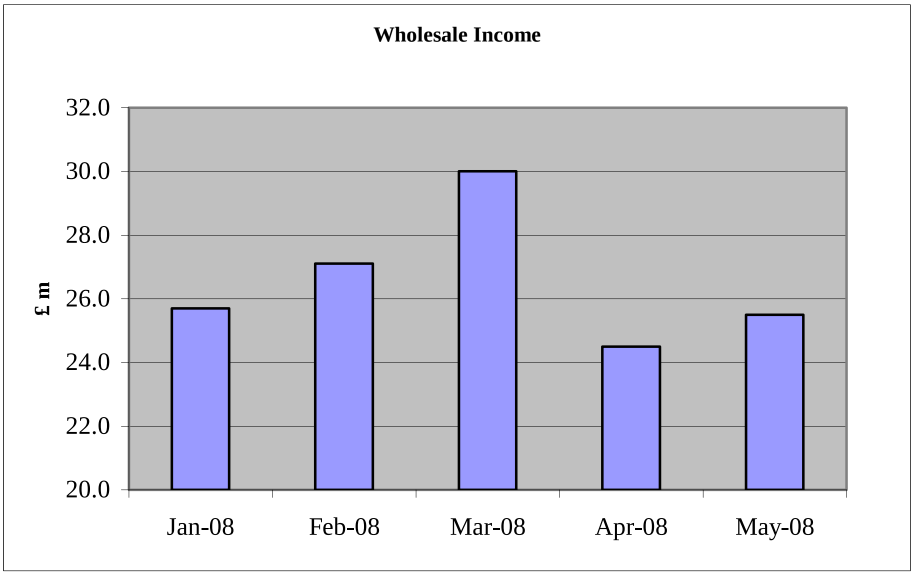
Turnover for the year increased by £14.5 million, or 1.4%, to £1,017.4 million. An analysis of turnover by category is summarised below:

	2007/08	2006/07	Change
	£m	**£m**	**£m**
Household	673.7	642.2	31.5
Wholesale	305.5	126.8	178.7
Commercial to 31 October 2006	-	193.6	-193.6
Other	7.5	10.2	-2.7
Total regulated turnover	**986.7**	**972.8**	**13.9**
Non regulated trading activities	30.7	30.1	0.6
Total turnover	**1,017.4**	**1,002.9**	**14.5**

Turnover from regulated water and wastewater services supplied to household customers increased by 4.9% to £673.7 million driven mainly by the tariff increase effective from 1 April 2007.

Wholesale turnover increased by £178.7 million to £305.5 million reflecting 12 months trading compared to only 5 months trading for 2006/07. 2007/08 was the first full year of business separation, SWBS having commenced trading on 1 November 2006, hence the £193.6 million reduction in Commercial sales.

Wholesale sales for the year to 31 March 2008 reflect a charge of £8.9 million relating to uncertainty around the wholesale non-domestic income. The graph below highlights the volatile fluctuations in monthly invoices to May 2008.



Operating costs

Operating costs of £660.2 million were £19.9 million higher than in 2006/07. The main cost increases were due to higher depreciation/amortisation charges of £25.9 million, increased power costs of £4.7million, new operating costs of £3.4 million, increased local authority rates and SEPA charges of £2.3 million and increased costs associated with higher levels of network maintenance in order to improve customer service of £5.8 million. However, these increases were partially offset by increased gains on asset sales of £7.9 million, a lower FRS17 pension charge of £1.9 million, lower bad debt atypical costs of £5.6 million and circa £ 6.7 million of retail household costs now carried out by SWBS.

The cost of the PFI schemes in the year was £127.5 million, £1.9 million higher than in 2006/07 due primarily to contract indexation.

Depreciation, including infrastructure depreciation, increased by £25.7m to £250.8m reflecting the impact of the substantial capital investment programme.

The average number of employees during the year increased by 148, or 4.6%, to 3,394. This reflects the in-house provision of a higher proportion of the capital investment programme.

Finance costs

During the year, net debt increased by £168.0 million to £2,603.3 million. The increase was driven by a £196.3 million increase in borrowings from the Scottish Government partially offset by a £28.3 million increase in cash balances.

The cash balance as at 31 March 2008 was £29.9million, of which £27.4 million was in respect of the out-performance generated in the period to 31 March 2007. These funds will be invested in Government Gilts, in line with the framework for any out-performance of the Regulatory Contract for 2006-2010.

As at 31 March 2008, the weighted average interest cost of the £2,633.29 million outstanding debt was 5.83% (2007 – 5.92%). Net interest charged during the year was £140.3 million, £2.3 million lower than in 2006/07.

Taxation

SW's tax charge was £38.1 million, (2007 - £68.7 million), an effective rate of 17.1%, (2007 – 30.8%) in respect of deferred taxation. During the year, as a result of the change in the UK corporation Tax rate from 30% to 28% that will be effective from 1 April 2008, deferred tax balances have been re-measured. Deferred tax expected to reverse in the future has been measured using the effective rate of 28%. This and the tax changes associated with industrial lands and buildings has resulted in the lower deferred tax charge and the associated effective tax rate.

Performance compared to the Final Determination

Scottish Water accepted the Final Determination of charges for 2006 – 2010 set by the Water Industry Commission for Scotland in November 2005. An integral part of this Regulatory Contract was that annual out-performance would be transferred to a "gilts" reserve. At the end of the regulatory period, once the final assessment of out-performance has occurred, the 'gilts' reserve that has built up, together with any necessary adjustments, will be formalised as the 'gilts' buffer. While the 'gilts' reserve will contain out-performance in the earlier years of a regulatory period, it is available to meet any unplanned expenditure during the latter part of a regulatory period.

Out-performance is measured by comparing actual closing net debt with that calculated in the Final Determination after adjustment for variances in the delivery profile of the capital investment programme. Scottish Water's out-performance to 31 March 2007 was £27.4million, and the provisional value for out-performance in the year to 31 March 2008 is £16.3 million, giving a cumulative total £43.7 million.

The table below summarises the calculation of the £43.7 million out-performance figure for Scottish Water only for the period to 31 March 2008 and reflects, retrospectively, the capitalisation of SWBS Holdings at £90 million.

Scottish Water Out-Performance to March 2008	**£m**
Closing net debt as at 31 March 2008	2,522.4
Closing net debt as at 31 March 2008 per the Final Determination (excluding £90m financing of SWBS Holdings)	2,684.6
Reduction in debt relative to the Final Determination	-162.2
Less:	
• Due to capital investment shortfall	96.1
• Infrastructure charges raised but not yet invested	22.4
Cumulative out-performance to 31 March 2008	**-43.7**
Less out-performance to 31 March 2007	27.4
Out-performance in the year to 31 March 2008	**-16.3**

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 2008, after taking account of deferred taxation, there was a shortfall of assets over respective liabilities of £34.2 million (2007 -£104.9 million). This was a reduction in the FRS 17 pension liability of £70.7 million from 2006/07 and was due mainly to the actuarial gain of £99.0 million, reflecting the higher discount rate of 6.9% (2007 – 5.4%) 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 was originally informed by Scottish Ministers to adopt IAS for the accounting period ending 31 March 2009. However, following the UK 2008 budget statement, adoption of IAS will now apply to the accounting period ending 31 March 2010. 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, and presentation of, 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 consolidated surplus before tax of £236.8 million for the year.

Borrowing Limit

Scottish Ministers set Scottish Water’s maximum net new borrowing limit at £196.4 million for 2007/08. Actual net new borrowings in 2007/08 were £196.3 million.