Financial and Business Review

Group Overview

The overarching strategy for the Scottish Water group of businesses is to deliver more for customers through enhancing our service and financial performance and ensuring our financial sustainability in the regulated and non-regulated parts of the Scottish Water group.

The operating environment for the Scottish Water group has changed significantly since March 2008:

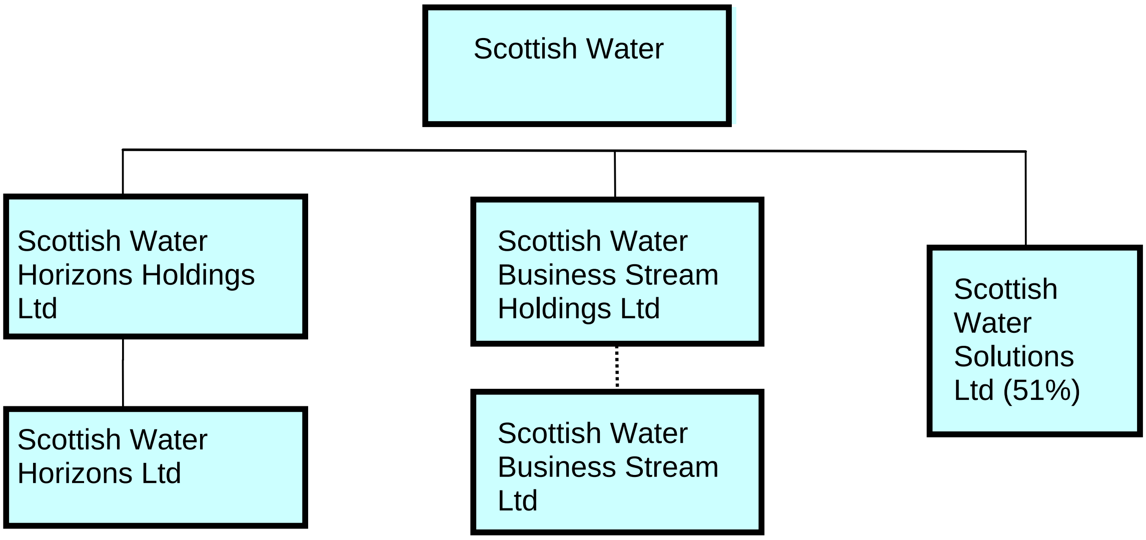
– A global economic downturn presents a turbulent operating environment and is already impacting on the growth in our customer base and the number of new connections in Scotland.

– The water retail market opened on 1 April 2008. The core regulated business is now operationally separated from Scottish Water Business Stream Ltd, our retail subsidiary, and we now operate with new licensed providers in the water retail to non-household market.

– On 1 April 2008, we transferred the commercial, non regulated activities into separate legal entities. For this purpose two wholly owned subsidiary companies were set-up - Scottish Water Horizons Holdings Ltd (SWHH) and Scottish Water Horizons Ltd (SWH). SWHH owns 100% of the shares in SWH which is the operating company. Both subsidiaries commenced trading on 1 April 2008 providing waste management, contracting and other business services.

– For the remainder of this regulatory period (2006–2010) and the 2010-2014 review period, our strategy is founded on ensuring that we continue to improve our service to customers while decreasing customer charges in real terms. The detail of our strategy was set out in our second draft business plan which was submitted to the Water Industry Commission in March 2009, to inform the Strategic Review of Charges 2010-14.

The Scottish Water group structure is summarised below:



The three main trading businesses of the Scottish Water group are Scottish Water, that supplies households and wholesale licensed providers with regulated water and waste water services, Scottish Water Business Stream Ltd (Business Stream), our licensed retail subsidiary which supplies water and waste water services to business customers, and Scottish Water Horizons Ltd (Horizons) that provides the bulk of non core services to customers. Business Stream is operated and managed independently of Scottish Water in accordance with the Governance Code, which sets out the terms of separation to enable the operation of the licensed retail market for business customers.

Borrowing Limit
Scottish Ministers set Scottish Water's (consolidated) maximum net new borrowing limit at £219.8 million for 2008/09. Actual net new borrowings in 2008/09 were £219.8 million, being £161.3 million for Scottish Water and £58.5m for SWBSH.

Scottish Water

Financial Framework

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

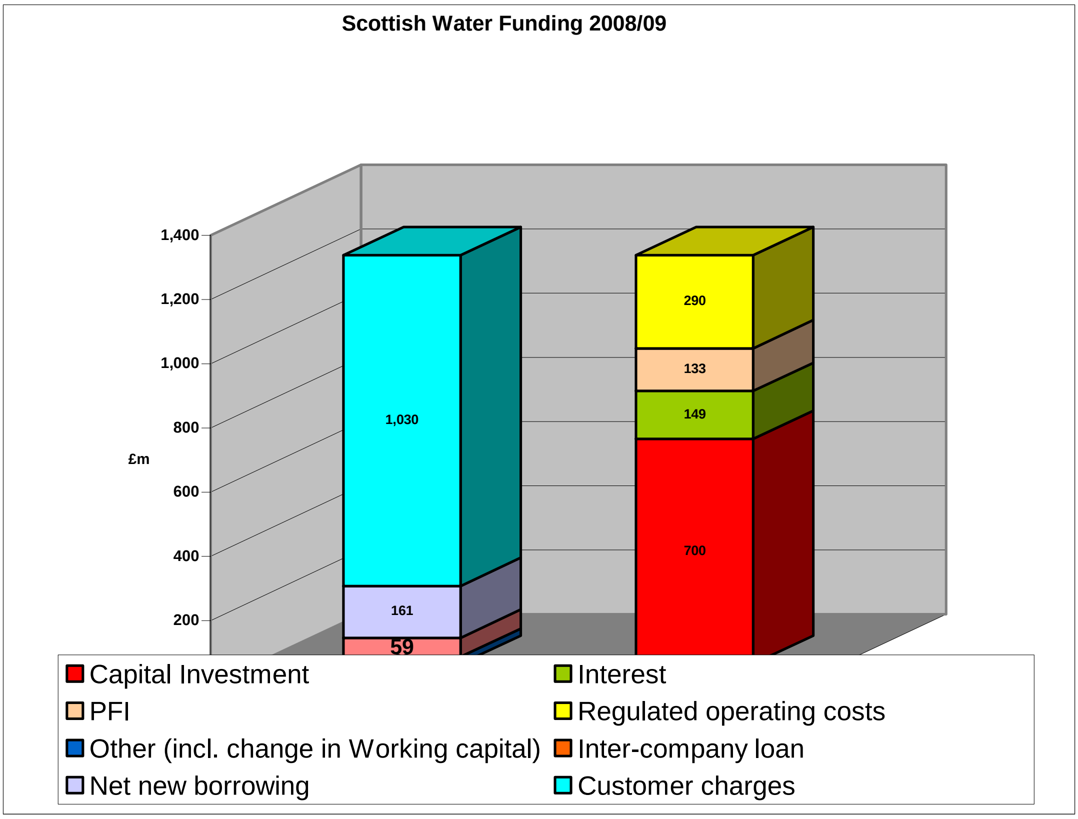
The Commission carries out four year price reviews and caps the prices that Scottish Water charge for water and wastewater services. The combination of regulated price caps and firm constraints on borrowing from the Scottish Government creates a clearly defined limit on the financing available to Scottish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

An integral part of this Regulatory Contract was that annual out-performance would be transferred to a financial reserve. At the end of the regulatory period, once the final assessment of out-performance has occurred, the financial reserve that has built up, together with any necessary adjustments, will be formalised as the financial buffer. However, no transfers to the financial reserve have been made because all available financing will be required to finance delivery of the capital investment programme in 2009/10.

Financial Performance

The surplus before tax in the year for Scottish Water was £195.2 million, £27.0 million lower than in 2007/08 (2008: £222.2 million). The regulated surplus before tax was £24.8 million lower at £194.4 million (2008: £219.2 million). The surplus for non regulated activities was £2.2 million lower at £0.8 million. This was due to many of the non regulated activities now being carried out by Horizons. The surplus made by Scottish Water on core service provision is required to finance our capital investment programme as is demonstrated in the chart below:



Regulated turnover

Regulated turnover for the year totalled £1,029.7 million (2008: £986.7 million) and is analysed by category in the table below:

	2008/09	2007/08	Change
	£m	£m	£m
Household	704.7	673.7	31.0
Wholesale	319.9	305.5	14.4
Other	5.1	7.5	-2.4
Total regulated turnover	**1029.7**	**986.7**	**43.0**

Turnover from services supplied to household customers increased by £31.0 million or 4.6% to £704.7 million driven mainly by the tariff increase effective from 1 April 2008. Turnover from wholesale services supplied to Licensed Providers increased by £14.4 million or 4.7% to £319.9 million. Turnover from other sales reduced by £2.4m to £5.1 million reflecting the transfer of building water services to Business Stream during 2008/09.

Operating costs

Operating costs of £286.9 million, including FRS 17 pension charges, (2008: £262.7 million) were 9.2% or £24.2 million higher than in 2007/08. The main cost increases were due to higher levels of network maintenance in order to improve customer service and reduce leakage of £12.5 million, higher bad debt charges of £9.1m, new operating costs associated with new assets coming into operation of £3.0 million and increased local authority rates and SEPA charges of £4.9 million. However, these increases were partially offset by a £7.0 million reduction in FRS 17 pension costs.

The cost of the PFI schemes in the year was £132.6 million, £5.1 million higher than in 2007/08 due primarily to contract indexation which on one scheme was impacted significantly by increases in gas prices.

Depreciation, including infrastructure depreciation, increased by £14.9 million to £266.5 million. The main reason for the increase was a higher Infrastructure Maintenance Charge to reflect the level of underlying and long term forecast infrastructure investment. The gain on sale from asset disposals was £7.8 million lower than in 2007/08 at £1.5 million.

Finance costs
As at 31 March 2009, the weighted average interest cost of the £2,794.5 million outstanding debt was 5.50% (2008: 5.83%). Net interest payable during the year was £149.5 million, £9.2 million higher than in 2007/08.

Other finance costs, being the expected return on pension scheme assets less interest on pension scheme liabilities, increased by £6.6 million to £1.3 million (2008: an income of £5.3 million).

During the year, net debt increased by £175.3 million to £2,778.6 million (being loans of £2,794.5 million less cash balances of £15.9 million). The increase was driven by a £161.3 million increase in borrowings from the Scottish Government and a £14.0 million reduction in cash balances.

Taxation
SW's tax charge was £59.1 million, (2008: £38.1 million), an effective rate of 30.3%, (2008: 17.1%) in respect of deferred taxation. The effective rate for the year was impacted by the requirement to revisit changes introduced by the Finance Act 2007 in relation to assets classed as industrial buildings. This required a cumulative catch-up in the 2008/09 deferred tax computation.

In 2007/08, as a result of the change in the UK corporation tax rate from 30% to 28% which was effective from 1 April 2008, deferred tax balances were re-measured as at 31 March 2008. Deferred tax expected to reverse in the future was measured using the effective rate of 28%. This, and the abolition of balancing adjustments for industrial buildings allowances, resulted in the lower deferred tax charge and the associated effective tax rate in 2008.

Group 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. Business Stream is a participating employer in the Strathclyde Pension Fund.

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 2008.

The actuarial funding position at 31 March 2008 of the Group's share of each pension fund is shown in the table below.

Fund	Value of assets £m	Total Accrued Liabilities £m	Deficit £m	Funding Level (%)
Strathclyde	361.6	365.7	4.1	99%
Aberdeen	197.2	220.3	23.1	90%
Lothian	214.3	256.1	41.8	84%

From 1 April 2009, under Regulation 4(2) (b) of the Local Government Pension Scheme (Benefits, Membership and Contributions) (Scotland) Regulation 2008, employee pension contributions are no longer levied on a flat rate basis (e.g. 5% or 6% of pensionable pay), but are determined according to the level of an employee's full time equivalent pensionable pay. A key feature of the new pension arrangements is that contribution rates are applied in tiers ranging from 5.5% to 12% depending on the employee's rate of pensionable pay on 31 March. Using these tiers average contribution rates will range from 5.5% up to 10.9% for employees. It is anticipated that this new approach to employees' contribution rates will ultimately result in a 2:1 ratio between Scottish Water's contributions and employees' contributions in a fully funded scheme.

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 2009, after taking account of deferred taxation, there was a shortfall of assets over respective liabilities of £160.9 million (2008: £34.2 million). This was an increase in the net pension liability of £126.7 million from 31 March 2008 and was due mainly to the actuarial loss of £183.0 million, reflecting the lower than expected return on scheme assets.

International Accounting Standards

All European Union listed companies were required to adopt International Accounting Standards (IAS) for their financial statements from 2005. Following the UK 2008 budget statement adoption of IAS within the public sector and central Government 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 presentation of, and accounting for, PFI contracts and taxation.

Members' report

For the year ended 31 March 2009

The Members present their annual report together with the audited financial statements for the year ended 31 March 2009.

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 group 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.

On 1 April 2008, the commercial, non regulated activities were transferred into Scottish Water Horizons Ltd (SWH), a wholly owned subsidiary. SWH is a commercial business enterprise which provides waste management, contracting and other business services.

Scottish Water Business Stream Ltd (Business Stream), our licensed retail subsidiary, supplies water and waste water services to business customers in the competitive retail market within Scotland which opened to competition on 1 April 2008.

A review of the business and future developments for Scottish Water are presented in the Chair's Statement on page 2 and in the Business and Financial Review on pages 20 to 25.

Members

The Chair and other Non Executive Members are appointed by Scottish Ministers. Executive Members are appointed by Scottish Water after receiving consent to their appointment from Scottish Ministers. The Members as at the date of the Annual Report and their biographies are set out on pages 26 to 27.

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 £144.9 million. Details of the financial results and associated accounting policies are set out on pages 40 to 62.

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. However, 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
The Scottish Water group of businesses employed an average of 3,737 staff during the year. Details of the costs incurred in relation to these staff can be found in note 4 to the financial statements on page 47. 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 consultative forums.

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 2009, the amount owed to trade creditors was equivalent to 28 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.

Members’ remuneration report

Quoted companies are required to include in their Annual Report a Directors’ Remuneration Report with specified contents. Even though Scottish Water is not a quoted company, the report follows the format and content required of quoted companies; where that is not possible, it is explicitly noted.

1. Remuneration Committee

a. Remit

The Remuneration Committee meets regularly to consider issues, in particular Executive Members terms and conditions, and makes recommendations to the Board. In respect of levels of Executive Members remuneration and incentive arrangements, its proposals have formed the basis of recommendations to the Scottish Government. No Executive Members are involved in deciding their own remuneration.

b. Membership

For the financial year under review, the Remuneration Committee has consisted of the following Non-Executive Members:

Mr Graeme Crombie	(Chair of the Committee to 31 March 2009)
Mr Donald Emslie	(Chair of the Committee from 1 April 2009)
Mr Pat Kelly	
Mrs Rita Theil	(until 31 March 2009)
Mr Alan Bryce	(from 1 April 2009)

During the year external independent advice has been provided by Hay Group Management Consultants. In addition, Hay Group Management Consultants provided Scottish Water with remuneration survey data. Internal advice was provided by the Chair of Scottish Water, the Chief Executive, and the Director of Human Resources & Development and Health and Safety. No Executive Member was present during discussions about their own remuneration.

c. Meetings

There were five meetings of the Committee in 2008/09. At each meeting a quorum of independent, Non-executive Members was present.

2. General Remuneration Policy

Scottish Water must continue to build on the progress made since its inception to be a successful water services company that provides the levels of service and value for money expected by its customers, regulators, the Scottish Government and benchmarked against the performance of the water companies in the United Kingdom.

Scottish Water considers staff remuneration to be a major contributor to achieving its goals. Scottish Water will continue to ensure that its working environment matches the expectations it places on its people to deliver best value outcomes in an empowered organisation. This requires terms of employment for all employees that, taken together, ensure Scottish Water is perceived as a fair employer that encourages excellence, rewards productivity and empowers its people as well as providing scope for personal development.

Scottish Water's overall remuneration policy aims are to:

- Attract, develop, motivate and keep highly talented people at all levels of the organisation
- Pay competitive salaries and benefits to all Scottish Water's people. When pay levels are set, account is taken of the work an employee does, what is paid in other organisations for similar work and how well Scottish Water is performing
- Incentivise and reward good individual and corporate performance.

3. Policy on Executive Members' Remuneration

a. Comparator Organisations

Scottish Water is publicly owned and accountable to the Scottish Parliament and Scottish Ministers. Within the context of public sector ownership, Scottish Water seeks to attract, retain and motivate leadership talent in competition not just with other utilities and other organisations in the public sector, but with organisations across the economy.

Scottish Water uses the remuneration database of Hay Group Management Ltd to ascertain the remuneration practices of industry in general. This is the largest remuneration database in the UK with each job subjected to the same method of job sizing.

b. Remuneration Elements

Scottish Water's Remuneration Policy for Executive Members consists of five principal elements:

- Base Salary;
- Annual Incentive Scheme;
- Long Term Incentive Plan (LTIP);
- Pension; and
- Allowances (for business needs, car, relocation, etc.).

c. Relative Importance of Performance Related Elements to Base Pay

Scottish Water is a performance-orientated organisation. It believes that Executive Members' remuneration should be closely related to both corporate performance and individual performance.

The aim is to pay a base salary that is as competitive as possible within public sector ownership and provide the opportunity for extra discretionary pay to be earned for out-performance of demanding targets.

The potential maximum annual incentives attainable by the Executive Members are 40% of base salary and are non-pensionable.

d. Performance Conditions for Annual Incentives and Awards Made – 2008/09

Scottish Water has an annual out-performance incentive plan (AOIP) that is designed to incentivise and reward the out-performance of targets agreed with regulators. Scottish Water out-performed the stretch targets on all measures, apart from the profit before tax measure where performance was between target and stretch target. The targets, stretch targets and actual performance in 2008/09 for each measure are set out below.

Measure	Target	Stretch target	Actual performance
– Profit before Tax excluding depreciation in comparison with the targets in the Final Determination	£446.1m	£461.1m	£458.9m
– Out-performing the Final Determination OPA target of 232	223	251	252
– Investment - outputs delivered - Q&S2/3a investment	 85% £650m	 110% £670m	 114% £686m
– Leakage reduction (mega-litres per day)	70	100	114

This performance generates the following awards, based on the criteria set at the start of the year:

Measure	% allocated	% awarded
– Profit before Tax excluding depreciation	30%	25.6%
– OPA score	40%	40%
– Investment out-turn	15%	15%
– Leakage	15%	15%

Overall AOIP awards in 2008/09 were 38% of annualised salary.

Non-executive Members are not eligible for incentive payments.

e. Long Term Incentive Plans for 2006 - 2010

The Long Term Incentive Plan (LTIP) has been agreed with the Scottish Government and provides clear targets for out-performance of the Water Industry Commission's Final Determination. Payments under the scheme will only be made to Executive Members remaining in employment with Scottish Water on 1st January 2011 if there is overall financial out-performance of the Final Determination.

The plan is based on:

- 50% for performance against financial targets, being the extent to which net debt is lower in March 2010 than was assumed in the Final Determination. Maximum LTIP would be payable for at least £100M out-performance.
- 50% for out-performance of OPA targets above those set out in the Final Determination. Maximum LTIP will be payable for an OPA score of at least 271, 30 points higher than the Final Determination target of 241.
- The LTIP will be funded by 15% of annual salary being accumulated each year for ultimately vesting if earned after four years by eligible Executive Members. Any LTIP payment will only be funded from financial out-performance after payment of any incentive awards to staff.

4. Service Contracts

Details of Executive Members' contracts are set out below.

<table>
<tr><th>Executive Member</th><th>Name</th><th>Date of Contract</th><th>Unexpired Term</th><th>Notice Period</th></tr>
<tr><td>Chief Executive</td><td>Richard Ackroyd</td><td>25 March 2008</td><td rowspan="5">All Members have Permanent contracts</td><td rowspan="5">All Members are required to give six months' notice of resignation. Scottish Water is required to give Members twelve months' notice of termination.</td></tr>
<tr><td>Asset Management Director</td><td>Geoff Aitkenhead</td><td>1 April 2002</td></tr>
<tr><td>Finance & Regulation Director</td><td>Douglas Millican</td><td>1 April 2002</td></tr>
<tr><td>Commercial Director</td><td>Chris Banks</td><td>1 April 2002</td></tr>
<tr><td>Customer Service Delivery Director</td><td>Peter Farrer</td><td>13 October 2008</td></tr>
</table>

Non-executive Board Member Appointments

The Non-executive Members do not have service contracts. Non-executive Members are expected to work four days per month for Scottish Water with the exception of the Chair, Ronnie Mercer, who works 2 days per week. No compensation is payable to any Non-executive Member if their appointment is terminated early. The expiry dates of Non-executive appointments are as follows:

Graeme Crombie	31 March 2009
Ian McMillan	31 March 2009
Rita Theil	31 March 2009
Alistair Buchanan	resigned 19 April 2009
Ronnie Mercer	30 September 2011
Donald Emslie	31 March 2012
David Gray	31 March 2012
Alan Bryce	31 March 2013*
Pat Kelly	31 March 2013*
Lynne Peacock	31 March 2013*
James Spowart	31 March 2013*
Andrew Wyllie	31 March 2013*

* Alan Bryce, James Spowart and Andrew Wyllie joined the Board with effect from 1 April 2009 and Pat Kelly was reappointed with effect from 1 April 2009. Lynne Peacock joined the Board on 6 May 2009.

The auditors are required to report on information contained in the following sections of the Remuneration Report.

5. Members' Remuneration

Details of Members' Remuneration, as defined in the Accounts Direction for 2008/09 by Scottish Ministers, are set out below for the year.

	Salary /Fees £'000	AOIP £'000	Benefits £'000	Total 2008/09 £'000	Total 2007/08 £'000
Executive Members					
Richard Ackroyd (i)	263	101	9	373	7
Geoff Aitkenhead	167	64	6	237	243
Chris Banks	155	59	9	223	229
Peter Farrer (ii)	70	44	4	118	-
Douglas Millican	168	65	8	241	261
Non - Executive Members					
Ronnie Mercer (Chair)	90	-	9	99	98
Alistair Buchanan	20	-	-	20	-
Graeme Crombie	20	-	-	20	20
Donald Emslie	20	-	-	20	-
David Gray	20	-	-	20	20
Pat Kelly	20	-	-	20	20
Ian McMillan	20	-	-	20	20
Rita Theil	20	-	-	20	20
Total Members' remuneration	**1,053**	**333**	**45**	**1,431**	**938**
Former Members					
Jon Hargreaves (iii)					198
Professor Paul Jowitt (iv)					20
Total	**1,053**	**333**	**45**	**1,431**	**1,156**

(i) The total for 2007/08 is from the date of appointment to the Board on 25 March 2008.

(ii) Salary was from date of appointment to the Board on 13 October 2008: Mr Farrer's AOIP award was in respect of his employment for the full year.

(iii) To date of resignation from the Board on 30 November 2007.

(iv) To date of resignation from the Board on 31 March 2008.

(v) A car or car allowance is provided to all Executive Members and the Chair for business needs. The associated benefit is included in the benefits section of the table above. The benefits section also includes the value of any holiday sale backs.

(vi) The AOIP criteria are explained in section '3d' of the Members' Remuneration Report.

(vii) Costs of £96,183 have been charged relating to the permanent relocation by Mr Ackroyd to Scotland to take up his appointment.

6. Pension

The Executive Members, other than Richard Ackroyd, participate in the Lothian Pension Fund – a defined benefit scheme. Details of their benefits under this scheme are set out below. Richard Ackroyd does not participate in this pension scheme but Scottish Water contributed £92,050 (2008: £1,732) to his pension arrangements during the year.

	Increase in accrued benefits during the year net of inflation			Accumulated total accrued benefits at 31 March 2009		Transfer Values (note 5)		
	Years in Scheme	Pension £'000	Lump sum £'000	Pension (note 4) £'000	Lump sum (note 4) £'000	At 31 March 2009 £'000	At 31 March 2008 £'000	Increase in 2008/09 net of Members' own contributions and inflation £'000
Geoff Aitkenhead	30.4	2	6	63	190	1,363	1,040	304
Chris Banks	14.7	2	6	28	85	521	388	120
Peter Farrer	24.7	n/a	n/a	40	121	694	n/a	n/a
Douglas Millican	14.1	0	1	30	90	470	375	82

Notes:-

1. Members of the pension scheme have the option to pay additional voluntary contributions; neither the contributions nor the resulting benefits are included in the above table.
2. The normal retirement age of Executive Members is 65.
3. The pension entitlement shown is that which would be paid annually on retirement along with the lump sum, based on service to the end of the year.
4. The increase in accrued pension, lump sum and transfer value during the year excludes any increase for inflation.
5. The transfer value of accrued pension is calculated in a manner consistent with Actuarial Guidance Note GN11.
6. On death, a spouse's pension is payable equal to one half of the Member's pension, and children's pension may also be payable.

This report was approved by the Board and signed on its behalf by:

Mr Donald Emslie,
Chair of the Remuneration Committee
3 June 2009.

Statement of Members’ responsibilities for the preparation of the financial statements

The following statement, which should be read in conjunction with the statement of auditors' responsibilities included in the Auditors' Report below, is made with a view to distinguishing the respective responsibilities of the Members and of the auditors in relation to the financial statements.

The Members are required by the Water Industry (Scotland) Act 2002 and directions made thereunder to prepare financial statements for each financial year which give a true and fair view of the state of affairs of Scottish Water and of its income and expenditure for that period. In preparing those financial statements, the Members are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state whether applicable accounting standards have been followed, subject to any material departures disclosed and explained in the financial statements; and
- prepare the financial statements on a going concern basis unless it is inappropriate to do so.

The Members are responsible for keeping proper accounting records, which disclose with reasonable accuracy, at any time, the financial position of Scottish Water and to enable them to ensure that the financial statements comply with statute and any financial reporting requirements. They are also responsible for taking reasonable steps to safeguard the assets of the business and to prevent and detect fraud and other irregularities.

Independent auditor's report

to the members of the Board of Scottish Water, the Auditor General for Scotland and the Scottish Parliament

We have audited the financial statements of Scottish Water for the year ended 31 March 2009 under the Water Industry (Scotland) Act 2002. These comprise the Income and Expenditure Account, Statement of Total Recognised Gains and Losses, the Balance Sheet, the Cash Flow Statement, and the related notes. These financial statements have been prepared under the accounting policies set out within them. We have also audited the information in the Remuneration Report that is described in that report as having been audited.

This report is made solely to the parties to whom it is addressed in accordance with the Public Finance and Accountability (Scotland) Act 2000 and for no other purpose. In accordance with paragraph 123 of the Code of Audit Practice approved by the Auditor General for Scotland, we do not undertake to have responsibilities to members or officers, in their individual capacities, or to third parties.

Respective responsibilities of the Board Members, Chief Executive and auditor

The Board Members and Chief Executive are responsible for preparing the Annual Report, which includes the Remuneration Report, and the financial statements in accordance with the Water Industry (Scotland) Act 2002 and directions made thereunder by the Scottish Ministers and for ensuring the regularity of expenditure and income. These responsibilities are set out in the Statement of Members' Responsibilities.

Our responsibility is to audit the financial statements and the part of the Remuneration Report to be audited in accordance with relevant legal and regulatory requirements and with International Standards on Auditing (UK and Ireland) as required by the Code of Audit Practice approved by the Auditor General for Scotland.

We report to you our opinion as to whether the financial statements give a true and fair view and whether the financial statements and the part of the Remuneration Report to be audited have been properly prepared in accordance with the Water Industry (Scotland) Act 2002 and directions made thereunder by the Scottish Ministers. We report to you whether, in our opinion, the information which comprises the Financial and Business Review included in the Annual Report, is consistent with the financial statements. We also report whether in all material respects the expenditure and income shown in the financial statements were incurred or applied in accordance with any applicable enactments and guidance issued by the Scottish Ministers.

In addition, we report to you if, in our opinion, the body has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by relevant authorities regarding remuneration and other transactions is not disclosed.

We review whether the Corporate Governance Statement reflects the body's compliance with those provisions in the Combined Code specified for our review in the Accounts Requirements, and we report if, in our opinion, it does not. We are not required to consider whether this statement covers all risks and controls, or to form an opinion on the effectiveness of the body's corporate governance procedures or its risk and control procedures.

We read certain of the other information contained in the Annual Report and consider whether it is consistent with the audited financial statements. This other information comprises only the Financial and Business Review. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

Basis of audit opinion

We conducted our audit in accordance with the Public Finance and Accountability (Scotland) Act 2000 and International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board as required by the Code of Audit Practice approved by the Auditor General for Scotland. Our audit includes examination, on a test basis, of evidence relevant to the amounts, disclosures and regularity of expenditure and income included in the financial statements. It also includes an assessment of the significant estimates and judgements made by the Board Members and Chief Executive in preparation of the financial statements, and of whether the accounting policies are most appropriate to the body'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 financial statements and the part of the Remuneration Report to be audited are free from material misstatement, whether caused by fraud or error, and that in all material respects the expenditure and income shown in the financial statements were incurred or applied in accordance with any applicable enactments and guidance issued by the Scottish Ministers. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements and the part of the Remuneration Report to be audited.

Opinion

Financial statements

In our opinion

- the financial statements give a true and fair view, in accordance with the Water Industry (Scotland) Act 2002 and directions made thereunder by the Scottish Ministers, of the state of affairs of the body as at 31 March 2009 and of its surplus, total recognised gains and losses and cash flows for the year then ended;
- the financial statements and the part of the Remuneration Report to be audited have been properly prepared in accordance with the Water Industry (Scotland) Act 2002 and directions made thereunder by the Scottish Ministers; and
- information which comprises the Financial and Business Review included with the Annual Report is consistent with the financial statements.

Regularity

In our opinion in all material respects the expenditure and income shown in the financial statements were incurred or applied in accordance with any applicable enactments and guidance issued by the Scottish Ministers.

PricewaterhouseCoopers LLP
Edinburgh
3 June 2009

Notes:

a. The maintenance and integrity of the Scottish Water website is the responsibility of the Members; 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 financial statements since they were initially presented on the website.
b. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.