



**Scottish
Water**
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SCOTTISH WATER
Water Industry Commission for Scotland (WICS) ANNUAL RETURN 2022/23

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Section N - Transfer Pricing

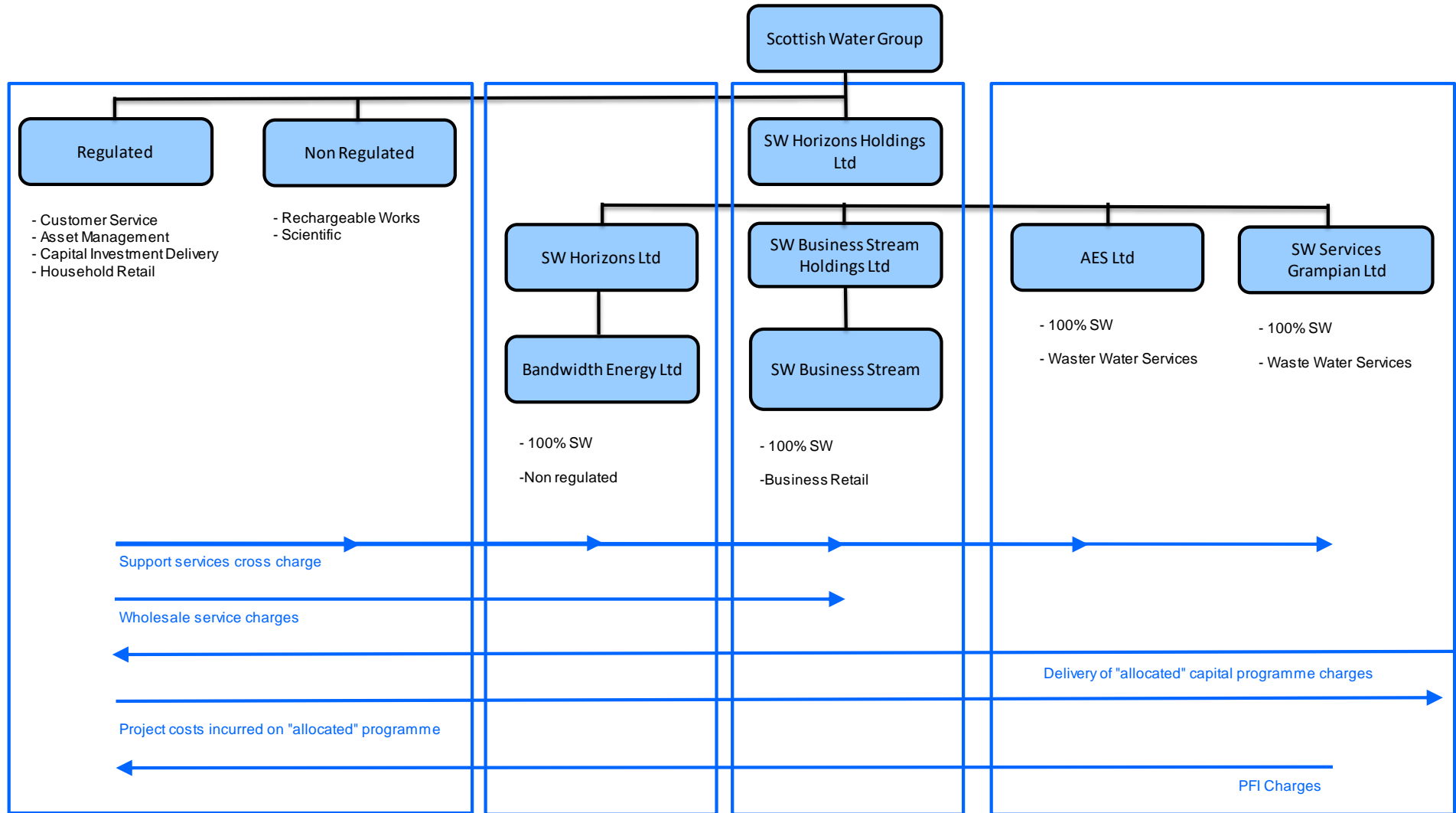
1 General Comments

The N tables for 2022-23 have been prepared in accordance with Regulatory Accounting Rule 5 and related definitions.

The N tables detail the financial and contractual transactions which have taken place between Scottish Water (Regulated) and the following associates:

- Scottish Water Business Stream Ltd (SWBS): the subsidiary responsible for retail – non household activities.
- Scottish Water Business Stream Holdings Ltd (SWBSH): the holding company for SWBS.
- Scottish Water Horizons Ltd (SWH): the subsidiary responsible for the majority of Scottish Water's non-regulated activities.
- Aberdeen Environmental Services Ltd (AES): the PFI concession operator for four wastewater treatment works in North-East Scotland, ceased trading in the year on 30 September 2022.
- Scottish Water Services (Grampian) Ltd (SWSG): which was the operating company of the four wastewater treatment works in North-East Scotland to 30 September 2022 and from 1 October 2022 it was the provider of people services for employees previously employed in the former Highland and North-East Scotland PFI schemes.
- Scottish Water Horizons Holdings Ltd (SWHH): the holding company for SWH, SWBSH, AES and SWSG.
- Scottish Water (Non-Regulated): activities undertaken by Scottish Water that are not necessary to fulfil the functions and duties of a water undertaker as defined in the Water (Scotland) Act 1980 as amended by subsequent legislation and as a sewerage undertaker as defined in the Sewerage (Scotland) Act 1968 or as amended by subsequent legislation. A small number of non-regulated activities did not transfer across to SWH. Activities which form an integral part of, or are incidental to, Scottish Water's core operations, such laboratory services, remain within Scottish Water as a separate accounting entity.

The main transfers between associates are illustrated below.



2 Compliance with Regulatory Accounting Rule 5 – Transfer Pricing

Contracts and transactions between Scottish Water and its associates are governed by Transfer Pricing Rules which comply with WICS' Regulatory Accounting Rule 5 (Transfer Pricing). Transfer prices for transactions reflect either the actual cost of the service where individual costs are directly attributable (e.g. actual fuel charge, actual mobile phone call charges) or the attributed cost of the service as calculated via our Activity Based Management System (ABM). ABM calculates the actual cost of the support activity and allocates the cost of that support activity across internal customers based on the share of activity cost drivers.

The policies and methods adopted for cost allocation, transfer pricing and reporting are consistent with previous years. There has been no market testing of transactions between Scottish Water and its associates in 2022-23.

Statement of Compliance

Brian Strathie, Director of Finance, has signed the N Table return and accompanying commentary, and in so doing has confirmed Scottish Water's compliance with Regulatory Accounting Rule 5 – Transfer Pricing.

Declaration of Interest

SWHH, SWH, and SWSG are fully owned subsidiary companies of Scottish Water with their own board of directors, as was AES to 30 September 2022. The actions of the directors are governed by the Companies Act 2006. From the 1 October 2022 the activities of the North-East PFI companies were absorbed into the regulated activities of Scottish Water from which point AES Ltd ceased trading.

SWBSH is a fully owned subsidiary of Scottish Water, via SWHH, with its own board of directors. The actions of SWBSH's Directors are governed by the Companies Act 2006 and the Governance Code agreed between the Water Industry Commission for Scotland, Scottish Water and Business Stream.

Scottish Water (Regulated) and Scottish Water (Non-Regulated) form part of the same legal entity and in most cases utilise common, shared resources. Therefore, in transactions between these associates, directors can act as both purchaser and supplier in any transaction with an associate entity. Compliance with transfer pricing rules is ensured, firstly through separate budgetary and accounting control at General Manager level and secondly through Finance and Regulatory enforcement of transfer pricing rules in cross-charges.

3 Significant Transactions in 2022-23

SWHH acquired the four North-East PFI companies for £16.2 million in December 2018 and continued to provide funding to Scottish Water Services (Grampian) since that date.

From 1 October 2022 the activities of the North-East PFI companies were absorbed into the regulated activities of Scottish Water. AES, Aberdeen Environmental Services (Holdings) Ltd and Aberdeen Holdco Ltd ceased trading from that date. The corresponding contracts for PFI services to Scottish Water also terminated on the same date.

To acquire the entities, and to establish a "hold harmless" position for SWHH, Scottish Water paid a consideration to SWHH of £19.7m (as detailed below) for £16.9m of net assets in AES. The loss of £3.1m including the cost of acquisition has been recognised within PFI costs on table M1 of the annual return.

'Hold harmless' payment summary	£m
SWHH original investment in December 2018	(16.2)
Acquisition costs incurred by SWHH in December 2018	(2.5)
Total Dividends received in period of ownership	17.8
Intercompany Loans provided to SWSG in period of ownership	(18.8)
Consideration paid to SWHH by Scottish Water	(19.7)

The table below provides additional analysis of the values presented on the cash flow statement for the company within the statutory financial statements for the year ended 31 March 2023:

	£m
Intercompany loan to AES to enable settlement of external debt	(30.9)
Consideration paid to SWHH for net assets in AES	(19.7)
Cost of acquisition	(0.2)
Cash absorbed into SW from AES net assets	15.5
Acquisition of assets and liabilities of subsidiary per cash flow	(35.3)
Property, plant and equipment absorbed into regulated activities	32.2
Non-cash impact of acquisition of assets and liabilities of subsidiary	(3.1)

4 Table N1 Transfer Pricing Summary (Capex)

SWS2 Ltd ceased trading during 2021/22. Therefore, table N1 has been left blank.

5 Table N2 Transfer Pricing Summary (P&L)

Market Testing

There has been no additional market testing of Table N2 services in 2022-23.

Cost Allocation - Recharges to Associate / Non-Core from Core

Scottish Water charges to Scottish Water Business Stream

(i) Service & Support Charges

Service agreements are in place between Scottish Water and Business Stream for the few services provided by SW.

Charges (line 2.1.2) reduced by £18k to £61k for the year. The services charged under service agreements were mainly in respect of the Internal Audit charge which is charged on a daily rate basis for the agreed audit plan.

(ii) Wholesale Charges

Scottish Water is required to charge business retailers for Primary and Non-Primary Water and Wastewater services. Cross-charges are based on the Wholesale Scheme of Charges.

Wholesale charges increased by £5.2m in 2022-23 to £200.9m (line 2.2.1) primarily reflecting average price increases of 4.2% in 2022-23. This increase was slightly offset by reductions in metering services (line 2.2.2), connections (line 2.2.6) and verification of services (line 2.2.7) charges due to higher recharges in AR22 resulting from backlogs following the suspension of non-essential field work during the initial COVID lockdowns in 2020/21, and AR23 represents a return to normalised activity patterns. Additionally, building water supplies (line 2.2.4) reduced due to fewer developers choosing to pay for unmeasured building water supply charges and instead opting for metered charges. This is recorded through primary charges.

Recharges from Scottish Water to Scottish Water Horizons

Table N2 reports the value of cross-charges between Scottish Water and Horizons, which includes the following transaction types:

- Labour, material and service costs transferred from Scottish Water as actually incurred on Horizons activities (projects); and
- Recharges from Scottish Water for support activities undertaken for Horizons. This includes the cost of functions such as IT, Fleet, Property, Finance, HR and Customer Services. Cross charges either reflect the actual cost of the service, e.g. actual fuel charge, actual mobile phone call charges; or the cost of the service as calculated via Activity Based Management System (ABM). ABM calculates the actual cost of the support activity and allocates the cost of that support activity across internal customers based on the share of activity cost drivers. This is in accordance with RAR 5 requirements.

During the year Scottish Water charges to Horizons were £2.6m, an increase of £0.3m compared to prior year. This was mainly due to an increase in waste & sludge processing costs (line 2.3.2). Detail behind the calculation of lines 2.3.1 to 2.3.7 is explained below:

- Line 2.3.1 - Management and support costs are captured within the regulated ledger and a recharge is made to Horizons for an element of these costs that relate to Non-Regulated work, based on work throughput. Management and support costs consist of Corporate Affairs, Contact Centre, Finance, Internal Audit, Legal, Payroll and Property recharges.
- Line 2.3.2 - Waste & Sludge Processing Charge for Waste Services is for waste being treated and disposed of using SW site assets and associated transport and labour costs. The value of this is based on the Mogden formula for third-party waste (liquids) treatment and sludge model costs for third-party waste (sludge) treatment. Waste services costs increased in 2022-23 by £269k explained by additional Third-party waste for the six months following the absorption of Grampian PFI into SW, and increased charges at Shieldhall and Cowdenbeath.
- Line 2.3.3 - The cross-charge for Aquatrine work was for the SW call centre taking calls from Aquatrine clients and sampling services from SW Scientific.
- Line 2.3.4 - The cross-charge for Support Shipping Water Services was related to costs recharged from the core business in relation to the provision of shipping water. The increase in shipping water recharges is a mix of increased volumes of c.£50k and price increases of c.£22k.
- Line 2.3.5 - The cross-charge for Asset Management costs are charges for SW staff working on Horizons capital projects, calculated using time sheets and hourly rates which include overhead recovery. The value in 2022-23 dropped by £147k due to a decrease in the number of project requests from Horizons.
- Line 2.3.6 - The cross-charge for ABM Support costs represents corporate overhead recovery.
- Line 2.3.7 - The cross-charge for IT Service costs was in respect of providing service desk support, mobile devices, provision of desktop support, security and systems management, applications management/support and IT communications. The increase between AR22 and AR23 can be broken down into the following key areas:

2021-22 IT service charge	£228,534	
Additional FTE impact	£7,557	
Inflation impact	£7,791	
MS Dynamics Horizons recharge	£30,619	Horizons Microsoft licences are procured separately as unable to use government rates.
Oracle EPM budgeting application	£21,056	Move to cloud product with increased charges
New cloud products	£1,159	
Cost reduction	(£10,682)	Reductions due to benefits of negotiated Managed Service Agreement/ceased services
2022-23 IT service charge	£286,034	

Recharges from Scottish Water (Regulated) to Scottish Water (Non-Regulated)

Scottish Water (Non-Regulated) is not a separate legal entity. However, Scottish Water (Non-Regulated) is set up as a separate accounting entity. Certain costs are directly captured within Scottish Water (Non-Regulated). These are direct employment, materials and external service costs. These costs are charged directly to Scottish Water (Non-Regulated), and therefore are not reported in table N2.

Table N2 does not report the total cost of Scottish Water (Non-Regulated) but reports the value cross-charged between the Scottish Water (Regulated) and Scottish Water (Non-Regulated) entities. The total cost of the Scottish Water Non-Regulated accounting entity is included within Table M18, in line with Regulatory reporting requirements.

There are certain non-regulated activities which utilise Scottish Water (Regulated) assets and staff, and cross-charges are made to reflect this. Cross-charges are fully compliant with RAR 5 in that they

reflect the full cost of services provided and are based on resource consumed. The main non-regulated activities utilising regulated assets and staff are:

- Operate & Maintain 3rd Party Assets
- Rechargeable Works
- Septic Tank Emptying
- Provision of non-Potable Water
- Lab Services

These also include Support Activity costs as described in the schedule for SWH.

Charges to non-core reduced by £0.5m from 2021/22 to £1.5m in 2022-23. The primary drivers for the reduction is explained below:

- Test & Sample processing charge for Scientific Services: decreased by £0.3m in 2022-23 due to a reduction in the number of samples and tests performed. This has been mainly driven by the absorption of the former North-East PFI activities into the regulated business from 1 October 2022.
- Material and contractor charge for rechargeable works: decreased by £0.2m in 2022-23 as 2021-22 included a charge of £0.2m for upgrading pumps within Perth & Kinross as part of the Flood Prevention Scheme, which was not repeated in 2022-23.

Recharges from Scottish Water to SWSG

Management and Support recharges to SWSG from SW were for Finance, Legal, IT, Scientific services and Group management. These costs were based on the intra group recharge rates for the SW group. Recharges to SWSG in 2022-23 reduced by £0.3m, of which £0.2m is for Management & Support Recharges (line 2.5.1) and £0.1m is for Scientific Recharges (line 2.5.2). The decrease is due to the absorption of the former North-East PFI activities into the Regulated Activities from 1 October 2022 as detailed in the significant transactions section above.

The fixed asset transfer from SWSG shown in line 2.5.3 of £1.5m relates to the transfer of fixed assets from SWSG into the regulated business. The assets were transferred at their carrying value (Net Book Value) for consideration of the same value (shown in line 3.1.5). This is consistent with the standard accounting practice for internal acquisitions.

Recharges from Scottish Water to AES

2022-23 recharges to AES from SW have reduced by £25k when compared to prior year mainly due to the absorption of the North-East PFI activities into the Regulated Activities from 1 October 2022. The recharges in the year were for Finance, Legal and IT services. These costs were based on the intra group recharge rates for SW group as explained in query N-7 for 2021/22.

Lines 2.6.2 to 2.6.4 have been added in the year to show the transfer of assets from AES as part of the significant transaction detailed above. All values presented represent the carrying value at the date of transfer to Scottish Water. This is consistent with standard accounting practice for internal acquisitions.

Cost Allocation - Recharges to Core from Associate / Non-Core

Cross-charges from Scottish Water Business Stream (Regulated) to Scottish Water (Regulated)

Interest paid to SWBS (line 2.8.1)

As per the wholesale agreement, Scottish Water Business Stream pays Scottish Water the wholesale charges (normally 2 months in advance). If interest is charged on this advance payment at 4% as specified by the Water Industry Commission for Scotland. There are also a series of subsequent reconciliations, as estimated charges are replaced with actuals, with interest paid on the resulting reconciliation payments between the parties.

In 2022-23 interest payments to SWBS increased by £0.8m to £1.4m. This reflected the phased reintroduction of wholesale charge prepayments during 2021-22 following the support provided to Licensed Providers in response to the Covid-19 pandemic.

Guaranteed Service Standard Payments (line 2.8.2)

During the year Scottish Water made Guaranteed Service Standard Payments to SWBS in line with the Wholesale Scheme of Charges. The Schedule 4 of the Wholesale Services Agreement sets out a number of Service Standards with which Scottish Water must comply. Where failures occur, payments must be made from Scottish Water to the Licensed Provider in accordance with section 14 of the Wholesale Scheme of Charges. These amounts relate to such Service Standard payments.

There was a higher number of Guaranteed Services Standard Payments claimed by Business Stream in AR23, as detailed below:

- AR23 41 claims (of which 11 were £1000 each)
- AR22 18 claims (of which 5 were £1000 each)

Gap incentives (line 2.8.3)

During the year Scottish Water made gap incentives payments to SWBS in line with the Wholesale Scheme of Charges.

Gap incentive payments reduced in A23 as fewer claims were submitted by Business Stream and the revenue from those previously submitted is not high enough to trigger the second payment. The Gap Incentive payments are paid in two instalments. If the revenue generated from the new supply point is lower than the total incentive payment, then the licence provider can't claim the 2nd instalment.

Miscellaneous (line 2.8.5)

This line represents the return of margin to SWBS under the temporary transfer scheme.

Cross-charges from Scottish Water Horizons (Non-Regulated) to Scottish Water (Regulated)

During the year SWH charged Scottish Water £2.9m, a decrease of £0.5m compared to prior year. This was primarily due to a decrease in activity relating to Scottish Water's Vesting project of £1.4m (programme winding down from 72 projects in 2021-22 to 15 in 2022-23), and a decrease in timesheet recharges (c.£0.1m) due to reduced levels of support provided by the test centre employees to the Scottish Water Research and Innovation team. This was offset by an increase in renewable energy supplied to Scottish Water of £0.9m mainly as a result of a new PPA at Dalmarnock (£0.5m) and price increase for the Stirling PPA (£0.3m) to reflect increased gas prices, and an increase in Test Centre recharges of £0.1m due to the creation of a membrane training facility, a cyber security unit and exclusivity to the Research and Innovation team for trials.

Additionally, property recharges increased reflecting a full year (AR22: 8 months) charge for use of a room at Scottish Water Horizons Deerdykes facility. The full list of services provided by SWH to Scottish Water is provided below:

- Impact assessments relating to the effects of new developments on the existing infrastructure
- The provision of plan and property searches
- The services of Horizons staff working mainly on SW projects
- Renewable energy supplied to SW from the renewable energy assets delivered and operated by SWH
- Trials and training carried out by SW at Test Centres operated by Horizons
- Supporting the delivery of SW's vesting project, bringing existing assets up to an adoptable standard to be vested by SW
- Property recharge with regards to the IT room in Deerdykes that it is being used by SW
- Developer Services Charge

Cross-charges from SWSG to Scottish Water (Regulated)

Lines 3.1.1 to 3.1.4 are new in the year and represent the recharge of costs incurred in SWSG for the operation and maintenance of the North-East PFI assets following the absorption of North-East PFI activities into the regulated activities of Scottish Water on 1 October 2022. Prior to the absorption the costs of SWSG were charged to AES because SWSG employed the staff that operated the site. All transactions are charged at cost in line with RAR 5.

Line 3.1.5 relates to the fixed assets transferred from SWSG to Scottish Water on 1 October 2022 at carrying value of £1.5m as detailed above in section B, part 4.

Recharges from AES to Scottish Water (Regulated)

Charges from AES to Scottish Water for PFI contract fees reduced by £11.2m to £13.1m. The reduction in the year relates to the absorption of the North-East PFI activities into the regulated activities of Scottish Water on 1 October 2022 and the cancellation of the service contract between Scottish Water and AES (see significant transaction section above).

Lines 3.2.2 and 3.2.3. Line 3.2.2 relates to the provision of an intercompany loan from Scottish Water to AES for the settlement of third-party bank debt (£30.9m as shown in the significant transactions section) and Line 3.2.3 relates to the transfer of a small amount of trade and other creditor balances from AES into Scottish Water.

Recharges from SWHH to Scottish Water (Regulated)

Line 3.3.1 is new in the year and represents the consideration paid by Scottish Water to SWHH for the net assets of AES (£19.7m). See the significant transactions section above.