

## N Tables Transfer Pricing

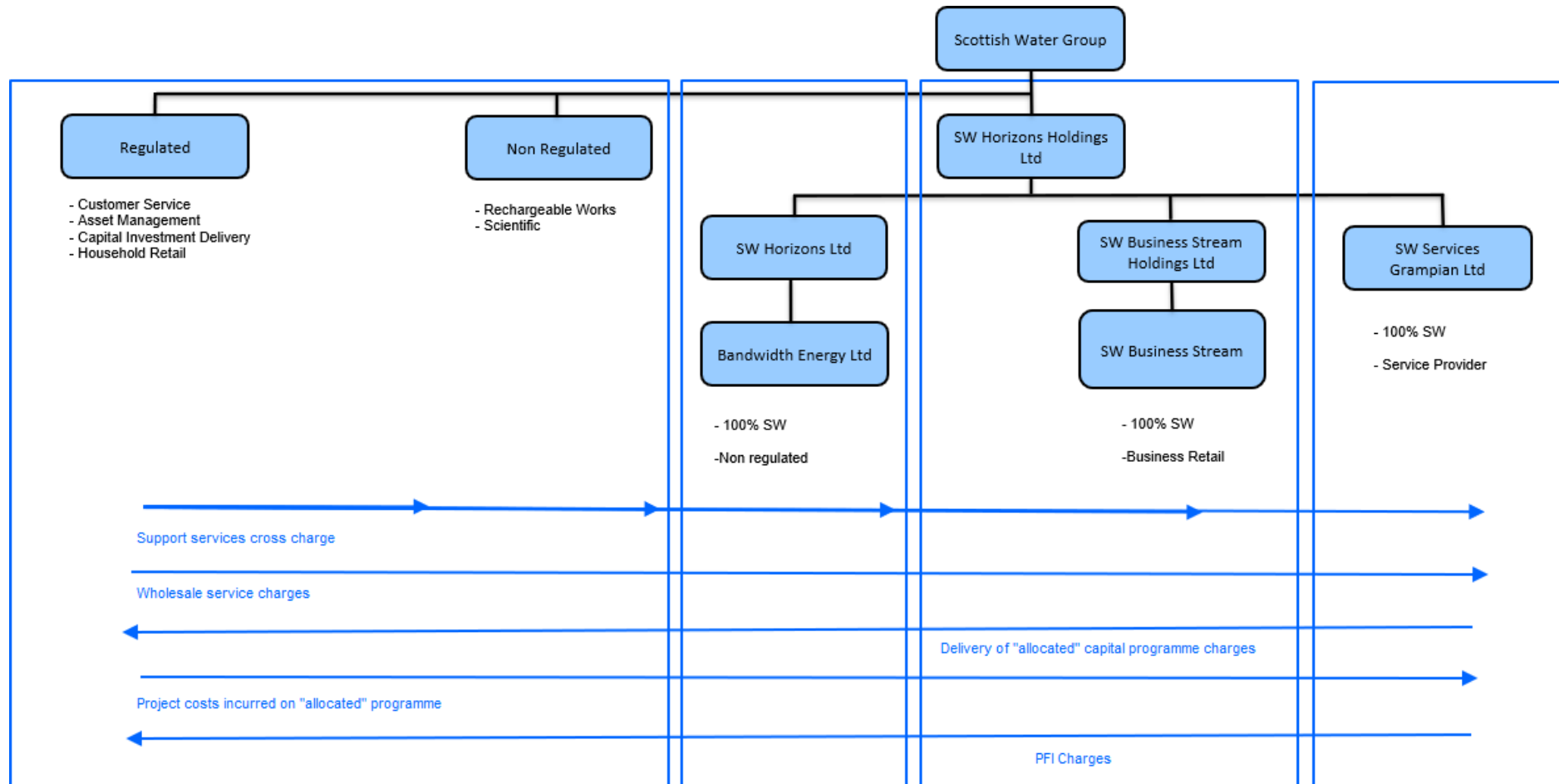
### General Comments

The N tables for 2023/24 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:

1. Scottish Water Business Stream Ltd (SWBS): the subsidiary responsible for retail – non household activities.
2. Scottish Water Business Stream Holdings Ltd (SWBSH): the holding company for SWBS.
3. Scottish Water Horizons Ltd (SWH): the subsidiary responsible for the majority of Scottish Water's non-regulated activities.
4. Scottish Water Services (Grampian) Ltd (SWSG): which was the operating company of the 4 wastewater treatment works in North-East Scotland to 30 September 2022 but since 1 October 2022, it's primary role is the servicing and accounting for the former employees of both the Grampian PFI and the Highland PFI sites. The main driver being to allow these employees to continue to be part of the defined contribution pension scheme for SWSG and Highland PFI employees. Employment costs are recharged to Scottish Water at cost.
5. Scottish Water Horizons Holdings Ltd (SWHH): the holding company for SWH, SWBSH, AES and SWSG.
6. 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.



## **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 reflect 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 2023/24.

### **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. 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.

## **Table N1 Transfer Pricing Summary (Capex)**

SWS2 Ltd ceased trading during 2021-22. Therefore, table N1 is blank.

## **Table N2 Transfer Pricing Summary (P&L)**

The approach taken involves analysing and providing detailed explanations for any year-on-year variances that exceed the threshold of £25,000.

### **A. Market Testing**

There has been no additional market testing of Table N2 services in 2023-24.

### **B. Cost Allocation. Recharges to Associate / Non-Core from Core**

#### **1. Scottish Water charges to SWBS**

##### **(i) Service & Support Charges**

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

Charges reduced 3.7% to £59k for the year (lines 2.1.1 and 2.1.2). The services charged under service agreements were mainly in respect of Internal Audit services which are 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 based on the Wholesale Scheme of Charges. The main driver for the increase was the £9.6m (4.8%) increase in wholesale charges to £210.5m (line 2.2.1) primarily reflecting average price increases of 5.0% applied on 1 April 2023.

#### **2. Recharges from Scottish Water to SWH**

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

- Labour, material and service costs transferred from Scottish Water as actually incurred on SWH activities (projects); and
- Recharges from Scottish Water for support activities undertaken for SWH. 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 our ABM system. 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 SWH were £2.7m, an increase of £0.1m compared to prior year. This was mainly due to an increase in waste services costs (Line 2.3.2) and management and support costs (Line 2.3.1) as explained below.

- Line 2.3.1 - Management and support costs increased by £23k in 2023-24. These costs are captured within the regulated ledger and a recharge is made to SWH 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 3rd party waste (liquids) treatment and sludge model costs for 3rd party waste (sludge) treatment. Waste services costs increased in 2023-24 by £134k reflecting a full year of Third Party Waste recharges for Nigg WWTW. In 2022-23 there was only 6 months of Third Party Waste recharges following the absorption of the North-East Scotland PFI into the regulated waste water operations on 1 October 2022.

- 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 relates to costs recharged from the core business in relation to the provision of shipping water.

- Line 2.3.5 - The cross-charge for Asset Management costs are charged for SW staff working on Horizons capital projects, calculated using time sheets and hourly rates which include overhead recovery. The value in 2023-24 dropped by £152k due to a decrease in the number of project requests from SWH.

- 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 IT Service Charge to Horizons is calculated based on the usage of Digital Applications. There are 3 different methods used to calculate the recharge of the contract costs:

- Based on the number of SWH employees as a percentage of the total number of employees across the Scottish Water group of companies, excluding SWBS;
- Based on the number of users for a specified IT applications multiplied by the user license cost; and
- Where Horizons have procured IT services separately from Scottish Water.

The increase between 2022-23 and 2023-24 can be broken down into the following key areas:

<b>2022-23 IT Service Recharge</b>	<b>£286,034</b>
Increased FTE Impact	£70,373
Inflation Impact	£19,445
Savings	-£27,687
<b>2023-24 IT Service Recharge</b>	<b>£348,165</b>

### 3. 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 activities 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 3<sup>rd</sup> Party Assets;
- Rechargeable Works;
- Septic Tank Emptying;
- Provision of non-Potable Water; and
- Lab Services.

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

Charges to non-core increased by £0.8m in 2023/24 to £2.3m. The primary drivers for the increase are explained below:

- Support Lab Plant & Veh Cross Charge for Aquatrine increased by £47k (49%) to £158k due to a one-off credit adjustment of £49k in 2022-23.
- Test & Sample processing charge for Scientific Services: increased by £311k to £1,503k in 2023-24 due to a 10% price increase and an increase in the volume of samples.
- Material & Contractor Charge for Rechargeable Works: increased by £277k to £485k due to an increase of income generated from recharges to third parties.
- Perth Flood Prevention scheme generated £122k of recharges in 23-24. The scheme relates to recharging part of the maintenance of several Wastewater Pumping Stations along the River Tay to Perth & Kinross Council to help alleviate any flooding when there is high rainfall.

## **C. Cost Allocation. Recharges to Core from Associate / Non-Core**

### **1. 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, SWBS pre-pays Scottish Water for wholesale charges. Interest was charged on this advance payment at an average interest rate of 4.74% across the year as specified by 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 2023-24 interest payments to SWBS increased by £1.1m to £2.5m reflecting the increase in interest rate and the increase of the number of months pre-payment.

#### **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 of £35k. 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.

### **Gap incentives (line 2.8.3)**

During the year Scottish Water made gap incentives payments of £5k to SWBS in line with the Wholesale Scheme of Charges.

## **2. Cross-charges from Scottish Water Horizons (Non-Regulated) to Scottish Water (Regulated)**

During the year SWH charged Scottish Water £3.6m an increase of £0.6m compared to prior year. This was mainly due to an increase in activity relating to renewable energy charges which increased £0.9m to £2.9m, reflecting an increase in Power Purchase Agreement charges to SW and growth in the number of renewables schemes, in particular at Balmore treatment works, and higher sales associated with heat from sewage schemes at Dalmarnock and Stirling. Test Centre recharges increased £0.1m to £0.4m due to the Water Pilot undertaken carried out in July 2023. These increases were partly offset by a reduction of £0.3m in recharges to SW as the vesting project came to an end. 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; and
- 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; and
- Developer Services Charges are for work undertaken by Horizons at the request of Scottish Water to support developer connections.

## **3. Recharges from SWSG to Scottish Water (Regulated)**

Lines 3.1.1 to 3.1.3 represent the recharge of costs incurred by SWSG for the operation and maintenance of the North-East PFI assets following the absorption of these activities into the regulated activities of Scottish Water on 1 October 2022. The majority of the charges (line 3.1.2) relate to the payroll costs of SWSG employees who are now working on SW assets (£1.5m) which is an increase of £986k (56%) from 2022/23. This is due to the costs being absorbed for the full year in 2023/24. In 2022/23 the costs were only absorbed for the six-month period beginning 1<sup>st</sup> October 2022.