Accounting Separation Methodology Statement for 2013/14

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 104-107 of the Company's 2014 Annual Report.

The statement is in two parts:

1. A review of the 2013/14 analyses, focusing on changes in methodologies or allocations from those adopted in previous years and an explanation of the key changes in costs from 2012/13; 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 2013/14, 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 page 91 and pages 98 and 99 of the Company's 2014 Annual Report and in this accounting separation methodology statement.

Part 1

Review of 2013/14 Accounting Separation Statements

Changes in allocations in 2013/14

There have been no changes in 2013/14 to the allocation of costs between Retail and Wholesale activities.

One allocation which the targeted review of 2011/12 data and methodologies suggested should be changed has not been changed. Indirect employment costs of £53k 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 2012/13

Total operating costs (excluding current cost capital maintenance charges) for the appointed business as a whole increased by £1,638k (5.9%), comprising power of £1,059k, inflation of £748k, PR14 costs of £500k and an increase in the bad debt provision of £187k, offset by savings in other areas of £856k.

Wholesale
Operating expenditure (before capital maintenance charges) increased by £1,202k, or 5.5%/, largely due to higher power costs of £1,059k, and additional PR14 costs of £400k allocated to the four Wholesale business units, in accordance with Ofwat guidance. If these two items are excluded, real savings were £849k, after allowing for inflation of £592k. Within Wholesale, the major increases on 2012/13 were in Water Treatment, which suffered the whole of the increase in power costs and £100k of the increase in regulation costs for PR14. Net other costs in Water Treatment reduced by £128k. Treated water distribution costs increased by only £40k, despite the impact of inflation and a share of the PR14 cost increases, largely due to savings from the mild (but exceptionally wet) winter. Water Resources costs also only increased marginally (by £20k), despite a share of the PR14 cost increase, with savings of £160k largely attributable to a waiving of the Environment Agency's EIUC charge. Operating expenditure for Raw Water Distribution increased by £111k (89%), due entirely to increased costs for PR14.

Retail
Operating expenditure (before capital maintenance charges) increased by £437k (7.6%), due to an increase of £187k in the bad debt provision and higher regulation costs of £100k already mentioned. Despite a number of efficiency initiatives, the impact of inflation (£157k) was not mitigated as such a high proportion of Retail costs are related to the costs of employment.

Within Retail, expenditure on household services increased by £382k or 7.3%, whilst non-household costs increased by £54k or 11.37%, both largely as a result of a the increase in bad debt provision already mentioned. Meter reading costs increased by

14.6%, due to the increased in metered customers. Local authority rates are allocated on the basis of the number of seats occupied within our head office building. A larger proportion of metered household customers has driven an increase in the number of call centre staff, which, when coupled with council tax charge £8k higher than the previous year, has led to an increase of 24.3% year-on-year. There has been a 14.1% increase in costs relating to Third Party Services, reflecting the higher value of works being undertaken.

Debt written off
No bills are raised in the name of “The Occupier”.

Outstanding balances on customers’ accounts are normally only written off as bad debts when the customer can no longer be located, all means of recovery have been exhausted or the cost of recovery is disproportionate to the value of the debt. There has been no change in this policy in the year. Provision is made for doubtful debt based on its age and the recovery processes already applied and historic recovery rates. There has been no material impact on the bad debt charge for the application of this policy during the year.

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 locational 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 (incl. 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 25%, 44%, 31% based on actual analyses undertaken. Process science activities are split 30%, 40%, 30% 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.

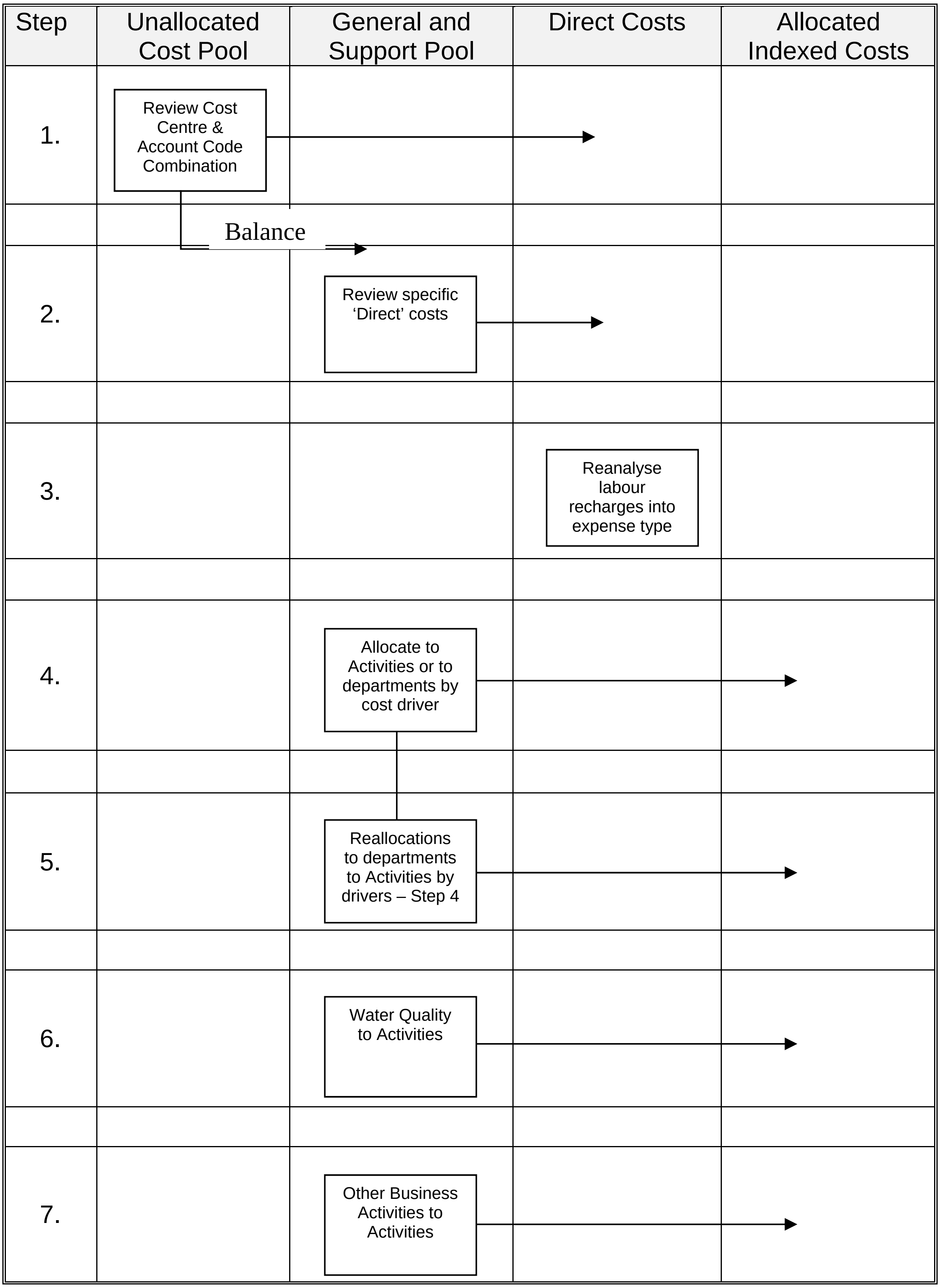
Current Cost Depreciation
Please refer to the Asset Methodology note.

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:

Line	Activity	Driver
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



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.

The Company maintains a CCA register which contains the same assets as the HCA Register.

The analysis of assets allocated to Retail is shown in the following table:

		Billing System	Other Assets
Gross replacement cost		£	£
At 1 April		1,085,597	856,934
Reclassification adjustment			0
RPI adjustment		26,627	16,798
Disposals			-111,858
Additions			256,327
At 31 March		1,112,224	1,018,201
Depreciation			
At 1 April		914,748	464,528
Reclassification adjustment			0
RPI adjustment		22,437	7,902
Disposals			-106,121
Charge for year		52,626	171,352
At 31 March		989,811	537,661
Net book value at	31/03/2014	122,413	480,540