Hafren Dyfrdwy Limited

Accounting Separation Methodology Statement

Year ended 31 March 2018

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Hafren Dyfrdwy Accounting Separation Methodology Statement

Contents

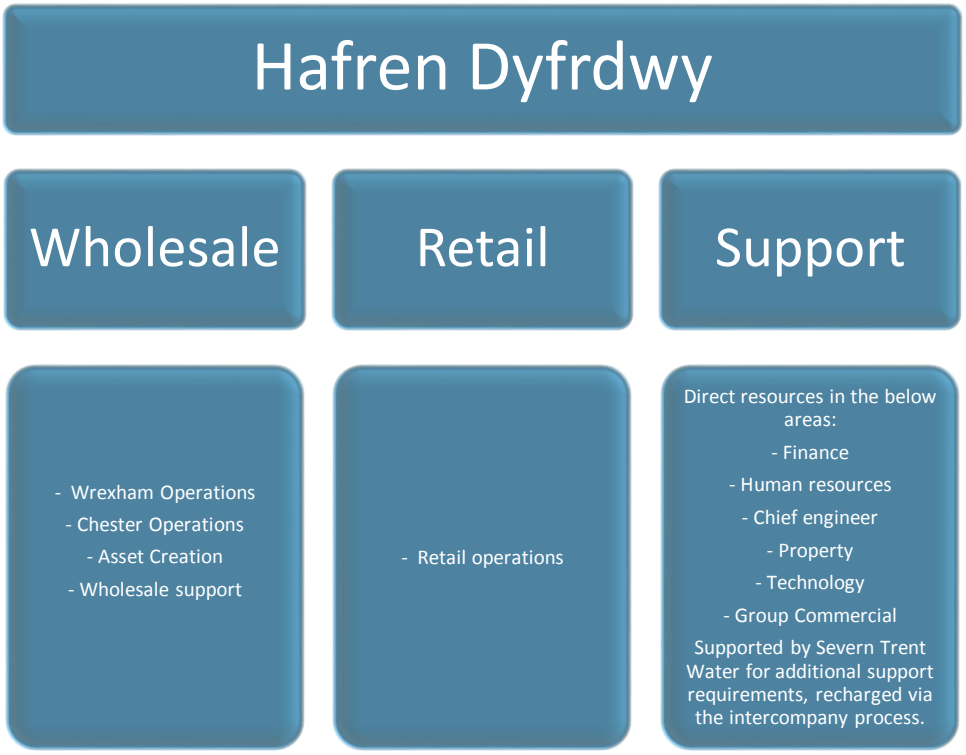
Introduction

The purpose of this statement is to explain the systems and processes used to populate tables in the Annual Performance Report (APR). We explain the methodology used in the allocation of revenue and expenditure between price controls, customer types and upstream services.

The Annual Performance Report tables can be found on our website (www.hdcymru.co.uk).

1. Business structure, systems and sources of information used to populate tables

The operating business structure at Hafren Dyfrdwy (HD) is as follows:



Systems in place

Information used to populate the tables originates from our SAP system, which was implemented in 2010. Our SAP system is interfaced with Tagetik (consolidation) and Business Warehouse (BW) systems. Financial reports are retrieved from these systems to produce the APR.

Information providers

Information in the Annual Performance Report (APR) is sourced from the operational teams within the business. In this document, we have provided details of:

- data used to populate the tables;
- the basis used for allocating income and expenditure; and
- the basis of management assumptions made in the allocation methodology.

2. Internal governance and consistency procedures

Table of responsibilities

Area	*Owner*	*Process / activity*
All financial tables	*Group Finance – Regulatory Accounting & Reporting*	Communicate regulatory reporting requirements and guidance to finance and non-finance stakeholders involved in the APR process. Co-ordinate delivery of APR tables and complete reconciliations between the statutory position and related tables. Co-ordinate external assurance for the regulatory tables.
Operational expenditure (Opex)	*Finance business partners – Production & Customer Delivery*	Determine cost allocation methodologies for price control and upstream services. Determine cost allocation methodology for third party and non appointed activities. Apply above cost allocation methodologies to year end financials and produce opex tables. Undertake variance analysis against prior year and final determination.
Capital expenditure (Capex)	*Strategic Asset Planning team*	Review source data capital expenditure assignments to capex regulatory categories for accuracy and provide cost allocation methodologies where applicable.
	Financial business partners - Capital Delivery & Commercial	Apply cost allocation methodologies to year-end financials and produce capex tables. Undertake variance analysis against prior year and final determination.
Fixed assets	*Capital Accounting team*	Prepare fixed asset tables by business unit and perform reconciliation between the statutory and regulatory position. Provide retail depreciation numbers for retail tables.
Revenue	*Income and debt team*	Analysis of revenue between regulatory categories.
	Finance business partners - Wholesale & Retail Revenue	Undertake variance analysis against prior year and final determination.

Recharges to/from associated companies

The process to allocate costs between price controls begins after services supplied by/to the appointee have been recharged.

In 2017/18 Hafren Dyfrdwy did not provide any services to associated companies, however did receive recharges of support services from Severn Trent Water.

The recharge process undertaken by Severn Trent Water is outlined below.

The recharges include both ad-hoc costs and recurring charges. Ad-hoc or one off expenses are recharged via an intercompany process usually within the month they are incurred. For recurring charges there is an established management recharge process which is undertaken on a quarterly basis to transfer expenses to/from associated companies. This process involves returns being completed which disclose time spent and expenditure incurred on activities which relate to associated companies. An overhead charge is added to this to account for the indirect costs associated with the activity. This is a percentage calculation which takes the expenditure on support functions over the total expenditure (excluding financing costs) undertaken within the business. The calculation is reviewed on an annual basis. The total direct and indirect cost is recharged to the relevant associated company.

The information is completed by the relevant support teams within the business and collated within Finance. The returns are reviewed by the Performance and Planning teams to ensure that recharges are accurate and complete. Any new activities within the company are raised by the analysts on an ongoing basis to ensure these are incorporated within the recharge process.

The price control allocation process therefore begins after recharges to/from associated companies has been completed.

A summary of the recharges can be found in the supplementary disclosures within the Annual Performance Report.

The OPEX accounting separation process

An accounting separation spreadsheet model is used to populate the operating expenditure section of Wholesale Totex analysis and Retail operating cost analysis (Tables 2B, 2C, 4D and 4F).

Inputs into the account separation model undergo a review process:

- first stage review is performed in the relevant business area
- second stage review is performed by the regulatory accounting team and other regulatory stakeholders
- third stage review is performed by external assurance providers to confirm the cost allocation principles comply with the regulatory requirements.

The table outputs of the model are reviewed and signed off by the senior finance management team for each respective area.

The OPEX accounting separation process is further detailed below:

Owner(s)	***Process / activity***
Finance business partners – Production & Customer Delivery	PRICE CONTROL AND BUSINESS UNIT/ACTIVITY ASSIGNMENT
	Identify direct cost centres for each respective area and assign to business units within price controls.
	Identify cost centres containing management costs, operational support costs and general and support costs which are utilised across price controls and determine appropriate cost driver to allocate the costs between price controls.
Finance business partners – Production & Customer Delivery	NON-APPOINTED AND THIRD PARTY COSTS
	Identify non-appointed and third party costs by referring to the guidance in the income categorisation table in RAG 4 to ensure completeness.
Group Finance – Regulatory Reporting & Accounting	APPLICATION OF ALLOCATIONS TO YEAR END FINANCIAL VALUES
	Run a download of all company cost centres using a SAP BW report which reports costs net of amounts which have been capitalised against projects. The costs are grouped by expense type e.g. costs of employment, materials and consumables etc.
	Adjust the total costs from the SAP report to account for items which are not captured in the report e.g. revenue reclassifications and exceptional items.
Finance business partners – Production & Customer Delivery	Perform year end cost allocation calculations following the cost allocation methodology.
Finance business partners – Production & Customer Delivery	UPSTREAM SERVICES ALLOCATIONS
	Determine upstream allocation principles by the use of financial/non-financial information or management estimate where management information is unavailable.
	Calculate and apply allocation percentages based on methodology provided above.
Group Finance – Regulatory Reporting & Accounting	RECONCILIATION

	A reconciliation is performed within the model which checks that the total operating expenditure has been allocated to a price control or classified as non-appointed and that all cost centres identified as having shared costs are zero post allocation.
Finance business partner leads and senior finance managers for respective table owners *Regulatory Accounting team* *Strategy & Regulation team*	REVIEW PROCESS
	Review the final accounting separation tables.

3. Cost allocation principles and changes in allocation methodology

Our approach to accounting separation applies the general principles set out in RAG 2 and RAG 5. Ofwat has set out the following general principles which we are required to comply with.

Principle	*OFWAT requires that…*	*At Hafren Dyfrdwy…*
Transparency	The attribution methods applied within the accounting separation system need to be transparent. This requires that the costs and revenues apportioned to each service and business unit should be clearly identifiable. The cost and revenue drivers used within the system should also be clearly explained to enable a review of their appropriateness.	Our accounting separation methodology is transparent. Direct costs to price controls are identifiable and can be traced back to our SAP ledger. Methodologies for allocated costs are captured in PDTs.
Causality	Cost causality requires that costs (and revenues) are allocated to those activities and services that cause the cost (or revenue) to be incurred. This requires that the attribution of costs and revenues to activities and services should be performed at as granular a level as possible.	Wherever possible, bases for costs are allocated to activities that cause the cost to be incurred. Some costs are more remote from the activities being allocated across than others (for example costs of regulation). The method applied to allocating such costs is described in the methodology statement.
Non-discrimination	The attribution of costs and revenues should not favour any business unit within the regulated company and it should be possible to demonstrate that internal transfer charges are consistent with the prices charged to external third parties.	Cost allocation bases are as objective as possible and are not designed to favour any price controls or associated companies.
Objectivity	The cost and revenue attribution criteria need to be objective and should not intend to benefit any business unit or service.	Cost allocation bases are as objective as possible and are not designed to favour any price controls or associated companies.
Consistency	The cost and revenue attribution criteria should be consistent from year to year to enable meaningful comparison of information over time. Changes to the attribution methodology from year to year should be clearly justified and documented.	We have been consistent in our cost allocation methodology. Any changes made are outlined below.
No cross subsidy between price controls	Companies should also ensure that there is no cross subsidy between price control units. In accordance with RAG 5, transfer prices for transactions between price control units should be based on market price unless no market exists, in which case transfer prices should be based on cost.	In line with the separate binding price controls introduced in 2014, costs are compliant with RAG 5 'Guideline for transfer pricing in the water and sewerage sectors.'
Principal use	Where possible, capital expenditures and associated depreciation should be directly attributed to one of the price control units. Where this is not possible as the asset is used by more than one service, it should be reported in the service of principal use with recharges made to the others services that use the asset reflecting the proportion of the asset used by the other services.	Where possible assets and associated depreciation are directly attributed to the relevant price control and applied the principal use guidance for shared assets.

Changes in allocation methodology

Where it is not possible to allocate costs directly to price controls, we look to keep the methods of apportionment as consistent as possible. However, the material changes in the basis of allocation compared to the previous year are outlined below:

Changes in organisational design leading to direct attribution or a change in allocation

Following acquisition of the company by Severn Trent Water in February 2017, a number of support and management activities were transferred during the year and are now being carried out by associated companies and recharged using the process described above. Front line operations activities are largely unaffected and retain the existing price control assignments. A full review of management and operational support cost centres was made to charge costs direct to business unit where possible and to determine the appropriateness of existing cost drivers.

The retail teams have also been largely unaffected and have also reviewed their allocation of retail management support costs to further align costs to retail activities. G&S costs were recorded in customer services in the prior year and are recorded other operating expenditure in the current year.

Enhanced management information to enable direct allocation or aid cost allocation

Water power costs

RAG 2 confirms that Pumping head' is the preferred driver to be used where pumps perform a joint function for both Water resources - Raw water abstraction and Network+ activities. The definition of average pumping head in Appendix 2 of RAG 2 has been applied in completing Average Pumping Head data in Table 4P (Non-financial data for WR, WT and WD - Wholesale water).

The business unit non financial data in Table 4P has subsequently been applied to the financial data to allocate power costs between Water Resources and Water Network +.

Changes/clarification in RAG guidance or arising from OFWAT reviews in specific areas

Bulk Supplies

In 2016/17, bulk supplies purchases were allocated to price control dependent on whether raw water or treated water was purchased. RAG 2 confirms that costs are to be split between Water Resources and Water Network + using:

1. Data provided by exporting company as to the treatment cost incurred in additional to supplying the original raw water; or
2. The average cost of the exporting company as a guide to a split of the cost (as shown in the APR).

The average cost of the exporting company has been used as a guide for allocating bulk supply costs between Water Resources and Water Network + in the APR.

4. Wholesale variance analysis to the prior year

Wholesale Water

OPEX analysis

Operating expenditure	*Current year figures (£m)*	*Prior year figures (£m)*	*Variance (£m)*	*Variance (%)*	*Commentary*
Water Resources					
Power	(1.017)	(0.011)	(1.006)	(9145.5)%	A change in allocation methodology based on improved average pumping head data is driving the majority of the increase in power costs. This adverse variance is offset by the favourable variance in Water Treatment. Underlying Power costs have increased by approximately 27% against prior year across all business units. This increase is predominantly driven by power price inflation.
Other operating expenditure (excluding atypicals)	(0.194)	(0.654)	0.460	70.3%	On an underlying basis, other operating expenditure costs have decreased by approximately 8% against prior year across all business units. Efficiencies driven by the integration of support functions within STW are the predominant driver of these savings. In addition, refined cost allocation methodologies have been used this year which have driven further reductions in these costs in Water Resources, this is offset in other business units
Local authority and Cumulo rates	(0.034)	(0.105)	0.071	67.6%	Rateable values increases in April 2017 have driven costs up by 42.0% across all business units on an underlying basis. In addition, refined cost allocation methodologies have been used this year which have driven reductions in these costs in Water Resources, this is offset in other business units

Operating expenditure	*Current year figures (£m)*	*Prior year figures (£m)*	*Variance (£m)*	*Variance (%)*	*Commentary*
Raw Water Distribution					
Power	(0.100)	(0.679)	0.579	85.3%	Power costs have increased by approximately 27% against prior year on an underlying basis across all business units. This increase is predominantly driven by power pricing. In addition, refined cost allocation methodologies have been used this year which have driven reductions in Raw Water Distribution power costs that are offset in other business units.
Other operating expenditure (excluding atypicals)	(0.333)	(0.256)	(0.077)	(30.1)%	On an underlying basis other operating expenditure costs have decreased by approximately 8% against prior year across all business units. Efficiencies driven by the integration of support functions within STW are the predominant driver of these savings. In addition, refined cost allocation methodologies have been used this year which have driven an increase in other operating costs in Raw Water Distribution, this is offset in other business units.
Local authority and Cumulo rates	(0.421)	(0.025)	(0.396)	(1584.0)%	Rateable values increased in April 2017 which have driven costs up by 42.0% across all business units on an underlying basis. In addition, refined cost allocation methodologies have been used this year which have driven further increases in these costs in Raw Water Distribution, this is offset in other business units
Water Treatment					

Power	(0.268)	(0.935)	0.667	71.3%	Refined cost allocation methodologies have been used this year which have driven reductions in Water Treatment power costs that are offset in other business units. Power costs have increased by approximately 27% against prior year on an underlying basis across all business units. This increase is predominantly driven by power pricing.
Renewals expensed in year (non-infrastructure)	(0.064)	(0.000)	(0.064)	(0.0)%	Efficiencies associated with maintenance activities have driven the reduction in costs against prior year.
Other operating expenditure (excluding atypicals)	(4.213)	(3.851)	(0.362)	(9.4)%	On an underlying basis other operating expenditure costs have decreased by approximately 8% against prior year across all business units. Efficiencies driven by the integration of support functions with associated companies are the predominant driver of these savings. In addition, refined cost allocation methodologies have been used this year which have driven an increase in other operating costs in Water Treatment, this is offset in other business units.
Local authority and Cumulo rates	(0.237)	(0.071)	(0.166)	(233.8)%	Rateable values increased in April 2017 which have driven costs up by 42.0% across all business units on an underlying basis. In addition, refined cost allocation methodologies have been used this year which have driven further increases in these costs in Water Treatment, this is offset in other business units
Treated Water Distribution					
Power	(1.058)	(0.306)	(0.752)	(245.8)%	Power costs have increased by approximately 27% against prior year on an underlying basis across all business units. This increase is predominantly driven by power pricing. In addition, refined cost

					allocation methodologies have been used this year which have driven further increases in Treated Water Distribution power costs that are offset in other business units.
Renewals expensed in year (infrastructure)	(0.786)	0.000	(0.786)	(0.0)%	Savings versus prior year are associated with efficiency savings on maintenance activities.
Other operating expenditure (excluding atypicals)	(2.629)	(4.704)	2.075	44.1%	On an underlying basis other operating expenditure costs have decreased by approximately 8% against prior year across all business units. Efficiencies driven by the integration of support functions with associated companies are the predominant driver of these savings. In addition, refined cost allocation methodologies have been used this year which have driven a further decrease in other operating costs in Treated Water Distribution, this is offset in other business units

Atypical expenditure

There was no atypical expenditure in the current year.

CAPEX analysis

Overall the Water CAPEX investment in 2017/18 was £15.265m. This is £6.800m (80%) higher than the full year investment in 2016/17 and is in line with our delivery programme which reflects investment to support delivery of our performance commitments and statutory requirements. The variances by business unit are explained below:

Business unit	*Current year figures (£m)*	*Prior year figures (£m)*	*Variance (£m)*	*Variance (%)*	*Commentary*
Water Resources	0.996	1.074	(0.078)	(7.30)%	Predominantly due to reduced spend on the refurbishment of Barrelwell Hill pump station in the current year.
Raw Water Distribution	0.069	0.199	(0.130)	(65.30)%	Driven by a change in methodology around the treatment of expenditure in the current year compared to prior year.
Water Treatment	9.788	0.532	9.256	1739.8%	Mostly due to the change in methodology compared to prior year. Major projects that are driving this variance are Legacy Alternative &Water Quality projects, which are 27% of the total in-year spend. There has also been an increase in M&G spend in the year, which is driven by the wholesale share of SAP integration costs and improved security at our business offices.
Treated Water Distribution	4.412	6.660	(2.248)	(33.80)%	Mostly due to the change in methodology compared to prior year. This has led to variances that offset each other at the business unit level. The biggest spend in current year is for the Bronwylfa pipeline.

5. Retail variance analysis to the prior year

Retail household

Retail household total operating costs of £2.204m are £0.314m (12.5%) higher than the prior year (Please note current year and prior year excludes depreciation). An analysis of significant variances compared to the prior year is outlined below:

Business unit	*Current year figures (£m)*	*Prior year figures (£m)*	*Variance (£m)*	*Variance (%)*	*Commentary*
Customer services	(0.446)	(1.212)	0.766	63.2%	The decrease in spend is due to refinement in the allocation methodology. In 2016/17, 'Other Operating Expenditure' items were reported as part of customer services but have been recognised separately this year. There has also been a shift of costs from Customer Services into Debt Management in 20171/8 to better reflect utilisation of resource.
Debt management	(0.310)	(0.093)	(0.217)	(233.3)%	Variance driven by refinement in allocation between Debt Management and Customer Services, there is now an allocation of headcount costs to debt management.
Doubtful debts	(0.446)	(0.340)	(0.106)	(31.2)%	Bad debt performance of 2.6% reflects management's best estimate of debt risk at the end of the financial year, resulting in an increased level of prudence in the bad debt provision year on year.
Meter reading	(0.107)	(0.135)	0.028	20.7%	This favourable variance has been driven by reduction in costs within the meter reading team compared to prior year and refinement in the allocation process.
Other operating expenditure	(0.758)	(0.023)	(0.735)	(3195.7)%	Other Operating Expenditure now includes general and support expenditure previously allocated to Customer Services. G&S costs have remained constant year on year.

Retail non-household

Retail non-household total operating costs of £0.304m are £0.113m (59.2%) higher than the prior year (Please note current year and prior year excludes depreciation). An analysis of significant variances compared to the prior year is outlined below:

Business unit	*Current year figures (£m)*	*Prior year figures (£m)*	*Variance (£m)*	*Variance (%)*	*Commentary*
Customer services	(0.024)	(0.075)	0.051	68.0%	Customer services costs have achieved a favourable variance against prior year. This reflects efficiencies delivered following the acquisition by Severn Trent Water
Debt management	(0.009)	(0.034)	0.025	73.5%	There has been a refinement in allocation between business activities resulting in a favourable variance against prior year.
Doubtful debts	(0.198)	(0.015)	(0.183)	(1220.0)%	Doubtful debts have seen an increase following a review of the provision methodology applied to Non-Household debt.
Meter reading	(0.015)	(0.009)	(0.006)	(66.7)%	There has been a refinement in allocation between business activities resulting in an adverse variance against prior year.
Service to developers	(0.009)	(0.005)	(0.004)	(74.9)%	There has been a refinement in allocation between business activities resulting in an adverse variance against prior year.

6. APR Section 2 Methodology – Price review and other segmental reporting

2A Segmental income statement

The segmental income statement analyses the appointed activities' operating profit between price controls and summarises the recharges made to/from other segments for the use of fixed assets.

2A line item	*Price controls*	*Data source*	*Process*
Revenue price control	All	Table 2I Revenue analysis and wholesale control reconciliation. Refer to table 2I for allocation methodology.	This table analyses revenue between wholesale water charges and retail revenue by Retail household and Retail non-household.
Revenue non price control	All	SAP general ledger codes which captures the financial values for all non price control revenue via the receivables billing ledger.	Separate general ledger codes are created for each non price control revenue stream. Each revenue stream is assigned to a price control income category using the guidance in the Income categorisation table included in RAG 4. A review is performed at the end of the year to ensure that the correct price control assignment has been made and adjusted where necessary.
Operating costs	Retail	Table 2C Operating costs analysis – retail	Operating costs from table 2C. Refer to table 2C for further detail.
	Wholesale water	Table 2B Totex analysis – wholesale.	Operating costs from table 2B. Refer to table 2B for further detail.
Depreciation and amortisation	All	Table 2D – Historic cost analysis of fixed assets SAP fixed asset register	Depreciation and amortisation charges are charged to the principal user price control. Refer to table 2D for further detail.
Other operating income	All	SAP fixed asset register	Analysis of profit/loss on disposal of assets by reference to the cost centre and related profit centre the asset was assigned to when in use.
Recharges to/from other segments	All	SAP fixed asset register and Accounting Separation model	Asset depreciation charges are used as a proxy for the transfer price recharges between price controls for the use of shared assets. All management and general asset cost centres are assigned an appropriate opex cost driver to allocate costs across price controls. The same cost driver determines the relative proportion of depreciation that should be assigned to

each price control. The price control with the largest allocation is deemed to be the principal user. The full depreciation cost for these assets is charged to the principal user. The recharge to/from segments is then calculated using the cost drivers allocation percentages applied to the depreciation charge.

2B Totex analysis – wholesale

The Wholesale Totex analysis disaggregates the Wholesale price control costs into Water Resources and Water Network+ by assignment of business units outlined below:

Price control	*Business unit*
Water resources	Water resources
Water Network+	Raw water distribution
	Water treatment
	Treated water distribution

Assignment of cost centres into direct business units occurs at the same time that the price control assignment is carried out. Cost centres which are identified as being shared between price controls are allocated to a business unit by using either the same cost driver used to allocate at price control level or by a different cost driver if more appropriate. Cost centres which relate entirely to a price control but more than one business unit are allocated using appropriate cost drivers.

Business unit allocations are explained below:

Operating Expenditure - water

Operating expenditure	*Expense type*	*Price control*	*Business unit allocation*
Power	Power	Water	Average pumping head allocation based on non-financial data in Table 4P.
	Carbon Reduction Commitment costs	Water	Average pumping head allocation based on non-financial data in Table 4P.
Service charges	Abstraction charges	Water	100% Water resources.
	Discharge consents (water treatment)	Water	100% Water treatment.
Bulk supply	Raw water supplies Treated water supplies	Water	Costs pro-rated based on the associated company Table 2B APR splits between Water resources & Water treatment.
Renewals expenses in the year (infrastructure)	Infrastructure renewals expenditure	Water	Refer to Capital expenditure section below.
Renewals expenses in the year (non-infrastructure)	Non-infrastructure (NI) renewals expenditure	Water	Analysis of number plant maintenance jobs at sites expressed as a percentage of total jobs.
Other operating expenditure	• Employment costs Staff costs (excludes hired and contracted) • Hired and contracted services • Materials and consumables • Other costs – utility costs, insurances, bad debt costs, OFWAT fees, fines, subscriptions, postage & printing, defined benefit administration fee, audit fees and recharges to/from other group companies	Allocated to water directly based on activity or by the use of appropriate cost drivers	Directly allocated to business units by the use of cost centres which are assigned to business units. Where other costs relate to more than one business unit they are allocated between the business units by: • identifying specific cost drivers by retrieving the relevant management information; • management estimate where management information is not available; or • pro-rated on total manpower costs of business units before general and support expenditure allocations.

Local authority and Cumulo rates	Pro rata to the gross MEAV value of infra and non-infra assets assigned to each water business unit.

Costs relating to general and support (G&S) activities are assigned to the appropriate cost line above and are allocated to price control and business units using costs drivers outlined in Section 7.

Capital expenditure

- The capital expenditure projects have been recorded line by line in an excel document for 2017/18. This has been analysed on a project by project basis against the business unit activities and related assets outlined in RAG 4.
- Each project is been assigned a business plan line (BPL) to allow regulatory categorisation.
- Each BPL is aligned to a regulatory driver and can have a one-to-one or one-to-many relationship. The drivers are listed below and recorded in the below lines of the Totex table:

Regulatory driver	*Table line*	*Infra/non infra allocation*
Infrastructure renewals expenditure (IRE)	4D.5	100% infra
Maintenance non-infra (MNI)	4D.13	100% non-infra
Enhance levels of service Quality Supply/demand balance	4D.14-15	Infra/non-infra allocation at project level (above ground/below ground categorisation)

- The price control BPL assignment is determined by reference to the nature of the spend in the BPL against the regulatory assets, activities and boundaries outlined in RAG 4.
- The capital expenditure projects listing is reviewed at the year-end by the Strategic asset planning team to identify any expenditure which may have been coded incorrectly at source so this can be corrected.
- The exercise also includes assigning the expenditure to business unit level to complete table 4D. The business unit BPL assignment is determined by reference to the nature of the spend in the BPL/project against the regulatory assets, activities and boundaries outlined in RAG 4.
- The assignment of material schemes/projects are also reviewed by the Strategic Asset Planning team.
- The total income and expenditure is reconciled to the year end schedules produced by the Capital Accounting team
- M&G expenditure is allocated as below:

Capex spend	*Price control/business unit allocation*
IT projects – Retail IT spend	Allocated entirely to retail.
IT projects – Wholesale IT spend	Based on management estimate.
Property projects	Based on the nature of spend, the area of the business it benefits and the property/site it relates to.

Cash Expenditure

Cash expenditure	*Price control allocation*	*Business Unit allocation*
Pension deficit recovery payments	Pro-rate cost against the number of employees in each price control who are members of the scheme.	Same as direct business unit cost percentages used in operating cost allocation.

2C Operating cost analysis – Retail

Where cost centres do not have teams aligning to discreet retail activities, the initial allocation of costs into retail activities e.g. billing or payments handling have been apportioned based on management information or management estimate. The apportioned costs to the retail activities are subsequently allocated to retail household and non-household referring to RAG 2 for guidance on allocation.

Costs associated with the relevant cost centres are downloaded from the financial ledger using a SAP Business Warehouse report and used as the starting point for the allocation of costs to activities. In addition, there are certain costs which are recorded outside of the Retail operational teams but which are included in the Retail price control for regulatory reporting. These costs are identified and transferred from the relevant areas of the business.

Retail recharges from other business areas

Distribution Services Technicians (DSTs) – The activities associated with investigatory visits in relation to water incidents sit within the Wholesale water teams. However, first time visits for issues that are on a customer property (where no further work is undertaken) and where there was no network issue found are considered retail activities. The cost of initial inspections has been taken from timesheets completed by the technicians. The costs relating to these jobs are transferred to Retail within the Customer Services activity.

Customer Side Leaks – The activities in relation to fixing customer side leaks are undertaken by the Wholesale water teams, these are identifiable via timesheets. The costs of the initial visit and follow up visit along with the associated FTE are transferred to Retail and allocated 100% to Customer Side Leaks.

General and Support Expenditure – General and support expenditure is allocated to Retail using appropriate cost drivers determined for each support function and is recorded in Other operating expenditure. Please refer to the section 7 for the general and support allocation methodology.

Team responsibilities and allocation to activities

Business Area	*Team(s) / activity*	*Retail activity types*	*Cost allocation/driver*
Metering Services	Costs relating to planning, scheduling and execution of meter reads. Predominantly people costs + costs of fuel, lease vehicles for meter readers.	Meter Reading	100% allocation
Credit Management	People + 3rd party costs relating to chasing debt and litigation (court costs). The bad debt charge sits within this cost centre.	Debt management Doubtful debt expense	100% allocation 100% allocation
Customer Contact	Costs predominantly relate to people costs of call centre agents and team leaders in relation to frontline Customer Service operational call centres and to Customer Contact and Credit Management.		The costs within the Customer Contact centre need to be first split based on the activities the individuals in the cost centres are undertaking. Specific individuals focus on debt collection and the remainder focus on a mixture of billing and payment handling and other queries. The costs attributed to the proportion of people focusing on debt is directly allocated to debt management retail activity. The remaining individuals are then split on the basis of customer contact volume. The customer contact volume report is provided by the operational team and breaks down all contacts by reason. Once all reasons have been assigned to a retail activity, a sum of the number of contacts for each retail activity is performed and shown as a % of the total volume of contacts.

Allocation to Household/Non-household

Business Area	*Team(s) / activity*	*Cost allocation/driver*
Billing	Number of bills raised	Split is determined using the Bill Volumes sent to Household and Non-Household Customers.
Payment handling, remittance and cash handling	Number of payments received from each group of customers	The costs associated with the total number of payments by each account type split by Household and Non-Household.
Vulnerable Customer Services	Direct Allocation	100% to Household
Non-network customer enquiries and complaints	Number of household and non-household Customer complaints	Pro-rated to household and non-household
Network customer enquiries and complaints	Number of household and non-household Customer complaints	Pro-rated to household and non-household
Network customer enquiries and complaints (Investigatory visits).	DST's Allocation	Investigatory visits / first visit to the customer - recharges from Wholesale. Retail Household and non-household is captured through customer jobs.
Other direct costs	Number of Household and Non-household Customers	The costs associated with this activity are apportioned between household and non-household
Debt management	The household and non-household proportion is based on debt write-off	Debt management costs are split using the value of aged debt over 1 year
Doubtful debts	Split of Bad Debt Charge	Split of Bad Debt Charge based on proportion of revenue
Meter reading	Number of meter read	The costs are allocated between Retail household and Retail non-household based on the number of reads
Services to developers	Direct Allocation	100% to Non-Household
Customer Side Leaks	BOPPs Allocation	The costs of the initial visit and follow up visit including repair costs along with the associated FTE are transferred to retail and allocated 100% to gross expenditure customer side leaks.

2D Historical cost analysis of fixed assets - Wholesale and Retail

The tangible fixed asset table is calculated allocating assets in the SAP fixed asset register to price control via use of cost centres and profit centres and allocating the work in progress (WIP) to price control via analysis of projects.

FIXED ASSET REGISTER

The full historic cost fixed asset register is downloaded into excel. Each asset has a cost centre assigned to it. Additional attributes are added to the data to enable the completion of the fixed asset table:

- Infra/non infra classification - this classification is based on the asset class code given to the asset
- Income/expenditure classification - as the fixed asset table excludes capital income (which is reclassed to deferred income in the balance sheet), all income asset class codes are excluded from the table
- Intangible/Tangible classification - Table 2D is only applicable for Tangible assets, therefore intangible assets are excluded
- The profit centre that the cost centre is assigned to is added to the register by looking up to a SAP cost centre download provided by Management Accounting. This is used to determine the price control and the relevant business unit and support area for Management & General (M&G) assets
- An adjustment is made to change the profit centre where the profit centre assigned to the cost centre was set up incorrectly in SAP

M&G principal user assignments

The percentages from the G&S opex allocations are applied to determine the principal user to be identified. This is the business unit with the highest percentage allocation. Where the finance business partner believes that the asset principal user is different from the opex percentages or where there is no opex activity in the cost centre, the principal user identified by the finance business partner is used instead.

Principal user cannot change year on year so once it has been assigned this is permanent. Recharges to/from calculations for Table 2A are then determined by multiplying the relevant depreciation by the opex cost drivers

Management and general assets are assigned to a principal user using the following bases:

Business area	*Basis of assignment*
Information systems	Assignment using IS business area costings
Transport	Assignment on the basis of vehicle recharges
Property services	Assignment on the basis of floor space used

Reclassifications

Other adjustments are made to record changes required to the underlying fixed asset register. This may be because assets have been posted to the incorrect cost centre at source or to include late adjustments at year end posted in Tagetik once SAP has closed.

Meter reclassifications - Water meter consumer boxes (infrastructure assets) which are recorded in Retail cost centres which are reclassified to Wholesale treated water distribution for regulatory purposes.

Reservoir reclassification – this arises as a result of the specific RAG 4 guidance on the classification of reservoirs (See Section 2. Disaggregation of wholesale activities – upstream services - raw water abstraction and raw water storage asset definitions).

Water resources (Raw water abstraction) reservoirs are those that have:

(1) their own abstraction licence or
(2) natural catchment or
(3) support downstream abstraction or
(4) None of the attributes of (1) to (3) above but have 15 days or more usable storage

Water Network + (Raw water storage) reservoirs are those that are:

Storage reservoirs and other storage assets that are not captured by the definitions in raw water abstraction and have less than 15 days usable storage

Water cost centres are set up at an area level whereby multiple sites are assigned to a cost centre. We therefore use the finance location which is assigned to each reservoir site to identify which cost centre and therefore which profit centre and price control business unit the asset has been assigned to in the fixed asset register. This is reviewed against the RAG 4 guidance and those requiring reclassification are identified. The respective values are then transferred from Water Resources to Water Network +.

The above adjustments have taken place in the fixed asset table in the current year, hence a reclassification of the opening balance position has been recorded in the adjustments line in 2D.

Other adjustments

As stated above, M&G assets are assigned to price control based on principal user assignment. A review of the prior year M&G assignments was undertaken as part of the current year process. This highlighted that M&G cost and related depreciation had been allocated instead of assigned on a principal user basis.

This has led to transfers in the adjustments line in the cost and depreciation sections of the fixed asset table which related to resetting the opening position of the M&G assets.

WORK IN PROGRESS

The WIP projects have been recorded line by line in an excel document for 2017/18. This has been analysed on a project by project basis against the business unit activities and related assets outlined in RAG 4.

A final reconciliation is performed between the net book value of the tangible assets in the statutory accounts to the regulatory accounts, the only difference expected being capitalised interest.

2E Analysis of capital contributions and land sales – wholesale

Grants and contributions have been allocated between water in accordance with the nature of the income. Grants and contributions fully recognised in the income statement relate to IRE income. All other grants and contributions received are capitalised and amortised against depreciation.

Connection charges are contributions received from developers for service connection charges for installing a new service pipe and meter. (Water Industry Act s45).

Infrastructure charge receipts are contributions received in the year for new connections. This reflects a contribution to the costs of enhancing the local water network. (Water Industry Act s146).

Requisitioned mains are contributions received from developers to requisition a new water main. (Water Industry Act s43, 55, 56 & 100).

Diversions are contributions received from local authorities, highway authorities and private companies to divert water mains. (Water Industry Act s185).

Other contributions are received from organisations towards the construction of specific capital projects, e.g. health authorities for fluoridation or government departments for environmental schemes.

Capitalised grants and contributions balance sheet

The opening value of capitalised grants and contributions has been brought forward as at 1 April. The total value of grants and contributions capitalised in the year agrees to the total value of grants and contributions recorded in the column 'capitalised and amortised against depreciation'. The total value of amortisation of the income assets agrees to the value released to the income statement in the year.

Proceeds from disposal of protected land

These are the net proceeds, after the deduction of all offsetting costs from disposals of protected land.

2F Household - revenues by customer type

The CIS billing system holds all customer data and the reporting system holds specific reports which are used to split the revenue into customer types.

Properties categorised as voids are excluded from billing and will not form part of the overall customer categorisation. The overall proportion of voids will amount to an insignificant proportion of total customers. Number of households billed is fully provided from the corporate source systems for all categories and will be for Water only.

2G Non-household water - revenues by customer type

Reports for large user and non-standard water customers are taken from the CIS system to give property numbers, meter size and volume usage for those customers. All remaining customers are broken down by meter size.

For the large users and non-standard water customers both their standing charge and their volumetric charge are calculated by multiplying either the property count, or the volume count respectively, by their appropriate charge for each tariff (linked to meter size). The wholesale/retail split for these charges are obtained by taking the relevant value for wholesale and retail from each tariff for each particular component.

For all other users their standing charges are calculated by taking property counts for each meter size and multiplying it by the standing charge for the appropriate tariff. The wholesale/retail split for the standing charges are obtained by taking the relevant value for wholesale and retail from each tariff for this particular component. Their volumetric charge is then the remaining value of measured revenue remaining once large user charges (standing and volumetric), non-standard user charges (standing and volumetric) and other users (standing charges only) have been deducted. The wholesale/retail split for this remaining charge is obtained by taking the average of the wholesale/retail split for the 50mm tariff for both Chester and Wrexham and applying this split.

All unmeasured charges are split based on property numbers within Chester and Wrexham with the appropriate tariffs applied to each charge element.

The revenue calculated for each service is then checked against the following:

- Management Accounts reported revenue – this is to ensure that before taking into account any movements for the Regulated reported revenue the revenue calculated was accurate
- Table 2I – to ensure reported revenue is aligned appropriately for each service component.

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2I Revenue analysis and wholesale control reconciliation

The wholesale/retail charges are determined as part of the Charges Submission process. Agreed tariffs are assigned a unique code which maps them to a customer type. Revenue will be broken down against the charge submission document and the wholesale/retail split applied appropriately based on customer splits.

2J Infrastructure network reinforcement costs

- A spreadsheet has been maintained recording spend on each project during the year.

- Each project is assigned to a business plan line (BPL) which aligns to regulatory reporting and internal categories to allow reporting of capital expenditure against planned activity.
- Specific business plan lines relate to infrastructure network reinforcement costs where the investment driver relates to managing supply demand balance specifically in relation to growth.
- Expenditure on low pressure improvements related to growth is included but expenditure on low pressure improvements related to enhanced service levels is excluded from the table.
- Expenditure on other non growth related supply demand balance projects are excluded e.g. hot weather action plans
- The projects in the infrastructure network reinforcement BPLs are reviewed by a subject matter expert on completion of the table to ensure that expenditure has been correctly coded at source with adjustments made where required.

Water

- BPLs identified as water infrastructure network reinforcement growth lines are:
  - Network reinforcement off-site capex - local reinforcements, hydraulic capacity (undersized assets) and strategic growth reinforcements
  - On-site capex – new development and new connections expenditure

- A further categorisation of the expenditure is made into distribution and trunk mains and pumping and storage facilities where the former is all infrastructure expenditure and the latter is non-infrastructure. This categorisation is derived from the purpose mapping for each project which identifies if the spend is infrastructure (below ground) or non-infrastructure (above ground) related.

7. Upstream services

The wholesale water operating and capital expenditure is allocated to upstream service by applying the below approach:

(1) direct where appropriate;
(2) by identifying specific cost drivers by retrieving the relevant management information;
(3) management estimate where management information is not available;

Capital expenditure allocated to upstream services is at the same point as business unit allocation by business plan line and purpose code analysis or once business unit allocation has occurred (if business plan line and purpose code cannot determine this) by use of appropriate cost driver based on management information or management estimate.

The table definitions in RAG 4 are used to identify the boundary points and assets in each upstream service.

Business Unit	*Cost type*	*Upstream allocation*
Water resources	*Abstraction charges*	100% Abstraction licences
	All other costs	100% Raw water abstraction
Raw water distribution	Power	100% Raw water transport. Raw water storage uses negligible power
	Cumulo rates	Analysed the assets on DSR and DIR locations and allocated on infra & non infra GMEAV.
	Other costs	Analysis of number plant maintenance jobs at sites with raw water transport and raw water storage assets expressed as a percentage of total jobs.
Water treatment		No disaggregation of water treatment to upstream services is required
Treated water distribution		No disaggregation of water treatment to upstream services is required

Derivation of the quantities used to calculate the unit cost information

Licenced volume available - The total volumes available from water licenced abstractions are recorded centrally in mega litres (Ml). These are the volumes available in any one year.

Volume abstracted/transported - The total daily volume data from Operator readings and telemetry data is collected across the region, these numbers are then totalled for all sites for the year, giving total abstractions. It is assumed that the total volume transported is the same as the volume abstracted.

Average volume stored – The total daily volume data is recorded weekly and the average volume stored number used is an average of these weekly numbers.

Distribution input volume - Water distributed into supply is calculated monthly and is based on meter readings recorded at Water Treatment Works across the estate. Distribution Input volume for Water Treatment is calculated as the volume of potable water produced by the water treatment works. Distribution Input volume for Treated Water Distribution is calculated as the volume of potable water input into the network including bulk imports from other companies and less bulk exports to other companies.

8. General and support allocation methodology

General and support costs are identified in the ledger by cost centre. These are apportioned between water and retail following the rules detailed in the table below.

For some central functions where the tasks do not specifically relate to water or retail, costs are allocated based on a FTE allocation percentage.

Employee FTE percentages have been used for allocation of general and support costs for specific functions across price controls and for a number of shared cost centres whose activity straddles more than one price control.

In SAP, FTE's are assigned to individual cost centres. A SAP business warehouse report identifies the number of FTE's in each cost centre on a monthly basis. This captures the below employees:

- Direct – employees on the payroll, including fixed term contractors
- Indirect – employees hired via our recruitment agency partner as contractors/agency

The average number of FTE's over the 12 month period is calculated for each cost centre.

Where FTE costs have been capitalised, we have removed a proportion of FTEs to reflect the costs removed from operating expenditure. For costs identified as non-appointed, FTE's related to this activity have been removed based on the material costs associated with these activities.

The FTE numbers are grossed up for the number of Wholesale/Retail direct operations and operations support FTEs which are recharged from Severn Trent Water. This ensures that the support costs are being allocated to the areas utilising the costs.

Allocation of general and support expenditure between business areas.

Type of cost	*Basis of Allocation*	*Process*
Finance	FTE	Ratio of Wholesale (excl. Asset Creation) to Retail FTE
HR	FTE	Ratio of Wholesale (excl. Asset Creation) to Retail FTE
General Counsel	FTE	Ratio of Wholesale (excl. Asset Creation) to Retail FTE
Strategy & Regulation	Regulation costs	1/5th to retail for water only companies
Health & Safety	Management estimate	Health & Safety activities are allocated between Wholesale and Retail. Standard Dams and Assurance and Resilience activities are allocated to Water.
Technology	Direct cost attribution & FTE	The ATOS CIS system cost has been identified separately as it is the customer billing system and therefore directly charged to Retail.

		The remainder of the costs are all allocated by number of FTE which is a proxy for number of computers
Packsaddle	Occupancy	The Packsaddle office site is shared by Wholesale and Retail and allocated number by heads occupying the building.
Property Management	Wholesale direct	The Property management costs are allocated based on causality – costs are attributed to wholesale activities as these activities have caused the cost to be incurred.
Group Commercial	Wholesale direct	Group Commercial cost centres are allocated based on causality – costs are attributed to wholesale activities as these activities have caused the cost to be incurred.
Stores Management	Wholesale direct	Stores management cost centres are allocated based on causality – costs are attributed to wholesale activities as these activities have caused the cost to be incurred.

G&S costs are allocated between household and non-household based on number of customers.

A summary of the G&S allocation by support function is outlined below:

Support area	*Water*	*Retail HH*	*Retail NHH*	*Total*
Finance	81.1%	17.8%	1.1%	100.0%
HR	81.1%	17.8%	1.1%	100.0%
General Counsel	81.1%	17.8%	1.1%	100.0%
Strategy & Regulation	80.0%	18.8%	1.2%	100.0%
Health & Safety	97.3%	2.5%	0.2%	100.0%
IT	44.6%	52.1%	3.3%	100.0%
Property	85.2%	13.9%	0.9%	100.0%
Group Commercial	100.0%	0.0%	0.0%	100.0%
Stores Management	100.0%	0.0%	0.0%	100.0%

9. Capital expenditure process

Capital investment framework (CIF)

The company's capital investment framework (CIF) manages large capital programmes. Capital projects go through a formal approval process as follows:

Owner(s)	*Process / activity*
Project Manager	Submit a business case template (project/ application) outlining the operating and capital expenditure.
Programme Board	Discuss and review project with the Finance Analyst teams.
Investment Governance Analyst	Scrutinise project applications and assess whether operating costs and capital expenditure have been allocated correctly. In the event that they disagree with the proposed accounting treatment the project manager is advised accordingly. In certain circumstances, the guidance issued by the Analyst Team may be contested by the project team. In such cases the proposal is referred to Group Finance who after referring to the appropriate International Financial Reporting Standard or Regulatory Accounting Guidance, provide a defining judgement on the issue.
Group Finance	Issue a guidance note to aid business users in the preparation of their capital investment proposals. This tends to occur for more complex areas where the applicable accounting principles, as defined in the capital expenditure accounting policy, are less easily understood by non-finance professionals.

Labour, pensions and overhead absorption rates ("Burdening")

This is a process that enables the recovery of costs from departments (primarily Support) whose activities are indirectly linked to the capital programme. The burdening process calculates these costs and allocates them to capital accordingly.

The overhead burden rate is calculated as follows:

Total allowable staff and support function costs to be recovered divided by the gross annual investment programme expressed as a percentage.

The burden rate is refreshed at half year and then finalised at the year end.

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