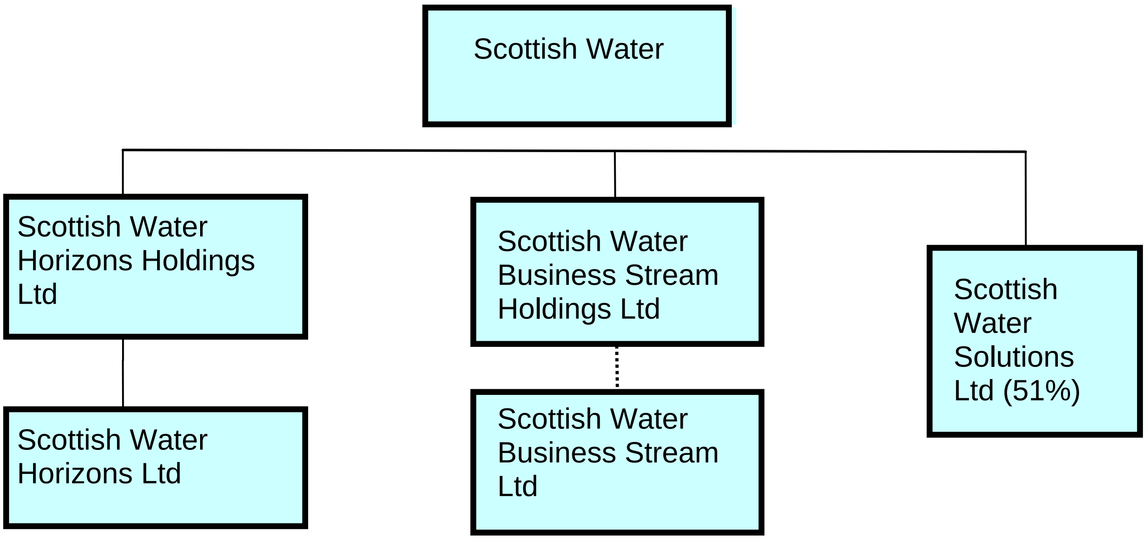
Financial and Business Review

Group Overview

Our vision is to become Scotland's most valued and trusted business, one we can all be proud of. Consequently, the overarching strategy for the Scottish Water group of businesses is to provide levels of service and value for money which exceed the expectations of customers, regulators and the Scottish Government whilst ensuring our financial strength in the regulated and non-regulated parts of the Scottish Water group.

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 non regulated 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.

The following table summarises turnover, surplus before tax, net assets and net debt, as at 31 March 2010, for the Scottish Water group of businesses.

Group Financial Summary as at 31 March 2010

	Scottish Water £m	Business Stream group £m	Horizons £m	Inter company £m	Total £m
Turnover	**1,070.9**	**356.3**	**17.2**	**-320.3**	**1,124.1**
Surplus before tax	**130.5**	**16.8**	**0.5**	**-2.5**	**145.3**
Net assets	**3,671.6**	**125.9**	**5.4**	**-50.4**	**3,752.5**
Net debt/(cash)	**2,859.8**	**-0.9**	**-5.6**		**2,853.3**

* Inter-company adjustments relate to the elimination of intercompany turnover and profit between Scottish Water and Business Stream.

Consolidated turnover in the year increased by 2.7% to £1,124.1 million (2009: £1,094.6 million). The benefit of this was offset by increased depreciation and infrastructure maintenance charges of £61.7 million, increased finance costs of £20.2 million, predominantly associated with lower returns on pension scheme assets, resulting in a surplus before tax for the year to 31 March 2010 of £145.3 million (2009: £203.8 million).

In the year consolidated net debt increased by £75.5 million to £2,853.3 million (2009: £2,777.8 million). The increase in net debt was driven by a £218.8 million increase in borrowings from the Scottish Government and a £143.3 million increase in cash balances.

Individual business performance is reviewed below.

Taxation

The consolidated tax charge on the income statement was £37.7 million, (2009: £76.8 million). The effective rate was 25.9%, (2009: 37.7%) in respect of deferred taxation. The effective rate in the year was favourably impacted by prior year adjustments associated with increased capital allowances claimed on work-in-progress reflected in the 2008/09 tax computation. The effective rate for 2009 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.

Borrowing Limit

Scottish Ministers set Scottish Water's (consolidated) maximum net new borrowing limit at £218.8 million for 2009/10. Actual net new borrowings in 2009/10 were £218.8 million.

Scottish Water

Financial Framework

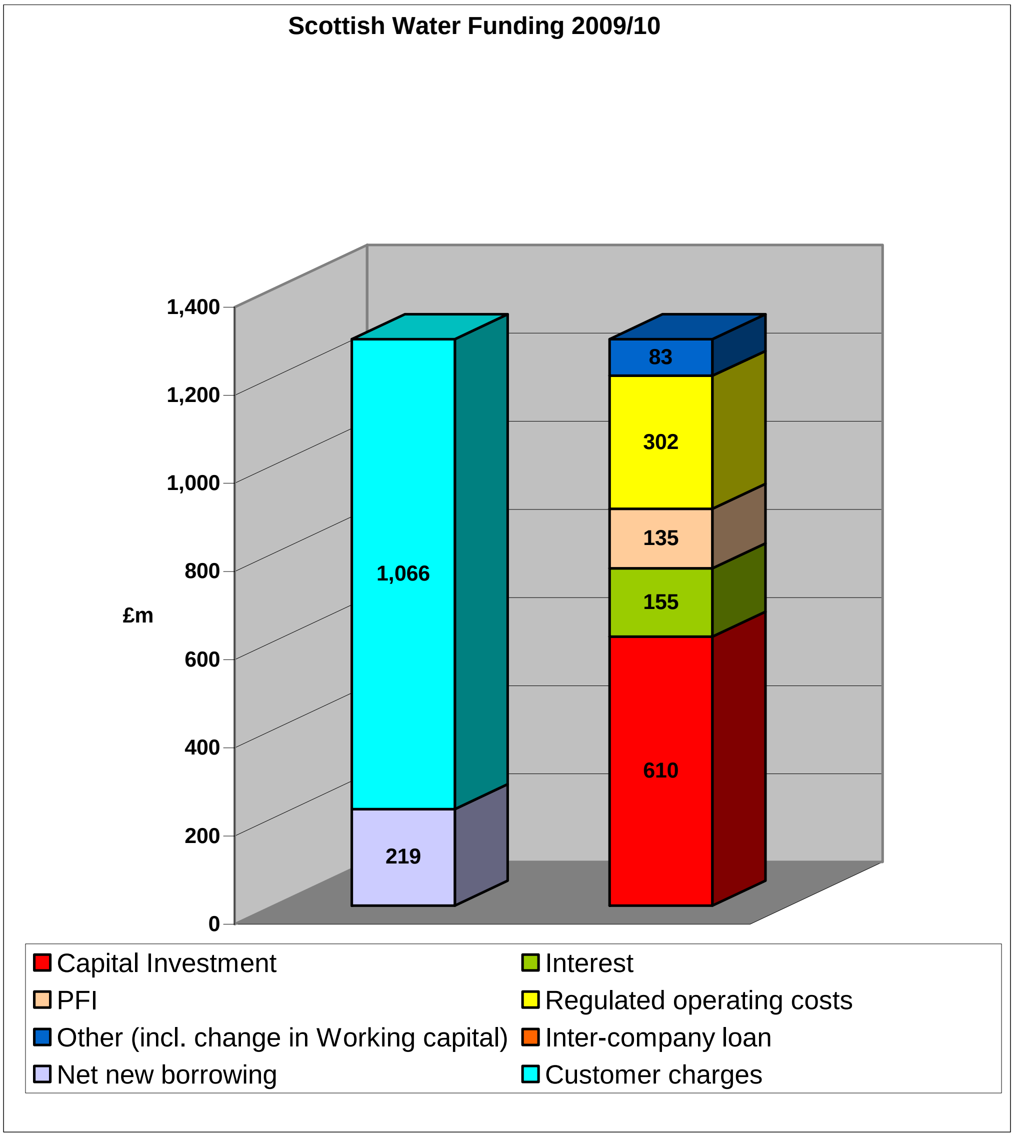
Scottish Water is subject to incentive-based regulation by the Water Industry Commission for Scotland (the Commission).

The Commission carries out five 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.

- Financial Performance

The surplus before tax in the year for Scottish Water was £130.5 million (2009: £190.1 million), exceeding our regulatory target by £12.1 million. The surplus for non regulated activities was £0.5 million lower at £0.3 million. 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 revenue

Regulated revenue for the year totalled £1,066.2 million (2009: £1,029.7 million) and is analysed by category in the table below:

	2009/10	2008/09	Change
	£m	£m	£m
Household	737.4	704.7	32.7
Wholesale	324.6	319.9	4.7
Other	4.2	5.1	-0.9
Total regulated revenue	**1066.2**	**1029.7**	**36.5**

Revenue from services supplied to household customers increased by £32.7 million or 4.6% to £737.4 million driven mainly by the tariff increase effective from 1 April 2009. Revenue from wholesale services supplied to Licensed Providers increased by £4.7 million or 1.5% to £324.6 million. Revenue from other sales reduced by £0.9 million to £4.2 million.

- Operating costs
Total operating costs increased by £76.4 million to £741.3m (2009: £664.9 million).

Regulated operating costs of £301.9 million (2009: £290.2 million) were 4.0% or £11.7 million higher than in 2008/09. Like-for-like costs actually reduced £10.1 million or 4.7%, but £21.8 million of specific additional costs were incurred namely: £3.1 million for costs associated with the extreme winter weather; £6.9 million associated with restructuring the business; £3.2 million of additional bad debt charges; £5.7 million for power price increases reflecting market conditions; and increased local authority rates charges of £1.3 million.

The operating cost of the PFI schemes in the year, including associated depreciation and amortisation charges, was £110.9 million, £2.0 million higher than in 2008/09.

Depreciation and infrastructure maintenance costs increased by £61.7 million to £326.9 million (2009: £265.2 million). £28.0 million of the increase reflected the higher level of infrastructure maintenance costs, associated with the level of long term forecast infrastructure investment, with the remainder of the increase reflecting a 20 % (£33.7 million) increase in depreciation charges associated with non-infrastructure assets as a consequence of the capital investment programme.

- Capital Investment
Reported capital investment under IFRS for Scottish Water in the year was £443.5 million (2009: £646.9 million). However capital investment, as measured on a regulatory accounting basis, was £648.3 million (2009: £714.3 million). The table below reconciles investment as stated in the statutory accounts with investment on a regulated accounting basis.

Reconciliation of capital additions	**2009/10 £m**	**2008/09 £m**
Company capital additions per note 9 to the financial statements	**443.5**	**646.9**
Add back base infrastructure maintenance included in operating costs under IAS 16	166.0	53.6
Add investment financed by infrastructure charges income & contributions	43.6	13.8
Deduct PFI capital additions	-4.8	-
Gross capital additions on a regulatory accounting basis	**648.3**	**714.3**

- Finance costs
As at 31 March 2010, the weighted average interest cost of the £3,013.3 million outstanding debt was 5.2% (2009: 5.5%). Net interest payable during the year was £155.3 million, £5.8 million higher than in 2008/09.

Finance costs associated with finance lease liabilities on PFI assets and the expected return on pension scheme assets less interest on pension scheme liabilities, increased by £13.9 million to £43.8 million (2009: £29.9 million) reflecting lower than expected returns on pension scheme assets caused by the deterioration of asset values between 2008 to 2009.

During the year, net debt increased by £81.2 million to £2,859.8 million (being loans of £3,013.3 million less cash balances of £153.5 million). The increase was driven by a £218.8 million increase in borrowing from the Scottish Government and a £137.6 million increase in cash balances.

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. 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 IAS 19, *Employee 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 2010, after taking account of deferred taxation, there was a shortfall of assets over respective liabilities of £333.2 million (2009: £160.9 million). This was an increase in the net pension liability of £172.3 million from 31 March 2009. This reflected the higher present value of scheme liabilities driven by the lower discount rate of 5.5% (2009: 6.5%) causing £421.2 million of the £467.8 million increase in the gross liability. This was partially offset by an actual return on pension scheme assets of £227.4 million (2009: £151.6 million loss).

Members' report

For the year ended 31 March 2010

The Members present their annual report together with the audited financial statements for the year ended 31 March 2010.

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.

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. Business Stream is operationally independent of Scottish Water, as required under the Governance Code agreed with the Water Industry Commission for Scotland. Its Board has two independent non-executive directors who have no other association with the Scottish Water group.

Scottish Water Horizons Ltd (SWH) is a commercial business enterprise which provides waste management, contracting and other business services.

A review of the business and future developments for Scottish Water are presented in the Chair's Statement on page 2 and in the Financial and Business Review on pages 16 to 21.

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 22 to 23.

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 £107.6 million. Details of the financial results and associated accounting policies are set out on pages 36 to 74.

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 contributions were made during the year. There was one charitable donation in respect of the year because the Chief Executive, Mr Ackroyd, elected to waive 25%

(£21,125) of his annual out-performance incentive plan and requested that the waived element be donated by Scottish Water to the charity Water Aid, 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 3,703 staff during the year. Details of the costs incurred in relation to these staff can be found in note 5 to the financial statements on page 45. 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 2010, the amount owed to trade creditors was equivalent to 32 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 Donald Emslie Chair
Mr Pat Kelly
Mr Alan Bryce

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 four meetings of the Committee in 2009/10. At each meeting a quorum of independent, Non-executive Members was present.

2. General Remuneration Policy

Scottish Water’s Vision is to become **Scotland’s most valued and trusted business, one we can all be proud of**. Scottish Water will build on its past success seeking to provide levels of service and value for money which exceed the expectation of its customers, regulators and the Scottish Government.

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 retain 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 individual performance and the work an employee does, what is paid in comparable 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 both comparator organisations and 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 Out-performance Incentive Plan (AOIP)
- 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 provides the opportunity for extra discretionary pay to be earned for out-performance of demanding targets.

d. Performance Conditions for Annual Incentives and Awards Made – 2009/10

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. The targets and actual performance in 2009/10 for each measure are set out below.

Measure	Delivery Plan target	Out-performance target	Actual performance
– Profit before Tax excluding depreciation in comparison with the Final Determination targets as reflected in the 2009 Delivery Plan Update	£463.4m	£478.4m	£475.5m
– Out-performing the Final Determination OPA target of 241	241	271	291
– Investment - outputs delivered - Q&S2/3a investment completion costs post 31 March 2010 (excluding the UID and water resources programmes)	85% £121.4	110% £108.5m	86.5% £129.4m
– Leakage (mega-litres per day)	750Mld	710Mld	704Mld

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%	24%
– OPA score	40%	40%
– Investment out-turn	15%	1%
– Leakage	15%	15%

The potential maximum annual incentive attainable for out-performance by the Executive Members is 40% of base salary and is non-pensionable. Overall AOIP awards in 2009/10 were 32% 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 for the 2006-10 period. 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, during the four years to March 2010, for ultimately vesting if earned by eligible

Executive Members. Any LTIP payment will only be funded from financial out-performance after payment of any incentive awards to staff.

Confirmation of awards under the LTIP will be completed by December 2010 following independent review of performance in the 2006-10 period by external auditors and our regulators.

4. Service Contracts

Details of Executive Members' contracts are set out below.

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

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 Chairs of the Audit and Remuneration Committees, David Gray and Donald Emslie respectively, who work five days per month and the Chair, Ronnie Mercer, who works 2.5 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:

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

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 Scottish Water Governance Directions 2009 by Scottish Ministers, are set out below for the year.

	Salary /Fees £'000	AOIP £'000	Benefits £'000	Total 2009/10 £'000	Total 2008/09 £'000
Executive Members					
Richard Ackroyd (i)	263	63	10	336	373
Geoff Aitkenhead	172	55	9	236	237
Chris Banks	159	51	13	223	223
Peter Farrer (ii)	155	49	10	214	118
Douglas Millican	173	55	9	237	241
Non – executive Members					
Ronnie Mercer (Chair)	90	-	9	99	99
Alan Bryce	20	-	-	20	-
Alistair Buchanan (iii)	2	-	-	2	20
Donald Emslie	25	-	-	25	20
David Gray	25	-	-	25	20
Pat Kelly	20	-	-	20	20
Lynne Peacock (iv)	18	-	-	18	-
James Spowart	20	-	-	20	-
Andrew Wylie	20	-	-	20	-
Total Members' remuneration	**1,162**	**273**	**60**	**1,495**	**1,371**
Former Members					
Graeme Crombie (v)					20
Ian McMillan (v)					20
Rita Theil (v)					20
Total	**1,162**	**273**	**60**	**1,495**	**1,431**

(i) Richard Ackroyd was entitled to a payment of £84,502 under the 2009/10 AOIP. Mr Ackroyd elected to waive 25% (£21,125) of his AOIP entitlement and requested that the waived element is donated to the charity Water Aid by Scottish Water. Mr Ackroyd has therefore restricted his AOIP award to £63,377.

(ii) The total for 2008/09 was from the date of appointment to the Board on 13 October 2008.

(iii) Resigned on 19 April 2009.

(iv) From date of appointment to the Board on 6 May 2009.

(v) Term of office expired on 31 March 2009.

(vi) A car or car allowance is provided to all Executive Members and the Chair for business needs. The associated annual benefit is included in the benefits section of the table above. For members opting out of the company car scheme, the car allowance can be paid monthly or as a lump sum payment of up to 36 months allowance.

(vii) During the year Messrs Banks and Millican opted for the lump sum option to enable the purchase of a car for business use and each received the sum of £28,512.

(viii) The benefits section also includes the value of any sale of annual leave by Executive Members.

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

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 (2009: £92,050) to his pension arrangements during the year.

	Increase in accrued benefits during the year net of inflation			**Accumulated total accrued benefits at 31 March 2010**		**Transfer Values (note 5)**		
	Years in Scheme	**Pension £'000**	**Lump sum £'000**	**Pension (note 4) £'000**	**Lump sum (note 4) £'000**	**At 31 March 2010 £'000**	**At 31 March 2009 £'000**	**Increase in 2009/10 net of Members' own contributions and inflation £'000**
Geoff Aitkenhead	31.4	5	6	68	196	1,529	1,363	147
Chris Banks	15.7	3	3	32	88	615	521	76
Peter Farrer	25.7	10	21	50	143	907	694	195
Douglas Millican	15.1	3	1	33	91	545	470	56

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.

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

Mr Donald Emslie,
Chair of the Remuneration Committee
2 June 2010.

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 auditors' 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 2010 under the Water Industry (Scotland) Act 2002. These comprise the Consolidated Income Statement, the Consolidated Statement of Comprehensive Income, the Consolidated and Company Statements of Changes in Equity, the Group and Company Balance Sheets, the Group and Company Statements of Cash Flow 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 auditors
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 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. An 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.

Opinions

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 2010 and of its surplus, changes in equity 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
2 June 2010