

N Tables Transfer Pricing

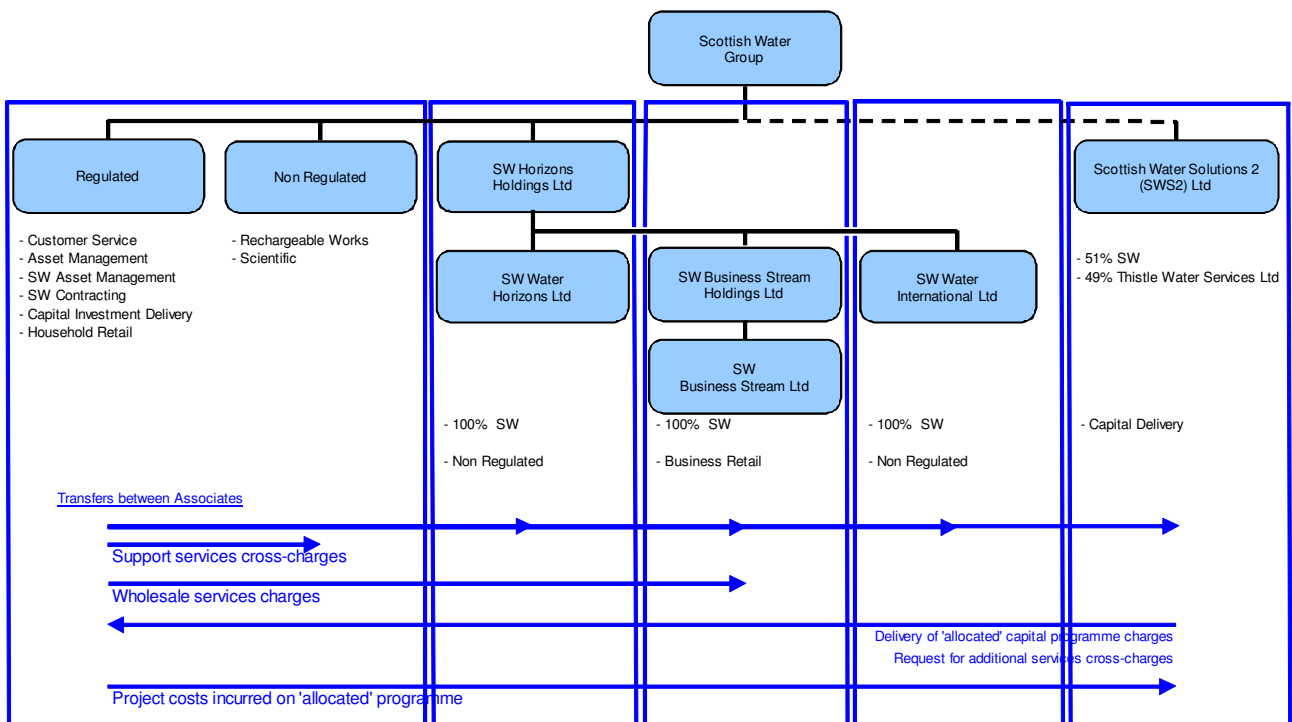
General Comments

The N tables for 2014/15 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 2 Ltd (SWS2): 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 International Ltd (SWI): the subsidiary, established in January 2012, responsible for overseas activities.
6. Scottish Water Horizons Holdings Ltd (SWHH): the holding company for SWH, SWI and SWBSH established in April 2008.
7. 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

Alan Scott, Finance 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 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 2 Ltd 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 Regulatory enforcement of transfer pricing rules in cross-charges.

Table N1 Transfer Pricing Summary (Capex)

A. Market Testing

1. Scottish Water Solutions 2 Ltd
 - (i) Delivery of the Capital Programme (2010-15) (line ref 1.1.1).

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 value of this contract was reduced to £427m as several large projects were removed from SWS2 in preparation for SWS2 being wound down. The total value of the services delivered by SWS2 in 2014/15 was £73.6m.

- (ii) Request for Additional Services (line ref 1.1.2).

Additional design and construction services to the value of £155k were delivered in 2014/15 by SWS2 for SW compared to £92k in 2013/14. 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 SWS2 (line ref 1.4.1).

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. The total value of project costs charged in 2014/15 was £4.2m (2013/14 £7.7m). The charge of £4.2m was made up of various charges including Fleet, Travel, I.T and other support costs.

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

1. Delivery of SWS2 allocated capital programme (line ref 1.5.1).

The total value of the services delivered by SWS2 in 2014/15 was £73.6m.

2. Request for Additional Services (line ref 1.5.2).

Contracts for additional services to the value £155k were delivered in 2014/15 for design and construction works by SWS2.

3. Purchase of plant and machinery from SWBS by SW (£50k) (line ref 1.6.1).

This relates to the purchase of a Microstrainer unit for Rosewell waste water treatment works.

4. Sale of renewable energy assets by Horizons to SW (£9,018k) (line ref 1.7.1).

This relates to the transfer of c 6.3 GWh of renewable energy assets from Horizons to SW over the year.

5. Developer support work carried out by Horizons on behalf of SW (£319k) (line ref 1.7.2).

This relates to four minor capital projects.

Table N2 Transfer Pricing Summary (P&L)

A. Market Testing

There has been no additional market testing of Table N2 services in 2014/15.

B. Cost Allocation. Recharges to Associate from Core

1. Recharges from Scottish Water (Regulated) to Scottish Water Solutions 2 (£1.1m; 2014: £1.3m)

Staff Costs (line ref 2.1.1).

As at 31 March 2015 there were 7 staff seconded from Scottish Water to SWS2. The average FTE for the year was 9. This was lower than the average number for the previous year 2013/14, where 12 staff 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 £492k in the year.

Support Services – IT (line ref 2.1.2).

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 £231k compared to previous year's charge of £250k.

Support costs – Property (line ref 2.1.3).

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 £199k which was a decrease on the previous year's figure of £250k.

Support costs – Fleet (£47k) (line ref 2.1.4).

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 – Financial Services (£64k) (line ref 2.1.5).

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 – Travel (£37k) (line ref 2.1.6).

This includes travel and hotel costs, and is charged at the full cost to Scottish Water as invoiced by Exptel.

2. Scottish Water charges to Scottish Water Business Stream

(i) Service & Support Charges £251k (2014: £281k).

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

Charges decreased to £251k for the year from £281k in 2013/14. The services charged under service agreements were:

- IT service charge (£105k) is for Oracle licence maintenance and support. (line ref 2.2.1).
- Legal services charge (£7K) on an hourly rate for actual legal work carried out. (line ref 2.2.2).
- Actual insurance premium costs incurred under group insurance arrangements (£54k). (line ref 2.1.3).
- Internal Audit charge (£85k) on a daily rate basis for the agreed audit plan. (line ref 2.2.4).

(ii) Wholesale Charges £251.2m (2014: £280.1m). (line ref 2.3.1-7).

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.

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 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 £3.7m (2014: £2.3m) for service and support charges with the increase primarily due to the additional waste processing requirements in Shetland.

- 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 relate to Non-Regulated work, based on work throughput. (line ref 2.4.1).
- 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 in 2014/15 was £2,269k (2013/14 £781k), and was based on mogden formula for 3rd party waste (liquids) treatment and sludge model costs for 3rd party waste (sludge) treatment. The year-on-year increase was due to the additional waste being processed by the Lerwick treatment plant because of development work at Sullom Voe for which Horizons are providing waste water disposal services; (line ref 2.4.2).
- The cross-charge for Aquatrine work transacted was £184k for the financial year 2014/15, in respect of the SW call centre taking calls from Aquatrine clients; (line ref 2.4.3).
- The cross-charge for Support Shipping Water Services was £436k for the financial year 2014/15. These relate to costs recharged from the core business in relation to the provision of shipping water; (line ref 2.4.4).
- The cross-charge for Asset Management costs was £51k for the financial year 2014/15. This recharge was for SW staff working on Horizons capital projects, calculated using time sheets and hourly rates which include overhead recovery; (line ref 2.4.5).
- The cross-charge for ABM Support costs during the year was £386k for the financial year 2014/15; (line ref 2.4.7).

- The cross-charge for Property Services Support costs was £47k for the financial year 2014/15. This recharge was in respect of Horizons' share of office, depot and other property costs in the year; (line ref 2.4.8).
- The cross-charge for IT Service costs was £104k for the financial year 2014/15. 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; (line ref 2.4.11).
- The cross-charge for Insurance costs was £13k for the financial year 2014/15. This is Horizons' share of SW insurance premiums; (line ref 2.4.12).
- The cross-charge for Legal costs was £63k for the financial year 2014/15. 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; (line ref 2.4.13).
- The cross-charge for Trade Effluent costs was £14k for the financial year 2014/15, and was for the cost of dealing with trade effluent at SW assets on behalf of Horizons. (line ref 2.4.15).

4. Recharges from Scottish Water to Scottish Water International

Table N2 reports the value of cross-charges between Scottish Water (Regulated) and International. The general increase in the recharges from SW to International reflects the increase in International's turnover from the previous year as International endeavour to grow their business. The transaction types included the following:

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

During the year Scottish Water charged International £645k (2014: £94k) for service and support charges.

- 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; (line ref 2.5.1).
- The cross-charge for Asset Management costs was £50k for the financial year 2014/15. This recharge was for SW staff working on International projects, calculated using time sheets and hourly rates, which include overhead recovery; (line ref 2.5.2).
- The cross-charge for Legal costs was £4k for the financial year 2014/15. 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; (line ref 2.5.7).
- The provision of documentation recharge of £348k was for the provision of documents by SW to International which International then sold on to their client. It was agreed that the fee from the client should be shared equally between SW and International; (line ref 2.5.8).

5. 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 (£2.2m; 2014: £2.3m). 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 the non-regulated activities are now with Horizons. The remaining non-regulated 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; and
- 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) (£2.0m; 2014: £2.4m)

Interest paid to SWBS (line ref 2.7.1).

As per the wholesale agreement Scottish Water Business Stream pays 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 £110k during the year.

Guaranteed Service Standard Payments (line ref 2.7.2).

During the financial year 2014/15 Scottish Water made £68k 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 of the Wholesale Scheme of Charges. These amounts relate to such Service Standard payments.

Gap and vacancy incentives (line ref 2.7.3-4).

During the financial year 2014/15 Scottish Water made £1,239k of gap incentives payments and £564k 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) (line ref 2.8.1-4).

During 2014/15 Horizons charged Scottish Water £309k (2013/14 £73k) 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 2014/15 Horizons charged Scottish Water £30k for the provision of plan and property searches.

3. Cross-charges from Scottish Water (Non-Regulated) to Scottish Water (Regulated) (line ref 2.9.1-2).

During 2014/15 £97K of recharges were charged to Scottish Water (Regulated) from Scottish Water (Non-Regulated), mainly for Rechargeable Works recharges.