

N Tables Transfer Pricing

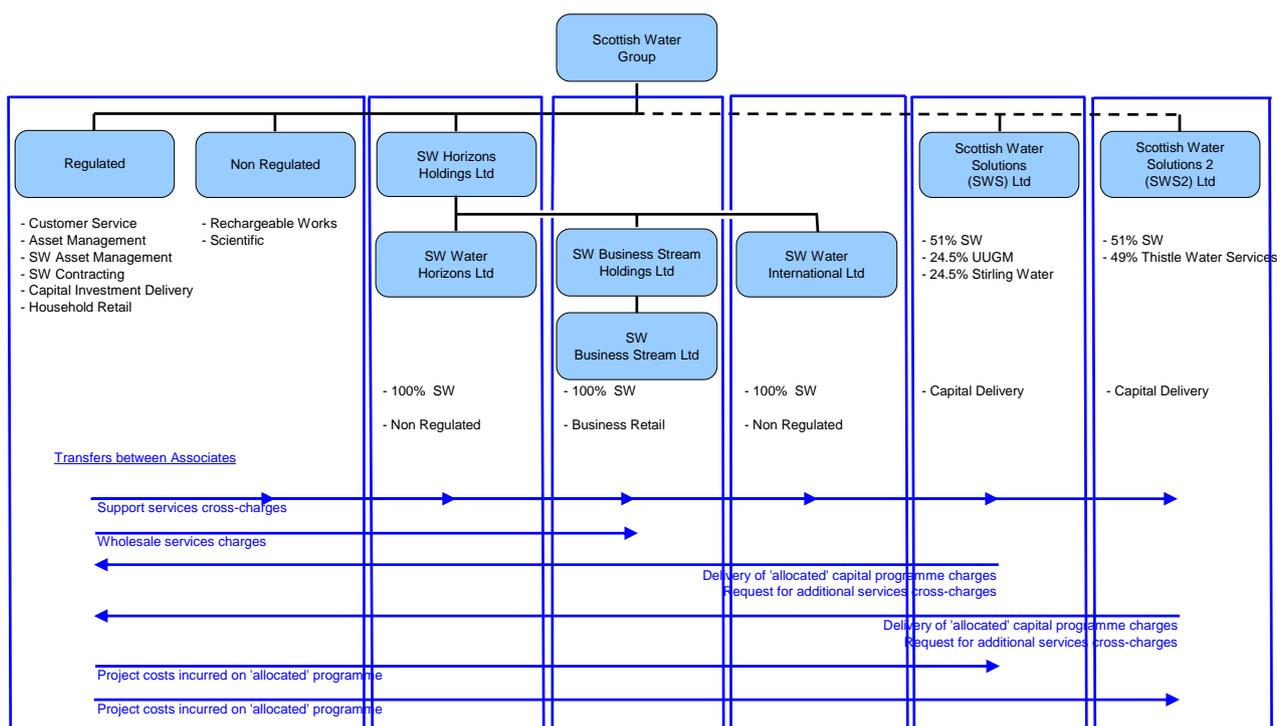
General Comments

The N tables for 2012/13 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 Solutions 2 Ltd (SWS2): the consortium responsible for delivering part of the capital programme under contract to Scottish Water.
3. Scottish Water Business Stream Ltd (SWBS): the subsidiary, established in November 2006, responsible for retail – non household activities.
4. Scottish Water Business Stream Holdings Ltd (SWBSH): the holding company for SWBS, established in November 2007.
5. Scottish Water Horizons Ltd (SWH): the subsidiary, established in April 2008, responsible for the majority of Scottish Water's non regulated activities.
6. Scottish Water International Ltd (SWI): the subsidiary, established in January 2012, responsible for overseas activities.
7. Scottish Water Horizons Holdings Ltd (SWHH): the holding company for SWH, SWI and SWBSH established in April 2008.
8. 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, 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, Chief Executive, 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 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.

Scottish Water Business Stream Holdings Ltd 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.

In accordance with directors' 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. On May 2012, SWS delivered the last remaining project to SW and is currently in the process of being wound down.

In accordance with directors' duties under the Companies Act 2006, Scottish Water Solutions 2 board of directors must act in the interest of SWS2 at all times and not in relation to any underlying shareholder interest. In addition, in the Declaration of Interest section of SWS2 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 SWS2 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 (2006-10)

This outlines details of the contract between Scottish Water and Scottish Water Solutions Ltd (SWS) for delivery of part of the capital programme for the 2006 to 2010 regulatory period. Following an extensive competitive tender process, the contract was awarded to SWS, 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 2012/13 was £17.2m. On May 2012, SWS delivered the last remaining project to SW and is currently in the process of being wound down.

(ii) Request for Additional Services

Additional design and construction services to the value of £8k were delivered in 2012/13 by SWS for SW compared to £0.3m in 2011/12. This decrease is due to the “wind down” of SWS with the de-secondment of staff back to their home organisations.

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.

2. Scottish Water Solutions 2 Ltd

(i) Delivery of the Capital Programme (2010-15)

This outlines details of the contract between Scottish Water and Scottish Water Solutions 2 Ltd (SWS2) for delivery of part of the capital programme for the 2010 to 2015 regulatory period. Following an extensive competitive tender process, the contract was awarded to SWS2, a consortium which includes Scottish Water and Thistle Water Limited. The total value of the contract awarded was £550m, which covers the period of the Quality & Standards III (b) investment programme. The total value of the services delivered by SWS2 in 2012/13 was £131.7m.

(iii) Request for Additional Services

Additional design and construction services to the value of £143k were delivered in 2012/13 by SWS2 for SW compared to £13k in 2012/13. The allowance for additional services is within the contractual arrangements, Services Agreement, which were negotiated and established at the formation of SWS2 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 2010, allows internal challenge and reasonableness to be applied as part of the management decision making process before deciding whether to allocate additional work to SWS2. Determined management and the formal approvals process ensure the most appropriate delivery route is selected to maximise efficient delivery and value for money.

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

1. Project costs incurred on ‘allocated’ projects SWS

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 2011/12 was £0.2m (2011/12 £1.8m). The charge of £0.2m was made up of various charges including Fleet, Travel, Hospitality and I.T.

2. Project costs incurred on 'allocated' projects SWS2

Costs incurred by Scottish Water (Regulated) on capital projects which have been contracted to SWS2 to deliver. These costs are recharged to (SWS2) at full cost incorporating overhead recovery. The total value of project costs charged in 2012/13 was £6.4m (2011/12 £6.9m). The charge of £6.4m was made up of various charges including Fleet, Travel, Hospitality and I.T.

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

1. Request for Additional Services

Contracts for additional services to the value £8K were delivered in 2012/13 for design and construction works by SWS.

2. Delivery of SWS allocated capital programme

The total value of the services delivered by SWS in 2012/13 was £17.2m.

3. Delivery of SWS2 allocated capital programme

The total value of the services delivered by SWS2 in 2012/13 was £131.7m.

4. Developer support work carried out by Horizons on behalf of SW (£0.6m)

This relates to two capital projects by far the largest of which was the diversion of mains at Fairmilehead to allow development of the old water treatment works site, for which formal testing was carried out to ensure that the bid cost was at a fair market value.

Table N2 Transfer Pricing Summary (P&L)

A. Market Testing

There has been no additional market testing of Table N2 services in 2012/13.

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

1. Recharges from Scottish Water (Regulated) to Scottish Water Solutions (£0.2m)

Staff Costs

As at 31 March 2013 there were no longer any staff seconded from Scottish Water to SWS. The average FTE for the year was 1. This was a reduction in terms of the average number for the previous year 2011/12, where 4 were seconded from Scottish Water to SWS. The costs associated with these staff (incl. basic salary, pension, NI, overtime etc) were recharged to SWS at cost, this totalled £0.2m in the year.

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 £8k compared to £0.1m for previous year. This decreased due to a reduction in the number of Scottish Water Solutions partner employees utilising Scottish Water office facilities, caused by the gradual close down of Scottish Water Solutions.

Support costs – Financial Services (£17k)

This includes recharges for the provision of Payroll, Financial Systems, Accounts Payable and Internal Audit services to SWS, which reflects the costs of the activities carried out by these Scottish Water departments for SWS.

Support costs – Fleet (£24k)

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 £24k compared to £56k for previous year.

2. Recharges from Scottish Water (Regulated) to Scottish Water Solutions 2 (£1.6m)

Staff Costs

As at 31 March 2013 there were 15 staff seconded from Scottish Water to SWS2. The average FTE for the year was 16. This was in line with the average number for the previous year 2011/12, where 16 were seconded from Scottish Water to SWS2. The costs associated with these staff (incl. basic salary, pension, NI, overtime etc) were recharged to SWS2 at cost, this totalled £0.7m 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 SWS2 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 £0.4m compared to previous year's charge of £0.4m.

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 £0.3m which was a slight increase on the previous year.

Support costs – Financial Services (£106k)

This includes recharges for the provision of Payroll, Financial Systems, Accounts Payable and Internal Audit services to SWS2, which reflects the costs of the activities carried out by these Scottish Water departments for SWS2.

Support costs – Fleet (£117k)

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.

Support costs – Customer Contact (£24k)

This includes the cost of handling customer calls related to SWS2 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 SWS2 capital projects/queries.

3. Scottish Water charges to Scottish Water Business Stream

(i) Service & Support Charges £0.2m.

Service agreements are in place between Scottish Water and Business Stream for some of the remaining services.

Charges reduced to £0.2m for the year from £1.2m in 2011/12

The services charged under service agreements were:

- IT service charge (£84k) includes the full cost of all IT services including desktop support; mobile, fixed voice, and data communications; and applications and infrastructure provision and support.
- Insurance team charge (£61k) for actual insurance premium costs incurred under group insurance arrangements.
- Internal Audit charge (£69k) on a daily rate basis for the agreed audit plan.

(ii) Wholesale Charges £300.5m.

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.

4. 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 as actually incurred on Horizons activities (projects); and
- 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 £2.7m 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 2012/13 was £669k, 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 £37k for the financial year 2012/13. This recharge is for work carried out by the Energy Efficiency team on Horizons assets;
- The cross-charge for Aquatrine work transacted was £156k for the financial year 2012/13, in respect of the SW call centre taking calls from Aquatrine clients;

- The cross-charge for Support Shipping Water Services was £414k for the financial year 2012/13. These relate to costs recharged from the core business in relation to the provision of shipping water;
- The cross-charge for Asset Management costs was £126k for the financial year 2012/13. This recharge was for SW staff working on Horizons capital projects, calculated using time sheets and hourly rates which include overhead.
- The cross-charge for ABM Support costs during the year was £523k for the financial year 2012/13;
- The cross-charge for Property Services Support costs was £120k for the financial year 2012/13. 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 £187k for the financial year 2012/13. 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 Insurance costs was £28k for the financial year 2012/13. This is Horizons' share of SW insurance premiums;
- The cross-charge for Legal costs was £93k for the financial year 2012/13. This was the cost of internal legal resource used by Horizons, based on time sheeted hours spent and rates agreed in the SW/Horizons legal SLA;
- The cross-charge for Trade Effluent costs was £278k for the financial year 2012/13, and was for the cost of dealing with trade effluent at SW assets on behalf of Horizons.
- 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.

5. Recharges from Scottish Water to Scottish Water International

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

- Labour, material and service costs transferred from Scottish Water as actually incurred on International activities (projects).

During the year Scottish Water charged International £118k for service and support charges.

- The cross-charge for Asset Management costs was £26k for the financial year 2012/13. This recharge was for SW staff working on International projects, calculated using time sheets and hourly rates which include overhead.
- The cross-charge for Legal costs was £27k for the financial year 2012/13. This was the cost of internal legal resource used by International, based on time sheeted hours spent and rates agreed in the SW/International legal SLA;
- Management & Support Charge. Management and support costs are captured within the regulated ledger and a recharge is made to International for an element of these costs that relates to Non Regulated work, based on work throughput.

6. 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 (£1.9m). The total cost of the Scottish Water Non Regulated accounting entity, is included within 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 non Potable Water
- Lab Services

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

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)

Guaranteed Service Standard Payments

During the financial year 2012/13 Scottish Water made £112k of 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. These amounts relate to such Service Standard payments.

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 £114k during the year.

Gap and vacancy incentives

During the financial year 2012/13 Scottish Water made £585k of gap incentives payments and £635k of vacancy incentives payments to SWBS in line with the Wholesale Scheme of Charges.

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

During 2012/13 Horizons charged Scottish Water £20k (2011/12 £93k) 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. The charge passes from Horizons to the core business for carrying out Mainlaying work.

During 2012/13 Horizons charged Scottish Water £30k for the provision of plan and property searches.