Accounting Separation Methodology Statement
for 2012/13

This statement explains the way in which the Company completes the Operating Cost Analysis and the Current Cost Analysis of Fixed Assets shown on pages 84-87 of the Company’s 2013 Annual Report.

The statement is in two parts:

1. A review of the 2012/13 analyses, focusing on changes in methodologies or allocations from those adopted in previous years and an explanation of the key changes in costs from 2011/12; and
2. A detailed procedure statement, summarising the steps involved in producing the analyses from the Company’s accounting records.

The statement is produced to meet the requirements of the Water Services Regulatory Authority’s (Ofwat’s) guidelines for accounting information, as published in Regulatory Accounting Guidelines (RAGs) 1.05, 2.04, 3.07, 4.04 and 5.05 and associated materials, including Information Note 13/01. The content of the Company’s regulatory accounts for 2012/13, including the Operating Cost Analysis and the Current Cost Analysis of Fixed Assets covered by this methodology statement, have been audited by the Company’s external auditors, who expressed an unqualified opinion that they conformed with Condition F of the Company’s Instrument of Appointment, the Regulatory Accounting Guidelines and the accounting policies set out on pages 53 to 55 and page 72 of the Company’s 2013 Annual Report and in this accounting separation methodology statement.
Changes in allocations in 2012/13

The principal changes in the allocation of costs between Retail and Wholesale activities implemented in 2012/13, and the reasons for the changes are:

1. Meter assets (and associated depreciation), previously included in Retail, have been transferred to Wholesale functions in response to a change in definition issued by the Water Services Regulatory Authority in RAG 4.04;
2. Meter maintenance activities, previously included in Retail, have been transferred to Wholesale functions in response to the same change in definition issued by the Water Services Regulatory Authority;
3. The cost of water quality samples taken as a result of a query on water quality by a customer has been transferred to Retail (whereas the cost of samples taken as part of the Company’s statutory compliance programme has remained within Wholesale), in response to discussions at the Company’s meeting with representatives of Ofwat and Ernst and Young undertaking the targeted review of 2011/12 accounting separation data and methodologies; and
4. Credit Rating Agency fees have been allocated to Wholesale rather than split across Wholesale and Retail, on the basis that the Company maintains published credit ratings to underpin the external borrowing required to fund the capital investment programme, which has been allocated entirely to Wholesale in accordance with the definition issued by the Water Service Regulatory Authority in RAG 4.04.

One allocation which the targeted review of 2011/12 data and methodologies suggested should be changed has not been changed. Indirect employment costs of £49k have continued to be treated as General and Support Expenditure within Retail, rather than being included within direct costs within Retail, because these costs are an allocation of shared, indirect support costs from central finance rather than costs directly attributable to the Retail function.

Key Changes in Costs from 2011/12

Total operating costs (including current cost capital maintenance charges) for the appointed business as a whole increased by £1,279k or 3.0%. Capital maintenance charges increased by £884k or 5.7% in aggregate, whilst third party services costs reduced by £478k or 26.6% from the atypically high levels of third party work recognised in 2011/12.

Comparisons of Wholesale and Retail expenditure and costs between the two years were distorted by the changes in reporting requirements described above. In particular, the transfer of meter assets from Retail to Wholesale had a major impact on
capital maintenance charges, which reduced by £1,226k for Retail and increased by £2,110k for Wholesale. The transfer of assets with a gross replacement cost of £49,381k and accumulated depreciation of £21,356k from Retail to Wholesale activities is shown on the face of the Current Cost Analysis of Fixed assets shown on pages 86 and 87 of the 2013 Annual Report.

Operating expenditure before capital maintenance charges moved broadly in line for Wholesale (up £721k or 3.6%) and Retail (up £152k or 2.7%). Within Retail, expenditure on household services increased by £191k or 3.8%, whilst non-household costs reduced by £36k or 7.0%, largely as a result of a reduction of £35k in doubtful debts associated with non-household customers.
Part 2
Accounting Separation Methodology Procedure Statement

The General Ledger in the Company’s accounting system (Navision) is the source for all the expenditure reflected in the Operating Cost Analyses for both Table 21 and the new accounting separation tables.

**Step 1** Transactions in the General Ledger all have Cost Centres and expense type account codes allocated at the time of their initial capture. For most operational areas the Cost Centre is location and purpose specific, so it is possible by reviewing each Cost Centre and account code combination to identify the appropriate accounting separation category. Operational costs which do not lend themselves to such direct allocation – typically covering centralised, support, or management costs such as GIS and Health & Safety – are dealt with subsequently.

Allocation of an accounting separation code is possible for the majority of transactions, which are recognised as Direct costs in the Operating Cost Analysis tables because the original coding is well established, detailed and reliable. The Cost Centre and account code structure has been in place since the early 1990’s and the employees involved in coding transactions for initial capture (those approving the original invoices) have generally been in post a number of years. They are therefore familiar with the requirement to ensure costs are captured with an appropriate degree of granularity, and will apply knowledge of the work undertaken/service provided to allocate a single invoice – for say a series of repairs carried out across a number of locations – to the appropriate location’s Cost Centre for capture in the General Ledger. Similarly, all internal costs are either location specific (for example, a works supervisor) or are charged to labour recharge rates which are then booked to location specific activities by timesheets and job costing processes. This enables identification of the cost of work done at each site by, for example, mechanical and electrical maintenance gangs – and consequently, by accounting separation activity classification. For network activity, job-type codes enable identification of work undertaken by District Inspectors and works gangs by type of work, which enables appropriate classification to raw and treated water distribution and retail.

Over 65% of total operating costs are allocated to Direct costs in the Operating Cost Analysis tables in this initial step. The remaining 35% is left in the “General and Support” pool for allocation in subsequent steps. Diagram 1 shows the subsequent steps in completion of the tables. Each step is described below.

**Step 2** involves coding specific costs in the residual “General and Support” pool to Direct costs of activities where this is known to be a requirement. This addresses a limited number of costs, including:

- Remittance processing – from Finance to Retail;
- GIS team – to Treated Water Distribution;
- Health & Safety – split across activities according to direct employment costs;
• Stores overhead recovery and support costs included in charges for third party work – allocated to Treated Water Distribution and Retail according to the direct third party costs already booked; and
• Water efficiency activities – from Treated Water Distribution to Retail.

**Step 3** involves the re-analysis of labour recharges already included in Direct costs into employment and other costs to ensure the split by expense type is correct.

**Step 4** is the allocation of the first tranche of General and Support costs to activities or to other areas of General and Support for subsequent allocation to activities. Allocations to activities have been based on the following drivers:
- Finance, Directors (including NEDs), secretaries, health insurance – by total direct costs;
- HR, pension scheme management fee, PPF levy, benefit changes consultancy and FRS17 adjustments – by direct employment costs;
- Insurance and operational rates – by MEAVs;
- IT – billing system costs to Retail;
- Publicity – to Retail; and
- OFWAT– equal split across all activities
- Credit Rating Agency fees – equal split across water service business units

All remaining costs have been re-allocated to departments within General and Support according to headcount, on the basis that the costs either relate to the Redhill head office site (and are primarily driven by the occupancy of the site) or lack a more appropriate driver. The costs reallocated in this way at this stage are:
- IT – remaining costs after billing system costs removed;
- Facilities – building maintenance, security, etc;
- Rates – for the Redhill office only;
- Telephones – the general switchboard lines (Customer Service lines are booked direct to Retail);
- General postage – billing and debt recovery postage are booked direct to Retail; and
- Legal and other professional fees – including tax advice, cost of the annual report, etc.

**Step 5** is to transfer the allocations undertaken in Step 4 to the reporting activity categories using the same drivers as was used to allocate the “direct” departmental costs to reporting activity categories. In 2011, the operational contact centre previously within Distribution and the Customer Accounts Department were restructured into a single Customer Services Department. In summary this results in “direct” and allocated departmental costs being allocated to reporting activities as follows:
- Customer Services – to Retail;
- Finance – remittance processing direct to Retail; other Finance costs allocated based on total Direct costs;
- Distribution –to Treated Water Distribution;
- Works – to Treated Water Distribution;
- Health & Safety, and Directors – allocated according to total Direct costs; and
• Laboratory – to Scientific Services (see below).

**Step 6** is to allocate Laboratory and Water Quality costs (Scientific Services) – both direct and allocated – to the reporting activity categories, based on separate analyses for sampling, laboratory analysis and process science activities. Sampling activities have been split 2.5%, 4%, 16% and 77.5% to retail (for sampling at customers' taps), water resources, water treatment, and treated water distribution respectively based on a management review of sampling activities. Analysis activities are split to the same three categories 21%, 43%, 36% based on actual analyses undertaken. Process science activities are split 25%, 60%, 15% based on management assessment.

**Step 7** is to allocate Other Business Activities (costs of regulation) across reporting activity categories. This has been split equally across the business units, in line with OFWAT's instruction to split the OFWAT licence fee accordingly.

This completes the cost allocations up to Total Operating Expenditure.

**Infrastructure Renewals Charge**
The IRC is allocated entirely to Treated Water Distribution, based on the MEA gross book value of the infrastructure assets in this category.

**Current Cost Depreciation**
Please refer to the Asset Methodology note.

**Amortisation of intangible assets**
This is the goodwill arising on the merger of Sutton District Water and East Surrey Water in 1996 and is split equally across the business units.

**Retail**
Direct costs are allocated to the Retail business unit as described in Step 1.
Other costs are allocated to the Retail business unit as described in Steps 2 to 7.
Costs are split between Household and Non-Household on the following bases:
<table>
<thead>
<tr>
<th>Line</th>
<th>Activity</th>
<th>Driver</th>
</tr>
</thead>
</table>
| 1    | Customer Services         | Billing – number of customers  
Payment handling – number of contacts  
Non-network contacts – number of enquiries  
Network customer enquiries – number of enquiries |
| 2    | Debt management           | Number of accounts in debt                                             |
| 3    | Doubtful debts            | Actual amounts written off, then number of accounts in debt            |
| 4    | Meter reading             | Number of metered customers                                            |
| 5    | Services to developers    | N/A                                                                    |
| 6    | Other operating expenditure | Percentages derived from total of line 1 to 5 allocations             |
| 7    | Local authority rates     | Number of properties                                                   |
| 8    | Third party services      | All non-household                                                      |
### Diagram 1: Steps in Completion of Activity Costing Analysis Tables

<table>
<thead>
<tr>
<th>Step</th>
<th>Unallocated Cost Pool</th>
<th>General and Support Pool</th>
<th>Direct Costs</th>
<th>Allocated Indexed Costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Review Cost Centre &amp; Account Code Combination</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>Balance</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2.</td>
<td>Review specific 'Direct' costs</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3.</td>
<td>Reanalyse labour recharges into expense type</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4.</td>
<td>Allocate to Activities or to departments by cost driver</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5.</td>
<td>Reallocations to departments to Activities by drivers – Step 4</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6.</td>
<td>Water Quality to Activities</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7.</td>
<td>Other Business Activities to Activities</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Asset Methodology
A Company engineer has reviewed the asset database used for statutory and regulatory accounts purposes and an additional code has been added to each operational asset to indicate either its business unit, or that it is a general and support or scientific services asset. Other tangible assets are already coded by their cost centre codes within the database, and each cost centre is allocated to a business unit, where possible. Where a cost centre spans business units, the asset is split in the same way as the opex for that cost centre has been split, for example by direct costs, direct employment costs, MEA asset values, etc.

The information is separated into Water Resources, Raw Water Distribution, Water Treatment, Treated Water Distribution, Retail, General and Support and Scientific Services.

The General and Support assets are allocated across the business units pro rata to the General and Support opex costs.

The Scientific Services assets are allocated across Water Resources, Raw Water Distribution and Water Treatment pro rata to the Scientific Services opex costs.

The Retail assets are split into Household and Non-Household by the number of metered customers.