



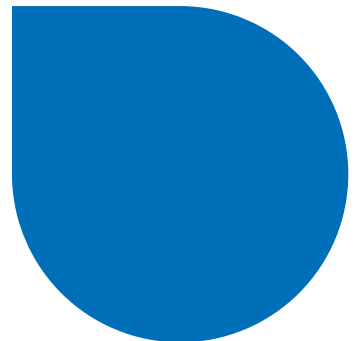
Scottish Water

Trusted to serve Scotland

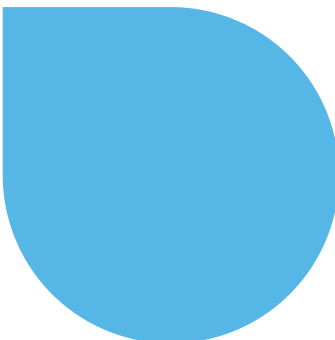
Annual Report & Accounts 2016/17



Trusted
Putting customers first



Serving
Delivering for Scotland 24/7



Our vital role

Scottish Water provides vital water and waste water services, essential to daily life, to 2.5 million households and 156,000 business premises across Scotland.

Each day we provide 1.35 billion litres of clear, fresh drinking water and take away 945 million litres of waste water, which we treat before returning safely to the environment.

The quality of drinking water provided to customers was sustained at a high level and our investment helps to support jobs and economic growth while protecting and enhancing water quality and the environment.

All of this is done at a cost which is among the lowest in Great Britain. Our average household charge is £38 lower per year than the average household charge in England and Wales.

2016/17 was the second year in the 6 year programme which will see over £3.5 billion invested in maintenance and further improvements to drinking water quality, protecting the environment and supporting the Scottish economy.

Customer charges go towards maintaining and improving:

30,124 miles of water pipes

31,814 miles of sewer pipes

245 water treatment works

1,848 waste water treatment works

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2016/17 highlights

Best ever customer service

Highest ever Customer Experience Measure score and lowest level of written complaints

High quality water maintained

More than 99.91% of tests at customers' taps pass stringent quality standards, equalling our best ever result

Major investment

Invested £627 million improving services and supporting the economy

Value for customers

Our average household charge remains £38 below England and Wales average

Trusted by customers

Scotland's water sector is the most trusted by consumers, according to Which? Consumer Insight Report

Best workplace

'Best workplace in Scotland' award and Scotland's 'Fair Work Employer 2016'

Chair's statement

Susan Rice, Chair



It's been a strong year for Scottish Water as we stepped up the delivery of our 6 year investment programme.

At Scottish Water we understand that our customers have high expectations of their public utility, including high quality drinking water, first class customer service and the protection of the natural environment. We also know that they need us to do this efficiently so that we can keep bills down.

The Board maintains a firm focus on ensuring that our objectives match those customer expectations and our performance delivers against them.

I'm pleased to report that in 2016/17 we have been able to continue the trend of year-on-year service improvement: our customers continue to benefit from one of the UK's best value water and waste water services, the quality of the water at customers' taps remains at very high levels and we are investing further to protect the environment.

In the second year of our 2015–21 regulatory period, we made great strides in the delivery of our investment programme, investing to achieve improvements in drinking water quality, the treatment of waste water we return to the environment and the resilience of our assets.

Our capital programme also supports jobs and economic growth across Scotland, notably in the construction and engineering sectors, and so contributes toward the policy objectives of the Scottish Government.

I'd like to thank all of our people at Scottish Water, who I know to be tireless and committed in achieving these objectives, for their hard work and considerable achievements in the year.

Since last year's report I'm delighted to have welcomed two new members to the Board – James Coyle and Paul Smith. Their expertise, which includes finance and energy, provides us with additional insight and perspective so important in ensuring Scottish Water maintains the highest possible levels of performance. Samantha Barber and Iain Lanaghan, who joined in April 2017, add to the diversity of the skills on the Board. Geoff Aitkenhead, who had served as an Executive Board member since the formation of Scottish Water retired in July 2016. Andrew Wyllie and Jim Spowart stepped down from the Board at the end of the financial year. I'm grateful to Geoff, Andrew and Jim for their service and significant contribution to Scottish Water's success.

During the year, the Board and committees have carried out extensive work to ensure that our management teams remain focused on our corporate objectives. We have also examined the areas of risk, compliance and governance. These efforts have confirmed that Scottish Water continues to deliver against the requirements of our customers, regulators and the Scottish Government.

Beyond Scottish Water's core responsibilities we also seek to use our assets, skills and people in other activities that can add further value for our customers and Scotland more generally, including the areas of renewable energy and advising in the delivery of water and waste water services overseas.

Scottish Water Horizons, a non-regulated subsidiary, has continued to pursue innovative approaches using Scottish Water assets to encourage environmental sustainability. I was delighted when we were able to announce that Scottish Water now owns or hosts more renewable energy generation on our sites, than the electricity required to run our operations. This achievement would not be possible without the vision to see these broader opportunities and the momentum to deliver them.

Scottish Water International, which offers consultancy advice to utilities, governments and other overseas clients, has involved 70 Scottish Water employees on assignments in Ireland, Australia, Norway, Qatar and Canada.

Business Stream has operated in a challenging environment with tough market conditions in Scotland. At the same time, it has reshaped its strategy ahead of the full opening of the English retail market in April 2017, and acquired Southern Water's non-domestic customer base to become one of the largest UK players in the non-domestic market.

The activities of all our subsidiaries contribute to Scottish Water's ability to deliver on the requirements of our customers while keeping customer charges low.

In the next year, in all parts of the group, we will continue to build on the progress made during 2016/17 and strive wherever possible to do even better, so that we can continue to maintain the trust of everyone who depends on Scottish Water.

Our strategy

Scottish Water delivers clear and fresh drinking water, treats waste water and helps protect the environment across Scotland – every day of the year.

We do this in an affordable and sustainable way.

- We put customers at the heart of our plans. Listening to customers' views and building these into our planning. This allows us to ensure our customers' needs shape our service delivery.
- We are committed to improving the services we provide to customers. Our strategies are geared to help us achieve that, innovating where we can to further improve performance and efficiency.
- We work hard to provide continuous clear and fresh drinking water, ensuring all our customers can turn on their taps to receive a safe and reliable supply, everywhere in Scotland.

- We strive to protect and enhance the environment of Scotland through investment in our waste water systems and good operational practice.
- We support Scotland's economy and communities by extending our infrastructure to meet new demand for our services.

[This annual report highlights our progress during 2016/17. Information on our plans for service improvement from 2015–21 is included on page 39.](#)

Our vision

Scottish Water's vision is to be trusted to care for the water on which Scotland depends. This is supported through 6 pillars.

Serving

Showing our customers that we care. Achieving year on year improvements in their experience of our service and having a positive impact on customers and communities.

Leading

Shaping our future for the benefit of customers. Listening to our customers, being proactive, working with customers, landowners, local authorities and developers to deliver even more efficient services.

Strong

Working hard to keep customers' prices low. Delivering savings to keep household customer price increases across the 2015–21 regulatory period which are below the overall level of CPI inflation.

Growing

Enabling a thriving Scotland. Supporting developers as a leading infrastructure partner, seeking innovative and low cost solutions for businesses to grow in Scotland, and supporting an efficient supply chain through world class procurement.

Responsible

Always doing the right thing for Scotland. Providing ever better drinking water, implementing plans to boost water supply resilience to communities, fulfilling our environmental obligations and reducing our carbon footprint.

Committed

Behaving safely and having agile, healthy people and workplaces. Building our skills and diversity to sustain high performance.

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Chief Executive's statement

Douglas Millican, Chief Executive



Trusted to serve Scotland is the strapline under our logo. This reflects our ambition to maintain the trust of our customers and communities as we deliver the services upon which they rely. That is why I am delighted that the water industry – led by Scottish Water but also including our partners and suppliers – was found to be the most trusted sector by Scottish consumers in a recent Which? Consumer Insight Report.

The past year has been another good year for Scottish Water. We made further significant improvements to our customer service, and this was reflected in our household Customer Experience Measure (CEM). During the year, we improved the CEM score by 1.56 points to 85.88 due primarily to achieving our highest ever customer satisfaction scores and lowest ever level of written complaints. Since we introduced CEM in 2015 we have reduced lost points by 10% per annum in each of the last 2 years. We also out-performed our regulatory performance target, achieving a score of 398 on the Overall Performance Assessment. Although our overall levels of customer service were very high, we faced some challenges dealing with a very small number of sensitive community matters. In 2016, we sustained water quality supplied to customers at a similar high level to 2015 with 99.91% of all tests taken at customers' taps complying with strict regulatory standards.

The group surplus before tax of £94.2 million was £12 million lower than in 2015/16, reflecting primarily a £12.8 million reduction in Business Stream's surplus arising from a reduction in their market share. Scottish Water's drive to deliver savings for our customers resulted in a regulated surplus of £86 million, £1.2 million greater than in 2015/16, and this will be reinvested to support delivery of future services to customers.

Our customers continue to benefit from one of the UK's best value water and waste water services, with average annual household charges £38 below the average combined water and waste water bill in England and Wales.

2016/17 was the second year of our 6 year regulatory period. We achieved a step-change in the pace of delivery of our capital programme, investing £627 million in the year, as we benefited from our new investment planning and delivery arrangements with strengthened in-house investment planning capability and three new alliances, supported by a framework of local contractors with bases around Scotland. Nearly every capital project, in each programme area, was delivered on, or ahead of, target timescales.

This investment programme makes Scottish Water one of the biggest investors in Scotland's infrastructure in both the public and private sectors. We are working hard to ensure we support Scotland's economic growth, jobs and supply chain as we deliver projects that improve water and waste water services. Throughout the year we also worked to improve the efficiency and effectiveness of the service provided to the development community, building on improvements to collaborate more proactively with property developers and build strategic capacity in our assets and networks.

As well as the Which? Report, the excellence of Scottish Water and our people has been recognised by a number of other awards including 'Fair Work Employer of the Year 2016' at the Scottish Business Awards and 'Best Workplace 2016' at the HR Network Awards for our progressive people policies, and Investors in Young People (IYYP) Gold Accreditation, the highest award possible for the recruitment and retention of young people. Developing and engaging our employees, and ensuring that Scottish Water is a great place to work, are at the heart of our drive to improve performance and customer satisfaction.

Our work to ensure the continued health, safety and wellbeing of our employees has been recognised by the Royal Society for the Prevention of Accidents (RoSPA) UK through the Water Industry sector award for health and safety. During the year we developed a new safety, health and wellbeing strategy which sets out our intent to lead the industry in Scotland towards the aim of zero harm.

We could not achieve any of this without the hard work of our people. The nature of any water company's activities is that challenges are often posed by adverse weather or other circumstances outside our control. In the last year, our teams have carried out some excellent work to maintain services in the face of challenging conditions, or restore normal service as quickly as possible where disruption has occurred. I would like to offer my personal thanks to everyone who has contributed to that achievement.

Throughout this regulatory period, our investment programme will see over £3.5 billion invested in improvements to vital infrastructure for the benefit of our customers between 2015 and 2021 and to meet Ministerial objectives. And every day we will seek to deliver even higher drinking water quality, customer service and environmental performance; working with customers and communities to deliver the services they need, and continuing to out-perform the requirements set for us by our regulators and the Scottish Government.

Our business model

Group overview

Our customers expect us to provide excellent customer service by delivering ever higher levels of water quality and environmental performance, all for an affordable price.

Our vision is therefore to be trusted by our customers to care for the water on which Scotland depends. To achieve this, the overarching aim 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. At the same time, we must maintain our financial strength across all parts of the Scottish Water group.

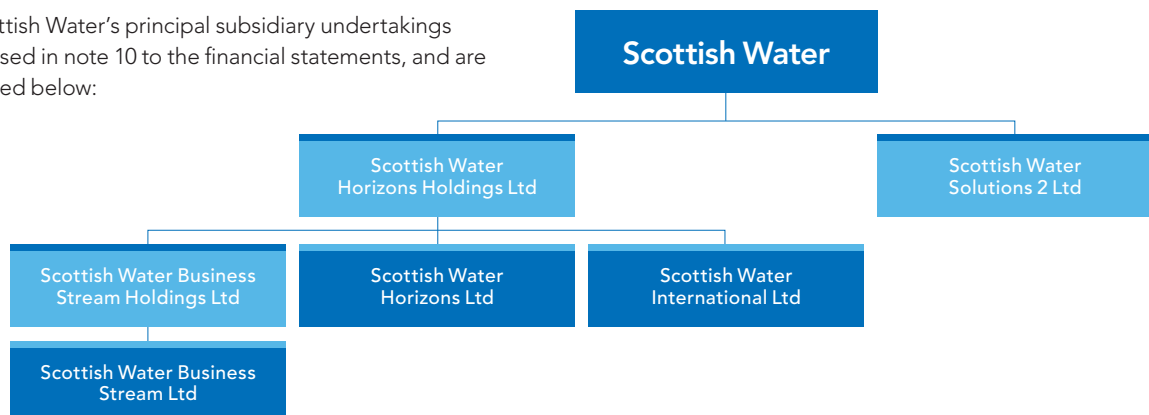
Group structure

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 30,810 square miles.

The 4 main trading businesses of the Scottish Water group are:

- **Scottish Water**, which supplies water and waste water services to households and wholesales to retailers (licensed providers) in the water retail market for businesses in Scotland;
- **Scottish Water Business Stream Ltd (Business Stream)**, our licensed provider (LP) that competes with other LPs to supply water and waste water services to business customers;
- **Scottish Water Horizons Ltd (Horizons)**, a subsidiary which provides non-regulated services to customers; and
- **Scottish Water International Ltd (International)**, a subsidiary which provides non-regulated services to clients outside Scotland.

All of Scottish Water’s principal subsidiary undertakings are disclosed in note 10 to the financial statements, and are summarised below:



Scottish Water

Scottish Water is a public sector body, classified as a corporation of a trading nature, and is answerable to the Scottish Parliament through Scottish Ministers. The Members of Scottish Water’s Board are accountable to the Scottish Government. The Board currently includes 3 Executive Members and 8 Non-executive Members.

Business Stream

Business Stream was formed in preparation for the opening to competition of the Scottish retail market for water and waste water services to business premises in 2008. As at March 2017, the company was one of 25 (2016: 23) Licensed Providers, while Scottish Water is the wholesaler to the business market. Business Stream is operated in accordance with the Governance Code (agreed with the Water Industry Commission for Scotland). The code sets out the operating regime that Scottish Water and Business Stream must comply with to enable the operation of the licensed retail market. Business Stream has the same Chair as Scottish Water but has its own independent Board and management team. The Board includes 2 Non-executive directors who have no other association with the Scottish Water group.

Scottish Water exercises governance over Business Stream through Scottish Water Business Stream Holdings Ltd (SWBSH) in accordance with the above code. The Board of SWBSH has several directors in common with Scottish Water. The SWBSH Board reviews reports from Business Stream management covering financial performance, business specific risks, dividend policy and strategic plans.

Horizons and International

Horizons is a commercial business enterprise, set up to deliver further value from Scottish Water's considerable physical and intellectual asset base. It operates facilities to test innovation, as well as waste management, infrastructure development and renewable energy development services. Horizons is managed by its own Board of Directors, including 4 Non-executive directors, 3 of whom are senior managers in Scottish Water.

International was established to develop business opportunities abroad using the skills and expertise in Scottish Water to offer specialist consultancy services to utilities, foreign governments and other international clients. International is managed by its own Board of Directors, including 4 Non-executive directors, 3 of whom are senior managers in Scottish Water.

Strategic framework

Scottish Water operates within a broad strategic framework set by Scottish Ministers. The agreed targets and milestones for Scottish Water and its non-regulated business are set out in our Group Plan. The Group Plan also sets out the resources required and proposals for meeting and out-performing the regulatory targets and delivering our growth ambitions in other commercial arenas. Scottish Water aims to maintain a level of financial strength that would be sufficient to enable it to secure commercial debt on cost effective terms, consistent with the Water Industry (Scotland) Act 2002.

Scottish Water generates value for our customers by planning for, and delivering, continuous efficiency improvements in operational and capital investment activities associated with regulated water and waste water services. The planned efficiency improvements therefore allow for below inflation increases in charges for customers, as set out in the Water Industry Commission for Scotland's (WICS) final determination for the 2015-21 period. The value generated by the out-performance of these efficiency targets is retained in Scottish Water until it is returned to customers through further improvements in service or below inflation increases in water and waste water charges at the next strategic review of charges, or earlier.

The profits generated from the other licensed and commercial activities are all retained within the group and invested in the future development of the business.

Financial framework

The Scottish Water regulated business is subject to incentive-based regulation by the Water Industry Commission for Scotland.

In 2014, WICS set out their final determination for the 2015-21 period, which caps the prices that Scottish Water charge for water and waste water services.

The combination of regulated price caps and constraints on borrowing from the Scottish Government creates a clearly defined limit on the financing available to Scottish Water.

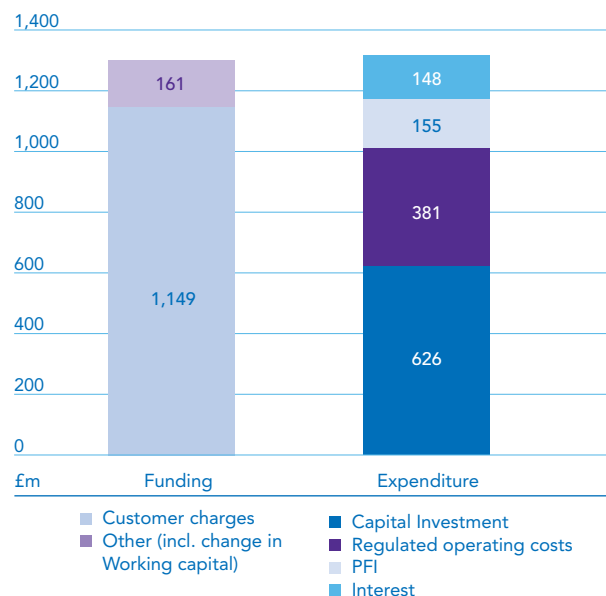
Within this financial framework, Scottish Water has an agreed Delivery Plan with Scottish Ministers that sets out Scottish Water's planned level of investment to deliver the required improvements and the expenditure to run the operation in respect of our core, regulated water and waste water services. Scottish Water's aim is to out-perform the targets set out in the Delivery Plan and thereby out-perform the final determination.

The funding and expenditure model for Scottish Water's Regulated Services

Scottish Water is funded through revenue raised from customer charges and borrowing from the Scottish Government. These finance Scottish Water's capital expenditure programme, operating costs, PFI service fees and interest charges on its loans.

The diagram below illustrates Scottish Water's funding and expenditure for the year ended 31 March 2017. The surplus made by Scottish Water is reinvested in the provision of services to customers.

Scottish Water Funding and Expenditure 2016/17



Our approach to risk management principal risks and uncertainties

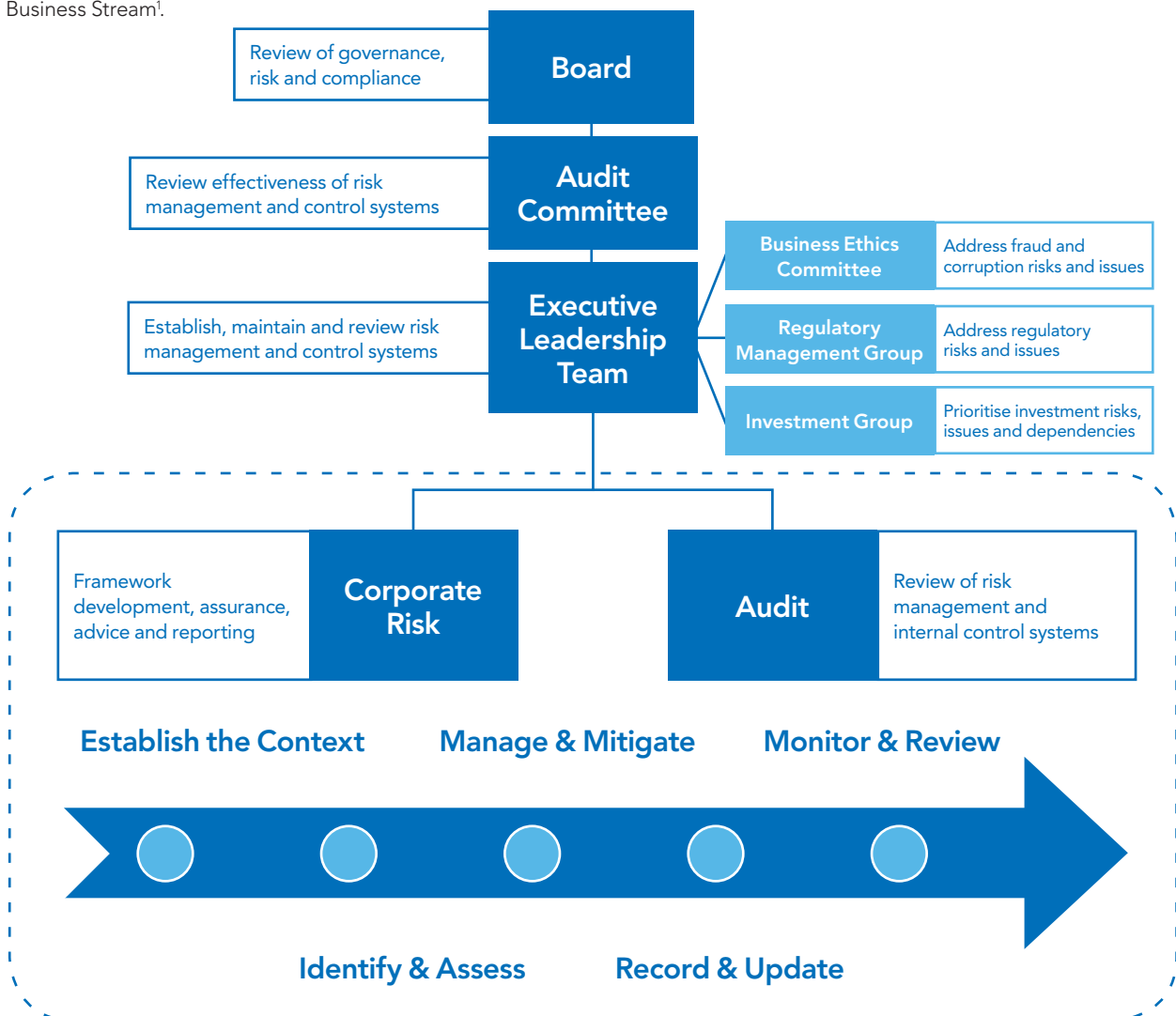
Overview

Sound risk management is integral to the achievement of Scottish Water’s vision and the delivery of Ministerial objectives. We recognise that risks, both positive (opportunities) and negative (threats) exist. These have the potential to impact the way we operate, the services we provide to customers, and ultimately affect the achievement of our business objectives, strategy and our corporate vision.

Our risk management framework includes Scottish Water Horizons and Scottish Water International but excludes Business Stream¹.

Risk control assurance

Scottish Water operates a formal governance structure to manage risk. While it is everyone’s responsibility to manage risk, the Scottish Water Board, supported by the Audit Committee and the Executive Leadership Team, has responsibility for this risk management framework. Regular reviews of the most significant risks are undertaken with appropriate mitigation strategies developed, implemented and monitored.



¹ Business Stream has its own governance structure in accordance with the Governance Code and operates its own risk management framework.

In order to efficiently and effectively manage opportunities and threats across Scottish Water, we embrace a systematic and structured approach to risk management. Our approach is based on the principles of the International Standard 31000 Risk Management (ISO 31000) and tailored to meet the needs of our business and the environment in which we operate.

Our approach is designed to provide assurance that the opportunities and threats facing the business are being appropriately identified, assessed and effectively managed; and that all necessary information is reported to managers, the Executive Leadership Team, Audit Committee and Board.

Risk management approach

Scottish Water has an established risk management policy which defines our risk appetite and sets out a clear and consistent approach to the management of risk. This is enabled by the Corporate Risk Register and supporting risk management processes.

Our systematic and structured risk management approach is designed to identify, assess and effectively manage business risks. The consequence and likelihood of risks are determined and scored using a risk scoring matrix to ensure a consistent approach is taken when assessing the overall impact to Scottish Water and our customers. When forming this assessment the business considers risks organised around four risk perspectives. These are reputational, financial, operational, and external risks. The current, or projected, level of risk is compared to the Board's risk appetite to ascertain whether further action is required to ensure the achievement of service delivery and business objectives in line with our vision and values.

Culture

The Board is aware that the effectiveness of risk management is dependent on Scottish Water's culture, which encompasses the knowledge, behaviours and attitudes of our people. We aim to foster a risk-aware culture throughout the business. We seek to do this by promoting a consistent tone from the top, outlining clear responsibilities and accountabilities for those managing risk.

Risk appetite

The level of risk we are willing to accept in the pursuit of our business objectives is reviewed and validated by the Board in advance of, and during, each regulatory period where there is a material change to the operating environment. The appropriateness of the mitigating actions is determined in accordance with the risk appetite for the relevant business areas.

We have established Risk Appetite Statements for key business areas. Beneath each statement is a series of measurable Risk Appetite Definitions which assist in providing a view as to whether we are operating within our appetite or whether additional risk action may be required. These metrics are routinely reviewed by the Corporate Risk Team and individual risk owners, and are incorporated into bi-annual reports to the Executive Leadership Team and Audit Committee, and the annual report to the Board.

Board

The Board has overall responsibility for reviewing governance, risk and compliance and receives a full annual risk report, supplemented by quarterly updates, which review the principal risks and uncertainties, including the mitigating actions being undertaken and their effectiveness.

Audit Committee

The Audit Committee assumes responsibility for the risk management framework on behalf of the Board, reviewing the effectiveness of risk management and supporting control systems. The Committee receives two comprehensive risk reports, supplemented by quarterly updates.

Executive Leadership Team

The Executive Leadership Team is responsible for establishing, maintaining and reviewing risk management and supporting control systems. The Executive Leadership Team receives regular risk reporting. A number of Executive sub-committees assist with oversight of specific risk areas. These include the Business Ethics Committee which meets quarterly to address fraud and corruption risks and issues; the Regulatory Management Group which meets monthly to address regulatory risks and issues; and the Investment Group which also meets monthly to address investment risks, issues and dependencies.

Corporate risk

Scottish Water has a Corporate Risk Function. This is headed by a Senior Manager, reporting to the Finance Director, who leads and manages the risk management framework and processes and is responsible for risk reporting and advice to the Executive Leadership Team, Audit Committee and the Board.

Audit

Assurance on risk controls is provided by internal management information, internal audits, external audits and Board oversight. There is also an externally supported whistleblowing facility.

Scottish Water operates a three Lines of Defence model with clearly defined roles and responsibilities.

First Line of Defence	Second Line of Defence	Third Line of Defence
Each directorate is responsible for the identification and assessment of risks, understanding and adopting appropriate controls.	Corporate Risk provides challenge on the completeness and accuracy of risk assessments, reporting and adequacy of mitigation plans.	Internal Audit provides independent and objective assurance on the robustness of the risk management framework and the appropriateness of internal controls.




Principal risks and uncertainties

As a water utility, Scottish Water manages an extensive network of ageing infrastructure which brings uncertainty. The Board regularly reviews robust assessments of the principal risks and uncertainties facing Scottish Water and our subsidiaries, as set out over the following pages. These are the risks that we presently consider to be the most material to our business and our performance, including those that would threaten the business model, future performance within our regulatory settlement, solvency and liquidity of Scottish Water.

This list does not comprise all of the risks that the Group may face and is not provided in any order of priority. The nature of these risks has remained largely unchanged over the year. There may be additional risks that could emerge in the future.

We have also commented on key mitigating actions that are employed to manage these risks as well as our risk appetite in each of the risk areas.

Scottish Water group principal risks and uncertainties

Risk or Uncertainty trend	Description	Risk Appetite	Key Mitigations
Operational			
Water Quality 	Risk of provision of water to customers which has the potential to have an immediate impact on health.	As a water utility company, provision of safe drinking water remains our highest priority.	<ul style="list-style-type: none"> – Skilled and trained employees operate our water assets. – Routine monitoring of the water in our catchments, and in our treatment and distribution activities. – Routine testing of water quality (beyond regulatory requirements) to manage drinking water quality and minimise associated risks. – Delivering significant investment to further improve water quality. – Detailed emergency response plans.
Compliance with water quality standards at customers' taps was sustained at over 99.91%. This is alongside a reduction in the number of customer contacts on water quality. Significant investment has continued across 2016/17 to further improve water quality.			
Critical Assets 	Risk to service to customers and the environment arising from failure of a critical asset or assets.	Delivering a continuous service to our customers is paramount.	<ul style="list-style-type: none"> – Developing detailed knowledge and understanding of our critical assets. – Undertaking operational inspections, maintenance and emergency planning activities to minimise the risk and consequences of failure. – Identifying and delivering investment to reduce this risk for promotion in our future investment programmes.
Across 2016/17 investigations have continued to be undertaken on critical assets to better inform our short and long-term strategies to then manage the risk.			
Safety, Health & Wellbeing 	Risk of potential harm to employees, contractors or the public.	Scottish Water recognises that we operate in a high-risk environment. The safety, health and wellbeing of our employees as well as the health and safety of our contractors, partners and the public remain paramount.	<ul style="list-style-type: none"> – Detailed health and safety management processes. – Embedment of safety, health and wellbeing in our culture and processes via training and awareness-raising. – Completion of risk assessments and regular inspections. – Investigation of all accidents and incidents and tracking of necessary remedial actions. – Performance metrics tracked and reported to the Executive Leadership Team and the Board.
While our safety, health and wellbeing performance is strong, working with and around water, waste water, construction/excavation sites, plant and equipment carries an inherent risk.			

Operational cont...

Cyber Security	Operational risk from loss of key IT service arising from a deliberate external attack (physical/virtual).	Scottish Water seeks to ensure the integrity and security of its IT estate.	<ul style="list-style-type: none"> - Organisation-wide education and awareness programme rolled out. - External Expert Vulnerability and Threat Management service utilised. - Security gap analysis undertaken, plans in place to further increase security level. - Regular application of updates to software and security products. - Detailed disaster recovery plans. - Participate in UK & Scottish Government and industry cyber incident exercises.
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While the water industry has not been subject to a notable attack in 2016/17, we note that the number of cyber-attacks is increasing in the UK and globally.

Financial

PFI Operations	Financial and operational risk should a PFI plant or operations fail to deliver in accordance with the contract terms.	Scottish Water seeks to deliver services in an efficient and cost effective manner including via a number of PFI waste water contracts.	<ul style="list-style-type: none"> - Maintaining ongoing strong relationships with the PFI companies. - Monitoring and management of PFI company performance. - Development of contingency plans for both the financing and operation of these contracts.
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There were no material changes to the risk faced across the PFI portfolio in 2016/17.

Business Stream

Business Stream	Risk of reducing value (both financial and reputational for the Scottish Water group) due to increasingly competitive Scottish and English retail markets.	Business Stream will maintain a financially viable retail business.	<ul style="list-style-type: none"> - Establishing strategic partnerships as a vehicle for service growth. - Continuous improvement of customer service and cost to serve. - Targeted entry into the English market for geographic growth.
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Over 2016/17 there has been a continued increase in the number of competitors entering the Scottish market in readiness to compete in the English market which opened on 1 April 2017.

In addition to the high impact risks above, we also actively manage a number of other high consequence but lower likelihood risks. Examples of these include:

- Service, reputational and financial risk arising from infrastructure diversions required to facilitate major highway construction.
- Service and financial risk arising from contractors not fulfilling their obligations/ liabilities.
- Reputational and financial risk arising from non-compliance with the EU Urban Waste Water Treatment Directive.
- Financial and operational risk and opportunity arising from constitutional change.

Notwithstanding our integrated approach to risk management, we acknowledge that we may not always be successful in fully mitigating all our known risks. In the event that such an issue occurs, service to customers could be affected. If this situation arises we will do everything we can to restore service promptly to customers.

Going concern and viability statements

Members have concluded that it is appropriate to adopt a going concern basis in preparing the financial statements. The going concern basis confirms that there are adequate resources to remain in operation for at least one year from the date of the financial statements are signed.

The viability statement required under the 2016 UK Corporate Governance Code, takes a longer term perspective of the group's operational sustainability. The two statements are set out below.

Going concern

Scottish Water's business model, activities and the factors that could impact on its future development and performance are described in the strategic report on pages 7 to 8. The principal risks and uncertainties are described on pages 9 to 13.

Scottish Water operates under an annual external financing limit (EFL) set by the Scottish Government. 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 through a regulatory process and charges are approved annually by the Water Industry Commission for Scotland.

As at 31 March 2017, Government loans totalled £3.4 billion. The Scottish Water group held cash and cash equivalents of £429.6 million as at 31 March 2017.

The Members, taking all relevant factors into account, consider that Scottish Water will have adequate resources to continue in operational existence for the next 12 months. Accordingly, the accounts continue to be prepared on a going concern basis.

Viability statement

In accordance with provision C.2.2 of the UK Corporate Governance Code, the Members have assessed the prospects of the group over the 3 year period to March 2020. The Members consider that the 3 year period is appropriate because it is consistent with the business planning process, which gives greater certainty over the forecasting assumptions used. Consequently, Members confirm that they have a reasonable expectation that the group will be able to continue in operation and meet its financial obligations as they fall due over the next 3 years to March 2020.

In making their assessment, the Members considered the resilience of the group, taking account of its strategic and financial frameworks, including the EFL and operational positions and the level of the capital investment programme. They considered the potential impacts, in severe but reasonable scenarios, of the principal risks, set out on pages 9 to 13, and the probable degree of effectiveness of current and available mitigating actions. The key processes used by Members for their assessment are summarised below:

The business and strategic planning processes cover the regulatory period to March 2021, based on key assumptions in respect of the funding of the business. Business planning is an annual process which forecasts the performance and liquidity of the group over the regulatory period with a detailed focus on the first 3 years of any planning period. The plan considers base, downside and severe downside financial and economic scenarios.

Quantitative stress and scenario testing which consider the primary individual and combined quantitative risks relating to liquidity and regulatory financial ratios.

Qualitative scenario testing which gives a qualitative understanding of plausible but severe risk scenarios which could threaten the viability of the group, and informs related management actions. The scenarios tested are based on the principal risks and include widespread contamination of water supply giving rise to emergency response and recovery, a critical infrastructure breakdown and cyber-attack.

In conclusion the Members consider that the 3 year period is appropriate because it is consistent with the business planning process. In addition, within the regulatory environment, at the mid-point of the regulatory period, there will be an interim review which will determine the cash and loan requirements to finance the business in the second half of the regulatory period.

Delivering ministerial objectives 2015–21

Scottish Ministers set objectives for Scottish Water for the period 1 April 2015 to 31 March 2021. This annual report looks at the second year of the delivery period – 2016/17.

Our Delivery plan for 2015–21 is geared towards achieving these objectives while preparing for the key challenges and opportunities facing Scotland’s water industry, including building increasingly resilient water and waste water services and dealing with climate change.

Our plan reflects the priorities and expectations of our customers following extensive research and consultation with customers, discussions with the Customer Forum for Water (established to represent the interests of customers in the 2015–2021 Strategic Review of Charges) and stakeholders including the Water Industry Commission for Scotland (WICS), Drinking Water Quality Regulator (DWQR), Scottish Environment Protection Agency (SEPA), Citizens Advice Scotland (CAS) and the Scottish Government. This plan will address our customers’ highest priorities for service improvement; such as improvements to drinking water quality, reducing flooding and addressing visible leakage from water pipes.

A major aspect of our long term plan in 2015–21 and beyond is to increase the resilience of the services we provide so that all customers can rely upon a consistently high standard of service. Ministers consulted with the DWQR, WICS, SEPA and CAS before making the following Directions for 2015–21:

- Helping to sustain better and more efficient public services by ensuring assets are maintained and improving services to customers.
- Helping people sustain and improve their health through the provision of continued, high-quality drinking water and improving resilience.
- Contributing to improvements in Scotland’s natural and built environment and the sustainable use and enjoyment of it.
- Supporting the delivery of the Government’s priorities in rural communities with a view to improving water and waste water provision in rural areas.

- Servicing demand for new strategic capacity to meet all new housing development and the domestic requirements of commercial and industrial customers.
- Improving Scotland’s resilience to climate change by identifying possible impacts and, where appropriate, investing to manage climate change impacts.
- Contributing to Scotland meeting its climate change obligations of reduced greenhouse gas emissions.
- Taking all necessary steps to fulfil duties and obligations set out in the Flood Risk Management (Scotland) Act 2009.

More information on our plans for the future can be found in the Looking Ahead section on page 39.

Performance

Household charges

Household charges in Scotland remain among the lowest in Great Britain.

In April 2017, household charges increased by 1.6% – around £6 a year for the average household. This means the average Scottish Water household charge in 2017/18 is £357. This is less than £1 a day¹ and £38 lower than the average charge in England and Wales.

Income from household charges is helping to pay for our investment programme which, between 2015 and 2021, will see over £3.5 billion invested to further improve drinking water quality, protect the environment and support jobs in the Scottish economy.

The 1.6% increase in Scottish Water household charges from 1 April 2017 applies to all council tax bands (A-H). This follows confirmation from the Scottish Government that the revised council tax bandings for households in Bands E-H, which apply from April 2017 for Council Tax, will not affect household water and waste water charges in 2017/18.

Scottish Water charges are in line with the price limits set by the Water Industry Commission for Scotland as part of a 6 year agreement between Scottish Water and the Customer Forum, which represented the interests of customers.

In November 2014, WICS published its final determination of the charges that will apply for water and waste water services from 2015 to 2021. In the first three years from 2015-16 to 2017-18, Scottish Water household charges can increase by 1.6% per year in nominal terms (in other words, irrespective of inflation).

Comparison with English & Welsh water companies based on OFWAT published average charge

Water and Sewerage Companies	Average household bill for 2017/18
South West Water	£491
Wessex Water	£470
Welsh Water	£439
United Utilities	£419
Anglian Water	£419
Southern Water	£418
England and Wales Average	£395
Northumbrian Water	£390
Thames Water	£374
Yorkshire Water	£373
Scottish Water	£357
Severn Trent Water	£341

Comparison with English & Welsh water companies based on DiscoverWater.co.uk published average charge

¹ The average household is between Council Tax Band B and Band C and has a combined bill of less than £1 a day. Individual Water Supply and Waste Water Collection charges are less than £1 a day for all households (except for the individual Waste Water Collection charges for Band G households and the individual Water Supply and Waste Water Collection charges for Band H households)

Performance

Customer service

In the last year, we have delivered our best ever customer experience results, received the lowest ever level of written complaints and improved our overall performance.

We have agreed challenging targets with our regulator, the Water Industry Commission for Scotland (WICS) and the Customer Forum, in order to deliver our customers', and the Scottish Government's, expectation of improving customer service.

The first of these is known as the Overall Performance Assessment (OPA), a basket of indicators which captures how well we are delivering water and waste water services. We have agreed a target with the Customer Forum of 381 points (in 2016/17) rising to 385 (by 2020/21) and we are committed to achieving a score at or above that threshold. We aspire to be best in class and target an OPA score at or above 400.

As a result of our continued focus on delivering high levels of customer service, we have exceeded the threshold this year with an out-turn of 398, up from 393 last year.

Our household Customer Experience Measure (CEM) ensures that the delivery of service to our customers is at the heart of what we do and a key driver of performance.

CEM is a basket of measures which, when brought together, allows us to measure and understand the experience of our customers – regardless of whether they have had direct contact with us or not. It also collects the views of customers who have had no service issues whatsoever. It gives us a much broader view of how well we are doing, of customers' perceptions and where we need to target improvements. CEM was developed in conjunction with the Customer Forum, in its role of representing the interests of customers and used for the first time last year.

Our aim is to minimise the loss of CEM points from a starting score of 100. The more we increase our service performance and customer satisfaction, while reducing complaints, the fewer points we lose.

During the year, we continued to build on the improvements of our first year by improving the CEM score by 1.56 points to 85.88, a reduction in lost points of more than 10%.

Delivering excellent customer service

The recent Which? Scotland Consumer Insight Report, which found that the water industry was the most trusted sector among Scottish consumers, is the latest of several customer surveys to rate us highly in recent years. Our own customer research also demonstrates that we are continuing

to build the trust and confidence of our customers and communities across Scotland across all aspects of our service delivery and investment activity.

Written customer complaints have continued to fall this year, reaching their lowest ever level, with a 30% reduction in 2016/17. We now consistently receive more formal compliments through our Go the extra Mile (GEM) customer nomination programme than we do formal complaints. This is a real testimony to the increased focus on resolving customers' issues first time, every time.

Results from the Institute of Customer Service show a slight decrease in levels of customer satisfaction at 76.4 in January 2017 compared to 78.6 in January 2016 although this still puts us towards the top of the leagues of both water companies and traditional utilities. The UK Customer Satisfaction Index also recognises particular strengths in relation to ease of contact and quick resolution of issues.

Responding to incidents

It is the nature of utilities that challenges are often posed by adverse weather or other circumstances outwith our control. In the last year, our teams worked together to maintain services for customers and reduce the impact of operational interruptions in the face of, at times, challenging conditions; or to restore normal service as quickly as possible where disruption has been experienced.

During 2016, we experienced a major burst on the water supply network in the Liberton area of Edinburgh due to a problem with a pressure reducing valve. This caused significant flooding and damage to a small number of properties in the immediate area of the burst, and also caused a loss of water supply and pressure to a large part of Edinburgh. Our teams worked to restore normal service quickly, and supported the affected customers with their immediate and longer term needs.

Following such events, we look closely at what we can learn as part of our drive for continuous improvement. We have continued to develop our communications in relation to incidents during the year, recognising the importance of providing relevant and up to date information to customers via the website and social media.

Performance

Investment overview

Scottish Water's 6 year investment programme will see over £3.5 billion of improvements to Scotland's water and waste water infrastructure.

In the last 12 months our investment programme has stepped up a gear and is delivering both the maintenance and improvements required to our assets to deliver improvements in drinking water quality, the protection of the environment, and support for economic growth.

Almost all of our enhancement programme has completed the feasibility stage and nearly half has started on site. Delivery of all of the 26 programme areas against which we are monitored are either on or ahead of target. Areas where previously identified risks are emerging are being closely managed. We have also made good progress in delivering the remaining projects from the 2010-15 period.

In 2016/17, £627 million was invested in upgrading essential treatment works, water mains, sewers and networks. This builds on more than £7 billion of investment undertaken since Scottish Water's formation in 2002, helping to secure the transformation of water services the length and breadth of Scotland.

During 2016/17, we worked hard to discharge undertakings to the Drinking Water Quality Regulator (DWQR) to complete necessary improvements at both Amlaird and Muirdykes. Muirdykes has now been completed, and we are working to complete improvements at Amlaird.

We have faced some challenges in the last year with sensitive community matters. For example, the plans for an investment project in Ardersier, to support development in the area, angered members of the local community; while in Aviemore, concerns about the water supply led to complaints about taste and odour. In both cases we have attempted to work with the community and local stakeholders to respond to community expectations.

Working together

Our supply chain is fully mobilised. In terms of wider economic benefit within Scotland, we are investing on average over £50 million a month with around 215 businesses employing over 2,200 people on the delivery of the programme. Our supply chain has also created employment opportunities for 96 modern apprentices and 70 graduates.

Our alliances – Caledonia Water Alliance (CWA), amey Black and Veitch (aBV) and Efficient Service Delivery (ESD), as well as Scottish Water's own internal Managed Delivery team, continue to be supported by a wider integrated supply chain that includes 13 Tier 1 contractor partners on frameworks specific to each delivery programme. This is further augmented by 58 local contractors attached to our regionally based rural framework, as well as frameworks covering process equipment, civil materials, hire and infrastructure products.

Scottish Water and our alliance partners have delivered in excess of £25 million of investment via our rural contractors and a series of rural workshops have created opportunities for engagement and knowledge-sharing with our four delivery vehicles and 58 rural contractors. The rural workshops explored our investment programme, Health and Safety best practice and working with local communities.

In every community we aim to build goodwill and trust by minimising the inconvenience as we carry out our essential work and ultimately ensure the benefits of our investment leave a positive and long-lasting legacy. We aim to put communities at the heart of our business by involving those affected by our work at the earliest possible stage. Our Communities Team is ISO9001 certified for the Management of Scottish Water Communications for Planned Projects. This certification is the stamp of approval from an independent body that as a business, we focus on our customers' needs, adhere to internationally recognised best practice and have documented procedures.

Delivering new investment

Investment activity across Scotland in 2016/17 included:

Greater Glasgow: Significant progress with the construction of the £100 million Shieldhall waste water tunnel in the south west of Glasgow has been made during the year. The tunnel, at 3.1 miles long, will be 5 times longer than the Clyde Tunnel and, at 4.7 metres in diameter, big enough to fit a double-decker bus inside when completed. This is a key part of our programme of work to improve river water quality in the Greater Glasgow area and alleviate flooding.

Ayrshire & East Renfrewshire: We are progressing well with over £120 million investment in the water supply network in much of Ayrshire and parts of East Renfrewshire including the installation of 30 miles of new water mains. This work, when completed, will help improve the resilience of water supplies and water quality, while enabling growth in the area.

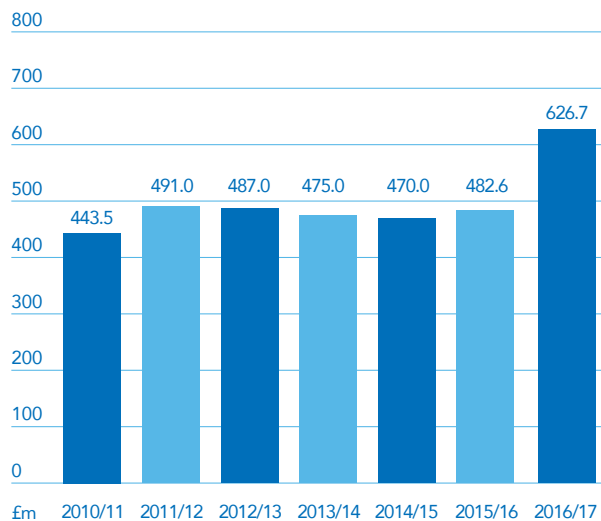
Dundee: We have invested £5 million to improve the water supply network in Dundee, with work due for completion in Autumn 2017. This has seen water mains relined and upgraded across the City, working closely with Dundee City Council and local communities in an effort to minimise disruption to customers.

Stromness, Orkney: This £10 million upgrade of the waste water network involves linking existing sewers to the Bu Point Waste Water Treatment Works . This will help improve the natural environment and reduce the risk of pollution to the surrounding coastal and recreational waters in Stromness Harbour. Work is due to finish on the project towards the end of 2017.

Oban: We are investing over £28 million in Oban’s water supply, including the construction of the new Tullich Water Treatment Works, which started in January 2016 and is expected to be completed in late 2017. This investment will ensure thousands of customers continue to enjoy high-quality drinking water that meets the most stringent quality standards and will also enable planned growth in the area.

Hawick: We have completed a £1.2 million investment to replace a stretch of the sewer network in Hawick in the Scottish Borders which was damaged in the major storms of December 2015. The sewer pipe on the side of the River Teviot was sheared when a section of the river bank broke away during severe flooding.

Improving services and supporting the Scottish economy – Total capital investment



Improvements to be delivered in the Regulatory Period

Objective	Programme area	2016/17 Year end Target	2016/17 Year end Actual	Programme delivery status March 2017
Improving drinking water quality and reliability	Number of water treatment works improved	1	1	●
	Number of zones made compliant with iron and manganese standards	No outputs planned to be delivered	No outputs planned to be delivered	●
	Distribution mains cleaned (km)			
	Number of improvements to reliability of supply (catchments and treatment)	1	3	●
	Number of improvements to reliability of supply (networks and storage)	9	11	●
	Number of water quality etc studies to inform future periods	44	86	●
	2010-15 outputs planned to complete in the 2015-21 period	2	6	●
Improving drinking water security of supply	Water supply resilience strategy and improvements made	3	7	●
	Number of zones with improved security of supply	1	1	●
	Number of security measures and improvements to the infrastructure of critical reservoirs	30	77	●
Protecting and enhancing the environment	Number of waste water treatment works improved to meet Urban Waste Water Treatment Directive (UWWTD)	7	7	●
	Number of waste water networks improved to meet UWWTD	7	17	●
	Number of improvements required to meet UWWTD – Glasgow completion	26	36	●
	Number of improvements required to meet the Water Framework Directive	1	1	●
	Number of revised Bathing Waters Directive studies	No outputs planned to be delivered	No outputs planned to be delivered	●
	Number of environmental studies to inform future periods	0	5	●
	Number of improvements required by the Compliance Assessment Scheme; odour reduction and sludge management	10	19	●
	2010-15 outputs planned to complete in the 2015-21 period	7	8	●

Improving flood risk management	Reservoirs Act: improvements to dams	7	11	●
	Flood Risk Management Act: models and integrated catchment studies	0	13	●
Supporting economic development	Number of new connections to household and business premises	Demand driven	41,796	●
	Delivery of new waste water capacity for 58,000 people	Demand driven	2,143	●
	Number of first time non-household meters installed	Demand driven	7,382	●
	Number of wholesale meters	Demand driven	18,170	●
Mitigating climate change	Number of climate change vulnerability assessments	4	54	●
Improving the long-term cost of service	Improvements in renewable power and energy efficiency (GWh)	7.0	9.29	●

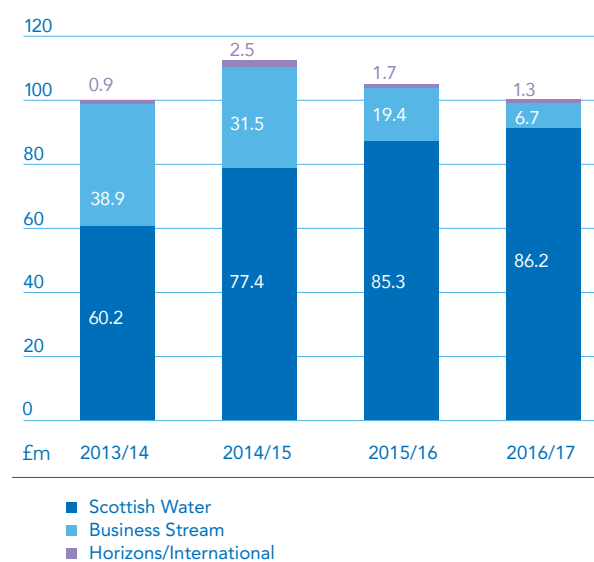
● On Target

Performance

Financial summary – group

The group surplus before tax for the year to 31 March 2017 was £94.2 million (2016: £106.2 million). The chart below illustrates the group surplus before tax by entity covering the last 4 financial years.

**Surplus before tax by entity – £m
(excluding Intercompany elimination)**



The split of the group surplus over the period reflects strong out-performance of the regulatory settlement in the second year of this period by Scottish Water together with the impact of increased competition within the business retail sector, and investment in preparation for the English market opening, which has reduced Business Stream's share of the group surplus to 7.1% in 2016/17 (2016: 18.2%). Horizons' and International's share of the surplus is 1.4% in 2016/17 (2016: 1.6%).

Further coverage of the financial performance by entity is shown on pages 24 to 28.

Consolidated revenue in the year increased by £16.7 million to £1,213.5 million (2016: £1,196.8 million). This benefit was offset by a £34.1 million increase in costs to £946.7 million (2016: £912.6 million). Net finance costs of £172.6 million were £5.4 million lower than in 2016.

In the year, consolidated net debt increased by £109.7 million to £2,994.7 million (2016: £2,885.0 million). The increase was driven by a reduction in cash balances of £109.7 million to £429.6 million, predominantly due to the level of Scottish Water's capital programme during the year. There was no additional borrowing from the Scottish Government during the year. The movement in cash is summarised below:

	Scottish Water £m	Business Stream group £m	Horizons & SW International group £m	Total £m
Opening balance at 1 April 2016	368.6	131.4	39.3	539.3
Cash (utilised) / generated	(133.4)	21.1	2.6	(109.7)
Closing balance at 31 March 2017	235.2	152.5	41.9	429.6

Cash balances within Scottish Water decreased by £133.4 million to £235.2 million. Cash balances are planned to be consumed significantly over the period to March 2021 under the agreed Delivery Plan.

Cash balances within the Business Stream group of companies increased by £21.1 million over the year to £152.5 million.

Taxation

The consolidated tax credit on the income statement was £2.0 million (2016: £17.8 million credit). Other taxes incurred by the group, and included in the cost base increased 7.7% to £83.6 million (2016: £77.6 million) and are summarised in the table below:

	2016/17 £m	2015/16 £m
National insurance	14.3	10.5
Local Authority rates	64.6	62.3
Carbon reduction commitment	4.0	4.0
Land fill tax	0.7	0.8
Normalised annual cost	83.6	77.6

Group pension arrangements

Scottish Water is a participating employer in the Scottish Local Government Pension Schemes (SLGPS) across three funds – Strathclyde Pension Fund, the North East Scotland Pension Fund and the Lothian Pension Fund. These funds are administered by Glasgow, Aberdeen and Edinburgh City Councils respectively. Business Stream is a participating employer in the Strathclyde Pension Fund.

The administering authority for each fund is required to conduct a triennial valuation of the assets and liabilities of the fund in line with SLGPS 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 three-year period. The last full actuarial valuations were carried out as at 31 March 2014 but were updated at 31 March 2017 by a qualified, independent actuary, to take account of the requirements of IAS 19 'Employee Benefits'. The full actuarial valuation as at 31 March 2017 is underway.

Under IAS 19 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 2017 the gross pension liability increased by £123.6 million to £234.2 million. The increase was driven by a 29%, or £412.5 million, increase in liabilities primarily caused by the discount rate reduction from 3.6% to 2.6% (£363.8 million). This was partially offset by a 22% increase in pension assets of £288.9 million driven by higher than expected returns of £250.6 million. The impact of these two changes (£363.8 million less £250.6 million) represents the actuarial loss recognised in the pension fund of £113.2 million which, net of deferred tax, represents the £94.4 million charge in the

consolidated statement of comprehensive income. Further detail is included in note 22 to the financial statements.

In December 2016, Business Stream introduced a new defined contribution scheme, administered by Standard Life. Employees who joined Business Stream after this date have been, and will be, enrolled in this scheme, with the SLGPS closed to new Business Stream employees from the same date.

Performance

Scottish Water regulated services

Financial performance

The surplus before tax in the year for Scottish Water was £1.2 million higher at £86.0 million (2016: £84.8 million). This surplus is reinvested to fund the capital investment programme and customer service improvements, as demonstrated in the chart on page 8.

Regulated revenue

Regulated revenue for the year totalled £1,149.0 million (2016: £1,120.4 million) and is analysed by category in the table below:

	2016/17 £m	2015/16 £m	Change £m
Household	840.0	820.7	19.3
Wholesale	298.3	291.5	6.8
Other	10.7	8.2	2.5
Total regulated revenue	1,149.0	1,120.4	28.6

Revenue from services supplied to household customers increased by £19.3 million, or 2.4%, to £840.0 million reflecting the 1.6% tariff increase, effective from 1 April 2016, and the increase in properties connected to the network. Revenue from wholesale services supplied to Licensed Providers increased by £6.8 million or 2.3% to £298.3 million reflecting the project to identify and bring into charge unregistered premises partly offset by an average tariff decrease of 0.4% and a reduction in consumption. Revenue from other sales increased by £2.5 million to £10.7 million due mainly to rental income received from windfarms sited on Scottish Water land.

Operating costs

Total operating costs increased by £32.9 million to £889.3 million (2016: £856.4 million).

On a regulatory accounting basis, operating costs for Scottish Water increased by £13.5 million, or 3.7%, to £381.1 million. The increase was primarily due to the changes to National Insurance, higher local authority rates and power prices and an increase in the bad debt charge for 2016/17. However, after adjusting for these specific cost increases and the impact of inflation, like-for-like controllable costs reduced in real terms by £4.3 million or 1.5%.

The operating cost of the PFI schemes in the year, including associated depreciation and amortisation charges, was £134.0 million, £2.2 million higher than in 2015/16. The increase was mainly attributable to the annual indexation of service costs of £1.4 million.

Depreciation and infrastructure maintenance costs increased by £19.3 million to £365.2 million (2016: £345.9 million). Non-infrastructure depreciation charges increased by £11.9 million due to the profile of capital investment. The gain on asset sales was £8.5 million lower than in 2015/16.

Capital investment

Reported capital investment under IFRS for Scottish Water in the year was £484.5 million (2016: £325.4 million). As measured on a regulatory accounting basis, 2016/17 capital investment was £626.6 million (2016: £482.6 million). The table below reconciles investment as stated in the statutory accounts with investment on a regulatory accounting basis.

	2016/17 £m	2015/16 £m
2016/17 investment on a regulatory accounting basis	625.6	479.0
Add PFI capital additions	1.0	3.6
Total capital investment on regulatory accounting basis	626.6	482.6
Less base infrastructure maintenance included in operating costs under IAS 16	(117.6)	(118.6)
Less investment financed by infrastructure charges & contributions	(24.5)	(38.6)
Company capital additions per note 9 to the financial statements	484.5	325.4

Finance costs

As at 31 March 2017, the weighted average interest cost of the outstanding long-term debt reduced to 4.43% (2016: 4.73%). Net interest payable decreased by £2.8 million to £148.0 million reflecting the timing of loan repayments, lower interest rates on the refinancing of debt, and no net new loan drawdowns during the year. Interest charges are analysed as follows:

	2016/17 £m	2015/16 £m
Scottish Consolidated Fund	97.8	97.9
National Loans Fund	44.0	45.2
Public Works Loan Board	6.4	8.3
Other – net	(0.2)	(0.6)
Net interest payable	148.0	150.8

Finance costs associated with finance lease liabilities on PFI assets and the interest on pension scheme net liabilities decreased by £3.6 million to £26.0 million (2016: £29.6 million).

During the year, net debt increased by £133.4 million to £3,189.1 million (being loans of £3,424.3 million less cash balances of £235.2 million). The increase was driven by a £133.4 million decrease in cash balances, with no change in the total borrowing from the Scottish Government.

Principal risks and uncertainties

Scottish Water has established a risk policy that sets out a consistent approach to the management of risk and the Board has defined its risk appetite. Details of our approach to risk management and principal risks and uncertainties are set out on pages 9 to 13.

Performance

Business customers

Scottish Water actively facilitates all entrants to the competitive water market in Scotland as the wholesale supplier of water and waste water services.

Wholesale services

The competitive retail market for water and waste water services to non-household premises in Scotland is open to competition, and gives business customers choice of retailer. In this situation Scottish Water acts as the wholesaler, providing services to Licensed Providers (LPs) who then provide retail services to non-household customers.

During 2016/17, the number of companies licensed to provide water and waste water services to business customers in Scotland increased from 23 to 25. A full list of companies who are licensed to sell to business customers is available on the Water Industry Commission for Scotland website and on the 'Scotland on Tap' website.

Throughout the year Scottish Water has continued to support the ongoing development of the Scottish Market, and supported companies in England and Wales and the market operator as they established the water retail market. We have also hosted visits from a number of English companies to show them how we work in the market.

Our market performance is measured by a basket of performance indicators. Our performance against the target over the year was 91%. Whilst falling short of the target of 95%, it was a marginal improvement on the previous year. At the end of the year we were operating above the target level.

Towards the end of 2016, Anglian Water Business Ltd took over the supply of retail water and waste water services to the public sector estate. The switch of circa 14,500 properties from Business Stream, the incumbent supplier, to Anglian Water Business has been smooth and we continue to work with both companies to ensure that any remaining issues are resolved.

There are also a number of arrangements in the market to encourage Licensed Providers to find unregistered properties which are using a service and bring them into charge. These arrangements are continuing to work well and in 2016/17 this increased Scottish Water's revenue to benefit all customers that Scottish Water serves.

Scottish Water has also run a number of market projects to ensure all businesses pay for the services they receive, further increasing our revenue. A comprehensive project is currently underway to link the market data to the Scottish Assessor's data set, which has created a step change in market completeness.

We have also worked throughout the year to increase our readiness to implement Scottish Government policy changes introducing charging for vacant properties from April 2017 and moving to live rateable values for charging from April 2018.

Business Stream

Business Stream is a wholly-owned subsidiary of Scottish Water with its own board and independent management team. It was formed in preparation for the opening of the competitive non-domestic retail market in Scotland in 2008.

Business Stream supplies water and waste water retail services to business customers throughout Scotland and to a growing number of customers in England, delivering a wide range of water and waste water management services, including water audits, waste water treatment, new connections, trade effluent, treatment hire kit and automated meter reading.

Competition in the Scottish market has intensified in the last year with 25 licensed providers now operating in the market, ranging from large English water companies through to small, low cost providers.

Performance review

Financial performance in the year reflected the combined impacts of margin compression from increased competition; the full year impact of the loss of the public sector framework contract; and one-off costs associated with English market readiness preparations including the transition of customers from Southern Water.

Although the reported profit before tax was £12.8 million lower than last year, at £6.5 million, it was in line with expectations.

Business Stream acquired the non-household customer base of Southern Water, on 1 April 2017, on the opening of the English market. The deal makes Business Stream one of the largest water retailers in the UK and positions it well for further growth in this market.

Future developments

Business Stream's strategy is to retain a healthy market share in Scotland while acquiring a sizeable and well-targeted market share in England utilising the knowledge, capability and experience gained from 9 years of operating in an increasingly competitive Scottish market.

Sustained investment in customer service has led to increased customer satisfaction levels and further investment is planned in automation and process re-engineering to deliver enhanced levels of service and operational efficiency.

During the last year, Business Stream entered into partnership agreements with Utilitywise and Veolia, enabling it to provide a broader service offering and more tailored solutions to complement its core water and waste water services.

Although the market in Scotland is expected to remain challenging, placing continued pressure on margins, the opening of the new £2.5 billion market in England creates sizeable new opportunities for Business Stream, which it is well positioned to capitalise on.

Performance

Non-regulated businesses

The main objectives of our non-regulated businesses are to harness the skills and expertise of our people and use innovative ideas, knowledge and Scottish Water assets to encourage economic growth across Scotland and provide water and waste water consultancy services to utilities, governments and other international clients.

Horizons

The activities of Horizons are aligned to support Scottish Water's core objectives, with particular emphasis on supporting its innovation agenda, carbon reduction targets and renewable energy ambitions across Scotland. The focus of the business is to identify, develop and deliver innovative, profitable and sustainable growth opportunities that maximise commercial and reputational benefits from Scottish Water's unique skills and market position and to add value to their and other Scottish Public Sector assets. In doing so, Horizons contributes to Scottish Water's key stakeholder requirements including Scottish Government initiatives such as Zero Waste and the Hydro Nation agenda.

Horizons' working capital requirements are financed by organic cash flow, loans from Scottish Water Horizons Holdings Ltd, grant funding and asset disposals.

The principal activities conducted during the year included capital investment in renewable energy schemes, waste management and recycling, water and waste water infrastructure development and the enabling of innovative technologies.

Performance review

Horizons returned a profit before tax for the 2016/17 financial year of £1.0 million, in line with expectations (2016: £1.4 million). Some highlights from the year include:

- A further investment of £1.4 million in renewable energy schemes, including photo-voltaic (PV) panels, wind and biomass technologies. The estimated annual output of installed PV panels is 1.3 GWh.
- £1.6 million investment to install two additional CHP (combined heat and power) engines at its food waste recycling facility at Deerdykes, Cumbernauld, enabling greater operational flexibility and increased biogas production.
- Further relationship development to accelerate the deployment of sewage heat recovery systems to help businesses and public organisations reduce heating costs and carbon emissions.

International

Scottish Water International's purpose is to provide water and waste water consultancy services, utilising the skills and expertise of our people, to utilities, governments and other international clients.

Performance review

In 2016/17 Scottish Water International increased income by £0.3 million, or 17%, to £2.1 million (2016: £1.8 million). Profit before tax in the year increased to £0.4 million (2016: £0.2 million). This was generated from four strategic target markets: Qatar, Ireland, Canada and Australia.

During the year, International continued an assignment in Qatar helping to oversee management of a 5 year programme to transform drainage and waste water services. In Canada, it completed its second assignment for the City of Calgary water and waste water units.

International has continued to provide advice and support to the creation of Irish Water, Ireland's new water utility, has carried out a review of Asset Management practices in Western Australia, and continues to support its client in South Australia to deliver their capital investment programme.

Innovation

Innovation is a key enabler for delivering a sustainable high quality affordable service to our customers.

Our research shows that customers expect higher levels of service and greater levels of resilience at an affordable cost. External factors such as climate change and the economic environment, together with opportunities offered by technology developments, mean that innovation is a key enabler of continuing to meet customer expectations.

Strategic approach

In 2016, we produced our first Annual Innovation Report which sets out our strategic approach to innovation that centres around three streams of activity; embedding innovation capability in Scottish Water, delivering knowledge and capability through our Research and Development Programme and trialling new technologies.

We have continued to raise awareness of the need for innovation at leadership events and have introduced training modules as part of our leadership development programme to equip leaders with the knowledge and tools to drive innovation in their areas.

Supporting innovation in the water sector

Our two Development Centres (Gorthleck Water Treatment Works and Bo'ness Waste Water Treatment Works) have been created to enable companies and academic institutions to test near-market technologies under unique, live conditions in a safe and controllable environment.

Large-scale testing has been carried out to deliver results for various technologies. These include:

- Testing flow technology to enable a company to develop its product.
- Trialling of a vacuum distillation unit to produce distilled clean, drinking water from raw water to support rural communities.

Bringing these exciting technologies and products to market contributes to Scotland's sustainable economic growth, it also unlocks the potential to increase international trade and collaboration, ultimately supporting Scotland's ambition as a Hydro Nation. We continue to be a member of the UK Water Partnership, which was established in 2015 to promote economic growth in the UK water sector through innovation.

Innovation in action

Heat from waste water

Building on the successful project at the Borders College in Galashiels where around 95% of the heat needs are recovered from waste water in our network, Scottish Water Horizons has developed a strategic partnership with SHARC Energy Systems to accelerate deployment of heat from sewage technology throughout Scotland.

Flow cytometry for effective water quality management

We are the first water company in the UK to routinely use a new scientific analysis tool, Flow Cytometry. Flow Cytometry can track total numbers of bacteria through a drinking water system, giving an overview of the microbiology from source to tap. This can help identify problem areas and target works optimisation and investment, so that we can provide the best quality drinking water for customers and continue to improve our compliance levels.

Granular activated sludge

As a result of successful trials of granular activated sludge (Nereda) technology, we are now progressing with our first full scale waste water treatment plant of this type at Inverurie in Aberdeenshire. This is only the second plant of this type in the UK. The process uses significantly less energy than conventional waste water treatment processes and can remove nutrients such as ammonia and phosphorus without the need for chemicals.

Vacuum excavation

A focus on safe working and minimising the impact of our work on communities has led to the development of a trailer-mounted vacuum excavation system for use on water mains repairs. The Tow-Vac unit improves safe working around utility services and also reduces the physical demands on our employees. It minimises the size of the excavation reducing customer impact. This has been trialled across Scotland and is now being rolled out in operational teams.

Research and Development activity

United Kingdom Water Industry Research (UKWIR)

We continue our contribution to the UKWIR programme that looks at cross-industry topics which aim to address climate change, leakage, asset management and compliance.

STREAM

We continue to support the STREAM Industrial Doctorate Centre – an engineering doctorate programme run by Cranfield University – that seeks to deliver practical applied research projects and develop high calibre employees for the water industry. We have 8 projects running including improving drinking water quality, enhancing the efficiency of our treatment systems and understanding the value (energy, heat, nutrients) that can be recovered from our waste water streams.

Ion Exchange and Alternative Membranes

Scottish Water needs to continually evaluate and improve water treatment systems to respond to the impacts of changing climate on our source waters. We have been working with Cranfield University to evaluate new and improved processes, particularly for organics (colour) removal. We have been trialling ion exchange processes and alternative membrane technologies that are showing improved performance in water quality with lower chemical use and waste by-product (sludge). These R&D trials are now leading to upgrades to existing treatment works.

Coagulation Control

New methods of controlling and optimising the use of coagulant for water treatment are being investigated at works in East Lothian. The use of on-line zeta potential analysers is providing improved control algorithms to better control and optimise the coagulant dose. We are still working to make improvements to the on-line analyser to ensure that it can provide robust and reliable control. The operational trial will be used to identify opportunities to further optimise the coagulation dose and improve the performance of our treatment works for more cost effective water quality.

Alternative Medias for Rapid Gravity Filtration

We are currently evaluating the performance of a range of new filter media for water treatment to determine their relative performance and to identify the right media for a given source water. This work allows us to determine whether the media can be incorporated into existing filter designs or whether plant modifications are required.

Performance Environment

Scottish Water depends upon, and contributes to, the protection and enhancement of the natural environment in Scotland.

To provide our customers with clear, fresh drinking water, we take water from supply sources such as rivers, lochs and boreholes and treat it to ensure it is of high-quality and ready to be distributed to homes and businesses. We then collect and treat waste water so that it can be safely returned to the environment.

Improving services

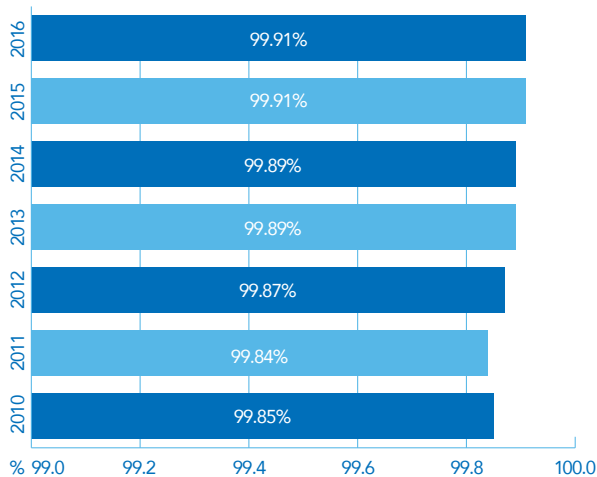
Drinking water quality

In 2016 we carried out over 311,000 quality tests on regulatory samples from our water treatment works, service reservoirs and customers' taps across Scotland.

The quality of water at customers' taps remains at the level achieved in 2015 of 99.91%. Meanwhile, 99.92% of all quality tests on regulatory samples during 2016 met strict microbiological and chemical regulatory standards, a slight drop from 99.93% in 2015 but an improvement from 99.90% in 2014.

Notwithstanding this achievement, we continue to focus on improvement to ensure all our customers can enjoy the look and taste of clear, fresh drinking water. As well as making improvements to water supply networks and treatment processes, we have also worked to improve the appearance and taste of drinking water for our customers in many areas.

Clear, fresh drinking water – tap water quality



Sustainable land management

Sustainable Land Management (SLM) helps to protect and improve source water quality in our drinking water catchments – the areas in which sources such as reservoirs are located.

In the last year we visited catchments that supply 38 water treatment works. During these visits we assess the condition of the land around watercourses and make suggestions to improve source water quality.

Since 2012 our SLM Incentive Scheme has provided financial assistance to help protect and improve source water quality in selected catchments across Scotland. This scheme came to a close in 2016, and a revised scheme in smaller, more targeted areas was launched in 2017.

In 2016/17, we assessed 510 activity notifications, 157 of which were within the vicinity of our drinking water sources. Activities include, forest management, aerial and non-aerial application of pesticides, hydro schemes and wind farms.

We have actively contributed to 24 research projects to expand our knowledge and understanding on how land use may influence source water quality.

Leakage management

Water is a precious resource and considerable effort has gone into minimising leakage from our network of water pipes. We respond to reported bursts and work to detect and fix underground leaks. In 2016/17 reported leakage was reduced by 5 million litres a day.

This means that, since the introduction of a targeted approach in 2006, leakage has been reduced by over 50%. As a result, we continue to operate at the economic level of leakage – the point where the cost of reducing leakage becomes greater than the savings from reduced water production.

We are continuing our work to further improve the data associated with leakage reporting both internally and through participation in UK improvement initiatives. We are also continuing to influence research and development in leakage management and reporting. We continue to invest in pressure management systems to reduce the chances of burst pipes disrupting customers' supplies.

Improving the environment

Waste water

Scottish Water has more environmental authorisations and licensed discharges than any other organisation in Scotland, due to the unique nature and national scale of our services.

Since our formation in 2002, we have delivered more than £1 billion of investment in environmental quality measures and reduced the number of waste water treatment works which do not comply with discharge standards from more than 70 to 4 in 2016/17, a reduction of two from 2015/16.

Scotland had 84 bathing waters officially designated for 2016, of which 71 could potentially be affected by Scottish Water assets. Overall performance was good and operational issues were managed by the agreed response and reporting protocols with SEPA to ensure compliance. Improvements will be delivered in this current period at Portobello West, Fisherrow Sands, Rockcliffe and Kinghorn, and investigations will be undertaken at a further 5 sites to confirm whether there is an impact from our assets.

In 2016/17, we experienced 12 category 1 or 2 environmental pollution incidents and 226 lesser category 3 pollution incidents. This compares to 10 category 1 or 2 and 247 category 3 incidents in 2015/16.

Our 2015–21 programme includes £500 million of planned investment in further initiatives to protect and enhance the environment. We continue to collaborate with SEPA, our environmental regulator, to focus and target our operational activities towards further improvements in environmental performance.

Flooding

The reduction of flooding and pollution from sewers remains one of our customers' highest priorities, and we have made good progress against our commitment to address internal flooding for those customers at highest risk, i.e. those customers with a 10% or greater chance per annum of internal sewer flooding. In total, 39 properties were removed from the internal register in 2016/17.

We have continued to address internal sewer flooding for those customers who have been on our 'high risk' internal flooding register (>10% chance per annum) for over 4 years. This year we completed our largest flooding project to date, in Elmvale Row, Glasgow, where £12 million has been invested to reduce the internal and external sewer flooding risk to 28 properties. These properties, and the local streets, have suffered recurring problems with sewer flooding over a number of years.

While progressing with the development and implementation of long-term solutions for properties with the highest risk of sewer flooding, we have also continued to provide support to customers through a range of other measures, including sewer response plans for sewer flooding incidents resulting from heavy rainfall.

Climate change adaptation

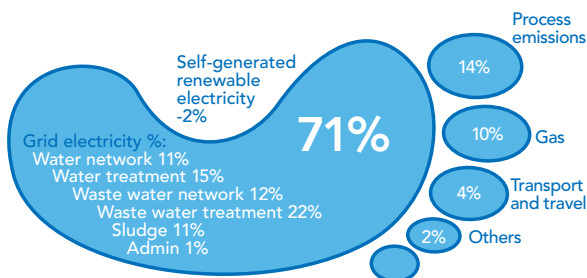
As we continue to meet customers' expectations, it is important we are able to adapt to potential changes. Climate impact projections indicate that the incidence of drought will increase over the coming decades and that there will also be an increase in the frequency and severity of extreme rainfall events.

In response, we are improving the reliability of water services in a number of water resource zones and have extended our water sampling programmes to gain a better understanding of water quality trends. Waste water networks and services are also likely to be impacted and we continue to assess the extent to which climate change will affect our assets and our services to customers.

Climate change mitigation

We are committed to reducing our greenhouse gas emissions and to ensuring all parts of the business consider carbon and wider sustainability when making decisions and taking action.

Greenhouse gas emissions footprint – by source 2016/17



We have improved our reporting processes and are now able to report our operational carbon footprint earlier. We therefore report two years' results this year: those for 2015/16 and 2016/17.

Our footprint for 2015/16 showed a reduction of 3.5% since 2014/15. The 2016/17 footprint saw a further reduction of 9.8%. Overall, our footprint has fallen by nearly 24% since we first reported it in 2006/07.

Our water service continues to have the lowest carbon intensity in the UK, largely due to the use of gravity to supply many of our customers rather than pumping, a positive legacy of the assets we inherited. Our waste water service is lower than the UK average.

Energy

A major milestone was reached this year when the amount of renewable energy Scottish Water generates itself and hosts on its estate exceeded the amount of power used annually – around 445 Gigawatt hours (GWh).

Our approach to energy management and development is focused on:

• Reducing consumption by improving the capability of our assets and operations

We have installed over 4,000 smart meters to measure consumption and help target opportunities. Over the last 5 years we have reduced base electricity consumption by around 5%. We have made changes to operational practices and our asset base to reduce consumption or move demand to cheaper tariff periods. We are also exploring and piloting other initiatives and long-term, low energy, low carbon treatment solutions.

• Increasing self-generation

Since 2013 we have doubled our installed renewable capacity to over 53 GWh and diversified our portfolio to include hydro, wind, biomass, photovoltaic solar and combined heat and power (CHP). We currently have 36 hydro turbines, 18 small scale wind turbines, 24 solar schemes and 3 CHP plants, helping to offset the amount of electricity we need from the grid, with several treatment works now self-sufficient.

In 2016, Scottish Water successfully connected our Girvan Waste Water Treatment Works to a privately-owned renewable Anaerobic Digestion Plant. This enables Scottish Water to receive low-cost green energy whilst supporting local businesses and the growth of the local economy. We are working with a number of local businesses and community renewable schemes in conjunction with Local Energy Scotland and hope to deliver similar schemes in future.

• Hosting private renewable investment

We host private investment in renewables on our estate where it provides a good return for customers and is compatible with providing high quality services. We now host over 420GWh of wind generation on our estate for example.

We are also investigating alternative approaches to extracting value from waste, and are actively involved in research and innovation projects across this area.

Through a combination of our own investment in renewable energy, and hosting private investment on our estate, we expect to facilitate the generation of renewable energy amounting to more than twice the level of energy we consume annually, by 2018. Our strategy is aligned with the Government's Hydro Nation ambitions, supports a greener and stronger economy, and is a key part of our desire to reduce the cost of delivering water and waste water services for customers.

Water efficiency

We have recently launched a series of pilot projects in partnership with the Energy Saving Trust and the Scottish Government's Warmer Homes Scotland programme, to promote the benefits of using water wisely; and making the link between this and the potential to reduce energy usage and bills. We are due to provide water efficiency advice and packs to 49,000 homes in priority areas across Scotland.

Our website features an interactive water use calculator, while we also have a range of water efficiency films that we promote through our website and social media channels which provide advice on how to use water wisely in the kitchen, bathroom and outdoors.

A water efficiency trial has successfully gathered data from 2,000 homes and the interactions with customers show a positive response to our water efficiency advice and encouraging results. We are committed to better understanding water use in and around homes as well as our own assets and will continue to promote more efficient use of water.

Asking customers for their help

Our 'Keep the Cycle Running' communication campaign encourages customers to play their part in helping to keep Scotland's water and waste water services going. It asks them to take simple steps to save water and help prevent blockages in drains and sewers.

Around 80% of blockages in Scotland's drains and sewer network attended by Scottish Water are caused by the wrong items being flushed down toilets or poured down sinks, including all wipes and fats, oils and grease. The Cycle campaign attempts to engage with customers and raise awareness on how we can all play our part in helping reduce the number of blocked drains and reduce the instances of sewer flooding.

In 2016/17, we ran a further 2 phases of the campaign, using television and radio advertising and social media, to promote campaign messages. We have continued to work in communities to promote our campaign messages, including visits to 50 primary schools across Scotland. The Cycle campaign is supported by our new 'Adopt a Beach' campaign which highlights how we can all help protect Scotland's beaches and coastal waters by putting items including wipes and cotton buds in the bin rather than down the toilet.

We have also worked with Sainsbury's, and their partners Olleco, on a trial to introduce a sustainable way for households to dispose of used cooking fat, oil and grease. The trial, which is supported by Recycle for Scotland and local authorities, provides dedicated cooking oil collection points set up near to recycling areas in 7 store car parks in Scotland where customers can drop containers of waste oil to be recycled. The waste oil, once processed, can then be converted into biodiesel for use in road vehicles.

We have also joined other UK and overseas water companies in a global push which calls on manufacturers to clearly label their products as non-flushable and end misleading claims that wipes are flushable, until an ISO flushability technical standard has been agreed with the water industry.

Since the Cycle campaign started, we have seen a downward trend in the number of blockages from 40,000 to just under 36,000 a year. While we cannot attribute this to the campaign alone, we believe one of the best ways to tackle blocked drains and sewer flooding is to work with customers to reduce blockages happening in the first place.

People

Scottish Water is committed to playing a positive role in the lives of our customers and our people – now and in the future.

Our people

In 2016, Scottish Water was named as 'Fair Work Employer of the Year' at the Scottish Business Awards and as the HR Network's 'Best Workplace in Scotland' for the second time in recent years. These awards were in recognition of Scottish Water creating jobs and work environments which allow people to thrive and demonstrate excellence.

We currently employ around 4,000 people across Scotland, with a diverse range of skills and talents in areas such as science, engineering, finance, regulation, customer service, project management, information technology and asset management. We also have a small number of employees working overseas on international assignments in Qatar, Ireland and Australia. We are a Living Wage accredited employer and are committed to playing a positive role in the lives of our people.

Safety, health and wellbeing

We take our responsibility to provide a safe working environment very seriously and are proud to have recently been awarded with a Gold Standard Award for 2017 by The Royal Society for the Prevention of Accidents (RoSPA), taking us to 8 consecutive Gold Achievement Awards. Our Capital Investment and Scientific Services also both received the Gold Medal Awards in 2016. We have made real improvements in our health and safety performance, achieving the lowest lost time accident rates in the UK water industry. However we believe that nobody should be injured or suffer ill-health as a result of work and that is why our objective must always be zero harm.

Our newly integrated safety, health and wellbeing strategy sets out our intent to:

- Keep people safe: by pursuing best practice on the journey to zero harm and ensuring that all our assets are constructed, operated and maintained safely.
- Keep people healthy: through behaviours and practices that ensure safe and healthy workplaces, and promote health and wellness to avoid preventable ill-health.
- Help people thrive: by encouraging and enabling employees to make positive lifestyle choices, build personal resilience and the ability to cope with change.

The foundations for safety, health and wellbeing are strong with 92% of employees in our most recent employee opinion survey agreeing that Scottish Water has a strong health and safety culture, and 88% agreeing that their line manager takes their safety, health and wellbeing seriously.

Scottish Water takes a pro-active approach to any sickness absence that balances 2 key aims: helping employees return to work as quickly and smoothly as they are able; plus offering appropriate support while someone is away from work due to illness. During 2016/17, the proportion of time lost to employee absence in Scottish Water was 2.91%, with 29% of this associated with short term absences, while 71% was linked to longer term absences greater than 28 calendar days.

Our approach to wellbeing also places high importance on belief in our vision and values, being part of something meaningful and supporting active engagement in life and wider society. Our volunteering programme (which allows each employee 2 days per year to help strengthen relationships with local communities), our fundraising activities for WaterAid, and a mentoring scheme for schoolchildren are examples of ways in which employees are supported to make a real difference to wider society.

Building capability

We have continued to develop our approach to succession planning and work hard to create opportunities for people to realise their full potential by developing their skills, talents and experiences. Our approach is therefore both inclusive, in that some opportunities are open to all, and selective, in that certain talent segments are offered specific interventions to help them progress.

• Leadership talent

Our GREAT Leadership development framework, launched in 2015 has four component parts – Genuine, Resilient, Engaging and Aware. These come together as part of an equation that is intended to enable a trusted leadership environment.

The Future Leaders Programme, a 2 year accelerated development programme for selected individuals with long-term senior leadership potential has facilitated cross-functional moves and ensured a pipeline of emerging leadership talent.

• Technical talent

Our skills academy model enables knowledge sharing between our experienced employees and the next generation of technical experts.

We also recognise the importance of attracting and developing the next generation of people to work in the water industry in Scotland. In 2016 we achieved the Investors in Young People Gold Standard, the highest level of recognition for our continued strong commitment to employing and developing young people.

In collaboration with our partners and relevant skills bodies, we have created qualifications, modern apprenticeship frameworks, internships and award-winning apprentice and graduate development programmes. We currently employ 49 graduates on structured development programmes and we will recruit a further 23 in 2017. We offer around 10 paid 3 month internships each year for those from Science, Technology, Engineering and Maths (STEM) backgrounds. In addition we run a number of well-established apprenticeship programmes, with 117 apprentices currently in training. We support the Career Ready model in Scotland, providing mentors and paid work experience for groups of 10-15 school pupils each year. We have a formal school and business partnership in Glasgow as part of our involvement in Developing the Young Workforce (DYW) and we are taking steps to increase our formal schools partnerships across Scotland in 2017.

Agile working

We work to ensure that our people, and our organisation, collectively have the adaptive capacity, resilience and agility to cope with change and to deliver sustainable out-performance. Alongside the range of working patterns and family-friendly policies in place, we remain committed to ensuring workspaces are agile environments and equipping our employees with the appropriate equipment, tools and technologies to help enable agile working for a fairer work/life balance wherever possible.

Increasing diversity

We recognise that diversity in the workplace makes good business sense and leads to fresh thinking, better decision-making and strong performance. As a family friendly employer, we have been awarded the Carers Positive Established Award.

We are working to increase the diversity of our recruitment candidate base and to ensure that we have barrier-free recruitment. We have a particular focus on encouraging more women into STEM based careers and are achieving an increasingly balanced gender profile, both as candidates

and new starts for graduate level opportunities. On our Future Leaders Programme, women made up 63% of those selected onto the first 2 groups. Across the business as a whole we have seen a gradual increase in the proportion of female employees, so that women now make up 27% of our workforce.

We encourage individuals with shared interests to form self-organising and governing networks and in addition to existing groups such as Women in Scottish Water, Nxt Gen (for people early in their careers), our Carers Support Network and the LGBT group, a Disabilities Forum was formed in 2016.

Engaging employees

Employee engagement remains at the heart of our people strategy and we continue to believe that high levels of employee engagement leads to high levels of customer satisfaction and productivity. We define engagement as "a rational and emotional connection with the organisation; resulting in employees knowing what their objectives are and being committed to achieving them and to going the extra mile in terms of their performance". We monitor how well we are doing through regular employee opinion surveys. Response rates are consistently high because our employees know that their views will be taken seriously and, where appropriate, acted upon.

Resource management

In addition to our employee base, like any organisation of our type, we also engage a number of workers through agency contracts, allowing greater flexibility. It also allows access to specialist skills that it might otherwise be unaffordable to engage. The table below sets out the number of agency workers at the end of 2016/17. 'Off payroll' workers are defined by HM Treasury guidance as those paid £220 or more per day and that last longer than 6 months.

Length of service	Less than 1 year	1-2 years	2-3 years	3-4 years	4 years or more
Number of "off payroll" agency workers	40	45	27	12	82
% of total workforce	0.9%	1.0%	0.6%	0.3%	1.8%

Scottish Water also engages a number of companies to deliver services in areas such as cleaning, catering, traffic management or grounds maintenance. Such contracts are not for the engagement of specific individuals although as part of our accreditation as a living wage employer, our procurement contracts for these services include the requirement for the employing organisation to pay at least the living wage.

Scottish Water operates severance terms as approved by the Scottish Government and which are used in a limited number of different circumstances. Where an employee's role becomes redundant all efforts are made to redeploy the individual into another role and/or another part of the business.

Occasionally however this is not possible and where the employee so desires, they can opt for voluntary redundancy. We also operate schemes for Flexible Retirement and Early Retirement which an employee can request in line with the regulations of the Local Government Pension Scheme. Any payments made for voluntary redundancies or flexible/early retirements are recovered through cost savings on average within two years. The table below sets out the exit packages made in the financial year 2016/17:

	No. of Employees	Total Cost	Average Cost
Voluntary Redundancy	5	£310,362	62,072
Early Retirement	24	£127,673	£5,320
Flexible Retirement ¹	59	£431,040	£7,306

1 Flexibly retired employees continue to work in Scottish Water until their agreed exit date, typically 1-3 years after flexible retirement.

Education

We are committed to engaging with customers of all ages and providing opportunities to learn about who we are, and the vital role the water and waste water services we provide every day have in daily life.

Our approach to education continues to focus on:

- Engaging with our customers now and in future generations
- Looking for innovative educational opportunities and partnerships; and
- Promoting the career opportunities in Scottish Water and the water industry

Our educational resources and activities, based on the requirements of the national curriculum, and our online games and free apps for mobile devices, continue to provide us with great ways to have conversations with school pupils and customers in communities across Scotland and bring our essential services to life.

We have continued our work with Glasgow Science Centre, which provides the opportunity to engage with future generations and start to build positive experiences and awareness of Scottish Water.

During the year, our innovative partnership approach has continued to help educate customers about the links between water, hydration, wellbeing, water safety and sport. Our partnership with Scottish Swimming to roll out the Swim Social programme provided us with the opportunity to engage with adults in 8 Local Authority areas across Scotland. We also teamed up with Triathlon Scotland for the 2016 National Championships season which provided us with the opportunity to engage with people interested in triathlon and open water swimming, and promote our important 'hydrate, stay safe and be great' messages to the competitors who took part, including participants from 57 secondary schools and 7 universities.

Across Scotland there are many miles of coastline, and paths along rivers and round lochs and reservoirs for us to all enjoy, and we believe that swimming is a key life skill as well as being great for general wellbeing and fitness. From 2017 we will be working with Scottish Swimming on a new partnership to roll the Learn to Swim programme out across Scotland over the next 3 years. This will help more than 100,000 children learn to swim, and give them the skills, confidence and knowledge to stay safe and be competent around water.

Volunteering

Since our volunteering programme launched in 2011 we have seen 4,003 employees dedicate 27,059 working hours to good causes. In 2016/17, 503 employees dedicated 3,060 working hours of their time to educational, charitable, environmental and community projects across Scotland.

Each employee is entitled to 2 days paid leave per year to volunteer which in turn develops their personal skills, aids their wellbeing and champions teamwork across the organisation. Volunteering puts our communities at the heart of our business focusing on the areas of Education, Environment and Local Community. The volunteering work our employees undertake helps to leave a legacy with our customers and their communities. In turn this helps build trust, strengthen relationships and our reputation, and helps us to achieve our vision.

Our 'Adopt a Beach' campaign, which supports employees to use their volunteering time to 'adopt', clean and survey a local beach has already adopted 39 beaches with plans for more in 2017/18. Local primary schools are encouraged to join our volunteers allowing pupils to understand that small changes to behaviours can make a positive difference to our environment, and the data gathered on beach cleans is sent to Marine Conservation Society (MCS).

WaterAid Scotland

Scottish Water's charity of choice is WaterAid Scotland, part of the specialist development charity WaterAid. WaterAid works with partners in some of the poorest communities in Africa, Asia and the Pacific region to deliver clean water and toilets, promote good hygiene and campaign for change.

The involvement of Scottish Water employees helps support the WaterAid vision to provide everyone, everywhere with access to clean water, sanitation and hygiene facilities by 2030.

In 2016/17, Scottish Water employees raised in excess of £162,000 to support WaterAid's work in Zambia. In addition £28,691 has also been raised for other WaterAid projects through the employee lottery. Our employees also contribute much of their own time to organise events such as bake sales, raffles and sponsored sports events to raise vital funding and awareness of the work WaterAid does.

Employees have also visited schools and local community events around the country to present on WaterAid's work, and 3 event committees from within Scottish Water organised the 2017 WaterAid Ball, the 2016 Golf Day and the 2016 Quiz Evening. The 2017 WaterAid Ball alone raised over £110,000.

The WaterAid Committee have refreshed their strategy and created a new business plan, which includes the creation of new events for 2017 such as the Tartan Trail, a Scotland-wide inclusive mass participation event, set among Scotland stunning natural environment.

Looking ahead

Our plan for 2015 to 2021

High quality service

We will continue to deliver high service levels during 2015–21 so that household and business customers receive a water and waste water service that is among the best in the UK, improving service in all their priority areas.

Household prices

Prices will be set to achieve an overall CPI minus 1.8% across the 2015 to 2021 period. This will be achieved by delivering further significant efficiencies and will keep prices lower than the average in England and Wales.

Wholesale charges

Wholesale charges will increase at 0.3% below CPI per annum.

Delivering value

We will build on our leading levels of employee engagement to continually improve the effectiveness and efficiency of our service delivery to customers.

Financing

The financing of this plan will require £760 million of net new government borrowing in the 4 years from 2018 to 2021.

Service to Licensed Providers

We will continue to listen to the needs of Licensed Providers operating in Scotland as the UK retail market develops and adapt our wholesale services to meet their needs.

Out-performance

We will endeavour to out-perform this plan. Savings arising from out-performance are available to support further investment subject to agreement with stakeholders and the Scottish Government.

Customer experience

We will further improve customers' experience of their service from us so that it is as good as that provided by leading suppliers of other essential products and services. We monitor our customer service through the Overall Performance Assessment and Customer Experience Measures.

Innovation

Our plans include both innovative and proven approaches to operating and investment solutions. Detailed studies and investigations have enabled us to avoid extensive investment where there would be no clear benefit. We will use the IR18 (Investment Review) process to address emerging priorities or requirements arising through innovation outcomes.

Risk

Inevitably, circumstances in the 2015–21 period will vary from those set out in our plan. In 2010–15, overall favourable circumstances and business out-performance enabled us to both reduce customer prices in real terms and new government borrowing. In 2015–21, actual circumstances may require greater or lesser financial resources than assumed in our plan.

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Executive Members:

1. Douglas Millican, Chief Executive

Douglas was appointed as Chief Executive in 2013 having previously been Finance and Regulation Director since Scottish Water was formed in 2002. He was formerly with East of Scotland Water and, prior to this, he worked with Price Waterhouse and Tyco. He is a Non-Executive Director and Trustee of World Vision UK, where he Chairs the Finance Audit and Risk Committee. He is a Chartered Accountant with a BCom from the University of Edinburgh and is an Associate Member of the Association of Corporate Treasurers.

2. Peter Farrer, Chief Operating Officer

Peter was formerly Customer Service Delivery Director and was General Manager of Operations. Prior to this he held various operational and engineering roles within Scottish Water's predecessor organisations, East of Scotland Water and Lothian Water and Drainage. He has 33 years' experience in the water industry since graduating from Heriot Watt University as a Civil Engineer in 1984. He is a Chartered Civil Engineer, gained an MBA from the Edinburgh Business School in 2001 and is a Fellow of the Institution of Civil Engineers and a Vice-President of the Institute of Customer Service.

3. Alan Scott, Finance Director

Alan joined Scottish Water in September 2013 from Balfour Beatty Regional where he was Finance Director, having previously held the roles of Finance Director and Interim Managing Director of Balfour Beatty Engineering Services. He was Finance Director of Miller Construction for 8 years and has also held Finance Director positions in the oil service industry. He has an MA in Economics and Accounting from Aberdeen University. He qualified as a Chartered Accountant with Arthur Andersen where he spent 10 years in the Corporate Recovery Services Team.

Non-Executive Members:

4. Lady Susan Rice CBE

Lady Susan Rice CBE was appointed Chair of Scottish Water on 1 June 2015. She is also Chair of the Scottish Fiscal Commission, Senior Independent Director of J Sainsbury Plc and Non-Executive Director of the North American Income Trust and Banking Standards Board. She was a member of the First Minister's Council of Economic Advisors, Managing Director of Lloyds Banking Group Scotland and was previously Chief Executive and then Chair of Lloyds TSB Scotland plc. She is also the Chair of Business Stream, the 2020 Climate Group and has held a range of other senior Non-Executive appointments, including a 7 year term as a Non-Executive Director of the Bank of England and 11 years as a Non-Executive Director of SSE plc. She is also the President of Scottish Council for Development and Industry.

5. Alan Bryce

Alan was formerly Managing Director of Energy Networks and Generation at Scottish Power, and a Non-Executive Director of Infinis Energy plc and of Iberdrola USA in New York. He is currently Chair of Viking Energy Shetland, a Non-Executive Director of Jersey Electricity Plc, and an advisor in the utilities industry. He holds a Masters degree in Electrical Power Engineering from the University of Strathclyde and is a Fellow of the Institution of Engineering and Technology.

6. Lynne Peacock

Lynne is a former Chief Executive of Clydesdale and Yorkshire Banks, a role that she held from 2004 until 2011. She started her career in banking in 1983 with the Woolwich, joining the Woolwich Board in 1996, and became Chief Executive in 2000. She became a Non-Executive Director of Nationwide Building Society in July 2011, and the Senior Independent Director in July 2016. She also chairs the Remuneration Committee. She joined the Board of the Standard Life Group as a Non-Executive Director in April 2012 and became Chair of Standard Life Assurance Limited in April 2016. Lynne is also Chair of the Trustees of the Westminster Society for People with Learning Disabilities.



7. Matt Smith OBE JP

Matt is the former Scottish Secretary of UNISON, served as STUC President in 1999/2000 and until recently was a member of the Standards Commission for Scotland. He is a member of the Scottish Police Authority; the Employment Appeal Tribunal; the Central Arbitration Committee and serves as a Scottish Human Rights Commissioner. Matt is a Fellow of the Scottish Council for Development and Industry and was recently appointed as Deputy Lieutenant for Ayrshire and Arran. He serves on the Regulation Board of ICAS and on CIPFA's Investigation Committee. He is a Director of Unity Enterprise and was a bench serving Justice for 30 years.

8. James Coyle

James is a Non-Executive Director and Chairman of the Risk Committee of HSBC Bank Plc, Chairman of HSBC Trust Co (UK) Ltd and Marks and Spencer Bank Plc. He is also a Non-Executive Director of the Scottish Building Society, a member of the Financial Reporting Council's Monitoring Committee, a member of the Board and Chairman of the Audit Committee of Honeycomb Investment Trust Plc. His former appointments include: Deputy FD for Lloyds Banking Group; Group Chief Accountant of Bank of Scotland; member of the Audit Committee of the British Bankers Association; a Director of Scottish Financial Enterprise; a member of the Board and Chairman of the Audit Committee of Vocalink Plc, and a member of the Financial Reporting Council's Reporting Review Panel and the ICAS Council.

9. Paul Smith

Paul is formerly the Managing Director of Generation at SSE Plc. He is currently chair of Capstone Power Corporation in Canada, a member of the Edinburgh University Business School International Advisory Board, Energy Institute Council Member, and also an advisor to the Energy, Infrastructure and Asset Management industries. Paul is a Chartered Chemical Engineer from Edinburgh University with an MBA from Henley Management College. He is a Fellow of both the Institute of Chemical Engineers and the Energy Institute.

10. Iain Lanaghan

Iain Lanaghan was appointed as a Non-Executive Director in April 2017. He is an experienced Non-Executive Director and former Main Board finance director. He is founder and Non-Executive Chairman of Metropolitan European Transport, one of Germany's largest private bus companies, and is also a Non-Executive Director of UK Government-owned National Nuclear Laboratory and Ministry of Defence DE&S, and of Northern Petroleum plc. Previously, he was Finance Director of FirstGroup plc, Faroe Petroleum plc, PowerGen International and Atlantic Power. He is a member of the Institute of Chartered Accountants of Scotland, having qualified with KPMG in London.

11. Samantha Barber

Samantha Barber was appointed as a Non-Executive Director in April 2017. She has worked at CEO and Board level in both the UK & Internationally for over 20 years. She worked in Brussels as a Policy Advisor in the European Parliament for 4 years and was CEO at Scottish Business in the Community for 9 years. Samantha took up her first Non-Executive Director position in 2000 joining the Board of Right Track in Glasgow. She also joined the Scottish Power Advisory Board in 2007 and was appointed to the main Board of the parent company, Iberdrola in 2008 where she is currently Chair of the Corporate Governance and Compliance Committee and a member of the Executive Committee. Samantha is also a Vice-Chair of the 2020 Business Group on Climate Change, Chair of the Scottish Ensemble and an Advisory Board member at Imperial College London.

Corporate governance

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 42 to 43.

Executive Board appointments are based on merit and candidates will be considered against objective criteria, having due regard for the benefits of diversity on the Board, including gender. Non-Executive Board appointments are made by the Scottish Government in accordance with equal opportunities guidance 'Diversity Delivers' introduced by the Commission for Ethical Standards in Public Life in Scotland and applicable to all public appointments.

The Board of Scottish Water comprised 10 members: 6 Non-executive Board Members and 4 Executive Members, until the retirement of Geoff Aitkenhead as an Executive Member on 31 July 2016 and the appointment of Paul Smith and James Coyle as Non-executive Board Members on 1 August 2016. For the remainder of the 2016/17 financial year, the Board comprised 8 Non-Executive Board Members and 3 Executive Members. Andrew Wyllie and James Spowart's terms as Non-executive Board Members expired on 31 March 2017. 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 Board Committees detailed below.

In accordance with the best practice recommended in the UK Corporate Governance Code, 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 financial year of 2016/17, the Board met on 10 occasions to review Scottish Water's operational and financial performance, business strategy and risk management.

UK Corporate Governance Code

Scottish Water complies with the UK Corporate Governance Code so far as applicable to its status as a Statutory Public Corporation. As Scottish Water is not a company registered under the Companies Act, the FCA listing rules are not applicable and an Annual Consultative Meeting with stakeholders is held in place of an Annual General Meeting. The arrangements for appointment and termination of Board Members and their remuneration are derived from the underlying statutory regime and set out in the Members' Remuneration Report. No Senior Independent Director has been appointed as other arrangements are in place to consult with stakeholders. The Audit Committee Report on pages 48 to 51 covers the appointment of the external auditor.

Board and Committees

Attendance at the Board and the two principal Board committees is shown in the table below.

	Board		Audit Committee		Remuneration Committee	
	Held	Attended	Held	Attended	Held	Attended
Lady Susan Rice	10	10	–	–	–	–
Geoff Aitkenhead ¹	3	3	–	–	–	–
Alan Bryce	10	10	6	6	4	4
Peter Farrer	10	10	–	–	–	–
Douglas Millican	10	10	–	–	–	–
Lynne Peacock	10	9	6	6	–	–
Alan Scott	10	10	–	–	–	–
Matt Smith	10	10	–	–	4	4
James Spowart	10	10	6	6	–	–
Andrew Wylie	10	9	6	6	–	–
James Coyle ²	6	6	2	2	–	–
Paul Smith ²	6	6	–	–	3	3

1 Until his retirement on 31st July 2016.

2 From his appointment on 1st August 2016.

Audit Committee

The Audit Committee reviews the financial reports of Scottish Water and considers the results of the auditor's 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. The Committee adheres to the requirements of the Audit Committee Handbook. Each year the Committee presents an annual report of its activities to the Board prior to the Board's consideration of the Annual Report.

A more detailed report of the Audit Committee's activities is provided on pages 48 to 51.

Remuneration Committee

The Remuneration Committee, in accordance with requirements of the Scottish Water Governance Directions 2009, monitors the contract terms, remuneration and other benefits for each of the Executive Members including performance related incentive schemes. The Committee has access to external independent advice as it sees fit.

A more detailed report of the Remuneration Committee's activities is provided on page 52.

Board and Committee performance

A formal review of performance was carried out by the Board and Committees, and actions arising from it are being implemented. Formal annual evaluation processes are in place for all Members including the Chair. Induction and ongoing training is provided for Members with specific emphasis on finance, regulation and risk analysis.

Executive Leadership Team

The Chief Executive is responsible for the management and operation of Scottish Water within the strategy determined by the Board and is supported by an Executive Leadership Team which he chairs. The members of the Executive Leadership Team who are also Executive Members are:

Douglas Millican	Chief Executive
Geoff Aitkenhead	Executive Director Capital Investment (until his retirement on 31 July 2016)
Peter Farrer	Chief Operating Officer
Alan Scott	Finance Director

Internal control

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 UK Corporate Governance Code and the Scottish Water Governance Directions 2009. They 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.

Risk management

Scottish Water has established a clear risk policy that defines risk appetite and sets out a consistent approach to the management of risk.

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

The business identifies key risks at corporate and functional levels. Risks are evaluated by considering their consequences, in terms of impact and likelihood, against risk appetite for the achievement of service delivery and business objectives. Existing arrangements for managing the risks are considered and, where these are not assessed to be effective, action plans are drawn up which aim to achieve the right balance between risk and control.

Key risks are being managed in a reasonable and prudent manner, having regard to the current regulatory framework and available resources.

The risk register and risk management processes are reviewed annually by the Board, and 4 times a year by the Audit Committee and the Executive Leadership Team. In addition, each quarter, the Board reviews the status of the most significant business risks. Further information is on pages 9 to 13.

Control activities

Scottish Water's Internal Control Framework incorporates:

- Policy-making 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 attention given by the Board and management to safety, health and wellbeing 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 a policy for the development and training of staff supports ethical standards.

Control effectiveness review

Reviewing control effectiveness is a continuous process throughout the financial 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 independent assessment by audit, and annual statements of assurance from senior management.

Sustainable development

Scottish Water recognises the importance of fulfilling its social responsibilities. To this end, the Board has a Sustainable Development Policy that includes social, economic and environmental aspects. The Board considers sustainable development as part of its ongoing activities and in the development of its business plans.

The Board is committed to providing an active but appropriate level of support to community projects.

Information and communication

Scottish Water has developed an annual budgeting and financial and performance reporting system that compares results with budget on a monthly basis, providing information for internal and external reporting. Key performance targets have been agreed with regulators and the Scottish Government.

Performance against these targets is reported monthly to the Board and quarterly to the regulators and the Scottish Government. 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 a Consultation Code setting out how it consults external stakeholders in relation to proposals for, and the undertaking of, significant core business activities.

Members of the Board meet quarterly with officials from the Scottish Government to discuss a range of business issues.

External Auditor

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

Independence of external auditor

The Auditor General for Scotland is responsible to the Scottish Parliament for securing the audit of the financial statements of Scottish Water. The Auditor General for Scotland appointed KPMG LLP as the auditor of Scottish Water for the financial years 2016/17 to 2020/21.

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, and must comply with Scottish Water's policy on provision of non-audit services (see page 51).

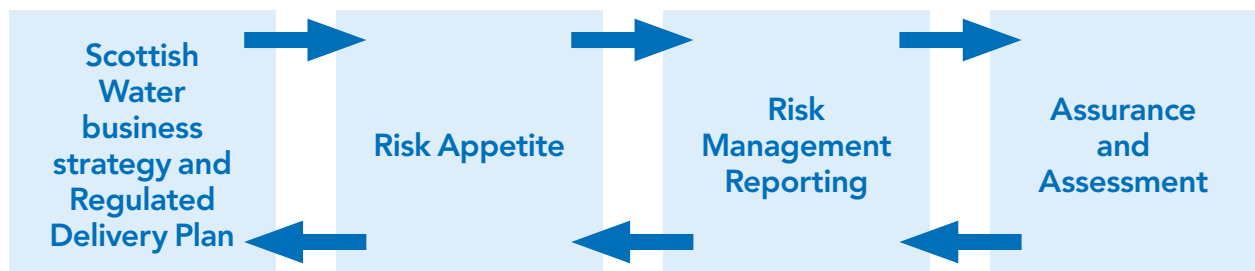
Audit committee report

I am pleased to present this report covering the role and function of the Audit Committee for the year ended 31 March 2017. I am the Chair of the Audit Committee and during the year I was supported by 4 other Non-executive Members; Alan Bryce, James Spowart, Andrew Wyllie and James Coyle, following his appointment on 1st August 2016. At the year end, James Spowart and Andrew Wyllie both stepped down and Iain Lanaghan has joined the Committee from 1st April 2017. I have relevant financial experience and my Committee members have been selected with the aim of providing the wide range of financial, governance and commercial expertise necessary to fulfil the Committee's duties and obligations. Emma Campbell, Scottish Water's Group Legal Counsel, is Secretary to the Committee.

Audit Committee Role and Responsibilities

The Audit Committee was established by the Board to support them in their responsibilities for issues of risk, control and governance and associated assurance and assessment through a process of constructive challenge. Although Scottish Water is not a quoted company it does adopt and follow, as far as is appropriate, the accounting and disclosure practices of a quoted company.

The governance framework adopted by the Audit Committee links the objectives of Scottish Water's business strategy through the stages, outlined below, with the sources of assurance received from senior management and other assurance providers on the operation of key financial and risk management controls.



The Committee's main responsibilities are to oversee and report to the Board on:

- The strategic processes for the assessment of risk, control and governance;
- The accounting policies, the financial statements, and the interim and annual reports;
- The planned activity and results of both internal and external audit, including the approval of the annual Internal Audit plan;
- The adequacy of management response to issues identified by audit activity;
- The assessment of the effectiveness of the internal control environment;
- The corporate governance requirements for the organisation;
- Anti-fraud policies, whistleblowing processes and arrangements for special investigations;
- Scottish Water's arrangements for complying with legislation and Directions issued by the WICS, including the Annual Return;
- The annual report prepared by the compliance officer; and
- The annual statement published by Scottish Water under the Modern Slavery Act 2015.

The Terms of Reference of the Committee are approved by the Board and in accordance with the Scottish Government Audit Committee Handbook are reviewed annually by the Committee. The Committee Terms of Reference are available on the Scottish Water website.

Committee Meetings

The Committee meets at least 4 times per year, 2 of which are co-ordinated with external reporting timetables. During 2016/17 the committee met on 6 occasions, with extra meetings in April and May 2016 to focus on corporate reporting requirements.

In addition to the Committee members, the Board Chair, Chief Executive, Finance Director, Head of Internal Audit, Group Financial Controller and the external audit partner also attends the meetings by invitation. The Committee invites other senior management to present to the Committee on a regular basis on a variety of topics relevant to its work. In line with best practice, the Committee meets in private, excluding any Executive Members, with the external auditor and the Head of Internal Audit at least on an annual basis, or more frequently if required.

The Audit Committee annually reviews its own effectiveness and reports the results to the Board.

The Committee's Activities

The Committee agrees an annual work programme including reports to be received from senior management, Internal Audit and external audit during the year. As well as the normal financial reporting activities, the Committee's main activities during the year included the following:

- Reviewing compliance with the 2016 UK Corporate Governance Code;
- Assessment of risk management controls covering risk appetite and business culture, risk management and control systems, the monitoring and review thereof including sources of assurance and associated public reporting covering going concern and future viability;
- Discussing the work, the issues and management actions in Internal Audit reports;
- Outcomes of investigations resulting from fraud investigations and whistleblowing; and
- Forming its view of the "fair, balanced and understandable" and viability reporting obligations.

Financial Reporting

In order to inform the Committee's reports to the Board, the Committee reviewed and considered the following areas in respect of financial reporting and the preparation of the interim and Annual Report and Accounts:

- The appropriateness and quality of accounting policies;
- Compliance with financial reporting standards and clarity of associated disclosures; and
- Material areas in which primary judgements have been applied.

To assist in the discharge of its duties the Committee considers reports from the Group Financial Controller and reports from the external auditor on the outcomes of their half-year review of interim financial statements, including confirmation that the Accounts are prepared on a going concern basis. The Committee also considered and was satisfied with the papers prepared by the Group Financial Controller and the external auditor covering the financial statements for full year 2016/17. These included a section from Management supporting the going concern basis which the external auditor confirmed was appropriate. Our view was also supported by Scottish Water's Delivery Plan, which was accepted by Scottish Ministers on 21 April 2015, which set out funding requirements for Scottish Water for the 2015-2021 regulatory period.

The Finance Director and external auditor of Scottish Water Business Stream are also in attendance when the Committee reviews the consolidated interim and annual financial statements. As a consequence of the regulatory framework, the independence of the Business Stream Board, and the associated limited disclosure regarding the activities of Business Stream, the Audit Committee is in large part reliant on the Board of Business Stream to provide much of the necessary assurance and governance requirements. Additional assurance is gained through governance exercised through Scottish Water Business Stream Holdings Ltd (SWBSH). The Board of SWBSH has several Directors in common with Scottish Water and receives reports from Business Stream management covering financial performance and specific risks facing Business Stream, in particular the impact of increased competition, competitive tendering within the Scottish business retail market and entry into the English business retail market.

The primary areas of judgement considered by the Committee in relation to the 2016/17 Accounts were:

- Risks within the corporate risk register which could impact on the financial statements and judgments therein. The primary areas of focus included the sensitivities on future household cash collection rates and the associated level of bad debt provisioning;
- The delivery costs associated with Scottish Water's capital investment programme and the associated expenditure classifications;
- Revenue recognition, in particular within the wholesale operational arena; and
- The key assumptions associated with determining the actuarial valuation of pension obligations, and the ring-fencing of the Scottish Water element of each pension fund.

After discussion of these with management and the external auditor the Committee was satisfied that the issues raised had been properly dealt with and that appropriate disclosures have been included in the accounts. The external auditor carried out their work using an overall materiality of £9.1 million, representing 1% of total expenses, incurred in 2015/16 (excluding interest), in the consolidated income statement for 2016/17. However, the Committee agreed with the external auditor that the firm would report any misstatements identified during the audit above £200,000, as well as misstatements below that amount that, in their view, warranted reporting for qualitative reasons. The external auditor confirmed to the Committee that there were no unadjusted misstatements that warranted reporting. In addition, the Head of Economic Strategy and Regulation, the Head of Internal Audit and the General Manager Revenue and Risk carried out a review to verify that the Annual Report and Accounts are fair, balanced and understandable, the results of which were considered by the Committee prior to recommending Board approval of the Annual Report and Accounts.

Consequently, and supported by a comprehensive management and statutory accounts process, with written confirmations provided by senior management on the 'health' of the financial and risk control environment, the Committee and the Board are satisfied that the Annual Report and Accounts, taken as a whole, are fair, balanced and understandable, and provide the information necessary to assess Scottish Water's performance, business model and strategy.

Scottish Water's Internal Control and Risk Management processes

Over the year the Committee received papers from Group Finance associated with the 2016 Corporate Governance Code, one of which included a risk management assessment control schedule. This schedule included a detailed 23 point checklist supported by a detailed record of evidence sources and satisfaction ratings of that evidence. Evidence sources were grouped into 6 categories including risk register & management processes, policy & procedure processes, assurance statements and independent reviews.

In addition, the Committee reviews the framework of internal controls and the processes by which the organisation's control environment is evaluated. To support this, the Committee receives and considers:

- Reports from Internal Audit on the effectiveness of internal controls and issues requiring improvement, including reported fraud allegations;
- Observations from the external audit on the internal control environment and any specific control issues identified;
- Corporate risk reports summarising key risks in the corporate risk register including mitigating actions, risk trends, and summarising compliance with Scottish Water's risk appetite;
- Reports covering the stress testing of the key quantitative and qualitative risks facing the Group;
- Bi-annual report from the Business Ethics Committee;
- An annual report from the compliance officer;
- An annual corporate governance report;
- An Internal Audit annual opinion and report;
- An annual report on regulatory compliance; and
- An annual statement of compliance with the Modern Slavery Act 2015.

In addition, during the year the Committee requested specific reports on compliance monitoring within the capital investment programme, drinking water quality, fixed asset register, bank reconciliations, PFI management processes and the consolidation of Business Stream.

The Committee provides the Board with an annual report on the effectiveness of the internal control framework. To support this, the Committee receives an annual report and opinion from the Head of Internal Audit.

Internal Audit

The Committee approves annually the Internal Audit Charter and the annual Internal Audit plan, with any subsequent changes requiring Committee approval. It also reviews the scope and results of Internal Audit reviews and its effectiveness throughout the year. At each main Committee meeting reports were received from the Head of Internal Audit. These reports included progress in delivering the Internal Audit plan, audit findings and management action plans to address these, performance in implementing management action plans, any fraud allegation investigations and details of relevant Audit Scotland reports. In addition to the private meetings with the Committee members, the Chair of the Audit Committee also meets the Head of Internal Audit outside of the formal Committee meetings.

External Audit

PwC's term as auditor came to an end in 2015/16. The Committee wishes to thank PwC for the assurance and advice provided to the Committee during their two terms. The Auditor General for Scotland is responsible for the appointment of the Scottish Water external auditor and undertook a robust tender and assessment exercise for Scottish Water and many other public sector organisations, which resulted in the appointment of KPMG as Scottish Water's external auditor for a 5 year period from 2016/17 to 2020/21. The Chair of the Committee and Finance Director engaged with Audit Scotland during this process but were not involved directly in the assessment process nor the decision made. Following KPMG's appointment, a period of shadow overlap with PwC was arranged and a robust onboarding process put in place.

The Committee received from KPMG an audit plan, including their assessment of key risks and confirmation of their independence. Following completion of their interim review and annual audit, the Committee receive an internal control report highlighting any internal control weaknesses and the management actions to address these.

Annually the Committee assess, with input from management, and provide feedback to Audit Scotland on the effectiveness of the external auditor. In addition to the private meetings with the Committee members, the Chair of the Audit Committee also meets the external audit partner outside of the formal Committee meetings.

Auditor Independence

During 2015/16 the Committee approved a policy on provision of non-audit services to Scottish Water and this was extended to all subsidiaries in 2016/17 by the firm appointed as external auditor. The aim of the policy is to support and safeguard the real and perceived independence and objectivity of the external auditor and covers:

- non-audit services which are not permitted;
- non-audit services which have been pre-approved by the Audit Committee, subject to financial limits; and
- non-audit services requiring specific approval.

The Committee monitors implementation of the policy through receipt of a report every 6 months, or as required, analysing fees paid for any non-audit work by the external auditor, with additional commentary on assignments and on work carried out or to be done relating to safeguards of independence.

Having considered compliance with our policy, the Committee is satisfied that KPMG has remained independent.

Lynne Peacock
Chair of the Audit Committee

Remuneration committee

Annual Statement by the Chair of the Remuneration Committee

It is my pleasure to present the Members' remuneration report for the year ended 31 March 2017. In preparing this report I am thankful for the support of fellow Remuneration Committee and Non-executive Members, Matt Smith and Paul Smith.

As required, the Committee receives internal advice and information from the Chair of Scottish Water, the Chief Executive, the Director for People, and the Group Legal Counsel. In May 2017, the Remuneration Committee received advice and specialist information on the UK executive skills landscape from Hoggett Bowers as context for future succession planning activities.

The Remuneration Committee meets regularly to consider the remuneration arrangements for Executive Members, and other related remuneration matters, making recommendations to the Board. There were 4 meetings of the Committee in 2016/17. At each meeting a quorum of independent, Non-executive Members was present. No Executive Member was present during discussions about their own remuneration.

We continue to operate a simple remuneration structure made up of base salary and benefits, an annual out-performance incentive plan (AOIP) and a single long-term incentive plan (LTIP) which provide a clear link between pay and our key strategic priorities.

The key decisions made by the Committee over the 2016/17 period were as follows:

Decisions / remuneration for 2016/17

- Agreeing the base salary increase of 2.0% of the Executive Members and Chief Executive from 1 April 2016.
- Confirming the 2017 AOIP payment calculated at 34.4% out of the 40% maximum opportunity for Executive Members and Chief Executive.
- Reviewing management's proposed salary increases for Scottish Water staff.
- Review of succession planning for posts on the Executive Leadership Team.

Changes / remuneration for 2017/18

- Agreeing base salary increases for Executive Members, with effect from 1 April 2017, at 2.0%.
- Setting the performance criteria for the 2017/18 AOIP.

Our Remuneration Policy and our Annual Report on Remuneration is set out on pages 53 to 62.

Alan Bryce
Chair of the Remuneration Committee

Members' remuneration report

The presentation of this Remuneration Report complies with the HM Treasury Financial Reporting Manual (December 2015) and, as far as is appropriate, also adopts the same practice as quoted companies even though Scottish Water is not a quoted company.

1. Statement of Executive Remuneration Policy

a. General Policy

Scottish Water's vision is to be trusted to serve Scotland by caring for the water on which Scotland depends. By building on past success we seek to provide levels of service, performance and efficiency which exceed the expectation of customers, regulators and the Scottish Government.

Scottish Water will continue to provide a working environment that matches the expectations placed on our people to deliver best value outcomes in an empowered organisation. 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 the organisation is perceived as a fair employer that encourages excellence, rewards performance and empowers its people while providing scope for personal development.

The overall remuneration policy aims are to:

- Attract, develop, motivate and retain highly talented people at all levels of the organisation; and
- Incentivise and reward good individual and corporate performance as well as out-performance.

b. Remuneration elements

The 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 business, where Executive Members' remuneration should be closely linked to corporate performance. The aim is to pay a base salary that is competitive, but appropriate for a public corporation, while providing for extra discretionary pay to be earned for out-performance of demanding targets.

d. Base Salary

Scottish Water is publicly owned and accountable to the Scottish Parliament and Scottish Ministers. Within the context of public sector ownership, the company 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 subscribes to the remuneration database of Hay Group Management Ltd and uses this as required to review the remuneration of comparator organisations and industry in general against its own. This is one of the largest remuneration databases in the UK with each job subjected to the same method of job sizing.

The aim is to pay in line with 95% of the median of an agreed industry benchmark group, reflecting remuneration levels in comparable organisations for similar work. Analysis last undertaken by Hay Group in November 2015 showed that continuing Executive Members' base salaries ranged between 74% and 85% of the industry median, with the average position being 80%. This analysis is not carried out every year, but there is no indication that the position to the external market has moved materially in the past 18 months.

e. Annual Out-performance Incentive Plan

Scottish Water has an AOIP designed to incentivise and reward the out-performance of targets agreed with regulators. Targets are set out in the Delivery Plan for the regulated business that has been approved by Scottish Ministers and reflect those set by the Water Industry Commission in its Final Determination of charges.

The Remuneration Committee maintains the right to withhold or vary AOIP payments (potentially to zero) should events undermine the financial stability or reputation of Scottish Water. Such reduction may be carried out at any time prior to AOIP payments being made.

The potential maximum annual incentive attainable for out-performance by Executive Members is 40% of base salary and is non-pensionable. Delivery Plan targets, out-performance targets, and actual performance for each measure in 2016/17 are set out below.

Measure	Weight	Delivery Plan target	Out-performance target	Actual performance
Regulated Profit before tax excluding depreciation	40% ⁽¹⁾	£405m	Profit Before Tax and Depreciation (PBTDA) to beat delivery plan by £0 to £20m. Sliding scale with 0% at delivery plan figure and 100% at +£20m.	£452m
Customer service OPA performance	25%	381 to 400 points	Overall Performance Assessment (OPA) based on sliding scale discussed with Customer Forum where, for 2016-17, the Leading score is 381 points and Best in Class is 400 points. Below leading score 0%; at leading score 30%; at best in class 90%; beat best in class 100%.	398 points
Customer Experience – Household Measure	25%	Exceed 82.6 points	The target operates on a sliding scale from 82.6 to the business target of 85.87 points with 0% payable below 82.6 points; 30% payable at 82.6 points; and 100% payable at 85.87 points or more.	85.88 points
Customer Benefit – Overall Measure of Delivery	10%	Exceed 83 points	Exceed the target Overall Measure of Delivery (OMD) of 83 points and ensure forecast capital programme cost is within the regulatory allowance ⁽²⁾ . Once these targets are achieved, payment depends on the number of Q&S3a and 3b projects outstanding at 31 March 2017, so that: 0% for more than 11 projects; 7% at 11; 8% at 10; 9% at 9; 10% at 8 projects or fewer.	108 points; 8 Q&S3b projects outstanding; programme forecast cost outside of regulatory allowance

Notes

- (1) PBTDA is a gateway on the AOIP scheme i.e. payments must be funded from financial out-performance; the delivery plan figure will be as updated for inflation and regulatory out-turn assumptions.
- (2) Plus customer contributions

The awards generated by this performance are detailed in the single figure table of the Members' Remuneration Report.

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

f. Long Term Incentive Plan to incentivise out-performance in the six years to March 2021

The 2015-21 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 2015-21 period. The LTIP is funded by 10% (2010-15 LTIP: 12%) of base salary that will be in payment at the end of the performance period being accumulated each year during the 6 years to March 2021, ultimately vesting as determined by the performance targets below and being paid as a single sum at the end of the 2015-21 period. Any LTIP payment is funded from financial out-performance after payment of any incentive awards to employees. The LTIP will only be payable if there is overall financial out-performance of the Final Determination.

The Remuneration Committee maintains the right to withhold or vary LTIP payments (potentially to zero) should events undermine the financial stability or reputation of Scottish Water. Such reduction may be carried out at any time prior to LTIP payments being made.

The LTIP structure for the 2015-21 period is as follows:

Measure	Weighting	Basis of calculation	Target
Growth in cash, measured as debt less cash, relative to the Final Determination	50%	Straight line sliding scale	£0 to £200m above Final Determination (before any cash returned to customers ¹)
OPA – the average performance 2015-21 linked to leading company and best in class thresholds agreed with the Customer Forum	50%	Sliding scale	<ul style="list-style-type: none"> • 0% below an avg. 382.5 points • 30% at an avg. 382.5 points • 90% at an avg. 400 points • 100% for an avg. >400 points

Notes:

(1) Cash growth is before the impact of valid changes to external costs (e.g. rates) and any restrictions of customer price increases.

Payments generated under the LTIP will be included in the Members’ Remuneration Report when those are made.

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

g. Pension

All employees, including Executive Members, are eligible to participate in the Scottish Local Government Pension Scheme (SLGPS) which is a contributory, defined benefit scheme operating under regulations determined by the Scottish Parliament. These regulations require Scottish Water to offer this pension to all employees and in the case of the Executive Members participation is via the Lothian Pension Fund. All pension scheme members may request flexible retirement from age 55, reducing their hours or grade to receive all or part of their pension while continuing to work.

The value of pension provided through the SLGPS is set out in section 2.c of the Members’ Remuneration Report.

Non-executive Members are not eligible to receive pension benefits.

h. Benefits

A car is provided to all Executive Members for business needs. For those opting out of car provision, a car allowance is payable instead. Non-executive members are not eligible for a car or car allowance.

Executive Members are covered by the Scottish Water Life Assurance Scheme that covers all employees.

The value of allowances received is set out in the benefits column of the single figure table in the Members’ Remuneration Report.

i. Approach to recruitment remuneration

The remuneration of any new Executive Member will be agreed with the Scottish Government prior to appointment of that Member. The Remuneration Committee will recommend a recruitment package, encompassing those elements that apply to other Executive Members and that are detailed elsewhere in this remuneration policy.

If recruitment of an Executive Member requires compensation for relocation this would normally be calculated as per Scottish Water's relocation policies and would be included in any recommendation made. Should recruitment of an Executive Member require compensation for forfeit of variable remuneration from a former employer, this would also be included in any recommendation made.

The appointment and remuneration of the Chair of Scottish Water and Non-executive Members is agreed by Scottish Ministers, with regard to the daily fee framework of the Scottish Government's Pay Policy for Senior Appointments. Fees paid reflect the time commitment anticipated for each role and are detailed in the Members' Remuneration Report.

j. Payments on loss of office

Executive Members are expected to work the notice periods in their service contracts and will not normally be compensated in lieu of notice. In circumstances where it is in the operational interests of Scottish Water for an Executive Member to leave before the end of their notice period, the Remuneration Committee will consider options such as 'garden leave' or paying in lieu for all or part notice on a case-by-case basis.

The Remuneration Committee may decide that a portion of the incentive payment is payable to former Executive Members in certain circumstances such as departure due to redundancy and efficiency, ill health or normal retirement, or death in service. Any incentive payment so determined will be paid no earlier than would have been the case had the Member not left Scottish Water. If an Executive Member leaves the employ of Scottish Water for any other reason and before incentive payments under the AOIP or LTIP would be due, their payment will normally be forfeit.

Where an Executive Member leaves for reasons of efficiency or redundancy, any severance payment that may apply will be on the same terms as for any other employee leaving under such circumstances and will be as set out under the approved redundancy scheme in operation at the time. Where the Executive Member is a member of the SLGPS then access to pension benefits on leaving will be determined by the regulations of that pension scheme, as for any other SLGPS member.

No compensation is payable to any Non-executive Member if their appointment is terminated early.

k. Consideration of employment conditions elsewhere in the company

The Remuneration Committee requests and receives information as required on pay and terms and conditions for all employees in order to provide context for decisions on executive pay. This information includes comparison of the salary and total pay of the Chief Executive versus that of the median and average salary and total pay of other employees; as well as consideration of the ratio between the lowest and highest potential total pay in the organisation.

When considering payments to be made under the AOIP, the Remuneration Committee draws comparison between the proportion of potential payment resulting to Executive Members and that being made to other employees under their AOIP arrangements. In addition, any review of executive salaries includes consideration of the pay adjustment opportunities available to other employees.

In addition, for the 2015-21 period, Scottish Water discussed its incentive plans with the Customer Forum to ensure that those measures and targets which must be out-performed, align with customer expectations of what matters most within Scottish Water's delivered performance.

I. 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
Chief Operating Officer	Peter Farrer	1 April 2013
Finance Director	Alan Scott	24 September 2013

All Members are required to give 6 months’ notice of resignation. Scottish Water is required to give Members 12 months’ notice of termination.

Non-executive Members

Non-executive Members do not have service contracts. Expiry dates of Non-executive appointments are as follows:

Lady Susan Rice, Chair	30 April 2019	James Coyle	31 July 2020
Alan Bryce	31 March 2018	Iain Lanaghan	31 March 2021
Lynne Peacock	31 March 2018	Samantha Barber	31 March 2021
Paul Smith	31 July 2020	Matt Smith	30 April 2021

2. Members' Remuneration Report

The auditor is required to report on information contained in sections 2.a to 2.d of the Remuneration Report.

a. Single Total Figure Table

		Salary/ Fees	Benefits (i)	AOIP (ii)	Total 2016/17	Pension (iii)	Total (iv)
		£000	£000	£000	£000	£000	£000
Executive Members							
Douglas Millican	2017	251	12	86	349	63	412
	2016	246	12	81	339	-165	174
Peter Farrer	2017	183	12	63	258	48	306
	2016	179	11	59	249	43	292
Alan Scott	2017	180	11	62	253	52	305
	2016	177	14	58	249	52	301
Non-executive Members (v)							
Chair – Lady Susan Rice (vi)	2017	100			100		100
	2016	83			83		83
Alan Bryce	2017	26			26		26
	2016	20			20		20
James Coyle (vii)	2017	14			14		14
	2016	-			-		-
Lynne Peacock	2017	26			26		26
	2016	25			25		25
Matt Smith	2017	20			20		20
	2016	20			20		20
Paul Smith (vii)	2017	14			14		14
	2016	-			-		-
James Spowart (viii)	2017	20			20		20
	2016	20			20		20
Andrew Wyllie (viii)	2017	20			20		20
	2016	20			20		20
Former Members							
Geoff Aitkenhead (ix)	2017	47	5	16	68		68
	2016	133	14	44	191		191
Donald Emslie (x)	2016	25			25		25
Ronnie Mercer (xi)	2016	23	3		26		26
Total Remuneration	2017	901	40	227	1,168	163	1,331
	2016	971	54	242	1,267	-70	1,197

Notes:

- (i) Benefits include the value of car benefit or car allowance and annual life assurance premiums associated with the Scottish Water Life Assurance Scheme as described in the Executive Remuneration policy. The value of each benefit is described in a separate table below.
- (ii) Annual Out-performance Incentive Plan as described in the Executive Remuneration Policy.
- (iii) The value of pension benefits accrued are calculated in accordance with section 5.3.21 (d) of the HM Treasury's Financial Reporting Manual 2016/17. This requires the real increase in accrued benefits, as detailed in section 2c below, to be multiplied by 20, plus the real increase in accrued lump sum and reduced by the contribution made by the individual member. The decrease in Mr Millican's pension benefit in 2016 reflected the impact of a tax charge associated with his accrued pension benefits resulting in a reduced future pension.
- (iv) To enable a like-for-like comparison of remuneration the 2016 total excludes the one-off LTIP (Long Term Incentive Plan) payment made in 2016 for out-performance in the 2010-15 regulatory period and declared in the 2016 Members' Remuneration Report. The current LTIP covering the 2015-21 regulatory period is described in section 1f above.
- (v) Fees are agreed by Scottish Ministers with regard to the daily fee framework of the Scottish Government's Pay Policy for Senior Appointments and payments reflect the time commitment required for each role.
- (vi) Payments to Lady Susan Rice in 2016 are from her appointment on 1 June 2015.
- (vii) Payments received by Paul Smith and James Coyle are from their appointments on 1 August 2016.
- (viii) James Spowart and Andrew Wyllie each stepped down from the Board on 31 March 2017.
- (ix) Payments received by Geoff Aitkenhead until his retirement on 31 July 2016.
- (x) Payments received by Donald Emslie until he stepped down from the Board on 31 March 2016.
- (xi) Payments received by Ronnie Mercer until he stepped down on 30 June 2015.

The Committee approved a 2.0% increase in base salaries for the three Executive Members with effect from 1 April 2017. Consequently, base salaries for 2017/18 are as follows: Douglas Millican £256,211; Peter Farrer £186,178; and Alan Scott £184,012. Fee levels for Non-executive Members, including the Chair, for 2017/18 will increase by 1.0%, also with effect from 1 April 2017.

b. Details of benefits received 2016/17

Name	Car benefit or car allowance £000	Life assurance premium £000	Total £000
Douglas Millican	10	2	12
Peter Farrer	10	2	12
Alan Scott	10	1	11

c. Total pension entitlements to end of financial year 2016/17

The Executive Members Douglas Millican, Peter Farrer and Alan Scott are eligible to participate in the Lothian Pension Fund, a defined benefit scheme. The table below presents pension accruals under the regulations of the SLGPS.

	Increase/(Decrease) in accrued benefits during the year net of inflation			Accumulated total accrued benefits at 31 March 2017		Transfer Values		
	Years in Scheme	Pension £000	Lump sum £000	Pension £000	Lump sum £000	At 31 March 2017 £000	At 31 March 2016 £000	Increase in 2016/17 net of Members' own contributions and inflation £000
Douglas Millican	22.1	5	–	68	133	1,451	1,268	126
Peter Farrer	32.7	3	–	82	169	1,648	1,471	123
Alan Scott	3.5	4	–	12	–	178	115	41

Notes:

- (i) 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.
- (ii) The normal retirement age of Executive Members is determined by the rules of the Scottish Local Government Pension Scheme. For pension accrued up to 31 March 2015 this is age 65. For pension benefits accrued after that date, normal retirement age is set equal to the individual's state pension age. Any pension benefits drawn before normal retirement age are usually reduced in value by actuarial factors reflecting the anticipated longer payment period.
- (iii) 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.
- (iv) The transfer value of accrued pension is calculated in a manner consistent with Actuarial Guidance Note GN11.

d. Pay multiples

The table below discloses the relationship between the Chief Executive's pay to the average pay of employees within Scottish Water.

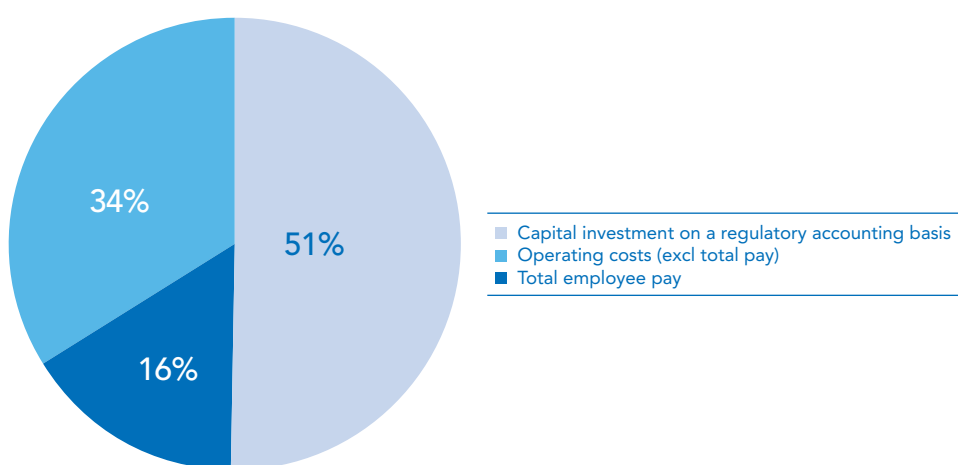
	Remuneration excluding movement in pension (i) £000	
	2016/17	2015/16
Chief Executive	349.0	339.3
Employees ⁽ⁱⁱ⁾	33.0	32.4
Ratio	10.6	10.5

Notes:

- (i) The total excludes the calculation of change in pension as the value relies heavily on length of pensionable service and so has little meaning when comparing one person (the Chief Executive) against a group of employees with varying lengths of service, i.e. an individual with greater pensionable service could see a faster increase in calculated pension value than someone with shorter pensionable service, even if they are paid the same during a financial year.
- (ii) Based on the average full time equivalent salary, AOIP and benefits of all employees with a full year of service, other than Executive Members. The 2015/16 figure is rebased to allow direct comparison with 2016/17, as the figure published last year included starters and leavers who were only paid for part of the year.

e. Relative importance of spend on pay

The importance of total annual spend on pay is shown in relation to other Operating costs and Capital investment during the year. As Scottish Water is a public sector organisation owned by the Scottish Government, there were no disbursements to shareholders.



f. Implementation of Remuneration Policy in 2017/18

As described in the Executive Remuneration Policy, Scottish Water operates an Annual Out-performance Incentive Plan (AOIP) designed to incentivise and reward the out-performance of targets agreed with regulators. To ensure that the AOIP targets remain suitably challenging they are reviewed each year and for 2017/18 the Remuneration Committee has determined the following out-performance targets.

Measure	Description	Weighting
Financial Out-performance	Profit Before Tax and Depreciation (PBTDA) to beat delivery plan by £0 to £33m. Sliding scale with 0% at delivery plan figure and 100% at +£33m.	40% ⁽¹⁾
Customer Service Provision	Overall Performance Assessment (OPA) – based on maintaining a score on a sliding scale between 382 and 400 points. 0% payable below 382; 30% payable at 382; 90% payable at 400; 100% payable for beating 400 points.	25%
Customer Experience	Improvement in the Household Customer Experience Measure (hCEM) as developed and agreed with the Customer Forum. Beat the baseline on a sliding scale so that: 0% payable below 82.6 points; 30% payable at 82.6 points; 100% payable for greater than or equal to 86.5 points.	25%
Customer Benefit Delivery	Exceed the delivery plan target Overall Measure of Delivery (OMD) of 124 points and ensure forecast capital programme cost is within the regulatory allowance ⁽²⁾ . Once these targets are achieved, payment depends on the number of Q&S3a and 3b projects outstanding at 31st March 2018, so that: 0% at more than 6 projects; 7% at 6 projects, 8% at 5 projects; 9% at 4 projects; and 10% at 3 projects or fewer.	10%

(1) PBTDA performance acts as a gateway and must be sufficient to fund AOIP payments; delivery plan baseline will be updated for inflation and regulatory out-turn assumptions.

(2) Plus customer contributions.

g. 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 to Scottish Water. During the year, Douglas Millican, Chief Executive, was appointed as a non-executive director and trustee of World Vision UK from which no remuneration is payable.

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

Alan Bryce

Chair of the Remuneration Committee

25 May 2017

Members' report

The Members present the Members' report together with the audited consolidated financial statements for the year ended 31 March 2017.

The Government Financial Reporting Manual 2016/17 (FReM), published by HM Treasury, sets out the form and content for the annual report and accounts. This includes the requirements to show a Performance Report, and Accountability Report. The Members have reviewed the requirements of the FReM, and are satisfied that they are covered within the Overview, Strategic and Governance reports within this annual report and accounts.

The Members' report comprises pages 63 to 65 and the sections of the annual report incorporated by reference are as follows:

Corporate governance report	See pages 42 to 65
Strategic report, including information in respect of: Scottish Water's results, key financial information and service performance, future developments and the principal risks and uncertainties faced by Scottish Water's group of companies	See pages 6 to 28
Going concern and viability statements	See page 14
Greenhouse gas emissions	See pages 31 to 34
People	See pages 35 to 38
Accounting requirements and basis of account preparation	See Note 1.2, page 78
Financial risk management	See page 105

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.

Appointment and replacement of Members

Schedule 3 of the Water Industry (Scotland) Act 2002 specifies Scottish Water's Board must comprise between 5 and 8 Non-Executive Members and between 3 and 5 Executive Members. One Member must have special knowledge of the interests of the employees of Scottish Water. Non-Executive appointments are made by the Scottish Ministers for 3 to 5 years following an open and transparent public appointment process. Executive Members are appointed by Scottish Water with the consent of the Scottish Ministers for an unidentified period. The Members appointments can be terminated under procedures set out in Paragraph 1 of Schedule 3 of the Water Industry (Scotland) Act 2002. Details of the Members' service contracts are on page 57 of the Members' Remuneration Report.

Employee relations and involvement

The Scottish Water group of businesses employed an average of 4,120 (2016: 3,839) 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 85. Scottish Water is committed to a policy of equal opportunities for all employees irrespective of race, religion, sex, sexual orientation, 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 safety, health and wellbeing. Through an extensive safety awareness campaign, safety briefings and ongoing training, awareness of safety, health and wellbeing issues is being encouraged and increased among employees.

Further information is contained in the People section of the Annual report on pages 35 to 38.

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. In addition, Horizons has developed and operates specialist innovation development centres at Gorthleck and Bo'ness to test new products and processes associated with the treatment of drinking water and waste water.

Political contributions

No political contributions were made during the year (2016: nil).

Public Services Reform (Scotland) Act 2010

Sections 31 and 32 of the Public Services Reform (Scotland) Act 2010 impose new duties on the Scottish Government and listed public bodies to publish information on expenditure and certain other matters as soon as is reasonably practicable after the end of each financial year.

In accordance with the Public Services Reform (Scotland) Act 2010, Scottish Water will publish the full information as required by the act on the Scottish Water website (www.scottishwater.co.uk) following the approval of the Scottish Water Annual Report and Accounts 2016/17. The report for this financial year will be available from August 2017.

Members' responsibilities

The following statement, which should be read in conjunction with the statement of auditor's responsibilities included in the Independent Auditor's Report on pages 68 to 73, is made with a view to distinguishing the respective responsibilities of the Members and of the auditor 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.

The Members are responsible for the maintenance and integrity of Scottish Water's website. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

The Members, as at the date of this report, consider that the Annual Report and Accounts taken as a whole is fair, balanced and understandable and provides the information necessary to assess Scottish Water's performance, business model and strategy.

Each of the Members, whose names and functions are listed in the Board Members section on pages 42 and 43, confirms that to the best of their knowledge and belief:

- the Group and Company financial statements, which have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the EU and interpreted by the Government Financial Reporting Manual (FRM), give a true and fair view of the assets, liabilities, financial position and surplus of Scottish Water;
- the Strategic report includes a fair review of the development and performance of the business and the position of Scottish Water, together with a description of the principal risks and uncertainties that it faces.

Each of the persons who is a Member at the date of approval of this report confirms that:

- so far as the Member is aware, there is no relevant audit information of which the Company's auditor is unaware;
- each Member has taken all the steps that he/she ought to have taken as a Member in order to make himself/herself aware of any relevant audit information and to establish that the Company's auditor is aware of that information.

By order of the Board,

Douglas Millican
Chief Executive
31 May 2017

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Independent auditor's report

Independent auditor's report to the members of Scottish Water, the Auditor General for Scotland and the Scottish Parliament.

Report on the audit of the financial statements

Opinion on financial statements

We have audited the financial statements in the annual report and accounts of Scottish Water for the year ended 31 March 2017 under the Water Industry (Scotland) Act 2002. The financial statements comprise the Group and Company Balance Sheets, the Consolidated Income Statement, the Consolidated Statement of Comprehensive Income, the Consolidated and Company Statements of Changes in Equity, the Group and Company Statements of Cash Flow and notes to the financial statements, including a summary of significant accounting policies. 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 2016-17 Government Financial Reporting Manual (the 2016-17 FReM).

In our opinion the financial statements:

- give a true and fair view in accordance with the Water Industry (Scotland) Act 2002 and directions made thereunder by the Scottish Ministers of the state of affairs of the body and its group as at 31 March 2017 and of the group's surplus 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 2016-17 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.

Basis of opinion

We conducted our audit in accordance with applicable law and International Standards on Auditing in the UK and Ireland (ISAs (UK&I)). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the body in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK including the Financial Reporting Council's Ethical Standards for Auditors, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Conclusion relating to principal risks, going concern and viability statement

We have nothing to report in respect of the following information in the annual report, in relation to which the ISAs (UK&I) require us to report to you whether we have anything material to add or draw attention to:

- the disclosures in the annual report and accounts that describe the principal risks and explain how they are being managed or mitigated;
- the members' confirmation in the annual report and accounts that they have carried out a robust assessment of the principal risks facing the group, including those that would threaten its business model, future performance, solvency or liquidity;
- the members' statement about whether they considered it appropriate to adopt the going concern basis in preparing the financial statements, and their identification of any material uncertainties to the group's ability to continue to do so over a period of at least twelve months from the date of the approval of the financial statements;
- the members' explanation in the annual report and accounts as to how they have assessed the prospects of the group, over what period they have done so and why they consider that period to be appropriate, and their statement as to whether they have a reasonable expectation that the group will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, including any related disclosures drawing attention to any necessary qualifications or assumptions.

Responsibilities of the board members for the financial statements

As explained more fully in the Statement of Members' Responsibilities set out on page 64, the board members are responsible for the preparation of financial statements that give a true and fair view in accordance with the financial reporting framework, and for such internal control as the board members determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor’s responsibilities for the audit of the financial statements

Our responsibility is to audit, and express an opinion on, the financial statements in accordance with applicable legal requirements and ISAs (UK&I) as required by the Code of Audit Practice approved by the Auditor General for Scotland. Those standards require us to comply with the Financial Reporting Council’s Ethical Standards for Auditors. 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 circumstances of the body and its group 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.

Our objectives are to achieve reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor’s report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs (UK&I) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

Our assessment of risks of material misstatement

In arriving at our audit opinion above on the financial statements, the risks of material misstatement that had the greatest effect on our audit, in decreasing order of audit significance, were as follows:

Risk		
<p>Capital additions (£484.5m, 2015-16: £325.4m) Refer to page 50 (Audit Committee Report), page 80 (accounting policy) and page 87 (note 9).</p>	<p>Accounting application Capital additions are significant, comprising the largest element of Scottish Water’s annual expenditure, and are related to the delivery plan for regulated activities for the period 2015-16 to 2020-21.</p> <p>Directors are incentivised across a number of financial and other measures including profit and completion of capital investment programmes.</p> <p>There is judgement involved in the allocation of expenditure between capital additions and revenue expenditure which can affect profit and investment measures reported in the financial statements.</p>	<p>Our procedures included:</p> <p>Control design</p> <ul style="list-style-type: none"> — Testing the design and operating effectiveness of controls over the allocation of costs between capital and revenue within the financial ledger at the project initiation stage and on an ongoing basis. — Testing the design and operating effectiveness of controls over the consistency between total capital expenditure reported in the financial statements and that reported in reports to those charged with governance as part of ongoing capital project monitoring arrangements. <p>Tests of detail</p> <ul style="list-style-type: none"> — Building on our work over control design we compared the reports of Scottish Water’s capital project monitoring group at the year end to amounts recorded as capital additions.

Risk

- In respect of a sample of capitalised additions, we evaluated the appropriateness of the classification as capital by considering the nature of the expenditure with reference to invoice, certificate or timesheets and considering the application of the relevant accounting policies.
- We assessed a sample of items allocated to revenue expenditure and considered whether they were correctly classified by considering the application of the relevant accounting policies.

Bad debt provision
(£446.6m, 2015-16:
£431.4m)

Refer to page 50 (Audit Committee Report), page 81 (accounting policy) and page 106 (note 26).

Forecast-based valuation

There are a number of assumptions included in the calculation of the bad debt provision; the most sensitive of these is the overall forecast collection rate based on historical data.

As at 31 March 2017, the Scottish Water regulated business reported a household revenue debtor of £478.9m (2016: £459.2m) which relates to household billings dating from 1996-97. Given the old age of the majority of these debts a bad debt provision of £446.6m (2016: £431.4m) is held against them. Household water debt is a statutory debt recoverable from the occupier. The household billing and cash collection is performed by local authorities and cannot be influenced by Scottish Water.

Our procedures included:

Control design

- Testing the design and operating effectiveness of controls over the review and approval of the provision and associated assumptions, by those charged with governance.
- Testing the design and operating effectiveness of controls in respect of the reconciliation of information provided by local authorities to Scottish Water in respect of amounts billed and collected to Scottish Water records, which forms the basis of the forecast collection rate.

Tests of detail

- We compared the information on historical collection rates, recorded by Scottish Water as the basis for the current year provision calculation in respect of prior year balances, to the records held in respect of prior years.
- We agreed the total amount billed and collected in respect of 2016-17, as recorded in Scottish Water's records, to confirmations received from individual local authorities.

Historical comparison

- We compared the change in forecast collection rate in the current year, to the historical trend of generally increasing collection rates since 1996-97.

Sensitivity analysis

- We performed sensitivity analysis and challenged management in respect of the forecast collection rate and its impact on the associated bad debt provision.

Assessing transparency

- We assessed the disclosure of sensitivities by the Directors, and description of the provision in note 26 of the financial statements.

Risk

Pension liability (£194.4m, 2015-16: £90.7m)
 Refer to page 50 (Audit Committee Report), page 81 (accounting policy) and page 99 (note 22).

Subjective valuation
 Small changes in the assumptions and estimates relating to discount rate, inflation rate, mortality/life expectancy and rate of increase in pensionable salaries which are used to value the pension obligation (before deducting scheme assets) would have a significant effect on the net pension liability.

Employees of Scottish Water participate in three local government defined benefit pension schemes; North East Scotland pension fund, the Lothian pension fund and the Strathclyde pension fund.

Our procedures included:

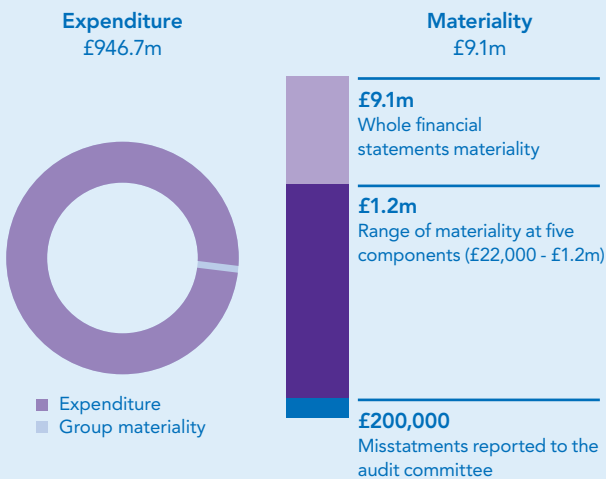
Benchmarking assumptions

- Challenging, with the support of our own actuarial specialists, the key assumptions applied, being the discount rate, inflation rate and mortality/life expectancy against externally derived data.
- Challenging the rate of increase in pensionable salaries assumption, by comparing it to other evidence such as the regulatory delivery plan and our understanding of Scottish Government expectations.

Assessing transparency

- Considering the adequacy of the disclosures in respect of the sensitivity of the deficit to these assumptions.

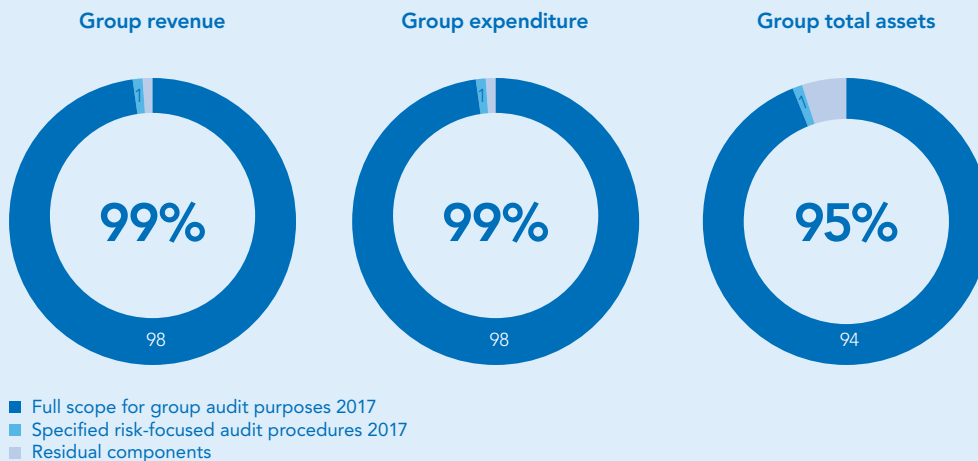
Our application of materiality and an overview of the scope of our audit



Materiality for the group financial statements as a whole was set at £9.1 million, determined with reference to a benchmark of group total expenditure of which it represents 1%. We consider total expenditure to be the most appropriate benchmark as the most significant part of the Group is its regulated business which is a Scottish Government owned body where the level of expenditure is the most important measure.

We reported to the Audit Committee any corrected or uncorrected identified misstatements exceeding £200,000, in addition to other identified misstatements that warranted reporting on qualitative grounds.

Of the group’s seven reporting components, we subjected two to full scope audits for group purposes and one component to specified risk-focused audit procedures over profit recognition. The latter was not individually financially significant enough to require a full scope audit for group purposes, but did present specific individual risks that needed to be addressed. Together these entities accounted for the following percentages of the group’s results: 99% of the Group’s total revenue, 99% of group expenditure and 95% of group total assets.



For the residual components, we performed analysis at an aggregated group level to re-examine our assessment that there were no significant risks of material misstatement within these. The work on all of the components was performed by the Group team. The component materialities ranged from £29,000 to £1.6 million, having regard to the mix of size and risk profile of the Group across the components.

Other information in annual report and accounts

The board members are responsible for the other information in the annual report and accounts. The other information comprises the information other than the financial statements and our auditor's report thereon. Our opinion on the financial statements does not cover the other information and we do not express any form of assurance conclusion thereon except on matters prescribed by the Auditor General for Scotland to the extent explicitly stated below and in the sections of our report headed Conclusion relating to principal risks, going concern and viability statement and Opinion on other prescribed matters.

In connection with our audit of the financial statements in accordance with ISAs (UK&I), our responsibility is to read all the financial and non-financial information in the annual report and accounts to identify material inconsistencies with the audited financial statements and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Under ISAs (UK&I) we are required to report to you if, based on the knowledge we acquired during our audit, we have identified other information in the Annual Report that contains a material inconsistency with either that knowledge or the financial statements, a material misstatement of fact, or that is otherwise misleading.

In particular, we are required to report to you if:

- we have identified material inconsistencies between the knowledge we acquired during our audit and the Board's statement that they consider that the Annual Report and financial statements taken as a whole is fair, balanced and understandable and provides the information necessary for stakeholders to assess the Group's position and performance, business model and strategy; or
- the Audit Committee Report does not appropriately address matters communicated by us to the Audit Committee.

We have nothing to report in respect of the above responsibilities.

Report on regularity of expenditure and income

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.

Responsibilities for regularity

The board members are also responsible for ensuring the regularity of expenditure and income. We are responsible for expressing an opinion on the regularity of expenditure and income in accordance with the Public Finance and Accountability (Scotland) Act 2000.

Report on other requirements

Opinion on other prescribed matters

We are required by the Auditor General for Scotland to express an opinion on the following 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 Scottish Ministers.
- based solely on the work required to be undertaken in the course of the audit of the financial statements:
 - the information given in the Strategic Report for the financial year for which the financial statements are prepared is consistent with the financial statements; and
 - the information given in the Governance Statement for the financial year for which the financial statements are prepared is consistent with the financial statements and that report has been prepared in accordance with the directions made under the Water Industry (Scotland) Act 2002 by the Scottish Ministers.

Matters on which we are required to report by exception

We are required by the Auditor General for Scotland to report to you if, in our opinion:

- adequate accounting records have not been kept; or
- the financial statements and the auditable part of the Members' Remuneration Report are not in agreement with the accounting records; or
- we have not received all the information and explanations we require for our audit.

We have nothing to report in respect of the above responsibilities.

The purpose of our audit work and to whom we owe our responsibilities

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 120 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.

Hugh Harvie
For and on behalf of KPMG LLP, Statutory Auditor
Chartered Accountants
Saltire Court
20 Castle Terrace
Edinburgh
EH1 2EG

6 June 2017

Consolidated income statement

For the year ended 31 March 2017

	Note	2017 £m	2016 £m
Revenue	3	1,213.5	1,196.8
Cost of sales		(805.7)	(774.2)
Gross surplus		407.8	422.6
Administrative expenses		(141.0)	(138.4)
Operating surplus	3, 4	266.8	284.2
Finance income	7	1.8	3.2
Finance costs	7	(174.4)	(181.2)
Surplus before taxation		94.2	106.2
Taxation	8	2.0	17.8
Surplus for the year	20	96.2	124.0

Consolidated statement of comprehensive income

For the year ended 31 March 2017

	Note	2017 £m	2016 £m
Surplus for the year	20	96.2	124.0
Other comprehensive income:			
Items which will not subsequently be reclassified to the income statement			
Actuarial (loss)/gain on post employment benefit obligations, net of deferred taxation	22	(94.4)	83.9
Total comprehensive income for the year		1.8	207.9

The surplus for the period and total comprehensive income for the period are attributable to the owners of Scottish Water.

Consolidated statement of changes in equity

	Note	Retained earnings £m	Other reserves £m	Total reserves £m
Balance at 1 April 2015		1,183.3	133.4	1,316.7
Surplus for the year	20	124.0	–	124.0
Other comprehensive income:				
Actuarial gain on post employment benefit obligations, net of tax	22	83.9	–	83.9
Total comprehensive income for the year		207.9	–	207.9
Balance at 31 March 2016		1,391.2	133.4	1,524.6
Surplus for the year	20	96.2	–	96.2
Other comprehensive loss:				
Actuarial loss on post employment benefit obligations, net of tax	22	(94.4)	–	(94.4)
Total comprehensive income for the year		1.8	–	1.8
Balance at 31 March 2017	20	1,393.0	133.4	1,526.4

Company statement of changes in equity

	Note	Retained earnings £m	Other reserves £m	Total reserves £m
Balance at 1 April 2015		1,028.6	133.4	1,162.0
Surplus for the year	20	107.8	–	107.8
Other comprehensive income:				
Actuarial gain on post employment benefit obligations, net of tax	22	82.3	–	82.3
Total comprehensive income for the year		190.1	–	190.1
Balance at 31 March 2016		1,218.7	133.4	1,352.1
Surplus for the year	20	89.9	–	89.9
Other comprehensive loss:				
Actuarial loss on post employment benefit obligations, net of tax	22	(90.2)	–	(90.2)
Total comprehensive income for the year		(0.3)	–	(0.3)
Balance at 31 March 2017	20	1,218.4	133.4	1,351.8

The 'Statement of changes in equity' above excludes Government loans which, in accordance with the Corporate Governance Direction, are recorded on the balance sheet under Equity. Full details of Government loans are provided in note 18.

Balance sheets

As at 31 March 2017

	Note	Group		Company	
		2017 £m	2016 £m	2017 £m	2016 £m
Assets					
Non-current assets					
Property, plant and equipment	9	5,758.6	5,546.5	5,741.8	5,532.3
Investments	10	–	–	37.6	37.6
Deferred tax asset	15	1.2	0.3	–	–
		5,759.8	5,546.8	5,779.4	5,569.9
Current assets					
Inventories	11	2.6	2.6	2.3	2.2
Trade and other receivables	12	149.4	136.7	103.7	67.5
Current tax asset		2.6	0.8	0.7	0.8
Cash and cash equivalents	13	429.6	539.3	235.2	368.6
		584.2	679.4	341.9	439.1
Total assets	3	6,344.0	6,226.2	6,121.3	6,009.0
Liabilities					
Current liabilities					
Trade and other payables	14	(394.9)	(368.6)	(353.2)	(318.6)
Other loans and borrowings	17	(20.5)	(19.3)	(20.5)	(19.3)
Current tax liabilities		–	(2.1)	–	–
Provisions for liabilities	16	(5.4)	(4.3)	(8.8)	(15.6)
		(420.8)	(394.3)	(382.5)	(353.5)
Non-current liabilities					
Trade and other payables	14	(74.1)	(73.0)	(67.9)	(66.6)
Other loans and borrowings	17	(324.8)	(345.3)	(324.8)	(345.3)
Deferred tax liabilities	15	(334.5)	(353.5)	(333.9)	(353.0)
Retirement benefit obligations	22	(234.2)	(110.6)	(230.5)	(112.1)
Provisions for liabilities	16	(5.9)	(1.6)	(6.6)	(3.1)
		(973.5)	(884.0)	(963.7)	(880.1)
Total liabilities		(1,394.3)	(1,278.3)	(1,346.2)	(1,233.6)
Net assets		4,949.7	4,947.9	4,775.1	4,775.4
Equity					
Government loans	18	3,423.3	3,423.3	3,423.3	3,423.3
Retained earnings	20	1,393.0	1,391.2	1,218.4	1,218.7
Other reserves		133.4	133.4	133.4	133.4
		4,949.7	4,947.9	4,775.1	4,775.4

The financial statements on pages 74 to 107 were approved by the Board of Members on 31 May 2017 and signed on its behalf by:

Douglas Millican
Chief Executive

Statements of cash flow

For the year ended 31 March 2017

	Note	Group		Company	
		2017 £m	2016 £m	2017 £m	2016 £m
Surplus before taxation		94.2	106.2	86.2	85.3
Depreciation charges		276.1	264.2	273.9	261.9
Amortisation of grants		(1.1)	(1.1)	(0.9)	(1.0)
Surplus on disposal of property, plant and equipment		(6.2)	(14.8)	(6.2)	(14.7)
Non cash adjustment for retirement benefit obligations		9.5	11.6	9.2	11.1
Finance costs – net		172.6	178.0	173.7	179.2
Operating cashflow before changes in working capital and provisions		545.1	544.1	535.9	521.8
Changes in working capital and provisions:					
(Increase)/decrease in receivables		(14.8)	15.3	(35.6)	13.9
(Increase)/decrease in inventories		–	(0.1)	(0.1)	0.1
Increase/(decrease) in payables		51.2	1.2	62.1	(3.8)
Increase/(decrease) in provisions		4.0	(3.1)	(4.7)	(2.7)
Cash flows from operating activities		585.5	557.4	557.6	529.3
Taxation (paid)/received		(3.0)	0.2	–	–
Net cash generated from operating activities		582.5	557.6	557.6	529.3
Cash flows from investing activities					
Purchase of property, plant and equipment		(525.0)	(345.3)	(522.8)	(339.8)
Sale of property, plant and equipment		7.3	16.2	7.3	15.5
Infrastructure income receipts		13.9	11.9	13.9	11.9
Net cash used in investing activities		(503.8)	(317.2)	(501.6)	(312.4)
Cash flows from financing activities					
Repayments of loans		(342.8)	(323.9)	(342.8)	(323.9)
Proceeds from borrowings		342.8	323.9	342.8	323.9
Interest received		1.5	2.0	0.6	0.9
Interest paid		(170.6)	(176.2)	(170.7)	(176.3)
Payment of finance lease liabilities		(19.3)	(18.3)	(19.3)	(18.3)
Net cash used in financing activities		(188.4)	(192.5)	(189.4)	(193.7)
Net (decrease)/increase in cash and cash equivalents		(109.7)	47.9	(133.4)	23.2
Cash and cash equivalents at beginning of year	13	539.3	491.4	368.6	345.4
Cash and cash equivalents at end of year	13	429.6	539.3	235.2	368.6

Notes to the financial statements

For the year ended 31 March 2017

1 Accounting policies

1.1 General information

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.

The principal accounting policies applied in the preparation of the consolidated financial statements are set out below.

1.2 Basis of preparation

The financial statements of Scottish Water for the year ended 31 March 2017 have been prepared in accordance with EU adopted and endorsed International Financial Reporting Standards (IFRS) and International Financial Reporting Interpretations Committee (IFRIC) interpretations, as interpreted by the Government Financial Reporting Manual (FRM). The FRM is published by HM Treasury and is available from their website.

The consolidated financial statements have been prepared on the going concern basis under the historical cost convention, as modified by the revaluation of derivative financial instruments at fair value through the profit and loss. The financial statements are prepared in a form directed by Scottish Ministers in accordance with section 45(2) of the Water Industry (Scotland) Act 2002. The Company's financial statements have been prepared on the same basis and, as permitted by Section 408 of the Companies Act 2006, no income statement or statement of comprehensive income is presented for the Company.

Scottish Water's accounting policies, as set out below, have been consistently applied to all the years presented, unless otherwise stated.

Scottish Water's financial statements have been prepared in accordance with IFRS since 1 April 2008. The preparation of financial statements in conformity with IFRS requires the use of certain critical accounting estimates. It also requires management to exercise its judgement in the process of applying the Group's accounting policies (note 2).

The consolidated financial statements are presented in Pounds Sterling which is the functional and presentational currency of Scottish Water and its subsidiaries.

1.3 Changes in accounting policy

Scottish Water has adopted the following new standards and amendments to standards, including any consequential amendments to other standards, with effect from 1 April 2016.

- Annual improvements to IFRSs 2012-2014 Cycle; and
- Amendments to IFRS 10 'Consolidated Financial Statements', IFRS 11 'Joint Arrangements', IFRS 12 'Disclosure of Interests in Other Entities', IAS 1 'Presentation of Financial Statements', IAS 16 'Property, Plant and Equipment', IAS 27 'Separate Financial Statements' and IAS 28 'Investments in Associates and Joint Ventures'.

The adoption of the amendments to the standards had no material impact on the overall results and financial position of Scottish Water.

1.4 Accounting standards not yet adopted by Scottish Water

As at the date of authorisation of these financial statements, the following key standards and interpretations were in issue but not yet effective (and in some cases had not yet been adopted by the EU). Consequently, Scottish Water has not applied these new IFRSs and IFRICs in the preparation of the financial statements.

- IFRS 9 'Financial Instruments';
- IFRS 14 'Regulatory Deferral Accounts';
- IFRS 15 'Revenue from Contracts with Customers';
- IFRS 16 'Leases';
- Annual improvements to IFRSs 2014-2016 Cycle; and
- Amendments to IAS 7 'Statement of cash flows' and IAS 12 'Income taxes'.

Scottish Water expects that only IFRS 16 will have a material effect on the results and net assets of Scottish Water. The impact on Scottish Water's financial statements of the future adoption of this and the other new standards, interpretations and amendments is currently under review.

1.5 Basis of consolidation

Subsidiaries

The consolidated financial information incorporates the results of Scottish Water (the Company) and its trading subsidiaries. The consolidated financial information does not include the non trading subsidiaries as permitted under section 405 of the

1 Accounting policies continued

Companies Act 2006. Subsidiaries are all entities over which Scottish Water has the power to direct the relevant activities of the entities, the rights to variable returns and the ability to use its power to influence the returns. Scottish Water Business Stream Limited (Business Stream) is treated as a subsidiary although there are special governance arrangements which were established in conjunction with the Water Industry Commission for Scotland and associated with the conditions attached to Business Stream's licence for the supply of water and waste water services. Scottish Water is, however, satisfied that the controls and governance in place are such that consolidation is appropriate. Subsidiaries are fully consolidated from the date on which control is transferred to Scottish Water; they are de-consolidated from the date when control ceases.

Intercompany transactions, balances and any unrealised gains on transactions between Scottish Water related companies have been eliminated within the consolidated financial statements. Uniform accounting policies have been adopted across the Group.

1.6 Operating segments

Operating segments are reported in a manner consistent with the internal reporting provided to the chief operating decision-maker. The chief operating decision-maker, who is responsible for allocating resources and assessing performance of the operating segments, has been identified as the Board of Scottish Water.

1.7 Revenue recognition

Revenue is recognised to the extent that it is probable economic benefits will flow to the Group and that the revenue can be reliably measured. Revenue is not recognised until the service has been provided to the customer. Revenue is shown net of associated sales taxes and value added tax and after eliminating sales between the Scottish Water related companies. Where services have been provided, but for which no invoice has been raised at the year end, an estimate of the value is included in revenue.

Revenue comprises charges to customers for water and waste water services, and related services provided during the year in the normal course of business. For measured customers, revenue 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 statement throughout the year.

1.8 Research and development expenditure

Research expenditure is recognised as an expense as incurred. Costs incurred on development projects which either do not meet the criteria defined in IAS 38 'Intangible assets' or are deemed to be not material, are recognised as an expense as incurred. Development costs which meet the relevant criteria are capitalised and written off over their expected useful lives. Development costs previously recognised as an expense are not recognised as an asset in subsequent periods.

1.9 Finance income and costs

Finance income comprises interest receivable on funds invested and recognised in the income statement. Finance costs comprise interest payable on borrowings and interest on pension scheme net liabilities. Interest income and costs are recognised in the income statement as they accrue, on an effective interest rate method.

Borrowing costs incurred by Scottish Water that are not directly attributable to the acquisition, construction or production of qualifying assets are expensed in the period in which they are accrued.

1.10 Taxation

The tax expense for the year comprises current and deferred tax. Tax is recognised in the income statement, unless it relates to items recognised directly in reserves in which case it is recognised in reserves.

Current tax is provided at amounts expected to be paid or recovered using the tax rates and laws that have been enacted or substantively enacted by the balance sheet date.

Deferred income tax is recognised, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the consolidated financial statements. Deferred income tax is determined using tax rates that have been enacted or substantively enacted by the balance sheet date and are expected to apply when the related deferred income tax asset is realised or the deferred income tax liability is settled.

Deferred income tax assets are recognised only to the extent that it is probable that future taxable profits will be available against which the temporary differences can be utilised.

Deferred income tax is provided on temporary differences arising on investments in subsidiaries and associates, except where the timing of the reversal of the temporary difference is controlled by the Group and it is probable that the temporary difference will not reverse in the foreseeable future.

Deferred income tax assets and liabilities are offset when there is a legally enforceable right to offset current tax assets against current tax liabilities and when the deferred income tax assets and liabilities relate to income taxes levied by the same taxation authority on either the taxable entity or different taxable entities where there is an intention to settle the balances on a net basis.

Notes to the financial statements

For the year ended 31 March 2017

continued

1 Accounting policies continued

1.11 Property, plant and equipment

Property, plant and equipment comprises water and waste water infrastructure assets and other assets, being overground assets including operational properties, plant, machinery and vehicles.

Property, plant and equipment are included at historical cost less accumulated depreciation and impairment. Cost includes the acquisition or construction cost together with any expenditure directly attributable to bringing the asset into use, including directly attributable internal costs and, where material, borrowing costs. Subsequent costs are included in the asset's carrying amount or recognised as a separate asset, as appropriate, only when it is probable that the future economic benefits associated with the item will flow to the Group and the cost of the item can be measured reliably. The carrying amount of the replaced part is derecognised. All other repairs and maintenance are charged to the income statement during the financial period in which they are incurred. All items of property, plant and equipment, with the exception of land and assets under construction, are subject to depreciation.

Infrastructure assets

The infrastructure assets comprise a network of water and waste water systems including mains, sewers, impounding and pumped raw water storage reservoirs, dams, sludge pipelines and sea outfalls. Expenditure on infrastructure assets, which relates to increases in capacity or enhancements of the network, is treated as additions. Expenditure incurred in maintaining and repairing the operating capability of the network is expensed in the year in which it is incurred. Depreciation is calculated for each component of the network with similar characteristics and asset lives.

Other assets

All other property, plant and equipment are depreciated on a straight-line basis over their estimated useful economic lives.

Depreciation

Depreciation is charged to the income statement to write-off cost, less residual values, on a straight-line basis over the estimated operational lives of the assets, from the date of beneficial use. The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each balance sheet date. Freehold land and assets under construction are not depreciated. The estimated useful lives for assets depreciated are as follows:

Infrastructure assets	80 to 150 years
Non-specialised operational buildings and structures	60 years
Fixtures, fittings and furniture within non-specialised operational buildings	5 years
Specialised operational buildings and structures	20 to 80 years
Plant, machinery and vehicles	1 to 20 years

1.12 Leased assets

Leases where Scottish Water control through ownership, beneficial entitlement or otherwise, any significant residual interest in the assets at the end of the service concession agreements are treated as finance leases. Private Finance Initiative (PFI) contracts are treated as finance leases, in accordance with IFRIC 12.

Assets held under finance leases are recognised as part of the property, plant and equipment of the Group at their fair value or, if lower, at the present value of the minimum lease payments, as determined at the inception of the PFI contract. The corresponding liability is included in the Balance Sheet as a finance lease obligation. Lease payments are apportioned between finance charges and reduction of the lease obligation. Finance charges are charged directly to the income statement. The property, plant and equipment acquired under finance leases are depreciated over the shorter of the useful life of the asset and the lease term.

All other leases are categorised as operating leases. Payments made under operating leases are charged to the income statement over the term of the lease on a straight-line basis.

1.13 Impairment of assets

The carrying values of the Group's non-current assets are reviewed for impairment when events or changes in circumstances indicate that the carrying value may not be justified. An impairment loss is recognised for the amount by which the asset's carrying value exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and value in use.

1.14 Capital grants and customer contributions

Capital grants and customer contributions in respect of infrastructure assets are deducted from the cost of the non-current asset. Grants and contributions received in respect of non-infrastructure assets are credited to deferred income and are released to the income statement over the expected useful lives of the relevant non-current assets.

1.15 Investments

Investments in subsidiaries, held as non-current assets, are stated at cost less any provision for impairment. Any impairment is charged to the income statement as it arises.

1 Accounting policies continued

1.16 Inventories

Inventories and work in progress are stated at the lower of cost or net realisable value. Cost is determined using the first-in, first-out (FIFO) method. 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.

1.17 Financial instruments

Financial assets and liabilities are recognised in Scottish Water's balance sheet when an obligation is identified and released as that obligation is fulfilled. Scottish Water's financial instruments comprise trade and other receivables, cash and cash equivalents, borrowings, as well as trade and other payables that arise directly from operations. Scottish Water's policy is not to trade or speculate in financial instruments but under special circumstances, Scottish Water may use financial instruments to mitigate certain financial risk exposures. As such circumstances are rare, approval is required from Scottish Ministers. All treasury activities are undertaken in accordance with the permitted activities as set out in the Scottish Water Governance Directions 2009.

a. Trade receivables

Trade receivables are recorded at net realisable value after deducting a provision where there is evidence that Scottish Water will not be able to collect all amounts due. The provision is calculated by applying expected recovery rates, based on actual historical cash collection performance, to the aged debt profile of the outstanding debt. Trade receivable balances, with the exception of statutory debt, are written off when Scottish Water determines that it is unlikely that future remittances will be received. Trade receivables do not carry any interest.

b. Cash and cash equivalents

Cash and cash equivalents include cash in hand and deposits with banks, which have a maturity of 3 months or less from the date of acquisition and which are subject to an insignificant risk of change in value.

c. Trade and other payables

Trade and other payables are stated at cost.

d. Interest-bearing loans and borrowings

Borrowings are recognised initially at fair value and are subsequently stated at amortised cost. Overdrafts and non Government loans are classified as current liabilities unless the Group has an unconditional right to defer settlement of the liability for at least 12 months after the balance sheet date.

e. Derivative financial instruments

In special circumstances, Scottish Water may use financial instruments to mitigate certain financial risk exposures such as foreign exchange fluctuations. As such circumstances are rare, in addition to the approval of the Scottish Water Board, approval is required from Scottish Ministers under the terms of section 42(3)(b) Water Industry (Scotland) Act 2002.

Financial derivative instruments are recognised at fair value and are re-measured to fair value each reporting period. Scottish Water has not applied hedge accounting and all derivatives are measured at fair value through the income statement. The fair values of foreign exchange contracts are calculated by reference to market forward rates at the balance sheet date.

1.18 Employee benefit obligations

Employees of Scottish Water participate in the Scottish Local Government Pension Scheme (SLGPS) administered by Aberdeen, Glasgow and Edinburgh City Councils, all of which are defined benefit schemes. Pension scheme assets are measured using the bid market values. Pension scheme liabilities are measured using the projected unit actuarial method and are discounted at the current rate of return on a high quality corporate bond of equivalent term and currency to the liability.

Any increase in the present value of liabilities within the defined benefit pension schemes expected to arise from employee service in the period is charged to operating surplus. The net interest cost for the period, calculated by applying the discount rate to the net pension scheme liabilities, is included in the finance costs. Actuarial gains and losses are recognised in full as an item of 'other comprehensive income' in the consolidated statement of comprehensive income. Pension scheme deficits and surpluses, to the extent that the surplus is considered recoverable, are recognised in full and presented on the face of the balance sheet.

In December 2016, Business Stream introduced a new defined contribution pension scheme, administered by Standard Life. Employees joining Business Stream after this date enrol in this scheme, with the SLGPS closed to new employees from the same date.

1.19 Provisions

Provisions are recognised when there is a present obligation for a past event, for which it is probable that a transfer of economic benefits will be required and a reliable estimate can be made of the amount of the obligation. Provisions currently relate to onerous property rental costs, income uncertainty and redundancy costs associated with employees who will leave Scottish Water under voluntary redundancy and early retirement. Pension related liabilities associated with employees who have left Scottish Water under the voluntary severance scheme are recognised in the pension liability.

Notes to the financial statements

For the year ended 31 March 2017

continued

1 Accounting policies continued

1.20 Foreign currency transactions

Transactions in foreign currencies are translated at the exchange rate ruling at the date of the transactions. Foreign exchange gains and losses resulting from (i) the settlement of such transactions and (ii) the retranslation to exchange rates ruling at the balance sheet date of monetary assets and liabilities denominated in foreign currencies are recognised in the income statement.

1.21 Indebtedness to the Scottish Ministers

Loans from the National Loans Fund, the Scottish Consolidated Fund and other Government borrowings are treated as part of equity, including loan repayments due within one year, in accordance with the Scottish Water Governance Directions 2009.

2 Accounting estimates and judgements

The preparation of financial statements to conform to IFRS requires the use of estimates, assumptions and judgements that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts for revenue and expenses during the reporting period. Estimates and judgements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. Although based on management's best knowledge of the amount, event or actions, actual results may ultimately differ from these estimates, the effect of which is recognised in the period in which the facts giving rise to the revision arise.

The most critical of these accounting judgement and estimation areas are noted below.

a. Revenue recognition

Revenue relating to metered customers includes an estimate of the value of water or waste water services supplied between the date of the last meter reading and the year end. At the balance sheet date, the estimated consumption by customers will either have been billed (estimated billed revenue) or accrued (unbilled revenue). Using historical consumption patterns, management apply judgement to the measurement of the quantum of the estimated consumption and to the valuation of that consumption. The judgements applied, and the assumptions underpinning these judgements, are considered to be appropriate. However, a change in these assumptions would have no material impact upon the amount of revenue recognised.

b. Impairment of trade and other receivables

Scottish Water and each of its subsidiaries evaluate the recoverability of their trade receivables as at the reporting date and assess the allowances for doubtful receivables based on experience. These allowances are based on, amongst other factors, actual collection history, forecast rates and customer category. The actual level of receivables collected may differ from those estimated, due to factors such as changes in customer behaviour, potential impact of government policy initiatives and the economic outlook, which could impact positively or negatively on operating results (see sensitivity analysis in note 26).

c. Carrying value of property, plant and equipment

Property, plant and equipment (PPE) represents the majority of the Group's asset base and a significant proportion of the Group's annual expenditure (see funding chart on page 8). Therefore the estimates and assumptions made in determining the carrying values and related depreciation are critical to the Group's financial performance and position.

The estimated useful economic lives and residual values of PPE are based on management's judgement and experience. Due to the significance of PPE investment, variations between actual and estimated economic lives could impact on operating results both positively and negatively. When management identifies that actual useful economic lives differ materially from the estimates used, the relevant depreciation charge is adjusted prospectively. However, historically, any changes to estimated useful lives and residual values have not resulted in material changes to the Group's depreciation charges.

Each financial year, in accordance with IAS 23 'Borrowing costs', Scottish Water calculates the amount of borrowing which would be attributable to the PPE acquired or under construction. To date these amounts have been immaterial and therefore not capitalised.

d. Provisions

The assessments undertaken in recognising provisions and contingencies have been made in accordance with IAS 37 'Provisions, Contingent Liabilities and Contingent Assets'. The evaluation of the likelihood of the contingent events has required the best judgement by management regarding the probability of exposure to potential loss. Should circumstances change following unforeseen developments, this likelihood could alter.

e. Retirement benefits

Scottish Water and its subsidiaries are participating employers in 3 Scottish Local Government Pension Schemes (SLGPS) which are defined benefit schemes. Actuarial valuations of the schemes are carried out by the administering authorities triennially in line with SLGPS regulations. The assumptions in relation to the cost of providing post-retirement benefits during the period are set after consultation with qualified actuaries. These assumptions include discount rates, returns on the schemes' assets, pay growth and increases to pension payments (see note 22) and, while these assumptions are believed to be appropriate, a change to the assumptions would impact the surplus of the Group and the carrying amount of pension obligations. These assumptions may differ from the actual results due to changes in market and economic conditions and longer or shorter lives of participants.

3. Segmental analysis

The principal activities of the Scottish Water Group are the supply of water and waste water 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 waste water collection, treatment and distribution within cost of sales.

Scottish Water's reportable segments are the provision of regulated water and waste water services, Business Stream (a Licensed Provider in the supply of water and waste water services to business customers) and other trading activities. The other trading activities include the results of Horizons, Scottish Water International and Scottish Water's non-regulated activities. These operating segments reflect the internal management reporting that are reviewed regularly by the Board in order to allocate resources to and assess the performance of the segments.

	2017 £m	2016 £m
Revenue		
Regulated water and waste water services	1,149.0	1,120.4
Business Stream	183.8	281.6
Other trading activities	21.4	20.0
	1,354.2	1,422.0
Intercompany elimination	(140.7)	(225.2)
	1,213.5	1,196.8

During the year Business Stream generated £8.2 million (2016: £8.6 million) of non-licensed trading revenue bringing the total revenue from other trading activities for the Group to £29.6 million (2016: £28.6 million).

	2017 £m	2016 £m
Operating surplus		
Regulated water and waste water services	259.7	264.0
Business Stream	5.7	18.4
Other trading activities	1.4	2.0
	266.8	284.4
Intercompany elimination	–	(0.2)
	266.8	284.2

Business Stream's operating surplus from non-licensed trading activities during the year was £1.0 million (2016: £1.8 million) bringing the total operating surplus from other trading activities for the Group to £2.4 million (2016: £3.8 million).

	2017 £m	2016 £m
Total assets		
Regulated water and waste water services	6,068.7	5,970.6
Business Stream	209.1	201.1
Other trading activities	66.2	54.5
	6,344.0	6,226.2

	Capital additions to property, plant & equipment		Depreciation on property, plant and equipment	
	2017 £m	2016 £m	2017 £m	2016 £m
Regulated water and waste water services	484.5	325.4	273.9	261.9
Business Stream	1.4	0.7	1.5	1.7
Other trading activities	16.3	35.9	0.7	0.6
Less: intercompany transfer	(12.9)	(33.7)	–	–
	489.3	328.3	276.1	264.2

Notes to the financial statements

For the year ended 31 March 2017

continued

3. Segmental analysis continued

Revenue by geographical location of customers is as follows:

	Revenue	
	2017 £m	2016 £m
United Kingdom	1,211.3	1,195.1
Rest of the World	2.2	1.7
	1,213.5	1,196.8

4. Operating surplus

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

	Note	2017 £m	2016 £m
PFI operating costs		114.8	112.9
Depreciation of property, plant and equipment	9	276.1	264.2
Surplus on sale of property, plant and equipment		(6.2)	(14.8)
Release of deferred income in relation to capital grants		(1.1)	(1.1)
Operating lease rentals		3.3	3.1
Auditor's remuneration – audit fee for audit of the company and consolidated financial statements (including £100,000 (2016: £70,000) in respect of the audit of subsidiary companies)		0.3	0.2
– other services		–	–
Research and development expenditure		1.1	1.0

5. Staff costs

	Note	2017 £m	2016 £m
Wages and salaries		139.8	130.2
Social security costs		14.3	10.5
IAS 19 total service costs	22	37.0	37.0
Employee benefit expense		191.1	177.7
Less: charged as capital expenditure		(72.3)	(59.6)
		118.8	118.1

The average monthly number of people (including Executive and Non-executive Members) employed by Scottish Water, split by activity, during the year was:

	2017	2016
Regulated water and waste water services	3,744	3,485
Business Stream	289	274
Other trading activities	85	76
Scottish Water Solutions 2 Limited secondees	2	4
	4,120	3,839

6. Members' remuneration

Information concerning Members' remuneration, incentive schemes and pensions is detailed in the Remuneration Report on pages 53 to 62.

7. Finance income and costs

	Note	2017 £m	2016 £m
Interest income:			
Short-term deposits		1.5	2.0
Fair value gains on financial instruments: forward currency contracts		0.3	1.2
Finance income		1.8	3.2
Interest expense:			
Government loans		(148.2)	(151.4)
Other loans		(0.3)	(0.2)
Finance lease liabilities		(21.5)	(22.6)
Interest on pension scheme net liabilities	22	(4.4)	(7.0)
Finance costs		(174.4)	(181.2)
Net finance costs		(172.6)	(178.0)

Notes to the financial statements

For the year ended 31 March 2017

continued

8. Taxation

	Note	2017 £m	2016 £m
Analysis of tax credit recognised in the income statement			
Current tax: UK corporation tax		1.6	4.8
Current tax: Overseas corporation tax		0.1	–
Current tax: Adjustment in respect of prior years		(2.6)	–
		(0.9)	4.8
Deferred tax: Origination and reversal of timing differences		19.2	15.7
Deferred tax: Effect of rate change		(20.3)	(38.3)
	15	(1.1)	(22.6)
Total tax credit		(2.0)	(17.8)
The credit for the year can be reconciled to the surplus per the income statement as follows:			
Group surplus before tax		94.2	106.2
Tax on surplus on ordinary activities at standard UK corporation tax rate of 20% (2016: 20%)		18.8	21.2
Adjustment in respect of prior years		1.4	1.1
Re-measurement of deferred tax due to change in UK corporation tax rate		(23.0)	(39.9)
Accounting gain with no capital gain		(1.2)	(2.4)
Depreciation on non qualifying additions		1.8	1.5
Other permanent differences		0.2	0.7
Total tax credit for the year		(2.0)	(17.8)

	Note	Group		Company	
		2017 £m	2016 £m	2017 £m	2016 £m
Tax (credit)/charge recognised directly in reserves					
Deferred tax relating to:					
Pension scheme actuarial movements	15	(18.8)	21.8	(18.0)	21.4

During the year, as a result of changes in the UK corporation tax rate from 18% to 17% that will be effective from 1 April 2020, deferred tax balances have been re-measured (2016: from 20% to 18%).

9. Property, plant and equipment

Group	Specialised operational properties and structures £m	Non-specialised operational properties £m	Infrastructure assets £m	Plant, machinery and vehicles £m	Assets under construction £m	Total £m
Cost						
At 1 April 2015	2,990.0	82.6	2,051.9	2,829.7	830.4	8,784.6
Additions	3.6	–	–	0.7	324.0	328.3
Disposals*	(7.6)	(10.0)	(0.1)	(549.7)	(0.3)	(567.7)
Reclassifications	146.0	2.5	170.1	201.8	(520.4)	–
At 31 March 2016	3,132.0	75.1	2,221.9	2,482.5	633.7	8,545.2
Additions	1.0	–	–	1.4	486.9	489.3
Disposals*	(152.8)	(1.5)	–	(152.9)	–	(307.2)
Reclassifications	84.0	5.9	55.0	188.9	(333.8)	–
At 31 March 2017	3,064.2	79.5	2,276.9	2,519.9	786.8	8,727.3
Accumulated depreciation						
At 1 April 2015	1,053.7	28.8	471.8	1,746.5	–	3,300.8
Charge for the year	70.2	1.8	16.6	175.6	–	264.2
Disposals*	(6.7)	(10.0)	–	(549.6)	–	(566.3)
At 31 March 2016	1,117.2	20.6	488.4	1,372.5	–	2,998.7
Charge for the year	70.0	2.8	16.4	186.9	–	276.1
Disposals*	(152.8)	(0.4)	–	(152.9)	–	(306.1)
At 31 March 2017	1,034.4	23.0	504.8	1,406.5	–	2,968.7
Net book value						
At 31 March 2017	2,029.8	56.5	1,772.1	1,113.4	786.8	5,758.6
At 31 March 2016	2,014.8	54.5	1,733.5	1,110.0	633.7	5,546.5

All capital investment is recognised initially within assets under 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 property, plant and equipment category.

Capital grants received during the year and credited to deferred income were £nil (2016: £nil). No capital grants were received during the year in respect of infrastructure assets.

* Disposals include the write down of redundant assets no longer in beneficial use.

Notes to the financial statements

For the year ended 31 March 2017

continued

9. Property, plant and equipment continued

Company	Specialised operational properties and structures £m	Non-specialised operational properties £m	Infrastructure assets £m	Plant, machinery and vehicles £m	Assets under construction £m	Total £m
Cost						
At 1 April 2015	2,972.1	82.6	2,051.9	2,812.0	831.4	8,750.0
Additions	3.6	–	–	–	321.8	325.4
Disposals*	(7.4)	(10.0)	(0.1)	(549.4)	–	(566.9)
Reclassifications	146.2	2.5	170.1	201.8	(520.6)	–
At 31 March 2016	3,114.5	75.1	2,221.9	2,464.4	632.6	8,508.5
Additions	1.0	–	–	–	483.5	484.5
Disposals*	(151.0)	(1.5)	–	(147.9)	–	(300.4)
Reclassifications	83.9	5.9	55.0	188.9	(333.7)	–
At 31 March 2017	3,048.4	79.5	2,276.9	2,505.4	782.4	8,692.6
Accumulated depreciation						
At 1 April 2015	1,047.5	28.8	471.8	1,732.3	–	3,280.4
Charge for the year	69.7	1.8	16.6	173.8	–	261.9
Disposals*	(6.7)	(10.0)	–	(549.4)	–	(566.1)
At 31 March 2016	1,110.5	20.6	488.4	1,356.7	–	2,976.2
Charge for the year	69.3	2.8	16.4	185.4	–	273.9
Disposals*	(151.0)	(0.4)	–	(147.9)	–	(299.3)
At 31 March 2017	1,028.8	23.0	504.8	1,394.2	–	2,950.8
Net book value						
At 31 March 2017	2,019.6	56.5	1,772.1	1,111.2	782.4	5,741.8
At 31 March 2016	2,004.0	54.5	1,733.5	1,107.7	632.6	5,532.3

* Disposals include the write down of redundant assets no longer in beneficial use.

9. Property, plant and equipment continued

Included within specialised operational properties and structures and plant, machinery and vehicles are the following PFI assets which are held under finance leases. These assets are included within the previous tables for both the Group and the Company.

	Specialised operational properties and structures £m	Plant, machinery and vehicles £m	Total £m
Group and Company			
Cost			
At 1 April 2015, 31 March 2016 and 31 March 2017	221.7	347.1	568.8
Accumulated depreciation			
At 1 April 2015	58.7	180.4	239.1
Charge for the year	3.7	11.6	15.3
At 31 March 2016	62.4	192.0	254.4
Charge for the year	3.7	11.6	15.3
At 31 March 2017	66.1	203.6	269.7
Net book value			
At 31 March 2017	155.6	143.5	299.1
At 31 March 2016	159.3	155.1	314.4

10. Investments

	Company	
	2017 £m	2016 £m
Cost and net book value		
At 31 March	37.6	37.6

Investment in subsidiaries

Principal subsidiary undertakings	Country of incorporation	% of Ordinary shares and votes held	Principal activity
Scottish Water Horizons Holdings Limited	Scotland	100.0	Holding company
Scottish Water Business Stream Holdings Limited*	Scotland	100.0	Holding company
Scottish Water Business Stream Limited**	Scotland	100.0	Licensed water and waste water services
Scottish Water Horizons Limited*	Scotland	100.0	Commercial non-regulated water and waste water services
Scottish Water International Limited*	Scotland	100.0	Overseas consultancy
Scottish Water Solutions 2 Limited	Scotland	100.0	Contracting services

* Owned by Scottish Water Horizons Holdings Limited

** Owned by Scottish Water Business Stream Holdings Limited

Notes to the financial statements

For the year ended 31 March 2017

continued

10. Investments continued

Scottish Water owns shares in a further 8 companies which did not trade during the year ended 31 March 2017. The companies' financial statements have not been consolidated as permitted by Section 405 of the Companies Act 2006, as they did not trade during the year and the issued share capital is immaterial. The companies are:

Scottish Water Ltd

Scottish Water Retail Ltd

Scottish Water Technology Ltd

Scottish Water Utilities Ltd

Scottish Water Wholesale Ltd

OneSource Infrastructure Services Ltd

Water Solutions Ltd

Business Stream Ltd ***

*** owned by Scottish Water Business Stream Limited

11. Inventories

	Group		Company	
	2017 £m	2016 £m	2017 £m	2016 £m
Raw materials and consumables	2.8	2.8	2.5	2.4
Less provision held	(0.2)	(0.2)	(0.2)	(0.2)
	2.6	2.6	2.3	2.2

All inventories will be recovered within 12 months.

12. Trade and other receivables

	Note	Group		Company	
		2017 £m	2016 £m	2017 £m	2016 £m
Trade receivables	26	558.4	527.7	502.6	466.5
Less provision for impairment of trade receivables	26	(461.9)	(449.7)	(449.2)	(434.4)
Net trade receivables		96.5	78.0	53.4	32.1
Other receivables		26.6	29.3	23.9	26.8
Prepayments and accrued income		26.3	29.4	11.6	8.1
Amounts due from subsidiaries		–	–	14.8	0.5
		149.4	136.7	103.7	67.5

The following table shows the development of the provision for impairment of trade receivables:

	Group		Company	
	2017 £m	2016 £m	2017 £m	2016 £m
Balance at 1 April	449.7	437.3	434.4	422.0
Charge for the year	18.4	16.9	15.8	12.8
Amounts written down during the year	(6.2)	(4.5)	(1.0)	(0.4)
Balance at 31 March	461.9	449.7	449.2	434.4

Management considers the carrying value of trade and other receivables are equal to the fair value.

13. Cash and cash equivalents

	Group		Company	
	2017 £m	2016 £m	2017 £m	2016 £m
Cash at bank and in hand	185.6	305.3	41.2	174.6
Short-term bank deposits	244.0	234.0	194.0	194.0
Cash and cash equivalents per the statement of cash flows	429.6	539.3	235.2	368.6

The fair values of cash and cash equivalents are not different from those disclosed above.

Notes to the financial statements

For the year ended 31 March 2017

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14. Trade and other payables

	Note	Group		Company	
		2017 £m	2016 £m	2017 £m	2016 £m
Current					
Trade payables		35.6	9.2	33.6	7.9
Non trade payables and accruals		78.3	99.4	75.5	88.1
Accruals		168.3	166.9	145.9	143.6
Payments received in advance		89.8	72.0	66.7	46.8
Other payables		12.1	12.8	1.5	0.8
Deferred income		7.1	5.1	1.4	1.4
Derivative financial liabilities	26	–	0.1	–	0.1
Other taxes and social security		3.7	3.1	3.3	2.8
Amounts due to subsidiaries		–	–	25.3	27.1
		394.9	368.6	353.2	318.6
Non-current					
Payments received in advance		56.6	54.3	56.6	54.3
Deferred income		17.5	18.7	11.3	12.3
		74.1	73.0	67.9	66.6

The fair values of trade and other payables are not different from those disclosed above.

15. Deferred taxation

The following are the deferred tax liabilities and assets recognised by the Group and movements thereon during the current and prior reporting periods:

	Note	Accelerated capital allowances £m	Retirement benefit obligations £m	Tax losses £m	Other £m	Total £m
Group						
At 1 April 2015		452.6	(40.3)	(49.3)	(9.0)	354.0
(Credit)/charge to income statement	8	(37.2)	(1.4)	14.8	1.2	(22.6)
Charge to reserves	22	–	21.8	–	–	21.8
At 31 March 2016		415.4	(19.9)	(34.5)	(7.8)	353.2
(Credit)/charge to income statement	8	(8.7)	(1.1)	8.7	–	(1.1)
Credit to reserves	22	–	(18.8)	–	–	(18.8)
At 31 March 2017		406.7	(39.8)	(25.8)	(7.8)	333.3
Company						
At 1 April 2015		452.4	(40.3)	(49.3)	(8.7)	354.1
(Credit)/charge to income statement		(37.1)	(1.3)	14.8	1.1	(22.5)
Charge to reserves	22	–	21.4	–	–	21.4
At 31 March 2016		415.3	(20.2)	(34.5)	(7.6)	353.0
(Credit)/charge to income statement		(8.8)	(1.0)	8.7	–	(1.1)
Credit to reserves	22	–	(18.0)	–	–	(18.0)
At 31 March 2017		406.5	(39.2)	(25.8)	(7.6)	333.9

Certain deferred tax assets and liabilities have been offset, including the asset balances analysed in the tables above. The following is an analysis of the deferred tax balances (after offset) for financial reporting purposes:

	Group		Company	
	2017 £m	2016 £m	2017 £m	2016 £m
Deferred tax assets	(1.2)	(0.3)	–	–
Deferred tax liabilities	334.5	353.5	333.9	353.0
At 31 March	333.3	353.2	333.9	353.0

The Members believe that the deferred tax assets will be recoverable against projected taxable profits over the foreseeable future in the companies to which they relate.

No deferred tax is provided on temporary differences arising on investments in subsidiaries because, in each case, the timing of the reversal of the temporary difference is controlled by the Group and it is probable that the temporary difference will not reverse in the foreseeable future. The amount of temporary differences associated with investments in subsidiaries for which a deferred tax liability has not been recognised is £178 million (2016: £172 million) for both the Company and the Group. No tax is expected to be payable in this regard.

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16. Provisions for liabilities

Group	Restructure provision £m	Income uncertainty provision £m	Other £m	Total £m
At 1 April 2015	0.5	1.6	1.3	3.4
Charged to the income statement	1.3	1.9	–	3.2
Utilised during the year	(0.3)	(0.3)	(0.1)	(0.7)
At 31 March 2016	1.5	3.2	1.2	5.9
Charged/(released) to the income statement	(0.2)	6.1	0.1	6.0
Utilised during the year	(0.6)	–	–	(0.6)
At 31 March 2017	0.7	9.3	1.3	11.3

Company	Restructure provision £m	Income uncertainty provision £m	Other £m	Total £m
At 1 April 2015	0.5	14.0	1.3	15.8
Charged to the income statement	1.3	6.3	–	7.6
Utilised during the year	(0.3)	(4.3)	(0.1)	(4.7)
At 31 March 2016	1.5	16.0	1.2	18.7
Charged/(released) to the income statement	(0.2)	5.7	–	5.5
Utilised during the year	(0.6)	(8.2)	–	(8.8)
At 31 March 2017	0.7	13.5	1.2	15.4

	Group		Company	
	2017 £m	2016 £m	2017 £m	2016 £m
Analysis of total provisions				
Current	5.4	4.3	8.8	15.6
Non-current	5.9	1.6	6.6	3.1
	11.3	5.9	15.4	18.7

The restructuring provision relates to redundancy costs associated with employees who will leave Scottish Water under voluntary redundancy and early retirement. It is expected that the provision will be utilised within the next year. Pension related liabilities associated with employees who have left Scottish Water under the voluntary severance scheme are recognised in the pension liability (note 22).

The income uncertainty provision relates to non-household revenues. The reconciliation process, through the Central Market Agency (CMA), relating to each financial year would normally be finalised 18 months after the end of the relevant financial year. However, at 31 March 2017, although the final settlements for the 2014/15 financial year had been agreed, they had not been processed through the CMA before the year end. It is expected that the provision will be utilised during 2018.

The other provision of £1.3 million relates primarily to onerous property rental costs.

17. Other loans and borrowings

	2017 £m	2016 £m
Group and Company		
Current		
Non-government loans	-	-
Obligations under finance leases	20.5	19.3
	20.5	19.3
Non current		
Non-government loans	1.0	1.0
Obligations under finance leases	323.8	344.3
	324.8	345.3
Total		
Non-government loans	1.0	1.0
Obligations under finance leases	344.3	363.6
	345.3	364.6

(i) Non-government loans

Other loans are repayable as follows:

	Up to 1 year £m	1-2 years £m	3-5 years £m	6-10 years £m	Total £m
At 31 March 2017	-	-	1.0	-	1.0
At 31 March 2016	-	-	1.0	-	1.0

The carrying amounts and fair value of the non-government borrowings are as follows:

	Book value 2017 £m	Book value 2016 £m	Fair value 2017 £m	Fair value 2016 £m
Non-government loans	1.0	1.0	1.3	1.4

Notes to the financial statements

For the year ended 31 March 2017

continued

17. Other loans and borrowings continued

(ii) Finance lease liabilities – PFI liabilities

Future finance lease commitments are as follows:

	Minimum lease payments		Present value of minimum lease payments	
	2017 £m	2016 £m	2017 £m	2016 £m
Amounts payable:				
Within one year	40.9	40.9	20.5	19.3
Between one and 5 years	159.3	161.7	115.1	111.0
After 5 years	307.7	346.2	208.7	233.3
Present value of minimum lease payments including finance charges	507.9	548.8		
Less future finance charges	(163.6)	(185.2)		
Present value of minimum lease payments	344.3	363.6	344.3	363.6

PFI – Service concession arrangements

Upon its creation in April 2002 Scottish Water inherited 9 concession contracts which had been entered into with 9 private sector consortia (PFI Cos) by its 3 predecessor authorities (i.e. East of Scotland Water Authority, North of Scotland Water Authority and West of Scotland Water Authority). Scottish Water acts as the client body to the 9 private sector consortia that provide waste water and sludge treatment and disposal services to Scottish Water.

These contracts are based over a wide geographic area including the Aberdeen, Dundee, Edinburgh, Glasgow and Inverness conurbations as well as the Ayrshire, Fife and Moray coasts.

Characteristics of the arrangements

Description

The length of these contracts varies between 25 and 40 years with expiry dates ranging from December 2021 through to October 2040. Under the terms of these contracts the private sector have either upgraded or built new waste water and sludge treatment assets, and, in certain circumstances, network assets (e.g. sewers and pumping stations) in order to meet Scottish Water's legal obligations in respect of the treatment and disposal of these products. These consortia are also responsible for the operation and maintenance of these assets over the lifetime of each contract.

Significant terms

The key terms relate to the basis upon which Scottish Water pays the services provided by the PFI Cos. The levels of such payments are predominantly dependent upon the volume of waste water and sludge treated, although in a minority of contracts there is either a partial availability payment element or some part of the payment is linked to the strength of the waste water. Scottish Water also has the power to levy payment deductions where the level of service falls below pre-determined standards, primarily linked to the quality of the treated waste water.

The contracts are structured such that either party may seek to amend the basis upon which the service is provided, primarily where driven by a change in law. This is subject to a formal variation procedure and is ultimately dependent upon the parties reaching agreement on the contractual changes required to give effect to the specific variation.

Nature and extent of rights and obligations

Scottish Water's primary obligations are to deliver waste water to the PFI Cos and thereafter pay for the treatment services provided, making the appropriate deduction where the PFI Cos fail to meet the appropriate performance standards. The PFI Cos provided the initial construction services through a sub-contract and also entered into a separate sub-contract for the operation and maintenance of these assets once satisfactorily commissioned. All such projects are now in their operational phase.

A majority of the contracts have limited extension options. However, termination during the contractual period can arise for a number of reasons including default (by either the PFI Co or Scottish Water), force majeure, uninsurable events or voluntary termination by Scottish Water. Each contract contains a formula from which termination compensation payable by Scottish Water is derived. Other than each party's unilateral right to propose an amendment to a contract, the most likely circumstance which would give rise to the re-negotiation of a contract is as a result of a change in law which requires the manner in which the treatment and disposal service is delivered to be changed, in order to ensure it meets the requirements of such legislative changes.

The contracts also stipulate a range of handback conditions linked to the remaining life of certain assets.

18. Government loans

	Group and Company	
	2017 £m	2016 £m
Government loans	3,423.3	3,423.3

Scottish Water’s borrowing powers are defined in Section 42 of the Water Industry (Scotland) Act 2002.

Government loans, both short and long-term, are recorded on the balance sheet under Capital and Reserves in accordance with the Scottish Water Governance Directions 2009. Other debt is recorded under short and long-term payables following best practice.

a. 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 – SW Company	76.0	80.0	256.3	375.6	1,920.7	2,708.6
Scottish Consolidated Fund – subsidiaries	–	–	–	–	–	–
Scottish Consolidated Fund – SW Group	76.0	80.0	256.3	375.6	1,920.7	2,708.6
National Loans Fund	30.0	31.0	110.0	268.4	212.5	651.9
Public Works Loan Board	16.6	12.0	17.2	13.7	3.3	62.8
At 31 March 2017	122.6	123.0	383.5	657.7	2,136.5	3,423.3
At 31 March 2016	342.8	122.7	381.8	680.3	1,895.7	3,423.3

b. Fair values

The carrying amounts and fair value of the Government borrowings are as follows:

	Book value 2017 £m	Book value 2016 £m	Fair value 2017 £m	Fair value 2016 £m
Scottish Consolidated Fund	2,708.6	2,669.7	3,651.8	3,379.3
National Loans Fund	651.9	675.9	908.9	936.3
Public Works Loan Board	62.8	77.7	79.6	99.1
	3,423.3	3,423.3	4,640.3	4,414.7

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For the year ended 31 March 2017

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19. Analysis of net debt

	Note	As at 1 April 2016 £m	Decrease in cash £m	Movement in debt £m	As at 31 March 2017 £m
Group					
Cash and cash equivalents	13	539.3	(109.7)	–	429.6
Government loans	18	(3,423.3)	–	–	(3,423.3)
Other loans	17	(1.0)	–	–	(1.0)
Net debt		(2,885.0)	(109.7)	–	(2,994.7)
Company					
Cash and cash equivalents	13	368.6	(133.4)	–	235.2
Government loans	18	(3,423.3)	–	–	(3,423.3)
Other loans	17	(1.0)	–	–	(1.0)
Net debt		(3,055.7)	(133.4)	–	(3,189.1)

20. Reserves

	Note	Retained earnings excluding actuarial gains £m	Actuarial gains/ (losses) on pension obligations £m	Retained earnings including actuarial gains/(losses) £m
Group				
At 1 April 2015		1,356.0	(172.7)	1,183.3
Retained surplus for the year		124.0	–	124.0
Actuarial gain, net of deferred taxation	22	–	83.9	83.9
At 31 March 2016		1,480.0	(88.8)	1,391.2
Retained surplus for the year		96.2	–	96.2
Actuarial loss, net of deferred taxation	22	–	(94.4)	(94.4)
At 31 March 2017		1,576.2	(183.2)	1,393.0
Company				
At 1 April 2015		1,200.2	(171.6)	1,028.6
Retained surplus for the year		107.8	–	107.8
Actuarial gain, net of deferred taxation	22	–	82.3	82.3
At 31 March 2016		1,308.0	(89.3)	1,218.7
Retained surplus for the year		89.9	–	89.9
Actuarial loss, net of deferred taxation	22	–	(90.2)	(90.2)
At 31 March 2017		1,397.9	(179.5)	1,218.4

21. Results of Scottish Water (the Company)

Of the results for the financial year, a retained surplus of £89.9 million (2016: £107.8 million) is dealt with in the consolidated financial statements of Scottish Water. The Members have taken advantage of the exemption available under section 408 of the Companies Act 2006 and do not present an income statement or a statement of comprehensive income for Scottish Water alone.

22. Pensions

Employees of Scottish Water participate in the North East Scotland Pension Fund, the Lothian Pension Fund and the Strathclyde Pension Fund, which are part of the Scottish Local Government Pension Scheme administered by Aberdeen, Edinburgh and Glasgow City Councils respectively. The schemes provide defined benefits based on career average pensionable pay. Actual pension costs for the year for each fund, as a % of pensionable pay, were 20.7% (2016: 20.7%), 21.8% (2016: 21.8%) and 22.9% (2016: 22.9%) respectively.

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.

A full actuarial valuation was carried out at 31 March 2014 for all 3 funds and updated at 31 March 2017 by a qualified independent actuary, to take account of the requirements of IAS 19.

The major assumptions used by the actuaries were:

	2017 %	2016 %
Rate of increase in pensionable salaries	2.5	2.3
Rate of increase in pensions payment	2.5	2.3
Discount rate	2.6	3.6
CPI inflation rate	2.5	2.3

Longevity assumptions on retiring at age 65 adopted for each fund:

	North East Scotland Years	Lothian Years	Strathclyde Years
Retiring at 31 March 2017			
Male	22.1	22.3	22.4
Female	24.7	23.9	23.8
Retiring at 31 March 2037			
Male	24.3	24.4	25.0
Female	27.6	26.4	26.4

The sensitivities regarding the principal assumptions used to measure the liability in the Funds are:

Assumption	Change in assumption	Approximate Impact on IAS 19 liability %	Approximate Impact on IAS 19 liability £m
Rate of increase in pensionable salaries	+/- 0.5% per annum	Increase/decrease by c. 2.9%	Increase/decrease by c. £53 million
Discount rate	+/- 0.5% per annum	Decrease/increase by c. 10.2%	Decrease/increase by c. £188 million
CPI Inflation rate	+/- 0.5% per annum	Increase/decrease by c. 7.1%	Increase/decrease by c. £131 million
Longevity	Increase life expectancy by 1 year	Increase by c. 3.0%	Increase by c. £55 million

Notes to the financial statements

For the year ended 31 March 2017

continued

22. Pensions continued

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

	Note	Group		Company	
		2017 £m	2016 £m	2017 £m	2016 £m
Total fair value of assets		1,607.5	1,318.6	1,576.9	1,295.5
Present value of scheme liabilities		(1,841.7)	(1,429.2)	(1,807.4)	(1,407.6)
Gross pension liability		(234.2)	(110.6)	(230.5)	(112.1)
Related deferred tax asset	15	39.8	19.9	39.2	20.2
Net pension liability		(194.4)	(90.7)	(191.3)	(91.9)

Scheme assets are stated at their bid values.

Reconciliation of opening and closing retirement benefit liabilities and assets

	Note	Group		Company	
		2017 £m	2016 £m	2017 £m	2016 £m
Movements in liabilities during the year:					
Opening value of total liabilities		(1,429.2)	(1,485.4)	(1,407.6)	(1,464.7)
Total service cost	5	(37.0)	(37.0)	(35.2)	(35.1)
Interest on pension scheme liabilities	7	(50.7)	(48.3)	(49.9)	(47.6)
Contributions by members		(8.4)	(7.7)	(7.9)	(7.2)
Actuarial (loss)/gain		(363.8)	104.8	(354.1)	102.7
Benefits paid		47.4	44.4	47.3	44.3
Closing value of total liabilities		(1,841.7)	(1,429.2)	(1,807.4)	(1,407.6)
Movement in assets during the year:					
Opening fair value of total assets		1,318.6	1,284.0	1,295.5	1,263.3
Interest on pension scheme assets	7	46.3	41.3	45.4	40.6
Contributions by members		8.4	7.7	7.9	7.2
Contributions by the employer		31.0	29.1	29.5	27.7
Actuarial gain		250.6	0.9	245.9	1.0
Benefits paid		(47.4)	(44.4)	(47.3)	(44.3)
Closing fair value of assets		1,607.5	1,318.6	1,576.9	1,295.5
Gross deficit in the schemes at 31 March		(234.2)	(110.6)	(230.5)	(112.1)

22. Pensions continued

Return on assets

As required by IAS 19, the expected return on assets for all asset categories is equal to the discount rate. Assets with higher volatility will no longer generate higher returns.

	Note	Group		Company	
		2017 £m	2016 £m	2017 £m	2016 £m
Actual return on pension scheme assets		296.9	42.2	291.3	41.6
Actuarial (loss)/gain in other comprehensive income in the consolidated statement of comprehensive income					
Gross actuarial (loss)/gain recognised in the pension fund		(113.2)	105.7	(108.2)	103.7
Deferred tax movement	15	18.8	(21.8)	18.0	(21.4)
Net actuarial (loss)/gain recognised in other comprehensive income in the consolidated statement of comprehensive income					
	20	(94.4)	83.9	(90.2)	82.3

Amounts recognised in the consolidated income statement

	Note	2017 £m	2016 £m
Total service cost	5	37.0	37.0
Interest cost on pension scheme net liabilities (see above)	7	4.4	7.0
		41.4	44.0

The unpaid contributions outstanding at the year end included in other payables (note 14) was £0.8 million (2016: £0.8 million). It is estimated that Scottish Water will make contributions of £25.1 million to the pension funds in financial year 2017/18.

Notes to the financial statements

For the year ended 31 March 2017

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22. Pensions continued

History of experienced gains and losses

Group	2017 £m	2016 £m
Difference between the expected and actual return on scheme assets:		
Amount	250.6	0.9
Fair value of assets	1,607.5	1,318.6
Experienced (losses)/gains on scheme liabilities:		
Amount	(8.2)	20.4
Present value of liabilities	1,841.7	1,429.2
Changes in assumptions underlying the present value of scheme liabilities:		
Amount	(355.6)	84.4
Total variance between pension fund actuarial assumptions and actual experience	(113.2)	105.7
Gross deficit in the schemes at 31 March	(234.2)	(110.6)

Company	2017 £m	2016 £m
Difference between the expected and actual return on scheme assets:		
Amount	245.9	1.0
Fair value of assets	1,576.9	1,295.5
Experienced (losses)/gains on scheme liabilities:		
Amount	(8.2)	20.3
Present value of liabilities	1,807.4	1,407.6
Changes in assumptions underlying the present value of scheme liabilities:		
Amount	(345.9)	82.4
Total variance between pension fund actuarial assumptions and actual experience	(108.2)	103.7
Gross deficit in the schemes at 31 March	(230.5)	(112.1)

23. Commitments

a. Capital commitments

The Group has contracted capital commitments of £393.2 million (2016: £331.9 million) relating to property, plant and equipment at the balance sheet date. These commitments are expected to be settled within the following 2 financial years.

b. Operating lease commitments

The Group leases various operational properties and offices under non-cancellable operating lease agreements. The lease terms are between 1 and 99 years, with the majority of lease agreements being renewable at the end of the lease period at market rates.

The Group also leases vehicles under cancellable operating lease agreements. The Group is able to give notice at any time within the lease period for the termination of these agreements. Termination costs are incurred on early termination. The lease expenditure charged to the consolidated income statement during the year is disclosed in note 4.

The total minimum lease payments under non-cancellable operating leases are as follows:

	2017 £m	2016 £m
Within one year	2.7	2.8
Between one and 5 years	8.1	6.9
After 5 years	18.0	16.0
	28.8	25.7

24. Contingent assets and liabilities

a. Contingent assets

During 2016/17 a commercial claim was raised by Scottish Water against a supplier in relation to performance under a long term contract. Discussions towards agreement of a settlement took place during the year and, subsequent to the year end, a non-binding agreement was reached, subject to various conditions. The settlement is valued at £13.75m which is expected to become receivable by Scottish Water following agreement of legal documentation. As the economic benefit of the settlement cannot be recognised until it is virtually certain, the results for the 2016/17 financial year do not include any asset in respect of the settlement of the claim.

b. Contingent liabilities

Scottish Water has the following contingent liabilities in respect of companies limited by guarantees:

Central Market Agency

The Central Market Agency (CMA), a company limited by guarantee, co-ordinates the non household retail market for business customers in Scotland. As a market participant, Scottish Water is liable to pay charges to the CMA to cover part of the operating, financing and any other capital costs of the organisation. These charges are set annually in advance and approved by the CMA Board. Scottish Water's liability, as a member, for the debts and liabilities of the CMA is limited to £1.

Water Regulatory Advisory Service

Water Regulatory Advisory Service Limited (WRAS) is a company established by all UK water companies as a company limited by guarantee to provide guidance on the development and application of the Water Regulations (England and Wales) and the Water Byelaws (Scotland). WRAS operates on a subscription basis. Scottish Water's liability, as a member, in the event of the company going into default, is limited to £1. Scottish Water may withdraw from the company by giving one year's notice.

Notes to the financial statements

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25. Related party transactions

The Group has related party relationships with the Scottish Government, with its subsidiaries (note 10), and with its Members and Executive Management. Details of transactions between the Group and other related parties are disclosed below.

Scottish Government

Scottish Water is a public corporation of a trading nature sponsored by the Scottish Government. During the year Scottish Water had various material transactions with the Scottish Government, namely the drawdown and repayment of loans and associated interest charges. Details of the loans from the Scottish Government are shown in note 18.

During the year Scottish Water had various material transactions with entities for which the Scottish Government is regarded as the parent. The main entities which fall into this category are the Local Authorities, the Scottish Environment Protection Agency, the Drinking Water Quality Regulator, the Water Industry Commission for Scotland and the Central Market Agency. However, as permitted under IAS 24 'Related Party Disclosures' paragraph 25, Scottish Water is exempt from the disclosure requirements of IAS 24, paragraph 18 in respect of these government related entities.

Subsidiaries

During the year the Company entered into the following transactions with its subsidiaries (note 10):

	2017 £m	2016 £m
Wholesale water and waste water services to Business Stream	140.7	225.2
Sale of waste water services to other subsidiaries	0.5	1.1
Seconded staff costs charged to subsidiaries	4.3	3.7
Other operating costs charged to subsidiaries	2.6	3.3
Purchase of property, plant and equipment from subsidiaries (note 3)	12.9	33.7

Key management personnel

The key management under IAS 24 'Related Party Disclosure' is defined as those persons who have authority and responsibility for planning, directing and controlling the entity's activities, directly or indirectly. The Group's key management comprises the Executive Members and Non-executive Members. The remuneration of the Members is determined by Scottish Water's Remuneration Committee in accordance with its stated policy. Further information about the remuneration and pension details of individual Members is provided in the Members' Remuneration Report on pages 53 to 62.

Scottish Water's non-executive members hold additional roles within other organisations (see Members on pages 42 to 43). During the year, 3 of these organisations were involved in business contracts with the Scottish Water group. However, the 2 non-executive members holding positions in these organisations were excluded from the Board meetings when the relevant agenda items were discussed and were not involved in the related decision making process.

26. Financial instruments and risks

The management of Scottish Water and the execution of strategy are subject to a number of risks as detailed below. All risks are reviewed by the Board and appropriate processes are in place to monitor and mitigate them. See the Strategic report on pages 9 to 13 and Corporate Governance report on pages 50 to 51.

a. Qualitative risk disclosures

Credit risk

Credit risk is the risk that Scottish Water is exposed to loss if another party fails to perform its financial obligation to Scottish Water. Credit risk arises from cash, cash equivalents and deposits with banks and financial institutions, as well as credit exposures to wholesale and retail customers, including outstanding receivables and committed transactions. Scottish Water monitors its credit exposure to its counterparties via their credit ratings (where applicable) and through its policy, thereby limiting its exposure to any one party to ensure that they are within Board approved limits and that there are no significant concentrations of credit risk. The maximum exposure to credit risk for receivables and other financial assets is represented by their carrying amount.

Liquidity risk

Liquidity risk is the risk that Scottish Water will have insufficient funds to meet its liabilities. Scottish Water's policy is to ensure that it has adequate financial resources to enable it to finance its day-to-day operations and capital investment programme, based on cash flow projections, while adhering to the annual limits set by the Scottish Government for new borrowings. Scottish Water's borrowing powers are defined in Section 42 of the Water Industry (Scotland) Act 2002.

Interest rate risk

All of Scottish Water's borrowings are at fixed interest rates. Therefore Scottish Water is not deemed to bear any interest rate risk.

Currency risk

In special circumstances, Scottish Water may use financial instruments to mitigate certain financial risk exposures such as foreign exchange fluctuations. As such circumstances are rare, in addition to the approval of the Scottish Water Board, approval is required from Scottish Ministers under the terms of section 42(3)(b) Water Industry (Scotland) Act 2002.

To manage the foreign exchange risk exposure relating to part of Scottish Water's capital investment programme, Scottish Water entered into forward Euro currency contracts.

b. Categories of financial assets and liabilities and fair values

Scottish Water's financial assets and liabilities comprise trade and other receivables (note 12), cash and cash equivalents (note 13), borrowings (notes 17 and 18) and trade and other payables (note 14). No trading in derivative financial instruments was undertaken.

Basis of determining fair value

The financial assets of the Group and the Company fall into the 'loans and receivables' category. The financial liabilities of the Group and the Company fall into the category of 'financial liabilities measured at amortised cost'.

Fair value is the amount at which a financial instrument could be exchanged in an arm's length transaction between informed and willing partners, other than in a forced or liquidation sale, and excludes accrued interest.

The carrying amounts of financial assets and liabilities, excluding borrowings, are equal to their fair values. Borrowings are held at cost in the balance sheet but the fair value is disclosed in notes 17 and 18.

Credit risk

Cash and cash equivalents comprise cash in hand and deposits which are readily convertible to cash. These are subject to insignificant risk of change in value or credit risk.

Notes to the financial statements

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26. Financial instruments and risks continued

The trade receivables total includes an allowance for impairment. Trade receivables comprise receivables from business customers and receivables from domestic household customers.

	Group		Company	
	2017 £m	2016 £m	2017 £m	2016 £m
Trade receivables per note 12:				
Trade receivables	558.4	527.7	502.6	466.5
Less provision for impairment of trade receivables	(461.9)	(449.7)	(449.2)	(434.4)
Net trade receivables	96.5	78.0	53.4	32.1
Analysed between:				
Household receivables	478.9	459.2	478.9	459.2
Less provision for impairment	(446.6)	(431.4)	(446.6)	(431.4)
Net household receivables	32.3	27.8	32.3	27.8
Business customer receivables	79.5	68.5	23.7	7.3
Less provision for impairment	(15.3)	(18.3)	(2.6)	(3.0)
Net business customer receivables	64.2	50.2	21.1	4.3

Household water and waste water services are billed to customers by Local Authorities as an element of the annual Council Tax bills. The Local Authorities are responsible for the collection and transfer to Scottish Water of the amounts due in accordance with the statutory regulations. Household charges are billed by individual financial year and are payable within the same year. Provision is made against outstanding debt, in respect of prior years, based primarily on historical collection rates and the near-term business outlook. Household water and waste water debt is a statutory debt recoverable from the occupier. Debt since the establishment of the former Water Authorities in 1996 continues to be collected. As at 31 March 2017 trade receivables in respect of household customers totalled £478.9 million with a provision of £446.6 million (2016: £459.2 million and £431.4 million respectively).

The sensitivities regarding the principal assumptions used to measure the level of the household bad debt provision are:

Assumption	Change in assumption %	Approximate Impact on bad debt charge £
Overall household collection rate	+/- 0.01%	Increase/decrease by c. £1.2m
In-year household bad debt provision charge	+/- 0.10%	Increase/decrease by c. £0.8m

As at 31 March 2017 trade receivables from business customers totalled £79.5 million (2016: £68.5 million). The ageing analysis of trade receivables from business customers and the related provisioning is as follows:

	Total £m	Current £m	<3 months overdue £m	3-12 months overdue £m	>12 months overdue £m
Group					
Gross receivable	79.5	54.5	6.3	9.8	8.9
Provision	(15.3)	-	(1.8)	(4.6)	(8.9)
Net trade receivable as at 31 March 2017	64.2	54.5	4.5	5.2	-
Gross receivable	68.5	43.3	6.8	8.1	10.3
Provision	(18.3)	-	(1.3)	(6.7)	(10.3)
Net trade receivable as at 31 March 2016	50.2	43.3	5.5	1.4	-

26. Financial instruments and risks continued

Company	Total £m	Current £m	<3 months overdue £m	3-12 months overdue £m	>12 months overdue £m
Gross receivable	23.7	21.0	1.1	0.7	0.9
Provision	(2.6)	–	(1.0)	(0.7)	(0.9)
Net trade receivable as at 31 March 2017	21.1	21.0	0.1	–	–
Gross receivable	7.3	3.6	2.0	0.5	1.2
Provision	(3.0)	–	(1.3)	(0.5)	(1.2)
Net trade receivable as at 31 March 2016	4.3	3.6	0.7	–	–

Forward foreign exchange contracts

In 2014, Scottish Water entered into forward foreign currency contracts, specifically a commitment to buy Euro currency. The notional principal amounts of the outstanding contracts at 31 March 2017 were £0.04 million (2016: £2.5 million). The maturity dates of the outstanding contracts are between April 2017 and May 2017.

	Note	2017 £m	2016 £m
Derivative financial liabilities			
Foreign exchange contracts: Total		–	0.1
Less non-current portion	14	–	–
Current portion	14	–	0.1

27. 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.

28. Regulatory information

The Water Industry Commission for Scotland (WICS) has the general function of promoting interests of customers in relation to the provision of core services. The WICS determines Scottish Water's price limits and approves Scottish Water's annual charges scheme.

The WICS monitors Scottish Water's performance on efficiency and customer service and approves the code of practice. Each year the WICS publishes reports on the exercise of its functions. In preparing these reports, the WICS assesses the performance by using information supplied by Scottish Water and by making comparisons with information obtained on other regulated water companies. In carrying out this performance monitoring, the WICS may make regulatory amendments to figures published in Scottish Water's audited financial statements to ensure like for like comparisons with other companies.

29. Post balance sheet event

On 1 April, Scottish Water Business Stream Limited (Business Stream) acquired the non-household customer book of Southern Water Services Limited. The purpose of the acquisition was to support Business Stream's entry into the newly opened English retail market for business customers. A consideration was paid on 3 April 2017 which is subject to future adjustment based on the actual customer book transferred and other measures which impact financial contribution. The financial results from this new customer book will be reported in the accounts for the 2017/18 financial year.

Direction by the Scottish Ministers

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

Under the Scottish Water Governance Directions 2009, which are available on the Scottish Government website, Scottish Water is required to disclose details of certain types of expenditure which exceed given thresholds and which are not disclosed elsewhere in the Annual Report and Accounts. The required information is presented in the following table:

Project expenditure	Threshold	Project	Cost
Capital expenditure on major works including improvements to existing assets	£10 million	Shieldhall tunnel project	£55.4m
		Amlaird & Corsehouse strategic main project	£52.5m
		Oban water treatment works	£13.8m
		Bradán trunk main	£12.9m
		Muirdykes water treatment works upgrade	£10.8m
Purchase of individual capital items, including land, with a life of more than one year	£1 million	None	–
Advertising	£1 million	None	–
Sponsorship	£10,000	Scottish Amateur Swimming Association*	£100,000
Gifts	£100	None	–

* Funded by Scottish Water Horizons Holdings Limited from the profits of non-regulated activities.

The water industry in Scotland

Regulators provide assurance that Scottish Water meets the interests of our customers, protects the quality of drinking water and the environment, and is accountable for our performance.

The water industry in Scotland is regulated as shown in the diagram below.



The Scottish Parliament

Holds Scottish Water and Scottish Ministers to account and regularly calls executives to its committees to give progress updates.

The Scottish Government

Scottish Ministers set the objectives for Scottish Water and appoint the Chair and Non-executive Members.

Scottish Water

Responsible for providing water and waste water services to household customers and wholesale Licensed Providers. Delivers the investment priorities of Scottish Ministers within the funding allowed by the Water Industry Commission for Scotland.

Water Industry Commission for Scotland (WICS)

Economic regulator. Sets charges and reports on costs and performance.

Drinking Water Quality Regulator (DWQR)

Responsible for protecting public health by ensuring compliance with drinking water quality regulations.

Scottish Environment Protection Agency (SEPA)

Responsible for environmental protection and improvement.

Scottish Public Services Ombudsman (SPSO)

Responsible for investigating complaints about public services in Scotland, including Scottish Water, once the services' complaints procedure has been completed and sharing lessons from complaints to improve the delivery of public services.

Citizens Advice Scotland (CAS)

Represents the interests of consumers within Scotland's water industry.

Customer Forum

Responsible for ensuring that customers have a clear voice in the business planning and price setting processes and at the heart of key decisions that affect the services Scottish Water customers pay for.

Other regulators

Like other companies and utilities, Scottish Water is also regulated by a variety of other bodies such as the Health and Safety Executive (HSE), Environmental Health Officers and the Scottish Road Works Commissioner.

For more information on Scottish Water and our services visit www.scottishwater.co.uk or contact our Customer Helpline on **0800 0778778***. Alternative formats of this document can be made available free of charge. For information on Braille, large print, audio and a variety of languages, please call our Customer Helpline.

* We record all calls for quality and training purposes.

