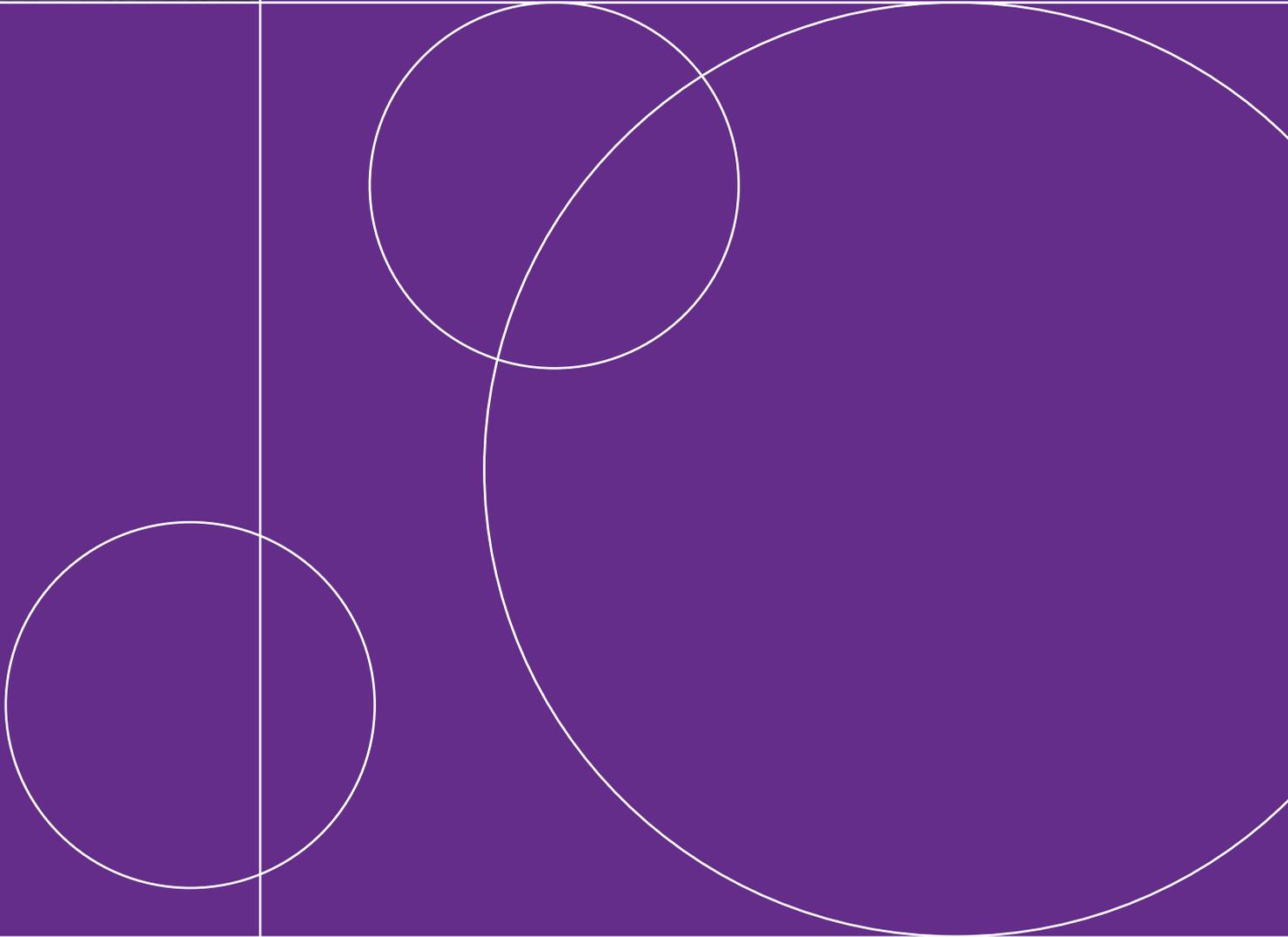


OVERVIEW REPORT



# Overview of the 2001/02 water authority audits



## Overview of the 2001/02 water authority audits

A report to the Scottish Parliament by the Auditor General for Scotland

### Auditor General for Scotland

The Auditor General for Scotland is the Parliament's watchdog for ensuring propriety and value for money in the spending of public funds.

He is responsible for investigating whether public spending bodies achieve the best possible value for money and adhere to the highest standards of financial management.

He is independent and not subject to the control of any member of the Scottish Executive or the Parliament.

The Auditor General is responsible for securing the audit of the Scottish Executive and most other public sector bodies except local authorities and fire and police boards.

The following bodies fall within the remit of the Auditor General:

- departments of the Scottish Executive eg the Department of Health
- executive agencies eg the Prison Service, Historic Scotland
- NHS boards and trusts
- further education colleges
- water authorities
- NDPBs and others eg Scottish Enterprise.

### Audit Scotland

Audit Scotland is a statutory body set up in April 2000, under the Public Finance and Accountability (Scotland) Act 2000. It provides services to both the Auditor General for Scotland and the Accounts Commission. Together they ensure that the Scottish Executive and public sector bodies in Scotland are held to account for the proper, efficient and effective use of public funds.

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# Executive summary

## Part 1: Introduction

### *The Scottish water industry*

1. Financial year 2001/02 was the final year of operation before merger of the three Scottish water authorities: East of Scotland Water Authority; North of Scotland Water Authority; and West of Scotland Water Authority. The authorities were established in 1996 following local government reorganisation and were responsible for providing safe water supplies to households and businesses and for receiving and treating waste water.
2. The water industry is essential to households and businesses across Scotland. It is vital to health and the quality of life and is a sufficiently large sector to have an influence on the Scottish economy. The combined turnover of the three water authorities in 2001/02 was £862 million, with capital assets with a book value of over £2.3 billion. The average number of staff employed by the three authorities in that year totalled about 5,600.
3. Under the Water Industry (Scotland) Act 2002 the business, assets and liabilities of the three former authorities were transferred to Scottish Water on 1 April 2002. Scottish Water is the fourth largest water services provider in the UK and the twelfth largest business in Scotland in terms of turnover. The principal benefits anticipated from the creation of Scottish Water are: harmonisation of charges across Scotland; an increase in the Scottish water industry's efficiency and competitiveness; and better value for money from economies of scale.

### *The purpose of this report*

4. This report, which is presented under section 23 of the Public Finance and Accountability (Scotland) 2000 Act, has been prepared principally from information contained in reports prepared by the external auditors appointed by the Auditor General at the conclusion of their 2001/02 audits of the three demitting water authorities. Overall, this report highlights issues reported by the external auditors relating to the final year of the demitting authorities and matters arising from those audits that may require action on the part of Scottish Water. It is my intention to report on the progress achieved by Scottish Water in its first year of operation, based on the external auditors' report on the 2002/03 audit.

## Part 2: Audit results

### *Completion of audits*

5. In recognition of the short timescale for the completion of water authority audits achieved in previous years, the Auditor General requested auditors to consider 14 June 2002 as the target for completion of the 2001/02 audits. In the event, the East of Scotland Water audit was signed off on 13 June 2002. As in previous years the auditors' certificate was qualified because no amounts had been allocated in the accounts to infrastructure assets transferred to the authority at its inception in April 1996. The auditors considered this material in the context of the accounts and qualified accordingly. Except for any adjustment that would have been necessary in this regard, the auditors concluded that East of Scotland Water's accounts give a true and fair view of the state of affairs and results for the year ended 31 March 2002. The West of Scotland Water and North of Scotland Water audits were signed off on 18 June 2002 and 28 June 2002 respectively. The auditors' certificates were unqualified. In all three cases, the auditors provided unqualified regularity opinions on the 2001/02 accounts.
  
6. On 7 June 2002 Scottish Ministers issued an Order instructing the formal dissolution of the three authorities. Dissolution accounts were prepared for each authority for the period 1 April 2002 to 28 June 2002 and were subject to audit by the respective auditors of the demitting authorities. In each case, the audit opinion was unqualified.

### *Governance and financial controls*

7. The board of each of the water authorities was required to include in its accounts a statement on the steps taken to comply with the best practice principles of corporate governance – all three authorities complied and no issues arose from the auditors' review of the statements.
  
8. Experience of similar exercises in local government and the NHS has confirmed the additional risk to financial systems and controls during periods of reorganisation. Key staff are often called upon to undertake additional duties relating to the establishment of the new organisation and there are inherent risks associated with the transfer of services, staff, assets and information. The external auditors' reports indicate that financial controls were maintained in the demitting water authorities in the period leading to the merger to form Scottish Water.

### *Other matters arising from the 2001/02 audits*

9. The auditors of East of Scotland Water reported that in July 2000 the authority's property committee approved the construction of a new building to accommodate 250 employees at an estimated cost of £5.75 million. The usual course of action would have been to involve the authority's capital projects group but, in this case, the authority decided that an alternative, 'fast track' approach was required. The change in purpose of the building from a headquarters building to a regional office and call centre for Scottish Water (to accommodate 500 employees) led to significant design revisions and price reviews. The auditors reported that the final construction cost is estimated at £8.4 million. Together with the inherited cost of £2.6 million the whole expenditure is £11 million which is close to open market value. The auditors reported that East of Scotland Water's property committee had carried out a detailed investigation into the project. This concluded that there were concerns about the way in which the project had been managed and recommended that all future property projects should be carried out in accordance with procedures laid down by the capital projects group. This recommendation was endorsed by the authority's audit committee.
10. The most significant cost of reorganisation relates to termination settlements to employees who elected to leave the employment of the water authorities. As part of their 2001/02 audits the external auditors reviewed a sample of payments made to ensure that they complied with the rules of the severance schemes. While auditors noted some specific points of detail, overall their reports indicate that the calculations were properly authorised and that proper procedures were applied.

### *Financial position in 2001/02*

11. The accounts of the three water authorities show that in each case their financial targets were achieved in 2001/02.
12. Across the three water authorities turnover in 2001/02 was £862 million and the operating surplus was £284 million. Taking the three demitting authorities together, there was an overall retained surplus of £50 million as at 31 March 2002.
13. The provision of water supplies and treatment of waste water requires significant capital assets; the net book value of capital assets across the three authorities at 31 March 2002 was of the order of £2.3 billion. Infrastructure assets comprise mains and sewers, raw water storage reservoirs, dams, sludge pipelines and sea outfalls. Across the three water authorities, the total infrastructure maintenance charge in the 2001/02 accounts was £90 million.

14. Significant levels of capital investment are required to meet more stringent environmental and drinking water quality standards. A considerable proportion of this has been financed through PFI/PPP schemes. Payments under PFI/PPP contracts are expected to be of the order of £100 million in 2002/03, rising to over £120 million by 2005/06.
15. The non-payment of water and sewerage charges is a significant issue in Scotland. The total value of trade debtors, which comprise amounts due from domestic and non-domestic customers, net of provision for bad debts across the three authorities was £95 million as at 31 March 2002. This compares with an overall total of £79 million at the end of the previous year, representing a year on year increase of over 20%.

### *Reorganisation costs and efficiency targets*

16. The accounts for the three demitting authorities disclose exceptional costs which they attribute to reorganisation arising from the creation of Scottish Water and efforts to improve efficiency. The total exceptional costs were £57 million in 2001/02 and £29.6 million in 2000/01, producing an overall total of £86.6 million in the two years to 31 March 2002. The principal components of these charges relate to costs incurred under voluntary severance schemes and to the cost of enhanced pension entitlements to employees who were offered early retirement under the schemes. The schemes governing termination settlements were in place before the Parliament had approved the creation of Scottish Water in March 2002 and were introduced by each of the demitting authorities as a means of reducing costs.
17. In providing advice to Ministers on the revenue cap, the Water Industry Commissioner (WIC) makes certain efficiency assumptions against which he will compare Scottish Water's performance. These efficiency targets will be agreed between Scottish Water and Scottish Ministers through the process of agreeing the 2002-06 strategic business plan. The '*Strategic Review of Charges 2002-2006*' published by the WIC in October 2001 reviewed the potential for efficiencies and proposed efficiency targets for Scottish Water. In addition the WIC assumed merger efficiencies from the integration of head offices and support services; economies of scale; and from the disposal of assets no longer required by Scottish Water.

### Part 3: Issues for Scottish Water

18. In the short term, Scottish Water will focus on the need for continuity of the services which it provides to its customers and on maintaining sound financial management arrangements based on systems inherited from its predecessor authorities. But the merger provides an opportunity for Scottish Water to review existing operational and management arrangements and the wider governance framework required to meet the challenges which it faces in future years. In establishing new arrangements Scottish Water will need to ensure that the risks associated with change are identified and addressed. Scottish Water is currently operating financial and other systems inherited from the demitting water authorities and financial information generated by these systems is consolidated to produce the overall results for Scottish Water. A key challenge for Scottish Water is to ensure that these systems are harmonised in a controlled and cost-effective manner.

#### *Corporate governance*

19. The merger process will not change the traditional public sector values of impartiality, openness and transparency and the highest standards of probity and propriety appropriate in cases where public money is involved. However, it does present an opportunity to re-emphasise certain key aspects of governance.

#### *Audit issues brought forward from the demitting authorities*

20. In reporting on the 2001/02 audits, the auditors highlighted matters which require to be addressed by Scottish Water. The auditors emphasised that these issues arose from their audits of the demitting authorities and that no assurance could be given on the financial standing of the new authority or of its controls. The following figure summarises the main points raised by the auditors of the demitting authorities relating to financial control and to the control environment generally. It also draws together other points which the auditors indicate may require action on the part of Scottish Water. Scottish Water may already have taken action to address all or some of these issues; the external auditors will be reviewing progress in each of these areas during the course of their 2002/03 audit and will report at the conclusion of that year's audit. This will form the basis for a report to Parliament on the progress achieved by Scottish Water in its first year of operation.

## Matters arising from auditors' 2001/02 reports: points for action by Scottish Water

### Financial control issues

- Scottish Water should compile a consolidated fixed asset register.
- Fixed assets should be reviewed in terms of their deployment and carrying values.
- Scottish Water should formulate a combined infrastructure asset maintenance plan.
- The practice of regular visits to local authorities to check domestic income systems and calculations should continue.
- Further progress is required in developing and harmonising non-domestic income systems and controls.
- An overall review of debt management arrangements should be considered. Levels of domestic and non-domestic debts should be monitored closely – particular action is required to improve domestic collection rates.
- As financial systems are harmonised, steps should be taken to ensure that the transfer process is planned and controlled.

### General control issues

- As operational systems are standardised, steps should be taken to ensure that changes are adequately planned and costs controlled.
- The audit committee should review points arising from the 2001/02 audits of the demitting authorities to ensure that all issues which are relevant to the new authority are addressed.
- Steps should be taken to ensure that internal audit is adequately resourced and that the status of internal audit as a key element of the control environment is confirmed.
- Internal audit should develop a long-term risk based audit plan. The audit committee should review the plan to ensure that the programme of work will provide the assurance required by the board, in terms of its corporate governance responsibilities.
- Scottish Water should take forward the work carried out in the demitting authorities to develop a comprehensive risk management framework. Attention should be given to areas where the loss of experienced key personnel may indicate increased risk.
- Scottish Water should consider developing authority-wide policies on fraud and 'whistle-blowing'.

### Other matters

- Harmonisation and standardisation will include a need for a human resource focus on developments.
- There is a need to improve the standard of personnel data and files.
- Steps should be taken to conclude the outstanding tax affairs of the demitting authorities.
- Steps should be taken to develop procedures for recording, reporting and monitoring key performance indicators.
- The arrangements for attaining efficiency savings should be monitored to ensure that agreed targets are achieved.

Source: External auditors' reports to the boards and the Auditor General 2001/02

# Part 1: Introduction

This part covers:

- the Scottish water industry
- the purpose of this report.

## 1 The Scottish water industry

### Background

- 1.1 Financial year 2001/02 was the final year of operation before merger of the three Scottish water authorities: East of Scotland Water Authority (EoSW); North of Scotland Water Authority (NoSW); and West of Scotland Water Authority (WoSW). The authorities were established in 1996 following local government reorganisation and were responsible for providing safe water supplies to households and businesses and for receiving and treating waste water.
- 1.2 Exhibit 1 sets out the areas in which the water authorities operated in 2001/02.

#### Exhibit 1: Provision of water/waste water services 2001/02

EoSW	Lothians, Borders, Fife and Central areas. EoSW also covered the Kinross area of Tayside.
NoSW	Highlands, Grampian and Tayside (excluding Kinross) areas and Orkney, Shetland and Western Isles.
WoSW	Dumfries and Galloway and Strathclyde areas.

Source: Audit Scotland

- 1.3 The water industry is essential to households and businesses across Scotland. It is vital to health and the quality of life and is a sufficiently large sector to have an influence on the Scottish economy. The combined turnover of the three water authorities in 2001/02 was £862 million, with capital assets with a book value of over £2.3 billion. The average number of staff employed by the three authorities in that year totalled about 5,600.

### Regulation

- 1.4 Responsibility for the regulation of the water industry in 2001/02 rested with a number of agencies. These are set out in Exhibit 2.

## Exhibit 2: Regulation of the Scottish water industry in 2001/02

- Scottish Executive Environment and Rural Affairs Department: overall responsibility for the regulatory framework including financial controls for the water industry and the regulation of drinking water quality.
- Scottish Environment Protection Agency: responsible for environmental protection and for regulating activities that may pollute water.
- Water Industry Commissioner for Scotland: responsible for promoting the interests of the water authorities' customers through economic and customer service regulation; responsible for considering and approving charges schemes with the water authorities.

[Further details are provided in Appendix 1].

Source: Audit Scotland

### Scottish Water

- 1.5 On 14 February 2002 the Scottish Parliament passed a Bill which proposed the merger of the three water authorities to form a single authority, Scottish Water. The resulting Act (the Water Industry (Scotland) Act 2002) received Royal Assent in March 2002 and on 1 April 2002 the business, assets and liabilities of EoSW, NoSW and WoSW were transferred on a going concern basis to Scottish Water. Scottish Water is a 'public corporation of a trading nature'. It is the fourth largest water services provider in the UK and the twelfth largest business in Scotland in terms of turnover. The new authority provides services to about 2.5 million household and business customers in Scotland, including the supply of a total of over 2.5 billion litres of water each day. Its assets include 401 water treatment works, 590 waste water treatment works, about 46,000 kilometres of water mains and nearly 30,000 kilometres of sewers.
- 1.6 In addition to establishing a single water authority for Scotland, the Act provides for Scottish Water to have a board structure that differs from the demitting authorities with a larger level of representation of executive directors on its board. The Act also provides Scottish Water with a greater measure of commercial freedom than its predecessors, for changes in the way in which customers' interests are taken into account and for the creation of a Drinking Water Quality Regulator whose powers apply to Scottish Water and private water supplies.
- 1.7 The principal benefits anticipated from the creation of Scottish Water are set out in Exhibit 3.

### Exhibit 3: Creation of Scottish Water – anticipated benefits

- Harmonisation of charges across Scotland.
- Increase in the Scottish water industry's efficiency and competitiveness.
- Better value for money as a result of economies of scale.

Source: Transport and Environment Committee, 9th Report 2001

- 1.8 In October 2001, the Water Industry Commissioner (WIC) published his first full *'Strategic Review of Charges'* covering the financial period from April 2002 to March 2006. This is a detailed document which assesses the prospects for Scottish Water over that four year period. On the basis of WIC's proposals, Scottish Ministers established a cap on the amount that Scottish Water can raise from charges at about 20% over the four year period. This means that average domestic bills for water and sewerage services will rise from about £230 in 2001/02 to about £275 in 2005/06. The cap proposed by WIC was based on the assumption that Scottish Water achieves certain efficiency targets over that period.

### Responsibilities and accountabilities

- 1.9 A summary of the current responsibilities and accountabilities for the Scottish water industry are set out in Exhibit 4.

### Exhibit 4: Scottish Water – summary of responsibilities and accountabilities

- **Scottish Ministers** are overall accountable to the Scottish Parliament for the functions of Scottish Water.
- The **Accountable Officer** of the Scottish Executive Environment and Rural Affairs Department is responsible to the Scottish Parliament for the propriety and regularity of funds provided to Scottish Water.
- The **board** of Scottish Water is responsible for the strategic direction of the organisation and for ensuring that it is managed and organised effectively and efficiently.
- Scottish Water's **Chief Executive** is responsible for the day-to-day operations and management of the organisation and for meeting its aims and objectives. The Chief Executive, as designated Accountable Officer, is accountable to the Scottish Parliament for the propriety and regularity of public funds administered by Scottish Water.

[Further details are provided in Appendix 2].

Source: Audit Scotland

## 2 The purpose of this report

- 2.1 Under the terms of the Public Finance and Accountability (Scotland) Act 2000 (the 2000 Act) the Auditor General for Scotland is responsible for securing the audit of each of the water authorities. In practice this involves the Auditor General in appointing auditors to undertake the annual audits. Appendix 3 sets out the auditors for 2001/02 and, from 2002/03 onwards, for Scottish Water.
- 2.2 This report, which is presented under section 23 of the 2000 Act, has been prepared principally from information contained in reports prepared by the external auditors appointed by the Auditor General at the conclusion of their 2001/02 audits of the three demitting water authorities. Its purpose is to cover all the significant issues arising out of the 2001/02 audits of the three water authorities which operated in that year, including issues relating to the merger process leading to the creation of Scottish Water.
- 2.3 Part 2 of the report relates to matters arising from the 2001/02 audits. The third part identifies matters reported by the external auditors as part of their 2001/02 audits which may be relevant to Scottish Water.
- 2.4 Overall, the report highlights issues reported by the external auditors relating to the final year of the demitting authorities and matters arising from those audits that may require action on the part of Scottish Water. The Auditor General intends to report on the progress achieved by Scottish Water in its first year of operation, based on the external auditors' report on the 2002/03 audit.

## Part 2: Audit results

This part covers:

- completion of audits
- governance and financial controls
- other matters arising from the 2001/02 audits
- financial position in 2001/02
- reorganisation costs and efficiency targets.

### 3 Completion of audits

- 3.1 Section 22(5) of the Public Finance and Accountability (Scotland) Act 2000 (the 2000 Act) requires Scottish Ministers to lay before Parliament a copy of every account and report sent to them by the Auditor General, including water authority accounts, not later than nine months after the financial period to which the account relates. This would require the audited accounts for financial year 2001/02 to be laid in Parliament by 31 December 2002. However, in recognition of the short timescale for the completion of water authority audits achieved in previous years, the Auditor General requested auditors to consider 14 June 2002 as the target for completion of the 2001/02 audits.
- 3.2 In the event, the EoSW audit was signed off on 13 June 2002. As in previous years the auditors' certificate was qualified because no amounts had been allocated in the accounts to infrastructure assets transferred to EoSW at its inception in April 1996. The reason for this treatment is explained in the authority's accounting policies and is attributed to the age and estimated condition of the infrastructure assets transferred at that date. The auditors of EoSW considered the omission of a deemed cost for transferred infrastructure assets to be material in the context of EoSW's accounts and qualified accordingly. Except for any adjustment that would have been necessary in this regard, the auditors concluded that EoSW's 2001/02 accounts give a true and fair view of the state of affairs and results for the year ended 31 March 2002.
- 3.3 The WoSW and NoSW audits were signed off on 18 June 2002 and 28 June 2002 respectively. The auditors' certificates were unqualified.

#### *Regularity opinion*

- 3.4 The 2000 Act requires auditors to include within their audit report an opinion as to whether, in all material respects, the expenditure and income shown in the accounts were incurred or applied in accordance

with applicable enactments and guidance issued by Scottish Ministers. This element of the audit report is in addition to the ‘true and fair’ opinion on the financial statements.

- 3.5 In all three cases, the auditors provided unqualified regularity opinions on the 2001/02 accounts.

### *Dissolution accounts*

- 3.6 The boards (with the exclusion of the former chief executives) of EoSW, NoSW and WoSW, together with their finance directors, remained in post until the dissolution of the three authorities. The boards were responsible for overseeing the dissolution, including the production of accounts recording financial transactions in the dissolution period. The finance directors were the designated Accountable Officers over this period.
- 3.7 On 7 June 2002 Scottish Ministers issued the ‘*New Water and Sewerage Authorities Dissolution (Scotland) Order 2002*’ instructing the formal dissolution of the three authorities on 29 June 2002.
- 3.8 Dissolution accounts were therefore prepared for each authority for the period 1 April 2002 to 28 June 2002. These accounts were subject to audit by the respective auditors of the demitting authorities and, in each case, the audit opinion was unqualified.

## **4 Governance and financial controls**

### *Governance*

- 4.1 Corporate governance is defined as the systems by which organisations are directed and controlled. The board of each of the water authorities was required to include in its accounts a statement on the steps taken to comply with the best practice principles of corporate governance as set out in the Combined Code on Corporate Governance issued by the London Stock Exchange (now the Financial Services Authority). As part of that statement, the board was required to state that it recognised its responsibility for establishing, maintaining and reviewing the system of internal control with reference to its arrangements for managing risk. All three authorities complied with these disclosure requirements.
- 4.2 The auditors were required to review the corporate governance statement and report if it did not comply with the provisions of the Combined Code or if it was misleading or inconsistent with other information which they were aware of from their audits. In this

context, no specific matters were raised by the external auditors of the three water authorities in 2001/02.

### *Financial systems and controls*

- 4.3 To ensure the proper conduct of their business, the water authorities had a responsibility to maintain adequate systems of internal control, including systems of financial control. The external auditors evaluated those systems and related controls and, where appropriate, reported their findings.
- 4.4 Experience of similar exercises in local government and the NHS has confirmed the additional risk to financial systems and controls during periods of reorganisation. Key staff are often called upon to undertake additional duties relating to the establishment of the new organisation and there are inherent risks associated with the transfer of services, staff, assets and information. These risks may contribute to weakened financial controls in the demitting organisations.
- 4.5 The external auditors' reports indicate that financial controls were maintained in the demitting water authorities in the period leading to the merger to form Scottish Water. The auditors of NoSW noted that substantial progress had been achieved in 2001/02 in raising awareness throughout the organisation of the importance of following financial procedures and in strengthening control processes.
- 4.6 At EoSW and WoSW, the external auditors highlighted continuing difficulties in 2001/02 in the non-domestic income systems. At EoSW the auditors reported that, although progress had been achieved in 2001/02, the problems experienced with the billing system in previous years had yet to be resolved fully. At WoSW, the auditors reported that a number of areas required to be kept under review, specifically in respect of the management of key accounts, collection of debts and operational issues surrounding the recently introduced billing system, where system related problems existed. WoSW's external auditors highlighted that these matters required to be addressed as a matter of urgency if the system is to realise its full potential.
- 4.7 The auditors identified a number of other specific matters arising from their review of financial systems which fall to be addressed by Scottish Water. These are considered in Part 3 of this report.

### *Internal audit*

- 4.8 Internal audit is an important part of management's arrangements for monitoring and reviewing internal control systems. Accordingly, as

part of their review of the control environment, external auditors undertake an assessment of the internal audit arrangements.

- 4.9 The external auditors' reports indicate that in the three water authorities in 2001/02 there was good liaison and co-operation between internal and external audit. In the case of all three authorities the external auditors were able to rely on the work of internal audit thereby making best use of the overall resources available for audit.
- 4.10 The external auditors have highlighted the key role of internal audit in reviewing and assessing the financial systems and controls operating in Scottish Water, particularly in its first years of operation. This is considered further in Part 3 of this report.

## 5 Other matters arising from the 2001/02 audits

- 5.1 The following specific issues relating to the 2001/02 audits were identified by the external auditors.

### *Development of HQ facility*

- 5.2 The auditors of EoSW reported that in July 2000 the authority's property committee approved the construction of a new building at Fairmilehead, Edinburgh to accommodate 250 employees at an estimated cost of £5.75 million. The usual course of action would have been to involve the authority's capital projects group but, in this case, the authority decided that an alternative, 'fast track' approach was required.
- 5.3 The change in purpose of the building from EoSW headquarters to a regional office and call centre for Scottish Water (to accommodate 500 employees) led to significant design revisions and price reviews. The auditors reported that the final construction cost is estimated at £8.4 million. Together with the inherited cost of £2.6 million the whole expenditure is £11 million which is close to the assessment of open market investment value for rental purposes of £10.5 - £11 million.
- 5.4 The auditors reported that EoSW's property committee had carried out a detailed investigation into the project. This concluded that there were a number of areas of concern about the way in which the project had been managed and recommended that all future property projects should be carried out in accordance with procedures laid down by the capital projects group. This recommendation was endorsed by the authority's audit committee.

### Termination settlements

- 5.5 The most significant cost of reorganisation relates to termination settlements to employees who elected to leave the employment of the water authorities. The overall costs of reorganisation and the merger process are considered in section 7 of this report.
- 5.6 As part of their 2001/02 audits the external auditors reviewed a sample of payments to ensure that they complied with the rules of the severance schemes. While auditors noted some specific points of detail, overall their reports indicate that the calculations were properly authorised and that proper procedures were applied.

## 6 Financial position in 2001/02

### Financial target performance

- 6.1 Under the financial regime in 2001/02, water authorities were required to achieve three financial targets: to achieve a rate of return on net operating assets of not less than 6.5% on a current cost basis; to break-even (taking one year with another) and to operate within an external financing limit (the 'EFL'). The annual accounts of the three water authorities show that these targets were achieved in each case in 2001/02.

### Financial position

- 6.2 As indicated earlier, the water industry in Scotland represents a significant undertaking. Exhibit 5 shows the business activity of the three authorities in terms of turnover in financial years 2000/01 and 2001/02.

**Exhibit 5: Turnover 2000/01 and 2001/02**

	EoSW		NoSW		WoSW	
	2001/02	2000/01	2001/02	2000/01	2001/02	2000/01
Turnover	£m	£m	£m	£m	£m	£m
Water	135	131	122	108	173	152
Waste water	120	99	114	99	198	162
Total	<b>255</b>	<b>230</b>	<b>236</b>	<b>207</b>	<b>371</b>	<b>314</b>

Source: Audited accounts 2001/02

6.3 Exhibit 6 provides an analysis of expenditure by the three authorities in 2001/02 across the major expenditure headings.

**Exhibit 6: Expenditure in 2001/02**



Source: Audit Scotland

6.4 Exhibit 7 shows operating surpluses in financial years 2000/01 and 2001/02. The operating surplus is also shown as a percentage of the year's turnover.

**Exhibit 7: Operating surpluses 2000/01 and 2001/02**

	EoSW				NoSW				WoSW			
	2001/02		2000/01		2001/02		2000/01		2001/02		2000/01	
Operating surplus (before interest and exceptional costs)	£m	% of turnover										
	71	28%	54	23%	66	28%	55	27%	147	40%	80	25%

Source: Audited accounts 2001/02

6.5 The main adjustment between the operating surplus (Exhibit 7) and the retained surplus for the year relate to (net) interest charges payable in respect of borrowing for capital purposes. However, in 2000/01 and 2001/02, the water authorities were required to meet exceptional costs arising from the reorganisation of the water industry. These charges are considered further in section 7. Exhibit 8 shows how interest and reorganisation costs are applied to the operating surpluses shown in Exhibit 7 to produce the retained surplus for the year. The retained surplus carried forward is also shown. Taking the three demitting authorities together, there was an overall retained surplus of £50 million as at 31 March 2002.

**Exhibit 8: Retained surpluses 2000/01 and 2001/02**

	EoS		NoS		WoS	
	2001/02 £m	2000/01 £m	2001/02 £m	2000/01 £m	2001/02 £m	2000/01 £m
Operating surplus	71	54	66	55	147	80
Net interest costs	(48)	(47)	(29)	(27)	(56)	(53)
Reorganisation costs	(12)	(10)	(20)	(3)	(26)	(17)
Other adjustments	(1)	–	2	1	(16)	(3)
Surplus/(deficit)	10	(3)	19	26	49	7
Surplus/(deficit) brought forward	(29)	(26)	(15)	(41)	16	9
Surplus/(deficit) at 31 March	(19)	(29)	4	(15)	65	16

Source: Audited accounts 2001/02

**Capital investment**

6.6 The provision of water supplies and treatment of waste water requires significant capital assets; the net book value of capital assets across the three authorities at 31 March 2002 was of the order of £2.3 billion. The Department has indicated that it is the intention of Scottish Water in preparing its accounts for 2002/03 to consider whether any adjustment is required in respect of the closing balance sheet values of the three demitting authorities, particularly in respect of infrastructure assets.

6.7 The term ‘infrastructure assets’ is used to describe the network of systems comprising mains and sewers, raw water storage reservoirs, dams, sludge pipelines and sea outfalls. Expenditure on infrastructure

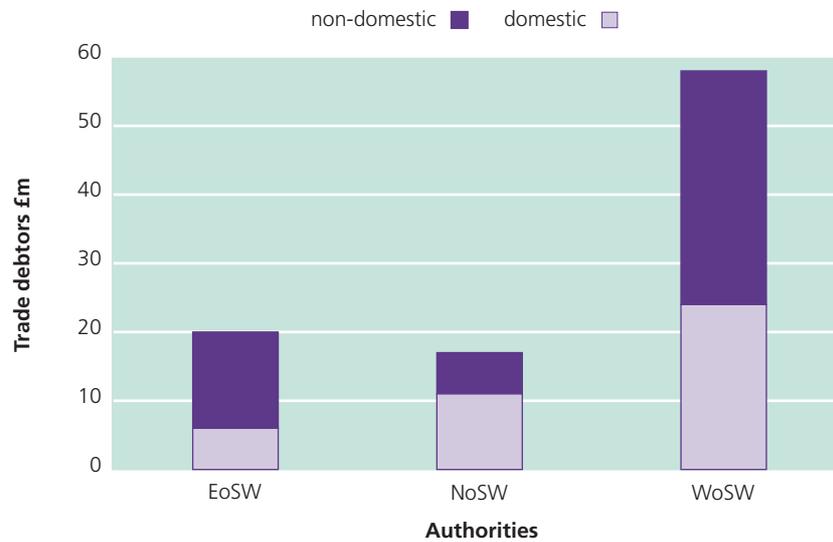
assets relating to increases in capacity or enhancements to the network are treated in the accounts as additions at cost. The depreciation charge for infrastructure assets, described as an 'infrastructure maintenance charge', is the estimated level of annual expenditure required to maintain the operating capacity of the network. This is derived from asset management plans and results in a smoothed annual charge to offset the uneven expenditure patterns which arise due to the timing of the investment programme and other operational considerations. Across the three water authorities, the total infrastructure maintenance charge in the 2001/02 accounts was £90 million. The other types of assets identified in the accounts relate to specialised and non-specialised operational properties and plant, machinery and vehicles.

- 6.8 Significant levels of capital investment are required to meet more stringent environmental and drinking water quality standards. Following a wide ranging review of quality and standards the Scottish Executive has estimated that investment in the order of £2 billion will be required in the four year period to 2006. This is intended to meet the statutory environment and quality standards and some improvements to assets, but in deciding on this course of action the Executive acknowledge that this will only permit sufficient investment in the underground infrastructure to prevent further deterioration.
- 6.9 A considerable proportion of the investment in capital assets has been financed through PFI/PPP schemes. The water authorities considered this approach to be the most effective when undertaking large scale projects such as the construction of new sewage treatment works. Payments under PFI/PPP contracts are expected to be of the order of £100 million in 2002/03, rising to over £120 million by 2005/06.

### *Debtors*

- 6.10 The total value of trade debtors, which comprise amounts due from domestic and non-domestic customers, net of provision for bad debts across the three authorities was £95 million as at 31 March 2002. This compares with an overall total of £79 million at the end of the previous year, representing a year on year increase of over 20%.
- 6.11 Exhibit 9 shows the position across the three authorities, highlighting the domestic and non-domestic elements of the total amount due as at 31 March 2002.

**Exhibit 9: Trade debtors (net of provision) as at 31 March 2002**



Source: Audit Scotland

- 6.12 The non-payment of water and sewerage charges is a significant issue in Scotland. In 2000/01 the average household bill was £194, £12 of which was attributable to non-payment. This problem was most significant in the WoSW area.

## 7 Reorganisation costs and efficiency targets

### *Reorganisation costs*

- 7.1 Included within the accounts of the three demitting authorities are 'exceptional costs' relating to financial years 2000/01 and 2001/02. The accounts attribute these costs to restructuring in preparation for the creation of Scottish Water and to the results of efforts to improve efficiency. The total exceptional costs for reorganisation were £57 million in 2001/02 and £29.6 million in 2000/01, producing an overall total of £86.6 million in the two years to 31 March 2002. Exhibit 10 summarises the position.

**Exhibit 10: Reorganisation – ‘exceptional costs’ 2000/01 and 2001/02**

Authorities	2001/02 £m	2000/01 £m
EoSW	11.5	9.5
NoSW	19.6	3.3
WoSW	25.9	16.8
Total	<b>£57.0m</b>	<b>£29.6m</b>

Source: Audited accounts 2001/02

- 7.2 The principal components of these charges relate to costs incurred under voluntary severance schemes and to the cost of enhanced pension entitlements to employees who were offered early retirement under the schemes. The schemes governing termination settlements were in place before the Parliament had approved the creation of Scottish Water in March 2002 and were introduced by each of the demitting authorities as a means of reducing costs.
- 7.3 In the year to 31 March 2002, a Scottish Water integration team and other project teams were established to focus on a range of matters relevant to the merger of the three demitting authorities. The related costs were initially met by EoSW; Scottish Water was subsequently recharged those amounts directly related to the new organisation. A total of £4.8 million was incurred by EoSW, of which £3.3 million was recharged to Scottish Water. The balance (£1.5 million ie, £0.5 million for each of EoSW, NoSW and WoSW) related to costs incurred by the demitting authorities in their activities prior to the merger.
- 7.4 As indicated in paragraph 3.6, the boards of the former authorities were responsible for overseeing the dissolution process. Accounts were prepared recording the financial transactions in the period 1 April 2002 to 28 June 2002. The total amount incurred by the three authorities in the dissolution period was £212,000 which related mainly to staff and board member costs and was funded by Grant-in-Aid allocated by the Scottish Executive.
- 7.5 In addition to the costs attributable to reorganisation and disclosed in the accounts, preparation for the merger involved significant input from staff, the cost of which is not separately identifiable.

- 7.6 The costs associated with merger will continue after the period to which this report relates as Scottish Water reconfigures its operations, standardises approaches and harmonises systems.

### Efficiency savings

- 7.7 As indicated earlier, the Water Industry Commissioner (WIC) advises Scottish Ministers on the revenue cap for Scottish Water. In providing that advice, the WIC makes certain efficiency assumptions against which he will compare Scottish Water's performance. Any efficiency targets will be agreed between Scottish Water and Scottish Ministers through the process of agreeing the 2002-06 strategic business plan.
- 7.8 The 'Strategic Review of Charges 2002-2006' published by the WIC in October 2001 reviewed the potential for efficiencies and proposed efficiency targets for Scottish Water. In addition the WIC assumed merger efficiencies from the integration of head offices and support services; economies of scale; and from the disposal of assets no longer required by Scottish Water.
- 7.9 The operating efficiency targets assumed by WIC are set out in Exhibit 11.

**Exhibit 11: Efficiency targets assumed by WIC 2002-2006**

	Operating cost efficiencies £m	Merger operating cost efficiencies £m	Total £m
2002/03	63	20	83
2003/04	97	25	122
2004/05	116	29	145
2005/06	136	29	165

Source: Water Industry Commissioner

## Part 3: Issues for Scottish Water

This part covers:

- corporate governance
- audit issues brought forward from the demitting authorities.

In the short term, Scottish Water will focus on the need for continuity of the services which it provides to its customers and on maintaining sound financial management arrangements based on systems inherited from its predecessor authorities. But the merger provides an opportunity for Scottish Water to review existing operational and management arrangements and the wider governance framework required to meet the challenges which it faces in future years. In establishing new arrangements Scottish Water will need to ensure that the risks associated with change are identified and addressed.

Scottish Water is currently operating financial and other systems inherited from the demitting water authorities and financial information generated by these systems is consolidated to produce the overall results for Scottish Water. A key challenge for Scottish Water is to ensure that these systems are harmonised in a controlled and cost-effective manner.

### 8 Corporate governance

- 8.1 The merger process will not change the traditional public sector values of impartiality, openness and transparency and the highest standards of probity and propriety appropriate in cases where public money is involved. However, it does present an opportunity to re-emphasise certain key aspects of governance, examples of which are set out in Exhibit 12.

#### Exhibit 12: Governance – examples of key issues

- A sound control environment
- Security of key financial systems
- Adequate and effective internal audit
- Strong audit committee arrangements
- Reliable accounts preparation processes
- Robust accountability and performance management arrangements

Source: Audit Scotland

- 8.2 The importance of strong governance arrangements at this crucial stage in the new authority are highlighted by the Water Industry Commissioner in the ‘*Strategic Review of Charges 2002-2006*’ document. His comments on governance are set out in Exhibit 13.

**Exhibit 13: Governance – views of the Water Industry Commissioner**

*“To meet these challenges (ie, those facing Scottish Water) will require the framework of corporate governance to be strengthened. A stronger governance framework will provide significant reassurance to customers that the existing authorities or the proposed Scottish Water are genuinely accountable. Such high standards of corporate governance can only be delivered by an experienced, commercially orientated board and by high-quality senior management.”*

Source: Water Industry Commissioner for Scotland ‘*Strategic Review of Charges 2002-2006*’

- 8.3 In exercise of powers available to them under the Water Industry (Scotland) Act 2002, Scottish Ministers issued the ‘*Scottish Water (Corporate Governance) etc Directions 2002*’ on 2 April 2002.
- 8.4 The Directions required Scottish Water by 30 September 2002 to establish written procedures to regulate proper internal control, and effective and efficient management, of its functions. In addition to specifying the minimum procedures to be implemented, the Directions included a requirement to establish an audit committee and remuneration committee by 30 June 2002 and to appoint a corporate secretary. The Directions also set out the general responsibilities of board members, with particular reference to the responsibilities and duties of the chief executive who is the designated accountable officer for Scottish Water. The final section of the Directions requires Scottish Water to produce a strategic business plan for the financial years 2002 to 2006 for approval by Scottish Ministers.

## 9 Audit issues brought forward from the demitting authorities

- 9.1 In reporting on the 2001/02 audits, the auditors highlighted matters which require to be addressed by Scottish Water. The auditors emphasised that these issues arose from their audits of the demitting authorities and that no assurance could be given on the financial standing of the new authority or of its controls.

- 9.2 The following exhibits summarise the main points raised by the auditors of EoSW, NoSW and WoSW. Exhibit 14 highlights matters relating to financial control and Exhibit 15 summarises issues relating to the control environment generally. Exhibit 16 draws together other points which the auditors indicate may require action on the part of Scottish Water.
- 9.3 Scottish Water may already have taken action to address all or some of these issues; the external auditors will be reviewing progress in each of these areas during the course of their 2002/03 audit and will report at the conclusion of that year's audit. This will form the basis for the Auditor General to report to Parliament on the progress achieved by Scottish Water in its first year of operation.

**Exhibit 14: Points for action by Scottish Water: financial control issues**

- Scottish Water should compile a consolidated fixed asset register.
- Fixed assets should be reviewed in terms of their deployment and carrying values.
- Scottish Water should formulate a combined infrastructure asset maintenance plan.
- The practice of regular visits to local authorities to check domestic income systems and calculations should continue.
- Further progress is required in developing and harmonising non-domestic income systems and controls.
- An overall review of debt management arrangements should be considered. Levels of domestic and non-domestic debts should be monitored closely – particular action is required to improve domestic collection rates.
- As financial systems are harmonised, steps should be taken to ensure that the transfer process is planned and controlled.

Source: External auditors' reports to the boards and the Auditor General 2001/02

### Exhibit 15: Points for action by Scottish Water: general control issues

- As operational systems are standardised, steps should be taken to ensure that changes are adequately planned and costs controlled.
- The audit committee should review points arising from the 2001/02 audits of the demitting authorities to ensure that all issues which are relevant to the new authority are addressed.
- Steps should be taken to ensure that internal audit is adequately resourced and that the status of internal audit as a key element of the control environment is confirmed.
- Internal audit should develop a long-term risk based audit plan. The audit committee should review the plan to ensure that the programme of work will provide the assurance required by the board, in terms of its corporate governance responsibilities.
- Scottish Water should take forward the work carried out in the demitting authorities to develop a comprehensive risk management framework. Attention should be given to areas where the loss of experienced key personnel may indicate increased risk.
- Scottish Water should consider developing authority-wide policies on fraud and 'whistle-blowing'.

Source: External auditors' reports to the boards and the Auditor General 2001/02

### Exhibit 16: Points for action by Scottish Water: other matters

- Harmonisation and standardisation will include a need for a human resource focus on developments.
- There is a need to improve the standard of personnel data and files.
- Steps should be taken to conclude the outstanding tax affairs of the demitting authorities.
- Steps should be taken to develop procedures for recording, reporting and monitoring key performance indicators.
- The arrangements for attaining efficiency savings should be monitored to ensure that agreed targets are achieved.

Source: External auditors' reports to the boards and the Auditor General 2001/02

# Appendix 1

## Regulation in the Scottish water industry

### *Scottish Executive Environment and Rural Affairs Department (SEERAD)*

Through its Water Services Unit, SEERAD acted as the sponsorship body of EoSW, NoSW and WoSW in 2001/02 and now of Scottish Water. It is responsible for setting expenditure limits for water authorities and for approving corporate plans, for monitoring performance against financial targets and other financial controls and for providing grants for specific purposes.

SEERAD was also responsible for regulating drinking water quality until 31 March 2002 when this function was transferred to the Drinking Water Quality Regulator under the Water Industry (Scotland) Act 2002.

### *Scottish Environment Protection Agency (SEPA)*

SEPA was formed in 1996 as the national public body for environmental protection and improvement. It is responsible for providing an efficient and integrated environment protection system for Scotland.

In relation to water, SEPA:

- has targets aimed at improving the quality of rivers, estuaries and coastal waters. Areas requiring improvement are addressed through action plans often involving SEPA, water authorities and other parties
- ensures that water authorities and other dischargers comply with statutory environmental protection standards through a licensing system involving the issue of legally binding consents to discharge
- monitors compliance with discharge consent conditions through inspection and sampling
- investigates pollution incidents including, if necessary, reporting offenders to procurators fiscal for consideration of prosecution
- measures river flows and provides advice to local authorities on potential flooding.

### *Water Industry Commissioner for Scotland (WIC)*

The post was created in 1999 by the Water Industry Act, taking over responsibilities from Scottish Water and Sewerage Customers' Council. The WIC is appointed by and accountable to Scottish Ministers through SEERAD.

The WIC is responsible for regulating all aspects of the water authorities' economic and customer service performance and for promoting the interests of customers. The WIC also provides advice to Ministers about the revenue cap for Scottish Water. Charges schemes are agreed annually between the WIC and Scottish Water; these are referred to Ministers where the two parties are unable to reach agreement.

The WIC's office is organised into three operational teams (plus corporate support) with the following responsibilities:

- Costs and performance: proposing operational and capital efficiency targets for the Scottish water authorities through a process of consulting and benchmarking with water companies in England and Wales; monitoring achievement against targets and other performance through the use of annual returns submitted by water authorities; conducting strategic reviews of charges.
- Asset management and investment: considering the Scottish water authorities' proposed investment plans and monitoring investment progress; assessing, developing and promoting best practice in the use of investment appraisal processes, strategic asset planning and management and the use of risk techniques and financial modelling.
- Revenue, tariffs and customer service: developing codes of practice and guaranteed minimum standards of service for customers; consulting with a wide range of customer groups; analysing and approving an annual scheme of charges.

### *Drinking Water Quality Regulator (DWQR)*

The post of DWQR was created under the Water Industry (Scotland) Act 2002. The DWQR is appointed by and is accountable to Scottish Ministers.

The DWQR is responsible for seeking to ensure that the public water supply in Scotland meets the statutory quality standards and for supervising the enforcement by local authorities of the standards that apply to private water supplies.

### *Comparative position in England and Wales*

Ten water and sewerage companies and 13 water only companies have delivered water services in England and Wales since privatisation in 1989.

SEERAD, SEPA and the Water Industry Commissioner all have similar bodies in England and Wales carrying out broadly similar functions (respectively DEFRA and the Welsh Assembly, the Environment Agency and OFWAT) although because the water companies in England and Wales are private organisations, Ministers do not set targets for financial performance as they do in Scotland.

A key difference between the Water Industry Commissioner and OFWAT is that the latter has set targets for the water companies in England and Wales to reduce the level of leakage from broken pipes. The Water Industry Commissioner for Scotland does not consider similar targets to be necessary for the Scottish water authorities believing that the scale of new investment required to address quality standards will address leakage problems as a matter of course. Other important differences between WIC and OFWAT include:

- the WIC advises Scottish Ministers on charges whereas OFWAT determines and enforces charges
- the WIC's advice deals with revenue caps while OFWAT determinations refer to prices
- companies are licensed under statute and OFWAT enforces licences. OFWAT has powers to issue fines, enforcement orders and, ultimately, to revoke licences.

## Appendix 2

### Responsibilities and accountabilities in the Scottish water industry

Scottish Ministers are required under statute to give Scottish Water directions as to the exercise of its powers and as to how its affairs are to be managed and conducted. Ministers also approve Scottish Water's strategic business plan, determine the conditions under which Scottish Water can borrow from them and are overall accountable to the Scottish Parliament for the functions of the body.

The Scottish Executive Environment and Rural Affairs Department is responsible for providing advice to the Scottish Ministers on all aspects of Scottish Water and for monitoring its performance against its strategic business plan and financial targets on behalf of Ministers. The departmental accountable officer is responsible to the Scottish Parliament for the propriety and regularity of funds provided to Scottish Water.

The board of Scottish Water is responsible for the strategic direction of the organisation and for ensuring that it is managed and organised effectively and efficiently. The board is required to submit to Ministers a report on the activities of Scottish Water every six months and to produce an annual report and accounts which is presented to Parliament.

The chief executive is responsible for the day-to-day operations and management of Scottish Water and for meeting its aims and performance objectives. He is also responsible for reporting to the board on the financial affairs of Scottish Water and for bringing to the board's attention any significant information which is likely to be pertinent to their consideration of the financial status of Scottish Water. As designated accountable officer, Scottish Water's chief executive is accountable to the Scottish Parliament for the propriety and regularity of public funds provided. The chief executive may also be required to appear before the Scottish Parliament's Audit Committee to give evidence on the economic, efficient and effective use of funds provided to the public body in discharging its functions.

# Appendix 3

## Water authority external auditors

**2001/02**

**Auditors**

East of Scotland Water Authority

KPMG

North of Scotland Water Authority

PricewaterhouseCoopers

West of Scotland Water Authority

PricewaterhouseCoopers

**2002/03**

**Auditors**

Scottish Water

KPMG



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