



WATER INDUSTRY COMMISSION FOR SCOTLAND

RULES AND GUIDELINES TRANSFER PRICING IN THE WATER INDUSTRY – SCOTLAND

REGULATORY ACCOUNTING RULE 5

**Operative: Financial Year 2009-10
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PART 1 TRANSFER PRICING

1.1 Introduction

1.1.1 Regulatory Accounting Rule 5 specifies how any trades between Scottish Water and Business Stream¹ and other businesses within Scottish Water should be carried out and reported.

Scottish Water must trade at arm's length and ensure that there is no cross-subsidy with respect to transactions between the Scottish Water core activity and non-core business and between its core activities and associate entities. Additionally, it must demonstrate that there is no cross-subsidy between its non-core (non-licensed) business and non-core (licensed) retail non-household business.

Scottish Water is also to ensure that these transactions do not adversely impact on the ability of the core activity to carry out its duties in an efficient and effective manner.

1.1.2 The onus is on Scottish Water to demonstrate transparently that its activities comply with this requirement. Scottish Water should be able to demonstrate transparently to the Water Industry Commission for Scotland (WICS), Licensed Providers, the public and other audiences, that it is meeting its requirement to trade at arm's length and that cross subsidy does not exist (A definition of terms is included in the Appendix).

1.1.3 Abuse of monopoly power, for example through the exclusive use of an associate or a non core business at above market rates, may lead to unfair competition in local and national markets. It may lead to greater costs for the regulated business, and ultimately to higher bills for customers. It may also breach the Competition Act 1998

1.1.4 WICS will monitor the performance of Scottish Water both through annual reports prepared by Scottish Water's Reporter, assisted where appropriate by the Auditor, and through independent studies into its performance commissioned by WICS.

1.1.5 At Strategic Reviews, WICS sets price limits on the basis of the costs involved in providing water and wastewater services. Where cross-subsidy between core and non-core customers is found, downward adjustments will be made to base costs in order that customers do not pay more than they should.

¹ Referred to in the regulatory accounting rules as non-core (licensed) retail non-household business.

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1.1.6 The aim of this rule is to establish a framework with which Scottish Water must comply.

1.2 The Competition Act 1998

1.2.1 The application of the Competition Act 1998 to the water sector has been published jointly by Ofwat and the Office of Fair Trading in: 'Competition Act 1998: Guidance on application in the water and sewerage sectors'.

1.2.2 When trading with associates and non-core activities, Scottish Water should pay particular regard to the specific application of the Act as outlined in the following sections of the report.

- Issues in pricing of water and sewerage services: Approach to Cost Assessment Section 4.9 – 4.10, Excessive Prices Section 4.14. Other Relevant Information Section 4.15, Refusal to Supply and Essential Facilities Section 4.21 – 4.24;
- Competition in providing Contestable Services, Section 4.25-4.29;
- Conduct relating to non-price terms, Section 4.30-4.33;
- Agreements that may restrict, distort or prevent competition, Section 4.53 – 4.54.

1.3 Rule Principles

1.3.1 The principles of this rule are that: -

- Scottish Water pays a fair price for services and products received;
- Transfer prices for transactions between Scottish Water and non core activities and associates are based on market price or less. Where no market exists, transfer prices are based on cost;
- Market testing is used, where possible, to establish market prices for supplies, works and services provided to Scottish Water.
- Costs are allocated in relation to the way resources are consumed.

1.3.2 Scottish Water is required to demonstrate transparently, through the application of these principles, the basis of arm's length trading and that cross subsidy does not exist.

1.3.3 Within the framework of these rules, Scottish Water must develop processes and procedures to meet its own specific circumstances, and ensure that transactions are supported and documented. A full account of the processes should be retained to allow monitoring by

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WICS and Scottish Water's Reporter. These records should demonstrate that the processes and procedures have been operated in an open and transparent manner. The policies and methods adopted for cost allocation, transfer pricing, market testing and reporting should be consistent. Where it is anticipated that a re-appraisal will result in system and/or policy changes, Scottish Water should ensure that proposed modifications comply with this rule and inform WICS of the modifications. It should seek advice from WICS where it considers that its proposals may differ from the spirit of the rule.

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1.4 Applicability

1.4.1 This rule will apply to transactions between core and non-core activities and to transactions between Scottish Water and associate entities. It also applies to transactions between the non-core (non-licensed) business and non-core (licensed) retail non-household business. To ensure complete transparency, an associate entity should be determined in accordance with the requirements of Financial Reporting Standard 8 (FRS8). Appendix 4 Diagram 2 outlines the Scottish Water (Group) transactions covered by RAR5.

1.4.2 For the purpose of this rule, the following are all to be considered associates of Scottish Water Wholesale:

- Non-core (licensed) retail non-household business;
- Scottish Water Retail – Household
- Non-core (non-licensed).

Non-core (non-licensed) businesses should be divided into related business groupings and transactions with the core and with the Non-core (licensed) retail analysed. This may be achieved by using the same breakdown and information as used for management accounts.

For the purposes of this rule, the following are all to be considered associates of Scottish Water non-core (licensed) retail non-household:

- Scottish Water core (wholesale and household retail)
- Non-core (non licensed)

1.4.3 These principles apply to:

- Cost allocation within Scottish Water between core and non-core activities;
- Transfer prices for the provision of supplies, works, services or resources between Scottish Water and an associate entity e.g., Scottish Water Retail-Non-household and Scottish Water Wholesale and vice versa.
- Transfer prices for rechargeable works where Scottish Water is a monopoly supplier to the associate entity, e.g., accommodation and other shared assets and resources; or where the parent or equivalent is a monopoly supplier, e.g., treasury costs to Scottish Water and associates.

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1.5 Principles of Transfer Pricing

Market Testing

- 1.5.1 The primary principle is that transfer prices should be based on market price or less and that market price, wherever possible, should be determined by market testing. The principles of market testing are described in Section 1.7. Market price should be the most economically advantageous price taking into account objective criteria such as completion date, quality, running cost, after sales service, technical merit, security of supply, effectiveness, whole life cost, capability, capacity etc.
- 1.5.2 The market testing process must be applied in a fair, open and transparent manner with no guarantee of success for associate entities. This will facilitate fairness of treatment between potential contractors and ensure that a competitive edge is maintained within the process. This provides the greatest assurance that cross subsidy of associates is not taking place. Where a service is market tested it should be a real market test and the work should be awarded to the tender² that is the most economically advantageous. Clear audit trails of the market testing process must be maintained.
- 1.5.3 Where an associate gains a substantial proportion of its turnover from Scottish Water i.e. more than half, the price the associate entity charges should incorporate a transparent discount from the external market price to reflect the following:
- inherent long-term guarantee of work;
 - volume of work;
 - lower marketing and sales costs;
 - lower bad debt risk;
 - lower commercial risk;
 - reduced credit period.

² All references to tender include related terms, such as bid or proposal to supply.

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Use of Cost Allocation

- 1.5.4 Where no market exists for particular supplies, works or a service, the transfer price should be based on cost, and the cost allocation rules followed. The principles of cost allocation are described in section 1.6.
- 1.5.5 On occasion, Scottish Water may choose to use the services of an associate for strategic reasons. For example, it may wish to retain intellectual properties within the group or it may require a particular product or service which can only be provided by an associate. Under these circumstances, the transfer price should also be based on cost. Due to the competitive nature of the activities undertaken by the Non-core (licensed) retail non-household entity, such strategic transactions should not be entered into either with or by this entity.
- 1.5.6 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. For price setting purposes WICS will assume that such supplies, works or services under these circumstances are provided at cost to Scottish Water, as if the services have been delivered within Scottish Water.
- 1.5.7 Where cost is used Scottish Water should have access to the costs of that associate and should conduct validation exercises to ensure that transfer prices are at cost. The relevant costs of the associate and any such validation exercises should be made available to WICS, or its representative, if requested.

Other Transfer Prices

- 1.5.8 Scottish Water may be indirectly supplied with goods, services and supplies by an associate via a third party. This may occur where an associate is sub-contracted to a third party as a nominated sub-contractor. Scottish Water is required to report on the value of transactions undertaken by associates via a third party. Reporting should record the value of such transactions and the associates involved including the nominated sub-contractor.
- 1.5.9 Not only do transfer prices apply to goods, services and supplies, they can also apply to staff where they provide services or are seconded to associates and non core activities or vice versa. Where Scottish Water staff undertake work for associates or non core activities, it should be reimbursed to reflect the individual's salary and overheads associated with that individual's employment, i.e. accommodation,

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pension, car etc.

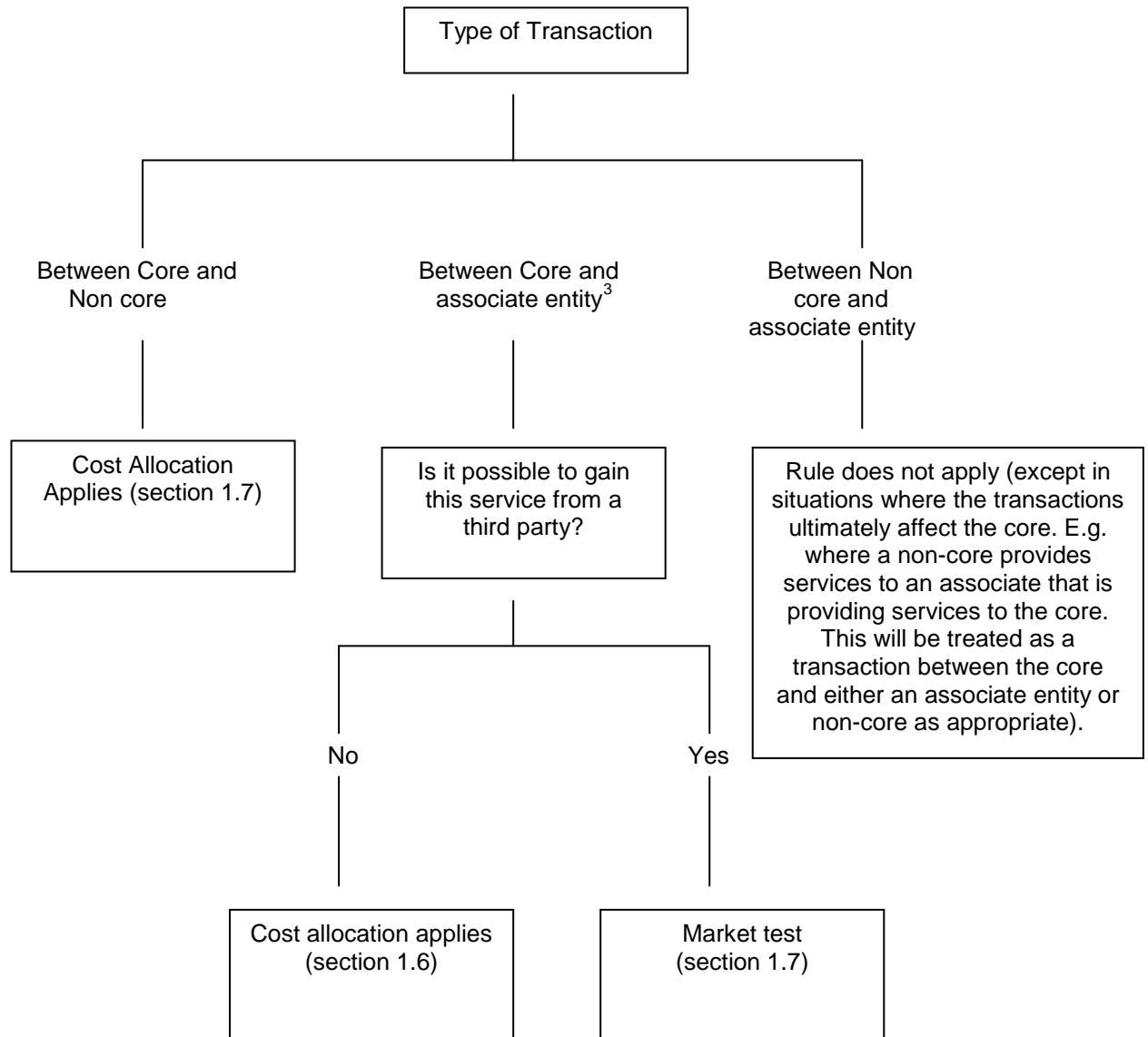
- 1.5.10 Scottish Water should have systems to record details of staff and time spent on associate or non core activities. Where Scottish Water employs or trains associate staff, it should document the requirements for that individual and the basis of remuneration.

- 1.5.11 In some circumstances Scottish Water may choose to transfer assets into and/or out of the core business. Where assets, including property are transferred out of Scottish Water to an associate or non core activity, the associate/non core activity should pay a fair market price, for those assets. Assets from Scottish Water core activity should not be charged out at a price below that which would be charged to a third party.

- 1.5.12 Diagram 1 overleaf provides an overview of the Rules.

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Diagram 1 Overview of Rules



³ For the purposes of this rule, transactions between Non-core (licensed) retail non-household and other non-core are assumed to fall into this category.

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1.6. Principles of Cost Allocation

- 1.6.1 Cost allocation is the means by which costs are divided between core and non-core activities of Scottish Water, and for specific products and services. Cost allocation rules can also apply to transfer prices from associates as outlined in section 1.5.
- 1.6.2 The key principle is that costs should be allocated in relation to the way resources are consumed. Allocations based entirely on turnover, volume or direct labour rates should not be used as they are unlikely to reflect the activities involved. Allocation must also be consistent with other Regulatory Accounting Rules, in particular RAR 4.
- 1.6.3 Costs can be considered as:
- direct costs of activities (e.g. materials and wages);
 - indirect costs which are directly consumed or allocated to activities (e.g. space occupied, IT resource used by an activity) and those not related to activities (e.g. management fees).
- 1.6.4 Allocating costs in relation to the way resources are consumed provides a means of building up service and product costs. This approach views a business as a series of activities, each of which consumes resources and, therefore, generates costs. An activity based approach should result in the majority of the total costs being allocated on a meaningful basis. It is expected that at least 80 per cent of costs will be allocated by activity. All costs must ultimately be allocated, including, where appropriate, depreciation charges (CCD charges in CC Reports and HC costs in HC Reports) on assets and financing charges (including a cost of capital).
- 1.6.5 Cost allocation must be fair and reasonable and there must be consistent treatment of costs for core and non core activities and where applicable, core and associate costs.
- 1.6.6 Scottish Water should have policies and procedures for a clear cost allocation methodology. These should specify:
- activities;
 - cost drivers for allocating costs to activities;
 - cost drivers for allocating activity costs to products and services;
 - departures from rule/implementation process;
 - review procedures;

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- documentation of procedures.
- 1.6.7 The onus is on Scottish Water to demonstrate transparently that all costs are ultimately allocated in accordance with this rule.
- 1.6.8 The allocation of indirect costs should be achieved by:
- identifying the activities that comprise a particular service or product and what drives the level of activity;
 - determining the relationships between activities and resources consumed;
 - costing the activities by costing the resources consumed;
 - pooling costs that cannot be related to activities and allocating them on a subjective basis, e.g. turnover or proportion of direct costs.
- 1.6.9 Scottish Water may pay a charge to a parent entity or equivalent for services provided. It is important that the basis of charging used reflects the group structure at the time charges are being levied and actual services provided. The charges paid must be related to the services provided and should be charged at cost, e.g., legal services and treasury services. The onus is on Scottish Water to demonstrate that charges reflect the costs incurred by the provider of the service. Management fees should not cover additional costs, e.g. where the parent, or equivalent, treasury function provides a guarantee to Scottish Water, a charge should not be made for the provision of that guarantee beyond that paid by the parent to a third party.
- 1.6.10 Although a significant proportion of costs can be allocated in relation to the way resources are consumed, it is recognised that a point of diminishing returns will be reached where the cost of further allocation outweighs the benefit. Where Scottish Water applies a de minimis level below which it will not seek to allocate costs, this should be declared in the commentary to the N Tables of the Annual Return.
- 1.6.11 In addition, it is recognised that some costs will not be driven by activities and that some subjective allocation will be necessary to arrive at the full cost. Where a subjective allocation is applied the principles governing this allocation should be set out in the commentary to the N Tables of the Annual Return.
- 1.6.12 Where it is not possible to charge for services on an activity basis, costs of this type should be distributed fairly between each subsidiary and between core and non core activities in a way that reflects the activities undertaken on behalf of the individual entities. Distributing charges to associates on the basis of profitability or turnover of individual associates will not provide a proxy for activity, and

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apportionment on this basis will be disallowed. Discrepancies between treatment in the regulatory and statutory accounts are also not allowed.

- 1.6.13 Allocations based on short run marginal costing techniques should not be used. In some instances it may be admissible to use long-run marginal costing. In cases where Scottish Water considers that a marginal costing technique is the most suitable means of charging for a particular service, it will be expected to justify its reasons for using this technique and should explicitly report this. Scottish Water will be expected to demonstrate that the contract term for a service provided at marginal cost is sufficiently long to enable the long-run benefits to be realised.

1.7 Principles of Market Testing

- 1.7.1 Market testing is the process of determining a market price for particular supplies, works or services. Transfer prices for transactions between the core business and associate entities can only be at a market rate if they are a result of market testing. This is essential to ensure that the price paid for a product or service does not exceed a fair market price.

Methods of Market Testing

- 1.7.2 There are a number of methods of market testing:
- competitive letting;
 - comparison to published list prices;
 - third party evaluation;
 - benchmarking.
- 1.7.3 The industry in England and Wales has used all of these methods to determine transfer prices, with varying degrees of success. A number of companies were unable to demonstrate arm's length trading and lack of cross subsidisation due to weaknesses in their market testing processes. As a result it has been concluded that market testing by comparison to published list prices, third party evaluation and benchmarking does not demonstrate arm's length trading because a large element of subjectivity is involved.
- 1.7.4 The most robust means of determining a fair market price is to invite independent contractors to tender a price for given supplies, works or services, i.e. competitive letting of a contract. Competitive letting is the only means of market testing which objectively tests and preserves the competitive market.
- 1.7.5 In exceptional circumstances, Scottish Water may need to engage the services of a third party at short notice to deal with operational needs.

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This would include dealing with emergency situations where the prompt action required would not enable a full procurement exercise to be undertaken. To alleviate concerns, Scottish Water should fully document the operational emergency and the reasons for selecting the associate. This process should accord with Scottish Water's stated emergency procedures.

- 1.7.6 Scottish Water will be expected to make a strong case for using methods other than competitive letting and will need to demonstrate the robustness of the methods used. Only well-documented and cogent exercises will satisfy WICS that transfer prices are at market rates.

Market testing procedures

- 1.7.7 Scottish Water should establish and apply clear policies and procedures for market testing. The reasons for the methods, thresholds and criteria adopted should be transparent and should be capable of withstanding scrutiny by WICS, customers and competing contractors. Policies and procedures should be documented and include the following as a minimum:

- market testing methods to be used;
- procedures to be adopted with respect to each method;
- frequency of market testing;
- review procedures;
- responsibilities for conducting market testing; and
- documentation of procedures.

- 1.7.8 Arm's length trading can be best demonstrated by retaining a detailed audit trail addressing each of the above points. Prior to commencing the competitive letting process Scottish Water should ensure the following decisions are taken:

- Contractual arrangement to be used and the circumstances in which they will be used e.g. fixed price, schedule of rates, partnering, term, negotiated and call-off contracts.
- The minimum number of bids to be obtained dependent on materiality of the contract.
- Qualification processes for potential contractors - Scottish Water should ensure that the qualification requirements do not give any undue advantage to associates.
- Evaluation process - the criteria on which tenders will be assessed and the respective weightings for each criterion

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should be documented before tenders are received.

- Policy on informing tenderers of results.

- 1.7.9 It will be difficult for Scottish Water to demonstrate that trading has been at arm's length or that cross subsidisation does not exist if cost is given a weighting of less than 50% compared to qualitative factors.
- 1.7.10 The use of a transparent, well-documented market testing process should demonstrate compliance with these rules. Where Scottish Water is unable to provide sufficient evidence to demonstrate this, WICS, or its representative, may require access to the relevant costs of associate entities.

Frequency of Market Testing

- 1.7.11 To demonstrate a fair market price, Scottish Water will need to undertake frequent market testing that produces valid results. There is a balance between the advantages of frequent market testing of short-run contracts and the benefit of stability, continuity and possibly lower costs for longer term work. As a general guide, contracts should normally be market tested every one to three years. Contract periods longer than three years could lead to Scottish Water paying prices that are very different from prevailing market rates. Where Scottish Water chooses to let a contract for longer than three years they should refer to the market on an annual basis thereafter.
- 1.7.12 Repeat market testing will be necessary when there is any material alteration to an existing contract, or extra work is to be awarded. Market testing that does not match the current profile of work will not remain valid.
- 1.7.13 In general, the greater the likelihood of fresh competition and new technology emerging, then the shorter the period between market testing. Scottish Water should have regard to these issues in determining its strategy.

Unacceptable practices

- 1.7.14 Market testing procedures should comply with EU directives where applicable.
- 1.7.15 Scottish Water should not split contracts or use artificial methods to calculate the value of contracts in order to circumvent applicable thresholds or the aggregation rules of the EU procurement directives.
- 1.7.16 Market testing should be used to award contracts to the most economically advantageous tender, not as a device to justify prices paid to associate entities. Where examples of this practice are found, WICS will assume these works, supplies and services are provided at

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cost, as arm's length trading cannot be demonstrated. This could also constitute grounds for an investigation under the Competition Act 1998.

- 1.7.17 Third parties will not continue to offer competitive bids to Scottish Water if they perceive that it is not seeking the most economically advantageous bid or that third party bids are mostly used to establish market prices to be paid to associate entities.

Partnering

- 1.7.18 It is recognised that partnering arrangements are becoming more common. Where Scottish Water pursues partnering arrangements with associate entities it should take account of the following principles:

- Selection of partners should be made following a competitive letting process;
- The partnering arrangement should run for a stated period of time (this should be made clear in the competitive letting documents); and
- Any partnering agreement should include mutually agreed and reasonable targets for improving performance and reducing costs.

- 1.7.19 Partnering arrangements with an associate entity run the risk of appearing to be too close i.e. 'not at arms length'. Scottish Water will therefore need to take steps to enable it to demonstrate that such arrangements operate at arm's length and are producing tangible benefits in terms of improved performance and reduced costs. This can best be achieved by:

- Proper documentation of the competitive letting and selection exercise;
- Clearly defined targets for reducing costs and improving performance including incentives;
- Rules for rewards and penalties where targets are surpassed or under achieved to reflect the risk borne by each party to the contract; and
- An open book policy providing details of the costs involved in providing the service and the level of profit achieved on the contract.

1.8 Scottish Water Structure

- 1.8.1 Systems should be in place to ensure that directors or senior managers who have responsibilities in both Scottish Water and associate entities do not face a conflict of interest. Clear guidance should be given to

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directors and senior managers in the event that a conflict of interest arises.

- 1.8.2 No individual, in such a position, should be able to influence either the purchase or supply of goods, services and supplies. Where cross-directorships exist these should be described in the commentary to the N Tables of the Annual Return and in the Regulatory Accounts. Transparency with regard to the existence of such cross-directorships will mitigate public concerns.

PART 2 REPORTING REQUIREMENTS

2.1 Introduction

- 2.1.1 Scottish Water must demonstrate that it complies with these Rules so that trade with associates is at arm's length, that cost allocation between core activities and non core activities and between non-core (non-licensed) activities and non-core (licensed) non-household retail activities accurately reflects the way that resources are consumed and cross subsidy is not occurring. Appendix 4 Diagram 2 outlines the Scottish Water (Group) transactions covered by RAR5.
- 2.1.2 Scottish Water should advise WICS, in its Annual Return, of any areas where policies and procedures may not comply with RAR 5 and the time frame for ensuring that they will
- 2.1.3 If Scottish Water is unable to provide any of the information requested below, it should make this, and the reasons for not providing the information, clear in its commentary to the N Tables of the Annual Return. For each of the requirements that do not apply to Scottish Water, a 'nil return' should be included.

2.2 Annual Return Reporting Requirements

- 2.2.1 Scottish Water will be expected to provide the following information with either the Regulatory Accounts and/or its Annual Return each financial year:
1. Directors of Scottish Water should state that Scottish Water complies with the objectives and principles of RAR 5, namely that transactions with associate entities are at arm's length, that cost allocation between core activities and non core activities accurately reflects the way that resources are consumed and that cross subsidy is not occurring.
 2. Directors of Scottish Water should include a declaration of interests with a statement that no Director has acted as both purchaser and supplier in any transaction with an associate entity. Scottish Water should give a description of procedures that it has put in place to ensure that conflicts of interest do not occur.
 3. For transactions with associate entities and non core activities (both licensed and non-licensed), Scottish Water should set out the following information in the N Tables of the Annual Return. Table N.1 should be used to record capital expenditure and Table N.2 should include profit and loss expenditure.
 4. Directors of Business Stream should state that Business Stream complies with the objectives and principles of RAR 5 and that in

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so doing complies with Ordinary Condition 4 and Ordinary Condition 5 of its Licences.

5. For transactions with Scottish Water Wholesale, Scottish Water Retail household and non core (non-licensed) activities Business Stream should set out the following information in the N Tables of the Annual Return. Table N.1 should be used to record capital expenditure and Table N.2 should include profit and loss expenditure. Appendix 4 Diagram 3 outlines the Business Stream transactions covered by RAR5.

The reporting requirements mean that the same cost and revenue information will be reported by both Scottish Water and Business Stream for transactions involving non-core (licensed) retail non-household. However, the breakdown of information may be different in each set of tables.

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Market Testing

2.2.2 For each associate, the following detail should be provided:

- The value of current individual contracts over the period of the contract. (An explanation of any significant variations between the anticipated contract value for the year and actual expenditure for the year should be given in the commentary).
- The date when the contract began and the date when it is due to expire. The period of the contract should include any options to extend.
- The type of market testing e.g competitive letting, benchmarking etc.
- The total value of supplies, works or services supplied to Scottish Water in the current year.
- The turnover of the associate/non core activity.
- The percentage of that turnover that transactions with the core company represents.

2.2.3 In addition Scottish Water should provide in its commentary, detail of a sample of the contracts let to each associate (normally the highest value) giving the following information. Detail of any partnering contracts with associates must be included:

- Details of the advertisement of the contract (if above EU threshold);
- The number of parties which expressed an interest;
- The number of companies that were invited to submit a tender and the basis for their selection.
- The number of tenders that were evaluated and the method used, including details where applicable, of the tender evaluation score sheet or other similar matrices.
- The outcome of any negotiations undertaken with tenderers.
- The reason for the award of the contact.
- The period of the contract.
- For partnering contracts, detail of performance targets and pain/gain mechanisms.

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2.2.4 Where the associate has been nominated as a subcontractor to a third party by Scottish Water, the commentary to the Tables should record the value of such transactions and the associates involved.

Cost Allocation

2.2.5 The following information on cost allocation between Scottish Water and its associates and between core/non core activities should also be provided in the N Tables of the Annual Return:

- The total value in the year of income received from associates or recharges made by Scottish Water to associates or non core activities. Where possible, the value of recharges should be split between direct and indirect recharges. This should also be recorded as non core income in the Regulatory Accounts where it is in excess of the thresholds for reporting.
- The total value of income received from Scottish Water or recharges made by associates or non core activities to Scottish Water.
- The turnover of the associate/non core activity.
- The percentage of that turnover that transactions with the core activity represents.

Information on transactions with non-core entities should be divided into related business groupings and transactions with the core analysed

2.2.6 Transfers of assets and loans

All transfers of assets, land or property that took place within the financial year should be recorded in the Tables as recharges. Detail should be given in the commentary. Any significant difference between 'fair market price' and the price at which assets were transferred should be recorded. The methodology used to establish a fair market price for the assets should also be recorded.

2.2.7 Details of loans, capital, issues or redemptions and dividends should be recorded, in the commentary where they relate to trade between Scottish Water and associates.

2.3 Reporter's Reporting Requirements

2.3.1 The Reporter should prepare a report with Scottish Water's Annual Return. This should identify material areas of judgement and any other material circumstances which appear to the Reporter to be relevant having regard to the rules and to the scope of work agreed with WICS including relevant levels of materiality.

2.3.2 WICS may require the Reporter to adopt a particular focus in examining compliance with this rule. To that end the Reporter will be required to

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provide for WICS agreement, prior to each financial year, proposals which have been discussed with Scottish Water, detailing the areas proposed to cover in relation to RAR 5 in the course of the audit in the forthcoming year. The audit plan will need to be prepared in accordance with 'Terms of Reference' issued annually by WICS. These will provide the framework of the Reporter's reporting requirements each financial year.

- 2.3.3 The purpose of the report is to provide WICS with information to allow it to form a judgement on the compliance or otherwise of Scottish Water with this RAR in respect of those matters reported. Having regard to the scope of work performed, WICS will provide feedback to the Reporter in writing on the compliance of Scottish Water with the rules.
- 2.3.4 In addition this report should identify any findings that were drawn to the attention of Scottish Water and what steps have been, or will be, taken to remedy any departures from RAR 5.
- 2.3.5 Reporting compliance with this rule falls to the Reporter. Scottish Water and its Reporter should also establish clear responsibilities for the Auditor. For instance, use should be made of Scottish Water's auditor in relation to allocation of costs particularly since these will be included in the Regulatory accounts. WICS may, on occasion, also require the Auditor to examine such transactions.

APPENDIX 1 DEFINITION OF TERMS

A number of terms have been used throughout the rules. To avoid confusion, they are defined as follows:

Accounting terms

The definitions to be used are as set out in Regulatory Accounting Rule 3 (RAR 3).

Activity

A logical grouping of tasks.

Core activity

Core business activities comprise the regulated activities of Scottish Water which are activities necessary in order for it to fulfil the functions and duties of a water and sewerage undertaker as defined in the Water (Scotland) Act 1980 as amended by any subsequent legislation and the Sewerage (Scotland) Act 1968 as amended by subsequent legislation. See RAR 4 for further clarification.

Arm's length trading

Arm's length trading is where the core activity treats the associate on the same basis as external third parties.

Associate Entity

An associate entity should be determined in accordance with Financial Reporting Standard 8 (FRS 8).

For the purpose of this rule, the following are all to be considered associates of Scottish Water Wholesale:

- Non-core (licensed) retail non-household business;
- Scottish Water Retail – Household
- Non-core (non-licensed).

Other non-core should itself be divided into related business groupings and transactions with the core analysed. This may be achieved by using the same breakdown and information as used for management accounts.

For the purposes of this rule, the following are all to be considered associates of Scottish Water non-core (licensed) retail non-household:

- Scottish Water core (wholesale and household retail)
- Non-core (non licensed)

Cost

The actual cost to an associate/ non core activity in a transaction with Scottish Water of the goods, works or services. Where the associate or non core activity also provides services to third parties then a reasonable rate of return on capital employed may be included.

APPENDIX 1 DEFINITION OF TERMS

Cost allocation

Cost allocation is the means by which all costs are allocated to core and non core businesses or core and associated entities.

Cost driver

A cost driver is the factor or factors which cause cost to occur. This can be further divided between the driver that causes an activity to occur, and a driver that determines how often it occurs.

Cross-subsidy

Cross-subsidy in this context is monetary aid or contributions from Scottish Water to the associate or non core activity which is not merited by services received or for which the core business has not received full reimbursement of costs incurred by it for the use of its assets or resources by the associate or non core activity.

Economically advantageous price

The economically advantageous price is the net cost to Scottish Water after taking account of all factors including the contract price, contractor management time, cash flow impact of the payment schedule, completion date, quality, after sales services, technical merit, aesthetics, security of supply, effectiveness, whole life cost, capability, etc.

Framework agreement

Framework agreements are as defined by the EU Utilities Directives. Broadly these are agreements covering terms, prices and, where appropriate, envisaged quantities for contracts to be awarded over a specified time period.

Indirect transaction

A transaction where Scottish Water has a contract with a third party and that third party has made use of an associate entity of Scottish Water to provide that service. In this instance Scottish Water does not have a contract with the associate entity, but part of the turnover of the associate entity is indirectly provided by it.

Marginal costing

Marginal costing is the additional variable cost of the production of the next unit. Short-run marginal costing merely includes the short-term costs involved in producing the additional unit, whereas long-run marginal costs include the additional costs, including a capital element, involved in producing the next unit.

Market price

The price of a good, service, supply as determined by market testing.

APPENDIX 1 DEFINITION OF TERMS

Market testing

Market testing is the process of determining a market price for a particular supply, works or service.

Non core activity

Non core activities are those activities engaged in by Scottish water which are not necessary in order for Scottish Water to fulfil the functions and duties of a water and sewerage undertaker as defined in the Water (Scotland) Act 1980 or as amended by subsequent legislation and the Sewerage (Scotland) Act 1968 or amended by subsequent legislation. See RAR 4 for a fuller definition.

Retail

The customer facing activities of Scottish water including Scottish Water Retail - Household and Scottish Water Retail – Non household. See RAR 4 for further guidance.

Transaction

For the purposes of RAR 5, a transaction occurs where Scottish Water and its associates supply goods, works or services to each other, directly or indirectly via a third party.

Transfer pricing

A transfer price is the price paid by one group entity to another for transactions between the two entities.

Wholesale

Scottish Water Wholesale includes the individually identified (primary) activities which must be pursued separately in order to provide water and sewerage services ie, water resources and treatment, water distribution, sewerage, sewage treatment and sludge treatment and disposal. See RAR 4 for further detail.

Column Definitions and Rows

The column definitions given below apply to both Tables N 1 (Capex) and N2 (P&L). Table N2 should act as part of the audit trail for information presented in the regulatory M tables (particularly M1 and M2). Scottish Water should also provide a commentary that explains the transactions, reveals material assumptions and details any manual adjustments from Scottish Water's accounting systems.

There are no row definitions. Scottish Water (the core activity) is required to provide information on transactions with each non-core activity and also information on individual contracts and other transactions that have occurred between the core activity and an associate. Note that this is only information on transactions and not information on the total costs of a non-core activity. Where possible, information relating to recharges should be categorised as either direct or indirect.

Non-core activities should be divided into related business groupings and transactions with the core analysed.

Rows can be added as required.

Block A: Market Testing

Detail of contracts let following market testing should be included in this block. If no market testing has been completed then detail should be provided in Block B.

| | | |
|---------------|-----------------------|--|
| Col: 1 | Line Reference | |
|---------------|-----------------------|--|

Sequential row number – to be completed by Scottish Water.

| | | |
|---------------|----------------------|--|
| Col: 2 | Core Activity | |
|---------------|----------------------|--|

Core business activities comprise the regulated activities of Scottish Water that are activities necessary in order for it to fulfil the functions and duties of a water and sewerage undertaker as defined in the Water (Scotland) Act 1980 as amended by any subsequent legislation and the Sewerage (Scotland) Act 1968 as amended by subsequent legislation. See RAR 4 for further clarification.

In any one year, for the purposes of RAR 5, the following activities **could** be considered core activities of Scottish Water:

- Scottish Water Wholesale
- Scottish Water Retail – Household

Where legislation changes the definition of core activities partway through a financial year, Scottish Water should report that activity as core for the period

APPENDIX 2 TRANSFER PRICING DEFINITIONS

that it is considered core. The commentary should explain any instances where this is the case.

Business Stream should complete this column by stating the licensed activity that is receiving the goods/service. It is acceptable either to report this at an aggregate level (eg non-core (licensed) retail non-household) or to split this into separate units within Business Stream.

See definition of 'associate' below.

The core activity that has received the goods/services is to be included in this column.

| | | |
|---------------|---------------------------|--|
| Col: 3 | Associate Activity | |
|---------------|---------------------------|--|

An associate entity should be determined in accordance with Financial Reporting Standard 8 (FRS 8).

For the purpose of this rule, the following are all to be considered associates of Scottish Water Wholesale:

- Non-core (licensed) retail non-household business;
- Scottish Water Retail – Household
- Non-core (non-licensed).

Other non-core should itself be divided into related business groupings and transactions with the core analysed. This may be achieved by using the same breakdown and information as used for management accounts.

Where an associate is also a core activity, each transaction need only be recorded once. For example, any transactions between Scottish Water Wholesale and Scottish Water Retail – Household should only be recorded once.

For the purposes of this rule, the following are all to be considered associates of Scottish Water non-core (licensed) retail non-household:

- Scottish Water core (wholesale and household retail)
- Non-core (non licensed)

| | | |
|---------------|--------------------------|-----------------|
| Col: 4 | Value of contract | £m (3dp) |
|---------------|--------------------------|-----------------|

The total anticipated value of the contract for the period during which it is operative. Include the value for any periods included in the contract as options to extend.

APPENDIX 2 TRANSFER PRICING DEFINITIONS

| | | |
|---------------|---------------------------|--|
| Col: 5 | Period of Contract | |
|---------------|---------------------------|--|

The period during which the contract is operative (excluding options to extend). Detail of any options to extend the contract i.e. the length of each possible extension, should also be given.

| | | |
|---------------|--------------------|--|
| Col: 6 | Description | |
|---------------|--------------------|--|

A brief description of the goods/services provided. Commentary should be used to explain fully any items that are unclear (such as "other").

| | | |
|---------------|-------------------------------|--|
| Col: 7 | Type of Market Testing | |
|---------------|-------------------------------|--|

The type of market testing undertaken. For example, competitive letting, comparison to published list prices, benchmarking, third party evaluation. See RAR 5 for further detail.

| | | |
|---------------|----------------------|-----------------|
| Col: 8 | Spend in Year | £m (3dp) |
|---------------|----------------------|-----------------|

The expenditure incurred under the contract in the Report year. Where the spend exceeds the anticipated annual value, an explanation should be given in the commentary.

| | | |
|---------------|------------------------------|-----------------|
| Col: 9 | Turnover of Associate | £m (3dp) |
|---------------|------------------------------|-----------------|

The annual turnover of the associate in the report year.

| | | |
|----------------|------------------------------------|----------|
| Col: 10 | Core spend as % of turnover | % |
|----------------|------------------------------------|----------|

The percentage of the associate turnover that the annual expenditure with that associate by the core activity represents. (i.e. col 8 as a percentage of col 9).

APPENDIX 2 TRANSFER PRICING DEFINITIONS

Block B: Cost Allocation. Recharges to Associate from Core.

This block includes detail of transactions which are based on cost allocation i.e. no market testing has been undertaken. For further details of the principles of cost allocation see RAR 5.

| | | |
|---------------|-----------------------|--|
| Col: 1 | Line Reference | |
|---------------|-----------------------|--|

Sequential row number – to be completed by Scottish Water.

| | | |
|---------------|----------------------|--|
| Col: 2 | Core Activity | |
|---------------|----------------------|--|

Core business activities comprise the regulated activities of Scottish Water that are activities necessary in order for it to fulfil the functions and duties of a water and sewerage undertaker as defined in the Water (Scotland) Act 1980 as amended by any subsequent legislation and the Sewerage (Scotland) Act 1968 as amended by subsequent legislation. See RAR 4 for further clarification.

For the purposes of RAR 5, Scottish Water Wholesale and Scottish Water Retail – Household and also Scottish Water Retail – Non-household are each core activities. See definition of ‘associate’ below.

Business Stream should complete this column by stating the licensed activity that is receiving the goods/service. It is acceptable either to report this at an aggregate level (eg non-core (licensed) retail non-household) or to split this into separate units within Business Stream.

The core activity that has received the goods/services is to be included in this column.

| | | |
|---------------|---------------------------|--|
| Col: 3 | Associate activity | |
|---------------|---------------------------|--|

An associate entity should be determined in accordance with Financial Reporting Standard 8 (FRS 8).

For the purpose of this rule, the following are all to be considered associates of Scottish Water Wholesale:

- Non-core (licensed) retail non-household business;
- Scottish Water Retail – Household
- Non-core (non-licensed).

Non-core (non-licensed) businesses should be divided into related business groupings and transactions with the core and with the Non-core (licensed) retail analysed. This may be achieved by using the same breakdown and information as used for management accounts.

APPENDIX 2 TRANSFER PRICING DEFINITIONS

For the purposes of this rule, the following are all to be considered associates of Scottish Water non-core (licensed) retail non-household:

- Scottish Water core (wholesale and household retail)
- Non-core (non licensed)

| | | |
|---------------|--------------------|-----------------|
| Col: 4 | Total Value | £m (3dp) |
|---------------|--------------------|-----------------|

The value of transactions with the associate/non core activity in the year. Recharges includes the transfer of assets.

| | | |
|---------------|------------------------------|-----------------|
| Col: 5 | Turnover of Associate | £m (3dp) |
|---------------|------------------------------|-----------------|

The annual turnover of the associate in the report year. This should be the associate referred to in Column 3 and not

| | | |
|---------------|------------------------------------|----------|
| Col: 6 | Core spend as % of turnover | % |
|---------------|------------------------------------|----------|

The percentage of the associate turnover that the annual expenditure with that associate by the core activity represents. (i.e. col 4 as a percentage of col 5).

Block C: Cost Allocation. Recharges to Core Activity from Associate

This block includes detail of transactions which are based on cost allocation i.e. no market testing has been undertaken. For further details on the principles of cost allocation see RAR 5.

| | | |
|---------------|------------------------------------|--|
| Col: 7 | Associate/Non core activity | |
|---------------|------------------------------------|--|

An associate entity should be determined in accordance with Financial Reporting Standard 8 (FRS 8).

For the purpose of this rule, the following are all to be considered associates of Scottish Water Wholesale:

- Non-core (licensed) retail non-household business;
- Scottish Water Retail – Household
- Non-core (non-licensed).

Other non-core should itself be divided into related business groupings and transactions with the core analysed. This may be achieved by using the same breakdown and information as used for management accounts.

For the purposes of this rule, the following are all to be considered associates of Scottish Water non-core (licensed) retail non-household:

- Scottish Water core (wholesale and household retail)
- Non-core (non licensed)

APPENDIX 2 TRANSFER PRICING DEFINITIONS

Non core activities are those activities engaged in by Scottish Water which are not necessary in order for Scottish Water to fulfil the functions and duties of a water and sewerage undertaker as defined in the Water (Scotland) Act 1980 or as amended by subsequent legislation and the Sewerage (Scotland) Act 1968 or amended by subsequent legislation. See RAR 4 for a fuller definition.

In this column, where the core activity is also an associate of a core activity, the associate/non core activity that has received the goods/services is to be included.

| | | |
|---------------|----------------------|--|
| Col: 8 | Core Activity | |
|---------------|----------------------|--|

An associate entity should be determined in accordance with Financial Reporting Standard 8 (FRS 8).

For the purpose of this rule, the following are all to be considered associates of Scottish Water Wholesale:

- Non-core (licensed) retail non-household business;
- Scottish Water Retail – Household
- Non-core (non-licensed).

Non-core (non-licensed) businesses should be divided into related business groupings and transactions with the core and with the Non-core (licensed) retail analysed. This may be achieved by using the same breakdown and information as used for management accounts.

For the purposes of this rule, the following are all to be considered associates of Scottish Water non-core (licensed) retail non-household:

- Scottish Water core (wholesale and household retail)
- Non-core (non licensed)

| | | |
|--------------|--------------------|-----------------|
| Col:9 | Total Value | £m (3dp) |
|--------------|--------------------|-----------------|

The value of transactions with the associate/non core activity in the year. A breakdown of the expenditure with associates should be included in the commentary. The reason why market testing has not been undertaken should also be given e.g. strategic, no market, emergency etc. See RAR 5 for further detail.

| | | |
|----------------|------------------------------|-----------------|
| Col: 10 | Turnover of Associate | £m (3dp) |
|----------------|------------------------------|-----------------|

The annual turnover of the associate in the report year.

APPENDIX 2 TRANSFER PRICING DEFINITIONS

| | | |
|----------------|------------------------------------|----------|
| Col: 11 | Core spend as % of turnover | % |
|----------------|------------------------------------|----------|

The percentage of the associate turnover that the annual expenditure with that associate by the core activity represents. (i.e. col 9 as a percentage of col 10).

APPENDIX 3 TRANSACTIONS COVERED BY RAR5

Regulatory Accounting Rule 5 requires analysis of Scottish Water's costs and revenues using four separate Business Groupings. Together, these business groupings cover the full extent of all activities undertaken by the statutory public corporation of Scottish Water.

The four groupings are:

Core:

Scottish Water Wholesale; and
Scottish Water retail household.

Non-core:

Non-core (licensed) retail non-household activities;
Non-core (non-licensed) activities.

Scottish Water Wholesale

This core activity covers all the costs of collecting, transporting and treating both water and effluent. It covers the following activities listed in Appendix 2 of RAR 4:

- 1.1 Water supply - resources and treatment
- 1.2 Water supply – distribution of treated water
- 1.3 Sewerage services – sewerage
- 1.4 Sewerage services – sewage treatment
- 1.5 Sewerage services – sludge treatment and disposal
- 1.7 Business Activities
- 2.0 Services provided for third parties

Scottish Water retail household

This core activity covers the costs of retailing both water and sewerage services to household customers. It comprises the following activity listed in Appendix 2 of RAR 4:

- 1.6 Retail activities (to the extent to which they refer to household customers only)

Non-core (licensed) retail non-household activities

This non-core activity covers the costs of retailing both water and sewerage services to non-household customers. It comprises the following activity listed in Appendix 2 of RAR 4:

- 1.6 Retail activities (to the extent to which they refer to non-household customers only)

APPENDIX 3 TRANSACTIONS COVERED BY RAR5

It also should comprise any other activities undertaken by Business Stream that are substantially:

- based in Scotland; and
- concerned with providing water and sewerage services to non-household customers.

Any activity that Business Stream undertakes that it considers does not fall into these two categories should be explained in the commentary. These should be analysed as Non-core (non-licensed activities) (see below).

It may also therefore include some activities from Appendix 2 of RAR 4 that fall into the following category, where these have been transferred to Business Stream:

2 Non-core activities.

All transactions associated with Business Stream Holdings should be included.

Non-core (non-licensed) activities

These comprise all activities that are not in the above three categories. These are activities that are not required either:

- to provide the core wholesale water and wastewater service;
- to provide the core household retail water and wastewater service; or
- to provide the non-core non-household retail water and wastewater service, for which Business Stream has been licensed.

These comprise activities from Appendix 2 of RAR 4 that fall into the following category:

2 Non-core activities

to the extent that they have not been covered above.

Diagram 2 Scottish Water (group) transactions covered by RAR5

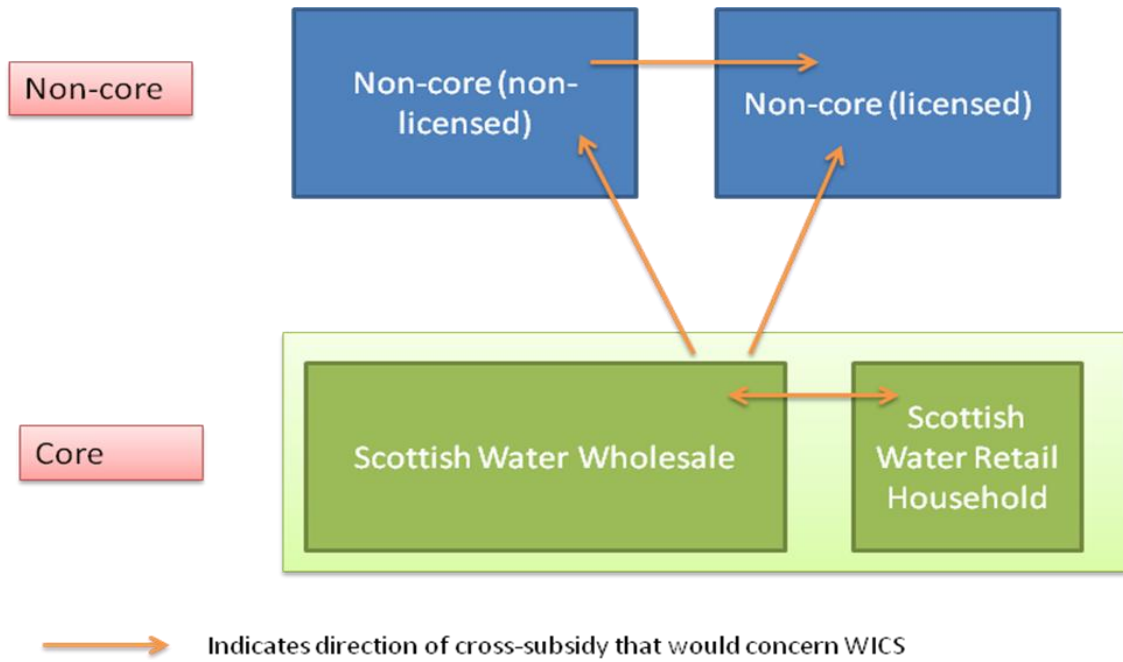


Diagram 3 Business Stream transactions covered by RAR5

