



**Scottish
Water**
Trusted to serve Scotland

Annual Report & Accounts 2018/19



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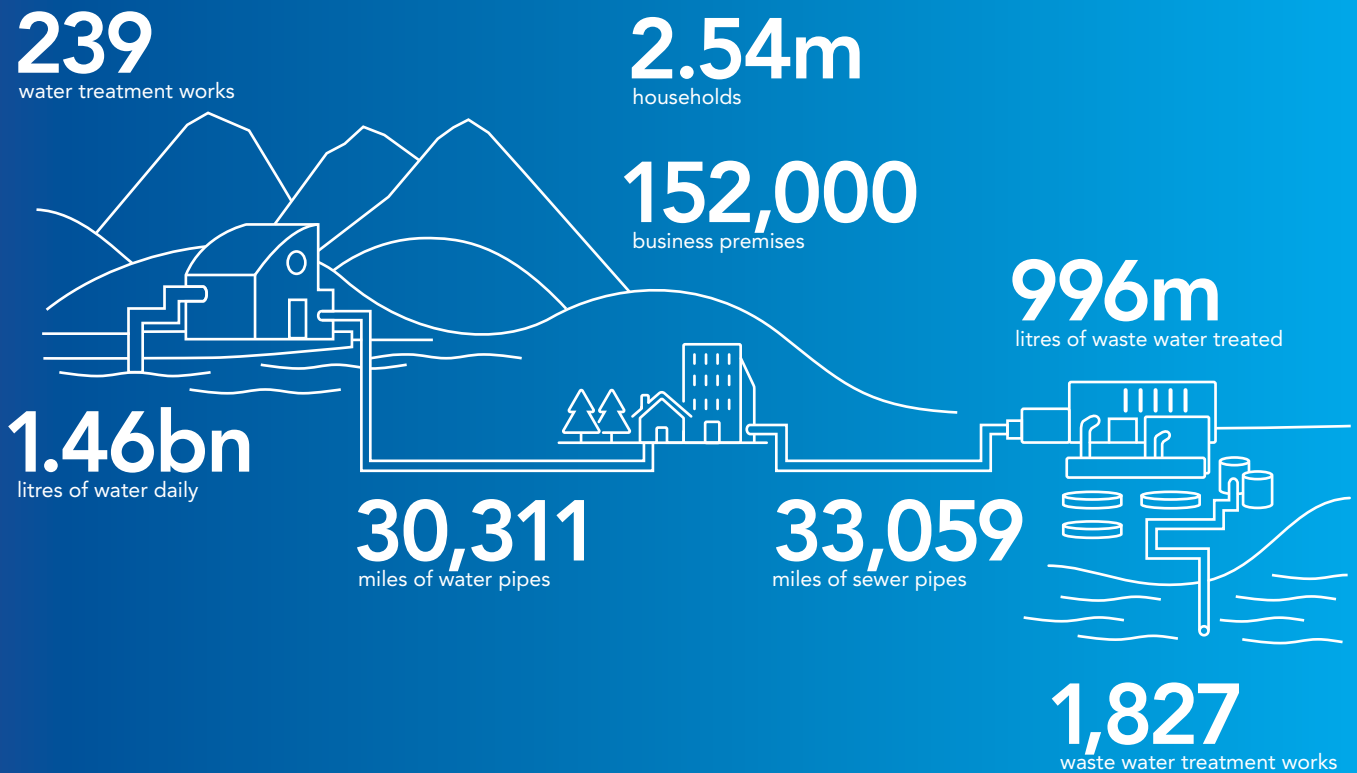
Scottish Water's vital role

Our services support the daily lives of 2.54 million households and 152,000 business premises. We are proud of the service we provide:

- delivering 1.46 billion litres of clear, fresh drinking water and;
- removing 996 million litres of waste water which we treat, recover resources from and return safely to the environment.

Over the six year period from 2015-21 £3.9 billion will be invested in managing our assets and further improvements to drinking water quality, protecting the environment and contributing to the Scottish economy. In 2018/19, the fourth year of the regulatory programme, we invested £660 million.

Our average household charge is £46 lower per year than in England and Wales.



2018/19 highlights



Outstanding customer service

Maintained supplies of high quality clear, fresh drinking water to our customers despite a demand increase of up to 30% through the hottest, driest, summer for 25 years



Increasing sustainability

Successfully reduced leakage by 12 million litres per day despite exceptionally dry weather



Excellent customer experience

Highest ever level of customer satisfaction and the lowest number of written complaints



Value for customers

The average household charge in Scotland remains among the lowest in Great Britain



High levels of water quality

99.92% of all tests passed stringent quality standards



Investing in communities

£660 million invested to improve services, protect the environment and contribute to the economy



Employee wellbeing

We have been recognised as a Times Top 50 Employer for Women and achieved Exemplary status in the Carer Positive initiative

Chair's statement

Dame Susan Rice



Scottish Water rose well to the challenges of an eventful year.

Strong fundamentals are key to any successful organisation and nowhere more so than in providers of essential services. Over the last year we have seen the benefits of good preparation, effective planning and an abundance of skills and experience. These fundamentals have enabled us to cope – and indeed to prosper – in the face of extreme weather that threatened to disrupt the services we provide to our customers.

The summer of 2018 was the driest and warmest in 25 years. In some parts of Scotland this posed a risk to water supplies to our customers. But the planning and preparation undertaken across Scottish Water, ahead of the summer, meant we were able to put in place a host of interventions that ensured customers' supplies continued with minimal interruption. I want to thank everyone in Scottish Water who played their part in the remarkable effort to maintain supplies.

As a Board, our key concern is ensuring the organisation has the resilience to live up to our vision of being trusted to care for the water on which Scotland depends. So it gave us great satisfaction to see the strength Scottish Water displayed in our response to the challenges of the summer.

Indeed, the organisation's strengths were evident across many of our activities: we further improved the service we provide customers, both household and non-household; the water we supply remains high quality and we are again one of the biggest investors in Scotland's vital infrastructure. All of this was achieved with customer charges among the lowest in Great Britain.

Our £3.9 billion capital programme across the 2015-21 period has real momentum, delivering new and upgraded infrastructure that will improve water quality, customer service and the reliability of our network. Our investment is creating work for hundreds of businesses, large and small, in our supply chain, supporting thousands of jobs and contributing to Scotland's economic wellbeing.

Political change has brought different challenges this year in the form of uncertainty around the Brexit negotiations. The United Kingdom's departure from the European Union has created risks around the availability of chemicals for the water and waste water sector in every part of the United Kingdom. The entire industry has worked together on these issues, with Scottish Water playing a key role, to ensure effective planning and coordination with the aim of maintaining service and standards for all customers.

This year the Board and its committees have continued to work to ensure that the Executive Leadership Team at Scottish Water remain focused on our key corporate objectives and ministerial directions. It's gratifying that, over the year, Scottish Water has, overall, exceeded the commitments that we made for the 2015-21 regulatory period.

Beyond our core water and waste water services we also undertake further activities, through one of our subsidiaries, Scottish

Water Horizons, which generate value to Scottish Water and create income that benefits customers either through increased investment or in helping to keep charges down. These include renewable energy schemes and working overseas to share our expertise with international clients.

Another subsidiary, Business Stream, operates under separate governance rules in the competitive non-household supply markets in Scotland and England. The business has grown significantly in the two years since English market opening, with £250 million of new business secured organically. In January, it announced the planned acquisition of the customer base of Yorkshire Water Business Services and Three-Sixty, both part of the Kelda Group. The acquisition will cement its position as one of the top 3 retailers in the UK non-household water market. The growth in customers will help lower the cost to serve and strengthen the business in a highly competitive market. Business Stream reduced bad debt and increased profit in the year.

During the year, a Board Effectiveness Review was carried out by the Corporate Secretary. The results of the internal Review were very positive, and Board Members explored other ways in which effectiveness could be further enhanced. It was noted that the Board Members contribute a wide range of board, industry, as well as personal experience.

I'd like to thank the Board and everyone who is leading and working in Scottish Water for a successful year of achievement. In the coming year, we will remain focused on fulfilling our vision of being trusted to care for the water on which Scotland depends.

Chief Executive's statement

Douglas Millican



Scottish Water must continue to deliver the water and waste water services that are vital to everyday life to support a flourishing Scotland.

Our customers and communities rightly expect the same flawless service from us – reliable supplies of high quality tap water and for us to take away their waste water and return it safely to the environment. Whatever the challenges, we must continue to meet those expectations.

The story of the last year would be a good story in any year. We have achieved our best-ever customer experience measure score, a water industry-leading score on our overall performance measure, reduced leakage and invested £660 million, maintaining and improving the water and waste water infrastructure of Scotland.

But the remarkable achievement of the last twelve months has been that this has all taken place against the backdrop of some very challenging weather. In just over four months,

Scotland saw two extreme weather events that stand out in recent history – the ‘beast from the east’ in March 2018, followed by the longest, driest spell of hot weather for 25 years during June and July.

The impacts of climate change have been evident to those of us who work in the water sector for some time, but there is no doubt that 2018 has been a stand-out year in terms of extreme weather.

The response of our team to these challenges was excellent, and I am very proud of it. Our people and partners worked extremely hard, innovating and pulling together, with the aim being to ensure the weather did not adversely impact on customers’ supplies. Our customers also helped our efforts to manage supplies when they responded to our calls to use water wisely and I am grateful to them too.

In terms of performance measures, we exceeded our targets and achieved our highest ever performance in both our household and non-household customer experience measures for the year. Our household Customer Experience Measure (hCEM) was 87.54, and our non-household CEM (nhCEM) was 81.74. On our Overall Performance Assessment, we achieved a score of 403, again exceeding the water industry ‘leading’ threshold of 400.

We delivered continuing high levels of water quality with 99.92% of all tests taken complying with strict regulatory standards. Our health and safety performance also improved with the Scottish Water and contractor combined reportable non-fatal injury rate reducing from 112 last year to 56 this year.

I am delighted that once again Scotland’s water sector, 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 at £86.1 million was £14.3 million higher than last year. This was primarily due to increased profits within Business Stream and Scottish Water. The higher surplus from Scottish Water’s regulated business was mainly a consequence of increased income and lower finance costs, partly offset by weather-related

costs. The surplus from Scottish Water’s regulated business will be fully reinvested in supporting future service delivery.

One of our biggest infrastructure projects, the Shieldhall Tunnel, in Glasgow, became fully operational this year. This project, which is already helping to improve water quality in the River Clyde and tackle sewer flooding, has won two prestigious awards, the Chartered Institution of Water and Environmental Management Drainage Group’s Urban WaPUG Prize and the Saltire Infrastructure Award.

We are also helping to protect the environment through our Your Water Your Life campaign, encouraging people to carry a refillable bottle and top up from the tap. The response so far has been very encouraging, particularly to the installation of the first ten Top up Taps of our planned network of 70 across Scotland.

In December 2018, we acquired two companies that operate four waste water treatment works in North-East Scotland under contract to Scottish Water. This opportunity arose because of the planned divestment of these companies by Kelda Group and will enable us to protect the service to customers in that area.

As we approach the final two years of the 2015-21 regulatory period, we are looking ahead to the 2021-27 period and working with regulators and other stakeholders on our next Strategic Review of Charges. In the last 12 months, we have consulted with more than 16,000 customers on the future of water and waste water services and are now busy building those views into our plans.

Thank you to our customers, employees, partners and stakeholders, who have all contributed to a year of great achievement. Looking ahead to 2019/20, I am confident our people and our partners will continue to deliver well for our customers and communities.

Strategic report

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Our business model

Who we are

Scottish Water 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 5.4 million customers in homes and businesses across Scotland covering an area of 30,810 square miles.

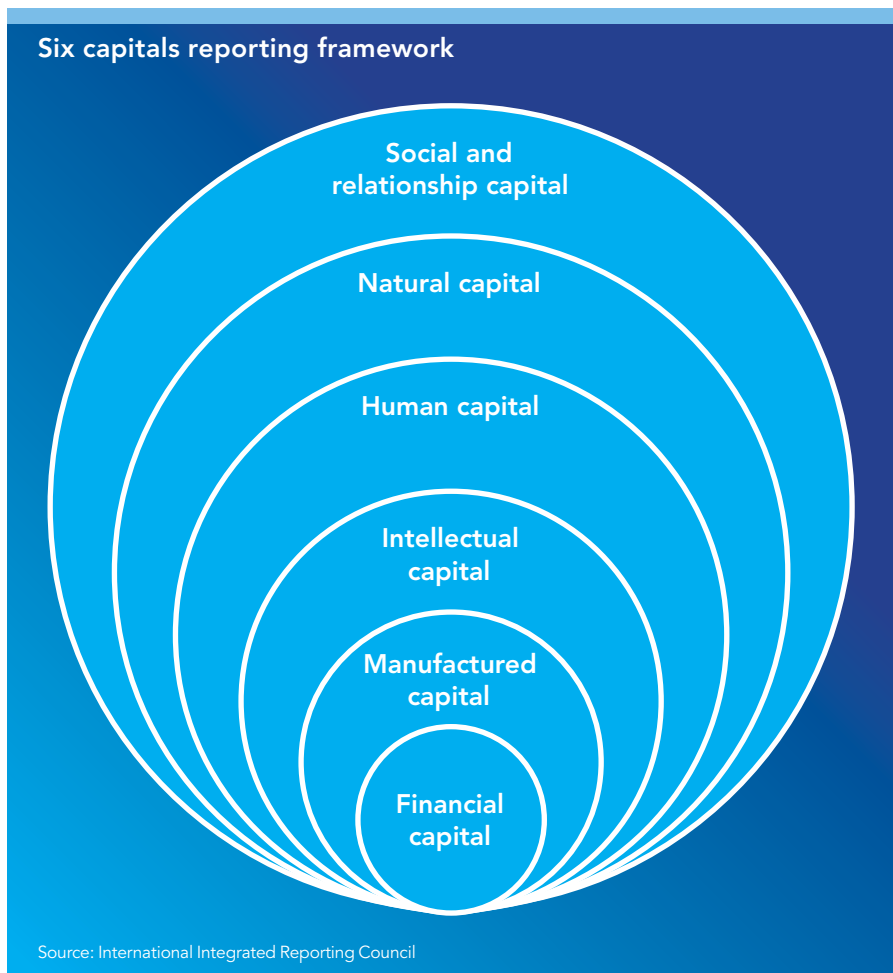
Scottish Water's regulated business supplies water and waste water services to households and is also the wholesaler to the 30 retailers (Licensed Providers (LPs)) who operate in the water retail market for businesses in Scotland. Within the Scottish Water group, our subsidiary, Business Stream, operates as a LP, competing with other LPs in the Scottish and English markets 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.

During the year, Scottish Water Horizons Holdings acquired the companies that operate four waste water treatment works in North-East Scotland, under contract to Scottish Water, from Kelda Group.

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 42 to 43.



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 incorporated are referenced in the regulated

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), reflecting that 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.

This report highlights performance over the period 1 April 2018 to 31 March 2019. Our performance has been recorded using the six capitals approach to integrated reporting as shown in the diagram above.

We are introducing the six capitals framework in our corporate reporting for the first time this year as it will enable us to report how Scottish Water creates value over time. The framework categorises the capital stocks as social and relationship, natural, human, intellectual, manufactured and financial.

The six capitals framework will also allow communication of the interdependencies and trade-offs between the capitals and how changes in the availability, quality and affordability can impact Scottish Water's ability to continue to create and demonstrate value over time. Our intention is to further develop our use of the six capital reporting framework in future years to keep pace with best practice in corporate reporting.

For more information on each of the six capitals please see pages 19 to 39.

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

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	31
Anti-corruption and anti-bribery	31

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

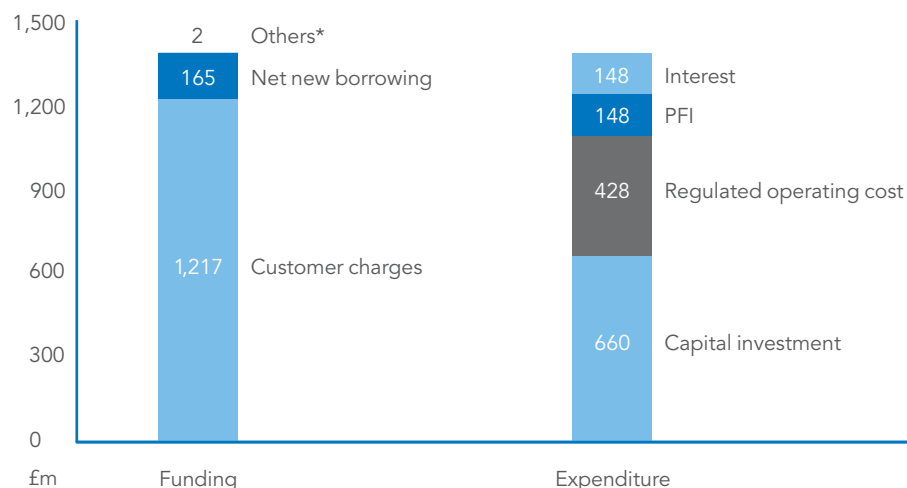
improvements and the expenditure to run the operation in respect of our core water and waste water services. Scottish Water's aim is to out-perform the targets set out in the Delivery Plan and thereby out-perform the regulatory contract.

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 2019. The surplus made by Scottish Water is reinvested in the provision of services to customers.

Scottish Water Funding and Expenditure 2018/19



*Inc. change in working capital

Our vision

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

Delivering savings to keep customers' prices low.

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

To deliver high quality clear, 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. Their views inform our planning and allow us to meet 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 high quality clear, fresh drinking water, ensuring all our customers can turn on their taps to receive a safe and reliable supply, everywhere in Scotland.
- We 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 investing in our assets to meet new demand for our services

Our plans for achieving this in the 2015-21 period are set out in our Delivery Plan 2015-21, which was updated in 2019 and is available at www.scottishwater.co.uk/deliveryplan.

[This annual report highlights our progress during 2018/19.](#)

Looking ahead

During the summer of 2018, we consulted with our customers and stakeholders about the future of their water and waste water services after 2021. Over 16,000 responses were received through both online and public events.

For the consultation we proposed three draft strategic ambitions:

- Improve the reliability, resilience and sustainability of our service to our customers.
- Deliver a consistently leading customer experience.
- Keep customer prices low.

During the consultation it became clear that protecting the wider environment was a key concern of customers and stakeholders and so we added a fourth draft strategic ambition. This is:

- Support a flourishing Scotland.

Further findings from the consultation will inform our Strategic Plan for 2021-27 that will be published by December 2019.

The Shaping the Future consultation report can be viewed at: www.scottishwater.co.uk/reports

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 fourth year of the delivery period – 2018/19.

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 2015-21 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. Our plan addresses our customers' highest priorities for service such as improvements to drinking water quality and reducing flooding from sewers.

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, the 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 clear, fresh 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 9.

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.

In addition to Scottish Water, our risk management framework also includes Scottish Water Horizons, Aberdeen Environmental Services and Scottish Water Services Grampian but excludes Business Stream¹ operational risk management.

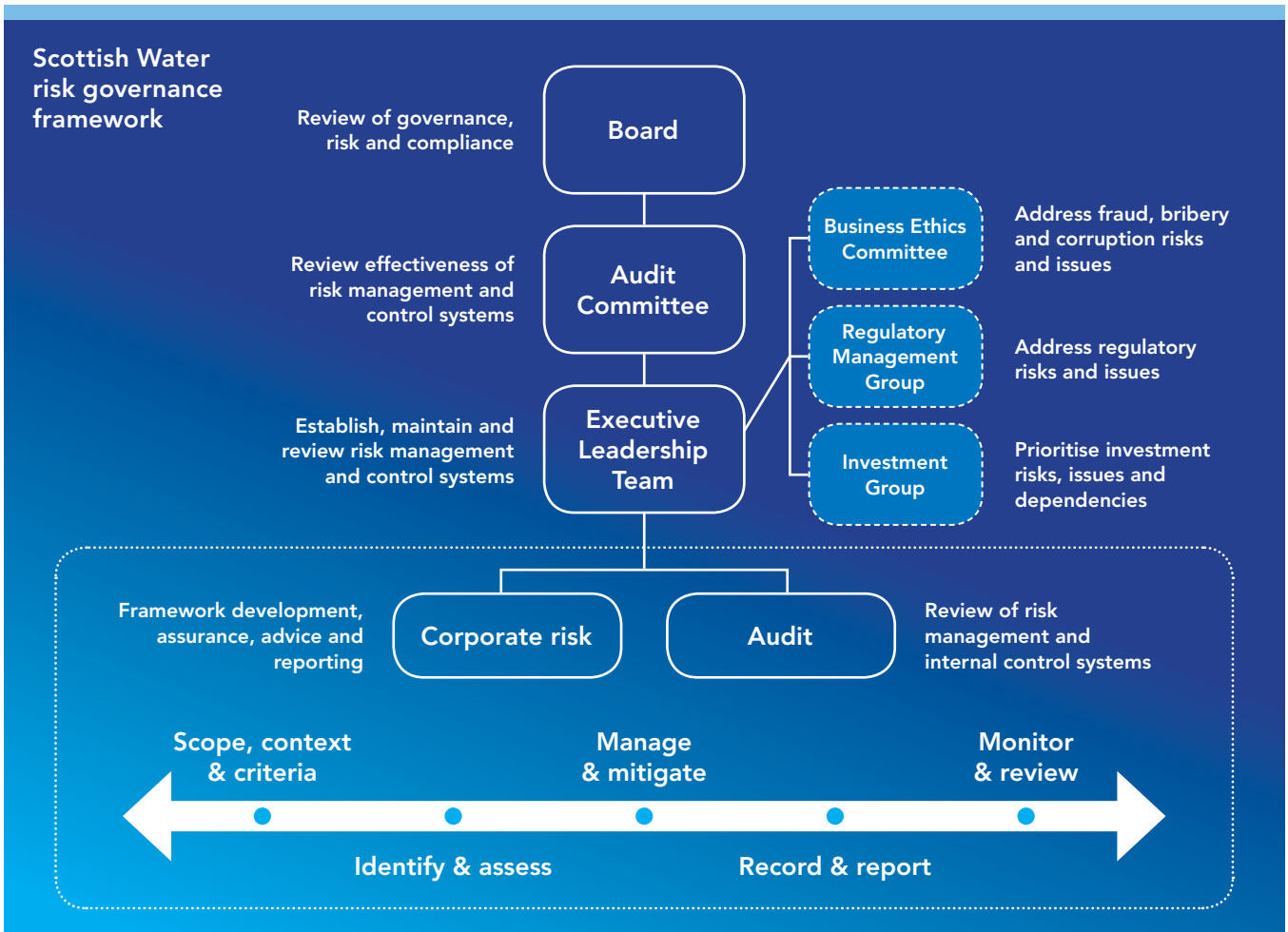
Risk control assurance

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.

In order to efficiently and effectively manage opportunities and threats across Scottish Water, we embrace a systematic and structured approach to risk management. Our approach is based on the principles of the International Standard 31000 Risk Management (ISO 31000) and is tailored to meet the needs of our business and the environment in which we operate. This system 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 senior managers and escalated to the Executive Leadership Team, Audit Committee and Board as appropriate.



¹ In line with the Water Industry (Scotland) Act 2002: Scottish Water Governance Directions 2009.

Our approach to risk management

Principal risks and uncertainties continued

Risk management approach

Scottish Water has an established risk management policy which was refreshed 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 a number of 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, we consider 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 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 two risk reports per year, 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. 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.

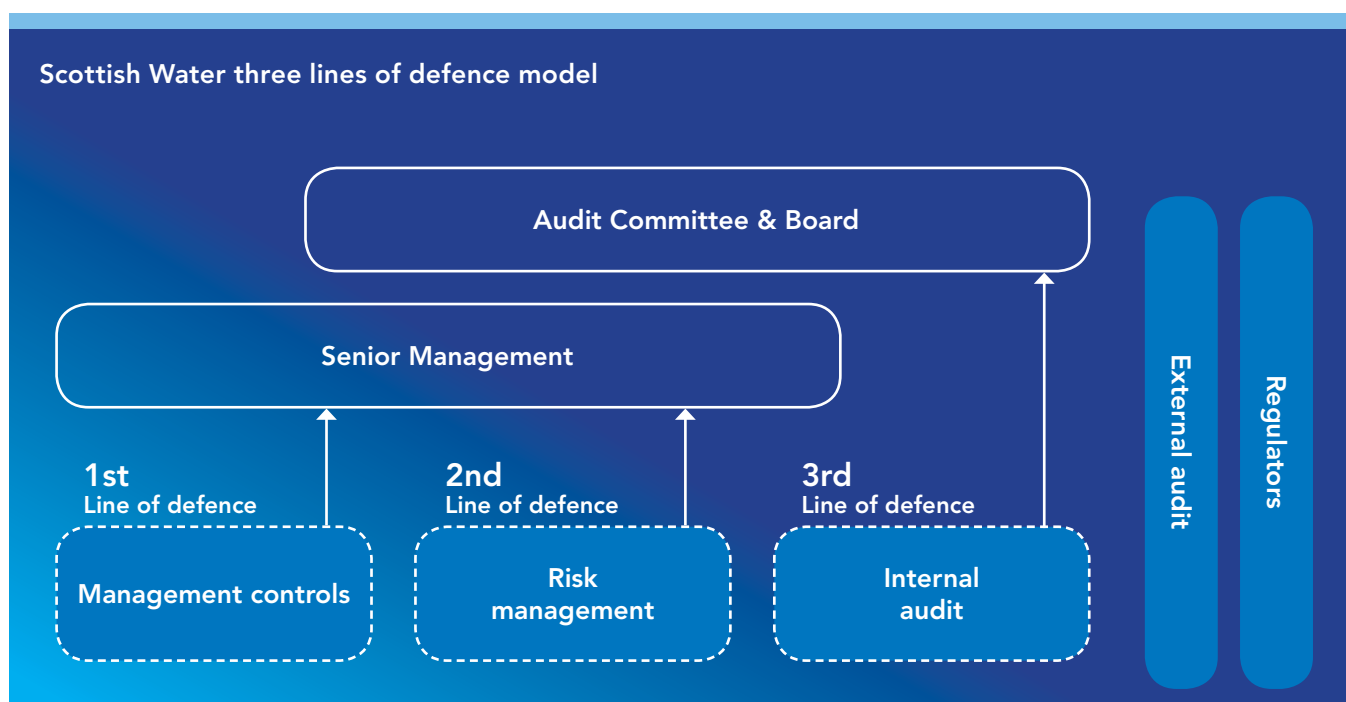
1. **First line of defence** – each business area is responsible for the identification and assessment of risks, understanding and adopting appropriate controls.
2. **Second line of defence** – risk management provides challenge on the completeness and accuracy of risk assessments, considers the adequacy of mitigation plans and enables risk reporting.
3. **Third line of defence** – internal 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 its 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 continued


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, 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. • Our water quality improvement group actively manages emerging water quality problems or issues and implements actions to address.
<p>The most recent DWQR Annual Report reported compliance with water quality standards at 99.90% demonstrating the continuing high quality of drinking water that consumers in Scotland receive.</p> <p>Significant investment has continued across 2018/19 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 in place. • External Expert Vulnerability and Threat Management service in place. • 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. • Planning to meet 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 2018/19, we note that the number of attempted 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 their 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 continued			
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 2018/19, 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.			
Strategic water mains 	Risk arising from failure of key/strategic water mains resulting in loss of service and 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.			
Climate change 	Risk of failure to deal with the impact of extreme and unpredictable weather events on our assets, infrastructure and services. Risk of changes to future water resource supply and demand due to climate change.	As a water utility company, provision of safe drinking water remains our highest priority. Delivering a continuous service to our customers is paramount. Scottish Water seeks to treat and return waste water in a way that does not harm the environment.	<ul style="list-style-type: none"> • Undertaking a Scottish Water climate change risk assessment. • Undertaking climate change vulnerability assessments. • Delivering investment in our water and waste water assets. • Participation in projects and studies of which the outputs inform our strategic plans.
Climate change and more variable and extreme weather patterns are anticipated to present a challenge across the water industry. Climate change will affect the availability of water resources and create the potential for extreme loads on our sewer systems. Climate change, by changing patterns of average and extreme rainfall, will also drive increased volumetric requirements and investment in our assets if sewer surcharging and flooding of waste water are to be avoided.			


Scottish Water Group

Principal risks and uncertainties continued

Risk or uncertainty trend	Description	Risk appetite	Key mitigations
Managing our assets continued			
Data protection 	Risk of failure to adequately manage data protection including the new obligations arising from the EU General Data Protection Regulation.	Scottish Water seeks to safeguard customer and employee data by complying with relevant standards.	<ul style="list-style-type: none"> • Reviewing and launching of policies, processes and guidelines. • Raising awareness of data protection and GDPR requirements. • 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) and Data Protection Act 2018 (DPA), introduced additional obligations. We continue to adapt and embed our policies, processes and guidelines in support of these.			
Working with people			
Health and safety 	Risk arising from our assets, activities and actions resulting in an impact on the health, safety or wellbeing of our people, contractors, supply chain and/or customers.	The health, safety and wellbeing of our people, including contractors, partners and the public remains one of our top priorities. Our behaviours, activities and assets should therefore not place at risk the health, safety or wellbeing of Scottish Water employees, partners, customers or members of the public.	<ul style="list-style-type: none"> • Integrated safety, health and wellbeing strategy. • 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. • Investigation of 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 will be a continuing area of strong focus in 2019/20.			
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 level of PFI project risk faced in 2018/19.			

Risk or uncertainty trend	Description	Risk appetite	Key mitigations
Developing the Business continued			
Business Stream 	Risk of reducing value of the business and increased demand on Scottish Water Group cash due to competitive market conditions and the complex operating environment in the developing English market.	Business Stream will maintain a financially viable retail business.	<ul style="list-style-type: none"> 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 developing retail market in England provides access to £2.5 billion of revenue opportunity. As anticipated, the English market environment is currently complex, with low margins available, data quality issues and complex wholesale tariff arrangements.

Managing external influences			
Constitutional change 	Operational and Financial risk and opportunity arising from constitutional change.	We will seek to maximise any opportunities and minimise any risks arising from constitutional change.	<ul style="list-style-type: none"> Ongoing review of potential risks and opportunities arising from the UK departure from the EU. Involvement in external workshops to ascertain areas of concern for water industry. Engagement with government and regulators, to shape priorities in both EU and domestic context. Supply chain analysis undertaken and ongoing discussions with the supply chain regarding contingency arrangements and contractual relationships. Established a Brexit Strategic Command Team and a Brexit Co-ordination Group. Contingency planning including the advance purchase of chemicals and strategic/critical spares. Review and update of Business Continuity Plans.

The impact from constitutional change remains uncertain and continues to be closely monitored and management of readiness plans continue to be refined.

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

These include reputational and financial risks arising from damage to third party assets, e.g. oil/gas transmission pipes and/or railway networks; non-compliance with the EU Urban

Waste Water Treatment Directive; risks to revenue, risk of water shortage, evolving regulatory processes and a 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

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 5 to 39. The principal risks and uncertainties are described on pages 11 to 17.

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 WICS.

As at 31 March 2019, Government loans totalled £3.7 billion and Scottish Water group held cash and cash equivalents of £434.8 million.

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

Viability statement

In accordance with provision C.2.2 of the UK Corporate Governance Code, the Members have assessed the prospects of the group over the three year period to March 2022. The Members consider that the three 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 three years to March 2022.

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 17, and the probable degree of effectiveness of current and available mitigating actions. Members considered extending the period of the viability statement, but given that planning for the next Strategic Review covering the 2021-27 period is ongoing, this was not seen as appropriate. Therefore, Members decided it premature for the 2018/19 viability period to be extended at this stage.

The key processes used by Members for their assessment are summarised below:

The business and strategic planning processes generally cover the regulatory period, based on key assumptions in respect of the funding of the business. The current regulatory period ends March 2021 but 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 three years of any planning period. The plan considers base, downside and severe downside financial and economic scenarios.

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

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

In conclusion, for this assessment, Members have assessed the prospects and viability of the group over a three year period to March 2022 and consider this appropriate for this year.

Social and relationship capital

We recognise the importance of the relationships we have with our customers, communities and stakeholders. Our ability to build and strengthen these relationships is directly linked to our ability to deliver our services, for example to manage demand for water or reduce sewer chokes, as well as deliver against our vision of being trusted to serve Scotland.

Overview

The effects of extreme weather in 2018 led to an unprecedented demand for our services. A combination of freezing weather in March followed by the driest summer in 25 years resulted in significant challenges around the delivery of our service to customers. Our employees worked tirelessly, throughout Scotland, over a prolonged period to keep the water flowing and customers informed.

Some areas of Scotland had a 30% increase in demand for water during the summer of 2018. At times, an additional 140 million litres of water was being produced daily to meet customer demand.

More than 25 million litres of water was moved by road tanker to keep supplies topped up in areas where demand increased. A total of 36 areas required action to be taken to preserve or supplement water supplies including: moving water around our network in different ways, overland temporary pipe installation, pumping from alternate sources and management of water quality risks caused by the use of alternate supplies. Customers were also asked to use water wisely to help maintain supplies. We worked with local authorities across Scotland to support customers with private water supplies.

Customer service

Overall Performance Assessment

For the 2015-21 period, we agreed challenging targets with our regulator, the WICS and the body which represents customers, the Customer Forum. These targets ensure our service levels keep pace with the expectations of our customers and we seek to go beyond these whenever possible.

These measures include an Overall Performance Assessment (OPA), a basket of measures which tracks how well we are delivering water and waste water services. Our target is to achieve an OPA score of 383 points in 2018/19 rising to 385 by 2020/21. We aspired to achieve a water industry leading score at or above 400. This year we have achieved a score of 403, out-performing our Delivery Plan target for the year.

Customer Experience Measure

Our Customer Experience Measure (CEM) is a basket of measures which allows us to understand the experience of our household customers and non-household customers. It tracks how well we are listening to our customers and making improvements based on their feedback.

Household customers

We measure household customer experience through the household CEM (hCEM) which was developed with the Customer Forum. This measure is a count of customer contacts, abandoned call rates, the total number of formal complaints and regulatory upheld complaints received combined with satisfaction with transactions. It also includes customers who have had an experience and not been in touch or had no experience at all other than receipt of our services. 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 2018/19, we recorded our highest ever hCEM score of 87.54, an improvement of 1.18 points. We have delivered improved customer experience every year since the measure was introduced in 2015/16.

Non-household customers

We also measure non-household customer and developer customer experience through the non-household CEM (nhCEM). Similar to the household measure we count contacts, formal complaints, regulatory upheld complaints and issues that have been processed through the formal escalation process. In addition to these counts we also measure satisfaction from LPs, the Developer community and business end user customers who have been in touch directly with Scottish Water. Although nhCEM is a fairly new measure it is already driving real change and delivering benefits to our non-household customers.

Social and relationship capital highlights



Highest ever household Customer Experience Measure score

87.54



More than 70% of our suppliers are Small Medium Enterprises

70%



We have a network of 10 Top Up Taps installed across Scotland so far and 64% of customers surveyed are now regularly carrying a reusable water bottle¹

64%

¹ Research from YouGov

Social and relationship capital continued

In 2018/19, we have seen significant improvements in our nhCEM scores, an improvement of 4.24 achieving a best ever score of 81.74. There are improvements in satisfaction of all the customer groups surveyed, noting very high levels of satisfaction from the LP community. Significant improvements have also been recorded in satisfaction of the Developer community and Business End User customers – business retail customers of LPs – these followed a specific focus on improvements to both customer groups.

Delivering excellent customer service
Which? Scotland Consumer Insight Report, consistently reports 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 through our service and investment activity.

Written customer complaints have continued to fall this year, reaching their lowest ever level, with a 28% reduction in 2018/19. 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. In the year, we saw 200% more GEM nominations than we did formal complaints coming in from customers, a positive endorsement of the efforts of our people.

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 78.1. This means we have out-performed the Utility Sector (73.8 overall average) by 4.3 points and the Water Sector (74.5 overall average) by 3.6 points. This is recognition of our improving service and sees us second only to one other company in the water sector.

Drinking water quality
Ensuring the people of Scotland receive high quality, clear, fresh drinking water is one of our primary responsibilities. We take source water from rivers, lochs, reservoirs and boreholes and treat it to ensure it is of high quality and ready to be distributed to homes and businesses. We have a vital role in managing the natural environment.

The quality of water at customers' taps in 2018 was marginally lower at 99.90%, compared with 99.91% achieved in 2017. The marginal decline was in part, related to weather challenges, very cold in March and very dry with water resource issues in the Summer.

At our reservoirs, treatment works and on our network, we are continually working to maintain and improve the quality of this essential service. In order to measure our performance in water quality in 2018, we carried out over 307,000 quality tests on regulatory samples from our water treatment works, service reservoirs and customers' taps across Scotland. 99.92% of all quality tests on regulatory samples during 2018 met strict microbiological and chemical regulatory standards, remaining at the same high level achieved in 2017.

Responding to incidents

In the past year, our teams have worked to maintain services, reduce the impact of interruptions or to restore normal service as quickly as possible where disruption had been experienced. This is often done in challenging conditions.

In January 2019, customers in parts of the north and north-west of Glasgow, Bearsden and Milngavie were affected by a burst on a 36-inch trunk main which caused a loss of normal supply and flooding of 19 properties.

Our teams worked to restore normal supplies as quickly as possible and worked with other agencies to ensure customers affected by flooding received the support they required.

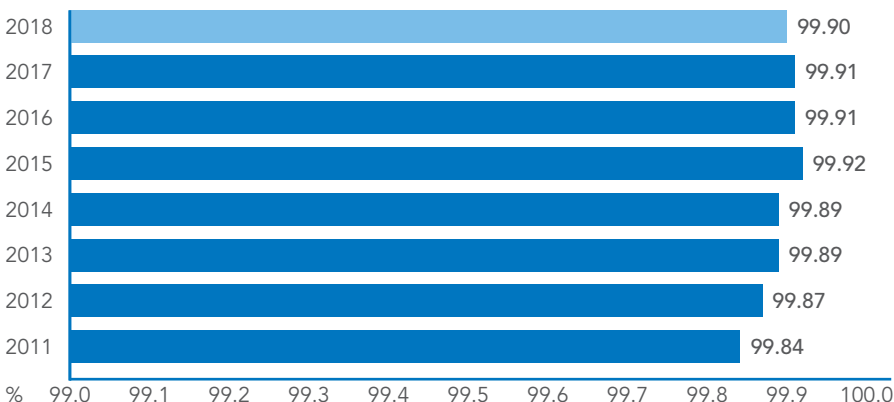
Flooding

The reduction of flooding and pollution from sewers remains a key area of focus and one of our customers' highest priorities.

We have made good progress against our commitment to address internal flooding for those customers at highest risk – those customers with a 10% or greater chance per annum of internal sewer flooding. In total, 101 properties were removed from the internal sewer flooding register in 2018/19.

We have continued to develop and promote schemes for customers who were on the internal sewer flooding register at the start of the 2015-21 regulatory period, helping to tackle longstanding flooding problems. Of the 302 properties on the register in March 2015, we have successfully removed 151 of these. We have also developed and promoted a number of schemes for problems that have emerged during this period.

Clear, fresh drinking water – tap water quality



The causes and solutions for internal sewer flooding are often very complex and expensive. Examples of projects to address internal sewer flooding are:

- **Haymarket Terrace, Edinburgh** – upgrade of the brick Victorian sewer, which was at capacity, with a new 1.2 metre diameter sewer. The complex project was planned in detail with the City of Edinburgh Council to minimise traffic and business disruption.
- **Oak Mall, Greenock** – the second phase of the delivery of the project protected a further 46 commercial properties at the mall complex. We have worked closely with Inverclyde Council to manage road closures and traffic management. This brings total properties protected by this project to 69.
- **Shieldhall Tunnel** – this project provided significant environmental benefits to the River Clyde and reduced the risk of sewer flooding. The tunnel also enabled a number of ancillary projects including the Aikenhead Road/Curtis Avenue project, which reduced the risk of internal and external sewer flooding to 12 properties. A further project at Robslee Drive, Giffnock, will deliver environmental benefits and reduce the risk of internal sewer flooding to 17 properties.

Communicating with customers

We recognise the value of social media and digital channels for communicating with our customers and communities across Scotland. Their use continues to increase as we seek to improve the information we provide to our customers.

During 2018/19 we received almost one million contacts from customers on our main communication channels – telephone, email, web portal, Twitter and Facebook and website. This included more than 307,000 telephone contacts. By the end of March 2019, our Scottish Water social media channels had a total of over 78,000 followers across Scotland.

Wholesale services

The retail market for water and waste water services gives business customers a choice of retailer. Scottish Water plays a key role in the market as the wholesaler, collaborating with all participants and leading market changes to facilitate the effective operation of the market.

Over the last year we have supported the WICS changes to the market framework and we continue to support its market review.

During 2018/19, the number of companies licensed to provide water and waste water services to business customers in Scotland increased from 25 to 30. A full list of companies providing services to business customers is available on the WICS website and on the 'Scotland on Tap' website.

The market in England and Wales opened on 1 April 2017. We benchmark our operational and transactional performance against wholesalers in that market and are at the forefront of performance across the two markets. We seek to learn from best practice by both wholesalers and retailers in the market in England and Wales.

Our market performance is measured by a basket of performance indicators. Our performance against the target over the year was 98.4% which is the best ever, exceeds the corporate target of 95% and continues our year on year improvement. In 2018/19 the Scottish Government implemented a policy change to begin using current rateable values in water charging. We are working with the Customer Forum and other stakeholders to plan for further improvements to LPs' and customers' experience of Scottish Water as the wholesaler for the 2021-27 period.

Social and relationship capital continued

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 targets, apart from in three areas. The principal area that was behind target is as a result of choices we made to allow us to more effectively manage the resilience of the supply of drinking water to customers served by the Amlaird system in Ayrshire.

Objective	Programme area	2018/19 Year end target	2018/19 Year end actual	Programme delivery status March 2019
Improving drinking water quality and reliability	Number of water treatment works improved	12	10	Behind target
	Number of zones made compliant with iron and manganese standards	33	38	Ahead of target
	Number of improvements to reliability of supply (catchments and treatment)	8	12	Ahead of target
	Number of improvements to reliability of supply (networks and storage)	9	22	Ahead of target
	Distribution mains cleaned (km)	364	564	Ahead of target
	Number of water quality etc., studies to inform future periods	223	263	Ahead of target
	2010-15 outputs planned to complete in the 2015-21 period	14	13	Behind target
Improving drinking water security of supply	Water supply resilience strategy and improvements made	9	12	Ahead of target
	Number of zones with improved security of supply (SOSI)	4	4	On target
	Number of security measures and improvements to the infrastructure of critical reservoirs	118	460	Ahead of target
Protecting and enhancing the environment	Number of WWTWs improved to meet UWWTD	21	21	On target
	Number of waste water networks improved to meet UWWTD	21	29	Ahead of target
	Number of improvements required to meet UWWTD – Glasgow completion	61	61	On target
	Number of improvements required to meet the Water Framework Directive	11	2	Behind target
	Studies to inform requirements under the revised Bathing Waters Directive	2	8	Ahead of target
	Number of environmental studies to inform future periods	32	66	Ahead of target
	Number of improvements required by the Compliance Assessment Scheme; odour reduction and sludge management	24	31	Ahead of target
2010-15 outputs planned to complete in the 2015-21 period	12	13	Ahead of target	
Improving flood risk management	Reservoirs Act – Number of improvements to dams	24	36	Ahead of target
	Flood Risk Management Act – models and integrated catchment studies	66	140	Ahead of target
Supporting economic development	Number of new connections to households and businesses	Demand driven	90,169	Demand driven
	Delivery of new waste water capacity for 73,290 people	Demand driven	6,002	Demand driven
	Number of first time non-household meters installed	Demand driven	12,793	Demand driven
	Number of business (or non-household) meters replaced	Demand driven	47,600	Demand driven
Mitigating climate change	Number of climate change vulnerability assessments	57	59	Ahead of target
Improving the long-term cost of service	Improvements in renewable power and energy efficiency (GWh)	11.0	17.5	Ahead of target

Household charges

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

In April 2019, household charges increased by 1.6% – around £6. This means the average Scottish Water household charge in 2019/20 is £369. This is £46 lower than the average charge in England and Wales.

Income from household charges helps to pay for our investment programme which, between 2015-21, 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 WICS as part of a six year agreement between Scottish Water and the Customer Forum. In the five years from 2015/16 to 2019/20, Scottish Water household charges have increased by 1.6% each year.

Supporting the economy

Our capital investment programme together with operational expenditures makes Scottish Water a significant contributor to the country's economic wellbeing.

Working with our suppliers

Our business and procurement strategies are aligned with the Scottish Government's ambition to create a greener and stronger

economy and our supply chain contributes to boosting Scotland's economy.

We spend more than £600 million annually on goods and services, through 173 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 business. Our supply chain ranges from local suppliers in Scotland to 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 large and complex projects, while rural contractors and operational alliances support smaller value asset repair and replacement work. More than 70% of our suppliers are Small Medium Enterprises (SMEs). 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 investment programme, the majority within Scotland and the UK. These jobs cover areas such as construction trades, manufacturing skills and, increasingly, digital skills.

Working with developers

Scottish Water continues to demonstrate our commitment to supporting a flourishing Scotland with a number of new initiatives

launched during the current investment period. A new team dedicated to modelling all existing water and waste water networks where future development is planned is now in place. Local Authority planning data is being mapped using hydraulic modelling software to allow us to plan for future infrastructure up to and exceeding a 20 year time horizon. In addition, similar approaches are being taken in relation to growth requirements at our water and waste water treatment works where plans are now being finalised for the next investment period taking into account the needs of Local Development Plans.

Opportunities for new entrant farmers

In line with Scottish Government policy, we recognise how important it is to support a new generation of farmers. Scottish Water is one of a number of organisations that has released land for fixed-term tenancy agreements for new farmers.

Scottish Water made land available to new farmers under Scottish Government's Farming Opportunities for New Entrants Scheme at Whiteadder Reservoir in the Lammermuir Hills, East Lothian and at Ballater, Aberdeenshire. Two new tenant farmers took up their respective occupancies in early 2019.

Communities matter

We recognise the wider role that Scottish Water plays in helping to create flourishing communities throughout the country. Our involvement in activities which extend beyond supplying water and managing waste water helps to strengthen the relationship with our customers and communities.

Your Water Your Life

In June 2018, our Your Water Your Life campaign was launched to encourage people to carry a refillable water bottle when they are out and about and to top up from the tap. The campaign promotes three benefits of drinking Scotland's high quality clear, fresh tap water: it is good for your health, your pocket and the environment.

A key part of the campaign has been the roll-out of a network of Top up Taps in public places to provide free access to drinking water. Top up Taps so far have been installed in Glasgow, Edinburgh, Ayr, Dunfermline, Aberdeen, Inverness, Oban, Dumfries, Milngavie and Fort William. The Top up Taps at Milngavie and Fort William are at the south and north ends of the West Highland Way.

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

Water and sewerage companies	Average household bill for 2019/20
South West Water	£491
Wessex Water	£485
Welsh Water	£444
United Utilities	£441
Anglian Water	£440
Southern Water	£438
England and Wales Average	£415
Northumbrian Water	£409
Yorkshire Water	£401
Thames Water	£398
Scottish Water	£369
Severn Trent Water	£354

Social and relationship capital continued

We have also partnered with a number of businesses who are happy to provide tap water to anyone who wants to top up a refillable bottle. These include the Fairmont Hotel near St Andrews, Buchanan Galleries shopping centre in Glasgow and Edinburgh Airport.

A further 60 Top up Tap installations are planned across Scotland over the next two years. This supports the Scottish Government's Programme for Government commitment to introduce a network of public water refill points across Scotland.

The Your Water Your Life campaign is already having an impact on behaviours, with research carried out by YouGov showing those regularly carrying a reusable water bottle in Scotland has increased 6% in the last year to 64%. In April 2019 our Your Water Your Life campaign won the UK Public Sector category at the Drum Awards.

Saving water in Scotland

During the summer of 2018, we also ran our Use Water Wisely campaign encouraging customers to reduce their water usage. Through engaging with our customers and communities, we played a positive role in helping reduce demand.

As well as our Use Water Wisely campaign, we also have a year-round initiative, in partnership with the Energy Saving Trust encouraging people to use water efficiently. The initiative, called Saving Water in Scotland? Really? involved delivering over 18,000 water saving packs throughout Scotland, including tap aerators and shower timers to save water in the kitchen, bathroom and garden.

Building on the success of a pilot in Galashiels in 2017, we have been working closely with a number of communities, including Dunkeld and Birnam and Barra to encourage water efficiency. We have also worked with Climate Challenge Fund groups across Scotland, to help deliver carbon savings through water efficiency. Our website features an interactive water use calculator and a range of films which provide advice on how to use water wisely in the kitchen, bathroom and outdoors.

A water efficiency trial covering 2,000 homes has highlighted that the provision of advice and devices can deliver water savings. We are committed to better understanding water use in and around homes and will continue to promote more efficient use of water.

Keep the Cycle Running

The Keep the Cycle Running campaign has continued to raise 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. We encourage everyone to only flush the 3Ps – pee, poo and paper – down the toilet. Since this campaign started in 2013, the number of blockages has reduced from 40,000 to just under 35,000 a year.

In 2018/19, we launched a pilot project in St Andrews to tackle fatbergs. The project involved sewer experts visiting food service establishments, including fast food outlets, cafes and restaurants, over a six-month period to provide advice on how to properly dispose of fats, oils and grease (FOG) to reduce the number of blocked drains and sewers. During the year, we visited 170 food service establishments and business owners are taking steps to make improvements. We also launched a local Keep the Cycle Running campaign in Midlothian to help raise awareness about the impact that flushing wet wipes and other bathroom waste items, including sanitary products, can have on local rivers and burns. We have worked with local stakeholders including the local authority and local primary schools to help spread campaign messages to pupils, parents and carers and the wider community. Pupils took part in a poster competition and their entries were used to help promote our campaign messages and influence bathroom flushing behaviours.

Learn to Swim

The Learn to Swim programme, a partnership between Scottish Water and Scottish Swimming, has continued to roll-out across more local authority areas in 2018/19. During the second year of our three year partnership more than 78,000 Scottish children, including over 10,000 pre-school age children, participated in swimming lessons to become safe, competent and confident swimmers.

The programme is now delivered by a total of 37 Leisure Trusts and Aquatic Providers in around 150 pools across Scotland from Shetland to Dumfries and Galloway. The programme helps to create quality learning environments for children from birth upwards where they can become competent swimmers with opportunities to progress through the aquatic pathway to club swimmer level or to continue to swim for fun. Launch events have taken place in Glasgow, Shetland, Cumbernauld and Falkirk during 2018/19.

Para swimmer Toni Shaw, the youngest athlete to compete for Scotland in the 2018 Commonwealth Games, joined Olympic swimmer Duncan Scott in 2018 as an ambassador for Learn to Swim to inspire the next generation of young swimmers.

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 their vision to provide everyone, everywhere with clean water, decent toilets and good hygiene by 2030. In 2018/19, Scottish Water employees raised over £190,000, through fundraising, to support two Scottish Government funded projects in Rwanda and Malawi. Projects include the construction of school toilet blocks and rainwater harvesting tanks and aim to improve the health of women, adolescent girls and under-five children.

Volunteering

In 2018/19, 535 individual employees dedicated 4,159 working hours of their time to educational, charitable, environmental and community projects across Scotland.

Each employee is entitled to up to two 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 supports employees to use their volunteering time to 'adopt' and survey a local beach. This has resulted in 56 beaches being adopted. This data is sent to the Marine Conservation Society to be recorded and contributes to its ongoing Beachwatch programme.

Consumer education

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

Our educational resources and activities, based on the requirements of the Curriculum for Excellence, and our online games and free apps for mobile devices are great ways to educate school pupils and their families about our essential services.

Community Empowerment (Scotland) Act 2015

During 2018/19, Scottish Water received a number of enquiries regarding Asset Transfer Requests from Community Transfer Bodies under the Community Empowerment (Scotland) Act 2015. One of these has led to an agreement being reached between Scottish Water and a community group for the transfer of a redundant asset.

Natural capital

Scotland's natural environment is one of its greatest resources. It is critical to our ability to provide over one billion litres of high quality clear, fresh drinking water each day and we play a key role in taking more than 900 million litres of waste water and returning it safely to the environment.

We seek to carry out our activities in ways which protect and, where possible, enhance the natural environment, for example through the responsible management of our land, by reducing our carbon emissions and by increasing the renewable energy that we generate.

Overview

The weather challenges of 2018 that directly impacted on our activities also had knock-on impacts on the natural environment. These included:

- the requirement to abstract water from lochs, rivers and aquifers that we do not normally take water from;
- challenges in waste water treatment processes because of changes to the make-up of waste water; and
- an increase in leaks in our networks due to movement of pipes in very dry ground.

Despite these challenges we were able to continue to deliver high quality services to customers while also continuing to protect the natural environment.

Climate change adaptation

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 continue to develop our understanding of the impact of extreme and unpredictable weather events on our assets, infrastructure and the essential services we provide to our customers by assessing current

and future risks in several ways. This includes: climate change risk assessments; vulnerability assessments which are incorporated into our 25-year Water Resource Plan; Integrated Catchment Studies; and asset flood risk assessments.

We are also developing a waste water resilience strategy, the aim of which is to identify and undertake mitigation and adaptation measures to enhance our resilience to future climate change. We recently signed a Sustainable Growth Agreement with SEPA, under the terms of which we will work together to explore new and innovative ways to manage resilience in rural and urban drainage catchments. We also contribute action on a number of objectives in the Scottish Climate Change Adaptation Programme.

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.

Our operational carbon footprint for 2018/19 showed a reduction of 13% since 2017/18. Overall, our footprint has fallen by 41% since we first reported it in 2006/07¹.

The most recent figures available show our water service continues to have one of 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 and Scotland's geography. The carbon intensity of our waste water service is around the UK average.

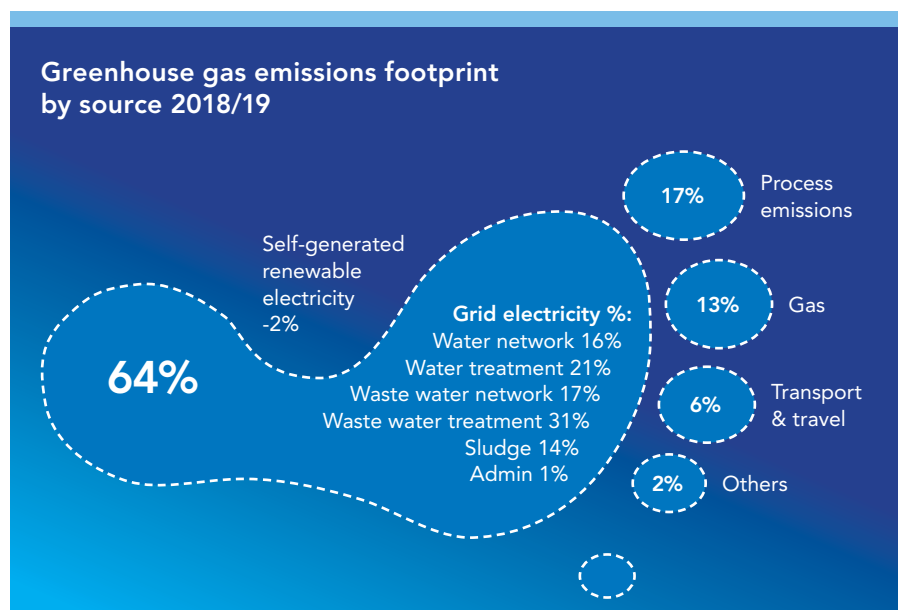
We have developed a Capital Carbon Accounting Tool. This enables the carbon emissions associated with our biggest capital projects to be measured, providing more opportunity for them to be reduced.

Sustainable land management

Sustainable Land Management helps to protect and improve water quality in our drinking water catchments which supply our water treatment works.

16 catchments that supply water treatment works were visited to assess the condition of the land around watercourses and determine how to improve source water quality.

We worked with private land owners to complete 36 interventions to improve our drinking water catchments in 2018/19.



¹ Due to an error in Sludge calculations, we reported a 10.4% reduction in 2017/18; this should have been 11.4%. Consequently, Process emissions in the 2017/18 footprint diagram should have been 14% instead of 15%, due to rounding. No other numbers were affected.

We assessed 707 activity notifications, 228 of which were within the vicinity of our drinking water sources and 38 deemed high risk in 2018/19. 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.

Leakage management

The water, energy and chemicals it takes to produce high quality clear, fresh drinking water every day has an inevitable impact on the environment. We are fortunate in Scotland that our water distribution system is largely gravity-fed and therefore requires less energy than distribution systems in many other parts of Great Britain. However, the process of treating and distributing high quality clear, fresh drinking water still uses valuable resources and it is important that these resources are used efficiently.

Since 2006, we have worked hard to reduce the level of leakage from our networks and therefore the energy and other resources required to produce and to distribute water. In that period we have been successful in reducing leakage by over 55%.

During 2018/19 leakage levels were significantly impacted by the freezing conditions in March 2018 followed closely by the very dry summer of 2018. This led to increased levels of burst pipes and related leakage. As a result of this we decided part way through the year to invest an extra £1.8 million in detecting and fixing leaks. This investment helped reduce leakage by 12 million litres each day, to our lowest ever. A number of initiatives helped deliver this including improved data, deployment of leak-detecting sniffer dogs and drones. We have also invested in innovative pressure management systems to reduce the risk of burst pipes disrupting customers' supplies and continue to influence UK research and development programmes in leakage management and reporting.

Waste water

In recent years a programme of investment has significantly improved the performance of our waste water treatment works against regulatory serviceability. At the end of 2018/19, 2 of the approximately 600 assessed waste water treatment works failed to meet agreed regulatory serviceability standard for discharge quality, an increase from 2017/18 when we had no failures but still one of our best ever years.

In total, 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.

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

The prolonged dry summer led to a build-up of material in the sewer network due to lower levels of flushing. This led to an increase in blockages when the rain eventually came.

In recent years we have significantly reduced the number of Environmental Pollution Incidents (EPIs), achieving our lowest ever level in 2017/18. It was a year of good performance considering the challenging weather conditions. We reported a total of 219 EPIs. This was 28 more than in 2017/18. Nine incidents were more serious Category 1 and 2 events, an increase of four from the year before. There were 210 Category 3 incidents, compared to 186 in 2017/18.

Natural capital highlights



Since 2006 we have been successful in reducing leakage by over 55%

55%



We achieved our 2015-21 17.5GWh renewables and energy efficiency regulatory target two years ahead of target

17.5^{GWh}



We currently purchase 17% of our electricity consumption from low-cost green energy production in Scotland.

17%

Natural capital continued

Bathing waters

Scotland had 86 bathing waters officially designated for 2018, of which 73 could potentially be affected by Scottish Water assets. SEPA reported that during summer 2018 10 out of Scotland's 86 bathing waters failed to comply with the 'sufficient' standard of the revised Bathing Waters Directive (rBWD); and that six of these have the potential to be impacted by Scottish Water assets.

Overall 88% of Scotland's beaches met the minimum rBWD water quality classifications. 28 bathing waters met the 'excellent' standard, an increase from 25 in 2017/18.

Significant investment and study work has been undertaken in partnership with SEPA over recent years to support bathing water quality improvements 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, Fisharrow, Rockcliffe; and Ayr South.

Energy

In March 2019, we successfully achieved our 2015-21 17.5GWh renewables and energy efficiency regulatory target, two years ahead of target which enables the programme savings to be maximised.

Our approach to energy management and development is focused on:

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. In 2018/19, 831GWh of electricity was generated by wind turbines or wind farms on our land and 0.7GWh of electricity was produced by hydro-electric generation.

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 ambition to maximise value from Scotland's water resources, 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.

Reducing consumption

We have made changes to operational practices and our asset base to reduce energy 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. We have installed over 4,000 electricity smart meters at our treatment works to measure the electricity supply into our assets to ensure we get accurate electricity bills, to identify periods of high demand and to collect other data that may enable us to target further energy efficiency opportunities.

Energy management and efficiency will play a key role in future years as we attempt to reduce our operating costs and carbon footprint.

Increasing self-generation

Since 2013, we have increased the renewable generation capacity on assets we own to 63GWh/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, 44 solar schemes, four CHP plants (including the Scottish Water Horizons Deerdykes plant and the recently purchased Nigg Waste Water Treatment Works), and three 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 currently purchase 17% of our electricity consumption from low-cost green energy production in Scotland. Electricity is purchased from the Burn of Whilk Wind Farm in Caithness, Millerhill Anaerobic Digestion Plant in Edinburgh and from a privately-owned renewable Anaerobic Digestion Plant adjacent to Girvan Waste Water Treatment Works. In 2018/19 we also started to purchase low-cost green energy from a local community owned renewable asset on the Fair Isle.

Electric-powered vehicles

We launched a trial of fully electric-powered sampling vehicles to the Scottish Water vehicle fleet and now have charging points at numerous sites across Scotland as part of our drive to help reduce carbon emissions. Equipment on board these vehicles needed to store water samples at specific temperatures is being powered by roof-mounted 150 watt solar panels. This is part of a broader drive to accelerate Scottish Water's contribution in support of the Scottish Government target of net-zero greenhouse gases by 2045.

Knowledge partnerships Sustainable Growth Agreement with SEPA

In June 2018 Scottish Water and SEPA signed a Sustainable Growth Agreement (SGA) outlining joint areas for innovation in driving more sustainable environmental protection. This aligns with SEPA's One Planet Prosperity strategy. Under this Agreement, Scottish Water and SEPA are committing to develop, trial and then seek to deliver (with partners) innovative ways of:

- Managing rainwater and waste water drainage to help protect the social, economic and environmental wellbeing of Scotland's towns and cities in a changing climate;
- Maximising the recovery of resources from Scotland's waste water and putting them back into a circular economy; and
- Making choices about how to invest in protecting the quality of Scotland's water environment that minimise energy and resource use and maximise social and economic benefit now and for the future.

Edinburgh and Lothians Drainage Partnership

A partnership to transform how we think about long-term growth and the management of surface water across Edinburgh and the Lothians was launched in 2018/19. Scottish Water, Scottish Government, SEPA and City of Edinburgh, Midlothian & East Lothian Councils have joined forces to enable a growing, sustainable and resilient region. We will work together to find innovative and effective ways to deliver growth and implement an integrated drainage plan for waste water and surface water flows for the region.

Human capital

The capacity and attributes of our people is a key enabler of our success. The contribution of our people and our ability to develop them is directly linked to our ability to deliver our services, for example to deliver a leading customer experience, as well as deliver against our vision of being trusted to serve Scotland.

Overview

At the end of March 2019 we directly employed 4,276 people and a further 404 temporary agency workers. We also rely upon an extended network of people who work with our supply chain and partners to help deliver our capital investment programme.

Ensuring the safety, health and wellbeing and development of our people is important to us. From recruitment through to retirement, we seek to deliver a positive employee experience and to be considered an employer of choice.

Our services are delivered around the clock every day of the year and the continued support of our employees is essential if we are to meet our customers' needs and expectations. During 2018/19, the response of our employees to day-to-day issues and significant incidents was a key part in ensuring we continue to be trusted to care for the water on which Scotland depends.

This year we are proud to be recognised as a Times Top 50 Employer for women.

People

We require a diverse group of employees with a broad range of skills and experience. We employ people across Scotland in areas such as science, engineering, operations delivery, finance, regulation, customer service, project management, information technology and asset management.

We also have a small number of people working overseas, leveraging Scottish Water's knowledge and capabilities to deliver for clients in Ireland and Australia. We are proud to continue to be a Living Wage (livingwage.org.uk/) accredited employer.

Safety, Health and Wellbeing

Safety, Health and Wellbeing is one of our highest priorities. Our expectation is that our people will return home safe and well every day. We have an integrated safety, health and wellbeing strategy which looks to lead the industry in Scotland on a journey to zero harm and create safe, healthy and productive workplaces where our people can meet their potential.

Health and Safety

The Scottish Water and contractor combined reportable injuries rate has reduced from 112 to 56 comparing favourably with other sectors. Whilst it is positive to see a reduction in injuries, no level of injury is ever considered acceptable.

Under the UK Health and Safety's Reportable Injuries Diseases Dangerous Occurrences Regulations (RIDDOR), Scottish Water reports all specified injuries, lost time injuries involving more than seven days lost time, work-related diseases and certain types of incidents not involving injury known as dangerous occurrences. The number of recordable Injuries (RIDDOR, lost time and medical treatment) also reduced from 17 to 15. The number of RIDDOR injuries reported by Scottish Water reduced from 11 to 4 in 2018/19.

As part of our increasing focus on our responsibility towards vulnerable people, we are taking a more proactive approach to safety incidents which involve members of the public. We identified four in 2018/19. All events are an important opportunity for learning, particularly as injury to customers often affects those who are elderly or vulnerable.

Keeping people healthy

Keeping our employees healthy is key to our success. In 2018/19, we increased our focus on occupational health testing across numerous locations and our understanding of risk exposure, including the review of over 250 job roles in 2018.

We recognise the benefit of health-screening and have increased the locations which offer this. Over 650 employees took up the offer.

During 2018/19, the proportion of time lost to employee absence in Scottish Water was 2.71% a reduction from 2.87% in 2017/18.

Human capital highlights



We employ 4,276 people and a further 404 temporary agency workers.

4,276



The Scottish Water and contractor combined reportable injuries rate has reduced from 112 to 56

56



Women now make up 28% of our workforce

28%

Human capital continued

Helping people thrive

Our approach to wellbeing is centred on our vision and values, being part of something meaningful and supporting active engagement in life and wider society.

We have a network of 100 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 important to our employees. Alongside the range of working patterns and family-friendly policies, we remain committed to ensuring workspaces are agile environments and our employees have access to the appropriate equipment, tools and technologies to enable agile working.

Our volunteering programme (see further information on Volunteering on page 25), allows each employee two 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

Diversity is an opportunity for our customers, employees, suppliers and our business. Ultimately, we believe we should be reflective as an organisation of the customers we serve. By valuing diverse perspectives, we can better serve our customers and help employees achieve their professional objectives. A corporate culture that is open and inclusive is fundamental to striving for excellence in all that we do.

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. For more information go to: www.scottishwater.co.uk/equalitydutyreport

We want all employees to feel that they belong at Scottish Water, and to feel valued for their differences and contributions. We encourage individuals with shared interests to form self-organising and governing networks and have seven established groups in place: Women in Scottish Water; Nxt Gen (for people early in their careers); LGBT and Allies; Disability Forum; Carers Support Network; Armed Forces Network and the Multicultural Group.

During 2018/19 we achieved Carers Exemplary Status, the highest level of award through the Scottish Government Carers Positive Scheme.

We currently hold the Defence Employer Recognition Scheme Bronze level award for our commitment to supporting serving and former military personnel and their families and the Armed Forces Network group are currently working on Gold level submission.

Resource management

We engage a number of people through agency contracts, allowing greater flexibility to resource projects and access to specialist skills. The table below sets out the number of agency workers at the end of 2018/19. HM Treasury procurement guidance for public appointments broadly defines 'off payroll' workers as those paid £220 or more per day for contracts that last longer than 6 months, so we have used this definition to report the numbers below.

Scottish Water engages a number of companies to deliver services in areas such as cleaning, catering, traffic management or grounds maintenance. Such contracts do not specify the workers who will deliver each service 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. We support the Scottish Government's expectation of no compulsory redundancy and where an employee's role does become 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 wishes to 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 (Scotland). Any payments made for voluntary redundancies or flexible/early retirements are recovered through cost savings on average within two years. The table on page 31 sets out the exit packages made in the financial year 2018/19.

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 ¹	8	21	10	14	59

¹ Off payroll worker data in the Scottish Water Annual Report 2017/18 was found to be incorrectly grouped by service length, despite being correct in aggregate. The grouping error has been corrected this year and in 2017/18 the numbers across the service groups should have read 19, 17, 22, 15, 62.

Human rights, dignity and respect

Scottish Water is committed to respecting human rights. We expect and require 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. In 2018/19, our Dignity at Work policy was refreshed to further clarify how concerns raised are recognised as different from other types of complaint and so are investigated with appropriate sensitivity and protections for those involved.

Scottish Water aims to provide and maintain a working environment that ensures everyone is treated with dignity and respect. Bullying, harassment, discrimination and victimisation are unacceptable behaviours and are not tolerated. All employees, managers and third parties are responsible for creating a working environment in which dignity is maintained. Scottish Water promotes an open and honest relationship between management and employees and commits to treating all allegations promptly, seriously and confidentially. While any breach of these standards will trigger an investigation that may result in disciplinary action up to and including dismissal, our primary aim is to draw attention to, and therefore prevent, all forms of unacceptable and inappropriate behaviour which do not support dignity at work for all.

Bribery and corruption prevention

Within the past two years, 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 and this plan is repeated on an annual cycle. For topics such as Fraud and Bribery and Corruption, mandatory compliance training is routinely undertaken by appropriate role-holders, with completion tracked and refresher training undertaken at regular intervals. In addition, there is an externally supported whistleblowing facility.

Gender pay gap

In March 2019 Scottish Water's median hourly base pay for full time men was £14.64 and for full time women was £15.26, a base pay gap of 4.23% in favour of women.

Gender pay gap legislation that applies in the UK private sector requires pay comparisons be made between the contractual pay of men and women including base salary, paid leave, pay allowances, shift pay and on-call and standby payments. Although Scottish Water is a public corporation, for transparency we have adopted a reporting approach of disclosing our gender pay gap in line with the private sector calculation, but using the two-year frequency of Public Sector Equality Duties (PSED) reporting, last updated April 2019.

Under this calculation Scottish Water has a gender pay gap in favour of men at both mean (6.4%) and median (2.6%), compared to the gender pay gaps reported in 2018/19 for Scotland (15%) and the whole UK (18%).

Our gender pay differences reflect distribution by job role and grade, while overall occupational gender segregation remains the most pertinent issue affecting pay. Our gender demographics mean that large numbers of men are employed in roles that require the provision of work outside normal hours, and which therefore attract associated additional contractual payments.

	Number of employees	Total cost £000s	Average cost £000s
Early Retirement and Voluntary Severance	34	175	5
Flexible Retirement ¹	45	145	3

¹ During the year there was only one case of voluntary severance. Flexibly retired employees continue to work in Scottish Water until their agreed exit date, typically 1-3 years after beginning flexible retirement.

Intellectual capital

Intellectual capital highlights



We have 166 apprentices in training

166



We employ 54 graduates on structured development programmes

54



In 2019 we signed up to the Procurement Skills Accord



PhD research projects across the business

21

The collective skills and knowledge of Scottish Water is key to our ability to deliver our services. The experience of our people is difficult to place a value on but is as important to our effective operation as our infrastructure.

As the challenges we face change, for example from the impacts of climate change, or the increasing demands placed upon us by our customers, we must continue to develop the knowledge and experience of our people and the organisation as a whole in order to keep pace.

Overview

We are always seeking to improve the services we provide to customers and communities through the adoption of new technologies and ways of working.

During 2018/19 we have progressed a number of initiatives, many in partnership, to help us achieve this objective.

Building capability

We want all employees to reach their full potential by developing their skills, talents and experiences, and to equip them to deal with changing working practices and technologies including our evolving needs as a business.

The development, retention and management of our employees and of our future talent pipelines are an integral part of the way we build our future capability.

Our ability to attract and retain the next generation of people to work in Scottish Water is vital to our future success and sustainability. We are proud to be recognised with the Investors in Young People Gold Standard, for our continued 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 strive to create the capacity for our youth pipelines to grow by supporting more flexible forms of retirement for our valued and experienced employees. We are actively using

the full range of apprenticeships in Scotland through foundation apprenticeships, graduate apprenticeships and modern apprenticeships.

We currently have 166 apprentices in training with us and have already commenced recruitment for a further 40 modern apprentices and 11 foundation apprentices to join us in 2019. We currently employ 54 graduates on structured development programmes and we will recruit a further 11 in 2019/20. In addition, we offer a number of paid three-month internships each year for those from Science, Technology, Engineering and Maths (STEM) backgrounds.

Our Future Leaders Programme, a two-year development programme has created a pipeline of talent with the agility and flexibility to adapt to new and emerging leadership roles in the workplace as well as developing people who will lead our more specialist and technical areas of capability.

In addition to our structured talent pipelines, we provide wide-ranging development opportunities for all our employees to grow and develop. This may be through the pursuit of further or higher education, the development of digital or interpersonal skills or broader life skills related to personal and financial wellbeing and resilience. We have an extensive multi-media digital learning portfolio to enable learning as and when this is required.

Our technical skills academies have been designed to develop specialist water industry skills while simultaneously passing on knowledge and wisdom from our experienced employees who serve as trainers within our academy faculties. Our aim is to create a legacy of skills, knowledge and experience and to integrate experience and wisdom with youth.

In 2019, we signed up to the Procurement Skills Accord, the Energy and Utility sector's approach to transforming skills delivery through procurement. The Accord has five commitments requiring companies to drive skills development within their own business and to encourage their supply chain to do the same. It focuses on formal training programmes, targeting areas of current and future technical skills shortages, to ensure impact in the right place.

This Skills Accord builds upon our existing supply chain collaboration which has so far seen 210 Modern Apprentices and 207 Graduate Trainees entering into training programmes with our supply chain partners in the 2015-21 regulatory period.

Innovation

All of our innovation activities are focused on finding solutions to challenges within our organisation. For example the impacts of climate change and the increase in micropollutants are issues that require us to try new and different technologies and approaches. We work collaboratively with our stakeholders, supply chain, academia and the wider water industry to develop our own innovation capacity and that of the sector.

Research and Development

Our Research and Development programme is focused on finding solutions to challenges in our organisation. We work collaboratively with stakeholders, including the Scottish Government, our supply chain, academia and the wider water industry to build our own research and development capacity and that of the sector.

The themes of the programme are: sustainable rural communities; exemplary compliance; value recovery from waste; and reducing economic levels of leakage. In 2018/19 there were 21 PhD research projects ongoing across different areas of the business, some are directly funded and others funded externally and supported by Scottish Water. Ongoing projects include:

The CAN DO Challenge

During 2018, Scottish Water launched an open innovation challenge as part of Scottish Enterprise's CAN DO programme. Open to public service organisations, businesses and universities across Europe, we are seeking solutions to treat high organic surface water to produce safe drinking water on a small scale. The goal is to create a water and waste water service that is truly affordable, resilient and sustainable to even the most remote of our communities.

Phos4You project

The potential of microalgae to recover phosphorous from small-scale waste water treatment plants is being piloted by Glasgow Caledonian University and will be trialed in

partnership with Scottish Water. After harvesting, the biomass, containing nitrogen and phosphorus containing biomass can be used directly as fertiliser.

Process intensification

We are testing new technology (Microvi MNE) at our Innovation Test Centre at Bo'ness. The process uses biocatalysts to intensify biological processes which, if successful, could help Scottish Water meet tightening environmental standards and enable growth by increasing the processing capacity of the waste water treatment works.

Alternative Media (Filtralite trials)

Rapid gravity filtration through sand has been used extensively for water treatment. New filtration media have come on to the market in recent years and an evaluation project has looked at potential applications of these new media. Recent trials of an expanded ceramic media have shown filtration performance and reduction in the risk of breakthrough. Installation of this media at one of our sites is providing significant performance improvements and has the potential to offset capital investment needs at a number of other water treatment sites.

Ion Exchange

We have evaluated the use of ion exchange resins that absorb dissolved impurities in water. These resins have the potential to absorb organic impurities that conventional treatment processes don't remove. We have evaluated two leading-edge ion exchange technologies, both suited to large-scale water treatment works. One of these processes has now been selected for a major treatment upgrade in Argyll and Bute and ion exchange is included as a treatment option across our investment programme.

New waste water technology

We are proud to be building Scotland's first new waste water treatment works which uses granular activated sludge (Nereda) technology and less chemicals, energy and materials than alternate methods. Further sites where this technology may be deployed are being considered.

Recovering heat from waste water

Scottish Water Horizons are continuing to facilitate the installation of waste water heat recovery projects. During the year, a waste

water heat recovery project at Aqualibrium Leisure Centre in Campbeltown and technical support to a district heating scheme at Clyde Gateway urban regeneration project in Glasgow have been completed.

Scottish Water Horizons has also developed an energy centre in collaboration with Stirling Council to provide power to the local waste water treatment works and deliver heat to a new district heating network being developed by the Council.

Digital partnership

In 2018, a five year strategic digital partnership was formed between Capgemini, Atos and Scottish Water with the aim of increasing the use of technology and innovation in Scotland's water supply and waste water management. The partnership is delivering IT services and technology solutions across our business.

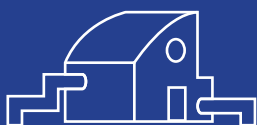
The partnership will also work to improve the reliability and resilience of our networks and systems. Data, information, analysis, digital applications and processes are critical to the delivery of our services.

Scottish Water has taken further significant steps to improve the service we offer to our customers. This will be achieved in part by embracing technology, including several internal and customer facing applications (apps).

- **Onsite productivity app** – The Scottish Water Improving Productivity and Efficiency (SWIPE) smart phone app uses data to drive performance improvement, improve collaboration with suppliers and improve customer and community satisfaction.
- **Remote Inspections mobile app** – Scottish Water undertakes over 22,000 requests for new water connection inspections per year. The app streamlines the inspection process. Customers are no longer required to give five days' notice as the inspection can now be done on the same day. Customers have noted there is a significant reduction in delays to inspections, there is much more certainty to move-in dates to new homes and a faster response time for the inspection. The time to complete an inspection has dropped from 4.5 hours to 15 minutes.

Manufactured capital

Manufactured capital highlights



£660 million has been invested in our assets across Scotland during 2018/19

£660m



2,448 projects are currently being progressed in communities across Scotland

2,448



Along with our alliance partners we have delivered over £19 million of investment through our rural contractors

£19m

To deliver consistently high quality services, we rely on large and complex water and waste water systems, including over 2,000 treatment works and an underground network of over 60,000 miles of pipes. We continually manage these assets and invest in their repair and replacement. We also invest in new infrastructure to support new housing and industry.

Overview

These complex systems vary in age, resilience and reliability. In some areas, our water mains and sewers are well over 100 years old. So it is inevitable that asset failures occur that can cause disruption to customers.

We seek to reduce the risks to the services we provide in the way we manage our assets and mitigate the disruption of asset failures through fast and effective operational response.

This year we have undertaken an assessment of our asset management maturity. This has highlighted that there are activities which are effective and are comparable or better to those in the water sector as a whole. We are now developing an asset management

improvement plan to get all our activities to be fully effective or excellent.

In 2018/19, we invested £660 million on our assets, including treatment works, large-diameter mains, historic sewers and IT. This investment has been aimed at improving customer service, drinking water quality, protecting the environment and supporting economic growth.

Delivering this investment ensures that we can address as many of our asset challenges as possible. Our supply chain and alliance partners play a vital role in the delivery of the investment programme.

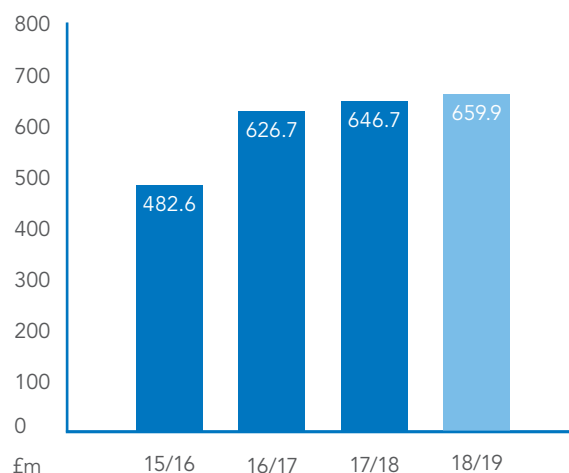
Investing in Scotland's water and waste water

There are currently 2,448 projects being progressed in communities across Scotland.

The investment made in 2018/19, £660 million, builds on more than £8 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 works often cause disruption to communities.

Improving services and supporting the Scottish economy – total capital investment



Wherever possible, we seek to accommodate the views of local communities when undertaking essential investment activities and work with them on delivery of these projects.

Working with our supply chain

Our investment programme is delivered in partnership with our capital alliance partners and our wider supply chain.

We currently have three alliance partners, Caledonia Water Alliance (CWA), amey Black and Veatch (aBV) and Efficient Service Delivery (ESD), who focus on our investment programme. Our in-house team, Managed Delivery, mostly supports smaller value capital maintenance and growth projects.

All of our delivery vehicles are supported by a wider integrated supply chain that includes 13 Tier 1 contractor partners on frameworks specific to each delivery programme. This is augmented by 55 local contractors on our regionally based rural framework, as well as frameworks covering process equipment, civil materials, hire and infrastructure products. In total, we have more than 200 suppliers employing an estimated 3,000 plus people on the delivery of the programme.

Scottish Water and our alliance partners have delivered in excess of £19 million of investment via our rural contractors.

Delivering new investment

Investment activity across Scotland in 2018/19 included:

Western Isles

We are delivering a significant package of investment to improve water quality, increase resilience of water supplies during dry weather and support economic development in the Western Isles. A new water treatment works has been built which provides a single, improved water supply to customers across North Uist and Berneray.

A project commenced in early spring 2019 to deliver an improved water supply to customers in Gobhaig and Huisinis, North Harris. Working to make use of existing good quality resources in the local area, the project will increase capacity to meet the needs of tourism and potential future connections. Smaller projects are nearing completion at Benbecula, North Lochs and West Lewis, with significant projects at an advanced stage of development for Uig, Ness and Tolsta.

Loch Ness

We have started a project to provide a single, improved water supply to about 1,250 customers in the heart of the Great Glen, with enhanced capacity to meet high seasonal demand from tourism. By 2020, a new water treatment works will be in place just south of Invermoriston to provide the area with a high quality and plentiful supply of clear, fresh drinking water from Loch Ness.

Ardersier

Scottish Water is delivering investment to support economic development in the A96 corridor between Inverness and Nairn while protecting the marine environment of the Moray Firth. The investment will enable the existing Ardersier Waste Water Treatment Works to accommodate growth in the local area, with scope for further incremental development in the future.

Inverurie

We are investing in a new waste water treatment works within the existing waste water treatment works site at Inverurie. The investment will ensure the site can meet higher environmental standards in the Don and Urie river catchments and will provide improved capacity for future development. The site will be the first in Scotland to use the innovative 'Nereda' treatment process.

South Edinburgh

A new water supply pipe is being built which will benefit 165,000 customers in and around Scotland's capital. This seven mile pipe, which runs through the Pentland Hills and will ensure a more resilient supply of fresh water in parts of Edinburgh and Livingston. The project will provide a two-way treated water link between Marchbank Water Treatment Works near Balerno and Glencorse Water Treatment Works near the Pentland Hills Regional Park.

Kinghorn

This year we completed a project in Kinghorn, Fife to help improve the bathing water quality at Kinghorn beach. Our teams worked closely with the community, including the local group, Kinghorn in Bloom, to keep them updated while constructing a new storm tank 12 metres deep into the ground.

Melrose to Earlston

We completed a new four mile pipeline which runs between Melrose and Earlston.

This project will ensure that the area receives a more resilient supply, while also helping to facilitate growth in the area.

Paisley

Work is progressing on our project which involves the construction of a one mile long sewer in Paisley. This project will substantially reduce the frequency of spills from the sewer network into the Espedair Burn and White Cart Water in storm conditions, improving the river water quality in the two watercourses and, in turn, the River Clyde.

A total of 15 shafts were installed along the sewer route, with the Tunnel Boring Machines (TBMs), tunnelling between them. In April 2019, the TBM, named 'Tunnelling Tanya' by local schoolchildren, broke through in the town's Saucelhill Park after completing the final section. The project is expected to be completed in summer 2019.

River Kelvin

We are undertaking a major investment project in Glasgow's West End to help improve the environment on the River Kelvin. The project spans 11 sites along the Kelvin Walkway and involves the installation of new and improved waste water infrastructure, including underground Combined Sewer Overflow (CSO) chambers and upgraded pipework. This will help reduce pollution caused by items such as wipes and plastic cotton buds that have been flushed down the toilet which, in turn, may cause sewer flooding and pollution of the River Kelvin during severe storm events.

Oban

We have completed one of our biggest ever investments in Argyll and Bute, with the new Tullich Water Treatment Works. More than 12,000 customers in the Oban area can now enjoy high quality clear, fresh drinking water for years to come.

Glasgow

Scotland's biggest sewer superstructure, the Shieldhall Tunnel, became operational in July 2018. The tunnel will substantially reduce the amount and frequency of waste water discharged from a number of Combined Sewer Overflows (CSOs) and enable more than 90% of what was discharged at these CSOs to be treated at Shieldhall Waste Water Treatment Works before being discharged there and reduce flooding.

Financial capital

Financial capital covers the financial resources that we can access to deliver our services and invest in our infrastructure. Our primary source of finance is revenue from customers but we also access borrowing from the Scottish Government. Sound financial management is essential to provide the other capitals and deliver high quality services for our customers.

Financial summary – group

The group surplus before tax for the year to 31 March 2019 increased by £14.3 million to £86.1 million (2018: £71.8 million). The increase was primarily due to increased profits within Business Stream and Scottish Water.

On 19 December 2018, Scottish Water Horizons Holdings Ltd (SWHH) acquired the companies which operate the North-East Scotland PFI waste water treatment sites, from the Kelda Group for a consideration of £16.2 million (or £5.9 million net of cash balances). The results of these companies are included in the consolidated accounts from that date.

Coverage of the financial performance by entity is shown on pages 37 to 39.

Consolidated revenue in the year increased by £45.1 million to £1,469.1 million (2018: £1,424.0 million). This benefit was accompanied by a £37.3 million increase in costs to £1,214.0 million (2018: £1,176.7 million). Net finance costs of £169.0 million were £6.5 million lower than in 2018.

In the year, consolidated net debt increased by £181.6 million to £3,319.5 million (2018: £3,137.9 million). The increase was driven by additional borrowing from the Scottish Government of £165.3 million and external bank loans within the companies acquired during the year of £44.7 million. Cash balances increased by £28.4 million to £434.8 million. The movement in cash is summarised in the Movement in cash table above.

	Scottish Water £m	Business Stream Group £m	Horizons Group £m	Total £m
Movement in cash				
Opening balance at 1 April 2019	270.6	90.0	45.8	406.4
Cash generated /(utilised)	40.3	(8.5)	(3.4)	28.4
Closing balance at 31 March 2019	310.9	81.5	42.4	434.8

Tax	2018/19 £m	2017/18 £m
National insurance	16.2	15.3
Local authority rates	66.2	64.0
Carbon reduction commitment	2.7	3.0
Land fill tax	0.7	0.7
Apprenticeship levy	0.7	0.8
Normalised annual costs	86.5	83.8

Cash balances within Scottish Water increased by £40.3 million to £310.9 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 £8.5 million over the year to £81.5 million reflecting a dividend paid to SWHH and Business Stream's increased activity in the English market. Cash balances within the Horizons group of companies decreased by £3.4 million to £42.4 million and reflects the acquisition of the North-East Scotland PFI companies.

Taxation

The consolidated tax charge on the income statement was £17.9 million (2018: £13.7 million). Other taxes incurred by the group, and included in the cost base, totalled £86.5 million (2018: £83.8 million) and are summarised in the Tax table above.

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 2019 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 2019, the gross pension liability increased by £73.0 million from £175.3 million to £248.3 million. The increase was driven by a 10.7%, or £193.0 million, increase in scheme liabilities primarily caused by changes in assumptions and experience gains of £131.4 million and a liability increase of £61.6 million as a result of the accrual of further benefits over the year to 31 March 2019. In addition, there was a £120.0 million, or 7.4% increase, in scheme assets, including higher than expected returns of £79.0 million. The impact of these two changes (£131.4 million less £79.0 million) represent the actuarial loss recognised in the pension fund of £52.4 million which, net of deferred tax, represents the £43.5 million charge 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 £7.4 million higher at £83.3 million (2018: £75.9 million). This was as a consequence of increased income and lower finance costs partially offset by significant weather related costs.

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 £1,216.9 million (2018: £1,191.4 million) and is analysed by category in the Regulated revenue table above.

Revenue from services supplied to household customers increased by £20.8 million, or 2.4%, to £881.7 million reflecting the 1.6% tariff increase, effective from 1 April 2018, and the increase in properties connected to the network. Revenue from wholesale services supplied to Licensed Providers increased by £3.1 million or 1.0% to £323.6 million reflecting an average tariff increase of 2%, partly offset by a reduction in consumption by customers. Revenue from other sales increased by £1.6 million to £11.6 million driven mainly by increased land rental income from windfarm developments.

Operating costs

Total operating costs increased by £22.5 million to £961.1 million (2018: £938.6 million). The increase reflects increased regulated costs of £32.2 million, increased depreciation and infrastructure maintenance costs of £10.0 million, partially offset by lower IAS19 pension cost adjustment of £8.3 million and lower PFI costs of £11.4 million.

	2018/19 £m	2017/18 £m	Change £m
Regulated revenue			
Household	881.7	860.9	20.8
Wholesale	323.6	320.5	3.1
Other	11.6	10.0	1.6
Total regulated revenue	1,216.9	1,191.4	25.5

	2018/19 £m	2017/18 £m
Capital investment		
2018/19 investment on a regulatory accounting basis	659.8	644.9
Add PFI capital additions	0.1	1.7
Total capital investment on a regulatory accounting basis	659.9	646.6
Less base infrastructure maintenance included in operating costs under IAS 16	(130.0)	(134.7)
Less investment financed by infrastructure charges & contributions	(26.5)	(18.1)
Company capital additions per note 9 to the financial statements	503.4	493.8

	2018/19 £m	2017/18 £m
Interest charges		
Scottish Consolidated Fund	103.4	100.7
National Loans Fund	40.6	42.8
Public Works Loan Board	3.4	4.7
Other – net	0.8	1.7
Net interest payable	148.2	149.9

On a regulatory accounting basis, operating costs for Scottish Water increased by £32.2 million, or 8.1%, to £428.1 million. The increase was primarily due to: one-off type costs for Digital transition and Brexit preparation costs; higher power prices; new legislative costs associated mainly with GDPR and increased pension contributions; higher bad debt charges; and weather related incident costs. After adjusting for these specific cost increases and the impact of inflation, like-for-like costs reduced in real terms by £5.9 million or 1.5%.

The operating cost of the PFI schemes in the year, including associated depreciation and amortisation charges, was £126.1 million, £11.4 million lower than in 2017/18. The decrease was mainly attributable to settlement of the commercial claim raised in 2016/17.

Depreciation and infrastructure maintenance costs, net of the gain on asset sales, increased by £10.0 million to £389.9 million (2018: £379.9 million) due to the profile of capital investment.

Capital investment

Reported capital investment under IFRS for Scottish Water in the year was £503.4 million (2018: £493.8 million). As measured on a regulatory accounting basis, 2018/19 capital investment was £659.9 million (2018: £646.6 million). The Capital investment table above reconciles investment as stated in the statutory accounts with investment on a regulatory accounting basis.

Financial capital continued

Finance costs

As at 31 March 2019, the weighted average interest cost of the outstanding long-term debt reduced to 3.98% (2018: 4.21%). Net interest payable decreased by £1.7 million to £148.2 million. This reflected the timing of loan repayments and new loan drawdowns during the year, in addition to lower interest rates on the refinancing of debt. Interest charges are analysed as displayed in the Interest charges table on page 37.

Finance costs associated with finance lease liabilities on PFI assets and the interest on pension scheme net liabilities decreased by £2.7 million to £24.3 million (2018: £27.0 million).

During the year, net debt increased by £125.0 million to £3,398.7 million (being loans of £3,709.6 million less cash balances of £310.9 million). The increase was driven by net new borrowing from the Scottish Government of £165.3 million partly offset by a £40.3 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 17.

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 England, including water efficiency, waste water treatment solutions, new connections support, trade effluent consultancy, treatment hire plant and automated meter reading.

Competition in the Scottish and English markets continues to intensify with 30 Licensed Providers operating in the Scottish market and with 49 retailers licensed to operate in the English market.

Performance review

In January 2019, Business Stream announced its planned acquisition of Yorkshire Water's 140,000 non-household customers, which will take place in the autumn subject to regulatory approval. This will help build scale allowing Business Stream to compete effectively in the new national market, firmly establishing the business as one of the top three largest players in the UK market, with sizable opportunities for further growth.

Business Stream has been widely recognised as one of the strongest performers in the English water market, having secured in excess of £250 million of new business in the two years since the market opened, including the UK wide portfolios for Royal Mail, Jaguar Land Rover, Network Rail, Cancer Research UK and Morrisons and securing the Yorkshire Purchasing Organisation (YPO) framework, which was the largest single public sector contract awarded this year.

In England, the market continues to be highly competitive for larger multi-site customers. The operating environment remains challenging for retailers, there are significant issues with the quality of the market data; the wholesale charging structures are complex; and the retail margins available are low. However, there are huge opportunities for growth with over a million customers and £2.5 billion of revenue available and, while the retail margins are currently low, Ofwat has set out initial proposals to increase the margins from 2020 as part of the PR19 price review process.

Financial Performance

Business Stream reported a profit before tax of £1.3 million (2018: £5.2 million loss) for the year. The improvement in performance can largely be attributed to an improvement in collection rates for vacant properties, following the industry wide removal of the charging exemption in April 2017.

Vacant property losses reduced from £5.8 million to a profit of £1.3 million in the year due to a reduction in the level of bad debt provisioning. Collection rates are expected to continue to increase over time as customer awareness improves and tracing and collection activities continue. Changes to the regulatory framework introduced from 1 April 2018 have provided additional mechanisms to improve recoverability; however, these changes do not address the recoverability challenges for all vacant properties.

Expenditure included £3.2 million of amortisation charges in relation to the Southern acquisition. Underlying operating costs reduced by £5.8 million from the previous year, reflecting the reduction in doubtful debt charges associated with vacant properties.

Cash balances remain strong at £40.7 million, although the working capital demand remains high due to the requirement to pay wholesalers in advance of customer receipts. Issues impacting all retailers operating in the English market, such as tariff complexity and the quality of the market data, are continuing to cause some customer payment delays; however steps are being taken on an industry wide level to try and address these concerns.

Future developments

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

Looking forward, the immediate focus will be on consolidating the acquisition of the Yorkshire Water non-household customer book and continuing to provide great service and innovative value for money services for customers across the UK.

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

Business Stream continues to benefit from a strong debt-free balance sheet with significant reserves to fund continued investment in customer service excellence and future growth.

Non-regulated businesses

Our non-regulated business activities are governed and monitored within Scottish Water Horizons Holdings (SWHH) and mainly operate under the Scottish Water Horizons (SWH) brand and include the North-East Scotland PFI waste water treatment operations acquired in December 2018.

The operating profit within this business segment was £0.6 million (2018: £0.9 million). This reflects £0.5 million profit from the North-East Scotland PFI, after charging acquisition costs of £2.1 million, a £0.8 million profit from SWH activities and the charging of costs associated with the Your Water, Your Life campaign and the Learn to Swim programme in partnership with Scottish Swimming.

The main objectives of the business activities within SWH 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.

With effect from 1 April 2018, the activities of Scottish Water International Limited (SWI) were transferred into Scottish Water Horizons (SWH). The activities of SWH 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 that maximise commercial and reputational benefits from Scottish Water's unique skills and market position. In doing so, SWH contributes to Scottish Water's key stakeholder requirements including Scottish Government initiatives such as Zero Waste and the Hydro Nation agenda.

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

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

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 in the Highlands;
- Development of a waste water heat recovery project at the Aqualibrium Leisure Centre in Campbeltown and technical support for the delivery of a district heating scheme at Clyde Gateway urban regeneration project in Glasgow;
- Development of an energy centre, in collaboration with Stirling Council, to provide power to the local waste water treatment works and deliver heat into a new district heating network being developed by Stirling Council;
- Formal launch with our partner organisations of a transnational network of water and waste water test facilities to support innovation within the small-medium enterprise market across North-West Europe;
- Increasing pipeline of research and testing opportunities at our Water and Waste Water Development Centres to support innovation and growth in the water industry;
- A further investment in renewable energy schemes bringing delivered capacity of renewable energy generation since April 2015 to 4.8GWh;
- Australia: supporting South Australia Water with improvements to service interruptions and efficiency of delivering its capital programme, as well as Tasmania with the delivery of treatment facilities to improve water quality;
- Ireland: continued support to Irish Water, Ireland's new water utility, as well as expertise to support the laboratories and trade effluent;
- Malawi: supporting Strathclyde University and the Scottish Government by providing a project management service to help Malawi achieve the United Nations Sustainable Development Goal 6 by 2030; and
- Romania: supporting the WICS with the strengthening of regulatory framework in Romania.

North-East Scotland Waste Water PFI

On 19 December 2018, SWHH acquired the companies that operate waste water treatment works (WWTW) in the North East of Scotland which were being managed under a Private Finance Initiative (PFI) for a consideration of £16.2 million (or £5.9 million net of cash balances). The PFI project consists of the concessionaire, Aberdeen Environmental Services (AES) and the operator, Scottish Water Services Grampian who run the four WWTW under contract to Scottish Water.

The acquisition will enable opportunities for Scottish Water to deliver value for customers through changes including shared purchasing with Scottish Water's waste water operations and optimisation of the works with waste water networks.

Governance

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Board members

Executive Members



Douglas Millican
Chief Executive

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

Peter Farrer
Chief Operating Officer

Peter was appointed as Chief Operating Officer in 2013 having formerly been 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 35 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.

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



Dame Susan Rice DBE

Dame Susan 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 of the North American Income Trust, Non-Executive Director of C Hoare & Co 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.

Samantha Barber

Samantha Barber 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 Sustainable Development 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.

James Coyle

James is a Non-Executive Director and Chairman of the Audit Committee of HSBC Bank Plc, Chairman of HSBC Trust Co (UK) Ltd and Marks and Spencer Unit Trust Management Limited. He is also a Non-Executive Director and member of the Audit and Risk Committees of M&S Bank Plc and HSBC Private Bank (UK) Limited. He is also a member of the Board and Chairman of the Audit Committee of Honeycomb Investment Trust Plc, a member of the Board of Worldfirst and also Chairs its Audit and Risk Committee and independent non-executive member of the Deloitte UK Oversight Board. 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 committees of the Financial Reporting Council, the ICAS Council and a Non-Executive Director of the Scottish Building Society.

Board members continued

Non-Executive Members



Iain Lanaghan

Iain is an experienced Non-Executive Director and former Main Board finance director. He is a Non-Executive Director of Ministry of Defence DE&S and UK Government-owned National Nuclear Laboratory. He is founder and Non-Executive Chairman of Metropolitan European Transport. 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.



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.



Deirdre Michie OBE

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 in the oil and gas industry, covering upstream, downstream and globally. As well as being a Non-Executive Board member of Scottish Water, she is also 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. Deirdre was awarded an OBE for her services to the Oil and Gas industry in the Queen's Birthday Honours 2018.



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.



Paul Smith

Paul currently has a portfolio of Non-Executive and Advisor roles across the Energy, Infrastructure and Utility sectors. He chairs the Board of Capstone Infrastructure Corporation – an independent power producer in Canada, is a Non-Executive Director of South East London CHP – a waste to energy and district heating business, and also a Non-Executive Director of Orbital Marine Power Ltd. He is also Senior Advisor to Icon Infrastructure LLP – an investor in Infrastructure businesses in the UK, Europe and North America. Prior to this Paul was Managing Director of Generation at SSE plc. He 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.

Corporate governance

Members

The Chair and other Non-Executive Members are appointed by Scottish Ministers. Executive Members are appointed by Scottish Water after receiving consent to their appointment from Scottish Ministers. The Members as at the date of the Annual Report and their biographies are set out on pages 42 to 43.

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

The Board of Scottish Water comprised 11 members: 8 Non-Executive Board Members and 3 Executive Members. Ken Marnoch was appointed as a Non-Executive Board Member on 1st April 2018. 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 2018/19, 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 47 to 49 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	–	–	3	3
James Coyle	10	9	5	5	–	–
Peter Farrer	10	10	–	–	–	–
Iain Lanaghan	10	10	5	5	–	–
Ken Marnoch	10	9	–	–	2 ¹	1 ¹
Deirdre Michie	10	9	3 ²	3 ²	–	–
Douglas Millican	10	10	–	–	–	–
Alan Scott	10	10	–	–	–	–
Matt Smith	10	10	–	–	3	3
Paul Smith	10	10	5	5	3	3

Notes:

- 1 From his appointment to the Remuneration Committee from 1st November 2018
- 2 From her appointment to the Audit Committee on 1st August 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 and Assurance 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 47 to 49.

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 50.

Board and Committee performance

An internal review of Board and Committee effectiveness was carried out during the financial year of 2018/19 and actions arising from it are being implemented as appropriate. 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 17.

Corporate governance continued

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 monitoring undertaken by the Board and management of 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 had 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 49).

Audit Committee report

Annual statement by the Chair of the Audit Committee

I am pleased to present this report covering the role and function of the Audit Committee for the year ended 31 March 2019. I am the Chair of the Audit Committee and during the year I was supported by 3 other Non-executive Members; Iain Lanaghan, Paul Smith and Deirdre Michie, following her appointment on 1 August 2018. 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 and during her absence on maternity leave Susan Hill is performing this role.

Audit Committee role and responsibilities

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

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



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

- The strategic processes for the assessment of risk, control and governance;
- The accounting policies, the financial statements, and the interim and annual reports;
- The planned activity and results of both internal and external audit, including the approval of the annual Internal Audit plan;
- The adequacy of management response to issues identified by audit activity;
- The assessment of the effectiveness of the internal control environment;
- The corporate governance requirements for the organisation;
- Anti-fraud policies, whistleblowing processes, arrangements for special investigations and activities and reports by the Business Ethics Committee;
- 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 2018/19 the committee met on 5 occasions, with an extra meeting in May 2018 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 & Risk, Director of Digital 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 it reported the positive results from the latest review to the Board.

Audit Committee report continued

The Committee's activities

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

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

Financial Reporting

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

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

To assist in the discharge of its duties the Committee considers reports from the Group Financial Controller and reports from the external auditor on the outcomes of their half-year review of interim financial statements, including confirmation that the Accounts are prepared on a going concern basis. The Committee also considered and was satisfied with the papers prepared by the Group Financial Controller and the external auditor covering the financial statements for full year 2018/19. 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 its strategy for developing growth opportunities in the English business retail market.

The primary areas of judgement considered by the Committee in relation to the 2018/19 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, the associated level of bad debt provisioning and risks to revenue;
- 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 move to live rateable values for charging purposes;
- The accounting treatment associated with the acquisition of the North-East Scotland PFI companies; and
- The key assumptions associated with determining the actuarial valuation of pension obligations, and the ring-fencing of the Scottish Water element of each pension fund.

After discussion of these with management and the external auditor the Committee was satisfied that the issues raised had been properly dealt with and that appropriate disclosures have been included in the accounts. The external auditor carried out their work using an overall materiality of £11.8 million, representing 1% of total expenses, incurred in 2017/18 (excluding interest), in the consolidated income statement for 2018/19. However, the Committee agreed with the external auditor that the firm would report any misstatements identified during the audit above £250,000, as well as misstatements below that amount that, in their view, warranted reporting for qualitative reasons. 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 and management processes, policy and 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 Scottish Water group of companies;
- 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 compliance with General Data Protection Regulation, cyber risks, the wholesale revenues operational arena, response to Audit Scotland report on Dundee City Council fraud, PFI acquisition accounting treatment and fraud investigations.

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, including an external quality assessment by the Institute of Internal Auditors which reported a very strong performance against the Public Sector Internal Audit Standards. 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 by the firm appointed as external auditor and this was extended to all subsidiaries in 2016/17.

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

I am pleased to present the Members' remuneration report for the year ended 31 March 2019, in the preparation of which I am thankful for the support of fellow Remuneration Committee and Non-Executive Members, Matt Smith, Paul Smith and Ken Marnoch.

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 2018/19 and in November 2018 membership was increased from three to four Non-Executive Members of the Board, when Ken Marnoch joined the Committee. At each meeting a quorum of independent, Non-executive Members was present. No Executive Member was present during discussions about their own remuneration.

When 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 November 2018, the Remuneration Committee received information on Executive Director Pay benchmarking from Mercers, a specialist external adviser.

We maintain and 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 2018/19 period were as follows:

Decisions/remuneration for 2018/19

- Agreeing the base salary increase of 1.5% plus £1,600 for Executive Members and Chief Executive from 1 April 2018.
- Confirming the 2018/19 AOIP payment calculated at 35.7% out of the 40% maximum opportunity for Executive Members and Chief Executive.
- Noting management's proposed salary increases for Scottish Water employees.
- Review of succession planning for posts on the Executive Leadership Team.

Decisions/remuneration for 2019/20

- Agreeing base salary increases for Executive Members, with effect from 1 April 2019, at 1.5% plus £1,600 in line with the Scottish Government's Public Sector Pay Policy.
- Setting the performance criteria for the 2019/20 AOIP.

Our Remuneration Policy and our Annual Report on Remuneration is set out on pages 51 to 57.

Samantha Barber

Chair of the Remuneration Committee

Members' remuneration report

The presentation of this Remuneration Report complies with the HM Treasury Financial Reporting Manual 2018/19 (December 2017) 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, out-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-driven 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. Incentive pay is awarded for exceeding demanding targets beyond the delivery plan, with the required degree of out-performance reviewed on an annual basis.

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 Korn Ferry Hay Group 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.

In addition, bespoke benchmark analysis is carried out approximately every three years and when last undertaken by Mercer in November 2018, showed that Executive Members' base salaries were below 70% of an industry median, a deterioration of the comparative position indicated three years previously.

Members' remuneration report continued

e. Annual Out-performance Incentive Plan (AIOP)

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 in 2018/19 are set out below.

Measure	Weight	Delivery Plan target	Out-performance target	Actual performance
Regulated Profit before tax ex. depreciation	40% ¹	£421m	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.	£470m
Customer service OPA performance	25%	383 to 400 points	Overall Performance Assessment (OPA) based on sliding scale discussed with Customer Forum where, for 2018/19, the Leading score is 383 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%.	403 points
Customer Experience Measure	20%	Exceed 82.6 hCEM points	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.	87.54 points
	5%	Exceed 73.74 nhCEM points	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.	81.74 points
Customer Benefit – Overall Measure of Delivery	10%	Exceed 179 points	Ensure forecast capital programme cost is within the regulatory allowance, as well as exceeding the target Overall Measure of Delivery (OMD) of 179 points ² .	Programme cost outside of regulatory allowance; 193 points

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 (LTIP) 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

Note:

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. All members may also choose to take full Early Retirement from age 55 with a reduction in pension value applied by the pension fund.

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.

Members' remuneration report continued

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.

l. 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:

Non-Executive Member	Date of contract
Dame Susan Rice, Chair	31 May 2023
James Coyle	31 July 2020
Paul Smith	31 July 2020
Samantha Barber	31 March 2021
Iain Lanaghan	31 March 2021
Matt Smith	30 April 2021
Deirdre Michie	30 November 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 £000	Benefits ¹ £000	AOIP ² £000	Total £000	Pension ³ £000	Total £000	
Executive Members								
Douglas Millican	2019	262	12	93	367	-1	366	
	2018	256	12	92	360	-17	343	
Peter Farrer	2019	191	12	68	271	4	275	
	2018	186	12	67	265	-15	250	
Alan Scott	2019	188	10	67	265	9	274	
	2018	184	9	66	259	21	280	
Non-Executive Members⁴								
Chair – Dame Susan Rice	2019	102			102		102	
	2018	101			101		101	
James Coyle ⁵	2019	26			26		26	
	2018	24			24		24	
Samantha Barber ⁶	2019	26			26		26	
	2018	21			21		21	
Iain Lanaghan	2019	21			21		21	
	2018	21			21		21	
Deirdre Michie ⁷	2019	21			21		21	
	2018	7			7		7	
Matt Smith	2019	21			21		21	
	2018	21			21		21	
Paul Smith	2019	21			21		21	
	2018	21			21		21	
Ken Marnoch ⁸	2019	21			21		21	
Former Members								
Alan Bryce ⁹	2018	26			26		26	
Lynne Peacock ⁹	2018	14			14		14	
Total Remuneration		2019	900	34	228	1,162	12	1,174
		2018	882	33	225	1,140	-11	1,129

Notes:

- 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.
- Annual Out-performance Incentive Plan as described in the Executive Remuneration Policy.
- The value of pension benefits accrued is calculated in accordance with section 5.3.21 (d) of the HM Treasury's Government Financial Reporting Manual 2018/19. This requires the real increase in accrued benefits, as detailed in section 2.c 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 table reflects the impact of a tax charge associated with their accrued pension benefits resulting in a reduced future pension.
- 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.
- Payments received by James Coyle reflect his appointment as Audit Committee Chair from 1st August 2017.
- Payments received by Samantha Barber reflect her appointment as Remuneration Committee Chair from 1st April 2018.
- Payments received by Deirdre Michie in 2018 are from her appointment on 1st December 2017.
- Kenneth Marnoch was appointed on 1st April 2018 and so received no remuneration in the 2018 reporting period.
- Alan Bryce and Lynne Peacock each stepped down from the Board on 31st March 2018 and 31 October 2017 respectively.

The Committee approved a 1.5% +£1,600 increase in base salaries for the three Executive Members with effect from 1 April 2019. Consequently, base salaries for 2019/20 are as follows: Douglas Millican £267,179; Peter Farrer £195,030; and Alan Scott £192,798. Fee levels for Non-executive Members, including the Chair, for 2019/20 will increase by £6 per day, also with effect from 1 April 2019 and in line with Public Sector Pay Policy for Senior Appointments.

Members' remuneration report continued

b. Details of benefits received 2018/19

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	9	1	10

Notes:

- i Non-executive Members are not eligible for car or life assurance benefits.

c. Total pension entitlements to end of financial year 2018/19

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 2019			Transfer values	
	Years in Scheme	Pension £000	Lump sum £000	Pension £000	Lump sum £000	At 31 March 2019 £000	At 31 March 2018 £000	Increase (Decrease) in 2018/19 net of Members' own contributions and inflation £000
Douglas Millican	24.1	1	–	73	138	1,567	1,474	28
Peter Farrer	34.7	1	–	88	176	1,797	1,752	(18)
Alan Scott	5.5	1	–	16	–	246	226	(5)

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 £1.055m 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.

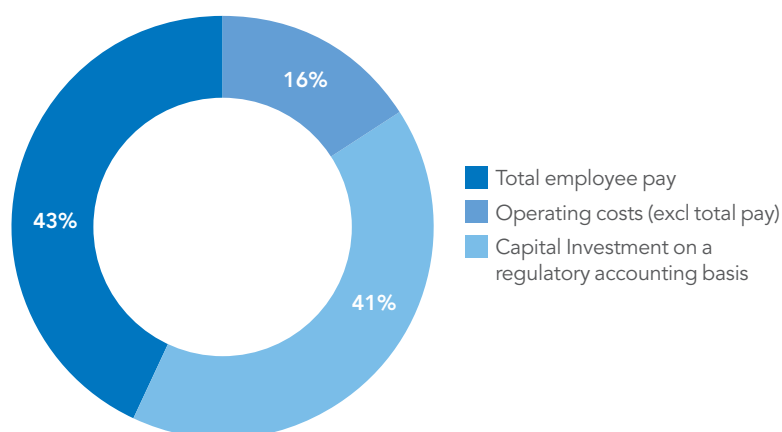
	Remuneration excluding movement in pension ¹ £000	
	2018/19	2017/18
Chief Executive	367	360.0
Employees ²	34.6	33.6
Ratio	10.6	10.7

Notes:

- 1 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.
- 2 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 2019/20

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, the degree of required out-performance has been increased over the course of the current regulatory period. For 2019/20 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 384 and 400 points. 0% payable below 384; 30% payable at 384; 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 87.82 points.	15%
	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 82.0 points.	10%
Customer benefit delivery	Ensure forecast capital programme cost is within the regulatory allowance as well as exceeding delivery plan target Overall Measure of Delivery (OMD) of 209 points.	10%

Notes:

- 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.
- 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 2019.

The Government Financial Reporting Manual 2018/19 (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 58 to 59 and the sections of the annual report incorporated by reference are as follows:

Corporate governance report	See pages 44 to 46
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 40
Going concern and viability statements	See page 18
Greenhouse gas emissions	See page 26
People	See pages 29 to 31
Accounting requirements and basis of account preparation	See Note 1.2, page 66
Financial risk management	See page 89

Members and their interests

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

Appointment and replacement of Members

Schedule 3 of the Water Industry (Scotland) Act 2002 specifies Scottish Water's Board must comprise between 5 and 8 Non-Executive Members and between 3 and 5 Executive Members. One Member must have special knowledge of the interests of the employees of Scottish Water. Non-Executive appointments are made by the Scottish Ministers for 3 to 5 years following an open and transparent public appointment process. Executive Members are appointed by Scottish Water with the consent of the Scottish Ministers for an unidentified period. The Members appointments can be terminated under procedures set out in Paragraph 1 of Schedule 3 of the Water Industry (Scotland) Act 2002. Details of the Members' service contracts are on page 54 of the Members' Remuneration Report.

Employee relations and involvement

The Scottish Water group of businesses employed an average of 4,467 (2018: 4,321) 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 78. 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 29 to 31.

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 Intellectual capital section on pages 32 to 33.

Political contributions

No political contributions were made during the year (2018: 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 2019.

Members' responsibilities

The following statement, which should be read in conjunction with the statement of the auditor's responsibilities included in the Independent Auditor's Report on pages 62 to 67, is made with a view to distinguishing the respective responsibilities of the Members and of the auditor in relation to the financial statements.

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

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

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

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

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

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

- the Group and Company financial statements, which have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the EU and interpreted by the Government Financial Reporting Manual (FRM), give a true and fair view of the assets, liabilities, financial position and surplus of Scottish Water; and
- 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; and
- 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

29 May 2019

Financials

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- 98 Direction by the Scottish Ministers

Independent auditor's report

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

Report on the audit of the financial statements

Opinion on financial statements

We have audited the financial statements in the annual report and accounts of Scottish Water for the year ended 31 March 2019 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 2018/19 Government Financial Reporting Manual (the 2018/19 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 2019 and of the group 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 2018/19 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 for opinion

We conducted our audit in accordance with applicable law and International Standards on Auditing (UK) (ISAs (UK)), as required by the Code of Audit Practice approved by the Auditor General for Scotland. 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 were appointed by the Auditor General on 31 May 2016. The period of total uninterrupted appointment is three years. 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. Non-audit services prohibited by the Ethical Standard were not provided to the body. 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.

2. 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.

	The risk	Our response
<p>Capital additions (£503.4 million; 2017-18: £493.8 million)</p> <p>Refer to page 47 (Audit Committee Report), page 72 (accounting policy) and page 80 (note 9).</p> <p>Risk of material misstatement vs 2017-18</p> 	<p>Accounting application Capital additions are significant related to the delivery plan for regulated activities for the period 2015-16 to 2020-21.</p> <p>Executive members 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 which can affect profit and investment measures reported in the financial statements.</p>	<p>Our procedures included:</p> <p>Control design:</p> <ul style="list-style-type: none"> Testing the design and operating effectiveness of controls over the allocation of costs between capital and revenue within the financial ledger at the project initiation stage and on an ongoing basis. Testing the design and operating effectiveness of controls over the consistency between total capital expenditure reported in the financial statements and that reported in reports to those charged with governance as part of ongoing capital project monitoring arrangements. <p>Tests of detail:</p> <ul style="list-style-type: none"> Building on our work over control design we compared the reports of Scottish Water's capital project monitoring group at the year end to amounts recorded as capital additions. 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.
<p>Bad debt provision £399.0 million (2017/18: £388.2 million)</p> <p>Refer to page 47 (Audit Committee Report), page 72 (accounting policy) and page 95 (financial disclosures).</p> <p>Risk of material misstatement vs 2017-18</p> 	<p>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.</p> <p>As at 31 March 2019, the Scottish Water regulated business reported a household revenue debtor of £435.5 million (2018: £422.6 million) which relates to household billings dating from 1996-97. Given the old age of these debts a bad debt provision of £399.0 million (2018: £388.2 million) is held against them.</p> <p>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.</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 review and approval of the provision and associated assumptions, by the Directors during the year and at the year end. Testing the design and operating effectiveness of controls in respect of the reconciliation of information provided on a monthly basis 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. <p>Tests of detail:</p> <ul style="list-style-type: none"> We compared the information on historical collection rates, recorded by Scottish Water as the basis for the current year provision calculation, to the records held in respect of prior years. We agreed the total amount billed and collected in respect of 2018-19 as recorded in Scottish Water's records, to confirmations received from individual local authorities. <p>Historical comparison:</p> <ul style="list-style-type: none"> We compared the change in forecast collection rate in the current year, to the historical trend of generally increasing collection rates since 1996-97. <p>Sensitivity analysis:</p> <ul style="list-style-type: none"> We performed sensitivity analysis and challenged management in respect of the forecast collection and its impact on the associated bad debt provision. <p>Assessing transparency:</p> <ul style="list-style-type: none"> We assessed the disclosure of sensitivities by the Directors, and description of the provision in note 27 of the financial statements.

Independent auditor's report continued

	The risk	Our response
<p>Pension liability (206.3 million; 2017-18: £145.5 million)</p> <p>Refer to page 47 (Audit Committee Report), page 72 (accounting policy) and page 95 (note 27).</p> <p>Risk of material misstatement vs 2017-18</p> 	<p>Subjective valuation Small changes in the assumptions and estimates used to value the pension obligation (before deducting scheme assets) would have a significant effect on the net pension liability.</p> <p>Employees of Scottish Water participate in three local government defined benefit pension funds; North East Scotland pension fund, the Lothian pension fund and the Strathclyde pension fund.</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 provision of membership information to the actuary who uses it, together with the assumptions, to calculate the pension liability. <p>Benchmarking assumptions:</p> <ul style="list-style-type: none"> 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 adequacy of the disclosures in respect of our understanding of Scottish Government expectations. <p>Assessing transparency:</p> <ul style="list-style-type: none"> Considering the sensitivity of the deficit to these assumptions.
<p>Purchase of new entities</p> <p>Refer to page 47 (Audit Committee Report), page 72 (accounting policy) and page 79 (note 8).</p> <p>New risk of material misstatement vs 2017-18</p>	<p>Accounting judgement Scottish Water entered into a PFI contract with Aberdeen Environmental Services Limited pre 2002 for the design, build and finance of a wastewater treatment scheme.</p> <p>On 19 December 2018, Scottish Water Horizons Holdings Limited acquired the project and associated four legal entities, namely Aberdeen Holdco Limited, Aberdeen Environmental Services (Holdings) Limited, Aberdeen Environmental Services Limited and Scottish Water Services (Grampian) Limited in exchange for a consideration of £16 million.</p> <p>There is judgement in respect of the application of accounting standards and accounting for elements of the transaction within the Group.</p>	<p>Our procedures included:</p> <p>Accounting analysis:</p> <ul style="list-style-type: none"> We critically assessed the accounting standards and policy applied to the transaction by challenging the relevant accounting standards and their interpretation. <p>Testing application:</p> <ul style="list-style-type: none"> We assessed the completeness of management's consideration of accounting for the elements of the transaction by comparing it against the acquisition agreement and relevant account balances in affected entities. We agreed the net proceeds paid by Scottish Water Horizon Holdings to the outgoing shareholders to the respective bank statements. We recalculated the consolidation and acquisition adjustments prepared by management and compared them to the journals posted to reflect the transactions. <p>Assessing transparency:</p> <ul style="list-style-type: none"> We considered the adequacy of the associated disclosures in the financial statements of Scottish Water Horizons Holdings in note 8.

Change to key audit matters

We continue to perform procedures over amortisation of intangible assets. However, following establishment of an audit approach to consider this area and historical data available, as it is the second year since the intangible asset was acquired, we have not assessed this as one of the most significant risks in our current year audit and, therefore, it is not identified as a key audit matter in our report this year.

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 £11.8 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 £11.8 million (2018: £9.5 million), determined with reference to total expenditure, of which it represents 1% (2018: 1%).

We reported to the Audit Committee all corrected or uncorrected identified misstatements exceeding £250,000. There were no identified misstatements that warranted reporting on qualitative grounds.

Of the group's ten (2018: seven) reporting components, we subjected four (2018: two) to full scope audits for group purposes and one (2018: one) 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 99% of each of the Group's total revenue, total expenditure and 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 £11,000 to £1.3 million, having regard to the mix of size and risk profile of the Group across the components.

Group expenditure
£1,214.0m (2018: £1,176.7m)



Group materiality
£11.8m (2018: £9.5m)



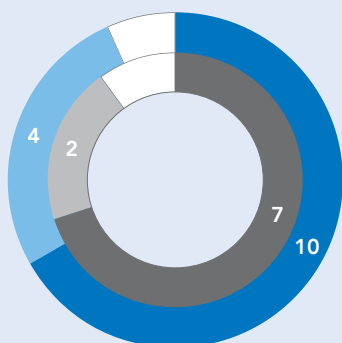
£11.8m
Whole financial statements materiality (2018: £9.5m).

£1.3m
Range of materiality at seven components (£11,000 to £1.3m) (2018: £22,000 to £1.2m).

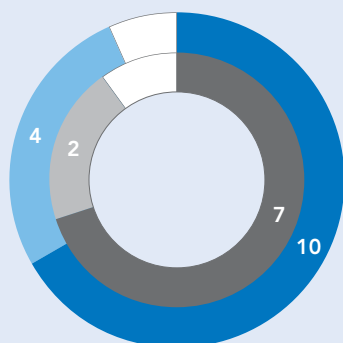
£250,000
Misstatements reported to the audit committee (2018: £200,000).

■ Group expenditure
■ Group materiality

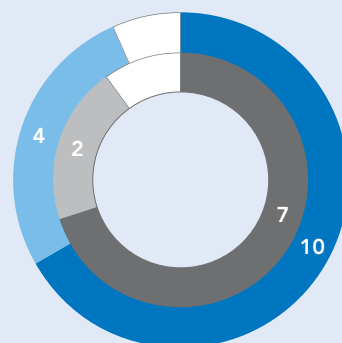
Group expenditure



Group revenue



Group total assets



■ Full scope for group audit purposes 2019
■ Specified risk-focused audit procedures 2019
■ Full scope for group audit purposes 2018
■ Specified risk-focused audit procedures 2018
■ Residual 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 deemed inappropriate.

Independent auditor's report continued

Auditor's responsibilities for the audit of the financial statements

Our objectives are to obtain 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.

The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, intentional omissions, misrepresentations, or the override of internal control. The capability of the audit to detect fraud and other irregularities depends on factors such as the skilfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved. We therefore design and perform audit procedures which respond to the assessed risks of material misstatement due to fraud.

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 the 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 Directors' 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 in the financial statements were incurred or applied in accordance with any applicable enactments and guidance issued by the Scottish Ministers.

Responsibilities for regularity

The board members are 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

Opinions on matters prescribed by the Auditor General for Scotland

In our opinion, the audited part of the Directors' 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 Directors' 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 these matters.

Conclusions on wider scope responsibilities

In addition to our responsibilities for the annual report and accounts, our conclusions on the wider scope responsibilities specified in the Code of Audit Practice are set out in our Annual Audit Report.

Use of our report

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, we do not undertake to have responsibilities to members or officers, in their individual capacities, or to third parties.

Hugh Harvie

for and on behalf of KPMG LLP

Chartered Accountants

Saltire Court
20 Castle Terrace
Edinburgh
EH1 2EG
5 June 2019

Consolidated income statement

For the year ended 31 March 2019

	Note	2019 £m	2018 £m
Revenue	3	1,469.1	1,424.0
Cost of sales		(1,047.4)	(1,014.4)
Gross surplus		421.7	409.6
Administrative expenses		(166.6)	(162.3)
Operating surplus	3, 4	255.1	247.3
Finance income	7	2.1	1.2
Finance costs	7	(171.1)	(176.7)
Surplus before taxation		86.1	71.8
Taxation	8	(17.9)	(13.7)
Surplus for the year	21	68.2	58.1

Consolidated statement of comprehensive income

For the year ended 31 March 2019

	Note	2019 £m	2018 £m
Surplus for the year	21	68.2	58.1
Other comprehensive income:			
<i>Items which will not subsequently be reclassified to the income statement</i>			
Actuarial (loss)/gain on post employment benefit obligations, net of deferred taxation	23	(43.5)	67.9
Effective portion of changes in fair value of cash flow hedge, net of deferred taxation		0.5	–
Total comprehensive income for the year		25.2	126.0

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	Cash flow hedging reserves £m	Retained earnings £m	Other reserves £m	Total £m
Balance at 1 April 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		–	1,519.0	133.4	1,652.4
Balance at acquisition of subsidiaries	27	(9.0)	–	–	(9.0)
Surplus for the year	21	–	68.2	–	68.2
Other comprehensive (loss)/gain:					
Actuarial loss on post employment benefit obligations, net of tax	23	–	(43.5)	–	(43.5)
Effective portion of changes in fair value of cash flow hedge, net of tax	27	0.5	–	–	0.5
Total comprehensive income for the year		0.5	24.7	–	25.2
Balance at 31 March 2019		(8.5)	1,543.7	133.4	1,668.6

Company statement of changes in equity

	Note	Retained earnings £m	Other reserves £m	Total reserves £m
Balance at 1 April 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		1,345.9	133.4	1,479.3
Surplus for the year	21	67.2	–	67.2
Other comprehensive loss:				
Actuarial loss on post employment benefit obligations, net of tax	23	(41.4)	–	(41.4)
Total comprehensive income for the year		25.8	–	25.8
Balance at 31 March 2019	21	1,371.7	133.4	1,505.1

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 2019

	Note	Group		Company	
		2019 £m	2018 £m	2019 £m	2018 £m
Assets					
Non-current assets					
Property, plant and equipment	9	6,214.7	5,981.8	6,184.7	5,962.9
Intangible assets	10	10.0	13.9	–	–
Investments	11	–	–	37.6	37.6
Deferred tax asset	16	1.8	0.8	–	–
		6,226.5	5,996.5	6,222.3	6,000.5
Current assets					
Inventories	12	3.7	2.9	2.9	2.6
Trade and other receivables	13	204.4	201.2	78.3	77.4
Current tax asset		2.7	0.4	0.8	–
Cash and cash equivalents	14	434.8	406.4	310.9	270.6
		645.6	610.9	392.9	350.6
Total assets	3	6,872.1	6,607.4	6,615.2	6,351.1
Liabilities					
Current liabilities					
Trade and other payables	15	(462.1)	(457.7)	(385.5)	(378.1)
Other loans and borrowings	18	(24.8)	(21.7)	(23.4)	(21.7)
Current tax liabilities		(0.1)	(0.8)	–	(0.9)
Provisions for liabilities	17	(10.4)	(8.5)	(13.5)	(10.4)
		(497.4)	(488.7)	(422.4)	(411.1)
Non-current liabilities					
Trade and other payables	15	(89.0)	(77.0)	(71.7)	(70.7)
Other loans and borrowings	18	(277.4)	(303.1)	(279.7)	(303.1)
Deferred tax liabilities	16	(368.1)	(360.0)	(364.2)	(359.3)
Retirement benefit obligations	23	(248.3)	(175.3)	(243.3)	(173.7)
Provisions for liabilities	17	(14.7)	(7.6)	(20.2)	(10.6)
		(997.5)	(923.0)	(979.1)	(917.4)
Total liabilities		(1,494.9)	(1,411.7)	(1,401.5)	(1,328.5)
Net assets		5,377.2	5,195.7	5,213.7	5,022.6
Equity					
Government loans	19	3,708.6	3,543.3	3,708.6	3,543.3
Retained earnings	21	1,543.7	1,519.0	1,371.7	1,345.9
Cash flow hedge reserve	27	(8.5)	–	–	–
Other reserves		133.4	133.4	133.4	133.4
		5,377.2	5,195.7	5,213.7	5,022.6

The financial statements on pages 68 to 97 were approved by the Board of Members on 29 May 2019 and signed on its behalf by:

Douglas Millican
Chief Executive

Statements of cash flow

For the year ended 31 March 2019

	Note	Group		Company	
		2019 £m	2018 £m	2019 £m	2018 £m
Surplus before taxation		86.1	71.8	83.6	76.0
Depreciation charges	9	282.6	274.8	281.1	272.7
Amortisation of intangible asset	10	3.2	3.5	–	–
Amortisation of grants		(1.3)	(1.2)	(1.0)	(1.0)
Surplus on disposal of property, plant and equipment		(0.9)	(7.0)	(0.9)	(7.0)
Non cash gain on consolidation	11	(0.5)	–	–	–
Non cash adjustment for retirement benefit obligations		17.9	26.2	17.0	25.0
Finance costs – net		169.0	175.5	172.5	176.9
Operating cash flow before changes in working capital and provisions		556.1	543.6	552.3	542.6
Changes in working capital and provisions:					
(Increase)/decrease in receivables		–	(60.1)	(1.8)	18.0
Increase in inventories		(0.2)	(0.3)	(0.3)	(0.3)
(Decrease)/increase in payables		(11.7)	45.2	(3.2)	6.5
Increase in provisions		7.5	3.1	11.2	4.0
Cash flows from operating activities		551.7	531.5	558.2	570.8
Taxation (paid)/received		(5.7)	1.3	(4.7)	–
Net cash generated from operating activities		546.0	532.8	553.5	570.8
Cash flows from investing activities					
Purchase of property, plant and equipment		(511.6)	(491.9)	(506.6)	(486.3)
Sale of property, plant and equipment		1.5	7.4	1.4	7.0
Purchase of intangible asset	10	0.7	(17.4)	–	–
Acquisition of subsidiary companies – cash acquired	11	10.3	–	–	–
Acquisition of subsidiary companies – consideration paid	11	(16.2)	–	–	–
Government grant income received		1.3	0.5	–	–
Infrastructure income receipts		16.4	15.7	16.4	15.7
Net cash used in investing activities		(497.6)	(485.7)	(488.8)	(463.6)
Cash flows from financing activities					
Repayments of loans		(124.8)	(122.6)	(123.0)	(122.6)
Proceeds from borrowings		288.3	242.6	288.3	242.6
Interest received		2.1	1.2	1.5	0.7
Interest paid		(166.6)	(171.0)	(169.5)	(172.0)
Payment of finance lease liabilities		(19.0)	(20.5)	(21.7)	(20.5)
Net cash used in financing activities		(20.0)	(70.3)	(24.4)	(71.8)
Net increase/(decrease) in cash and cash equivalents		28.4	(23.2)	40.3	35.4
Cash and cash equivalents at beginning of year	14	406.4	429.6	270.6	235.2
Cash and cash equivalents at end of year	14	434.8	406.4	310.9	270.6

Notes to the financial statements

For the year ended 31 March 2019

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 2019 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 Scottish Water'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 2018 were:

- Annual improvements to IFRSs 2014-2016 Cycle;
- IFRS 9 'Financial Instruments'; and
- IFRS 15 'Revenue from Contracts with Customers'.

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 16 'Leases';
- Annual improvements to IFRSs 2015-2017 Cycle; and
- Amendments to the Conceptual Framework, IAS 19 'Employee benefits'.

The impact on Scottish Water's financial statements of the future adoption of the new standards, interpretations and amendments is currently under review. Scottish Water expects that only IFRS 16 will have an impact on its financial results. Although it is not expected to have a material impact on the results and net assets of Scottish Water, it is expected to have a material impact on non-current assets and liabilities. This standard came into effect for financial periods beginning on or after 1 January 2019 for subsidiary companies, but the FRoM has deferred implementation for the public sector to 1 April 2020. Early adoption is not an option for Scottish Water as the relevant criteria, based on the size of relevant subsidiary companies, are not met.

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 Scottish Water group of companies.

1 Accounting policies continued

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 it is probable that economic benefits will flow to Scottish Water and that the revenue can be reliably measured. Revenue is recognised when, or as, the performance obligations to the customer are satisfied. 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 Scottish Water and it is probable that the temporary difference will not reverse in the foreseeable future.

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

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 Scottish Water 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.

Notes to the financial statements continued

For the year ended 31 March 2019

1 Accounting policies continued

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

1.14 Capital grants and customer contributions

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

1.15 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 is currently 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 Accounting policies continued

1.18 Financial instruments

Financial assets and liabilities are recognised in the 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 Scottish Water 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 with the exception of derivatives that qualify for cash flow hedge accounting.

f. Cash flow hedges

Where the hedged risk is the variable interest rate risk in a debt instrument measured at amortised cost the effective part of any gain or loss on the derivative financial instrument is recognised in other comprehensive income (OCI). Any ineffective portion of the hedge is recognised immediately in the income statement.

When the hedging relationship ends or when a hedge no longer meets the criteria for hedge accounting, any hedging gain or loss recognised in OCI is reclassified to the income statement.

1.19 Employee benefit obligations

Employees of the Scottish Water group of companies 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.

Within the subsidiary companies there are also two defined contribution pension schemes under which the companies pay fixed contributions and will have no legal or constructive obligation to pay further amounts. Obligations for contributions to defined contribution pension plans are recognised as an expense in the Income Statement.

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.

Notes to the financial statements continued

For the year ended 31 March 2019

1 Accounting policies continued

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. The group has adopted IFRS 9 'Financial instruments' from 1 April 2018 which requires an expected loss method of impairment of financial assets to be used. This is 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 asset base and a significant proportion of 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 Scottish Water'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 Scottish Water'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 Scottish Water and the carrying amount of pension obligations. These assumptions may differ from the actual results due to changes in market and economic conditions and longer or shorter lives of participants.

3 Segmental analysis

The principal activities of the Scottish Water group of companies 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.

	2019 £m	2018 £m
Revenue		
Scottish Water regulated water and waste water services	1,216.9	1,191.4
Business Stream	372.1	356.1
Scottish Water non-regulated activities	27.7	20.0
	1,616.7	1,567.5
Intercompany elimination	(147.6)	(143.5)
	1,469.1	1,424.0

	2019 £m	2018 £m
Operating surplus		
Scottish Water regulated water and waste water services	257.8	252.8
Business Stream	0.3	(6.4)
Scottish Water non-regulated activities	0.6	0.9
Reversal of IFRIC 12 adjustments on consolidation	(3.6)	–
	255.1	247.3

	2019 £m	2018 £m
Total assets		
Scottish Water regulated water and waste water services	6,577.2	6,313.0
Business Stream	217.8	224.8
Scottish Water non-regulated activities	111.1	69.6
Reversal of IFRIC 12 adjustments on consolidation	(34.0)	–
	6,872.1	6,607.4

	Capital additions to property, plant and equipment		Depreciation on property, plant and equipment	
	2019 £m	2018 £m	2019 £m	2018 £m
Scottish Water regulated water and waste water services	503.4	493.8	281.1	272.7
Business Stream	1.0	1.7	1.3	1.1
Scottish Water non-regulated activities	4.8	4.3	0.2	1.0
Less: intercompany transfer	–	(1.4)	–	–
	509.2	498.4	282.6	274.8

Revenue by geographical location of customers is as follows:

	Revenue	
	2019 £m	2018 £m
United Kingdom	1,468.0	1,422.5
Rest of the World	1.1	1.5
	1,469.1	1,424.0

Notes to the financial statements continued

For the year ended 31 March 2019

4 Operating surplus

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

	Note	2019 £m	2018 £m
Scottish Water PFI operating costs*		106.8	118.0
Depreciation of property, plant and equipment	9	282.6	274.8
Amortisation of intangible asset	10	3.2	3.5
Surplus on sale of property, plant and equipment		(0.9)	(7.0)
Release of deferred income in relation to capital grants		(1.3)	(1.2)
Operating lease rentals		3.5	3.4
Auditor's remuneration – audit fee for audit of the company and consolidated financial statements (including £118,000 (2018 £89,000) in respect of the audit of subsidiary companies)		0.3	0.3
– other services		–	–
Research and development expenditure		1.5	1.1
Acquisition fees relating to investment in subsidiaries	11	2.1	–

* PFI costs for 2019 include a £13.75 million credit in settlement of the commercial claim raised in 2016/17.

5 Staff costs

	Note	2019 £m	2018 £m
Wages and salaries		156.8	149.3
Social security costs		16.9	16.1
IAS 19 total service costs	23	54.1	54.9
Other pension costs		0.3	0.2
Employee benefit expense		228.1	220.5
Less: charged as capital expenditure		(91.0)	(81.0)
		137.1	139.5

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

	2019	2018
Regulated water and waste water services	3,976	3,898
Business Stream	362	340
Scottish Water non-regulated activities	129	83
	4,467	4,321

6 Members' remuneration

Information concerning Members' remuneration, incentive schemes and pensions is detailed in the Remuneration Report on pages 51 to 57.

7 Finance income and costs

	Note	2019 £m	2018 £m
Interest income:			
Short-term deposits		2.1	1.2
Finance income		2.1	1.2
Interest expense:			
Government loans		(147.4)	(148.2)
Other loans		(2.5)	(1.4)
Finance lease liabilities		(16.1)	(20.4)
Interest on pension scheme net liabilities	23	(5.1)	(6.7)
Finance costs		(171.1)	(176.7)
Net finance costs		(169.0)	(175.5)

8 Taxation

	Note	2019 £m	2018 £m
Analysis of tax charge recognised in the income statement			
Current tax: UK corporation tax		2.9	1.6
Current tax: Overseas corporation tax		–	0.1
Current tax: Adjustment in respect of prior years		0.6	–
		3.5	1.7
Deferred tax: Origination and reversal of timing differences – current year		14.8	11.9
Deferred tax: Origination and reversal of timing differences – prior years		(0.4)	0.1
	16	14.4	12.0
Total tax charge		17.9	13.7

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

Group surplus before tax		86.1	71.8
Tax on surplus on ordinary activities at standard UK corporation tax rate of 19% (2018: 19%)		16.4	13.7
Adjustment in respect of prior years		0.2	0.1
Re-measurement of deferred tax due to change in UK corporation tax rate		(1.6)	(1.4)
Accounting gain with no capital gain		(0.2)	(1.3)
Depreciation on non qualifying additions		1.9	1.8
Other permanent differences		1.1	0.8
Deferred tax not provided		0.1	–
Total tax charge for the year		17.9	13.7

	Note	Group		Company	
		2019 £m	2018 £m	2019 £m	2018 £m
Tax (credit)/charge recognised directly in reserves					
Deferred tax relating to:					
Pension scheme actuarial movements	23	(8.9)	13.9	(8.5)	13.3
Movements in cash flow hedge	27	0.1	–	–	–
Total	16	(8.8)	13.9	(8.5)	13.3

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

Notes to the financial statements continued

For the year ended 31 March 2019

9 Property, plant and equipment

	Note	Specialised operational properties and structures £m	Non-specialised operational properties £m	Infrastructure assets £m	Plant, machinery and vehicles £m	Assets under construction £m	Total £m
Group							
Cost							
At 1 April 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 ¹		–	(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
Additions		0.1	–	–	1.8	507.3	509.2
Acquisition of subsidiary companies:							
Cost at acquisition	11	–	–	–	104.0	–	104.0
Reversal of IFRIC 12 adjustments		(19.0)	–	–	(57.1)	–	(76.1)
Disposals ¹		(2.8)	–	–	(113.8)	–	(116.6)
Reclassifications		38.9	1.8	170.1	169.4	(380.2)	–
At 31 March 2019		3,176.6	84.1	2,557.7	2,818.4	975.4	9,612.2
Accumulated depreciation							
At 1 April 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 ¹		–	(0.5)	–	(33.1)	–	(33.6)
At 31 March 2018		1,104.4	25.2	522.5	1,557.8	–	3,209.9
Acquisition of subsidiary companies:							
Depreciation at acquisition	11	–	–	–	60.9	–	60.9
Reversal of IFRIC 12 adjustments		(5.7)	–	–	(34.2)	–	(39.9)
Charge for the year		68.4	2.6	18.0	193.6	–	282.6
Disposals ¹		(2.4)	–	–	(113.6)	–	(116.0)
At 31 March 2019		1,164.7	27.8	540.5	1,664.5	–	3,397.5
Net book value							
At 31 March 2019		2,011.9	56.3	2,017.2	1,153.9	975.4	6,214.7
At 31 March 2018		2,055.0	57.1	1,865.1	1,156.3	848.3	5,981.8

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

Capital grants received during the year and credited to deferred income were £1.3m (2018: £nil). No capital grants were received during the year in respect of infrastructure assets.

¹ Disposals include the write down of redundant assets no longer in beneficial use.

9 Property, plant and equipment continued

	Specialised operational properties and structures £m	Non-specialised operational properties £m	Infrastructure assets £m	Plant, machinery and vehicles £m	Assets under construction £m	Total £m
Company						
Cost						
At 1 April 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 ¹	–	(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
Additions	0.1	–	–	–	503.3	503.4
Disposals ¹	(2.7)	–	–	(113.3)	–	(116.0)
Reclassifications	37.4	1.8	170.1	169.4	(378.7)	–
At 31 March 2019	3,172.1	84.1	2,557.7	2,754.0	972.3	9,540.2
Accumulated depreciation						
At 1 April 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 ¹	–	(0.5)	–	(33.1)	–	(33.6)
At 31 March 2018	1,097.9	25.2	522.5	1,544.3	–	3,189.9
Charge for the year	67.7	2.6	18.0	192.8	–	281.1
Disposals ¹	(2.3)	–	–	(113.2)	–	(115.5)
At 31 March 2019	1,163.3	27.8	540.5	1,623.9	–	3,355.5
Net book value						
At 31 March 2019	2,008.8	56.3	2,017.2	1,130.1	972.3	6,184.7
At 31 March 2018	2,039.4	57.1	1,865.1	1,153.6	847.7	5,962.9

¹ Disposals include the write down of redundant assets no longer in beneficial use.

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 Scottish Water group and company.

	Group Total £m	Company Total £m
Cost		
At 1 April 2017, 31 March 2018	568.8	568.8
Acquisition of subsidiary companies – reversal of IFRIC 12 adjustments	(76.1)	–
At March 2019	492.7	568.8
Accumulated depreciation		
At 1 April 2017	269.7	269.7
Charge for the year	15.3	15.3
At 31 March 2018	285.0	285.0
Acquisition of subsidiary companies – reversal of IFRIC 12 adjustments	(39.9)	–
Charge for the year	13.1	15.3
At 31 March 2019	258.2	300.3
Net book value		
At 31 March 2019	234.5	268.5
At 31 March 2018	283.8	283.8

The reversal of IFRIC 12 adjustments relates to the acquisition of the North-East Scotland PFI companies.

Notes to the financial statements continued

For the year ended 31 March 2019

10 Intangible asset

The consideration paid by Business Stream for the acquisition of the non-household customer base of Southern Water Services Limited was capitalised as an intangible asset. The initial consideration, paid in April 2017, of £17.4m has been adjusted down by £0.7m during the financial year based on the actual customer base transferred and other measures which impact on the financial contribution.

The intangible asset is treated as having a finite life and is being amortised on a straight-line basis over its expected useful life, currently set at 5 years. The cost, amortisation charge and carrying value are shown in the table below.

	As at 1 April 2018 £m	Adjustment to consideration £m	Amortisation charge £m	As at 31 March 2019 £m
Acquisition cost	17.4	(0.7)	–	16.7
Amortisation total	(3.5)	–	(3.2)	(6.7)
Net book value	13.9	(0.7)	(3.2)	10.0

11 Investments

	Company	
	2019 £m	2018 £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 ¹	Scotland	100.0	Holding company
Scottish Water Business Stream Limited ²	Scotland	100.0	Licensed water and waste water services
Scottish Water Horizons Limited ¹	Scotland	100.0	Commercial non regulated water and waste water services
Scottish Water International Limited ¹	Scotland	100.0	Non trading
Scottish Water Solutions 2 Limited	Scotland	100.0	Contracting services
Aberdeen Environmental Services Limited ³	Scotland	100.0	PFI concession operator
Scottish Water Services (Grampian) Limited ¹	Scotland	100.0	Waste water services operator
Bandwidth Energy Limited ⁵	Scotland	50.0	Heat from waste water projects
Aberdeen Environmental Services (Holdings) Limited ⁴	Scotland	100.0	Holding Company
Aberdeen Holdco Limited ¹	Scotland	100.0	Holding Company

1 owned by Scottish Water Horizons Holdings Limited

2 owned by Scottish Water Business Stream Holdings Limited

3 owned by Aberdeen Environmental Services (Holdings) Limited

4 owned by Aberdeen Holdco Limited

5 joint venture between Scottish Water Horizons Limited and SHARC Energy Limited

Scottish Water owns shares in a further 8 companies which did not trade during the year ended 31 March 2019. 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 Ltd⁶

6 owned by Scottish Water Business Stream Limited

11 Investments continued

Group

On 19 December 2018, Scottish Water Horizons Holdings Limited (SWHH) acquired 100% of the issued share capital of Aberdeen Environmental Services Limited and Scottish Water Services (Grampian) Limited (formerly Kelda Water Services (Grampian) Limited) which operate waste water treatment sites in the North-East of Scotland under PFI service concession arrangements. At the same time, the 2 holding companies, Aberdeen Environmental Services Holdings Limited and Aberdeen Holdco Limited, were also acquired from the Kelda Group.

The consideration paid by SWHH of £16.2m was determined based on the net present value of the projected future cash flows of the acquired companies. The acquisition fees and other related costs incurred, totalling £2.1m, were expensed in the year, in accordance with IFRS 3 'Business Combinations' within SWHH's and the consolidated total administrative expenses (note 4).

The following table summarises the net assets acquired within Aberdeen Environmental Services Limited and Scottish Water Services (Grampian) Limited.

	£m
Property, plant and equipment (see note 9)	43.1
Cash	10.3
External bank loans	(46.5)
Other net liabilities	(2.3)
	4.6

Under the requirements of IFRIC 12 'Service concession arrangements', Scottish Water recognises PFI contracts as finance leases, recognising a lease asset under Property, plant and equipment and a corresponding finance lease liability, in line with the accounting policies (note 1, section 1.12).

Following this acquisition, the property, plant and equipment assets and related external financing of the acquired companies have been brought into the Scottish Water consolidation, thereby replacing the IFRIC 12 adjustments in the consolidated results. Therefore, in determining the net cost/benefit to the Scottish Water group, the adjustments calculated under IFRIC 12 in respect of the North-East of Scotland PFI service concession contract have been reversed. Due to the timings and phasing of the IFRIC 12 elements at the date of acquisition, the reduction to the finance lease liability was £12.1m higher than the reduction to Property, plant and equipment. When taken together with the value of the net assets acquired and the consideration paid, there was a net benefit to the Scottish Water group of £0.5m, as shown in the table below.

	£m
Consideration paid by SWHH	(16.2)
Net assets acquired	4.6
Gain on reversal of IFRIC 12 net reserves charged in Scottish Water	12.1
Net benefit to Scottish Water group	0.5

The net benefit to the Scottish Water group of £0.5m has been recognised within the Consolidated Income Statement.

12 Inventories

	Group		Company	
	2019 £m	2018 £m	2019 £m	2018 £m
Raw materials and consumables	3.9	3.0	3.1	2.7
Less provision held	(0.2)	(0.1)	(0.2)	(0.1)
	3.7	2.9	2.9	2.6

All inventories will be recovered within 12 months.

Notes to the financial statements continued

For the year ended 31 March 2019

13 Trade and other receivables

	Note	Group		Company	
		2019 £m	2018 £m	2019 £m	2018 £m
Trade receivables	27	545.1	523.8	444.6	432.8
Less provision for impairment of trade receivables	27	(425.9)	(411.3)	(402.0)	(391.2)
Net trade receivables		119.2	112.5	42.6	41.6
Other receivables		25.6	26.1	23.7	24.6
Prepayments and accrued income		59.6	62.6	11.8	11.0
Amounts due from subsidiaries		–	–	0.2	0.2
		204.4	201.2	78.3	77.4

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

	Group		Company	
	2019 £m	2018 £m	2019 £m	2018 £m
Balance at 1 April	411.3	461.9	391.2	449.2
Charge for the year	25.8	31.4	18.4	17.4
Amounts written down during the year	(11.2)	(82.0)	(7.6)	(75.4)
Balance at 31 March	425.9	411.3	402.0	391.2

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

14 Cash and cash equivalents

	Group		Company	
	2019 £m	2018 £m	2019 £m	2018 £m
Cash at bank and in hand	160.0	166.6	36.1	31.6
Short-term bank deposits	274.8	239.8	274.8	239.0
Cash and cash equivalents per the statement of cash flows	434.8	406.4	310.9	270.6

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

15 Trade and other payables

	Note	Group		Company	
		2019 £m	2018 £m	2019 £m	2018 £m
Current					
Trade payables		27.6	37.5	16.0	25.2
Non trade payables and accruals		109.6	91.9	109.2	89.8
Accruals		188.6	200.8	154.9	159.1
Payments received in advance		103.3	98.0	74.8	70.0
Other payables		26.1	20.2	1.1	1.4
Deferred income		2.7	5.3	1.4	1.4
Other taxes and social security		4.2	4.0	3.8	3.6
Amounts due to subsidiaries		–	–	24.3	27.6
		462.1	457.7	385.5	378.1
Non-current					
Payments received in advance		62.2	59.7	62.2	59.7
Deferred income		16.5	17.3	9.5	11.0
Other financial liabilities – interest rate swap	27	10.3	–	–	–
		89.0	77.0	71.7	70.7

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

16 Deferred taxation

The following are the deferred tax liabilities and assets recognised by Scottish Water and the 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 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	–	13.9	–	–	13.9
At 31 March 2018		420.6	(29.8)	(22.0)	(9.6)	359.2
Charge/(credit) to income statement	8	15.4	(3.5)	2.6	(0.1)	14.4
(Credit)/charge to reserves	8	–	(8.9)	–	0.1	(8.8)
Addition of balances of companies acquired		3.4	–	–	(1.9)	1.5
At 31 March 2019		439.4	(42.2)	(19.4)	(11.5)	366.3
Company						
At 1 April 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	–	13.3	–	–	13.3
At 31 March 2018		420.2	(29.5)	(22.0)	(9.4)	359.3
Charge/(credit) to income statement		15.6	(3.3)	2.8	(1.7)	13.4
Credit to reserves	8	–	(8.5)	–	–	(8.5)
At 31 March 2019		435.8	(41.3)	(19.2)	(11.1)	364.2

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	
	2019 £m	2018 £m	2019 £m	2018 £m
Deferred tax assets	(1.8)	(0.8)	–	–
Deferred tax liabilities	368.1	360.0	364.2	359.3
At 31 March	366.3	359.2	364.2	359.3

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 income 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 Scottish Water 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 £143m (2018: £175m) for both the Company and the group. No tax is expected to be payable in this regard.

Notes to the financial statements continued

For the year ended 31 March 2019

17 Provisions for liabilities

	Income uncertainty provision £m	Restructure and other provision £m	Total £m
Group			
At 1 April 2017	9.3	2.0	11.3
Charged to the income statement	6.5	–	6.5
Utilised during the year	(1.2)	(0.5)	(1.7)
At 31 March 2018	14.6	1.5	16.1
Charged to the income statement	11.6	0.4	12.0
Utilised during the year	(2.8)	(0.2)	(3.0)
At 31 March 2019	23.4	1.7	25.1

Company			
At 1 April 2017	13.5	1.9	15.4
Charged to the income statement	11.2	–	11.2
Utilised during the year	(5.2)	(0.4)	(5.6)
At 31 March 2018	19.5	1.5	21.0
Charged to the income statement	17.8	0.4	18.2
Utilised during the year	(5.3)	(0.2)	(5.5)
At 31 March 2019	32.0	1.7	33.7

	Group		Company	
	2019 £m	2018 £m	2019 £m	2018 £m
Analysis of total provisions				
Current	10.4	8.5	13.5	10.4
Non-current	14.7	7.6	20.2	10.6
	25.1	16.1	33.7	21.0

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 over 2020 and 2021.

The restructuring and other provision relates primarily to onerous property rental costs.

18 Other loans and borrowings

	Group		Company	
	2019 £m	2018 £m	2019 £m	2018 £m
Current				
Non-government loans	4.8	–	0.5	–
Obligations under finance leases	20.0	21.7	22.9	21.7
	24.8	21.7	23.4	21.7
Non current				
Non-government loans	40.9	1.0	0.5	1.0
Obligations under finance leases	236.5	302.1	279.2	302.1
	277.4	303.1	279.7	303.1
Total				
Non-government loans	45.7	1.0	1.0	1.0
Obligations under finance leases	256.5	323.8	302.1	323.8
	302.2	324.8	303.1	324.8

(i) Non-government loans

Other loans are repayable as follows:

	Note	Up to 1 year £m	1-2 years £m	3-5 years £m	6-10 years £m	Total £m
Other loans – SW Company		0.5	0.5	–	–	1.0
Other loans – SW subsidiaries	20	4.3	4.5	10.2	25.7	44.7
At 31 March 2019		4.8	5.0	10.2	25.7	45.7
At 31 March 2018		–	0.5	0.5	–	1.0

Non-government loans of £44.7m represent amounts borrowed by a subsidiary under a facility agreement with a consortium of banks which bear interest at a margin over LIBOR and are repayable in instalments over the period ending 31 March 2027. These are secured by fixed and floating charges over the undertaking, property, assets and rights of that and over the parent company's shares in that subsidiary. These loans have certain covenants attached.

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

	Book value 2019 £m	Book value 2018 £m	Fair value 2019 £m	Fair value 2018 £m
Non-government loans	45.7	1.0	51.2	1.2

(ii) Finance lease liabilities – PFI liabilities

Group

Future finance lease commitments are as follows:

	Minimum lease payments		Present value of minimum lease payments	
	2019 £m	2018 £m	2019 £m	2018 £m
Amounts payable:				
Within one year	35.0	40.9	20.0	21.7
Between one and 5 years	131.4	156.9	106.5	119.5
After 5 years	196.6	269.3	130.0	182.6
Present value of minimum lease payments including finance charges	363.0	467.1		
Less future finance charges	(106.5)	(143.3)		
Present value of minimum lease payments	256.5	323.8	256.5	323.8

Notes to the financial statements continued

For the year ended 31 March 2019

18 Other loans and borrowings continued

Company

Future finance lease commitments are as follows:

	Minimum lease payments		Present value of minimum lease payments	
	2019 £m	2018 £m	2019 £m	2018 £m
Amounts payable:				
Within one year	40.8	40.9	22.9	21.7
Between one and 5 years	154.5	156.9	124.3	119.5
After 5 years	230.9	269.3	154.9	182.6
Present value of minimum lease payments including finance charges	426.2	467.1		
Less future finance charges	(124.1)	(143.3)		
Present value of minimum lease payments	302.1	323.8	302.1	323.8

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. On 19th December 2018, the companies operating the contract for Aberdeen were acquired by Scottish Water Horizons Holdings Limited, with Scottish Water remaining a client under the contract.

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.

19 Government loans

	Group and Company	
	2019 £m	2018 £m
Government loans	3,708.6	3,543.3

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

Group and company	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	87.5	97.6	198.3	359.5	2,340.6	3,083.5
National Loans Fund	27.0	33.0	176.0	217.4	137.5	590.9
Public Works Loan Board	10.1	3.7	10.0	7.8	2.6	34.2
At 31 March 2019	124.6	134.3	384.3	584.7	2,480.7	3,708.6
At 31 March 2018	123.0	124.6	381.5	631.6	2,282.6	3,543.3

b. Fair values

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

	Book value 2019 £m	Book value 2018 £m	Fair value 2019 £m	Fair value 2018 £m
Scottish Consolidated Fund	3,083.5	2,875.2	4,289.3	3,801.2
National Loans Fund	590.9	621.9	805.8	833.7
Public Works Loan Board	34.2	46.2	44.3	58.1
	3,708.6	3,543.3	5,139.4	4,693.0

20 Analysis of net debt

	Note	As at 1 April 2018 £m	Increase in cash £m	Movement in debt £m	As at 31 March 2019 £m
Group					
Cash and cash equivalents	14	406.4	28.4	–	434.8
Government loans	19	(3,543.3)	–	(165.3)	(3,708.6)
Other loans	18	(1.0)	–	(44.7)	(45.7)
Net debt		(3,137.9)	28.4	(210.0)	(3,319.5)
Company					
Cash and cash equivalents	14	270.6	40.3	–	310.9
Government loans	19	(3,543.3)	–	(165.3)	(3,708.6)
Other loans	18	(1.0)	–	–	(1.0)
Net debt		(3,273.7)	40.3	(165.3)	(3,398.7)

The movement in other loans of £44.7m is the balance as at 31 March 2019 of the external bank loans within the new companies acquired by Scottish Water Horizons Holdings Ltd. At the date of acquisition, these loans totalled £46.5m (note 11). The net new borrowing available to Scottish Water for the 2018/19 financial year was £210m, as outlined in the Delivery Plan. As a result of the acquisition, the net new borrowing drawn down from the Scottish Government was reduced to £165.3m, in order to maintain total net new debt at £210m. It is expected that as the external bank debt is repaid, additional borrowing of an equal amount will be available from the Scottish Government in order to maintain the forecast net new borrowing requirements of Scottish Water.

Notes to the financial statements continued

For the year ended 31 March 2019

21 Retained earnings reserve

	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 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
Retained surplus for the year		68.2	–	68.2
Actuarial loss net of deferred taxation	23	–	(43.5)	(43.5)
At 31 March 2019		1,702.5	(158.8)	1,543.7
Company				
At 1 April 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
Retained surplus for the year		67.2	–	67.2
Actuarial loss net of deferred taxation	23	–	(41.4)	(41.4)
At 31 March 2019		1,527.5	(155.8)	1,371.7

22 Results of Scottish Water (the Company)

Of the results for the financial year, a retained surplus of £67.2 million (2018: £62.4 million) is dealt with in the consolidated financial statements of Scottish Water. The Members have taken advantage of the exemption available under section 408 of the Companies Act 2006 and do not present an income statement 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 18.5% (2018: 20.7%), 31.8% (2018: 21.8%) and 19.3% (2018: 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 2019 by a qualified independent actuary, to take account of the requirements of IAS 19.

The major assumptions used by the actuaries were:

	2019 %	2018 %
Rate of increase in pensionable salaries	2.45	2.30
Rate of increase in pensions payment	2.45	2.30
Discount rate	2.40	2.60
CPI inflation rate	2.45	2.30

23 Pensions continued

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

	North East Scotland Years	Lothian Years	Strathclyde Years
Retiring at 31 March 2019			
Male	22.6	21.7	21.4
Female	24.8	24.3	23.7
Retiring at 31 March 2039			
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. 2.0%	Increase/decrease by c. £40m
Discount rate	+/- 0.5% per annum	Decrease/increase by c. 10.0%	Decrease/increase by c. £199m
CPI Inflation rate	+/- 0.5% per annum	Increase/decrease by c. 8.0%	Increase/decrease by c. £159m
Longevity	Increase life expectancy by 1 year	Increase by c. 4.0%	Increase by c. £80m

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

	Note	Group		Company	
		2019 £m	2018 £m	2019 £m	2018 £m
Total fair value of assets		1,742.8	1,622.8	1,706.9	1,590.5
Present value of scheme liabilities		(1,991.1)	(1,798.1)	(1,950.2)	(1,764.2)
Gross pension liability		(248.3)	(175.3)	(243.3)	(173.7)
Related deferred tax asset	16	42.2	29.8	41.3	29.5
Net pension liability		(206.1)	(145.5)	(202.0)	(144.2)

Scheme assets are stated at their bid values.

Guaranteed Minimum Pension (GMP) equalisation

In considering the potential impact of GMP equalisation, the advice and responses provided by the 3 pension funds and Scottish Water's actuarial advisors has been as follows:

- the general expectation is that a 'trigger event' is yet to occur in the Scottish Local Government Pension Scheme and our default approach will be to ignore any GMP equalisation impact in the employer's 31 March 2019 IAS 19 reports.

This opinion is shared by CIPFA.

Notes to the financial statements continued

For the year ended 31 March 2019

23 Pensions continued

Reconciliation of opening and closing retirement benefit liabilities and assets

Note	Group		Company	
	2019 £m	2018 £m	2019 £m	2018 £m
Movements in liabilities during the year:				
Opening value of total liabilities	(1,798.1)	(1,841.7)	(1,764.2)	(1,807.4)
Total service cost	5 (54.1)	(54.9)	(52.0)	(52.3)
Interest on pension scheme liabilities	7 (46.9)	(48.0)	(46.0)	(47.1)
Contributions by members	(9.0)	(8.8)	(8.6)	(8.3)
Actuarial (loss)/gain	(131.4)	105.7	(127.6)	101.5
Benefits paid	48.4	49.6	48.2	49.4
Closing value of total liabilities	(1,991.1)	(1,798.1)	(1,950.2)	(1,764.2)
Movement in assets during the year:				
Opening fair value of total assets	1,622.8	1,607.5	1,590.5	1,576.9
Interest on pension scheme assets	7 41.8	41.3	40.9	40.5
Contributions by members	9.0	8.8	8.6	8.3
Contributions by the employer	38.6	38.7	37.4	37.3
Actuarial gain/(loss)	79.0	(23.9)	77.7	(23.1)
Benefits paid	(48.4)	(49.6)	(48.2)	(49.4)
Closing fair value of assets	1,742.8	1,622.8	1,706.9	1,590.5
Gross deficit in the schemes at 31 March	(248.3)	(175.3)	(243.3)	(173.7)

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	
	2019 £m	2018 £m	2019 £m	2018 £m
Actual return on pension scheme assets	120.8	17.4	118.6	17.4
Actuarial (loss)/gain in other comprehensive income in the consolidated statement of comprehensive income				
Gross actuarial (loss)/gain recognised in the pension fund	(52.4)	81.8	(49.9)	78.4
Deferred tax movement	16 8.9	(13.9)	8.5	(13.3)
Net actuarial (loss)/gain recognised in other comprehensive income in the consolidated statement of comprehensive income	21 (43.5)	67.9	(41.4)	65.1

Amounts recognised in the consolidated income statement

Note	2019 £m	2018 £m
Total service cost	5 54.1	54.9
Interest cost on pension scheme net liabilities (see above)	7 5.1	6.7
	59.2	61.6

The unpaid contributions outstanding at the year end included in other payables (note 15) was £0.9 million (2018: £0.9 million). It is estimated that Scottish Water will make contributions of £33.0 million to the pension funds in financial year 2019/20.

23 Pensions continued

History of experienced gains and losses

	2019 £m	2018 £m
Group		
Difference between the expected and actual return on scheme assets:		
Amount	79.0	(23.9)
Fair value of assets	1,742.8	1,622.8
Experienced (losses)/gains on scheme liabilities:		
Amount	(3.6)	45.5
Present value of liabilities	1,991.1	1,798.1
Changes in assumptions underlying the present value of scheme liabilities:		
Amount	(127.8)	60.2
Total variance between pension fund actuarial assumptions and actual experience	(52.4)	81.8
Gross deficit in the schemes at 31 March	(248.3)	(175.3)

	2019 £m	2018 £m
Company		
Difference between the expected and actual return on scheme assets:		
Amount	77.7	(23.1)
Fair value of assets	1,706.9	1,590.5
Experienced (losses)/gains on scheme liabilities:		
Amount	(3.6)	42.8
Present value of liabilities	1,950.2	1,764.2
Changes in assumptions underlying the present value of scheme liabilities:		
Amount	(124.0)	58.7
Total variance between pension fund actuarial assumptions and actual experience	(49.9)	78.4
Gross deficit in the schemes at 31 March	(243.3)	(173.7)

24 Commitments

a. Capital commitments

Scottish Water has contracted capital commitments of £388.1 million (2018: £380.2 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

Scottish Water 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.

Scottish Water also leases vehicles under cancellable operating lease agreements. Scottish Water 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:

	2019 £m	2018 £m
Within one year	2.8	2.8
Between one and five years	8.6	7.0
After five years	16.0	16.5
	27.4	26.3

Notes to the financial statements continued

For the year ended 31 March 2019

25 Contingent assets and liabilities

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

Scottish Water 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 Scottish Water entered into the following transactions with its subsidiaries (note 11):

	2019 £m	2018 £m
Wholesale water and waste water services to Business Stream	139.6	143.5
Sale of waste water services to other subsidiaries	0.5	0.5
Purchase of waste water services from other subsidiaries	7.8	–
Seconded staff costs charged to subsidiaries	4.5	4.4
Other operating costs charged to subsidiaries	0.9	1.9
Purchase of property, plant and equipment from subsidiaries (note 3)	–	1.4

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. Scottish Water'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 51 to 57. Scottish Water's non-executive members hold additional roles within other organisations (see Members on pages 42 to 43).

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 6 to 39 and Corporate Governance report on pages 41 to 59.

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 Government borrowings are at fixed interest rates. Therefore Scottish Water is not deemed to bear any interest rate risk.

Other borrowings, following the acquisition of Aberdeen Environmental Services Limited (note 11), are linked to LIBOR and are therefore exposed to changes in LIBOR which could have a material effect on interest costs from year to year and over time. In order to manage the exposure to movements in LIBOR a floating interest rate to fixed rate swap exists. The fair values of these derivatives at the balance sheet date are determined by reference to their market values, which are provided by a third party (note 15).

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 Scottish Water fall into the 'loans and receivables' category. The financial liabilities of Scottish Water 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.

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

Notes to the financial statements continued

For the year ended 31 March 2019

27 Financial instruments and risks continued

	Group		Company	
	2019 £m	2018 £m	2019 £m	2018 £m
Trade receivables per note 13:				
Trade receivables	545.1	523.8	444.6	432.8
Less provision for impairment of trade receivables	(425.9)	(411.3)	(402.0)	(391.2)
Net trade receivables	119.2	112.5	42.6	41.6
Analysed between:				
Household receivables	435.5	422.6	435.5	422.6
Less provision for impairment	(399.0)	(388.2)	(399.0)	(388.2)
Net household receivables	36.5	34.4	36.5	34.4
Business customer receivables	109.6	101.2	9.1	10.2
Less provision for impairment	(26.9)	(23.1)	(3.0)	(3.0)
Net business customer receivables	82.7	78.1	6.1	7.2

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 2019 trade receivables in respect of household customers totalled £435.5 million with a provision of £399.0 million (2018: £422.6 million and £388.2 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 £m
Overall household collection rate	+/- 0.01%	Increase/decrease by c. £1.4m
In-year household bad debt provision charge	+/- 0.10%	Increase/decrease by c. £0.9m

As at 31 March 2019 trade receivables from business customers totalled £109.6 million (2018: £101.2 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	109.6	55.8	37.0	12.4	4.4
Provision	(26.9)	–	(12.5)	(10.0)	(4.4)
Net trade receivable as at 31 March 2019	82.7	55.8	24.5	2.4	–
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

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	9.1	4.6	1.7	1.1	1.7
Provision	(3.0)	–	(0.2)	(1.1)	(1.7)
Net trade receivable as at 31 March 2019	6.1	4.6	1.5	–	–
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	–	–

Group

Other financial liabilities – interest rate swap

As at the acquisition of Aberdeen Environmental Services Limited on 19 December 2018, the floating interest rate to fixed rate interest swap liability had a carrying value of £10.9 million. Any gains or losses on the effective portion of the hedging instruments are recognised within the Consolidated statement of comprehensive income or as an expense within the Consolidated income statement. The maturity of the interest rate swap coincides with the maturity of the loan (31 March 2027).

Interest rate swap – financial liability	Note	2019 £m
Balance at acquisition of subsidiaries		(10.9)
Effective portion of changes in fair value of cash flow hedge		0.6
Balance at 31 March	15	(10.3)

The fair values of these derivatives at the balance sheet date are determined by reference to their market values, which are provided by a third party.

The cash flow hedge reserve in the balance sheet, and the corresponding change in fair value recognised in the Consolidated statement of comprehensive income reflect, the movement in the interest rate swap liability net of deferred taxation.

	Cash flow hedging reserve		
	Gross reserve £m	Deferred tax £m	Net reserve £m
Balance at acquisition of subsidiaries	10.9	(1.9)	9.0
Effective portion of changes in fair value of cash flow hedge	(0.6)	0.1	(0.5)
Balance at 31 March	10.3	(1.8)	8.5

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	£16.7m
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 ¹	£150,000
Gifts	£100	None	–

¹ 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.

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.