Transfer pricing in the Scottish water industry: Scottish Water's compliance with Regulatory Accounting Rule 5

A report to the Water Industry Commission for Scotland

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Water Industry Commission for Scotland
Transfer Pricing Review

Contents

1 Summary

Scottish Water must demonstrate that trading with its associates is at arm's length and that it is not subsidising its associates or its non-core activities.

Regulatory Accounting Rule 5 provides a framework to be followed by Scottish Water for trade with its associates and for transactions between core and non-core activities. In 2006, the Water Industry Commission appointed a team of experts to review whether Scottish Water had implemented the guidelines contained within this Rule. In December 2008, a reduced team was again appointed to complete a follow up review

A similar approach has been adopted to that for the previous review. Review meetings were held with Scottish Water staff responsible for dealing with associates and non-core activities. Notes of the meetings were submitted to Scottish Water to confirm their factual accuracy. Scottish Water also provided background information and this was analysed by the team.

The transfer pricing team would like to thank Scottish Water for the cooperation and assistance that they again received during the review visits.

Business Stream

We have found that Scottish Water has complied with Regulatory Accounting Rule 5 with respect to the allocation of costs to Business Stream. Scottish Water was also able to demonstrate that a robust arm's length relationship is maintained with its associate.

Scottish Water demonstrated that its market-testing of the rates paid to Business Solutions, a subsidiary of Business Stream, is consistent with Regulatory Accounting Rule 5

However, we suggest that Scottish Water improves the recording of its negotiations, particularly relating to service agreements, with Business Stream so that a transparent audit trail is available to demonstrate the robustness of this relationship.

We have also noted that the recording of transactions in the 'N' tables with Business Stream Holdings means that some information is not included in the table but specified. The transactions, relating to the sale and purchase of shares between Scottish Water and Business Stream Holdings Limited and the repayment of the loans to Scottish Water by Business Stream, have been included in the N tables commentary as required under Regulatory Accounting Rule 5, but not in the tables. We suggest to the Commission that it amends this guidance so that any similar transactions in the future would be captured in the table.

Scottish Water Solutions

We have found that Scottish Water has improved its processes for the control and monitoring of Scottish Water Solutions and we are satisfied that a robust arms length relationship in accordance with Regulatory Rule 5 is being maintained. We note that Scottish Water has implemented the recommendations of the last transfer pricing review and has strengthened its structure to avoid conflicts of interests in order to comply fully with Regulatory Accounting Rule 5. We understand that Scottish Water has also issued revised guidance to Directors on conflicts of interest.

Cross charges to Scottish Water Solutions have been compared with the ABM cost analysis to ensure that costs of these services are being fully recovered. For Scottish Water Solutions the cross charges are currently not sufficient to cover the costs incurred.

The primary reason given for this shortfall is that the contract terms were negotiated before ABM had been sufficiently refined and that it is not possible to renegotiate these terms.

As we understand that negotiation on a number of aspects within the agreements between Scottish Water and Scottish Water Solutions is undertaken, we believe that there may also be some scope for the renegotiation of these charges.

Non-core activities

In 2007, Scottish Water reclassified the activities of Scottish Water Contracting as core as a result of the decision to manage infrastructure work through Scottish Water rather than through Scottish Water Solutions.

The accounting for remaining non core activities has been improved with monthly amounts being included for central overheads and recharges from the core business. While a number of non core activities remained loss making for 2007-08, these losses are covered sufficiently by profits from other non core activities.

In April 2008, two new companies were created – Scottish Water Horizons Holdings Limited and Scottish Water Horizons Limited. A number of non core activities have been transferred into Scottish Water Horizons Limited to allow them to be managed at an arm's length basis from Scottish Water. The activities include the non core activities of Scottish Water Contracting.

These shared arrangements could create challenges in respect of project and resource prioritisation for the management teams of Scottish Water Horizons and Scottish Water Contracting, who will still be expected to report within Scottish Water based on all of its activities – core and non core. These arrangements will require to be monitored carefully by Scottish Water on an ongoing basis to ensure that they continue to comply with RAR 5.

In addition, Scottish Water will need to be able to demonstrate that transfer prices for services provided to it by Scottish Water Horizons are based on market price or less. These market prices should be determined, wherever possible, by market testing in accordance with Regulatory Accounting Rule 5. When trading with associates, Scottish Water should also pay particular regard to the application of the Competition Act 1998.

During 2007-08 Scottish Water received a proportion of the revenue generated from the sale of the rights to locate telephone masts and aerials on Scottish Water Land. This revenue was shared with non core activities. We have found no evidence to suggest that the proportionment is unfair to customers but note a concern to the Water Industry Commission that this arrangement may set a precedent on the treatment of such asset based windfalls.

2 Introduction

2.1 Transfer Pricing Team Remit

The Water Industry Commission published guidelines (Regulatory Accounting Rule 5) in respect of prices determined for transactions between Scottish Water and its associates and the allocation of common costs between core and non-core activities. This is to ensure that price limits are set based on the actual costs of providing water and sewerage services and not inflated by cross subsidy.

In 2006, the Water Industry Commission appointed a team of experts, working closely with internal staff, to review Scottish Water's implementation of the guidelines. In December 2008, a team was again appointed to complete a more limited review . The aims of the review were twofold:

- To review Scottish Water's compliance with Regulatory Accounting Rule 5 in 2007-08;

- To review its progress in implementing the recommendations of the October 2006 Transfer Pricing Report.

This report sets out the transfer pricing team's approach and its findings.

2.2 Transfer Pricing Team Approach

The main tenets of Regulatory Accounting Rule 5 are that:

- Cost shared between Scottish Water core activities and its non-core activities should be allocated in relation to the way that resources are consumed; and

- Transfer prices for goods or services received from an associate by Scottish Water are based on market price or less. Where no market exists, or where Scottish Water does not choose to test the market, transfer prices are based on cost.

The transfer pricing team concentrated on activities with a high level of transactions with the core business, namely:

- Business Stream;

- Scottish Water Solutions; and

- Scottish Water Contracting.

2.2.1 Transfer Pricing Methodology

The approach of the team was similar for each area under review. First, the team sought to understand the context within which transfer pricing decisions were made. It then sought further understanding of the processes and decision-making pertinent to those areas under review.

A questionnaire was sent to Scottish Water in advance of the first meeting. The responses to this questionnaire were used to inform subsequent discussions and highlight subjects for further investigation. Successive meetings went into greater levels of detail. Scottish Water also provided substantial amounts of supporting information for examination by the team.

Scottish Water was given the opportunity to comment on the factual accuracy of the team's resulting meeting notes.

A schedule of supporting documentation received is given in Annex 4.

3 Findings

3.1 Implementation of recommendations from Transfer pricing review October 2006

The following table sets out the above recommendations and subsequent actions by Scottish Water to implement these recommendations.

Ref	Recommendations	Action
Business Stream		
5.1.1	Verification of costs transferred to Business Stream on commencement of trading in 2006	Reviewed by Water Industry Commission
5.1.2	Detailed Service Level Agreements to be implemented reflecting commercial arrangements including full cost recovery	Service Level Agreements now in place and reflect full cost (see 5.4 below)
5.1.3	Review the final transfer of assets to Scottish Business Stream	Reviewed by Water Industry Commission
5.1.4	Impact of Business Stream on M and N tables to be discussed with the Water Industry Commission	Tables amended by Water Industry Commission
Scottish Water Solutions		
5.2.1	Avoid agreeing with one associate pre-determined levels of work for another associate or non core activity without market testing	Arrangements for Scottish Water Contracting discontinued (see 7.2. below)
5.2.2	Clear guidance required for Directors in the event of conflicts of interest	Guidance provided by both Scottish Water and legal advisers (see 6.5 below)

5.2.3	Compliance with Regulatory Accounting Rule 5 when tendering for the remaining elements of the Quality and Standards II programme	Regulatory Rule 5 complied with during tendering process
Scottish Water Contracting and other non core activities		
5.3.1	Cost allocation methods to be improved to allow ABM to be used without manual adjustments. Improvements to include: • Monthly recharges to cover as many costs as possible • Reconciliation between the ledger system and the ABM system • Improve transparency of costs through clearer and consistent audit trails	Monthly management accounts now reflect ABM allocations and are reconciled on a six monthly basis. Improved audit trails are now available (See 7.2 below)
5.3.2	N2 table to be amended to be more closely aligned with the way information is collected within Scottish Water. Regulatory Accounting Rule 5 should also be reviewed to reflect changes that have occurred since it was first issued	N2 Table and Regulatory Accounting Rule 5 updated by Water Industry Commission
5.3.3	Scottish Water Contracting to be considered as a core activity	Scottish Water Contracting considered as a part of the core business undertaking a limited amount of non core activity (see 7.2 below)

3.2 Compliance with Regulatory Accounting Rule 5 in 2007-08. Business Stream

3.2.1 Was the process for identifying and allocating the costs to Business Stream in accordance with Regulatory Accounting Rule 5? Have costs been allocated in the way that resources have been consumed?

We have found that Scottish Water has complied with Regulatory Accounting Rule 5 with respect to the allocation of costs to Business Stream.

3.2.2 Are the rates included in the service agreements reflective of the full costs of providing the service i.e. have they been calculated in accordance with the way that resources will be consumed as required by Regulatory Accounting Rule 5?

We confirm that Scottish Water has complied with Regulatory Accounting Rule 5 in deriving the rates for the service agreements. Scottish Water provided a clear audit trail for the rates, as is required by Regulatory Accounting Rule 5.

In 2006, the rates included in the interim service agreements were based on departmental agreed budget costs for 2006-07. Drivers used to allocate costs in Scottish Water's ABM system were used to inform the allocation of indirect costs.

The ABM system has been refined since we first reviewed it in 2006 and cross charges to Business Stream are compared with the ABM cost analysis to ensure that costs of these services are being fully recovered. In the case of Business Stream the cross charges in 2007-08 were in excess of the costs calculated through the ABM analysis.

3.2.3 Do the service agreements in place demonstrate robust arms length trading between Scottish Water and Business Stream as required by Regulatory Accounting Rule 5?

We consider that the agreements in place are based on a solid commercial framework and reflect terms that would exist in such agreements with external parties.

3.2.4 Is there a robust arm's length relationship between Scottish Water and Business Stream?

We are satisfied that a commercial tension exists and that an arm's length relationship is being maintained.

The transfer pricing team sought demonstration of a robust arms length relationship being maintained between Scottish Water and Business Stream by assessing the commercial tension that existed between the parties when negotiating the service agreements. However, although formal correspondence is centralised in one place, e-mail files are not centralised and were provided from individual mail boxes. Our assessment was therefore based on paper copies of emails presented to us by Scottish Water. From a review of these documents, we are satisfied that a commercial tension exists and that an arm's length relationship is being maintained.

3.2.5 Have transactions been correctly recorded on the N tables?

We consider that there is an inaccuracy in the recording of transactions in the 'N' tables with Business Stream Holdings.

The transactions, relating to the sale and purchase of shares between Scottish Water and Business Stream Holdings Limited and the repayment of the loans to Scottish Water by Business Stream, have not been included in the N tables as required under Regulatory Accounting Rule 5.

3.2.6 Has Scottish Water demonstrated that its transactions with Business Solutions, a subsidiary of Business Stream, are at arm's length and in accordance with Regulatory Rule 5?

Scottish Water demonstrated that it has undertaken a valid market testing exercise for transactions with Business Solutions as required by Regulatory accounting Rule 5.

Regulatory Accounting Rule 5 requires that transfer prices for transactions between Scottish Water and its associates are based on market price (or less). It states that competitive letting is the most robust means of determining a fair market price. Scottish Water demonstrated to us that it had completed a valid competitive tendering exercise that followed EU procurement procedures.

3.3 Compliance with Regulatory Accounting Rule 5 in 2007-08 Scottish Water Solutions

3.3.1 Does Scottish Water have appropriate governance in place to monitor the delivery of its capital investment programme by an associate, as required to demonstrate arm's-length trading?

We are satisfied that Scottish Water is exercising sufficient control and monitoring of the performance of its associate in order to comply with Regulatory Accounting Rule 5.

Regulatory Accounting Rule 5 requires Scottish Water to demonstrate that the relationship with its associate, Scottish Water Solutions, is at arm's length. One of the ways that this can be demonstrated is through evidence that there is proper client control. The transfer pricing team reviewed the governance procedures and controls it implements over Scottish Water Solutions

Scottish Water uses Key Performance Criteria to monitor the performance of Scottish Water Solutions. These criteria impact on the final amounts paid for a project. The criteria have been strengthened for Quality and Standards III.

We reviewed Scottish Waters processes and systems for monitoring of Scottish Water Solutions during Quality and Standards II. Based on the evidence provided, we are satisfied that Scottish Water has improved its monitoring of the performance of Scottish Water Solutions

A conclusion of the previous transfer pricing review in 2006 was that whilst projects are let on an open book basis, Scottish Water only audits the books of its partners when there is a cost increase. We expected audits to be conducted on a more frequent and random basis. Scottish Water demonstrated to us that it has now improved its control over costs submitted by Scottish Water Solutions.

3.3.2 Are procedures in place to ensure that there is no conflict of interest at board level as required by Regulatory Accounting Rule 5?

In 2006, the transfer pricing team was not convinced that Scottish Water's processes were sufficient to prevent directors having to deal with conflicts of interest as required by Regulatory Accounting Rule 5.

Scottish Water stated that new guidance is now in place. The transfer pricing team requested a copy of the written procedures in place to prevent conflicts of interest and also evidence that these were applied. We received no evidence but have no reason to doubt that these procedures are in place.

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A potential conflict of interest was noted in the last transfer pricing review in 2006 when Scottish Water's General Manager of Capital Investment was also a Director of SWS. A staff member reporting to this General Manager represented Scottish Water's interests in relation to SWS.

Scottish Water confirmed that this conflict of interest no longer exists. The current client manager is the General Manger of the Capital Investment team, who is no longer a Director of SWS.

3.3.3 Are the rates included in the service agreements reflective of the full costs of providing the service i.e. have they been calculated in accordance with the way that resources are consumed as required by Regulatory Accounting Rule 5?

The rates in the service agreements are not reflective of the full cost of providing services to Scottish Water Solutions and compliance with Regulatory Rule 5 has not been demonstrated.

Cross charges to Scottish Water Solutions have been compared with the ABM cost analysis to ensure that costs of these services are being fully recovered. For Scottish Water Solutions the cross charges are currently not sufficient to cover the costs incurred.

The primary reason given for this shortfall is that contract terms were negotiated before ABM had been sufficiently refined and that it is not possible to renegotiate these terms.

As we understand that negotiation on a number of aspects within the agreements between Scottish Water and Scottish Water Solutions is undertaken, we believe that there may also be some scope for the renegotiation of these charges.

3.4 Compliance with Regulatory Accounting Rule 5 in 2007-08 Scottish Water Contracting and other non-core activities

3.4.1 Does Scottish Water comply with Regulatory Accounting Rule 5 by ensuring non-core cost allocations reflect the consumption of resources by those activities?

The transfer pricing review team in 2006, found evidence that suggested that Scottish Water was not complying with Regulatory Accounting Rule 5 and may have been been subsidising non-core activities by not allocating full costs to these activities.

Scottish Water has continued to refine its ABM systems with particular focus on enhancing the quality of the non financial data used for calculating cost reallocations. In addition to improving the means by which ABM cost allocations have been calculated these have been more closely aligned with monthly management accounts.

On the basis of the information provided we are satisfied that the non core cost allocations reflect the consumption of resources for these activities.

3.4.2 How are profits and losses of the non-core activities accounted for within Scottish Water, i.e. could any losses from non-core activities be subsidised by customers of the core business in contravention of Regulatory Accounting Rule 5?

As suggested in the Transfer Pricing Review of 2006, Scottish Water Contracting was transferred into the core business in 2007. During 2007-08 Scottish Water Contracting continued to deliver non core projects for third parties or non core divisions of Scottish Water. These projects are identified within the projects ledger and form the basis for the entries in the N tables.

Each of the non core activities are accounted for separately including recharges for use of core resources and allocation of central overheads based on ABM. While a small number of these non core activities make losses the remaining activities are generating sufficient profits to ensure that customers are not cross subsidising these losses.

In April 2008, two new companies were created – Scottish Water Horizons Holdings Limited and Scottish Water Horizons Limited – into which a number of non core activities have been transferred, including the non core work of Scottish Water Contracting.

These shared arrangements could create challenges in respect of project and resource prioritisation for Scottish Water Horizons and Scottish Water Contracting, who will still be expected to report within Scottish Water based on all of its activities – core and non core. These arrangements, and the recharging of support costs, will require to be monitored carefully by Scottish Water on an ongoing basis to ensure that they continue to comply with RAR5.

3.4.3 Is the process for allocating costs transparent and were clear audit trails provided as required by Regulatory Accounting Rule 5?

Costs are allocated to non core activities based on direct allocation when incurred, recharges based on standard rates for use of core resources and allocation of central overheads through the use of ABM.

We have been provided with detailed evidence supporting each of these foms of allocation and are satisfied that the audit trails are sufficiently clear as required by Regulatory Accounting Rule 5.

3.4.4 Has Scottish Water followed the guidance for completion of the Regulatory Accounting 'N' tables so that the reporting of transactions between core and non core activities is transparent?

With the exception of the reporting of the funding transactions undertaken when creating Business Stream Holdings, we are satisfied that the transactions have been recorded following the guidance provided for the completion of Regulatory Accounting 'N' Tables.

A number of unusual transactions have occurred during 2007-08 which have not readily fitted within the existing guidance. In particular, the creation of the Business Stream Holdings company, including the issue of bonus shares, and the apportionment of revenue for aerials and masts have proven difficult to report within the existing guidance.

This revenue was shared with non core activities. We have found no evidence to suggest that the proportionment is unfair to customers but note a concern to the Water Industry Commission that this arrangement may set a precedent on the treatment of such asset based windfalls.

4 Suggestions for improving compliance with RAR 5

4.1 Business Stream

1. Currently, although formal correspondence between Scottish Water and Business Stream is centralised in one place, e-mail files relating to negotiations of service agreements are not centralised and are kept in individual mail boxes. Scottish Water needs to continue to demonstrate an arm's length relationship with its associate through the provision of a transparent audit trail detailing transactions. We suggest that any such communications are held in one place, either in hard copy or electronically.

2. The 2007-08 N Tables should be revised to correctly reflect the transactions arising as a result of the creation of Business Stream Holdings Limited.

3. Clarification is also required by the Water Industry Commission on how non cash transactions such as the issue of bonus shares by Business Stream to Scottish Water should be reported under Regulatory Accounting Rule 5.

4.2 Scottish Water Solutions

1. Rates in the service agreements, covering the provision of services by Scottish Water to Scottish Water Solutions, do not cover the costs of providing these services i.e they do not reflect the consumption of resources. In order to comply with Regulatory Rule 5, we suggest that this service agreement is re - negotiated to reflect the actual costs of providing the service.

4.3 Non-core activities

1. There is likely to be wider opportunities for Scottish Water to make innovative use of core assets but arrangements must ensure that core customers who own these assets are receiving a sufficient return on the inherent if not direct value of the asset.

2. The reporting of transactions involving Scottish Water Horizons need to be monitored by Scottish Water to ensure that there are no conflicts of interest and risks of cross subsidisation arising as a result of the non core activities of Scottish Water Contracting being part of Scottish Water Horizons while being managed as part of the core Scottish Water Contracting.

3. Scottish Water will need to be able to demonstrate that transfer prices for services provided to it by Scottish Water Horizons are based on market price or less. These market prices should be determined, wherever possible, by market testing in accordance with Regulatory Accounting Rule 5.

4. When trading with associates, Scottish Water should also pay particular regard to the application of the Competition Act 1998.

5 Appendix 1: Business Stream - detailed information

5.1 Introduction

Business Stream (Business Stream) is the non household retail subsidiary of Scottish Water. It shares some resources with Scottish Water. Regulatory Accounting Rule 5 requires that trading with associates is at arm's length and that where resources are shared, costs are allocated in the way in which resources are consumed.

The objective of the transfer pricing review was to confirm Scottish Water's progress in implementing the recommendations of the October 2006 transfer pricing report and to assess compliance with Regulatory Accounting Rule 5 in 2007-08 through:

- A review of the allocation of costs between Scottish Water and Business Stream in 2007-08.
- The examination of background documentation relating to the negotiation of service agreements, to assess whether or not an arms length relationship is being maintained.
- A review of the market testing process for services provided to Scottish Water that are not covered by a service agreement (Business Solutions).

5.2 Service Agreements

5.2.1 Status of service agreements

At the time of the last review in October 2006, a number of interim service agreements were in place to formalise the provision of those support services that Scottish Water continued to supply to Business Stream in the period 1 October to 31 December 2006. The interim service level agreements were brief but included basic clauses such as services to be provided, contract rates and respective responsibilities of both parties.

The transfer pricing team concluded that these agreements did not mirror those that could normally be expected between two separate entities and hence did not fully demonstrate arm's length trading and comply fully with Regulatory Accounting Rule 5. We recommended that in order to demonstrate arm's length trading, any service level agreements for the period from 1 January 2007 be detailed and reflect similar commercial arrangements in the market place between two unrelated entities.

Scottish Water have implemented this recommendation and we are satisfied that the arrangements in place are based on a solid commercial framework, reflecting terms that would exist in such agreements with external parties.

The table below details the service agreements that have been let between Scottish Water and Business Stream:

Service Agreement	Services	Status
Provision of Facilities Services	• Provide office space at Fairmile Head, Bullion House and Balmore Road • Provide office services	Extension beyond 30/09/09 under review. Balmore road vacated and Bullion House to be vacated by 31/3/09
Professional services agreement	• HR system • H&S support • Tax, VAT &insurance services • Internal audit services	Extension for Tax, Vat & insurance services beyond 30/9/09 under review. H&S no longer taken.
Provision of IT services	• IT operations • Infrastructure services • Communication services • Applications management &support • Data & security services • Systems development	Extension beyond 30/09/09 for managed services and fixed communications under review.
Provision of Emergency Planning and handling and operational contact services	• Receiving calls and report/updating Business Stream on incidents. • Handle operational contacts to agreed standards	Expired 31/3/08
Provision of meter reading services	• Meter reading service • Metering issues resolution • Operational contacts	Expired 31/10/07
Provision of New connections services	• Process water, sewerage &building water applications	Expired 31/12/07
	• Assist in clearing backlog of applications	Short term service commenced 13/10/08 and expired 7/11/08
Provision of trade effluent services	• Volume &charge calculation services • Handling enquiries • Manage system interfaces & data services	Expired 31/03/08 with exception of billing calculation services expired 31/8/08
Provision of household billing & continuation of supply services	• Invoicing, collection, credit management • Handling customer contacts	Expired 31/03/08
Provision of information for wholesale services	• Provision of information used to calculate wholesale charges	Expired (staggered expiry dependent on service) .Final expiry 30/11/08

As can be seen, Business Stream's dependency on Scottish Water is declining, although those agreements remaining are unlikely to expire, at least in the short term.

Extensions are being sought and will be sent to WICS for approval. However, substantial changes are being proposed for some agreements, notably IT. Negotiations are still being undertaken and hence are not yet ready to be submitted to the Commission.

An agreement for trade effluent was proposed but has been abandoned as Business Stream decided that the terms were not acceptable. The Company is now calculating its own volume of effluent. Scottish Water stated that such an agreement would be available to Business Stream's competitors if required.

5.2.2 Shared resources

The transfer pricing team queried whether there were any resources shared that were not covered by service agreements. Two areas were identified:

- Scottish Water is exempt from paying water charges and Business Stream also were not paying water charges. We understand that this has since been addressed and Business Stream are now paying water charges.

- Business Stream get a small benefit of being part of a larger VAT group. A small charge is made for this. We did not verify this statement.

5.2.3 Stranded assets

The transfer pricing team raised a concern that if the number of service agreements becomes less, is it possible that some costs will be stranded within the core. Scottish Water responded that service agreements cover man hours and expertise and do not cover fixed assets used solely by Business Stream. The only potential; area where this could happen is IT architecture but no instance had been identified to date.

Detail of the IT resource shared with Business Stream is given below:

- PeopleSoft, Financial Control System - logical separation of a single system.
- Quest, HR system - logical separation of a single system.
- GIS, Geospatial Information System - a very small part of Business Stream named 'Business Customer Solutions' has been given access to Scottish Water's Intranet thin-client GIS named 'Query View Print/QVP', which provides read-only access to Water and Waste Water network:
- Data Warehouse, Reporting system - separate Business Stream data marts sitting within a shared warehouse environment. Database and Reporting tool logon security enforces separation:

- Integration arrangements - Business Stream also share the Integration service, in that all data flows pass through the same hub and are scheduled by the same instance of Informatica. However Business Stream has its own interfaces that deliver only its data through the shared hub. Scottish Water considers that this can also be described as logical separation.
- Bespoke Apex Applications, ie Apex development tool - Business Stream has a bespoke application, TESS (Trade Effluent System). This has its own schemas and security but it does reside in the same database as SW applications, so again Scottish Water considers it would be regarded as logically separate.

Business Stream also logically shares the single-sign on that logs it on to the Portal. Scottish Water stated that so do other external companies who have a log on, but Business Stream only need to do so because it has applications hosted with Scottish Water.

5.3 Allocation of costs

The transfer pricing team compared cross charges to Business Stream with the ABM cost analysis to ensure that costs of these services are being fully recovered i.e. that the rates included in the service agreements are reflective of the costs incurred by Scottish Water in providing the service.

In the case of Business Stream the cross charges are in excess of the costs calculated through the ABM analysis.

A comparison of the charges and related costs is provided below:

	Costs per ABM £'000	**Charges made £'000**
Scottish Water Business Solutions	3,585	3,967

5.4 Negotiations

The overall process was that Business Stream stated its requirements and Scottish Water responded with its proposed terms. Charges were based on ABM outputs.(see section 5.3 above for allocation of costs).

Scottish Water stated that finalisation of the service agreements took some time and there was substantial negotiation involving lawyers (including commercial external lawyers) and professional staff such as procurement managers and service providers. There was no benchmarking to external service level agreements, although there was comparison to similar agreements in existence within the Scottish Water Group e.g. Scottish Water Solutions

The transfer pricing team sought demonstration of a robust arms length relationship between Scottish Water and Business Stream by assessing the commercial tension that existed between the parties when negotiating the service agreements. Sight of files relating to the negotiation of service agreements was requested. Complete files were not available but paper copies of various emails (selected by Scottish Water) were provided and some were chosen for detailed review.

A resume of the challenges resulting from the review of these emails is given below:

5.4.1 Credit/payment terms for Business Stream

There appeared to have been a change in credit/payment terms between Business Stream and Scottish Water for services provided under the Service Agreements. Scottish Water stated that 10 business days was consistent with other service agreements for non primary services. However, it was agreed to accept 30 days as these are Scottish Water's terms to external parties.

It confirmed that charges were uplifted to compensate for the change in payment terms although no detail was received.

5.4.2 Cross-subsidy concerns

The transfer pricing team queried the evidence of a debate on the potential for cross subsidies, asking for an explanation of the concerns and how they were addressed

Scottish Water stated that these references reflected the need for regulatory imperatives and were based on a generic rather than specific concern. Business Stream were pushing on a more commercial front.

The transfer pricing team confirmed that clauses requiring the supplier (Scottish Water) and Business Stream to comply with regulatory requirements in relation to transfer pricing are standard in all the services agreements. The generic preamble to the services agreements states:

"This Agreement reflects the duties and responsibilities on the Supplier and Business Stream to comply with the regulatory requirements in relation to transfer pricing and specifically the requirement on each party not to give any cross subsidy to the other or receive any cross subsidy from the other without the Commission's consent. Accordingly, in order to comply with the regulatory requirements, the parties acknowledge that the rates specified in this Agreement and any costs which may be due by Business Stream pursuant to this Agreement are such that those regulatory requirements are complied with."

5.4.3 Payment of costs in event of a change in law

This was a legal point raised by lawyers as to who pays costs in the event of a change in law –initially Business Stream considered that it was bearing the risk. It was agreed that the party affected should bear the cost but that services agreement charges should be adjusted if appropriate. It was noted that there is an introduction to the generic clause .4.5 which states that:

"Save for the provisions of any regulatory requirements in relation to transfer pricing to be complied with by the Supplier and Business Stream"

5.4.4 Annual Inflation of charges

Scottish Water stated that the increases for hourly rate services, e.g. VAT, Internal Audit, H&S, reflect employment costs inflation which was 4%. IT, Facilities, Financial Systems and Insurance were separately calculated to reflect cost increases, service changes and efficiencies.

The agreements state that the first review should take place by 31st January and take effect from the 31st March 2008.

5.4.5 Cost challenge between core and associate

Operational calls – site visits

Under a service agreement which expired on 31st March 2008, Scottish Water handled operational calls on behalf of Business Stream. As an example of an area of challenge of costs between Scottish Water and Business Stream, the transfer pricing team asked for the audit trail of the agreed £33.56 per hour for on-site customer visits. Also, an explanation of how this was calculated (i.e. costs included and excluded).

Scottish Water provided an hourly rate calculation, which included direct costs, consumption based recharges (i.e. Fleet, IT mobile, Facilities, etc.) and ABM overheads (all other support areas, e.g. HR, Finance, IT Applications and Infrastructure, etc.). The hourly rate (with inflation) was shown to be £33.56.

New connections

There appeared to be some debate about the service to be provided and the costs of new connections. Business Stream seemed concerned about the low margins achieved.

Scottish Water explained that Business Stream was challenging the cost of processing applications. Scottish Water had agreed to reconsider the proposed charge of £82.68, but since the actual costs of providing a service could not be amended, negotiations centred on the scope of the service provided and not the cost of providing them. The end result was that the cost / application was reduced to reflect the change in activities performed by Scottish Water on behalf of Business Stream. These reduced with a corresponding reduction in FTE's involved (from fewer than 3 to fewer than 1).

The revised price was based on the same cost base calculation (2007/8 budget plus previous period's ABM overhead) with predicted application numbers.

The original agreement covering the period 2007-08 was signed on 28th August 2007 although rates had been agreed before this date. The transfer pricing team queried how charges were calculated for the intervening period from 1st April. Scottish Water responded that normally charges are backdated for revisions to 1st April, although this did not apply in this instance as rates had been agreed prior to charging.

5.4.6 Energy

The transfer pricing team asked how energy costs are apportioned between core and non-core and whether they were set for a year in advance, or reviewed throughout.

Scottish Water responded that energy costs are charged to individual buildings, and energy, along with other costs is split between communal areas and office space. Office space costs are allocated based on m^2 usage, and include a share of the communal area costs split based on office space m^2.

The 2007/8 service agreement prices were based on the 2007/8 budget plus the previous period's ABM overhead. Energy costs are budgeted based on planned volumes and forecast energy prices. Scottish Water entered into an energy contract in December 2006, which provided energy unit price certainty.

Energy expenditure in 2007/8 was in line with budgeted expenditure for Business Stream premises, and hence fully covered by service agreement prices.

5.4.7 Resolution of disputes

The transfer pricing team noted a reference which indicated that an issue was to be escalated to the Scottish Water chairman for resolution.

Scottish Water responded that this could be attributed to ‘posturing’ during negotiations. In fact, no issue has been raised to Chairman level for resolution, nor is it the intention that this will ever happen. Clause 15 of the Services Agreements covers dispute resolution and the final recourse is for a mediator to be appointed - the choice of mediator to be agreed by both parties.

5.5 Business Stream Holdings Ltd

In November 2007, with the approval of the Water Industry Commission, a new Holding company, Business Stream Holdings Limited was created, into which Scottish Water’s interest in Business Stream was transferred through a series of transactions as follows:

- Business Stream capitalised £9.6m reserves and issued £9.6m of shares to Scottish Water as a bonus share issue. Scottish Water’s original shareholding was nominal (£1).

- Scottish Water invested £34.6m in new shares in Business Stream Holdings Limited

- Business Stream Holdings Limited purchased Scottish Water’s interest in Business Stream for £9.6m

- Business Stream Holdings Limited purchased £1.9m of new shares in Business Stream

It was originally intended that Business Stream Holdings Limited would be directly funded by the Scottish Government. However, due to delays within the Scottish Government, it was agreed with the Water Industry Commission that loans of £58.5m would be channelled through Scottish Water to Business Stream Holdings Limited. Business Stream Holdings Limited created loans to Business Stream Limited of £78.5m allowing Business Stream to repay £44.5m of loans to Scottish Water.

These transactions are summarised in the following table:

Source	**Recipient**	**Amount £**	**Description**	**Included in N Table**
Business Stream	SW	9.6m	Issue of Bonus shares	N/A
SW	Business Stream Holdings	34.6m	Purchase of new shares	Yes*
Business Stream Holdings	SW	9.6m	Purchase of interest in Business Stream	Yes*
Business Stream Holdings	Business Stream	1.9m	Purchase of new shares	N/A
SG	SW	58.5m	Loan intended for Business Stream Holdings	N/A
SW	Business Stream Holdings	58.5m	Loan originally from SG	Yes
Business Stream Holdings	Business Stream	78.5m	New Loan	N/A
Business Stream	SW	44.5m	Repayment of loans	No

Notes:

SW Scottish Water
Business Stream Business Stream
Business Stream Holdings Business Stream Holdings
SG Scottish Government

Yes*- An amount of £25m representing the net cash movement was included in Block B of Table N1. However, an amount of £34.6m was also shown in Block C of Table N1.

As can be seen from the above table, the transactions relating to sale and purchase of shares between Scottish Water and Business Stream Holdings Limited and the repayment of the loans to Scottish Water by Business Stream have not been included in the N tables, but are included in the commentary as required under Regulatory Accounting Rule 5.

We believe entries should be:

Table N1: Block B Cost allocation, recharges to Associate from Core

Core Activity	Associate Activity	Total Value £
Wholesale	Business Stream Holdings Purchase of new shares	34,600,000
Wholesale	Business Stream Holdings Loan	58,500,000

Table N1: Block C Cost allocation, recharges to Core from Associate

Core Activity	Associate Activity	Total Value £
Business Stream Holdings	Wholesale Purchase of interest in Business Stream	9,600,000
Business Stream	Wholesale Repayment of loans	44,500,000

We suggest to the Commission that it amends its guidance so that any similar transactions in the future would be captured in the N tables. Clarification is also required by the Water Industry Commission on how non cash transactions such as the issue of bonus shares by Business Stream to Scottish Water should be reported under Regulatory Accounting Rule 5.

5.6 Business Solutions

5.6.1 Introduction

Business Solutions carries out a range of services both for external parties and for Scottish Water. These activities include:

Water mains upgrades
Water mains diversions
Sewer condition assessment
Sewer diversions
Sewer upgrades.

This activity has now been transferred from the non core business to Business Stream. In its review of trading between Scottish Water and Business Stream, the transfer pricing team noted that Scottish Water had stated a number of issues that had to be addressed prior to the transfer of this business to Business Stream. These included:

- Transfer to be carried out under an Addendum to the Transfer Agreement.

- There should be no shared resource and Service agreement i.e. everything should be transferred.

- Where Business Solutions put equipment on Scottish Water network, terms for this should be established. This is still being discussed. The parties are seeking to find a contractual framework that takes on Scottish Water's leakage concerns with leakage and loggers - an issue since Business Stream does not want to be liable for loggers it does not own.

- Some business activities will be carried out for Scottish Water and will need to be covered by a service agreement or benchmarked. (In fact, these services were market tested.)

- Access to Scottish Water systems to be reviewed and accommodation sought.

As a result of discussion on these issues, assets were transferred to Business Solutions based on written book value and agreed with WICS. Contracts with customers and suppliers were transferred under a legal statute and a consideration for the business transferred, was made under statutory provision.

A framework contract has been let to Business Solutions by Scottish Water following a market testing exercise.

5.6.2 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.

Scottish Water provided a clear and detailed audit trail of the market testing process.

Invitation to tender
A full EU process was followed, although it is likely that spend will be considerably below the qualifying threshold. It is estimated at £500k per annum.

The Utilities vendor database (Achilles) was used to identify potential tenderers. As a result of this search, 9 potential tenderers were identified. A prequalification exercise was considered unnecessary and all the nine potential contractors were asked if they were interested in tendering. Only two contractors expressed a willingness to tender including Business Solutions..

Evaluation
Both tenderers were scored according to a predetermined matrix covering such aspects as rates, insurance, subcontracting, service provision, rebates, response times, quality assurance and health &safety. Overall Business Solutions was the highest scorer at 67% as against 44% for the other

contractor. and notably, was consistently the lowest tenderer in terms of the rates offered.

The Award Recommendation states that Business Solutions are the only identified supplier that can meet both front end (design and planning) and back end (contracting) requirements and provided fixed rates for two years. It has also agreed to a 5% capped rebate.

The other contractor was unable to demonstrate competency or experience in delivering the front end design and planning solution and in addition can only directly support the central belt. It agreed to a 1% capped rebate but required a contract price adjustment clause due to uncertainty over fuel prices.

Contract award
It was considered important to maintain an element of competitive tension on the framework. It was therefore recommended that both Business Solutions and the other contractor be awarded framework agreements for an initial period of three years with options to extend for two further 12 month periods.

The frameworks agreements were let in August 2008. The internal Scottish Water business instruction is that this is a 'mini framework' with no preference and users are required to obtain quotes from both contractors. To date there has been no spend against the Agreement.

6 Appendix 2: Scottish Water Solutions detailed information

6.1 Introduction

6.1.1 Background

Scottish Water Solutions (SWS) is a joint venture in which Scottish Water has 51% of the equity shares with two consortia, UUGM ltd and Stirling Water Ltd sharing the balance equally. In Quality and Standards 111 (Q&SIII), Scottish Water is managing and delivering the bulk of the infrastructure programme directly.

Scottish Water Solutions is responsible for the design and project management of mainly non infrastructure expenditure. SWS will deliver approximately 40% of the programme through its in house delivery teams, 40% through its associate delivery partners (approximately 9 appointed following a tendering process) and Scottish Water Solutions will tender the remaining 20%.

Scottish Water Solutions has no direct employees and it operates with staff seconded from Scottish Water and each of the partner companies. All of Scottish Water Solutions' activity supports the delivery of Scottish Water's Capital Investment Programme.

There are two agreements with Scottish Water; the service agreement based on cost reimbursable terms and a partnership agreement which sets out the commercial arrangement and behaviours of the partners.

The service agreement contains 3 schedules, 2,2a and 2b which describe the projects to be delivered. Different risks to the parties accrue across the different schedules:

- Schedule 2- This is an absolute list of 'at risk' projects (approximate value £424m) against which SWS bid a price and which have to be delivered by a due date.

- Schedule 2a – This is a list of projects similar to Schedule 2 with a bid price and due dates but for which an option exists for SW to discontinue projects if it chooses.

- Schedule 2b – This has 2 components .There was no pre-agreed definition of costs or timescales. The Schedule is fundamentally a (i) design, project management framework and (ii) delivery framework against both of which Scottish Water can call off services. Call off of delivery services effectively ended in September 2007.

6.1.2 Purpose of transfer pricing review

At the transfer pricing review in 2006, the transfer pricing team concluded that Scottish Water had undertaken a valid market testing benchmarking exercise for transactions with Scottish Water Solutions, as required by Regulatory Accounting Rule 5. This area of compliance was not revisited.

Regulatory Accounting Rule 5 requires Scottish Water to demonstrate that the relationship with its associate, Scottish Water Solutions, is at arm's length. One of the ways that this can be demonstrated is through evidence that there is proper client control. The transfer pricing team reviewed the governance procedures and controls it implements over Scottish Water Solutions. In particular we reviewed:
:

- The auditing of SWS costs. The latter was identified as a weakness following the transfer pricing review in 2006, when we commented that:

  " we note that whilst projects are let on an open book basis, Scottish Water only audits the books of its partners when there is a cost increase. We would expect audits to be conducted on a more frequent and random basis".

- Those aspects of project monitoring that were identified in the previous review such as the implementation of performance criteria, which were to be strengthened under Q&S111.

,

- Governance of the relationship between Scottish Water and Scottish Water Solutions, again identified as a weakness in the last transfer pricing review. We were not convinced that Scottish Water's processes were sufficient to prevent directors having to deal with conflicts of interest as required by Regulatory Accounting Rule 5.

6.2 Client control

The Capital Investment team has three sections responsible for the monitoring of progress of capital projects:

The Cost management team - responsible for cost base efficiency, project benchmarking and the cost estimating service.

The Investment planning team – primary role is to effectively manage the capital investment programme in terms of financial liability and regulatory outputs and the Approvals Process.

The Governance team whose key role is to ensure that the way the programme is managed is robust by ensuring robust procedures and processes and ensuring compliance with the governance framework.

6.3 Cost verification

The transfer pricing team asked Scottish Water what it considered were the major improvements in its control over costs in Q&SIII over Q&SII. It responded:

- The creation of an expanded audit team looking at costs.

- The Engineering Estimating system

- The investment approvals process (Stages Capex 1, 2 and 3) giving project mangers a greater awareness of the feasibility and budget for a project

- Increased consistency and transparency of expenditure.

6.3.1 Open book audits

A conclusion of the transfer pricing review in 2006 was that whilst projects are let on an open book basis, Scottish Water only audited the books of its partners when there was a cost increase. The transfer pricing team expected audits to be conducted on a more frequent and random basis.

We queried whether the amount and nature of auditing had changed since 2006. Scottish Water confirmed that there had been a number of improvements:

- An Engineering Estimating System (EES) has been created. This is a cost database and is used by the Delivery Partners extensively for the purpose of ensuring that a standard set of costs is used consistently for estimating the cost of new works, or for capturing actual/outturn cost data. It is maintained and continually updated by Scottish Water's Cost management team. The database is used by Scottish Water's supply chain including SWS, who also provide updated costs. Where external contractors are used by SWS, tenders are required and input retrospectively into EES.

- A capital investment audit team of 4 plus auditors has been created. Previously this was an adhoc activity with one auditor completing irregular checks. The emphasis of this team is to look at costs in proposed Target Costs for projects where the value has not been prescribed until seeking approval i.e. typically Schedule 2b projects and also those projects above £150k where additional funding has been requested.

  Evidence of completion of these audits was presented at the meeting as well as examples of where costs had been reduced as a result of the team's activities.

6.4 Monitoring of SWS performance

6.4.1 Pain/Gain Share account

Both the Service Agreements negotiated for Q&SII and Q&SIII include provision for sharing risk and rewards on the outcome of the programme. Savings/penalties accrue into a notional share account depending on the expenditure outcome of individual projects. The outturn cost is calculated when the project is put into service (beneficial use), based on costs incurred and accrued. The cost includes an estimate of future costs to complete any remaining work. The difference between this and the allocated capital for the project, either pre-agreed at the outset of the programme or, in the case of

Schedule 2b projects, agreed at the approvals Capex 3 stage, is notionally added or deducted from the share account.

Both Q&SII and Q&SIII make provision for payment from the share account on 31 March each year, subject to Release conditions having been met. This means for all delivered projects where programme outputs (other than those exempt) have been delivered to the satisfaction of the appropriate regulators and Scottish Water. To date the release conditions have not been met and no payment has been made from the Share account. This position is currently not expected to change by 31st March 2009.

Quality and Standards II – This is still running as SWS is still delivering Q&SII projects. A Memorandum of Understanding was signed between SWS and Scottish Water. This basically was an agreement to resolve a number of disputes within the programme and an undertaking to work towards a maximum gain position of £5m. A number of projects which were protracted and overrunning have been returned to Scottish Water. We were informed that these projects are those covered by a 'long stop 'clause in the Services agreement which allows projects to be dealt with separately if, despite SWS using 'best endeavours', progress has been hindered for example by land and other 3rd party issues.

We note however that the clause appears to apply in situations where there is non approval by the client - a different interpretation to that given at the meeting.

An extract of the clause is given below

*"if that Particular Project were to be implemented in accordance with the period of time allowed for that Particular Project in the Allocated Capital Investment Programme or such reasonable period having regard to the Contractor's obligations under this Agreement and the resources reasonably available to it (whichever is the lesser), it would not reach Beneficial Use before the Non-Delivery Date (**a "Failure to Approve**"), any such Particular Project shall be omitted from the Allocated Capital Investment Programme and the Client upon any such Failure to Approve arising shall be deemed to have issued a Change and the Project Initial Target Costs of that Particular Project shall be adjusted to equal the Total Project Costs in respect thereof incurred at the date of the Failure to Approve."*

SWS are currently reporting significantly less gain in the Share Account than £5m (it was agreed that a zero figure be reported at the November SWS Board meeting although there seems to be a possibility that it could be below zero).

Quality &Standards III – The Share account is currently reported as zero although from reports provided, it seems that both delivery and expenditure targets have not been met.

6.4.2 Key Performance Criteria (KPC)

These are reported on a monthly basis by Scottish Water Solutions. The report is scrutinised by Scottish Water, and challenged where applicable. The SWS November monitoring reports for these performance measurements were tabled at the meeting*.* In addition, *t*he Services Agreement requires SWS to provide an annual report on the Capex KPC performance.

Reporting KPCs relate to presentation of agreed reports and data. The measurement is what should have been complied with, actually complied with and % of failures. The SWS report for November 2008 showed 100% compliance. Failure to comply with the agreed indicators would result in a reduction of up to 7.5% in the management fee for the month. Scottish Water stated that SWS are diligent in presenting reports to the agreed timescales.

Capex KPC are incentivised/penalised through impact on the pain/gain share account –up to 10% impact. These are calculated annually in April. Scottish Water stated that given the current status of the Share Account and release conditions, the KPCs are not the priority mechanism for monitoring and incentivising SWS performance at this mid programme stage. We queried this statement and Scottish Water explained further that the Services Agreement sets out the mechanism for the adjustment of any Savings Release through the Capex Key Performance Criteria.

In summary, the three KPCs (H&S, Customer Service and Delivery Date performance) only become effective when a Savings Release takes place or Recovery sum is paid. These KPC are used to adjust the Savings Release due to each party by up to 10% or the Recovery sum by up to 5%. Given that the current balance of the Share Account is zero, there are no current plans for a Savings Release or Recovery sum is to be paid. The KPC score in 2007-08 was a negative 50% although it did improve during the year.

Scottish Water stated that this situation is under constant review as part of the SWS and SW monthly reporting process. The SWS report on its 2008/09 Capex KPC Performance will become due in April 2009 and the situation will then be formally reviewed between the parties.

A summary of the current performance under the Capex KPC is given below:

Health & Safety - These have been measured and show that SWS have met the target for inspection scores but in 2008-09 are forecast to fail the target for the notifiable accident frequency rate.

Customer Satisfaction - These relate to customer satisfaction with telephone and written contacts. The methodology for measuring these criteria has yet to be agreed with SWS. Scottish Water also stated that these are not being actively monitored due to the dominance of the Delivery date KPC relative to the overall ceiling. From emails reviewed, it appears that SWS are anxious to resolve this as zero points are awarded due to no reporting mechanism being agreed.

Delivery Date - It was apparent from the monthly report that SWS have not met the set targets. We note from an email exchange in June 2008 between Scottish Water Solutions and Scottish Water that SWS considered that performance should be re-based to align with the Delivery Plan later agreed between the two parties, rather than the original Services Agreement milestones. Scottish Water disagreed with this statement and considered that the original Services Agreement target milestone dates should still apply.

Opex KPC is based on approved OPEX values at Capex 3. There is an incentive, capped at £2m, if the total new opex is less that £7m and a pain cap of £2m if total new opex is greater than £13.3m. This KPC is to be applied at the end of the Services Agreement. Opex data is being collected for each project by Scottish Water as part of the Approvals process to allow final reconciliation.

6.5 Conflicts of interest

6.5.1 Guidance to directors

Following the transfer pricing review in 2006, the team concluded that it was not convinced that Scottish Water's processes were sufficient to guide directors when dealing with conflicts of interest as required by Regulatory Accounting Rule 5. We did not see any clear guidance as to the action to be taken by a Director when faced with a conflict of interest

Scottish Water stated that it had implemented new procedures governing conflicts of interest. The transfer pricing team requested a copy of the written procedures now in place and also evidence that these were applied. We received no evidence of their application but have no reason to doubt that these procedures are in place

6.5.2 Client representative on SWS Board

A potential conflict of interest was noted in the last transfer pricing review in 2006 when the Scottish Water's General Manager of Capital Investment was also a Director of SWS. A staff member reporting to the General Manager represented Scottish Water's interests in relation to SWS. Scottish Water confirmed that this conflict of interest no longer exists. The current client manager is the General Manger of the Capital Investment team. The General Manager is no longer a Director of SWS.

6.6 Service charges

Cross charges to Business Stream and Scottish Water Solutions are compared with the ABM cost analysis to ensure that costs of these services are being fully recovered. In the case of Business Stream the cross charges are in excess of the costs calculated through the ABM analysis. However, for Scottish Water Solutions the cross charges are currently not sufficient to cover the costs incurred.

A comparison of the charges and related costs is provided below:

Associate	**Costs per ABM £'000**	**Charges made £'000**
Scottish Water Business Solutions	3,585	3,967
Scottish Water Solutions	5,206	4,602

The primary reason given for this shortfall is that the contract terms were negotiated before ABM had been sufficiently refined and that it is not possible to renegotiate these terms.

As we understand that the partners within Scottish Water Solutions are negotiating the return of some of the more challenging projects to Scottish Water we believe that there may also be some scope for the renegotiation of these charges.

7 Appendix 3- Scottish Water Contracting and non-core activities

7.1 Overview

During 2007-08 accounting for non core transactions was achieved through a combination of General Ledger coding and project accounting through subsidiary systems for divisions within Scottish Water that work on both core and non core activities including Customer Operations and Scottish Water Contracting.

A summary of the Non Core Profit and Loss Account for 2007-08 for non core activities is provided below:

Non Core Activity	Income	Operating Expenditure	Recharges	Other Costs / (Income)	Net Surplus / (Deficit)
Scottish Water Contracting (Non Core projects)	6,155,741	5,604,923	(159,772)	0	710,590
Business Developer Services	15,401,961	9,079,960	5,262,080	0	1,059,922
Waste Services	3,855,249	4,283,500	206,127	(430,824)	(203,554)
Customer Connections	0	0	8,800	0	(8,800)
Property Services	1,193,395	225,656	119,205	289,201	559,333
Aquatrine	0	216,269	(130,615)	0	(85,654)
Rechargeable works	1,440,655	221,978	947,091	0	271,586
Non Domestic Septic Tanks	18,564	(4,986)	4,986	0	18,564
Shipping Water	1,466,625	0	552,646	0	913,979
Labs and sampling	400,446	269,116	73,275	0	58,055
Legal & estates	656,602	287,142	8,117	880	360,463
HR	62,374	60,395	6,501	0	(4,522)
Customer Operations	65,830	26,452	102,030	0	(62,652)
Facilities management	0	84	0	0	(84)
"Overlay" (central overhead)	0	0	609,652	0	(609,652)
TOTAL	**30,717,441**	**20,270,489**	**7,610,123**	**(140,743)**	**2,977,573**

Points to note regarding the above analysis include:

- Income is sums charged to external parties for services provided
- Operating expenditure represents those costs which have been directly attributed to a non core activity within the General Ledger (eg Waste Services) or to a project within a core division which has been designated as being non core (eg Scottish Water Contracting).

- Recharges are a combination of amounts recharged to or from Capital Expenditure and internal reallocation of costs to reflect use of other divisions' resources (e.g. IT, Fleet etc).

- Other income and costs are either grants or contributions received or depreciation adjustments

As can be seen from the above analysis, overall non core activities are generating surpluses of nearly £3m. However, within this total are a number of activities such as Customer Operations (including their delivery of the Aquatrine project) and Waste Services which are failing to cover their costs even excluding any apportionment of the overlay share of corporate overheads.

7.2 Changes since 2006

Since the transfer pricing review in 2006, there have been a number of notable changes in how non core activities and related income and costs have been accounted for. These changes have included:

7.2.1 Improved use of Activity Based Methodology (ABM) data

Scottish Water has continued to refine its ABM systems with particular focus on enhancing the quality of the non financial data used for calculating cost reallocations. This improvement has been evidenced through better audit trails which clearly demonstrate the basis upon which shared costs have been allocated including the non financial data used.

In addition to improving the means by which ABM cost allocations have been calculated these have been more closely aligned with monthly management accounts through the inclusion of an estimated ABM adjustment on a monthly basis which is the reconciled more fully on a six monthly basis. This ensures that the monthly management accounts provide a more meaningful indication of an activity's financial performance including allocation of central costs.

7.2.2 Changes in accounting for Scottish Water Contracting

As suggested in the Transfer Pricing Review of 2006, Scottish Water Contracting was transferred into the core business in 2007. This was primarily as a result of the decision to discontinue the work that had previously been contracted through Scottish Water Solutions in favour of a more direct relationship between Scottish Water Contracting and the newly formed central procurement unit (CID). This resulted in most of the work being undertaken by Scottish Water Contracting being re-classified as core.

During 2007-08 Scottish Water Contracting continued to deliver non core projects for third parties or non core divisions of Scottish Water. These projects are identified within the projects ledger and form the basis for the entries in the N tables.

Staff within Scottish Water Contracting are managed within three divisions:

Division A – Undertakes primarily Scottish Water CID Infrastructure work

Division B – Undertakes primarily other regulated projects but are available for other projects

Division C – Undertakes primarily non regulated projects but are available for regulated projects if required

For the 2007-08 N tables all Scottish Water Contracting costs relating to non core activities have been included within the N1 Table. This includes:

- All costs which have been charged directly to a non core project such as materials and employment costs for all staff within Division C

- Recharges for resources (such as fleet and IT) used within non core projects based on a recharge cost basis

- ABM based allocation of overheads

This approach for Scottish Water Contracting differs for 2007-08 from other non core activities such as Waste Services, where any costs directly attributed to the activity are excluded from the N1 table and only those costs which have been recharged from the core business are recorded.

7.3 Creation of Scottish Water Horizons

In April 2008 Scottish Water created two new companies – Scottish Water Horizons Holdings Limited and Scottish Water Horizons Limited. The Holdings company was created to provide greater corporate flexibility for potential future developments. Scottish Water Horizons was created to bring together a number of the non core activities under a separate trading entity.

These activities are:

- Developer Support Services;
- Waste Services;
- Property Services;
- Aquatrine; and
- The Non Core part of Scottish Water Contracting

The intention is to operate Scottish Water Horizons as an arm's length business. In future only costs relating to Scottish Water Horizons which are recharged from or to the core business will be recorded in the N1 table. This should result in less Scottish Water Contracting costs being included as any costs directly charged to non core projects will be excluded from the costs reported within the N table.

However, it is likely that where staff who are nominally attached to Division C within Scottish Water Contracting and therefore primarily working on non regulated projects, work on core projects these time costs will need to be identified and recorded as cost recharges from an associate in Block C of the N1 table.

That these arrangements could create challenges in respect of project and resource prioritisation for Scottish Water Horizons and Scottish Water Contracting, who will still be expected to report within Scottish Water based on all three divisions. Scottish Water should monitor these arrangements on an ongoing basis to ensure that they continue to comply with RAR5.

7.4 Treatment of Masts and Aerials contracts

Scottish Water have sold income rights for the use of Scottish Water land to site telephone masts and towers to WIG for a total of £5.9m of which £5.2m was received during 2007-08. The remainder will be received in 2008-09.

This revenue (less VAT and legal costs) was allocated between core and non core businesses based on a 39%:61% apportionment. This calculation was based on the value attributed to the PV of the future rental income stream of the portfolio of masts and towers prior to the transfer from core to non core assuming rental income for the next 80 years and a discount rate of 8%.

The commentary to the N tables supports this calculation on the basis that any land value for the masts and aerials is minimal and therefore 31% of the future rentals is higher than would otherwise be achieved given that there is no statutory obligation to provide this service.

We have not reviewed the contractual arrangements involved but note a concern to the Water Industry Commission that this will set a precedent for the treatment of such asset based windfalls. There is likely to be wider opportunities for Scottish Water to make innovative use of core assets but arrangements must ensure that core customers who own these assets are receiving a sufficient return on the inherent if not direct value of the asset.

7.5 Cost of Capital in recharges

There is no direct attribution of a cost of capital to non core activities other than where there is a recognised use of working capital. An example is the service charge applied to Business Stream which includes a cost of capital to reflect the working capital employed in delivering the service.

Clearer guidance needs to be given by the Water Industry Commission on how cost of capital should be applied to recharges to non core business activities.

8 Appendix 4 – Information received

During the review we received a range of information. This was received electronically through the Scottish Water Regulation team and in hard copy at meetings. The information received is listed in the following tables.

Information Received by email

Date	File	Description
11/12/08	Copy of Non Reg P&L	Non Reg P&L and supporting data
11/12/08	ABM Business Stream 2008F	Business Stream Cross charging v ABM
11/12/08	SWC Regulated 12 2008	Year end SWC Mgt Accounts for Regulated activities
11/12/08	Queries	Analysis of N Table amounts with notes and Mgt accs for non reg activities
11/12/08	N Table Reconciliation Non reg	Reconciliation of N table amounts with GL costs
11/12/08	Horizons ABM Back Up	Spreadsheet with supporting breakdown of ABM charges
12/12/08	ABM SWS 2008F	SWS x charge and supporting data
12/12/08	Extract from N table commentary	Explanation of under recovery of X charge to SWS
12/12/08	SWS Services and costs 090104	List of services and costs
12/12/08	Swsla(solutions) 20-5-03	SLA for SWS
15/12/08	Queries 2	Non Regulated mgt accounts for year end
15/12/08	SLA P&F SWS Workplace Final version	Property and facilities SLA for SWS
15/12/08	SLA P&F SWS Workplace Appendix – Final version	Property and facilities SLA for SWS
15/12/08	SLA Facilities Appendix	Blank Property and Facilities SLA
15/12/08	SLA Property & Facilities Workplace	Blank Property and Facilities SLA
17/12/08	2007-08 Head Office income analysis	Analysis of SWC Sundry income
17/12/08	2007-08 Head Office Cost allocation	Analysis of SWC Sundry costs
17/12/08	SWC Operations Non Regulated 8 2009	SWC Non Regulated mgt accs (detailed)
17/12/08	Property Services 8 2009	Mgt Accs to Nov 2009 for new parts of Horizon
17/12/08	Developer Support 8 2009	Mgt Accs to Nov 2009 for new parts of Horizon
17/12/08	Aquatrine 8 2009	Mgt Accs to Nov 2009 for new parts of Horizon

17/12/08	Waste Services 8 2009	Mgt Accs to Nov 2009 for new parts of Horizon
17/12/08	SWC_GL_LD_ACT_PROJ_09. 04._Final Day Pivot08	Data used for SWC pivot tables (44,000 lines)
1712/08	Directors Liability – Subsidiary company	Explanatory notes re Directors responsibilities
1712/08	D&W Directors Conflict of Interest	Explanatory notes re Directors responsibilities
18/12/08	ABM Recharge Supporting Analysis	ABM Supporting calculations
18/12/08	Directors Allocation	Supporting evidence for ABM data
18/12/08	Driver R IT application	Supporting evidence for ABM data
18/12/08	Driver R Recharge IT	Supporting evidence for ABM data
19/12/08	Email: List of systems and technical nature of separation	Description of Bus Stream systems and separation achieved from a technical point
19/12/08	FCA Hourly Rate	Business Stream explanations
19/12/08	Mast and Towers Income Split	Calculation and basis for allocation of mast and aerial income
19/12/08	SWS Board (Item 6) Q&SII Efficiency Update	Comments and supporting papers for SWS Governance
19/12/08	SWS Board – (Item 0) SWS Board Agenda 19 Nov 08	Comments and supporting papers for SWS Governance
19/12/08	Q&S III SW-SWS Service Agreement (KPC Extract)	Comments and supporting papers for SWS Governance
19/12/08	CIT Report Period 7 v1.2	Comments and supporting papers for SWS Governance
19/12/08	SWS Board (Ites 6&7) Performance Report Q&S II and III	Comments and supporting papers for SWS Governance
19/12/08	M* Report Oct 08	Comments and supporting papers for SWS Governance
19/12/08	WIC Audit – Fixed Assets Transfer Analysis	No Reg asset transfer
19/12/08	Copy of Copy of Feb08_10.03.08	Notes and supporting data for Bus Stream recharges
19/12/08	CDR_TAR Master Journals – 2008-02v2	Notes and supporting data for Bus Stream recharges
19/12/08	Actual – Timecards_Stephen – Feb 08	Notes and supporting data for Bus Stream recharges
19/12/08	20080303 BI Journals – Feb 08	Notes and supporting data for Bus Stream recharges
19/12/08	Business Stream Activities Feb 08	Notes and supporting data for Bus Stream recharges
19/12/08	Email: Basis of the costs for invoicing and Process for creating invoices	Notes and supporting data for Bus Stream recharges
9/1/09	D1-PD-15.12.=SWS Monitoring and governance.2	Updates of meeting notes

9/1/09	D1-PD-15.12.-SWS.Moniroring and Governance – SW Response to further questions (9-1-09)	Updates of meeting notes
9/1/09	D1-CML.SWC Follow up telecall with Andrew Charters	Updates of meeting notes
9/1/09	D1-CML.SWC Discussions 11 dec AC Mark Up1	Updates of meeting notes
9/1/09	D1-CML.Horizons BS Gill MacDonald 16 dec	Updates of meeting notes
9/1/09	D1-CML. Fixed Assets Peter Haddow	Updates of meeting notes
9/1/09	B3-PD-17.12.-Business Stream Business Solutions AN	Updates of meeting notes
9/1/09	B2_PD-16 12_Business Stream arms length trading	Updates of meeting notes
9/1/09	B1- CML Holding Company transactions 15 Dec	Updates of meeting notes
9/1/09	A!-CML.Scott Turkington re ABM and cross charging 15 Dec	Updates of meeting notes
9/1/09	A!-CML.D McGrattan re cost analysis	Updates of meeting notes
9/1/09	A1-CML.Clarification of staff charging	Updates of meeting notes
9/1/09	E Table Finance Final Commentary Extract	Updates of meeting notes
9/1/09	Q&SIII Service Agreement	SWS Governance documentation re Q&S
9/1/09	D1-PD-15.12.-SWS Monitoring & Governance	SWS Governance documentation re Q&S
9/1/09	SW-SWS Q&SII Services Agreement (Extract)	SWS Governance documentation re Q&S
9/1/09	SWS 0708 KPC Summary of Performance	SWS Governance documentation re Q&S
9/1/09	Q&S II Commercial Settlement	SWS Governance documentation re Q&S
9/1/09	FW SWS 0708 KPC Summary of Performance	SWS Governance documentation re Q&S

Information Received during meetings

Date	Description
10/12/08	Non regulated Profit & Loss summary account
10/12/08	Management Accounts for Customer Operations by Income Stream YTD covering all Aquatrine areas
10/12/08	Management Accounts for Commercial Non Regulated YTD which covers Commercial Non Regulated Aquatrine
10/12/08	Reconciliation of wholesale charges to Non Regulated per N Tables to General Ledger
10/12/08	ABM Support Charges and Driver Data Period 06 2007/08 for the following: • Waste Services • Contract Services • Aquatrine • Business Solutions • Developer Support • Property Services
10/12/08	Business Stream – ABM costs versus Service Charges for 07/08 indicating the costs accumulated through ABM against the charges made against the Business Stream charges
11/12/08	Management Accounts for Regulated and Non Regulated Scottish Water Contracting (Summary and Detailed)
11/12/08	Transaction listings supporting cross charging
11/12/08	Allocation of Head office costs
11/12/08	Pivot Table analyses by Division and Reg/Non Regulated
12/12/08	Management Accounts for each of the Non Regulated Business Units
15/12/08	Diagrams illustrating the changes in systems arising from introduction of SW Horizons
15/12/08	ABM Analysis of SWC by reg/non reg customer
15/12/08	Analysis of SW Horizons Opening Balance Sheet
16/12/08	Debtors Analysis
16/12/08	Accrued Income – project analysis
16/12/08	Creditors – List of outstanding amounts
16/12/08	Deferred Income – Analysis and list of projects
17/12/08	Detailed transaction analysis and Pivot tables
17/12/08	Head Office Cost allocation
17/12/08	Head Office Income Analysis
17/12/08	Horizons & SWC Non Reg Mgt Accounts showing ABM cross charge
9/12/08	Services Agreement –IT services
9/12/08	Services Agreement - Human Resources/ Health &Safety/Financial services/Internal audit (Final. October 2007)
9/12/08	Services Agreement - Facilities services (Final. Oct 2007)
9/12/08	Services Agreement - Trade effluent volume calculation services (Draft. January 2008)
9/12/08	Services Agreement -Trade Effluent services (Final. November 2007.
9/12/08	Services provided by SW to Business Stream

17/12/08	Folder containing full audit trail of Business Solutions market testing process
15/12/08	EES Estimating Rules rev3
15/12/08	Frequency of auditing of SWS projects
15/12/08	Investment Approvals process version 1.6
15/12/08	SWS Capex KPC and Reporting KPC reports for P7.
15/12/08	CIT organograms for each team (from Wavelength).