



**Scottish
Water**
Trusted to serve Scotland

Annual Report &
Accounts 2017/18



Contents

Overview			
Scottish Water's vital role	1	People	42–44
2017/18 highlights	2	Community matters	45
Chair's statement	3	Looking ahead: our plan for 2015 to 2021	46
Chief Executive's statement	4	Governance section	
Strategic report		Board members	48–49
Our business model	6–7	Corporate governance	50–53
Our vision	8	Audit committee report	54–57
Our strategy	9	Remuneration committee	58
Delivering ministerial objectives 2015–21	10	Members' remuneration report	59–68
Our approach to risk management	11–13	Members' report	69–71
principal risks and uncertainties		Financials	
Scottish Water Group	14–18	Independent auditor's report	74–79
principal risks and uncertainties		Consolidated income statement	80
Going concern and viability statements	19	Consolidated statement of comprehensive income	80
Performance:		Consolidated statement of changes in equity	81
Customer service	20–22	Company statement of changes in equity	81
Investment overview	23–27	Balance sheets	82
Drinking water quality	28–29	Statements of cash flow	83
Environment	30–32	Notes to the financial statements	84–114
Innovation	33	Direction by the Scottish Ministers	115
Supporting the economy	34	The water industry in Scotland	116
Household charges	35		
Financial summary – group	36–37		
Financial summary – regulated services	38–39		
Business Stream	40		
Non-regulated businesses	41		

Scottish Water’s vital role

Every day, we deliver 1.38 billion litres of clear, fresh drinking water and take away 929 million litres of waste water which we treat and return safely to the environment.

The service we provide to 2.52 million households and 153,000 business premises is essential to daily life in Scotland.

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

We do all of this at a cost which is among the lowest in Great Britain. Our average household charge is £42 lower per year than the average household charge in England and Wales.

During the six years of our investment period 2015-21, we plan to invest around £3.9 billion in maintaining and replacing our infrastructure and in delivering further improvements to drinking water quality, protecting the environment and supporting the Scottish economy. In 2017/18, the third year of that programme, we invested a total of £647 million.

Customer charges go towards maintaining and improving:

30,246

miles of water pipes

242

water treatment works

32,940

miles of sewer pipes

1,826

waste water treatment works

2017/18 highlights

Delivering for customers

Highest ever customer service and customer experience score

Real value for customers

Delivering service at a cost which is £42 below England and Wales average for household customers

Water quality maintained

More than 99.9% of tests at customers' taps pass stringent quality standards

Protecting the environment

Best ever environmental performance with lowest number of environmental pollution incidents

Investing in communities

£647 million invested to improve the reliability and resilience of our services and contribute to the economy

Energy efficiency

We host and generate more than double the amount of renewable energy than the electricity that we use in our operations

Chair's statement

Dame Susan Rice, Chair



Scottish Water's performance has been very strong this year.

Key to our success has been an intense focus on our vision of being trusted to care for the water on which Scotland depends. We provide high quality drinking water, protect Scotland's natural environment and continually seek greater efficiency so that we can keep customers' charges down. We take a long-term approach to planning for the future, recognising the responsibility that comes with the stewardship of the nation's vital water and waste water assets and infrastructure.

Our Board is focused on ensuring that our priorities match our vision and the requirements that our five million customers, the communities they form and indeed the nation, have of us.

I'm pleased to report that in 2017/18 we have continued to improve the service received by our customers despite some challenges, including severe winter weather. The water at customers' taps remains of a very high quality and our household charges are among the lowest in Great Britain.

Our capital investment programme has increased further this year, and we have now invested more than £1.7 billion over the first three years of this investment period. Our investment ensures that we maintain water quality, improve customer service and increase the resilience of our networks in future.

In England, there is an increasing debate about the most appropriate ownership and governance of water and waste water companies. Regardless of how that debate evolves, I am extremely proud that the Scottish Water model of public ownership with robust regulation and governance is one that delivers real value and accountability.

That is in no small part down to the skill and dedication of Scottish Water's people and Board, who possess a strong mix of commercial acumen and industry experience. I would like to take this opportunity to thank all of them for their tireless efforts and great achievements this year.

I am pleased to have welcomed two new members to the Board – Deirdre Michie and Ken Marnoch. Their insight and fresh thinking is vital to ensuring the effective functioning of the Board. I'd like to thank Lynne Peacock, who stepped down from the Board in October 2017, and Alan Bryce, who stood down in March 2018, for their invaluable contributions over many years.

The Board and its committees always work to ensure that our executive team remain focused on our key corporate objectives including the areas of risk and compliance. This work has confirmed that, during the year, Scottish Water has delivered against the expectations of our customers, regulators and the Scottish Government.

Aside from our core water and waste water services, we also carry out additional activities which add value to Scottish Water and ultimately help our customers through increased income that is reinvested or used to help keep charges down. These activities include renewable energy schemes and advising international clients on water and waste water services.

Business Stream, a subsidiary which operates in the competitive non-domestic market in Scotland and the newly-opened English market has had a transformational year, doubling the size of its customer base with the acquisition of the Southern Water non-household customer book and securing £155 million of new contracts in the English retail market.

Following the introduction of an industry-wide policy change to remove the charging exemption for vacant premises, Business Stream incurred £5.8 million of net costs, resulting in a reported pre-tax loss for the year of £5.2 million. Underlying profitability, excluding the impact of vacant properties and £3.5 million of amortisation charges in relation to the newly acquired Southern Water customer book, was in line with expectations at £4.1 million. I anticipate that, with its strong foothold in both the Scottish and English markets, Business Stream is well positioned to deliver profit growth in future years.

In the coming year, Scottish Water will strive to deliver the service our customers and stakeholders require and to remain trusted to serve Scotland.

Chief Executive's statement

Douglas Millican, Chief Executive



It's our responsibility to deliver for our customers today while building the capability and infrastructure to safeguard Scotland's water and waste water services for future generations.

The record levels of customer service and environmental performance that we delivered this year are a result of the drive and dedication of our people in delivering for our customers, and our proactive maintenance of our extensive asset base that enables us to deliver water and waste water services across Scotland. From some of our smallest island communities to our biggest and busiest urban centres, we are always investing to safeguard Scotland's vital water and waste water services.

Scottish Water is one of Scotland's biggest infrastructure investors, investing £647 million this year in sustaining high levels of water quality, improving customer service and increasing the resilience of our networks. One of our biggest current investment projects, the Shieldhall Tunnel in Glasgow, is a great example of how this major investment will improve the local environment and help to protect the local community from the impact of flooding.

We have delivered further improvements in customer service, increasing our household Customer Experience Measure (hCEM) by 0.48 points to 86.36 due to our highest ever customer satisfaction score. We also outstripped the performance target agreed with our regulator, achieving a score of 406 on our Overall Performance Assessment, a basket of performance measures. We sustained high levels of water quality with 99.9% of all tests taken at customers' taps complying with strict regulatory standards and achieved record levels of environmental performance. I am delighted that once again Scotland's water sector, led by us and including our partners and suppliers, has been recognised by Which? as being the most trusted sector by Scottish consumers.

The headline group surplus before tax was £22.4 million lower than last year at £71.8 million. The reduction was primarily due to the £11.8 million reduction in Business Stream's surplus and the expected increase in non-cash pension charges of £16.7 million. However, Scottish Water, on a regulatory accounting basis, generated a surplus before tax of £107.8 million, £8.3 million higher than last year. This will be reinvested in future service delivery. We have achieved all of this while keeping customer charges down. The average household charge in 2018/19 is £363, less than £1 a day and £42 lower than the average in England and Wales.

Our people at Scottish Water are key to delivering our strong performance and developing our plans for the future. In autumn 2017, we held a series of 21 employee engagement events all over Scotland to explore our vision, look to the future and consider the part our employees play in delivering excellent service for our customers. From all our conversations, there is clear commitment, loyalty and dedication among our people to deliver against our objectives and ensure we live up to our vision of being trusted to care for the water on which Scotland depends.

We have also faced some challenges in the last 12 months with an increase in safety incidents among Scottish Water employees and those of our alliance partners and contractors. In January, an employee of Veolia, the operator of Whitburn Waste Water Treatment Works under a long-term contract, lost his life while at work. On behalf of Scottish Water I offer my condolences to his family, friends and colleagues. Our aim is to have a working environment for everyone which is safe, healthy and productive and we will work with our partners to maintain a strong focus on our collective approach to this vital aspect of our activities.

In March 2018, exceptional snowfall and sustained cold temperatures caused burst pipes and flooding to many places across Scotland. However, we managed these challenges well, with minimal adverse impact on our customers due to robust forward planning and an excellent response by our people.

In closing, I want to thank all our people and partners for their dedication and contribution to a successful year of achievement. As I look ahead to 2018/19, I am confident that everyone in Scottish Water and our partners will continue to deliver well for our customers and communities.

Strategic report

Our business model	6-7
Our vision	8
Our strategy	9
Delivering ministerial objectives 2015–21	10
Our approach to risk management principal risks and uncertainties	11–13
Scottish Water Group principal risks and uncertainties	14–18
Going concern and viability statements	19
Performance:	
Customer service	20–22
Investment overview	23–27
Drinking water quality	28–29
Environment	30–32
Innovation	33
Supporting the economy	34
Household charges	35
Financial summary – group	36–37
Financial summary – regulated services	38–39
Business Stream	40
Non-regulated businesses	41
People	42–44
Community matters	45
Looking ahead: our plan for 2015 to 2021	46

Our business model

Who we are

Scottish Water was formed in 2002 following the merger of the three regional water authorities in Scotland and is a public sector body, classified as a public corporation of a trading nature, answerable to the Scottish Parliament through Scottish Ministers. Consequently, Scottish Water does not have shareholders. This ownership model allows the surplus generated to be reinvested in the provision of services to our customers.

Group overview

The principal activities during the year were the supply of water and waste water services to around 5 million customers in homes and businesses across Scotland covering an area of 30,810 square miles.

Scottish Water's regulated business supplies water and waste water services to households and is also the wholesaler to the retailers (Licensed Providers) who operate in the water retail market for businesses in Scotland. Within the Scottish Water group, our subsidiary, Business Stream, operates as a Licensed Provider (LP), competing with other LPs in the market to supply water and waste water retail services to business customers. The group also provides non-regulated and other commercial services to clients both within Scotland and internationally.

Group structure

Scottish Water's principal subsidiary undertakings, all of which are disclosed in note 11 to the financial statements, have their own boards of directors.

The Members of Scottish Water's Board are accountable to the Scottish Government. Details of the current Board Members are provided on pages 48 to 49.

Business Stream is operated in accordance with the Governance Code (agreed with the Water Industry Commission for Scotland (WICS)). The code sets out the operating regime that Scottish Water and Business Stream must comply with to enable the operation of the licensed retail market. Business Stream has the same Chair as Scottish Water but has its own independent Board and management team. Scottish Water exercises governance over Business Stream through Scottish Water Business Stream Holdings Ltd (SWBSH) in accordance with the above code.

Strategic framework

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

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

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

What we do

Our vision is to be trusted to care for the water on which Scotland depends (see page 8), and our customers expect us to provide excellent customer service by delivering high levels of water quality and environmental performance, all for an affordable price.

Using Scotland's natural resources and the skills of our people, Scottish Water is committed to improving our services for customers and communities while protecting and enhancing the environment of Scotland. How we do this is covered in more detail in the following sections:

Environment	pages 30 to 32
People	pages 42 to 44
Community matters	page 45
Customer service	pages 20 to 22

In accordance with the Non-Financial Reporting Regulations, additional information on Scottish Water’s policies and training in respect of the following items are detailed:

- Human rights page 44
- Anti-corruption and anti-bribery page 44

The key performance indicators used throughout the business to measure financial and non-financial performance are detailed throughout the annual report in the relevant sections.

Financial framework

The Scottish Water regulated business is subject to incentive-based regulation by the WICS.

In 2014, the WICS carried out a six year price review for the 2015–21 period, which caps the prices that Scottish Water charge for water and waste water services. The combination of regulated price caps and constraints on borrowing from the Scottish Government creates a clearly defined limit on the financing available to Scottish Water.

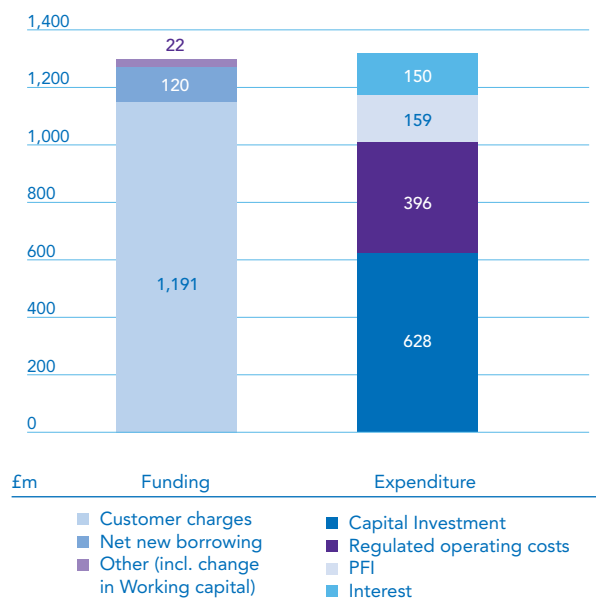
Within this financial framework, Scottish Water has an agreed Delivery Plan with Scottish Ministers that sets out our planned level of investment to deliver the required improvements and the expenditure to run the operation in respect of our core water and waste water services. Scottish Water’s aim is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

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

Scottish Water is funded through revenue raised from customer charges and borrowing from the Scottish Government. These finance Scottish Water’s investment programme, operating costs, Private Finance Initiative service fees and interest charges on loans.

The diagram below illustrates Scottish Water’s funding and expenditure for the year ended 31 March 2018. The surplus made by Scottish Water is reinvested in the provision of services to customers.

Scottish Water Funding and Expenditure 2017/18



Our vision

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

Serving

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

Leading

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

Strong

Working hard to keep customers' prices low. Delivering savings to keep household customer price increases below the overall level of inflation.

Growing

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

Responsible

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

Committed

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

Our strategy

We deliver clear and fresh drinking water, treat waste water and help protect Scotland's environment – every day of the year.

We do this in an affordable and sustainable way.

- We put customers at the heart of our plans. Listening to customers' views and building these into our planning allows us to ensure our service delivery meets their needs.
- We are committed to improving the services we provide to customers. Our strategies help us achieve this and we innovate to further improve performance and efficiency.
- We work hard to provide continuous clear and fresh drinking water, ensuring all our customers can turn on their taps to receive a safe and reliable supply, everywhere in Scotland.
- We strive to protect and enhance the environment of Scotland through investment in our waste water systems and good operational practices.
- We support Scotland's economy and communities by extending our infrastructure to meet new demand for our services.

This annual report highlights our progress during 2017/18. Information on our plans for service improvement from 2015–21 is included on page 46.

Our ambitions

In February 2018, we launched Shaping the Future, our consultation to seek customers' and stakeholders' views on the future of their water and waste water services, and their thoughts on the challenges, opportunities and ambitions that we have identified. This consultation sets out our intent, and our three long-term ambitions, to achieve a level where our services are truly reliable and sustainable for future generations:

- Ambition 1: Delivering a consistently leading customer experience.
- Ambition 2: Keeping customer prices low by driving for further innovation and efficiency and through smart investment choices.
- Ambition 3: Increasing the reliability, resilience and sustainability of all our services.

The Shaping the Future consultation runs until August 2018, and can be completed at www.yourwater.scot

Delivering ministerial objectives 2015–21

Scottish Ministers set objectives for Scottish Water for the period 1 April 2015 to 31 March 2021. This annual report looks at the third year of the delivery period – 2017/18.

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

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

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

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

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

More information on our plans for the future can be found in the Looking Ahead section on page 46.

Our approach to risk management principal risks and uncertainties

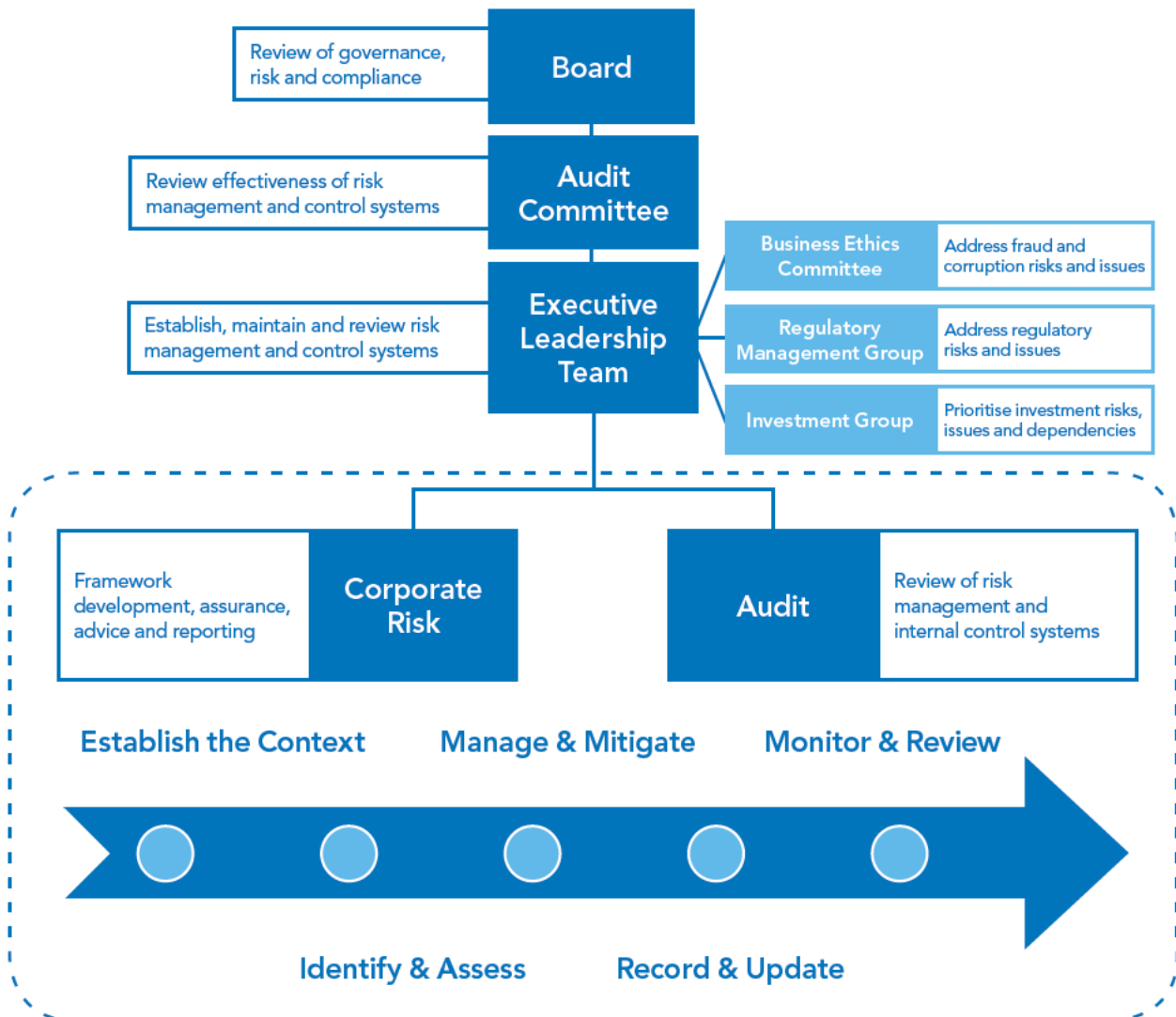
Overview

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

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

Risk control assurance

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



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

In order to efficiently and effectively manage opportunities and threats across the Scottish Water business, we embrace a systematic and structured approach to risk management. Our approach is based on the principles of the International Standard 31000 Risk Management (ISO 31000) and is tailored to meet the needs of our business and the environment in which we operate; and was independently audited in March 2017.

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

Risk management approach

Scottish Water has an established risk management policy which underwent a refresh in August 2017. This policy sets out a clear and consistent approach to the management of risk and defines our risk appetite. This is enabled by the Corporate Risk Register and supporting risk management processes.

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

Culture

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

Risk appetite

The level of risk we are willing to accept in the pursuit of our business objectives is reviewed and validated by the Board in advance of, and during, each regulatory period or where there is a material change to the operating environment.

We have established Risk Appetite Statements for key business areas. Beneath each statement is a series of measurable Risk Appetite Definitions which assist in providing a view as to whether we are operating within our appetite or whether additional risk action may be required.

These metrics are routinely reviewed by the Corporate Risk Team and individual risk owners, and are incorporated into bi-annual reports to the Executive Leadership Team and Audit Committee, and the annual report to the Board. The appropriateness of the mitigating actions is determined in accordance with the risk appetite for the relevant business areas.

Board

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

Audit Committee

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

Executive Leadership Team

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

Corporate risk

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

Audit

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

Three Lines of Defence

Scottish Water operates a Three Lines of Defence model with clearly defined roles and responsibilities. This model ensures the effectiveness of the risk management framework by providing key governance groups with appropriate assessment, monitoring and assurance at three different points.

- 1. First line of defence** – each business area is responsible for the identification and assessment of risks, understanding and adopting appropriate controls.

- 2. Second line of defence** – risk management provides challenge on the completeness and accuracy of risk assessments, considers the adequacy of mitigation plans and enables risk reporting.

- 3. Third line of defence** – audit provides an independent and objective assurance of the robustness of the risk management framework and the appropriateness of internal controls.

Principal risks and uncertainties

At the time of this report, the Board has carried out a robust assessment of the principal risks and uncertainties facing Scottish Water and our subsidiaries, as set out over the following pages. These are the risks that we presently consider to be the most material to our business and our performance, including those that would threaten the business model, future performance within our regulatory settlement, solvency and liquidity of Scottish Water.



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



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



Scottish Water Group



principal risks and uncertainties



Risk or Uncertainty Trend	Description	Risk Appetite	Key Mitigations
Managing Our Assets			
Water Quality 	Risk of provision of water to customers which has the potential to have an immediate impact on health.	As a water utility company, provision of safe drinking water remains our highest priority.	<ul style="list-style-type: none"> – Skilled and trained employees operate our water assets. – Routine monitoring of the water in our catchments, and in our treatment and distribution activities. – Routine testing on water quality (beyond regulatory requirements) to manage drinking water quality and minimise associated risks. – Delivering significant investment to further improve water quality. – Detailed emergency response plans.
<p>The most recent DWQR Annual Report reported compliance with water quality standards at 99.91% demonstrating the continuing high quality of drinking water that consumers in Scotland receive. Significant investment has continued across 2017/18 to further improve water quality.</p>			
Cyber Security 	Operational risk from loss of key IT service arising from a deliberate external or internal attack (physical/virtual).	Scottish Water seeks to ensure the integrity and security of its IT estate.	<ul style="list-style-type: none"> – Organisation-wide education and awareness programme rolled out. – External Expert Vulnerability and Threat Management service utilised. – Security gap analysis undertaken, plans and funding in place to further increase security level. – Regular application of updates to software and security products. – Detailed disaster recovery plans. – Participate in UK & Scottish Government and industry cyber incident exercises. – Achieving and retaining ISO 27001 certification for Scottish Water Data Centres. – Meeting the requirements of the Network and Information Systems Directive (NIS) and the Scottish Government Public Sector Action Plan.
<p>While the water industry has not been subject to a notable attack in 2017/18, we note that the number of cyber-attacks continues to increase in the UK and globally. As an “operator of an essential service”, Scottish Water is required under the NIS to take appropriate and proportionate security measures to manage risks to our network and information systems, and report serious incidents to the relevant national authority.</p>			

Risk or Uncertainty Trend	Description	Risk Appetite	Key Mitigations
Managing Our Assets (Cont.)			
Critical Assets 	Risk to service to customers arising from failure of a critical asset or assets.	Delivering a continuous service to our customers is paramount.	<ul style="list-style-type: none"> - Developing detailed knowledge and understanding of our critical assets. - Undertaking operational inspections, maintenance and emergency planning activities to minimise the risk and consequences of failure. - Identifying investment to reduce this risk for promotion in our future investment programmes. - Meeting the requirements of the Network and Information Systems Directive (NIS) and the Scottish Government Public Sector Action Plan.
During 2017/18, investigations have continued to identify critical assets and better inform our short and long-term strategies. As this work continues, our awareness of our risk exposure will increase. Over the long-term, and with sustained investment in inspections, maintenance, and network connectivity, our risk exposure will reduce. Until all key mitigations are in place however, we will remain exposed to service impacts.			
Strategic Water Mains 	Risk arising from failure of key/strategic water mains resulting in significant water damage to surrounding properties and/or infrastructure.	Delivering a continuous service to our customers is paramount. Scottish Water seeks to minimise adverse impacts to our customers.	<ul style="list-style-type: none"> - Identify locations where previous bursts have caused flooding and develop options to mitigate risk exposures. - Delivering mitigations at known historic flooding locations. - Developing policy on management of flooding risk from current infrastructure for new developments. - Securing further investment to address via strategic planning process (SR21).
Historic high-profile flooding locations are being reviewed and addressed, with further work to identify wider flooding risks. This work remains at an early stage in developing methodology, with assessments still to be carried out and investment required to address.			

Scottish Water Group

principal risks and uncertainties

Risk or Uncertainty Trend	Description	Risk Appetite	Key Mitigations
Managing Our Assets (Cont.)			
Climate Change 	<p>Risk of failure to deal with the impact of extreme and unpredictable weather events on our assets, infrastructure and services.</p> <p>Risk of changes to future water resource supply and demand due to climate change.</p>	<p>As a water utility company, provision of safe drinking water remains our highest priority.</p> <p>Delivering a continuous service to our customers is paramount.</p> <p>Scottish Water seeks to treat and return waste water in a way that does not harm the environment.</p>	<ul style="list-style-type: none"> – Undertaking a Scottish Water climate change risk assessment. – Undertaking climate change vulnerability assessments. – Delivering capital investment in our water and waste water assets. – Publication of an annual Sustainability Report. – Participation in projects and studies of which the outputs inform our strategic plans.
Climate change and more variable weather patterns are anticipated to continue to present a challenge across the water industry in future years, including the volume of water available.			
Data Protection 	<p>Risk of failure to adequately manage data protection, in particular the new obligations arising from the EU General Data Protection Regulation.</p>	<p>Scottish Water seeks to safeguard customer and employee data by complying with relevant standards.</p>	<ul style="list-style-type: none"> – Reviewing and launching of policies, processes and guidelines. – Raising awareness of GDPR requirements across Scottish Water. – Producing and publishing corporate privacy notices. – Developing and communicating a process to ensure breaches are identified and reported in a timely manner.
As the data security landscape continues to mature, Scottish Water has undertaken significant work to improve data protection practices to ensure compliance with the new and changing standards. For example, the introduction of the EU General Data Protection Regulation (GDPR), introduces additional obligations.			
Working with People			
Health & Safety 	<p>Risk arising from our assets, activities and actions resulting in an impact on the health and safety of our people, contractors, supply chain and/or customers.</p>	<p>The health and safety of our people, including contractors, partners and the public remains paramount.</p>	<ul style="list-style-type: none"> – Detailed health and safety management system and supporting processes. – Embedding of health and safety in our culture and processes via training and awareness raising. – Completion of risk assessments and regular inspections. – Investigating all accidents and incidents and tracking of necessary remedial actions. – Regular health and safety reporting to key governance groups.
Health and safety risk continues to be closely managed and mitigated given the inherent risks faced by our business. Health and Safety is a continuing area of strong focus in 2018/19.			

Risk or Uncertainty Trend	Description	Risk Appetite	Key Mitigations
Developing the Business			
PFI Operations 	Financial and operational risk should a PFI plant or operations fail to deliver in accordance with the contract terms.	Scottish Water seeks to deliver services in an efficient and cost-effective manner including via a number of PFI waste water contracts.	<ul style="list-style-type: none"> - Maintaining ongoing strong relationships with the PFI companies. - Monitoring and management of PFI company performance. - Undertaking deep dive PFI plant audits. - Developing contingency plans for both the financing and operation of these contracts as they enter their final stages.
There were no material changes to the risk faced across the PFI portfolio in 2017/18. Plans are under way to consider our approach to the maturity of these contracts as they enter their final stages over the 2021–27 regulatory period.			
Business Stream 	Risk of reducing value of the business due to competitive market conditions and the complex operating environment in the newly opened English retail market.	Business Stream will maintain a financially viable retail business.	<ul style="list-style-type: none"> - Increased scale through targeted acquisition of customers to dilute cost to serve. - Targeted acquisition of customers in both the English and Scottish markets, for future profit growth. - Continued transformation of customer service and cost base. - Improvements to English market customer data sets and payment arrangements. - New regulatory framework providing additional tools to manage vacant charging risks.
The Scottish market remains very competitive. The new retail market in England provides access to £2.5 billion of revenue opportunity. As anticipated, the market environment is complex, with low margins available, data quality issues and complex wholesale tariff arrangements.			

Scottish Water Group principal risks and uncertainties

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

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

Notwithstanding our integrated approach to risk management, we acknowledge that we may not always be successful in fully mitigating all our known risks. In the event that a risk materialises, service to customers could be affected. In this situation, we will enact our contingency and emergency plans, mobilising resources to minimise the impact and restore service promptly to customers.

Going concern and viability statements

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

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

Going concern	Viability statement
<p>Scottish Water’s business model, activities and the factors that could impact on its future development and performance are described in the strategic report on pages 6 to 7. The principal risks and uncertainties are described on pages 11 to 18.</p> <p>Scottish Water operates under an annual borrowing limit set by the Scottish Government. The annual borrowing limit controls the amount by which Scottish Water can increase externally sourced finance. 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.</p> <p>As at 31 March 2018, Government loans totalled £3.5 billion and Scottish Water group held cash and cash equivalents of £406.4 million.</p> <p>The Members, taking all relevant factors into account, consider that Scottish Water will have adequate resources to continue in operational existence for the next 12 months. Accordingly, the accounts continue to be prepared on a going concern basis.</p>	<p>In accordance with provision C.2.2 of the UK Corporate Governance Code, the Members have assessed the prospects of the group over the 3 year period to March 2021. The Members consider that the 3 year period is appropriate because it is consistent with the business planning process, which gives greater certainty over the forecasting assumptions used. Consequently, Members confirm that they have a reasonable expectation that the group will be able to continue in operation and meet its financial obligations as they fall due over the next 3 years to March 2021.</p> <p>In making their assessment, the Members considered the resilience of the group, taking account of its strategic and financial frameworks, including the borrowing limit and operational positions and the level of the capital investment programme. They considered the potential impacts, in severe but reasonable scenarios, of the principal risks, set out on pages 11 to 18, and the probable degree of effectiveness of current and available mitigating actions. 2017/18 is at the mid-point of the 2015–21 regulatory period (SR15) and Scottish Water has started the planning and analysis process for the new 2021–27 regulatory period (SR21).</p> <p>The key processes used by Members for their assessment are summarised below:</p> <p>The business and strategic planning processes cover the regulatory period to March 2021, based on key assumptions in respect of the funding of the business. Business planning is an annual process which forecasts the performance and liquidity of the group over the regulatory period with a detailed focus on the first 3 years of any planning period. The plan considers base, downside and severe downside financial and economic scenarios.</p> <p>Quantitative stress and scenario testing which consider the primary individual and combined quantitative risks relating to liquidity and regulatory financial ratios.</p> <p>Qualitative scenario testing which gives a qualitative understanding of plausible but severe risk scenarios which could threaten the viability of the group, and informs related management actions. The scenarios tested are based on the principal risks and include widespread contamination of water supply giving rise to emergency response and recovery, a critical infrastructure breakdown and cyber-attack.</p> <p>In conclusion, the Members consider that the 3 year period is appropriate for this year because it is consistent with the business planning process.</p>

Customer service

Household customers

Delivering a consistently leading customer service is at the heart of what we do. During 2017/18, we built on the success of the previous year and again delivered our best ever customer experience results with even higher ratings, saw a further drop in written complaints to their lowest level ever and improved our overall performance.

We have agreed challenging targets with our regulator the Water Industry Commission for Scotland (WICS) and the body which represents consumers, the Customer Forum. We are focused on delivering improving service levels in line with the expectations of our customers and Scottish Ministers.

The first of these is known as the Overall Performance Assessment (OPA), a basket of indicators which tracks how well we are delivering water and waste water services.

We have agreed a target with the Customer Forum of 382 points in 2017/18 rising to 385 by 2020/21, and we are committed to achieving a score at or above that threshold. We aspire to be best in class and target an OPA score at or above 400.

As a result of our continued focus on delivering ever improving customer service, we have achieved our best ever OPA score this year with an out-turn of 406, up from 398 last year.

Our household Customer Experience Measure (hCEM) ensures that we are always listening to our customers and maintain focus on the delivery of service to our customers.

hCEM represents a basket of measures which, when brought together, allows us to measure and understand the experience of our customers – regardless of whether they have had direct contact with us or not. The measure also helps to ensure we are listening to customers who have had no service issues whatsoever. It gives us a much broader view of how well we are doing, of customers' perceptions and where we need to target improvements. hCEM was developed in conjunction with the Customer Forum, in its role of representing the interests of customers.

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

In 2017/18, we recorded our highest ever hCEM score which saw an improvement of 0.48 points to 86.36. This means that we have delivered improved levels of satisfaction every year since the measure was introduced in 2015/16.

Non-household customers

We have continued to measure non-household and developer customer experience through a new non-household CEM (nhCEM). Many of the nhCEM measurements are in their infancy; however, we have worked to deliver improvements in the stability of the measure during the year to provide a baseline figure from which to deliver improvements. During the year, Scottish Water introduced a new survey within the property developer community to truly understand their experience and establish actionable insights. In 2018/19, nhCEM becomes one of our key business performance targets aimed at improving customer experience for non-household and developer customers.

Delivering excellent customer service

The Which? Scotland Consumer Insight Report continues to track the water industry as the most trusted sector among Scottish consumers. Our own customer research also demonstrates that we continue to build the trust and confidence of our customers and communities across Scotland across our service and investment activity.

Written customer complaints have continued to fall this year, reaching their lowest ever level, with an 18% reduction in 2017/18. We continue to receive more formal endorsements through our Go the Extra Mile (GEM) customer nomination programme directly from our customers than we do formal complaints. During the year, staff from our Customer Service teams continued to receive GEM nominations from customers. In particular, two employees received personalised platinum awards to recognise over 250 GEM's each since the programme began. A further 23 staff received gold awards for over 100 GEM's and 47 employees received silver awards for over 50 GEM's. The continued success of this programme is a real testimony to the increased focus on resolving customers' issues first time, every time.

In the most recent wave of the UK Customer Satisfaction Index (a national benchmark survey run by the Institute of Customer Service), we achieved a score of 76.4. This means we continue to out-perform the Utility Sector (74.4 overall average) by 2 points and the Water Sector (75.2 overall average) by 1.2 points. We recognise there is still more we can do to deliver a consistently leading customer experience.

Responding to incidents

Scottish Water, like all utilities, is often required to respond to dynamic incidents caused by a range of factors, often outwith our control, such as adverse weather.

In the last year, our teams worked together to maintain services for customers and reduce the impact of operational interruptions in the face of, at times, challenging conditions; or to restore normal service as quickly as possible where disruption has been experienced.

In May 2017, customers in Cumbernauld saw supplies disrupted following a burst main. This caused interruption to normal water supplies and reduced water pressure to a large number of customers in the area. Our teams worked to restore normal service as quickly as possible and to reduce the disruption to supply.

In February and March 2018, our teams worked around the clock over several weeks to deal with challenges caused by severe winter weather on our assets, infrastructure and service. Heavy snow meant some water and waste water treatment sites were difficult to reach, travel on the road network for our fleet was hampered and we responded to a very high number of burst pipes and mains. While it was a challenging period, service was largely maintained because of robust contingency planning and effective execution of those plans.

Social media has become an important feature of our approach to customer service. Digital platforms are increasingly being used to inform customers and communities of planned and unplanned work, particularly using social media to reach geographic areas where work is taking place. Scottish Water was recognised for Use of Social Media at the UK Customer Experience Awards of 2017, where we were also recognised in the Customer Experience Team (Customer Engagement) category.

Customer service

Wholesale services

This is the 10th anniversary of the retail market for water and waste water services being open to competition in Scotland, giving business customers a choice of retailer. Scottish Water has played a key role in the market as the only wholesaler since the market opening in 2008, collaborating with all participants and leading market changes to facilitate the market operation.

Over the past three years Scottish Water has led significant market data improvement projects to improve the quality of market data. This ensures that customers are charged correctly for the services they receive.

The market in Scotland opened on 1 April 2008. Scottish Water actively facilitates all entrants to the competitive water market in Scotland as the wholesale supplier of water and waste water services.

During 2017/18, the number of companies licensed to provide water and waste water services to business customers in Scotland increased from 25 to 26. A full list of companies who are licensed to sell to business customers is available on the Water Industry Commission for Scotland website and on the 'Scotland on Tap' website. There have also been a number of mergers and acquisitions among licensed providers, and we have carefully managed these changes to ensure continuity of service.

The market in England and Wales opened on 1 April 2017. We are now benchmarking our operational and transactional performance against wholesalers in that market, and lead their performance. We now have the opportunity to learn from both wholesalers and retailers in that market.

Our market performance is measured by a basket of performance indicators. Our performance against the target over the year was 97.4%. This is a significant improvement on the previous year.

Accurate market data is essential for a high quality service to non-household customers. We have carried out many significant data projects since the market opened to increase the level of accuracy and completeness in the market data. In 2017/18, we achieved over 99% match between premises in the market and premises registered with the Scottish Assessors which is key to successful market operation. This has underpinned the successful implementation of new Scottish Government policies of charging for vacant premises and readiness for the policy change regarding use of consistent current rateable values in the values for water charging which took effect in April 2018.

Investment overview

Scottish Water’s six year investment programme will see around £3.9 billion of improvements to Scotland’s water and waste water infrastructure.

We are continuing to invest in maintaining and replacing our infrastructure and in delivering further improvements in drinking water quality, the protection of the environment, and support for economic growth.

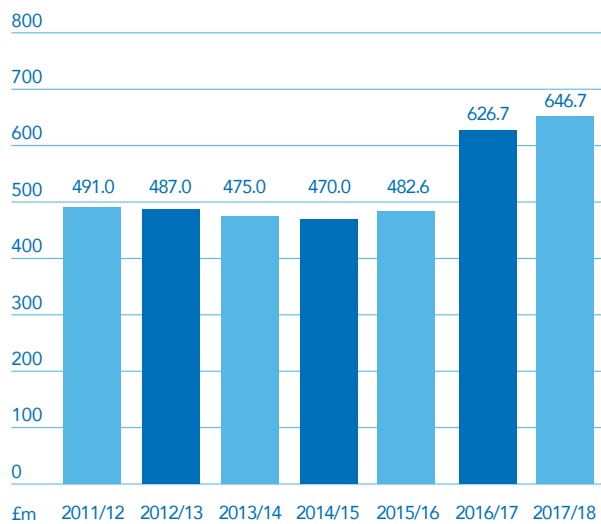
There are currently 2,600 projects being progressed across our communities, both large and small scale. Larger projects, such as the resilience programme connecting the Ayrshire and Glasgow water supply systems through a new 30-mile pipeline and to smaller localised works such as extending the sewer network in Stromness, are essential to delivering improvements in infrastructure and service throughout Scotland.

In 2017/18, £647 million was invested in upgrading essential treatment works, water supply and sewer networks. This builds on more than £7 billion of investment undertaken since Scottish Water’s formation in 2002, helping to secure the transformation of water services throughout the country.

Over the past year, we have ensured that planned investment work in communities is underpinned by strong communication and engagement. Rehabilitation of water mains, upgrading of sewers or improvements to water and waste water treatment sites inevitably generate views and opinions from customers, particularly regarding any disruption which might result.

Engagement has taken place in communities from Strathpeffer in the Highlands to Haymarket in the centre of Edinburgh, to provide information regarding upgrade work, the requirement for the projects, the impact of the work and the intended outcomes. Wherever possible, we seek to accommodate the views of local communities when undertaking essential investment activities.

Improving services and supporting the Scottish economy – Total capital investment



Working together

Our investment programme is delivered in partnership with our capital alliance partners and wider supply chain. Capacity and capability are key enablers to the delivery of our capital work. In terms of wider economic benefit within Scotland, we are investing on average over £53 million a month with more than 200 suppliers employing an estimated 3,000 plus people on the delivery of the programme. Our supply chain has also created employment opportunities for 170 modern apprentices and 162 graduates, enabling opportunities for young people to learn and build the skills and knowledge that they need to become the next generation of water industry leaders and experts. We are aiming with the businesses in our supply chain to create a total of around 750 modern apprentices and graduates by the end of our regulatory period.

We currently have four main delivery vehicles; three Alliance partners, who mostly focus on our investment programme; and our own inhouse team, Managed Delivery, who support smaller value capital maintenance, growth and study projects.

Caledonia Water Alliance (CWA), amey Black and Veatch (aBV) and Efficient Service Delivery (ESD), as well as Scottish Water's own internal Managed Delivery team, continue to be supported by a wider integrated supply chain that includes 13 Tier 1 contractor partners on frameworks specific to each delivery programme. This is further augmented by 57 local contractors attached to our regionally based rural framework, as well as frameworks covering process equipment, civil materials, hire and infrastructure products.

Scottish Water and our alliance partners have delivered in excess of £13 million of investment via our rural contractors. A series of rural workshops have created opportunities for engagement and knowledge-sharing with our four delivery vehicles and 57 rural contractors.

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

Delivering new investment

Investment activity across Scotland in 2017/18 included:

Greater Glasgow: A state-of-the-art tunnel boring machine completed the construction of the Shieldhall Tunnel and 'broke through' in Queen's Park, Glasgow in October 2017. The 3.1 mile tunnel, expected to be in operation in Summer 2018, will improve water quality in the River Clyde and reduce the risk of flooding in a number of communities. Over 90% of the material excavated during construction has or will be recycled. This year we also completed, ahead of schedule, enhancements to the existing sewer network around the Toryglen area to help reduce the risk of sewer flooding.

Paisley: We began our investment in Paisley's waste water infrastructure, which will substantially reduce the frequency of spills from the sewer network into the Espedair Burn and White Cart Water in storm conditions. The project, which includes the construction of a one-mile sewer under the streets and the installation of combined sewer overflows, is expected to complete in late 2020.

Ayrshire & East Renfrewshire: Installation of about 30 miles of new water mains, connecting the system in Ayrshire with the Greater Glasgow network, is due to be completed in 2020. In 2017, we tunnelled under the A77 and River Irvine to reduce travel disruption and the impact on the environment. One stretch of the new main, from Waulkmill Glen reservoir near Newton Mearns to the Fenwick/Waterside area, came into supply in February 2018. The overall investment will improve the resilience of water supplies for around 200,000 people and enable growth. As part of the investment, we are changing the way we treat the water to improve the water quality at customers' taps.

Stromness, Orkney: This upgrade of the waste water network involves linking existing sewers to the Bu Point Waste Water Treatment Works. This will help improve the natural environment and reduce the risk of pollution to the surrounding coastal and recreational waters in Stromness Harbour.

Oban: Construction of the new Tullich Water Treatment Works was due to complete in Autumn 2017, however we have encountered various unforeseen difficulties and it is now due to complete in Summer 2018. Our investment in Oban will ensure that thousands of customers continue to enjoy clear, fresh drinking water that meets the most stringent quality standards and will also accommodate planned growth. We have worked closely with the local community, including school visits to talk to pupils about the water treatment process and the importance of hydration.

Inverurie: We are investing to upgrade the existing waste water treatment works at Inverurie, working with our Alliance partner ESD. This is Scotland's first Nereda treatment plant – using the innovative new technology to reduce energy usage and carbon footprint, reduce odour and treat waste water more effectively. The project, to improve water quality around the River Don and provide better capacity for the future, started in September 2017. It is expected to take 18 months to complete.

Haymarket/Edinburgh: In September 2017, work began to upgrade the Victorian sewer under the capital's Haymarket Terrace. The modern sewer will increase capacity and reduce the risk of flooding for local properties and businesses. The Haymarket project is just one of the waste water infrastructure projects across the city during our 2015–2021 regulatory period. Construction has also just begun to lay a new water main to the south of Edinburgh. The investment will ensure the resilience of the water supply for generations to come.

Lochaline: A new water treatment works was built offsite in Muir of Ord and transported 118 miles to Lochaline on the Morvern peninsula via the A9, A82 and the Corran Ferry. Designing and assembling offsite meant less disruption for communities and a quicker build-time. Work to install the new transportable treatment unit started in early 2017 and was completed in the summer. It involved installing new clear water tanks, a standby generator and connections to the existing network.

Renfrewshire: More than 80,000 customers in communities across Renfrewshire and south Paisley served by the Muirdykes Water Treatment Works benefited from an upgrade. The upgrade, which involved the installation of a new filtration building and process, reduced the risk in the network of discoloured water caused by naturally-occurring manganese.

Improvements to be delivered in the Regulatory Period

We made good progress during the year on delivering the improvements required to enhance drinking water quality and reliability of supply to customers, protect and enhance the environment and support economic growth across Scotland.

Overall delivery was on or ahead of the year-end target apart from the improvements needed to meet the requirements of the Water Framework Directive. This one area is behind the plan to allow us to more effectively manage the resilience of the supply of drinking water to customers from the Amlaird system while work on the Ayrshire Resilience Scheme is progressed.

Objective	Programme area	2017/18 Year end Target	2017/18 Year end Actual	Programme delivery status March 2018
Improving drinking water quality and reliability	Number of water treatment works improved	4	4	●
	Number of zones made compliant with iron and manganese standards	No outputs planned to be delivered	4	●
	Distribution mains cleaned (km)	93	184	●
	Number of improvements to reliability of supply (catchments and treatment)	4	8	●
	Number of improvements to reliability of supply (networks and storage)	9	13	●
	Number of water quality etc studies to inform future periods	124	220	●
	2010–15 outputs planned to complete in the 2015–21 period	6	8	●
Improving drinking water security of supply	Water supply resilience strategy and improvements made	6	8	●
	Number of zones with improved security of supply	1	1	●
	Number of improvements to the infrastructure of critical reservoirs	9	28	●
	Number of improvements to comply with the Security and Emergency Measures Direction	109	243	●

Protecting and enhancing the environment	Number of waste water treatment works improved to meet Urban Waste Water Treatment Directive (UWWTD)	8	15	●
	Number of waste water networks improved to meet UWWTD	17	22	●
	Number of improvements required to meet UWWTD – Glasgow completion	42	51	●
	Number of improvements required to meet the Water Framework Directive	10	1	see text on page 26
	Number of revised Bathing Waters Directive studies and improvements	1	8	●
	Number of environmental studies to inform future periods	1	33	●
	Number of improvements to meet the requirements of the Habitats Directive	1	1	●
	Number of improvements required by the Compliance Assessment Scheme	No outputs planned to be delivered	13	●
	Number of improvements to reduce malodour	3	4	●
	Number of improvements to sludge management	9	9	●
	2010–15 outputs planned to complete in the 2015–21 period	9	12	●
Improving flood risk management	Reservoirs Act: improvements to dams	16	18	●
	Flood Risk Management Act: models and integrated catchment studies	24	65	●
Supporting economic development	Number of new connections to household and business premises	Demand driven	65,710	●
	Delivery of new waste water capacity for 58,000 people	Demand driven	5,325	●
	Number of first time non-household meters installed	Demand driven	9,968	●
	Number of wholesale meters	Demand driven	32,038	●
Mitigating climate change	Number of climate change vulnerability assessments	55	57	●
Improving the long-term cost of service	Improvements in renewable power and energy efficiency (GWh)	7.9	12.4	●

Drinking water quality

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

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

Improving services

Drinking water quality

In 2017, we carried out over 302,000 quality tests on regulatory samples from our water treatment works, service reservoirs and customers' taps across Scotland.

The quality of water at customers' taps remains at the level achieved in 2016 of 99.91%. Meanwhile, 99.92% of all quality tests on regulatory samples during 2017 met strict microbiological and chemical regulatory standards, remaining at the same high level achieved in 2016, but a slight drop from 99.93% in 2015.

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

Carfin water quality incident

Scottish Water was convicted at Hamilton Sheriff Court on 6 June 2017 of supplying water unfit for human consumption on or between 17 and 19 June 2015 at Carfin, North Lanarkshire and other nearby areas under Section 76C of the Water (Scotland) Act 1980. Lessons from the analysis of the incident were developed into an action plan which has been substantially progressed.

Sustainable land management

Sustainable Land Management (SLM) helps to protect and improve source water quality in our drinking water catchments. These are the areas which supply water to our water treatment works.

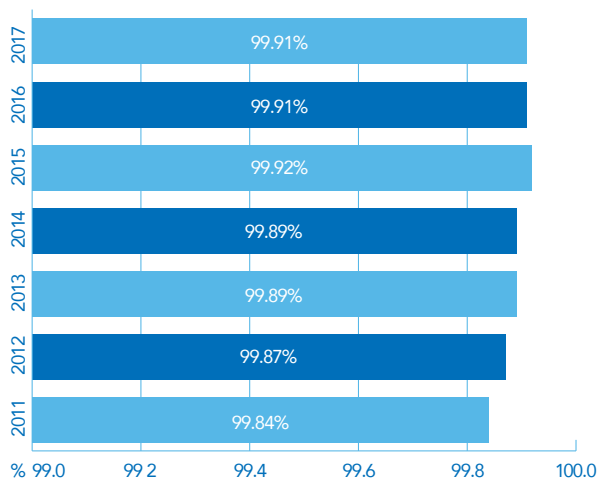
In the last year, our specialist team visited catchments that supply 29 water treatment works. During these visits, we assessed the condition of the land around watercourses and made suggestions to improve source water quality. In one of these catchments, around Sandy Loch in Shetland, we noticed large areas of exposed and damaged peat. To help protect water quality within the area, we financed our first peat restoration project. The benefit of this work was recognised by the local community and we received the Shetland Environmental Award in November 2017.

During 2017/18, we completed 71 interventions to help improve our drinking water catchments. Just over half of these were where we liaised with private land owners or stakeholders to give advice on how to protect water quality.

In 2017/18, we assessed 739 activity notifications, 274 of which were within the vicinity of our drinking water sources. Activities included forest management, aerial and non-aerial application of pesticides, hydro schemes and wind farms. Through this assessment process, we gave advice to contractors, operators and developers to help ensure that our drinking water sources are protected.

We have actively contributed to 33 research projects to expand our knowledge and understanding of how land use may influence source water quality. During 2017/18, there has been a focus on natural organic matter.

Clear, fresh drinking water – tap water quality



Leakage management

We take our responsibility to manage water, a precious resource, seriously. Significant activity has taken place to minimise leakage from our network. We respond to all visible bursts and work to detect and fix underground leaks.

In 2017/18, reported leakage has reduced by 3 million litres a day. This year, our network operations were significantly affected by the cold weather experienced during December 2017 and March 2018. A significant winter recovery plan was implemented during this period.

Since the introduction of a targeted approach in 2006, leakage has been reduced by over 55%. As a result, we continue to operate at the economic level of leakage – the point where the cost of reducing leakage becomes greater than the savings from reduced water production.

To enable our more targeted approach, we are working to improve the data associated with leakage reporting both internally and through participation in UK improvement initiatives. We are also influencing research and development in leakage management and reporting. We continue to invest in pressure management systems to reduce the chances of burst pipes disrupting customers' supplies.

Environment

Improving the environment

Waste water

In 2017/18, our performance across our waste water services was our best ever with a number of improvements achieved in key areas ensuring that we continue to do all we can to protect the natural environment across Scotland.

In many places across Scotland, we typically operate combined sewers that carry both foul sewage and surface water drainage, and due to the nature and scale of our services, Scottish Water has more environmental authorisations and licensed discharges than any other organisation in Scotland.

We have delivered more than £1 billion of investment in environmental quality measures since we were formed in 2002 and reduced the number of waste water treatment works which fail our serviceability measures from more than 70 to 0 in 2017/18, a reduction of four from 2016/17.

Scotland had 86 bathing waters officially designated for 2017, of which 73 could potentially be affected by Scottish Water assets. This increased from 2016 due to two new designations at Gairloch. For 2017, SEPA reported that 11 out of Scotland's 86 bathing waters failed to comply with at least the 'sufficient' standard of the revised Bathing Waters Directive (rBWD) an improvement from 17 in 2016/17. This means that 87% of Scotland's beaches now meet minimum rBWD water quality classifications. The number of bathing waters meeting 'excellent' standard reduced from 26 in 2016/17 to 25 in 2017/18. The two new designated bathing waters at Gairloch achieved 'excellent' classification in their first bathing season.

Significant investment and study work has been undertaken in partnership with SEPA in recent years to support bathing water quality against the new directive. Through this process we have identified where Scottish Water assets may limit the ability of the bathing water to meet the new directive standards, and sought to make the most appropriate investment decisions.

Further investment is required at Portobello West, Fisherrow, Rockcliffe, Kinghorn Harbour and Ayr South. Further studies are being undertaken to confirm any additional investment that may be required at Eyemouth and Monifieth.

In 2017/18, we delivered our best performance to date in environmental pollution incidents (EPIs) with a total of 191 EPI events – 47 fewer than in 2016/17 with only five being more serious Category 2 events.

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

Dunnswood environmental pollution incident

Scottish Water was charged on 7 February 2018 at Airdrie Sheriff Court of an environmental pollution incident between 11 and 14 July 2014 at Dunnswood Waste Water Treatment Works, Cumbernauld. This followed an unauthorised spill of untreated sewage from an emergency overflow, which resulted in pollution of the Red Burn in breach of regulation 4 and 44(1) (a) of the Water Environment (Controlled Activities) (Scotland) Regulations 2011 and Section 20(3) (a) of the Water Environment and Water Services (Scotland) Act 2003.

Flooding

The reduction of flooding and pollution from sewers remains one of our customers' highest priorities. We have made good progress against our commitment to address internal flooding for those customers at highest risk, i.e. those customers with a 10% or greater chance per annum of internal sewer flooding. In total, 54 properties were removed from the internal register in 2017/18.

We have continued to develop and promote schemes for all customers who were on the register in March 2015, helping to tackle longstanding flooding problems and address our business plan commitment. Of the 302 properties on the register in March 2015, we have successfully removed 108 of these. We have also developed and promoted a number of schemes for problems that have emerged during this timeframe, to enable us to move towards our aspiration of dealing with internal flooding within four years of incidence.

This year we completed the Nelson Street/South Scott Street, Baillieston project where we have invested over £3.5 million to reduce the risk of internal and external sewer flooding to 32 properties and local streets that have suffered recurring flooding problems since 2011.

A number of high-profile, complex projects were underway in 2017/18. Work started in October 2017 in Haymarket Terrace, Edinburgh to upgrade the brick Victorian sewer, which is at capacity, with a new 1.2 metre diameter sewer. The project was planned in detail with the City of Edinburgh Council to minimise traffic and business disruption.

Work on the first phase of the delivery of the Oak Mall project in Greenock was completed and delivered protection to 23 commercial properties at the north end of the Mall complex. The second phase of works is scheduled for completion in autumn 2018, delivering the remainder of the project. We have worked closely with Inverclyde Council and Transport Scotland to coordinate around a number of their infrastructure projects and manage road closures and traffic management.

We are investigating technical solutions for high priority external-only sewer flooding areas where customers experience repeat external incidents in areas such as gardens, roads and public parks.

Climate change adaptation

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

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

Climate change mitigation

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

We have developed a Capital Carbon Accounting Tool. This enables the carbon emissions associated with our biggest capital projects to be measured, providing more opportunity for them to be reduced.

Our operational carbon footprint for 2017/18 showed a reduction of 10.4% since 2016/17. Overall, our footprint has fallen by nearly 32% since we first reported it in 2006/07.

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

Energy

Major milestones were reached in March 2018 when the amount of renewable energy the Scottish Water Group generates itself and hosts on our land exceeded twice the amount of electricity used annually – around 440 Gigawatt hours (GWh). Our approach to energy management and development is focused on:

• **Reducing consumption**

We have installed over 4,000 smart meters to measure consumption and help target energy efficiency opportunities. Over the last 6 years, we have reduced base electricity consumption from the grid by around 5%. We have made changes to operational practices and our asset base to reduce consumption or move demand to cheaper tariff periods. We are also exploring and piloting other initiatives and long-term, low energy, low carbon treatment solutions. Energy management and efficiency will play a key role in future years with the objective to reduce our operating costs and carbon footprint.

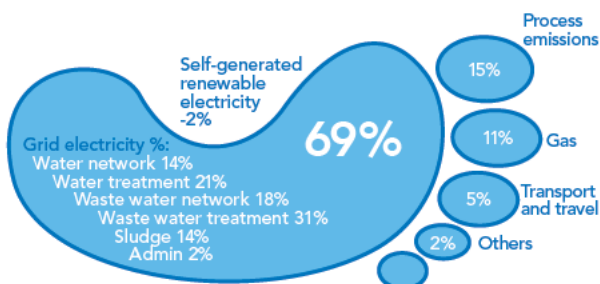
• **Hosting private renewable investment**

We host private investment in renewables on our land where it provides a good return for customers and is compatible with providing high quality services. We now host over 831GWh of wind generation on our land.

Working with local communities and developers, we are actively investigating further opportunities to host renewable developments on our land. We are also investigating alternative approaches to extracting value from waste and are actively involved in research projects across this area.

Our strategy is aligned with the Government’s Hydro Nation ambitions, supports a greener and stronger economy, and is a key part of our desire to reduce the cost of delivering water and waste water services for customers.

Greenhouse gas emissions footprint – by source 2017/18



• Increasing self-generation

Since 2013, the Scottish Water Group has increased the renewable generation capacity to 58GWh/annum, almost three times our capacity in 2013. The portfolio of assets has been diversified to include hydro, wind, biomass, photovoltaic solar, combined heat and power (CHP) and biomass boilers. We currently have 38 hydro turbines, 18 sites with small scale wind turbines installed, 31 solar schemes, 3 CHP plants (including the Scottish Water Horizons Deerdykes plant), and 3 biomass boilers. More than 70 of our water and waste water treatment works are either self-sufficient or partly self-sufficient in their power requirements. This is helping us become a more sustainable business and is leading to lower operating costs.

• Purchasing low-cost green energy

We continue to purchase low-cost green energy from a privately-owned renewable Anaerobic Digestion Plant adjacent to Girvan Waste Water Treatment Works and have concluded an agreement to purchase green energy from local renewable assets on the Fair Isle, which will supply our local water treatment works.

We understand the benefits these schemes bring to local businesses and communities and we are currently working with a number of local businesses and community schemes in conjunction with Local Energy Scotland.

Water efficiency

We are working in partnership with the Energy Saving Trust, who actively manage the main household and community energy programmes in Scotland, to provide water efficiency advice and packs to 49,000 homes in priority areas across Scotland. By working collaboratively to promote the benefits of using water wisely, customer engagement is taking place to better understand the link between saving water, saving energy and saving money on energy bills with the aim of long-term behavioural change. In summer 2017, we ran a series of events in Galashiels to promote water efficiency and delivered more than 1,200 water saving packs to householders, which will help them to save water and energy.

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

A water efficiency trial covering 2,000 homes showed a positive response to our water efficiency advice and devices with encouraging results. We are committed to better understanding water use in and around homes as well as our own assets and will continue to promote more efficient use of water.

Customer behaviours

Customers have an important part to play in helping to keep Scotland's vital water and waste water services running smoothly.

Since 2013, our 'Keep the Cycle Running' advertising and information campaign has raised customer awareness about the steps they can take to help prevent blocked drains and reduce instances of sewer flooding.

Around 80% of blockages in Scotland's drains and sewer network attended by Scottish Water are caused by the wrong items being flushed down toilets or poured down sinks, including all wipes and fats, oils and grease. Our campaign encourages everyone to only flush the 3Ps – pee, poo and paper – down the toilet. Since the Cycle campaign started, we have seen a reduction in the number of blockages from 40,000 to just under 35,000 a year.

In 2017/18, we continued to work in communities to promote our campaign messages, including visits to around 40 primary schools across Scotland. We also worked with relevant organisations to jointly promote the campaign, including the NHS in Fife and the Highlands, Perth & Kinross Council and Edinburgh Zoo to help raise awareness of how to properly dispose of bathroom and kitchen waste.

In early 2018, we asked households to help protect Scotland's natural environment by simply binning bathroom waste items, such as cotton buds and wipes, rather than flushing them away. We support the Scottish Government proposal and consultation to ban the sale and manufacture of plastic-stemmed cotton buds to help reduce the impact of plastics on the environment.

Innovation

We are committed to delivering a sustainable, high quality and affordable service for our customers. Fresh thinking and new ideas help us meet our customer expectations and address future challenges. Our approach is to deliver a focused Research & Development programme, adopt new technologies and develop an organisational culture which harnesses opportunities for improvement.

In 2017/18, we enhanced our innovation capability by:

- Developing our leaders' innovation knowledge.
- Reinforcing innovation as a driver for high performance.
- Implementing research and development projects.

Our activities focused on two particular areas – exemplary compliance in water and waste water and sustainable rural communities.

Strategic approach

We aim to be an organisation which is open to new ideas so we have the strongest platform on which to meet the challenges from our customers, regulators and the broader environment. We are focused on: embedding innovation capability; trialling new technologies through our Innovation Management Adoption Process (IMAP); and delivering knowledge and capability through our ambitious Research & Development programme.

We are focused on enhancing the capabilities of our people to be more innovative, to accelerate new technologies into the business and to target our research activities. IMAP enables our people to take their ideas and navigate through the stages of 'discovery', 'development' and 'deployment'.

Partnerships with Scottish Government, our supply chain, academia and the wider industry, including our regulators and centres of expertise and universities in the UK and Europe are crucial to our success and allow us to share knowledge and access funding streams.

Innovation in action

New waste water technology

We are constructing Scotland's first waste water treatment works which uses granular activated sludge (Nereda) technology in Inverurie. This waste water treatment works will use less chemicals, energy and materials.

Recovering heat from waste water

Scottish Water Horizons and SHARC Energy formed a joint venture to deliver heat from waste water technology, including one at a leisure centre in Campbeltown, Argyll.

This followed the successful implementation of heat from waste water technology at Scottish Borders College, a UK first which was recognised with two separate industry awards in 2017.

Onsite productivity app

The Scottish Water Improving Productivity & Efficiency (SWIPE) smart phone app uses data to drive performance improvement, improve collaboration with suppliers and improve customer and community satisfaction.

Our Research & Development programme

Our Research & Development programme themes are: sustainable rural communities; exemplary compliance; value recovery from waste; reducing economic levels of leakage; and automation and real-time control.

We are actively addressing the challenges of providing cost-effective and sustainable services for customers in rural areas, exploring new technologies and systems that will deliver better outcomes. Ongoing projects include:

INNOQUA project – Scottish Water will host one of seven European project demonstration sites at a small waste water treatment works in the Highlands. This project combines ecological processes in a system which treats waste water while producing zero waste.

Toolbox of technologies – We are trialling more efficient and effective technologies to use in drinking water supplies in rural areas. Anticipated benefits include enhanced water quality and reduced chemical waste.

Exemplary compliance – We are exploring ways to optimise existing water systems, evaluate new systems and address immediate and future waste water needs.

Disinfection efficiency – This project will make 'real time' modelling and management of drinking water chlorine disinfection systems a reality, ensuring effective disinfection under all operating conditions.

Managing sludge – We are trialling new technologies to help us reduce the cost of managing the by-products of waste water treatment and associated risks. As well as increasing understanding of the technologies, this programme of work will provide us with more sustainable routes for recovering value from sludge.

Supporting the economy

Our capital investment programme makes Scottish Water a significant contributor to the country's economic well-being.

Our business and procurement strategies are aligned with the Scottish Government's ambition to create a greener and stronger economy, and our supply chain actively enables wider economic value.

We spend more than £600 million annually on goods and services, through 167 frameworks and around 400 suppliers, including more than 200 engaged on our capital programme. This equates to over 50% of the turnover of Scottish Water's regulated businesses. Our supply chain ranges from local suppliers in Scotland to businesses across the UK, Europe, the USA, India and China.

Scottish Water's procurement strategy is aligned to business requirements, with capital alliance partners working on complex projects, while rural contractors and operational alliances support smaller value capital maintenance. More than 70% of our suppliers are Small Medium Enterprises (SMEs) and more than 70% of our spend is focused on organisations with locations in Scotland. We look to work with suppliers who have a focus on sustainability and innovation.

An estimated 3,000-plus supply chain jobs are currently enabled by our external spend – the majority of these are within Scotland and the UK. These jobs cover areas such as construction trades, manufacturing skills and, increasingly, digital skills.

As we move into the second half of our six year investment period, we anticipate further annual increases in capital investment projects and these are expected to focus on enhancing existing infrastructure through replacement and repair.

Other activities that contribute to supporting Scotland's economy included working with partners, such as O2, to enable Scottish Water land to be used to locate broadband and mobile transmitters to increase connectivity of rural communities.

Modern Slavery Act

The Modern Slavery Act was published in 2015 to tackle slavery and human trafficking. Businesses such as Scottish Water with turnover greater than £36 million are required to publish an annual statement explaining the steps they have taken to ensure that slavery and human trafficking are not taking place in their business or in their supply chain.

Scottish Water publishes an annual statement, has a Modern Slavery Policy and all other relevant policies have been updated to include references to the Act. An online training module is being developed for our employees.

In relation to our supply chain, we have undertaken the following actions:

- As part of the tender process, all potential suppliers are required to confirm that they adhere to the requirements of the Act.
- All framework supplier contracts have a clause relating to the Act within the agreements.
- Ensuring that all framework suppliers with turnover greater than £36 million have statements published on their website.
- All framework suppliers with turnover less than £36 million are required to sign and declare compliance to the Act on an annual basis.
- Risk assessed the supply chain.

Household charges

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

In April 2018, household charges increased by 1.6% – around £6 a year for the average household. This means the average Scottish Water household charge in 2018/19 is £363. This is less than £1 a day¹ and £42 lower than the average charge in England and Wales.

Income from household charges is helping to pay for our investment programme which, between 2015 and 2021, will see around £3.9 billion invested to further improve drinking water quality, protect the environment and support jobs in the Scottish economy.

Scottish Water charges are in line with the price limits set by the Water Industry Commission for Scotland as part of a six year agreement between Scottish Water and the Customer Forum, which represented the interests of customers. In the four years from 2015–16 to 2018–19, Scottish Water household charges increased by 1.6% each year.

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

Water and Sewerage Companies	Average household bill for 2018–19
South West Water	£491
Wessex Water	£479
Welsh Water	£439
Southern Water	£436
United Utilities	£435
Anglian Water	£428
England and Wales Average	£405
Northumbrian Water	£402
Yorkshire Water	£385
Thames Water	£383
Scottish Water	£363
Severn Trent Water	£348

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

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

Financial summary – group

The group surplus before tax for the year to 31 March 2018 reduced by £22.4 million to £71.8 million (2017: £94.2 million). The reduction was primarily due to the £11.8 million reduction in Business Stream's surplus and the expected increase in non-cash pension charges under IAS19 of £16.7 million.

Coverage of the financial performance by entity is shown on pages 38 to 41.

Consolidated revenue in the year increased by £210.5 million to £1,424.0 million (2017: £1,213.5 million). This benefit was accompanied by a £230.0 million increase in costs to £1,176.7 million (2017: £946.7 million). Net finance costs of £175.5 million were £2.9 million higher than in 2017.

In the year, consolidated net debt increased by £143.2 million to £3,137.9 million (2017: £2,994.7 million). The increase was driven by additional borrowing from the Scottish Government of £120 million, with a reduction in cash balances of £23.2 million to £406.4 million. The movement in cash is summarised below:

	Scottish Water £m	Business Stream group £m	Horizons group £m	Total £m
Opening balance at 1 April 2017	235.2	152.5	41.9	429.6
Cash generated / (utilised)	35.4	(62.5)	3.9	(23.2)
Closing balance at 31 March 2018	270.6	90.0	45.8	406.4

Cash balances within Scottish Water increased by £35.4 million to £270.6 million. Cash balances are planned to be consumed significantly over the period to March 2021 under the agreed Delivery Plan.

Cash balances within the Business Stream group of companies decreased by £62.5 million over the year to £90.0 million reflecting the acquisition of Southern Water's non-household customer base, the increased prepayment terms in the market in Scotland, market credit terms with wholesalers and the start-up phase for billing customers in the new market in England.

Taxation

The consolidated tax charge on the income statement was £13.7 million (2017: £2.0 million credit). Other taxes incurred by the group, and included in the cost base, totalled £83.8 million (2017: £83.6 million) and are summarised in the table below:

	2017/18 £m	2016/17 £m
National insurance	15.3	14.3
Local Authority rates	64.0	64.6
Carbon reduction commitment	3.0	4.0
Land fill tax	0.7	0.7
Apprenticeship Levy	0.8	–
Normalised annual cost	83.8	83.6

Group pension arrangements

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

The administering authority for each fund is required to conduct a triennial valuation of the assets and liabilities of the fund in line with SLGPS regulations. This must be conducted by a qualified actuary. The purpose of the valuation is to review the financial position of the fund and specify the employer contribution rates for the next three-year period. The last full actuarial valuations were carried out as at 31 March 2017 but were updated at 31 March 2018 by a qualified, independent actuary, to take account of the requirements of IAS 19 'Employee Benefits'.

Under IAS 19 a snapshot is taken of pension fund assets and liabilities at a specific point in time. Thus movements in equity markets and discount rates create volatility in the calculation of scheme assets and liabilities. At 31 March 2018, the gross pension liability decreased by £58.9 million from £234.2 million to £175.3 million. The reduction was driven by a 2.4%, or £43.6 million, reduction in scheme liabilities primarily caused by changes in assumptions and experience gains of £105.7 million partially offset by a liability increase of £62.1 million as a result of the accrual of further benefits over the year to 31 March 2018. In addition, there was a £15.3 million, or 0.9% increase, in scheme assets despite lower than expected returns of £23.9 million. The impact of these two changes (£105.7 million less £23.9 million) represent the actuarial gain recognised in the pension fund of £81.8 million which, net of deferred tax, represents the £67.9 million credit in the consolidated statement of comprehensive income.

Further detail is included in note 23 to the financial statements.

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

Financial summary

– regulated services

Financial performance

The surplus before tax in the year for Scottish Water's regulated business was £10.1 million lower at £75.9 million (2017: £86.0 million). This is as a consequence of the expected increase in non-cash pension charges under IAS19 of £15.8 million but, on a regulatory accounting basis, the surplus increased by £8.3 million to £107.8 million. This surplus is reinvested to fund the capital investment programme and customer service improvements, as demonstrated in the chart on page 7.

Regulated revenue

Regulated revenue for the year totalled £1,191.4 million (2017: £1,149.0 million) and is analysed by category in the table below:

	2017/18 £m	2016/17 £m	Change £m
Household	860.9	840.0	20.9
Wholesale	320.5	298.3	22.2
Other	10.0	10.7	(0.7)
Total regulated revenue	1,191.4	1,149.0	42.4

Revenue from services supplied to household customers increased by £20.9 million, or 2.5%, to £860.9 million reflecting the 1.6% tariff increase, effective from 1 April 2017, and the increase in properties connected to the network. Revenue from wholesale services supplied to Licensed Providers increased by £22.2 million or 7.4% to £320.5 million reflecting the introduction of charging at vacant business premises, the project to identify and bring into charge unregistered premises and an average tariff increase of 0.6% partly offset by a reduction in consumption by customers. Revenue from other sales decreased by £0.7 million to £10.0 million.

Operating costs

Total operating costs increased by £49.3 million to £938.6 million (2017: £889.3 million). The increase includes increased regulated costs of £14.8 million, higher infrastructure maintenance costs under IAS16 of £16.3 million and an increased IAS19 pension cost adjustment of £15.8 million.

On a regulatory accounting basis, operating costs for Scottish Water increased by £14.8 million, or 3.9%, to £395.9 million. The increase was primarily due to increased incident costs associated with the "beast from the east" weather event in March 2018, new legislative costs associated with the apprenticeship levy, holiday pay and land registration, and higher bad debt charges.

However, after adjusting for these specific cost increases and the impact of inflation, like-for-like costs reduced in real terms by £5.0 million or 1.3%.

The operating cost of the PFI schemes in the year, including associated depreciation and amortisation charges, was £137.5 million, £3.5 million higher than in 2016/17. The increase was mainly attributable to the annual indexation of service costs of £3.6 million.

Depreciation and infrastructure maintenance costs, net of the gain on asset sales, increased by £14.7 million to £379.9 million (2017: £365.2 million) due to the profile of capital investment.

Capital investment

Reported capital investment under IFRS for Scottish Water in the year was £493.8 million (2017: £484.5 million). As measured on a regulatory accounting basis, 2017/18 capital investment was £646.6 million (2017: £626.6 million). The table below reconciles investment as stated in the statutory accounts with investment on a regulatory accounting basis.

	2017/18 £m	2016/17 £m
2017/18 investment on a regulatory accounting basis	644.9	625.6
Add PFI capital additions	1.7	1.0
Total capital investment on regulatory accounting basis	646.6	626.6
Less base infrastructure maintenance included in operating costs under IAS 16	(134.7)	(117.6)
Less investment financed by infrastructure charges & contributions	(18.1)	(24.5)
Company capital additions per note 9 to the financial statements	493.8	484.5

Finance costs

As at 31 March 2018, the weighted average interest cost of the outstanding long-term debt reduced to 4.21% (2017: 4.43%). Net interest payable increased by £1.9 million to £149.9 million reflecting the additional interest cost incurred under the advanced payment scheme for wholesale bills. Interest cost in respect of government loans was unchanged at £148.2 million, reflecting the timing of loan repayments and lower interest rates on the refinancing of debt offset by net new loan drawdowns during the year. Interest charges are analysed as follows:

	2017/18 £m	2016/17 £m
Scottish Consolidated Fund	100.7	97.8
National Loans Fund	42.8	44.0
Public Works Loan Board	4.7	6.4
Other – net	1.7	(0.2)
Net interest payable	149.9	148.0

Finance costs associated with finance lease liabilities on PFI assets and the interest on pension scheme net liabilities increased by £1.0 million to £27.0 million (2017: £26.0 million).

During the year, net debt increased by £84.6 million to £3,273.7 million (being loans of £3,544.3 million less cash balances of £270.6 million). The increase was driven by net new borrowing from the Scottish Government of £120 million partly offset by a £35.4 million increase in cash balances.

Principal risks and uncertainties

Scottish Water has established a risk policy that sets out a consistent approach to the management of risk and the Board has defined its risk appetite. Details of our approach to risk management and principal risks and uncertainties are set out on pages 11 to 18.

Business Stream

Business Stream is a wholly-owned subsidiary of Scottish Water with its own board and independent management team.

Business Stream supplies water and waste water services to business customers throughout Scotland and to a growing number of customers in England following the opening of the English retail market on 1 April 2017.

Business Stream delivers a wide range of retail water and waste water management solutions, including water audits, waste water treatment solutions, water efficiency services, new connections, trade effluent consultancy, treatment hire plant and automated meter reading.

Competition in the Scottish and English markets continues to intensify with 26 licensed providers operating in the Scottish market and with 29 retailers operating in the English market.

Performance review

Business Stream reported a loss before tax of £5.2 million (2017: £6.5 million surplus) for the year.

The loss was largely attributable to £6.6 million of doubtful debt provisions required to reflect the initial low collection rates experienced following the introduction of charging for vacant premises in Scotland.

Charging for vacant premises was introduced in Scotland following the industry-wide removal of the water charge exemption for vacant properties. The policy change was effective from 1 April 2017. As the incumbent holding the majority of vacant properties in the market, Business Stream was significantly impacted by the combined challenges of identifying, tracing, contacting and bringing in to charge liable parties, with low awareness among property owners of their liability for this new charge.

Billing and collection rates are expected to improve over time as industry awareness improves and tracing and collection activities continue. Following an industry-wide consultation, changes to the regulatory framework have been introduced from 1 April 2018 which provide retailers with mechanisms to address recoverability issues, which will reduce the financial impact of vacant charging going forward.

Business Stream acquired the non-household customers of Southern Water in April 2017 which coincided with the opening of the market for non-domestic retail water services in England. The purchase doubled the size of the customer base, positioning Business Stream as the fourth largest water retailer in the UK, providing a strong foothold for future growth in the new market.

Business Stream made a strong start in the new English market, securing contracts worth £155 million with an annualised income of £66 million in the first 12 months, in addition to the acquisition of the Southern Water customer book.

Expenditure included £3.5 million of amortisation charges in relation to the Southern acquisition and £6.9 million of operating costs and doubtful debt charges associated with vacant properties. Underlying operating costs increased by £3.6 million from the previous year, reflecting the one-off costs of market entry, the costs of acquiring, on-boarding and integrating new customers and costs associated with servicing the enlarged customer base which is now twice as big as it was a year ago.

The cash balance remains strong at £43.4 million. The reduction in the year reflects: the acquisition of the Southern Water non-household customer base; increased wholesaler prepayment terms in Scotland; market credit terms with wholesalers in England; and the start-up phase for billing customers in the new market in England. Cash flow is expected to improve going forward as improved credit terms are implemented with English wholesalers and billing and collection rates improve.

Future developments

Business Stream's strategy is to retain market share in Scotland and the Southern Water region, while acquiring market share in Scotland and England utilising the knowledge, capability and experience gained from 10 years of operating in a competitive market.

Sustained investment in customer service has led to increased customer satisfaction levels and further investment is planned in automation, continuous improvement capability and process re-engineering, to deliver customer service excellence and improve operational efficiency.

Although the market in Scotland is now well established, which will place continued pressure on margins, the new English market, 1.2 million customers and £2.5 billion of revenue, creates sizeable new opportunities for profitable growth. Business Stream continues to benefit from a strong debt-free balance sheet with £43.4 million of cash balances as at March 2018.

Non-regulated businesses

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

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

International business activities are focused on countries where governments and utilities are keen to learn about the transformation journey of Scottish Water into an efficient publicly-owned service provider and are aligned with the Scottish Government's Hydro Nation ambitions.

The non-regulated businesses working capital requirements are financed by organic cash flow, loans from Scottish Water Horizons Holdings Ltd, grant funding and asset disposals.

Performance review

Non-regulated businesses returned a profit before tax for the year ending 31 March 2018 of £1.0 million (2017: £1.5 million). Some highlights from the year include:

- Completion of a design and build project to facilitate new waste water infrastructure to support the new town of Tornagrain, near Inverness, is imminent but slight delays are the primary reason for the reduction in profit highlighted above.
- Creation of a joint venture with International Waste Water Systems UK Ltd (SHARC Energy) to expand and accelerate the roll-out of heat from waste water schemes across Scotland. Projects due to commence, with support from the Scottish Government's Low Carbon Infrastructure Transition Programme, are a leisure centre in Campbeltown and the Kelvingrove Art Gallery & Museum in Glasgow.
- Securing a grant, in conjunction with our partner organisations, to create a pan-European network of water and waste water test facilities to support innovation within the small-medium enterprise market across Europe.
- A further investment in renewable energy schemes, including photo-voltaic panels, wind and biomass technologies, bringing delivered capacity of renewable energy generation since April 2015 to 3.9GWh. This represents 60% of the Scottish Water Group target to be delivered by March 2021.
- The focus in 2017/18 for international business activities was the planned transition from the six year contract in Qatar which ended in March 2018 and the development of further channels to market primarily in Australia, New Zealand and Ireland which have required up-front investment. This has already helped it gain new contracts in the final quarter of the year to the value of circa £950,000 in Australia, Canada, Romania, and Ireland.
- Business success in Australasia was achieved by winning work in Brisbane and Tasmania to support delivery of their investment programmes and completing commissions with Sydney Water to support the implementation of a new treatment operating model. Work also progressed with Wellington Water in New Zealand to review their customer strategy.
- Continued to provide advice and support to the creation of Irish Water, Ireland's new water utility.
- Supporting Strathclyde University and the Scottish Government by providing a project management service to develop a strategic plan to help Malawi achieve the United Nations Sustainable Development Goal 6 by 2030.

People

People – our employees and our customers – are at the very heart of what we do and we're committed to ensuring we make a positive contribution to their lives, now and in the future.

Our people

We employ people across Scotland with a diverse range of skills and talents in areas such as science, engineering, finance, regulation, customer service, project management, information technology and asset management. Our people at Scottish Water are key to delivering our strong performance and in developing our plans for the future. We also have a small number of employees working overseas on international assignments in Qatar, Ireland and Australia. We are a Living Wage accredited employer.

Safety, health and wellbeing

Our integrated safety, health and wellbeing strategy sets out our intent to lead our industry in Scotland on a journey to zero harm and create safe, healthy and productive workplaces where our people can thrive.

Keeping people safe

In 2017/18, there was an increase in safety incidents among Scottish Water employees and those of our alliance partners and contractors. Slips, trips and falls remain the most common cause of workplace injury. Falls from height remain infrequent but can be the most serious.

During the year, two significant safety incidents occurred. In January 2018, an employee of Veolia, the operator of Whitburn Waste Water Treatment works, sadly lost his life while at work. A serious injury occurred to a Scottish Water employee involving a fall from height in June 2017.

While our key health and safety incident rates, including Lost Time Accidents, continue to be lower than average industry levels, we will continue to increase our focus in 2018/19 to ensure the safety of our people, and the public as well as our contractors and partners.

We have an ambitious plan of safety improvement initiatives up to 2021. During 2017/18, we focused on collaboration with our alliance partners and management of contingency workers on safety, health and wellbeing.

Keeping people healthy

In 2017, voluntary health-screening was offered for the first time to employees based at our six main office locations around the country. Over 700 employees took up the offer, and the intention is to extend the programme across a wider range of locations in 2018/2019.

In December 2017, Scottish Water introduced a new nurse-led advice and sickness absence reporting service for our employees. During 2017/18, the proportion of time lost to employee absence in Scottish Water was 2.87%.

Helping people thrive

We have a network of around 70 Wellbeing Champions across the business. These are employees who are passionate about good work being good for health and who have volunteered to support our health and wellbeing initiatives. Our wellbeing initiatives include Flourish courses, aimed at building employees' personal resilience, and Mentally Healthy Working Lives training, aimed at building line managers' confidence to support employees who are experiencing mental health issues.

Agile working practices are one of the key priorities for our employees. Alongside the range of working patterns and family-friendly policies in place, we remain committed to ensuring workspaces are agile environments and our employees are equipped with the appropriate equipment, tools and technologies to help enable agile working.

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

Increasing diversity

We recognise that diversity in the workplace makes good business sense and leads to dynamic teams, different contributions, better decision-making and strong performance.

Scottish Water is committed to equality of opportunity and diversity in employment, including in the way we reward our employees. We have seen a gradual increase in the proportion of female employees; women now make up 28% of our workforce. Scottish Water's Public Sector Equality Duties Report is published in full on our website.

In 2017, we won The Herald/GenAnalytics Diversity in the Public Sector Award. The judges commented on our proactive approach to managing our workforce

demographics, and our focus on creating an inclusive work environment. We want everyone to feel that they belong at Scottish Water, and to feel as though they are valued for their differences and contributions. We encourage individuals with shared interests to form self-organising and governing networks and now have seven established groups in place. These are Women in Scottish Water, Nxt Gen (for people early in their careers), LGBT and Allies, Disability Forum, Carers Support Network, Armed Forces Network and Multicultural Group.

In October 2017, Scottish Water signed the Armed Forces Covenant and committed to supporting serving and former military personnel and their families.

Building capability

We work hard to create opportunities for all our people to realise their full potential by developing their skills, talents and experiences, and to equip them to deal with changing working practices and technologies.

We recognise the importance of attracting and developing the next generation of people to work in the water industry in Scotland. We have attained the Investors in Young People Gold Standard, the highest level of recognition for our continued strong commitment to employing and developing young people. In collaboration with our partners and relevant skills bodies, we have created qualifications, modern apprenticeship frameworks, internships and award-winning apprentice and graduate development programmes. We currently employ 56 graduates on structured development programmes and we will recruit a further 25 in 2018/19. We run a number of well-established apprenticeship programmes, with 138 apprentices currently in training.

The Future Leaders Programme, a two-year development programme for employees with senior leadership potential has created a pipeline of talent. The Programme was awarded Best Talent Management Programme at the HR Network 2017 Awards. In addition, we offer a number of paid three-month internships each year for those from Science, Technology, Engineering and Maths (STEM) backgrounds.

Resource management

We engage a number of workers through agency contracts, allowing greater flexibility and access to specialist skills. The table below sets out the number of agency workers at the end of 2017/18. 'Off payroll' workers are defined by HM Treasury guidance as those paid £220 or more per day and that last longer than 6 months.

Length of service	Less than 1 year	1-2 years	2-3 years	3-4 years	4 years or more
Number of "Off Payroll" Agency Workers	19	38	26	49	3

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

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

Occasionally, however, this is not possible and where the employee so desires they can opt for voluntary redundancy. We also operate schemes for Flexible Retirement and Early Retirement which an employee can request in line with the regulations of the Local Government Pension Scheme. Any payments made for voluntary redundancies or flexible/early retirements are recovered through cost savings on average within two years. The table below sets out the exit packages made in the financial year 2017/18:

	No. of Employees	Total Cost	Average Cost
Voluntary Redundancy	2	£14,062	£7,031
Flexible Retirement ¹	46	£351,983	£7,651

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

Human rights

Scottish Water is committed to respecting human rights. We expect all those who work for and with us to show dignity and respect at work and to adhere to our zero tolerance approach to slavery and human trafficking.

Bribery and corruption

In 2017/18, we developed and reviewed a number of policies including: Anti-Slavery; Code of Ethical Conduct; Whistleblowing; and Fraud Management. A Policy Awareness Communication plan was developed to ensure all employees are aware of their rights and obligations. For topics such as Fraud and Bribery and Corruption, mandatory compliance training is routinely undertaken by appropriate role-holders.

Community matters

As a responsible business, we recognise the broader role Scottish Water has in the communities we serve.

Customer education

We are committed to engaging with customers of all ages about who we are, what we do, the vital role that water and waste water services have in our daily lives, and the water cycle.

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

Learn to Swim

Our three-year partnership with Scottish Swimming's Learn to Swim programme gathered real momentum during the first full year of activity in 2017/18.

The programme reached 17 local authorities and leisure trusts and saw more than 53,000 children participate in swimming lessons at 110 swimming pools throughout the country. This exceeded the target of 50,000 children set for the first year.

Our country has many miles of coastline, rivers, lochs and reservoirs and we believe that swimming is a key life skill as well as being great for general wellbeing and fitness. We will continue to work with Scottish Swimming to promote Learn to Swim in the remaining two years of the partnership. This aims to help more than 100,000 children learn to swim, and give them the skills, confidence and knowledge to stay safe and be competent around water.

Volunteering

Since our volunteering programme launched in 2011, we have seen 1,137 individual employees dedicate 21,452 working hours to good causes. In 2017/18, 506 individual employees dedicated 4,162 working hours of their time to educational, charitable, environmental and community projects across Scotland.

Each employee is entitled to up to 2 days paid leave per year to volunteer which in turn develops their personal skills, aids their wellbeing and champions teamwork across the organisation. The volunteering work our employees undertake helps to leave a positive legacy with our customers and their communities. In turn this helps build trust, strengthen relationships and our reputation, and helps us to achieve our vision.

Our Adopt a Beach campaign, which supports employees to use their volunteering time to 'adopt' and survey a local beach, has seen us adopt 50 beaches. Local primary schools are also encouraged to join our volunteers, allowing pupils to understand that small changes to behaviours can make a positive difference to our environment. We will continue to support employees with this campaign and the work of Marine Conservation Society (MCS) who use the data we provide in their campaigns to rid our shores of litter.

WaterAid Scotland

We are proud to support WaterAid, which works with partners in some of the poorest communities in Africa, Asia and the Pacific region to deliver clean water and toilets, promote good hygiene and campaign for change. The involvement of Scottish Water employees helps support the WaterAid vision to provide everyone, everywhere with clean water, decent toilets and good hygiene by 2030. In 2017/18, Scottish Water employees raised in excess of £208,900 to support WaterAid's work. In addition, an extra £10,569 has been raised through the #Untapped match funding by the Department for International Development.

WaterAid Scotland secured £1.08 million in funding from the Scottish Government for a project in Rwanda which aims to improve health and sanitation. Over the lifetime of the project, school toilet blocks and rainwater harvesting tanks will be constructed. In January 2018, Scottish Water employees visited Rwanda with WaterAid Scotland and representatives from the Scottish Government to see the project first-hand.

Community Empowerment (Scotland) Act 2015

During 2017/18, under Part 5 of the Act, Scottish Water received no formal Asset Transfer Requests from Community Transfer Bodies.

Scottish Water promotes awareness of the legislation by publishing an asset register as required under the Act on our website.

We have regularly met with local community groups where issues relating to the future use of assets – particularly those which may become, or already are, non-operational – are discussed and highlighted for further investigation.

Looking ahead

Our plan for 2015 to 2021

High quality service

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

Customer experience

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

Service to Licensed Providers

We will continue to listen to the needs of Licensed Providers operating in Scotland as the Scottish and English retail markets develop and adapt our wholesale services to meet their needs.

Household prices

We will keep prices low for our customers through being ever more efficient and innovative and balancing investment priorities and opportunities with available financing.

Wholesale charges

Wholesale charges, across the 2015–21 period, will increase at 0.3% below CPI per annum.

Delivering value

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

Innovation

Our plans include both innovative and proven approaches to operating and investment solutions. Detailed studies and investigations have enabled us to avoid extensive investment where there would be no clear benefit.

Financing

The financing of this plan will require £760 million of net new government borrowing across the 2015 to 2021 period.

Out-performance

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

Risk

Inevitably, circumstances will vary from those set out in our plan. In 2010–15, overall favourable circumstances and business out-performance enabled us to both reduce customer prices in real terms and new government borrowing. From 2018 to 2021, we may require greater or lesser financial resources than assumed in our plan.

Governance

Board members	48–49
Corporate governance	50–53
Audit committee report	54–57
Remuneration committee	58
Members' remuneration report	59–68
Members' report	69–71

Board members



Executive Members:

1. Douglas Millican, Chief Executive

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

2. Peter Farrer, Chief Operating Officer

Peter was formerly Customer Service Delivery Director and General Manager of Operations. Prior to this he held various operational and engineering roles within Scottish Water's predecessor organisations, East of Scotland Water and Lothian Water and Drainage. He has 34 years' experience in the water industry since graduating from Heriot Watt University as a Civil Engineer in 1984. He is a Chartered Civil Engineer, gained an MBA from the Edinburgh Business School in 2001 and is a Fellow of the Institution of Civil Engineers and a Vice-President of the Institute of Customer Service.

3. Alan Scott, Finance Director

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

Non-Executive Members:

4. Dame Susan Rice DBE

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

5. Matt Smith OBE DL

Matt is the former Scottish Secretary of UNISON and STUC President. He is a member of: the Scottish Police Authority; the Employment Appeal Tribunal; the Central Arbitration Committee; the ICAS Regulation Board and CIPFA's Investigation Committee. He is a Fellow of the Scottish Council for Development and Industry and a former member of the Scottish Standards Commission, the Scottish Human Rights Commission and the Broadcasting Council for Scotland. Matt served as a Justice of the Peace for over 30 years and is a Deputy Lieutenant for Ayrshire and Arran.

6. James Coyle

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



Chairman of the Audit Committee of Vocalink Plc, a member of the Financial Reporting Council's Reporting Review Panel, the ICAS Council and a Non-Executive Director of the Scottish Building Society.

7. Paul Smith

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

8. Iain Lanaghan

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

9. Samantha Barber

Samantha Barber was appointed as a Non-Executive Director in April 2017. She has worked at CEO and Board level in both the UK & Internationally for over 20 years. She worked in Brussels as a Policy Advisor in the European Parliament for 4 years and was CEO at Scottish Business in the Community for 9 years. Samantha took up her first Non-Executive Director position in 2000 joining the Board of Right Track in Glasgow. She also joined the Scottish Power Advisory Board in 2007 and was appointed to the main Board of the parent company, Iberdrola in 2008 where

she is currently Chair of the Corporate Governance and Compliance Committee and a member of the Executive Committee. Samantha is also Chair of the Scottish Ensemble and an Advisory Board member at Imperial College London.

10. Deirdre Michie

Deirdre was appointed CEO of Oil and Gas UK in May 2015. She has an LLB Hons in Scots Law and has extensive experience as a senior business leader for Shell in the oil and gas industry, covering upstream, downstream and globally. She is a member of MER, the UK Government and Industry forum, and is also on the UK Treasury's Oil Industry Fiscal Forum. As well as being a Non-Executive Board member of Scottish Water, she is a Board member of Opportunity North East and Chair of Common Data Access Limited. Deirdre is also a member of the Women's Business Council, a UK Government body focused on increasing women's contribution to economic growth and is also Sponsor of AXIS.

11. Ken Marnoch

Ken brings 29 years of energy industry experience having worked for Shell since graduating from Heriot-Watt University in 1988. Initially based offshore in the North Sea and onshore in Aberdeen, and subsequently 17 years in assignments overseas. His recent roles include leading regional and country businesses in the Gulf of Mexico, USA and Brunei, South-East Asia focusing on corporate responsibility, safety, bottom line delivery, digitalisation and investment in people. His international career has also included leading Internal Audit, major asset and infrastructure project delivery, strategic planning, managing Government and corporate joint ventures and delivering significant organisational change.

Corporate governance

Members

The Chair and other Non-executive Members are appointed by Scottish Ministers. Executive Members are appointed by Scottish Water after receiving consent to their appointment from Scottish Ministers. The Members as at the date of the Annual Report and their biographies are set out on pages 48 to 49.

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

The Board of Scottish Water comprised 11 members: 8 Non-executive Board Members and 3 Executive Members, with the appointment of Samantha Barber and Iain Lanaghan as Non-executive Board Members on 1st April 2017 and the appointment of Deirdre Michie as a Non-Executive Board Member on 1st December 2017. Lynne Peacock's term as a Non-Executive Board Member expired on 31st October 2017. For the remainder of the 2017/18 financial year, the Board comprised 8 Non-executive Board Members and 3 Executive Members, with Alan Bryce's term as Non-executive Board Member expiring on 31st March 2017. The Board has a formal schedule of matters specifically reserved to it for decision making. Reporting to the Board are the Chief Executive and the Executive Members who have responsibility for the management of Scottish Water, and the Board Committees detailed below.

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

During the financial year of 2017/18, the Board met on 10 occasions to review Scottish Water's operational and financial performance, business strategy and risk management.

UK Corporate Governance Code

Scottish Water complies with the UK Corporate Governance Code so far as applicable to its status as a Statutory Public Corporation. As Scottish Water is not a company registered under the Companies Act, the Financial Conduct Authority (FCA) listing rules are not applicable and an Annual Consultative Meeting with stakeholders is held in place of an Annual General Meeting. The arrangements for appointment and termination of Board Members and their remuneration are derived from the underlying statutory regime and set out in the Members' Remuneration Report. No Senior Independent Director has been appointed as other arrangements are in place to consult with stakeholders. The Audit Committee Report on pages 54 to 57 covers the appointment of the external auditor.

Board and Committees

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

	Board		Audit Committee		Remuneration Committee	
	Held	Attended	Held	Attended	Held	Attended
Dame Susan Rice	10	10	–	–	–	–
Samantha Barber	10	10	–	–	2 ¹	2 ¹
Alan Bryce ²	10	10	5	5	3	3
James Coyle	10	9	5	5	–	–
Peter Farrer	10	10	–	–	–	–
Iain Lanaghan	10	10	5	5	–	–
Deirdre Michie ³	3	3	–	–	–	–
Douglas Millican	10	10	–	–	–	–
Lynne Peacock ⁴	6	6	3	3	–	–
Alan Scott	10	9	–	–	–	–
Matt Smith	10	9	–	–	3	3
Paul Smith	10	10	1 ⁵	1 ⁵	3	3

1 From her appointment to the Remuneration Committee on 1st November 2017

2 Until expiry of his term on 31st March 2018

3 From her appointment on 1st December 2017

4 Until expiry of her term on 31st October 2017

5 From his appointment to the Audit Committee on 1st March 2018

Audit Committee

The Audit Committee reviews the financial reports of Scottish Water and considers the results of the auditor's examination and review of the financial statements. It meets with management and with internal and external auditors to review the effectiveness of internal controls and business risk management. The Chair of the Audit Committee reports to the Board on internal control and risk management matters following each Audit Committee meeting. The Committee adheres to the requirements of the Audit Committee Handbook. Each year the Committee presents an annual report of its activities to the Board prior to the Board's consideration of the Annual Report.

A more detailed report of the Audit Committee's activities is provided on pages 54 to 57.

Remuneration Committee

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

A more detailed report of the Remuneration Committee's activities is provided on page 58.

Board and Committee performance

An independent external review of Board and Committee effectiveness was carried out in 2017 and actions arising from it are being implemented. Formal annual evaluation processes are in place for all Members including the Chair. Induction and ongoing training is provided for Members with specific emphasis on finance, regulation and risk analysis.

Executive Leadership Team

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

Douglas Millican	Chief Executive
Peter Farrer	Chief Operating Officer
Alan Scott	Finance Director

Internal control

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

The systems of internal control are compliant with the relevant sections of the UK Corporate Governance Code and the Scottish Water Governance Directions 2009. They are based on an ongoing process designed to identify those risks material to the achievement of Scottish Water's policies, aims and objectives, to evaluate those risks and to manage them effectively in accordance with good risk management practices.

Risk management

The risk management process has been in place for the full year under review and up to the date of approval of the Annual Report and financial statements.

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

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

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

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

The risk register and risk management processes are reviewed annually by the Board, supplemented by quarterly updates which review the status of the most significant business risks. The Audit Committee and the Executive Leadership Team receive two risk reports per year, supplemented by quarterly updates. Further information is on pages 11 to 18.

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.
- Close attention given by the Board and management to safety, health and wellbeing issues.

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

Control effectiveness review

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

Sustainable development

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

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

Information and communication

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

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

Scottish Water has a Consultation Code setting out how it consults external stakeholders in relation to proposals for, and the undertaking of, significant core business activities.

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

External Auditor

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

Independence of external auditor

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

Under the terms of KPMG LLP's appointment, they may not carry out any non-audit work for Scottish Water without the prior approval of Audit Scotland, and must comply with Scottish Water's policy on provision of non-audit services (see page 57).

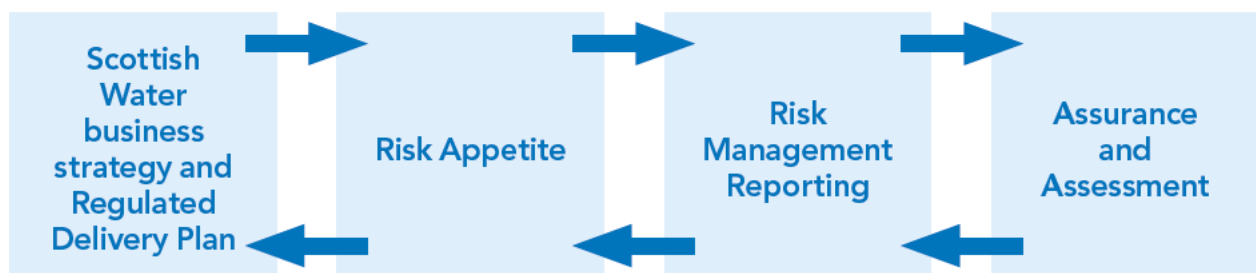
Audit committee report

I am pleased to present this report covering the role and function of the Audit Committee for the year ended 31 March 2018. I became Chair of the Audit Committee on 1 August 2017, following Lynne Peacock who stepped down from the Board on 31 October 2017. I would like to thank Lynne for her contribution as Chair of the Committee for 5 years. During the year, Lynne and I were supported by 3 other Non-executive Members; Alan Bryce, Iain Lanaghan and, as from 1 March 2018, Paul Smith. At the year end, Alan Bryce stepped down. I have relevant financial experience and my Committee members have been selected with the aim of providing the wide range of financial, governance and commercial expertise necessary to fulfil the Committee's duties and obligations. Emma Campbell, Scottish Water's Group Legal Counsel, is Secretary to the Committee.

Audit Committee Role and Responsibilities

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

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



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

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

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

Committee Meetings

The Committee meets at least 4 times per year, 2 of which are co-ordinated with external reporting timetables. During 2017/18 the committee met on 5 occasions, with an extra meeting in May 2017 to focus on corporate reporting requirements.

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

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

The Committee's Activities

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

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

Financial Reporting

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

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

To assist in the discharge of its duties the Committee considers reports from the Group Financial Controller and reports from the external auditor on the outcomes of their half-year review of interim financial statements, including confirmation that the Accounts are prepared on a going concern basis. The Committee also considered and was satisfied with the papers prepared by the Group Financial Controller and the external auditor covering the financial statements for full year 2017/18. These included a section from Management supporting the going concern basis which the external auditor confirmed was appropriate. Our view was also supported by Scottish Water's Delivery Plan, which was accepted by Scottish Ministers on 21 April 2015 and is refreshed annually in March, which set out funding requirements for Scottish Water for the 2015-2021 regulatory period.

The Finance Director and external auditor of Scottish Water Business Stream are also in attendance when the Committee reviews the consolidated interim and annual financial statements. As a consequence of the regulatory framework, the independence of the Business Stream Board, and the associated limited disclosure regarding the activities of Business Stream, the Audit Committee is in large part reliant on the Board of Business Stream to provide much of the necessary assurance and

governance requirements. Additional assurance is gained through governance exercised through Scottish Water Business Stream Holdings Ltd (SWBSH). The Board of SWBSH has several Directors in common with Scottish Water and receives reports from Business Stream management covering financial performance and specific risks facing Business Stream, in particular the impact of increased competition within the Scottish business retail market and entry into the English business retail market.

The primary areas of judgement considered by the Committee in relation to the 2017/18 Accounts were:

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

After discussion of these with management and the external auditor the Committee was satisfied that the issues raised had been properly dealt with and that appropriate disclosures have been included in the accounts. The external auditor carried out their work using an overall materiality of £9.5 million, representing 1% of total expenses, incurred in 2016/17 (excluding interest), in the consolidated income statement for 2017/18. However, the Committee agreed with the external auditor that the firm would report any misstatements identified during the audit above £200,000, as well as misstatements below that amount that, in their view, warranted reporting for qualitative reasons. The external auditor confirmed to the Committee that there were no unadjusted misstatements that warranted reporting. In addition, the Chief Scientist, the Head of Internal Audit and the General Manager Revenue and Risk carried out a review to verify that the Annual Report and Accounts are fair, balanced and understandable, the results of which were considered by the Committee prior to recommending Board approval of the Annual Report and Accounts.

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

Scottish Water's Internal Control and Risk Management processes

Over the year the Committee received papers from Group Finance associated with the 2016 Corporate Governance Code, one of which included a risk management assessment control schedule. This schedule included a detailed 23 point checklist supported by a detailed record of evidence sources and satisfaction ratings of that evidence.

Evidence sources were grouped into 6 categories including risk register & management processes, policy & procedure processes, assurance statements and independent reviews. The Committee also approved Scottish Water's new risk management policy.

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

- Reports from Internal Audit on the effectiveness of internal controls and issues requiring improvement, including reported fraud allegations;
- Observations from the external audit on the internal control environment and any specific control issues identified;
- Corporate risk reports summarising key risks in the corporate risk register including mitigating actions, risk trends, and summarising compliance with Scottish Water's risk appetite;

- Reports covering the stress testing of the key quantitative and qualitative risks facing the Group;
- Bi-annual report from the Business Ethics Committee;
- An annual report from the compliance officer;
- An annual corporate governance report;
- An Internal Audit annual opinion and report;
- An annual report on regulatory compliance;
- An annual statement of compliance with the Modern Slavery Act 2015; and
- An annual Tax Strategy.

In addition, during the year the Committee requested specific reports on drinking water quality, compliance with General Data Protection Regulation, finance systems implementations and supplier rebates.

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

Internal Audit

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

External Audit

The Auditor General for Scotland is responsible for the appointment of the Scottish Water external auditor and undertook a robust tender and assessment exercise for Scottish Water and many other public sector organisations, which resulted in the appointment of KPMG as Scottish Water's external auditor for a 5 year period from 2016/17 to 2020/21.

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

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

Auditor Independence

During 2015/16 the Committee approved a policy on provision of non-audit services to Scottish Water and this was extended to all subsidiaries in 2016/17 by the firm appointed as external auditor.

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

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

James Coyle
Chair of the Audit Committee

Remuneration committee

Annual Statement by the Chair of the Remuneration Committee

It is my pleasure to present the Members' remuneration report for the year ended 31 March 2018. In preparing this report I am thankful for the support of fellow Remuneration Committee and Non-executive Members, Matt Smith and Paul Smith. I would also like to thank former Remuneration Committee Chair, Alan Bryce, for his contribution over 9 years, before he stepped down as a Non-executive Member on 31st March 2018.

As required, the Committee receives internal advice and information from the Chair of Scottish Water, the Chief Executive, the Director for People, and the Group Legal Counsel. In March 2018, the Remuneration Committee received advice and information on UK pension tax legislation from Mercers, a specialist adviser in such matters.

The Remuneration Committee meets regularly to consider the remuneration arrangements for Executive Members, and other related remuneration matters, making recommendations to the Board. There were 3 meetings of the Committee in 2017/18. At each meeting a quorum of independent, Non-executive Members was present. No Executive Member was present during discussions about their own remuneration.

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

The key decisions made by the Committee over the 2017/18 period were as follows:

Decisions / remuneration for 2017/18

- Agreeing the base salary increase of 2.0% of the Executive Members and Chief Executive from 1 April 2017.
- Confirming the 2017/18 AOIP payment calculated at 35.75% out of the 40% maximum opportunity for Executive Members and Chief Executive.
- Reviewing management's proposed salary increases for Scottish Water employees.
- Review of succession planning for posts on the Executive Leadership Team.

Changes / remuneration for 2018/19

- Agreeing base salary increases for Executive Members, with effect from 1 April 2018, at 1.5% plus £1,600 in line with the Scottish Government's Public Sector Pay Policy.
- Setting the performance criteria for the 2018/19 AOIP.

Our Remuneration Policy and our Annual Report on Remuneration is set out on pages 59 to 68.

Samantha Barber

Chair of the Remuneration Committee

Members' remuneration report

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

1. Statement of Executive Remuneration Policy

a. General Policy

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

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

The overall remuneration policy aims are to:

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

b. Remuneration elements

The Remuneration Policy for Executive Members consists of five principal elements:

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

c. Relative importance of performance incentives

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

d. Base Salary

Scottish Water is publicly owned and accountable to the Scottish Parliament and Scottish Ministers. Within the context of public sector ownership, the company seeks to attract, retain and motivate leadership talent in competition with private sector utilities and other organisations across the UK economy, as well as with employers in the public sector.

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

The aim is to pay in line with 95% of the median of an agreed industry benchmark group, reflecting remuneration levels in comparable organisations for similar work. Analysis is carried out approximately every three years and when last undertaken by Hay Group in November 2015, showed that Executive Members' base salaries ranged between 74% and 85% of the industry median, with the average position being 80%. There is no indication that the position to the external market has moved materially since then.

e. Annual Out-performance Incentive Plan

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

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

The potential maximum annual incentive attainable for out-performance by Executive Members is 40% of base salary and is non-pensionable. Delivery Plan targets, out-performance targets, and actual performance for each measure in 2017/18 are set out below.

Measure	Weight	Delivery Plan target	Out-performance target	Actual performance
Regulated Profit before tax excluding depreciation	40% ⁽¹⁾	£415m	Profit Before Tax and Depreciation (PBTDA) to beat delivery plan by £0 to £33m. Sliding scale with 0% at delivery plan figure and 100% at +£33m	£469m
Customer service OPA performance	25%	382 to 400 points	Overall Performance Assessment (OPA) based on sliding scale discussed with Customer Forum where, for 2017-18, the Leading score is 382 points and Best in Class is 400 points. Below leading score 0%; at leading score 30%; at best in class 90%; beat best in class 100%.	406 points
Customer Experience – Household Measure	25%	Exceed 82.6 points	The target operates on a sliding scale from 82.6 to the business target of 85.87 points with 0% payable below 82.6 points; 30% payable at 82.6 points; and 100% payable at 86.5 points or more.	86.36 points
Customer Benefit – Overall Measure of Delivery	10%	Exceed 124 points	Exceed the target Overall Measure of Delivery (OMD) of 124 points and ensure forecast capital programme cost is within the regulatory allowance ⁽²⁾ . Once these targets are achieved, payment depends on the number of Q&S3a and 3b projects outstanding at 31 March 2018, so that: 0% for more than 6 projects; 7% at 6; 8% at 5; 9% at 4; 10% at 3 projects or fewer.	148 points; 3 Q&S3b projects outstanding; programme forecast cost outside of regulatory allowance

Notes

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

(2) Plus customer contributions.

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

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

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

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

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

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

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

Notes:

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

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

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

g. Pension

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

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

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

h. Benefits

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

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

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

i. Approach to recruitment remuneration

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

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

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

j. Payments on loss of office

Executive Members are expected to work the notice periods in their service contracts. In circumstances where it is in the operational interests of Scottish Water for an Executive Member to leave before the end of their notice period, the Remuneration Committee will consider options such as 'garden leave' or paying in lieu for all or part notice on a case-by-case basis.

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

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

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

k. Consideration of employment conditions elsewhere in the company

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

When determining payments to be made under the AOIP, the Remuneration Committee considers the proportion of potential payment resulting to Executive Members from corporate out-performance and how that same out-performance drives payments to other employees under their AOIP arrangements. In addition, any review of executive salaries includes consideration of the pay adjustment opportunities available to other employees.

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

I. Service contracts

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

Executive Member	Name	Date of Contract
Chief Executive	Douglas Millican	1 February 2013
Chief Operating Officer	Peter Farrer	1 April 2013
Finance Director	Alan Scott	24 September 2013

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

Non-executive Members

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

Dame Susan Rice, Chair	30 April 2019	Iain Lanaghan	31 March 2021
James Coyle	31 July 2020	Matt Smith	30 April 2021
Paul Smith	31 July 2020	Deirdre Michie	30 November 2021
Samantha Barber	31 March 2021	Kenneth Marnoch	31 March 2022

2. Members' Remuneration Report

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

a. Single Total Figure Table

		Salary/ Fees	Benefits (i)	AOIP (ii)	Total	Pension (iii)	Total (iv)
		£000	£000	£000	£000	£000	£000
Executive Members							
Douglas Millican	2018	256	12	92	360	-17	343
	2017	251	12	86	349	63	412
Peter Farrer	2018	186	12	67	265	-15	250
	2017	183	12	63	258	48	306
Alan Scott	2018	184	9	66	259	21	280
	2017	180	11	62	253	52	305
Non-executive Members (iv)							
Chair – Dame Susan Rice	2018	101			101		101
	2017	100			100		100
Samantha Barber (vi)	2018	21			21		21
	2017	-			-		-
Alan Bryce (viii)	2018	26			26		26
	2017	26			26		26
James Coyle (v)	2018	24			24		24
	2017	14			14		14
Iain Lanaghan (vi)	2018	21			21		21
	2017	-			-		-
Deirdre Michie (vii)	2018	7			7		7
	2017	-			-		-
Lynne Peacock (viii)	2018	14			14		14
	2017	26			26		26
Matt Smith	2018	21			21		21
	2017	20			20		20
Paul Smith (v)	2018	21			21		21
	2017	14			14		14
Former Members							
Geoff Aitkenhead (x)	2017	47	5	16	68		68
James Spowart (xi)	2017	20			20		20
Andrew Wyllie (xi)	2017	20			20		20
Total Remuneration	2018	882	33	225	1,140	-11	1,129
	2017	901	40	227	1,168	163	1,331

Notes:

- (i) Benefits include the value of car benefit or car allowance and annual life assurance premiums associated with the Scottish Water Life Assurance Scheme as described in the Executive Remuneration policy. The value of each benefit is described in a separate table below.
- (ii) Annual Out-performance Incentive Plan as described in the Executive Remuneration Policy.
- (iii) The value of pension benefits accrued is calculated in accordance with section 5.3.21 (d) of the HM Treasury’s Financial Reporting Manual 2017/18. This requires the real increase in accrued benefits, as detailed in section 2c below, to be multiplied by 20, plus the real increase in accrued lump sum and reduced by the contribution made by the individual member. The decrease in Mr Millican’s and Mr Farrer’s pension benefits in the year reflects the impact of a tax charge associated with their accrued pension benefits resulting in a reduced future pension.
- (iv) Fees are agreed by Scottish Ministers with regard to the daily fee framework of the Scottish Government’s Pay Policy for Senior Appointments and payments reflect the time commitment required for each role.
- (v) Payments received by Paul Smith and James Coyle in 2017 are from their appointments on 1st August 2016. James Coyle’s remuneration in 2018 reflects his position as Audit Committee Chair from 1st August 2017.
- (vi) Payments received by Samantha Barber and Iain Lanaghan are from their appointments on 1st April 2017.
- (vii) Payments received by Deirdre Michie are from her appointment on 1st December 2017.
- (viii) Alan Bryce and Lynne Peacock each stepped down from the Board on 31st March 2018 and 31 October 2017 respectively.
- (ix) Kenneth Marnoch was appointed on 1st April 2018 and so received no remuneration in this reporting period.
- (x) Payments received by Geoff Aitkenhead until his retirement on 31 July 2016.
- (xi) James Spowart and Andrew Wyllie each stepped down from the Board on 31 March 2017.

The Committee approved a 1.5% + £1,600 increase in base salaries for the three Executive Members with effect from 1 April 2018. Consequently, base salaries for 2018/19 are as follows: Douglas Millican £261,654; Peter Farrer £190,571; and Alan Scott £188,372. Fee levels for Non-executive Members, including the Chair, for 2018/19 will increase by £6 per day, also with effect from 1 April 2018 and in line with Public Sector Pay Policy for Senior Appointments.

b. Details of benefits received 2017/18

Name	Car benefit or car allowance £000	Life assurance premium £000	Total £000
Douglas Millican	10	2	12
Peter Farrer	10	2	12
Alan Scott	7	2	9

c. Total pension entitlements to end of financial year 2017/18

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

	Increase/(Decrease) in accrued benefits during the year net of inflation			Accumulated total accrued benefits at 31 March 2018		Transfer Values		
	Years in Scheme	Pension £000	Lump sum £000	Pension £000	Lump sum £000	At 31 March 2018	At 31 March 2017	Increase /(Decrease) in 2017/18 net of Members' own contributions and inflation £000
						£000	£000	
Douglas Millican	23.1	1	-1	70	135	1,471	1,451	-49
Peter Farrer	33.7	-	-2	85	172	1,752	1,648	35
Alan Scott	4.5	2	-	14	-	226	178	22

Notes:

- (i) Members of the pension scheme have the option to pay additional voluntary contributions; neither the contributions nor the resulting benefits are included in the above table.
- (ii) The normal retirement age of Executive Members is determined by the rules of the Scottish Local Government Pension Scheme. For pension accrued up to 31 March 2015 this is age 65. For pension benefits accrued after that date, normal retirement age is set equal to the individual's state pension age. Any pension benefits drawn before normal retirement age are usually reduced in value by actuarial factors reflecting the anticipated longer payment period.
- (iii) The pension entitlement shown is that which would be paid annually on retirement along with the lump sum, based on service to the end of the year.
- (iv) The transfer value of accrued pension is calculated in a manner consistent with Actuarial Guidance Note GN11.
- (v) The rate of tax payable on pension savings above the lifetime allowance of £1.03m depends on how the money is paid to individuals. The current rate is 55% if the individual takes a lump sum, or 25% if the individual takes it as pension payments or cash withdrawals.

d. Pay multiples

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

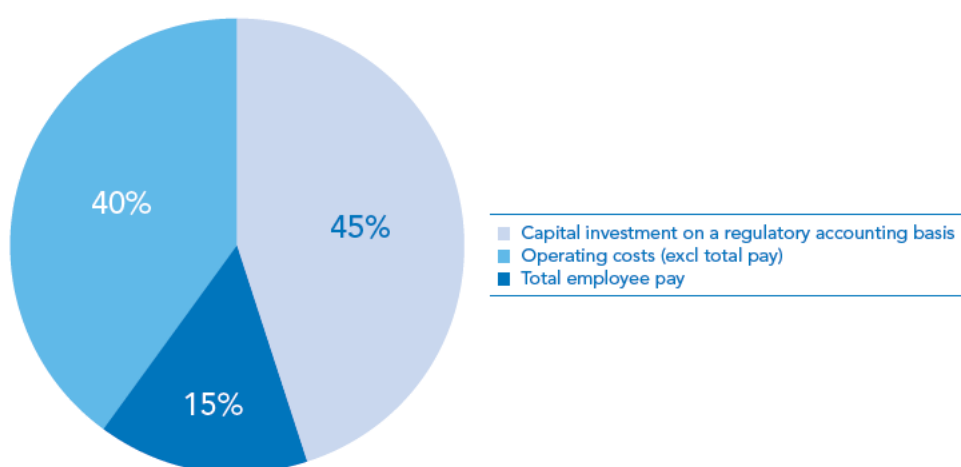
	Remuneration excluding movement in pension (i) £000	
	2017/18	2016/17
Chief Executive	360.0	349.0
Employees ⁽ⁱⁱ⁾	33.6	33.0
Ratio	10.7	10.6

Notes:

- (i) The total excludes the calculation of change in pension as the value relies heavily on length of pensionable service and so has little meaning when comparing one person (the Chief Executive) against a group of employees with varying lengths of service, i.e. an individual with greater pensionable service could see a faster increase in calculated pension value than someone with shorter pensionable service, even if they are paid the same during a financial year.
- (ii) Based on the average full time equivalent salary, AOIP and benefits of all employees with a full year of service, other than Executive Members.

e. Relative importance of spend on pay

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



f. Implementation of Remuneration Policy in 2018/19

As described in the Executive Remuneration Policy, Scottish Water operates an Annual Out-performance Incentive Plan (AOIP) designed to incentivise and reward the out-performance of targets agreed with regulators. To ensure that the AOIP targets remain suitably challenging they are reviewed each year and for 2018/19 the Remuneration Committee has determined the following out-performance targets.

Measure	Description	Weighting
Financial Out-performance	Profit Before Tax and Depreciation (PBTDA) to beat delivery plan by £0 to £50m. Sliding scale with 0% at delivery plan figure and 100% at +£50m.	40% ⁽¹⁾
Customer Service Provision	Overall Performance Assessment (OPA) – based on maintaining a score on a sliding scale between 383 and 400 points. 0% payable below 383; 30% payable at 383; 90% payable at 400; 100% payable for beating 400 points.	25%
Customer Experience	Improvement in the Household Customer Experience Measure (hCEM) as developed and agreed with the Customer Forum. Beat the baseline on a sliding scale so that: 0% payable below 82.60 points; 30% payable at 82.60 points; 100% payable for greater than or equal to 87.17 points.	20%
	Improvement in the Non-Household Customer Experience Measure (nhCEM) as developed and agreed with the Customer Forum. Beat the baseline on a sliding scale so that: 0% payable below 73.74 points; 30% payable at 73.74 points; 100% payable for greater than or equal to 79.19 points.	5%
Customer Benefit Delivery	Exceed the delivery plan target Overall Measure of Delivery (OMD) of 179 points and ensure forecast capital programme cost is within the regulatory allowance ⁽²⁾ .	10%

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

(2) Plus customer contributions.

g. Executive Members' Directorships of other companies

The Remuneration Committee supports active development of Executive Members including their involvement with other companies and public bodies where this is compatible with fulfilling their responsibilities to Scottish Water. In line with this policy, Douglas Millican, Chief Executive, was appointed as a non-executive director and trustee of World Vision UK in March 2017, from which no remuneration is payable.

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

Samantha Barber

Chair of the Remuneration Committee

Members' report

The Members present the Members' report together with the audited consolidated financial statements for the year ended 31 March 2018.

The Government Financial Reporting Manual 2017/18 (FRoM), published by HM Treasury, sets out the form and content for the annual report and accounts. This includes the requirements to show a Performance Report and Accountability Report. The Members have reviewed the requirements of the FRoM, and are satisfied that they are covered within the Overview, Strategic and Governance reports within this annual report and accounts.

The Members' report comprises pages 69 to 71 and the sections of the annual report incorporated by reference are as follows:

Corporate governance report	See pages 48 to 71
Strategic report, including information in respect of: Scottish Water's results, key financial information and service performance, future developments and the principal risks and uncertainties faced by Scottish Water's group of companies	See pages 6 to 46
Going concern and viability statements	See page 19
Greenhouse gas emissions	See page 31
People	See pages 42 to 44
Accounting requirements and basis of account preparation	See Note 1.2, page 84
Financial risk management	See page 112

Members and their interests

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

Appointment and replacement of Members

Schedule 3 of the Water Industry (Scotland) Act 2002 specifies Scottish Water's Board must comprise between 5 and 8 Non-Executive Members and between 3 and 5 Executive Members. One Member must have special knowledge of the interests of the employees of Scottish Water. Non-Executive appointments are made by the Scottish Ministers for 3 to 5 years following an open and transparent public appointment process. Executive Members are appointed by Scottish Water with the consent of the Scottish Ministers for an unidentifiable period. The Members appointments can be terminated under procedures set out in Paragraph 1 of Schedule 3 of the Water Industry (Scotland) Act 2002. Details of the Members' service contracts are on page 63 of the Members' Remuneration Report.

Employee relations and involvement

The Scottish Water group of businesses employed an average of 4,321 (2017: 4,120) 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 92. Scottish Water is committed to a policy of equal opportunities for all employees irrespective of race, religion, sex, sexual orientation, disability or age and uses a number of forums to encourage employee involvement. Employees are kept involved through a process of regular team meetings, employee newsletters and representation on consultative forums.

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

Further information is contained in the People section of on pages 42 to 44.

Research and development

To ensure that Scottish Water derives benefit from the most up-to-date research being undertaken within the industry, research expenditure is targeted towards collaborative research with other water operators and regulators within the UK. This ensures that access is gained to high value, widely based research programmes in the Environmental, Quality, Engineering, Operational and Regulatory fields. Research into issues common to the UK water industry is procured through membership of the UK Water Industry Research Centre and the Foundation of Water Research. In addition, Horizons has developed and operates specialist innovation development centres at Gorthleck and Bo'ness to test new products and processes associated with the treatment of drinking water and waste water. Further information is contained within the Innovation section on page 33.

Political contributions

No political contributions were made during the year (2017: nil).

Public Services Reform (Scotland) Act 2010

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

In accordance with the Public Services Reform (Scotland) Act 2010, Scottish Water will publish the full information as required by the act on the Scottish Water website (www.scottishwater.co.uk) following the approval of the Scottish Water Annual Report and Accounts 2017/18. The report for this financial year will be available from August 2018.

Members' responsibilities

The following statement, which should be read in conjunction with the statement of auditors' responsibilities included in the Independent Auditor's Report on pages 74 to 79, is made with a view to distinguishing the respective responsibilities of the Members and of the auditor in relation to the financial statements.

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

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

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

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

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

Each of the Members, whose names and functions are listed in the Board Members section on pages 48 and 49, confirms that to the best of their knowledge and belief:

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

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

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

By order of the Board,

Douglas Millican
Chief Executive
30 May 2018

Financials

Independent auditor's report	74
Consolidated income statement	80
Consolidated statement of comprehensive income	80
Consolidated statement of changes in equity	81
Company statement of changes in equity	81
Balance sheets	82
Statements of cash flow	83
Notes to the financial statements	84
Direction by the Scottish Ministers	115
The water industry in Scotland	116

Independent auditor's report

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

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

This report is made solely to the parties to whom it is addressed in accordance with the Public Finance and Accountability (Scotland) Act 2000 and for no other purpose. In accordance with paragraph 120 of the Code of Audit Practice approved by the Auditor General for Scotland, we do not undertake to have responsibilities to members or officers, in their individual capacities, or to third parties.

Report on the audit of the financial statements

Opinion on financial statements

We have audited the financial statements in the annual report and accounts of Scottish Water for the year ended 31 March 2018 under the Water Industry (Scotland) Act 2002. The financial statements comprise the Group and Company Balance Sheets, the Consolidated Income Statement, the Consolidated Statement of Comprehensive Income, the Consolidated and Company Statements of Changes in Equity, the Group and Company Statements of Cash Flow and notes to the financial statements, including a summary of significant accounting policies. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union, and as interpreted and adapted by the 2017–18 Government Financial Reporting Manual (the 2017–18 FReM).

In our opinion the accompanying financial statements:

- give a true and fair view in accordance with the Water Industry (Scotland) Act 2002 and directions made thereunder by the Scottish Ministers of the state of affairs of the body and its group as at 31 March 2018 and of the group's surplus for the year then ended;
- have been properly prepared in accordance with IFRSs as adopted by the European Union, as interpreted and adapted by the 2017–18 FReM; and
- have been prepared in accordance with the requirements of the Water Industry (Scotland) Act 2002 and directions made thereunder by the Scottish Ministers.

Basis of opinion

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

Conclusion relating to principal risks, going concern and viability statement

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

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

Key audit matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period and include the most significant assessed risks of material misstatement (whether or not due to fraud) we identified, including those which had the greatest effect on: the overall audit strategy, the allocation of resources in the audit; and directing the efforts of the audit team. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

Risk		
<p>Capital additions (£493.8m, 2016–17: £484.5m)</p> <p>Refer to page 56 (Audit Committee Report), page 86 (accounting policy) and page 95 (note 9).</p> <p>Risk of material misstatement vs 2017</p>	<p>Accounting application</p> <p>Capital additions are significant, comprising the largest element of Scottish Water’s annual expenditure, and are related to the delivery plan for regulated activities for the period 2015–16 to 2020–21.</p> <p>Directors are incentivised across a number of financial and other measures including profit and completion of capital investment programmes.</p> <p>There is judgement involved in the allocation of expenditure between capital additions and revenue expenditure which can affect profit and investment measures reported in the financial statements.</p>	<p>Our procedures included:</p> <p>Control design:</p> <ul style="list-style-type: none"> • Testing the design and operating effectiveness of controls over the allocation of costs between capital and revenue within the financial ledger at the project initiation stage and on an ongoing basis. • Testing the design and operating effectiveness of controls over the consistency between total capital expenditure reported in the financial statements and that reported in reports to those charged with governance as part of ongoing capital project monitoring arrangements. <p>Test of details:</p> <ul style="list-style-type: none"> • Building on our work over control design we compared the reports of Scottish Water’s capital project monitoring group at the year end to amounts recorded as capital additions. • In respect of a sample of capitalised additions, we evaluated the appropriateness of the classification as capital by considering the nature of the expenditure with reference to invoice, certificate or timesheets and considering the application of the relevant accounting policies. • We assessed a sample of items allocated to revenue expenditure and considered whether they were correctly classified by considering the application of the relevant accounting policies.

Risk

**Bad debt provision
(£388.2m, 2016–17:
£446.6m)**

Refer to page 56 (Audit Committee Report), page 87 (accounting policy) and page 113 (note 27).

Risk of material misstatement vs 2017

Forecast-based valuation

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

As at 31 March 2018, the Scottish Water regulated business reported a household revenue debtor of £422.6m (2017: £478.9m) which relates to household billings dating from 1996–97. Given the old age of the majority of these debts a bad debt provision of £388.2m (2017: £446.6m) is held against them.

Household water debt is a statutory debt recoverable from the occupier. The household billing and cash collection is performed by local authorities and cannot be influenced by Scottish Water.

Our procedures included:

Control design:

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

Tests of detail:

- We compared the information on historical collection rates, recorded by Scottish Water as the basis for the current year provision calculation in respect of prior year balances, to the records held in respect of prior years.
- We agreed the total amount billed and collected in respect of 2017–18, as recorded in Scottish Water's records, to confirmations received from individual local authorities.

Historical comparison

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

Sensitivity analysis

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

Assessing transparency

- We assessed the disclosure of sensitivities by the Directors, and description of the provision in note 27 of the financial statements.

Risk

**Pension liability
(£145.5m, 2016–17:
£194.4m)**

Refer to page 56 (Audit Committee Report), page 89 (accounting policy) and page 106 (note 23).

Risk of material misstatement vs 2017

Subjective valuation

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

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

Our procedures included:

Benchmarking assumptions

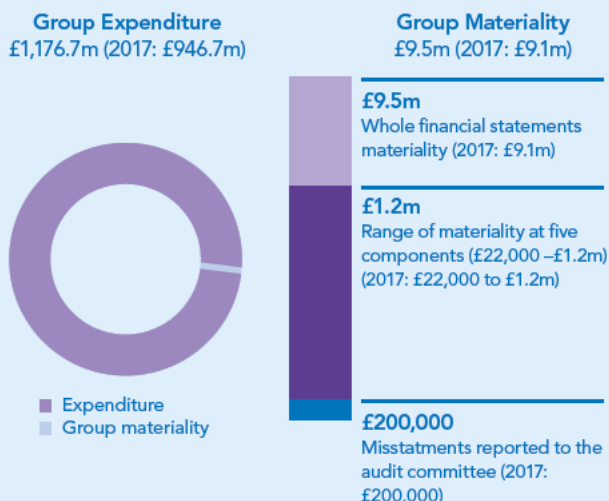
- Challenging, with the support of our own actuarial specialists, the key assumptions applied, being the discount rate, inflation rate and mortality/life expectancy against externally derived data.
- Challenging the rate of increase in pensionable salaries assumption, by comparing it to other evidence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

Assessing transparency

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

Risk		
<p>Intangible asset amortisation (Scottish Water Business Stream intangible asset £13.9m, 2016–17 £nil)</p> <p>Refer to page 56 (Audit Committee Report), page 87 (accounting policy) and page 96 (note 10).</p> <p>New risk of material misstatement vs 2017</p>	<p>Subjective estimate Following the acquisition of the non-domestic customer list of Southern Water an intangible asset was recognised and subject to amortisation.</p> <p>Amortisation of the customer list is judgemental being based upon the period of time over which the business is expected to benefit from this intangible asset.</p>	<p>Our procedures included:</p> <p>Sensitivity analysis</p> <ul style="list-style-type: none"> We performed sensitivity analysis and challenged management over the expected life of the customer list by increasing and decreasing each based upon our judgement. <p>Tests of detail:</p> <ul style="list-style-type: none"> We compared the expected customer attrition rate with that experienced in the period since acquisition to assess management’s assessment of customer retention rates (i.e. the period over which the business is expected to benefit from this intangible). <p>Assessing transparency</p> <ul style="list-style-type: none"> We assessed the disclosure of the transaction and relevant information surrounding the approach to amortisation.

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



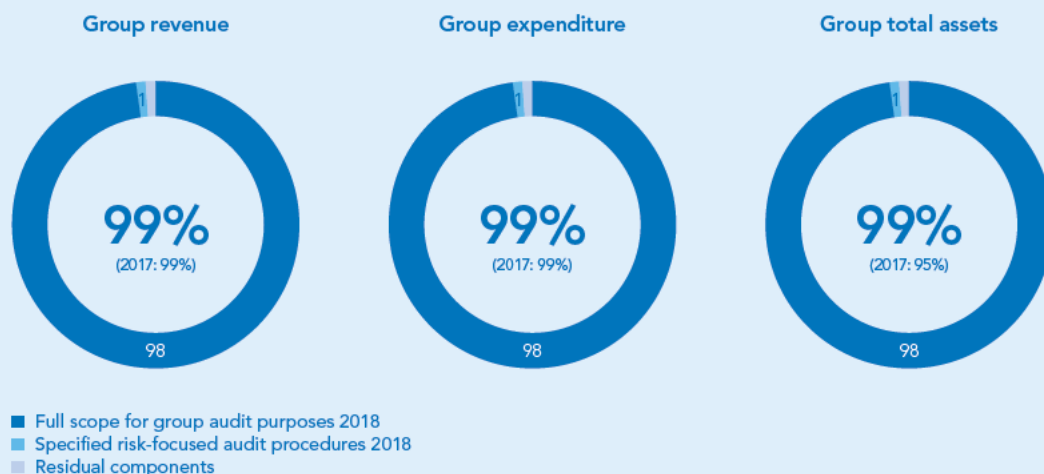
Materiality for the group financial statements as a whole was set at £9.5 million, determined with reference to a benchmark of group total expenditure of which it represents 1%. We consider total expenditure to be the most appropriate benchmark as the most significant part of the Group is its regulated business which is a Scottish Government owned body where the level of expenditure is the most important measure.

Materiality for the parent company financial statements as a whole was set at £9.5 million (2017: £9.1 million), determined with reference to total expenditure, of which it represents 1% (2017: 1%).

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

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

For the residual components, we performed analysis at an aggregated group level to re-examine our assessment that there were no significant risks of material misstatement within these. The work on all of the components, including the parent Company, was performed by the Group team. The component materialities ranged from £22,000 to £1.2 million, having regard to the mix of size and risk profile of the Group across the components.



Responsibilities of the board members for the financial statements

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

In preparing the financial statements, the Accountable Officer is responsible for assessing the ability of the body and its group to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless, after discussions with their sponsors, deemed inappropriate.

Auditor's responsibilities for the audit of the financial statements

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

A further description of the auditor's responsibilities for the audit of the financial statements is located on the Financial Reporting Council's website www.frc.org.uk/auditorsresponsibilities. This description forms part of our auditor's report.

Other information in annual report and accounts

The board members are responsible for the other information in the annual report and accounts. The other information comprises the information other than the financial statements, the audited part of the Members' Remuneration Report, and our auditor's report thereon. Our opinion on the financial statements does not cover the other information and we do not express any form of assurance conclusion thereon except on matters prescribed by the Auditor General for Scotland to the extent explicitly stated later in this report.

In connection with our audit of the financial statements, our responsibility is to read all the other information in the annual report and accounts and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If we identify such material inconsistencies or apparent material misstatements, we are required to determine whether there is a material misstatement in the financial statements or a material misstatement of the other information. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

In this context, we also have a responsibility to specifically address the following items in the other information and to report as uncorrected material misstatements of the other information where we conclude that those items meet the following conditions:

- The statement given by the board members that they consider that the annual report and accounts taken as a whole is fair, balanced and understandable and provides the information necessary for stakeholders to assess the position and performance, business model and strategy of the body and its group is materially inconsistent with our knowledge obtained in the audit; or
- The Audit Committee Report does not appropriately address matters communicated by us to the Audit Committee.

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

Report on regularity of expenditure and income

Opinion on regularity

In our opinion in all material respects the expenditure and income for the year ended 31 March were incurred or applied in accordance with any applicable enactments and guidance issued by the Scottish Ministers.

Responsibilities for regularity

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

Report on other requirements

Opinion on matters prescribed by the Auditor General for Scotland

In our opinion, the audited part of the Members' Remuneration Report has been properly prepared in accordance with the Water Industry (Scotland) Act 2002 and directions made thereunder by the Scottish Ministers.

In our opinion, based on the work undertaken in the course of the audit:

- the information given in the Strategic Report for the financial year for which the financial statements are prepared is consistent with the financial statements; and
- the information given in the Governance Statement for the financial year for which the financial statements are prepared is consistent with the financial statements and that report has been prepared in accordance with the directions made under the Water Industry (Scotland) Act 2002 by the Scottish Ministers.

Matters on which we are required to report by exception

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

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

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

Hugh Harvie
for and on behalf of KPMG LLP
Chartered Accountants
Saltire Court
20 Castle Terrace
Edinburgh
EH1 2EG

5 June 2018

Consolidated income statement

For the year ended 31 March 2018

	Note	2018 £m	2017 £m
Revenue	3	1,424.0	1,213.5
Cost of sales		(1,014.4)	(805.7)
Gross surplus		409.6	407.8
Administrative expenses		(162.3)	(141.0)
Operating surplus	3, 4	247.3	266.8
Finance income	7	1.2	1.8
Finance costs	7	(176.7)	(174.4)
Surplus before taxation		71.8	94.2
Taxation	8	(13.7)	2.0
Surplus for the year	21	58.1	96.2

Consolidated statement of comprehensive income

For the year ended 31 March 2018

	Note	2018 £m	2017 £m
Surplus for the year	21	58.1	96.2
Other comprehensive income:			
Items which will not subsequently be reclassified to the income statement			
Actuarial gain/(loss) on post employment benefit obligations, net of deferred taxation	23	67.9	(94.4)
Total comprehensive income for the year		126.0	1.8

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 2016		1,391.2	133.4	1,524.6
Surplus for the year	21	96.2	–	96.2
Other comprehensive loss:				
Actuarial loss on post employment benefit obligations, net of tax	23	(94.4)	–	(94.4)
Total comprehensive income for the year		1.8	–	1.8
Balance at 31 March 2017		1,393.0	133.4	1,526.4
Surplus for the year	21	58.1	–	58.1
Other comprehensive gain:				
Actuarial gain on post employment benefit obligations, net of tax	23	67.9	–	67.9
Total comprehensive income for the year		126.0	–	126.0
Balance at 31 March 2018	21	1,519.0	133.4	1,652.4

Company statement of changes in equity

	Note	Retained earnings £m	Other reserves £m	Total reserves £m
Balance at 1 April 2016		1,218.7	133.4	1,352.1
Surplus for the year	21	89.9	–	89.9
Other comprehensive loss:				
Actuarial loss on post employment benefit obligations, net of tax	23	(90.2)	–	(90.2)
Total comprehensive income for the year		(0.3)	–	(0.3)
Balance at 31 March 2017		1,218.4	133.4	1,351.8
Surplus for the year	21	62.4	–	62.4
Other comprehensive gain:				
Actuarial gain on post employment benefit obligations, net of tax	23	65.1	–	65.1
Total comprehensive income for the year		127.5	–	127.5
Balance at 31 March 2018	21	1,345.9	133.4	1,479.3

The 'Statement of changes in equity' above excludes Government loans which, in accordance with the Scottish Water Governance Directions 2009, are recorded on the balance sheet under Equity. Full details of Government loans are provided in note 19.

Balance sheets

As at 31 March 2018

	Note	Group		Company	
		2018 £m	2017 £m	2018 £m	2017 £m
Assets					
Non-current assets					
Property, plant and equipment	9	5,981.8	5,758.6	5,962.9	5,741.8
Intangible assets	10	13.9	–	–	–
Investments	11	–	–	37.6	37.6
Deferred tax asset	16	0.8	1.2	–	–
		5,996.5	5,759.8	6,000.5	5,779.4
Current assets					
Inventories	12	2.9	2.6	2.6	2.3
Trade and other receivables	13	201.2	149.4	77.4	103.7
Current tax asset		0.4	2.6	–	0.7
Cash and cash equivalents	14	406.4	429.6	270.6	235.2
		610.9	584.2	350.6	341.9
Total assets	3	6,607.4	6,344.0	6,351.1	6,121.3
Liabilities					
Current liabilities					
Trade and other payables	15	(457.7)	(394.9)	(378.1)	(353.2)
Other loans and borrowings	18	(21.7)	(20.5)	(21.7)	(20.5)
Current tax liabilities		(0.8)	–	(0.9)	–
Provisions for liabilities	17	(8.5)	(5.4)	(10.4)	(8.8)
		(488.7)	(420.8)	(411.1)	(382.5)
Non-current liabilities					
Trade and other payables	15	(77.0)	(74.1)	(70.7)	(67.9)
Other loans and borrowings	18	(303.1)	(324.8)	(303.1)	(324.8)
Deferred tax liabilities	16	(360.0)	(334.5)	(359.3)	(333.9)
Retirement benefit obligations	23	(175.3)	(234.2)	(173.7)	(230.5)
Provisions for liabilities	17	(7.6)	(5.9)	(10.6)	(6.6)
		(923.0)	(973.5)	(917.4)	(963.7)
Total liabilities		(1,411.7)	(1,394.3)	(1,328.5)	(1,346.2)
Net assets		5,195.7	4,949.7	5,022.6	4,775.1
Equity					
Government loans	19	3,543.3	3,423.3	3,543.3	3,423.3
Retained earnings	21	1,519.0	1,393.0	1,345.9	1,218.4
Other reserves		133.4	133.4	133.4	133.4
		5,195.7	4,949.7	5,022.6	4,775.1

The financial statements on pages 80 to 114 were approved by the Board of Members on 30 May 2018 and signed on its behalf by:

Douglas Millican
Chief Executive

Statements of cash flow

For the year ended 31 March 2018

	Note	Group		Company	
		2018 £m	2017 £m	2018 £m	2017 £m
Surplus before taxation		71.8	94.2	76.0	86.2
Depreciation charges	9	274.8	276.1	272.7	273.9
Amortisation of intangible asset	10	3.5	–	–	–
Amortisation of grants		(1.2)	(1.1)	(1.0)	(0.9)
Surplus on disposal of property, plant and equipment		(7.0)	(6.2)	(7.0)	(6.2)
Non cash adjustment for retirement benefit obligations		26.2	9.5	25.0	9.2
Finance costs – net		175.5	172.6	176.9	173.7
Operating cashflow before changes in working capital and provisions		543.6	545.1	542.6	535.9
Changes in working capital and provisions:					
(Increase)/decrease in receivables		(60.1)	(14.8)	18.0	(35.6)
Increase in inventories		(0.3)	–	(0.3)	(0.1)
Increase in payables		45.2	51.2	6.5	62.1
Increase/(decrease) in provisions		3.1	4.0	4.0	(4.7)
Cash flows from operating activities		531.5	585.5	570.8	557.6
Taxation received/(paid)		1.3	(3.0)	–	–
Net cash generated from operating activities		532.8	582.5	570.8	557.6
Cash flows from investing activities					
Purchase of property, plant and equipment		(491.9)	(525.0)	(486.3)	(522.8)
Sale of property, plant and equipment		7.4	7.3	7.0	7.3
Purchase of intangible asset	10	(17.4)	–	–	–
Government grant income received		0.5	–	–	–
Infrastructure income receipts		15.7	13.9	15.7	13.9
Net cash used in investing activities		(485.7)	(503.8)	(463.6)	(501.6)
Cash flows from financing activities					
Repayments of loans		(122.6)	(342.8)	(122.6)	(342.8)
Proceeds from borrowings		242.6	342.8	242.6	342.8
Interest received		1.2	1.5	0.7	0.6
Interest paid		(171.0)	(170.6)	(172.0)	(170.7)
Payment of finance lease liabilities		(20.5)	(19.3)	(20.5)	(19.3)
Net cash used in financing activities		(70.3)	(188.4)	(71.8)	(189.4)
Net (decrease)/increase in cash and cash equivalents		(23.2)	(109.7)	35.4	(133.4)
Cash and cash equivalents at beginning of year	14	429.6	539.3	235.2	368.6
Cash and cash equivalents at end of year	14	406.4	429.6	270.6	235.2

Notes to the financial statements

For the year ended 31 March 2018

1 Accounting policies

1.1 General information

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

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

1.2 Basis of preparation

The financial statements of Scottish Water for the year ended 31 March 2018 have been prepared in accordance with EU adopted and endorsed International Financial Reporting Standards (IFRS) and International Financial Reporting Interpretations Committee (IFRIC) interpretations, as interpreted by the Government Financial Reporting Manual (FRoM). The FRoM is published by HM Treasury and is available from their website.

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

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

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

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

1.3 Changes in accounting policy

There were no new standards, amendments or interpretations that were effective for the first time during the year that had a material impact on Scottish Water. The amendments to standards which were adopted by Scottish Water with effect from 1 April 2017 were:

- Annual improvements to IFRSs 2014–2016 Cycle;
- Amendments to IAS 7 'Statement of cash flows' and IAS 12 'Income taxes';

1.4 Accounting standards not yet adopted by Scottish Water

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

- IFRS 9 'Financial Instruments';
- IFRS 15 'Revenue from Contracts with Customers';
- IFRS 16 'Leases';
- Annual improvements to IFRSs 2015–2017 Cycle; and
- Amendments to the Conceptual Framework, IAS 19 'Employee benefits' and IAS 28 'Investment in associates & joint ventures'.

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

1 Accounting policies continued

1.5 Basis of consolidation

Subsidiaries

The consolidated financial information incorporates the results of Scottish Water (the Company) and its trading subsidiaries. The consolidated financial information does not include the non trading subsidiaries as permitted under section 405 of the Companies Act 2006. Subsidiaries are all entities over which Scottish Water has the power to direct the relevant activities of the entities, the rights to variable returns and the ability to use its power to influence the returns. Scottish Water Business Stream Limited (Business Stream) is treated as a subsidiary although there are special governance arrangements which were established in conjunction with the Water Industry Commission for Scotland and associated with the conditions attached to Business Stream's licence for the supply of water and waste water services. Scottish Water is, however, satisfied that the controls and governance in place are such that consolidation is appropriate. Subsidiaries are fully consolidated from the date on which control is transferred to Scottish Water; they are de-consolidated from the date when control ceases.

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

1.6 Operating segments

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

1.7 Revenue recognition

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

Revenue comprises charges to customers for water and waste water services, and related services provided during the year in the normal course of business. For measured customers, revenue includes an estimate of the value of water and waste water services supplied to customers between the date of the last meter reading and the year end. For unmeasured customers billed in advance, income is deferred and released to the income statement throughout the year.

1.8 Research and development expenditure

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

1.9 Finance income and costs

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

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

1.10 Taxation

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

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

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

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

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

Notes to the financial statements

For the year ended 31 March 2018

continued

1 Accounting policies continued

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

1.11 Property, plant and equipment

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

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

Infrastructure assets

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

Other assets

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

Depreciation

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

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

1.12 Leased assets

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

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

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

1.13 Impairment of assets

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

1 Accounting policies continued

1.14 Capital grants and customer contributions

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

1.15 Intangible assets

Intangible assets represent the acquisition of a non-household customer base, by Business Stream. Intangible assets are recognised at cost and treated as having a finite life. They are stated at cost less accumulated amortisation. Amortisation is charged to the income statement to write off the cost, less any residual value, on a straight-line basis over the expected useful life from the date of beneficial use. The expected useful life has initially been set at 5 years.

The expected useful lives and residual values are reviewed annually, and adjusted if appropriate, at the balance sheet date.

1.16 Investments

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

1.17 Inventories

Inventories and work in progress are stated at the lower of cost or net realisable value. Cost is determined using the first-in, first-out (FIFO) method. Cost includes all costs incurred in bringing each asset to its present location and condition. The valuation of work in progress is based on the cost of labour and materials plus appropriate overheads.

1.18 Financial instruments

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

a. Trade receivables

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

b. Cash and cash equivalents

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

c. Trade and other payables

Trade and other payables are stated at cost.

d. Interest-bearing loans and borrowings

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

e. Derivative financial instruments

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

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

Notes to the financial statements

For the year ended 31 March 2018

continued

1 Accounting policies continued

1.19 Employee benefit obligations

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

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

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

1.20 Provisions

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

1.21 Foreign currency transactions

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

1.22 Indebtedness to the Scottish Ministers

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

2 Accounting estimates and judgements

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

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

a. Revenue recognition

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

b. Impairment of trade and other receivables

Scottish Water and each of its subsidiaries evaluate the recoverability of their trade receivables as at the reporting date and assess the allowances for doubtful receivables based on experience. These allowances are based on, amongst other factors, actual collection history, forecast rates and customer category. The actual level of receivables collected may differ from those estimated, due to factors such as changes in customer behaviour, potential impact of government policy initiatives and the economic outlook, which could impact positively or negatively on operating results (see sensitivity analysis in note 27).

c. Carrying value of property, plant and equipment

Property, plant and equipment (PPE) represents the majority of the Group's asset base and a significant proportion of the Group's annual expenditure (see funding chart on page 7). Therefore the estimates and assumptions made in determining the carrying values and related depreciation are critical to the Group's financial performance and position.

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

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

d. Provisions

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

e. Retirement benefits

Scottish Water and its subsidiaries are participating employers in 3 Scottish Local Government Pension Schemes (SLGPS) which are defined benefit schemes. Actuarial valuations of the schemes are carried out by the administering authorities triennially in line with SLGPS regulations. The assumptions in relation to the cost of providing post-retirement benefits during the period are set after consultation with qualified actuaries. These assumptions include discount rates, returns on the schemes' assets, pay growth and increases to pension payments (see note 23) and, while these assumptions are believed to be appropriate, a change to the assumptions would impact the surplus of the Group and the carrying amount of pension obligations. These assumptions may differ from the actual results due to changes in market and economic conditions and longer or shorter lives of participants.

Notes to the financial statements

For the year ended 31 March 2018

3. Segmental analysis

The principal activities of the Scottish Water Group are the supply of water and waste water services to household and business customers across Scotland. In view of the integrated nature of Scottish Water's operational activities, the financial statements include all of the costs of water and waste water collection, treatment and distribution within cost of sales.

Scottish Water's reportable segments are the provision of regulated water and waste water services, Business Stream (a Licensed Provider in the supply of water and waste water services to business customers in Scotland and England) and non-regulated businesses. 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.

	2018 £m	2017 £m
Revenue		
Scottish Water regulated water and waste water services	1,191.4	1,149.0
Business Stream	356.1	183.8
Scottish Water non-regulated activities	20.0	21.4
	1,567.5	1,354.2
Intercompany elimination	(143.5)	(140.7)
	1,424.0	1,213.5

	2018 £m	2017 £m
Operating surplus		
Scottish Water regulated water and waste water services	252.8	259.7
Business Stream	(6.4)	5.7
Scottish Water non-regulated activities	0.9	1.4
	247.3	266.8

	2018 £m	2017 £m
Total assets		
Scottish Water regulated water and waste water services	6,313.0	6,068.7
Business Stream	224.8	209.1
Scottish Water non-regulated activities	69.6	66.2
	6,607.4	6,344.0

	Capital additions to property, plant & equipment		Depreciation on property, plant and equipment	
	2018 £m	2017 £m	2018 £m	2017 £m
Scottish Water regulated water and waste water services	493.8	484.5	272.7	273.9
Business Stream	1.7	1.4	1.1	1.5
Scottish Water non-regulated activities	4.3	16.3	1.0	0.7
Less: intercompany transfer	(1.4)	(12.9)	-	-
	498.4	489.3	274.8	276.1

3. Segmental analysis continued

Revenue by geographical location of customers is as follows:

	Revenue	
	2018 £m	2017 £m
United Kingdom	1,422.5	1,211.3
Rest of the World	1.5	2.2
	1,424.0	1,213.5

4. Operating surplus

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

	Note	2018 £m	2017 £m
PFI operating costs		118.0	114.8
Depreciation of property, plant and equipment	9	274.8	276.1
Amortisation of intangible asset	10	3.5	–
Surplus on sale of property, plant and equipment		(7.0)	(6.2)
Release of deferred income in relation to capital grants		(1.2)	(1.1)
Operating lease rentals		3.4	3.3
Auditor's remuneration – audit fee for audit of the company and consolidated financial statements (including £89,000 (2017: £100,000) in respect of the audit of subsidiary companies)		0.3	0.3
– other services		–	–
Research and development expenditure		1.1	1.1

Notes to the financial statements

For the year ended 31 March 2018

continued

5. Staff costs

	Note	2018 £m	2017 £m
Wages and salaries		149.3	139.8
Social security costs		16.1	14.3
IAS 19 total service costs	23	54.9	37.0
Other pension costs		0.2	–
Employee benefit expense		220.5	191.1
Less: charged as capital expenditure		(81.0)	(72.3)
		139.5	118.8

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

	2018	2017
Regulated water and waste water services	3,898	3,744
Business Stream	340	289
Scottish Water non-regulated activities	83	87
	4,321	4,120

6. Members' remuneration

Information concerning Members' remuneration, incentive schemes and pensions is detailed in the Remuneration Report on pages 59 to 68.

7. Finance income and costs

	Note	2018 £m	2017 £m
Interest income:			
Short-term deposits		1.2	1.5
Fair value gains on financial instruments: forward currency contracts		–	0.3
Finance income		1.2	1.8
Interest expense:			
Government loans		(148.2)	(148.2)
Other loans		(1.4)	(0.3)
Finance lease liabilities		(20.4)	(21.5)
Interest on pension scheme net liabilities	23	(6.7)	(4.4)
Finance costs		(176.7)	(174.4)
Net finance costs		(175.5)	(172.6)

8. Taxation

	Note	2018 £m	2017 £m
Analysis of tax charge/(credit) recognised in the income statement			
Current tax: UK corporation tax		1.6	1.6
Current tax: Overseas corporation tax		0.1	0.1
Current tax: Adjustment in respect of prior years		–	(2.6)
		1.7	(0.9)
Deferred tax: Origination and reversal of timing differences		12.0	19.2
Deferred tax: Effect of rate change		–	(20.3)
	16	12.0	(1.1)
Total tax charge/(credit)		13.7	(2.0)

The charge/(credit) for the year can be reconciled to the surplus per the income statement as follows:

Group surplus before tax		71.8	94.2
Tax on surplus on ordinary activities at standard UK corporation tax rate of 19% (2017: 20%)		13.7	18.8
Adjustment in respect of prior years		0.1	1.4
Re-measurement of deferred tax due to change in UK corporation tax rate		(1.4)	(23.0)
Non taxable gains on profit on asset disposals		(1.3)	(1.2)
Depreciation on non qualifying additions		1.8	1.8
Other permanent differences		0.8	0.2
Total tax charge/(credit) for the year		13.7	(2.0)

	Note	Group		Company	
		2018 £m	2017 £m	2018 £m	2017 £m
Tax charge/(credit) recognised directly in reserves					
Deferred tax relating to:					
Pension scheme actuarial movements	16	13.9	(18.8)	13.3	(18.0)

As a result of changes in the UK corporation tax rate from 18% to 17% that will be effective from 1 April 2020, deferred tax balances had been re-measured at 31 March 2017.

Notes to the financial statements

For the year ended 31 March 2018

continued

9. Property, plant and equipment

Group	Specialised operational properties and structures £m	Non-specialised operational properties £m	Infrastructure assets £m	Plant, machinery and vehicles £m	Assets under construction £m	Total £m
Cost						
At 1 April 2016	3,132.0	75.1	2,221.9	2,482.5	633.7	8,545.2
Additions	1.0	–	–	1.4	486.9	489.3
Disposals*	(152.8)	(1.5)	–	(152.9)	–	(307.2)
Reclassifications	84.0	5.9	55.0	188.9	(333.8)	–
At 31 March 2017	3,064.2	79.5	2,276.9	2,519.9	786.8	8,727.3
Additions	1.7	–	–	1.7	495.0	498.4
Disposals*	–	(0.5)	–	(33.2)	(0.3)	(34.0)
Reclassifications	93.5	3.3	110.7	225.7	(433.2)	–
At 31 March 2018	3,159.4	82.3	2,387.6	2,714.1	848.3	9,191.7
Accumulated depreciation						
At 1 April 2016	1,117.2	20.6	488.4	1,372.5	–	2,998.7
Charge for the year	70.0	2.8	16.4	186.9	–	276.1
Disposals*	(152.8)	(0.4)	–	(152.9)	–	(306.1)
At 31 March 2017	1,034.4	23.0	504.8	1,406.5	–	2,968.7
Charge for the year	70.0	2.7	17.7	184.4	–	274.8
Disposals*	–	(0.5)	–	(33.1)	–	(33.6)
At 31 March 2018	1,104.4	25.2	522.5	1,557.8	–	3,209.9
Net book value						
At 31 March 2018	2,055.0	57.1	1,865.1	1,156.3	848.3	5,981.8
At 31 March 2017	2,029.8	56.5	1,772.1	1,113.4	786.8	5,758.6

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

Capital grants received during the year and credited to deferred income were £nil (2017: £nil). No capital grants were received during the year in respect of infrastructure assets.

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

9. Property, plant and equipment continued

Company	Specialised operational properties and structures £m	Non-specialised operational properties £m	Infrastructure assets £m	Plant, machinery and vehicles £m	Assets under construction £m	Total £m
Cost						
At 1 April 2016	3,114.5	75.1	2,221.9	2,464.4	632.6	8,508.5
Additions	1.0	–	–	–	483.5	484.5
Disposals*	(151.0)	(1.5)	–	(147.9)	–	(300.4)
Reclassifications	83.9	5.9	55.0	188.9	(333.7)	–
At 31 March 2017	3,048.4	79.5	2,276.9	2,505.4	782.4	8,692.6
Additions	1.7	–	–	–	492.1	493.8
Disposals*	–	(0.5)	–	(33.1)	–	(33.6)
Reclassifications	87.2	3.3	110.7	225.6	(426.8)	–
At 31 March 2018	3,137.3	82.3	2,387.6	2,697.9	847.7	9,152.8
Accumulated depreciation						
At 1 April 2016	1,110.5	20.6	488.4	1,356.7	–	2,976.2
Charge for the year	69.3	2.8	16.4	185.4	–	273.9
Disposals*	(151.0)	(0.4)	–	(147.9)	–	(299.3)
At 31 March 2017	1,028.8	23.0	504.8	1,394.2	–	2,950.8
Charge for the year	69.1	2.7	17.7	183.2	–	272.7
Disposals*	–	(0.5)	–	(33.1)	–	(33.6)
At 31 March 2018	1,097.9	25.2	522.5	1,544.3	–	3,189.9
Net book value						
At 31 March 2018	2,039.4	57.1	1,865.1	1,153.6	847.7	5,962.9
At 31 March 2017	2,019.6	56.5	1,772.1	1,111.2	782.4	5,741.8

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

Notes to the financial statements

For the year ended 31 March 2018

continued

9. Property, plant and equipment continued

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

	Specialised operational properties and structures £m	Plant, machinery and vehicles £m	Total £m
Group and Company			
Cost			
At 1 April 2016, 31 March 2017 and 31 March 2018	221.7	347.1	568.8
Accumulated depreciation			
At 1 April 2016	62.4	192.0	254.4
Charge for the year	3.7	11.6	15.3
At 31 March 2017	66.1	203.6	269.7
Charge for the year	3.7	11.6	15.3
At 31 March 2018	69.8	215.2	285.0
Net book value			
At 31 March 2018	151.9	131.9	283.8
At 31 March 2017	155.6	143.5	299.1

10. Intangible asset

In April 2017, Business Stream acquired the non-household customer base of Southern Water Services Limited. The purpose of the acquisition was to support Business Stream's entry into the newly opened English retail market for business customers. An initial consideration of £17.4m, which was paid on 3 April 2017, is subject to future adjustment based on actual customer base transferred and other measures which impact the financial contribution. Management considered the requirements of IFRS 3 'Business Combinations' and concluded that the transaction was an asset purchase rather than a business combination.

The initial consideration has been capitalised as an intangible asset. The intangible asset is treated as having a finite life and is being amortised on a straight-line basis over its expected useful life. The useful life has initially been set at 5 years as the level of competition in the newly opened English market is assessed in conjunction with customer attrition rates and tendering activities. The cost, amortisation charge and carrying value are shown in the table below:

	Group	
	2018 £m	2017 £m
Acquisition cost – April 2017	17.4	–
Amortisation charge for the year	(3.5)	–
Net book value at 31 March	13.9	–

11. Investments

	Company	
	2018 £m	2017 £m
Cost and net book value At 31 March	37.6	37.6

Investment in subsidiaries

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

* owned by Scottish Water Horizons Holdings Limited

** owned by Scottish Water Business Stream Holdings Limited

Scottish Water owns shares in a further 8 companies which did not trade during the year ended 31 March 2018. The companies' financial statements have not been consolidated as permitted by Section 405 of the Companies Act 2006, as they did not trade during the year and the issued share capital is immaterial. The companies are:

Scottish Water Ltd

Scottish Water Retail Ltd

Scottish Water Technology Ltd

Scottish Water Utilities Ltd

Scottish Water Wholesale Ltd

OneSource Infrastructure Services Ltd

Water Solutions Ltd

Business Stream Limited ***

*** owned by Scottish Water Business Stream Limited

12. Inventories

	Group		Company	
	2018 £m	2017 £m	2018 £m	2017 £m
Raw materials and consumables	3.0	2.8	2.7	2.5
Less provision held	(0.1)	(0.2)	(0.1)	(0.2)
	2.9	2.6	2.6	2.3

All inventories will be recovered within 12 months.

Notes to the financial statements

For the year ended 31 March 2018

continued

13. Trade and other receivables

	Note	Group		Company	
		2018 £m	2017 £m	2018 £m	2017 £m
Trade receivables	27	523.8	558.4	432.8	502.6
Less provision for impairment of trade receivables	27	(411.3)	(461.9)	(391.2)	(449.2)
Net trade receivables		112.5	96.5	41.6	53.4
Other receivables		26.1	26.6	24.6	23.9
Prepayments and accrued income		62.6	26.3	11.0	11.6
Amounts due from subsidiaries		–	–	0.2	14.8
		201.2	149.4	77.4	103.7

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

	Group		Company	
	2018 £m	2017 £m	2018 £m	2017 £m
Balance at 1 April	461.9	449.7	449.2	434.4
Charge for the year	31.4	18.4	17.4	15.8
Amounts written down/utilised during the year	(82.0)	(6.2)	(75.4)	(1.0)
Balance at 31 March	411.3	461.9	391.2	449.2

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

Household debt, which is billed and collected by the 32 Councils on Scottish Water's behalf, is deemed to be statutory debt with no period of prescription on the debt itself. During 2017/18, the decision was taken to mirror the approach taken by Councils in respect of the limited criteria they apply to writing down Council Tax debt. These criteria include where the debtor is deceased with insufficient funds in their estate, the debt is uneconomical to collect or the householder has been sequestered. In 2017/18, Scottish Water processed a cumulative catch up write down covering the financial years 1996/97 to 2016/17, totalling £75.4m, to mirror the Councils' approach based on the same criteria. This was offset by a write down of the associated provision for impairment. Therefore, the net household receivable total is unchanged and there is no cash or profit impact.

14. Cash and cash equivalents

	Group		Company	
	2018 £m	2017 £m	2018 £m	2017 £m
Cash at bank and in hand	166.6	185.6	31.6	41.2
Short-term bank deposits	239.8	244.0	239.0	194.0
Cash and cash equivalents per the statement of cash flows	406.4	429.6	270.6	235.2

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

15. Trade and other payables

	Group		Company	
	2018 £m	2017 £m	2018 £m	2017 £m
Current				
Trade payables	37.5	35.6	25.2	33.6
Non trade payables and accruals	91.9	78.3	89.8	75.5
Accruals	200.8	168.3	159.1	145.9
Payments received in advance	98.0	89.8	70.0	66.7
Other payables	20.2	12.1	1.4	1.5
Deferred income	5.3	7.1	1.4	1.4
Other taxes and social security	4.0	3.7	3.6	3.3
Amounts due to subsidiaries	–	–	27.6	25.3
	457.7	394.9	378.1	353.2
Non-current				
Payments received in advance	59.7	56.6	59.7	56.6
Deferred income	17.3	17.5	11.0	11.3
	77.0	74.1	70.7	67.9

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

Notes to the financial statements

For the year ended 31 March 2018

continued

16. 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 2016		415.4	(19.9)	(34.5)	(7.8)	353.2
(Credit)/charge to income statement	8	(8.7)	(1.1)	8.7	–	(1.1)
Credit to reserves	8, 23	–	(18.8)	–	–	(18.8)
At 31 March 2017		406.7	(39.8)	(25.8)	(7.8)	333.3
Charge/(credit) to income statement	8	13.9	(3.9)	3.8	(1.8)	12.0
Charge to reserves	8, 23	–	13.9	–	–	13.9
At 31 March 2018		420.6	(29.8)	(22.0)	(9.6)	359.2
Company						
At 1 April 2016		415.3	(20.2)	(34.5)	(7.6)	353.0
(Credit)/charge to income statement		(8.8)	(1.0)	8.7	–	(1.1)
Credit to reserves	8, 23	–	(18.0)	–	–	(18.0)
At 31 March 2017		406.5	(39.2)	(25.8)	(7.6)	333.9
Charge/(credit) to income statement		13.7	(3.6)	3.8	(1.8)	12.1
Charge to reserves	8, 23	–	13.3	–	–	13.3
At 31 March 2018		420.2	(29.5)	(22.0)	(9.4)	359.3

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	
	2018 £m	2017 £m	2018 £m	2017 £m
Deferred tax assets	(0.8)	(1.2)	–	–
Deferred tax liabilities	360.0	334.5	359.3	333.9
At 31 March	359.2	333.3	359.3	333.9

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 £175 million (2017: £178 million) for both the Company and the Group. No tax is expected to be payable in this regard.

17. Provisions for liabilities

	Restructure provision £m	Income uncertainty provision £m	Other £m	Total £m
Group				
At 1 April 2016	1.5	3.2	1.2	5.9
Charged/(released) to the income statement	(0.2)	6.1	0.1	6.0
Utilised during the year	(0.6)	–	–	(0.6)
At 31 March 2017	0.7	9.3	1.3	11.3
Charged to the income statement	–	6.5	–	6.5
Utilised during the year	(0.4)	(1.2)	(0.1)	(1.7)
At 31 March 2018	0.3	14.6	1.2	16.1
Company				
At 1 April 2016	1.5	16.0	1.2	18.7
Charged/(released) to the income statement	(0.2)	5.7	–	5.5
Utilised during the year	(0.6)	(8.2)	–	(8.8)
At 31 March 2017	0.7	13.5	1.2	15.4
Charged to the income statement	–	11.2	–	11.2
Utilised during the year	(0.4)	(5.2)	–	(5.6)
At 31 March 2018	0.3	19.5	1.2	21.0

	Group		Company	
	2018 £m	2017 £m	2018 £m	2017 £m
Analysis of total provisions				
Current	8.5	5.4	10.4	8.8
Non-current	7.6	5.9	10.6	6.6
	16.1	11.3	21.0	15.4

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 23).

The income uncertainty provision relates to non-household revenues. The reconciliation process, through the Central Market Agency (CMA), relating to each financial year will normally be finalised 18 months after the end of the relevant financial year. It is expected that the provision will be utilised during 2019.

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

Notes to the financial statements

For the year ended 31 March 2018

continued

18. Other loans and borrowings

	2018 £m	2017 £m
Group and Company		
Current		
Non-government loans	–	–
Obligations under finance leases	21.7	20.5
	21.7	20.5
Non current		
Non-government loans	1.0	1.0
Obligations under finance leases	302.1	323.8
	303.1	324.8
Total		
Non-government loans	1.0	1.0
Obligations under finance leases	323.8	344.3
	324.8	345.3

(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 2018	–	0.5	0.5	–	1.0
At 31 March 2017	–	–	1.0	–	1.0

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

	Book value 2018 £m	Book value 2017 £m	Fair value 2018 £m	Fair value 2017 £m
Non-government loans	1.0	1.0	1.2	1.3

18. Other loans and borrowings continued

(ii) Finance lease liabilities – PFI liabilities

Future finance lease commitments are as follows:

	Minimum lease payments		Present value of minimum lease payments	
	2018 £m	2017 £m	2018 £m	2017 £m
Amounts payable:				
Within one year	40.9	40.9	21.7	20.5
Between one and 5 years	156.9	159.3	119.5	115.1
After 5 years	269.3	307.7	182.6	208.7
Present value of minimum lease payments including finance charges	467.1	507.9		
Less future finance charges	(143.3)	(163.6)		
Present value of minimum lease payments	323.8	344.3	323.8	344.3

PFI – Service concession arrangements

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

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

Characteristics of the arrangements

Description

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

Significant terms

The key terms relate to the basis upon which Scottish Water pays for 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.

Notes to the financial statements

For the year ended 31 March 2018

continued

19. Government loans

	Group and Company	
	2018 £m	2017 £m
Government loans	3,543.3	3,423.3

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

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

a. Analysis of borrowings by type and maturity

	Up to 1 year £m	1-2 years £m	3-5 years £m	6-10 years £m	Over 10 years £m	Total £m
Scottish Consolidated Fund – SW Company	80.0	87.5	253.8	351.6	2,102.3	2,875.2
Scottish Consolidated Fund – subsidiaries	–	–	–	–	–	–
Scottish Consolidated Fund – SW Group	80.0	87.5	253.8	351.6	2,102.3	2,875.2
National Loans Fund	31.0	27.0	115.0	271.4	177.5	621.9
Public Works Loan Board	12.0	10.1	12.7	8.6	2.8	46.2
At 31 March 2018	123.0	124.6	381.5	631.6	2,282.6	3,543.3
At 31 March 2017	122.6	123.0	383.5	657.7	2,136.5	3,423.3

b. Fair values

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

	Book value 2018 £m	Book value 2017 £m	Fair value 2018 £m	Fair value 2017 £m
Scottish Consolidated Fund	2,875.2	2,708.6	3,801.2	3,651.8
National Loans Fund	621.9	651.9	833.7	908.9
Public Works Loan Board	46.2	62.8	58.1	79.6
	3,543.3	3,423.3	4,693.0	4,640.3

20. Analysis of net debt

	Note	As at 1 April 2017 £m	(Decrease)/ increase in cash £m	Movement in debt £m	As at 31 March 2018 £m
Group					
Cash and cash equivalents	14	429.6	(23.2)	–	406.4
Government loans	19	(3,423.3)	–	(120.0)	(3,543.3)
Other loans	18	(1.0)	–	–	(1.0)
Net debt		(2,994.7)	(23.2)	(120.0)	(3,137.9)
Company					
Cash and cash equivalents	14	235.2	35.4	–	270.6
Government loans	19	(3,423.3)	–	(120.0)	(3,543.3)
Other loans	18	(1.0)	–	–	(1.0)
Net debt		(3,189.1)	35.4	(120.0)	(3,273.7)

21. Reserves

	Note	Retained earnings excluding actuarial gains £m	Actuarial gains/ (losses) on pension obligations £m	Retained earnings including actuarial gains/(losses) £m
Group				
At 1 April 2016		1,480.0	(88.8)	1,391.2
Retained surplus for the year		96.2	–	96.2
Actuarial loss, net of deferred taxation	23	–	(94.4)	(94.4)
At 31 March 2017		1,576.2	(183.2)	1,393.0
Retained surplus for the year		58.1	–	58.1
Actuarial gain net of deferred taxation	23	–	67.9	67.9
At 31 March 2018		1,634.3	(115.3)	1,519.0
Company				
At 1 April 2016		1,308.0	(89.3)	1,218.7
Retained surplus for the year		89.9	–	89.9
Actuarial loss, net of deferred taxation	23	–	(90.2)	(90.2)
At 31 March 2017		1,397.9	(179.5)	1,218.4
Retained surplus for the year		62.4	–	62.4
Actuarial gain net of deferred taxation	23	–	65.1	65.1
At 31 March 2018		1,460.3	(114.4)	1,345.9

Notes to the financial statements

For the year ended 31 March 2018

continued

22. Results of Scottish Water (the Company)

Of the results for the financial year, a retained surplus of £62.4 million (2017: £89.9 million) is dealt with in the consolidated financial statements of Scottish Water. The Members have taken advantage of the exemption available under section 408 of the Companies Act 2006 and do not present an income statement or a statement of comprehensive income for Scottish Water alone.

23. Pensions

Employees of Scottish Water participate in the North East Scotland Pension Fund, the Lothian Pension Fund and the Strathclyde Pension Fund, which are part of the Scottish Local Government Pension Scheme administered by Aberdeen, Edinburgh and Glasgow City Councils respectively. The schemes provide defined benefits based on career average pensionable pay. Actual pension costs for the year for each fund, as a % of pensionable pay, were 20.7% (2017: 20.7%), 21.8% (2017: 21.8%) and 22.9% (2017: 22.9%) respectively.

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

A full actuarial valuation was carried out at 31 March 2017 for all 3 funds and updated at 31 March 2018 by a qualified independent actuary, to take account of the requirements of IAS 19.

The major assumptions used by the actuaries were:

	2018 %	2017 %
Rate of increase in pensionable salaries	2.3	2.5
Rate of increase in pensions payment	2.3	2.5
Discount rate	2.6	2.6
CPI inflation rate	2.3	2.5

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

	North East Scotland Years	Lothian Years	Strathclyde Years
Retiring at 31 March 2018			
Male	22.6	21.7	21.4
Female	24.8	24.3	23.7
Retiring at 31 March 2038			
Male	25.5	24.7	23.4
Female	27.8	27.5	25.8

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

Assumption	Change in assumption	Approximate Impact on IAS 19 liability %	Approximate Impact on IAS 19 liability £m
Rate of increase in pensionable salaries	+/-0.5% per annum	Increase/decrease by c. 1.7%	Increase/decrease by c. £31 million
Discount rate	+/-0.5% per annum	Decrease/increase by c. 9.1%	Decrease/increase by c. £164 million
CPI Inflation rate	+/-0.5% per annum	Increase/decrease by c. 7.3%	Increase/decrease by c. £131 million
Longevity	Increase life expectancy by 1 year	Increase by c. 4.0%	Increase by c. £72 million

23. Pensions continued

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

	Note	Group		Company	
		2018 £m	2017 £m	2018 £m	2017 £m
Total fair value of assets		1,622.8	1,607.5	1,590.5	1,576.9
Present value of scheme liabilities		(1,798.1)	(1,841.7)	(1,764.2)	(1,807.4)
Gross pension liability		(175.3)	(234.2)	(173.7)	(230.5)
Related deferred tax asset	16	29.8	39.8	29.5	39.2
Net pension liability		(145.5)	(194.4)	(144.2)	(191.3)

Scheme assets are stated at their bid values.

Reconciliation of opening and closing retirement benefit liabilities and assets

	Note	Group		Company	
		2018 £m	2017 £m	2018 £m	2017 £m
Movements in liabilities during the year:					
Opening value of total liabilities		(1,841.7)	(1,429.2)	(1,807.4)	(1,407.6)
Total service cost	5	(54.9)	(37.0)	(52.3)	(35.2)
Interest on pension scheme liabilities	7	(48.0)	(50.7)	(47.1)	(49.9)
Contributions by members		(8.8)	(8.4)	(8.3)	(7.9)
Actuarial gain/(loss)		105.7	(363.8)	101.5	(354.1)
Benefits paid		49.6	47.4	49.4	47.3
Closing value of total liabilities		(1,798.1)	(1,841.7)	(1,764.2)	(1,807.4)
Movement in assets during the year:					
Opening fair value of total assets		1,607.5	1,318.6	1,576.9	1,295.5
Interest on pension scheme assets	7	41.3	46.3	40.5	45.4
Contributions by members		8.8	8.4	8.3	7.9
Contributions by the employer		38.7	31.0	37.3	29.5
Actuarial (loss)/gain		(23.9)	250.6	(23.1)	245.9
Benefits paid		(49.6)	(47.4)	(49.4)	(47.3)
Closing fair value of assets		1,622.8	1,607.5	1,590.5	1,576.9
Gross deficit in the schemes at 31 March		(175.3)	(234.2)	(173.7)	(230.5)

Notes to the financial statements

For the year ended 31 March 2018

continued

23. Pensions continued

Return on assets

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

	Note	Group		Company	
		2018 £m	2017 £m	2018 £m	2017 £m
Actual return on pension scheme assets		17.4	296.9	17.4	291.3
Actuarial gain/(loss) in other comprehensive income in the consolidated statement of comprehensive income					
Gross actuarial gain/(loss) recognised in the pension fund		81.8	(113.2)	78.4	(108.2)
Deferred tax movement	16	(13.9)	18.8	(13.3)	18.0
Net actuarial gain/(loss) recognised in other comprehensive income in the consolidated statement of comprehensive income					
	21	67.9	(94.4)	65.1	(90.2)

Amounts recognised in the consolidated income statement

	Note	2018 £m	2017 £m
Total service cost	5	54.9	37.0
Interest cost on pension scheme net liabilities (see above)	7	6.7	4.4
		61.6	41.4

The unpaid contributions outstanding at the year end included in other payables (note 15) was £0.9 million (2017: £0.8 million). It is estimated that Scottish Water will make contributions of £32.0 million to the pension funds in financial year 2018/19.

23. Pensions continued

History of experienced gains and losses

	2018 £m	2017 £m
Group		
Difference between the expected and actual return on scheme assets:		
Amount	(23.9)	250.6
Fair value of assets	1,622.8	1,607.5
Experienced gains/(losses) on scheme liabilities:		
Amount	45.5	(8.2)
Present value of liabilities	1,798.1	1,841.7
Changes in assumptions underlying the present value of scheme liabilities:		
Amount	60.2	(355.6)
Total variance between pension fund actuarial assumptions and actual experience	81.8	(113.2)
Gross deficit in the schemes at 31 March	(175.3)	(234.2)
	2018 £m	2017 £m
Company		
Difference between the expected and actual return on scheme assets:		
Amount	(23.1)	245.9
Fair value of assets	1,590.5	1,576.9
Experienced gains/(losses) on scheme liabilities:		
Amount	42.8	(8.2)
Present value of liabilities	1,764.2	1,807.4
Changes in assumptions underlying the present value of scheme liabilities:		
Amount	58.7	(345.9)
Total variance between pension fund actuarial assumptions and actual experience	78.4	(108.2)
Gross deficit in the schemes at 31 March	(173.7)	(230.5)

Notes to the financial statements

For the year ended 31 March 2018

continued

24. Commitments

a. Capital commitments

The Group has contracted capital commitments of £380.2 million (2017: £393.2 million) relating to property, plant and equipment at the balance sheet date. These commitments are expected to be settled within the following 2 financial years.

b. Operating lease commitments

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

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

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

	2018 £m	2017 £m
Within one year	2.8	2.7
Between one and 5 years	7.0	8.1
After 5 years	16.5	18.0
	26.3	28.8

25. Contingent assets and liabilities

a. Contingent assets

During 2016/17 a commercial claim was raised by Scottish Water against a supplier in relation to performance under a long-term contract. Discussions towards agreement of a settlement have taken place and non-binding heads of terms have been signed. The settlement is valued at £13.75m which is expected to become receivable by Scottish Water following agreement of legal documentation. As the economic benefit of the settlement cannot be recognised until it is virtually certain, the results for the 2017/18 financial year do not include any asset in respect of the settlement of the claim.

b. Contingent liabilities

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

Central Market Agency

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

Water Regulatory Advisory Service

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

26. Related party transactions

The Group has related party relationships with the Scottish Government, with its subsidiaries (note 11), and with its Members and Executive Management. Details of transactions between the Group and other related parties are disclosed below.

Scottish Government

Scottish Water is a public corporation of a trading nature sponsored by the Scottish Government. During the year Scottish Water had various material transactions with the Scottish Government, namely the drawdown and repayment of loans and associated interest charges. Details of the loans from the Scottish Government are shown in note 19.

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

Subsidiaries

During the year the Company entered into the following transactions with its subsidiaries (note 11):

	2018 £m	2017 £m
Wholesale water and waste water services to Business Stream	143.5	140.7
Sale of waste water services to other subsidiaries	0.5	0.5
Seconded staff costs charged to subsidiaries	4.4	4.3
Other operating costs charged to subsidiaries	1.9	2.6
Purchase of property, plant and equipment from subsidiaries (note 3)	1.4	12.9

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 59 to 68. Scottish Water's non-executive members hold additional roles within other organisations (see Members on pages 69 to 72).

Notes to the financial statements

For the year ended 31 March 2018

continued

27. Financial instruments and risks

The management of Scottish Water and the execution of strategy are subject to a number of risks as detailed below. All risks are reviewed by the Board and appropriate processes are in place to monitor and mitigate them. See the Strategic report on pages 11 to 13 and Corporate Governance report on pages 56 to 57.

a. Qualitative risk disclosures

Credit risk

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

Liquidity risk

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

Interest rate risk

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

Currency risk

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

b. Categories of financial assets and liabilities and fair values

Scottish Water's financial assets and liabilities comprise trade and other receivables (note 13), cash and cash equivalents (note 14), borrowings (notes 18 and 19) and trade and other payables (note 15). 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 18 and 19.

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.

27. Financial instruments and risks continued

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

	Group		Company	
	2018 £m	2017 £m	2018 £m	2017 £m
Trade receivables per note 13:				
Trade receivables	523.8	558.4	432.8	502.6
Less provision for impairment of trade receivables	(411.3)	(461.9)	(391.2)	(449.2)
Net trade receivables	112.5	96.5	41.6	53.4
Analysed between:				
Household receivables	422.6	478.9	422.6	478.9
Less provision for impairment	(388.2)	(446.6)	(388.2)	(446.6)
Net household receivables	34.4	32.3	34.4	32.3
Business customer receivables	101.2	79.5	10.2	23.7
Less provision for impairment	(23.1)	(15.3)	(3.0)	(2.6)
Net business customer receivables	78.1	64.2	7.2	21.1

Household water and waste water services are billed to customers by the 32 Councils as an element of the annual Council Tax bills. The Councils 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 by the Councils. Debt since the establishment of the former Water Authorities in 1996 continues to be collected. As at 31 March 2018 trade receivables in respect of household customers totalled £422.6 million with a provision of £388.2 million (2017: £478.9 million and £446.6 million respectively).

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

Assumption	Change in assumption %	Approximate Impact on bad debt charge £
Overall household collection rate	+/-0.01%	Increase/decrease by c. £1.3m
In-year household bad debt provision charge	+/-0.10%	Increase/decrease by c. £0.9m

As at 31 March 2018 trade receivables from business customers totalled £101.2 million (2017: £79.5 million). The ageing analysis of trade receivables from business customers and the related provisioning is as follows:

	Total £m	Current £m	<3 months overdue £m	3-12 months overdue £m	>12 months overdue £m
Group					
Gross receivable	101.2	31.5	44.3	15.8	9.6
Provision	(23.1)	-	(4.7)	(10.2)	(8.2)
Net trade receivable as at 31 March 2018	78.1	31.5	39.6	5.6	1.4
Gross receivable	79.5	54.5	6.3	9.8	8.9
Provision	(15.3)	-	(1.8)	(4.6)	(8.9)
Net trade receivable as at 31 March 2017	64.2	54.5	4.5	5.2	-

Notes to the financial statements

For the year ended 31 March 2018

continued

27. Financial instruments and risks continued

	Total £m	Current £m	<3 months overdue £m	3-12 months overdue £m	>12 months overdue £m
Company					
Gross receivable	10.2	6.3	1.8	1.1	1.0
Provision	(3.0)	–	(0.9)	(1.1)	(1.0)
Net trade receivable as at 31 March 2018	7.2	6.3	0.9	–	–
Gross receivable	23.7	21.0	1.1	0.7	0.9
Provision	(2.6)	–	(1.0)	(0.7)	(0.9)
Net trade receivable as at 31 March 2017	21.1	21.0	0.1	–	–

28. 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.

29. Regulatory information

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

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

Direction by the Scottish Ministers

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

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

Project expenditure	Threshold	Project	Cost
Capital expenditure on major works including improvements to existing assets	£10 million	Ayrshire strategic resilience project	£41.3m
		Shieldhall tunnel project	£11.5m
		Oban water treatment works	£11.3m
		Bradán water treatment works	£11.3m
		Amlaird & Corsehouse strategic main project	£10.3m
Purchase of individual capital items, including land, with a life of more than one year	£1 million	None	–
Advertising	£1 million	None	–
Sponsorship	£10,000	Scottish Amateur Swimming Association*	£150,000
Gifts	£100	None	–

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

The water industry in Scotland

The water industry in Scotland is regulated. This model provides assurance that Scottish Water meets the interests of our customers, protects the quality of drinking water and the environment, and is accountable for our performance.

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



The Scottish Parliament

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

The Scottish Government

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

Scottish Water

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

Water Industry Commission for Scotland (WICS)

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

Drinking Water Quality Regulator (DWQR)

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

Scottish Environment Protection Agency (SEPA)

Responsible for environmental protection and improvement.

Scottish Public Services Ombudsman (SPSO)

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

Citizens Advice Scotland (CAS)

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

Customer Forum

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

Other regulators

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



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

* We record all calls for quality and training purposes.