

ACCOUNTING SEPARATION METHODOLOGY STATEMENT: 2016-17

Document revisions

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ACCOUNTING SEPARATION METHODOLOGY STATEMENT: 2016-17

The purpose of this methodology statement is to assist the reader of the company Annual Performance Report 2016-17, in particular to give information on how the company has met the requirements of the Regulated Accounting Guidelines (RAGS) for the attribution of costs between price control units and further subdivisions of costs by activities. It includes any material changes to the methodology from previous years.

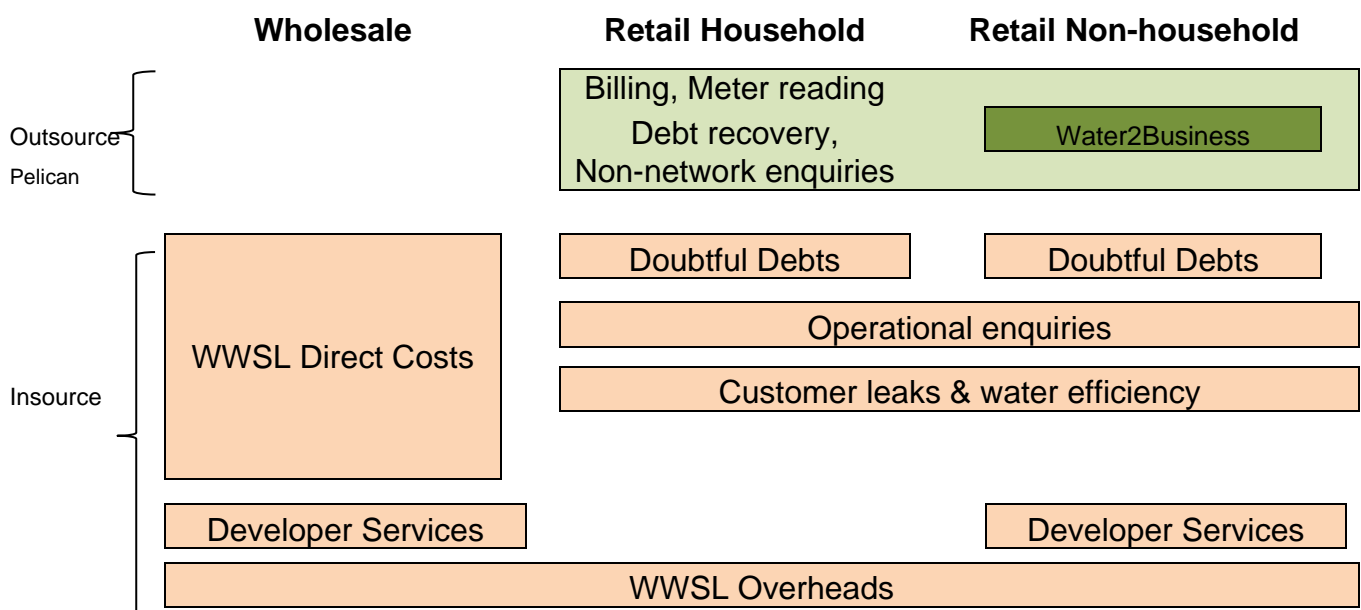
Business structure – Background to the business

Wessex Water’s appointed operational activities are largely carried out on an insourced basis.

The major exception to this is the use of Pelican Business Services Ltd (Pelican) for billing, debt recovery and customer services. Just over 40% of total retail costs are invoiced to Wessex Water Services Ltd. (WWSL) by Pelican.

Pelican has functionally separated its non-household retail services into a division operating under the trading name Water2Business (W2B). Since April 2016, Water2Business Ltd has replaced Pelican as the appointed non household billing agent for WWSL.

During the reporting year operational enquiries and developer services activities continue to be dealt with on an insourced basis within WWSL. Retail customer-side leak repairs and water efficiency promotional activities are undertaken by WWSL, predominantly using in-house resources.



Principles Applied

Our methodology is aligned with the RAG 2.06 and RAG 4.06 to the extent that they cover the principles, definitions and cost drivers to be used in pro forma tables 1A to 1D, 2B, 2C, 2D, 4D, 4E and 4F of the annual performance report between:

- Retail and wholesale services
- Household and no-household retail services
- Services for measured and unmeasured customers

We have separately confirmed that WWSL complies with the principles of RAG 5.06 – Transfer Pricing in the Annual Performance Report.

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

We confirm we have followed the general principles as set out in RAG 2.06 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.

Material Changes to methodology for 2016-17

There have been very few material changes since 2015-16, the two changes of note are:

- The allocation of power and business rates are our largest collocated ST/STC, this is now captured directly rather than being reliant on apportionment and a manual adjustment
- The separation of Pelican and W2B has removed the need for most manual allocation of costs between retail business units, this is covered in greater detail later
- We have adjusted the infrastructure maintenance in the upstream tables, transferring a portion to other operating expenditure to align to current IFRS accounting standards

Operating Costs

All operating costs are booked against a cost centre with an owner that manages the costs.

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

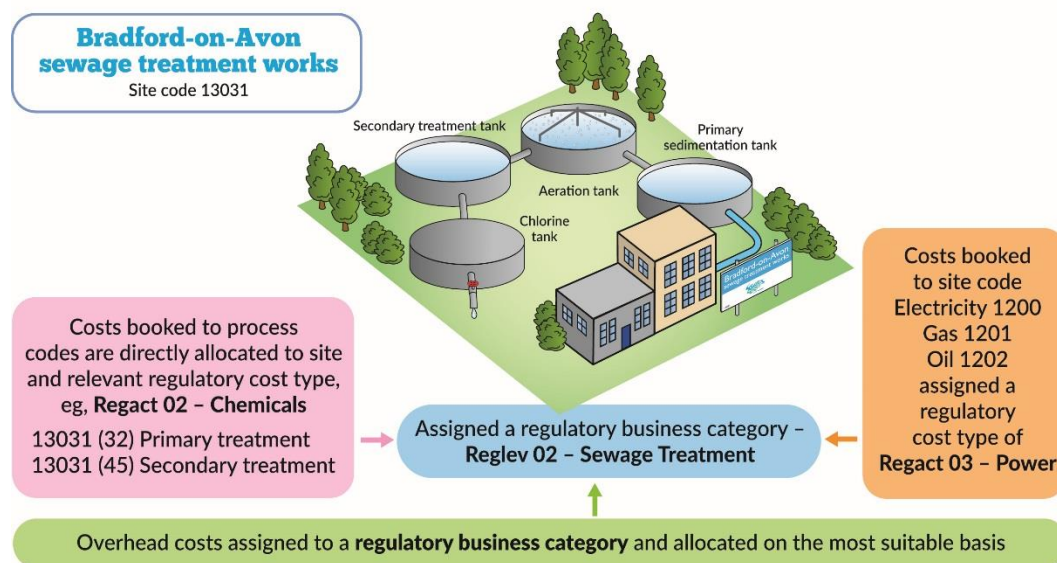
All cost centres within the company General Ledger system are aligned to regulatory business units for accounting separation reporting purposes.

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. local authority rates.

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 year we have specifically reviewed the allocation of these account codes and cost centres in light of increased focus on the separation of our water resources and bioresources business units.

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 new 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 each 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 Services, 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, Chief Executives office, Legal & estates and Public relations.

Significant movements in the year

We have identified significant movements in costs from 2015-16 below:

- Water resources service charges have increased following a one off credit from the Environment Agency for abstraction charging in 2015-16
- Water distribution third party costs have reduced following a reduction in developer activity, specifically mains diversions
- Sewerage power costs have reduced due to the reduced rainfall in 2016-17 when compared to prior years (710mm vs 908mm)
- Other direct costs on sewage treatment have increased, and sludge treatment has decreased as a result of the allocation of the IAS19 pension adjustment

Compliance with RAG 2.06

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 has functionally separated its 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 or W2B and no allocation is required.

Payment handling

All payment-handling costs are captured directly to cost centres associated with Pelican or W2B 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 have general management, finance and accommodation allocated directly and costs charged to non-household. Charges from Pelican are apportioned to non-household, where Water2Business is supported by Pelican, based on customer numbers.

Services for measured and unmeasured customers

All cost centre areas are considered separately by management to determine what service is provided to measured and unmeasured customers. All the other operating expenditure areas are split using a billing system report by customer numbers. Water2Business non-household activities are predominantly for measured customers, the split is based on non-household customer numbers. All the meter reading costs and leakage are 100% measured.

Non-Pelican retail costs

The costs attributable to doubtful debts, £11.85m, is directly attributed to customer type (meaning household or non-household).

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 BWBSL 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

The starting point for the analysis is to take the values as reported in Table 2B of the Annual Performance Report for 2015-16 and allocate to each upstream service.

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 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 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 separated 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

We separately identify the operating costs of abstraction licences within the corporate finance system and allocate the remaining balance to the costs of raw water abstraction. Abstraction charges are set by the Environment Agency and are designed to recover the costs incurred in ensuring water

resources are managed effectively. This includes ensuring the rights of existing licence holders to abstract water are protected against the granting of new licences.

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 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	588 MI/d
Additional storm flows	283 MI/d
Total SWIMS flow at works	871 MI/d

Capital charges are allocation based on the length of sewers with a weighting to the likely use:

	Foul Only	Storm only	Dual	Rising Main	Total	%
Sewer length (km)	7151	6100	3359	1178	17788	
Foul proportion (%)	100%	0%	80%	100%	11016	62%
Storm proportion (%)	0%	100%	20%	0%	6772	38%

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

Upstream Services – Cost Drivers

Business Unit	Cost Driver	Comments
Water resources – Abstraction licenses	Licensed volume available (MI)	Consistent with the companies water resource management plan
Water resources – Raw water abstraction	Volume abstracted (MI)	Equivalent to the Junes return 2011 Table 10b line 4 but on an annual rather than daily basis
Water treatment	Distribution input volume (MI)	Equivalent to the June return 2011 Table 10 line 26 but on an annual rather than daily basis
Treated water distribution	Distribution input volume (MI)	Equivalent to the June return 2011 Table 10 line 26 but on an annual rather than daily basis.
Sewage collection - foul	Volume collected (MI)	June return 2011 table 14 line 4 but on an annual rather than daily basis multiplied by the split used to allocate opex to foul sewers (c68%)
Sewage collection – surface water drainage	Volume collected (MI)	June return 2011 table 14 line 4 but on an annual rather than daily basis multiplied by the

		split used to allocate opex to surface water drainage (c16%)
Sewage collection – highway drainage	Volume collected (MI)	June return 2011 table 14 line 4 but on an annual rather than daily basis multiplied by the split used to allocate opex to highway drainage (c16%)
Sewage treatment and disposal	Biochemical oxygen demand (BOD) tonnes	This is equivalent to the June Return 2011 definition table 15 line 5
Imported liquor treatment	Biochemical oxygen demand (BOD) tonnes	This is an engineering estimate based on the sites that we capture costs for the liquor treatment processes
Sludge transport	Volume transported	This is the volume captured by the in-house sludge tankering team which transports sludge from sewage treatment works to sludge treatment centres
Sludge treatment	Dried solid mass in tonnes of dried solids (ttds)	This is equivalent to the June Return 2011 definition table 15 line 14
Sludge disposal	Dried solid mass in tonnes of dried solid (ttds)	This is equivalent to the June Return 2011 definition table 15 line 14

The additional cost driver required this year connected population.

Table 4F – Disaggregation of the household retail analysis

We have reviewed the potential candidate cost drivers as set out in the guidance: “possible cost drivers for allocation household retail operating costs between measured and unmeasured”. We have used this as a guide to identify the cost drivers used below to allocated expenditure:

Heading	Cost	Cost driver used
Customer services	Billing	Number of bills raised
Customer services	Payment handling, remittance and cash handling	Number of bills raised
Customer services	Vulnerable customer schemes	Number of customers
Customer services	Non-network customer enquiries and complaints	Number of enquiries

Customer services	Network customer enquiries and complaints	Customer numbers
Customer services	Investigatory visits/first visit to the customer	Customer numbers
Customer services	Other customer services	Customer numbers
Debt management	Debt management	Debt outstanding for more than 30 days for the measured / unmeasured split then based on customer numbers between the further three categories
Doubtful debts	Customer doubtful debts	Direct attribution to measured and unmeasured then allocation between the further categories based on number of services
Meter reading	Meter reading	Direct attribution to measured then allocated to the three measured customer types based on customer numbers
Other operating expenditure	Demand side water efficiency initiatives	Customer numbers
Other operating expenditure	Customer side leaks	Customer numbers
Other operating expenditure	Other direct costs	Customer numbers
Other operating expenditure	General and support costs (exc. transport)	Customer numbers
Other operating expenditure	General and support costs - transport	The costs of Meter reading vans are passed on as part of the management fee. The vans are owned and maintained by Pelican and allocated entirely to measured services.
Other operating expenditure	Other business activities	Customer numbers
Other operating expenditure	Local authority rates	Customer numbers
Depreciation	Depreciation	HCD is driven by assets allocated individually to household and non-household. The household

		<p>measured/non-measured split is by customer numbers.</p> <p>Support function HCD is recharged from wholesale based on the same drivers as used for the allocation of opex overheads for corresponding overhead departments.</p>
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Ongoing Improvements

In light of further separation of the business into five price control units (Water resources, Water Network+, Wastewater Network+, Bioresources & Retail) we are currently investing in additional monitoring equipment to greatly increase the accuracy of in subsequent years.

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 company group finance manager and the Pelican Director of finance.

The Regulatory finance manager, group finance manager 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 reform and 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 Financial controller is satisfied.

An external audit is carried out by our financial auditors, KPMG, with reference to current regulatory accounting guidelines and any annual specific guidance.

Following internal and external challenge, the Regulatory accounts are presented in full to the company Audit Committee. The Audit Committee use the meeting as an opportunity to challenge specific areas and presentations made by senior managers. Feedback from the Audit 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.