Scottish Water

Always serving Scotland

Annual Report and Accounts 2011/12

Serving Scotland for ten years

Our vital role

Scottish Water is always serving Scotland, providing vital services which are essential to daily life. We continue to deliver excellent value for our customers.

We provide clean, safe and high quality drinking water to 2.4 million households and 152,000 business premises across Scotland. Every day we provide 1.3 billion litres of clear, fresh drinking water and take away 839 million litres of waste water, which we treat before returning to the environment.

We are delivering one of the largest investment programmes in the UK water industry during 2010-15. This is at a time when our average household charge is the lowest in the UK. In 2012/13 the average household charge in Scotland is £52 lower per annum than the average household charge in England and Wales.

The quality of our drinking water is at an all-time high and our investment is delivering the benefits Scotland needs and supporting thousands of construction jobs.

Your charges go to maintaining and improving:

29,762
miles of water pipes

31,477
miles of sewer pipes

1,863
waste water treatment works

266
water treatment works

1.3 billion
litres of high quality drinking water every day

Contents

Customers receiving record levels of service

Our Overall Performance Assessment (OPA) reached a record score of 355 points in 2011/12, out-performing our Delivery Plan target by 12%.

Delivering benefits across Scotland

Scottish Water delivered £491 million of investment in 2011/12 and out-performed our Delivery Plan target by 20%, improving drinking water supplies, protecting the environment and supporting the economy across Scotland.

Highest drinking water quality

The percentage of samples of drinking water complying with strict quality standards is at its highest level of 99.86%.

Leakage reduced further

During 2011/12 we have, on average, reduced leakage by a further 70 million litres of water per day across Scotland.

Lowest bills in the UK

For the fourth year running the average combined household charge in 2012/13 is £324, the equivalent of less than £1 a day[1]. This is £52 lower than the average charge south of the border.

Contributing to a greener Scotland

Our latest carbon footprint shows that our use of grid electricity has fallen by 4%[2]. We continue to have the lowest emissions per megalitre of drinking water in the UK water industry.

1 The average household is between Council Tax Band B and Band C and has a combined bill of less than £1 a day. Individual water supply and waste water collection charges are less than £1 a day for all households (except for the individual waste water collection charges for Band H households).

2 In 2009/10 our grid electricity consumption was 461GWh (gigawatt/hour), which was reduced to 441GWh in 2010/11.

"Scottish Water is a high performing Scottish business because we never lose sight of our role in serving Scotland and all of our customers."

Ronnie Mercer
Chair

Scottish Water is 10 years old. Formed in 2002 we have made real achievements in our first decade to deliver the investment Scotland needs and the improvements in our service that our customers deserve.

As we reduced real operating costs by 40%, we ensured that at the same time we improved our service by putting our customers at the heart of the business. This results in the average household charge in Scotland being the lowest in the whole of the UK water industry, while service levels improve dramatically.

These achievements are the foundation for everyone involved in Scottish Water as we continue this rapid progress in transforming Scotland's water infrastructure to achieve our vision of becoming Scotland's most valued and trusted business.

In this annual report for 2011/12 Scottish Water has delivered another excellent performance. This is the second year of our regulatory period 2010-15 and another stage in our journey to match the best in the UK water industry.

Scottish Water is a billion pound business and 2011/12 saw the growth of a number of new business units which will help us to thrive as a dynamic modern business in the spirit of a hydro nation and bring value to our customers and to Scotland.

Scottish Water Horizons, a wholly owned subsidiary of Scottish Water, is driving forward our green agenda, leading the way with a sizeable market share of biodegradable food waste management in the central belt of Scotland, developing renewables and leveraging commercial value from our assets to contribute towards a greener and better connected Scotland. The appointment of a new Managing Director of this subsidiary will further enhance our drive to become a low carbon business as we look at a range of renewables from hydro power, to wind farms, recycling and energy production.

Scottish Water Business Stream, formed in 2006 to compete in the retail market, is delivering real benefits to business consumers with more of its retail customers now paying less than they would have done without competition. Scottish Water acts as wholesaler in the non-household market.

We saw the launch of Scottish Water International which has already secured contracts, in partnership, in North America, the Middle East and Europe. Scottish Water has matured into a respected high performing utility and is now sharing its in-demand expertise across the world.

As we continue to grow the business and add value to Scotland both in its economy and reputation, we are committed to ensuring that our service to our customers in communities the length and breadth of the country continues to improve.

We work closely with Consumer Focus Scotland and listen to our customers to understand what matters to them, to help us decide the priorities for the water industry.

Later this year we will launch the biggest consultation ever carried out by a water company to gather the views of our customers as we look 25 years ahead to 2040. Just what sort of service will our customers want in the future? We will be asking our customers to work with us to decide the priorities for future investment with a changing climate and demand for water resources.

We remain committed to helping to create career opportunities in the water industry through our modern apprentice, graduate and work experience programmes.

Scottish Water today is a very different business from 10 years ago. It is a high performing Scottish business with a growing reputation and new horizons in the spirit of a hydro nation. But we will never lose sight of our role in serving Scotland and all of our customers. I am confident that we will continue to out-perform the expectations others have of us and deliver for our customers and Scotland.

I would like to thank my Board, management team and staff for their continued commitment to the business and our customers. I would personally like to thank David Gray for his long and valuable service to the Board of Scottish Water.

"2011/12 saw another year of strong performance by the business, the second year of our five year regulatory programme."

Richard Ackroyd
Chief Executive

The past year has been one of real achievement for Scottish Water, delivering benefits for our customers and for Scotland.

Drinking water quality is at an all-time high in Scotland and hundreds of thousands of our customers enjoyed clearer, fresher water coming through their taps in the last year.

In Edinburgh and parts of Midlothian up to 450,000 people are now receiving an improved quality drinking water supply with the switch on of the new Glencorse Water Treatment Works, near Edinburgh, which blends into the neighbouring environment and provides a sustainable blueprint for the future.

In and around the Highland resort of Aviemore visitors and residents can enjoy the clearer, fresher and reliable water supply from the newly built Blackpark Water Treatment Works on the outskirts of the community.

In 2011/12 we delivered £491 million worth of investment, part of the £2.5 billion investment in this regulatory period 2010-15. This investment programme supports thousands of construction jobs across Scotland.

Customer service is measured in a number of ways called the Overall Performance Assessment (OPA) score. This looks at 17 measures such as time without a normal water supply, water pressure, water quality and pollution incidents. We have outperformed our regulatory target on OPA and we are working towards being in the top quarter of the leading water companies in the UK.

To reinforce our commitment to listen to our customers we will carry out a major consultation to allow customers to tell us what is important to them in our investment plans for the future, from 2015. We are also looking at innovative and educational ways to engage with our customers now and future generations to raise awareness of the value of water in daily life.

We have reduced the amount of water wasted from Scottish Water pipes and we are encouraging all our customers to work with us to ensure we all use water wisely for the sake of the environment.

All this comes at a time when household water charges remain at the same level as they have for the last three years. The average household charge at £324 is the lowest in the whole of the UK water industry, achievable through our continued efficiency.

While it is right to help our customers in these financially challenging times by freezing charges the Board of Scottish Water is of the view that, in the future, this issue will need to be balanced with ensuring that Scottish Water has adequate revenues to maintain the programme of proper maintenance of our assets. We maintain a close dialogue with the Scottish Government over the amount of monies they can lend to Scottish Water and we welcome their aspiration for Scottish Water to be funded by issuing bonds in the markets.

Surplus before tax reduced by £39 million to £107 million reflecting primarily the benefits of around £34 million to household customers of freezing household charges at a time when the Retail Price Index was 4.5%.

The water industry, including Scottish Water, is already facing up to a new set of challenges and opportunities, not least, climate change impacts and a need for more innovation within the industry. Last winter we faced challenges with extreme wind and storms. I want to reassure our customers that we prepare for all eventualities such as droughts or extreme weather and our teams go out in any conditions to ensure they provide the service our customers expect.

Our employees are the backbone of the business and give confidence as we grow and mature that Scottish Water will continue to make Scotland proud, as we fulfil our vision of becoming Scotland's most valued and trusted business, one that we can all be proud of.

Serving Scotland for 10 years

The Water Industry Commission for Scotland has described Scottish Water as the fastest improving water company in the UK.

In our first 10 years we have grown into a financially strong business delivering first class water services to our customers to achieve our goal of becoming Scotland's most valued and trusted business, one that we can all be proud of.

1 Customer service

We have improved customer service levels. Our Overall Performance Assessment (OPA) score has more than doubled since 2002[1].

2 Keeping customer charges low

In 2012/13 the average household charge is the lowest in the UK water industry, £52 lower than the average in England and Wales. This is a transformation from 2002/03 when the average household charge in Scotland was £30 higher than in England and Wales.

3 Investment across scotland

In the last 10 years we have invested a total of £5.5 billion. This has delivered investment across Scotland to improve drinking water quality and protect the natural environment.

4 Improving drinking water quality

Our compliance with strict water quality standards has improved from 99.44% of all samples meeting the required criteria in 2002 to 99.86% in 2011. Since 2002 we have improved 4,876 miles of water pipes.

[1] OPA score increased from 39% of the maximum points in 2002 to 85% of our maximum possible points in 2011/12.

5 Waste water treatment

We are helping to protect the natural environment of Scotland. Our waste water treatment works compliance has improved by 87% since 2002.

6 Leakage reduction

Leakage has been reduced from 1,132 million litres of water a day in 2002/03 to 629 million litres a day in 2011/12 – a reduction of over 44%.

7 Improving water pressure

We have reduced the number of households on our low pressure register by 90%, from 14,942 properties in 2002/03 to 1,542 in 2011/12 – and we continue to work to improve pressure for the remaining customer properties on the low pressure register.

8 Reducing risk of flooding

The number of customer properties affected by internal sewer flooding has fallen by 61% since 2002/03 from 710 to 277 in 2011/12. In addition, we have reduced the number of general sewer flooding incidents, which do not affect customer properties, by 61% from 551 to 213.

9 Resilience to climate change

We have made significant progress in renewable energy provision since 2002 and are now producing over 5% of our own annual energy demand.

10 Keeping costs low

Since 2002 we have reduced our real operating costs by around 40% through using new cost-saving technologies, rationalising our asset base and incorporating more innovative and efficient ways of working.

Always serving Scotland

Scottish Water delivers clear, fresh drinking water, safely treats waste water and helps protect the environment across Scotland – every day of the year. We do this in an affordable and sustainable way while supporting economic growth.

- We aim to deliver the very highest standards of service, ensuring our customers turn on their taps to enjoy the highest quality drinking water Scotland has ever had, while we protect and enhance the natural environment of rivers, lochs and beaches across the country.
- We will continue to deliver the investment Scotland needs, and will do so efficiently while building innovation into the business.
- We aim to deliver the best value for money in the UK water industry.
- We will continue the transformation of the water industry in Scotland taking into account the new challenges of a changing climate and becoming a low carbon business.

This annual report highlights our success in achieving these ambitions during 2011/12 and our plans to help us deliver our vision in the future.

Scottish Water's vision is to be Scotland's most valued and trusted business, one that we can all be proud of. This is supported through:

Serving

Ensuring the customer is at the heart of our business. Always delivering a positive customer experience is a key priority and everything we do links to improving the service and the value we provide to our customers.

Responsible

Always doing the right thing for Scotland. Our investment supports the Scottish economy, benefits our customers, visitors and local communities the length and breadth of Scotland and helps protect public health and the environment.

Committed

Ensuring we have the right people, trained, proud to work for Scottish Water and committed to improving the service for our customers across Scotland. The health and safety of our people, the contractors who work for us and our customers is built into everything we do. Ensuring we are a Scottish business that people respect.

Leading

As we work to become a low carbon business we will ensure that we will be innovative in delivering service and value for our customers, while tackling climate change and taking action to protect the environment for today's customers and future generations.

Growing

Delivering the investment to help ensure our customers continue to enjoy clear, fresh drinking water from their taps and protect our environment. We will also help communities across Scotland grow and prosper and ensure that we look at innovative and creative ways to improve service and value for our customers.

Strong

We will maintain our financial strength, continue to explore innovative ways to help deliver the best value for money for our customers and protect Scottish Water for a sustainable future.

Our objectives for 2010-15

Scottish Ministers set objectives for Scottish Water for the period 1 April 2010 to 31 March 2015. This annual report looks at the second year of the delivery period 2010-15.

We are continuing to improve the level of service to our customers and our delivery plan details the specific outputs required. These were agreed with the Drinking Water Quality Regulator (DWQR), the Scottish Environment Protection Agency (SEPA) and WaterWatch Scotland[1].

These outputs will continue to deliver real benefits to our customers across Scotland – clearer, fresher drinking water at their taps; protecting the natural environment and improving service levels.

To individual customers this could mean reducing the risk of low pressure which can affect the water-using appliances in their homes, addressing odour issues from waste water treatment works in their local area or reducing the number of customer properties at risk of external flooding from overloaded sewers.

We will deliver these benefits to our customers by improving operational practices and processes, maintaining our existing assets and investing in new or enhanced assets.

Across Scotland, we are listening to the needs of communities and delivering investment in the water and waste water networks where it is most needed.

Our objectives for 2010-15 include:

- Improving the quality, look and taste of drinking water for around 950,000 customers through a mixed programme of cleaning, upgrading or replacing 2,816 miles of water mains.
- Investing £1.1 billion to ensure, as a minimum, that the standards of service provided to customers are maintained across Scotland.
- Continuing to service new development across Scotland, addressing water and waste water capacity to enable further growth.
- Continuing to protect Scotland's natural environment by enhancing the waste water treatment processes at 182 works and making improvements at 223 unsatisfactory intermittent discharges to rivers, lochs and coastal waters.
- Reducing odour issues at four waste water treatment works.
- Creating and maintaining a register of all properties affected by external sewer flooding.
- Reducing the number of customer properties that have problems with poor water pressure.
- Improving the water supply and demand balance to provide security of supply for over 800,000 customers.

We will take steps to deliver a lower carbon water service by reducing our demand for energy, driving energy efficiency and developing our renewable energy capacity.

Delivering these objectives continues to improve the water environment and water quality in Scotland and provide real value for money for our customers.

[1] Responsibilities of the former WaterWatch Scotland's customer representation function transferred to Consumer Focus Scotland on 16 August 2011.

No increase in household bills

less than £1 a day[1]

On average each Scottish household continues to pay £324 a year for water and waste water services, the equivalent of less than £1 a day[1].

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

Water and Sewerage companies	Average household bill for 2012/13
South West	£543
Wessex	£455
Welsh	£427
Anglian	£423
Southern	£416
United Utilities	£395
England & Wales average	**£376**
Yorkshire	£361
Northumbrian (North East)	£352
Thames	£340
Severn Trent	£326
Scottish Water	**£324**

Scottish Water is continuing to offer our customers best value, our average combined household water and waste water charge is the lowest in the UK water industry in 2012/13 while we continue to deliver one of the country's largest investment programmes. We are investing to deliver clearer, fresher drinking water to our 5 million customers in communities across Scotland, while also improving the natural environment of our rivers, lochs and coastal waters.

We announced the average household charge will remain steady for 2012/13 at £324, making it the lowest in the UK. This marks the fourth year running that Scottish Water's household charges have remained steady. The average household charge in Scotland is now £52 lower than that in England and Wales.

In 2011/12, we invested £491 million – the equivalent of £202 for every household in Scotland. Our customers continue to see increasing value for the charges they pay, as we continue to improve the services we provide.

We strive to continue to deliver best value and service to our customers, while making the right decisions to deliver the investment that communities across Scotland need and to adapt to our ever changing climate – making the most of our natural resources and expert knowledge to the benefit of our customers.

1 The average household is between Council Tax Band B and Band C and has a combined bill of less than £1 a day. Individual water supply and waste water collection charges are less than £1 a day for all households (except for the individual waste water collection charges for Band H households).

Delivering record levels of service for our customers

Scottish Water has recorded its highest ever levels of service for our customers in 2011/12. As part of our Vision we are committed to keeping our customers at the heart of everything we do.

As part of the Ministerial requirement to improve customer service, we agreed with our regulator, the Water Industry Commission, challenging targets to improve service for customers. These improvements are measured by the Overall Performance Assessment (OPA) score. Our target for 2011/12 was to achieve a Customer OPA score of 317. We achieved 355 points, out-performing our target by 12%. Exceeding this target illustrates our focus on delivering real benefits for our customers.

We are committed to delivering benefits to our customers in terms of better quality drinking water, better water pressure and a reduction in the number of homes experiencing interruptions to water supply or problems with sewers. This has seen us achieve increasing levels of customer satisfaction in the last year.

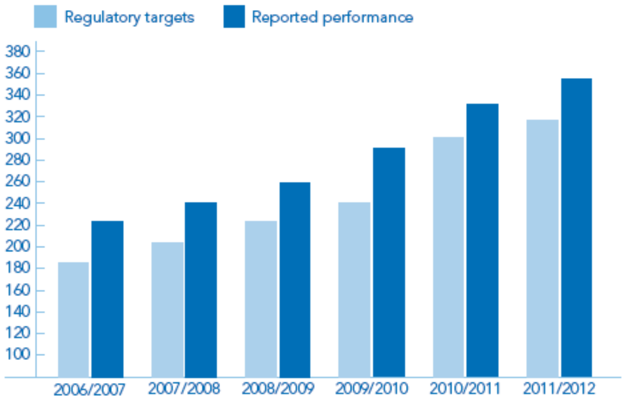
Our Customer OPA has reached a record score of 355 in 2011/12.

It is our aim to always deliver a positive customer experience. In 2011/12 we continued to make improvements to the service that we provide, recording our highest ever level of customer satisfaction at 83%, up 3%. We are committed to continuing to improve this even further.

Central to our strategy has been to find out the areas where we are not performing as our customers expect – and to put in place actions to meet or exceed their expectations.

Written complaints have fallen steadily with 2011/12 seeing an 11% reduction from levels in 2010/11. A Service Review Team has been put in place to review complaints.

Overall Performance Assessment



The key successes in 2011/12 can be attributed to improvements in a wide range of the 17 OPA indicators:

- We beat our target by 36% for environmental pollution incidents, an overall improvement of 39% on last year.
- An extra 41,700 customers are now being served by compliant waste water treatment works.
- We have improved the pressure to 1,627 more properties. Only 0.04% of all properties in Scotland are now affected by low pressure.
- We have scored maximum points for leakage reduction as we have beaten the regulatory leakage target.
- We continue to experience no hosepipe restrictions, by maintaining water supplies at all times.
- We improved our compliance in water quality resulting in an increase in OPA points.
- We have scored maximum points for sludge disposal by ensuring that all our sludge is treated according to regulations.
- We reduced the number of incidents of sewer flooding due to overloaded sewers by 2%.
- We scored maximum points on the Assessed Customer Service indicator, which takes account of our performance on customer specific activities such as our Additional Support Register, Supply Pipe Repair Policy and Compensation Policy.
- The number of written complaints dropped by 11% and we were fully compliant with our 10-day target to respond to written complaints.

All of the improvements above illustrate how our focus on improving customer service is delivering real benefits for our customers. We will continue to make further improvements to the services our customers receive in 2012/13.

Continued investment across Scotland

During 2011/12 Scottish Water has continued the rapid transformation of the water industry in Scotland, delivering clearer, fresher drinking water for our customers and improving the natural environment. We have delivered £491 million of Quality and Standards (Q&S) investment to improve treatment works, water mains, sewers and networks across Scotland, continuing to beat our Overall Measure of Delivery target for projects.

In the last year we have completed our major water treatment works projects at Glencorse, near Edinburgh, and Aviemore. Investment in waste water systems continues to help improve Scotland's natural environment.

During these challenging economic conditions our investment programme continues to support thousands of construction jobs. We actively promote improvements in Health and Safety working practices, resulting in improved performance and a reduction in accidents on our sites across Scotland. Our construction and engineering partners and other industry bodies are taking the lessons learned on Scottish Water sites to other utility projects and developments.

Scottish Water continues to work more efficiently with our supply chain partners, reducing costs and helping to keep our customer charges low.

We are building a sustainable business in line with Scottish Government objectives on sustainability and carbon reduction. In developing the next generation of assets, we are looking to make them resilient, ensuring our ability to maintain service to our customers continues in various climate change scenarios. As part of this we are working to incorporate wind, hydro and solar energy to help offset our power requirements at as many of our assets as possible in the future.

During 2011/12 we achieved ISO9001 accreditation. This is a major stepping stone to achieving PAS55 certification, the international qualification in best practice asset management. Achieving this PAS55 accreditation will place Scottish Water at the forefront of UK utilities and as a leader on the international stage.

Drinking water quality and standards

We have invested £90.1 million to ensure we continue to provide a high standard of quality drinking water to 2.4 million households throughout Scotland.

Environmental quality enhancements

We are playing our part to protect the natural environment of Scotland, investing £83.9 million on our waste water treatment works and infrastructure.

Enabling growth and development

In order to support the economic growth and development of Scotland we have invested £26.4 million to increase capacity at water and waste water treatment works, while continuing to address leakage within our network.

Capital maintenance

We invested a total of £200.6 million to maintain service standards in our water and waste water treatment works and infrastructure, for customers now and future generations across Scotland.

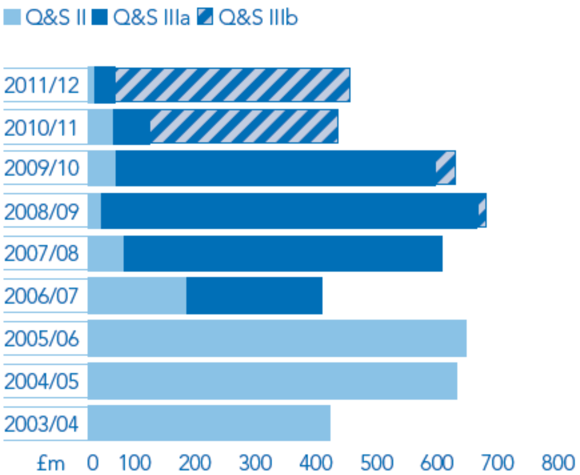
Service improvements

Investment of £12.8 million will help maintain the steady improvement of service levels for our customers.

Completion programme

We have invested £76.9 million in our completion programme, to deliver the remaining projects from the previous Q&S II and Q&S IIIa programmes.

Total Q&S Capital Investment



For 2011/12, £490.7 million total is split £413.8 million for Q&S IIIb and £76.9 million for Q&S IIIa and Q&S II combined.

Continued investment across Scotland continued

The table below shows the performance highlights delivered in 2011/12, the second year of our five year investment programme.

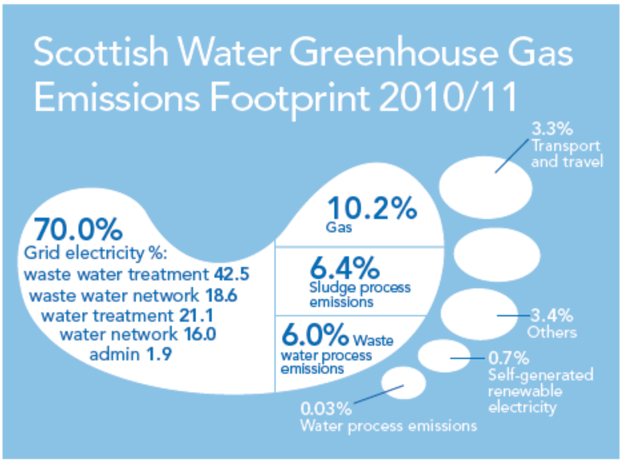
Targets specified in Ministerial Objectives

Output measure specified in Ministerial Directions	Actual March 2012	Cumulative Values 2010-12	Ministerial Objectives 2010-15
Customer service			
Number of sites where odour is reduced	3	3	4
Number of properties removed from low pressure register	1,017	1,475	2,309
Number of properties removed from low pressure register (exclusions under Water (Scotland) Act 1980)	102	152	128
Number of properties alleviated from external sewer flooding	31	31	68
Growth			
Water strategic capacity (population equivalent)	22,090	30,131	–
Waste water strategic capacity (population equivalent)	13,529	23,025	–
Drinking water quality			
Number of water treatment works receiving improved disinfection controls	12	12	33
Number of zones with reduced lead levels	21	28	64
Number of backflow prevention devices installed	173	177	275
Number of sites covered by drinking water safety plans	87	196	174
Environment			
Number of unsatisfactory intermittent discharges improved (excluding 7 stage)	2	5	24
Number of unsatisfactory intermittent discharges improved (7 stage)	33	33	197
Number of waste water treatment works discharges improved to meet new licence requirements	26	27	74
Number of waste water treatment works upgraded to meet existing licence requirements	10	10	25
Number of waste water pumping stations upgraded to comply with existing licence requirements	5	5	23
Number of waste water treatment works brought into compliance with licence non-sanitary requirements	6	6	83
Number of waste water network assets made compliant with licence requirements	15	15	230

Doing the right thing for Scotland

We are committed to acting responsibly in how we deliver our services and to making the right choices in terms of service, cost and carbon. Our goal is to deliver a service that is resilient to climate change whilst achieving a low carbon water industry in Scotland.

We believe that this is the right thing for our customers, the economy and the environment.



Climate change

Our climate change strategy is to proactively address the climate challenges, seeking to achieve a service that is resilient to climate change and minimises emissions.

Scottish Water continues to work with the 2020 Climate Change group of leading Scottish businesses. We are confident that we can help Scotland meet its ambitious carbon reduction targets.

We continue to build on work to develop a whole life carbon assessment tool for use in capital planning which will help the business to understand the carbon impact of the investment decisions we make across the life of an asset. This will help us understand how we can evolve a more sustainable asset base in the future.

Carbon footprint

Our steady progress in addressing the significant challenges of our changing climate and carbon management continues. Our carbon footprint has remained relatively steady for 2010/11, despite the additional service demands of the extreme weather.

During 2010/11 our use of grid electricity has fallen. This has been helped by the continued success of our leakage delivery programme which has helped to drive down the volume of water we need to treat to meet our customers' demands. Scottish Water continues to have the lowest CO_2 equivalents per megalitre for drinking water across the UK water industry.

Emissions associated with the waste water side of our business remain the largest element of our footprint, as indicated in the Greenhouse Gas Emissions Footprint. We are working to identify the energy potential from our waste water treatment works across Scotland. We are carrying out studies to identify opportunities where energy consumption can be reduced and waste transformed into a source of sustainable electricity to exceed the power needs of these sites.

We remain committed to measuring and managing our carbon footprint and to sharing this with our customers. From 2012 we will share this in our annual Sustainability Report.

Renewable energy

During 2011/12 we have driven our ambitious 'green' agenda, seeking to significantly out-perform Scottish Government targets in carbon reduction. We continue to work on projects to generate green energy, with over 5% of our annual energy demands now being met through renewable sources.

Scottish Water Horizons is working on a range of opportunities in the wind, hydro and waste to energy sectors, utilising our assets, land and pipelines to generate sustainable power.

Reducing pollution

During 2011/12 we have dramatically reduced the number of environmental pollution incidents (EPI) improving the natural environment across Scotland, protecting our rivers, lochs and coastal waters.

We are developing our Sustainable Land Management programme to support landowners and farmers, providing education and advice on diffuse pollution. This surface water run-off issue was identified by Audit Scotland as the single largest source of environmental pollution in Scotland.

Doing the right thing for Scotland continued

Leakage

In 2011/12 we have further improved our leakage performance to out-perform the leakage targets agreed with our regulator. We have reduced leakage by 44% since 2002/03.

As the amount of leakage decreases in our network it requires more innovation and ingenuity to further improve performance.

We are now using cutting edge technology that transmits data over the mobile phone network; helping us to locate and fix leaks faster. This has ensured our leakage reduction performance remains strong.

An innovative project in Kirkcudbright used an abandoned gas main as a sleeve for a new water pipe that offered the two-fold benefit of reducing leakage in the network and laying a new water main for a fraction of the normal cost.

Over the last year we have reduced leakage, on average, by 70 million litres of water a day. As a result we are using less raw water and less power and resources to treat and pump it to homes. This helps us protect the environment and minimise our carbon footprint.

Our teams are responding to bursts and leaks around the clock, helping to save water. We aim to respond within three working days to all incidents where water is being lost from our network as a result of bursts.

We will continue to work closely with our customers on water efficiency in 2012/13.

Water efficiency

It is easy to take water for granted. We are working hard to ensure that protection of this precious natural resource is always a key consideration in our wide variety of operations.

The less water we use, the less energy we use treating and supplying it. This is part of our commitment to become a sustainable, low carbon business, part of our drive to become Scotland's most valued and trusted business.

Water efficiency is not just down to water companies; it is the responsibility of all who use water to ensure they make the most of it and that they conserve it wherever possible.

We are working to improve our internal practices and use water wisely at our assets and offices. We are also making use of grey water, recycled water and water saving devices wherever possible, while tackling leakage across our network. This is helping to reduce the volume of water we need to treat and supply.

We are engaging with our customers and working in partnership with other water companies throughout the UK to promote how customers can use water wisely in and around their home. This will not only help save water, but it will also help customers save energy and reduce their carbon footprint. We are also working with key stakeholders, developers and policy makers to help them understand the importance of more water efficient practice.

Innovation

During 2011/12 innovation has helped us find ways to further improve our service and create efficiencies in running the business, delivering value for our customers.

Innovation Pool

Innovation, in addition to working with external partners to drive new thinking, has become embedded in the culture of Scottish Water. Our Innovation Pool continues to provide our employees with the ability to share innovative ideas across the business. In the last year this group has grown to include almost a third of our employees and this social network style portal provides a transparent mechanism for promoting opportunities, innovation and business change and is now shared as a case study worldwide.

Delivering benefits

Scottish Water and our customers are already seeing the benefits from some key innovations introduced in 2011/12.

Our pump blockage detection system is helping to protect the natural environment and minimise disruption to our customers. This low cost detection and control unit identifies blockages in the waste water network and automatically clears them before they become a problem.

We are implementing a pilot project which combines pressure management with hydro technology. This uses the excess pressure in the water network that was previously lost through pressure reducing valves to generate renewable energy.

We are sharing our knowledge through new technology such as Scottish Water Wiki, a fast and easy online channel which allows groups of employees to discuss and share documents and topics of interest. This helps make our business more efficient, improving our service to our customers.

Working with others

We are working closely with our supply chain partners to speed up the adoption of innovative technologies, to help to increase efficiencies and productivity. We are confident this will also help to drive Scottish Water's continued evolution and support economic growth and development within the small to medium business community.

Our Scottish Water Horizons subsidiary is helping to support the Digital Scotland platform, with two of Scotland's major cities already using the Scottish Water sewer network to host secure, high-speed broadband cables, offering ease of installation, minimal disruption and improved security.

We are also developing external partnerships with stakeholders from the academic and enterprise communities to develop a Scottish Innovation group. This aligns to the Scottish Government's Hydro Nation agenda.

We believe that innovation, knowledge, new technology and thinking will help to equip the water industry for a sustainable future.

Scottish Water International

In 2011/12 Scottish Water launched our international arm to export the expertise we have built up in the past 10 years.

Scottish Water International was established to develop business opportunities abroad using the skills and expertise in Scottish Water to offer products and specialist consultancy services to utilities, foreign governments and other international clients.

The business is also providing advice internationally to countries where governments and utilities are keen to learn about the transformation of Scottish Water into an efficient publicly-owned service provider.

The work of the new international arm will not affect the continuing progress of Scottish Water in delivering the investment, value and improvements in customer service for our household customers and the core business. We believe the international arm will help enhance the reputation of Scottish Water, Scotland and its skill base around the world.

Gulf states

Working alongside a global engineering firm, Scottish Water International competed against major multinational competition to secure a 5 year contract in the Middle East to overhaul waste water and drainage infrastructure and systems to meet the rapidly rising demands and growth of the region.

A small team of Scottish Water staff is currently deployed on early enabling work.

Canada

The first international contract won was to provide training to operational staff in the water industry throughout Alberta, Canada. We delivered 15 training workshops on techniques to manage water supply from source to tap and identify risks to public health.

Poland

Scottish Water International has signed a co-operation agreement as partner with ECM Polska, a major engineering firm in Poland, to advise water utilities throughout Poland on the application of best-practice asset management.

Other developments

We are also well advanced in pursuing a number of other opportunities around the world.

Other major international developments include:

- Advising clients in the Republic of Ireland on the reform of the water industry there, using our experience from the creation and transformation of Scottish Water over the last ten years.
- We are also well advanced in pursuing opportunities in India, New Zealand, Tajikistan, USA and other countries.

Scottish Water International will provide exclusively advisory services. It has no plans to make financial investments in overseas assets.

The start-up costs of Scottish Water International's activities are funded from the retained profits of other, non-regulated commercial activities of Scottish Water.

Horizons

Scottish Water Horizons uses innovative ideas, knowledge and assets to encourage economic growth and the use of sustainable technologies across Scotland. We are actively pursuing a green agenda to ensure we become a sustainable, low carbon generator.

We are concentrating our efforts on the continued development of our renewables portfolio, utilising our assets and expertise and that of our partners, to make the most of Scotland's raw assets. Across Scotland we have approved and are delivering investment at a number of sites for hydro turbine initiatives. We are using innovative technology to generate renewable energy through pressure reduction in our water mains network.

During 2011/12, we have invested over £4 million as part of a 4-year programme to develop renewable projects such as mini hydro, wind farms and waste-to-energy schemes.

We are committed to growing our organics treatment and waste recycling business, which offers local authorities and businesses smart waste management solutions to avoid increasing landfill taxes and help Scotland towards its Zero Waste ambition.

This year we completed the commissioning of our Deerdykes Anaerobic Digestion facility, near Cumbernauld.

Our renewables

We are committed to generating more of our own renewable energy through the innovative use of our assets which will lower our reliance on traditional energy sources and reduce our exposure to changes in energy prices.

Wind

By hosting turbines on our land and agreeing to buy power from wind farms, we are contributing to a greener Scotland. We are partnering with some of Europe's leading firms to jointly exploit opportunities and minimise our investment risk. In addition to larger developments on Scottish Water land, we have initiatives in place for single turbine installations at a number of our operational sites.

Hydro

We are assessing nearly 200 sites for hydro power potential. In the last year we have developed 39 of these locations which show the greatest capacity for sustainable hydro energy generation. During 2011/12 we developed potential to generate 13.1GWh per year from hydro power.

Anaerobic digestion

Our Deerdykes Organics Recycling facility converts 30,000 tonnes of food waste a year into green electricity, offsetting around 1% of Scottish Water's annual energy demand. During 2011/12, we began accepting waste from the City of Edinburgh Council and Stirling Council. The Glasgow West councils consortium awarded their green and food waste disposal contracts to Scottish Water Horizons.

Solar

We have taken advantage of a number of incentive mechanisms during 2011/12 to develop the renewables potential of our assets, helping us to promote the installation of solar panel arrays at a number of our sites.

Other opportunities

We are working with leading telecommunications providers, utilising many of Scottish Water's sites to host radio mast towers.

Scottish Water is supporting Scotland's vital North Sea oil and gas industry, providing potable water supplies for offshore workers.

Currently our waste-to-energy experts are developing initiatives to produce bio-methane from the sludge produced at our waste water treatment works.

During 2011/12 we continued to work closely with the construction community, supporting the economic growth and development of Scotland commercially through connections to the network.

Business Stream

Business Stream delivers better value, innovation and improved customer service for business customers.

Formed in Autumn 2006 in preparation for retail competition being introduced in Scotland in 2008, Business Stream quickly established its role as the leading non-household water supplier. In this market Scottish Water is the wholesaler and Business Stream is one of a number of competing retailers.

Added value service

Since creation Business Stream has built a customer-centric, service led business that delivers non-household customers with improved customer service, increased innovation and better value for money. As well as offering licensed services such as water and waste water billing, Business Stream offers customers a range of added value services such as water efficiency, waste water management and new connections services.

Thanks to water efficiency advice customers of the company have saved a total of £25 million (that's 16,000 tonnes of CO_2 equivalent to taking over 4,600 cars off the road), as a result many customers now pay less for their water service needs than they would have done previously. In fact Business Stream has made available over £39.5 million worth of discounts.

Business Stream also raised the bar on customer service with customer satisfaction increasing by over 26% since creation. Complaints have also reduced by 45%. Business Stream has also invested in developing a range of additional services for customers and to date over 46% of customers have signed up for their online billing service.

Unique efficiency model

In the public sector, Business Stream won a competitive tender to supply all of Scotland's public bodies, saving the public sector over £20 million. Glasgow City Council was keen to save water across its 720 sites. However, budget pressure meant it was unable to find initial investment for this work. To overcome this hurdle, Business Stream offered a new 'gainshare' model. It has funded investment in new infrastructure and analysis, in return for a share of the expected £1.3 million savings over four years.

Business Stream has also worked with a range of private sector clients in Scotland and across the rest of the UK including Coca-Cola, Marks & Spencer, Co-operative Group and Tesco, helping them with water efficiency projects to reduce their costs and environmental impact.

In the last year Business Stream has focused on maximising its market share in Scotland as new retail providers move into the market in anticipation of the competitive market opening in England. The Water White Paper from the Department for Environment, Food and Rural Affairs (Defra) in December 2011 paves the way for non-household retail competition in England.

Today Business Stream provides more than 96,000 non-household customers with their water supply and waste water customer service and that expertise, built up in the last 3 years, is now being used to explore opportunities in the emerging non-household retail market in England.

Doing the right thing for the future

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

Education

We aim to engage with our customers to raise awareness of the services we provide as part of the vital role we play in daily life in terms of public health and the environment. We also want to share our knowledge and expertise on the many areas of our business, including water and waste water treatment, engineering, science, water efficiency, renewables, innovation and career opportunities in the water industry.

Our approach to education is framed around 3 areas:

- Engaging with our customers now and in future generations through our education programme;
- Looking at innovative educational opportunities and partnerships;
- Promoting the career opportunities within Scottish Water and the water industry.

Our education programme includes a range of online Scottish Water-related activities, experiments and interactive games which have been developed for use with primary school age audiences. We continually work to develop our education programme to ensure it links to the current Curriculum for Excellence.

Our innovative partnership approach for our Water Ways exhibit in Glasgow Science Centre has brought the message about water's journey from source to tap, to a wider audience of over 300,000 children and adults, in a fun, interactive and educational environment.

As a major employer in Scotland we are committed to developing our employees and have achieved record levels of employee engagement. We are passionate about creating opportunities for young people to learn and to building the skills, knowledge, experience and qualifications that will help them become the next generation of water industry experts, taking the industry forward in Scotland.

Taking part in careers events, such as the Big Bang Scotland 2011 event in Perth, helps to inspire future generations of engineers, scientists and technicians and promotes the career opportunities within the water industry in Scotland, including our modern apprentice, graduate and work experience programmes.

During 2011/12 our commitment to create career opportunities in the water industry included having 53 modern apprentices and 30 graduates on structured development programmes. We continue to support work experience for secondary school pupils across Scotland and internships for higher education students. We have worked with our partners and with relevant skills bodies to create the qualifications, modern apprenticeship frameworks and opportunities within the water industry in Scotland at all levels.

We will continue to develop our approach to education to help us shape our future by developing the relationship with both our customers and stakeholders, which in turn will help us to shape our role in the water industry in Scotland.

Doing the right thing for the future continued

Volunteering

Scottish Water's Volunteering Programme was officially launched in Spring 2011 with around 500 employees now participating. Doing the right thing for communities, the environment and Scotland is a key part of our Vision to be Scotland's most valued and trusted business, one that we can all be proud of.

In 2011/12 Scottish Water employees committed around 4,000 working hours to the benefit of charities, the environment and communities across Scotland.

We support employee volunteering in the following areas:

- Education;
- Environment;
- Local community volunteering.

Organisations the length and breadth of Scotland have benefited from our programme, our volunteers helped to clean up the Broadford war memorial on Skye, while another group painted garden furniture at a South Ayrshire hospice.

Our education programme and our partnerships are also providing opportunities for our employees to get involved in education related activities in communities across Scotland that fit with the Scottish Water Volunteering programme.

Around 80 charities have hosted Scottish Water volunteers, with our employees receiving a minimum of 2 days paid leave to participate in everything from charity gift wrapping to weeding community gardens and organising international sailing events to walking rescued greyhounds.

We also support activities relating to WaterAid, Scottish Water's charity of choice. Our employees contribute much of their own time to support the charity's efforts in raising vital funding for water, sanitation and hygiene projects in the developing world.

Across Scotland our volunteers have given talks for various groups on the water cycle and the vital role Scottish Water plays in daily life, helping to educate our customers now and future generations about the importance of this natural resource in communities across the country.

Having built our network of charities during the last year, we are now able to offer a range of opportunities for our employees looking to identify where they can volunteer within a specific area.

Improving services

Flooding

Our climate continues to change and flooding remains a concern to our customers because of the direct impact it has on their lives, their homes and their businesses. Flooding is a complicated issue, which requires the support of many agencies, working closely together, through various legislative responsibilities.

During 2011/12 Scottish Water has continued to play our part within multi-agency partnerships to identify solutions to flooding issues within communities the length and breadth of Scotland.

We continue to focus on our duties under the Flood Risk Management (Scotland) Act 2009. We are working with nearly half of Scotland's 32 local authorities to help them identify flooding issues in their catchments and work on long-term Surface Water Management Strategies. This will help to determine the necessary investment to address flood risk in these areas.

Across Greater Glasgow we continue to work with our counterparts in the Metropolitan Glasgow Strategic Drainage Partnership – Glasgow City Council, SEPA and others – on a number of significant projects to help reduce the risk of flooding, improve the natural environment and support the economic growth and development of the city and surrounding communities.

Also in Glasgow, we have started work on a multi-million pound investment programme to modernise the waste water network across the city, identifying areas of the sewer system which need to be upgraded in order to help protect the natural environment of the local watercourses for years to come.

Together, these initiatives will help Scottish Water play our part in the success of Clyde Gateway's regeneration programme and help the city as it prepares for the Glasgow 2014 Commonwealth Games and other major events.

During 2011/12 we also completed the flood risk assessment of more than 200 of our assets across Scotland. This major programme of work will help us to identify where investment may be required to address the potential impact of our changing climate.

Drinking water quality

Scottish Water has continued the underlying trend of improvement, with the quality of Scotland's drinking water at the highest level it has ever been.

In 2011 we carried out more than 320,000 quality tests on regulatory water samples from our water treatment works, service reservoirs and customers' taps across Scotland.

Of these samples, 99.86% of all tests met statutory microbiological and chemical regulatory standards.

During 2011/12 we have replaced, repaired or improved 23 water treatment works and more than 550 miles of water pipes.

This helps to ensure our customers enjoy the look and taste of their refreshing, sustainable drinking water, which is vital to our well-being.

Clearer, fresher drinking water – water quality

Overall compliance with microbiological and chemical standards

2011	**99.86%**
2010	99.86%
2009	99.83%
2008	99.81%
2007	99.81%
2006	99.76%
2005	99.64%
2004	99.57%
2003	99.44%
2002	99.36%

Waste water treatment

Scottish Water has continued its strong performance in waste water management during 2011/12, with more compliant treatment works passing strict standards combined with a significant decrease in pollution incidents.

This is part of our continuing investment to help protect and improve the natural environment of Scotland's rivers, lochs and coastal waters.

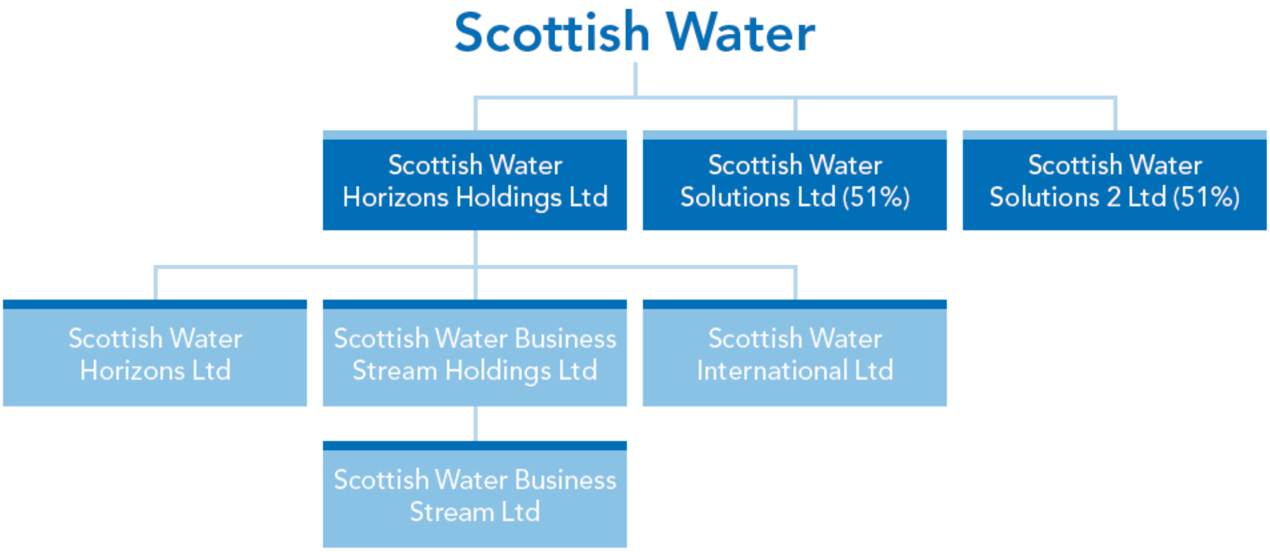
Despite the potential to impact on 71 of the 83 bathing waters officially designated under the EU Bathing Water Directive for the 2011 season, our assets were not responsible for any of the 4 failures and have, over the last few years, continued to show improvements.

Our continuing investment in our sewer network and at our waste water treatment works serving communities across Scotland will help to ensure that we continue to play our part in improving the standards of Scotland's bathing waters and aquatic environment.

Group Overview

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

The Scottish Water group structure is summarised below:



The three main trading businesses of the Scottish Water group are Scottish Water, that supplies households and wholesale licensed providers with regulated water and waste water services, Scottish Water Business Stream Ltd (Business Stream), our licensed retail subsidiary which supplies water and waste water services to business customers, and Scottish Water Horizons Ltd (Horizons) that provides non-regulated services to customers. Business Stream is operated and managed independently of Scottish Water in accordance with the Governance Code, which sets out the terms of separation to enable the operation of the licensed retail market for business customers.

During 2011/12 the group was restructured to facilitate the financing of growth opportunities in the non-regulated areas of the business. Scottish Water's interest in Scottish Water Business Stream Holdings Ltd (and its subsidiary Business Stream) was transferred to its wholly owned subsidiary, Scottish Water Horizons Holdings Ltd. In addition, a new company was set up – Scottish Water International Ltd. Its purpose is to export Scottish Water's skills, experience and knowledge around the globe primarily by means of consultancy.

The following table summarises turnover, surplus before tax and exceptional items, net assets and net debt, as at 31 March 2012, for the Scottish Water group of businesses.

Group Financial Summary for 2011/12

	Scottish Water £m	Business Stream group £m	Horizons & SW International group £m	Inter company[1] £m	Total £m
Revenue	1,047.5	363.3	18.5	(290.8)	1,138.5
Surplus before tax	74.0	33.9	1.5	(2.4)	107.0
Net assets	4029.4	169.7	45.6	(86.4)	4,158.3
Borrowing	3,169.3	58.5	–	–	3,227.8
Cash	241.0	110.4	3.8	–	355.2

1 Inter-company adjustments relate to the elimination of inter-company trading and investments.

The group surplus before tax for the year to 31 March 2012 was £107.0 million (2011: £146.2 million before exceptional items). Consolidated revenue in the year increased by only £11.4 million to £1,138.5 million (2011: £1,127.1 million). This benefit was offset by a £55.1 million increase in costs to £844.2 million (2011: £789.1 million before exceptional items) driven mainly by a £7.9 million increase in Scottish Water total operating costs, a £12.2 million increase in Business Stream operating costs and a £35.6 million increase in depreciation and infrastructure maintenance costs. Net finance costs of £187.3 million were £4.5 million lower than in 2011.

Individual business performance is reviewed below.

In the year consolidated net debt increased by £34.2 million to £2,872.6 million (2011: £2,838.4 million). The increase was driven by additional borrowing from the Scottish Government of £50.0 million partially offset by a £15.8 million increase in cash balances to £355.2 million. The movement in cash is summarised below:

Cash movement

	Scottish Water £m	Business Stream group £m	Horizons & SW International group £m	Total £m
Opening balance as at 1 April 2011	**252.3**	**82.3**	**4.8**	**339.4**
New loan from the Scottish Government	50.0	–	–	50.0
Cash generated/(utilised)	(61.3)	28.1	(1.0)	(34.2)
Closing cash balance as at 31 March 2012	**241.0**	**110.4**	**3.8**	**355.2**

Cash balances within the Business Stream group of companies increased by £28.1 million over the year to £110.4 million reflecting around £10 million of additional monies received from advance payments by customers. The group cash balance at 31 March 2012 at £355.2 million represents around 16 weeks of forecast cash requirements.

Taxation

The consolidated tax charge on the income statement was £8.5 million, (2011: £45.2 million). During the year, as a result of the change in the UK corporation tax rate from 26% to 24% that was effective from April 2012, deferred tax balances have been re-measured. Consequently, the effective rate for the year was 7.9%, (2011: 19.7%).

Borrowing limit

Scottish Ministers set Scottish Water's (consolidated) maximum net new borrowing limit at £50.0 million for 2011/12. Actual net new borrowings in 2011/12 were £50.0 million.

Scottish Water

Financial framework

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

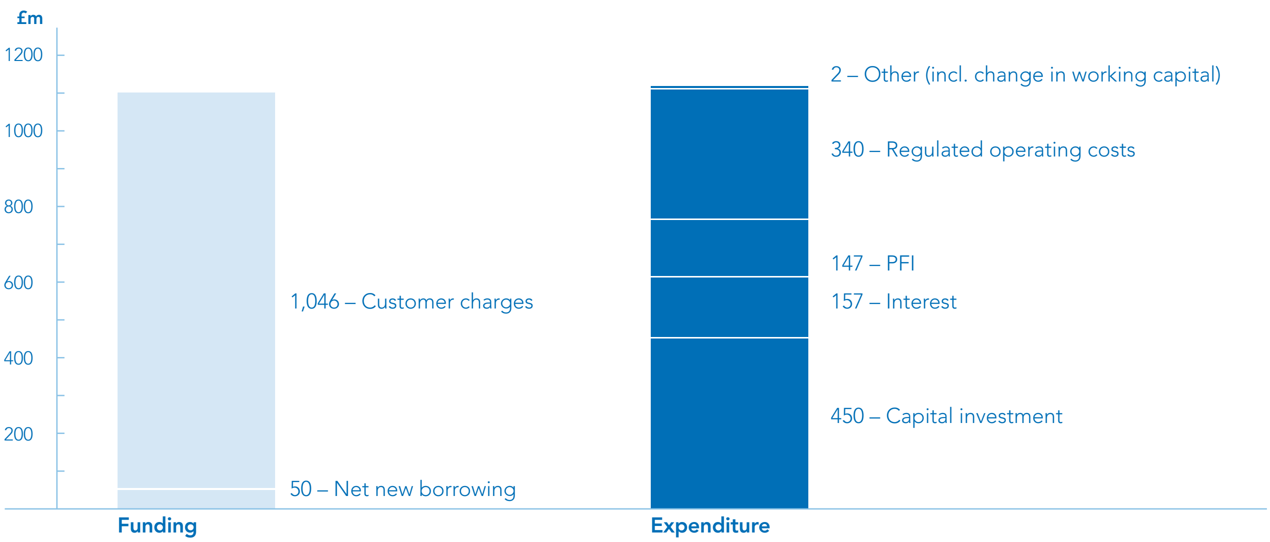
The Commission carries out five year price reviews and caps the prices that Scottish Water charge for water and waste water services. The combination of regulated price caps and firm constraints on borrowing from the Scottish Government creates a clearly defined limit on the financing available to Scottish Water.

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

Financial performance

The surplus before tax in the year for Scottish Water was £43.2 million lower at £74.0 million (2011: £117.2 million before exceptional items) reflecting primarily the £34 million benefit to household customers of freezing household charges at a time when inflation (as measured by the Retail Price Index) was 4.5%. The surplus made by Scottish Water on core service provision is required to finance our capital investment programme as is demonstrated in the chart below:

Scottish Water Funding 2011/12



Regulated revenue

Regulated revenue for the year totalled £1,045.8 million (2011: £1,049.8 million) and is analysed by category in the table below:

Regulated revenue

	2011/12 £m	2010/11 £m	Change £m
Household	745.6	743.5	2.1
Wholesale	294.7	302.4	(7.7)
Other	5.5	3.9	1.6
Total regulated revenue	**1,045.8**	**1,049.8**	**(4.0)**

Revenue from services supplied to household customers increased by only £2.1 million to £745.6 million reflecting the increase in connected properties and the tariff freeze effective from 1 April 2011. Revenue from wholesale services supplied to Licensed Providers reduced by £7.7 million or 2.5% to £294.7 million driven primarily by the reduction in regulated wholesale charges to Licensed Providers. Revenue from other sales increased by £1.6 million to £5.5 million.

Operating costs

Total operating costs increased by £43.1 million to £787.0 million (2011: £743.9 million excluding exceptional items).

Although headline regulated operating costs of £340.2 million (2011: £327.8 million) were 3.8% or £12.4 million higher than in 2010/11, this increase was due primarily to a £10.0 million increase in local authority rates costs and Carbon Reduction Commitment costs of £3.0 million. After adjusting for these specific cost increases and the impact of inflation, like-for-like costs reduced in real terms by £9.6 million or 3.8%.

The operating cost of the PFI schemes in the year, including associated depreciation and amortisation charges, was £123.4 million, £9.6 million higher than in 2010/11 mainly because of inflation.

Depreciation and infrastructure maintenance costs increased by £35.7 million to £333.7 million (2011: £298.0 million). Infrastructure maintenance costs were £24.3 million higher than last year, which reflects the phasing of the planned maintenance investment programme for infrastructure assets across the 2010-15 regulatory period. Non-infrastructure depreciation increased by £6.4 million as a consequence of the capital investment programme and the gain on asset sales was £5.0 million lower than in 2010/11.

Capital investment

Reported capital investment under IFRS for Scottish Water in the year was £347.7 million (2011: £367.6 million). However 2011/12 capital investment, as measured on a regulatory accounting basis, was £490.7 million (2011: £443.4 million). The table below reconciles investment as stated in the statutory accounts with investment on a regulatory accounting basis.

Reconciliation of capital additions

	2012 £m	2011 £m
2011/12 investment on a regulatory accounting basis	**490.7**	**443.4**
Less base infrastructure maintenance included in operating costs under IAS 16	(101.9)	(77.6)
Less investment financed by infrastructure charges income & contributions	(11.9)	(6.4)
Less SWS 1 investment realignment	(30.0)	–
Add PFI capital additions	0.8	8.2
Company capital additions per note 9 to the financial statements	**347.7**	**367.6**

Finance costs

As at 31 March 2012, the weighted average interest cost of the outstanding long-term debt was 5.15% (2011: 5.15%). Net interest payable during the year was £156.8 million, £1.4 million higher than in 2010/11.

Finance costs associated with finance lease liabilities on PFI assets and the interest on pension scheme liabilities less the expected return on pension scheme assets reduced by £5.7 million to £29.7 million (2011: £35.4 million).

During the year, net debt increased by £61.3 million to £2,928.3 million (being loans of £3,169.3 million less cash balances of £241.0 million). The increase was driven by a £50.0 million increase in borrowing from the Scottish Government, partly offset by a £11.3 million reduction in cash balances.

Business Stream

The surplus before tax for Business Stream in the year was £32.8 million, an increase of £9.7 million or 42% from 2010/11. Gross surplus increased by £15.8 million on a turnover in the year of £363.3 million (2011: £358.2 million). Operating costs increased year-on-year by £6.1 million or 26% reflecting higher costs associated with bad and doubtful debts, and continuing investment to improve data quality and business transformation projects.

Horizons

Horizons is responsible for the management, development and provision of non-regulated business services. Horizons' working capital requirements and investment plan are financed by organic cash flow, loans from Scottish Water Horizons Holdings, grant funding and asset disposals.

Horizons contributed £1.8 million (2011: £0.5 million) to the Group's surplus before tax from a turnover of £18.4 million (2011: £17.6 million). This growth was primarily driven by increased returns on self generation energy investments and following restructure of activities.

Group Pension arrangements

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

The administering authority for each scheme is required to conduct a triennial valuation of the assets and liabilities of the scheme in line with LGPS regulations. This must be conducted by a qualified actuary. The purpose of the valuation is to review the financial position of the fund and specify the employer contribution rates for the next 3 year period. The last valuation was carried out as at 31 March 2011. The actuarial funding position at 31 March 2011 of the Group's share of each pension fund is shown in the table below.

Fund

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

Employee pension contributions are determined according to the level of an employee's full time equivalent pensionable pay. A key feature of the pension arrangements is that contribution rates are applied in tiers ranging from 5.5% to 12% depending on the employee's rate of pensionable pay on 31 March. It is anticipated that this approach to employees' contribution rates will ultimately result in a 2:1 ratio between Scottish Water's contributions and employees' contributions in a fully funded scheme.

Under IAS 19, Employee Benefits, a snapshot is taken of pension fund assets and liabilities at a specific point in time. Movements in equity markets and discount rates create volatility in the calculation of scheme assets and liabilities. At 31 March 2012 after taking account of deferred taxation, there was a shortfall of assets over respective liabilities of £213.6 million (2011: £210.2 million).

1	2	3	4	5
6	7	8	9	10
11	12			

Executive Members

1 | Richard Ackroyd Chief Executive

Richard Ackroyd was appointed as Chief Executive in March 2008 and has over twenty years experience in the water industry. Prior to joining Scottish Water Richard had been a Director of Yorkshire Water since 1996, latterly as Director of Regulation and Investment. Richard was also Chairman of Water UK from 2006 to 2008.

He is a solicitor by profession and has previously been Head of Legal Services for Yorkshire Water following a period in private practice.

2 | Geoff Aitkenhead Asset Management Director

Geoff was formerly General Manager, Customer Services and Networks at East of Scotland Water (ESW) where he led the Asset Management Group. Previously, he was Strategic Development Manager, Operations at ESW and Capital Planning Manager at Borders Regional Council. 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. Geoff is Chairman of WaterAid (Scotland), an organisation dedicated to the provision of clean water and sanitation in the developing world, and Chairman of Scottish Water Solutions.

3 | Chris Banks Commercial Director

Chris was formerly Business Development Director with Ennstone plc. Previously, he was Commercial Director at Scottish Coal and Celtic Energy, following his earlier career in minerals, shipping and construction products. He gained an MA in History at Oxford University and an MBA at Cranfield School of Management. Chris is also a Fellow of Chartered Institute of Marketing and a Member of Chartered Institute of Purchasing and Supply. Chris is a Non-executive Director of Sgoiltean Ura LLP.

4 | Douglas Millican Finance and Regulation Director

Douglas was formerly with East of Scotland Water, initially as Financial Controller and latterly as Commercial Director. Prior to this, he worked with Price Waterhouse in Edinburgh and New Zealand and with Tyco International in Australia. He is a Chartered Accountant with a BCom from the University of Edinburgh and is an Associate Member of the Association of Corporate Treasurers.

5 | Peter Farrer Customer Service Delivery Director

Peter was formerly General Manager of Tactical Planning and Performance and General Manager of Operations within Scottish Water's Asset Management Team.

Prior to this, Peter has held various operational management and engineering roles within Scottish Water's predecessor organisations, East of Scotland Water and Lothian Regional Council.

He has 28 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.

Non-executive Members

6 | Ronnie Mercer

Ronnie was appointed Chair of Scottish Water in October 2007 after having been Interim Chair of Scottish Water since April 2006. Until his retirement from Scottish Power in March 2006 he was Executive Vice President – Operations at Scottish Power's PacifiCorp subsidiary and an Executive Team Member of Scottish Power. Ronnie moved to Scottish Power from British Steel in 1994 as Generation Director. In 1998 he became Managing Director of Scottish Power's Southern Water subsidiary, after which he became a Group Director in the company.

7 | Pat Kelly

Pat was formerly Scottish Secretary of the Public and Commercial Services Union and President of the STUC. He was educated at Glasgow University and is a Chartered Civil Engineer. Pat has held Non-executive Director positions in Scottish Enterprise Edinburgh and Lothian, and in NHS 24, and was a member of the Civil Service Appeal Board.

8 | Donald Emslie

Donald Emslie was formerly Chief Executive of SMG plc and is currently Chair of CHMC Ltd a hotel management company that he owns. He is also, Chair of the Royal Lyceum Theatre, a Non Executive Director of Scottish Rugby PLC and works with a start-up technology company Queuebay Ltd.

9 | James Spowart

Jim Spowart was the founder and Chief Executive of Direct Line Financial Services, Standard Life Bank and Intelligent Finance. Jim 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 assisted many companies including providing consultancy advice to various Banks' located both abroad and in the UK. He is currently a Commissioner to the General Assembly of the Church of Scotland (Special Economics Commission).

10 | Alan Bryce

Alan was the Managing Director at Energy Networks Scottish Power, part of the Iberdrola group. He joined the company in 1981 after graduating from the University of Strathclyde as an electrical engineer. He has gained a broad experience of regulated utilities, including electricity and water, and managed the initial public offering of Scottish Power's telecoms subsidiary in 1999. Prior to this post, he was responsible for Scottish Power's Generation business and for the group's UK strategy. He is a Fellow of the Institution of Engineering and Technology, and a Non-executive Director of Iberdrola USA, an electricity and gas utility, with 2.4 million customers, in the US states of New York and Maine.

11 | Andrew Wyllie

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 Fellow 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.

12 | 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.

Lynne became a Non Executive Director of Nationwide Building Society in July 2011 and joined the Board of Standard Life as a Non Executive Director in April 2012.

The Members present their annual report together with the audited financial statements for the year ended 31 March 2012.

Accounting requirements
The financial statements have been prepared in a form directed by Scottish Ministers in accordance with section 45(2) of the Water Industry (Scotland) Act 2002.

Principal activities
Scottish Water group principal activities during the year were the supply of water and waste water services to around 5 million customers in homes and businesses across Scotland covering an area of 30,410 square miles.

Scottish Water Business Stream Ltd (Business Stream), our licensed retail subsidiary, supplies water and waste water services to business customers in the competitive retail market within Scotland. Business Stream is operationally independent of Scottish Water, as required under the Governance Code agreed with the Water Industry Commission for Scotland. Its Board has two independent non-executive directors who have no other association with the Scottish Water group.

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

A review of the business and future developments for Scottish Water are presented in the Chair's Statement on page 2 and in the Financial and Business Review on pages 22 to 27.

Members
The Chair and other Non-executive Members are appointed by Scottish Ministers. Executive Members are appointed by Scottish Water after receiving consent to their appointment from Scottish Ministers. The Members as at the date of the Annual Report and their biographies are set out on pages 28 to 29.

Members and their interests
All Members have declared that they had no material interests in any contracts awarded during the year by Scottish Water. A register of Members' interests is maintained at Scottish Water's head office and is open for inspection during normal office hours.

Results
The surplus for the year after taxation amounted to £98.5 million. Details of the financial results and associated accounting policies are set out on pages 42 to 75.

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

Political and charitable contributions
No political or charitable contributions were made during the year. However, Scottish Water supports WaterAid, a charity founded by the UK water industry, which raises funds for water related projects overseas. Employees represent Scottish Water at fundraising events and on regional fundraising committees, which are periodically provided with facilities and other support.

Employee relations and involvement
The Scottish Water group of businesses employed an average of 3,442 staff during the year. Details of the costs incurred in relation to these staff can be found in note 5 to the financial statements on page 53. Scottish Water is committed to a policy of equal opportunities for all employees irrespective of race, religion, sex, disability or age and uses a number of forums to encourage employee involvement. Employees are kept involved through a process of regular team meetings, employee newsletters and representation on consultative forums.

Scottish Water is committed to continually improving its performance in relation to Health and Safety. Through an extensive safety awareness campaign, safety briefings and ongoing training, awareness of health and safety issues is being encouraged and increased among employees.

Payment of suppliers
Scottish Water agrees terms and conditions with suppliers before business takes place. Provided that all trading terms and conditions have been complied with, it is Scottish Water's policy and practice to pay agreed invoices in accordance with the terms of payment. At 31 March 2012, the amount owed to trade creditors was equivalent to 33 days of purchases from suppliers.

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

Scottish Water is committed to the principles of good governance and the code of best practice with regard to corporate governance.

The Members of Scottish Water are accountable to the Scottish Government through the Scottish Water Governance Directions 2009. This statement describes how the Members comply with the requirements of the above Directions and the provisions set out in the UK Corporate Governance Code issued by the Financial Reporting Council in June 2010.

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

a. The relevant sections of the UK Corporate Governance Code issued by the Financial Reporting Council in June 2010; and
b. The Scottish Water Governance Directions 2009 and other Directions, requirements and guidance issued by Scottish Ministers in so far as such matters relate to the functions of Scottish Water.

The Members of the Board
The Board of Scottish Water comprised thirteen members, eight Non-executive Board Members and five Executive Board Members (see Members' biographies on pages 28 to 29) during the 2011/12 financial year. David Gray's term as a Non-executive Member of the Board expired on 31 March 2012. 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 year, the Board met on eleven occasions to review Scottish Water's operational and financial performance, business strategy and risk management.

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

	Board		Audit Committee		Remuneration Committee	
Name	**Held**	**Attended**	**Held**	**Attended**	**Held**	**Attended**
Ronnie Mercer	11	11	–	–	–	–
Richard Ackroyd	11	11	–	–	–	–
Geoff Aitkenhead	11	11	–	–	–	–
Chris Banks	11	11	–	–	–	–
Alan Bryce	11	11	–	–	4	4
Donald Emslie	11	11	–	–	4	4
Peter Farrer	11	10	–	–	–	–
David Gray	11	11	5	5	–	–
Pat Kelly	11	10	–	–	4	4
Douglas Millican	11	11	–	–	–	–
Lynne Peacock	11	11	5	5	–	–
James Spowart	11	11	5	5	–	–
Andrew Wyllie	11	9	5	4	–	–

Remuneration Committee
The Remuneration Committee, which is chaired by a Non-executive Member, Donald Emslie, comprises two other Non-executive Members: Alan Bryce and Pat Kelly.

The 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 met on four occasions during the year.

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

Audit Committee
The Audit Committee, which until 31 March 2012 was chaired by a Non-executive Member with a financial background, David Gray, comprises three other Non-executive Members: Lynne Peacock, James Spowart and Andrew Wyllie. David Gray left the Committee on the expiry of his term as a Board Member on 31 March 2012 and was replaced as chair of the Committee from that date by Lynne Peacock who has recent relevant financial experience. The Committee met on five occasions during the year.

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

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 Directors, are:

Richard Ackroyd	Chief Executive
Geoff Aitkenhead	Asset Management Director
Chris Banks	Commercial Director
Peter Farrer	Customer Service Delivery Director
Douglas Millican	Finance and Regulation Director

Strategic Framework
Scottish Water operates within a broad strategic framework set by Scottish Ministers. The targets and milestones that Scottish Water has agreed to meet are set out in its Group Plan. The Group Plan also sets out the resources required and proposals for meeting and out-performing the regulatory targets and delivering on its growth ambitions. 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, in the expectation that this may be required following the enactment of the Scotland Bill.

Scottish Water generates value for its customers by planning for, and delivering, continuous efficiency improvements in operational and capital investment activities associated with its regulated water and waste water services. The efficiency improvements assumed by the Water Industry Commission for Scotland in its strategic review of charges are passed directly to customers through real reductions in water and waste water charges. The value generated by the out-performance of these efficiency targets is retained in Scottish Water until it is returned to customers through further 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 growth of the business.

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 risk policy that defines risk appetite and sets out a consistent approach to the management of risk.

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

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

Risk management is 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 risk register and risk management processes are reviewed annually by the Board, 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.

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 given by the Board and management to Health & Safety issues.

High quality personnel are viewed as an essential part of the control environment. Ethical behaviour is incorporated into staff conditions of service and demanding recruitment criteria and a policy for the development and training of staff supports ethical standards.

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

Sustainable Development
Scottish Water recognises the importance of fulfilling its social responsibilities. To this aim the Board has a Sustainable Development Policy that includes social, economic and environmental aspects. 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, introduced 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.

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.

Independence of Auditors
The Auditor General for Scotland is responsible to the Scottish Parliament for securing the audit of the financial statements of Scottish Water. For 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.

Going Concern
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.

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

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

In accordance with the Public Services Reform (Scotland) Act 2010, Scottish Water will publish the full information as required by the act on the Scottish Water website (www.scottishwater.co.uk) following the approval of the Scottish Water Annual Report and Accounts 2011/12. The report for this financial year will be available from July 2012.

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

1. Remuneration Committee

a. Remit

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

b. Membership

The Remuneration Committee is chaired by a Non-executive Member, Donald Emslie, and includes Pat Kelly and Alan Bryce, both Non-executive Members.

During the year external independent advice was provided by Hay Group Management Consultants. In addition, Hay Group Management Consultants provided Scottish Water with remuneration data analysis. Internal advice was provided by the Chair of Scottish Water, the Chief Executive and the Director of Human Resources & Development. No Executive Member was present during discussions about their own remuneration.

c. Meetings

There were four meetings of the Committee in 2011/12. At each meeting a quorum of independent, Non-executive Members was present.

2. General remuneration policy

Scottish Water's vision is to become **Scotland's most valued and trusted business, one that we can all be proud of.** Scottish Water will build on its past success by seeking to provide levels of service, performance and efficiency which exceed the expectation of its customers, regulators and the Scottish Government.

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

Scottish Water's overall remuneration policy aims are to:

– Attract, develop, motivate and retain highly talented people at all levels of the organisation.
– Incentivise and reward good individual and corporate performance.

3. Policy on Executive Members' remuneration

a. Comparator organisations

Scottish Water is publicly owned and accountable to the Scottish Parliament and Scottish Ministers. Within the context of public sector ownership, Scottish Water seeks to attract, retain and motivate leadership talent in competition not just with other utilities and other organisations in the public sector, but with organisations across the UK economy.

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

Scottish Water aims to pay in line with 95% of the median of an agreed industry benchmark group, reflecting remuneration levels in comparable organisations for similar work. The Committee reports that with base salaries of Executive Members continuing to be held at the same level since April 2009 (or March 2008 in the case of the Chief Executive), the current levels of remuneration are falling further behind that benchmark.

b. Remuneration elements

Scottish Water's Remuneration Policy for Executive Members consists of five principal elements:

– Base salary;
– Annual out-performance incentive plan (AOIP);
– Long term incentive plan (LTIP);
– Pension; and
– Allowances (for business needs, car, relocation, etc.).

c. Relative importance of performance incentives

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

d. Annual out-performance incentive plan – 2011/12

Scottish Water has an annual out-performance incentive plan (AOIP) that is designed to incentivise and reward the out-performance of targets agreed with regulators. The targets are set out in the Delivery Plan that has been approved by Scottish Ministers, and reflect the targets set by the Water Industry Commission in its Final Determination of charges for 2010-15. The Delivery Plan targets, out-performance targets, and actual performance for each measure in 2011/12 are set out below.

Measure	Delivery Plan target	Out-performance target	Actual performance
Profit before tax excluding depreciation (measured on a regulatory accounting basis)	£385.0m	£400.0m	£402.8m
Customer service OPA performance	317	337	355
Investment delivery			
• Q&S2/3a completion projects outstanding	38	29	29
• Q&S3b overall measure of delivery score	131	>131	160

This performance generated the following awards, based on the criteria set at the start of the year:

Measure	Allocated %	Awarded %
Profit before tax excluding depreciation	40%	40%
OPA score	40%	40%
Investment delivery	20%	20%

The potential maximum annual incentive attainable for out-performance by the Executive Members is 40% of base salary and is non-pensionable. Overall AOIP awards in 2011/12 were 40% of annualised salary.

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

The Long Term Incentive Plan (LTIP) has been agreed with the Scottish Government and provides clear targets for out-performance of the Water Industry Commission's Final Determination for the 2010-15 period. Payments under the scheme will only be made to Executive Members remaining in employment with Scottish Water on 1 January 2016. The LTIP will only be payable if there is overall financial out-performance of the Final Determination.

The plan is based on:

- 50% for performance against financial targets, being the extent to which adjusted net debt is lower in March 2015 than was assumed in the Final Determination. Maximum LTIP would be payable for at least £100 million out-performance.
- 50% for out-performance of OPA targets above those set out in the Final Determination, measured as the average performance in 2013/14 and 2014/15. Maximum LTIP will be payable for an OPA score of at least 400, 20 points higher than the Final Determination target of 380.
- The LTIP will be funded by 12% of annual salary being accumulated each year, during the five years to March 2015, ultimately vesting if earned by eligible Executive Members. Any LTIP payment will only be funded from financial out-performance after payment of any incentive awards to staff.

Confirmation of awards under the LTIP will be made following independent review of performance in the 2010-15 period by external auditors and our regulators.

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

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

Executive Member	Name	Date of Contract
Chief Executive	Richard Ackroyd	25 March 2008
Asset Management Director	Geoff Aitkenhead	1 April 2002
Finance and Regulation Director	Douglas Millican	1 April 2002
Commercial Director	Chris Banks	1 April 2002
Customer Service Delivery Director	Peter Farrer	13 October 2008

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

Non-executive Board Member appointments
The Non-executive Members do not have service contracts. Non-executive Members are expected to work four days per month for Scottish Water with the exception of the Chairs of the Audit and Remuneration Committees, David Gray and Donald Emslie respectively, who work five days per month and the Chair, Ronnie Mercer, who works 2.5 days per week. No compensation is payable to any Non-executive Member if their appointment is terminated early. The expiry dates of Non-executive appointments are as follows:

Ronnie Mercer	31 March 2015
David Gray	31 March 2012
Alan Bryce	31 March 2013
Pat Kelly	31 March 2013
Lynne Peacock	31 March 2013
James Spowart	31 March 2013
Andrew Wyllie	31 March 2013
Donald Emslie	31 March 2016

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

5. Members' Remuneration

Details of Members' Remuneration, as defined in the Scottish Water Governance Directions 2009 by Scottish Ministers, are set out below for the year.

Remuneration in respect of 2011/12	Salary/ Fees £000	AOIP £000	Benefits £000	Total £000	Total 2010/11 £000
Executive Members					
Richard Ackroyd	263	105	12	380	352
Geoff Aitkenhead	172	69	11	252	232
Chris Banks	159	64	11	234	217
Peter Farrer	155	62	11	228	211
Douglas Millican	173	69	11	253	235
Non-Executive Members					
Ronnie Mercer (Chair)	90	–	10	100	99
Alan Bryce	20	–	–	20	20
Donald Emslie	25	–	–	25	25
Pat Kelly	20	–	–	20	20
Lynne Peacock	20	–	–	20	20
James Spowart	20	–	–	20	20
Andrew Wyllie	20	–	–	20	20
Total Members' remuneration	**1,137**	**369**	**66**	**1,572**	**1,471**
Former Members					
David Gray (i)	32	–	–	32	25
Total	**1,169**	**369**	**66**	**1,604**	**1,496**

(i) Appointment to the Board of Scottish Water expired on 31 March 2012. His fee includes the sum of £7,000 for his additional role as a Director of Scottish Water Horizons Limited.

(ii) A car or car allowance is provided to all Executive Members and the Chair for business needs. The associated annual benefit is included in the benefits section of the table above. For Members opting out of the company car scheme, a car allowance is payable. The benefits section also includes values for any holiday sale backs and annual life assurance premiums associated with the Scottish Water Life Assurance Scheme.

(iii) The AOIP criteria are explained on page 35.

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

	Increase in accrued benefits during the year net of inflation			Accumulated total accrued benefits at 31 March 2012		Transfer Values (note 4)		
	Years in Scheme	Pension £000	Lump sum £000	Pension £000	Lump sum £000	At 31 March 2012 £000	At 31 March 2011 £000	Increase in 2011/12 net of Members' own contributions and inflation £000
Geoff Aitkenhead	33.4	3	–	74	196	1,582	1,484	77
Chris Banks	17.7	3	–	37	88	699	598	81
Peter Farrer	27.7	2	–	55	143	942	850	73
Douglas Millican	17.1	3	–	39	91	600	510	69

Notes:
1. Members of the pension scheme have the option to pay additional voluntary contributions; neither the contributions nor the resulting benefits are included in the above table.
2. The normal retirement age of Executive Members is 65.
3. The pension entitlement shown is that which would be paid annually on retirement along with the lump sum, based on service to the end of the year.
4. The transfer value of accrued pension is calculated in a manner consistent with Actuarial Guidance Note GN11.

Richard Ackroyd does not participate in the Lothian Pension Scheme but Scottish Water contributed £92,050 (2011: £92,050) to his pension arrangements during the year.

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

During the year ended 31 March 2012, Chris Banks held a Non-executive Director position with Sgoiltean Ura LLP, receiving £6,000 in fees (2011: £3,000). With effect from April 2012, Geoff Aitkenhead has been appointed a Non-executive Director of British Waterways (Scotland).

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

Mr Donald Emslie,
Chair of the Remuneration Committee
30 May 2012

The following statement, which should be read in conjunction with the statement of auditors' responsibilities included in the Auditors' Report on pages 40 to 41, is made with a view to distinguishing the respective responsibilities of the Members and of the auditors in relation to the financial statements.

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

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

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

Independent auditors' report

to the members of the Board of Scottish Water, the Auditor General for Scotland and the Scottish Parliament

We have audited the financial statements of Scottish Water and its group for the year ended 31 March 2012 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 2011/12 Government Financial Reporting Manual (the 2011/12 FReM).

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

Respective responsibilities of the Board Members and auditor
As explained more fully in the Statement of Members' Responsibilities set out on page 39, the Board Members are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view, and are also responsible for ensuring the regularity of expenditure and income. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland) as required by the Code of Audit Practice approved by the Auditor General for Scotland. Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors. We are also responsible for giving an opinion on the regularity of expenditure and income.

Scope of the audit of the financial statements
An audit involves obtaining evidence about the amounts, disclosures, and regularity of expenditure and income 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. In addition, we read all the financial and non-financial information in the Annual Report to identify material inconsistencies with the audited financial statements. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

In addition, we are required to obtain evidence sufficient to give reasonable assurance that the expenditure and income reported in the financial statements have been applied to the purposes intended by Parliament and the financial transactions conform to the authorities which govern them.

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 2012 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 2011/12 FReM; and
- have been prepared in accordance with the requirements of the Water Industry (Scotland) Act 2002 and directions made thereunder by the Scottish Ministers.

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

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

Matters on which we are required to report by exception
We have nothing to report in respect of the following matters where we are required to report to you if, in our opinion:
- adequate accounting records have not been kept; or
- the financial statements and the part of the Members' Remuneration Report to be audited are not in agreement with the accounting records; or
- we have not received all the information and explanations we require for our audit; or
- the Corporate Governance Statement does not comply with the UK Corporate Governance Code.

PricewaterhouseCoopers LLP
Appointed Auditors
Glasgow
14 June 2012

Consolidated income statement

For the year ended 31 March 2012

	Note	2012 Total £m	2011 Before exceptional items £m	2011 Exceptional items (Note 4) £m	2011 Total £m
Revenue	3	**1,138.5**	**1,127.1**	–	**1,127.1**
Cost of sales		(718.7)	(674.4)	52.0	(622.4)
Gross surplus		**419.8**	**452.7**	**52.0**	**504.7**
Administrative expenses		(125.5)	(114.7)	31.0	(83.7)
Operating surplus	3, 4	**294.3**	**338.0**	**83.0**	**421.0**
Finance income	7	64.9	62.0	–	62.0
Finance costs	7	(252.2)	(253.8)	–	(253.8)
Surplus before taxation		**107.0**	**146.2**	**83.0**	**229.2**
Taxation	8	(8.5)	(22.0)	(23.2)	(45.2)
Surplus for the year	20	**98.5**	**124.2**	**59.8**	**184.0**

Consolidated statement of comprehensive income

For the year ended 31 March 2012

	Note	2012 £m	2011 £m
Surplus for the year	20	98.5	184.0
Other comprehensive income:			
Actuarial (loss)/gain on post employment benefit obligations, net of deferred taxation	22	(10.0)	65.3
Total comprehensive income for the year		88.5	249.3

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 2010		463.4	133.4	596.8
Surplus for the year		184.0		184.0
Other comprehensive income:				
Actuarial gain on post employment benefit obligations, net of tax	22	65.3		65.3
Balance at 31 March 2011		**712.7**	**133.4**	**846.1**
Surplus for the year		98.5		98.5
Other comprehensive income:				
Actuarial loss on post employment benefit obligations, net of tax	22	(10.0)		(10.0)
Balance at 31 March 2012	20	**801.2**	**133.4**	**934.6**

Company statement of changes in equity

	Note	Retained earnings £m	Other reserves £m	Total reserves £m
Balance at 1 April 2010		441.0	133.4	574.4
Surplus for the year	20	162.7		162.7
Other comprehensive income:				
Actuarial gain on post employment benefit obligations, net of tax	22	64.9		64.9
Balance at 31 March 2011		**668.6**	**133.4**	**802.0**
Surplus for the year	20	74.2		74.2
Other comprehensive income:				
Actuarial loss on post employment benefit obligations, net of tax	22	(12.0)		(12.0)
Balance at 31 March 2012	20	**730.8**	**133.4**	**864.2**

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.

Balance sheets

As at 31 March 2012

	Note	Group 2012 £m	Group 2011 £m	Company 2012 £m	Company 2011 £m
Assets					
Non-current assets					
Property, plant and equipment	9	5,196.1	5,096.7	5,177.0	5,082.2
Investments	10	–	–	37.6	37.6
Deferred tax asset	15	–	0.5	–	–
		5,196.1	5,097.2	5,214.6	5,119.8
Current assets					
Inventories	11	1.9	2.3	1.7	2.1
Trade and other receivables	12	185.5	167.9	58.9	52.2
Current tax asset		1.0	1.2	0.9	0.7
Cash and cash equivalents	13	355.2	339.4	241.0	252.3
		543.6	510.8	302.5	307.3
Total assets		**5,739.7**	**5,608.0**	**5,517.1**	**5,427.1**
Liabilities					
Current liabilities					
Trade and other payables	14	(404.0)	(403.0)	(321.3)	(338.1)
Other loans and borrowings	17	(17.2)	(16.2)	(17.2)	(16.2)
Current tax liabilities		(4.4)	(3.2)	–	–
Provisions for liabilities	16	(5.4)	(10.6)	(5.1)	(9.9)
		(431.0)	(433.0)	(343.6)	(364.2)
Non-current liabilities					
Trade and other payables	14	(70.6)	(61.7)	(64.4)	(55.4)
Other loans and borrowings	17	(417.9)	(435.0)	(417.9)	(435.0)
Deferred tax liabilities	15	(379.7)	(374.9)	(379.0)	(373.8)
Retirement benefit obligations	22	(281.1)	(284.0)	(281.7)	(281.9)
Provisions for liabilities	16	(1.1)	(1.2)	(1.1)	(1.2)
		(1,150.4)	(1,156.8)	(1,144.1)	(1,147.3)
Total liabilities		**(1,581.4)**	**(1,589.8)**	**(1,487.7)**	**(1,511.5)**
Net assets		**4,158.3**	**4,018.2**	**4,029.4**	**3,915.6**
Equity					
Government loans	18	3,223.7	3,172.1	3,165.2	3,113.6
Retained earnings	20	801.2	712.7	730.8	668.6
Other reserves		133.4	133.4	133.4	133.4
		4,158.3	**4,018.2**	**4,029.4**	**3,915.6**

These financial statements were approved by the Board of Members on 30 May 2012 and signed on their behalf by

Richard Ackroyd
Chief Executive

Statements of cash flow

For the year ended 31 March 2012

	Note	Group 2012 £m	Group 2011 £m	Company 2012 £m	Company 2011 £m
Surplus before taxation		107.0	229.2	74.1	199.6
Depreciation charges		252.6	245.4	251.1	244.2
Amortisation of grants		(0.9)	(1.1)	(0.9)	(0.9)
Surplus on disposal of property, plant and equipment		(0.5)	(5.7)	(0.7)	(5.7)
Non cash adjustment for retirement benefit obligations		(12.0)	(80.4)	(12.0)	(79.9)
Finance costs – net		187.3	191.8	186.5	190.9
Operating cashflow before changes in working capital and provisions		**533.5**	**579.2**	**498.1**	**548.2**
Changes in working capital and provisions:					
Increase in receivables		(17.6)	(24.1)	(6.7)	–
Decrease in inventories		0.4	0.3	0.4	0.4
Increase/(decrease) in payables		26.9	24.7	9.0	(2.9)
Decrease in provisions		(3.6)	(11.0)	(3.2)	(7.2)
Cash flows from operating activities		**539.6**	**569.1**	**497.6**	**538.5**
Taxation paid		(7.8)	(6.1)	(0.2)	(0.5)
Net cash generated from operating activities		531.8	563.0	497.4	538.0
Cash flows from investing activities					
Purchase of property, plant and equipment		(377.1)	(362.5)	(370.7)	(360.2)
Sale of property, plant and equipment		2.4	6.0	2.5	6.0
Government grants and other contributions		0.1	0.3	–	–
Infrastructure income receipts		7.8	7.3	7.8	7.3
Net cash used in investing activities		(366.8)	(348.9)	(360.4)	(346.9)
Cash flows from financing activities					
Repayments of loans		(96.0)	(181.9)	(96.0)	(181.9)
Proceeds from borrowings		146.0	287.9	146.0	287.9
Interest received		2.6	1.4	1.9	0.9
Interest paid		(187.3)	(185.7)	(185.7)	(184.3)
Payment of finance lease liabilities		(14.5)	(14.9)	(14.5)	(14.9)
Net cash used in financing activities		(149.2)	(93.2)	(148.3)	(92.3)
Net increase/(decrease) in cash and cash equivalents		**15.8**	**120.9**	**(11.3)**	**98.8**
Cash and cash equivalents at beginning of year	13	339.4	218.5	252.3	153.5
Cash and cash equivalents at end of year	13	**355.2**	**339.4**	**241.0**	**252.3**

1 Accounting policies

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.

Basis of preparation
The financial statements of Scottish Water for the year ended 31 March 2012 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 International Government Financial Reporting Manual (FReM). The FReM 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, 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).

Scottish Water has adopted the following IFRS, IFRIC and amendments with effect from 1 April 2011. They did not have a material effect on the results or net assets of the group:
– 'Improvements to IFRS 2010', issued in May 2010 is a collection of amendments to six standards and one IFRIC, part of the IASB's programme of annual improvements. The effective dates vary between 1 July 2010 and 1 January 2011.
– IFRIC 14 'IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction' was amended by the issue of 'Prepayments of a Minimum Funding Requirement'. This covers the accounting associated with pensions and other employee benefit plans and is effective from periods commencing on or after 1 January 2011. This removes an unintended consequence arising from the treatment of prepayments of future contributions in some circumstances when there is a minimum funding requirement for pensions or other employee benefit plans.

Scottish Water had already adopted early the revised IAS 24 'Related Party Disclosures' which simplifies and clarifies the definition of a related party. It also removes the requirement for government related entities to disclose details of all transactions with the government and other government related entities.

As at the date of authorisation of these financial statements, the following IFRSs were in issue but not yet effective as they still require endorsement by the EU. Consequently, Scottish Water has not applied these new IFRSs and IFRICs in the preparation of the financial statements. The impact on Scottish Water's financial statements of the future adoption of the standards is currently under review. All of these standards are applicable for periods commencing on or after 1 January 2013.
– IFRS 9 'Financial Instruments' will establish principles for the financial reporting of financial assets that will present relevant and useful information to users of financial statements for their assessment of the amounts, timing and uncertainty of the entity's future cash flows.
– IFRS 10 'Consolidated Financial Statements' introduces a new approach to determining which investees should be consolidated and provides a single model to be applied in the control analysis for all investees.
– IFRS 11 'Joint Arrangements' focuses on the rights and obligations of joint arrangements, rather than the legal form. It distinguishes joint arrangements between joint operations and joint ventures.
– IFRS 12 'Disclosure on Interests in Other Entities' contains the disclosure requirements for entities that have interests in other entities including subsidiaries, joint arrangements (i.e. joint operations or joint ventures), associates and/or unconsolidated structured entities.
– IFRS 13 'Fair Value Measurement' replaces the fair value measurement guidance contained in individual IFRSs with a single source of fair value measurement guidance. It defines fair value, establishes a framework for measuring fair value and sets out disclosure requirements for all fair value measurements.
– IAS 27 'Separate Financial Statements' and IAS 28 'Associates and Joint Ventures' have been revised following the issue of IFRS 10 and IFRS 11.

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

1 Accounting policies continued

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 govern the financial and operating policies, generally accompanying a shareholding of more than one half of the voting rights. In assessing control, potential voting rights that are currently exercisable or convertible are taken into account. Scottish Water Business Stream Limited (Business Stream) is treated as a subsidiary although special governance arrangements, 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, limit Scottish Water's control over its operating policies. 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.

b. Jointly controlled operations

The nature of the contractual agreements between Scottish Water and the other shareholders in both Scottish Water Solutions Limited (SWS) and Scottish Water Solutions 2 Limited (SWS2) are such that the parties are engaged in joint activities that do not constitute an entity carrying on a trade or business in its own right. Consequently, SWS and SWS2 have been accounted for under IAS 31 'Interests in joint ventures', as jointly controlled operations. On this basis Scottish Water accounts directly for its own gross assets, liabilities and cash flows in the joint operations.

Operating segments

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

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 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, turnover includes an estimate of the value of water and waste water services supplied to customers between the date of the last meter reading and the year end. For unmeasured customers billed in advance, income is deferred and released to the income statement throughout the year.

Research and development costs

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.

Finance income and costs

Finance income comprises interest receivable on funds invested and expected returns on pension scheme assets recognised in the income statement. Finance costs comprise interest payable on borrowings and interest on pension scheme 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 Accounting policies continued

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 taxes 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.

Property, plant and equipment
Property, plant and equipment is held at fair value.

Where an item of property, plant and equipment comprises major components having different useful lives, the components are accounted for as separate items of property, plant and equipment, and depreciated accordingly.

Due to the specialised nature of the majority of these assets, they are measured at cost less depreciation and after impairments where applicable. Cost includes expenditure that is directly attributable to the acquisition of the items or, for self-constructed assets, includes the cost of materials, direct labour and an appropriate proportion of production overheads. 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.

Gains and losses on disposals are determined by comparing proceeds with carrying amounts. These are included in the income statement.

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. All items of property, plant and equipment within infrastructure assets, with the exception of land, are subject to depreciation.

Depreciation
Freehold land and assets under construction are not depreciated. Depreciation is provided on other assets to write-off cost, less residual values, on a straight-line basis over their estimated operational lives, from the date of beneficial use as follows:

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

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each balance sheet date.

1 Accounting policies continued

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.

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.

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.

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.

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.

Financial instruments
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.

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 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 three 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.

Financial instruments are recognised in the balance sheet when an obligation is identified and released as that obligation is fulfilled. No trading in derivative financial instruments was undertaken.

Scottish Water's policy is not to trade or speculate in financial instruments. All treasury activities are undertaken in accordance with the permitted activities as set out in the Scottish Water Governance Directions 2009.

1 Accounting policies continued

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 expected return on the schemes' assets and the increase during the period in the present value of the schemes' liabilities arising from the passage of time are included in finance income and 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.

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.

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

2 Accounting estimates and judgements

In the process of applying the Group's accounting policies, management necessarily makes judgements and estimates that have a significant effect on the amounts recognised in the financial statements. 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. 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. Retirement benefits
The assumptions in relation to the cost of providing post-retirement benefits during the period are set after consultation with qualified actuaries. Further information is provided in note 22. While these assumptions are believed to be appropriate, a change in these assumptions would impact the earnings of the Group and the carrying amount of pension obligations.

c. 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.

d. Impairment of trade and other receivables
Scottish Water follows the guidance of IAS 39 to determine when trade and other receivables have been impaired. This determination requires significant judgement. In making this judgement, Scottish Water evaluates, amongst other factors, the duration and extent to which the carrying value of a receivable is less than its cost, the risk profile of the customer, historical experience and near-term business outlook.

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 non-household customers) and other trading activities. The other trading activities include the results of Horizons 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.

In January 2012, Scottish Water established a new legal entity, Scottish Water International Limited (see note 10), the results of which are included in 'Other trading activities' below.

Revenue and operating surplus arising from continuing operations within the United Kingdom totalled £1,138.4 million and £294.6 million respectively. Revenue and operating loss arising from continuing operations in the rest of the world totalled £0.1 million and £0.3 million respectively. (2010/11: all revenue and operating surplus arose from activities within the United Kingdom.)

An analysis of revenue, operating surplus and total assets by segment is provided below:

	2012 £m	2011 £m
Revenue		
Regulated water and waste water services	1,045.8	1,049.8
Business Stream	363.3	358.2
Other trading activities	20.2	19.7
	1,429.3	1,427.7
Less Intercompany elimination	(290.8)	(300.6)
	1,138.5	**1,127.1**

During the year Business Stream generated £8.9 million (2011: £9.4 million) of non-licensed trading revenue bringing the total revenue from other trading activities for the Group to £29.1 million (2011: £29.1 million).

	2012 £m	2011 £m
Operating surplus		
Operating surplus before exceptional items		
Regulated water and waste water services	260.3	307.9
Business Stream	34.7	24.4
Other trading activities	1.7	0.6
	296.7	**332.9**
Exceptional items		
Regulated water and waste water services	–	82.4
Business Stream	–	0.6
Other trading activities	–	–
	–	83.0
Operating surplus after exceptional items		
Regulated water and waste water services	260.3	390.3
Business Stream	34.7	25.0
Other trading activities	1.7	0.6
	296.7	415.9
(Less)/add Intercompany elimination	(2.4)	5.1
	294.3	**421.0**

Business Stream's operating surplus from non-licensed trading activities during the year was £3.5 million (2011: £5.8 million) bringing the total operating surplus from other trading activities for the Group to £5.2 million (2011: £6.4 million).

3 Segmental analysis continued

	2012 £m	2011 £m
Total assets		
Regulated water and waste water services	5,477.7	5,387.6
Business Stream	238.9	200.1
Other trading activities	23.1	20.3
	5,739.7	**5,608.0**

4 Operating surplus

a. Exceptional items in 2011
Exceptional items are those which, because of their size, incidence or nature, are separately disclosed to give a proper understanding of the underlying results for the period. Items classified as exceptional are as follows:

	2011 £m
Exceptional items – charged to operating surplus	
Past service pension costs adjustment to reflect change to CPI allocated to:	
Cost of sales	52.0
Administrative expenses	31.0
Exceptional items – before taxation	83.0

With effect from 1 April 2010, following the announcement made on 22 June 2010 as part of the Emergency Budget, pension increases are now based on the Consumer Price Index (CPI) and are no longer related to the Retail Price Index (RPI). This change reduced Pension Scheme liabilities and reduced past service costs by £83 million, before deferred tax.

In line with the guidance included in Abstract 48, issued on 17 December 2010 by the Urgent Issues Task Force of the Financial Reporting Council, this benefit was recognised in 2010/11. However, given the exceptional nature of this benefit, it was recognised as an exceptional item in the consolidated income statement. The recognised income benefit had no beneficial impact on cash in that year. The cash benefit will be reflected through lower pension contributions made in future years.

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

	Note	2012 £m	2011 £m
PFI operating costs		105.8	96.6
Depreciation of property, plant and equipment	9	252.6	245.4
Surplus on sale of property, plant and equipment		(0.5)	(5.7)
Release of deferred income in relation to capital grants		(0.9)	(1.1)
Operating lease rentals		2.5	3.0
Auditors' remuneration – audit services		0.2	0.2
– other		–	–
Research and development expenditure		0.9	0.8

5 Staff costs

	Note	2012 £m	2011 £m
Wages and salaries		111.9	114.5
Social security costs		9.3	9.6
IAS 19 current service costs relating to current period	22	17.7	22.3
Other pension costs (Remuneration Report, section 6)		0.1	0.1
Employee benefit expense		**139.0**	**146.5**
Less: charged as capital expenditure		(33.9)	(38.6)
Less: seconded staff charged to Scottish Water Solutions Limited and Scottish Water Solutions 2 Limited		(1.0)	(1.1)
		104.1	**106.8**

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

	2012	2011
Regulated water and waste water services	3,140	3,191
Business Stream	218	186
Other trading activities	64	144
Scottish Water Solutions Limited and Scottish Water Solutions 2 Limited secondees	20	21
	3,442	**3,542**

6 Members' remuneration

Information concerning Members' remuneration, incentive schemes and pensions is detailed in the Remuneration Report on pages 34 to 38. 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	2012 £m	2011 £m
Interest income:			
Short-term deposits		2.6	1.4
Expected return on pension scheme assets	22	62.3	60.6
Finance income		**64.9**	**62.0**
Interest expense:			
Government loans		(159.7)	(157.1)
Other loans		(0.5)	(0.7)
Finance lease liabilities		(26.3)	(27.3)
Interest on pension scheme liabilities	22	(65.7)	(68.7)
Finance costs		**(252.2)**	**(253.8)**
Net finance costs		**(187.3)**	**(191.8)**

8 Taxation

	Note	2012 £m	2011 £m
Analysis of tax charge recognised in the income statement			
Current tax: UK corporation tax		9.2	6.1
Deferred tax: Origination and reversal of timing differences	15	(0.7)	39.1
Total taxation charge		**8.5**	**45.2**
The charge for the year can be reconciled to the surplus per the income statement as follows:			
Group surplus before tax		107.0	229.2
Tax on surplus on ordinary activities at standard UK corporation tax rate of 26% (2011: 28%)		27.8	64.2
Adjustment in respect of prior years		14.5	11.8
Remeasurement of deferred tax due to change in UK corporation tax rate		(38.6)	(35.1)
Accounting gain with no capital gain		–	(0.7)
Depreciation on non qualifying additions		4.8	5.0
Total tax charge for the year		**8.5**	**45.2**

	Note	Group 2012 £m	Group 2011 £m	Company 2012 £m	Company 2011 £m
Tax charge recognised directly in reserves					
Deferred tax relating to:					
Pension scheme actuarial movements	15	6.0	34.3	5.3	34.1

During the year, as a result of the change in the UK corporation tax rate from 26% to 24% that will be effective from 1 April 2012, deferred tax balances have been remeasured.

Changes to the UK corporation tax system were announced in the March 2011 budget statement and subsequently updated in the March 2012 budget statement. The Finance Act 2012 is expected to reduce the main rate of corporation tax to 23% from 1 April 2013. A further reduction of 1% is expected to be enacted separately to reduce the rate to 22% by 1 April 2014. These changes had not been substantively enacted at the balance sheet date and so are not included in these financial statements.

The effect of the expected reduction to 23% with effect from April 2013, if applied to the deferred tax balance at 31 March 2012, would be to reduce the deferred tax liability by £15.8 million. This would increase the surplus for the year by £18.6 million and decrease other comprehensive income by £2.8 million.

The effect of the further expected reduction to 22% with effect from April 2014, if applied to the deferred tax balance at 31 March 2012, would be to reduce the deferred tax liability by £15.8 million. This would increase the surplus for the year by £18.6 million and decrease other comprehensive income by £2.8 million.

9 Property, plant and equipment

	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
Group						
Cost						
At 1 April 2010	2,416.0	66.2	1,640.9	1,848.6	1,070.9	7,042.6
Additions	8.2	–	–	1.2	360.5	369.9
Disposals	(0.5)	(1.3)	–	(2.1)	–	(3.9)
Reclassifications	133.0	3.7	128.0	256.7	(521.4)	–
At 31 March 2011	2,556.7	68.6	1,768.9	2,104.4	910.0	7,408.6
Additions	0.8	–	–	2.1	351.0	353.9
Disposals	(1.3)	(1.0)	–	(5.4)	–	(7.7)
Reclassifications	211.1	1.9	66.4	248.4	(527.8)	–
At 31 March 2012	2,767.3	69.5	1,835.3	2,349.5	733.2	7,754.8
Accumulated depreciation						
At 1 April 2010	736.1	25.6	401.6	906.8	–	2,070.1
Charge for the year	59.2	1.3	13.9	171.0	–	245.4
Disposals	(0.4)	(1.2)	–	(2.0)	–	(3.6)
At 31 March 2011	794.9	25.7	415.5	1,075.8	–	2,311.9
Charge for the year	67.9	1.2	13.4	170.1	–	252.6
Disposals	–	(0.7)	–	(5.1)	–	(5.8)
At 31 March 2012	862.8	26.2	428.9	1,240.8	–	2,558.7
Net book value						
At 31 March 2012	**1,904.5**	**43.3**	**1,406.4**	**1,108.7**	**733.2**	**5,196.1**
At 31 March 2011	1,761.8	42.9	1,353.4	1,028.6	910.0	5,096.7

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 fixed asset category.

Capital grants received during the year and credited to deferred income were £0.1 million (2011: £0.3 million). No capital grants were received during the year in respect of infrastructure assets.

9 Property, plant and equipment continued

	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
Company						
Cost						
At 1 April 2010	2,412.1	66.2	1,640.9	1,838.2	1,064.3	7,021.7
Additions	8.2	–	–	–	359.4	367.6
Disposals	(0.5)	(1.3)	–	(2.1)	–	(3.9)
Reclassifications	132.9	3.7	128.0	256.7	(521.3)	–
At 31 March 2011	2,552.7	68.6	1,768.9	2,092.8	902.4	7,385.4
Additions	0.8	–	–	–	346.9	347.7
Disposals	(1.3)	(1.0)	–	(4.7)	–	(7.0)
Reclassifications	202.0	1.9	66.4	248.3	(518.6)	–
At 31 March 2012	2,754.2	69.5	1,835.3	2,336.4	730.7	7,726.1
Accumulated depreciation						
At 1 April 2010	735.7	25.6	401.6	899.7	–	2,062.6
Charge for the year	59.1	1.3	13.9	169.9	–	244.2
Disposals	(0.4)	(1.2)	–	(2.0)	–	(3.6)
At 31 March 2011	794.4	25.7	415.5	1,067.6	–	2,303.2
Charge for the year	67.7	1.2	13.4	168.8	–	251.1
Disposals	–	(0.7)	–	(4.5)	–	(5.2)
At 31 March 2012	862.1	26.2	428.9	1,231.9	–	2,549.1
Net book value						
At 31 March 2012	**1,892.1**	**43.3**	**1,406.4**	**1,104.5**	**730.7**	**5,177.0**
At 31 March 2011	1,758.3	42.9	1,353.4	1,025.2	902.4	5,082.2

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.

Group and Company	Specialised operational properties and structures £m	Plant, machinery and vehicles £m	Total £m
Cost			
At 1 April 2010, 31 March 2011 and 31 March 2012	221.7	347.1	568.8
Accumulated depreciation			
At 1 April 2010	40.2	122.4	162.6
Charge for the year	3.7	11.6	15.3
At 31 March 2011	43.9	134.0	177.9
Charge for the year	3.7	11.6	15.3
At 31 March 2012	47.6	145.6	193.2
Net book value			
At 31 March 2012	**174.1**	**201.5**	**375.6**
At 31 March 2011	177.8	213.1	390.9

10 Investments

	Company	
	2012 £m	2011 £m
Cost and net book value		
At 1 April 2011	37.6	37.6
Increase of shareholding in Scottish Water Horizons Holdings Limited	34.6	–
Transfer of shareholding in Scottish Water Business Stream Holdings Limited	(34.6)	–
At 31 March 2012	**37.6**	**37.6**

During 2011/12 the Scottish Water group of companies was restructured to optimise the financing of Scottish Water's non-regulated trading activities. In November 2011, Scottish Water transferred its shareholding in Scottish Water Business Stream Holdings Limited (and its subsidiary Scottish Water Business Stream Limited) to Scottish Water Horizons Holdings Limited (SWHH). In exchange, SWHH issued the equivalent number of ordinary shares to Scottish Water, thereby increasing its investment to £37.6 million. A new legal entity, Scottish Water International Limited, was set up in January 2012. Its share capital of £1.0 million is 100% owned by SWHH.

Investment in subsidiaries

Principal subsidiary undertakings	Country of incorporation	% of Ordinary shares and votes held	Value £m	Principal activity
Scottish Water Horizons Holdings Limited	Scotland	100.0	37.6	Holding company
Scottish Water Business Stream Holdings Limited *	Scotland	100.0	34.6	Holding company
Scottish Water Business Stream Limited**	Scotland	100.0	11.5	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	1.0	Overseas consultancy

* owned by Scottish Water Horizons Holdings Limited
** owned by Scottish Water Business Stream Holdings Limited

Scottish Water owns shares in a further seven companies, which did not trade during the year ended 31 March 2012. 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.

Group
Investment in Jointly Controlled Operations
On 26 June 2002 Scottish Water formed a company, Scottish Water Solutions Limited (SWS). This company, which commenced trading on 30 June 2003 and is jointly owned with Stirling Water Limited and UUGM Limited, delivered the majority of Scottish Water's capital investment programme for the 2006 to 2010 regulatory period. The nature of the contractual agreement between Scottish Water and the other shareholders in Scottish Water Solutions Limited is such that the parties are engaged in joint activities that do not constitute an entity carrying on a trade or business in its own right. Consequently, Scottish Water Solutions Limited has been accounted for, under IAS 31 'Interests in Joint Ventures', as a Jointly Controlled Operation.

On 6 April 2010 Scottish Water Solutions 2 Limited (SWS2) commenced trading. This company is jointly owned with Thistle Water Limited and will deliver part of Scottish Water's capital investment programme for the 2010 to 2015 regulatory period. The nature of the contractual agreement between Scottish Water and the other shareholder in Scottish Water Solutions 2 is such that the parties are engaged in joint activities that do not constitute an entity carrying on a trade or business in its own right. Consequently, Scottish Water Solutions 2 is accounted for, under IAS 31 'Interests in Joint Ventures', as a Jointly Controlled Operation.

Details of the investments are as follows:

	Country of incorporation	% of Ordinary shares and votes held	Value £	Principal activity
Scottish Water Solutions Limited	Scotland	51.0	510	Contracting services
Scottish Water Solutions 2 Limited	Scotland	51.0	510	Contracting services

10 Investments continued

Summary aggregated financial information on jointly controlled entities – 51%:

	2012 £m	2011 £m
Current assets	22.8	21.0
Current liabilities	22.8	21.0
Income	79.5	84.7
Expenses	79.5	84.7

The information detailed above for 2012 was extracted from the financial statements for SWS and SWS2. SWS and SWS2 themselves have no contingent liabilities and there are no contingent liabilities relating to Scottish Water's interest in SWS or SWS2.

11 Inventories

	Group		Company	
	2012 £m	2011 £m	2012 £m	2011 £m
Raw materials and consumables	2.0	2.4	1.8	2.2
Less provision held	(0.1)	(0.1)	(0.1)	(0.1)
	1.9	**2.3**	**1.7**	**2.1**

All inventories will be recovered within 12 months.

12 Trade and other receivables

	Group		Company	
	2012 £m	2011 £m	2012 £m	2011 £m
Trade receivables	445.7	423.7	376.9	354.9
Less provision for impairment of trade receivables	(358.3)	(331.7)	(346.0)	(322.0)
Net trade receivables	87.4	92.0	30.9	32.9
Other receivables	23.5	16.3	21.0	13.9
Prepayments and accrued income	74.6	59.6	5.5	4.4
Amounts due from subsidiaries	–	–	1.5	1.0
	185.5	**167.9**	**58.9**	**52.2**

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

	Group		Company	
	2012 £m	2011 £m	2012 £m	2011 £m
Balance at 1 April	331.7	307.7	322.0	297.7
Charge for the year	31.3	27.7	24.3	24.3
Amounts written down during the year	(4.7)	(3.7)	(0.3)	–
Balance at 31 March	358.3	331.7	346.0	322.0

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

13 Cash and cash equivalents

	Group		Company	
	2012 £m	2011 £m	2012 £m	2011 £m
Cash at bank and in hand	68.3	134.6	20.1	84.5
Short-term bank deposits	286.9	204.8	220.9	167.8
Cash and cash equivalents per the statement of cash flows	**355.2**	**339.4**	**241.0**	**252.3**

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

14 Trade and other payables

	Group		Company	
	2012 £m	2011 £m	2012 £m	2011 £m
Current				
Trade payables	26.3	28.2	23.9	26.4
Non trade payables and accruals	86.5	105.7	86.4	105.4
Accruals	146.1	143.6	133.6	122.3
Payments received in advance	84.9	67.3	8.9	14.6
Other payables	20.6	18.5	5.5	7.4
Deferred income	2.5	2.6	1.1	1.0
Other taxes and social security	2.6	2.7	2.5	2.6
Amounts due to subsidiaries	–	–	24.9	24.0
Amounts due to jointly owned operations	34.5	34.4	34.5	34.4
	404.0	**403.0**	**321.3**	**338.1**
Non-current				
Other payables	47.8	37.8	47.8	37.8
Deferred income	22.8	23.9	16.6	17.6
	70.6	**61.7**	**64.4**	**55.4**

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

15 Deferred taxation

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

	Note	Accelerated capital allowances £m	Retirement benefit obligations £m	Tax losses £m	Other £m	Total £m
Group						
At 1 April 2010		498.9	(129.6)	(44.7)	(23.6)	301.0
Charge/(credit) to income statement	8	21.5	21.5	(19.7)	15.8	39.1
Charge to reserves	22	–	34.3	–	–	34.3
At 31 March 2011		520.4	(73.8)	(64.4)	(7.8)	374.4
Charge/(credit) to income statement	8	(2.3)	0.3	2.8	(1.5)	(0.7)
Charge to reserves	22	–	6.0	–	–	6.0
At 31 March 2012		**518.1**	**(67.5)**	**(61.6)**	**(9.3)**	**379.7**
Company						
At 1 April 2010		498.3	(128.7)	(44.4)	(22.4)	302.8
Charge/(credit) to income statement		21.1	21.3	(19.9)	14.4	36.9
Charge to reserves	22	–	34.1	–	–	34.1
At 31 March 2011		519.4	(73.3)	(64.3)	(8.0)	373.8
Charge/(credit) to income statement		(2.5)	0.4	2.8	(0.8)	(0.1)
Charge to reserves	22	–	5.3	–	–	5.3
At 31 March 2012		**516.9**	**(67.6)**	**(61.5)**	**(8.8)**	**379.0**

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	
	2012 £m	**2011 £m**	**2012 £m**	**2011 £m**
Deferred tax assets	–	(0.5)	–	–
Deferred tax liabilities	379.7	374.9	379.0	373.8
At 31 March	**379.7**	**374.4**	**379.0**	**373.8**

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 £72 million (2011: £42 million) for both the Company and the Group. No tax is expected to be payable in this regard.

16 Provisions for liabilities

	Restructure provision £m	Income uncertainty provision £m	Other £m	Total £m
Group				
At 1 April 2010	8.3	7.1	0.5	15.9
Charged to the income statement	11.3	0.5	0.4	12.2
Utilised during the year	(11.8)	(4.2)	(0.3)	(16.3)
At 31 March 2011	7.8	3.4	0.6	11.8
Charged to the income statement	1.7	1.4	0.1	3.2
Utilised during the year	(8.3)	–	(0.2)	(8.5)
At 31 March 2012	**1.2**	**4.8**	**0.5**	**6.5**
Company				
At 1 April 2010	7.9	7.1	0.5	15.5
Charged to the income statement	10.6	4.2	0.4	15.2
Reclassified to accruals	–	(4.1)	–	(4.1)
Utilised during the year	(11.4)	(3.8)	(0.3)	(15.5)
At 31 March 2011	7.1	3.4	0.6	11.1
Charged to the income statement	1.6	1.4	0.1	3.1
Utilised during the year	(7.8)	–	(0.2)	(8.0)
At 31 March 2012	**0.9**	**4.8**	**0.5**	**6.2**

	Group		Company	
Analysis of total provisions	**2012 £m**	**2011 £m**	**2012 £m**	**2011 £m**
Current	5.4	10.6	5.1	9.9
Non-current	1.1	1.2	1.1	1.2
	6.5	11.8	6.2	11.1

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, relating to each financial year would normally be finalised 18 months after the end of the relevant financial year. However, at 31 March 2012, the final settlement reports for the 2008/09 and 2009/10 financial years had not been finalised. It is expected that the provision will be utilised during 2013.

The other provision of £0.5 million relates primarily to onerous property rental costs which will be utilised over the next two years.

17 Other loans and borrowings

	2012 £m	2011 £m
Group and Company		
Current		
Non-government loans	1.7	1.6
Obligations under finance leases	15.5	14.6
	17.2	**16.2**
Non current		
Non-government loans	2.4	4.1
Obligations under finance leases	415.5	430.9
	417.9	**435.0**
Total		
Non-government loans	4.1	5.7
Obligations under finance leases	431.0	445.5
	435.1	451.2

(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 2012	1.7	0.9	0.5	1.0	4.1
At 31 March 2011	1.6	1.7	1.4	1.0	5.7

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

	Book value 2012 £m	Book value 2011 £m	Fair value 2012 £m	Fair value 2011 £m
Non-government loans	4.1	5.7	5.0	6.7

(ii) Finance lease liabilities – PFI liabilities
Future finance lease commitments are as follows:

	Minimum lease payments		Present value of minimum lease payments	
	2012 £m	2011 £m	2012 £m	2011 £m
Amounts payable:				
Within one year	40.9	40.9	15.5	14.6
Between one and five years	163.6	163.5	91.7	86.7
After five years	507.9	548.8	323.8	344.2
Present value of minimum lease payments including finance charges	712.4	753.2		
Less future finance charges	(281.4)	(307.7)		
Present value of minimum lease payments	431.0	445.5	431.0	445.5

17 Other loans and borrowings continued

PFI – Service concession arrangements
Upon its creation in April 2002 Scottish Water inherited nine concession contracts which had been entered into with nine private sector consortia ("PFI Cos") by its three 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 nine 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		Company	
	2012 £m	2011 £m	2012 £m	2011 £m
Government loans	3,223.7	3,172.1	3,165.2	3,113.6

Scottish Water's borrowing powers are defined in Section 42 of the Water Industry (Scotland) Act 2002. The limit at 31 March 2012 on these powers was that total net new borrowings for the year ended 31 March 2012 should not exceed £50.0 million. Net new borrowings were £50.0 million in the year.

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	211.5	82.5	227.5	372.3	1,363.5	2,257.3
Scottish Consolidated Fund – subsidiaries	58.5	–	–	–	–	58.5
Scottish Consolidated Fund – SW Group	270.0	82.5	227.5	372.3	1,363.5	2,315.8
National Loans Fund	34.0	7.0	43.0	171.0	480.9	735.9
Public Works Loan Board	6.4	19.9	82.9	45.8	17.0	172.0
At 31 March 2012	**310.4**	**109.4**	**353.4**	**589.1**	**1,861.4**	**3,223.7**
At 31 March 2011	152.9	105.9	343.9	603.4	1,966.0	3,172.1

b. Fair values
The carrying amounts and fair value of the Government borrowings are as follows:

	Book value 2012 £m	Book value 2011 £m	Fair value 2012 £m	Fair value 2011 £m
Scottish Consolidated Fund	2,315.8	2,230.7	2,660.3	2,291.0
National Loans Fund	735.9	756.9	1,008.4	928.8
Public Works Loan Board	172.0	184.5	231.0	239.1
	3,223.7	3,172.1	3,899.7	3,458.9

19 Analysis of net debt

	Note	As at 1 April 2011 £m	Increase/ (decrease) in cash £m	Decrease/ (increase) in debt £m	As at 31 March 2012 £m
Group					
Cash and cash equivalents	13	339.4	15.8	–	355.2
Government loans	18	(3,172.1)	–	(51.6)	(3,223.7)
Other loans	17	(5.7)	–	1.6	(4.1)
Net debt		(2,838.4)	15.8	(50.0)	(2,872.6)
Company					
Cash and cash equivalents	13	252.3	(11.3)	–	241.0
Government loans	18	(3,113.6)	–	(51.6)	(3,165.2)
Other loans	17	(5.7)	–	1.6	(4.1)
Net debt		(2,867.0)	(11.3)	(50.0)	(2,928.3)

20 Reserves

	Note	Retained earnings excluding actuarial gains/(losses) £m	Actuarial gains/ (losses) on pension obligations £m	Retained earnings including actuarial gains/(losses) £m
Group				
At 1 April 2010		734.8	(271.4)	463.4
Retained surplus for the year		184.0	–	184.0
Actuarial gain, net of deferred taxation	22	–	65.3	65.3
At 31 March 2011		**918.8**	**(206.1)**	**712.7**
Retained surplus for the year		98.5	–	98.5
Actuarial loss, net of deferred taxation	22	–	(10.0)	(10.0)
At 31 March 2012		**1,017.3**	**(216.1)**	**801.2**
Company				
At 1 April 2010		709.9	(268.9)	441.0
Retained surplus for the year		162.7	–	162.7
Actuarial gain, net of deferred taxation	22	–	64.9	64.9
At 31 March 2011		**872.6**	**(204.0)**	**668.6**
Retained surplus for the year		74.2	–	74.2
Actuarial loss, net of deferred taxation	22	–	(12.0)	(12.0)
At 31 March 2012		**946.8**	**(216.0)**	**730.8**

21 Results of Scottish Water (the Company)

Of the results for the financial year, a retained surplus of £74.2 million (2011: £162.7 million, after an exceptional item of £82.4 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 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 final pensionable pay. Actual pension costs for the year for each fund, as a % of pensionable pay, were 19.3% (2011: 19.2%), 24.0% (2011: 23.2%) and 19.3% (2011: 18.5%) respectively.

A full actuarial valuation was carried out at 31 March 2011 for all three funds and updated at 31 March 2012 by a qualified independent actuary, to take account of the requirements of IAS 19.

The major assumptions used by the actuaries were:

	2012 %	2011 %
Rate of increase in pensionable salaries	2.5	1.0
Rate of increase in pensions payment	2.7	3.1
Discount rate	4.7	5.5
Inflation rate	2.7	3.1

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

	North East Scotland Years	Lothian Years	Strathclyde Years
Retiring at 31 March 2012			
Male	22.3	20.5	21.1
Female	25.3	22.9	23.5
Retiring at 31 March 2032			
Male	24.5	22.7	23.4
Female	27.7	25.5	25.4

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 deficit £m
Rate of increase in pensionable salaries	+/- 0.5% per annum	Increase/decrease by c. 2%	Increase/decrease by c. £25 million
Discount rate	+/- 0.5% per annum	Decrease/increase by c. 9%	Decrease/increase by c. £110 million
Inflation rate	+/- 0.5% per annum	Increase/decrease by c. 7%	Increase/decrease by c. £85 million
Longevity	Increase life expectancy by 1 year	Increase by c. 3.0%-4.0%	Increase by c. £36 million to £49 million

22 Pensions continued

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

	Group				Company			
	Long term rate of return %	Value 2012 £m	Long term rate of return %	Value 2011 £m	Long term rate of return %	Value 2012 £m	Long term rate of return %	Value 2011 £m
Equities	6.3	721.2	7.5	720.0	6.3	713.3	7.5	714.0
Bonds	3.7	90.4	4.9	91.7	3.7	89.2	4.9	90.7
Property	4.4	73.6	5.5	71.9	4.4	72.9	5.5	71.3
Other	0.5	50.0	0.5	31.6	0.5	49.3	0.5	31.3
Total market value of assets		**935.2**		**915.2**		**924.7**		**907.3**
Present value of scheme liabilities		(1,216.3)		(1,199.2)		(1,206.4)		(1,189.2)
Gross pension liability		**(281.1)**		**(284.0)**		**(281.7)**		**(281.9)**
Related deferred tax asset		67.5		73.8		67.6		73.3
Net pension liability		(213.6)		(210.2)		(214.1)		(208.6)

Scheme assets are stated at their bid values.

Reconciliation of opening and closing retirement benefit liabilities and assets

	Group		Company	
	2012 £m	2011 £m	2012 £m	2011 £m
Movements in liabilities during the year:				
Opening value of total liabilities	(1,199.2)	(1,306.7)	(1,189.2)	(1,297.1)
Current service cost	(17.7)	60.7	(16.8)	60.9
Interest on pension scheme liabilities	(65.7)	(68.7)	(65.1)	(68.2)
Contributions by members	(6.4)	(6.7)	(6.1)	(6.4)
Actuarial gain	39.5	96.0	37.7	95.4
Impact of curtailments	(2.4)	(6.2)	(2.4)	(6.2)
Benefits paid	35.6	32.4	35.5	32.4
Closing value of total liabilities	(1,216.3)	(1,199.2)	(1,206.4)	(1,189.2)
Movement in assets during the year:				
Opening fair value of total assets	915.2	843.9	907.3	837.5
Expected return on pension scheme assets	62.3	60.6	61.7	60.1
Contributions by members	6.4	6.7	6.1	6.4
Contributions by the employer	28.0	26.6	27.1	25.9
Actuarial (loss)/gain	(52.4)	4.8	(53.3)	4.8
Impact of settlements	11.3	5.0	11.3	5.0
Benefits paid	(35.6)	(32.4)	(35.5)	(32.4)
Closing fair value of assets	935.2	915.2	924.7	907.3
Gross deficit in the schemes at 31 March	(281.1)	(284.0)	(281.7)	(281.9)

22 Pensions continued

Return on assets
As required by IAS 19, the expected return on assets is based on the long-term expectation of returns for each asset class at the beginning of the year. The return on equities is 2.6% per annum in excess of the yield on government bonds. Historical markets are studied and assets with higher volatility are assumed to generate higher returns consistent with widely accepted capital market principles. The assumed long-term rate of return on each asset class is set out within this note. The overall expected rate of return on assets is then derived by aggregating the expected rate for each class over the actual asset allocation at 31 March 2012.

	Group		Company	
	2012 £m	**2011 £m**	**2012 £m**	**2011 £m**
Actual return on pension scheme assets	10.2	65.4	10.1	64.9
Actuarial (loss)/gain in other comprehensive income in the consolidated statement of comprehensive income				
Variance between pension fund actuarial assumptions and actual experience	(12.9)	100.8	(15.6)	100.2
Impact of settlements and curtailments	8.9	(1.2)	8.9	(1.2)
Gross actuarial (loss)/gain recognised in the pension fund	**(4.0)**	**99.6**	**(6.7)**	**99.0**
Deferred tax movement	(6.0)	(34.3)	(5.3)	(34.1)
Net actuarial (loss)/gain recognised in other comprehensive income in the consolidated statement of comprehensive income	**(10.0)**	**65.3**	**(12.0)**	**64.9**

Amounts recognised in the consolidated income statement

	Note	2012 £m	2011 £m
Current service cost relating to current period	5	17.7	22.3
Past service cost adjustment to reflect pension increases now based on CPI	4	–	(83.0)
Total current service cost		17.7	(60.7)
Interest cost on pension scheme liabilities	7	65.7	68.7
Expected return on pension scheme assets	7	(62.3)	(60.6)
		21.1	(52.6)

The unpaid contributions outstanding at the year end included in other payables (note 14) was £2.2 million (2011: £2.1 million). It is estimated that Scottish Water will make contributions of £24.5 million to the pension funds in financial year 2012/13.

22 Pensions continued

History of experience gains and losses

Group	2012 £m	2011 £m	2010 £m	2009 £m	2008 £m
Difference between the expected and actual return on scheme assets:					
Amount	(52.4)	4.8	189.1	(184.0)	(80.7)
Fair value of assets	935.2	915.2	843.9	615.5	749.4
Experienced gains/(losses) on scheme liabilities:					
Amount	56.4	2.3	(0.4)	13.1	(0.3)
Present value of liabilities	1,216.3	1,199.2	1,306.7	838.9	796.9
Changes in assumptions underlying the present value of scheme liabilities:					
Amount	(16.9)	93.7	(420.8)	(12.1)	180.0
Total variance between pension fund actuarial assumptions and actual experience	**(12.9)**	**100.8**	**(232.1)**	**(183.0)**	**99.0**
Gross deficit in the schemes at 31 March	(281.1)	(284.0)	(462.8)	(223.4)	(47.5)

Company	2012 £m	2011 £m	2010 £m	2009 £m	2008 £m
Difference between the expected and actual return on scheme assets:					
Amount	(53.3)	4.8	187.7	(183.5)	(80.4)
Fair value of assets	924.7	907.3	837.5	611.5	746.6
Experienced gains/(losses) on scheme liabilities:					
Amount	54.7	2.3	(0.4)	13.3	(0.3)
Present value of liabilities	1,206.4	1,189.2	1,297.1	834.4	794.2
Changes in assumptions underlying the present value of scheme liabilities:					
Amount	(17.0)	93.1	(416.6)	(12.2)	179.1
Total variance between pension fund actuarial assumptions and actual experience	**(15.6)**	**100.2**	**(229.3)**	**(182.4)**	**98.4**
Gross deficit in the schemes at 31 March	(281.7)	(281.9)	(459.6)	(222.9)	(47.6)

23 Commitments

a. Capital commitments
The Group has contracted capital commitments of £233.4 million (2011: £638.3 million) relating to property, plant and equipment at the balance sheet date. These commitments are expected to be settled within the following four 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 150 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:

	2012 £m	2011 £m
Within one year	2.0	2.1
Between one and five years	5.5	6.0
After five years	19.1	22.4
	26.6	30.5

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.

25 Related party transactions

The Group has related party relationships with the Scottish Government, with its subsidiaries and jointly controlled operations (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. 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 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.

Jointly controlled operations
In the course of normal operations, Scottish Water contracted on an arms-length basis with Scottish Water Solutions Limited (a Joint Arrangement between Scottish Water, Stirling Water Limited and UUGM Limited) and Scottish Water Solutions 2 Limited (a Joint Arrangement between Scottish Water and Thistle Water Limited). The aggregate transactions which are considered to be material and which have not been disclosed elsewhere in the financial statements are summarised below, gross of value added tax:

	2012 £m	2011 £m
Sales and costs charged to Scottish Water Solutions Limited	2.9	7.6
Purchases from Scottish Water Solutions Limited	(19.5)	(106.5)
Amounts due to Scottish Water Solutions Limited (note 14)	2.3	19.1
Sales and costs charged to Scottish Water Solutions 2 Limited	10.3	31.0
Purchases from Scottish Water Solutions 2 Limited	(167.2)	(92.8)
Amounts due to Scottish Water Solutions 2 Limited (note 14)	32.2	15.3

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

	2012 £m	2011 £m
Sale of water and waste water services	290.8	300.6

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 34 to 38.

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 Corporate Governance report on pages 31 to 33.

a. Qualitative risk disclosures

Operational and business risk

This is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. It also includes losses due to external factors such as the market situation or government regulations. Reputational risk is included in this category. The risk register and risk management processes identify key operational and other risks and are reviewed on a regular basis.

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.

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.

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

	Group		Company	
	2012 £m	2011 £m	2012 £m	2011 £m
Trade receivables per note 12:				
Trade receivables	445.7	423.7	376.9	354.9
Less provision for impairment of trade receivables	(358.3)	(331.7)	(346.0)	(322.0)
Net trade receivables	87.4	92.0	30.9	32.9
Analysed between:				
Household receivables	372.3	348.6	372.3	348.6
Less provision for impairment	(344.9)	(320.9)	(344.9)	(320.9)
Net household receivables	27.4	27.7	27.4	27.7
Business customer receivables	73.4	75.1	4.6	6.3
Less provision for impairment	(13.4)	(10.8)	(1.1)	(1.1)
Net business customer receivables	60.0	64.3	3.5	5.2

26 Financial instruments and risks continued

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 2012 trade receivables in respect of household customers totalled £372.3 million with a provision of £344.9 million (2011: £348.6 million and £320.9 million respectively).

As at 31 March 2012 trade receivables from business customers totalled £73.4 million (2011: £75.1 million). The ageing analysis of trade receivables from business customers and the related provisioning is as follows:

	Total £m	Current £m	<3 months overdue £m	3-12 months overdue £m	>12 months overdue £m
Group					
Gross receivable	73.4	47.3	9.0	11.3	5.8
Provision	(13.4)	–	(2.0)	(5.6)	(5.8)
Net trade receivable as at 31 March 2012	60.0	47.3	7.0	5.7	–
Gross receivable	75.1	53.8	7.9	10.6	2.8
Provision	(10.8)	–	(3.6)	(5.0)	(2.2)
Net trade receivable as at 31 March 2011	64.3	53.8	4.3	5.6	0.6
Company					
Gross receivable	4.6	2.0	0.6	1.1	0.9
Provision	(1.1)	–	–	(0.2)	(0.9)
Net trade receivable as at 31 March 2012	3.5	2.0	0.6	0.9	–
Gross receivable	6.3	3.9	0.7	1.0	0.7
Provision	(1.1)	–	–	(0.4)	(0.7)
Net trade receivable as at 31 March 2011	5.2	3.9	0.7	0.6	–

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

The Commission monitors Scottish Water's performance on efficiency and customer service and approves our code of practice. Each year the Commission publishes reports on the exercise of its functions. In preparing these reports, the Commission assesses our 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 Commission may make regulatory amendments to figures published in Scottish Water's audited financial statements to ensure like for like comparisons with other companies.

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	National Operations Centre and office accommodation, Stepps, Glasgow design and build	£14.9 million
		National Operations Centre – Phase 2 IT hardware, software and telemetry	£11.8 million
		Rolling Programme – replacement of chlorine gas dosing	£15.8 million
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	None	–
Gifts	£100	None	–

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

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 Ministers within the funding allowed by the Water Industry Commission for Scotland.

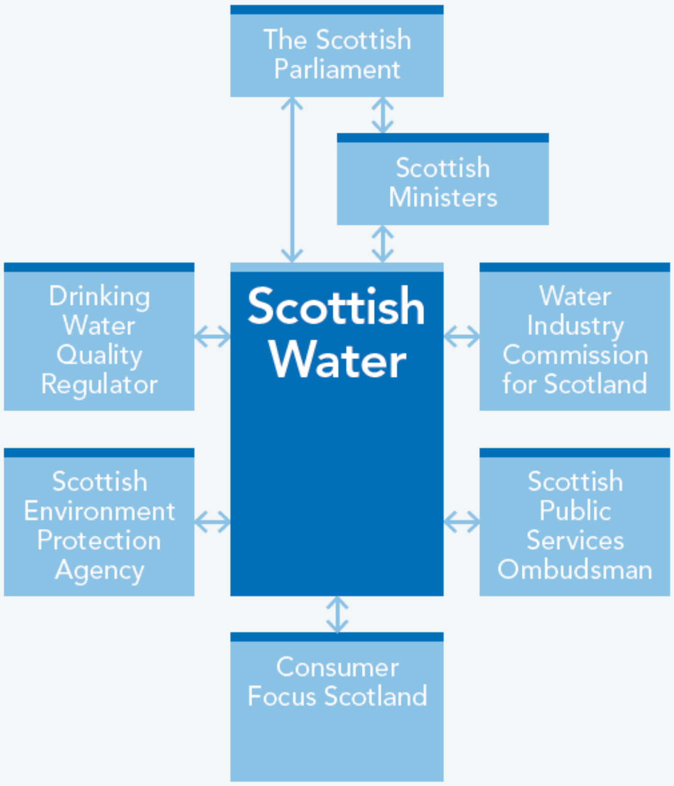
Water Industry Commission for Scotland (WICS)
Economic regulator. Sets charges and reports on costs and performance.

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.

Consumer Focus Scotland (CFS)
Responsible for representing the views and interests of Scottish Water customers and is a statutory consultee for matters relating to the Scottish water industry.



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