Accounting Separation Methodology Statement
for 2017/18

This statement explains the way in which Sutton and East Surrey Water plc, trading as SES Water (the ‘Company’), completes the analysis of costs between the relevant binding price controls (Wholesale and Household Retail) for the relevant tables in the Company’s 2018 Regulatory Accounts.

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) 1.08, 2.07, 3.10, 4.07 and 5.07 and associated materials.

This methodology statement covers the following tables:

Table 2B Wholesale Totex Analysis
Table 2C Operating Costs Analysis: Retail
Table 2D Historic Cost Analysis of Fixed Assets: Wholesale & Retail

The content of the abovementioned tables has 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 RAGs and the accounting policies set out on pages 70 to 73 of the Company’s Annual Report 2018 and in this accounting separation methodology statement.
**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 the 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. This makes it possible to review 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 and Safety – are dealt with subsequently.

Allocation of an accounting separation code is possible for the majority of transactions, which are directly allocated in the Totex Analysis – Wholesale and Operating Cost Analysis - Retail 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. They will apply knowledge of the work undertaken/service provided to allocate a single invoice – for example for 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. This enables appropriate classification to raw and treated water distribution and retail.

Over 63% of total operating costs are allocated directly in the Totex Analysis – Wholesale and Operating Cost Analysis - Retail tables in this initial step. The remaining 37% is left in General and Support, Scientific Services, Rechargeable Works and Other Business Activities for allocation in subsequent steps. In Appendix 1 diagram 1 shows the subsequent steps in completion of the tables. Each step is described below.

**Step 2**
Requires 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:

- Production Administration costs – split across wholesale business units in proportion to direct costs
- Water efficiency activities – from Treated Water Distribution to Retail; and
• Billing system costs – to Retail.

Step 3
General and Support costs are allocated between Wholesale and Retail using the following drivers:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
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</thead>
<tbody>
<tr>
<td>Corporate Services (Administration)</td>
<td>FTE’s</td>
</tr>
<tr>
<td>Amenities</td>
<td>All Wholesale</td>
</tr>
<tr>
<td>Compliance and Assurance</td>
<td>FTE’s</td>
</tr>
<tr>
<td>IT</td>
<td>FTE’s</td>
</tr>
<tr>
<td>Executive and Non-Executive Directors</td>
<td>FTE’s</td>
</tr>
<tr>
<td>Finance and Human Resources</td>
<td>FTE’s</td>
</tr>
<tr>
<td>Health &amp; Safety</td>
<td>FTE’s</td>
</tr>
<tr>
<td>Innovation</td>
<td>FTE’s</td>
</tr>
<tr>
<td>Non-Operational Buildings</td>
<td>Floor space</td>
</tr>
<tr>
<td>Communications</td>
<td>FTE’s</td>
</tr>
</tbody>
</table>

Cumulo Rates have been allocated based on CCA asset values and council tax has been allocated based on Floor Space.

Step 4
Allocate Laboratory and Water Quality costs (Scientific Services) to the reporting activity categories, based on separate analyses for sampling, laboratory analysis and process science activities. Sampling activities have been split 3.3%, 21.9%, 36.9% and 37.9% to Retail (for sampling at customers’ taps), Water Resources, Water Treatment, and Treated Water Distribution respectively based on a management review of sampling activities.

Step 5
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.
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 5. The company no longer has Non-Household customers and all costs are therefore allocated to Household.
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 operating expenditure 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. General and Support assets are allocated to the Wholesale business unit and the capital costs are recharged using the same drivers as used for operating expenditure.

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

The Retail assets are allocated to Household.
Appendix 1

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>Balance</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

2. Review specific ‘Direct’ costs

3. Allocate General and Support costs

4. Water Quality to Activities

5. Other Business Activities to Activities