

Annual Return 2007/08

Overview

DOCUMENT CONTROL

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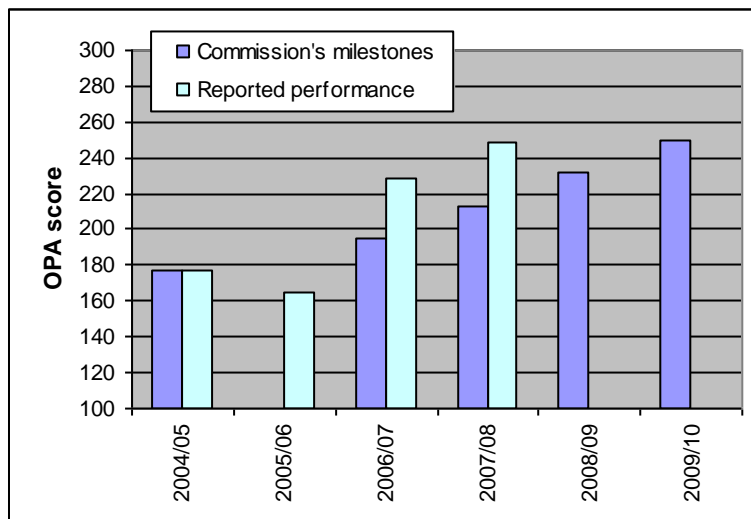
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1. Executive Summary

This overview document reports on Scottish Water's performance and activities in 2007/08, the second year of the 2006 - 10 regulatory period. We are pleased with the progress we have made addressing the challenges we took on when accepting the final determination of the 2006 price review. In particular we are pleased with our OPA performance and output delivery, where we have delivered 46.9% of outputs against a target of 33.6%. Our principal achievements in 2007/08 are highlighted below.

Overall Performance Assessment

We are delivering a major programme to improve performance in most of the thirteen measures that comprise the Overall Performance Assessment (OPA). That programme has demonstrated good progress, with the score for 2007/08 of 248 showing a 50% improvement over the corresponding reported performance for 2005/06. While our OPA score is sensitive to events which may reduce our score we believe that we remain on course to out-perform the 250 target for 2009/10.



Leakage

Our reported leakage for this report year is 924 MI/d, an 80 MI/d (8%) reduction on our reported leakage in 2006/07 of 1,004 MI/d. However, we have not succeeded in meeting our interim leakage target for 2007/08 to reduce leakage to 855 Mld.

A determined approach to establishing robust DMA coverage has moved us from 70.3% coverage in March 2007 to 94.4% by March 2008, and we have put in place additional resources to ensure that we achieve the volume leakage reduction in 2008/09, and meet our regulatory leakage target.

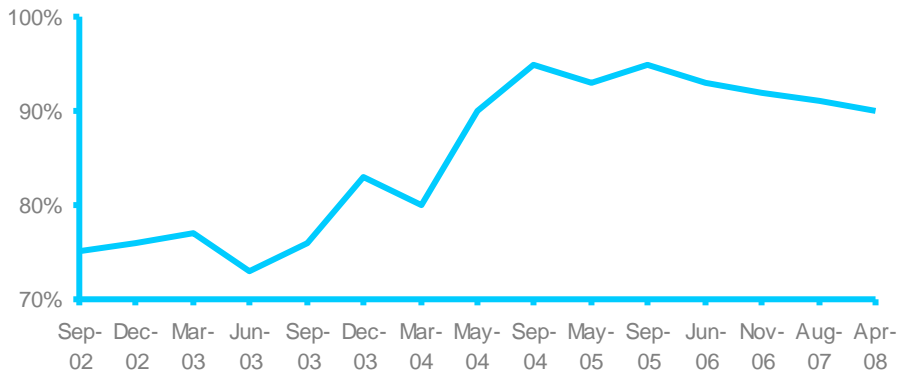
Customer Satisfaction Measures

There are two main measures of satisfaction that we use:

- Perceptions Survey
- Transactional Survey

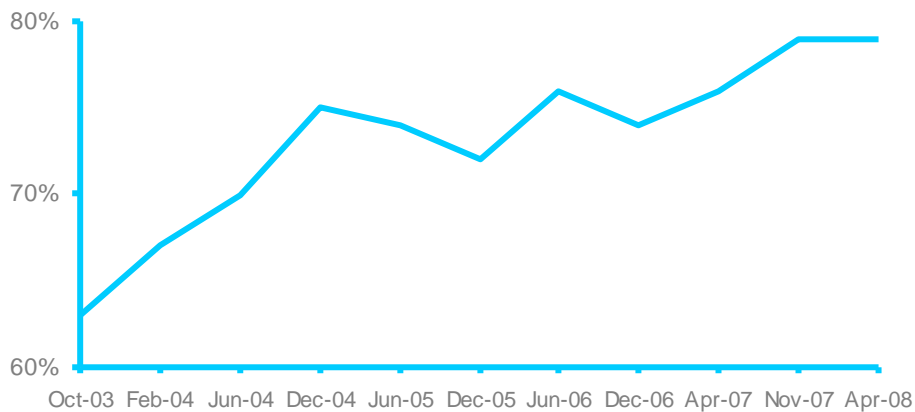
Perceptions Survey

We monitor the needs, expectations and experiences of our customers through a survey of a random sample of the Scottish household population. According to this survey, satisfaction has risen from 75% in September 2002 to around 90% as shown in the graph below. Scottish Water has been consistently recording perception based customer satisfaction at, or above, 90% since April 2004.



Transactional Survey

It is important that we continue to drive improvements in the experiences that we provide to our customers when they have reason to contact us. We track our customers' satisfaction with how effectively we do this, through this independently managed survey.



Our performance against our published guaranteed standards of service improved from 98% in 2005/06 to 99.16% in 2007/08. This compares with 91.4% at the formation of Scottish Water.

We again maintained unconstrained supplies to all our customers during the report year and our water resources and are forecast to meet demand in 2008/09.

We have continued with our programme of community and stakeholder engagement on a wide number of issues.

Compliance

Overall compliance with water quality standards continued to improve in 2007, with 99.81% of all water quality tests conducted in our sampling programme complying with quality standards (2006: 99.76%; 2005: 99.64%).

Compliance at customers' taps (used for calculation of OPA) improved to 99.76% in 2007, up from 99.65% in 2006.

During the 2007 Bathing Season, four of the 58 bathing waters that can be impacted by Scottish Water's discharges failed to achieve the minimum mandatory standard. However none of the failures were attributed directly to discharges from Scottish Water assets.

The final WWTW Compliance figures have not yet been finalised & agreed with SEPA. However, Scottish Water is forecasting 30 failing WWTW at 31 March 2008 against a target of 39.

Investment

Overall Performance

Scottish Water delivered £625m of investment in 2007/08. The 2007/08 outputs target of 99% for Q&SII has been met and outputs out-performance has been achieved on the Q&SIII Programme with 46.9% of outputs delivered against a target of 33.6%. At March 2008, we were behind programme with the regulatory output signoff process but action is being taken to recover this position in the first half of 2008/09.

The planned target for investment in 2008/09 presented in the refreshed Delivery Plan is £650m-£690m.

Q&SII Programme 2007-08

The current estimate of the Q&SII overhang investment is a net £321m. This includes additional obligations in respect of the DSEAR legislative requirements, enhanced security provision and projects delayed by the substitution process, in addition to completion of the Q&SII programme.

Financials

In 2007/08 Scottish Water (excluding Business Stream and SWBS Holdings) out-performed the Final Determination by £16.3 million bringing total out-performance to 31 March 2008 to £43.7 million.

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.

Non Regulated Business Governance

In line with the recommendations arising from the review of transfer pricing in the Scottish water industry, carried out in 2006/07, we transferred, on 1 April 2008, our principal non-core activities into a separate holding company, Scottish Water Horizons Holdings Ltd (Horizons Holdings), which in turn transferred then into a non-core operating subsidiary, Scottish Water Horizons Ltd.

Board Changes

The Board appointed Richard Ackroyd as the new Chief Executive Officer following the retirement of Jon Hargreaves during the report year. Paul Jowitt left the Board of Scottish Water at the end of his appointment on 31 March 2008. Alistair Buchanan and Donald Emslie joined the Board on 1 April 2008.

Asset Revaluation

For the first time, our Annual Return includes a Modern Equivalent Asset Valuation (MEAV) of our entire asset stock. For previous years, we valued our assets with their Equivalent Asset Replacement Cost (EARC).

During 2007, we undertook a major project to derive a MEAV methodology that would be suitable for Scottish Water and the Commission. We engaged consultants experienced in similar valuations for English water companies to advise us.

The summary of our gross MEAV is set out below.

	Gross MEAV (£m)	%
Water Infrastructure	£11,556.4	31.9%
Water Non – Infrastructure	£3,028.9	8.4%
Wastewater Infrastructure	£18,692.6	51.6%
Wastewater Non-Infrastructure	£2,784.2	7.7%
Support Services	£183.9	0.5%
Total	£36,246.0	100.0%

Information Improvements

We have continued to build on the foundations we laid in 2006/07 improving the completeness, availability, reliability, access to and reporting of information. This has enabled us progressively to improve the confidence grades we report to the Commission and this year confidence grades have improved for the reporting of internal sewer flooding, GMS measures and distribution input. There has also been a general improvement in data associated with monitoring of the capital programme and outputs.

Climate Change

During 2007/08 we developed our strategy to adapt to and mitigate the causes of climate change. We have the calculation of our first greenhouse gas emissions footprint covering all major greenhouse gases (CO₂, CH₄, N₂O). We will repeat this exercise annually while building improved systems for the active management of carbon in our operational practices. Scottish Water's 2006-7 Greenhouse Gas Emissions Footprint was 469,000 tonnes of CO₂ equivalents.

Sustainable Procurement

We are well advanced with the development of our capital delivery model for the 2010 - 2014 investment period. The delivery model for the 2010 - 2014 period will be a combination of integrated in-house delivery capability and a Joint Venture partnering model.

Governance of the Annual return

The methodologies and processes used for producing the detailed information in Scottish Water's 2007/08 Annual Return have been further enhanced this year with the Audit Committee reviewing the governance process and seeking assurance from the Executive Directors and Senior Managers. The Reporter has also attended the Audit Committee to outline his view of the 2007/08 Annual return process. The approved Reporter's report will be supplied to the Commission by the Reporter.

Scottish Water's Board has endorsed the Annual Return Overview and charged the Chief Executive, with the responsibility to establish and maintain sound systems of internal control that support the completion of the Annual Return submission to the Water Industry Commission. The Board assurance statement signed by the Chief Executive is included in Appendix 1.

2. Key Outputs and Service Delivery

2.1 Service outputs and performance

Overall Performance Assessment (OPA)

We are delivering a major programme to improve performance in most of the thirteen measures that comprise the Overall Performance Assessment (OPA). That programme has demonstrated good progress, with the score for 2007/08 of 248 showing a 50% improvement over the corresponding reported performance for 2005/06. While our OPA score is sensitive to events which may reduce our score we believe that we remain on course to out-perform the 250 target for 2009/10.

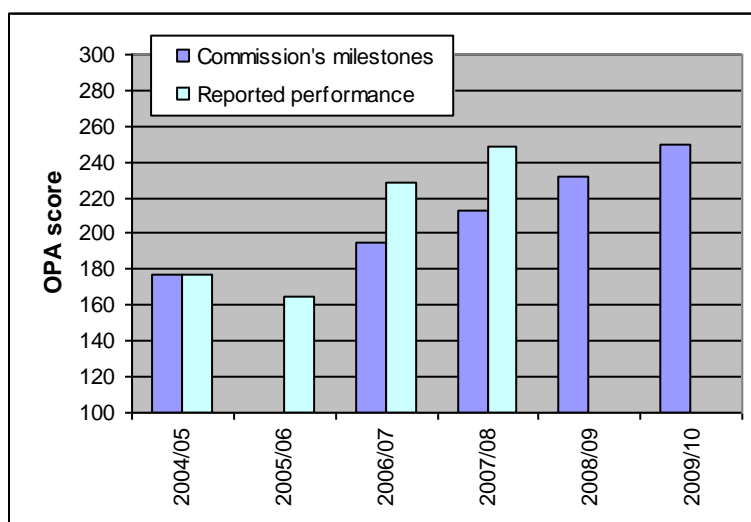
OPA Performance by Service

	2006-07	2007-08
Water Service	104	114
Sewerage Service	68	69
Customer Service	25	27
Environmental Performance	35	38
Total	232	248
WIC Target	195	213

Biggest Improvements

The areas, in which we made the biggest improvements in 2007/08, contributing to our improvement over the year, are:

- Connected properties experiencing unplanned interruptions to supply reduced from 1.43% to 0.80% (+7.4 points)
- Properties subject to inadequate water pressure reduced from 7,772 (0.31% of properties) to 5,907 (0.24%) (+5.2 points);
- Water samples that comply with parameters increased from 99.65% to 99.76% (+3.1 points).



The table over shows our performance on each of the measures:

Table 2.1: OPA Performance

Indicator	2006/2007 performance	2007/2008 performance	2006/07 weighted OPA score	2007/08 weighted OPA score	Change
% of water samples that comply with parameters	99.65%	99.76%	40.2	43.3	3.1
% of properties subject to inadequate water pressure	0.31%	0.24%	16.4	21.6	5.2
Connected properties experiencing unplanned interruptions	1.43%	0.80%	22.3	29.6	7.4
Hosepipe restrictions	0	0	25.0	25.0	0.0
Leakage	4.56%	7.49%	17.5	15.0	-2.5
% properties suffering sewer flooding incidents caused by overloading	0.00244%	0.00184%	24.4	24.8	0.4
% properties suffering sewer flooding incidents caused by other causes	0.00777%	0.00768%	33.2	33.4	0.1
Sewer flooding (at risk)	0.03244%	0.02232%	9.9	11.2	1.3
Sewage sludge disposal	0.00%	0.00%	12.5	12.5	0.0
% pe served by non-compliant sewerage treatment works	20.32%	10.11%	5.0	5.0	0.0
% customer billing contacts responded to within 5 days	99.29%	99.32%	8.8	8.8	0.0
% written complaints responded to within 10 days	98.73%	99.95%	7.2	9.3	2.1
% telephone calls answered within 30 seconds	97.22%	97.34%	8.9	9.0	0.1
			231.2	248.3	17.1

Percentage of water samples that comply with parameters

Our water quality performance is discussed in Section 2.2 below.

Percentage of properties subject to inadequate water pressure

During 2006/07 we put in place new systems and processes to record properties that have reported inadequate water pressure. This gave us a comprehensive, live corporate system with the address of every property in Scotland which has a historic report of inadequate pressure. Using this new system in the reporting year, we have targeted the zones with the most number of affected properties and performed detailed pressure measurement tests to confirm the current water pressure. This has led to a reduction of the number of properties on the register from 7,772 to 5,907, resulting from a combination of better measurement of pressure and recent improvements to the water networks that have increased pressure in certain areas.

Connected properties experiencing unplanned interruptions

Table 2.2 shows the improvement in reducing the number of properties that experience unplanned interruptions. We have placed great emphasis on the speed of restoration following an unplanned interruption with a strong focus on maximising the number of restorations that can be achieved in less than six hours.

Table 2.2: Unplanned interruptions to supply

	2006/07	2007/08
Properties interrupted for 6 to 12 hours	24,459	15,474
Properties interrupted for 12 to 24 hours	4,142	934
Properties interrupted for more than 24 hours	668	666
Total number of properties interrupted for more than 6 hours	29,269	17,074
Total number of properties interrupted for more than 12 hours	4,810	1,600

Hosepipe restrictions

We have not required any hosepipe restrictions since Scottish Water was formed in 2002.

Leakage

Our reported leakage for this report year is 924 MI/d, an 80 MI/d (8%) reduction on our reported leakage in 2006/07 of 1,004 MI/d. However, we have not succeeded in meeting our interim leakage target for 2007/08 to reduce leakage to 855 Mld.

The improved methodology and data for calculating leakage have led to a reduction in reported leakage of about 45 MI/d. The remaining 35 MI/d of the reduction reported in 2006/07 arose from real leakage reduction due to the actions of the leakage teams in finding and fixing leaks.

A determined approach to establishing robust DMA coverage has moved us from 70.3% coverage in March 2007 to more than 94% by March 2008, and we have put in place additional resources to ensure that we achieve the volume leakage reduction in 2008/09.

The reported OPA score for leakage reflects the feedback received from the Commission on 26 May 2008 in relation to their assessment of our provisionally reported OPA performance.

Number of incidents of sewer flooding caused by overloading of main sewers

In 2007/08 there were 44 incidents of flooding from overloaded main sewers that caused internal flooding of customers' properties. This was a reduction of 14 incidents from the 58 incidents reported for 2006/07. During 2006/07, we overhauled, extensively, our systems and processes for reporting internal sewer flooding and validating the information about flooding incidents. Field staff have purpose-built laptop computers which provide them with information directly from the contact centre staff, identifying the properties concerned and the customers' perception of the cause of the flooding. Field staff attend the incident and, on determining the cause, enter this information into the laptop computer, specifying whether the incident did indeed cause internal flooding and whether this was due to overloading of Scottish Water's main sewers.

During 2007/08 we have been embedding these systems and processes and improving compliance with the processes. In the early months of the year, there was up to 30% of incidents for which we did not capture all the required information, such as whether the flooding was confirmed to be internal or external, or whether it was caused by a main or lateral sewer. This means that for this 30%, it is not certain from subsequent analysis whether the incident did cause internal flooding, whether it was caused by overloading of a main or lateral sewer, or was possibly caused by a failure of the customer's internal plumbing. For this year's results, as last year, we have taken the total of such incidents (without resolution codes) and applied them pro-rata to the categories of incident that were identified correctly with resolution codes.

Our work in 2007/08 has improved greatly the compliance with our new systems and processes, such that in February and March 2008 compliance was consistently greater than 90%. We have therefore ceased the off-line uplift of data from 1 April 2008 and now report sewer flooding information directly from corporate systems.

Number of incidents of sewer flooding from other causes on main sewers

We use the same new systems and processes to capture information about incidents of flooding from sewers for all causes, not just for hydraulic overloading. The resolution codes identified by field staff specify whether the staff consider the flood to have been caused by overloading. If so, office based staff investigate the incident, analysing the sewer network when necessary, to confirm the diagnosis.

Incidents of flooding that cannot be shown to be caused by overloading are recorded as being due to ‘other causes’. These are typically blockages (‘chokes’) in sewers or, less commonly, collapsed sewers. Blockages occur more commonly in the smaller diameter lateral sewers than in main sewers. Scottish Water is responsible for lateral sewers, but water and sewerage companies in England and Wales are not. Therefore the information shown in the Annual Return relates only to internal flooding caused by blockages or failures of main sewers to enable a comparison to be made across all English and Welsh companies. We report the incidents caused by lateral sewers separately in the commentary to Table B.

In the same manner as we described for our analysis of internal flooding from overloading, we have applied a pro-rata increase to our records of internal flooding from other causes, to reflect the incidents for which we have incomplete information (either about whether the flood was indeed internal, or whether the cause was a main or lateral sewer, or whether it was caused by overloading). This pro-rata increase has been discontinued from 1 April 2008.

Sewer flooding (properties at risk)

Our register of properties at risk of flooding from overloaded sewers has reduced from 1,042 in 2006/07 to 563 in 2007/08. This reduction has resulted from a combination of reviews of information, to remove properties where there has been no record of flooding, and investment to upgrade the sewer networks.

Table 2.3: Properties at risk of flooding from sewers

	2006/07	2007/08
At risk of flooding twice in ten years	496	307
At risk of flooding once (but less than twice) in ten years	546	256
Total number of properties at risk of flooding at least once in ten years	1,042	563

Sewage sludge disposal

All sewage sludge in Scotland is disposed of through approved routes in compliance with all relevant legislation.

Percentage of population equivalent served by non-compliant sewerage treatment works

The compliance of Scottish Water’s waste water treatment works remains unsatisfactory. In 2007/08, 10.1% of the population equivalent in Scotland was served by waste water treatment works that were non-compliant. This is poorer than the typical performance in England and Wales. However, our performance in 2007/08 was better than in 2006/07 (20.32% non-compliant) but this improvement falls far short of the targets we have set ourselves for 2010. We have a major programme of works in hand to improve performance

to less than 5% non-compliance. Almost half of the waste water load in Scotland is treated at waste water treatment works operated under PFI contracts. A number of these PFI works are non-compliant and contribute significantly to the poor performance on this measure. Our programme of works includes investment and actions at many works to improve performance.

Percentage customer billing contacts responded to within 5 days

Customer billing is performed only by Business Stream and that organisation’s performance on this measure contributed to our OPA score for 2007/08. This measure will be excluded from OPA for 2008/09 and subsequent years. The figures we have reported in the Annual Return for 2007/08 include information provided to us by Business Stream, to enable a report for the full year to be provided.

Business Stream’s response rate to customer billing contacts is reported to have improved marginally during 2007/08, with 99.32% response within five days, compared with 99.29% in 2006/07.

Percentage written complaints responded to within 10 days

Performance on this measure has shown an improvement to 99.95% in 2007/08 from 98.73% in 2006/07. This is due to a recovery from the shortfall in performance by Business Stream at the end of 2006/07 as that entity set up its new systems and processes and appointed new staff. The figures reported here for the Annual Return 2007/08 are the combined results for Scottish Water and Business Stream.

Percentage telephone calls answered within 30 seconds

We answered telephone calls more quickly in 2007/08 than in 2006/07. A total of 97.3% of calls were answered within thirty seconds, compared with 97.2% in 2006/07.

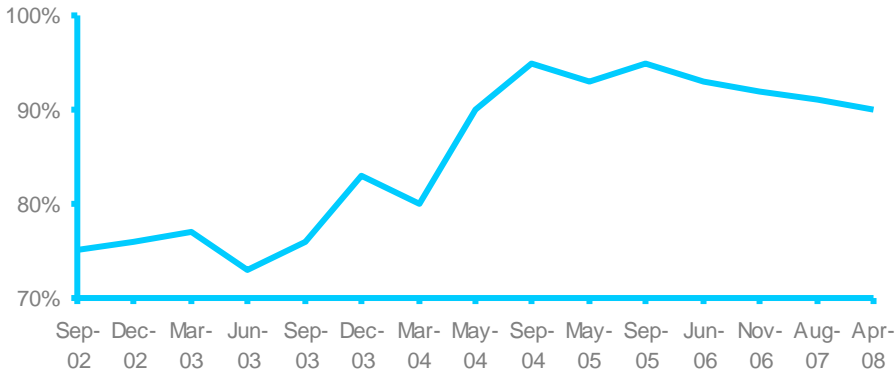
Other Customer Service measures

There are two main measures of satisfaction that we use:

- Perceptions Survey
- Transactional Survey

Perceptions Survey

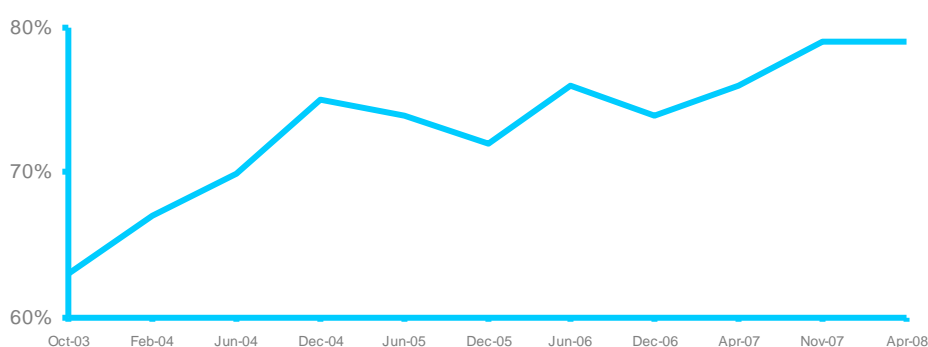
We monitor the needs, expectations and experiences of our customers. This is measured independently twice a year through a survey of a random sample of the Scottish household population. Satisfaction has risen from 75% in September 2002 to around 90% as shown in the graph below. Scottish Water has been consistently recording perception based customer satisfaction at, or above, 90% since April 2004.



Transactional Survey

It is important that we continue to drive improvements in the experiences that we provide to our customers when they have reason to contact us. In general, customers who contact Scottish Water have an issue which we should endeavour to resolve as quickly as possible while keeping them updated on our progress. We track our customers' satisfaction with how effectively we do this, through this independently managed survey. The survey is carried out twice a year with 1,600 customers who have contacted us. We have clear focus on the need to provide consistently positive experiences, and feedback from our customers indicates that they are increasingly satisfied with our services.

Within this survey we track customers' experience against different points in their journey; these are initial contact, visit from a representative and work carried out. For all of these, overall satisfaction has reached an all time high, with most notable increases against work carried out which was 69% in December 2004 and is now 81% (April 2008).



Our performance against our published guaranteed standards of service improved from 98% in 2005/06 to 99.16% in 2007/08. This compares with 91.4% at the formation of Scottish Water.

We again maintained unconstrained supplies to all our customers during the report year and our water resources remain secure and are forecast to meet demand in 2007/08.

We have continued with our programme of community and stakeholder engagement on a wide number of issues.

2.2 Drinking Water Service

Compliance - Water quality compliance

Overall water quality compliance

Overall compliance with water quality standards continued to improve in 2007, with 99.81% of all water quality tests conducted in our sampling programme complying with quality standards (2006: 99.76%, 2005: 99.64%)

Compliance at customer's taps (used for calculation of OPA) improved to 99.76%, up from 99.65% in 2006.

Microbiological quality

Microbiological standards apply to water leaving treatment works, in service reservoirs and supplied at customers' taps.

a) water leaving treatment works

During 2007, 32,555 samples were taken for total and faecal coliform analysis. Compliance with total coliforms standards was 99.90% (99.79% in 2006) and with faecal coliform standards was 99.97% (99.93% in 2006).

b) water in service reservoirs

56,315 samples were taken for total and faecal coliform analysis in 2007. Compliance with total coliform standards was 99.77% (99.78% in 2006) and with faecal coliform standards was 99.97% (99.94% in 2006).

c) water at customers' taps

In 2007, 14,554 samples were taken at customers' taps for total coliform analysis and 14,555 samples were taken for faecal coliform analysis (29,109 tests in total). Compliance with the total coliform standards was 99.46% (99.22% in 2006) and for faecal coliform standards was 99.97% (99.94% in 2006).

The following summary table highlights performance in water quality for microbiological quality from 2004 to 2007 based on regulation samples:

Table 3.1: Microbiological quality of water

		2004 fails	2004 compliance	2005 fails	2005 compliance	2006 fails	2006 compliance	2007 fails	2007 compliance
Treatment Works	Coliforms	118	99.66%	130	99.61%	70	99.79%	33	99.90%
	Faecal Coliforms	55	99.84%	57	99.85%	24	99.93%	10	99.97%
Service Reservoirs	Coliforms	327	99.42%	224	99.60%	123	99.78%	128	99.77%
	Faecal Coliforms	73	99.87%	35	99.94%	32	99.94%	16	99.97%
Customer Taps	Coliforms	123	99.12%	138	99.03%	114	99.22%	78	99.46%
	Faecal Coliforms	18	99.87%	21	99.85%	9	99.94%	5	99.97%

Chemical sampling

Physical and chemical standards apply to water supplied at customers' taps. During 2007, 124,400 tests were carried out for these parameters. Of these 99.76% (99.66% in 2006) complied with the regulatory standards.

The following summary table highlights the performance of the key chemical parameters for 2004 to 2007.

Table 3.2: Chemical quality of water

	2004 fails	2004 compliance	2005 fails	2005 compliance	2006 fails	2006 compliance	2007 fails	2007 compliance
THM Total	131	92.58%	101	94.20%	93	94.75%	77	95.57%
Iron	127	97.49%	79	98.52%	70	98.70%	50	99.07%
Colour	165	96.74%	81	98.49%	46	99.15%	28	99.48%
Manganese	62	98.77%	44	99.18%	43	99.20%	45	99.16%
Aluminium	27	99.46%	33	99.38%	28	99.48%	16	99.70%

Abstraction Licensing

The introduction of the Water Environment Water Services (Controlled Activities) Regulations 2007 brings an additional requirement on provision of the water service. Under these regulations our abstraction and impoundment activity is now regulated by Scottish Environment Protection Agency (SEPA). In accordance with our licences we have been submitting monitoring plans for all sites to identify what measurement equipment is required to monitor our compliance against licence conditions. The information in the monitoring plans is used as the basis for installation in the flow monitoring programme, as detailed in our delivery plan.

Water Resource Strategic Studies

We have been progressing with the development of water resource strategic studies to inform our investment programme during the current period. These studies are focused on understanding the limitations that the new standards associated with Water Framework Directive have on our abstraction activity. This work has been progressed in partnership with SEPA and SNH.

In the reporting year we have completed all the strategic studies to the point where both we and SEPA understand which of the 78 water resource zones identified in the technical expression require capital interventions to ensure compliance and which zones can become compliant through the licensing process. As a result of this work 20 zones have been identified as potentially requiring significant investment and these are subject to value management workshops over the coming months. These workshops will confirm the preferred option with all stakeholders.

2.3 Wastewater Service

Compliance - Wastewater Serviceability

Wastewater Treatment

The final WWTW Compliance figures have not yet been finalised & agreed with SEPA. However, we are forecasting 30 Failing WWTW at 31 March 2008 against a target of 39. This is an improvement of 17 in the year, (2006/07 47 failing WWTW). We are continuing to drive WWTW compliance by investing in "not fit for purpose" assets; tackling non compliant trader discharges; and improvements in operating activities.

Bathing Waters

Scotland had 61 bathing waters officially designated under the EU Bathing Water Directive for the 2007 Bathing Season, with 58 bathing waters that can be directly impacted by Scottish Water assets. The bathing water results were significantly poorer this year than they have been for several years and this has been attributed to the wet summer experienced in Scotland in 2007. This was also typical of the UK as a whole in 2007.

During the 2007 Bathing Season, four of the 58 bathing waters that can be impacted by Scottish Water's discharges failed to achieve the minimum mandatory standard. However none of these failures were attributed directly to discharges from Scottish Water assets.

Pollution Incidents

As agreed with SEPA and the Commission, during this report year Scottish Water recorded pollution incidents using definitions that are consistent with those used in England & Wales by the Environment Agency. We have worked closely with SEPA throughout the report year

to agree new and/or improved processes to aid more robust reporting of pollution incidents arising from Scottish Water assets. We have also jointly undertaken close scrutiny of the pollution incident records for the report year such that Scottish Water's 'baseline' performance is more accurately understood and reflected in the data reported. The number of pollution incidents recorded in 2007/08 was 941.

Scottish Water & SEPA have agreed the number of Pollution Incidents for the report year 2007 – 2008. The data in Scottish Water's return reflects this agreement. It is recognised that this number is subject to verification by the Commission and OMG.

There still remains a level of uncertainty with the accuracy of this serviceability indicator and hence we have reported a low confidence grade of C4. Further data collection improvements are being implemented and planned, both internally and in conjunction with SEPA, and we anticipate that we will be able to report an improved confidence grade in next year's return.

Unsatisfactory Intermittent Discharges (UIDs)

During 2007/08 Scottish Water completed the four Strategic UID Technical Studies (Portobello, Glasgow, Meadowhead and Stevenston) and completed several of the Non-Strategic UID catchment studies, the remainder of which will be completed during 2008. The output from the studies completed so far has identified the need for significant changes to the SR06 Technical Expression, both removals and additions, to ensure that the Ministerial Objectives are met. 37 additions and 8 removals have been formally agreed with the Regulators (SEPA/WICS) and acknowledged by the OMGWG via the Change Process. Further required changes will be formally agreed with the Regulators in due course. It is currently anticipated that the SR06 UID programme will comprise some 300 outputs as opposed to the original 277.

Also during 2007/08, Scottish Water has continued with delivery of Q&SIII UID outputs, with a total of 54 number being completed by 31 March 2008. The outputs comprise physical improvement, operational interventions, and those where modelling has confirmed no need for physical intervention.

2.4 Progress on Q&SII and Q&S III Capital Investment Programme

Q&SII OUTPUT DELIVERY

The outputs delivered to date against the WIC18 Ver 3.6 baseline targets¹, are detailed in the table below. Scottish Water delivered outputs for 2007-08 which result in 99% of Q&SII outputs being delivered. 981 projects out of the reported total of 1167 projects within the Quality programmes, or 84%, obtained sign-off from the Quality Regulators by March 2008.

Q&SII PROGRAMME			Delivered Outputs to End March 2008	% To date	WIC18 Target
DW – FT	Properties receiving FT provision of water	nr	408	100%	408
DW – P	Removal of properties from the poor pressure register	nr	1391	100%	1391
DW – WQ	Drinking Water drivers addressed	nr	579	97%	594
WM – R	Mains rehabilitated	km	3051	100%	3051
WW – C	Continuous discharges removed	nr	560	96%	585
WW – FR	Removal of properties from 'at risk' flooding register	nr	829	100%	829
WW – FT	Properties receiving FT provision of sewerage	nr	667	100%	667
WW – R	Sewers rehabilitated	km	409	100%	409
WW – UCISO	UCISO's removed	nr	421	98%	429
			Overall	99%	

The 4 WW_C outputs for Loch Ryan have been removed from the target as no further substitution funding remains, and the project scope is subject to confirmation from the OMG, and delivery in Q&SIIIB. The delivery of the WW_C output at Invergordon is now also forecast beyond March 2010 due to land and planning issues. Campbeltown is being considered by Ministers in relation to licence applications for variations to the existing Kinloch Park WWPS CSO, and the new pumped CSO at Slaty Farlan. The shortfall in flooding outputs that arose from this delay was offset by the acceleration of Q&SIII flooding outputs and the Campbeltown outputs will be delivered in future years as part of the Q&SIII programme.

Slippage into 2010-11 on DW_WQ is reported due to water resource issues at Sheildaig. This project is now being promoted as a transfer into Q&SIIIb. Of the remaining DW-WQ outputs Glenconvinth, Altnahara and Badcaul are scheduled for delivery in 2008/09. Lochinver, Tarbert, and Ullapool are scheduled for delivery in 2009/10. These projects have been delayed by land issues and scope changes to overcome water resource and growth issues.

¹ with adjustments for further changes discussed with the Quality Regulators thereafter

Q&SIII OUTPUT DELIVERY

We outperformed our 2007-08 Delivery Plan target of 33.6% (as revised by OMGWG) of outputs with an out-turn of 46.9%. Early delivery of customer and environmental benefits was achieved across much of the programme (see table below). There were a number of areas where early delivery of the benefits was significant. For example, we delivered 8 outputs against a March 2008 target of 4 for 'the Number of Works where Odour Problem is Addressed'. We delivered early benefits in the 'Number of Backflow Prevention Devices Installed' with 164 being installed against the target of 110. We also completed the programme of work for the flood studies undertaken significantly ahead of plan. This programme was advanced in order to allow Scottish Water to plan ahead for the necessary works identified in these studies.

Q&SIII PROGRAMME			Delivered Outputs to End March 2008	% To 31/3/08	2006-10 Target
Customer Service	Number of works where odour problem is addressed	nr	8	57.1	14
WQ	Improve drinking water quality for 1.5m people (m)	nr	0.84	27.9	3.00m
WQ	Improve disinfection control for 4m people	nr	0.87	19.9	4.31m
WQ	Number of water resource zones with reduced abstraction	nr	21	26.9	78
WQ	Number of water sources provided with flow monitoring and recording	nr	287	55.1	521
WQ	Number of flood studies undertaken	nr	29	100	29
WQ	Number of backflow prevention devices installed	nr	164	69.8	235
WQ	Number of cross connections made redundant	nr	2811	51.1	5200
WQ	Number of sites with increased security	nr	594	58.4	1016
WQ	% of population covered by water safety plans	%	26%	52	50
WWQ	Number of unsatisfactory intermittent discharges improved	nr	54	19.5	300
WWQ	Number of WW treatment works discharges improved to meet new consent requirements	nr	11	37.9	29
WWQ	Number of First Time Provision projects to meet environmental objectives in the Directions (cumulative)	nr	1	10	10
WWQ	Number of WW treatment works upgraded to meet existing consent requirements	nr	6	33.3	18
WWQ	Number of management and monitoring systems at works to meet IPPC Regulations	nr	1	100	1
WWQ	Number of landfill sites contained, monitored and decommissioned	nr	10	58.8	17
Relieving development constraints	Provide strategic capacity at WW treatment works (pe)	nr	21010	49.9	42094
Relieving development constraints	Provide strategic capacity at W treatment works (pe)	nr	29857	17.2	174693
			Overall	46.9%	

At March 2008, we were behind programme with the regulatory output signoff process with 16.9% of outputs signed-off by Regulators.

Progress has been slow for a number of reasons relating to ownership of sign-off; greater levels of detail required by Regulators than in previous regulatory periods; and establishment of a sign-off process for some output categories. We now have all areas of the output process defined and agreements are in place with all stakeholders to ensure that the correct level of detail is submitted with each output claim and whether output sign-off is at project level or batch level. We anticipate significant improvement on output sign-off position during the first half of 2008/09.

Q&SIII and Q&SII Conclusion Programme Financial Profiles

We delivered £625.3m of investment, within the Delivery Plan range of £610m-£650m.

Total forecast expenditure including the Q&SII Conclusion Programme remains within the final determination allowance for the 2006-10 period. The forecast outturn for Q&SIIIa Programme is £2117m including risk reserve.

The current estimate of the Q&SII completion investment is a net £321m based on a programme of £326.8 million (less £5.8 million of contributions from third parties to enable development). The completion includes additional obligations in respect of the DSEAR legislative requirements, enhanced security provision and projects delayed by the substitution process, in addition to completion of the Q&SII programmes.

The current estimate of the Q&SIII completion beyond March 2010 is £102m, but we will endeavour to reduce this through earlier delivery of projects. This total comprises £28m from the Q&S II Programme and the £74m from the Q&SIIIa Programme.

The forecast completion beyond March 2010 is split as follows:

- £26m of investment forecast for strategic UID and water resource projects.
- £31m of investment forecast for projects which deliver their outputs ahead of 31 March 2010, but on which there is residual investment post that date.
- £17m of investment forecast on projects currently forecasting to deliver outputs post 31 March 2010.
- £28.1m of investment forecast for Q&S2 completion of which a significant proportion is for Campbeltown and Dunoon, the result of those projects being held in planning, CPO and consent determination.

3. Expenditure, Financial Performance and Efficiency

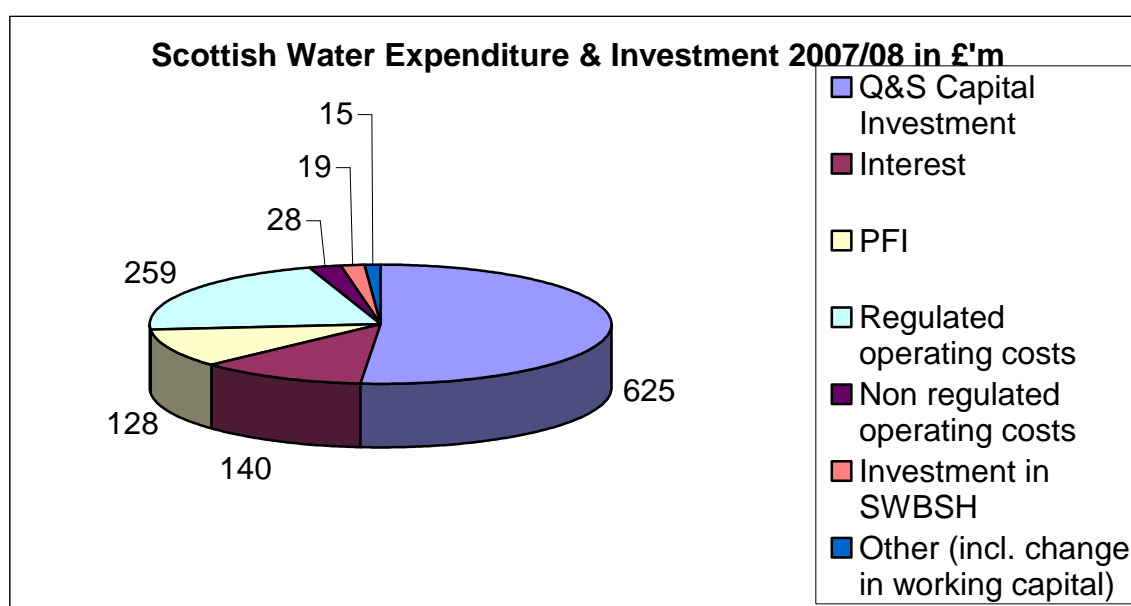
HCA financial results

The table below compares the Historical Cost Accounting results for Scottish Water's activities to March 2008 excluding subsidiaries. The financial results reflect Financial Reporting Standard No 17 "Retirement Benefits" (FRS 17).

£'M HCA	2007/08	2006/07	Variance
Turnover	1,017.4	1,002.9	14.5
Operating Costs	414.4	410.6	-3.8
Depreciation/amortisation	251.4	225.5	-25.9
Gain on Sale of Assets	-9.3	-1.4	7.9
FRS17 Adjustment	3.7	5.6	1.9
Total costs	660.2	640.3	-19.9
Operating Surplus before Interest	357.2	362.6	-5.4
FRS17 Adjustment -Finance adjustment	-5.3	-2.8	2.5
Net Interest	140.3	142.6	2.3
Profit before tax	222.2	222.8	-0.6
Taxation Charge	38.1	68.7	30.6
Profit after tax	184.1	154.1	30.0

For the year ending 31 March 2008 Scottish Water's costs (excluding subsidiaries and FRS 17 costs) totalled £656.5 million. Costs included in tables E1 (£284.2 million), E2 (£246.1million) and E3 (£130.3 million) total £660.6 million. The £4.1 million difference relates to costs charged to Business Stream under Service Agreements. This cost has been netted off against Scottish Water's expenditure in line with group inter-company transaction reporting.

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 £14.5m 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.

Total costs

Total 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 Business Stream.

From a regulatory cost perspective, nominal operating costs (i.e. excluding depreciation, PFI charges, FRS 17 pension charges and costs associated with non regulated activities) increased by £2.5 million to £259.0 million compared to £256.5 million in 2006/07. On a like-for-like basis regulated operating costs increased by £7.3m, a 2.9% nominal increase. The table below summarises this movement:

	2007/08	2006/07	Mvt fav/(adv)
	£m	£m	£m
SW Regulated operating costs	259.0	256.5	-2.5
Less retail non-household costs		-6.7	-6.7
CMA "a typical"	-2.0	-1.5	0.5
Bad debt provision release "a typical"	11.6	6.0	-5.6
Leakage	-8.3	-5.5	2.8
Non household septic tank emptying costs treated as non regulated in 2006/07		0.8	0.8
Additional new opex	-3.4		3.4
Like-for-like costs	256.9	249.6	-7.3

The 2.9% increase in like-for-like operating costs is after absorption of a £4.7 million, or 17% increase in power costs (before new opex), a £2.3m increase in local authority rates and SEPA charges and £5.8 million associated with higher levels of network maintenance.

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 £25.7 million to £250.8 million 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 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 £2,633.3 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 have 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 over 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

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.

Efficiency

We have provided our analysis of our efficiency position within our draft business plan submitted to the Commission on 30 May 2008. We have therefore not replicated this analysis within the Annual Return Overview.

4. Key Supporting Information

Water Resources, Supply and Demand and Security of Supply Index

This year, we have developed our draft Water Resource Plan (WRP) which was issued to SEPA in May 2008 for consultation. The aim of the water resource planning process is to enable us to move towards the optimum balance of supply and demand across Scotland and where investment is required to restore this balance; it is planned and prioritised to meet the needs of customers and the environment. The draft WRP defines our water resource strategy and provides the basis of our water resource investment programme for the SR10 planning period (2010-2014).

This year we have continued to provide unconstrained services with none of the population affected by hosepipe restrictions.

The reporting of our Security of Supply Index (SOSI) is a relatively new requirement for Scottish Water. The SOSI is an indicator of the extent to which a company is able to guarantee provision of its planned level of service. This measure is used in England and Wales (E&W) to assess a company's security of supply to its customers but also to track changes in the service offered to customers over time.

Our SOSI is currently a negative number. The application of the full supply demand balance assessment across Scotland has identified that almost half of our customer base is in zones which would require investment to ensure consistent supply against exceptional circumstances (1 in 40 year drought) and peak demand.

In our 2010 to 2014 Business Plan we are promoting additional prioritised investment (over and above reducing leakage to the economic level) to meet the challenge of securing the long term supplies in selected zones. This will have a resultant positive impact on the SOSI and OPA scores.

5. Competition

Opening the market to retail competition

On 1 April 2008, the non-household market opened to retail competition. Over the year 2007-08, Scottish Water engaged in extensive preparations to support the opening of the market to competition and completed a further phase of business separation between Scottish Water and Business Stream.

Market Opening

Under the arrangements set up to support the competitive framework, Scottish Water sells water and sewerage services to Licensed Providers who in turn retail these services to their customers.

Market arrangements

There is a body of directions, codes and agreements which govern the competitive market arrangements. Scottish Water has worked with the Commission, and increasingly over the year, the Central Market Agency (CMA), to input to the shaping of these arrangements. In the year the Commission made a number of Directions applying to Scottish Water requiring compliance with the new codes.

In the year, Scottish Water signed Wholesale Services Agreements with Business Stream, Aquavitae and Satec.

The Central Market Agency (CMA) was established to administer the market. It is a company limited by guarantee and Scottish Water is a founding member with a seat on the Board. Scottish Water nominated its Commercial Director, Chris Banks, to the Board of the CMA. The CMA is responsible for administering customer switching between Licensed Providers and for calculating the amount due to Scottish Water from Licensed Providers. The CMA also provides support for the Technical Panel, the body responsible for considering and agreeing changes to the Market and Operational Codes. Scottish Water is a member of the Technical Panel.

Preparations in Scottish Water

The competitive market is supported by a set of business processes and data flows which operate between the various parties. In the year Scottish Water has developed the internal processes to allow it to comply with these activities, along with the necessary systems developments. At the same time, Scottish Water completed the major and most complex part of systems separation from Business Stream.

As part of the preparations for market opening, Scottish Water completed an extensive Market Readiness Assurance audit, conducted by the Gemserv assurance team for the Commission. This included a review of all Scottish Water's plans, specifications, process descriptions, systems requirements and test results to support compliance with the Market Code as well as testing between Scottish Water, Business Stream and the CMA.

In addition to the systems development activity, there was a data migration from Business Stream to the CMA and to Scottish Water. This data was required to support the market and enable systems separation. The data migration was undertaken in mid February to support systems go-live in advance of market opening.

There has been an extensive awareness and training programme involving staff in both front line operational roles as well as other areas of the business. The competitive market demands new behaviours as well as compliance with the range of specific requirements set out in the Codes and Agreements.

Business Separation between Business Stream and Scottish Water

Management and operational separation is a key aspect of regulatory policy, to demonstrate a level playing field. The regulatory requirement is set out in a number of Directions. In the year 2007-08 the Commission made a new Direction on Scottish Water bringing into effect the Governance Code. The latter provides for the establishment of Scottish Water Business Stream Holdings Ltd (SWBSH), and regulates financial policy and governance arrangements between Scottish Water, SWBSH and Business Stream. The Governance Code also addresses the conduct of meetings held between Scottish Water, SWBSH and Business Stream

Scottish Water's Plan for Separation was reviewed by the Commission and is reported upon to the Board. The plan included the transfer of people and assets; service agreements for the provision of certain defined intra-group services; operational and managerial separation; systems separation; and a compliance regime to support compliance with the requirements of separation.

6. Further information

Board Changes

During the report year Jon Hargreaves, Chief Executive Officer, retired in November 2007 and Douglas Millican, Finance and Regulation Director, fulfilled the role of Interim Chief Executive between November 2007 and March 2008.

The Board appointed Richard Ackroyd as the new Chief Executive Officer and he took up his role on 25 March 2008.

Paul Jowitt left the Board of Scottish Water on 31 March 2008 at the end of his appointment.

Alistair Buchanan and Donald Emslie joined the Board on 1 April 2008.

Asset Revaluation

For the first time, our Annual Return includes a Modern Equivalent Asset Valuation (MEAV) of our entire asset stock. For previous years, we valued our assets with their Equivalent Asset Replacement Cost (EARC).

In previous years, because we had no suitable alternative methodology, we presented Equivalent Asset Replacement Costs (EARC) in our Annual Return to the Commission. The EARC was derived as a single cost of each function (e.g. the total cost of a water treatment works, or of a sewage pumping station) based on the technology that was present on site. We took no account of whether modern design would have provided different components, nor did we seek a cost for any component of the works.

For the MEAV this year we are completing the same tables, but in general we have derived a value for each unit (component) at each works, rather than a single cost for the whole works. We have also taken into account modern design techniques and derived the value of the modern equivalent of an asset to perform the same function.

Comparison of gross valuations for 2006/07 and 2007/08

Line ref.	Asset type	2006/07		2007/08		Change in gross value 06/07 - 07/08	
		Gross value £m	Gross value £m less redundant and decommissioned	Gross value £m	% of gross value	£m	%
H1.1	Water treatment works	2,349.01	1,870.85	1,870.39	5.2%	-0.46	0%
H1.2	Water storage	985.16	754.06	938.67	2.6%	184.62	24%
H1.3	Water pumping stations	219.51	171.47	219.85	0.6%	48.37	28%
H1.4	Water resources	4,697.54	3,520.71	2,476.23	6.8%	-1,044.49	-30%
H1.5	Water mains	8,129.03	8,129.03	9,080.16	25.1%	951.14	12%
H1.6	Sewers	11,323.80	11,323.80	18,017.55	49.7%	6,693.75	59%
H1.7	Sewer structures	538.77	538.77	363.19	1.0%	-175.59	-33%
H1.8	Sea outfalls	398.29	398.29	311.85	0.9%	-86.44	-22%
H1.9	Sewage pumping stations	295.07	289.35	730.34	2.0%	440.99	152%
H1.10	Sewage treatment works	1,175.43	1,031.55	1,992.68	5.5%	961.13	93%
H1.11	Sludge treatment facilities	159.21	125.99	61.19	0.2%	-64.79	-51%
H1.12	Support services	191.79	188.54	183.93	0.5%	-4.61	-2%
	Total	30,462.60	28,342.41	36,246.02	100.0%	7,903.62	28%

The Gross Valuation in 2006/7 was reported at £30.5 billion. This included valuations for our decommissioned and redundant assets. In this year's report we have excluded these assets from our valuations and only valued operational assets.

Our reported valuation this year is £36.2 billion, a rise of 28% from the valuation last year excluding the decommissioned and redundant assets. The primary reason for the movements in the valuations of all the asset types is due to the change in the valuation methodology from EARC to MEAV.

During 2007, we undertook a major project to derive a MEAV methodology that would be suitable for Scottish Water and the Commission. We engaged consultants experienced in similar valuations for English water companies to advise us.

The approach to applying the MEAV methodology differs for infrastructure and non infrastructure assets. Infrastructure assets account for 83% of the total Gross MEAV. With the exception of dams and reservoirs, raw water intakes, outfalls, communication pipes and water meters, we have valued all infra-structure assets using per km rates differentiated by diameter, surface type, and infrastructure type (mains, sewer and rising mains).

Non-infrastructure assets account for 17% of the final MEAV. We have valued the majority of non-infrastructure assets by assessing the replacement asset at unit level (i.e. each component) and building up the value of the site based on the sum of the components.

The primary source of the asset data used has been Scottish Water's asset inventory systems, primarily Ellipse and GIS. This has been supplemented by gap filling procedures where additional data is required. For example, if the capacity of each of the six individual filters on a works is not known, we infer the capacity of each filter to be one sixth of the works' capacity.

Summary of Gross MEAV

Scottish Water's reported gross asset valuation is £36.2billion, as set out below.

	Gross MEAV (£m)	%
Water Infrastructure	£11,556.4	31.9%
Water Non – Infrastructure	£3,028.9	8.4%
Wastewater Infrastructure	£18,692.6	51.6%
Wastewater Non-Infrastructure	£2,784.2	7.7%
Support Services	£183.9	0.5%
Total	£36,246.0	100.0%

Summary of Net MEAV (non-infrastructure assets)

		Gross MEAV (£m)	Net MEAV (£m)	%
B1.3	Water treatment works [101]	£1,870.4	£1,079.2	33.3%
B1.4	Water storage [102]	£938.7	£499.5	15.4%
B1.5	Water pumping stations [103]	£219.9	£110.3	3.4%
B1.9	Sewage pumping stations [109]	£730.3	£399.7	12.3%
B1.10	Sewage treatment works [110]	£1,992.7	£1,010.4	31.1%
B1.11	Sludge treatment facilities by disposal type [111]	£61.2	£40.1	1.2%
B1.12	Support services [112]	£183.9	£105.7	3.3%
	Total	£5,997.1	£3,244.9	

The total net depreciated value of Scottish Water's non-infrastructure asset inventory (including support services depreciable assets) is £3.24 billion. The total Gross value for these assets is almost £6 billion, which is around 17% of the total Gross valuation.

Information improvements

We have continued to build on the foundations we laid in 2006/07 improving the completeness, availability, reliability, access to and reporting of information. This has enabled us progressively to improve the confidence grades we report to the Commission, with an 8% increase in confidence grades greater than B2. In addition we have implemented or are in the process of implementing recommendations made by the Reporter to improve data further. We have seen improvements in confidence grades for distribution input, internal sewer flooding and GMS measures. There has also been a general improvement in data associated with G tables.

Climate Change

The water industry is clearly in the front line of climate change – we are a large energy user and depend on a good quality water environment to deliver services. During 2007-8 Scottish Water developed a strategy and actions to both understand the impacts presented and to begin taking action on behalf of customers. We have also been involved in developing industry tools for carbon management and climate adaptation.

With a clear focus on service, cost and quality our strategy is to proactively address the risks and responsibilities of climate change on behalf of our customers. We will:

- *ADAPT to climate change*: understand the impacts and service risks, and secure long term service and compliance from our assets
- *MITIGATE the causes of climate change*: contribute appropriately to a reduction in our carbon emissions in line with Scotland's greenhouse gas targets.

We will work to minimise our carbon emissions by adopting a clear hierarchy of mitigation measures of reducing energy demand, maximising energy efficiency and maximising self generation from renewable resources. Currently we generate around 5% of our electricity demand from renewable sources within our asset base (predominantly hydro power) and we are considering opportunities to double this.

Adaptation and mitigation are long term issues and these strategic approaches are being built into investment and operational planning across Scottish Water.

Scottish Water's Carbon Footprint

2007 saw the completion of our first Greenhouse Gas Emissions footprint covering all the major greenhouse gases (CO₂, CH₄, N₂O). We will repeat this exercise annually while building improved systems for the active management of carbon in our operational practices. Scottish Water's 2006-7 Greenhouse Gas Emissions Footprint was 469,000 tonnes of CO₂ equivalents.

Currently, Scottish Water is on a rising emissions trend. Between 2002 and 2010 we will have invested around £4bn in new assets and infrastructure to meet enhanced quality targets and to improve service. Meeting new quality standards often means a step change in treatment intensity with attendant increases in energy demand. Scottish Water is committed to working with government and with regulators to halt this rising trajectory and ensure we contribute towards Scotland's greenhouse gas emissions targets.

Scottish Water Horizons

In line with the recommendations arising from the review of transfer pricing in the Scottish water industry, carried out in 2006/07, we transferred, on 1 April 2008, our principal non-core

activities into a separate holding company, Scottish Water Horizons Holdings Ltd (Horizons Holdings), which in turn transferred then into a non-core operating subsidiary, Scottish Water Horizons Ltd.

Looking forward

2010 - 2014

We submitted our first draft regulatory business plan for 2010-14 on 30 May 2008. We have agreed the technical expression for Q&SIIIb with the quality regulators and the Scottish Government.

Sustainable Procurement

We are well advanced with the development of our capital delivery model for the 2010 - 2014 investment period. The delivery model for the 2010 - 14 period will be a combination of integrated in-house delivery capability for areas of the programme that are not well defined (e.g. infrastructure, capital maintenance and strategic studies); and a Joint Venture partnering model to deliver the programme where outputs are well defined for quality enhancement and capital maintenance. The delivery model will be underpinned by the establishment of frameworks covering construction delivery partners, consultancy service providers and kit and plant.

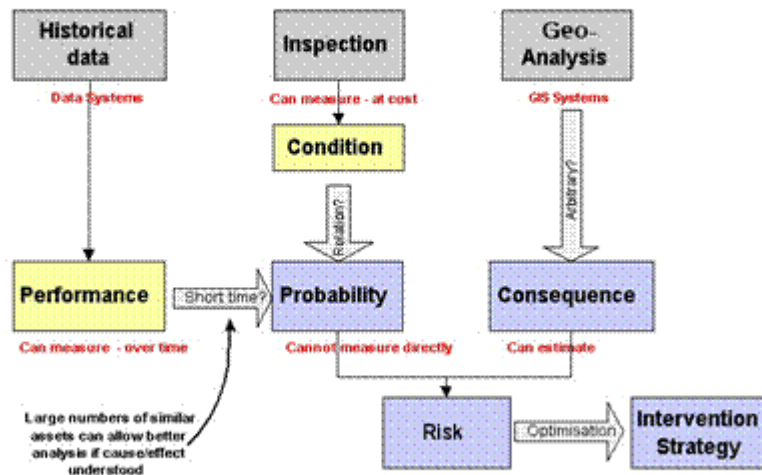
Risk Based Approach to Capital Maintenance

We are continuing to develop our capability in risk based capital maintenance planning and decision making.

We have implemented the Scottish Water Investment Support System (SWISS), a tool for investment optimisation based primarily on risks to service.

We are implementing a predictive model of the water network across Scotland. This tool will allow the future deterioration of assets to be modelled along with the consequential impact on customers. The work will be used to assist in identifying cost effective investment in network assets to meet serviceability targets for the 2010-14 period and beyond.

The approach draws on the common framework for capital maintenance, as shown in the diagram below, and seeks to determine the likelihood of failure and consequence of failure associated with network assets. The tool is being developed for use on the water and wastewater systems and will allow predictive network planning to be examined and appraised for the first time at an asset level. This work will also identify key data sets which require to be improved further to enable confidence in the model's predictions to be increased.



Governance

The methodologies and processes used for producing the detailed information in Scottish Water's 2007/08 Annual Return to the Water Industry Commission have been further enhanced this year to ensure robust reporting of data and to show data sources, calculations, assumptions and dependencies. This approach, along with the formal audits carried out by the Regulatory Reporter has ensured that this submission is based on sound processes. The governance of the production of this Return has increased this year with the Audit Committee reviewing the governance process and seeking assurance from the Executive Directors. The Reporter has attended the Audit Committee to outline his view of the effectiveness of the 2007/08 Annual return process.

Scottish Water's Board has endorsed the Annual Return Overview and charged the Chief Executive, with the responsibility to establish and maintain sound systems of internal control that support the completion of the Annual Return submission to the Water Industry Commission. The Board assurance statement signed by the Chief Executive is included in Appendix 1.

Annual Return 2007/08 ASSURANCE STATEMENT

Background

The Board is required to confirm that it has endorsed the Overview to the Annual Return.

The Board has charged the Chief Executive, with the responsibility to establish and maintain sound systems of internal control that support the completion of the Annual Return submission to the Water Industry Commission.

The systems of internal control that support completion of the Annual Return are designed to ensure:

- The accuracy and consistency of reporting
- That soundly based assumptions and judgements are used
- Audit trails are maintained for origination and approval of all data in the Annual return
- The identification, understanding and reporting on material data exceptions
- The reliability of information for decision making and for performance assessment.
- Compliance with applicable regulatory and legislative reporting requirements.

The systems of control are designed to reduce the risk of material error and to provide effective assurance on the completion of the Annual return.

Process

The Board gains assurance as to the effectiveness of internal control through:

- the controls and assurance process put in place by the Executive Directors to ensure that the Annual Return is consistent with the requirements of regulatory reporting;
- a signed assurance statement from the Chief Executive concerning the operation of the systems of internal control;
- reporting from Executive Directors on associated matters;
- the results of both internal and external audit, and other internal and external review agencies;
- the adequacy of management response to issues identified by audit and review activity; assurances relating to the corporate governance requirements for the organisation; and
- the operation of anti-fraud policies, whistle-blowing processes, and arrangements for special investigations.

Outcomes

Based on the Board's knowledge of the effectiveness of the systems of internal control that support the completion of the Annual Return, the Board has endorsed the overview to the Annual Return. The Board has been assured that the assumptions, judgements and confidence grades used are appropriate, reasonable and consistent with the requirements of regulatory reporting.

SIGNED 
(on behalf of the Board of Scottish Water)

CHIEF EXECUTIVE OFFICER

Date 3/6/08