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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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. The Water Industry Commission appointed a team of experts to review whether Scottish Water has implemented the guidelines contained within this rule.

The approach adopted by the team was to hold review meetings 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 received during the review visits.

Scottish Water Business Stream

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

However, Scottish Water recognises that there is scope for improvement in the collection of cost data. We suggest that a further cost verification exercise is undertaken next year, once trading has commenced.

Scottish Water Solutions

We have also found that Scottish Water has generally complied with Regulatory Accounting Rule 5 with respect to transactions relating to Scottish Water Solutions. Scottish Water demonstrated that its market-testing of the rates paid to Scottish Water Solutions and control and monitoring of the performance are consistent with Regulatory Accounting Rule 5.

However, we recommend that Scottish Water strengthens its procedures for avoiding conflicts of interests in order to comply fully with Regulatory Accounting Rule 5.

Non-core activities including Scottish Water Contracting

We have found evidence that suggests that Scottish Water is not complying with Regulatory Accounting Rule 5 and may be subsidising non-core activities by not allocating full costs to these activities. We are also concerned that losses in the non-core business may be paid for by core customers and that the audit trails for the allocation of some costs are not sufficiently clear.

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.

The Water Industry Commission appointed a team of experts, working closely with internal staff, to review Scottish Water's implementation of the guidelines. 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 the following main areas:

- Scottish Water Business Stream;
- Scottish Water Solutions; and
- Cost allocation to non-core activities including Scottish Water Contracting.

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 that the team examined. The team gave Scottish Water the opportunity to comment on the factual accuracy of meeting notes.

3 Summary of Information provided

This section presents a summary of the information provided in each of the areas under review. More detailed information on each area is presented in the appendices.

3.1 Scottish Water Business Stream

3.1.1 Introduction

Scottish Water Business Stream is the non-household retail subsidiary of Scottish Water.

Regulatory Accounting Rule 5 requires that where resources are shared, costs are allocated in the way in which resources are consumed. The transfer pricing team concentrated its review on the allocation of costs between Scottish Water and Scottish Water Business Stream and the compliance of the service level agreements in place with Regulatory Accounting Rule 5.

3.1.2 Cost allocation

The costs transferred to Scottish Water Business Stream can be divided into two categories:

- Costs for activities where Scottish Water Business Stream is the provider of the service and for which it is planned to second staff in November 2006.

- Recharges from Scottish Water for services that it will continue to provide and which are covered by interim service level agreements .

Costs - Scottish Water Business Stream activities

Costs associated with non-household retail were identified in 2005-06 and passed to Scottish Water Business Stream. For 2006-07, Scottish Water Business Stream has been passed the budgeted cost for the year. The costs allocated by the ABM in 2005-06 totalled £11.64m (£11.93m inflated) and the budget allocated to Scottish Water Business Stream for 2006-07 was £12.54m.

The 2005-06 allocations were determined by staff who apportioned their time between retail and wholesale where appropriate. Scottish Water explained that detailed discussions took place that challenged and, in some cases corrected, assumptions made. These have driven down the initial estimate of staff involved in the retail operation.

A separate set of financial ledgers have been created for Scottish Water Business Stream for 2006-07 with access restricted to its staff.

The transfer pricing team asked whether a charge for Scottish Water corporate overheads was being made to Scottish Water Business Stream. Scottish Water responded that no charge will be made other than that included in the service level agreement rates.

Recharges - service level agreements

Interim service level agreements are in place to formalise the provision of those support services that Scottish Water will continue to supply to Scottish Water Business Stream in the period 1 October to 31 December 2006. The interim service level agreements are brief. However, they include basic clauses such as services to be provided, contract rates and respective responsibilities of both parties.

To date, interim service level agreements have been negotiated for nine service areas. At the time of the transfer pricing review, further service agreements were in the process of being negotiated, including several where Scottish Water Business Stream is providing a service to Scottish Water.

Where Scottish Water continues to provide a support activity after January 2007, full service agreements will be negotiated that will replace those in existence at the time of this report.

Scottish Water told us that a detailed exercise was undertaken to agree the rates included in these service level agreements. In most instances, the rate is based on departmental agreed budget costs for 2006-07. Drivers used to allocate costs in Scottish Water's ABM system have informed the allocation of indirect costs. Scottish Water provided audit trails showing how each of the rates were calculated.

3.2 Scottish Water Solutions

3.2.1 Introduction

Scottish Water spends around £500 million every year on construction work, such as new treatment works and the laying of water mains and sewers.

Scottish Water created Scottish Water Solutions through a tendering process to help it meet the efficiency targets that it was set for 2002-06. All of Scottish Water Solutions' activity supports the delivery of Scottish Water's Capital Investment Programme.

Scottish Water has 51% of the equity shares in Scottish Water Solutions with two consortia, UUGM Limited and Stirling Water Limited sharing the balance equally. Each of these two consortia contains partners from utility companies and contractors. Scottish Water Solutions has no direct employees and it operates with staff seconded from Scottish Water, each of the partner companies, design consultants drawn from framework contracts and agency staff.

Scottish Water Solutions is responsible for the delivery of around 70% of the Quality and Standards II investment programme. Scottish Water is responsible for the remainder of the programme.

In 2006, the contract with Scottish Water Solutions was extended to cover up to £700m of the Quality and Standards III investment programme and to provide design and project management services on up to a further £240m of projects.

Payments to Scottish Water Solutions for individual projects are based on the out-turn cost rather than the target cost. Any differences, gain or loss, are added to a share account. Scottish Water commented that this mechanism provides an incentive to Scottish Water Solutions to deliver the programme for less, whilst protecting Scottish Water in the event of an overspend (up to a limited value).

With approximately 85% of the programme complete, a small gain is currently projected, although the actual final pain or gain position will be determined by the outcome of a number of material risks and the completion of a number of challenging projects.

3.2.2 Market testing

In order to benchmark Scottish Water Solutions' rates for the Quality and Standards III programme, Scottish Water asked it to submit a shadow bid against the Associate Delivery Partners framework contract.

The evaluation showed that following renegotiation of its rates, Scottish Water Solutions were competitive for 76% of the evaluation cost analysis.

Scottish Water stated that the benchmarked rates are those now being applied to the Scottish Water Solutions contract.

3.2.3 Monitoring of associate

Scottish Water must be able to demonstrate an arm's length relationship with an associate. One of the ways this can be demonstrated is through evidence of proper client control.

Scottish Water provided detail of its governance procedures. Given that projects are let on an open book basis, we asked how frequently Scottish Water audits its partners' and contractors' books. It stated that it only does so if project costs change.

Key Performance Criteria are used by Scottish Water to monitor the performance of Scottish Water Solutions; these impact on the final amounts paid for the programme. Based on experience under Quality and Standards II, Scottish Water told us that the criteria have been strengthened for Quality and Standards III.

3.2.4 Conflicts of interest

Regulatory Accounting Rule 5 states that systems should be in place to ensure that directors or senior managers with responsibilities in both Scottish Water and associate entities do not face a conflict of interest. It also states that no individual in such a position should be able to influence the supply of services.

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. Scottish Water supplied a number of documents including minutes of relevant Scottish Water Solutions Board meetings. Scottish Water also stated that generally there is an alignment of interests and that the client's representative is not the General Manager of Capital Investment (who is a director of Scottish Water Solutions) but a member of his staff.

3.2.5 Service level agreements

Scottish Water Solutions has entered into Service level agreements with Scottish Water for the provision of support services.

The Property and Facilities service level lgreement is high level. It excludes any form of compensation mechanism for failure of delivery. There is a stipulated objective to reduce the costs of the basic service by 20% by the second year. There is no allowance for any review of charges to reflect increased costs.

The IT service was market tested by Scottish Water Solutions in 2003 and as a result was reduced by 29%.

3.3 Scottish Water Non-core Activities

3.3.1 Introduction

Regulatory Accounting Rule 5 requires that costs should be allocated in relation to the way that resources are consumed. The transfer pricing team thus reviewed Scottish Water's process for allocating its costs to non-core activities. The onus is on Scottish Water to demonstrate that its core business is not subsidising its non-core activities through the mis-allocation of costs.

The use of core assets and resources varies between non-core activities. Whilst all share core support and corporate activities, some also use operational assets and resources:

- The Aquatrine project involves maintenance of MOD assets using core operational staff.

- Waste Services has its own dedicated treatment plants but disposes of liquid waste and sludge to Scottish Water treatment works. It also occasionally uses Scottish Water tankers.
- Non-domestic septic tank emptying is carried out in conjunction with domestic tank emptying using the same vehicles and drivers.
- Developer Support use Scottish Water staff in an advisory role e.g. asset operators and inspectors.
- Commercial masts and wind farms use core operational staff, again in an advisory capacity.

The transfer pricing team concentrated its review on those non-core activities that share resources with the Scottish Water core function and the allocation of costs between them.

3.3.2 Cost Allocations - management accounts

The cost centres within Scottish Water's General Ledger are classified as either core or non-core.

All direct and some support costs are allocated to the cost centres within the General Ledger to allow monthly management accounts to be prepared for each of the cost centres. No recharges are made for other support services such as human resources, legal services, IT application support or corporate overheads. The monthly management accounts therefore only indicate the contribution made towards other unallocated support costs and corporate overheads.

3.3.3 Cost allocation

On a six-monthly basis, Scottish Water uses an Activity Based Management (ABM) system to allocate all costs to a set of activities (rather than a department or cost centre). Allocating costs to activities allows Scottish Water to build a clearer picture of the way in which its costs are incurred. These activities are also defined as either core or non-core.

The methods used to allocate the direct costs are similar to those used within the ledgers. However, the ABM system also allocates all support costs and corporate overheads to provide a more complete picture of costs for each of the activities.

The output of the ABM system is used primarily for the completion of regulatory accounts. For 2005-06, Scottish Water made manual adjustments to reflect management concerns regarding the automated allocation of corporate overheads to non-core activities.

It should be noted that the transfer pricing team did not carry out an audit of the ABM system but reviewed the processes involved and examined a sample of activities to gain an understanding of issues arising from its use.

3.3.4 Cost allocation – sample audit

The two examples selected were North East Septic Tank Emptying, which comprises both the non-core non-domestic service and core domestic service, and North West Aquatrine which is part of the non-core Aquatrine contract. These were traced from originating cost entries in the General Ledger to the ABM output.

Septic tank emptying – non-domestic

The General Ledger contains direct costs incurred on the provision of septic tank emptying in the North East of £271,000. Scottish Water's General Ledger recharges a further £214,000 of support costs to North-East septic tank emptying, giving a total cost for the service of £484,000. Using the ABM system, the same level of direct costs (£271,000) are attributed to septic tank emptying, but a total of £421,000 of support costs are allocated. This difference in recharges is due to the limited scope of support costs accounted for within the General Ledger.

Once corporate overheads have been included, the total costs for the non-core non-domestic element of the septic tank emptying service is £599,000.

We have compared these costs with the relevant income (as shown in the N table supporting documents) of £458,000. We have found that this results in a loss on this non-core activity in excess of £140,000 for the year.

North West Aquatrine

North West Aquatrine is a sub section of the contract entered into by Scottish Water with Thames Water for the maintenance of Ministry of Defence assets. Within the General Ledger, there is a core cost centre, which is used to collate the costs incurred within the North West operational area on the maintenance of Aquatrine assets. These costs should then be recharged to the non-core Business Development Aquatrine cost centre.

We found that there was an understatement of £306,489 in the recharges made from the core NW Aquatrine cost centre to the non-core Business Development Aquatrine cost centre within the General Ledger. Scottish Water has also identified this anomaly and said that steps have been taken to ensure this is not repeated. Scottish Water also states that the loss in 2005-06 is due to initial set-up costs and incorrect revenue allocations and that these will be corrected in 2006-07.

3.3.5 Reporting of transactions

Information on transactions between core and non-core activities and the core business and associates are submitted as part of the Regulatory Accounts in the N tables.

Information in the ‘N’ tables is obtained from the General ledger whereas the ‘M’ tables are compiled using the ABM system. The transfer pricing team attempted to reconcile transactions as shown in the Annual Return Table ‘N’ with the ABM system and also with the management accounts given for some non-core activities. In some cases, it was not clear which recharges were included in the information. In addition, the N tables reported total costs for non-core cost centres and not just costs recharged to or from core cost centres as required by Regulatory Accounting Rule 5.

We noted that the breakdown of non-core costs given in the ‘N’ tables, did not reflect the cost centres used for management accounts. For example, it was not possible to calculate Scottish Water Contracting’s total transactions with the core as its activities were split over a number of lines, some of which also included transactions with other non-core activities.

3.4 Scottish Water Contracting

Scottish Water Contracting is a non-core business within Scottish Water that mainly undertakes water mains rehabilitation capital investment (water mains cleaning, relining and replacement).

During the Quality and Standards II programme, Scottish Water Contracting was a contractor for Scottish Water Solutions. The rates it charged were negotiated with Scottish Water Solutions and benchmarked against external suppliers. In 2005-06, approximately 70% of Scottish Water Contracting’s turnover was from Scottish Water Solutions.

In Quality and Standards III, Scottish Water Contracting works directly for Scottish Water. A new team within Scottish Water (including staff sourced from Scottish Water Solutions previously engaged in the infrastructure programme) is managing the capital programme for infrastructure.

Scottish Water stated that Scottish Water Contracting has been given an indicative target to achieve a 50/50 split between work for Scottish Water and that for third parties. Currently external work accounts for £6 million (19%) of total business (assuming an annual turnover of £25 million with Scottish Water).

3.4.1 Guarantee of work

As part of the negotiation of the Scottish Water Solutions contract for Quality and Standards II, Scottish Water Contracting was guaranteed a share of work without reference to the market place. No other contractor was given the chance to compete for this allocation.

We note from information provided by Scottish Water that Scottish Water Contracting has made a claim on Scottish Water Solutions for loss of profit on the amount actually awarded and the amount of work that should have been awarded under the Scottish Water Solutions partnership agreements. Scottish Water has since stated that this claim was not progressed since it was related to a separate backlog of claims that Scottish Water Contracting did not feel that Scottish Water Solutions was progressing quickly enough.

Management accounts for 2005-06 show that Scottish Water Contracting made a profit of £1.2 million. However, this did not include a full contribution to support costs and corporate overheads. Once these overheads are included, it appears that Scottish Water Contracting may have made a loss in 2005-06.

The delivery methods for Quality and Standards III mean that Scottish Water Contracting is unlikely to deliver the same level of turnover in 2006-07 as 2005-06. Scottish Water stated that there is a high risk that Scottish Water Contracting will make a further loss in the current financial year because of the lower revenue amount and its fixed cost base.

3.4.2 Construction activity for Scottish Water Solutions

We reviewed the commercial terms of the agreements between Scottish Water Contracting and Scottish Water Solutions during Quality & Standards II, including the negotiated rates and how target costs were agreed.

Scottish Water Solutions provided us with evidence of the relative performance of Scottish Water Contracting against other delivery partners. This suggested that its performance was comparable to the in-house delivery partners and some stand-alone delivery teams.

3.4.3 Financial management

A range of financial information was received from Scottish Water relating to Scottish Water Contracting. This included:

- Management accounts for the year to 31 March 2006 from staff at Scottish Water Contracting
- Analysis of Scottish Water Contracting costs derived from the ABM system
- A comparison of costs from both the General Ledger and the ABM systems
- Cost analyses provided to support information contained within the 'M' and 'N' tables
- A variety of "reconciliations" explaining variances and adjustments made to the above information

3.4.4 Cost Of Capital

Non-core activities, such as Scottish Water Contracting, must either finance capital expenditure from revenue received or be financed by Scottish Water as they cannot borrow money directly. Scottish Water confirmed that it does not charge the cost of capital to non-core activities.

3.4.5 Accounting standards - FRS15

Under Quality and Standards II, Scottish Water Contracting charged Scottish Water Solutions for the work it delivered in respect of mains rehabilitation. This cost was included within charges from Scottish Water Solutions to Scottish Water for the capital programme. These were capitalised in full within Scottish Water's accounts.

As Scottish Water Solutions is accounted for as a JANE[1], no consolidation was required and therefore no adjustment made to the charges to the capital programme to reflect any impact of the Financial Reporting Standard 15 (FRS 15). This standard sets out which costs can be treated as capital expenditure, particularly when a project is undertaken internally.

With the change in contractual arrangements under Quality and Standards III, Scottish Water Contracting will make an internal recharge to the capital programme. As this will be an internal recharge, the company is unlikely to be able to capitalise the full recharge, as this will include indirect administration overheads and a profit margin. These are specifically excluded from the costs that can be capitalised under FRS15.

[1] Joint Arrangement non-entity.

4 Findings

4.1 Scottish Water Business Stream

4.1.1 Was the process for identifying and allocating the costs to be transferred to Scottish Water 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 generally complied with Regulatory Accounting Rule 5 with respect to the allocation of costs to Scottish Water Business Stream.

Scottish Water was able to demonstrate to us that a satisfactory process has been used to identify costs associated with its retail subsidiary in order to comply with Regulatory Accounting Rule 5. For 2005-06, costs relating to non-household retail activities were identified using the Activity Based Management (ABM) system and these were used to inform the costs transferred to Scottish Water Business Stream for 2006-07. From 2006-07, direct costs will be captured using a separate ledger system with support costs recharged under service level agreements. 2006-07 budgets are in line with 2005-06 costs.

We were unable to verify the accuracy of the costs recorded in the ABM as these are dependent on the input of staff at the time that the costs were incurred. Scottish Water acknowledges that there may be discrepancies and other costs that have yet to be identified.

4.1.2 Do the interim service level agreements in place for shared services demonstrate arm's length trading between Scottish Water and Scottish Water Business Stream?

The current service level agreements do not mirror those that could normally be expected between two separate entities and hence do not fully demonstrate arm's length trading and comply fully with Regulatory Accounting Rule 5. We consider, however, that they are 'fit for purpose' in this regard, as an interim arrangement.

Interim service level agreements are in place to formalise the provision of those support services that Scottish Water will continue to supply to Scottish Water Business Stream in the period 1 October to 31 December 2006. The interim service level agreements are brief. However, they include basic clauses such as services to be provided, contract rates and respective responsibilities of both parties.

To date, interim service level agreements have been negotiated for nine service areas. At the time of the transfer pricing review, further service agreements were in the process of being negotiated, including several where Scottish Water Business Stream is providing a service to Scottish Water.

4.1.3 Are the rates included in these 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?

In general, we consider that Scottish Water has complied with Regulatory Accounting Rule 5 in deriving the rates for the interim service level agreements – we have found only minor discrepancies. Scottish Water provided a clear audit trail for the rates, as is required by Regulatory Accounting Rule 5.

A detailed exercise has been undertaken to agree the rates included in the service level agreements. In most instances, the rate is based on departmental agreed budget costs for 2006-07. Drivers used to allocate costs in Scottish Water's ABM system for 2005-06 have informed the allocation of indirect costs.

Examples of discrepancies we found from reviewing Scottish Water's audit trail include the exclusion of telephone call costs from the IT agreement and using a marginally high denominator for the calculation of per-hour staff costs.

4.2 Scottish Water Solutions

4.2.1 Was Scottish Water able to demonstrate that its transactions with Scottish Water Solutions are based on a discount from market price as required by Regulatory Accounting Rule 5?

Scottish Water demonstrated that it had undertaken a valid market testing benchmarking exercise for transactions with Scottish Water Solutions, as required by Regulatory Accounting Rule 5. Scottish Water did not demonstrate that it pays Scottish Water Solutions a discount to market rates, as is also 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). Where no market exists or market testing is not undertaken, transfer prices should be based on cost.

Regulatory Accounting Rule 5 also states that where an associate gains a substantial proportion of its turnover from Scottish Water (more than half) the price the associate charges should incorporate a discount from the external market price.

We considered whether the recent extension of the contract for Quality and Standards III complies with these Regulatory Accounting Rules.

Although the exercise undertaken by Scottish Water in respect of Quality and Standards III was not a competitive tendering exercise, we are satisfied that this represented a valid market testing of the Scottish Water Solutions rates through benchmarking. Scottish Water also assured us that the benchmarked rates are those now being applied to the Scottish Water Solutions contract.

It could be argued that Scottish Water Solutions, having provided the lowest rates for 76% of the analysis, has in effect provided a discount to market rates. However, Scottish Water did not demonstrate this negotiation of a discount as a discrete part of its process.

4.2.2 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 therefore 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 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. We specifically examined:

- how target costs are agreed;
- operation of the share account and other contractual procedures;
- Scottish Water influence over the proposed project solution;
- acceptance/handover of projects on completion; and
- auditing of project costs.

Based on the evidence provided, we are satisfied that Scottish Water is exercising reasonable control and monitoring the performance of Scottish Water Solutions.

However, 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.

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

We are not convinced that Scottish Water's processes are sufficient to prevent directors having to deal with conflicts of interest as required by Regulatory Accounting Rule 5.

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 did not see any clear guidance as to the action to be taken by a Director when faced with a conflict of interest

According to the 'Responsibilities of Directors', a Director of Scottish Water Solutions must act in Scottish Water Solutions' interest not the interests of Scottish Water. Scottish Water's General Manager of Capital Investment is also a Director in Scottish Water Solutions. A staff member that reports to the General Manager of Capital Investment represents Scottish Water's interests with respect to Scottish Water Solutions. It seems unreasonable to expect a member of staff to challenge their manager in respect of decisions made by that manager as a director of Scottish Water Solutions

4.3 Scottish Water Contracting and other non-core activities.

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

We have found evidence that suggests Scottish Water is not complying with Regulatory Accounting Rule 5 and may be subsidising non-core activities by not allocating full costs to these activities.

Scottish Water has made significant efforts to align the financial ledgers to operational activities. The work in developing the ABM system has further helped identify the true costs of activities. However the evidence we have reviewed suggests that customers of the core activity may be subsidising non-core activities. Our conclusion is based on the following factors:

- From a sample audit trail of the costs recharged to Aquatrine, we identified a recharge of £306k not passed to Aquatrine. We also identified a difference of £125k between recharges identified by the ABM and those shown in the General Ledger for non-domestic septic tank emptying in the North-East region.

  We therefore cannot verify that recharges to non-core activities reflect in full the consumption of resources.

- The net recharge from the core to the non-core for waste services, as shown in the management accounts, was £35k. We believe that this recharge is understated since recharges should also include the charges for emptying liquid waste and sludge in Scottish Water treatment works[2].

- Output from the ABM has been adjusted downwards by £1.8m for the costs of non-core activities. Although Scottish Water provided reasoning for this adjustment, we are not convinced that the adjustment is a thorough reflection of the use of core resource by non-core activities. It may be possible to configure ABM so that this adjustment would not be required. It would also have been beneficial if this information had formed part of the commentary relating to the 'N' tables.

- Due to market pressure being placed on the core by an associate (the recharge of IT costs to Scottish Water Solutions), some recharges have been negotiated downwards by the associate to reflect market-tested prices. Regulatory Accounting Rule 5 requires Scottish Water to recharge at cost. Failure to charge full cost represents subsidisation of associates by core customers.

- The cost of capital is not allocated to non-core activities. Given the nature of activities such as Scottish Water Contracting, the amount of working capital required could be substantial. Since Scottish Water Contracting is operating in a competitive market place, potentially against European competitors, it might be argued that subsidised capital is contrary to European state aid legislation as well as competition law.

The 'M1' and 'M2' tables, submitted as part of the Regulatory Accounts to the Water Industry Commission, are based on the output from the ABM system. The output is reliant on operational data used to allocate costs to activities. Scottish Water recognises that there is scope for improvement in the collection of data, particularly since it will be required to compile full regulatory accounts for the first time for 2006-07[3].

4.3.2 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?

It is not clear to the transfer pricing team that profit from other non-core businesses is sufficient to cover losses. We are therefore concerned that Scottish Water's core customers are funding these losses.

Scottish Water has stated that overall, non-core activities made a profit of £1.7 million in 2005-06. It has not, however, provided a clear audit trail that shows how this was calculated. We have found evidence to suggest that in 2005-06:

[2] Scottish Water provided further information that the gross recharge was £104k and that the difference was due to a £69k cross-charge to Project Aquatrine. As Project Aquatrine is also a non-core service, this does not provide a clear audit trail that core customers are not subsidising non-core customers. The further information provided also did not include a recharge for emptying waste into core treatment works.

[3] Scottish Water submitted partial regulatory accounts in 2003-04, 2004-05 and 2005-06.

- Non-domestic septic tank emptying made an operating loss in excess of £140k.
- Project Aquatrine made an estimated operating loss of at least £238k;
- The external laboratory service is breaking even, prior to the addition of corporate overheads. This suggests that in fact this service is also making a loss;
- Estates activities made losses[4]; and
- We were informed that Scottish Water Contracting broke even. In 2006-07, it is expected to operate at a loss.

Should Scottish Water Contracting make a profit on work for Scottish Water based on market rates, this could be used to finance third party activities. This means that there could be subsidisation by customers of the core activity of the non-core activity. To prevent this, Regulatory Accounting Rule 5 requires that transactions between core and non-core activities be based on cost, not on market rates. It is not reasonable for a non-core activity to recharge a profit element whereas the core adds no profit element to its recharges.

4.3.3 Was the guarantee of work for Scottish Water Contracting in the Scottish Water Solutions Contract with Scottish Water, in accordance with Regulatory Accounting Rule 5?

We consider that this guarantee of work means that Scottish Water is unable to demonstrate an appropriate arm's length relationship and therefore does not comply with Regulatory Accounting Rule 5.

Regulatory Accounting Rule 5[5]. states that:

"If there is a market for a service/good and Scottish Water does not choose to test the market for that service/good then transfer prices should be at cost. If Scottish Water uses an associate for a service for which there is a market, without market testing, the prices paid cannot demonstrate arm's length trading and it is possible that a challenge could be made under the Competition Act".

Given that Scottish Water Contracting, in this instance, acted as a 'quasi associate,' indirectly providing services to Scottish Water, we consider that transfer prices to Scottish Water Solutions should have been charged at cost. As the rates used by Scottish Water Contracting were at "market rates", which may have been lower than cost, this placed Scottish Water core customers at risk through having to support a loss making non-core activity. This is particularly relevant as the charges from Scottish Water Contracting to Scottish Water Solutions had no impact on the charges to Scottish Water[6].

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[4] Scottish Water has stated that the loss on Estates Activities in 2005-06 was due to an incorrect classification of the costs of 'Right to Roam' legislation as non-core.
[5] We acknowledge that this rule was not in place at the time of the Scottish Water Solutions Contract being developed.
[6] Other than on its share of the pain/gain mechanism

Under Quality and Standards III, Scottish Water Contracting has again been awarded an allocation of work without reference to the market place, although in this instance this work has been awarded directly by Scottish Water.

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

Scottish Water has generally provided audit trails for financial information it has supplied. Some information provided was inconsistent and therefore reviewing transfer pricing transactions proved difficult. We believe that better presentation of financial information may improve compliance with Regulatory Accounting Rule 5.

Regulatory Accounting Rule 5 requires that 'records should demonstrate the processes and procedures have been operated in an open and transparent manner'.

Scottish Water has developed a sophisticated activity based costing system which allows costs to be allocated to detailed activities in a more granular fashion than traditional management accounts. The ABM system is complex and reliant on a significant input from supporting systems.

Additional efforts have also been made to align the financial ledgers, from which the management accounts are prepared, to this activity based approach. This includes conducting reconciliations at a summary level between the financial ledgers and the output from the ABM system.

Although it is possible to follow the reallocation processes involved, it is not currently possible to determine profitability by individual activity and therefore effectively assess the risks of subsidisation of non-core activities by core customers.

The lack of transparent and consistent audit trails between the management accounts and output from ABM diminishes the value of the ABM system. It also increases the likelihood that core customers are being put at financial risk due to management decisions being made based on management accounts that are not based on the full cost of activities.

We would encourage Scottish Water in their work to align the management information produced from the financial ledgers with the output from the ABM system. We would also encourage improved presentation of audit trails in respect of consistency and granularity.

4.3.5 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?

We consider that Scottish Water can improve its presentation of information in its regulatory 'N' table submission in order to increase compliance with Regulatory Accounting Rule 5.

The transfer pricing team reviewed Scottish Water's submission for 2005-06. Our concerns are:

- The presentation of non-core activities in the tables is not sufficiently granular. A clear description of those activities that Scottish Water include as non core activities is not provided and transactions between core and each of the non-core entities is not transparent.

- Total costs of the non-core activities are reported. This means that costs incurred from third parties as well as recharges from the core are included. This is not in line with the table guidance and again, reduces transparency of transactions between the core and non-core activities.

Additional commentary (as requested in the guidance) on the N tables explaining the adjustments made to cost allocations, such as the £1.8 million reduction in recharges to non-core activities, would be helpful.

4.3.6 Will accounting standard FRS 15 impact on the capitalisation of Scottish Water Contracting costs?

This is not directly a transfer pricing matter but is an issue that WICS needs to take account of when reviewing the consistency of regulatory accounts and the treatment of charges from Scottish Water Contracting. We are aware that Scottish Water has recognised this issue.

Under Quality and Standards II, Scottish Water Contracting charged Scottish Water Solutions for the work it delivered in respect of mains rehabilitation. This cost was included within charges from Scottish Water Solutions to Scottish Water for the capital programme. These were capitalised in full within Scottish Water's accounts.

As Scottish Water Solutions is accounted for as a JANE[7], no consolidation was required and therefore no adjustment made to the charges to the capital programme to reflect any impact of the Financial Reporting Standard 15 (FRS 15). This standard sets out which costs can be treated as capital expenditure, particularly when a project is undertaken internally.

Whilst Scottish Water Contracting may still be able to recharge the full cost of the service to the core capital programme, we expect that some of these costs may then be accounted for as operating expenditure rather than being capitalised.

[7] Joint Arrangement non-entity.

5 Suggestions for improving compliance with RAR5

5.1 Scottish Water Business Stream

1. Scottish Water be asked to undertake a further exercise verifying costs transferred to Scottish Water Business Stream late in 2006-07 or in 2007-08, following the commencement of trading of Scottish Water Business Stream.

2. In order to demonstrate arm's length trading, that any service level agreements for the period from 1 January 2007, are detailed and reflect similar commercial arrangements in the market place between two unrelated entities.

   Rates included in these agreements should reflect the full costs of Scottish Water in providing the service, regardless of market rates. Scottish Water should ensure that the rates in each agreement include a full corporate recharge. Rates that are below the costs of providing the service could lead to suggestions of cross subsidisation.

3. A specific review of the final assets transferred is completed once these arrangements have been finalised between the two parties. This review should include:

   - a review of the basis upon which the costs for the regulatory databases were originally capitalised and an assessment of current value, and
   - a review of the working capital balances to confirm validity.

4. The impact of retail separation on the regulatory tables submitted as part of the June Return (M and N tables) for 2006-07 should be understood in advance and discussed with the Water Industry Commission prior to their submission.

5.2 Scottish Water Solutions

1. In the future, Scottish Water should avoid entering into agreements with an associate that includes pre-determined levels of business for a different associate or non-core activity without market testing (unless charges are based on cost). This would be contrary to the principles of Regulatory Accounting Rule 5 and possibly the Competition Act.

2. In order to demonstrate arm's length trading, we recommend that Scottish Water tightens its procedures to provide clear guidance to directors as to the action to be taken in the event of a conflict of interest.

3. Scottish Water should continue to ensure compliance with Regulatory Accounting Rule 5 as it tenders for the remaining elements of the Quality and Standards II programme.

5.3 Scottish Water Contracting and other non-core activities

1. Regulatory Accounting Rule 5 requires that costs be allocated in the way that resources are consumed. If Scottish Water is concerned that the current ABM output does not correctly reflect the above principle in respect of corporate management overheads, then the underlying cost allocation methods should be adjusted rather than making manual adjustments.

   Scottish Water has acknowledged that further refinements to the ledger and ABM systems are required in order that it can submit full regulatory accounts for 2006-07. We strongly urge that this work is undertaken.

   Areas of improvement include:

   - The current process of monthly recharges within the ledger system be expanded to ensure that as many costs as possible are attributed to the correct cost centres.
   - The costs accumulated by cost centre within the ledger system, being reconciled with the output from the ABM system, to ensure that business managers are basing management decisions on correct information.
   - Presentation of clearer and consistent audit trails allowing easy traceability from General Ledger to activity based accounts. This would improve transparency of cost allocation particularly in respect of non-core activities reported in summary within the M Tables.

2. We discussed our concerns on the presentation of the N2 (Profit and Loss) table with Scottish Water. The transfer pricing team suggests that it may be possible to amend the table so that it more closely aligns with the way in which Scottish Water now collects information.

   It may be possible for Scottish Water to use the management accounts prepared for each of the non-core activities to populate the table. This would require that these management accounts are reconciled to the output from the ABM system.

   We recommend to the Water Industry Commission that consideration be given to the amendment of this table in light of the findings of this report. Also, there have been changes in the regulatory framework since Regulatory Accounting Rule 5 was first introduced; it is therefore appropriate that a revision be considered.

   The N2 Table should provide details of solely those transactions between core and non-core cost centres and between Scottish Water and its associates. The table should not simply report the total transactions for each of these groups. The transactions should cover all forms of transactions including capital works.

The N2 Table should be supported by sufficiently detailed management accounts to allow the review of transactions and profitability by individual cost centre.

We recommend that a revision be considered for Regulatory Accounting Rule 5 to clarify the requirements for this table in light of changes which have occurred since it was originally issued.

3. Given the likely dependency of Scottish Water Contracting on the core activity, it is suggested that Scottish Water considers bringing this activity into the core and that charges be based on cost. We understand that plans to generate external work are still to be formulated but, if Scottish Water Contracting is able to generate the targeted percentage of external work, this decision can be reconsidered.

1 Appendix: Scottish Water Business Stream - detailed information.

1.1 Introduction

Scottish Water Business Stream is the non-household retail subsidiary of Scottish Water.

Regulatory Accounting Rule 5 requires that where resources are shared, costs are allocated in the way in which resources are consumed. The transfer pricing team concentrated its review on the allocation of costs between Scottish Water and Scottish Water Business Stream and the compliance of the service level agreements in place with Regulatory Accounting Rule 5.

1.2 Background

1.2.1 Structure

Scottish Water Business Stream is currently a wholly owned subsidiary of Scottish Water. It will be based at Fairmilehead and is targeted to commence trading on 1 November 2006.

Scottish Water Business Stream has its own board consisting of a chairman (also the chairman of Scottish Water), managing director, and two non-executive directors currently in the process of being appointed. The Chief Executive of Scottish Water has a short-term directorship until the non-executives are in post.

The number of staff originally allocated by Scottish Water was circa 170 - this has been reduced to circa 130 staff. At the time of the transfer pricing review, it was planned that they would be seconded with effect from 1 October and will be formally transferred in April. The secondment was delayed until the Provisional Licence was awarded (this occurred on 1 November 2006).

1.2.2 Financial Ledgers

With effect from 1st April 2006, a separate business unit was created within Peoplesoft-the Scottish Water financial management system. The ledger includes separate procurement, accounts payable and general ledger functionality. Access to the Scottish Water Business Stream ledgers is only available to Scottish Water Business Stream finance staff and IT staff. Scottish Water Business Stream staff have no access to Scottish Water's ledgers.

1.2.3 Transfer of Assets

It is intended that Scottish Water Business Stream will purchase working capital balances and fixed assets from Scottish Water. Scottish Water stated that the current target for this transfer is 1 November 2006. The forecast values of these assets at 1 October 2006 were:

Figure 1.1 - Value of Assets

	Forecast Value @ 1 Oct 06 £m
Fixed Assets	1.5
Gross Trade Debtors	60.0
Credit Note Provision	-7.0
Bad Debt Provision	-15.5
Net Trade Debt	37.5
Accrued Income (unbilled)	39.0
Cash	1.0
Meter rightsizing accrual	-1.0
Deferred Income	-33.0
Credit balances on customer accounts	-5.0
Total	**40.0**

Source: Scottish Water Business Stream board paper

All working capital balances will be purchased at cost with the fixed assets, which include the Hi-Affinity billing system, WIC22 and 52 databases, Aperta cash management and credit card payment systems transferred at net book value as a proxy to fair market value.

1.2.4 Scottish Water Business Stream Budget

The Scottish Water Business Stream budget can be divided into two parts:

- Costs for activities where Scottish Water Business Stream is the provider of the service and for which staff are being seconded prior to formal transfer in April 2007.

- Recharges from Scottish Water for services covered by Service Level Agreements.

A reconciliation between costs identified in the Activity Based Management (ABM) system and the budget provided to Scottish Water Business Stream for 2006-07 is given below.

1.2.5 Comparison of ABM to Scottish Water Business Stream budget.

Scottish Water provided a breakdown which showed the allocation of costs to retail non-household in 2005-06 in the ABM and those passed to Scottish Water Business Stream. A summary of this breakdown is given below in Figure 1.2 for activities transferred to Scottish Water Business Stream, Figure 1.3 for support services where recharges will be covered by the agreed Service Level Agreements and Figure 1.4 for other shared costs.

Figure 1.2 – Comparison ABM to Scottish Water Business Stream budget for activities transferred to Scottish Water Business Stream

Activity transferred to Scottish Water Business Stream	**ABM allocation 2005-06 %**	**Budget to Scottish Water Business Stream 2006-07 %**	**Budget to Scottish Water Business Stream 2006-07 £**	**Comment**
Customer Accounts	18.9%	19.1%	£10.08m	Includes management customer accounts, billing, collections, metering, performance & planning. The bulk of costs remain in the core (£41.289m) for household collection.
Customer operations	35.6%	0	0	Field operations business & community relations. Scottish Water Business Stream will have its own marketing function.
Contact centre	35.9%	22.3%	£1.31m	95% of the business customer contact centre costs are being transferred to Scottish Water Business Stream. Household Contact centre management costs, customer relations and household customer costs are remaining with SW.
CS support, Strategic liaison	87.2%	0	0	CS staff previously working on strategic review of charges and now working elsewhere in SW. KCMs will pick up activity of strategic liaison.
Retail management	0	34.8%	£0.16m	New cost –retail and wholesale management team budgets.
KCMs	93.1%	90.8%	£0.99m	16 out of 17 KCMs being transferred to Scottish Water Business Stream.
TOTAL	**21.7% £11.64m**	**20.3%**	**£12.54m**	

Source: Scottish Water

Figure 1.3. Shared costs covered by Service Level Agreements

SLA	SLA in place	ABM 2005-06 %	ABM 2005-06 £m	Comment
IT	Y	8.7%	1.15	
Facilities	Y	7.8%	0.64	
Org Devel (HR)	Y	14.4%	0.18	Scottish Water Business Stream likely to outsource training requirements
Trade effluent	TBA	10.4%	0.10	
Payroll and Accounts payable	Y	2.1%	0.09	
Regulation & strategy	N/A	2.8%	0.06	Management overhead
Internal audit	Y	11.9%	0.05	
Corp Affairs	Y	3%	0.04	
Financial systems	Y	10.9%	0.03	
Legal	Y	1.7%	0.02	
Sub Total		**7%**	**2.36**	
HR policy & employee relations	Y	5.9%	0.05	SLA in place for HR
Fleet	TBA	0.8%	0.16	To be included in 'catch all' SLA
Total			**£2.57m**	

Source: Scottish Water

Figure 1.4. Other shared costs

ABM	2005-06 %	2005-06 £m	Comment
Overlay	5.2%	0.65	Year end adjustment to bad debt charge to be costed directly to Scottish Water Business Stream
Asset Operations	0.1%	0.14	Primarily relates to meter reading activity. Cost to be charged to Scottish Water Business Stream together with all internal SW metering costs.
Total		**£0.79m**	

Source: Scottish Water

Remaining overheads of £0.38m allocated to the retail non household activity in 2005-06 related to such activities as Scottish Water management overheads, procurement, laboratories, and the operations management centre. These overheads are considered to be not applicable to Scottish Water Business Stream.

1.2.6 Scottish Water Business Stream Activities

Scottish Water Business Stream will be solely responsible for the provision of certain activities relating to retail non household customers. As shown in Figure 1.2 above, costs associated with this activity were identified from the ABM for 2005-06 and the budgeted amount for 2006-07 was passed to Scottish Water Business Stream.

The ABM allocations were determined by staff who apportioned their time between retail and wholesale where appropriate. Detailed discussions took place that challenged and, in some cases corrected, assumptions made and these have driven down the initial estimate of staff involved in the retail operation.

However, some of these costs have remained with Scottish Water. The reasons for this are detailed below:

Customer contact – Whilst all of the business contact centre activity is being transferred to Scottish Water Business Stream, it is recognised that this will initially include some contact with Scottish Water's sundry billed customers. Scottish Water Business Stream will be recharging Scottish Water an amount each month to recover the associated costs. This equates to approximately 5% of the total contact centre activity and this amount has been subtracted from the Scottish Water Business Stream contact centre budget.

In addition to the major activities of the contact centre, billing and meter reading, Scottish Water has a number of staff in its customer accounts team who also deal with customers. These are remaining with Scottish Water for the following reasons:

- The business and community relations section of Scottish Water tends to deal mostly with notifying householders of significant capital developments taking place in their area. The bulk of disputes are household operational disputes with less than 10% being attributed to business customers. Scottish Water Business Stream will have its own customer relation section to deal with these and will refer to wholesale as necessary.

- The key customer managers (KCM) team is the subject of negotiation with Scottish Water. A total of 16 KCMs are being transferred to Scottish Water Business Stream and it is probable that any staff remaining with Scottish Water will deal with non-core activities.

Marketing - Scottish Water Business Stream will have its own marketing and customer relations team. The existing marketing department, which deals primarily with mail shots and customer surveys for household customers, is staying with Scottish Water.

Regulation and Finance - Scottish Water Business Stream will have its own regulation and finance teams. Staff have already been recruited for finance.

Other costs for which an allowance has been made in the Scottish Water Business Stream budget, but which are not shared with Scottish Water, include the costs of directors, legal fees, licensing costs, and external audit fees.

1.2.7 Service Level Agreements.

There are a number of services for which Scottish Water will continue to provide support to Scottish Water Business Stream or in some instances where Scottish Water Business Stream is providing a service for Scottish Water. In order to allow separation to proceed, a number of interim Service Level Agreements have been negotiated to cover these services.

The transfer pricing team queried whether Scottish Water will be exclusively providing the services included in these interim Service Level Agreements. Scottish Water responded that Scottish Water will provide the services until December, or earlier if the Service Level Agreements are terminated. Scottish Water Business Stream will be undertaking a complete 'make or buy' review of all services during November/December. Individual options will be evaluated and where Scottish Water is the preferred supplier for any services, comprehensive Service Agreements will be prepared.

To date, interim Service Level Agreements have been negotiated for 9 areas. These are:

- Legal Services;
- Human Resources;
- Internal Audit;
- Financial Systems;
- Property Services;
- Accounts Payable;
- Payroll Services;
- IT; and
- Corporate Affairs (public affairs and media services)

At the time of the transfer pricing review, further service agreements were in the process of being negotiated for:

- Meter reading;
- Trade effluent billing;
- Sundry billing;
- Procurement;
- Emergency planning; and
- A 'catch all' Service Level Agreement which will cover such areas as fleet services, insurance and tax compilation.

Meter Reading – Scottish Water stated that metering is still a 'grey area'. At the time of the review, this Service Level Agreement was still being negotiated. Scottish Water plans it that the existing outsourced meter-reading contract will be novated to Scottish Water Business Stream. Scottish Water Business Stream will be responsible for meter reading (since the bulk of meters are non household) and the management of the meter installation programme but not installation itself. It will also be responsible for the checking of meters if required. It is likely that Scottish Water Business Stream will read the small number of household meters remaining with Scottish Water and charge Scottish Water accordingly.

Trade Effluent - The trade effluent bill will be produced by Scottish Water Business Stream but data will be compiled by the equivalent of 3 FTE's remaining in Scottish Water. The bulk of this work is dealing with consents etc and hence rests with the core business.

Sundry Billing - The Hi- Affinity billing system is being transferred to Scottish Water Business Stream and, as well as providing a sundry billing service for Scottish Water for non-core services and metered households, Scottish Water Business Stream will also have to provide some management reports to Scottish Water, e.g. aged debt for sundry customers.

The IT requirements of Scottish Water Business Stream are currently being assessed and this includes a full review of the current and future requirements for Hi – Affinity support and development.

Procurement - Scottish Water Business Stream will have its own procurement function although there is pressure from Scottish Water to use some existing contracts including the existing meter reading contract and debt recovery contract. The costs of processing orders and supplier maintenance are included under the Accounts payable Service Level Agreement.

Emergency Planning - This will rest with Scottish Water although some work may be done for Scottish Water Business Stream and hence a Service Level Agreement is planned.

1.2.8 Service Level Agreements – Content

All the interim Service Level Agreements cover the period 1 October 2006 to 31 December 2006 and have been drafted to provide Scottish Water Business Stream with the same level of service as provided prior to business separation. They are to be replaced with comprehensive service agreements by January 2007, although there is no reference to this in some of the Service Level Agreements, which state that they will continue until 3 months notice is given or the activity is transferred to Scottish Water Business Stream. At the time of the transfer pricing review, negotiation of these 'final' agreements had yet to commence.

The interim Service Level Agreements are brief but include standard clauses such as services to be provided, contract rates and respective responsibilities of both parties. Some of the Service Level Agreements also refer to Water Industry Commission approval being obtained prior to the formal Service

Level Agreement being implemented in January. Invoices will be issued either monthly or quarterly, varying by Service Level Agreement.

Whilst the Service Level Agreements provide basic descriptions of the services that Scottish Water provides to Scottish Water Business Stream, some are clearly not a comprehensive record of the services and do not contain many of the features that may be expected in such agreements if they were entered into with a third party provider. For example, the agreements do not include compensation events and liabilities. Scottish Water Business Stream stated that the final agreements will include such clauses.

1.2.9 Service Level Agreements – Rates

A detailed exercise has been undertaken to agree the rates included in these Service Level Agreements. In most instances the rate is based on departmental agreed budget costs for 2006-07. Drivers used to allocate costs in Scottish Water's ABM system for 2005-06 have informed the allocation of indirect costs.

A sense check has been completed against the ABM and against the costs allocated in 2005-06. Detail is given in Figure 1.3 above.

Broadly, Scottish Water has employed three methodologies to establish the unit rates in the contracts. These are:

- Method 1: base the service provided on an hourly rate for the input of staff members.

- Method 2: base the service provided on a monthly fee based on the number of 'units' of service that Scottish Water Business Stream uses compared with the rest of Scottish Water.

- Method 3: base the service charge on an arbitrary estimation of likely use.

The method used for each contract is shown in figure 1.5.

Figure 1.5: Method of establishing rates in each contract

	Method 1 Hourly rate	**Method 2 Unit charge**	**Method 3: Arbitrary rate**
Legal Services	✓		
Human Resources	✓		
Internal Audit	✓		
Financial Systems		✓	
Property Services		✓	
Accounts Payable		✓	
Payroll Services		✓	
IT		✓	
Corporate Affairs			✓

Method 1- Hourly rate

The legal rate is based on the budget for that department which does not include a corporate overhead. The transfer pricing team queried the lack of corporate overhead. Scottish Water responded that it was not considered material and as Scottish Water Business Stream will be using external legal advisors, any use of Scottish Water legal staff is likely to be minimal.

Scottish Water Solutions will also carry out most of its HR work itself and will directly hire in additional training expertise where required. Two Customer Service training staff are being seconded to Scottish Water Business Stream.

As it is a subsidiary of Scottish Water, Scottish Water Business Stream will be required to employ Scottish Water's internal audit function.

The hourly rate in the these Service Level Agreements is calculated as follows:

Figure 1.6. Calculation of Hourly rate for Method 1

Staff related costs + Employee's share of department overheads + Employee's share of corporate overheads	
divided by	assumed annual working days
divided by	assumed hours in working day.
Where	
Staff related costs = salary costs (incl. bonus and travel) + IT Charge + property charge (reflecting desk use etc)	
Employee's share = Staff Related costs *divided by* Total department staff related costs.	

Source: Scottish Water

Scottish Water Business Stream provided an audit trail for the hourly rates that form part of each SLA calculated using method 1. The transfer pricing team followed the audit trail for an HR assistant. We noted that:

- Calculations are based on a named individual expected to provide the service, not the average salary for all staff that could provide that service. However, salaries are generally consistent for similar levels of staff.

- Calculations assume 220 days as annual days worked. Scottish Water stated that this is based on 52 weeks with 5 days per week less 40 days for annual and public holidays.

Method 2 – Unit Charge

Method 2 relies more on Scottish Water's ABM system than method 1 and is not as standardised as method 1. It involves identifying:

- Total direct costs of the service being provided (for all of Scottish Water)

- Indirect costs of the service being provided.

Costs have been obtained from the ABM for 2005-06 and used to inform departmental budgets for 2006-07, which form the basis for each SLA. These costs are then apportioned according to a 'cost driver'.

Figure 1.7 summarises the cost drivers used for each SLA where rates are calculated in this way. It then summarises the resulting percentage that Scottish Water Business Stream contributes to the total cost.

Figure 1.7 – SLA Cost drivers

	Cost drivers	**£ month**	**Department Total £**	**Scottish Water Business Stream/SW Total (%)**
Financial Systems	Number of users Estimated use of system	£73,147	£435,034	16.8%
Property Services [1]	Number of desks	£43,500	£138,206	31.5%
Accounts Payable [2]	Hours worked	£16,746	£108,036	15.5%
Payroll Services	Time spent by payroll staff on each activity	£3,738	£20,275	18.4%
IT [3]	Number of users per application	£56,073	£2,430,413	2.3%

Source: Scottish Water

Notes:

1. Assumes 150 employees. The property charge per desk is based upon the costs of the specific building.

2. Charge includes a monthly fixed charge, plus a charge per standard and anomalous invoice processed. Costs shown relate to monthly fixed charge only.

3. IT includes four categories of charge:

    - Standard charges. The transfer pricing team queried the basis for these charges. Scottish Water responded that 'they are based on the Scottish Water rates which are applied to every employee. The rates are being used in the interim period to December but will be replaced by cost effective rates specific to Scottish Water Business Stream if Scottish Water's IT department is successful in their tender for the services.

    - Charges based on 'actual cost', i.e. where service is provided by an external party. Scottish Water has signed annual contracts a number of external IT support services. Charges for services received from these external parties will be recharged to Scottish Water Business Stream at cost whereas those provided directly by Scottish Water include a corporate overhead. No system support will be directly provided for the Hi-Affinity system by Scottish Water as this is provided by a third party.

- A monthly fixed charge to cover the IT application costs being used by Scottish Water Business Stream and based on a cost per user.

- Non-standard charges. The share of Scottish Water Business Stream costs that are not directly included elsewhere.

The transfer pricing team noted that telephone charges were specifically excluded from the IT SLA and did not appear elsewhere. Scottish Water responded that these should have been itemised in the IT SLA. Costs will be recharged from Scottish Water to Scottish Water Business Stream based on the actual costs charged by the third party supplier.

Method 3 – Arbitrary Rate

For corporate communication services, Scottish Water has assumed a monthly charge of £1,500 that is not based on any drivers.

2 Appendix: Scottish Water Solutions detailed information

2.1 Introduction

Scottish Water Solutions is responsible for managing a large part of Scottish Water's capital programme. It is a joint venture and is an associate of Scottish Water. Regulatory Accounting Rule 5 outlines the principles that are to be applied in order to demonstrate that transactions with an associate are on an 'arm's length' basis.

2.2 Background

2.2.1 Delivery of the capital programme

This section provides a summary of the procurement methods used by Scottish Water to deliver their capital programme, beginning with the Quality and Standards II (Q&S II) period. This is followed by an update on the current situation in the first year of the Quality and Standards III(a) (Q&S III), which began in April 2006.

2.2.2 Procurement in Quality and Standards II (2002-06)

For Quality and Standards II, Scottish Water needed to deliver a significant investment programme (£1.8 billion) set by the Scottish Executive. The environmental regulators (SEPA and DWQR) set the required improvements to be delivered. The Water Industry Commission determined the effects of these improvements on customer's bills and set efficiency targets.

Scottish Water believed that the historic methods of procurement used by the former water authorities would not meet the efficiency targets that were set. It therefore developed a unique business model, based on a limited company within a public authority - Scottish Water Solutions.

Scottish Water is the majority owner in Scottish Water Solutions with 51% of the equity shares. Two consortia, UUGM Limited and Stirling Water Limited share the balance equally. Each of these two consortia contains partners from utility companies and contractors.

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.

In Quality and Standards II, Scottish Water Solutions were to manage and deliver around 70% of the investment programme. Scottish Water directly managed and delivered the remainder.

Scottish Water Solutions procures the delivery of the capital programme from a number of sources, summarised in figure 2.1:

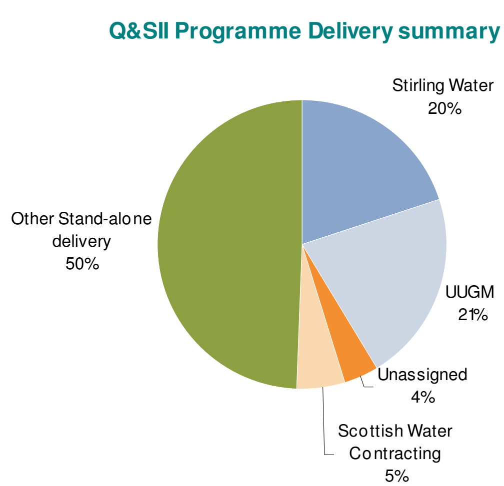
Figure 2.1 – Delivery of Capital programme

Type of activity	Resources used	Notes
Construction (including detailed design)	In-house delivery partners (IHDP's)	e.g. McAlpine, Morgan-Est etc. who are shareholders in Scottish Water Solutions
	Stand-Alone Delivery Teams (SADT's)	Independent contractors, procured through Scottish Water frameworks
	Scottish Water Contracting (Scottish Water Contracting)	Use of Scottish Water Contracting for water mains rehabilitation (relaying, relining)
Design and Planning	In-house teams	Using seconded staff, for feasibility and planning work
	External consultants	Independent consultants, procured via Scottish Water frameworks
	Agency staff	Some temporary staff to meet short term demands
Materials and Equipment	External suppliers	Procured via Scottish Water frameworks where available, otherwise direct purchase through the lead contractor.
Support services	Scottish Water service-level agreements (SLA's)	Covers provision of property, Information Systems etc.
	Directly procured	Some activity is directly procured by Scottish Water Solutions
	Management staff	Staff seconded to Scottish Water Solutions

Scottish Water Contracting is a non-core activity within Scottish Water, whose main activity is water mains rehabilitation (renew and replace water mains). In Quality and Standards II, Scottish Water Contracting worked almost entirely for Scottish Water Solutions, on a similar commercial basis to the Stand-Alone Delivery Teams (SADTs).

The following figure shows the original work allocation in Quality and Standards II (at September 2006).

Figure 2.2 – Original Work allocation in Quality and Standards II



This shows the original contract allocated combined in-house delivery teams over 45% of the programme, with the Stand-alone delivery teams being allocated nearly 50% of the programme. In fact, as the Quality and Standards II contract has progressed, around 55% of the work has been completed by in-house delivery partners and Stand-alone delivery teams have delivered the remainder.

2.2.3 Procurement in Quality and Standards III (2006-10)

For the Quality and Standards III period, Scottish Water extended the Scottish Water Solutions contract to cover up to £700m of the Quality and Standards III investment programme and to provide design and project management services on up to a further £240m of projects..

Scottish Water Solutions will deliver around 40% of the programme through its in-house delivery teams and 40% through its associate delivery partners. Scottish Water will procure the remainder of the programme through competitive tendering.

In Quality and Standards III, Scottish Water will manage and deliver the majority of the infrastructure programme directly. Scottish Water Solutions previously delivered this work in Quality and Standards II. A new team within Scottish Water, the Capital Investment Delivery (infrastructure) team, will manage the infrastructure programme. They will use a combination of Scottish Water Contracting and external contractors to deliver the programme.

The Stand-alone delivery partners re-tendered for the Quality and Standards III period. They will deliver around 40% of the programme and are now known as Associate Delivery Partners.

2.2.4 Contractual procedures Quality and Standards II

This section discusses some of the most important contractual mechanisms contained in the Project Agreement between Scottish Water and Scottish Water Solutions.

Scottish Water Solutions are required to deliver the Allocated Capital Investment Programme (ACIP), with a value of around £1 billion. The Project Agreement between Scottish Water and Scottish Water Solutions defines this programme and the outputs to be delivered.

A shareholders agreement defines the arrangements between Scottish Water, Stirling Water and UUGM. In particular, this agreement covers arrangements such as allocation of workload, management fees, cost allocation to projects and the release of savings from the share account.

The original Project Agreement ACIP value was £1,016m and is subject to change to account for additions and deletions to the programme. This programme contains a schedule of identified projects, together with their individual ACIP values.

The contract requires that Scottish Water Solutions shareholders (self-delivery, via IHDP's) deliver between 47.5% and 50% of the programme and that Scottish Water Contracting be allocated £85 million of work. The contract provides for amendments to be made to these targeted percentages through agreement of its shareholders. Independent contractors known as Stand-alone delivery teams (SADT's) deliver the remainder of the programme. These contractors have a framework contract with Scottish Water, and are independent of Scottish Water Solutions. The following table summarises the workload allocation as stated in the Project Agreement.

Figure 2.3 – Quality and Standards II Project Agreement

Delivery team	**Shareholders Agreement**	
In-house delivery	47.5 to 50%	
Stand-alone delivery	43%	
Scottish Water Contracting	£85m	7.1%

From our meetings with Scottish Water, we were told that in-house delivery teams had undertaken proportionately more of the programme than expected, whereas Scottish Water Contracting had delivered proportionately less of the programme.

Initial work allocation in Quality and Standards II was set to meet the shareholder targets as outlined in the Shareholders Agreements, but the allocation was optimised based on quoted schedules of rates, to achieve the lowest overall cost of delivery taking regard of contractor's delivery capacity and skill base.

2.2.5 Sharing risk and reward

The contract includes provision for sharing risk and rewards on the outcome of the programme. Savings accrue into a notional share account, depending on the outcome of individual projects in the programme.

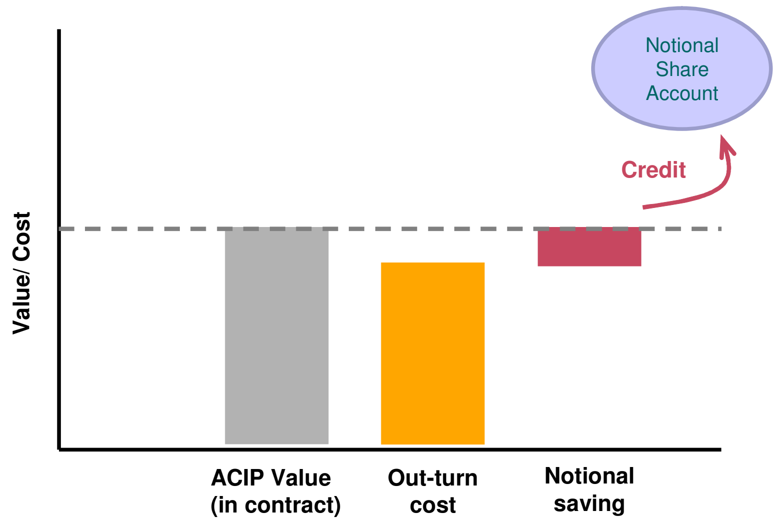
At the end of the programme, the notional share account balance is resolved between the three parties: Scottish Water, Stirling Water and UUGM.

No cash transfers are made to or from the notional share account during the life of the contract; it is simply a means of accruing the amounts payable at the end of the contract.

On individual contracts, the out-turn cost is calculated when the project is put into service (beneficial use), based on costs incurred and accrued. This value includes an estimate of future costs to complete any remaining work - the Estimated Total Project Cost (ETPC).

The difference between the ETPC and ACIP value is notionally added or deducted from the share account, depending whether there was a saving or overspend on the project, as shown on the following figure:

Figure 2 4 - Notional Share Account



Key Performance Criteria (KPC's) are used within the project as an incentive to deliver the required outputs without prejudicing customer service or other important external relations. If Scottish Water Solutions failed to perform to the required standards, this failure could have affected the management fees providing the share account was in credit.

2.2.6 Inflation

As the ACIP values are in real (historic) prices and the out-turn costs are in nominal (current prices), the comparison will often show a loss due to the effects of inflation. To correct this, notional additions to the share account reflect the impact of inflation on the original ACIP values.

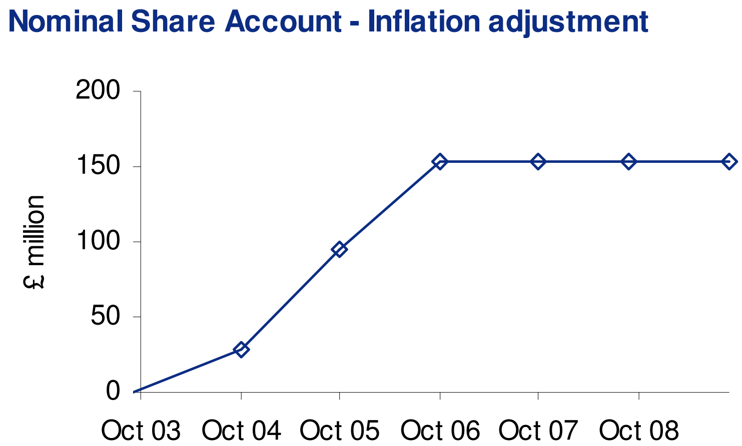
The original prices are at October 2002 prices. Four amounts are added to the account as follows:

At contract execution date, £787,170 is added to reflect effect of inflation on the contract prices (at October 2002 prices) to the date of contract execution.

To reflect the anticipated expenditure profile of the programme, a further three additions are made at end of each year (1 October 2004 to 1 October 2006). These additions are base on the change in the COPI construction price index.

The estimated effects of this adjustment to the share account are shown below:

Figure 2.5 - Nominal Share Account



This method of adjusting for inflation means that any additional price inflation arising from a delay to the programme is Scottish Water Solutions risk.

2.2.7 Target costs

Project Initial Target Costs (PITC's) for Quality and Standards II were originally calculated by Scottish Water and the adjustment to the notional share account is based on these values. These were subject to due diligence by the partners before the joint venture arrangements were agreed. There is also a review of variations from original PITC to Capex 3 target costs within Scottish Water Solutions.

The Capital Investment Team within Scottish Water are responsible for signing-off the Scottish Water Solutions proposed target costs (PITC's) and any subsequent revisions (Capex 4).

The Project Agreement also contains a schedule of cost base rates. These include unit rates for elements of work such as laying water mains or constructing certain types and sizes of treatment works. These rates were used to develop a PITC where the project was not contained in the original ACIP or where a PITC value was not given.

Furthermore, the Agreement contains a schedule of rates, including categories of labour and plant, which may be used for pricing projects from first principals where appropriate.

For IHDP's, Scottish Water Solutions charge both a project fee and a programme management fee. For externally delivered projects (SADT or Scottish Water Contracting), Scottish Water Solutions only charge the programme management fee. These are explained in the following table:

Figure 2.6 - Fees

Cost element	IHDP	ADP/ Scottish Water Contracting
Construction cost	Based on actual cost	Based on standard rates
Project fee	percentage of construction cost	Included in rates
Scottish Water Solutions Overheads	Design, planning and management costs. Plus SW recharges for property, IT etc.	Design, planning and management costs. Plus SW recharges for property, IT etc.
Misc other (inc SW costs)	Land, legal, power supply, SW recharges	Land, legal, power supply, SW recharges
Programme fee	Percentageof the above	Percentageof of the above

The Programme Management Fee received by Scottish Water Solutions is split 50:50 between Stirling Water and UUGM. IHDP project fees are distributed based on the appropriate delivery contractor.

2.2.8 Recording actual costs

Projects allocated and delivered by IHDTs are cost reimbursable with any project pain or gain rolled up into the programme pain/gain.

The partners operate an open book approach to their costs. Costs from external contractors such as SADT's or Scottish Water Contracting are allocated to project ledgers as they arise.

Project ledgers record the actual costs incurred by Scottish Water Solutions in the month against individual projects. Offset against this are the costs which Scottish Water Solutions need to pay to Scottish Water. These include staff secondments, property and IT charges.

Secondments to Scottish Water Solutions from the partner organisations (including Scottish Water) are at cost. Individual Secondment Agreements govern these payments.

2.2.9 Market Testing

If prices agreed between Scottish Water and Scottish Water Solutions are not fair market rates, then customers could be paying higher prices than are necessary.

In this section, we first provide more detail on the events leading to the initial appointment of Scottish Water Solutions. We then provide an overview of the commercial arrangements with Scottish Water Solutions in Quality and Standards II. Finally, we comment on the recent contract extension into Quality and Standards III.

2.2.10 Scottish Water Solutions initial appointment

Development of the procurement model began in January 2002. An OJEU Notice was placed in February 2002 (2002/S/ 43-03404). Scottish Water received seventeen "Expressions of interest", which were short-listed to ten.

The selection process included selecting the optimum business model in consultation with the short-listed parties. Scottish Water told us that the specific business model was not fully defined at the time of inviting the expressions of interest. Scottish Water identified a range of options and two options were chosen. The bidders commented on these.

A further two-stage selection process then took place with interested parties taking part in pre-qualification prior to a formal invitation to tender. This was based on a detailed business plan, cost information and assessment of "partnering fit". This process reduced the choice to three bidders and eventually two partners – Stirling Water and UUGM.

Scottish Water told us that the rationale behind the model was to bring to Scotland new skills and experience in regulatory programme delivery, to secure market capacity and to share risk.

In June 2003, a paper presented to the Scottish Water Board provided the following commentary on the state of the business model for Scottish Water Solutions:

Two categories of work to be allocated:

- Contracts already awarded by Scottish Water (Post Capex 3) - £150m "the Managed Programme".

- Contracts not yet awarded (Pre Capex 3) - £900m to £1bn – "the allocated programme"

Scottish Water entered into a contract with Scottish Water Solutions in September 2003 for the delivery of the Quality and Standards II programme. The contract continues in force until all the contracted outputs are delivered (at present, this work is still ongoing).

Contract extension for Quality and Standards III
In 2006, Scottish Water extended the contract with Scottish Water Solutions to cover up to £700m of the Quality and Standards III investment programme and to provide design and project management services on up to a further £240m of projects.

This process began before March 2004, when the Scottish Water Board considered options for delivering the Quality and Standards III programme, to be:

- Revert to historical model;

- Current JV model; back to market to select new partners;
- Current JV model; negotiate with existing partners; or
- Totally outsource.

Scottish Water assessed each of these options against the following issues:

- Ownership and Control;
- Risk Transfer or Sharing;
- Reservation of Capacity;
- Future Capital Efficiencies;
- HR Issues;
- Ease of Transition to New Model;
- Impact on Scottish Water Reputation;
- Timescales; and
- Commercial.

On the basis of this assessment, Scottish Water assessed that the preferable option was to negotiate with the existing JV partners. Scottish Water noted that re-tendering of the current SADT's would provide added commercial tension, on the basis that they already delivered around half of the programme in Quality and Standards II.

In October 2005, Scottish Water sought legal opinion as to whether the existing Scottish Water Solutions contract could be extended. The original OJEU notice stated that the programme was for a maximum of four years duration and a maximum £1.8 billion programme. This placed limits on the extension that could be awarded (i.e. a maximum date of September 2007).

2.2.11 Benchmarking Scottish Water Solutions Market rates for Quality and Standards III

Scottish Water commenced a tendering process to replace the existing Stand-alone delivery partners. In Quality and Standards III, these are known as Associate Delivery Partners (ADP's). Scottish Water appoints these independent contractors directly, but they work as subcontractors to Scottish Water Solutions. Scottish Water stated that the benefits of this process were:

- Submitted prices would be used to market test the prices submitted by Scottish Water Solutions partners in the same timescale.

- In the event of unsuccessful negotiations with Scottish Water Solutions, the ADP's could deliver year 1 of Quality and Standards III programme.

- Rates would provide a basis for discussions with the Water Industry Commission prior to final determination

An OJEU notice was issued in December 2004, seeking Expressions of interest from contractors for a workload range of £16-£24 million per annum. Tenders were received from 14 companies in May 2005. The evaluation of the tenders was undertaken on the basis of Price and Quality with the financial aspects of the tenders being evaluated in house by Scottish Water and Scottish Water Solutions assisting in the technical evaluation.

In parallel with the tendering process, exploratory discussions were being held with Scottish Water Solutions to develop an overall delivery model. In order to benchmark Scottish Water Solutions rates, it was asked to 'shadow bid' the commercial part only of the tender. EC Harris received the contractor tenders on behalf of Scottish Water. Scottish Water stated that Scottish Water Solutions submitted its bid at the same time. Scottish Water also stated that tenderers were aware that Scottish Water Solutions was submitting a shadow bid

Following the initial evaluation, meetings were held with all tenderers, including Scottish Water Solutions, to clarify the basis of pricing and to offer the opportunity to resubmit prices. Each tenderer was given an indication of the overall amount by which rates had to be reduced to be within 10% of the 'best' rate.

Re-submitted tenders, including that from Scottish Water Solutions were received at the same time. Scottish Water Solutions had not been competitive in the northern area and a major change was made to its regional uplifts. The transfer pricing team asked whether Scottish Water Solutions were given any more information than other tenderers. Scottish Water responded that it was given the same level of information.

Following a second evaluation, Scottish Water Solutions were competitive in 76% of the cost analysis.

However, the team note that, following perusal of a board paper in November 2005, there is a degree of conflict in that the above differs from the board paper referred to below.

In November 2005, an update was presented to the Scottish Water Board on the status of negotiations with Scottish Water Solutions. The Board papers state that Scottish Water intended to share the ADP cost detail with the Scottish Water Solutions shareholders to enable them to carry out further due diligence. In parallel, Scottish Water was still negotiating with Scottish Water Solutions to deliver lower prices for the Quality and Standards III period.

At the same Board meeting, Scottish Water notes that Scottish Water Solutions had already reduced their prices by around £55 million from an assumed £1,938 million programme. This equates to a 2.8% reduction

The Scottish Water Solutions extension contract for Quality and Standards III is now in place and contracts have been let to 9 ADPs.

2.2.12 Quality and Standards III Contract Conditions

Scottish Water had identified a number of changes to the commercial terms that it wanted to include in the contract extension with Scottish Water Solutions. These included:

- Better visibility of workload allocation to obtain best value.
- Rates & prices, targeted no higher than Quality and Standards II (on same base date).
- Management fee to be lower, based only on programme level.
- Pain/ gain – all of management fee at risk.
- KPI's aligned with "hard delivery" issues.
- Defined management fees for Additional Services.
- Better governance/ approvals process for capex.
- Reporting requirements improved and tied to Management Fee payments.

2.2.13 Governance procedures

A number of mechanisms are in place to monitor work carried out by Scottish Water Solutions. These include:

- A Capital Monitoring Panel chaired by the Director of Finance and Regulation.

- Two senior level capital programme meetings per month at which approval for schemes is given. No investment can proceed without approval being given by Scottish Water. Projects greater than £10m also require Scottish Water Board and Scottish Executive approval.

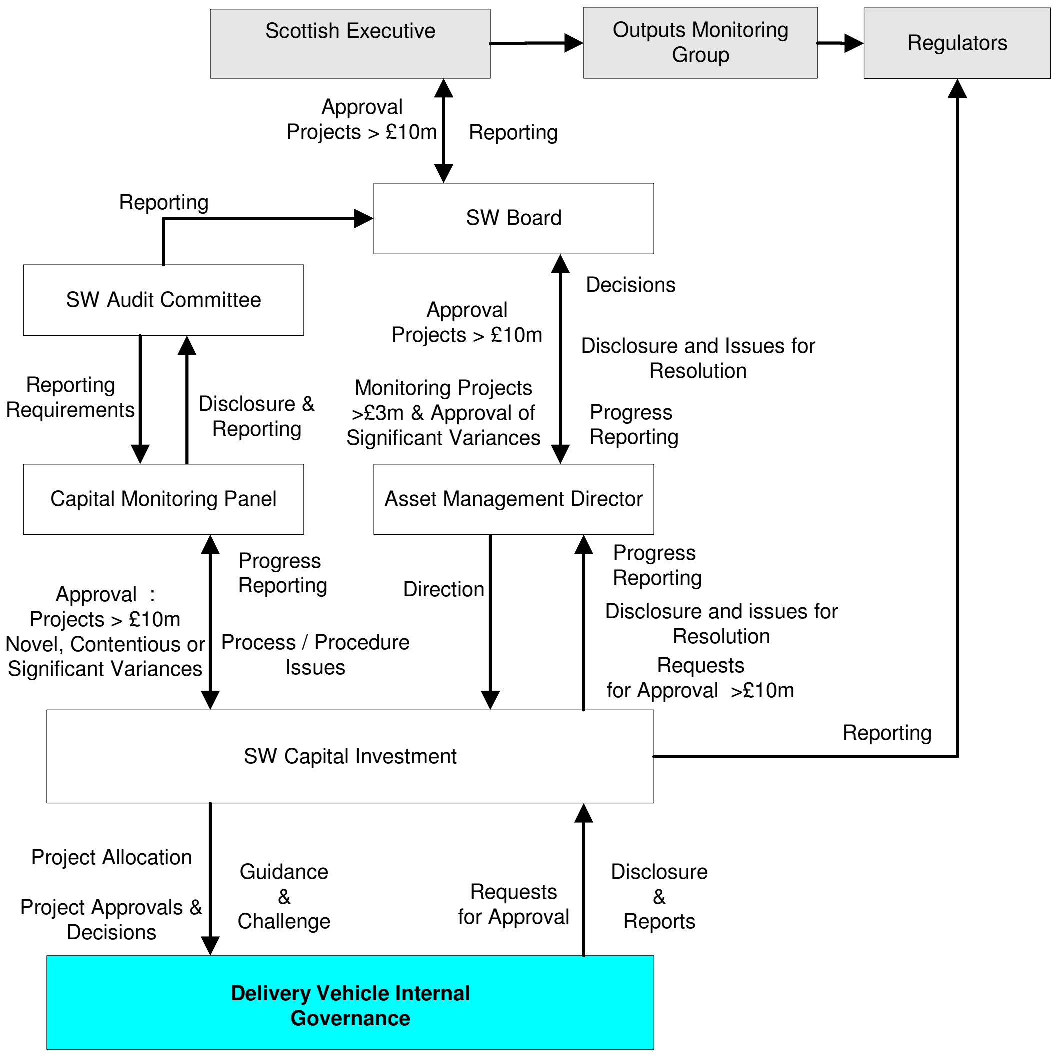
- Monthly progress meetings with both internal and external ADPs delivery teams (CID and Scottish Water Solutions).

- Regular progress reports including review of Key Performance Criteria (KPC's).

- A formalised mechanism for approval of project changes. Projects are let on an open book basis and Scottish Water has the right to audit but only does so if project costs change.

Given below is a diagram, provided by Scottish Water, which illustrates the governance process:

Figure 2.7 – Scottish Water Capital Investment Governance Model



Scottish Water stated that monitoring is improving under Quality and Standards III. The focus in Quality and Standards II was on programme management whereas in Quality and Standards III there is a drive to contractor led project management. Scottish Water considers that this will reduce overheads and drive design costs down.

We reviewed Scottish Waters processes and systems for monitoring of Scottish Water Solutions during Quality & Standards II. We specifically examined:

- How target costs are agreed;
- Operation of the share account and other contractual procedures;
- Scottish Water influence over the proposed project solution;
- Acceptance/ handover of projects on completion; and
- Auditing of project costs.

On target costs, we reviewed a number of schemes with different delivery partners, to verify that targets were being agreed on a consistent basis. For example, we reviewed the standard assumptions for risk and site conditions.

We reviewed the Scottish Water/ Scottish Water Solutions Project Agreement and Shareholders Agreement. Scottish Water explained the operation of the share account and other contractual procedures.

We met with Scottish Water and Scottish Water Solutions to understand the process of agreeing a project solution and the mechanisms for handover of a completed scheme to Scottish Water.

During our review, Scottish Water Solutions explained that the in-house delivery partners' open-book accounts are monitored in a number of ways:

- All the final accounts are audited.
- Projects are subject to ongoing review of costs during construction.
- External audits by Scottish Water.
- Internal Scottish Water Solutions audits.

However it also stated that, in practice, partner's books are only audited when the costs of a project change.

2.2.14 Conflicts of interest

The Scottish Water Solutions Board includes 3 out of 7 directors who are Scottish Water employees, 2 of whom are also executive directors of Scottish Water. The transfer pricing team asked how conflicts of interest are resolved and whether there were formal procedures in place to deal with these.

Scottish Water responded that that there is no conflict of interest because there is an alignment of interests. However in the event of conflict:

- The Scottish Water Solutions board members are not Scottish Water's representatives. Scottish Water is represented by a member of staff (working for one of the Directors) who will challenge Scottish Water Solutions management when necessary.

- Any interests are declared at the start of a Scottish Water Solutions board meeting.

The transfer pricing team requested written copy of procedures in place and also evidence that these were applied. Scottish Water supplied a number of documents including minutes of relevant Scottish Water Solutions Board meetings.

A document entitled "Responsibilities of Company Directors" included statements that:

- They (Directors) must act in the interest of the Company to which they are appointed not Scottish Water. There could be a conflict between the interests of a subsidiary and Scottish Water.

- Directors must disclose any potential conflict of interest…where a director is also a director or shareholder of another company and the two companies propose doing business together. In this situation, the director must fully disclose his or her interest in the company and the contract at a meeting of directors and must not vote on whether the proposed transaction will go ahead.

Extracts of the minutes of two Scottish Water Solutions board meetings were supplied. At the meeting on 19 December 2005, it was minuted that "The Directors declared their respective interests in contracts that are the subject of Board discussion and may be awarded to Members of their consortia. The Directors agreed in reviewing such matters they would act in the best interests of the company (Scottish Water Solutions) at all times." No further minute in relation to any action taken by Directors in relation to such discussions was provided.

The only instances where action was recorded relate to compensation disputes between Scottish Water Solutions and Scottish Water Contracting. For example:
"a claim of some £6.7m in relation to indexation, interest due, unrecovered costs and loss of profit due to reduced work allocation had been lodged. Mr Banks declared an interest and left the room whilst the matter was discussed."

It was minuted for another meeting that Mr McLean (not a Director of Scottish Water Solutions) would need to resign his now conflicted position as a Tier 1 in Solutions to further Scottish Water Contracting's claim.

3 Appendix: Scottish Water Non-Core Activities detailed information

3.1 Introduction

There is an onus on Scottish Water to demonstrate transparently to the Water Industry Commission, the public and other audiences that core customers are not subsidising non-core activities. Regulatory Accounting Rule 5 (RAR 5) requires that all transactions between core and non-core activities be based on cost and states that costs should be allocated in relation to the way that resources are consumed.

The transfer pricing team reviewed a sample of the activities classified by Scottish Water as non-core and the process for allocating costs used by Scottish Water.

3.2 Background - Allocation of Costs

3.2.1 Management accounts

Costs are captured within the Peoplesoft financial ledgers against the team, function or asset cost centres for which they have been incurred. These costs centres are categorised as either core or non-core.

Monthly management accounts are prepared for cost centres and summarise the following:

- Third party income.
- External costs directly incurred by the cost centre.
- Amounts credited to the cost centre for the use of its resources by other cost centres (eg maintenance staff working on assets).
- Amounts recharged to the cost centre for its use of other assets or functions. This includes recharges for some support services such as IT support (excluding application support), property and fleet.

No recharges are made for other support services such as human resources, legal services and IT application support, or for corporate overheads. As many of the recharges made are calculated using estimated charge rates, the management accounts provide only an indication of the contribution towards other support costs and central overheads.

As is illustrated in the examples shown below, this can result in the management accounts providing a misleading picture of a cost centre's profitability. As management is relying on the monthly management accounts for operational decisions, there is a risk that core customers will subsidise loss making non-core activities as a result of management decisions.

3.2.2 *Activity Based Methodology (ABM)*

On a six monthly basis Scottish Water analyse all costs using an Activity Based Management system (ABM). This is intended to allocate the costs more accurately to the activities which have caused them to arise.

The costs from the General Ledger are entered into the ABM system exclusive of any recharges that have been made. The costs are then allocated against a range of specified activities based on an array of drivers which have been defined as causing the costs to arise. For example, the allocation of employment costs for maintenance departments are based primarily on the time analysis collated within the Ellipse Works Order Management system. Some adjustments are made for management who are not covered by the time recording system.

Support costs are also allocated using a set of drivers which allow for actual costs to be allocated to relevant activities rather than the simpler estimates used in the management accounts monthly recharges. The ABM allocation is also more comprehensive covering a broader range of support services than the monthly recharges. For example, the monthly IT recharges cover only the costs of mobile telephones and desktop computers. The ABM system includes not only these costs but also voice communications and application support.

Once the directly attributable overheads have been allocated, there remain a number of corporate overheads, which cannot be so readily attributed to activities. These are then allocated across a set of defined product, customers and channels based on a further set of drivers.

The ABM provides a more accurate allocation of costs in terms of the use of a resource by activity. Adjustments were made to the output of the ABM system for 2005-06:

- There has been an adjustment of £1.6m for water connections allocated to non-core which was agreed with the Water Industry Commission as being core.

- £1.8m of costs, allocated by the ABM to non-core activities, have remained within the core business. Scottish Water's justification of this adjustment is included in an Appendix to this report.

The final outcome is a set of data that is used primarily for the completion of the regulatory accounts (M Tables).

The accuracy of this final allocation is determined by a range of factors including:

- The appropriateness of the allocation drivers.
- The non-financial data used as the key allocation denominators.
- The correct allocation of the original direct costs.

It should be noted that we have not carried out an audit of the ABM system but have reviewed the processes involved and examined a sample of activities to gain an understanding of issues arising from its use.

The two examples selected were North East Septic Tank Emptying, which comprises both the non-domestic service and core domestic service, and North West Aquatrine which is part of the non-core Aquatrine contract. These were traced from originating cost entries in the Peoplesoft General Ledger to the ABM output.

North East Septic Tank Emptying

Within the General Ledger there are three relevant cost centres for which the following costs had been accumulated:

- North East Septic Tank Service, a team of staff who deliver the septic tank service to both domestic and non-domestic customers and are classed in the General Ledger as a core cost centre.

- Domestic Septic Tanks NE, the service to domestic customers and therefore is classed as a core cost centre in the General Ledger.

- Non Domestic Septic Tanks NE, the service to non domestic customers and therefore classed as a non-core cost centre.

The transactions within the General Ledger were as follows:

Figure 3.1 –Transactions within the General Ledger.

Cost Centre	**Basic Pay**	**Other Costs**	**Total Excl Recharges**	**Recharges Out**	**Recharges In**	**Operating Cost**	**Revenue**
North East Septic Tank Service	£240,958	£29,095	£270,053	(£260,436)	£192,204	£201,821	£223,773
Domestic Septic Tanks NE					£243,818	£243,818	£436,282
Non Domestic Tanks NE					£38,506	£38,506	£174,911
Total	£240,958	£29,095	£270,053	(£260,436)	£474,528	£484,145	£834,966

For the ABM analysis, the North East Septic Tank team are included in the North East Waste Water Treatment group. The group's costs are allocated across a range of activities including: Domestic Septic Tank Emptying, Third Party Waste Transportation and Non Domestic Septic Tank Emptying.

The output from the ABM analysis, after the allocation of direct costs, is shown in figure 3.2.

Figure 3.2 –Output from ABM analysis.

Activity	**Direct Costs £'000**	**Other allocated costs £'000**	**Total activity costs £'000**
NE Domestic Septic Tank Emptying	199	316	515
NE Third Party Waste Transportation	6	9	15
NE Non Domestic septic tank emptying	66	96	163
Total	271	421	693

The direct costs total of £271,000 compares with the General Ledger total of £270,053 prior to recharges. The final total of £693,000 is greater than that within the General Ledger as the ABM system allocates greater levels of recharges.

The total of £163,000 for non-domestic septic tank emptying is then combined with the same service from other areas to arrive at a total excluding corporate overheads of £504,000. £95,000 of corporate overheads were allocated using ABM to give a total cost for non domestic septic tank emptying of £599,000. This compares with total revenue for private septic tank emptying non-domestic of £457,876 (Source: N Table supporting documents) indicating a loss on this non-core activity in excess of £140,000. This loss must be financed from either other non-core activities or core customers.

North West Aquatrine

North West Aquatrine is a sub section of the contract entered into by Scottish Water with Thames Water for the maintenance of Ministry of Defence assets. Within the Peoplesoft General Ledger there is a core cost centre which is used to collate the costs incurred within the North West operational area on the maintenance of Aquatrine assets. These costs should then be recharged to the non-core Business Development Aquatrine cost centre. However, the transactions which were processed through the Peoplesoft ledger are shown in figure 3.3.

Figure 3.3 – North West Aquatrine Transactions

Cost centre	**Direct Costs**	**Recharges In**	**Recharges Out**	**Net Operating Cost**
NW Aquatrine	24,066	520,069	-237,646	306,489
Business Development Aquatrine	210,439	889,274	0	1,099,713

Source: Scottish Water – North West Aquatrine Analysis 2005-06

This indicates that there was an understatement of £306,489 in the recharges made from the core NW Aquatrine cost centre to the non-core Business

Development Aquatrine cost centre within the Peoplesoft General Ledger. Scottish Water have recognised this anomaly and have said that steps have been taken to ensure this is not repeated.

The output from the ABM system used for the preparation of the regulatory reporting indicated that only £50,000 of costs were allocated to the non-core activity of operating and maintaining third party assets within the North West Aquatrine cost centre. This supports our view that the ABM system should be reconciled more frequently with the Peoplesoft ledger system to ensure a more accurate analysis of non-core activities is available.

3.2.3 Reported transactions - Core/Non-core (N Tables)

Information on transactions between core and non-core activities and the core business and associates are submitted as part of the Regulatory Accounts in the 'N' tables.

Data to complete the N tables is obtained from cost centre management accounts. Most non-core activities have their own cost centre into which direct costs are either directly posted or allocated through recharges from other cost centres. In addition, a recharge is made in respect of a limited number of support services.

Costs which cannot be directly allocated, such as indirect support costs and corporate overheads, are not allocated within the General Ledger system. These costs are only allocated as part of the preparation of the M table providing a summary for core and non-core activities.

The transfer pricing team attempted to reconcile transactions as shown in the Annual Return Table N2 with the ABM system and also with the management accounts given for some non-core activities. Information in the 'N' tables is obtained from the General ledger whereas the M tables are compiled using the ABM system.

It was not possible to reconcile the two sets of tables. Also, the breakdown of non-core activities given in the N2 table did not reflect the cost centres used for management accounts. For example, Scottish Water Contracting's transactions with the core business were split between a number of activities rather than being shown as a total for the business.

The N1 table for capital transactions also appears to be incomplete with respect to transactions with Scottish Water Contracting. As Scottish Water is a non-core activity, its transactions with the core should be reported in Block C.

We discussed our concerns on the presentation of the N2 (Profit and Loss) table with Scottish Water. It was suggested that the management accounts, prepared for each of the non-core activities, are used to populate the table, with a rider that these are reconciled to the output from the ABM system.

3.2.4 Audit trails

A range of financial information was received from Scottish Water relating to Scottish Water Contracting. This included:

- Management accounts for the year to 31 March 2006 from staff at Scottish Water Contracting
- Analysis of Scottish Water Contracting costs derived from the ABM system
- A comparison of costs from both the General Ledger and the ABM systems
- Cost analyses provided to support information contained within the 'M' and 'N' tables
- A variety of "reconciliations" explaining variances and adjustments made to the above information

The different elements of financial information supplied were not readily reconcilable and there was no clear audit trail for some of the differences arising as required by Regulatory Accounting Rule 5.

3.2.5 Service Level Agreements (SLA's)

Service Level Agreements have been entered into for the provision of support services between Scottish Water and some of its associates. The terms of the contracts cover

- The parties involved and their respective responsibilities
- Definition of the services involved
- Specific exclusions
- Service standards and availability
- Performance monitoring and reviews
- Rates and invoicing
- Management of the SLA including termination and variations

The Service Level Agreements contain either an agreement to charge cost or set out fixed rates for the specified service. While we were provided with some evidence of how these fixed rates were calculated, we have seen no evidence that the amounts charged have matched the costs incurred in delivering the related service. In respect of the IT costs for Scottish Water Solutions, it would appear that, under pressure from the subsidiary, rates were reduced to remain competitive. This suggests that the full cost of the service was not being passed on resulting in core customers subsidising the service to Scottish Water Solutions.

3.2.6 Scottish Water Solutions

Scottish Water has service level agreements with Scottish Water Solutions for the following functions:

- Property and facilities
- Employees
- Information Technology

The Transfer Pricing Team were provided with copies of the Service Level Agreements for Property and Facilities (excluding charges schedule) and IT (charges schedule dated January 2004 only).

The Property and Facilities SLA is high level and excludes any form of compensation mechanism for failure of delivery. There is a stipulated objective to reduce the costs of the basic service by 20% by year 2. There is no allowance for any review of charges to reflect increased costs.

The IT service was market tested by Scottish Water Solutions in 2003 resulting in the following comparison of charge per user per annum:

Figure 3.5 – Scottish Water Solutions

	SW 2003-04	**SW 2004 onwards**	**Thames Water Internal recharge**	**United Utilities Internal recharge**	**Accenture Full Outsource**
Charge per user per annum	£2,435	£1,723	£1,714	£1,695	£2,113

The reduction of 29% as a result of the market testing suggests that Scottish Water may not be fully recovering costs. This view is strengthened when this unit rate is compared with that now proposed for Scottish Water Business Stream (see below) The new rate was backdated for 5 months providing a further reduction to Scottish Water Solutions of £87,000.

3.2.7 Comparison of IT costs recharged to Associates

To assess whether consistent methods have been applied, the following comparison is available:

Figure 3.6 –Comparison IT costs. Scottish Water Solutions to Scottish Water Business Stream

	Scottish Water Solutions	**Scottish Water Business Stream**
Date of agreement	January 2004	October 2006
Charge per user for IT	£1,723	PC - £2,100 Laptop - £2,280
Project Management	£388.65/day	£388.65/day
Business Analyst	£363.63/day	£363.63/day
Technical Analyst	£306.75/day	£306.75/day
Developer/DBA	£388.65/day	£388.65/day

While Scottish Water Business Stream appear to be benefiting from no increase in the daily rate for staff, they are paying higher charges for use of desktop equipment. Given the services delivered are the same, as evidenced by the service descriptions in the Service Level Agreements, this would support the view that Scottish Water Solutions is receiving a subsidised service following its market testing exercise.

Scottish Water supplied information relating to the IT costs which had been incurred by them in support of Scottish Water Solutions. However, these costs are incomplete as any costs, which are incurred directly on behalf of Scottish Water Solutions, are not processed through the Scottish Water Profit and Loss accounts, although they are covered by the monthly recharge invoices. We are therefore not able to assess the scale of the subsidy we believe is being provided to Scottish Water Solutions by core customers.

3.3 Background – Scottish Water Contracting

3.3.1 Introduction

Following amalgamation of the separate water authorities, Scottish Water had an in-house construction department of around 720 people. Scottish Water had to make a number of decisions about the future of the department. Factors considered were:

- The contracting element of Scottish Water had to deliver efficiencies required by the Water Industry Commission.
- Scottish Water needed infrastructure maintenance capability and it was not logical to pay out severance and then re-employ staff as contractors.
- The contracting work force is important to the unions and Scottish Water wanted their cooperation in the change process.
- Scottish Water was nervous about the prospects of construction price inflation.

The unit therefore had to be streamlined and it was considered that the best way of doing this was to encourage it to adopt commercial terms and to work in a competitive market. The workforce has now reduced to around 240 and its capacity is augmented by a number of alliance partners particularly in the north of Scotland.

Scottish Water Contracting mainly undertakes water mains rehabilitation work (renewal, relining and cleaning of water mains). A summary of activity for 2005/06 is shown below:

Figure 3.7 – Scottish Water Contracting Activity

Activity	**Operating Expenditure (2005/06)**
Lead pipe renewals	£2.1m
Install & repair fire hydrants	£0.5m
Leakage detection & repair	£2.7m
Mains laying	£2.5m
Mains rehabilitation	£26.8m
Meter installation & maintenance	£5.2m
Non-standard water connections	£0.6m
Sewer laying	£2.0m
Standard water connections	£4.7m
Total	**£47.1m**

Source: Scottish Water ABM

3.3.2 Scottish Water Contracting activity in Quality and Standards II

In the Quality and Standards II period, most of Scottish Water Contracting's work was delivered through Scottish Water Solutions.

When the original Scottish Water Solutions model was developed in 2002, it was recognised that this offered the opportunity to help Scottish Water Contracting to become more efficient and provide some commercial skills transfer from the private sector. This would enable them to provide a long resource in infrastructure delivery for Scottish Water.

The project agreement between Scottish Water and Scottish Water Solutions therefore included an obligation to offer Scottish Water Contracting £85m of work in Quality and Standards II.

During our review we were told that the reduction in the agreement workload that subsequently occurred was mutually agreed on the basis of Scottish Water Contracting's resources and that Scottish Water Solutions were under no obligation to use Scottish Water Contracting resources.

We subsequently found that Scottish Water Contracting had submitted a claim to Scottish Water Solutions for £6.7 million arising from "indexation, interest due, unrecovered costs and loss of profit due to reduced work allocation". This contradicts what we were told on a number of occasions during our review.

Scottish Water has since stated that this claim was not progressed since it was related to a separate backlog of claims that Scottish Water Contracting did not feel that Scottish Water Solutions was progressing quickly enough. This may suggest that Scottish Water Contracting was able to use this to exert commercial pressure on Scottish Water Solutions that was not available to other Associate Delivery Partners.

The Project Agreement states that the commercial terms shall include:

- The parties shall enter into a contract using either the ICE 7th edition contract or ECC Option B. Both of these are remeasurement contracts, based on bills of quantities.

- The total amount payable to Scottish Water Contracting shall equal the relevant parts of the Project Target Cost, allowing Scottish Water Contracting to recover within that amount a fee calculated at 6% of the value.

- Scottish Water Contracting shall bear any losses incurred which are not recoverable under the contract.

In practice the parties used the ECC Option A contract. This is a lump-sum contract, which places higher risk on the contractor than the ECC Option B contract identified above. The way that the contract has been administered, this has probably had little effect.

Pricing was based on negotiated rates with Scottish Water Solutions, which were benchmarked against external suppliers and Scottish Water Solutions' own cost-base rates. We were told that Scottish Water Contracting rates were lower than the Scottish Water Solutions rates "in all relevant cases".

We reviewed the rates; in all cases the Scottish Water Contracting rates were lower than the Scottish Water Solutions rates. These rates were used in the process of agreeing lump sum prices for each project.

The construction element of the project (payable to Scottish Water Contracting) formed part of the Project Target Cost (PTC) calculation by Scottish Water Solutions. The build-up to the PTC for the Williamshaw project (9478) is shown as a separate annex.

Scottish Water Contracting told us that the risk allowances were negotiated with Scottish Water Solutions on a project-basis. This approach to risk management is not unusual in these types of contracts.

During our review, we examined a number of projects to check whether Scottish Water Solutions had treated Scottish Water Contracting equally with their other suppliers.

Figure 3.8 - Completed Contracts

Project ID	Project Name	Delivery	Contractor
19	Kemback PS & rising main	SADT	Purac Leslie
756	Forehill WTW	IDHP	Gleeson
781	Salen WTW	IDHP	Galliford Morgan JV
790	Glenachulish (Duror) WTW	SADT	Edmund Nuttall
3159	Kerse – rehab	Scottish Water Contracting	Scottish Water Contracting
3959	Unallocated mains renewal (Edinburgh)	SADT	Balfour Beatty Utilities Ltd
7998	Ruchazie	IHDP	Alfred MacAlpine
8534	Glendale	SADT	Corrie Construction
8617	Buckie	Scottish Water Contracting	Scottish Water Contracting
9478	Williamshaw	Scottish Water Contracting	Scottish Water Contracting
10477	Hotspots group 34 – SWW	Scottish Water Contracting	Scottish Water Contracting
10848	Kirkcaldy uCSO	IHDP	Gleeson

We examined these contracts in an overview level of detail. It appeared that all contractors were treated on the same basis.

A comparison of the information reviewed is included as a separate annex.

During our review, Scottish Water provided us with information on the comparison of the out-turn costs (the eventual price agreed including variations and compensation events) for water mains renewal activity.

Our analysis suggests that the performance of Scottish Water Contracting is comparable to one of the larger In-house delivery teams and one of the stand-alone delivery teams. However, this is a high-level analysis which does not provide information on the true reasons for the increases. Such variations may be explained by the way in which the contracts were administered.

3.3.3 Scottish Water Contracting activity in Quality and Standards III

For Quality and Standards III, Scottish Water has decided to bring the management and some delivery of the infrastructure programme back in-house. In June 2006, Scottish Water established the Capital Investment Delivery (infrastructure) team (CID), to manage the £300m infrastructure renewals programme in Quality and Standards III.

This means that much of the work of Scottish Water Contracting will now be undertaken directly for the core business. Scottish Water expect external work for Scottish Water Contracting in 2006/07 to be in the region of £6-10 million.

This compares to around £30-40 million of work classified as external activity during 2005/06 when work for Scottish Water Solutions was included.

The Scottish Water CID team comprises around 50 people who have been sourced from Scottish Water Solutions as an Additional Service. They were previously delivering this programme in Quality and Standards II as part of Scottish Water Solutions.

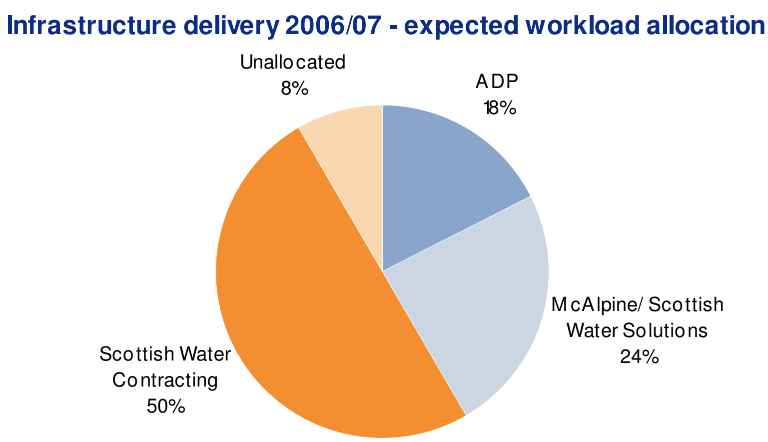
Scottish Water expects that this part of the capital programme will be around £50m delivery this year, rising to c£80-85m in 2007/08 and £85-90m in 2008/09 before falling slightly.

Scottish Water explained that their delivery model was developed to deliver the most efficient outputs, using a combination of Scottish Water Contracting, ADP's and Scottish Water Solutions (for the current year only).

Scottish Water explained that there is an expectation that Scottish Water Contracting can deliver a consistent £25m of this Water Mains Renewal (WMR) programme, but that this is dependant upon their performance (cost, Health & Safety, planning and delivery of road closures and customer satisfaction).

For this year, Scottish Water Solutions explained that they will continue to rely on McAlpine (a Scottish Water Solutions in-house delivery partner) as an Additional Service for around £12m of the programme. The expected workload allocation for 2006/07 is shown below:

Figure 3.11 –Infrastructure delivery



Scottish Water has placed commercial pressure on the Scottish Water Contracting department to become more efficient. For the Quality and Standards III programme, Scottish Water Contracting is expected to deliver the outputs at the lowest market rate received in the recent ADP tendering process.

Contractually, Scottish Water explained that Scottish Water Contracting will soon operate on the same basis as the ADPs – namely using ECC Option C contract (target cost), which will be formalised via a service level agreement.

If Scottish Water Contracting is unable to deliver to these rates, then any losses incurred will be borne by customers.

Scottish Water explained that they are looking at whether Scottish Water Contracting can undertake other work such as leakage reduction, to ensure that productivity is maintained, but that this requires additional training.

Scottish Water explained that Scottish Water Contracting has clear visibility of performance through their management accounts: on core business, their challenge is to understand their cost base and improve performance; on non-core, if this is loss-making, then they should stop doing this work.

3.3.4 Project costing systems

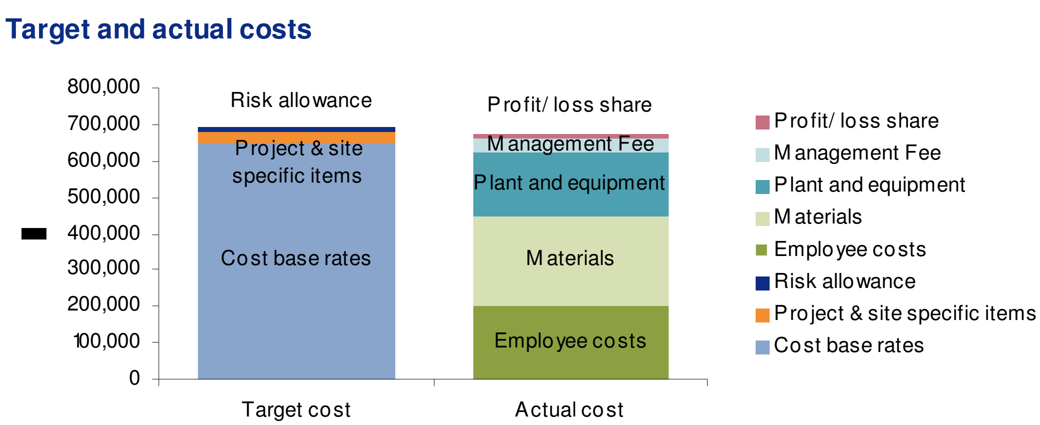
The proposed commercial terms between Scottish Water and Scottish Water Contracting will require some enhancements to the existing project costing systems which are used.

The ECC Option C contract has two components:

a) The target cost, built up using agreed market rates, with adjustments for site specific factors and risk;
b) The actual cost, which is the accrued cost in the project ledger.

These are represented in the following figure:

Figure 3.12 – Comparison target and actual costs



At the end of the contract, these two values are compared. The difference, whether an overspend or underspend, is then shared between the client and contractor (Scottish Water and Scottish Water Contracting in this case) to an agreed formula.

However, not all of the costs are reimbursed directly. The contract requires that many of the indirect costs (site and office overheads, insurance, profit etc.) are built into a management fee percentage, which is applied to the sum of the direct costs. In future, Scottish Water Contracting explained that its management fee percentage will include

- Scottish Water corporate overheads (e.g. legal);
- Scottish Water Contracting overheads; and
- profit margin (%).

This management fee is still in the process of being calculated by Scottish Water Contracting, but they expect that it will lie within a market rate.

3.3.5 Scottish Water Contracting – third party work

Scottish Water Contracting told us that their business objectives were to be efficient and profitable and to grow to £50 million per annum turnover, split approximately 50/50 between work for Scottish Water and third party work.

Currently, Scottish Water Contracting have forecast around £6m of third party work in 2006/07, which may increase to £10m.

Scottish Water Contracting explained that it undertook other minor third party work during Quality and Standards II period such as lead pipe replacement work (for councils), install, maintain and repair of fire hydrants and installation of water meters, but these were relatively low volumes of work compared to the water mains rehabilitation programme.

3.4 Background - Other Non-core Activities

3.4.1 Business Development

Business Development includes a number of activities classified by Scottish Water as new non-core. These are:

Commercial Operations – Aquatrine and Northern Ireland.

Waste Services – Primarily the collection and treatment of green waste, liquids and sludge from industrial and commercial customers and Local Authorities.

Developer Support - Provision of advice and completion of infrastructure projects for developers.

Business Customer Solutions –Range of services to key customers including treatment technology (particularly in relation to trade effluent), water efficiency and metering service e.g. BAA meter reading contract.

Commercial – A number of small discrete activities such as masts & towers and plumbing insurance.

The Profit and Loss account for Business Development, that the team was shown, includes Developer Support and Business Customer Solutions only, (Waste Services and Commercial Operations have their own Profit and Loss). For 2005-06, this showed a profit of £704k and operating costs of £2,864k. Recharges from the core to Business Development for 2005-06 amounted to £77k (net of a £16k recharge from Business Development to the core business).

3.4.2 Commercial Operations

The intention was originally that Scottish Water could sell its PFI experience to third parties but it is now withdrawing from the market and is concentrating on projects that are complimentary to its core activities. Two long term projects exist:

MoD Project Aquatrine

This is a 25 year contract that commenced 2 years ago for the maintenance of MOD water and waste water assets in Scotland. Scottish Water Commercial acts as a subcontractor to Thames Water although originally it was planned that it would be a partner in the consortia.

Thames Water provides the asset investment and holds risk and liabilities. Scottish Water completes the operational maintenance of assets. A service level agreement is in place which contains key performance indicators -these require the service to be provided at set times. The work is complimentary to the core and is completed by Scottish Water core staff.

Recharges are based on works orders issued by WAMS (Scottish Water's works management system) and are based on costs contained within WAMS. Operating costs of this contract for 2005-06 were £1.586m with income at £1.528m (information source: N table background).

The transfer pricing team reviewed several Aquatrine jobs on the WAMS system to establish how costs were recharged to the non-core. We were satisfied that mechanisms are in place to recharge costs to the asset but note that in the sample jobs we reviewed the estimated time to complete the job was substantially lower than the actual amount of time taken. We queried whether there was a limit on the amount that Scottish Water core could charge the non-core project for maintenance work undertaken on the Aquatrine project. Scottish Water responded that there was no limit and that all costs incurred by Asset Operations and Lab Services are recharged to Business Development.

Northern Ireland

This contract is three years old and Scottish Water is a member of a consortium with PWC to provide advice on PFIs. Scottish Water stated that no resource is used from the core business and that the income achieved is minimal.

3.4.3 Waste Services

Nature of Business

Scottish Water Waste Services provides both end treatment and transport to a Sewage treatment works. Initially it used core assets however it now has two dedicated sites that sit in the non-core. Most activity is at the Cumbernauld site (Deerdykes) which treats green waste and includes a composting plant – the product of which 'POD' is sold. Any remaining waste goes to land fill. Trade effluent goes to Scottish Water's sewage treatment works.

The land upon which Waste Services treatment works are built was originally owned by Scottish Water but was sold to it at a market rate. Scottish Water stated that the non-core activity is not allowed to borrow money from Scottish Water nor is it allowed to fund itself from external parties. Approximately £3m was spent on the two sites and this was funded from revenue received in the non-core since 2002 and also grant funding of approximately £600k.

Scottish Water Waste Services has recently taken over the non-domestic (non core) septic tank emptying service.

Waste Services employs 12 staff including a dedicated commercial marketing manager.

Use of Scottish Water Assets

Tankering is primarily sub contracted but some tanks are leased from the Royal Bank of Scotland and Scottish Water tankers are occasionally used. Waste services also has some specialist composting equipment that is leased from the Royal Bank of Scotland

The non-domestic septic tank emptying service uses the same tankers as the domestic service to promote economic runs

The recharge from the core is based on an hourly rate, similar to that applied for the core activity, which includes the cost of the tank, tank driver, fuel and overheads. Fleet recharges include an element of depreciation. The work order issued to the tank driver shows whether jobs are core or non-core.

Liquid waste delivered to Scottish Water core treatment sites is calculated using the Mogden formula. Scottish Water confirmed that Waste Services pay the full Mogden charge, on the same basis as its competitors. Both Deerdykes and Cowdenbeath Waste Service installations have trade effluent discharges and trade effluent consents that limit what can be discharged from the sites. They pay the full trade effluent charge according to published rates and methodologies i.e. split Mogden.

Sludge delivered to Scottish Water treatment works is recharged on the basis of Scottish Water sludge costs. Scottish Water stated that no other competitor to waste services delivers sludge to treatment works.

Other recharges include a cost of £250 per desk for office facilities. This is the same charge as applied within the core.

The net recharge from the core to the non-core for waste services, as shown in the management accounts, was £35k. This amount should include an allocation for some support overheads. It should also include, as stated above, charges from the core for empting liquid waste and sludge into the Scottish Water treatment works. The transfer pricing team asked for a detailed breakdown of the:

- Costs that generated the Waste Services gross recharge of £104k.
- Services that were provided from Waste Services to the core business that generated the £69k reduction between the gross and net recharges.

Scottish Water responded that the business services recharges from the core business make up the gross recharge of £104k and cover; Fleet costs £17k, Vehicle & Plant Hires £47k, IT equipment £21k, Mobile phones £1k and office space £18K.

The service provided by the waste team that generated the £69k of income was for services associated with Project Aquatrine.

3.4.4 Developer support

Nature of business

Developer support provides services for two main groups of customers – land developers and house builders. No work is done directly for the core although most work is referred to the team by the core. Developer Support focuses on the laying of mains not communication pipes and hence it is not involved in self lay.

Developers or builders will approach Developer support generally to complete investigative and feasibility studies for the laying of mains. Construction may or may not be part of the project as the developer has the option of doing the physical work (aside from connecting to the mains) itself.

The team consists of 8 staff with most services provided to clients being bought in. The majority of the service providers including consultancy, design and contractors, operate under framework agreements with Scottish Water. Developer Support also makes use of Scottish Water resources, principally asset operators, planners and NSOs (inspectors).

The market is competitive for high value work where developers can go to consultancies and contractors directly. No standard rate is used to cost projects, the rate depends generally on the risk that the client is prepared to accept.

Costs

Developer Support has its own Profit and Loss. The Profit and Loss for 2005-06 showed an operating profit for the period (before tax) of £584k. Operating costs were £1,430K. Costs include internal recharges for the use of Scottish Water staff and also a recharge for indirect overheads. All other costs are incurred directly.

The recharge from the core of £33k includes fleet, IT and property costs but, as for other non-core activities, costs included in the £1.6m allocated to non- core by the ABM have been excluded.

We queried how an accurate assessment of time spent on Developer Support projects by Scottish Water staff is achieved. There is no asset to cost the work against and hence WAMS (the Scottish Water works management system) cannot be used to record staff time. Scottish Water replied that the core staff record the time spent manually and then recharge the non-core. The amount of time to be spent on a project is agreed in advance and costed using rates in WAMS for similar types of work. This is translated into a fixed Scottish Water cost for the project. Developer Support bears the risk of increased costs.

Given the imperative on operational managers to meet their budgets, it was considered unlikely that the core would not charge for work undertaken on the non-core's behalf.

3.4.5 Business customer solutions

Business Solutions provides a range of services, primarily to key customers on treatment solutions particularly for trade effluent. It also has a number of projects in England and Wales normally where the customer already has a site in Scotland where Business Solutions are involved. Other projects include a contract with BAA for meter reading in conjunction with H2O.

No Scottish Water core resources are used, the entity has its own engineers and process technicians. Business Customer Solutions has its own Profit and Loss and for the year 2005-06, this shows an operating profit of £120k against operating expenditure of £1,416k. Recharges of £44k were made from the core. (information source: Profit and Loss).

3.4.6 Commercial

This consists of a small number of discrete activities including:

Property Enquiries – 4 non-core staff. This is a verification service provided mainly for local authorities. In 2005-06, income was £0.492m and costs £0.207m. (information source: N table background).

Plumbing - Administers the sale of the HomeServe (ex South Staffs) plumbing insurance service. This is a handling activity only and no staff are employed solely to deal with it. The Transfer Pricing team asked whether a charge had been made from the non-core for the use of its database. Scottish Water replied that it does not allow third party access to its database.

Masts and Towers – This activity makes land available for third parties to construct masts, towers and wind farms. The management of this is outsourced to agents. There is limited involvement by core operational staff whose interest is to ensue that the statutory functions of the core are protected. Two sites are currently being considered for wind farms and the catchment manager attends bi-weekly meetings.

Where core staff are involved, a works order is raised and costs allocated to a specific cost centre. Income goes to the non-core with payment to the core only if there are special requirements such as out of hours access and also for power although often these sites have their own power source. No rent for the land use is paid to the core.

Turnover for masts & towers was £0.403m with costs at £0.169m. (information source: N table background).

3.4.7 Estates

Scottish Water estates includes:

- 70,000 acres of catchment land - mostly let out on agricultural leases.
- Several thousand acres of forestry - directly managed.
- 60 to 70 reservoirs - fishing rights leased out.
- 60 houses approximately 20 of which are subject to secure tenancy agreements.

Most of the non-core management activity is outsourced to external framework agents (e.g. management of rented properties, woodland management, reservoir fishing) under instruction from the estates manager and his team.

Grass cutting is now done by operational staff with only one site, at Milngavie, outside Glasgow, being more intensively managed as the public uses it frequently. The steamship at Loch Katrine is now operated under charter by a charitable trust.

3.4.8 Cost and income

The Profit and Loss is split between core and non-core and the non-core costs generally are captured in separate accounts. Income also goes directly to the non-core business. Most activities including fishing, forestry and housing showed an operating loss in 2005-06 but the target is to break even. Housing rents are being gradually increased to match those in the market place, although in some instances this is difficult as they are occupied by staff.

Scottish Water pursues the disposal of its houses wherever this is operationally and legally possible.

The costs of three staff in estates are currently all allocated to the core. Scottish Water agreed that this would be amended for 2006-07. A rough estimate is that 10% of the estate manager's time and 90% of one member of staff's time is spent on non-core activities although this is obviously subject to further assessment.

3.4.9 Laboratory Services

Extent of external work

In 2002, when the separate companies were amalgamated, there was significant external business, particularly in the east for contaminated land analysis. The lab external turnover was approximately £1.6m across the three companies. In 2004, the labs were restructured and a decision was taken to pull out of external work. It has now reduced to approximately £500k (£250k excluding Scottish Water Solutions). External work remaining includes:

- Private water regulatory work for councils.
- Local authority work such as leachates, landfill monitoring, risk assessment for pesticides and testing water.
- A small amount for consultancies mainly Scottish Water Solutions and the PFI consortia.

Approximately 90% of income comes through the ten most frequent tests and it is intended in the future to focus on these. The only real area for development is as a result of the recent private water regulations. No specific equipment or resource is purchased for external work and any growth will use existing capacity and equipment in the labs.

There is competition in the market place, Alcontro (Northumbrian Water labs) is particularly active in Scotland and competes for work against Scottish Water.

Charging the external market

Currently scientific services are going through a pricing review. Prices, with effect from Quarter 2, are based on the marginal cost for each test plus a 25% mark up so that it is reflective of the cost base. Scottish Water stated that previously charges were based on the market rate although the costs did include overheads. A comparison showing the microbiological analysis rates for Quarter 1 to the rates now charged was provided to the Transfer Pricing Team. There was no demonstrable pattern of difference with some prices charged at market rates being higher and some lower.

The worksheets showing how charges for microbiological analysis have been calculated were provided. Basically the methodology is as follows:

- Each test was weighted by complexity.
- The numbers of each test undertaken in the year were obtained.
- The scientific budget for microbiological testing was then split, based on the number of each test and the weighting to give a weighted cost per test.
- A profit margin was added.

The same principles for calculating charges have been applied to chemical analysis.

In the future it is intended to split costs between variable and fixed costs so that costs can be more accurately allocated to particular tests.

A number of contracts were let prior to the recent review. The mark up on contract rates varies e.g. the mark up on the UU contract is 34%.

Recharges from the core

From 2006, a separate Profit and Loss ledger is being run for scientific services, non-core activities.

The budget allocated to the non-core activity is based on the percentage of total turnover of scientific services allocated to external parties. Turnover has been calculated on the total number of each tests undertaken (as recorded in LIMS - the lab management system) multiplied by the cost of the test (excluding mark up). This calculation is based on the breakdown of customer sector for Edinburgh as shown below:

Figure 3.13 I - Calculation of external income.

	Number of tests	**Total Value £**	**Income %**	**Calculated Income %**
All Edinburgh	451,834	8,617,356	73.07	100
All elsewhere	454,745	3,176,455	26.93	
PFI Edinburgh	105,051	549,103	4.66	4.77
PFI elsewhere	1,037	12,963	0.11	
Scottish Water Solutions Edinburgh	32,929	220,734	1.87	4.13
Scottish Water Solutions elsewhere	47,170	265,843	2.25	
External Edinburgh	19,504	197,910	1.68	2.89
External elsewhere	27,006	143,503	1.22	

On the basis of the above, 2.9% of costs have been allocated to the non-core for 2006-07. It is noted that for the purpose of allocating costs, Scottish Water Solutions and PFI are not included as external activities. Scottish Water confirmed however, that income from Scottish Water Solutions and PFI contracts is also allocated to the core activity.

Annex: Comparison of target costs within Scottish Water Solutions

	Project Name:	**Glendale Mains Rehab**		**Williamshaw WSZ**		**Ruchazie (South Moorside)**	
	Project Autocode:	**8534**		**9478**		**7998**	
	Contractor:	**Corrie Construction (ADP)**		**Scottish Water Contracting**		**McAlpine (IHDP)**	
Ref	**Description**	**PTC (£)**	**Notes**	**PTC (£)**	**Notes**	**PTC (£)**	**Notes**
A1	Scottish Water Solutions Cost base solutions	846,608	Cost-base rates	664,058	Cost-base rates	809,048	Cost-base rates
A2	CBS exclusions add/omit	20,241	Crossings, meters, valves	0	None	795	
A3	CBS assumptions add/omit	(92,679)	Changes to standard assumptions	(78,818)	Changes to standard assumptions	71,888	Changes to standard assumptions
A4	Project/ site specific	267,089	High %'s as on Skye	29,262	Standard %'s for location	30,861	Low
A5	Project risk	35,835	2.69%	15,363	1.95%	48,031	3.9%
C9(ii)	SW historic costs	0		0		0	
A6	Inflation on Scottish Water Solutions costs	14,864	COPI less 1.5% pa	8,692	COPI Less 1.5% pa	13,257	COPI Less 1.5% pa
	Sub-Total	**1,091,958**		**638,557**		**973,880**	
B7	Project development cost (incl Scottish Water Solutions overheads)	93,099	8.55%	69,343	10.89%	99,155	10.21%
B8	Scottish Water Solutions Project Management Fee	44,159	4%	25,823	4%	39,384	4%
C10	SW Direct Costs	0		0		0	
C11	Inflation on SW direct costs	0		0		0	
B8	Programme Management Fee	52,628	4.24%	31,408	4.24%	47,621	4.24%
C9(i)	SW Historic costs	0		0		0	
D12a	Scottish Water Solutions risk	35,835	As A5	15,363	As A5	48,031	As A5
D12b	Insurance	12,012	1.1%	7,024	1.1%	10,713	1.1%
D12c	Licence & fees	0		0		0	
	Project Target Cost	**1,329,691**		**787,518**		**1,218,784**	

Project Name:	**Glendale Mains Rehab**	**Williamshaw WSZ**	**Ruchazie (South Moorside)**
Project Autocode:	**8534**	**9478**	**7998**
Contractor:	**Corrie Construction (ADP)**	**Scottish Water Contracting**	**McAlpine (IHDP)**
ACIP Value (v0.2a)	**1,610,165**	**886,465**	**902,832**
Final Account Cost	**1,307,700**	**1,443,687**	**1,182,397**
Adjustment to Share Account	**302,465**	**(557,222)**	**(279,565)**

Annex: Explanation of corporate overhead recharge reduction

Area of Corporate Overhead	£'000	Reason
Corporate accruals Total	804.64	Primarily Employee Bonus Accrual. SW Contracting Bonus scheme charged and paid on an ongoing basis. Therefore corporate bonus accrual should not be applied to SWC Non Core Activity.
Develop business strategy Total	370	Primarily IT & Regulation & Strategy work on defining business strategy, which is wholly attributable to the Core Business, and should not have been levied on Non Core Business.
External Reporting and Liason Total	140.1	Mainly Corporate Affairs activity, over and above their activity dealing with Poltical and Media Enquiries, which are charged to Non Core business (based on number of enquiries). This is wholly attributable to the Core Business, and should not have been levied on non core business.
Financial transaction processing Total	58.17	This is mainly Financial Control staff activity. SW Contracting have their own Finance team, which is charged direct to the non core business. This should not have been charged to the Non Core Business to this extent.
Manage excess staff Total	196.08	This is the cost of staff, who were displaced from their roles through efficiency initiatives, and charegd to HR. These staff did not work on Non Core activities. Therefore the cost should not have been levied on the non core business.
Manage political stakeholders Total	0.01	
Manage public relations Total	18.91	
Production and implementation of environmental and sustainability policies Total	24.13	
Provide corporate governance Total	261.12	This is primarily the cost of the Board, and Directors attending Board meetings. An undue proportion of this activity cost was levied on the Non Core Business.

Regulatory reporting and liason with WIC office Total	610.22	This is primarily the cost of WIC Fees, and Business Staff working on Regulatory Reporting activity. This activity is predominately associated with the Core Business. An undue proportion of this activity cost was levied on the Non Core Business.
Statutory reporting Total	91.36	
Non Core Total	2574.74	
Reduction in Allocation	1800.00	
Allocation of corporate overheads to non core activities	774.74	