Accounting Methodology Statement

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Wessex Water
YTL GROUP

Contents

1. Introduction

Purpose

The Annual Performance Report (APR) aims to provide clear information regarding our delivery of performance commitments and financial performance.

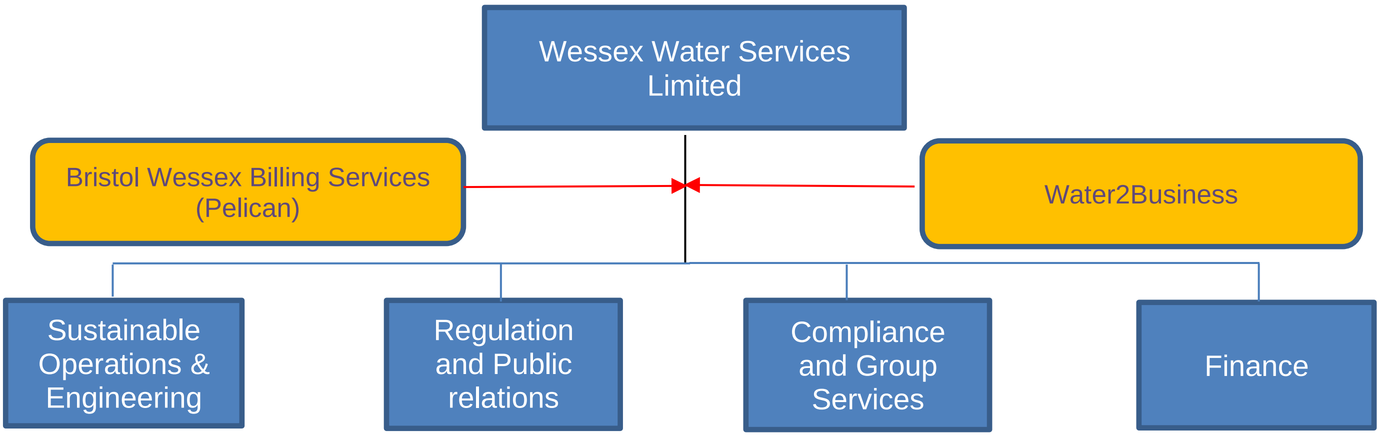
The purpose of this methodology statement is to assist the reader of the APR, in particular on how the company has met the requirement of the Regulated Accounting Guidelines (RAGs). This covers the attribution of costs between price control units and further subdivisions of costs by activities as required by Ofwat.

2. Overview

Overview – this section contains:

- **Business Structure**
- **Insourced Functions**
- **Outsourced Functions**
- **Data Sources**

Business Structure:



Wessex Water Services Limited (WWSL) is the legal entity containing all regulatory costs. The company is managed by a Board of Directors and executive leadership team who manage the significant business areas.

The majority of our activities are insourced within four business areas, a reduction from five last year:

Sustainable Operations and Engineering, newly formed in 2022-23, includes areas previously in Operations; Water, Waste, Bioresources, Control room and Developer Services, and areas previously in Engineering and Sustainable Delivery; our inhouse construction department, procurement, contract management and fleet management.

Compliance and Group Services includes People, Legal, Information Technology and Security and Environmental Compliance.

Finance represents all financial functions except procurement, but including performance reporting, investment and risk management.

Our largest outsourced activity is carried out by Bristol Wessex Billing Services Limited (Pelican Business Services). They are used for retail household billing, collection, debt recovery and customer services. Over 30% of total retail costs are invoiced to WWSL by Pelican.

The non-household retail services are carried out by a separate group company Water2Business Ltd.

Note – Retail customer-side leak repairs and water efficiency promotional activities are undertaken by WWSL, predominantly using in-house resources.

Data Sources:

Wessex Water uses the accounting software Unit4 Business World (previously known as Agresso). The system allows detailed cost allocation to site, process and job level. Whilst cross referenced to detailed account cost types within headings of employment, chemicals, power, equipment, transport, IT and external services.

3. Reporting Principles

Principles:

Our methodology is aligned with RAG 2.09 and RAG 4.11 to the extent they cover the principles, definitions and cost drivers to be used in pro forma tables sections 1, 2, 4, 5, 7 and 8 of the annual performance report between:

- Retail and wholesale services
- Household and non-household retail services
- Services for measured and unmeasured customers

We have separately confirmed WWSL complies with the principles of RAG 5.07 – Transfer Pricing in the Annual Performance Report.

This statement explains the basis on which we have confirmed that we have prepared our APR in accordance with RAG2 as required by RAG3.

We confirm we have followed the general principles as set out in RAG 2.09 as follows:

Transparency: the attribution methods applied within the accounting separation system need to be transparent. This requires that the costs and revenues apportioned to each service and business unit should be clearly identifiable. The cost and revenue drivers used within the system should also be clearly explained to enable a review of their appropriateness.

Causality: cost causality requires that costs (and revenues) be allocated to those activities and services that cause the cost (or revenue) to be incurred. This requires that the attribution of costs and revenues to activities and services should be performed at as granular level as possible.

Non-discrimination: the attribution of costs and revenues should not favour any business unit within the regulated company, and it should be possible to demonstrate that internal transfer charges are consistent with the prices charged to external third parties.

No cross subsidy between price controls: companies cannot transfer costs between price control units. Transfer prices for transactions should be based on market prices, or in the following circumstances, they should be based on cost:

- No market exists
- The service or activity is company specific and is being provided internally to all price control units
- The service or activity is provided solely to both the appointed and non-appointed business

Objectivity: the cost and revenue attribution criteria need to be objective and should not intend to benefit any business unit or service. Cost allocation must be fair and reasonable and should be consistent between appointed and non-appointed activities.

Consistency: the cost and revenue attribution criteria should be consistent from year to year. Changes to the attribution methodology from year to year should be clearly justified and documented.

Principal Use: Where an asset is used by more than one service it should be reported (capex and depreciation) in the price control unit where the service of principal use occurs with a recharge made to other services reflecting the proportion of the asset used by those services. The basis of recharges between services should reflect the nature of the asset being recharged.

4. Cost Allocation

This section includes:

- **Material changes**
- **Operating cost allocation**
- **Significant movements in year**

Material changes to methodology for 2022-23

We have amended our classification of customer side leakage expenditure. We have booked all of our customer-side leak repair expenditure to wholesale Water Distribution (2C.28) as there is a clear link to a wholesale outcome, in this case leakage, and in line with the industry standard.

Operating cost allocation

All operating costs are booked against a cost centre with an owner that manages those costs and their budget.

All costs are given an account code that describes the type of cost that has been incurred.

All cost centres within the company General Ledger system are aligned to regulatory business units for accounting separation reporting purposes.

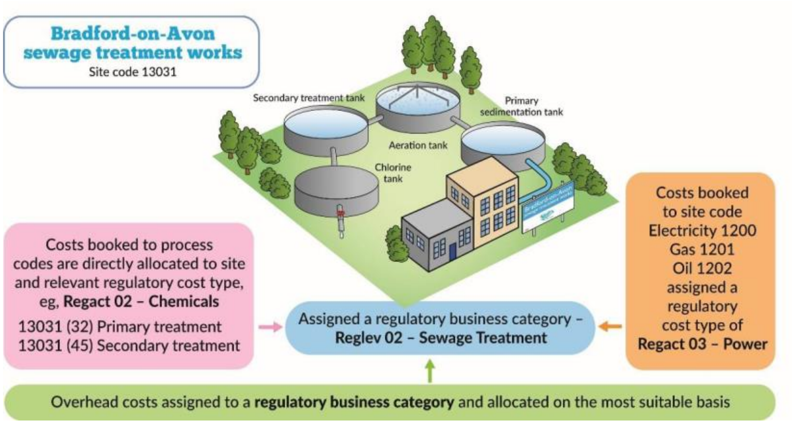
All account codes are linked to a regulatory account code that conforms to the cost types that companies are required to show separately in the accounting separation tables, e.g., Power, local authority rates, service charges.

Each time a new account code or cost centre is created within the corporate finance system it is linked to the appropriate business unit or cost type with reference to the latest regulatory guidelines.

This is reviewed annually to ensure consistency and continual improvement of accuracy.

The diagram below shows how costs booked against the corporate General Ledger system are attributed to the correct regulatory business category (Reglev) (In this instance – Sewage Treatment) and correct regulatory cost type (Regact).

We continue to develop our work and asset management systems so that we make



greater use of site process and asset codes within the General Ledger system to help automate the split of costs where certain sites undertake activities for more than one regulatory business category.

These codes sit below the cost centre in the system hierarchy. For instance, within a sewage treatment works cost code the process codes would be primary treatment, secondary treatment, sludge treatment, sludge disposal and each asset code is allocated to one of these treatment processes depending on its function. In this way the costs of maintaining and operating assets can be collected at an asset level and charged automatically to the appropriate business category without (or with less) manual intervention.

Support functions require allocation to the published business units. In many cases, we use the internal charges used in the management accounts as the basis for the allocations – in this way the accounting separation data most closely reflects how the business charges itself for use of support services. We carry out this analysis for Information Technology, Scientific Services, Facilities Management and the Mechanical & Electrical departments.

In line with guidance, we allocate the costs of the following activities based on full time equivalent employees: Human resources including training and payroll, Finance & treasury, Legal & estates and public relations.

We use OFWATs request of 1/9th split to price controls of Economic Regulation. The cost allocation noted above resulted in the following split of Management and general costs in 2022-23

Water Resources	Water Treatment	Water Distribution	Sewerage	Sewage Treatment	Sludge Transport	Sludge Treatment	Sludge Disposal	Retail
5%	18%	24%	16%	23%	6%	5%	1%	2%

Significant movements in the year

We have identified significant movements in costs from 2021-22 below:

- Power consumption decreased across all areas:

15.9GWh (6.5%) reduction total, 1.8GWH (2.3%) in Water Treatment, 1.8GWh (7.0%) in Sewerage and 12.2GWh (8.8%) in Sewage and Sludge Treatment.

- Power price increased across all areas

An average £64.71 per MWh (56.9%) in total. £67.40/MWh (62.02%) in Water Treatment, £71.09/MWh (54.3%) in Sewerage and £61.39/MWh (54.2%) in Sewage / Sludge Treatment. Of the power costs incurred in the year, 98% were coded directly to price control.

- Income treated as negative expenditure has increased by circa £0.9m from 2021-22, also as a result of the increase in energy prices. Developer Services saw a £1.5m decrease in Supply New Connections which is driven by a lower level of new connections compared with 2021-22.

- Third Party Services saw a £0.9m decrease in Sewage Treatment rechargeable work relating to the provision of Covid sampling at WRC's that was undertaken in 2021-22 but not repeated at the same level 2022-23.

- Other Operating and Enhanced Operating expenditure increased by £23.0m overall of which 40% was coded directly to price control. Increases that impacted all areas included:
    - Soaring fuel prices £1.1m
    - Chemical price increases amounting to £3.1m
    - Insurance premiums costs increased £1.7m

In addition, variances for specific price controls in other operation expenditure are noted below:

- Water Resources – Increased by £1.5m of Other operating expenditure, primarily relating to salary, chemical and consumable cost increases.

- Water Treatment – Increased by £2.7m including of £0.7m personnel costs, £0.9m chemical prices and a share of the insurance premium increase noted above.

- Water Distribution – Increased by £6.1m including £3.7m related to employment costs (£2.6m for customer leaks), £0.7m for chemical prices and a share of the insurance premium increase. There was also and increase on £1.3m for hired and contracted costs (£0.9m customer leaks related).See table 4J commentary regarding the treatment of customer leaks for APR 22-23.

- Sewerage - Increased by £7.2m with additional spend on employment and external contractors of £3.6m, the biggest contributors being increased sewer jetting and tankering costs for pollution prevention, £0.9m for materials which is driven by chemicals and fuel price increases.

- Sludge Transport – Increased by £1.7m. Increased employment and contractor costs on sludge transport by £1.1m. Materials increased by £0.3m year on year due to increased chemical prices.

- Sludge Treatment - Increased by £4.0m. £1.9m employment related to increases to health and safety, site management and maintenance

- Sludge Disposal – Increased by £0.8m. Increased employment and contractor costs of £0.7m relating to increased costs of haulage and spreading largely reliant on fuel price.

5. Compliance & Audit

Compliance with RAG 2.09

We confirm that we have applied the principles and guidance as set out in:

- Table 2.4.1. Cost drivers for allocation operating costs between retail and wholesale, with the exception of:

Executive and Non-Executive Directors' remuneration is not captured on a timesheet basis. It is identified through the accounts as a support activity and therefore is allocated to service by FTE's.

We confirm that we have applied the principles and guidance as set out in:

- Table 2.5.1. Cost drivers for allocated operating costs between household and non-household

Specific details around the attribution of these costs are below:

Pelican legally and functionally separates the non-household function (Water2business) from its household function. This has lessened the need to make allocation of costs between household and non-household services.

Billing

All billing costs are captured directly to cost centres associated with Pelican and no allocation is required.

Payment handling

All payment-handling costs are captured directly to cost centres associated with Pelican Business Services and no allocation is required.

Vulnerable customer schemes

All vulnerable customer schemes administration is handled in one department and is wholly within the household service.

Non-network customer enquiries

We have separate call centres for Pelican and W2B and so costs relating to non-network customer enquiries are booked directly with no manual allocation required.

Debt management

We have separate debt management teams for Pelican and W2B and so costs relating to debt management are booked directly with no manual allocation required.

Meter reading

Meter reading costs are allocated between HH & NHH based on the number of meter readings taken.

Overheads – IT costs, finance, HR, payroll, facilities management

Water2Business Ltd have general management, finance and accommodation allocated directly. Charges from Pelican are excluded, where Water2Business is supported by Pelican Business Services, based on customer numbers.

Non-Pelican retail costs

The costs attributable to doubtful debts, £13.1m, is directly attributed to household customers.

Operational customer services costs are included within the "Customer Services" cost type and allocated based on the volume of network customer enquiries and complaints (contacts).

Operational customer services costs include:

- The scheduling of jobs triggered by a customer contact by our control room schedulers
- The inspectors that visit a customer's address to investigate a problem where it is found not to be a network issue
- Internally generated calls to the retail call centre to enable the customer contacts to be resolved.

The costs of our customer magazine are included as retail costs and are allocated to customer type based on customer numbers.

Centrally incurred debt management charges are allocated in full to household and represent the payment made to independent debt advice agencies such as the Citizens Advice Bureau. These payments support the agencies work in providing holistic debt advice. It enables our customers to have access to the Wessex Water's "tap" programme of affordability assistance.

The retail element of developer services costs are charged in full to non- household and include the cost of customer contact and raising quotes for new connections. Developer services costs are split between the administration (retail function) and the physical works on the network (wholesale). This allocation is possible due to separate cost centres and management review of work activities.

Local authority rates are allocated between customer numbers. The overall cost of local authority rates within Retail is small as it relates solely to our offices occupied by Pelican and an allocation for retail staff based at our head office.

Other operating expenditure includes the full cost of repairing and/or replacing customers' service pipes where there are leaks and the costs associated with the provision of water efficiency initiatives. The costs of customer side leaks between household and non-household are based on the categorisation of jobs and is reported directly from the workflow system.

Both Customer-side leak repairs and Demand-side water efficiency are allocated in full to the retail business unit, as we have no identified wholesale outcomes.

WWSL Capital costs

Our asset management framework subdivides our asset base into multiple asset groups. All capex is then allocated to one of these as the scheme is set up and then reviewed quarterly.

In most cases the asset groups align to the business units required, this is outlined in the table below:

Asset Group	Reporting Area
Impounding Reservoirs	Water Resources
Raw Water Aqueducts	Raw Water Transport
Trunk Mains	Treated Water Distribution
Distribution Mains	Treated Water Distribution
Service Pipes	Treated Water Distribution
Boreholes	Water Resources
Springs	Water Resources
Water Treatment Works	Water Treatment
Service Reservoirs	Treated Water Distribution
Booster Pumping Stations	Treated Water Distribution
Water Meters	Treated Water Distribution
Sewers	See note [1]
Rising Mains	Foul Sewers
Sea Outfalls	Foul Sewers
CSOs	See note [1]
Sewage Pumping Stations	See note [1]
Sewage Treatment Works	See note [2]
Sludge Treatment Centres	See note [3]
Transport and Plant	See note [4]
Information Systems	See note [4]
Lab Equipment	See note [4]
Property and FM	See note [4]
Monitoring and Control	See note [4]
Retail HH	See note [5]
Retail NHH	See note [5]

1. Sewers, CSOs and sewage pumping stations are allocated between foul, surface water & highway drainage based on:
    a. Capital maintenance is based on an analysis of our in-use sewer length
    b. Enhancement expenditure is allocated directly at a scheme level
2. Sewage treatment works costs at collocated sludge treatment centres are allocated between sewage treatment and returned sludge liquors:
    a. Capital maintenance is allocated using the same methodology as

operational costs

   b. Enhancement expenditure is allocated directly at scheme level

3. Sludge expenditure is allocated based on a scheme level review of all capital expenditure
4. Management and general expenditure is allocated to the price control units based on principle use; this is then allocated within the price control units based on the split of depreciation

5. Retail HH and NHH capex is assessed directly at a scheme level

Disaggregation of wholesale activities – Upstream reporting

Some costs are not allocated to the Ofwat requirements in our corporate finance system and it has been necessary to make a small number of adjustments. We make such adjustments where we consider the initial analysis is materially inconsistent with Ofwat guidance e.g., all fisheries costs charged to third party services rather than direct costs of resources.

Power costs are booked within the general ledger system at a site level. Where sites conduct more than one activity and there is no sub-metering then we make manual adjustments to allocated power costs appropriately. The allocation of power between the different water service activities is based on an average of three years pumping head data at a site level.

Historically we have aimed to identify specific operating costs that are identifiable as raw water distribution; however, the only material opex cost would potentially be power as we do have pumping costs for pumping raw water from sources to treatment works. Applying the rule that water is transferred to one business unit to another via a pump means that these power costs are actually included in the water resources business unit as the pumps are located at the water resources site. Considering this, along with the small amount of raw water aqueducts we have and the fact that we have no customers supplied with raw water, we do not believe there is a viable separated raw water distribution business unit within our boundary.

Similarly, we have no raw water storage facilities and so do not consider that there is a viable separate raw water storage business unit within our boundary. As such, we allocate ‘Other business activities’ costs equally across eight business units – seven Wholesale and one Retail.

Table 4D - Water supply analysis

Water resources

Raw water distribution

As discussed above we do not consider ourselves to have a viable raw water distribution business unit and so no costs are allocated here.

Raw water storage

As discussed above we do not consider ourselves to have a viable raw water storage business unit and so no costs are allocated here.

Water treatment

This activity is not required to be analysed further.

Treated water distribution

This activity is not required to be analysed further.

Depreciation costs

Each asset is allocated to the individual business unit as appropriate, based on principal use. Support function HCD and any capitalised interest allocation is now based on principle use of the asset and recharged as appropriate based on the same cost drivers as opex allocation.

Table 4E - Waste water analysis

Sewage collection

Sewage collection has continued to prove particularly difficult to allocate to the required upstream services. We have however developed an approach to deriving an allocation and this is described below:

The starting point is Table 2B from the Annual Performance Report, Wastewater.

Operating costs are allocated based on the measured foul flow at works as a proportion of total measured flows. These values are taken from our sewage works information management system (SWIMS) which has been independently certified by MCERTS. The foul flows element is allocated to the foul water sewerage consistent with our measured dry weather flow (DWF) at sewage treatment works with the balance being equally apportioned to surface water and highways drainage. This information is based on a three- year rolling average basis.

Foul flow at works	460 Ml/d
Additional storm flows	442 Ml/d
Total SWIMS flow at works	906 Ml/d

Capital charges are allocation based on the length of sewers with a weighting to the likely use (taken from Table 7C):

	Foul Only	Storm only	Dual	Rising Main	Total	%
Sewer length (km)	9,237	4,479	3,121	1,260	18,096	
Foul proportion (%)	100%	0%	80%	100%	12,994	72%
Storm proportion (%)	0%	100%	20%	0%	5,103	28%

Sewage treatment and disposal

This activity is not required to be analysed further except to remove the costs involved in imported sludge liquor treatment as below.

Imported sludge liquor treatment

Liquors from sludge treatment arise from both thickening and dewatering. These liquors are returned to the head of the sewage treatment works (STW) associated with the sludge treatment centre (STC) for treatment with incoming sewage. The proportion of STW costs associated with liquor treatment has been derived from an estimation of the sludge liquor volume and organic load and comparing it with the total load and flow treated by the STW.

To estimate sludge liquor volume and load, we calculate sludge production figures (mass and volume). This data originates from measured loads exported from each STC. These figures are shared between indigenous and imported sludge based on logger data for imported sludge (volume and thickness) and theoretically calculated figures for indigenous sludge. The costs of liquor treatment have been calculated and subtracted from the sewage treatment business unit.

The pipework to take liquors back to the head of the works are accounted for as non-infrastructure.

Sludge transport

The operating costs are captured separately within our corporate finance system, as it is run as if it were a separate business entity. The internal business unit is fully responsible for tankering between STW and STC. The business unit includes running an internal fleet of tankers and using external tankers when operational requirements cannot be met by the internal facility.

The cost types captured include staffing and fuel costs. This makes capturing costs at this disaggregated level more straightforward.

Sludge disposal

This activity is not required to be analysed further.

Each asset is allocated to the individual business unit as appropriate, based on principal use.

Support function HCD allocation is now based on principle use of the asset and recharged as appropriate based on the same cost drivers as opex allocation.

Depreciation costs

Each asset is allocated to the individual business unit as appropriate, based on principal use.

Support function HCD and any capitalised interest allocation is now based on principle use of the asset and recharged as appropriate based on the same cost drivers as opex allocation.

Assurance processes

The assurance process involves an internal review procedure that includes segregated roles and sign off of individual table certificates by data originators, data compilers and owners. This process is carried out to ensure compliance with Ofwat letter MD209 and a true and fair view of the performance of the company.

In this area, the data owners are the WWSL Head of Finance and the Pelican Head of Finance.

The Regulatory finance manager, WWSL Head of Finance, Regulatory Accountant and Financial Accountant compile the analysis and methodology statement.

Both the analysis and methodology statement are scrutinised and challenged by the Director of Regulation and Group Financial Controller. A version and change control process is used throughout the process and a “major” version is recorded when the table owner, in this case, the Group Financial Controller is satisfied.

An external audit is carried out by our financial auditors, Ernst & Young LLP and our technical auditors, Mott MacDonald, with reference to current regulatory accounting guidelines and any annual specific guidance.

Following internal and external challenge, the Annual Performance Report is presented in full to the company Audit & Risk Committee. The Audit & Risk Committee use the meeting as an opportunity to challenge specific areas and presentations made by senior managers. Feedback from the Audit & Risk Committee is acted upon before being approved by Board members prior to publication.

Through this challenge and signoff process, the company’s management is satisfied that the attribution and allocation of costs is reasonable.