

Dee Valley Water plc
Year ended 31 March 2017

Annual Performance Report - accounting separation and upstream services methodology statement

This methodology statement explains how the accounting separation analysis tables in the 2016/17 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 2016/17 accounts is consistent with the guidance included in IN17/03 '*Expectations for monopoly company reporting 2016-17*' and the current version of the RAGs, published in October 2016.

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 senior management team.

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 2017 was £3.4 million (2016: £6.6 million). Revenue was £24.4 million, an increase on the previous year (£23.1 million). The increase in revenue was due to three main factors:

- an increase in tariff prices of 4.5% that corrected the price reduction from the previous year;
- some major non-household customers consuming more water in the year;
- one-off gain due to a move away from estimating bills to raising bills based on actual meter readings.

Operating profit has reduced mainly due to incurring transaction costs of £2.4 million. There was also a planned increase in staff costs as the Company geared up to deliver the largest capital programme in its history.

Profit after taxation of £0.3 million is £4.4 million lower than the prior year (2016: £4.7 million). Whilst operating profit fell by £3.0 million, the non-cash loan indexation charge was £1.0 million higher due to the higher rate of RPI inflation during the year, and taxation charge was £0.7 million higher as the deferred tax credit was smaller than the previous year.

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. Debt management

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;

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	22
Other operating expenditure	General and support – Finance, Payroll, HR general management	FTE's for HR costs; management estimates of activity for finance / general management costs	15
Other operating	Executive/ non-executive	Management estimate of	10

expenditure	directors' remuneration	activity / time proportion	
Other operating expenditure	General and support – facilities, buildings, ground maintenance	Floor space	13
Other operating expenditure	General and support – insurance/ Other general and support	Total FTE's	17
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	1.4

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.

Table 2C – Household/ Non-Household

	Household £m	Non-household £m	Total £m
Operating expenditure			
Customer services	1.212	0.075	1.287
Debt management	0.093	0.034	0.127
Doubtful debts	0.340	0.015	0.355
Meter reading	0.135	0.009	0.144
Services to developers	–	0.005	0.005
Other operating expenditure	0.023	0.002	0.025
Total operating expenditure excluding third party services	1.803	0.140	1.943
Third party services	–	–	–
Total operating expenditure	1.803	0.140	1.943
Depreciation - tangible fixed assets	0.715	0.051	0.766
Amortisation - intangible fixed assets	–	–	–
Total operating costs	2.518	0.191	2.709
Debt written off	0.135	0.016	0.151

Table 4F – Household Measured/ Unmeasured

	Household unmeasured				Household measured				Total £m
	Water only £m	Wastewater only £m	Water and wastewater £m	Total unmeasured £m	Water only £m	Wastewater only £m	Water and wastewater £m	Total measured £m	
Operating expenditure									
Customer services	0.467	–	–	0.467	0.745	–	–	0.745	1.212
Debt management	0.049	–	–	0.049	0.044	–	–	0.044	0.093
Doubtful debts	0.271	–	–	0.271	0.069	–	–	0.069	0.340
Meter reading	–	–	–	–	0.135	–	–	0.135	0.135
Other operating expenditure	0.009	–	–	0.009	0.014	–	–	0.014	0.023
Total operating expenditure excluding third party services	0.796	–	–	0.796	1.007	–	–	1.007	1.803
Third party services	–	–	–	–	–	–	–	–	–
Total operating expenditure	0.796	–	–	0.796	1.007	–	–	1.007	1.803
Depreciation	0.287	–	–	0.287	0.428	–	–	0.428	0.715
Amortisation	–	–	–	–	–	–	–	–	–
Total operating costs	1.083	–	–	1.083	1.435	–	–	1.435	2.518

Customer services, debt management, meter reading and other operating expenditure (retail business): Operationally the customer services cost comprised three cost centres in FY16/17; 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;
- The element of other customer services expenditure that cannot be directly attributed has been sub-allocated using appropriate customer number proportions.
- Depreciation costs have been allocated specifically where direct asset usage can be identified; remaining depreciation is allocated based on customer numbers.

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.

All debts that are greater than two years old are fully provided and the provision specifically provides for customers' debts based on historical 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

- **Sewerage cost allocation**

In the prior year 10% of customer service costs were allocated to sewerage work and thus classed as non-appointed. However, this year the costs have been split evenly between water and sewerage business streams as this is considered to be a better representation of the costs incurred. By doing this, the profitability of the sewerage business stream is more reasonable. This moves £0.6m of cost to non-appointed.

Based on a like-for-like comparison using the same 10% allocation method from last year, then total operating expenditure would have risen by £84k compared to last year. Using the 50% allocation method retail operating expenditure has reduced by £477k.

- **Depreciation**

This has almost doubled to £0.7m as a result of allocating assets to retail more accurately as part of a line by line review of the fixed asset register.

- **Debt written off**

This is £150k this year against £190k last year.

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		Network +				Total
	Abstraction licences	Raw water abstraction	Raw water transport	Raw water storage	Water treatment	Treated water distribution	
	£m	£m	£m	£m	£m	£m	£m
Operating expenditure							
Power	–	0.011	0.679	–	0.935	0.306	1.931
Income treated as negative expenditure	–	–	–	–	–	–	–
Abstraction charges	0.801	–	–	–	–	–	0.801
Bulk supply	0.003	–	–	–	–	–	0.003
Other operating expenditure	–	0.654	0.230	0.026	3.851	4.704	9.465
Local authority and Cumulo rates	–	0.105	0.025	–	0.071	0.897	1.098
Total operating expenditure excluding third party services	0.804	0.770	0.934	0.026	4.857	5.907	13.298
Third party services	–	–	–	–	–	–	–
Total operating expenditure	0.804	0.770	0.934	0.026	4.857	5.907	13.298
Capital expenditure							
Maintaining the long term capability of the assets - infra	–	0.001	0.146	–	0.003	3.374	3.524
Maintaining the long term capability of the assets - non-infra	–	0.026	0.033	–	0.104	0.255	0.418
Other capital expenditure - infra	–	–	(0.001)	–	–	0.627	0.626
Other capital expenditure - non-infra	–	1.047	0.021	–	0.425	2.404	3.897
Total gross capital expenditure excluding third party services	–	1.074	0.199	–	0.532	6.660	8.465
Third party services	–	–	–	–	–	–	–
Total gross capital expenditure	–	1.074	0.199	–	0.532	6.660	8.465
Grants and contributions	–	–	–	–	–	(0.777)	(0.777)
Totex	0.804	1.844	1.133	0.026	5.389	11.790	20.986

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:

- **Other operating expenditure:** Staff cost increase due to higher numbers, and more temporary staff.

End.