

**Dee Valley Water plc**  
**Year ended 31 March 2016**

**Annual Performance Report - accounting separation and upstream services methodology statement**

This methodology statement explains how the accounting separation analysis tables in the 2015/16 Annual Performance Report ('APR') have been produced, with specific reference to the wholesale and retail activity costing analysis (tables 2C, 4D and 4F in the pack submitted alongside the APR).

The methodology applied in the preparation of the 2015/16 accounts is consistent with the guidance included in IN15/18 '*Expectations for company reporting 2015-16*' and the current version of the RAGs, published in October 2015.

**1. Background to the business**

The compliance statement included in the APR gives details of internal systems, processes and Board governance procedures relevant to Dee Valley Water Plc ('DVW'), including the steps taken during the year to enhance the Company's internal assurance processes and the role of this internal assurance team in the delivery of the Company's assurance plan.

The underlying internal structure of DVW is broadly consistent with the previous year. Operating expenditure is captured in a series of departments, including operational functions, customer service and other support functions. The activities of these departments are controlled by the 'Executive Management team', composed of the Company's Executive Directors and senior managers.

Costs are recorded both by department and by expense type for internal reporting purposes, and are then further sub-allocated between upstream services and retail activities for the purpose of the APR. Indirect costs (defined as 'general and support costs' in this statement) are allocated between the wholesale business units and retail activities using relevant cost drivers. Further details of this allocation process are provided below.

*Outsourcing*

The company outsources its main water quality testing facilities, an immaterial proportion of billing and collection activities (see section 3) and bills and collects monies on behalf of sewerage providers operating in the Company's licence area. Commission income received in respect of this activity, and the associated cost, is outside of the Company's appointed business and therefore does not feature in the APR tables.

## 2. Commentary

### 2.1 *Current year financial performance*

Operating profit for the year ended 31 March 2016 was £6.6 million (2015: £7.5 million), with the impact of a reduction in revenue (£1.5 million) partially offset by a £0.7 million reduction in operating expenses.

Revenue for the year (£23.1 million; 2015: £24.6 million) was impacted by a 4% reduction in prices in this first year of AMP6, effective from 1 April 2015, and a reduction in consumption amongst certain large, non-household customers.

The reduction in operating expenses in comparison to the prior year was influenced by a reduction in the bad debt charge and an increase in the capitalisation of labour costs.

A review of the doubtful debt provisioning estimate in the prior year led to a one-off increase in the provision to ensure that it covered all debts that were greater than two years old and to specifically provide for customers' debts based on historic default and non-payment. A consistent provisioning methodology has been applied in the current year, with the bad debt charge falling by £0.3 million year-on-year to a total of £0.5 million.

In the year ended 31 March 2016, the capitalisation of labour costs has increased due to the additional headcount required and recruited to enable the Company to deliver its largest ever capital investment programme.

The operating cost benefit arising from the above factors has been partially offset by investment to enhance the Company's Customer Service function. This investment will ensure that the Company continues to offer sector leading customer service, supported by an improved website and enhanced online payment options.

### 2.2 *Underlying processes and systems*

The purpose of tables 2C, 4D and 4F is to analyse the operating costs and capital expenditure of the Company's wholesale and retail services (appointed business only). The tables are populated in accordance with the relevant Regulatory Accounting Guidelines ('RAGs').

The allocation of costs to each line of these tables is considered annually by management of the company. Whilst there has been no change in the underlying systems from which the relevant data is extracted, the allocation between wholesale and retail activities has been reviewed in light of the updated allocation guidance in RAGs 2.05 and 4.05.

The APR tables referred to above contain the following information:

- **Table 2C – Operating cost analysis – retail:** this table presents the allocation of retail operating expenditure between key cost categories. Examples of these include Customer Services, Debt Management, Doubtful Debts and Meter Reading costs.
- **Table 4D – Wholesale totex analysis – water:** this table analyses totex into the wholesale business units (water resources, raw water distribution, water treatment and treated water distribution). The table includes operating, capital and cash expenditure incurred in the year.
- **Table 4F – Operating cost analysis – household retail:** this table further analyses household retail operating expenditure between measured and unmeasured customers.

### **3. Billing and collection**

#### *Outsourcing of billing and collection*

The Company outsourced £169,495 of water billing to Flintshire County Council in 2015/16. The council collects the money and transfers this to the Company but the bad debt risk remains with the Company. In 2015/16 the total outsourced billing and collection income represented less than 1% of the Company's revenue.

#### *Bills issued to 'the occupier'*

Water charges are, on rare occasions, billed to 'the occupier' if the customer accounts team are aware that a property is occupied but have been unable to identify the residents. The turnover associated with bills raised to 'the occupier' was £12,318 (FY14/15: £4,639).

#### *Debt management policy in respect of customers that have vacated a property*

The full debt management policy in respect of previous occupiers is outlined in the accounting policies note of the regulatory accounts and summarised below:

- Where there is no forwarding address, any debts under £50 and where there has been no response to issuing the final bill are written-off;
- Any debts greater than £50 are passed to a third party trace collection agency. If third parties cannot trace the debt it will be written-off;
- Where a forwarding address is held, debts will be processed through the usual cycle. If payment is not made, debts under £50 will be written-off as uneconomical to collect and debts over £50 will be passed to a third party agency for collection;
- Only where third party debt collection fails will a debt over £50 be written-off. In most instances debt can be left on the system for longer than 12 months if it is believed that information can be obtained to enable the debt to be pursued;
- The total FY15/16 debtor write-off in respect of previous occupiers was £157,513 (2014/15: £148,542).

#### *Bad debt provisioning policy*

See section 4.2 for details of the Company's bad debt provisioning policy, including amendments to this policy in the prior year.

#### 4. Cost allocations – retail operating expenditure (tables 2C and 4F)

##### 4.1 Basis of preparation

All operating expenditure is recorded in the General Ledger by cost centre and account code. Operating expenditure is reported by cost centre, where a cost centre represents an area of activity. In general, costs can either be categorised as ‘direct’ or ‘general and support’.

The process for allocating costs between the retail/ wholesale price controls and the retail activities is then as follows:

- **Labour costs:** labour costs are allocated to the appropriate retail cost category based on the percentage of employees time in each cost centre spent performing the relevant activity;
- **Other overhead costs:** other overhead costs are directly allocated to a retail cost category where possible. General and support costs which cannot be directly attributed are allocated in accordance with the guidance in RAG 2.05.

General & support operating expenditure is allocated between the retail and wholesale price controls using the following cost drivers:

Retail/ Wholesale allocation			
Heading per proforma table	Cost category	Cost driver used for allocation	Retail %
Other operating expenditure	General and support – IT costs	Number of computers	16.5
Other operating expenditure	General and support – motor vehicles	Number of motor vehicles	13.3
Other operating expenditure	General and support – Finance, Payroll, HR general management	FTE’s	16.5
Other operating expenditure	Executive/ non-executive directors’ remuneration	Management estimate	10
Other operating expenditure	General and support – facilities, buildings, ground maintenance	Floor space	1.5
Other operating expenditure	General and support – insurance/ Other general and support	FTE’s	16.5
Other operating expenditure	Other business activities (regulation costs)	Directly attributed or, if not possible, 20% to retail.	20
Other operating expenditure	Local authority rates	Floor space	1.5

Retail costs are subsequently analysed between the household/ non-household price controls and measured/ unmeasured customers using the allocation guidance in RAG 2.05.

## 4.2 Retail cost allocation - analysis

Tables 2C and 4F, as presented in the APR, are included below along with an explanation for each category in the table and any significant year-on-year movements.

<b>Table 2C – Household/ Non-Household</b>	<b>Household £'000</b>	<b>Non-Household £'000</b>	<b>Total £'000</b>
<b>Operating expenditure</b>			
Customer services	950	70	1,020
Debt management	217	9	226
Doubtful debts	454	42	496
Meter reading	186	13	199
Services to developers	-	20	20
Other operating expenditure	562	52	614
<b>Total operating expenditure excluding third party services</b>	<b>2,369</b>	<b>206</b>	<b>2,575</b>
Third party services operating expenditure	-	-	-
<b>Total operating expenditure</b>	<b>2,369</b>	<b>206</b>	<b>2,575</b>
Depreciation	376	13	389
<b>Total operating costs</b>	<b>2,745</b>	<b>219</b>	<b>2,964</b>
	<b>HH unmeasured £'000</b>	<b>HH measured £'000</b>	<b>Total £'000</b>
<b>Table 4F – Household Measured/ Unmeasured</b>			
<b>Operating expenditure</b>			
Customer services	333	617	950
Debt management	153	64	217
Doubtful debts	398	56	454
Meter reading	-	186	186
Other operating expenditure	227	335	562
<b>Total operating expenditure excluding third party services</b>	<b>1,111</b>	<b>1,258</b>	<b>2,369</b>
Depreciation	53	323	376
<b>Total operating costs excluding third party services</b>	<b>1,164</b>	<b>1,581</b>	<b>2,745</b>

**Customer services, debt management, meter reading and other operating expenditure (retail business):** Operationally the customer services cost comprised three cost centres in FY15/16; Customer Services, Customer Accounts and Meter Reading.

The overhead costs of the cost centres have been allocated as follows:

- The Company has out-sourced the majority of its bill and reminder printing. Billing volumes have been used to allocate printing and postage costs between household and non-household customers;
- Payment processing costs incurred have been allocated using the number of payments received from each group of customers;
- Labour and other costs associated with the resolution of non-network queries have been allocated using call type data and estimations of the employee time spent on this activity;
- Debt collection costs have been allocated between household and non-household based on the proportions of outstanding debt related to each;

- Costs associated with the meter reading activity have been allocated to the meter reading category and sub-allocated using the number of meter reads by customer type;
- Other customer services expenditure has been sub-allocated using appropriate customer number proportions.

**Doubtful debts:** The Company bad debt provision is calculated on a monthly basis. Figures are extracted from aged debt reports produced from the billing system at the end of each month.

The provisioning policy divides debt in to the following categories:

- Measured billing system debt;
- Unmeasured billing system debt – current occupier;
- Unmeasured billing system debt – previous occupier;
- Measured and unmeasured debt transferred to summons ledger

An additional exercise is undertaken at the end of each quarter to split the provisions between household and non-household customers.

Following an amendment to the bad debt provisioning policy in the prior year, all debts that are greater than two years old are now fully provided and the provision specifically provides for customers' debts based on historic default and non-payment. The provisioning policies applied are as follows:

- **Measured billing over 3 months:** debt over 3 months old is provided in full unless it is either being paid under a payment arrangement or it is subject to a query which does not affect its recoverability;
- **Unmeasured billing current occupier:** 50% provision for debts less than one year old, 100% provision if the debt is two years old;
- **Unmeasured billing previous occupier:** 100% provision against all debts;
- **Debt transferred to summons ledger (measured and unmeasured):** where debt remains unpaid after the 'pre summons stage' of the company's debt code of practice, it is transferred to the summons ledger. Summons ledger debt over 1 year old is provided in full unless it is the subject of a payment arrangement.

#### **4.3 Retail cost allocation – year-on-year variances**

The expenditure allocated to the following retail cost categories has fluctuated by more than 10% year-on-year:

- **Debt management, services to developers, other operating expenditure:** the total cost associated with these activities has reduced by £0.8m year-on-year.

Excluding the reduction in the bad debt charge, total operating expenses have fallen by £0.3m in the year (further detail provided in section 2.1), contributing to the reduced allocation to these activities. Furthermore, the allocation of costs to the retail service in general has been reviewed following the release of the updated cost allocation guidance in RAG 2.05, leading to a lower allocation to some of these activities.

- **Doubtful debts:** the doubtful debt charge has reduced by £0.5m year-on-year. As noted in section 2.1 of this report, the bad debt provisioning estimate was updated in the prior year to include full provision against all debts that are greater than two years old and also to specifically provide for customers' debts based on historic default and non-payment. In the current year a consistent methodology has been applied and the doubtful debt charge has reduced as a result.

## 5. Cost allocations – wholesale totex (table 4D)

### 5.1 Wholesale totex allocation – basis of preparation and analysis

Table 4D, as presented in the regulatory accounts, is included below along with an explanation for each category in the table and any significant year-on-year movements.

	Water resources		Raw water distribution		Water treatment £'000	Treated water distribution £'000	Total £'000
	Abstraction licences £'000	Raw water abstraction £'000	Raw water transport £'000	Raw water storage £'000			
<b>Operating expenditure</b>							
Power	-	4	635	-	412	745	1,796
Income treated as negative expenditure	-	-	-	-	-	-	-
Service charges/ discharge consents	795	-	-	-	-	-	795
Bulk supply/ Bulk discharge	-	2	-	-	1	-	3
Other operating expenditure	-	426	195	35	3,520	3,431	7,607
Local authority rates	-	104	25	-	71	888	1,088
<b>Total operating expenditure excluding third party services</b>	<b>795</b>	<b>536</b>	<b>855</b>	<b>35</b>	<b>4,004</b>	<b>5,064</b>	<b>11,289</b>
Third party services	-	-	18	-	-	-	18
<b>Total operating expenditure</b>	<b>795</b>	<b>536</b>	<b>873</b>	<b>35</b>	<b>4,004</b>	<b>5,064</b>	<b>11,307</b>
<b>Capital expenditure</b>							
Maintaining the long term capability of the assets - infra	-	50	27	11	397	1,314	1,799
Maintaining the long term capability of the assets - non- infra	-	65	33	14	516	1,707	2,335
Other capital expenditure - infra	-	22	11	5	173	572	783
Other capital expenditure - non-infra	-	15	8	4	126	416	569
<b>Total gross capital expenditure excluding third party services</b>	<b>-</b>	<b>152</b>	<b>79</b>	<b>34</b>	<b>1,212</b>	<b>4,009</b>	<b>5,486</b>
Third party services	-	-	-	-	-	-	-
<b>Total gross capital expenditure</b>	<b>-</b>	<b>152</b>	<b>79</b>	<b>34</b>	<b>1,212</b>	<b>4,009</b>	<b>5,486</b>
<b>Grants and contributions (price control)</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>970</b>	<b>970</b>
<b>Totex</b>	<b>795</b>	<b>688</b>	<b>952</b>	<b>69</b>	<b>5,216</b>	<b>8,103</b>	<b>15,823</b>
<b>Cash expenditure</b>							
Pension deficit recovery payments	-	9	17	-	192	210	428
Other cash items	-	-	-	-	-	-	-
<b>Totex including cash items</b>	<b>795</b>	<b>697</b>	<b>969</b>	<b>69</b>	<b>5,408</b>	<b>8,313</b>	<b>16,251</b>

### *Direct Costs*

- (a) **Power:** Power costs are captured by site and allocated accordingly between the wholesale business units, considering the functions performed at each site and the allocation guidance in RAG 4.05.
- (b) **Service Charges:** The charge associated with the abstraction licence is allocated wholly to the 'Water resource – abstraction licence' activity.
- (c) **Bulk Supplies:** Payments associated with bulk supply imports are allocated between the Water Resources and Water Treatment activities, with the latter allocation reflecting the incremental cost saving associated with the importation of treated water.
- (d) **Other operating expenditure:** This includes expenditure in relation to labour, materials and consumables and other direct costs together with general and support costs, scientific services and costs of regulations.
- (e) **Local Authority Rates:** Non Domestic Rates have been allocated based on the gross MEAVs per business unit.
- (f) **Third party services:** Costs relating to the supply of non-potable water are included in third party services.

### *Capital expenditure*

- (g) **Maintaining the long term capability of the assets and other capital expenditure (infra/non-infra):** Capex has been allocated between business units using an analysis of capital expenditure by upstream service, analysed between capital maintenance and other spend. The cost centre allocation process allows us to associate assets with the activity for which they are used.

### *Cash expenditure*

- (h) **Pension deficit recovery payments:** deficit recovery payments have been allocated between the wholesale business units in proportion to the allocation of salary costs.

## **5.2 Upstream services – sub-allocation**

Wholesale totex has been further allocated into the water resource and raw water distribution sub-categories outlined in table 4D. The sub-allocation process for these upstream services is described below.

### **Water Resources**

The water resources business unit has been sub-allocated into two services, 'abstraction licence' and 'raw water abstraction'.

The operating expenditure allocated to 'abstraction licence' reflects the cost of the licence itself. In line with the guidance in RAG 4.05, it does not include activities that are associated with the selection of abstraction sites or the optimisation of abstraction.

All other costs associated with raw water abstraction, including catchment management and the abstraction infrastructure, have been allocated to the 'raw water abstraction' service.

### ***Raw water distribution***

Costs allocated to the raw water distribution business unit have been sub-allocated between transport and storage services where possible; the approach to this allocation was as follows:

- **Operating expenditure:** The majority of direct and indirect operating expenditure has been allocated to raw water transport. Although certain sites do have assets that are classified in the 'raw water storage' category, only a small proportion of labour and maintenance costs are associated with these assets.
- **Capital expenditure:** Capex has been allocated in accordance with the guidance in RAG 4.05; spend on raw water booster stations and aqueducts has been allocated to 'raw water transport' and that on storage reservoirs to the 'raw water storage' service.

### **5.3 Wholesale totex allocation – year-on-year variances**

The expenditure allocated to the following water service cost categories has fluctuated by more than 10% year-on-year:

- **Service charges:** a reduction in the abstraction licence cost from NRW led to the lower service charge in 2015/16.
- **Bulk supply imports:** the Company imports water from United Utilities and Severn Trent in relation to four sites bordering our respective licence areas. The cost associated with these imports has reduced from £36k in FY14/15 to £3k, largely due to a reduction in imports at one site and a £5k credit received in the year.