

N Tables

Transfer Pricing

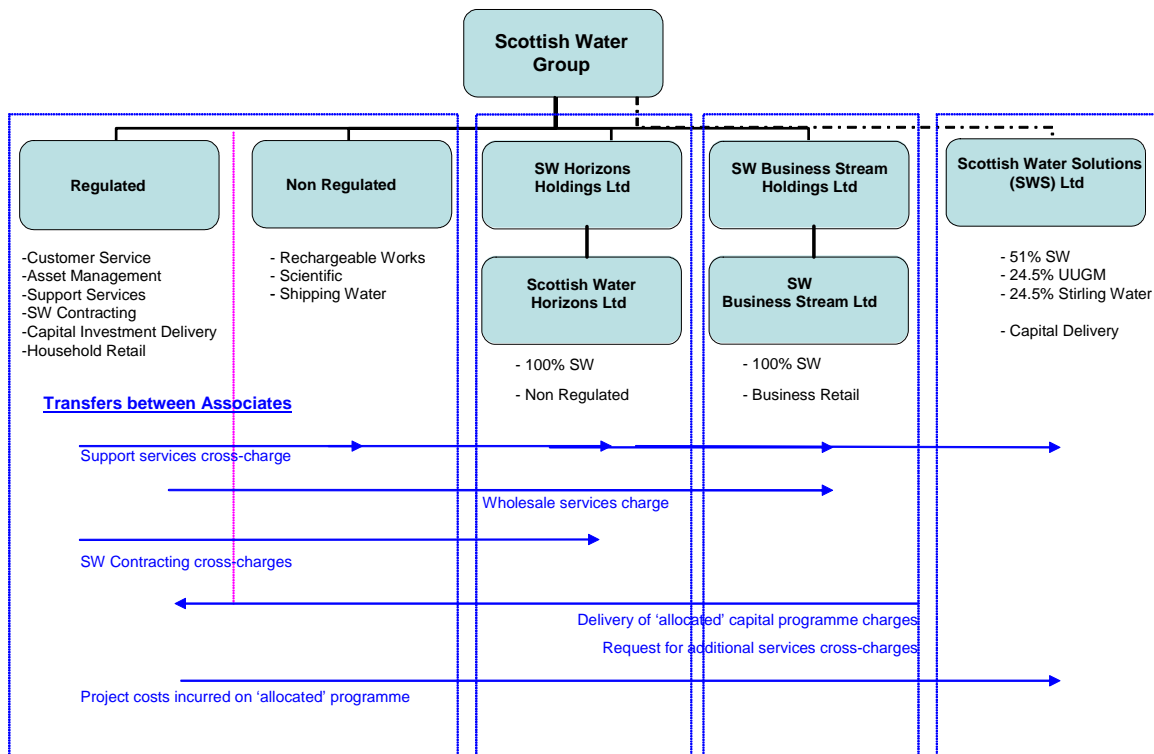
General Comments

The N tables for 2008/09 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 Business Stream Holdings Ltd (SWBSH): the holding company for SWBS, established in November 2007.
4. Scottish Water Horizons Ltd (SWH): the subsidiary, established in April 2008, responsible for the majority of Scottish Water's non regulated activities.
5. Scottish Water Horizons Holdings Ltd (SWHH): the holding company for SWH, established in April 2008.
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 as rechargeable works, shipping water, and laboratory services, remain within Scottish Water as a separate accounting entity.

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

Scottish Water Business Stream Holdings Ltd is a fully owned subsidiary of Scottish Water 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 and Scottish Water and Business Stream.

Scottish Water Horizons Holdings Ltd is a fully owned subsidiary of Scottish Water with its own board of directors. The actions of SWHH's Directors are governed by the Companies Act 2006.

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
 - (i) 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 £2.2bn, 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 2008/9 was £344m.

- (ii) Request for Additional Services

Additional design and construction services to the value of £5.9m were delivered in 2008/9 by SWS for SW compared to £12.2m in 2007/8. This decrease is due to the "wind down" of SWS with the de-secondment of staff back to their home organisations. SW staff previously seconded to SWS are back within Scottish Water and therefore have the capacity and skills

to directly perform the tasks, principally with the Capital Investment Delivery team (CID), which were previously requested under as Additional Services.

The allowance for additional services is within the contractual arrangements, Services Agreement, which were negotiated and established at the formation of SWS and were therefore subject to the formal tendering and competitive processes. The classification of "Additional Services", allows internal visibility of those activities which were not deemed to be part of the "Allocated" programme.

The benchmarking and comparison to framework contractor rates, established through a SW competitive process in 2006, allows internal challenge and reasonableness to be applied as part of the management decision making process before deciding whether to allocate additional work to SWS. Determined management and the formal approvals process ensure the most appropriate delivery route is selected to maximise efficient delivery and value for money.

(iii) Reconciliation of SWS Turnover to Charge to SW

| | |
|---|------------------|
| N Table total of SWS charges to SW (N1 Block C) | £349,525k |
| Less Invoices Charged to Expenditure | £ (908)k |
| Plus Invoices to 3 rd Parties | <u>£ 141k</u> |
| SWS Turnover | <u>£348,758k</u> |

(iv) Business Solutions Framework Contract

In most circumstances Scottish Water carries out the services provided by Business Solutions itself or by using other framework contractors. This agreement was let to cover situations where there is a lack of in house capacity and for work that is outside the core scope of Scottish Water's existing framework agreements, typically the design and installation of minor upgrades to infrastructure networks. The framework was awarded on 4th Jul 2008 for the Provision of Network Services (Minor Works). The value was est. at £500K per annum for a 2 year term with 3 further 1 year extension options. A full EU invitation to tender process was followed.

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 full cost incorporating overhead recovery. The total value of project costs charged in 2008/9 was £3.1m (2007/08 £5.6m). This includes £0.4m of legal costs (including £0.1m land purchase costs and £0.3m compensation claims), £1.8m of Construction costs (including £0.7m of consultancy costs) and £0.7m operational labour and material costs. This compares to a total value of £5.6m in 2007/08

2. Services provided to Scottish Water Solutions from Scottish Water (Regulated – Contracting) (£121,693)

This relates to mains rehabilitation activities carried out by Scottish Water contracting in 2007/08. The transaction relates to agreement of final accounts on a small number of projects.

3. Transfer of Assets from Scottish Water (Regulated) to Scottish Water Business Stream (£126,843)

Business Solutions staff, contracts and smart meter assets were transferred to Business Stream at the end of February 2008, assuming transfer but pending Water Industry Commission approval. This reflects agreement on final transfer value of £191k, less £64k reported in 2007/08.

4. Scottish Water Horizons Holdings set up

On 1 April 2008, the commercial, non regulated activities were transferred into separate legal entities. For this purpose two wholly owned subsidiary companies – Scottish Water Horizons Holdings Ltd (SWHH) and Scottish Water Horizons Ltd (SWH) – were set up. SWHH owns 100% of the shares in SWH which is the operating company. Net assets of £3.0m were transferred from SW's non regulated business into the new Horizons group in exchange for £3.0m of share capital in SWHH. This investment is held by the sundry non regulated section within SW (see table M2, line 2.3). As agreed, this transaction is not reflected in the N tables themselves, but detailed in this commentary.

5. Repayment Of Intercompany Loan to SWBSH

During the year SWBSH repaid the £58.5m intercompany loan from Scottish Water due to receiving direct funding from the Scottish Government. As agreed this transaction is not included in the N tables.

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 (£41k). This service ceased in October 2008 when SW de-seconded AP staff back into Scottish Water shared services

2. Request for Additional Services

Contracts for additional services to the value £5.9m were delivered in 2008/9 for design and construction works.

3. Delivery of SWS allocated capital programme

The total value of the services delivered by SWS in 2007/8 was £344m.

4. Developer support work carried out by Horizons on behalf of SW (£1,824,506)

This relates to developer support work (modelling £0.7m and main laying £1.1m) carried out by Horizons, and funded by Scottish Water under growth funding.

Table N2 Transfer Pricing Summary (P&L)

A. Market Testing

There has been no additional market testing of Table N2 services in 2008/9.

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

1. Recharges from Scottish Water (Regulated) to Scottish Water Solutions (£8,238,910)

Staff Costs

As at 31 March there were 70 staff seconded from Scottish Water to SWS. The average FTE for the year was 92. The costs associated with these staff (incl. basic salary, pension, NI, overtime etc) were recharged to SWS at cost, this totalled £4.6 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 £1.5m compared to previous year's charge of £2.2m due to the reduction in the FTE number seconded to SWS. Historically there has been a gap between the cost of this service and the value of the cross-charge. In 2008/9 the gap reduced (£1.8m cost versus £1.5m charge). This was due to the reduction in FTE number triggering a fixed cost threshold in the service contract.

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 £1.9 compared to £1.8m for previous year. This increased due to an increase in the number of Scottish Water Solutions partner employees utilising Scottish Water office facilities, and increase in the rent on one office charged to SWS.

Support costs – Payroll (£18,487)

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 (£30,270)

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 (£124,385)

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). The cross-charge for the year was £0.1m compared to £0.5m for previous year.

Support costs – Customer Contact (£24,000)

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.

Support Costs – Accounts Payable (£17,515)

Following de-secondment in October of AP staff back to Scottish Water shared services, Scottish Water now charge Scottish Water Solutions for AP.

2. Scottish Water charges to Scottish Water Business Stream

(i) Service & Support Charges £1.7m

Initial service level agreements (SLA's) were put in place for support services provided by Scottish Water (SW) to Business Stream (SWBS), and for services delivered by SW on behalf of SWBS, on an interim basis, until full systems and process separation was completed. These were replaced by full service agreements requiring WICS approval or by transfer of these activities to Business Stream. Services were priced based on ABM analysis of full service costs, including direct costs, overheads, working capital and depreciation.

The services charged under SLA's were:

A number of services ceased in 2007/08 and therefore the overall charge to Business Stream has dropped from £4.0m in 2007/08 to £1.7m in 2008/09. The services remaining are Business Stream's utilisation of Scottish Water IT architecture and office facilities, and Scottish Water group services on Tax, Insurance and Audit, as follows:

- Trade Effluent Billing Services charge (£0.1m) includes the full cost of providing final retail trade effluent billing calculations for 2007/08;
- IT service charge (£0.9m) 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 (£0.5m) for the provision of office facilities to SWBS based on office space utilised;
- Financial Systems charge for support and minor development of Peoplesoft Financials based on service activity volumes and module usage / users;
- Tax team charge for group VAT processing and reporting; and actual insurance premium costs incurred under group insurance arrangements;
- Internal Audit charge (£0.1m) on a daily rate basis for the agreed audit plan;
- Miscellaneous actual costs incurred by Scottish Water on behalf of SWBS in 2008/9, billed to SWBS, included £36K credit from SWBS for invoices relating to Business Solutions which were included in the transfer value, electricity costs of £6k, labs and Sampling costs of £4K as well as Inspection costs £1K.

(ii) Wholesale Charges £320.8m

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.

(iii) Interest Charges £0.1m

This relates to interest charges on additional monies due from SWBS for Wholesale charges from the reconciliation statements. The interest is calculated at Bank of Scotland Base Rate.

a. Scottish Water interest charges to Scottish Water Business Stream Holdings

Following the refinancing of SWBS, and set up of SWBSH, interest charges of £2.9m were charged to SWBSH on the following loans:

| 1. Loans outstanding at 31/3/08 | Value | Rate |
|---|--------------|-------------|
| New loan from 20 th March 2008 | £58,500.00 | 7.15% |
| | | |
| 2. Replacement Loans in 2008/09 | | |
| New loan from 30 th May 2008 | £58,500,000 | 7.18% |
| New loan from 31 st October 2008 | £58,500,000 | 6.93% |

After set up and initial capitalisation, the intention was for SWBSH to borrow directly from the Scottish Government. However, delays within the Scottish Government in obtaining the budgetary approval resulted in a continuation of the required funding being via SW until December 2008. This temporary arrangement was agreed with Scottish Government and WICS.

The interest rates to SWBSH were based on 3 month LIBOR + 1.25%,

There were no loans outstanding as at 31 March 2009

3. Recharges from Scottish Water to Scottish Water Horizons

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

- Labour, material and service costs transferred from Scottish Water (Regulated - Contracting) as actually incurred on Horizons activities (projects)
- Recharges from Scottish Water (Regulated) 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 (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 charged Horizons £2.4m for service and support charges.

- Waste & Sludge Processing Charge for Waste Services is for waste being treated and disposed of using SW assets and any additional costs such as SW tankers being used to transport waste, or Labour costs of SW staff at an SW asset used to deal with the waste. The value of this in 2008/9 was £314k, and was based on mogden formula for 3rd party waste (liquids) treatment and sludge model costs for 3rd party waste (sludge) treatment;
- The cross-charge for Energy Efficiency work transacted was £35K for the financial year 2008/9. This recharge is for work carried out by the Energy Efficiency team on Horizons assets;
- The cross-charge for Aquatrine work transacted was £15k for the financial year 2008/9, this was for SW call centre taking calls from Aquatrine clients
- The cross-charge for ABM Support costs during the year was £715k for the financial year 2008/9;
- The cross-charge for Finance Support costs was £61k for the financial year 2008/9, this was for Financial Systems team time spent on set up of Horizons GL, Billing, Accounts Receivable and other systems and IT charges for technical changes in support of the set up of these systems;
- The cross-charge for Property Services Support costs was £125k for the financial year 2008/9, this recharge was in respect of Horizons share of office, depot and other property costs in the year;
- The cross-charge for IT Service costs was £157k for the financial year 2008/9, this recharge was in respect of providing service desk support, mobile devices, provision of desktop support, security and systems management, applications management and support and IT communications.
- The cross-charge for Contracting Regulated Labour Costs during the year was £55k for the financial year 2008/9, and was in respect of Regulated Contracting staff working on Non Regulated projects based on Timesheets;
- The cross-charge for Trade Effluent costs was £202k for the financial year 2008/9, and was for the cost of dealing with trade effluent at SW assets on behalf of Horizons.

- Contracting Management & Support Charge. Management and support costs are captured within the regulated ledger and a recharge is made to Horizons for an element of these costs that relates to Non Regulated work, based on work throughput.

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

Scottish Water (Non Regulated) was not set up as a separate legal entity in 2008/9. 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 (£3.1m). The total cost of the Non Regulated entity (£3.8m) is reported in Table M18, in line with Regulatory Reporting requirements.

The majority of these activities are now with Horizons. The remaining activities 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 (Aquatrine)
- Rechargeable Works
- Provision Of Shipping Water
- Provision of non Potable Water
- Lab Services

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

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

Household retail activity and residual Business retail activity (management of Licensed Provider interfaces, Wholesale Billing and CMA 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.

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

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

During 2008/9 SWBS paid Business Solutions staff a bonus relating to 2007/8 of £26,906. These staff were SW staff until February 2008 so SWBS recharged SW for the bonus which was attributable to SW relating to the period from April 2007 to February 2008. SW also made £192,477 of Guaranteed Service Standard Payments to SWBS in line with the Wholesale Scheme of Charges

2. Recharges From Business Solutions

During 2008/09 SWBS invoiced SW £0.5m for works carried out for Asset management by Business Solutions

3. Interest paid to SWBS

As per the wholesale agreement Scottish Water Business Stream pay Scottish Water Wholesale 10 business days in advance of the month to which the charge relates. Interest is charged on this advance payment at Bank of Scotland base rate and is payable to SWBS, this totalled £778k during the year.

4. Interest paid to SWBSH

During 2008/9 Scottish Water paid SWBSH £448k in interest on the following intercompany loans.

| 1. New Loans in 2008/09 | | |
|--|-------------|-------------------------|
| New loan from 26 th Sept 2008 | £18,000,000 | 5.25% & 4.75% |
| New loan from 29 th Sept 2008 | £20,000,000 | 5.25% & 4.75% |
| New loan from 31 st October 2008 | £38,000,000 | 4.75% & 3.25% |
| New loan from 08 th December 2008 | £37,500,000 | 2.25%, 1.75% & 1.25% |
| New loan from 20 th February 2008 | £5,000,000 | 1.25% |

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

During 2008/9 there was £27k of internal recharges from Horizons to Regulated (Regulated) The cross-charge was for Horizons Labour Costs and was in respect of Horizons staff working on Regulated projects based on Timesheets.

During 2008/9 Horizons charged Scottish Water £147k for customer connections and main-laying work. This contract was awarded to Scottish Water Contracting (Non Regulated) in January 2008, prior to the set up of Scottish Water Horizons, after a formal tendering process.

During 2008/9 Scottish Water paid Horizons £13K in interest on the following Intercompany loans.

| 1. New Loans in 2008/09 | | |
|--|------------|-------|
| New loan from 15 th October 2008 | £7,500,000 | 4.75% |
| New loan from 28 th October 2008 | £7,500,000 | 4.75% |
| New loan from 06 th November 2008 | £3,500,000 | 3.25% |
| New loan from 27 th November 2008 | £5,000,000 | 3.25% |
| New loan from 27 th February 2009 | £5,000,000 | 1.35% |

6. Interest Paid to Scottish Water Horizons Holdings

During 2008/9 Scottish Water paid Scottish Water Horizons Holdings £5k in interest on intercompany loans.