



Members' report
Members' remuneration report

Members' report

The members present their Annual Report together with the audited financial statements for the year ended 31 March 2004.

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's 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 also performed a number of related but non-core operating activities, which fall outside the range of services that it is legally obliged to provide.

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 21 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 the appointment from Scottish Ministers. The members as at the date of the Annual Report and their biographies are set out on pages 28 to 31.

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 £60.6m. Details of the financial results and associated accounting policies are set out on pages 44 to 59 and a review of the year's performance is included in the Financial and Business Review on pages 21 to 27.

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. Scottish Water supports WaterAid, a charity founded by the UK water industry which raises funds for water related projects overseas. Employees represent Scottish Water on regional fundraising committees, which are periodically provided with facilities and other incidental support.

Employee relations and involvement

Scottish Water employed an average of 4,516 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 50. 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 innovative forums that are designed to encourage employee involvement and interest to develop employees' awareness of the business aims and objectives. Employees are kept involved through a process of regular team meetings, employee newsletters and representation on the Scottish Water and Business Unit Councils. These forums facilitate a partnership approach to the development of Scottish Water and the associated employee relations issues.

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 increased amongst 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 2004, the amount owed to trade creditors was equivalent to 39 days of purchases from suppliers.

Auditors

KPMG 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.

Corporate governance

Scottish Water is committed to the principles of good governance and the code of best practice with regard to corporate governance. The members of Scottish Water's Board are accountable to the Scottish Executive through the Scottish Water (Corporate Governance) etc. Directions 2002. This statement describes how the members comply with the requirements of the above Direction and the provisions set out in the Combined Code (section 1) of the listing rules of the Financial Services Authority. The revised Code, introduced in July 2003 does not require to be addressed in the year ended 31 March 2004 but the Board have adopted a Corporate Governance Action Plan to ensure compliance with the Code for the year to 31 March 2005.

Compliance

The members confirm that throughout the year and up to the date of approval of the Annual Report and Accounts Scottish Water complied with:-

- (a) The relevant sections of the Combined Code of Corporate Governance as set out in the listing rules of the Financial Services Authority; and
- (b) The Scottish Water Corporate Governance etc. Directions 2002 and other Directions, requirements and guidance issued by the Scottish Ministers (other than the Cryptosporidium (Scottish Water) Directions 2002 and 2003) in so far as such matters relate to the functions of Scottish Water;

The Cryptosporidium (Scottish Water) Directions 2002 was in force until 31 December 2003 when it was replaced by the Cryptosporidium (Scottish Water) Directions 2003. The members confirm that throughout the year and up to the date of approval of the Annual Report, Scottish Water substantially complied with the requirements of the Cryptosporidium (Scottish Water) Directions 2002 and 2003 apart from:-

1. An assessment to determine those raw water supplies which had experienced rapid variations in quality during the past 2 years. This was due to be completed by 31 March 2004 and was completed prior to approval of the Annual Report.
2. The operation of an enhanced document control system, which is currently being populated and implemented.

The members of the board

The Board of Scottish Water comprises 13 members, eight non-executive board members and five executive board members (see members' biographies on page 28). The Board has a formal schedule of matters specifically reserved to it for decision making. Reporting to the Board are the Chief Executive and the executive members who have responsibility for the management of Scottish Water, and the three Board Committees detailed below.

In accordance with best practice, there is a clear division of responsibilities between the Chair and the Chief Executive. Scottish Water also benefits from the expertise of its non-executive members whose range of experience brings independent judgement on issues of strategy and performance, which are vital to the success of Scottish Water.

During the year, the Board met on eleven occasions to review Scottish Water's operational and financial performance, business strategy and risk management.

Business management team

The Business Management Team is responsible for the management and operation of Scottish Water within the strategy determined by the Board. The Business Management Team is chaired by Dr Jon Hargreaves and comprises:

Mark Adderley	Business Services Director
Geoff Aitkenhead	Asset Management Director
Chris Banks	Commercial Director
Cheryl Black	Customer Service Director
Douglas Millican	Finance Director
Paul Pagliari	Human Resources Director

Board committees

Remuneration committee

The Remuneration Committee which is chaired by a non-executive member, Mr Graeme Crombie, comprises four other non-executive members: Mr Bill Cameron, Professor Paul Jowitt, Mr Pat Kelly (appointed 7 October 2003) and Mrs Rita Theil.

The Committee, in accordance with requirements of the Corporate Governance Direction, monitors the contract terms, remuneration and other benefits for each of the executive members, directors and senior managers including performance related bonus schemes. The committee met on five occasions during the year.

The committee has access to external independent advice as it sees fit.

Audit committee

The Audit Committee, which is chaired by a non-executive member with a financial background, Mr David Gray, comprises four other non-executive members: Mr Graeme Crombie, Professor Paul Jowitt, Mr Pat Kelly (appointed 7th October 2003) and Mr Ian McMillan. The Committee met on four occasions during the year.

The Committee reviews the financial reports of Scottish Water and considers the results of the Auditors examination and review of the financial statements. It meets with management and with internal and external auditors to review the effectiveness of internal controls and business risk management. The Chair of the Audit Committee reports to the Board on internal control and risk management matters following each Audit Committee meeting.

Commercial committee

The Commercial Committee, which is chaired by a non-executive member, Mr Ian McMillan, comprises three other non-executive members: Mr David Gray, Mr Bill Cameron and Mrs Rita Theil.

The Committee met on five occasions during the year to review commercial and property proposals, to monitor performance thereon, and report to the Board on specific proposals.

Internal control

Scottish Water operates within a broad strategic framework set out by Scottish Ministers. Policies for delivering objectives are set out in the Business Plan, which details services and quality objectives, financial targets for both capital and revenue expenditure, and charging proposals.

The members of the Board recognise their responsibility for establishing, maintaining and reviewing the systems of internal control and risk management from a financial and operational perspective. These systems are designed to manage, rather than eliminate, the risk of failure to achieve business and operational objectives and to provide reasonable, but not absolute, assurance against material misstatement or loss.

The systems of internal control are compliant with the relevant sections of the Combined Code and the Scottish Water (Corporate Governance) etc. Directions 2002. These are based on an ongoing process designed to identify those risks material to the achievement of Scottish Water's policies, aims and objectives, to evaluate those risks and to manage them effectively in accordance with good risk management practices. The risk management process has been in place for the full year under review and up to the date of approval of the Annual Report and financial statements.

Scottish Water recognises the importance of fulfilling its social responsibilities. To this aim the Board has a Sustainable Development Policy that includes social, economic and environmental aspects. A Working Group including external stakeholders has been established to review the delivery of outputs and report to the Board.

Risk management

Scottish Water has established a Risk Policy that sets out a consistent approach to the management of risk. The business identifies key risks at corporate and functional levels. Risks are evaluated by considering their consequences, in terms of impact and likelihood, on the achievement of service delivery and business objectives. Existing arrangements for managing the risks are considered and, where these are not perceived to be effective, action plans are drawn up which aim to achieve the right balance between risk and control.

Key risks in relation to monitoring water quality, planning for and managing water quality incidents are being managed in a reasonable and prudent manner having regard to the current regulatory framework and available resources.

Risk management is closely linked to the business planning process in Scottish Water and this continues to develop in line with business needs. Escalation procedures are in place.

The risk register and risk management processes are reviewed annually by the Board.

Control activities

Scottish Water's Internal Control Framework incorporates:

- Policymaking and strategic direction at board level. There is a formal schedule of matters reserved for decision by board members.
- An organisational structure which clearly defines lines of authority and accountability.
- A statement of general principles pertaining to rules and procedures for the regulation of the business.
- Financial authority limits governing delegation of authority by the Board.
- Regular review by the Board and management of service, quality and financial performance compared to plan.
- Development of procedure manuals for staff instruction and guidance.
- Project approval, monitoring and control processes specifically developed for capital expenditure.
- High profile given by Board and management to Health & Safety issues.

High quality personnel are viewed as an essential part of the control environment. Ethical behaviour is incorporated into staff conditions of service and demanding recruitment criteria and this is supported by a policy for the development and training of staff. Registers of interests are maintained and are available for public inspection. The Register of members declared interests is available on the Scottish Water website.

Control effectiveness review

Reviewing control effectiveness is a continuous process throughout the year. The Board gains assurance as to the effectiveness of internal control through a collaborative approach, based on the work of internal and external audit, other internal and external review agencies, and executive members' reports. The controls assurance process is co-ordinated by internal audit, and incorporates self-assessment by management, independent assessment by audit, and annual statements of assurance from senior management.

Information and communication

Scottish Water has developed an annual budgeting and financial reporting system that compares results with budget on a monthly basis, providing information for internal and external reporting. Key Performance Indicators have been established for non-financial performance and are reported regularly to the Board and to external regulators.

Scottish Water has an ongoing programme of developing systems to assist customer service and decision making in financial and operational areas of the business. The overall aim is to produce relevant, reliable and timely operational, financial, and compliance related information, consistent with the objectives of the business, to enable management to exercise effective control and direction.

Scottish Water has prepared and consulted on a draft Consultation Code setting out how it intends to consult external stakeholders in relation to proposals for, and the undertaking of, significant core business activities. This has been approved by the Scottish Ministers.

Independence of auditors

The Auditor General for Scotland is responsible to the Scottish Parliament for securing the audit of the financial statements of Scottish Water. For 2002/03 to 2005/06, the Auditor General appointed KPMG LLP as the auditors of Scottish Water.

Under the terms of KPMG LLP's appointment, they may not carry out any non-audit work for Scottish Water without the prior approval of Audit Scotland.

Going concern

Scottish Water operates under an annual external financing limit (EFL) set by the Scottish Executive. The annual EFL controls the amount by which Scottish Water can increase its externally sourced finance, including borrowings. In addition, Scottish Water's charging structure is reviewed and approved annually by the Water Industry Commissioner for Scotland.

The members, taking all relevant factors into account, consider that Scottish Water will have adequate resources to continue in operational existence for the foreseeable future. The accounts are therefore prepared on a going concern basis.

Members' remuneration report

Since 1 January 2003, quoted companies have been required to include in their Annual Report a Directors' Remuneration Report with specified contents. Despite the fact that Scottish Water is not a quoted company, the members of Scottish Water have approved this report. The report follows the format and content required of quoted companies; where that is not possible, it is explicitly noted.

1. Remuneration committee

Remit

The Remuneration Committee meets regularly to consider Human Resource issues, particularly executive member remuneration, terms and conditions across the company, key succession planning and safety performance and makes recommendations to the Board. In respect of levels of executive member remuneration and bonus schedules, its proposals have formed the basis of recommendation to the Scottish Executive. No Directors are involved in deciding their own remuneration.

Membership

For the Financial Year under review, the Remuneration Committee has consisted of:

Mr Graeme Crombie	(Chair of the Committee, Non-Executive Member)
Prof Paul Jowitt	(Non-Executive Member)
Mr Bill Cameron	(Non-Executive Member)
Mr Pat Kelly	(Non-Executive Member) – appointed 7 October 2003
Ms Rita Theil	(Non-Executive Member)

During the year external independent advice has been provided by Hay Group Management Limited, a consultancy appointed by the Remuneration Committee in October, 2002. Internal advice was provided by the Chair of Scottish Water, the Chief Executive and the Human Resources Director.

Meetings

There were five meetings of the committee in 2003/04. At each meeting a quorum of independent non-executive members was present.

2. General remuneration policy

Scottish Water must continue to build on the progress made over the last two years to create a successful water services company that will provide the levels of service and value for money expected by its customers and regulators, and, in the medium term, catch up with performance of water companies elsewhere in the UK.

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 organisational approach. This requires terms of employment for all employees that taken together ensure Scottish Water is perceived as a fair employer that encourages excellence and rewards productivity and empowers its people as well as providing scope for personal development.

Scottish Water's overall remuneration policy aims are to:

- Attract, develop, motivate and keep highly talented people at all levels of the organisation;
- Pay competitive salaries and benefits to all its people. When pay levels are set, account is taken of the work an employee does, what is paid in other organisations for similar work and how well Scottish Water is performing; and
- Incentivise and reward good individual performance in a remuneration structure that is seen as fair when viewed as a whole.

3. Policy on executive members' remuneration

a) Comparator organisations

Scottish Water is publicly owned, accountable to the Scottish Parliament and Scottish Ministers. However, it requires to attract, retain and motivate leadership talent in competition not just with other utilities, nor just with other organisations in the public sector, but with organisations across the economy – as do other public sector organisations which have to operate commercially.

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

b) Remuneration elements

Scottish Water's Remuneration Policy for executive members will now consist of four principal elements:

- Base Salary;
- Annual Incentive Scheme;
- Long Term Incentive Scheme (LTIP); and
- Pension.

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 performance – both corporate performance and individual performance.

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

In line with the three year award agreed with employees the increase in base salary for continued good performance of executive members will also be 8% in aggregate over the period 2003-2006.

The potential annual incentives attainable by the executive members have now been levelled at 40% of base salary (affecting the Chief Executive and two Directors previously only eligible for 20-30% of base salary) and are non-pensionable. Performance to date has resulted in annual bonus awards falling typically in the range 67-79% of the available maximum. After review of practice elsewhere in the Water Industry, to ensure long term objectives are not compromised by short term expedience, a long term incentive plan (LTIP) is being established for rewarding executives if the challenging goals in the current business plan ending March 2006 are met or surpassed.

The maximum amount payable in this LTIP would be the residue unpaid from the 40% annual bonus potential each year in the period to March 2006, and would therefore be modest in comparison with the more traditional plc share option schemes which are not open to Scottish Water. The five areas of results in which performance will determine the terminal payout are:

- Opex Reduction;
- Capital Efficiency;
- Guaranteed Customer Service Standard;
- Water Quality 1000 Index and,
- Waste Water Treatment Works Compliance

Any payout due under the LTIP will be paid in March 2007 and will only be made to Directors remaining in employment with Scottish Water as of 31 December 2006.

Non-executive members are not eligible for incentive payments.

d) Performance conditions for annual incentives and awards made

For the 2003/04 financial year, performance targets against which potential bonus payments would be judged for each executive member were established by the Remuneration Committee. Performance of the business is measured against key performance indicators set by the Board. Of these, six are classed as team KPIs and the remainder are used within the appropriate division. Half of the bonus potential (20%) could be earned against challenging team targets where attainment would reflect significant progress towards 2006 goals set by the Board and agreed with ministers. Of this half, 76% is allocated to reduction in core operating costs, 14% is allocated to KPI targets, and 10% is allocated to Capital Investment. The remaining potential bonus (20%) could be earned against personal targets relating to functional attainments that support the company goals. For example a minimum of 24% of the personal target element was allocated to financial performance at a divisional level:

In assessing the overall balance for making awards the Remuneration Committee took into consideration the achievement of further real core operating cost reductions of £41m. This brings total real savings delivered by the executive team over the first two years of Scottish Water to £71m (20%) excluding the operating cost consequences of newly commissioned plant.

Of the team KPIs, customer guaranteed standard, response to written complaints and cash flow bettered or met the targets, whilst drinking water quality and health and safety improved on 2002/03 performance. Debtor days performance was slightly worse than previous year. Quality and standards capital expenditure at £389.3m was lower than budget by £60.7m but more outputs (i.e. projects) were delivered than planned.

Overall bonus awards in 2004 were made in the range 71-79% of the maximum potential bonus.

4. Performance graph

Scottish Water is not a quoted company. It is, therefore, not possible to include in this report one of the standard elements of Members' Remuneration Reports in quoted companies – a graph comparing total shareholder return on shares in the company against a broad equity market index over the latest five financial years.

5. Service contracts

Details of executive members' contracts are set out below.

Executive member	Name	Date of contract	Unexpired term	Notice period
Chief Executive	Jon Hargreaves	19 March 02		
Asset Management Director	Geoff Aitkenhead	1 April 02	All executive members have permanent contracts.	Members are required to give six months' notice of resignation. Scottish Water is required to give members twelve months' notice of termination.
Finance Director	Douglas Millican	1 April 02		
Customer Services Director	Cheryl Black	1 April 02		
Commercial Director	Christopher Banks	1 April 02		

There are no provisions for pre-determined compensation in service contracts. In the event of the termination of any service contract or appointment, the Board would seek to ensure that legally appropriate mitigation factors would be applied to any compensation that may be payable.

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 Alan Alexander, the chairman, who works 3.5 days per week. From 1 April 2004 the chairman's commitment has been reduced to 2.5 days per week. No compensation is payable to any non-executive director if their appointment is terminated early. The expiry date of non-executive appointments is as follows:

Alan Alexander	31 March 2005
David Gray	31 March 2005
Paul Jowitt	31 March 2005
Bill Cameron	31 March 2005
Rita Theil	31 March 2006
Ian McMillan	31 March 2006
Graeme Crombie	31 March 2006
Pat Kelly	31 March 2006

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

6. Members' remuneration

Details of members' remuneration and other Directors, as defined in the Accounts Direction for 2003/04 by Scottish Ministers, are set out below for the year.

	Salary/fee £'000	Bonus £'000	Benefits £'000	Total 2004 excluding Pension contributions £'000	Total 2003 £'000
Executive members					
Jon Hargreaves	154	45	4	203	175
Geoff Aitkenhead	120	34	3	157	145
Christopher Banks	115	35	9	159	139
Cheryl Black	115	34	4	153	139
Douglas Millican	120	38	5	163	146
Non-executive members					
Professor Alan Alexander – Chair	72	-	5	77	75
Bill Cameron	18	-	-	18	18
Graeme Crombie	18	-	-	18	18
David Gray	18	-	-	18	18
Paul Jowitt	18	-	-	18	18
Pat Kelly	11	-	-	11	-
Ian McMillan	18	-	-	18	18
Rita Theil	18	-	-	18	18
Total members' remuneration	815	186	30	1,031	927
Other Directors					
Mark Adderley	103	32	7	142	119
Paul Pagliari	105	32	5	142	126
Total	1,023	250	42	1,315	1,172

All members, with the exception of Mr Pat Kelly who became a member on 1 September 2003, were in post for the full financial year.

Relocation costs of £46,217 (2003 – £40,640) have been charged and relate to the appointment of Christopher Banks £22,352 (2003 – £22,648) and Cheryl Black £23,865 (2003 – £11,545). These are not included in the above table.

7. Options on shares

There are no shares in Scottish Water.

8. Long term incentive scheme

No payments were made under the plan rules which are yet to come into effect. Subject to meeting the performance criteria awards under the LTIP rules will be made to those Directors eligible in March 2007.

9. Pension

The Executive members and other Directors 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 2004		Transfer values (note 5)		
	Years in scheme	Pension £'000	Lump sum £'000	Pension (note 3) £'000	Lump sum (note 3) £'000	At 31 March 2004 £'000	At 31 March 2003 £'000	Increase in 2003/04 net of members own contributions and inflation £'000
Jon Hargreaves	3.7	1	4	5	15	59	41	11
Geoff Aitkenhead	25.4	4	14	38	114	575	487	78
Christopher Banks	2.1	1	4	3	9	27	13	7
Cheryl Black*	4.3	3	10	5	15	60	21	32
Douglas Millican	10.4	1	4	13	39	143	125	12
Mark Adderley	3.3	1	4	4	12	43	25	11
Paul Pagliari*	6.5	6	20	8	24	93	14	71

*Cheryl Black and Paul Pagliari during the year transferred in an additional 1.65 and 4.32 years respectively.

Notes:

- (1) Members of the pension scheme have the option to pay additional voluntary contributions; neither the contributions nor the resulting benefits are included in the above table.
- (2) The normal retirement age of executive members is 65.
- (3) The pension entitlement shown is that which would be paid annually on retirement along with the lump sum, based on service to the end of the year.
- (4) The increase in accrued pension, lump sum and transfer value during the year excludes any increase for inflation.
- (5) The transfer value of accrued pension is calculated in a manner consistent with Actuarial Guidance Note GN11.
- (6) Professor Alan Alexander, the Chair of Scottish Water, does not participate in the pension scheme but Scottish Water does contribute to a private money purchase scheme for him. For 2003/04 the contribution was £12k (2003 – £11k) and represented 16.5% of his fee, the same employer contribution rate for members of the Lothian Pension Fund.
- (7) In addition to the above Dr Hargreaves will receive an additional lump sum from a top-up arrangement of £103k payable at age 62 an increase in the year of £31k.
- (8) On death, a spouse's pension is payable equal to one half of the member's pension and children's pension may also be payable.
- (9) With the exception of Mr Aitkenhead (due to his period of membership of the pension scheme) retirement benefits are restricted to the Inland Revenue earnings cap of £99k pa. Scottish Water does not contribute to unfunded retirement benefits for salary above the Inland Revenue cap.

10. Provision of cars

A car or a car allowance is provided to all executive members for business needs. The associated benefit is included in the table of members' remuneration above.

This report was approved by the Board on 16th June 2004 and signed on its behalf by Mr G Crombie, Chair of the Remuneration Committee.

Statement of members' responsibilities
Independent auditors' report
Financial statements

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, 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 Scottish Parliament and the Auditor General for Scotland

We have audited the financial statements on pages 44 to 59 under the Water Industry (Scotland) Act 2002. The financial statements have been prepared under the historical cost convention and in accordance with the accounting policies set out on pages 48 and 49. We have also audited the information in the Members' Remuneration Report that is described as having been audited.

This report is made solely to the members of the Board of Scottish Water and to the Auditor General for Scotland, in accordance with sections 21 and 22 of the Public Finance and Accountability (Scotland) Act 2000. Our audit work has been undertaken so that we might state to those two parties those matters we are required to state to them in an auditor's report and for no other purpose. In accordance with the Statement of Responsibilities of Auditors and of Audited Bodies prepared by Audit Scotland, this report is also made to the Scottish Parliament, as a body. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the members of the Board of Scottish Water and the Auditor General for Scotland, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of the Board Members, Accountable Officer and Auditors

As described on page 42 the Board and the Accountable Officer are responsible for the preparation of the financial statements in accordance with the Water Industry (Scotland) Act 2002 and directions made thereunder and for ensuring the regularity of expenditure and income. Our responsibilities, as independent auditors, are established by the Public Finance and Accountability (Scotland) Act 2000 and the Code of Audit Practice approved by the Auditor General for Scotland, and guided by the auditing profession's ethical guidance.

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 Members' Remuneration Report to be audited have been properly prepared in accordance with statute and whether, in all material respects, the expenditure and income shown in the financial statements have been incurred or applied in accordance with any applicable enactments and guidance issued by the Scottish Ministers. We also report if, in our opinion, the Members' Report is not consistent with the financial statements, if the Board has not kept proper accounting records or if we have not received all the information and explanations we require for our audit or if information specified by law regarding members' remuneration and transactions with Scottish Water is not disclosed.

We review whether the Corporate Governance Statement on page 34 and 35 reflects the Board's compliance with those provisions in the Combined Code as specified for our review in the Accounts Requirements. We report if, in our opinion, the statement does not comply with these provisions or if it is misleading or inconsistent with other information we are aware of from our audit. We are not required to consider whether the statement covers all risks and controls, or form an opinion on the effectiveness of the Board's corporate governance procedures or its risk and control procedures.

We read the other information contained in the Annual Report and the unaudited part of the Members' Remuneration Report and consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements.

Basis of audit opinions

We conducted our audit in accordance with the Public Finance and Accountability (Scotland) Act 2000 and the Code of Audit Practice, which requires compliance with relevant United Kingdom Auditing Standards issued by the Auditing Practices Board.

An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures and the regularity of the expenditure and income shown in the financial statements and the part of the Members' Remuneration Report to be audited. It also includes an assessment of the significant estimates and judgements made by the Board Members and Accountable Officer in the preparation of the financial statements and of whether the accounting policies are appropriate to Scottish Water'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 Members' Remuneration Report to be audited are free from material misstatement, whether caused by fraud or other irregularity 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 Members' Remuneration Report to be audited.

Opinions

Financial statements

In our opinion the financial statements give a true and fair view of the state of affairs of Scottish Water as at 31 March 2004 and of its surplus and cash flows for the year then ended; and 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.

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.

KPMG LLP

KPMG LLP
Chartered Accountants
Registered Auditor
Edinburgh
16 June 2004

Income and expenditure account

For the year ended 31 March 2004

	Notes	2004 £m	2003 £m
Turnover	2	958.3	895.3
Cost of sales		560.8	543.1
Gross surplus		397.5	352.2
Administrative expenses		120.2	138.6
Operating surplus before exceptional items	2, 3	277.3	213.6
Exceptional items	4	52.8	24.6
Operating surplus on ordinary activities before interest		224.5	189.0
Net interest payable	7	136.7	137.6
Surplus on ordinary activities before taxation		87.8	51.4
Taxation	8	27.2	16.5
Retained surplus for the financial year		60.6	34.9

Statement of total recognised gains and losses

There are no recognised gains or losses other than the surplus for the year, as was the case in 2003.

Balance sheet

As at 31 March 2004

	Notes	2004 £m	2003 £m
Fixed assets			
Tangible assets	9	2,581.2	2,437.3
Other investments	10	0.1	0.1
Current assets			
Stocks	11	4.5	3.8
Debtors	12	205.8	201.6
Cash at bank and in hand		10.6	1.7
		220.9	207.1
Creditors: amounts falling due within one year	13	252.8	248.2
Net current liabilities		(31.9)	(41.1)
Total assets less current liabilities		2,549.4	2,396.3
Creditors: amounts falling due after more than one year	14	67.2	68.6
Provisions for liabilities and charges			
Deferred taxation	15	48.6	21.4
Other provisions	16	66.2	67.0
Net assets		2,367.4	2,239.3
Capital and reserves			
Government loans	17	2,138.5	2,071.0
Other reserves		133.4	133.4
Income and expenditure account reserve		95.5	34.9
		2,367.4	2,239.3

These financial statements were approved by the Board of Members on 16th June 2004 and signed on their behalf by



Dr Jon Hargreaves, Chief Executive

Cash flow statement

For the Year Ended 31 March 2004

	Notes	2004 £m	2003 £m
Net cash inflow from operating activities	(i)	475.5	451.7
Net cash outflow from returns on investment and servicing of finance	(ii)	(136.7)	(138.3)
		338.8	313.4
Purchase of tangible fixed assets		(377.8)	(369.6)
Sale of tangible fixed assets		5.1	3.7
Government grants and capital contributions		0.8	1.2
Net cash outflow before management of liquid resources and financing		(33.1)	(51.3)
Net cash inflow from financing	(iii)	42.0	51.1
Increase/(decrease) in cash		8.9	(0.2)

Reconciliation of net cash flow to movement in net debt

	2004 £m	2003 £m
Increase/(decrease) in cash	8.9	(0.2)
Cash inflow from increase in debt financing	(42.0)	(51.1)
Movement in net debt	(33.1)	(51.3)
Net debt at 1 April	(2,149.1)	(2,097.8)
Net debt at 31 March	(2,182.2)	(2,149.1)

Analysis of net debt

	As at 1 April 2003 £m	Increase in cash £m	(Increase)/ decrease in debt £m	As at 31 March 2004 £m
Cash at bank and in hand	1.7	8.9	-	10.6
Debt due within one year	(115.5)	-	(49.9)	(165.4)
Net borrowings due within one year	(113.8)	8.9	(49.9)	(154.8)
Net borrowings due after more than one year	(2,035.3)	-	7.9	(2,027.4)
Net debt	(2,149.1)	8.9	(42.0)	(2,182.2)

Notes to the cash flow statement

For the Year Ended 31 March 2004

(i) Reconciliation of operating surplus to net cash inflow from operating activities

	2004 £m	2003 £m
Operating surplus	277.3	213.6
Exceptional items charged	(52.8)	(24.6)
Depreciation of tangible fixed assets	119.0	105.1
Infrastructure maintenance charge	143.0	140.0
Amortisation of grants and PFI assets	0.6	1.2
(Surplus) on disposal of tangible fixed assets	(2.4)	(0.8)
(Increase)/decrease in debtors	(5.7)	6.2
(Increase)/decrease in stocks	(0.7)	0.1
Increase/(decrease) in creditors	(2.0)	25.3
Decrease in provisions	(0.8)	(14.4)
Net cash inflow from operating activities	475.5	451.7

(ii) Returns on investment and servicing of finance

	2004 £m	2003 £m
Interest received	1.0	0.7
Interest paid	(137.7)	(139.0)
Net cash outflow from returns on investments and servicing of finance	(136.7)	(138.3)

(iii) Financing

	2004 £m	2003 £m
Borrowings due within one year – repayment of loans	(152.5)	(205.5)
– increase in loans	192.5	191.0
Borrowings due after one year – repayment of loans	(100.4)	(74.4)
– increase in loans	102.4	140.0
Net cash inflow from financing	42.0	51.1

Notes to the financial statements

For the Year Ended 31 March 2004

1. Principal accounting policies

Basis of accounting

The financial statements have been prepared under the historical cost convention, in a form directed by Scottish Ministers in accordance with section 45(2) of the Water Industry (Scotland) Act 2002. The financial statements comply with all applicable United Kingdom accounting standards. The principal accounting policies are summarised below and have been applied consistently.

Basis of consolidation

On 26 June 2002 Scottish Water formed a company, Scottish Water Solutions Limited. This company commenced trading on 30 June 2003 and is jointly owned with Stirling Water Limited and UUGM Limited, to deliver a significant majority of Scottish Water's capital investment programme. Scottish Water Solutions Limited is owned 51% by Scottish Water and 24.5% each by Stirling Water Limited and UUGM Limited. However, the nature of the contractual agreement between Scottish Water and the other shareholders in Scottish Water Solutions Limited is such that the parties are engaged in joint activities that do not constitute an entity carrying on a trade or business in its own right. Consequently, Scottish Water Solutions Limited, has been accounted for under FRS 9 Associates and Joint Ventures, as a JANE (Joint Arrangement Non Entity). On this basis Scottish Water accounts directly for its own gross assets, liabilities and cash flows in the joint arrangement.

Depreciation

Freehold land and assets under construction are not depreciated.

The infrastructure network which comprise a network of water and wastewater systems including mains, sewers, impounding and pumped raw water storage reservoirs, dams, sludge pipelines and sea outfalls are considered to have an infinite life. Expenditure to maintain the network infrastructure is dealt with under a renewals accounting approach whereby the annualised planned expenditure to maintain the operating capacity of this infrastructure is treated and charged as depreciation to the income and expenditure account. The actual expenditure incurred on infrastructure assets is capitalised, as is any expenditure that increases the capacity of the network.

Depreciation is provided on other tangible fixed assets to write-off cost, less residual values, on a straight-line basis over their estimated operational lives, from the date of beneficial use as follows:

	Years
Non operational buildings and structures	60
Specialised operational buildings and structures	20 to 60
Plant, machinery, vehicles and fencing	3 to 20
Fixtures and fittings, furniture and temporary buildings	5

The carrying values of tangible fixed assets are reviewed for impairment when events or changes in circumstances indicate that the carrying value may not be justified. The resulting impairment charge is included within depreciation.

Capital grants and customer contributions

Capital grants and customer contributions in respect of infrastructure assets are deducted from the cost of the fixed asset. This treatment is not in accordance with the Companies Act 1985 but has been adopted to show a true and fair view since, as explained above, infrastructure assets have an infinite economic life and hence no basis exists on which to recognise such contributions as deferred income. Grants and contributions received in respect of non-infrastructure assets are credited to deferred income and are released to the income and expenditure account over the expected useful lives of the relevant fixed assets.

Stock

Stocks and work in progress are stated at the lower of cost or net realisable value. Cost includes all costs incurred in bringing each asset to its present location and condition. The valuation of work in progress is based on the cost of labour and materials plus appropriate overheads.

Income recognition

Turnover comprises charges to customers for water and waste water services, excluding value added tax. For measured customers, turnover includes an estimate of the value of water and waste water services supplied to customers between the date of the last meter reading and the year-end. For unmeasured customers billed in advance, income is deferred and released to the income and expenditure account throughout the year.

Leased assets

Rentals payable under operating leases are charged to the income and expenditure account over the term of the lease on a straight-line basis. Scottish Water has no amounts due under finance leases.

Private Finance Initiative (PFI) costs

All costs incurred in relation to the development of PFI schemes are charged to the income and expenditure account as incurred. However, costs relating to other tangible fixed assets belonging to Scottish Water and transferred to the PFI operator are treated as a debtor and amortised over the length of the service contract. PFI land transferred to the operator is not amortised. Rental costs arising under PFI operating leases are expensed to the income and expenditure account over the terms of the lease.

Research and development costs

Research and development expenditure is charged to the income and expenditure account in the year in which it is incurred.

Indebtedness to the Scottish Ministers and other long term loans

Loans from the National Loans Fund, the Scottish Consolidated Fund and other Government borrowings are treated as part of capital and reserves, including loan repayments due within one year.

Overdrafts and other loans are included under creditors as appropriate in accordance with the Companies Act.

Derivatives and financial instruments

Scottish Water's financial instruments comprise borrowing, some cash and liquid resources, and various items such as debtors and creditors that arise directly from operations.

Scottish Water's policy is not to trade or speculate in financial instruments. All treasury activities are undertaken in accordance with the permitted activities as set out in the Delegated Limits Direction made under the Water Industry (Scotland) Act 2002.

Taxation

Deferred tax is recognised in respect of all timing differences, which have originated but not reversed at the balance sheet date, subject to certain exceptions. Deferred tax assets are recognised to the extent that they are recoverable.

Pensions

Employees of Scottish Water participate in the Local Government Pension Scheme administered by Aberdeen, Glasgow and Edinburgh City Councils. Contributions to these funds are charged to the income and expenditure account in order to spread the cost of pensions over the average service lives

of employees. The contributions are determined by a qualified actuary on the basis of triennial valuations. The capital cost of ex gratia and supplementary pensions is charged to the income and expenditure account in the accounting period in which they are granted.

2. Turnover and segmental analysis

All turnover and surplus before taxation arises from continuing operations within Great Britain.

Scottish Water's principal activity is the supply of water and wastewater services to household and business customers across Scotland. In view of the integrated nature of Scottish Water's operational activities, the financial statements include all of the costs of water and wastewater collection, treatment and distribution within cost of sales. An analysis of turnover, operating surplus and net assets by activity is provided below:

	Turnover		Operating surplus before exceptionals		Net assets/(liabilities)	
	2004 £m	2003 £m	2004 £m	2003 £m	2004 £m	2003 £m
Statutory water and wastewater services	935.4	874.5	275.8	213.2	2,582.3	2,471.2
Non statutory water and wastewater services	15.5	19.7	1.3	1.0	6.7	4.2
	950.9	894.2	277.1	214.2	2,589.0	2,475.4
Other trading activities	7.4	1.1	0.2	(0.6)	2.8	-
	958.3	895.3	277.3	213.6	2,591.8	2,475.4
Unallocated net liabilities					(224.4)	(236.1)
					2,367.4	2,239.3

Unallocated net liabilities include provisions, loans and accrual balances which cannot be directly allocated to business segments.

Other trading activities are new non statutory activities, which have been substantially commenced since April 2001.

Turnover includes £0.1m of revenue grants received from Scottish Ministers in respect of the current year (2003 – £0.2m).

3. Operating surplus

Operating surplus is arrived at after charging/(crediting):

	2004 £m	2003 £m
PFI operating costs – service charges	109.1	92.8
PFI operating costs – other	3.9	12.6
Total PFI operating costs	113.0	105.4
Infrastructure maintenance charge	143.0	140.0
Depreciation of tangible fixed assets	119.0	105.1
Operating lease rentals – hire of other assets	7.4	6.9
Amortisation of assets transferred to PFI service companies	1.6	1.6
Gain on sale of assets	(2.4)	(0.8)
Release of deferred income in relation to capital grants	(1.0)	(0.4)
Auditors remuneration – audit services*	0.2	0.2
Auditors remuneration – other**	0.1	0.1
Research and development expenditure	0.4	0.4

* This includes charges by Audit Scotland of £19.5k (2003 – £19.9k)

** This relates to the provision of tax services

4. Exceptional items

Exceptional costs charged to the income and expenditure account total £52.8m (2003 – £24.6m) and relate to restructuring and transformation costs undertaken as part of the £200m Spend to Save programme allowed for by the Water Industry Commissioner for Scotland in the Strategic Review of Charges. These exceptional costs incurred during the year, include staff severance costs of £34.1m (2003 – £9.3m) and £18.7m (2003 – £15.3m) of other external and internal costs, predominantly IT related, associated with the fundamental restructuring and transformation of the business.

5. Staff costs

	2004 £m	2003 £m
Wages and salaries	112.7	123.8
Social security costs	9.6	9.4
Pension costs (note 19)	14.0	13.0
	136.3	146.2
Less: charged as capital expenditure	(25.7)	(26.9)
Less: seconded staff charged to Scottish Water Solutions Limited	(5.9)	-
	104.7	119.3

The monthly average number of people (including executive and non-executive members) employed by Scottish Water during the year was 4,516 (2003 – 5,007):

	2004	2003
Statutory water and wastewater services	3,972	4,712
Non-statutory water and wastewater services	233	276
Other trading activities	91	19
Scottish Water Solutions Limited secondees	220	-
	4,516	5,007

The number of people employed at 31 March 2004 was 4,345 FTE, (2003 – 4,927).

6. Members' remuneration

Information concerning members' remuneration, incentive schemes and pensions is detailed in the Remuneration Report on pages 36 to 40. No member or director had, during the year or at the end of the year, any material interest in any contract of significance in relation to Scottish Water's business.

7. Net interest payable

	2004 £m	2003 £m
Interest receivable		
Interest from short-term deposits	0.9	0.6
Other interest receivable	0.1	0.1
	1.0	0.7
Interest payable		
Government capital loans	132.2	130.5
Other loans	5.5	7.8
	137.7	138.3
Net interest payable	136.7	137.6

8. Taxation

Analysis of tax charge in the year

	2004 £m	2003 £m
Current tax: UK corporation tax on surplus for the year	-	-
Deferred tax: origination and reversal of timing difference	27.2	16.5
Tax on surplus on ordinary activities	27.2	16.5

Factors affecting current tax charge

	2004 £m	2003 £m
Notional tax charge at UK corporation tax rate of 30%	26.4	15.4
Tax effect of:		
Expenses not deductible for tax purposes	0.3	0.1
Increase in general provisions not deductible for tax purposes	7.1	20.9
Other timing differences	1.0	-
Capital allowances in excess of depreciation	(37.0)	(55.4)
(Loss)/gain on disposal of fixed assets and other non taxable income	(0.7)	0.4
Tax losses	2.9	18.6
Current tax charge for the year	-	-

9. Tangible fixed assets

	Specialised operational properties & structures £m	Non- specialised operational properties £m	Infra- structure assets £m	Plant, machinery and vehicles £m	Assets in the course of construction £m	Total £m
Cost						
At 1 April 2003	1,559.3	53.9	1,012.7	324.2	462.0	3,412.1
Additions	-	-	-	-	408.6	408.6
Disposals	(5.7)	(2.6)	-	(0.9)	-	(9.2)
Transfers	47.6	4.4	105.8	52.5	(210.3)	-
At 31 March 2004	1,601.2	55.7	1,118.5	375.8	660.3	3,811.5
Depreciation						
At 1 April 2003	331.0	11.5	475.8	156.5	-	974.8
Charge for the year	69.1	1.4	143.0	48.5	-	262.0
Disposals	(5.5)	(0.3)	-	(0.7)	-	(6.5)
At 31 March 2004	394.6	12.6	618.8	204.3	-	1,230.3
Net Book Value						
At 31 March 2004	1,206.6	43.1	499.7	171.5	660.3	2,581.2
Net Book Value						
At 1 April 2003	1,228.3	42.4	536.9	167.7	462.0	2,437.3

All capital investment is recognised initially within assets in the course of construction. When assets are capable of performing the function for which they were constructed and come into beneficial use, they are reclassified and transferred from assets under construction to the appropriate fixed asset category.

£0.6m of capital grants were received during the year and credited to deferred income (2003 – £0.2m). These amounts will be released to the income and expenditure account over the expected useful lives of the relevant fixed assets. A further £0.2m of capital grants in respect of infrastructure assets were received during the year. These grants were deducted from the cost of infrastructure fixed assets in the balance sheet. An analysis of the amounts received is provided below:

Source	Purpose	2004 £m	2003 £m
National Security Grant	Improvements to security at service reservoirs	0.6	0.2
European Regional Development Fund	Building works at Ullapool waste-water treatment works	0.2	-

10. Investments

Investments in Joint Arrangements Non Entity (JANE)

On 26 June 2002 Scottish Water formed a company, Scottish Water Solutions Limited. This company commenced trading on 30 June 2003, and is jointly owned with Stirling Water Limited and UUGM Limited, to deliver a significant majority of Scottish Water's capital investment programme. The nature of the contractual agreement between Scottish Water and the other shareholders in Scottish Water Solutions Limited is such that the parties are engaged in joint activities that do not constitute an entity carrying on a trade or business in its own right. Consequently, Scottish Water Solutions Limited, has been accounted for under FRS 9 Associates and Joint Ventures, as a JANE.

Details of the investment are as follows:

	Country of Incorporation	Holding %	Value £	Principal Activity
Scottish Water Solutions Limited	Scotland	51	510	Contracting services

Other Investments

	2004 £m	2003 £m
At 31 March	0.1	0.1

Investments at cost represent 8% of unsecured loan stock and 38,792 £1 Ordinary 'A' shares in the Water Research Council plc, valued at £78k.

Scottish Water owns shares in eight companies, which did not trade during the year ended 31 March 2004. The companies' financial statements have not been consolidated as permitted by Section 229 of the Companies Act 1985, as they did not trade during the year and the issued share capital is immaterial.

11. Stocks

	2004 £m	2003 £m
Raw materials and consumables	3.3	3.4
Work in progress – recoverable work	1.2	0.4
	4.5	3.8

12. Debtors

	2004 £m	2003 £m
Amounts falling due within one year:		
Trade debtors	90.6	100.0
Other debtors	24.5	19.3
Prepayments and accrued income	51.0	43.4
	166.1	162.7
Amounts falling due after more than one year:		
Other debtors	0.9	0.4
PFI assets transferred to service contractors	38.8	38.5
	205.8	201.6

13. Creditors: amounts falling due within one year

	2004 £m	2003 £m
Non-government loans	12.7	25.6
Trade and capital creditors	79.1	85.7
Payments received in advance	6.5	8.2
Other taxes and social security	3.2	2.1
Other creditors	15.9	19.2
Accruals and other deferred income	112.0	107.4
Amounts due to Scottish Water Solutions Limited	23.4	-
	252.8	248.2

14. Creditors: amounts falling due after more than one year

	2004 £m	2003 £m
Non-government loans	41.6	54.2
Other creditors and deferred income	25.6	14.4
	67.2	68.6

15. Deferred taxation

	2004 £m	2003 £m
At 1 April	21.4	4.9
Deferred tax charged to the income and expenditure account	27.2	16.5
Closing provision for deferred tax liability as at 31 March	48.6	21.4
Analysed as follows:		
Accelerated capital allowances on fixed assets	177.5	140.9
Other timing differences	(79.2)	(72.7)
Tax losses carried forward	(49.7)	(46.8)
Provision for deferred tax	48.6	21.4

16. Provisions for liabilities and charges

	Restructure £m	Others £m	Total 2004 £m
At 1 April 2003	65.0	2.0	67.0
Charged to income and expenditure account	34.9	0.7	35.6
Utilised during the year	(36.1)	(0.3)	(36.4)
At 31 March 2004	63.8	2.4	66.2

The restructuring provision relates to expected costs associated with the continuing rationalisation of the business. The costs mainly comprise employee related costs, principally redundancy and early retirement costs. The majority of this expenditure is expected to be incurred over the next two years.

The other provision of £2.4m relates to onerous property rental costs, which will be utilised over the next seven years.

17. Government and other loans

Scottish Water's borrowing powers are defined in Section 42 of the Water Industry (Scotland) Act 2002. The limit at 31 March 2004 on these powers was that total net new borrowings for the year ended 31 March 2004 should not exceed £164.7m. Net new government borrowings were £42.0m in the year.

At 31 March 2004 Scottish Water had outstanding debt on borrowings from Scottish Ministers of £2,138.5m (2003 – £2,071.0m). This consisted of £1,213.9m (2003 – £1,236.8m) of debt issued prior to 1 April 1999 and £924.6m (2003 – £834.2m) issued on or after that date. In addition Scottish Water had a committed bank overdraft facility of £40.0m which is guaranteed by Scottish Ministers.

Government loans, both short and long-term, are recorded on the balance sheet under Capital and Reserves in accordance with the Accounts Direction. Other debt is recorded under short and long-term creditors in accordance with the Companies Act.

Analysis of borrowings by type and maturity

	Up to 1 Year £m	1-2 Years £m	3-5 Years £m	6-10 Years £m	Over 10 Years £m	Total £m
Scottish Consolidated Fund	115.5	20.0	67.5	112.8	608.8	924.6
National Loans Fund	20.0	10.0	62.0	85.0	694.9	871.9
Public Works Loan Board	17.2	30.2	58.4	90.5	145.7	342.0
Total Government Loans	152.7	60.2	187.9	288.3	1,449.4	2,138.5
Other Loans	12.7	10.7	20.7	8.6	1.6	54.3
At 31 March 2004	165.4	70.9	208.6	296.9	1,451.0	2,192.8
At 1 April 2003	115.5	90.4	178.5	295.2	1,471.2	2,150.8

Interest rate profile

The interest rate profile of total borrowings was as follows:

	Total £m	Floating rate £m	Fixed rate £m
At 31 March 2004	2,192.8	3.4	2,189.4
At 1 April 2003	2,150.8	3.4	2,147.4

Fixed rate borrowings

	Weighted average interest rate %	Weighted average period for which rate is fixed Years
At 31 March 2004	6.34	15
At 1 April 2003	6.45	16

Fair values

The table below sets out a comparison of the book and fair values of the loan debt.

	2004		2003	
	Book value £m	Fair value £m	Book value £m	Fair value £m
	2,192.8	2,470.5	2,150.8	2,464.9

18. Obligations under leases

Scottish Water had no amounts due under finance leases.

Annual commitments under non-cancellable operating leases are as follows:

	Land and buildings £m	Others £m	PFI Schemes £m	Total 2004 £m	Total 2003 £m
Operating leases which expire:					
Within one year	0.3	0.4	-	0.7	0.7
Between two and five years	0.4	2.4	-	2.8	2.9
After five years	1.3	-	119.7	121.0	119.5
	2.0	2.8	119.7	124.5	123.1

PFI schemes

As at 31 March 2004, there were nine PFI contracts in operation with contract start dates ranging from December 1996 to October 2000 and contract end dates ranging from December 2021 to October 2040.

19. Pensions

Employees of Scottish Water participate in the Aberdeen City Council Pension Fund, the Lothian Pension Fund, and the Strathclyde Pension Fund, which are part of the Local Government Pension Scheme, a defined benefit scheme administered by Aberdeen, Edinburgh and Glasgow City Councils respectively. The three schemes are funded by the payment of contributions to the separately administered funds.

Pension costs are determined with the advice of independent qualified actuaries on the basis of triennial valuations using the projected unit method. The results of the most recent valuations, which were conducted as at 31 March 2002, were as follows:

	Aberdeen Pension Fund	Lothian Pension Fund	Strathclyde Pension Fund
Main assumptions:			
Investment return %	6.1	6.5	6.5
Rate of salary increase %	4.3	4.1	4.1
Inflation/rate of pension increase %	2.8	2.6	2.6
Total market value of assets £m	1,138.2	1,783.8	6,039.2
Funding level as a % of fund liabilities	94.2	96.0	108.0

Pension costs for the year for each fund as a % of employees contributions, were 245% (2003 – 230%), 275% (2003 – 265%) and 230% (2003 – 220%) respectively. Total pension costs for Scottish Water were £14.0m (2003 – £13.0m) (note 5). The unpaid contributions outstanding at the year-end, included in other creditors (note 13), was £1.6m (2003 – £1.7m).

FRS 17 Retirement Benefits

The valuation used for FRS 17 disclosures has been based on an actuarial valuation as at March 2002 and updated at March 2004 by a qualified independent actuary to take account of the requirements of FRS 17.

The financial assumptions used to calculate scheme liabilities under FRS17 are:

	2004 %	2003 %
Rate of increase in pensionable salaries	4.4	4.0
Rate of increase in pensions payment	2.9	2.5
Discount rate	5.5	5.4
Inflation rate	2.9	2.5

Scottish Water's share of the assets in the schemes and the expected rate of return were:

	Long term rate of return %	Value 2004 £m	Long term rate of return %	Value 2003 £m
Equities	7.7	361.0	8.0	270.8
Bonds	5.1	55.7	4.8	46.9
Property	6.5	37.1	6.0	37.5
Other	4.0	24.4	4.0	15.3
Total market value of assets		478.2		370.5
Present value of scheme liabilities		(665.5)		(578.4)
Gross deficit in the schemes		(187.3)		(207.9)
Related deferred tax asset		56.2		62.4
Net pension liability		(131.1)		(145.5)

The amount of this net pension liability would have a consequential effect on reserves.

Movement in the deficit during the year:

	2004 £m	2003 £m
Gross surplus/(deficit) in scheme at the beginning of year	(207.9)	2.3
Current service cost	(16.2)	(18.2)
Contributions paid	22.0	17.5
Other finance income/(cost)	(5.9)	4.1
Actuarial gain/(loss)	20.7	(213.6)
Gross deficit in the schemes at year end	(187.3)	(207.9)

If FRS 17 had been fully adopted in these financial statements the pension costs for defined benefit pension schemes would have been:

Analysis of other pension costs charged in arriving at operating surplus:

	2004 £m	2003 £m
Current service cost	16.2	18.2

Note: Past service costs, curtailment and settlements have been charged against the reorganisation provision.

Analysis of amounts included in other finance income/(costs):

	2004 £m	2003 £m
Expected return on pension scheme assets	27.1	32.2
Interest on pension scheme liabilities	(33.0)	(28.1)
	(5.9)	4.1

Analysis of amount recognised in statement of total recognised gains and losses:

	2004 %	2004 £m	2003 %	2003 £m
Difference between the expected and actual return on scheme assets		69.0		(128.7)
Percentage of year end scheme assets	14.4		(34.7)	
Experienced gains/(losses) arising on scheme liabilities		(14.5)		(62.7)
Percentage of present value of year end scheme liabilities	(2.2)		(10.8)	
Changes in assumptions underlying the present value of scheme liabilities		(33.8)		(22.2)
Percentage of present value of year end scheme liabilities	(5.1)		(3.8)	
Total amount to be recognised in Statement of Total Recognised Gains & Losses being 3.1% of the present value of liabilities		20.7		(213.6)

20. Capital commitments

Amounts contracted for but not provided in the financial statements amounted to £526.0m (2003 – £158.6m).

21. Contingent liabilities

There are no material contingent liabilities (2003 – Nil).

22. Related party transactions

Scottish Water is a public corporation of a trading nature sponsored by The Scottish Executive Environment and Rural Affairs Department (the 'Department'). In terms of Financial Reporting Standard 8 'Related Party Transactions', the Department is regarded as a related party. During the year Scottish Water has had various material transactions with the Department, with Local Authorities and with entities for which the Department is regarded as the parent.

In the course of normal operations, Scottish Water contracted on an arms-length basis with Scottish Water Solutions Limited, a Joint Arrangement between Scottish Water, Stirling Water Limited and UUGM Limited. The aggregate transactions which are considered to be material and which have not been disclosed elsewhere in the financial statements are summarised below:

	2004 £m	2003 £m
Sales and costs charged to Scottish Water Solutions Limited	17.6	-
Purchases from Scottish Water Solutions Limited	(76.0)	-
Amounts due to Scottish Water Solutions Limited (note 13)	23.4	-

23. Ultimate controlling body

Scottish Water is a public sector body, classified as a public corporation of a trading nature, and is answerable to the Scottish Parliament through Scottish Ministers.

24. Current cost accounts

Scottish Water is obliged under the Directions from Scottish Ministers under section 45(2) of the Water Industry (Scotland) Act 2002 to prepare accounts on a current cost basis. These are available on request from Scottish Water, Castle House, 6 Castle Drive, Carnegie Campus, Dunfermline, KY11 8GG.

25. Regulatory information

The Water Industry Commissioner for Scotland has the general function of promoting the interests of customers of Scottish Water in relation to the provision of core services, and must investigate any complaints made by customers. The Commissioner also advises Scottish Water on any matter that relates to the standard of service provided by Scottish Water to its customers or the manner in which it conducts its relations with its customers. When required by Scottish Ministers, the Commissioner must advise them on periodic charging schemes in line with the requirements set out in the Water Industry (Scotland) Act 2002.

Each year the Commissioner publishes reports on the exercise of his functions. In preparing these reports, the Commissioner assesses Scottish Water's performance by using information supplied by Scottish Water, and by making comparisons with information obtained on other regulated utilities. As part of this process, the Commissioner may make regulatory amendments to figures published in the audited financial statements of Scottish Water, in order to aid comparisons with other regulated utilities.

Compliance with government targets

a) Sufficiency of revenue

Scottish Water reported a surplus before tax of £87.8m for the year (2003 – £51.4m). The surplus before tax consisted of a trading surplus £140.6m (2003 – £76.0m) before charging exceptional costs of £52.8m (2003 – £24.6m).

b) Borrowing limit

Net borrowings during the year to 31 March 2004 were £42.0m compared with the borrowing limit of £164.7m set by Scottish Ministers.

Direction by the Scottish Ministers

in accordance with section 45(2) of the Water Industry (Scotland) Act 2002

1. The Report and Accounts, which it is the duty of Scottish Water to prepare, in respect of its financial year ending on 31 March 2004 and each subsequent financial year shall comprise:
 - 1.1. a foreword;
 - 1.2. an income and expenditure account;
 - 1.3. a statement of total recognised gains and losses;
 - 1.4. a balance sheet; and
 - 1.5. a cashflow statementtogether with such further information as may be necessary to comply with this Direction.
2. The Report and Accounts referred to in paragraph 1 shall give a true and fair view of the income and expenditure and cash flows for the financial year, and of the state of affairs at the end of the financial year.
3. The Report and Accounts shall also meet in as far as they are appropriate:
 - 3.1. the accounting and disclosure requirements of the Companies Act 1985;
 - 3.2. generally accepted accounting practice including financial reporting standards issued by the Accounting Standards Board;
 - 3.3. the accounts disclosure requirements of paragraph 43 of Chapter 12 of the Listing Rules issued by the Financial Services Authority (formerly the London Stock Exchange);
 - 3.4. the accounting and disclosure requirements given in 'The Scottish Public Finance Manual' as amended or augmented from time to time; and
 - 3.5. the accounting and disclosure requirements contained in other guidance issued by the Scottish Ministers from time to time in respect of Accounts, which are required to give a true and fair view.
4. Clarification of the application of the accounting and disclosure requirements of the Companies Acts and financial reporting standards is given in Schedule 1 attached. Additional disclosure requirements are set out in Schedule 2 attached.
5. The Report and Accounts referred to in paragraph 1 shall be prepared under the historical cost convention.
6. The foreword and balance sheet shall be signed by the Chief Executive of Scottish Water and dated.
7. The Report and Accounts shall be audited and laid before the Parliament not later than 6 months after the end of the financial year.
8. These requirements shall be reproduced as an appendix to the Report and Accounts.

Schedule 1

Application of the accounting and disclosure requirements of the Companies Act 1985 and Accounting Standards

1. The income and expenditure account shall be prepared in accordance with profit and loss account format 1 set out in Schedule 4, Companies Act 1985.
 2. The Report and Accounts need not include a 'Note of historical cost profits and losses' as required by Financial Reporting Standard 3.
 3. The balance sheet shall be prepared in accordance with balance sheet format 1 set out in Schedule 4, Companies Act 1985.
 4. The balance sheet shall include indebtedness to the Scottish Ministers under the heading 'capital and reserves'. The notes thereto shall show separately any amounts falling due for payment within 12 months of the date of the balance sheet.
 5. Grants and contributions in respect of expenditure on fixed assets shall be treated as deferred income and recognised in the income and expenditure account over the expected useful lives of the related assets, except that grants and contributions specifically relating to infrastructure assets shall be deducted from the cost of those assets.
 6. The Accounts' presentation and disclosure exemptions permitted by the Companies Act 1985 shall not apply unless specifically approved by the Scottish Ministers.
3. The foreword to the Report and Accounts shall contain, insofar as it is appropriate:
 - a) a statement that the Accounts have been prepared in a form directed by Scottish Ministers in accordance with section 45(2) of the Water Industry (Scotland) Act 2002;
 - b) a brief history of Scottish Water and its statutory background;
 - c) a statement confirming compliance by Scottish Water with any Directions, requirements and guidance issued by the Scottish Ministers insofar as such matters relate to the functions of Scottish Water;
 - d) a statement of Scottish Water's members' responsibilities in respect of the preparation of the Report and Accounts;
 - e) the information required the Companies Act 1985 to be included in the directors report; and
 - f) a discussion and analysis of Scottish Water's performance and the factors underlying its results and financial position, having regard to the guidance in the Statement 'Operating and Financial Review' published by the Accounting Standards Board.
 4. The notes to the Report and Accounts shall include:
 - a) an analysis of operating costs and assets having regard to prevailing practice in the water industry;
 - b) details of Scottish Water's members' and senior employees' remuneration in accordance with the guidance contained in the Resource Accounting Manual published by HM Treasury for the financial year, except that the amounts disclosed should be to the nearest £'000 and not in bands;
 - c) a comparison of Scottish Water's financial targets set for a financial year by the Scottish Ministers with the outturn for that year.

Schedule 2

Additional disclosure requirements

1. The notes to the income and expenditure account shall disclose:
 - a) an analysis of turnover and operating surplus before interest and tax over the following activities – water, sewerage and other services;
 - b) in turnover, separately identified, the amount of revenue grants received from the Scottish Ministers and the source and authority for each grant, broken down between payments in respect of earlier years and the current year;
 - c) an analysis of the interest charge, showing separately the interest on capital loans.
 2. The notes to the balance sheet shall disclose:
 - a) Scottish Water's maximum borrowing limit as specified by Scottish Ministers;
 - b) indebtedness to the Scottish Ministers, showing separately loans issued prior to 1 April 1999 and loans issued on and after that date, and other borrowings and showing when repayments are due;
 - c) an analysis of net assets over the activities set out in paragraph 1a) above; and
 - d) the amount, source and purpose of capital grants received and receivable.
5. Notwithstanding the requirements relating to corporate governance contained in paragraph 12.43 of the Listing Rules issued by the Financial Services Authority referred to above, the Report and Accounts shall also include such additional disclosures relating to corporate governance as may be required by any Directions or guidance issued by the Scottish Ministers from time to time.

Notes

Additional information

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