

N Tables

Transfer Pricing

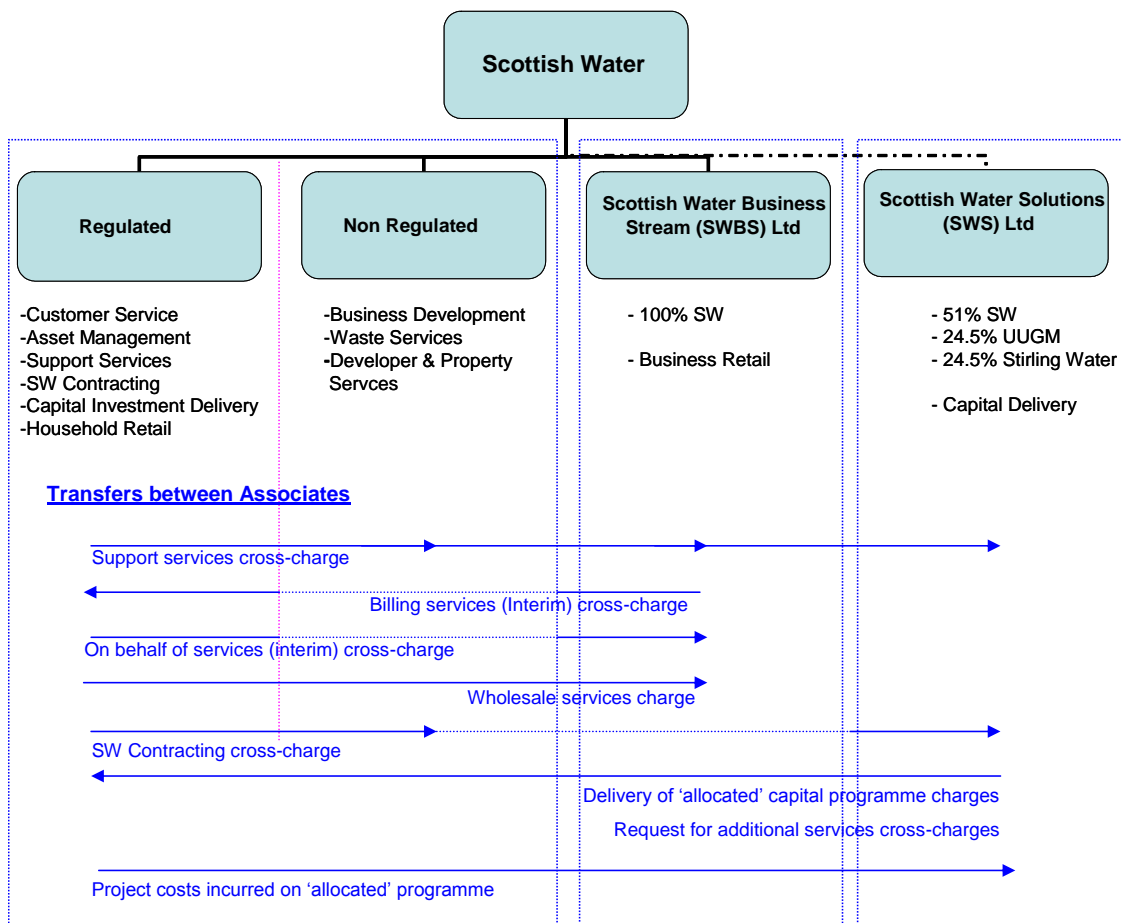
General Comments

The N tables for 2006/07 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 Solutions Ltd (SWS): the consortium responsible for delivering part of the capital programme under contract to Scottish Water.
2. Scottish Water Business Stream Ltd (SWBS): the subsidiary, established in November 2006, responsible for retail – non household activities
3. 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.

The main transfers between associates are illustrated below.



Statement of Compliance

Douglas Millican, Finance & Regulation Director, 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

SWBS has a separate board of directors from Scottish Water. Scottish Water Business Stream Directors' actions are governed by the Companies Act 2006, and by a Scheme of Delegation agreed between Scottish Water and Scottish Water Business Stream.

In accordance with director's duties under the Companies Act 2006, Scottish Water Solutions board of directors must act in the interest of SWS at all times and not in relation to any underlying shareholder interest. In addition, in the Declaration of Interest section of SWS Board meetings, the Directors declared their respective interest in contracts that were the subject of Board discussion and may be awarded to Members of their consortia and agreed in reviewing such matters they would act in the best interests of SWS at all times.

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 Regulation enforcement of transfer pricing rules in cross-charges.

Table N1 Transfer Pricing Summary (Capex)

A. Market Testing

1. Scottish Water Solutions Ltd

1. Delivery of the Capital Programme

This outlines details of the contract between Scottish Water and Scottish Water Solutions Ltd (SWS) for delivery of part of the capital programme. Following an extensive competitive tender process, the contract was awarded to SWS Ltd a consortium which includes Stirling Water, Scottish Water and UUGM. The total value of the contract awarded was £1.8bn, which covers the period of the Quality & Standards II and Quality & Standards III investment programmes. The total value of the services delivered by SWS in 2006/7 was £179m.

2. Request for Additional Services

Additional design and construction services to the value £3.1m were delivered in 2006/7 for by SWS for SW. Requests for additional services are made to SWS, quotes submitted, and rates benchmarked against Scottish Water framework contractor rates, before work is formally approved, and charged on a timesheet and cost recovery basis.

3. Project costs incurred on 'allocated' capital projects

Project costs directly incurred by Scottish Water on the SWS allocated capital programme, to the value of £5.9m, were recharged to SWS in 2006/7. Costs include land purchase and compensation payments, power charges, etc.

4. Scottish Water Contracting work for Scottish Water Solutions Ltd

Scottish Water Contracting were contracted to undertake Quality and Standards II work by SWS. In most cases contracts used ECC Option A lump sum contracts. The value charged in 2006/7 was £4.4m. All jobs were live at the end of the previous financial year. No "new" contracts were negotiated between SWC and SWS. The income arose from the completion of live projects and the agreement of Final Accounts. The cost charged to these contracts in 2006/7 was £5.7m. The loss on these projects was due to several factors:

1. There was a delay in the provision of Q&SIII works. As a result, SWC over-resourced existing mains rehabilitation projects, whilst awaiting Q&SIII start-up. This was deemed preferable to laying staff off and re-employing shortly after, or sending staff 'back to the depot'.
2. Defects on projects
3. Final Accounts concluded at lower values than income accruals
4. Cost of preparing individual final accounts and negotiating with SWS was significant.
5. Insufficient allowances for completing projects live at 31 March 2006

B. Cost Allocation. Recharges to Associate / Non Core from Core

1. Project costs incurred on 'allocated' projects

Costs incurred by Scottish Water (Regulated) on capital projects which have been contracted to SWS to deliver. These costs are recharged to (SWS) at cost and include land purchase costs, labour costs associated with staff who support the delivery of the capital programme, but who have not been seconded to SWS on a full time basis, and stock issues to capital projects.

2. Services provided to Scottish Water Solutions from Scottish Water (Regulated – Contracting)

This relates to mains rehabilitation and other capital investment activities carried out on a commercial basis by Scottish Water Contracting for SWS. Income from these activities reduced from £32.8m in 2005/6 to £4.4m in 2006/7, reflecting the set up of a Capital Investment Delivery (CID) function within Scottish Water, and increased level of internal cost transfers.

3. Services provided to Scottish Water (Non Regulated) from Scottish Water (Regulated – Contracting)

This relates to non regulated mainlaying and connection tie-in work undertaken by Scottish Water Contracting for Scottish Water Customer Connections. This charge reflects the actual cost of projects carried out by Scottish Water Contracting, which for 2006/7 was £1.6m. The actual cost of these projects is transferred to SWC Non Regulated. Work is called off and recharged internally between SW Contracting (Non Regulated) and SW Customer Connections (Non Regulated) based on an agreed schedule of rates.

4. Transfer of Assets from Scottish Water (Regulated) to Scottish Water Business Stream

Fixed Assets were transferred to Scottish Water Business Stream at 1st November 2006, being the Hi Affinity billing system which was transferred at a net book value of £1.6m.

Working Capital was transferred to Scottish Water Business Stream with a book value of £33.3m.

C. Cost Allocation. Recharges to Core from Associate / Non Core

1. Accounts Payable Service

This relates to Scottish Water Solutions providing a capital invoice processing service on behalf of Scottish Water (Regulated). This charge reflects the actual cost of the service provided.

2. Request for Additional Services

Contracts for additional services to the value £3.1m were delivered in 2006/7 for design and construction works.

3. Delivery of SWS allocated capital programme

The total value of the services delivered by SWS in 2006/7 was £179m.

Table N2 Transfer Pricing Summary (P&L)

A. Market Testing

There has been no additional market testing of Table N2 services in 2006/7.

B. Cost Allocation. Recharges to Associate / Non Core from Core

1. Recharges from Scottish Water (Regulated) to Scottish Water Solutions

Staff Costs

As at 31 March there were 191 staff seconded from Scottish Water to SWS. The average FTE for the year was 209. The costs associated with these staff (incl. basic salary, pension, NI, overtime etc) were recharged to SWS at cost, this totalled £9.3 m in the year.

Support Services – IT

IT costs include desktop support, applications support and maintenance and telecoms infrastructure and support. These costs have been recharged to SWS as follows:

Desktop support:	number of PC's and number of help-desk calls
Applications support/maintenance:	actual costs and number of users
Infrastructure and support:	actual consumption

The cross-charge for the year was £1.9m compared to previous year's charge of £2.8m. This is partly due to SWS headcount reductions, and partly due to SWS investment in IT in lieu of SW IT provision.

SWS benchmarked the cost of IT service in 2003 for provision of the above service, and concluded the service prices to be competitive.

In 2006/7 the cost of the IT service provided to SWS, including all overheads and depreciation is deemed to be £4.3m. This suggests that SWS are being under-charged by

£2.4m. The main component of this deficit is the charge for depreciation of applications and infrastructure utilised by SWS. The current service agreement does not fully recover these costs because:

- Scottish Water does not consider depreciation on IT infrastructure and applications to be allowable under FRS 15 – Tangible fixed assets. Therefore the charge to SWS, which would ultimately be recharged back to Scottish Water’s capital programme, should not include IT depreciation.
- The service agreement between IT and SWS was established in 2003 for the period. Therefore, service agreement pricing does not recognise subsequent investment in applications and infrastructure
- IT driver data has been improving year on year, and robustness of cost allocation has improved from 2003

This is a legacy position with pricing agreed in contract with SWS. The contract is not open to re-negotiation.

Support costs – Property

The property recharge was based on a standard unit charge per employee, which includes recovery of all direct costs, depreciation and overhead. The cross-charge for the year was £2.0m compared to £2.8m for previous year. This reduced for a number of reasons:

- SWS staff moving to a new external facility, paid for by SWS
- Reduction in the number of SWS staff
- Reduction to property charges to reflect SW property cost savings

Support costs – Payroll

This includes recharges for the provision of payroll services to SWS, which reflects the costs of the activities carried out by Scottish Water’s Payroll department, and the number of SWS employee payments and activities undertaken.

Support costs – Financial Systems

This includes recharges for the provision of Financial Systems services to SWS, which reflects the costs of the activities carried out by Scottish Water’s Finance Systems department, and the level of development and maintenance undertaken for SWS.

Support costs – Fleet

The fleet recharge was based on a standard unit cost per vehicle type, plus a charge for actual consumption of variable expenditure (e.g. fuel, wear and tear and hire).

Support costs – Customer Contact

This includes the cost of handling customer calls related to SWS activity, and reflects an activity cost and volume of calls. Customer contact is charged at £2K per month based on the estimated number of contacts being handled by the call centre for SWS capital projects/queries.

2. Recharges from Scottish Water (Regulated) to Scottish Water (Non Regulated)

Scottish Water (Non Regulated) is not set up as 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 for the following functions:

- Scottish Water (Non Regulated – Business Development)
- Scottish Water (Non Regulated – Waste Services)
- Scottish Water (Non Regulated – Property Services)

- Scottish Water (Non Regulated – Customer Connections)

These costs are charged directly to Scottish Water (Non Regulated), and therefore are not reported in table N2. Table N2 reports the value of cross-charges between Scottish Water (Regulated) and Scottish Water (Non Regulated), which includes the following transaction types:

- Labour, material and service costs transferred from Scottish Water (Regulated – Contracting) as actually incurred on Non Regulated activities (projects)
- Recharges from Scottish Water (Regulated) for support activities undertaken for Scottish Water (Regulated). 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 (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.
- Labour, material and service costs transferred from Scottish Water (Regulated – Customer Operations) incurred on Non Regulated activities based on operational timesheets and job cost capture
- Other functions on agreed activity and driver basis, e.g. Scientific Services based on volume and cost of samples and tests, waste services based on mogden formula for 3rd party waste (liquids) treatment and sludge model costs for 3rd party waste (sludge) treatment.

Table N2 does not report the total cost of Scottish Water (Non Regulated), but reports the value cross-charged between the 2 entities (£16.5m). The total cost of Non Regulated (£28.3m) is reported in Table M18, in line with Regulatory Reporting requirements.

The following cross-charges have been made in 2006/7:

i) Services provided to Scottish Water (Non Regulated) from Scottish Water (Regulated – Contracting).

Scottish Water Contracting was transferred from Non Regulated to Regulated in 2006/07. This decision was taken because of the change in workload from external work (3rd parties and Scottish Water Solutions) to predominately internal Regulated activity in support of in-house delivery of the capital investment programme.

Costs have been cross-charged from SW Contracting (Regulated) to Non Regulated based on:

- direct costs charged to non regulated projects, e.g. materials, contractors
- labour and contractor costs timesheeted to non regulated projects
- support activities charged to non regulated based on actual costs incurred or as calculated via ABM, and recharged to SWC (Non Regulated).

The following main activities have been cross-charged from SW Contracting (Regulated) to Non regulated

- Main laying work for Business Development (£1.2m). Business Development looks at its portfolio of suppliers and some projects are allocated to SWC. Most projects are 2 stage: optioneer and provide offer to construct. SWC tenders are based on cost base solution rates plus an uplift to cover project-specific factors, and risk.

- Mains Rehabilitation and other capital work for Scottish Water Solutions (£5.7m). This is the cost transferred from Regulated to Non regulated for the work undertaken for SWS, reported in N1 (£4.4m).
- Other infrastructure work directly for 3rd parties, e.g. Developers, Nevis Water (£3.8m) gained via competitive tendering.

The charges to SWC Non Regulated include ABM calculated charges for support activities and SWC head office costs of £1.3m, in addition to standard fleet, IT and property recharges.

The value of SWC Non Regulated work dropped significantly in 2006/07 compared to 2005/6 due to the change in workload from supporting external / SWS activities to supporting the in-house delivery of the capital investment programme.

ii) Support activities provided to Scottish Water (Non Regulated) from Scottish Water (Regulated).

Costs have been cross-charged to all Non Regulated functions for a share of all relevant support activities. 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 support activity cross-charges are described below:

- Actual Fleet – actual fuel costs, fleet hire costs, and vehicle wear, tear and damage costs as incurred
- Recharge Fleet – standard recharge by vehicle type to cover fixed vehicle costs (e.g. depreciation, lease costs, etc.)
- Actual IT – actual mobile phone charges
- Recharge IT – standard recharge by asset type (e.g. laptop, pda, PC) to cover asset-related costs (e.g. depreciation, desktop support, etc.)
- Activity Based IT based on the actual costs and drivers of activities such as: Application Support & Provision (cost by application, split by users), Infrastructure Availability (split based on capacity useage), Integration (split based on interface useage). Actual costs include all operating expenditure, including employment costs, licenses, depreciation, etc.
- Recharge Property – standard recharge per workstation to cover provision of office accommodation. Costs include rates, depreciation, direct costs and overhead.
- Activity Based HR – based on the actual costs and drivers of activities such as: Training (split based on training course places), Staff Recruitment (split based on number of staff recruited), etc.
- Activity Based Finance - based on the actual costs and drivers of activities such as: Supplier Invoice Processing (split based on number of invoices), Insurance Premiums (split based on risk and employee / asset values, weighted for risk), etc.
- Activity Based Customer Services - based on the actual costs and drivers of activities such as: Bad Debt (split based on split of aged debt by service), Handling Customer Calls (split based on number of customer calls), etc.
- Activity Based Procurement and Logistics - based on the actual costs and drivers of activities such as: Procure Goods and Services (split based on number of purchase orders), Issue Stock (split based on number of stock issues)
- Activity Based Scientific – based on the actual costs and drivers of activities such as – Take Samples (split based on number of sample visits), Analyse Tests (split based on number of tests analysed, weighted for lab cost)

The value of standard fleet, IT & property recharges was £0.5m (excluding SWC), and the value for activity based recharges was £1.9m (excluding SWC stated in i above)

iii) Labour, material and services provided to Scottish Water (Non Regulated) from Scottish Water (Regulated) on specific Non regulated activities.

Certain non regulated activities 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:

- Non Domestic Septic Tank Emptying
- Operate & Maintain 3rd Party Assets (Aquatrine)
- Rechargeable Works
- Provision of Shipping Water
- Provision of non Potable Water
- Lab Services

The labour, plant and vehicle cross charge for Business Development of £1.0m includes

- £0.7m charge for SW Customer Operations staff working on Aquatrine (MoD) assets.
- £0.2m charge for SW Scientific Services costs of processing Aquatrine (MoD) asset samples and tests.
- £0.1m of charges for other SW (Regulated) staff time and resource

The labour, plant and vehicle cross charge for Waste Services of £0.3m includes a charge from Customer Operations (Regulated) for waste treated and disposed at Scottish Water assets. The charge for liquids is based on the mogden formula, and the charge for sludge is based on Scottish Water's sludge model which reflects the estimated cost of treating and disposing of sludge at each of Scottish Water's works.

The labour, plant and vehicle cross charge for Customer Connections of £0.1m includes

- £0.1m charge from SW Customer Operations for staff time spent on connections.

The labour, plant and vehicle cross charge, and material and contractors charge for Rechargeable Works of £0.9m includes all costs captured against rechargeable work orders. The total cost of each work order is captured by Customer operations and transferred to the SW Customer Operations (Non regulated).

The labour, plant and vehicle cross charge for Shipping Water of £0.4m includes the costs of Customer Operations staff involved in non regulated shipping water activity.

The labour, plant and vehicle cross charge for Non Domestic Septic Tank Emptying of £0.3m includes the costs of Customer Operations staff and tankers involved in non regulated septic tank emptying activity.

The test and sample processing charge for Scientific Services of £0.2m includes the cost of processing non regulated samples and tests, charged based on full activity cost and number of tests and samples.

3. Scottish Water charges to Scottish Water Business Stream

(i) Wholesale Charges £126.8m

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.

(ii) Interest Charges £1.3m

The interest charges are on the following loans to SWBS:

	Value	Rate
Transferred Loans, with charges being calculated from 1st November 2006	£ 5,000,000	5.75%
	£ 20,000,000	4.50%
	£ 10,000,000	3.75%
New loan from 1st November 2006	£ 25,000,000	4.70%
New loan from 15th November 2006	£ 10,000,000	5.16%
New loan from 1st March 2007	£ 4,500,000	5.50%

(iii) Service & Support Charges £1.7m

Initial service level agreements (SLA's) were put in place for support services provided by Scottish Water (SW) to Scottish Water Business Stream (SWBS), and for services delivered by SW on behalf of SWBS, on an interim basis, until full systems and process separation is completed. SLA's were priced based on ABM analysis of full service costs, including direct costs, overheads and depreciation.

Full service agreements are in the process of being negotiated with SWBS, which require WICS approval.

The services charged under SLA's were:

- Metering Services charge includes the full cost of providing retail metering activities for business customers, on behalf of SWBS. A monthly charge was made to cover the agreed costs.
- Trade Effluent Billing Services charge includes the full cost of providing retail trade effluent billing and enquiries activities for business customers, on behalf of SWBS. A monthly charge was made to cover the agreed costs.
- Customer Operational Contact Services charge includes the full cost of providing operational contact activities for business customers, on behalf of SWBS. Charges were levied on a £ / call basis levied on the retail element of customer calls.
- IT charge includes the full cost of all IT services including desktop support; mobile, fixed voice, and data communications; and applications and infrastructure provision and support.
- Property charge for the provision of office facilities to SWBS
- Other Corporate Services (Payroll, Financial Systems, Fleet, HR, Corporate Affairs, Accounts Payable, Legal, Procurement, Tax, Treasury & Insurance, Internal Audit)
- Miscellaneous costs billed to SWBS include £55K, mainly for recruitment consultancy

iv) Business Retail (pre 1st November 2006) and Household Retail activities

Business retail activity prior to 1st November 2006, and Household retail activity, were not separate legal or accounting entities during the year. Scottish Water does, however, report the full cost of these services in M18 tables.

The cost of Business retail activity to 1st November 2006 was £11.2m, and household retail activity the full year was £31.9m. Costs are a combination of direct cost capture of activity/customer costs, and allocation support and retail activity between customer groupings based on activity drivers. Further details of cost allocation are included in M18 table commentary.

C. Cost Allocation. Recharges to Core from Associate / Non Core

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

As of 1st November 2006, Scottish Water's Customer Billing system (Hi Affinity) and Billing staff transferred to Scottish Water Business Stream, and with this went Scottish Water's billing capability. Scottish Water is currently developing a new billing capability within its Peoplesoft Financial System. Until this is implemented, Scottish Water Business Stream is providing billing services to Scottish Water under service agreements. Between 1 November 2006 and 31 March 2007, Scottish Water paid Scottish Water Business Stream £0.1m for a Sundry Billing Service.

2. Interest paid to SWBS

As per the wholesale agreement Scottish Water Business Stream pay Scottish Water Wholesale in advance. Interest is charged on this advance payment at a rate of 0.5% below base rate and is payable to SWBS.