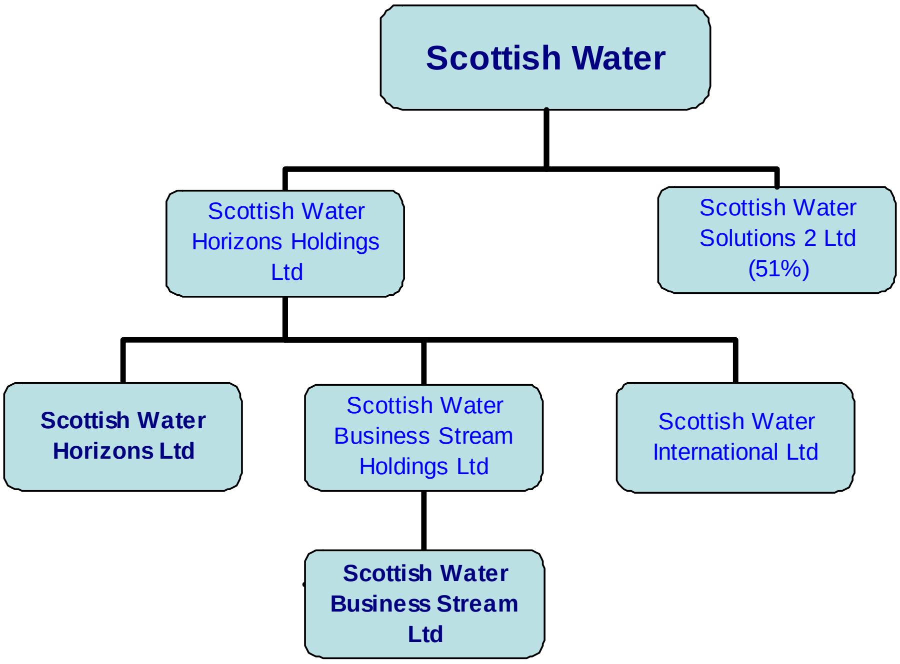
Financial and business review

Group overview
Our vision is to become Scotland's most valued and trusted business, one that 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 while ensuring our financial strength across all 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, which 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) which 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 group surplus before tax for the year to 31 March 2013 was £95.1 million (2012: £107.0 million). Consolidated revenue in the year increased by £13.5 million to £1,145.7 million (2012: £1,132.2 million). This benefit was offset by a £28.1 million increase in costs to £866.0 million (2012: £837.9 million). Net finance costs of £184.6 million were £2.7 million lower than in 2012.

Individual business performance is reviewed below.

In the year, consolidated net debt increased by £39.6 million to £2,912.2 million (2012: £2,872.6 million). The increase was driven by additional borrowing from the Scottish Government of £100.0 million, partially offset by a £60.4 million increase in cash balances to £415.6 million. The movement in cash is summarised below:

Cash movement

	Scottish Water £m	Business Stream group £m	Horizons &SW International group £m	Total £m
Opening balance at 1 April 2012	**241.0**	**110.4**	**3.8**	**355.2**
New loan from the Scottish Government	100.0	-	-	100.0
Cash generated / (utilised)	(95.5)	48.0	7.9	(39.6)
Closing cash balance as at 31 March 2013	**245.5**	**158.4**	**11.7**	**415.6**

Cash balances within the Business Stream group of companies increased by £48.0 million over the year to £158.4 million, reflecting around £35 million of additional monies received from advance payments by customers.

Since the year end, a total of £245 million of short-term borrowing has been repaid, being £217 million by Scottish Water and £28 million by Scottish Water Business Stream Holdings Ltd (SWBSH). In addition, SWBSH is due to repay its remaining loan of £30.5 million to the Scottish Government during 2013.

Taxation

The consolidated tax charge on the income statement was £5.9 million (2012: £8.5 million). During the year, as a result of the change in the UK corporation tax rate from 24% to 23% that was effective from April 2013, deferred tax balances have been re-measured. Consequently, the effective rate for the year was 6.2% (2012: 7.9%).

Borrowing limit

Scottish Ministers set Scottish Water's (consolidated) maximum net new borrowing limit at £100.0 million for 2012/13. Actual net new borrowings in 2012/13 were £100.0 million.

Scottish Water

Financial framework

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

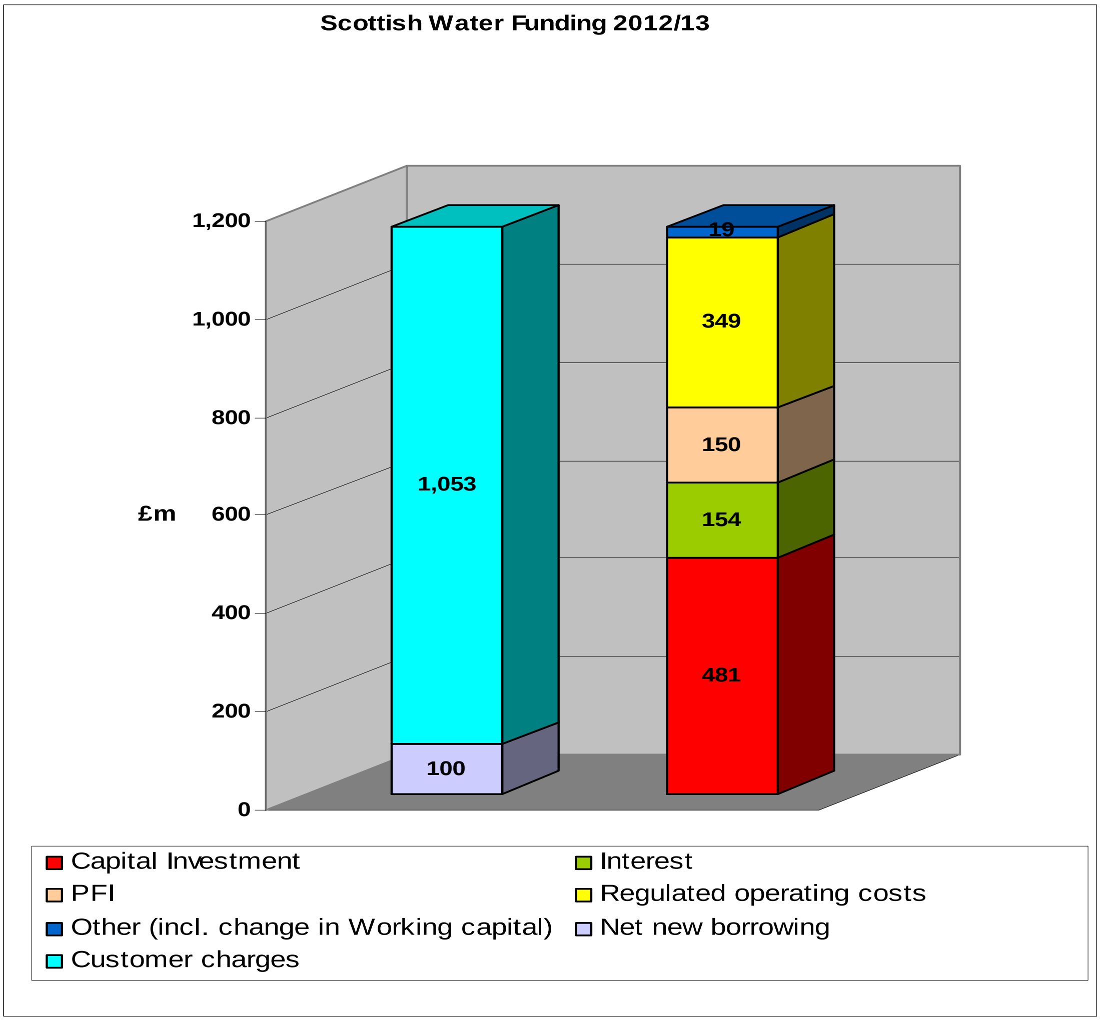
In 2009, the Commission carried out a five year price review for the 2010-15 period, which caps the prices that Scottish Water charge for water and waste water services. The combination of regulated price caps and firm constraints on borrowing from the Scottish Government creates a clearly defined limit 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 £10.4 million lower at £63.6 million (2012: £74.0 million), reflecting the £40 million benefit to household customers of freezing household charges at a time when applicable inflation (as measured by the Retail Price

Index) was 5.4%. 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 £1,053.0 million (2012: £1,045.8 million) and is analysed by category in the table below:

Regulated reveune

	2012/13 £m	2011/12 £m	Change £m
Household	750.9	745.6	5.3
Wholesale	296.7	294.7	2.0
Other	5.4	5.5	(0.1)
Total regulated revenue	**1,053.0**	**1,045.8**	**7.2**

Revenue from services supplied to household customers increased by only £5.3 million to £750.9 million reflecting the increase in connected properties and the tariff freeze effective from 1 April 2012. Revenue from wholesale services supplied to Licensed Providers increased by £2.0 million or 0.7% to £296.7 million. Revenue from other sales decreased by £0.1 million to £5.4 million.

Operating costs
Total operating costs increased by £20.6 million to £807.6 million (2012: £787.0 million).

Although headline regulated operating costs of £349.3 million (2012: £340.2 million) were 2.7% or £9.1 million higher than in 2011/12, this increase was due primarily to higher charges for bad debt provisioning and local authority rates costs. However, after adjusting for these specific cost increases and the impact of inflation, like-for-like costs reduced in real terms by £1.3 million or 0.6%.

The operating cost of the PFI schemes in the year, including associated depreciation and amortisation charges, was £126.8 million, £3.4 million higher than in 2011/12 mainly because of inflation.

Depreciation and infrastructure maintenance costs decreased by £4.1 million to £329.6 million (2012: £333.7 million). Infrastructure maintenance costs were £4.7 million lower than last year, which reflects the phasing of the planned maintenance investment programme for infrastructure assets across the 2010-15 regulatory period. Non-infrastructure depreciation increased by £2.0 million as a consequence of the capital investment programme and the gain on asset sales was £1.4 million higher than in 2011/12.

Capital investment
Reported capital investment under IFRS for Scottish Water in the year was £384.2 million (2012: £347.7 million). However 2012/13 capital investment, as measured on a regulatory accounting basis, was £487.4 million (2012: £490.7 million). The table below reconciles investment as stated in the statutory accounts with investment on a regulatory accounting basis.

Reconciliation of capital additions

	2013 £m	2012 £m
2012/13 investment on a regulatory accounting basis	**487.4**	**490.7**
Less base infrastructure maintenance included in operating costs under IAS 16	(96.7)	(101.9)
Less investment financed by infrastructure charges & contributions	(8.1)	(11.9)
Less SWS 1 investment realignment	-	(30.0)
Add PFI capital additions	1.6	0.8
Company capital additions per note 9 to the financial statements	**384.2**	**347.7**

Finance costs
As at 31 March 2013, the weighted average interest cost of the outstanding long-term debt was 5.03% (2012: 5.15%). Net interest payable during the year was £154.4 million, £2.4 million lower than in 2011/12 and is analysed in the following table:

Net interest payable

	2012/13 £m	2011/12 £m
Scottish Consolidated Fund	90.1	91.4
National Loans Fund	48.3	49.9
Public Works Loan Board	15.9	16.8
Other - net	0.1	(1.3)
Net interest payable	**154.4**	**156.8**

Finance costs associated with finance lease liabilities on PFI assets and the interest on pension scheme liabilities less the expected return on pension scheme assets increased by £0.3 million to £30.0 million (2012: £29.7 million).

During the year, net debt increased by £95.5 million to £3,023.8 million (being loans of £3,269.3 million less cash balances of £245.5 million). The increase was driven by a £100.0 million increase in borrowing from the Scottish Government, partly offset by a £4.5 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 North East Scotland 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 2011. The actuarial funding position at 31 March 2011 of the Group's share of each pension fund is shown in the table below.

Fund	Value of Assets £m	Total Accrued Liabilities £m	Surplus / (Deficit) £m	Funding Level %
Strathclyde	436.8	418.5	18.3	104%
North East Scotland	228.9	246.2	(17.3)	93%
Lothian	249.3	266.7	(17.4)	93%

Employee pension contributions are determined according to the level of an employee's full-time equivalent pensionable pay. A key feature of the 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 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 2013, after taking account of deferred taxation, there was a shortfall of assets over respective liabilities of £189.6 million (2012: £213.6 million).

Members' report
For the year ended 31 March 2013

The Members present their annual report together with the audited financial statements for the year ended 31 March 2013.

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. 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 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 22 to 27.

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 28 to 29.

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 £89.2 million. Details of the financial results and associated accounting policies are set out on pages 42 to 75.

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

Political and charitable contributions
No political or charitable contributions were made during the year. However, Scottish Water supports WaterAid, a charity founded by the UK water industry, which raises funds for water related projects overseas. Employees represent Scottish Water at fundraising events and 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 3,540 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 53. 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 2013, the amount owed to trade creditors was equivalent to 31 days of purchases from suppliers.

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

Members' remuneration report

As far as is possible, Scottish Water adopts the same practice as quoted companies in the presentation of this Remuneration Report, even though it is not a quoted company.

1. Remuneration Committee

a. Remit

The Remuneration Committee meets regularly to consider the remuneration arrangements for Executive Members, and other related remuneration matters, and makes recommendations to the Board. No Executive Members are involved in deciding their own remuneration.

b. Membership

The Remuneration Committee is chaired by a Non-executive Member, Donald Emslie, and included two other Non-executive Members; Alan Bryce and Pat Kelly until his contract expired on 31 March 2013.

During the year external independent advice and remuneration analysis were provided by Hay Group Management Consultants. Internal advice was provided by the Chair of Scottish Water, the Chief Executive and the Director of People and Organisational Development. No Executive Member was present during discussions about their own remuneration.

c. Meetings

There were five meetings of the Committee in 2012/13. 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 that we can all be proud of*. Scottish Water will build on its past success by seeking to provide levels of service, performance and efficiency which exceed the expectation of its customers, regulators and the Scottish Government.

Scottish Water will continue to provide a working environment that matches the expectations it places on its people to deliver best value outcomes in an empowered organisation. Scottish Water's staff remuneration and incentivisation policies are a major contributor to achieving Scottish Water's goals. This requires terms of employment for all employees that, taken together, ensure that Scottish Water is perceived as a fair employer that encourages excellence, rewards performance 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.
- Incentivise and reward good individual and corporate out-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 with private sector utilities and other organisations across the UK economy, as well as with employers in the public sector.

Scottish Water uses the remuneration database of Hay Group Management Ltd to review the remuneration practices of comparator organisations and industry in general against its own. This is the largest remuneration database in the UK with each job subjected to the same method of job sizing.

Scottish Water aims to pay in line with 95% of the median of an agreed industry benchmark group, reflecting remuneration levels in comparable organisations for similar work.

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 incentives

Scottish Water is a performance-orientated organisation. It believes that Executive Members' remuneration should be closely related to corporate performance. The aim is to pay a base salary that is competitive, but appropriate for a public corporation, and provides the opportunity for extra discretionary pay to be earned for out-performance of demanding targets.

d. Annual out-performance incentive plan – 2012/13

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 are set out in the Delivery Plan that has been approved by Scottish Ministers, and reflect the targets set by the Water Industry Commission in its Final Determination of charges for 2010-15. The Delivery Plan targets, out-performance targets, and actual performance for each measure in 2012/13 are set out below.

Measure	**Delivery Plan target**	**Out-performance target**	**Actual performance**
Profit before tax excluding depreciation (measured on a regulatory accounting basis)	£375.0m	£390.0m	£401.4m
Customer service OPA performance	338	358	368
Investment delivery:			
• Q&SII/IIIa completion projects outstanding	12	12	9
• Q&SIIIb overall measure of delivery score	192	>192	205

This performance generated the following awards, based on the criteria set at the start of the year adjusted for the financial performance within Scottish Water Horizons Ltd.

Measure	% allocated	% awarded
Profit before tax excluding depreciation	40%	28%
OPA score	40%	40%
Investment delivery	20%	20%

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 2012/13 were 35% of annualised salary.

e. Long term incentive plan to incentivise out-performance in the five years to March 2015

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 2010-15 period. Payments under the scheme will be made to Executive Members for their service during the 2010 to 2015 period in January 2016. The LTIP will only be payable 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 adjusted net debt is lower in March 2015 than was assumed in the Final Determination. Maximum LTIP would be payable for at least £100 million out-performance.
- 50% for out-performance of OPA targets above those set out in the Final Determination, measured as the average performance in 2013/14 and 2014/15. Maximum LTIP will be payable for an OPA score of at least 400, 20 points higher than the Final Determination target of 380.
- The LTIP will be funded by 12% of annual salary being accumulated each year, during the five years to March 2015, 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 made following independent review of performance in the 2010-15 period by external auditors and our regulators.

Non-executive Members are not eligible for annual or long term incentive payments.

4. Service contracts

Details of Executive Members' permanent contracts are set out below.

Executive Member	Name	Date of Contract
Chief Executive	Douglas Millican	1 February 2013
Asset Management Director	Geoff Aitkenhead	1 April 2002
Commercial Director	Chris Banks	1 April 2002
Chief Operating Officer	Peter Farrer	1 April 2013

All Members are required to give six months' notice of resignation. Scottish Water is required to give Members twelve months' notice of termination.

Non-executive Board Member remuneration and 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, Lynne Peacock and Donald Emslie respectively, who work five days per month and the Chair, Ronnie Mercer, who works 2.5 days per week.

Remuneration for the Chair of Scottish Water and Non-executive Members are agreed by Scottish Ministers. Remuneration for Non-executive Members comprise a basic fee for acting as a Non-executive Member of £19,872 (2012: £19,872) but the Chairs of the Remuneration and Audit Committees receive a higher fee of £24,840 (2012: £24,840), reflecting the increased time commitment required in these roles.

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	31 March 2015
Alan Bryce	31 March 2018
Lynne Peacock	31 March 2018
James Spowart	31 March 2017
Andrew Wyllie	31 March 2017
Douglas Reid*	31 March 2017
Matt Smith*	31 March 2017
Donald Emslie	31 March 2016

* Matt Smith and Douglas Reid were appointed as Non-executive Members on 1 May 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.

Remuneration in respect of 2012/13	**Salary/ Fees £'000**	**AOIP £'000**	**Benefits £'000**	**Total £'000**	**Total 2011/12 £'000**
Executive Members					
Geoff Aitkenhead	172	61	8	241	252
Chris Banks	159	56	11	226	234
Peter Farrer	155	55	11	221	228
Douglas Millican (i)	200	65	11	276	253
Non – executive Members					
Ronnie Mercer (Chair)	90	-	10	100	100
Alan Bryce	20	-	-	20	20
Donald Emslie	25	-	-	25	25
Lynne Peacock	25	-	-	25	20
James Spowart	20	-	-	20	20
Andrew Wyllie	20	-	-	20	20
Total Members' remuneration	**886**	**237**	**51**	**1,174**	**1,172**
Former Members					
Richard Ackroyd (ii)	153	53	7	213	380
Pat Kelly (iii)	20	-	-	20	20
David Gray (iv)	-	-	-	-	32
Total	**1,059**	**290**	**58**	**1,407**	**1,604**

(i) The salary in the year paid to Mr Millican reflects his position as Finance & Regulation Director until 31 January 2013, his responsibility as Interim Chief Executive from 29 October 2012, and his appointment as Chief Executive from 1 February 2013.
(ii) Payments made in respect of Mr Ackroyd's service up to his death on 28 October 2012.
(iii) Appointment to the Board of Scottish Water expired on 31 March 2013.
(iv) Appointment to the Board of Scottish Water expired on 31 March 2012.
(v) 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, a car allowance is payable. The benefits section also includes the value of any holiday sale backs / purchases and annual life assurance premiums associated with the Scottish Water Life Assurance Scheme.
(vi) The AOIP criteria are explained on page 35.

For 2013/14 (with effect from 1 April 2013), the Committee approved an increase in salary for Peter Farrer to £172,000, reflecting his new role as Chief Operating Officer. The Committee also approved the salary for Douglas Millican in his new role as Chief Executive, effective from 1 February 2013, at £236,700, 10% less than the salary paid to the previous Chief Executive, Mr Ackroyd.

6. Pension

The Executive Members Geoff Aitkenhead, Chris Banks, Peter Farrer and Douglas Millican are eligible to participate in the Lothian Pension Fund, a defined benefit scheme. Details of their benefits under this scheme are set out below.

	Increase in accrued benefits during the year net of inflation			Accumulated total accrued benefits at 31 March 2013		Transfer Values (note 4)		
	Years in Scheme	Pension £'000	Lump sum £'000	Pension £'000	Lump sum £'000	At 31 March 2013 £'000	At 31 March 2012 £'000	Increase in 2012/13 net of Members' own contributions and inflation £'000
Geoff Aitkenhead	33.4	-	-	74	196	1,630	1,582	46
Chris Banks	18.7	3	-	40	88	751	699	34
Peter Farrer	28.7	3	-	58	143	1,044	942	82
Douglas Millican	18.1	5	5	44	97	727	600	104

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 transfer value of accrued pension is calculated in a manner consistent with Actuarial Guidance Note GN11.

Richard Ackroyd did not participate in the Lothian Pension Fund but Scottish Water contributed £53,696 (2012: £92,050) to his pension arrangements up to the date of his death on 28 October 2012. Geoff Aitkenhead no longer receives contributions to the Lothian Pension Fund, but an equivalent value (£41,282) was accrued and will become payable on his retirement from Scottish Water.

7. Executive Members' Directorships of other companies

The Remuneration Committee supports active development of Executive Members including their involvement with other companies and public bodies where this is compatible with fulfilling their responsibilities for Scottish Water. Any fees received are retained by the Member.

During the year ended 31 March 2013, Chris Banks held a Non-executive Director position with Sgoiltean Ura LLP, receiving £6,000 in fees (2012: £6,000). With effect from 1 April 2012, Geoff Aitkenhead has been a Non-executive Director of Scottish Canals and received fees of £4,800 (2012: nil).

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

Mr Donald Emslie,
Chair of the Remuneration Committee
28 May 2013

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 on pages 40 to 41, 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 and its group for the year ended 31 March 2013 under the Water Industry (Scotland) Act 2002. The financial statements 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. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union, and as interpreted and adapted by the 2012/13 Government Financial Reporting Manual (the 2012/13 FReM).

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 125 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 and auditor

As explained more fully in the Statement of Members' Responsibilities, the Board Members are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view, and are also responsible for ensuring the regularity of expenditure and income. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland) as required by the Code of Audit Practice approved by the Auditor General for Scotland. Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors. We are also responsible for giving an opinion on the regularity of expenditure and income in accordance with the Public Finance and Accountability (Scotland) Act 2000.

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the group's and company's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the Board Members; and the overall presentation of the financial statements. It also involves obtaining evidence about the regularity of expenditure and income. In addition, we read all the financial and non-financial information in the Annual Report to identify material inconsistencies with the audited financial statements. If we become aware of any apparent material misstatements, irregularities, or inconsistencies we consider the implications for our report.

Opinion on 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 group and of the company as at 31 March 2013 and of the surplus of the group and the company for the year then ended;
- have been properly prepared in accordance with IFRSs as adopted by the European Union, as interpreted and adapted by the 2012/13 FReM; and
- have been prepared in accordance with the requirements of the Water Industry (Scotland) Act 2002 and directions made thereunder by the Scottish Ministers.

Opinion on regularity

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

Opinion on other prescribed matters

In our opinion:

- the part of the Members' Remuneration Report to be audited has been properly prepared in accordance with the Water Industry (Scotland) Act 2002 and directions made thereunder by the Scottish Ministers; and
- the information given in the Financial and Business Review included in the Annual Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which we are required to report by exception

We are required to report to you if, in our opinion:

- adequate accounting records have not been kept; or
- the financial statements and the part of the Members' Remuneration Report to be audited are not in agreement with the accounting records; or
- We have not received all the information and explanations we require for our audit; or
- the Corporate Governance statement does not comply with the UK Corporate Governance Code.

We have nothing to report in respect of these matters.

PricewaterhouseCoopers LLP
Appointed Auditors
Glasgow
11 June 2013