



# Scottish Water

Trusted to serve Scotland

## Annual Report and Accounts 2015/16



**Putting customers first**  
Working for the nation,  
every day of the year

**Held in trust**  
Building resilient  
services for the future

# Our vital role

Scottish Water provides vital water and waste water services, essential to daily life, to 2.49 million households and 152,000 business premises across Scotland.

Every day we provide 1.37 billion litres of clear, fresh drinking water and take away 921 million litres of waste water, which we treat before returning to the environment.

The quality of drinking water provided to customers has reached an all-time high and our investment helps to support jobs and the economy of Scotland, while protecting and enhancing the environment.

Our average household charge remains among the lowest in Great Britain – £38 lower per year than the average household charge in England and Wales.

In 2015/16, we commenced a 6 year programme which will see £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:

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**30,062** miles of water pipes    **244** water treatment works  
**31,621** miles of sewer pipes    **1,851** waste water treatment works

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# 2015/16 highlights

## Highest ever customer satisfaction

Institute of Customer Service results show satisfaction reaches new high of 78.6 points

## Great value for customers

Average household charge remains below average in England and Wales

## Major investment programme kicks off

£3.5 billion to deliver improved services, resilience and environmental improvements

## Best ever drinking water

99.93% of all tests meet stringent quality standards

## Top employer accolade

Scottish Water named Scotland's Best Large Employer

## Health and safety excellence

Winner of prestigious UK Water Industry Sector Award for Health and Safety 2016

# Chair's statement

Susan Rice, Chair



I'm delighted to report that Scottish Water overall has had another good year and laid the foundations for a strong 2015–21 regulatory period.

We are a public utility. But far from taking our position for granted, we believe this unique status makes it even more important that we do all we can to earn trust. Which is why our vision is to be trusted to care for the water on which Scotland depends.

That's also why the Board's priority is to ensure that Scottish Water consistently focuses on delivering high-quality services. Our customers expect us to provide excellent service, ever higher levels of water quality, and strong environmental performance – all for an affordable price.

I came onto the Board last summer after Ronnie Mercer's successful term as Chair. From the very start, I was genuinely impressed by the commitment and hard work of Scottish Water's people, supply chain and business partners, and their shared focus on delivering ever-improving customer service.

I'd like to thank all our people, the Executive Leadership Team and the Board for their support and their contribution. I'd also like to pay tribute to Donald Emslie, who recently stood down after 8 years of valued service as a Board member and Chair of the Remuneration Committee.

Scottish Water's principal activity is the supply of water and waste water services. In the last year, we started the 2015–21 regulatory period which has been shaped to meet Ministerial objectives, support Scotland's economy and communities, protect and enhance the environment, and ensure that all customers can enjoy the benefits of continuous, high-quality drinking water.

I'm pleased to report that the quality of drinking water our customers receive has reached a new high, at the same time as customer satisfaction has reached record levels.

In 2015/16, we also commenced a 6 year, £3.5 billion investment programme which will see further improvements to water and waste water infrastructure around Scotland, improving drinking water quality, enhancing the environment and supporting jobs in the Scottish economy.

For example, we announced specific plans to build increased resilience into our water supply network so that our customers receive an even more reliable service into the future.

Meanwhile, our average household charge continues to be lower than the average household charge in England and Wales.

During the year, a formal review of performance was carried out by the Board and Committees. The Board, meanwhile, regularly reviews governance, risk and compliance. These reviews have confirmed that Scottish Water continues to be well-focused on achieving our corporate objectives.

Within the Scottish Water group, we are seeing the impact of increased competition in the retail market for water and waste water services to business premises. Scotland moved to open up this market long before the rest of the UK, and Scottish Water, as wholesale supplier in Scotland, has supported all Licensed Providers since the introduction of competition in 2008.

As anticipated, Business Stream, our licensed retail subsidiary, has faced significantly increased competitive activity and, with that, the loss of the water and waste water services framework contract for the public sector. Business Stream is therefore seeking to strengthen customer ties by offering innovation, tailored solutions and value for money and reshaping its strategy in anticipation of full opening of the English retail market in 2017 for business customers, when there will be fresh opportunities to pursue.

It's been a busy year as well for Scottish Water Horizons, one of our non-regulated subsidiaries. Horizons combines innovative approaches with Scottish Water assets to encourage growth and use of sustainable technologies. Horizons has continued to support the developing low carbon economy with initiatives such as the UK's first heat from waste water scheme in Galashiels, and a growing renewables portfolio.

Scottish Water International, our other non-regulated subsidiary, meanwhile, continues to use skills and expertise from within the business to offer specialist consultancy services to international clients. In the last year, International has participated in assignments as far afield as Canada and Australia.

Wherever I look in the company, I've been greatly impressed by the way customer benefit defines and drives the business.

With such a firm focus on providing all our customers with a consistently high – and improving – standard of water and waste water services, coupled with great value for money, I'm confident that we will continue to demonstrate that we are indeed 'Trusted to care for the water on which Scotland depends'.

# 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 aim to put customers at the heart of our plans. Listening to customers' views and building these into our planning is part of our ongoing customer engagement. This allows us to ensure our customers' needs are at the heart of our service delivery.
  - We aim to improve our services for customers. We know from our research that customers do not wish to see us compromise existing service levels. Our strategies are geared to help us achieve these aims and further improve our performance and efficiency.
  - We aim to provide continuous clear and fresh drinking water, ensuring all our customers – regardless of where they live – can turn on their taps to receive a safe and reliable supply.
- We work to protect and enhance the environment of Scotland, and to achieve reductions in pollution and flooding.
  - We support Scotland's economy and communities, delivering improved water and waste water infrastructure while supporting employment and meeting new demand for our services.

[This annual report highlights our progress during 2015/16. 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.

## 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.

## 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.

## 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.

## 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.

## 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**

I am pleased to report that Scottish Water has made a good start to the 2015–21 regulatory period and that we continue to be one of the UK's top performing water companies. The quality of drinking water in Scotland has reached a new record high, with 99.93% of all tests taken in 2015 complying with strict regulatory standards – and we are determined to make it even better.

Our new household Customer Experience Measure (CEM) was introduced in April 2015 to ensure a continued focus on customer service performance. It allows us to measure the experience of customers while giving us a much broader view of how well we are performing. During the year, we improved the score by 1.7 points to 84.3, a reduction in lost points of 10%.

We also out-performed our regulatory customer service target, achieving a score of 393 on the Overall Performance Assessment (OPA). Customer surveys by the Institute of Customer Service show that customer satisfaction with Scottish Water has reached a record level and is now among that of other leading household service providers.

The group surplus before tax of £106.2 million was £4.5 million lower than in 2014/15, reflecting primarily an £11.7 million reduction in Business Stream's surplus and a £7.9 million increase from Scottish Water arising from our drive to deliver savings for our customers. Scottish Water's regulated surplus of £84.8 million will be reinvested to support delivery of future services to customers.

Our customers continue to enjoy the benefits of an average household charge which is among the lowest in Great Britain. In 2016/17, the average Scottish Water household bill is £38 lower than the average in England and Wales. Scottish Water received a number of accolades in 2015/16, which reflects the excellence demonstrated by our people. We won the prestigious Business Insider Award for Scotland's Best Large Employer, reflecting our commitment to creating a highly engaged workforce. Engaging our employees and ensuring Scottish Water is a great place to work are at the heart of our drive to improve performance and customer satisfaction.

Our procurement procedures were described as world-class by the Chartered Institute of Procurement and Supply, who awarded us with platinum accreditation status. Our commitment to achieving the highest levels of health and safety were recognised again when we were named as winner of the prestigious UK Water Industry Sector Award for Health and Safety 2016.

We could not achieve any of this without the hard work of our people and the commitment of our leaders. The nature of any water company's activities is that challenges are often posed by adverse weather or other circumstances outwith our immediate control. In the last year, our teams have

carried out excellent work to maintain services in the face of, at times, very challenging conditions, or to restore normal service as quickly as possible where disruption has been experienced. Very rarely, customers have been inconvenienced by service events such as those in Motherwell, Cumbernauld and Bathgate. We sought to minimise the impact from those events and learn from them as part of our drive for continuous improvement.

We have continued to develop our approach to succession planning. Geoff Aitkenhead, Executive Director Capital Investment, will be retiring from Scottish Water in July having served as an Executive Board member since the formation of Scottish Water. Geoff has played a key role in the transformation of Scottish Water and I wish to record our deep appreciation for all that Geoff has contributed to our success. Mark Dickson, who is currently Director of Technology, Information and Business Change, will assume responsibility for capital investment leadership.

Looking ahead, the new regulatory period requires us to deliver even higher drinking water quality, customer service and environmental performance. At the same time, we have a firm focus on ensuring our infrastructure is increasingly resilient and our service is responsive to the needs of our customers. Our investment programme will see £3.5 billion invested in improvements to vital infrastructure for the benefit of our customers between 2015 and 2021 and to meet Ministerial objectives.

Our new investment planning and delivery arrangements are now in place, with strengthened in-house investment planning capability and three new alliances, each delivering part of the investment programme, supported by a framework of local contractors with bases around Scotland. Putting in place these strengthened arrangements has inevitably impacted on our rate of investment delivery in the first year of the new regulatory investment. As such, and in agreement with our regulators and the Scottish Government, we have re-phased our investment programme for the 2015–21 period.

Recognising our important role in the Scottish economy, we are taking a number of actions to improve the efficiency and effectiveness of the service provided to the development community. This includes the establishment of a new strategic planning team to collaborate proactively with developers and build strategic capacity in our assets and networks.

While we can be rightly proud of our achievements, we are determined to raise the bar even further. This will ensure we continue to focus on earning the trust of all the customers and communities that we serve. I am confident we will rise to the challenge.



# 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 to care for the water on which Scotland depends. To achieve this, the overarching strategy for the Scottish Water group of businesses is to provide levels of service and value for money which exceed the expectations of customers, regulators and the Scottish Government. 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 30,410 square miles.

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

1. **Scottish Water**, which supplies households and wholesale licensed providers (LPs) with regulated water and waste water services;
2. **Scottish Water Business Stream Ltd (Business Stream)**, our licensed provider that competes with other LPs to supply water and waste water services to business customers;
3. **Scottish Water Horizons Ltd (Horizons)**, a subsidiary which provides non-regulated services to customers; and
4. **Scottish Water International Ltd (International)**, a subsidiary which provides non-regulated services to clients outside Scotland.

## 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 6 Non-executive Members.

## Business Stream

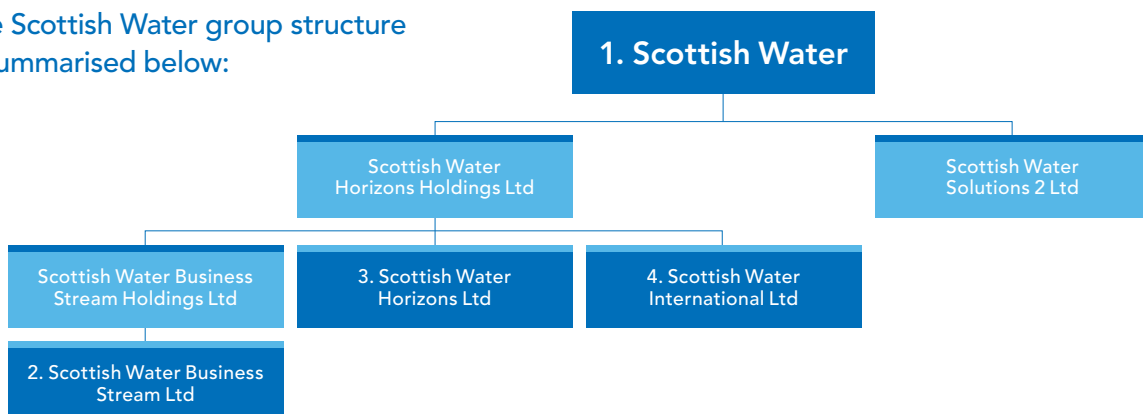
Business Stream was formed in preparation for the opening to competition of the Scottish retail market for water and waste water services to business premises in 2008. As at March 2016, the company was one of 23 (2015: 18) Licensed Providers, while Scottish Water is the wholesaler to the business market. 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; however, it 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

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

The Scottish Water group structure is summarised below:



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

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 3 Non-executive directors, all 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 Scotland Act 2012.

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 real term reductions 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 real reductions 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, the WICS carried out a 6 year price review 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.

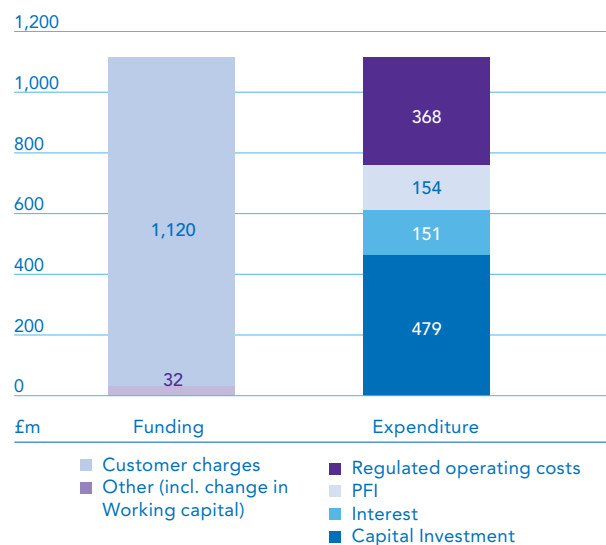
Within this financial framework, Scottish Water has an agreed Delivery Plan with Scottish Ministers that sets out Scottish Water's planned level of investment to deliver the required improvements and the expenditure to run the operation in respect of our core, regulated water and waste water services.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

#### 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 2016. The surplus made by Scottish Water is reinvested in the provision of services to customers.

#### Scottish Water Funding and Expenditure 2015/16



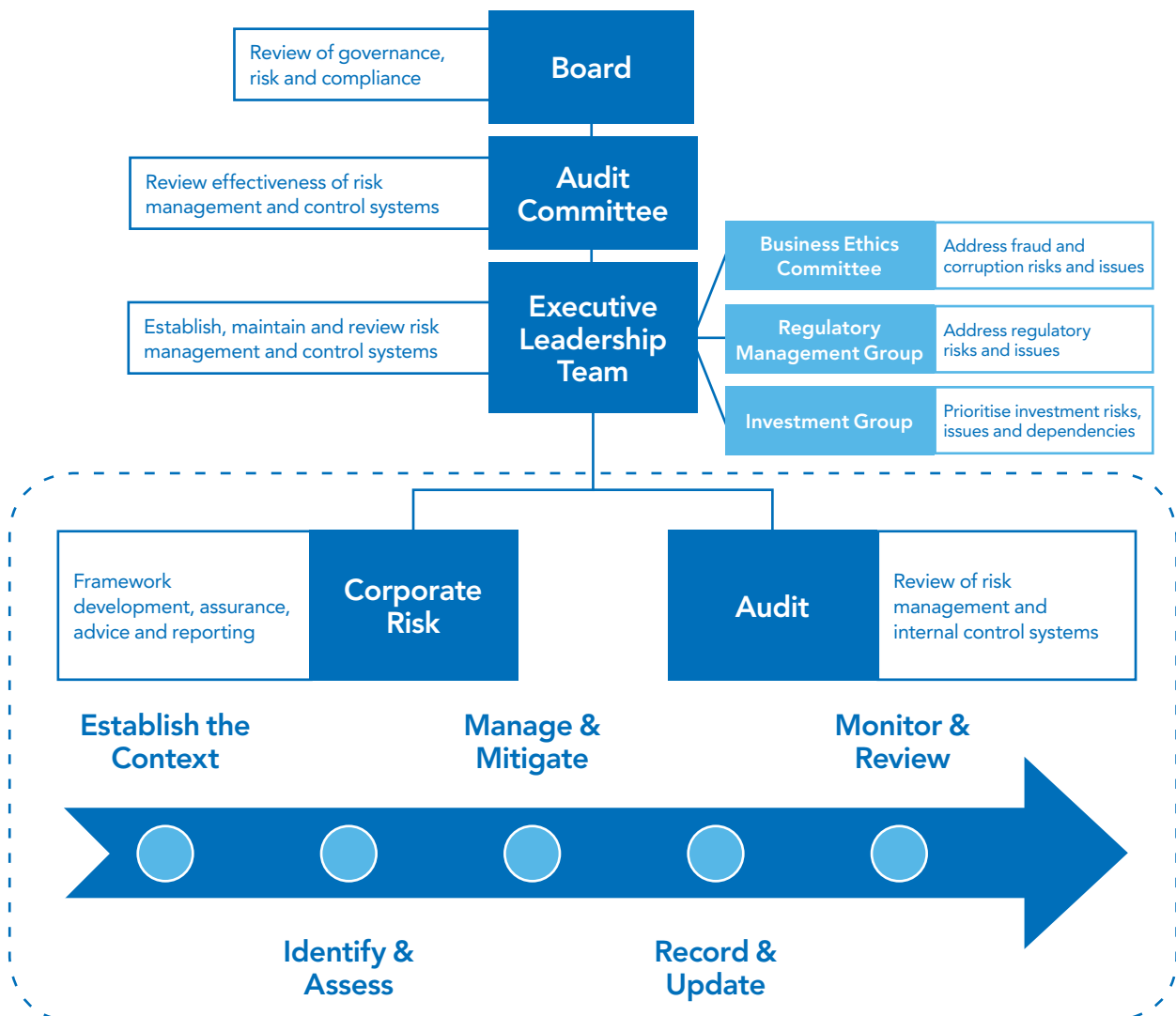
# Our approach to risk management principal risks and uncertainties

## Overview

Sound risk management is integral to Scottish Water’s achievement of our vision and delivery of Ministerial objectives. Scottish Water’s risk management framework includes Horizons and Scottish Water International but excludes Business Stream<sup>1</sup>. We recognise that risks, both positive (opportunities) and negative (threats) exist, and have the potential to impact on both the routine operations we undertake and services we provide to our customers. Risks have the potential to affect the achievement of our business objectives and ultimately our corporate vision.

## 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, and undertakes regular reviews of the most significant risks and ensures the appropriate mitigation strategies are in place.



<sup>1</sup> 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 the Scottish Water business, 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 4 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, beliefs 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, recognising and rewarding individuals managing risk effectively and who share and report risk information in a timely manner.

### 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 2 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 3 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



At the time of this report, the Board has carried out a robust assessment 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			
Critical Assets 	Risk to service to customers arising from failure of a critical asset or assets.	Delivering a continuous service to our customers is paramount.	<ul style="list-style-type: none"> <li>– Developing detailed knowledge and understanding of our critical assets.</li> <li>– Undertaking operational inspections, maintenance and emergency planning activities to minimise the risk and consequences of failure.</li> <li>– Identifying investment to reduce this risk for promotion in our future investment programmes.</li> </ul>
Across 2015/16 investigations have been undertaken on critical assets to better inform our short and long-term strategies to then manage the risk.			
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"> <li>– Skilled and trained employees operate our water assets.</li> <li>– Routine monitoring of the water in our catchments, and in our treatment and distribution activities.</li> <li>– Routine testing on water quality (beyond regulatory requirements) to manage drinking water quality and minimise associated risks.</li> <li>– Delivering significant investment to further improve water quality.</li> <li>– Detailed emergency response plans.</li> </ul>
There were no material changes to the level of water quality risk faced in 2015/16.			
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"> <li>– Organisation-wide education and awareness programme rolled out.</li> <li>– External Expert Vulnerability and Threat Management service utilised.</li> <li>– Security gap analysis undertaken, plans in place to further increase security level.</li> <li>– Regular application of updates to software and security products.</li> <li>– Detailed disaster recovery plans.</li> <li>– Participate in UK &amp; Scottish Government and industry cyber incident exercises.</li> </ul>
In common with many large organisations cyber security remains a significant risk. This risk has not changed materially in 2015/16.			

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"> <li>- Maintaining ongoing strong relationships with the PFI companies.</li> <li>- Monitoring and management of PFI company performance.</li> <li>- Development of contingency plans for both the financing and operation of these contracts.</li> </ul>
There were no material changes to the risk faced across the PFI portfolio in 2015/16.			
Business Stream			
Business Stream 	Risk of continuing reduction in value of Business Stream arising from the increasing number of competitors in the market.	Business Stream will maintain a financially viable retail business.	<ul style="list-style-type: none"> <li>- Development of innovative, tailored, competitive customer offerings.</li> <li>- Focus on Save and Retention of customers.</li> <li>- Continuous improvement of customer service and focus on cost efficiency.</li> <li>- Actively looking to the English market.</li> </ul>
This risk did increase in 2015/16 with a marked increase in competitors entering the Scottish market. The loss of the framework contract for the public sector resulted in a 20% reduction in Business Stream's market share.			

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 risk from a reduction of Scottish Government borrowing.

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 the financial statements are signed. The new viability statement, required under the 2014 UK 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 our 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 2016, Government loans totalled £3.4 billion. The Scottish Water group held cash and cash equivalents of £539.3 million as at 31 March 2016.

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 2014, the Members have assessed the prospects of the group over the 3 year period to March 2019. 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 liabilities as they fall due over the next 3 years to March 2019.

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 scenarios 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 assessed 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 first year of the delivery period – 2015–16.

Our plan for 2015–21 is geared towards achieving these objectives and delivering the next steps for the future of water and waste water services, while preparing for the key challenges and opportunities facing Scotland's water industry, including increasingly resilient water services and climate change.

Our plans for the future reflect 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) and the Scottish Government.

A major aspect of our plan is to increase the resilience of the services we provide so that all customers reap the benefits of a consistently high standard of service. This will address customers' highest priorities for service improvement such as improvements to drinking water quality, reducing flooding and visible leakage from water pipes.

The Ministerial objectives that were set for 2015–21, which were agreed with DWQR and SEPA, include:

- Helping to sustain better and more efficient public services by ensuring assets are maintained and improve services to customers.
- Helping people sustain and improve their health through the provision of continued, high-quality drinking water and improved 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 as 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

Scottish Water customers continue to benefit from an average household charge which is among the lowest in Great Britain.

In April 2016, household charges increased by 1.6% – just over £5 a year for the average household. It means the average Scottish Water household charge in 2016/17 is £351. This is less than £1 a day\* and £38 lower than the average charge in England and Wales.

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

At the start of each investment period, the Water Industry Commission for Scotland (WICS) sets price limits which enable Scottish Water to deliver Ministerial objectives at the lowest reasonable overall cost for the benefit of customers.

In November 2014, the WICS published its final determination of the charges that apply for water and waste water services from 2015 to 2021. It means that, in the first 3 years from 2015/16 to 2017/18, Scottish Water household charges can increase by 1.6% per year in nominal terms.

This reflected an agreement Scottish Water reached in January 2014 with the Customer Forum for Water – which was established to play a formal role in the 2015–2021 Strategic Review of Charges – based on extensive customer feedback about Scottish Water’s future priorities. The agreement is focused on providing price certainty and stability for customers.

Overall, in the 6 year period from 2015/16 to 2020/21, Scottish Water charges must increase by no more than 1.8% below the Consumer Prices Index (CPI) rate of inflation. This follows the 2010–15 regulatory period which saw Scottish Water charges fall by 10% in real terms.

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

Water and Sewerage Companies	Average household bill for 2016/17
South West Water	£488
Wessex Water	£460
Welsh Water	£438
United Utilities	£415
Southern Water	£411
Anglian Water	£411
England and Wales Average	£389
Northumbrian Water	£378
Thames Water	£374
Yorkshire Water	£366
Scottish Water	£351
Severn Trent Water	£329

\* The average household is between Council Tax Band B and Band C and has a combined bill of less than £1 a day.

# Performance

## Customer service

In the last year, we have achieved some of our best ever customer service results and introduced a new, comprehensive way of measuring customer experience.

In recent years, we agreed challenging targets with our regulator – the Water Industry Commission for Scotland (WICS) – in order to meet the Scottish Government’s expectation of improved customer service. Using a measurement known as the Overall Performance Assessment (OPA), we looked at a range of indicators to determine how well we are performing for the benefit of customers.

To ensure we continue to deliver high levels of service we have retained the OPA and committed to achieving a score at, or above, the threshold for leading water and waste water companies – 380 points in 2015/16 rising to 385 points by 2020/21. Our aspiration is to be best in class, achieving an equivalent OPA score at, or above, 400 points. As a result of our continued focus on delivering high levels of customer service, we exceeded the 2015/16 commitment and were close to our aspiration to be best in class, with an outturn of 393.

### Customer experience

Our new household Customer Experience Measure (CEM) was introduced in April 2015 to ensure that the delivery of service to our customers continues to sit at the heart of what we do and be a key driver of our performance.

CEM allows us to measure the experience of our customers – regardless of whether they have had direct contact with us, or experienced no service issues whatsoever. It gives us a much broader view of how well we are performing and the perception of customers, putting them truly at the heart of everything we do. CEM was developed in conjunction with the Customer Forum, in their role as representing the interests of customers.

The aim is to minimise the loss of points from a starting score of 100. The more we increase customer satisfaction while reducing complaints, the fewer points we lose. During the year, we improved the score by 1.7 points to 84.3, a reduction in lost points of 10%.

### Customer service excellence

Our excellence in customer service saw us receive ServiceMark accreditation from the Institute of Customer Service during the year.

In December 2015, our customer contact centre received the lowest number of calls in the history of Scottish Water. An increasing number of customers are choosing to enquire about services using social media and, in the last year, we have seen our number of Twitter followers increase from around 12,500 to around 17,500.

Written customer complaints have continued to fall this year to their lowest ever level, with a 13% reduction in 2015/16.

Results from the Institute of Customer Service show that satisfaction with Scottish Water has increased from 76.2 in January 2015 to 78.6 points to January 2016. Results from the UK Customer Satisfaction Index show we continue to be among the UK’s most trusted utilities.

### Maintaining services

Challenges are often posed to water companies by adverse weather or other circumstances outwith our immediate control. In the last year, our teams have carried out excellent work to maintain services for customers in the face of, at times, very challenging conditions, or to restore normal service as quickly as possible where disruption has been experienced. Very rarely, customers have been inconvenienced by service events in the last year, such as those in Motherwell, Cumbernauld and Bathgate. In all these circumstances, we have focused on minimising the impact of customer service disruption. Following such events, we look closely at what we can learn for the future as part of our drive for continuous improvement.

# Performance

## Investment overview

In the last year, Scottish Water has commenced a 6 year investment programme, which will see around £3.5 billion of improvements to Scotland's essential water and waste water infrastructure.

In 2015/16, £482.5 million was invested in upgrading essential treatment works, water mains, sewers and networks.

This builds on more than £7 billion of investment since Scottish Water's formation in 2002 – helping to secure the transformation of water services the length and breadth of Scotland.

### Delivery model

The involvement of supply chain partners, contractors and construction companies with our investment programme helps to sustain employment opportunities and support local economies.

A new delivery model has been put in place for our 2015–21 investment programme. This involves working in partnership with 3 alliances to deliver both maintenance and improvements to our existing assets.

Caledonia Water Alliance (CWA), a partnership of Morrison Utility Services and Aecom, is our water infrastructure alliance partner. They are responsible for the delivery of investment projects to improve our water supply networks.

aBV Alliance, a partnership of Black and Veatch and Byzak (part of Amey), is our waste water infrastructure alliance partner. They are responsible for investment projects to improve our waste water networks.

Efficient Service Delivery (ESD), a joint venture between Galliford Try, MWH Treatment and Black and Veatch, is our non infrastructure alliance partner. ESD are overseeing the delivery of projects including work on reservoirs, water treatment works and pumping stations.

These alliances, as well as Scottish Water's own internal Managed Delivery team, are supported by a wider integrated supply chain that includes the appointment of 13 Tier 1 contractor partners on frameworks specific to each delivery programme. This is further augmented by 58 local contractors to our regionally based rural framework, as well as frameworks covering process equipment, civil materials, hire and infrastructure products.

These appointments underline our commitment to supporting local employment in the communities we serve. The businesses – which have a range of skills including pipe fitting, pipe laying, electricians, electrical and mechanical fitters, welders, labourers and water and waste water repair squads – will support the investment programme at a local level.

### Delivering new investment

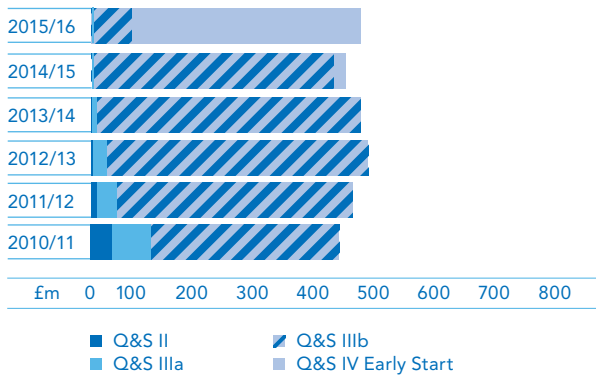
Investment activity in 2015/16 included significant preparatory work for construction of the new Shieldhall tunnel in south west Glasgow. At 3.1 miles long, the tunnel will be 5 times longer than the Clyde Tunnel. At 4.7 metres in diameter, the tunnel will be big enough to fit a double-decker bus inside. It is a key part of Scottish Water's £250 million, 5 year programme of work to improve river water quality and the natural environment in the Greater Glasgow area.

Meanwhile, we announced plans for a £120 million investment in the water supply network to benefit 200,000 people and businesses in much of Ayrshire and parts of East Renfrewshire. This will see the installation of 30 miles of new water mains.

In Oban, we have announced plans to build a new £21 million water treatment works which will ensure thousands of customers continue to enjoy continuous, high-quality drinking water.

While our first year of the new regulatory period was successful in many areas there were challenges in terms of our investment delivery. Putting in place our new, strengthened planning and delivery arrangements has inevitably impacted on our rate of investment delivery in the first year of the new regulatory period. As such, and in agreement with our regulators and the Scottish Government, we have re-phased our investment programme for the 2015–21 period.

**Total Quality and Standards (Q&S) Capital Investment**



For 2015/16, £482.5 million is split £99.8 million for Q&S IIIb Completion and £382.7 million for Q&S IV.

## Targets agreed with the Scottish Government

Objective	Programme area	2015/16 Year end Actual	Total number of outputs in the 2015–21 programme
Improving drinking water quality and reliability	Number of water treatment works improved		28
	Number of zones made compliant with iron & manganese standards	No outputs planned to be delivered in 2015/16	88
	Distribution mains cleaned (km)		5,928
	Number of improvements to reliability of supply (catchments and treatment)		2
	Number of improvements to reliability of supply (networks and storage)	1	82
	Number of water quality etc studies to inform future periods	10	341
	2010–15 outputs planned to complete in the 2015–21 period	2	23
Improving drinking water security of supply	Water supply resilience strategy and improvements made	4	18
	Number of zones with improved security of supply	1	11
	Number of security measures and improvements to the infrastructure of critical reservoirs	3	689
Protecting and enhancing the environment	Number of waste water treatment works improved to meet Urban Waste Water Treatment Directive (UWWTD)	6	22
	Number of waste water networks improved to meet UWWTD	4	62
	Number of improvements required to meet UWWTD – Glasgow completion	24	94
	Number of improvements required to meet the Water Framework Directive	1	21
	Number of revised Bathing Waters Directive studies	No outputs planned to be delivered in 2015/16	7
	Number of environmental studies to inform future periods		131
	Number of improvements required by the Compliance Assessment Scheme; odour reduction and sludge management	10	38
2010–15 outputs planned to complete in the 2015–21 period	7	16	

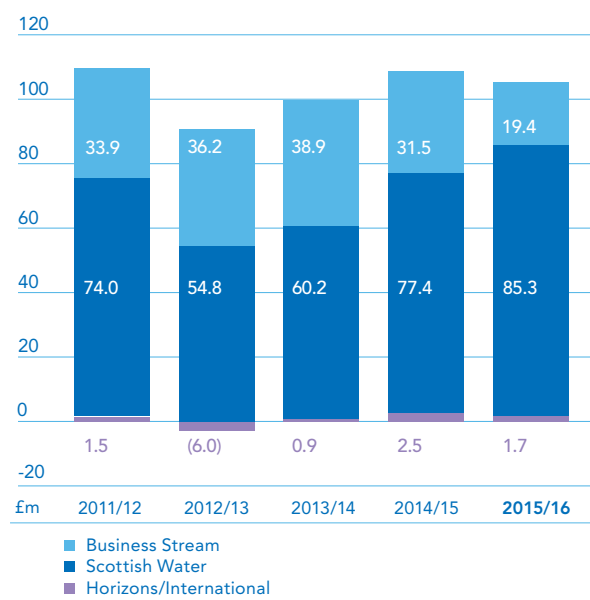
Improving flood risk management	Reservoirs Act: improvements to dams	No outputs planned to be delivered in 2015/16	45
	Flood Risk Management Act: models and integrated catchment studies		218
Supporting economic development	Number of new connections to households and business premises	15,098	56,500
	Delivery of new waste water capacity for 58,000 people	0	58,000
	Number of first time non-household meters installed	4,069	18,000
	Number of wholesale meters	7,729	84,000
Mitigating climate change	Number of climate change vulnerability assessments	4	122
Improving the long-term cost of service	Improvements in renewable power and energy efficiency (GWh)	1.64	17.5

# Performance

## Financial summary – group

The group surplus before tax for the year to 31 March 2016 was £106.2 million (2015: £110.7 million). The chart below illustrates the group surplus before tax by entity covering the last 5 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 first year of the new period by Scottish Water and the increased competition within the business retail sector. This has reduced Business Stream's share of the group surplus to 18.2% in 2015/16 (2015: 28.3%). Horizons' and International's share of the surplus is 1.6% in 2015/16 (2015: 2.2%).

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

Consolidated revenue in the year increased by £9.4 million to £1,196.8 million (2015: £1,187.4 million). This benefit was offset by a £22.5 million increase in costs to £912.6 million (2015: £890.1 million). Net finance costs of £178.0 million were £8.6 million lower than in 2015.

In the year, consolidated net debt decreased by £47.9 million to £2,885.0 million (2015: £2,932.9 million). The decrease was driven by cash balances increasing by £47.9 million to £539.3 million, with 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 2015	345.4	113.1	32.9	491.4
Cash generated	23.2	18.3	6.4	47.9
<b>Closing balance at 31 March 2016</b>	<b>368.6</b>	<b>131.4</b>	<b>39.3</b>	<b>539.3</b>

Cash balances within Scottish Water increased by £23.2 million to £368.6 million. Since the year end, a total of £223.9 million of short-term borrowing has been repaid by Scottish Water leaving a balance that equates to just over one month's expenditure. 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 £18.3 million over the year to £131.4 million consistent with the profit generated for the year.



## Taxation

The consolidated tax credit on the income statement was £17.8 million (2015: £19.7 million charge). This was as a result of the re-measurement of deferred tax balances due to the change in the UK corporation tax rate from 20% to 19% that will be effective from 1 April 2017, and to 18% from 1 April 2020. Other taxes incurred by the group, and included in the cost base, totalled £77.6 million (2015: £78.2 million) and are summarised in the table below:

	2015/16 £m	2014/15 £m
National insurance	10.5	9.9
Local Authority rates	62.3	61.8
Carbon reduction commitment	4.0	4.2
Land fill tax	0.8	2.3
<b>Normalised annual cost</b>	<b>77.6</b>	<b>78.2</b>

## Group pension arrangements

Scottish Water is a participating employer in the Local Government Pension Schemes (LGPS) across 3 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 LGPS regulations. This must be conducted by a qualified actuary. The purpose of the valuation is to review the financial position of the fund and specify the employer contribution rates for the next 3 year period. The last full actuarial valuations were carried out as at 31 March 2014 and were updated at 31 March 2016 by a qualified, independent actuary, to take account of the requirements of IAS 19 'Employee Benefits'.

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 2016, after taking account of deferred taxation, there was a shortfall of assets over respective liabilities of £90.7 million (2015: £161.1 million). Further detail is included in note 22 to the financial statements.

# Performance

## Scottish Water regulated services

### Financial performance

The surplus before tax in the year for Scottish Water was £7.7 million higher at £84.8 million (2015: £77.1 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 £1,120.4 million (2015: £1,096.9 million) and is analysed by category in the table below:

	2015/16 £m	2014/15 £m	Change £m
Household	820.7	800.8	19.9
Wholesale	291.5	289.2	2.3
Other	8.2	6.9	1.3
<b>Total regulated revenue</b>	<b>1,120.4</b>	<b>1,096.9</b>	<b>23.5</b>

Revenue from services supplied to household customers increased by £19.9 million to £820.7 million reflecting the 1.6% tariff increase, effective from 1 April 2015, and the increase in properties connected to the network. Revenue from wholesale services supplied to Licensed Providers increased by £2.3 million or 0.8% to £291.5 million reflecting the project to identify and bring into charge unregistered premises and an average tariff increase of 0.5%, partly offset by a reduction in consumption. Revenue from other sales increased by £1.3 million to £8.2 million due mainly to rental income received from windfarms sited on Scottish Water land.

### Operating costs

Total operating costs increased by £24.4 million to £856.4 million (2015: £832.0 million).

On a regulatory accounting basis, operating costs for Scottish Water increased by £14.5 million to £367.6 million. The increase was primarily due to: a £15.1 million increase in local authority rates charges, reflecting the one-off refund received in 2014/15 (associated with the successful revaluation appeal) and the unwinding of an accrual in 2014/15 that was no longer required (associated with potential retrospective landfill tax charges) of £5.5 million. These variances were partially offset by a reduction of £7.0 million in the bad debt charge for 2015/16. After adjusting for these items, the increase in energy prices, carbon reduction charges and new operating costs associated with capital investment, like-for-like costs, decreased in real terms by 2.4% or £7.1 million.

The operating cost of the PFI schemes in the year, including associated depreciation and amortisation charges, was £131.8 million, £1.6 million higher than in 2014/15. The increase was attributable to the annual indexation of service costs of £1.4 million and the higher volumes of waste being treated by the PFI schemes.

Depreciation and infrastructure maintenance costs decreased by £15.9 million to £345.9 million (2015: £361.8 million). Infrastructure maintenance costs were £17.6 million lower than last year, reflecting the planned maintenance investment programme for infrastructure assets during this first year of the 2015–21 regulatory period. Non-infrastructure depreciation charges increased by £3.9 million due to the profile of capital investment. The gain on asset sales was £4.0 million higher than in 2014/15.

### Capital investment

Reported capital investment under IFRS for Scottish Water in the year was £325.4 million (2015: £317.7 million). However, 2015/16 capital investment, as measured on a regulatory accounting basis, was £479.0 million (2015: £470.0 million). The table below reconciles investment as stated in the statutory accounts with investment on a regulatory accounting basis.

	2015/16 £m	2014/15 £m
<b>2015/16 investment on a regulatory accounting basis</b>	<b>479.0</b>	<b>470.0</b>
Less base infrastructure maintenance included in operating costs under IAS 16	(118.6)	(136.2)
Less investment financed by infrastructure charges & contributions	(38.6)	(27.2)
Add PFI capital additions	3.6	11.1
<b>Company capital additions per note 9 to the financial statements</b>	<b>325.4</b>	<b>317.7</b>

### Finance costs

As at 31 March 2016, the weighted average interest cost of the outstanding long-term debt reduced to 4.73% (2015: 4.86%). Net interest payable decreased by £5.8 million to £150.8 million reflecting the timing of loan repayments during the year and no net new loan drawdowns for the financial year. Interest charges are analysed as follows:

	2015/16 £m	2014/15 £m
Scottish Consolidated Fund	97.9	99.5
National Loans Fund	45.2	45.8
Public Works Loan Board	8.3	12.0
Other – net	(0.6)	(0.7)
<b>Net interest payable</b>	<b>150.8</b>	<b>156.6</b>

Finance costs associated with finance lease liabilities on PFI assets and the interest on pension scheme net liabilities decreased by £0.2 million to £29.6 million (2015: £29.8 million).

During the year, net debt decreased by £23.2 million to £3,055.7 million (being loans of £3,424.3 million less cash balances of £368.6 million). The decrease was driven by a £23.2 million increase 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 retail market for water and waste water services to non-household premises in Scotland is open to competition, giving business customers choice of retailer. In this non-household situation Scottish Water acts as the Wholesaler, providing water and waste water services to Licensed Providers (LPs) who then provide retail services to non-household customers.

During the 2015/16 financial year, the number of companies licensed to provide water and waste water services to business customers in Scotland increased from 18 to 23. 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 actively support the ongoing development of the Scottish market, leading a number of change proposals for the benefit of market participants.

Our market performance is measured by a basket of performance indicators. Our performance against the target in the year was 91%. Whilst falling short of the target of 95%, it was an improvement on the previous year.

In 2015, Anglian Water Business Ltd won the public sector tender for water and waste water retail services and on 1 March 2016 we successfully switched circa 14,500 public sector customer properties from Business Stream to Anglian Water Business.

There are also a number of arrangements in the market to encourage Licensed Providers to find and bring properties who are using a service into charge. These arrangements are continuing to work well and in 2015/16 this increased Scottish Water's revenue which benefits all customers that Scottish Water serves.

### Business Stream

Business Stream is Scottish Water's licensed retail subsidiary, which supplies water and waste water services to business customers in Scotland and to a limited number of customers in England.

Business Stream offers 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 industry has intensified this year, with 23 licensed providers now operating in the market. Following the loss of the water and waste water service framework contract for the public sector, Business Stream successfully supported the seamless transition of public sector customers to their new provider in February 2016.

Business Stream continues to strengthen its customer propositions by offering customers innovative, tailored solutions and value for money services. Continued investment in customer service improvements has allowed Business Stream to steadily increase customer satisfaction levels over the past 8 years.

Business Stream's transformation programme places great customer experience at the heart of their activities, which will deliver further improvements in customer service levels. Business Stream has delivered financial benefits for customers too, saving businesses and public sector organisations over £130 million since the opening of the Scottish market and helping customers to conserve more than 24 billion litres of water.

### Performance review

The 2015/16 financial year proved to be the most competitively challenging year since the opening of the Scottish market. Within the tough market conditions, Business Stream delivered a strong set of financial results. Profit before tax in 2015/16 was £19.3 million. Whilst £11.7 million below the prior year driven by the increase in competitor activity and compression of retail margins, the result was in line with expectations.

Administrative costs, whilst £0.3 million higher than in the prior year, included over £2 million of one-off costs relating to the business' transformation programme.

Business Stream repaid all outstanding debt balances in the year, leaving its balance sheet strong with significant cash reserves to fund investment in continuous improvement initiatives and to finance its growth aspirations.

### Future developments

Business Stream continues to see new competitors enter the Scottish market with 23 providers now operating, ranging from large English based incumbents to small, start-up companies.

The impact of increased competition remains the principal risk and uncertainty for the business with deeper price discounting and continued commoditisation of services compressing retail margins and therefore future profits. Business Stream project future margins in the Scottish market to be significantly lower given the increasingly competitive operating environment.

Business Stream's aspiration is to retain a healthy market share in Scotland and acquire a significant, and well-targeted, market share in England.

The opening of the retail market in England in April 2017 creates significant opportunities for Business Stream, with access to 1.2 million business customers and £2.5 billion of revenue. Business Stream is ideally placed to secure market share by leveraging their knowledge, capability and experience, gained from 8 years of operating in the Scottish market.

Business Stream has spent the last 12 months driving through operational efficiencies and continuing to develop their strategy to respond to the opportunities that this new market will present. Central to this has been their transformation programme which has delivered £2.9 million of operational benefits. These transformation activities are supported by significant levels of investment in automation and process re-engineering to deliver customer service excellence and improve operational efficiency.

In order to help ensure that the market in England is a success for business customers, Business Stream believe there are still some key areas that need to be addressed in order to create a market that is fair and simple to use, which encourages competition and innovation and most important of all, which delivers tangible benefits for customers. Business Stream will continue to engage in the process to help ensure this happens.

# Performance

## Non-regulated businesses

### Horizons

Scottish Water Horizons uses innovative ideas, knowledge and Scottish Water assets to encourage economic growth and the use of sustainable technologies across Scotland.

The activities of Horizons are aligned to support Scottish Water's core objectives, with particular emphasis on supporting its innovation agenda and renewable energy projects. The focus of the business is to identify, develop and deliver innovative, profitable and sustainable growth opportunities for Scottish Water that maximise commercial gain for the Scottish Water Group from its intellectual and property 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 technology, waste management and water and waste water infrastructure development and consultancy services.

### Performance review

Horizons had another successful year building upon the opportunities identified from the annual strategic review returning a profit before tax for the 2015/16 financial year of £1.4 million (2015: £2.0 million), in line with expectations. Horizons also performed well during the year against the key performance indicators set by the Horizons Board. Some highlights from the year include:

- Profits from the third party waste business increased by £0.5 million to £1.8 million;
- A further investment of £2.9 million in renewable energy schemes;
- The food waste recycling service significantly improved over the year after the successful completion of the clean out of the anaerobic digester at the Deerdykes site;
- Development of the Aggregates recycling business which also provided significant benefits for Scottish Water on the Shieldhall Tunnel project; and
- Horizons enabled the first UK heat from waste water scheme to be commissioned at Galashiels.

### International

Scottish Water International's purpose is to develop business opportunities abroad utilising the skills and expertise in Scottish Water to offer specialist consultancy services to utilities, governments and other international clients. This is particularly the case for countries where governments and utilities are keen to learn about the transformation journey of Scottish Water into an efficient publicly-owned service provider.

### Performance review

In 2015/16, International made a profit before tax of £0.2 million (2015: £0.4 million). Revenue came from International's 4 strategic target markets, being Qatar, Ireland, Canada and Australia.

During the year, International continued with its major assignment in Qatar where it is helping to oversee management of a 5 year programme to transform drainage and waste water services. International also began work on its second assignment for the City of Calgary Water Resources Unit. International has continued to provide advice and support for the creation of Irish Water, Ireland's new water utility, to help develop its operations and maintenance functions and has supported a major project to develop the Water Industry Operating Framework in Ireland. In the latter months of the year, International secured 2 contracts with utility clients in South and Western Australia.

# Performance Environment

Scottish Water depends upon, and contributes to, the preservation of a high-quality natural environment in Scotland.

In order to provide customers with wholesome drinking water, we must first take water from supply sources such as rivers, reservoirs and boreholes. This water is then treated to ensure it is of high-quality and ready to be piped onwards to customers for use. We then collect and treat waste water, which is in turn safely returned to the environment.

## Improving services

### Drinking water quality

Throughout 2015, we carried out over 311,000 quality tests on regulatory samples from our water treatment works, service reservoirs and customers' taps across Scotland. Of these samples, 99.93% of tests met the strict microbiological and chemical regulatory standards – this means drinking water quality is better than it has ever been before. The quality of water at customers' taps was also at a record high – 99.91%.

We recognise the need for a further focus on improvements and continue to work to ensure all our customers can enjoy the look and taste of their clear, refreshing Scottish drinking water. For example, we are making improvements to water supply networks and treatment processes. We have also been improving the appearance and taste of drinking water for our customers.

### Clear, fresh drinking water – water quality

#### Overall compliance with microbiological and chemical standards.

2015	99.93%
2014	99.90%
2013	99.91%
2012	99.88%
2011	99.86%
2010	99.86%

### Sustainable land management

Our work on 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.

During 2015/16, we visited catchments that supply over 20 water treatment works, to assess and report on the condition of the land around watercourses and make suggestions to improve source water quality.

Our SLM Incentive Scheme, launched in 2012, provides financial assistance to protect and improve source water quality within specific catchments. There are currently 9 catchments across Scotland where land managers are eligible to apply. We have received 20 applications during 2015/16, making a total of 187 applications since 2012.

In 2015/16, we assessed more than 500 activity notifications, around 150 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 continue to work in close partnership with a number of agencies to deliver sustainable land management and ensure that source water quality is protected and the status of the environment is enhanced.

### Leakage management

Water is a precious resource and considerable effort has been put into minimising leakage from our network of water pipes. We respond to reported bursts and work to detect and fix underground leaks. In 2015/16 reported leakage was reduced by over 44 million litres a day. This reduction is made up of 14 million litres of volume reduction, and 30 million litres associated with leakage reporting data improvements. The data improvement relates to an improved understanding of household customers' water use at night.

This means that, since the introduction of a targeted approach in 2006, leakage has been reduced by one half. As a result, we continue to operate in the economic level of leakage range – 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 and influence research and development in leakage management. We have also continued investing 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. This is due to the unique nature and national scale of the services we provide.

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 fully comply with discharge standards from more than 70 to just 6 in 2015/16.

In 2015, the effective operation of our waste water treatment works and networks contributed to all bathing waters which have the potential to be affected by our assets achieving at least minimum compliance.

In 2015/16, we experienced 10 category 1 or 2 environmental pollution incidents and 247 lesser category 3 or 4 pollution incidents. This compares to 8 category 1 or 2 and 241 category 3 or 4 incidents in 2014/15.

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

### Flooding

One of our top customer priorities is to reduce internal sewer flooding. We have been making good progress in delivering our commitment to remove properties from our flooding register. We plan to remove properties from the register as quickly as possible – typically within 4 years of their problem being confirmed – and, by 2021, to remove all properties that were on the register as of 31 March 2015, or provide a date by which they will have been removed.

While 79 properties have been added to the register in the last year, 47 were removed. We are also developing solutions for around 400 external sewer flooding areas where customers have experienced repeat flooding events.

During 2015/16, the number of internal and external sewer flooding incidents due to overloaded sewers has increased by 38% (34 to 47) & 19% (293 to 349) respectively. However, 2015 was the second wettest year since records began in 1910.

In the last year, the number of internal flooding incidents from sewers due to other causes (blockages or equipment failures) increased marginally by 2% (340 to 346). However, since 2010 the number of incidents has decreased by 47% (658 to 346).

Similarly, we have continued to reduce the number of external flooding incidents from sewers due to other causes [blockages or equipment failures] year on year since 2010, with 7% fewer incidents than last year and 28% fewer than 2010.

While we are progressing with the development and implementation of long-term solutions for customers with the highest risk of sewer flooding, we have continued to provide customer support through the provision of mitigation measures. We have also started to provide additional customer support through the implementation of sewer response plans that seek to be prepared for and to mitigate sewer flooding incidents resulting from heavy rainfall. Pre-event planning based on weather forecasts and flood risk probability is now a key part of an enhanced service implemented to protect customers, where possible, from the threat of flooding.

### Climate change

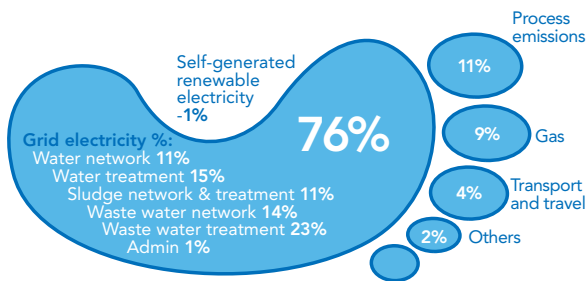
We are continuing work to assess the extent to which climate change will affect our assets and the resultant impact on services to customers. It is important we are able to adapt to potential changes to continue meeting customers' expectations of reliable services.

Climate impact projections indicate that the incidence of drought will increase over the coming decades, so we are improving the reliability of water services in a number of water resource zones. Waste water networks and services are also likely to be impacted by an increase in the frequency and severity of extreme rainfall events, as demonstrated by the flooding seen during the recent winter. Such climate projections help to inform our planning and investment, helping to ensure that we continue to meet our customers' expectations of reliable services.



We are committed to reducing our greenhouse gas emissions and to ensuring all parts of the business consider carbon and wider sustainability within decisions and actions.

**Scottish Water Greenhouse Gas Emissions Footprint 2014/15**



The measurement of our carbon footprint for 2014/15, the most recently reported year, showed an underlying reduction of 1.4% since 2013/14. Overall, we have seen our operational footprint fall by over 15% since we began reporting it in 2006/07. Our water service continues to have the lowest carbon intensity in the UK, largely due to the opportunity to use gravity to supply many of our customers rather than pumping. Our waste water service faces greater challenges due to the amount of pumping required.

**Energy**

In providing essential services to customers, Scottish Water is a large user of electricity, requiring around 445 Gigawatt hours (GWh) per year. Our efforts to reduce our energy bill saw us win the Renewing Scotland award at the annual Scottish Green Energy Awards in December 2015.

Our approach to energy management and development is focused on:

- Reducing consumption by improving 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 over 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 demand-side-response initiatives and long-term low energy, low carbon treatment solutions. We aim to reduce base consumption by 11GWh by 2021.

- Increasing self-generation

Since 2013 we have doubled our installed renewable capacity to over 53 GWh and diversified our portfolio to include hydro, wind, photovoltaic solar and combined heat and power (CHP). We currently have 28 hydro turbines, 18 small scale wind turbines, 23 solar schemes and 2 CHP plants, helping to offset the amount of electricity we need from the grid, with several treatment works now self-sufficient.

We are also exploring private wire contracts which will connect our assets to adjacent third party renewable assets – for example local community owned.

- 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. For example, we currently host 350GWh of third party wind turbines.

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**

Our approach to water efficiency is geared towards improving the security of a sustainable supply for both our present and future customers. Our website features an interactive online water use calculator, while we also have a range of water efficiency films that provide advice on how to use water wisely in the kitchen, bathroom and garden.

Our Water Efficiency Trial has moved to the next stage where we have a year’s consumption data from most homes involved and are in the process of introducing a number of interventions to try to change water use by reducing waste.

A project will be commissioned to allow us to better understand water efficiency in our operational sites. The output from which will be a programme of prioritised improvement options.

We are committed to better understanding water use in and around homes and our own assets and will continue to promote water efficiency to support our wider business objectives.

### **Customer awareness campaign**

Our Cycle campaign, launched in 2013, continues to highlight how everyone can play their part in helping to keep Scotland's water cycle moving. For example, taking 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. The Cycle campaign actively supports our work to educate and work with customers to alleviate the consequences of sewer flooding.

In 2015/16, we ran a further 2 phases of the campaign, using channels such as advertising and social media, to engage with customers and highlight the correct ways to dispose of items such as wipes or cooking fats.

A wide range of activities have taken place during 2015/16, including working with local schools and communities in areas such as Kilmarnock and Musselburgh, and we continue to work in partnership with organisations such as local authorities and the NHS to raise awareness of our campaign messages. During the year, we joined forces with the Marine Conservation Society and were helped by pupils from Burgh Primary School, Musselburgh. They took part in a beach clean at Fisherrow Sands to help highlight how we can all help protect Scotland's beaches and coastal waters by putting items like wipes and cotton buds in the bin instead of down the toilet.

Since the campaign started, we have seen a 12% reduction in the number of blockages from 40,000 to just over 35,000 a year. While this cannot necessarily be attributed to the campaign alone, we believe one of the best ways to tackle blocked drains and sewer flooding is to work with our customers to reduce preventable 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 2015, Scottish Water was named as Scotland's Best Large Employer at the prestigious Business Insider awards. This was as a result of direct feedback from a large cross-section of our workforce as to how positively they view working life at Scottish Water, as well as the demonstration of our clear link between people strategy and business results. It is extremely rewarding to know that we are considered an employer of choice and to know that our people are engaged and proud to work for Scottish Water. We currently employ around 3,800 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 Australia, Canada and Qatar.

We are committed to playing a positive role in the lives of our people and constantly challenge ourselves to do things that will make a difference in building a capable, agile, diverse and engaged workforce.

## Health and safety

Health and safety is integral to the day-to-day work activities undertaken by Scottish Water and our various partners. We are committed to continually improving performance in relation to health and safety and encourage partners, contractors and suppliers to do likewise. We work to build a holistic view of health and safety risks. This is done through proactive measures such as annual health and safety improvement plans, best practice forums with capital delivery partners, extensive safety awareness campaigns, H&S weeks, a continuous focus on improving safety behaviours and enhancing the overall safety culture of the organisation.

The foundations for health and safety are strong with senior managers demonstrating good safety leadership practices. This is done by using the various communication processes to deliver positive safety messages through site visits, safety briefings and alerts and in encouraging increased awareness of health and safety among employees. The on-going skills and competency of employees is also very important with an investment in H&S training being a key focus during this year with 3,517 people trained over 2,323 training days.

Ensuring the safety and wellbeing of our employees is an integral part of the way we work. As part of our drive for continuous improvement, we have participated in benchmarking exercises within the water industry and across other utility companies and international organisations and have been recognised as a high performer.

Our progress has been further recognised and externally verified for the fourth time in 5 years by the Royal Society for the Prevention of Accidents (RoSPA) through winning their highly competitive Sector Awards. In April, it was announced that we were again the winner of the prestigious UK Water Industry Sector Award for Health and Safety 2016. This achievement is one that that we are all particularly proud of as it demonstrates a consistently excellent and continuously improving performance.

## Building Capability

All our employees have talents which should be identified and deployed to best effect across the business. We 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.

The Executive Leadership Team holds quarterly 'Talking Talent' sessions where succession plans for senior roles are reviewed and the focus alternates between leadership and technical talent.

## Leadership Talent

In May 2015, a new leadership behavioural framework called GREAT Leadership was launched in line with our refreshed vision. Over the past year our leadership development offering has also been refreshed to ensure our wider leadership population can develop the knowledge, skills and behaviours essential for GREAT leadership. GREAT Leadership has 4 main component parts – Genuine, Resilient, Engaging, Aware and Trust. 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 proven beneficial in facilitating a higher level of cross-functional moves and ensuring a pipeline of emerging leadership talent.

A second group has recently been selected following self-nomination and a robust validation process.

**Technical Talent** – In the last year, we have continued to roll out our skills academy model to develop the skills of engineers and operatives from around Scotland. The model taps into skills and knowledge of our experienced people with 5 of our long-serving employees – with more than 120 years of combined experience between them – recruited into our academy to pass on their skills and expertise. Our academy training and testing facility, located within an existing water treatment works, allows us to simulate real-life scenarios in a training environment.

We also recognise the importance of attracting and developing the next generation of people to work in the water industry in Scotland. In a report published in 2015, Investors in People Scotland praised our ‘exceptionally strong commitment to employ and develop young people’. We are a Living Wage accredited employer and were one of the first public sector organisations to have been formally accredited as an Investor in Young People. We are supporting the career academies UK model in Scotland, which is providing paid work experience for groups of school pupils. We are also working with our partners to create a Knowledge Centre of Engineering Excellence as part of our £250 million Glasgow environmental programme.

In collaboration with our partners and relevant skills bodies, we have created qualifications, modern apprenticeship frameworks, internships and award-winning apprentice and graduate development schemes. In 2015, Scottish Water was voted as ‘the large Scottish employer graduates most aspire to work for’ following a survey run by the Adopt an Intern organisation.

We currently employ 36 graduates on structured development programmes and in 2016 our intake number will increase to 22. We offer around 10 paid 3 month internships each year for those from Science, Technology, Engineering and Maths (STEM) backgrounds and by actively supporting the development of STEM related skills among young people through our internship and graduate programmes, we aim to build further both the technical talent and leadership talent, required for the future. In addition we run a number of well-established apprenticeship programmes, with 96 currently in training.

### Agile Working

Together we are Scottish Water and we need to ensure that both individually and collectively we have the adaptive capacity, agility and resilience to cope with pace of change and to deliver sustainable out-performance. A key strand of our approach to equipping and energising our employees in this way is our Wellbeing programme which encourages employees to ‘bring their whole self to work’. The programme provides support for employees in 4 key areas:

- Physical wellbeing – promoting positive health and bodily functioning, exercise and good nutrition, physical safety and access to good health care and information. Initiatives in this area include toolbox talks on various health topics, the introduction of defibrillators into key locations across Scottish Water, and participation in a 100 day team challenge aimed at participants averaging at least 10,000 steps per day.
- Emotional wellbeing – emotional resilience, promoting feelings of self-confidence, self-esteem, trust and co-operation and supportive relationships. We recognise that our leaders play a key role in creating agile, healthy workplaces and we offer a number of training programmes which are aimed to help them create the right environment for success. Over 300 leaders have received personal resilience training.
- Agility in the workplace – enabling employees to work in a way that enhances employees’ lifestyles. We have equipped our employees with appropriate tools and technology for their role in order that they are able to view work as ‘what you do’ rather than ‘where you go’. We are committed to providing a fair work/life balance and any employee is able to ask for flexible working. We have a range of working patterns and family friendly policies in place, including shared parental leave and the ability to buy additional annual leave, and in 2015 won Large Public Sector of the Year award at the inaugural Scottish Top Employers for Working Family Awards. We have recently introduced a flexible retirement option to enable our mature colleagues to re-balance their work/life responsibilities and ease into a different period in their lives whilst still retaining key skills and knowledge. Flexible retirement also facilitates the ‘free-ing up’ of roles resulting in opportunities being opened up to others with enhanced individual and business benefits.

- The energised person – belief in our vision and values, being part of a meaningful enterprise 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); fundraising activities for WaterAid; acting as mentors for local schoolchildren and a WaterAid trip to Zambia for 13 employees from different roles across the business are all recent examples of ways in which employees are supported to find meaning in their work and make a real difference to wider society.

### Increasing Diversity

We recognise that diversity in the workplace makes good business sense and leads to fresh thinking, better decision-making and strong performance. Scottish Water strives to be a leader in behaviour and attitudes to diversity and inclusion. As a family friendly employer, we have been awarded the Carers Positive kite mark. We have developed new policies on shared parental leave and introduced new online modules to create a respectful working environment. In 2015, we signed up to the Scottish Business Pledge – a voluntary commitment made by companies in Scotland to uphold some of the best in modern business practices and to embrace the principles of fairness, equality, opportunity and innovation.

We are working hard 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 slow increase in the proportion of female employees, so that women now make up 26% of our workforce. There is clearly more to be done, particularly in tackling the effects of occupational segregation.

Our Women in Leadership network events – aimed at inspiring, supporting and encouraging women – continue to attract good support. We have run internal workshops for women interested in taking up Board positions with external organisations, charitable and social enterprises. Within our own Board, we have been pleased to support the Scottish Government and Institute of Directors ‘Shadow Boards’ initiative, both in offering opportunities and providing participants.

We encourage individuals with shared interests to form self-organising and governing networks and in addition to existing groups such as Nxt Gen (for people early in their careers), and our Carers Support Network, the LGBT group was formed in 2015. This included Scottish Water taking a stand at the Glasgow Pride event with very positive feedback being received from participants and members of the public. As a Scottish public sector employer we monitor and report every 2 years on our Public Sector Equality Duties (PSED), including being aware of how representative our workforce is of our customers.

### Engaging employees

Employee engagement remains at the heart of our people strategy and we continue to believe that high levels of employee engagement lead 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 – in our latest survey both the overall response rate and level of employee engagement have continued to rise. This is because our employees know that their views will be taken seriously and, where appropriate, acted upon.

We understand the key drivers of employee engagement in Scottish Water, and always strive to improve or maintain those aspects of working life which are most important to our people. For example, we know from our most recent survey that over 90% of employees feel trusted to work in an agile way and this is one of the things they value most about working for us. Being trusted to serve Scotland is also extremely important, with 93% of employees committed to playing their part in helping Scottish Water achieve our vision, and 96% responding positively to the statement ‘I understand that “I am Scottish Water” to the customer and how that requires me to behave.’

We use a wide range of channels to communicate across the business and in the last year have continued to hold 6 monthly events for our leadership community to discuss our current performance and our future ambitions to further benefit our customers.

### Education

Providing customers with the opportunity to learn about the value of water and how it is produced is a great way of bringing our essential services to life. In the last year, we have continued to focus our approach 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 fun, interactive and hands-on package of educational resources and online activities, based on the requirements of the national curriculum, continue to be taken into communities and schools across Scotland. In the last year, we piloted our 9 mobile education exhibits in the Glasgow area to engage with people and build understanding about Scottish Water and the vital water and waste water services we provide every day. These are complemented by games on the Scottish Water website and free apps for mobile devices.

In the last year, we continued to work with the Scottish Professional Football League (SPFL) Trust to deliver the H2-O programme, working with 3 football clubs, Kilmarnock FC, Greenock Morton FC and Queen's Park FC. The programme delivers fun, interactive sessions about the water cycle and water, hydration and physical activity to around 1,000 pupils in primary schools in each of the clubs' areas, combining a physical and mental workout for pupils. The H2-O programme was recognised as a finalist in the Best Corporate Social Responsibility (CSR) Scheme category at the Football Business Awards 2015.

In 2015/16, our innovative partnership approach has helped educate customers about the links between water, hydration, wellbeing, water safety and sport. We teamed up with Scottish Swimming to roll out the Swim Social programme to get adults swimming and encourage people across Scotland, including our employees, to take part. We have also teamed up with Triathlon Scotland for their 2016 National Championship events to promote the importance of hydration and water safety linked to open water swimming.

## Volunteering

Since its launch in 2011, our volunteering programme has seen more than 3,000 employees dedicate approximately 20,000 working hours to good causes. Each employee is entitled to 2 days paid leave each year to help develop their own skills and teamwork, helping to strengthen relationships with local communities and support equality and diversity outcomes. Volunteering opportunities are focused on:

- Education

- Environment; and
- Local community volunteering

In 2015/16, 568 employees have dedicated 3,356 working hours for the benefit of charitable, environment or community projects across Scotland, spread from Orkney to Dumfries and Galloway.

A key development witnessed in 2015 was the introduction of skills-based volunteering, encouraging employees to share their wide range of commercial skills to help a good cause. This included social media and PR training for Limelight Music – a Glasgow based inclusive music production and education company, which works with school pupils and disabled adults.

Further standout projects included 10 employees carrying out extensive gardening at Newton Park, Ayr, for a charitable group, 'Friends of Newton Park'.

Volunteering also plays a key role in engaging and communicating with our customers. As part of our Cycle campaign, a number of volunteers have visited schools, community groups and supermarkets across the country to have conversations with customers of all ages about how they can help avoid blocked drains.

## WaterAid Scotland

Scottish Water's charity of choice is WaterAid Scotland, part of the specialist development charity WaterAid. WaterAid work 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 2015/16, Scottish Water employees raised in excess of £150,000 to support WaterAid's work in Zambia. Our employees 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 2015/16 WaterAid ball, gold day and quiz. The WaterAid ball alone raised over £105,000.

In October 2015, a group of WaterAid supporters from Scottish Water visited communities and local authorities in Zambia to see the challenges they face and the impact our donations can make.

# Innovation

## Customers expect higher levels of service, greater levels of resilience and affordable prices.

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.

### Supporting innovation in the water sector

The Scottish Government recently launched the Hydro Nation Water Innovation Service (HNWIS) to support Scottish businesses in developing their innovations for the water sector. Scottish Water is working with this service so that HNWIS can focus efforts on ensuring new suppliers get their products to market quickly.

Our Development Centres at Gorthleck Water Treatment Works and Bo'ness Waste Water Treatment Works support the HNWIS by providing facilities to test and develop new technologies more rapidly without impacting customers or the environment.

Scottish Water is also 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

Our waste water networks are now being used to power a heating system at a college campus in the Scottish Borders. Scottish Water Horizons, who managed the installation and commissioning of the scheme, has facilitated access to our waste water networks to enable heat to be captured for use as a renewable energy source. Using innovative technology developed by Scottish Water Horizons' partner, SHARC, energy is extracted from our waste water network and transferred as heat for export to the college. The system is expected to provide around 95% of the heat needed by the Galashiels campus and does not impact on the normal operation of our local waste water networks.

#### Hothouse workshop

Research has indicated that one of our customers' top priorities is to see a faster response to addressing leakage. In the last year, we ran a 'hothouse workshop' over 2 days, in which around 30 people from different teams across Scottish Water and suppliers collaborated to identify possible solutions and ways of responding more efficiently. Participants developed a number of proof of concept ideas, covering a mix of new technologies and business processes, which we are now progressing to assess their suitability for possible implementation.

The workshop enabled participants to focus minds on responding more efficiently and effectively to visible leakage, as well as ways of being more proactive in identifying any required action before leakages occur. The workshop exemplifies our approach to building and embedding an innovative culture throughout Scottish Water.

#### Transportable water treatment unit

We developed a transportable membrane water treatment unit which can be moved between locations and used to provide compliant, high-quality drinking water on a temporary or short-term basis, to meet operational requirements as required. The unit was first introduced at Craignure Water Treatment Works in Argyll and Bute and was designed, built and fully operational in just 14 weeks. By building the unit off-site we were able to minimise impact on the local community at the height of the tourist season. Knowledge was gathered from other rural water treatment works in order to implement an effective and sustainable solution.

#### Granular activated sludge

Chemicals have traditionally been used to control phosphate levels in the final effluent from the treatment of waste water. Through our work to protect and enhance the environment, we identified an alternative and innovative approach to controlling phosphate levels without the need for chemical addition. To test whether the process was effective, we commissioned a year-long trial of the technology at 2 of our sites in Glasgow. The results of this were encouraging, with the process shown to be positive. As a result of this successful trial of technology, we are now progressing with our first full scale plant of this nature at Inverurie in Aberdeenshire.

#### Prevention of discolouration in distribution systems (PoDDS)

Working in collaboration with the University of Sheffield, we have been trialling a new approach to the management of our water networks to minimise customer disruption from discolouration. A model has been developed that provides greater understanding of the processes associated with the causes of discolouration. Using information from the model we are evaluating distribution system operating approaches that minimise the risk of discolouration events impacting customers. The potential is to improve water quality for customers and reduce the cost of managing and maintaining our distribution networks.

### Alternative storm storage solutions

Work is progressing across the Greater Glasgow area to convert ageing infrastructure into a modern, integrated and sustainable drainage system that will improve the environment on the River Clyde and its tributaries and help tackle flooding and climate change.

As part of the £250 million, 5 year upgrade, we are investing more than £12 million in a project which will tackle sewer flooding in the Elmvale Row area of Springburn. The project incorporates an alternative design that utilises a vacuum flush column formed from precast concrete units. This column draws in water during storm events and provides a flushing volume as the flood storage draws down, cleaning the system. The vac-flush design results in a significant reduction in the cost of construction due to the shallower excavation depth required.

### New fish pass

Historically, fish passes in dams have been designed to work at a specific water level. Working with Aquatic Control Engineering, Fishway Engineering and George Leslie Ltd., we designed and installed a series of tilting weirs at Loch Duntelchaig. This allows for the weirs to be adjusted depending on the water level, meaning that fish passage is possible across a wider range of water levels.

## Research and Development activity

### United Kingdom Water Industry Research (UKWIR)

We are active contributors to the UKWIR programme that looks at cross industry topics which look to address climate change, leakage, asset management and compliance.

### STREAM

We 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 10 projects running including sustainable catchment management, 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.

### Technology pilot trials

We continually seek to improve the services for our customers and look for new technologies and processes to support this. A significant proportion of our research and development funding is used to test and evaluate new technologies and processes in a controlled way. This allows for planned deployment of appropriate technologies minimising risk to customer service and cost.

Some of the areas in which we are evaluating technologies and processes include:

- Energy recovery from sludge
- Filter medias for improved water treatment
- Advanced water and waste water treatment
- Provision of water and waste water services for rural customers
- Reducing the time to repair visible leakage

### International collaboration

We continue to be active members of the NoMiNor (Natural Organic Matter in Northern waters) project with partners from the Nordic regions (Norway and Sweden) and Cranfield University. This project is looking to increase the understanding of environmental factors that influencing levels of Natural Organic Matter (NOM) in drinking water sources and how to optimise treatment. Due to the upland nature of our waters, NOM is the significant treatment challenge for drinking water. If our processes do not remove this effectively it results in colour, taste and odour and disinfection by-products.



# 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 provided across the UK, improving service in all their priority areas.

### Household prices

We are committed to annual household prices which increase by 1.6% for 2014/15 to 2017/18. Thereafter 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

A revenue cap will be set for wholesale customers, based on increases at 0.3% below CPI. This will protect household customers from revenue uncertainties in the business customer market and provide a further incentive to Licensed Providers to introduce new customers.

### 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 £830 million of net new government borrowing in the 7 years from 2014 to 2021. Financing this plan with our proposed mix of customer prices and new borrowing will enable us to maintain our financial strength.

### Service to Licensed Providers

We will continue to listen to the needs of Licensed Providers 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. We propose that any savings arising from out-performance are held until 2018 to support the ambition of nominal household price increases of 1.6% from 2018 to 2021 and/or investment in further improvements to improve the resilience of water supplies and to reduce the risk and incidence of sewer flooding. These would be agreed at the time 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 will monitor our customer service through the Overall Performance Assessment and enhanced Customer Experience Measures.

### Innovation

Our plans are based on a detailed assessment of the most cost effective way to deliver customers' expectations and improved compliance. These involve both innovative and proven approaches to operating and investment solutions. Our 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 this 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 this plan.



# Governance

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# Board members



## 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, initially as Financial Controller and latterly as Commercial Director. Prior to this, he worked with Price Waterhouse and Tyco. 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. Geoff Aitkenhead, Executive Director Capital Investment

Geoff was formerly Asset Management Director from 2012–15, and prior to that General Manager, Customer Services and Networks, at East of Scotland Water (ESW). He is a graduate of Newcastle University, a member of the Chartered Institute of Water and Environmental Management and a Fellow of the Institution of Civil Engineers. He is the Chairman of Scottish Water International Limited and a former Chairman of WaterAid (Scotland), an organisation dedicated to the provision of clean water and sanitation in the developing world.

### 3. 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 32 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.

### 4. 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

### 5. 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 and a Non-Executive Director of J Sainsbury plc and the North American Income Trust. 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 and has held a range of other senior non-executive appointments including a seven 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.

### 6. 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.



### 7. 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, where she chairs the Remuneration Committee and joined the Board of the Standard Life Group as a Non-executive Director in April 2012. She became Chair of Standard Life Assurance Limited in April 2016 and Chair of the Trustees of the Westminster Society for People with Learning Disabilities from the same date.

### 8. Matt Smith OBE JP

Matt was Scottish Secretary of UNISON until 2010 and STUC President in 1999/2000. He currently serves as a Scottish Human Rights Commissioner, a Member of the Standards Commission for Scotland, a Member of the Employment Appeal Tribunal, a Director of Irvine Bay Regeneration Company and a Director of UNITY Enterprise. He is a Fellow and Policy Committee Member of the Scottish Council for Development and Industry. He has served as a Justice for 30 years and is a JPAC Member, is a Member of the CIPFA disciplinary scheme and a Member of ICAS's Regulation Board.

### 9. Jim Spowart

Jim was the founder and Chief Executive of Direct Line Financial Services, Standard Life Bank and Intelligent Finance. He has considerable corporate experience and retired from Intelligent Finance in 2002. He was awarded an Honorary Doctorate from Edinburgh Napier University for his contribution to banking and also to the economic development of the central belt of Scotland where he created over 5,000 banking jobs. Since he retired, he has been involved in various consultancy projects and currently he is the Chairman of a Church of Scotland Charity We-evolution. He was also a Commissioner to the Church of Scotland during 2012 and 2013.

### 10. Andrew Wyllie CBE

Andrew is Chief Executive of Costain Group PLC, the worldwide construction and engineering group. Prior to taking up this role in 2005, he worked for Taylor Woodrow where he was Managing Director of the construction business and was a member of the Group Executive Committee. He is a graduate of the University of Strathclyde, has an MBA from London Business School and is a Vice-President of the Institution of Civil Engineers. He is also a Fellow of the Royal Academy of Engineering, a member of the CBI Construction Council and a Companion of the Chartered Management Institute.

# 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 will be 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 11 members: 7 Non-executive Board Members and 4 Executive Members. Following the expiration of his term, Ronnie Mercer was replaced as Chair by Lady Susan Rice on 1 June 2015. Donald Emslie's term as a Non-executive Board Member expired on 31 March 2016. 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 2015/16, the Board met on 9 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 auditors.

## Board and Committees

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

Name	Board		Audit Committee		Remuneration Committee	
	Held	Attended	Held	Attended	Held	Attended
Ronnie Mercer <sup>1</sup>	2	2	–	–	–	–
Lady Susan Rice <sup>2</sup>	7	7	–	–	–	–
Geoff Aitkenhead	9	9	–	–	–	–
Alan Bryce	9	9	5	5	3	3
Donald Emslie	9	8	–	–	3	3
Peter Farrer	9	9	–	–	–	–
Douglas Millican	9	9	–	–	–	–
Lynne Peacock	9	9	5	5	–	–
Alan Scott	9	9	–	–	–	–
Matt Smith	9	8	–	–	3	3
James Spowart	9	9	5	5	–	–
Andrew Wyllie	9	8	5	4	–	–

<sup>1</sup> Until his resignation on 31 May 2015

<sup>2</sup> From her appointment on 1 June 2015

### Audit Committee

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

<b>Douglas Millican</b>	Chief Executive
<b>Geoff Aitkenhead</b>	Executive Director Capital Investment
<b>Peter Farrer</b>	Chief Operating Officer
<b>Alan Scott</b>	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 twice 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 health and safety issues.

High quality personnel are viewed as an essential part of the control environment. Ethical behaviour is incorporated into staff conditions of service and demanding recruitment criteria and 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, following widespread consultation, recently updated 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 Auditors

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

### Independence of external auditors

The Auditor General for Scotland is responsible to the Scottish Parliament for securing the audit of the financial statements of Scottish Water. For 2011/12 to 2015/16, the Auditor General re-appointed PricewaterhouseCoopers LLP as the auditors of Scottish Water.

Under the terms of PricewaterhouseCoopers 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).

KPMG LLP has been selected by Audit Scotland as the auditors of Scottish Water for the financial years 2016/17 to 2020/21.

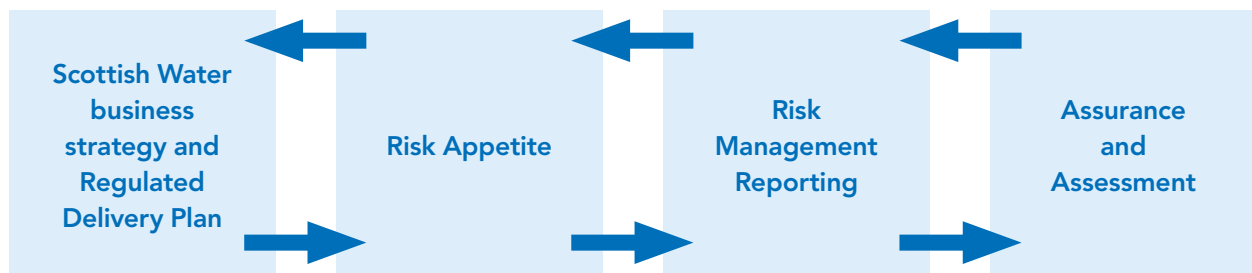
# Audit committee report

I am pleased to present this report covering the role and function of the Audit Committee for the year ended 31 March 2016. I am the Chair of the Audit Committee and I am supported by 3 other Non-executive Members; Alan Bryce, James Spowart and Andrew Wyllie. 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. Ramsay Milne 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; and
- The annual report prepared by the compliance officer.

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 2015/16 the committee met on 5 occasions, with an extra meeting in April 2015 to focus on new corporate reporting requirements.

In addition to the Committee members, the Board Chair, Chief Executive, Finance Director, Head of Internal Audit and the external audit partner from PricewaterhouseCoopers LLP (PwC) also attend the meetings by invitation. The Committee also invites other senior management to present to the Committee on a regular basis on a variety of topics. In addition, the Committee meets in private, excluding any Executive Members, with the external auditor and the Head of Internal Audit 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 the implementation of The 2014 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 was also satisfied by the annual joint paper prepared by the Group Financial Controller and the external auditor covering the financial statements for 2015/16 which 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 and competitive tendering within the Scottish business retail market.

The primary areas of judgement considered by the Committee in relation to the 2015/16 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 £10.9 million, representing 1% of total expenses (including interest) in the consolidated income statement. However, we agreed with the external auditor that they 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 three papers from Group Finance associated with The 2014 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; and
- An annual report on regulatory compliance.

In addition, during the year the Committee requested specific reports on the monitoring of the capital investment programme, a review of PFI management processes, vehicle operating licence compliance, the requirements of the Modern Slavery Act 2015, bank reconciliations and maturity of the anti-fraud framework.

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, and 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

Audit Scotland is responsible for the appointment of the external auditors. PwC was re-appointed external auditors for the 5 year period from 2011/12 to 2015/16. PwC provides a taxation advisory service to Scottish Water Business Stream but no other non-audit services are provided by them. The committee has been informed by Audit Scotland that KPMG has been appointed external auditors for the 2016/17 to 2020/21 period.

The Committee receive from PwC 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

The Committee approved a policy on provision of non-audit services to Scottish Water, which was applied during the year, and will be extended to all subsidiaries in 2016/17 by the firm appointed as External Auditors. 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 PwC 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 2016. I would like to take the opportunity to thank the previous Chair, Donald Emslie, for all of his work during the year until he stepped down as a Non-executive Member of Scottish Water on 31 March 2016. In preparing this report I have been supported by fellow Remuneration Committee and Non-executive Member, Matt Smith.

As required, the Committee receives internal advice and information from the Chair of Scottish Water, the Chief Executive, the Director for People, Workplace and Organisational Development and the Corporate Secretary. During the year the Remuneration Committee engaged Hay Group for the production of market based pay data on senior executive posts; and Mercer for information on pension taxation changes coming into effect in April 2016.

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 3 meetings of the Committee in 2015/16. At each meeting a quorum of independent, Non-executive Members was present. No Executive Member was present during discussions about their own remuneration.

We 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 2015/16 period were as follows:

### Decisions / remuneration for 2015/16

- Agreeing the base salary increase of 1.8% of the Executive Members and Chief Executive from 1 April 2015.
- Confirming the 2016 AOIP payment calculated at 32.9% out of the 40% maximum opportunity for Executive Members and Chief Executive.
- Reviewing management's proposed salary increases for Scottish Water staff.
- Setting the performance criteria for the LTIP period 2015–21.
- Agreeing the level of LTIP payment for 2010–15, as paid in January 2016.
- Review of succession planning for posts on the Executive Leadership Team.

### Changes / remuneration for 2016/17

- Agreeing base salary increases for Executive Members, with effect from 1 April 2016, at 2.0%.
- Setting the performance criteria for the 2016/17 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 care for the water on which Scotland depends. By building on past success it will seek to provide levels of service, performance and efficiency which exceed the expectation of its customers, regulators and the Scottish Government.

Scottish Water will continue to provide a working environment that matches the expectations it places on its people to deliver best value outcomes in an empowered organisation. Remuneration and incentivisation policies are a major contributor to achieving Scottish Water's goals. This requires terms of employment for all employees that, taken together, ensure that the organisation is perceived as a fair employer that encourages excellence, rewards performance and empowers its people as well as 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.

### 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 related 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 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%.

#### 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 the Executive Members is 40% of base salary and is non-pensionable. The Delivery Plan targets, out-performance targets, and actual performance for each measure in 2015/16 are set out below.

Measure	Weighting	Delivery Plan target	Out-performance target	Actual performance
Regulated Profit before tax excluding depreciation	40%	£410m	Up to £20m ahead of 2015 Delivery Plan, payment on a sliding scale 0% to 100% <sup>(i)</sup>	£450m
Customer service OPA performance	25%	381 to 400 points	Zero payment below 380; 30% payable at 380 points; 90% payable at 400 points; 100% payable for greater than 400 points.	393 points
Customer Experience – Household Measure	25%	Beat 82.6 points	0% payable below 82.6; 30% payable at 82.6; 100% payable for greater than or equal to 84.3 points.	84.3 points
Customer Benefit – Overall Measure of Delivery	10% all or nothing payment	Beat 73 points	Beat 73 points and have no more than nine Q&S3a and 3b projects outstanding	75.3 points delivered but 15 Q&S3b projects outstanding

Note

(i) 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.

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 five years to March 2015

The Long-Term Incentive Plan (LTIP) was agreed with the Scottish Government and provided clear targets for out-performance of the Water Industry Commission's Final Determination for the 2010–15 period. Payments under the scheme were made to Executive Members for their service during 2010 to 2015 in January 2016. LTIP payment was also dependent on there being overall financial out-performance of the Final Determination.



The plan structure and actual performance are set out below:

Measure	Weighting	Basis of calculation	Target	Actual performance
Growth in financial reserve, measured as debt less cash, relative to the final determination <sup>(i)</sup>	50%	Straight line sliding scale	£0 to £100m above Final Determination target	£122.4m <sup>(iii)</sup>
OPA – measured over the average performance in 2013/14 and 2014/15 <sup>(ii)</sup>	50%	Straight line sliding scale	380 to 400 points	399 points

Notes:

- (i) The financial target is the extent to which adjusted net debt is lower in March 2015 than was assumed in the Final Determination. Maximum LTIP would be payable for at least £100m out-performance (after adjusting for 2010 rates revaluation and lower charge increases than allowed under the Final Determination).
- (ii) Out-performance of OPA targets above those set out in the Final Determination is measured as the average performance in 2013/14 and 2014/15. Maximum LTIP for an OPA score of at least 400, 20 points higher than the Final Determination target of 380.
- (iii) £122.4m out-performance of the Final Determination was generated in the period April 2010 to March 2015.

Confirmation of awards under the LTIP was made in September 2015 following independent review of underpinning performance in the 2010–15 regulatory period with our regulators. 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 long-term incentive payments.

#### g. Pension

All employees, including Executive Members, are eligible to participate in the Local Government Pension Scheme (LGPS) (Scotland) 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 LGPS 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 put forward a recommended 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 LGPS (Scotland) then access to pension benefits on leaving will be determined by the regulations of that pension scheme, as for any other LGPS 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
Executive Director Capital Investment	Geoff Aitkenhead	20 April 2015*
Chief Operating Officer	Peter Farrer	1 April 2013
Finance Director	Alan Scott	24 September 2013

\* Mr Aitkenhead will retire on 31st July 2016

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:

<b>Lady Susan Rice, Chair</b>	30 April 2019
<b>Alan Bryce</b>	31 March 2018
<b>Lynne Peacock</b>	31 March 2018
<b>Matt Smith</b>	30 April 2017
<b>James Spowart</b>	31 March 2017
<b>Andrew Wyllie</b>	31 March 2017

## 2. Members' Remuneration Report

The auditors are 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 2015/16	Pension (iii)	LTIP 2010-15 (iv)	Total including one-off LTIP payment
		£000	£000	£000	£000	£000	£000	£000
Executive Members								
Douglas Millican	2016	246	12	81	339	-165	142	316
	2015	242	12	82	336	47		383
Geoff Aitkenhead (v)	2016	133	14	44	191	0	101	292
	2015	175	9	59	243	42		285
Peter Farrer	2016	179	11	59	249	43	103	395
	2015	176	12	60	248	32		280
Alan Scott	2016	177	14	58	249	52	30	331
	2015	174	13	59	246	39		285
Non – Executive Members (vi)								
Chair – Lady Susan Rice (vii)	2016	83			83			83
Alan Bryce	2016	20			20			20
	2015	20			20			20
Donald Emslie	2016	25			25			25
	2015	25			25			25
Ronnie Mercer (viii)	2016	23	3		26			26
	2015	90	10		100			100
Lynne Peacock	2016	25			25			25
	2015	25			25			25
James Spowart	2016	20			20			20
	2015	20			20			20
Andrew Wyllie	2016	20			20			20
	2015	20			20			20
Matt Smith	2016	20			20			20
	2015	20			20			20
Former Members								
Chris Banks	2016	0	0		0		74	74
Douglas Reid (ix)	2015	15	0	0	15			15
<b>Total Remuneration</b>	<b>2016</b>	<b>971</b>	<b>54</b>	<b>242</b>	<b>1,267</b>	<b>-70</b>	<b>450</b>	<b>1,647</b>
	<b>2015</b>	<b>1,002</b>	<b>56</b>	<b>260</b>	<b>1,318</b>	<b>160</b>	<b>0</b>	<b>1,478</b>

## 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; plus any holiday sale backs / purchases. 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) Pension amounts are calculated in accordance with section 5.3.21 (d) of the HM Treasury Financial Reporting Manual (December 2015). Because Mr Aitkenhead is not a member of the pension scheme the £42k charge in 2015 represents a cash in lieu sum equivalent to the amount the company would have contributed to the scheme if he had been a member. The increase in transfer values and full detail of Executive Members' pension entitlement are included below in section 2.c. The decrease in Mr Millican's pension benefit reflects the impact of a tax charge associated with his accrued pension benefits resulting in a reduced future pension.
- (iv) Long-Term Incentive Plan payments covering the 5 years to March 2015 as described in the Executive Remuneration Policy. These relate to the out-performance of the regulatory settlement for the period from April 2010 to March 2015 by £122.4 million and for improving customer service, as measured by OPA to 399 points (see note 1f above). The award to Former Member, Chris Banks was for the period of his service covering April 2010 to March 2014. In addition £77k was paid to the estate of Richard Ackroyd for the period of his service from April 2010 until his death in October 2012.
- (v) Mr Aitkenhead's remuneration for 2016 reflects his 4 days per week service as Executive Director Capital Investment from 20 April 2015. His remuneration for 2015 reflects his services as Asset Management Director to 27 March 2015. Mr Aitkenhead will retire from Scottish Water on 31 July 2016.
- (vi) 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.
- (vii) Payments to Lady Susan Rice are from her appointment on 1 June 2015.
- (viii) Payments received by Ronnie Mercer until 30 June 2015.
- (ix) Payments received by Douglas Reid until his resignation on 31 December 2014.

The Committee approved a 2.0% increase in base salaries for 3 Executive Members with effect from 1 April 2016. Consequently, base salaries for 2016/17 are as follows: Peter Farrer £182,527; Douglas Millican £251,187; and Alan Scott £180,404. Fee levels for Non-executive Members, including the Chair, for 2016/17 will increase by 1.0%, also with effect from 1 April 2016.

## b. Details of benefits received 2015/16

Name	Car benefit or car allowance £000	Life assurance premium £000	Total £000
Douglas Millican	10	2	12
Geoff Aitkenhead	13	1	14
Peter Farrer	10	1	11
Alan Scott	12	1	13
Ronnie Mercer (to 30 June 2015)	3		3

### c. Total pension entitlements to end of financial year 2015/16

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 LGPS (Scotland).

	Increase/(Decrease) in accrued benefits during the year net of inflation			Accumulated total accrued benefits at 31 March 2016		Transfer Values <sup>(iv)</sup>		
	Years in Scheme	Pension £000	Lump sum £000	Pension £000	Lump sum £000	At 31 March 2016 £000	At 31 March 2015 £000	Increase in 2015/16 net of Members' own contributions and inflation £000
Douglas Millican	21.1	-5	2	62	130	1,268	1,139	102
Peter Farrer	31.7	5	3	77	166	1,471	1,353	98
Alan Scott	2.5	4	-	8	-	115	64	31

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 Local Government Pension Scheme. For pension accrued up to 31st 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.
- (v) The decrease in accrued benefits in the year for Douglas Millican reflects the impact of a tax charge associated with his accrued pension benefits, resulting in a reduced future pension.
- (vi) On 27 March 2015, Geoff Aitkenhead took the opportunity of phased retirement under terms available from the pension scheme and accrued no further pension benefits after that date. Mr Aitkenhead will retire on 31st July 2016.

### d. Percentage change in Chief Executive pay versus employees as a whole

The tables below compare the change in the Chief Executive's pay from 2014/15 to 2015/16 to employees within Scottish Water.

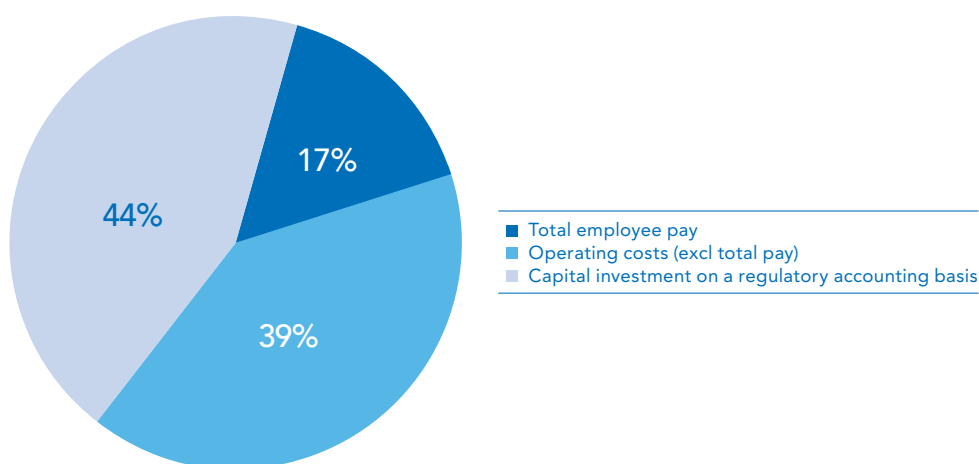
	Total excluding LTIP payment and movement in pension		Change %
	2015/16	2014/15	
Chief Executive	339.3	336.2	0.9
Employees <sup>(ii)</sup>	30.6	30.3	1.0
Ratio	11.1	11.1	-

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 other than Executive Members. The average figure for employees is affected by starters and leavers during the year, as well as by pay awards, changes in job role or promotions.

### 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 2016/17

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 2016/17 the Remuneration Committee has determined the following out-performance targets.

Measure	Description	Weighting
Financial Out-performance	Regulated Profit Before Tax and Depreciation (PBTDA) to beat the 2015 Delivery Plan for 2016/17 by £0 to £20m. 0% payable at the Delivery Plan figure; 100% at +£20m.	40% <sup>(1)</sup>
Customer Service Provision	Overall Performance Assessment (OPA) – based on maintaining a score on a sliding scale between 381 and 400 points. 0% payable below 381; 30% payable at 381; 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 85.87 points.	25%
Customer Benefit Delivery	Exceed the target Overall Measure of Delivery (OMD) of 83 points and ensure forecast capital programme cost is within the regulatory allowance <sup>(2)</sup> . Once these targets are achieved, payment depends on the number of Q&S3a and 3b projects outstanding at 31st 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.	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. 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 six 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) <sup>(1)</sup>
OPA – the average performance 2015–21 linked to leading company and best in class thresholds agreed with the Customer Forum	50%	Sliding scale	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

Note:

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

All other aspects of Executive and Non-executive Member remuneration will operate as described in the Executive Remuneration Policy.

## h. 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. However, during the year none of the Executive Members received remuneration from any such appointments.

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

**Alan Bryce**

Chair of the Remuneration Committee

25 May 2016



# Members' report

The Members present the Members' report together with the audited consolidated financial statements for the year ended 31 March 2016.

The FReM 2015/16 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 29 to 32
People	See pages 33 to 36
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 or 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 3,839 (2015: 3,683) 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 Health and Safety. Through an extensive safety awareness campaign, safety briefings and ongoing training, awareness of health and safety issues is being encouraged and increased among employees.

Further information is contained in the People section of the Annual report on pages 33 to 36.

## 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 operate 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 (2015: 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](http://www.scottishwater.co.uk)) following the approval of the Scottish Water Annual Report and Accounts 2015/16. The report for this financial year will be available from August 2016.

## Members' responsibilities

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

The Members are required by the Water Industry (Scotland) Act 2002 and directions made thereunder to prepare financial statements for each financial year which give a true and fair view of the state of affairs of Scottish Water and of its income and expenditure for that period. In preparing those financial statements, the Members are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state whether applicable accounting standards have been followed, subject to any material departures disclosed and explained in the financial statements; and
- prepare the financial statements on a going concern basis unless it is inappropriate to do so.

The Members are responsible for keeping proper accounting records, which disclose with reasonable accuracy, at any time, the financial position of Scottish Water and to enable them to ensure that the financial statements comply with statute and any financial reporting requirements. They are also responsible for taking reasonable steps to safeguard the assets of the business and to prevent and detect fraud and other irregularities.

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 auditors are 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 auditors are aware of that information.

**By order of the Board,**

Douglas Millican, Chief Executive

1 June 2016



# Financials

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# Independent auditors' report

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

We have audited the financial statements of Scottish Water and its Group for the year ended 31 March 2016 under the Water Industry (Scotland) Act 2002. The financial statements comprise the Consolidated Income Statement, the Consolidated Statement of Comprehensive Income, the Consolidated and Company Statements of Changes in Equity, the Group and Company Balance Sheets, the Group and Company Statements of Cash Flow and the related notes. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union, and as interpreted and adapted by the 2015/16 Government Financial Reporting Manual (the 2015/16 FReM).

This report is made solely to the parties to whom it is addressed in accordance with the Public Finance and Accountability (Scotland) Act 2000 and for no other purpose. In accordance with paragraph 125 of the Code of Audit Practice approved by the Auditor General for Scotland, we do not undertake to have responsibilities to members or officers, in their individual capacities, or to third parties.

## Respective responsibilities of the Board Members and auditors

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

## Scope of the audit of the financial statements

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

## Opinion on financial statements

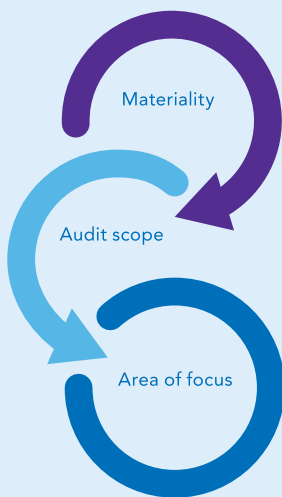
In our opinion the financial statements:

- give a true and fair view in accordance with the Water Industry (Scotland) Act 2002 and directions made thereunder by the Scottish Ministers of the state of affairs of the Group and of the Company as at 31 March 2016 and of the surplus of the Group 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 2015/16 FReM; and
- have been prepared in accordance with the requirements of the Water Industry (Scotland) Act 2002 and directions made thereunder by the Scottish Ministers.

## Opinion on regularity

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

### Overview



- Overall group materiality: £10.9m which represents 1% of total expenses.

- We performed an audit of the complete financial information of the Scottish Water Group Company and Scottish Water Business Stream reporting units.
- Our audit scope addressed 98% of the Group’s total expenses and 98% of the Group’s surplus before tax.

- Risk of fraud in expenditure and capital additions
- Household bad debt provision
- Pension obligations

## The scope of our audit and our areas of focus

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) (ISAs (UK & Ireland)).

We designed our audit by determining materiality and assessing the risks of material misstatement in the financial statements. In particular, we looked at where the Directors made subjective judgements, for example in respect of significant accounting estimates that involved making assumptions and considering future events that are inherently uncertain. As in all of our audits, we also addressed the risk of management override of internal controls, including evaluating whether there was evidence of bias by the Directors that represented a risk of material misstatement due to fraud.

The risks of material misstatement that had the greatest effect on our audit, including the allocation of our resources and effort, are identified as “areas of focus” in the table below. We have also set out how we tailored our audit to address these specific areas in order to provide an opinion on the financial statements as a whole, and any comments we make on the results of our procedures should be read in this context. This is not a complete list of all risks identified by our audit.

Area of focus	How our audit addressed the area of focus
<p><b>Risk of fraud in expenditure and capital additions</b> Refer to page 50 (Audit Committee Report), page 80 (significant accounting policies) and page 87 (notes).</p> <p>For the Scottish Water regulated business, the Directors are incentivised across a number of financial and other measures including profit and completion of capital investment programmes.</p> <p>We focused on the appropriateness of capital additions as the Directors may feel pressure to manipulate expenditure recognition by inappropriately capitalising maintenance costs to achieve planned targets on two of the incentive measures being profit and capital investment delivery.</p>	<p>We evaluated and tested the controls established by the Directors, checking that income statement expenditure and capital expenditure were correctly recorded and classified in the financial ledger. This included key authorisation controls.</p> <p>On a sample basis, we also selected items to test from the capitalised amounts and tested these by agreeing them to external completion certificates, invoices or employee timesheets as appropriate. We agreed that the amounts capitalised were appropriate.</p> <p>We tested material fixed assets transferred from assets under construction into asset categories for a period of one month before and one month after the balance sheet date. We tested that these transfers were appropriate by agreeing the assets to completion certificates and appropriate approval from within Scottish Water. We agreed that these capital programmes were complete and that the transfer of the assets was therefore appropriate.</p> <p>We also identified material manual journals being posted to reallocate costs to fixed assets from expenditure accounts, understood the rationale for the adjustments, and obtained appropriate evidence to check it was reasonable for the amounts in question to be reallocated to fixed assets.</p> <p>We agreed that there was sufficient evidence to support the re-allocation journals posted between fixed assets and expenditure accounts in the circumstances.</p>
<p><b>Household bad debt provision</b> Refer to page 50 (Audit Committee Report), page 81 (significant accounting policies) and page 106 (notes).</p> <p>As at 31 March 2016, the Scottish Water regulated business reported a household revenue debtor of £459.2m (2015: £439.4m) and a corresponding bad debt provision of £431.4m (2015: £418.6m) on household billings from all years dating back to 1996/97. Household water debt is a statutory debt recoverable from the occupier. The household billing and cash collection is performed by local councils and Scottish Water cannot influence either of these areas.</p> <p>There are a number of key assumptions included in the calculation of the bad debt provision; the most sensitive of these is the overall forecast collection rates for the most recent years (2013/14, 2014/15 and 2015/16) as these are the years with the most significant level of outstanding household debtors. We focused on this area as determining these assumptions is judgemental and changes to the assumptions could lead to a significant change in the closing bad debt provision amount.</p>	<p>We re-performed the bad debt provision calculation and reconciled the total billings, cash collected and closing debtor positions which form the basis of the provision calculation to the underlying ledger and prior year working papers.</p> <p>We agreed the closing debtor position and household revenue recorded in the year directly with the local councils which collect the household revenue and obtained 100% coverage.</p> <p>In challenging the Directors' underlying assumptions, we compared the provision to the previous years of operation, our understanding of developments in the business and external economic factors. This included understanding the trends in cash collection rates from previous years. We agreed that the assumptions used appeared reasonable.</p> <p>We performed sensitivity analysis over the forecast collection rate and considered the impact of the historical cash collection rates, and other external factors. The expected range produced by the sensitivity analysis was within the overall materiality threshold.</p> <p>We also checked the sensitivities disclosed by the Directors associated with the household bad debt provision in note 26 to the financial statements.</p> <p>This is an area which requires significant judgement and has a range of possible outcomes. From the evidence we obtained, and the sensitivity analysis performed, we did not identify any material misstatement in the household bad debt provision.</p>



Area of focus	How our audit addressed the area of focus
<p><b>Pension obligations</b>                      Refer to page 50 (Audit Committee Report), page 81 (significant accounting policies) and page 99 (notes).</p> <p>Employees of Scottish Water participate in three pension funds; North East Scotland pension fund, the Lothian pension fund and the Strathclyde pension fund which are all part of Local Government defined benefit pension schemes.</p> <p>We focused on this area because of the materiality of the obligations to the financial statements and the significant level of judgement required to be made by the Directors in determining the pension assumptions.</p> <p>The net pension liability at the year end was £90.7m (2015: £161.1m).</p> <p>The key assumptions involved in determining the net pension obligation include discount rates, inflation rates and mortality rates which are specific to Scottish Water. Changes in a number of these key assumptions can have a material impact on the calculation of the liability.</p>	<p>We obtained and read the independent actuary’s report commissioned by the Directors which reports on the assumptions and methodology used to calculate the pension liabilities and the compliance of these with relevant accounting standards. We also assessed the qualification and competence of the actuaries and found that they were suitably experienced in the sector.</p> <p>We tested the pension scheme census data information on a sample basis by agreeing the records held by the pension funds to the company’s records, as this is a key input to the overall pension liability calculation. We agreed that the census data held by the pension funds was accurate.</p> <p>We checked the proportion of pension scheme assets applied to the Scottish Water net calculation to confirmations received directly from the Local Authority pension funds at the date of the last triennial valuation (31 March 2014). There were no material differences identified between our expectation and the actual asset values reported by the actuary at 31 March 2016.</p> <p>We evaluated the Directors’ key judgements taking into account the specific characteristics of the pension schemes. We assessed the assumptions with respect to discount rate, inflation rates and mortality rates used by comparing them with our own independently formed expectations.</p> <p>In light of the above, we found the judgements made by the Directors to be reasonable and the pension assumptions to be within an acceptable range.</p>

## Materiality

The scope of our audit was influenced by our application of materiality. We set certain quantitative thresholds for materiality. These, together with qualitative considerations, helped us to determine the scope of our audit and the nature, timing and extent of our audit procedures and to evaluate the effect of misstatements, both individually and on the financial statements as a whole.

Based on our professional judgement, we determined materiality for the financial statements as a whole as follows:

<b>Overall Group materiality</b>	<b>£10.9m (2015: £10.8m).</b>
How we determined it	1% of total expenses
Rationale for benchmark applied	We believe that total expenses is an appropriate benchmark for materiality as the most significant part of the Scottish Water group is its regulated business which is a Scottish Government owned body where the level of expenditure is the most important measure.

We agreed with the Audit Committee that we would report to them misstatements identified during our audit above £200,000 as well as misstatements below that amount that, in our view, warranted reporting for qualitative reasons. There were no material unadjusted misstatements identified.

## How we tailored the audit scope

We tailored the scope of our audit to ensure that we performed enough work to be able to give an opinion on the financial statements as a whole, taking into account the geographic structure of the Group, the accounting processes and controls, and the industry in which the Group operates.

The Group has four main trading businesses located in Scotland: Scottish Water, Scottish Water Business Stream Limited, Scottish Water Horizons Limited and Scottish Water International Limited. The four main trading businesses provide households, wholesale licensed providers and businesses with regulated water, waste water and non-regulated services. The Group financial statements are a consolidation of seven reporting units, comprising the Group's trading businesses and centralised functions.

In establishing the overall approach to the Group audit, we determined the type of work that needed to be performed at the reporting units by us, as the Group engagement team, or component auditors within PwC UK operating

under our instruction. Where the work was performed by component auditors we determined the level of involvement we needed to have in the audit work at those reporting units to be able to conclude whether sufficient appropriate audit evidence had been obtained as a basis for our opinion on the Group financial statements as a whole.

Accordingly, of the Group's reporting units, we identified that Scottish Water Group Company and Scottish Water Business Stream, in our view, required an audit of their complete financial information due to their financially significant contribution to the Group's overall results. These entities accounted for 98% of the Group's total expenses. This, together with additional procedures performed at the Group level, gave us the evidence we needed for our opinion on the Group financial statements as a whole.

## Going concern

Under ISAs (UK & Ireland) we are required to report to you if we have anything material to add or to draw attention to in relation to the Directors' statement, set out on page 14, about whether they considered it appropriate to adopt the going concern basis in preparing the financial statements. We have nothing material to add or to draw attention to.

As noted in the Directors' statement, the Directors have concluded that it is appropriate to adopt the going concern basis in preparing the financial statements. The going concern basis presumes that the Group and Company have adequate resources to remain in operation, and that the Directors intend them to do so, for at least one year from the date the financial statements were signed. As part of our audit we have concluded that the Directors' use of the going concern basis is appropriate. However, because not all future events or conditions can be predicted, these statements are not a guarantee as to the Group's and Company's ability to continue as a going concern.

## Opinion on other prescribed matters

In our opinion:

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

## Other matters on which we are required to report by exception

Under the ISAs (UK & Ireland), we are required to report to you if, in our opinion, information in the Annual Report is:

- materially inconsistent with the information in the audited financial statements; or
- apparently materially incorrect based on, or materially inconsistent with, our knowledge of Scottish Water and its Group acquired in the course of performing our audit; or
- otherwise misleading.

In particular, we are required to consider whether we have identified any inconsistencies between our knowledge acquired during the audit and the boards' statement that they consider the annual report and accounts taken as a whole is fair, balanced and understandable and whether the annual report appropriately discloses those matters that we communicated to the audit committee which we consider should have been disclosed.

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

- adequate accounting records have not been kept; or
- the financial statements and the part of the Members' Remuneration Report to be audited are not in agreement with the accounting records; or
- we have not received all the information and explanations we require for our audit; or
- the Corporate Governance Statement required by The Scottish Water Governance Directions 2009 does not address the ten provisions of the UK Corporate Governance Code specified for auditor review by the Listing Rules.

We have nothing to report in respect of these matters.

## The Directors' assessment of the prospects of the Group and of the principal risks that would threaten the solvency or liquidity of the Group

**Under ISAs (UK & Ireland) we are required to report to you if we have anything material to add or to draw attention to in relation to:**

<ul style="list-style-type: none"> <li>• the Directors' confirmation on page 11 of the Annual Report, in accordance with provision C.2.1 of the Code, 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.</li> </ul>	We have nothing material to add or to draw attention to.
<ul style="list-style-type: none"> <li>• the disclosures in the Annual Report that describe those risks and explain how they are being managed or mitigated.</li> </ul>	We have nothing material to add or to draw attention to.
<ul style="list-style-type: none"> <li>• the Directors' explanation on page 14 of the Annual Report, in accordance with provision C.2.2 of the Code, 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.</li> </ul>	We have nothing material to add or to draw attention to.

### Mark Hoskyns-Abrahall

For and on behalf of PricewaterhouseCoopers LLP  
 Atria One  
 144 Morrison Street  
 Edinburgh  
 EH3 8EX  
 7 June 2016

## Consolidated income statement

### For the year ended 31 March 2016

	Note	2016 £m	2015 £m
<b>Revenue</b>	3	<b>1,196.8</b>	<b>1,187.4</b>
Cost of sales		(774.2)	(754.6)
<b>Gross surplus</b>		<b>422.6</b>	<b>432.8</b>
Administrative expenses		(138.4)	(135.5)
<b>Operating surplus</b>	3, 4	<b>284.2</b>	<b>297.3</b>
Finance income	7	3.2	2.0
Finance costs	7	(181.2)	(188.6)
<b>Surplus before taxation</b>		<b>106.2</b>	<b>110.7</b>
Taxation	8	17.8	(19.7)
<b>Surplus for the year</b>	20	<b>124.0</b>	<b>91.0</b>

## Consolidated statement of comprehensive income

### For the year ended 31 March 2016

	Note	2016 £m	2015 £m
Surplus for the year	20	124.0	91.0
Other comprehensive income:			
Items which will not subsequently be reclassified to the income statement			
Actuarial gain/(loss) on post employment benefit obligations, net of deferred taxation	22	83.9	(62.6)
<b>Total comprehensive income for the year</b>		<b>207.9</b>	<b>28.4</b>

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 2014		1,154.9	133.4	1,288.3
Surplus for the year	20	91.0	–	91.0
Other comprehensive loss:				
Actuarial loss on post employment benefit obligations, net of tax	22	(62.6)	–	(62.6)
Total comprehensive income for the year		28.4	–	28.4
<b>Balance at 31 March 2015</b>		<b>1,183.3</b>	<b>133.4</b>	<b>1,316.7</b>
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
<b>Balance at 31 March 2016</b>	20	<b>1,391.2</b>	<b>133.4</b>	<b>1,524.6</b>

## Company statement of changes in equity

	Note	Retained earnings £m	Other reserves £m	Total reserves £m
Balance at 1 April 2014		1,024.7	133.4	1,158.1
Surplus for the year	20	64.6	–	64.6
Other comprehensive loss:				
Actuarial loss on post employment benefit obligations, net of tax	22	(60.7)	–	(60.7)
Total comprehensive income for the year		3.9	–	3.9
<b>Balance at 31 March 2015</b>		<b>1,028.6</b>	<b>133.4</b>	<b>1,162.0</b>
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
<b>Balance at 31 March 2016</b>	20	<b>1,218.7</b>	<b>133.4</b>	<b>1,352.1</b>

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 2016

	Note	Group		Company	
		2016 £m	2015 £m	2016 £m	2015 £m
<b>Assets</b>					
<b>Non-current assets</b>					
Property, plant and equipment	9	5,546.5	5,483.8	5,532.3	5,469.6
Investments	10	–	–	37.6	37.6
Deferred tax asset	15	0.3	0.5	–	–
		5,546.8	5,484.3	5,569.9	5,507.2
<b>Current assets</b>					
Inventories	11	2.6	2.5	2.2	2.3
Trade and other receivables	12	136.7	154.1	67.5	83.5
Current tax asset		0.8	3.7	0.8	0.8
Cash and cash equivalents	13	539.3	491.4	368.6	345.4
		679.4	651.7	439.1	432.0
<b>Total assets</b>	<b>3</b>	<b>6,226.2</b>	<b>6,136.0</b>	<b>6,009.0</b>	<b>5,939.2</b>
<b>Liabilities</b>					
<b>Current liabilities</b>					
Trade and other payables	14	(368.6)	(385.5)	(318.6)	(338.1)
Other loans and borrowings	17	(19.3)	(18.3)	(19.3)	(18.3)
Current tax liabilities		(2.1)	–	–	–
Provisions for liabilities	16	(4.3)	(1.8)	(15.6)	(12.7)
		(394.3)	(405.6)	(353.5)	(369.1)
<b>Non-current liabilities</b>					
Trade and other payables	14	(73.0)	(68.3)	(66.6)	(61.6)
Other loans and borrowings	17	(345.3)	(364.6)	(345.3)	(364.6)
Deferred tax liabilities	15	(353.5)	(354.5)	(353.0)	(354.1)
Retirement benefit obligations	22	(110.6)	(201.4)	(112.1)	(201.4)
Provisions for liabilities	16	(1.6)	(1.6)	(3.1)	(3.1)
		(884.0)	(990.4)	(880.1)	(984.8)
<b>Total liabilities</b>		<b>(1,278.3)</b>	<b>(1,396.0)</b>	<b>(1,233.6)</b>	<b>(1,353.9)</b>
<b>Net assets</b>		<b>4,947.9</b>	<b>4,740.0</b>	<b>4,775.4</b>	<b>4,585.3</b>
<b>Equity</b>					
Government loans	18	3,423.3	3,423.3	3,423.3	3,423.3
Retained earnings	20	1,391.2	1,183.3	1,218.7	1,028.6
Other reserves		133.4	133.4	133.4	133.4
		<b>4,947.9</b>	<b>4,740.0</b>	<b>4,775.4</b>	<b>4,585.3</b>

The financial statements on pages 74 to 108 were approved by the Board of Members on 1 June 2016 and signed on its behalf by:

**Douglas Millican**  
Chief Executive

# Statements of cash flow

## For the year ended 31 March 2016

	Note	Group		Company	
		2016 £m	2015 £m	2016 £m	2015 £m
Surplus before taxation		106.2	110.7	85.3	77.4
Depreciation charges		264.2	258.1	261.9	255.4
Amortisation of grants		(1.1)	(1.0)	(1.0)	(1.0)
Surplus on disposal of property, plant and equipment		(14.8)	(10.7)	(14.7)	(10.7)
Non cash adjustment for retirement benefit obligations		11.6	(13.3)	11.1	(13.1)
Finance costs – net		178.0	186.6	179.2	187.8
<b>Operating cashflow before changes in working capital and provisions</b>		<b>544.1</b>	<b>530.4</b>	<b>521.8</b>	<b>495.8</b>
Changes in working capital and provisions:					
Decrease/(increase) in receivables		15.3	7.4	13.9	(9.2)
(Increase)/decrease in inventories		(0.1)	(0.1)	0.1	(0.2)
Increase/(decrease) in payables		1.2	(62.0)	(3.8)	(0.3)
Decrease in provisions		(3.1)	(7.9)	(2.7)	(8.9)
<b>Cash flows from operating activities</b>		<b>557.4</b>	<b>467.8</b>	<b>529.3</b>	<b>477.2</b>
Taxation received		0.2	0.7	–	–
Net cash generated from operating activities		557.6	468.5	529.3	477.2
<b>Cash flows from investing activities</b>					
Purchase of property, plant and equipment		(345.3)	(289.5)	(339.8)	(295.1)
Sale of property, plant and equipment		16.2	11.3	15.5	11.3
Government grants and other contributions		–	1.6	–	–
Infrastructure income receipts		11.9	10.3	11.9	10.3
Net cash used in investing activities		(317.2)	(266.3)	(312.4)	(273.5)
<b>Cash flows from financing activities</b>					
Repayments of loans		(323.9)	(224.4)	(323.9)	(224.4)
Proceeds from borrowings		323.9	294.4	323.9	294.4
Interest received		2.0	2.0	0.9	1.0
Interest paid		(176.2)	(182.1)	(176.3)	(182.3)
Payment of finance lease liabilities		(18.3)	(17.3)	(18.3)	(17.3)
Net cash used in financing activities		(192.5)	(127.4)	(193.7)	(128.6)
<b>Net increase in cash and cash equivalents</b>		<b>47.9</b>	<b>74.8</b>	<b>23.2</b>	<b>75.1</b>
Cash and cash equivalents at beginning of year	13	491.4	416.6	345.4	270.3
<b>Cash and cash equivalents at end of year</b>	13	<b>539.3</b>	<b>491.4</b>	<b>368.6</b>	<b>345.4</b>

# Notes to the financial statements

## For the year ended 31 March 2016

### 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 2016 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 (FRoM). The FRoM 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 2015.

- Amendments to IAS 19 'Employee Benefits';
- Annual improvements to IFRSs 2010-2012 Cycle; and
- Annual improvements to IFRSs 2011-2013 Cycle.

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';
- 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 impact on Scottish Water's financial statements of the future adoption of these new and amended standards is currently under review, but Scottish Water does not expect any of these changes to have a material impact on the results or financial position of Scottish Water.

#### 1.5 Basis of consolidation

##### a. 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 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.

### b. Jointly controlled operations

In previous years, Scottish Water Solutions 2 Limited (SWS2) had been accounted for under IFRS 11 'Joint Arrangements', as a joint operation due to the nature of the contractual agreement between Scottish Water and the other shareholder being that the parties were engaged in joint activities that did not constitute an entity carrying on a business in its own right. On that basis Scottish Water accounted directly for its own gross assets, liabilities and cash flows in the joint operations. During 2015/16, SWS2 became a fully owned subsidiary company of Scottish Water and has therefore been consolidated as such (see accounting policy 1.5a above).

## 1.6 Operating segments

Operating segments are reported in a manner consistent with the internal reporting provided to 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 2016

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
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.

## 1.16 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 Local Government Pension Scheme 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.

## 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.

## 1.20 Foreign currency transactions

Transaction 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.

# Notes to the financial statements

## For the year ended 31 March 2016

continued

### 1. Accounting policies continued

#### 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 Local Government Pension Schemes (LGPS) which are defined benefit schemes. Actuarial valuations of the schemes are carried out by the administering authorities triennially in line with LGPS 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.

	2016 £m	2015 £m
<b>Revenue</b>		
Regulated water and waste water services	1,120.4	1,096.9
Business Stream	281.6	320.0
Other trading activities	20.0	22.5
	1,422.0	1,439.4
Intercompany elimination	(225.2)	(252.0)
	<b>1,196.8</b>	<b>1,187.4</b>

During the year Business Stream generated £8.6 million (2015: £12.1 million) of non-licensed trading revenue bringing the total revenue from other trading activities for the Group to £28.6 million (2015: £34.6 million).

	2016 £m	2015 £m
<b>Operating surplus</b>		
Regulated water and waste water services	264.0	264.9
Business Stream	18.4	30.4
Other trading activities	2.0	2.7
	284.4	298.0
Intercompany elimination	(0.2)	(0.7)
	<b>284.2</b>	<b>297.3</b>

Business Stream's operating surplus from non-licensed trading activities during the year was £1.8 million (2015: £2.5 million) bringing the total operating surplus from other trading activities for the Group to £3.8 million (2015: £4.2 million).

	2016 £m	2015 £m
<b>Total assets</b>		
Regulated water and waste water services	5,970.6	5,895.5
Business Stream	201.1	191.2
Other trading activities	54.5	49.3
	<b>6,226.2</b>	<b>6,136.0</b>

	Capital additions to property, plant & equipment		Depreciation on property, plant and equipment	
	2016 £m	2015 £m	2016 £m	2015 £m
Regulated water and waste water services	325.4	317.7	261.9	255.4
Business Stream	0.7	0.9	1.7	2.0
Other trading activities	35.9	2.3	0.6	0.7
Less: intercompany transfer	(33.7)	(9.0)	–	–
	<b>328.3</b>	<b>311.9</b>	<b>264.2</b>	<b>258.1</b>

# Notes to the financial statements

## For the year ended 31 March 2016

continued

### 3. Segmental analysis continued

Revenue and operating surplus by geographical location of customers is as follows:

	Revenue		Operating surplus	
	2016 £m	2015 £m	2016 £m	2015 £m
United Kingdom	1,195.1	1,185.0	284.0	296.9
Rest of the World	1.7	2.4	0.2	0.4
	<b>1,196.8</b>	<b>1,187.4</b>	<b>284.2</b>	<b>297.3</b>

### 4. Operating surplus

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

	Note	2016 £m	2015 £m
PFI operating costs		112.9	112.1
Depreciation of property, plant and equipment	9	264.2	258.1
Surplus on sale of property, plant and equipment		(14.8)	(10.7)
Release of deferred income in relation to capital grants		(1.1)	(1.0)
Operating lease rentals		3.1	2.9
Auditors' remuneration – audit fee for audit of the company and consolidated financial statements (including £70,000 (2015: £60,000) in respect of the audit of subsidiary companies)		0.2	0.2
– other services		–	–
Research and development expenditure		1.0	1.3

## 5. Staff costs

	2016 £m	2015 £m
Wages and salaries	130.2	123.7
Social security costs	10.5	9.9
IAS 19 current service costs relating to current period	36.5	20.2
<b>Employee benefit expense</b>	<b>177.2</b>	<b>153.8</b>
Less: charged as capital expenditure	(59.6)	(45.2)
Less: seconded staff charged to Scottish Water Solutions 2 Limited	–	(0.5)
	<b>117.6</b>	<b>108.1</b>

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

	2016	2015
Regulated water and waste water services	3,485	3,315
Business Stream	274	294
Other trading activities	76	65
Scottish Water Solutions 2 Limited secondees	4	9
	<b>3,839</b>	<b>3,683</b>

## 6. Members' remuneration

Information concerning Members' remuneration, incentive schemes and pensions is detailed in the Remuneration Report on pages 53 to 62. No Member or Director had, during the year or at the end of the year, any material interest in any contract of significance in relation to Scottish Water's business.

## 7. Finance income and costs

	Note	2016 £m	2015 £m
Interest income:			
Short-term deposits		2.0	2.0
Fair value gains on financial instruments: forward currency contracts		1.2	–
<b>Finance income</b>		<b>3.2</b>	<b>2.0</b>
Interest expense:			
Government loans		(151.4)	(157.3)
Other loans		(0.2)	(0.2)
Finance lease liabilities		(22.6)	(23.6)
Interest on pension scheme net liabilities	22	(7.0)	(6.1)
Net foreign exchange losses		–	(0.1)
Fair value losses on financial instruments: forward currency contracts		–	(1.3)
<b>Finance costs</b>		<b>(181.2)</b>	<b>(188.6)</b>
<b>Net finance costs</b>		<b>(178.0)</b>	<b>(186.6)</b>

# Notes to the financial statements

## For the year ended 31 March 2016

continued

### 8. Taxation

	Note	2016 £m	2015 £m
<b>Analysis of tax (credit)/charge recognised in the income statement</b>			
Current tax: UK corporation tax		4.8	6.8
Current tax: Adjustment in respect of prior years		–	(5.6)
		4.8	1.2
Deferred tax: Origination and reversal of timing differences		15.7	18.5
Deferred tax: Effect of rate change		(38.3)	–
	15	(22.6)	18.5
<b>Total tax (credit)/charge</b>		<b>(17.8)</b>	<b>19.7</b>
The (credit)/charge for the year can be reconciled to the surplus per the income statement as follows:			
Group surplus before tax		106.2	110.7
Tax on surplus on ordinary activities at standard UK corporation tax rate of 20% (2015: 21%)		21.2	23.2
Adjustment in respect of prior years		1.1	(2.5)
Remeasurement of deferred tax due to change in UK corporation tax rate		(39.9)	(0.8)
Accounting gain with no capital gain		(2.4)	(1.7)
Depreciation on non qualifying additions		1.5	1.4
Other permanent differences		0.7	0.1
<b>Total tax (credit)/charge for the year</b>		<b>(17.8)</b>	<b>19.7</b>

	Note	Group		Company	
		2016 £m	2015 £m	2016 £m	2015 £m
<b>Tax charge/(credit) recognised directly in reserves</b>					
Deferred tax relating to:					
Pension scheme actuarial movements	15	21.8	(15.7)	21.4	(15.2)

During the year, as a result of the change in the UK corporation tax rate from 20% to 19% that will be effective from 1 April 2017 and to 18% that will be effective from 1 April 2020, deferred tax balances have been remeasured.



## 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
<b>Cost</b>						
At 1 April 2014	2,887.3	84.1	1,974.3	2,611.9	928.2	8,485.8
Additions	11.1	–	–	0.9	299.9	311.9
Disposals	(2.3)	(3.6)	–	(7.2)	–	(13.1)
Reclassifications	93.9	2.1	77.6	224.1	(397.7)	–
At 31 March 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
<b>Accumulated depreciation</b>						
At 1 April 2014	988.5	30.7	457.0	1,579.0	–	3,055.2
Charge for the year	66.9	1.7	14.8	174.7	–	258.1
Disposals	(1.7)	(3.6)	–	(7.2)	–	(12.5)
At 31 March 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
<b>Net book value</b>						
<b>At 31 March 2016</b>	<b>2,014.8</b>	<b>54.5</b>	<b>1,733.5</b>	<b>1,110.0</b>	<b>633.7</b>	<b>5,546.5</b>
At 31 March 2015	1,936.3	53.8	1,580.1	1,083.2	830.4	5,483.8

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 (2015: £1.6 million). 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 2016

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
<b>Cost</b>						
At 1 April 2014	2,871.0	84.1	1,974.3	2,595.1	920.8	8,445.3
Additions	11.1	–	–	–	306.6	317.7
Disposals	(2.3)	(3.6)	–	(7.1)	–	(13.0)
Reclassifications	92.3	2.1	77.6	224.0	(396.0)	–
At 31 March 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
<b>Accumulated depreciation</b>						
At 1 April 2014	982.9	30.7	457.0	1,566.8	–	3,037.4
Charge for the year	66.3	1.7	14.8	172.6	–	255.4
Disposals	(1.7)	(3.6)	–	(7.1)	–	(12.4)
At 31 March 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
<b>Net book value</b>						
<b>At 31 March 2016</b>	<b>2,004.0</b>	<b>54.5</b>	<b>1,733.5</b>	<b>1,107.7</b>	<b>632.6</b>	<b>5,532.3</b>
At 31 March 2015	1,924.6	53.8	1,580.1	1,079.7	831.4	5,469.6

\* 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
<b>Group and Company</b>			
<b>Cost</b>			
At 1 April 2014, 31 March 2015 and 31 March 2016	221.7	347.1	568.8
<b>Accumulated depreciation</b>			
At 1 April 2014	55.0	168.8	223.8
Charge for the year	3.7	11.6	15.3
At 31 March 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
<b>Net book value</b>			
<b>At 31 March 2016</b>	<b>159.3</b>	<b>155.1</b>	<b>314.4</b>
At 31 March 2015	163.0	166.7	329.7

## 10. Investments

	Company	
	2016 £m	2015 £m
<b>Cost and net book value</b>		
<b>At 31 March</b>	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

During the year, Scottish Water increased its shareholding in Scottish Water Solutions 2 Limited (SWS2) from 51% to 100%. Therefore, SWS2 has been consolidated as a subsidiary undertaking under IFRS 10 'Consolidated Financial Statements' in the results for the year to 31 March 2016. In the results for the year to 31 March 2015, the contractual agreement between Scottish Water and the other shareholders in SWS2 was such that the parties were engaged in joint activities, with SWS2 accounted for as a joint operation (under IFRS 11 'Joint Arrangements'). The share capital of SWS2 is £1,000.

# Notes to the financial statements

## For the year ended 31 March 2016

continued

### 10. Investments continued

Scottish Water owns shares in a further 8 companies which did not trade during the year ended 31 March 2016. 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	
	2016 £m	2015 £m	2016 £m	2015 £m
Raw materials and consumables	2.8	2.7	2.4	2.5
Less provision held	(0.2)	(0.2)	(0.2)	(0.2)
	<b>2.6</b>	<b>2.5</b>	<b>2.2</b>	<b>2.3</b>

All inventories will be recovered within 12 months.

## 12. Trade and other receivables

	Note	Group		Company	
		2016 £m	2015 £m	2016 £m	2015 £m
Trade receivables	26	527.7	513.7	466.5	449.7
Less provision for impairment of trade receivables	26	(449.7)	(437.3)	(434.4)	(422.0)
Net trade receivables		78.0	76.4	32.1	27.7
Other receivables		29.3	39.8	26.8	36.5
Prepayments and accrued income		29.4	32.9	8.1	8.4
Amounts due from subsidiaries		–	–	0.5	5.9
Amounts due from jointly owned operations		–	5.0	–	5.0
		<b>136.7</b>	<b>154.1</b>	<b>67.5</b>	<b>83.5</b>

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

	Group		Company	
	2016 £m	2015 £m	2016 £m	2015 £m
Balance at 1 April	437.3	417.8	422.0	402.4
Charge for the year	16.9	23.2	12.8	19.8
Amounts written down during the year	(4.5)	(3.7)	(0.4)	(0.2)
Balance at 31 March	449.7	437.3	434.4	422.0

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

## 13. Cash and cash equivalents

	Group		Company	
	2016 £m	2015 £m	2016 £m	2015 £m
Cash at bank and in hand	305.3	247.4	174.6	151.4
Short-term bank deposits	234.0	244.0	194.0	194.0
<b>Cash and cash equivalents per the statement of cash flows</b>	<b>539.3</b>	<b>491.4</b>	<b>368.6</b>	<b>345.4</b>

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 2016

continued

### 14. Trade and other payables

	Note	Group		Company	
		2016 £m	2015 £m	2016 £m	2015 £m
<b>Current</b>					
Trade payables		9.2	20.3	7.9	18.6
Non trade payables and accruals		99.4	119.7	88.1	119.1
Accruals		166.9	157.3	143.6	135.7
Payments received in advance		72.0	66.3	46.8	37.8
Other payables		12.8	13.3	0.8	0.7
Deferred income		5.1	4.6	1.4	1.3
Derivative financial liabilities	26	0.1	1.0	0.1	1.0
Other taxes and social security		3.1	3.0	2.8	2.7
Amounts due to subsidiaries		–	–	27.1	21.2
		<b>368.6</b>	<b>385.5</b>	<b>318.6</b>	<b>338.1</b>
<b>Non-current</b>					
Payments received in advance		54.3	47.8	54.3	47.8
Deferred income		18.7	20.2	12.3	13.5
Derivative financial liabilities	26	–	0.3	–	0.3
		<b>73.0</b>	<b>68.3</b>	<b>66.6</b>	<b>61.6</b>

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
<b>Group</b>						
At 1 April 2014		435.7	(27.4)	(48.9)	(8.2)	351.2
Charge/(credit) to income statement	8	16.9	2.8	(0.4)	(0.8)	18.5
Credit to reserves	22	–	(15.7)	–	–	(15.7)
At 31 March 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
<b>At 31 March 2016</b>		<b>415.4</b>	<b>(19.9)</b>	<b>(34.5)</b>	<b>(7.8)</b>	<b>353.2</b>
<b>Company</b>						
At 1 April 2014		435.3	(27.8)	(48.5)	(8.2)	350.8
Charge/(credit) to income statement		17.1	2.7	(0.8)	(0.5)	18.5
Credit to reserves	22	–	(15.2)	–	–	(15.2)
At 31 March 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
<b>At 31 March 2016</b>		<b>415.3</b>	<b>(20.2)</b>	<b>(34.5)</b>	<b>(7.6)</b>	<b>353.0</b>

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	
	2016 £m	2015 £m	2016 £m	2015 £m
Deferred tax assets	(0.3)	(0.5)	–	–
Deferred tax liabilities	353.5	354.5	353.0	354.1
<b>At 31 March</b>	<b>353.2</b>	<b>354.0</b>	<b>353.0</b>	<b>354.1</b>

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 £172 million (2015: £155 million) for both the Company and the Group. No tax is expected to be payable in this regard.

# Notes to the financial statements

## For the year ended 31 March 2016

continued

### 16. Provisions for liabilities

Group	Restructure provision £m	Income uncertainty provision £m	Other £m	Total £m
At 1 April 2014	2.4	–	0.7	3.1
Charged to the income statement	–	1.7	0.7	2.4
Utilised during the year	(1.9)	(0.1)	(0.1)	(2.1)
At 31 March 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)
<b>At 31 March 2016</b>	<b>1.5</b>	<b>3.2</b>	<b>1.2</b>	<b>5.9</b>

#### Company

At 1 April 2014	2.4	13.4	0.7	16.5
Charged to the income statement	–	2.7	0.7	3.4
Utilised during the year	(1.9)	(2.1)	(0.1)	(4.1)
At 31 March 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)
<b>At 31 March 2016</b>	<b>1.5</b>	<b>16.0</b>	<b>1.2</b>	<b>18.7</b>

Analysis of total provisions	Group		Company	
	2016 £m	2015 £m	2016 £m	2015 £m
Current	4.3	1.8	15.6	12.7
Non-current	1.6	1.6	3.1	3.1
	<b>5.9</b>	<b>3.4</b>	<b>18.7</b>	<b>15.8</b>

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 2016, although the final settlements for the 2012/13 and 2013/14 financial years have been agreed, they had not been processed through the CMA before the year end. It is expected that the provision will be utilised during 2017.

The other provision of £1.2 million relates primarily to onerous property rental costs.



## 17. Other loans and borrowings

	2016 £m	2015 £m
<b>Group and Company</b>		
<b>Current</b>		
Non-government loans	–	–
Obligations under finance leases	19.3	18.3
	<b>19.3</b>	<b>18.3</b>
<b>Non current</b>		
Non-government loans	1.0	1.0
Obligations under finance leases	344.3	363.6
	<b>345.3</b>	<b>364.6</b>
<b>Total</b>		
Non-government loans	1.0	1.0
Obligations under finance leases	363.6	381.9
	<b>364.6</b>	<b>382.9</b>

### (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 2016	–	–	1.0	–	1.0
At 31 March 2015	–	–	1.0	–	1.0

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

	Book value 2016 £m	Book value 2015 £m	Fair value 2016 £m	Fair value 2015 £m
Non-government loans	1.0	1.0	1.4	1.4

# Notes to the financial statements

## For the year ended 31 March 2016

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	
	2016 £m	2015 £m	2016 £m	2015 £m
Amounts payable:				
Within one year	40.9	40.9	19.3	18.3
Between one and 5 years	161.7	163.4	111.0	107.1
After 5 years	346.2	385.4	233.3	256.5
Present value of minimum lease payments including finance charges	548.8	589.7		
Less future finance charges	(185.2)	(207.8)		
Present value of minimum lease payments	363.6	381.9	363.6	381.9

#### 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	
	2016 £m	2015 £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	303.9	76.0	265.1	381.8	1,642.9	2,669.7
Scottish Consolidated Fund – subsidiaries	–	–	–	–	–	–
Scottish Consolidated Fund – SW Group	303.9	76.0	265.1	381.8	1,642.9	2,669.7
National Loans Fund	24.0	30.0	91.0	283.4	247.5	675.9
Public Works Loan Board	14.9	16.7	25.7	15.1	5.3	77.7
<b>At 31 March 2016</b>	<b>342.8</b>	<b>122.7</b>	<b>381.8</b>	<b>680.3</b>	<b>1,895.7</b>	<b>3,423.3</b>
At 31 March 2015	323.9	118.9	370.2	687.2	1,923.1	3,423.3

### b. Fair values

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

	Book value 2016 £m	Book value 2015 £m	Fair value 2016 £m	Fair value 2015 £m
Scottish Consolidated Fund	2,669.7	2,617.2	3,379.3	3,297.4
National Loans Fund	675.9	689.9	936.3	964.4
Public Works Loan Board	77.7	116.2	99.1	143.8
	<b>3,423.3</b>	<b>3,423.3</b>	<b>4,414.7</b>	<b>4,405.6</b>

# Notes to the financial statements

## For the year ended 31 March 2016

continued

### 19. Analysis of net debt

	Note	As at 1 April 2015 £m	Increase in cash £m	Movement in debt £m	As at 31 March 2016 £m
<b>Group</b>					
Cash and cash equivalents	13	491.4	47.9	–	539.3
Government loans	18	(3,423.3)	–	–	(3,423.3)
Other loans	17	(1.0)	–	–	(1.0)
<b>Net debt</b>		<b>(2,932.9)</b>	<b>47.9</b>	<b>–</b>	<b>(2,885.0)</b>
<b>Company</b>					
Cash and cash equivalents	13	345.4	23.2	–	368.6
Government loans	18	(3,423.3)	–	–	(3,423.3)
Other loans	17	(1.0)	–	–	(1.0)
<b>Net debt</b>		<b>(3,078.9)</b>	<b>23.2</b>	<b>–</b>	<b>(3,055.7)</b>

### 20. Reserves

	Note	Retained earnings excluding actuarial gains £m	Actuarial gains/ (losses) on pension obligations £m	Retained earnings including actuarial gains/(losses) £m
<b>Group</b>				
At 1 April 2014		1,265.0	(110.1)	1,154.9
Retained surplus for the year		91.0	–	91.0
Actuarial loss, net of deferred taxation	22	–	(62.6)	(62.6)
<b>At 31 March 2015</b>		<b>1,356.0</b>	<b>(172.7)</b>	<b>1,183.3</b>
Retained surplus for the year		124.0	–	124.0
Actuarial gain, net of deferred taxation	22	–	83.9	83.9
<b>At 31 March 2016</b>		<b>1,480.0</b>	<b>(88.8)</b>	<b>1,391.2</b>
<b>Company</b>				
At 1 April 2014		1,135.6	(110.9)	1,024.7
Retained surplus for the year		64.6	–	64.6
Actuarial loss, net of deferred taxation	22	–	(60.7)	(60.7)
<b>At 31 March 2015</b>		<b>1,200.2</b>	<b>(171.6)</b>	<b>1,028.6</b>
Retained surplus for the year		107.8	–	107.8
Actuarial gain, net of deferred taxation	22	–	82.3	82.3
<b>At 31 March 2016</b>		<b>1,308.0</b>	<b>(89.3)</b>	<b>1,218.7</b>

## 21. Results of Scottish Water (the Company)

Of the results for the financial year, a retained surplus of £107.8 million (2015: £64.6 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 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% (2015: 19.3%), 21.8% (2015: 24.0%) and 22.9% (2015: 19.3%) 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 2016 by a qualified independent actuary, to take account of the requirements of IAS 19.

### The major assumptions used by the actuaries were:

	2016 %	2015 %
Rate of increase in pensionable salaries	2.3	2.3
Rate of increase in pensions payment	2.3	2.3
Discount rate	3.6	3.3
CPI inflation rate	2.3	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 2016			
Male	22.1	22.3	22.4
Female	24.7	23.9	23.8
Retiring at 31 March 2036			
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. 2.6%	Increase/decrease by c. £39 million
Discount rate	+/- 0.5% per annum	Decrease/increase by c. 9.7%	Decrease/increase by c. £139 million
CPI Inflation rate	+/- 0.5% per annum	Increase/decrease by c. 7.0%	Increase/decrease by c. £100 million
Longevity	Increase life expectancy by 1 year	Increase by c. 3.0%	Increase by c. £43 million

# Notes to the financial statements

## For the year ended 31 March 2016

continued

### 22. Pensions continued

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

	Group		Company	
	2016 £m	2015 £m	2016 £m	2015 £m
Total fair value of assets	1,318.6	1,284.0	1,295.5	1,263.3
Present value of scheme liabilities	(1,429.2)	(1,485.4)	(1,407.6)	(1,464.7)
<b>Gross pension liability</b>	<b>(110.6)</b>	<b>(201.4)</b>	<b>(112.1)</b>	<b>(201.4)</b>
Related deferred tax asset	19.9	40.3	20.2	40.3
<b>Net pension liability</b>	<b>(90.7)</b>	<b>(161.1)</b>	<b>(91.9)</b>	<b>(161.1)</b>

Scheme assets are stated at their bid values.

#### Reconciliation of opening and closing retirement benefit liabilities and assets

	Group		Company	
	2016 £m	2015 £m	2016 £m	2015 £m
<b>Movements in liabilities during the year:</b>				
Opening value of total liabilities	(1,485.4)	(1,299.2)	(1,464.7)	(1,285.0)
Total service cost	(37.0)	(20.6)	(35.1)	(19.3)
Interest on pension scheme liabilities	(48.3)	(55.5)	(47.6)	(54.9)
Contributions by members	(7.7)	(7.3)	(7.2)	(6.8)
Actuarial gain/(loss)	104.8	(144.5)	102.7	(140.4)
Benefits paid	44.4	41.7	44.3	41.7
<b>Closing value of total liabilities</b>	<b>(1,429.2)</b>	<b>(1,485.4)</b>	<b>(1,407.6)</b>	<b>(1,464.7)</b>
<b>Movement in assets during the year:</b>				
Opening fair value of total assets	1,284.0	1,162.0	1,263.3	1,145.7
Interest on pension scheme assets	41.3	49.4	40.6	48.7
Contributions by members	7.7	7.3	7.2	6.8
Contributions by the employer	29.1	40.8	27.7	39.3
Actuarial gain	0.9	66.2	1.0	64.5
Benefits paid	(44.4)	(41.7)	(44.3)	(41.7)
<b>Closing fair value of assets</b>	<b>1,318.6</b>	<b>1,284.0</b>	<b>1,295.5</b>	<b>1,263.3</b>
<b>Gross deficit in the schemes at 31 March</b>	<b>(110.6)</b>	<b>(201.4)</b>	<b>(112.1)</b>	<b>(201.4)</b>

## 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	
		2016 £m	2015 £m	2016 £m	2015 £m
Actual return on pension scheme assets		42.2	115.6	41.6	113.2
<b>Actuarial gain/(loss) in other comprehensive income in the consolidated statement of comprehensive income</b>					
<b>Gross actuarial gain/(loss) recognised in the pension fund</b>		<b>105.7</b>	<b>(78.3)</b>	<b>103.7</b>	<b>(75.9)</b>
Deferred tax movement	15	(21.8)	15.7	(21.4)	15.2
<b>Net actuarial gain/(loss) recognised in other comprehensive income in the consolidated statement of comprehensive income</b>	<b>20</b>	<b>83.9</b>	<b>(62.6)</b>	<b>82.3</b>	<b>(60.7)</b>

### Amounts recognised in the consolidated income statement

	Note	2016 £m	2015 £m
Total service cost		37.0	20.6
Interest cost on pension scheme net liabilities	7	7.0	6.1
		44.0	26.7

The unpaid contributions outstanding at the year end included in other payables (note 14) was £0.8 million (2015: £0.6 million). It is estimated that Scottish Water will make contributions of £23.0 million to the pension funds in financial year 2016/17.

# Notes to the financial statements

## For the year ended 31 March 2016

continued

### 22. Pensions continued

#### History of experienced gains and losses

Group	2016 £m	2015 £m
<b>Difference between the expected and actual return on scheme assets:</b>		
Amount	0.9	66.2
Fair value of assets	1,318.6	1,284.0
<b>Experienced gains/(losses) on scheme liabilities:</b>		
Amount	20.4	58.1
Present value of liabilities	1,429.2	1,485.4
<b>Changes in assumptions underlying the present value of scheme liabilities:</b>		
Amount	84.4	(202.6)
<b>Total variance between pension fund actuarial assumptions and actual experience</b>	<b>105.7</b>	<b>(78.3)</b>
Gross deficit in the schemes at 31 March	(110.6)	(201.4)
<b>Company</b>		
<b>Difference between the expected and actual return on scheme assets:</b>		
Amount	1.0	64.5
Fair value of assets	1,295.5	1,263.3
<b>Experienced gains/(losses) on scheme liabilities:</b>		
Amount	20.3	57.5
Present value of liabilities	1,407.6	1,464.7
<b>Changes in assumptions underlying the present value of scheme liabilities:</b>		
Amount	82.4	(197.9)
<b>Total variance between pension fund actuarial assumptions and actual experience</b>	<b>103.7</b>	<b>(75.9)</b>
Gross deficit in the schemes at 31 March	(112.1)	(201.4)



## 23. Commitments

### a. Capital commitments

The Group has contracted capital commitments of £331.9 million (2015: £138.9 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:

	2016 £m	2015 £m
Within one year	2.8	2.0
Between one and 5 years	6.9	8.2
After 5 years	16.0	17.2
	25.7	27.4

## 24. 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

## For the year ended 31 March 2016

continued

### 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):

	2016 £m	2015 £m
Wholesale water and waste water services to Business Stream	225.2	252.0
Sale of waste water services to other subsidiaries	1.1	2.3
Seconded staff costs charged to subsidiaries	3.7	2.8
Other operating costs charged to subsidiaries	3.3	3.7
Purchase of property, plant and equipment from subsidiaries (note 3)	33.7	9.0

#### 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.

## 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

## For the year ended 31 March 2016

continued

### 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	
	2016 £m	2015 £m	2016 £m	2015 £m
Trade receivables per note 12:				
Trade receivables	527.7	513.7	466.5	449.7
Less provision for impairment of trade receivables	(449.7)	(437.3)	(434.4)	(422.0)
Net trade receivables	78.0	76.4	32.1	27.7
Analysed between:				
Household receivables	459.2	439.4	459.2	439.4
Less provision for impairment	(431.4)	(418.6)	(431.4)	(418.6)
Net household receivables	27.8	20.8	27.8	20.8
Business customer receivables	68.5	74.3	7.3	10.3
Less provision for impairment	(18.3)	(18.7)	(3.0)	(3.4)
Net business customer receivables	50.2	55.6	4.3	6.9

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 2016 trade receivables in respect of household customers totalled £459.2 million with a provision of £431.4 million (2015: £439.4 million and £418.6 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. £1.0m
In-year household bad debt provision charge	+/- 0.10%	Increase/decrease by c. £0.8m

As at 31 March 2016 trade receivables from business customers totalled £68.5 million (2015: £74.3 million). The ageing analysis of trade receivables from business customers and the related provisioning is as follows:

Group	Total £m	Current £m	<3 months overdue £m	3-12 months overdue £m	>12 months overdue £m
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	–
Gross receivable	74.3	48.8	5.8	9.1	10.6
Provision	(18.7)	(0.2)	(2.0)	(5.9)	(10.6)
Net trade receivable as at 31 March 2015	55.6	48.6	3.8	3.2	–

## 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	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	–	–
Gross receivable	10.3	7.1	1.0	0.8	1.4
Provision	(3.4)	(0.2)	(1.0)	(0.8)	(1.4)
Net trade receivable as at 31 March 2015	6.9	6.9	–	–	–

### 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 2016 were £2.5 million (2015: £13.0 million). The maturity dates of the outstanding contracts are between April 2016 and May 2017.

	Note	2016 £m	2015 £m
Derivative financial liabilities			
Foreign exchange contracts: Total		0.1	1.3
Less non-current portion	14	–	0.3
Current portion	14	0.1	1.0

The forward currency contracts are measured, subsequent to initial recognition, at fair value. The fair value is determined using valuation techniques that utilise observable inputs, with the key assumption being the exchange rate for GBP:Euro. Based on the degree to which the fair value is observable, this valuation method is classified as Level 2. The fair value level definitions are summarised below.

- Level 1: Quoted prices (unadjusted) in active markets for identical assets or liabilities.
- Level 2: Inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices).
- Level 3: Inputs for the asset or liability that are not based on observable market data.

	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Derivative financial liabilities				
Foreign exchange contracts	–	0.1	–	0.1

# Notes to the financial statements

## For the year ended 31 March 2016

continued

### 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.

# 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	Amlaird & Corsehouse strategic main project Shieldhall tunnel project	£11.5m £32.6m
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*	£50,000
		H2-O programme for primary schools in partnership with the Scottish Professional Football League Trust*	£20,000
		IWRA World Water Congress*	£10,000
Gifts	£100	None	–

\* Funded by Scottish Water Horizons Holdings Limited

# 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 on this page.

## 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](http://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.

