

## N Tables      Transfer Pricing

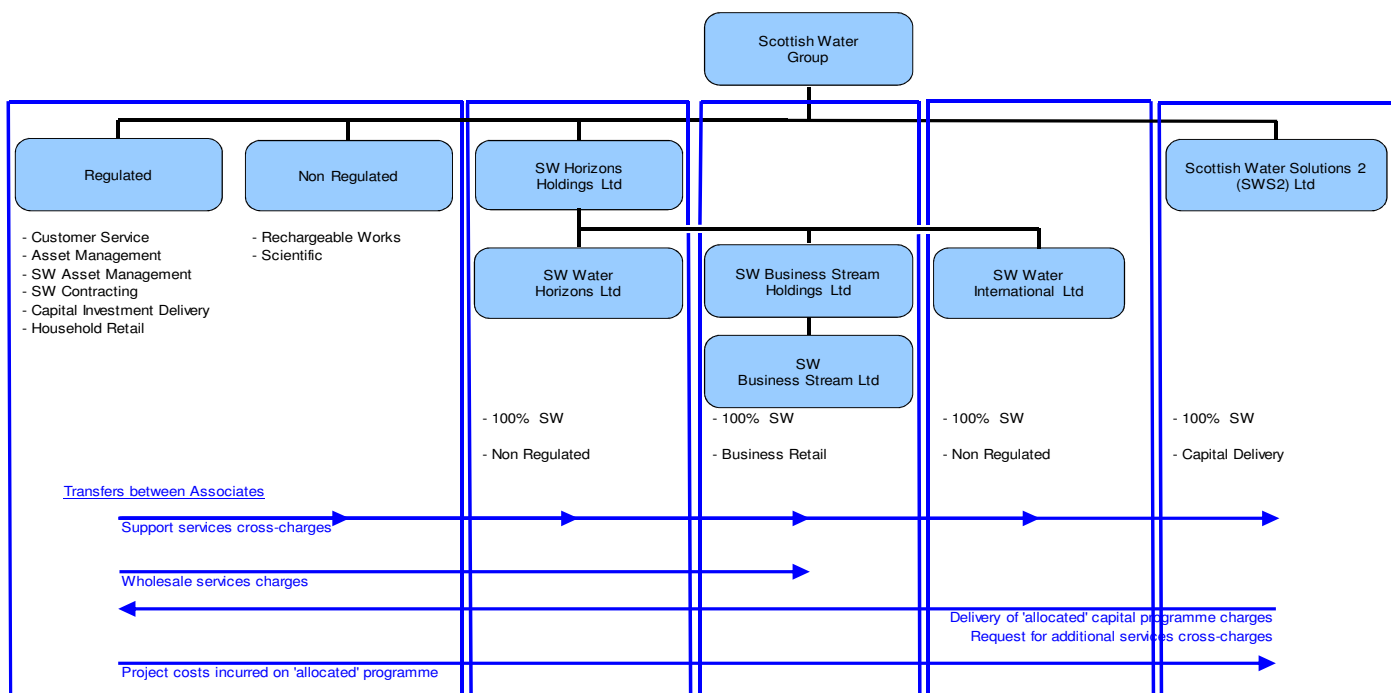
### General Comments

The N tables for 2015/16 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 subsidiary responsible for delivering part of the capital programme under contract to Scottish Water. During 2015/16 SW increased its shareholding in SWS2 from 51% to 100%, therefore SWS2 is now a fully owned subsidiary company of SW.
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.

Scottish Water Solutions 2 Ltd is a fully owned subsidiary of Scottish Water with its own board of directors. The actions of SWS2's Directors are governed by the Companies Act 2006.

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)

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, which became a wholly owned subsidiary of Scottish Water in 2015/16. 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 2015/16 was £34.6m.

- (ii) Request for Additional Services

Additional design and construction services to the value of £29k were delivered in 2015/16 by SWS2 for SW compared to £155k in 2014/15. 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. 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

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 2015/16 was £3.7m (2015 £4.2m). The charge of £3.7m 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. Request for Additional Services

Contracts for additional services to the value £29k were delivered in 2015/16 for design and construction works by SWS2.

2. Delivery of SWS2 allocated capital programme

The total value of the services delivered by SWS2 in 2015/16 was £34.6m.

3. Sale of renewable energy assets by Horizons to SW (£542k)

This relates to the transfer of c 1.1 GWh of renewable energy assets from Horizons to SW over the year.

4. Developer support work carried out by Horizons on behalf of SW (£118k)

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 2015/16.

- 1. Recharges from Scottish Water (Regulated) to Scottish Water Solutions 2 (£649k; 2015: £1,074k)**

#### **Staff Costs**

As at 31 March 2016 there were 2 staff seconded from Scottish Water to SWS2. The average FTE for the year was 4 (2015: 9). The costs associated with these staff (incl. basic salary, pension, NI, overtime etc) were recharged to SWS2 at cost, this totalled £253k 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 £205k compared to previous year's charge of £231k.

### **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 £101k which was a decrease on the previous year's figure of £199k.

### **Support costs – Financial Services (£18k)**

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 (£19k)**

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 – Travel (£52k)**

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

## **2. Scottish Water charges to Scottish Water Business Stream**

- (i) Service & Support Charges £166k (2015: £251k).

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

Charges decreased to £166k for the year from £251k in 2014/15. The services charged under service agreements were:

- IT service charge (£9k) Oracle license maintenance and support for 1 month.
- Actual insurance premium costs incurred under group insurance arrangements (£56k).
- Internal Audit charge (£79k) on a daily rate basis for the agreed audit plan.
- Legal services charge (£11K) on an hourly rate for actual legal work carried out, £6k related to the adoption of Glenmuir with the remaining £5k being for legal costs associated with disconnections.
- Human Resources charge (£11k) on an hourly rate for actual work carried out.

- (ii) Wholesale Charges £225.6m (2015: £251.2m).

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 £2.6m (2015: £3.7m) for service and support charges with the decrease primarily due to the reduced waste processing requirements in Shetland.

- 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 2015/16 was £1,116k (2015: £2,269k), 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 decrease was due to the reduction in waste being processed by the Lerwick treatment plant because of the cessation of development work at Sullom Voe for which Horizons were providing waste water disposal services.
- The cross-charge for Aquatrine work transacted was £226k for 2015/16, this was for SW call centre taking calls from Aquatrine clients (£35k), a Water Operations process scientist working on Aquatrine projects (£37k) and sampling services from SW Scientific (£154k).
- The cross-charge for Support Shipping Water Services was £427k for 2015/16. 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 £146k for 2015/16. This recharge was for SW staff working on Horizons capital projects, calculated using time sheets and hourly rates which include overhead recovery.
- The cross-charge for contact centre costs was £23k for 2015/16. This recharge was for calls handled on behalf of Horizons.
- The cross-charge for ABM Support costs during the year was £443k for 2015/16.
- The cross-charge for Property Services Support costs was £23k for 2015/16. This recharge was in respect of Horizons' share of office, depot and other property costs in the year.
- The cross-charge for Internal Audit Support costs was £11k for 2015/16. This recharge was in respect of Internal audit work carried out for Horizons as per the agreed audit programme and is based on actual hours worked.
- The cross-charge for Sampling costs was £6k for 2015/16. This recharge was in respect of samples taken on behalf of Horizons and is based on the actual number of samples taken and the testing required of those samples.
- The cross-charge for IT Service costs was £104k for 2015/16. 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 £20k for 2015/16. This is Horizons' share of SW insurance premiums.
- The cross-charge for Legal costs was £38k for 2015/16. 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 Management & Support Charge was £12k for 2015/16. 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.
- The Payroll and Timesheet Charge was £18k for 2015/16. This charge relates to timesheet recharges to Horizons and is based on actual timesheeted costs. The majority of these charges relate to Finance services support given to Horizons during the financial year.

#### **4. Recharges from Scottish Water to Scottish Water International**

Table N2 reports the value of cross-charges between Scottish Water (Regulated) and International.

- The cross-charge for Asset Management costs was £77k for 2015/16. This recharge was for SW staff working on International projects, calculated using time sheets and hourly rates which include overhead recovery.
- The cross-charge for Customer Service costs was £17k for 2015/16. This recharge was for SW staff working on International projects, calculated using time sheets and hourly rates which include overhead recovery.
- The cross-charge for IT Service costs was £22k for 2015/16. 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 £12k for 2015/16. This is International's share of SW insurance premiums.
- The Management & Support Charge was £56k for 2015/16. 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.

The decrease in the recharges from SW to International is largely due to a recharge of £348k in 2014/15 for the provision of SW documents which International then provided to Irish Water.

#### **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 (£2.1m; 2015: £2.2m). 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 3<sup>rd</sup> 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 1<sup>st</sup> 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 the M18 tables.

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

#### **1. Cross-charges from Scottish Water Business Stream (Regulated) to Scottish Water (Regulated) (£1.8m; 2015: £2.0m)**

##### **Guaranteed Service Standard Payments**

During the financial year 2015/16 Scottish Water made £64k 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.

##### **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 £145k during the year.

##### **Gap and vacancy incentives**

During the financial year 2015/16 Scottish Water made £911k of gap incentives payments and £697k 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 2015/16 Horizons charged Scottish Water £85k (2015: £309k) for impact assessments relating to the effects of new developments on the existing infrastructure.

During 2015/16 Horizons charged Scottish Water £32k for the provision of plan and property searches.

During 2015/16 Horizons charged Scottish Water £13k for Research and Innovation, for the use of Horizons development centre at Gorthleck.