Accounting separation methodology statement for activity costing analysis 2013/14

sembcorp
bournemouth water

Accounting Separation Methodology Statement for Activity Costing Analysis 2013/14

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Overview of the accounting separation methodology statement for 2013/14

The purpose of this document is to outline the way we allocate costs and assets between the different functions, or "business units", of the Company.

These costs and assets are presented by business unit in tables A – D in the notes to the Regulated Business Current Cost Accounts, which form part of the Directors' Report and Regulatory Accounts for the year ended 31 March 2014.

The five business units referred to in this document are:

Service Area	Business Unit
Wholesale water services	Water resources Raw water distribution Water treatment Treated water distribution
Retail water services	Retail household & non-household

Wholesale water services include identifying water sources, abstraction, storage, treatment, and transportation of water.

Retail water services include sales, billing, debt collection and customer services.

Most costs and assets are recorded directly to business units. Where they are not, we reallocate costs to the relevant business unit. The methods used to calculate the reallocation of costs varies depending on the type of cost or asset in question and are detailed in this document.

The following pages are designed as a detailed commentary for Ofwat and other technical regulatory accounting readers.

Detailed accounting separation methodology statement for 2013/14 (prepared for Ofwat).

1. Company background

Our appointed business consists of two service areas – wholesale and retail; which comprise five business units (as detailed on page 2). Wholesale water services are further identified into sites and/or departments. Retail water services are further identified into departments.

Our core customer service activity comprises a number of functions, including billing; payment handling, remittance and cash handling; charitable donations; vulnerable customer schemes; non-network customer enquiries; and network customer enquiries and complaints. The related overheads are included as general and support expenditure.

We outsource some of our functions to other companies based in the UK, including pipe maintenance, printing our bills and some debt collection. Some water sampling is outsourced to South East Water. We outsource some IT and senior management support services to our ultimate parent company based in Singapore.

Billing and collection of debts is largely undertaken internally. However we do outsource the collection of a small volume of debts where the customer has vacated the property. We retain the risk for collecting these debts. The amount of debt collected by this method is very small and represents a negligible amount of our water income.

Bills may be issued in the name of "the occupier" when a property is believed to be occupied but the occupier's details are not known. £0.054m of turnover and £0.013m of doubtful debt are recognised in the 2013/14 accounts in respect of bills issued in the name of "the occupier".

Debts are provided for based on historic trends of debt collectability by customer class. The Company's bad debt provision and write off policy has not changed from that of 2012/13.

When a customer vacates a property leaving unpaid debts, efforts are made to trace the customer and legal action may be pursued if it is considered to be cost effective. We do not raise credit notes to cancel debts relating to customers vacating properties. Any uncollected debt is treated as a bad debt.

2. Changes and improvements from the 2012/13 methodology

We have made minor changes in our methodology for accounting separation compared to 2012/13. These changes reflect the updated regulatory accounting guidelines, including the allocation of regulatory costs and scientific services.

We have made improvements to the allocation of some wholesale costs which we previously allocated to general & support costs. These costs are now directly allocated internally to the relevant employment or hired & contracted line. This change has had no effect on the numbers reported in the accounts as the detailed internal allocation is summarised within the same line in other operating expenditure in the wholesale operating cost table[1].

We have also made minor changes to the allocation of household and non-household retail costs, to more closely reflect the underlying activities.

All changes to cost allocations are incorporated in the finance system, rather than using spreadsheets. This improves the underlying integrity of the process and efficiency for future years.

We allocate many of the costs directly to the business units, reducing the need for manual calculation. In future years we are looking to continue to improve this process of automating the allocation of costs. In particular we seek to simplify the method that costs are automatically allocated, without reducing the level of accuracy that is achieved.

[1] Operating Cost Analysis for the Wholesale Business, table A in the Notes to the Regulated Business Current Cost Accounts

Detailed changes made in 2013-14 Retail

Customer services: Billing

The majority of account management costs, including such costs as printing bills and postage have been allocated to billing costs. This is a change from the prior year when the costs were allocated to other operating expenditure. We think it is appropriate to make this change since these costs relate to customer bills. The costs of billing are allocated between household and non- household based on the number of bills raised in the year, by customer.

Customer services: Payment handling, remittance and cash handling

These costs are now allocated between household and non- household based on the number of payments each area received. This change more closely reflects the activity from the prior year where costs were allocated on the number of bills raised.

Customer services: Network and non-network customer enquiries and complaints

These costs are allocated based on the network call logs by customer type. However, if there is only a minor change in this (less than 2%) the prior year numbers are used for simplicity. We plan to use actual updated information in future, regardless of movement, for accuracy.

Debt management

Costs of debt management are allocated according to the number of accounts overdue for more than 30 days at year end for household and non-household customers. This is an improvement from the prior year, which was allocated based on the total outstanding debt, rather than overdue debt.

Meter reading

Meter reading costs are allocated based on the number of meter readings made by customer type during the year. The number of meter connections has been used in the past. We have changed to using meter readings as this will better reflects the costs.

Services to developers

The costs of a designated network service officer and a small percentage of customer service cost are allocated 100% to non-household. We believe this has improved the accuracy of allocation compare to the previous year when only customer service costs had been allocated.

Other operating expenditure: Metering operating expenditure

Other meter costs were previously allocated to other operating expenditure. As detailed above they have now been moved to Customer services.

Other operating expenditure: Other business activities (regulation)

Regulation costs and the Ofwat licence fees have been split equally between BUs as per Ofwat guidance (retail is treated as one BU). These costs are then allocated between household and non-household based on customer numbers. Management estimated time was used in the prior year.

Significant changes and commentary

The following tables outline the significant changes in retail costs from the prior year. We consider "significant" to be when the movement is greater than 10% of the prior year balance.

Retail household	2013-14 (£m)	2013-14 (£m)	Commentary
Customer Service HH	1.344	0.745	This is largely due to increased staff numbers and higher salary levels awarded to retain staff and improve service. A new role of communications manager was created to further improve our customer service. Meter related customer service costs were also transferred from other operating expenditure.
Debt management HH	0.473	0.412	The change in methodology has increased costs allocated to HH, and there is a small general costs increase.
Third party services operating expenditure HH	0.040	0.089	The reduction is caused by a lower level of demand in the year.
Current cost deprecation HH	0.238	0.194	The increase is due to additional assets being acquired in the year.
Recharges to other business units HH	0.000	-0.013	Transfer of deprecation to NHH no longer required.
Recharges from other business units HH	0.039	0.026	Reduction of transfer to NHH. See below NHH.

Retail non-household	2013-14 (£m)	2013-14 (£m)	Commentary
Customer Service NHH	0.160	0.068	Additional costs were transferred from other operating expenditure NHH, see below.
Debt management NHH	0.022	0.039	Change in method has decreased costs allocated to NHH.
Doubtful debt NHH	0.021	0.063	This decrease is due to fewer bad debt write offs. One large bad debtor has significant effect to this small base number.
Services to developers NHH	0.035	0.001	The increase is due to additional assets being acquired in the year.
Other operating expenditure NHH	0.262	0.365	A review of cost allocations identified that some meter related customer service costs had previously been misallocated to other operating expenditure. This was corrected in 2013/14.
Third party services operating expenditure NHH	0.002	0.005	Affected by lower level of demand in the year.
Recharges from other business units NHH	0.021	0.030	Reduction of transfer to NHH. See above HH.

3. Systems used and sources of information

We operate a SAP accounting system which has a mirror accounting system called a Special Purpose Ledger (SPL). The SPL is used for accounting separation purposes. It allows costs to be reported by business unit (BU) for accounting separation, after the reallocation of costs.

A process called “allocation cycles” is used within the SPL to allocate the costs, as detailed below. In effect, most costs are summarised directly into a specific cell in the water service and retail service cost tables[2].

Information regarding staff activity is collected using a number of operational systems, including job management, billing and telephone logging systems. We also maintain an information management function which allows reliable timesheet information regarding staff activity to be collected.

We have developed a formal process for allocating management time and support costs where these are spread across more than one BU or line in the cost tables. This process is specifically for the purpose of accounting separation.

4. Processing of data - Operational costs

We gather the information required to allocate costs, such as job hours, water samples, IT calls and floor space occupied. We then calculate the allocation percentages and apply these to the allocation cycles in the SPL.

We run the current year allocation cycles to allocate the costs between the BUs. Next we run three reports which are designed to populate the operational cost tables[3]. The reports created within the SPL are exported to an excel spreadsheet where we summarise the data into the OFWAT table layout.

These tables are reconciled to the main SAP general ledger and to the Company management accounts to ensure completeness and accuracy.

[2] Tables A – D in the Notes to the Regulated Business Current Cost Accounts
[3] Tables A and B in the Notes to the Regulated Business Current Cost Accounts

5. Assumptions made - Operational Costs

In allocating operational costs between the BUs, some assumptions have been made:

Control Room costs

We maintain two control rooms and costs are allocated to these directly. However the control rooms effectively share costs, as staff move between them and each location provides back-up support for the other. As a result we have combined the control room costs and then allocated the combined costs over the BUs.

Line allocation hierarchy

Where costs are directly attributable to the activities undertaken in a BU, these costs are allocated in the direct cost lines.

General company costs from departments such as Finance, IT and HR are reflected in the “Other operating expenditure” line rather than the direct cost lines. Support costs (including audit fees, payroll, procurement, general computer software support and maintenance) are treated the same way. These costs are then allocated to the BUs using the most appropriate basis to reflect activity, for example telephone logs.

Household and non-household

The retail operating cost table[4] shows the allocation of costs between household and non-household. We do not have a separate non household department, so most direct retail costs are initially recorded as household costs and are reallocated from there.

[4] Operating Cost Analysis for the Retail Business, table B in the Notes to the Regulated Business Current Cost Accounts

6. Cost allocation principles applied

This methodology has been prepared in accordance with Ofwat's cost allocation principles, as outlined in RAG 4.04 "Guideline for the definitions for the regulatory accounts table":

Transparency

Our accounting system has been set up with the Ofwat reporting requirements in mind. This enables us to more easily identify costs which need to be allocated. These cost allocations are then made within the finance system, according to cost drivers explained elsewhere within the methodology statement.

Causality

Costs are allocated to those activities and services that cause the costs to be incurred. Costs are attributed to the cost centre which generates the cost. A cost centre is made up from sites, departments and activities, which enables a detailed level of costing.

Non-discrimination

We allocate the costs to the business units using the most appropriate drivers. Our internal transfer charges are consistent across all business units. Where the external parties are charged at cost the same labour rates are used.

Objectivity

Costs and revenue are allocated to the "owning" cost centre, with no regard to how such an allocation might, or might not, affect a business unit or service.

Consistency

The vast majority of our costs are treated consistently from year to year. However, should guidance change, or we identify a way to improve our accuracy in reporting, we will then make changes. These improvements are referred to elsewhere in this document (see section 2 – Changes and improvements in this methodology statement) where they are clearly identified and the reasons for any changes given.

7. Allocation basis used

This section details the basis for allocating costs between the rows in the current cost tables and the BUs.

Wholesale water services

Row allocation

All direct line costs are allocated to lines straight from the general ledger.

Business unit allocation

The majority of sites (physical sites and operational functions) within the Company fall into only one BU. Direct costs relating to these sites are therefore allocated entirely to that BU.

Where sites do not fall entirely within a single BU, activity based methods are applied to allocated costs between BUs. This is considered to most accurately reflect where the costs sit. A variety of cost drivers are used to reflect the activity basis for the site. The most appropriate cost driver is used depending upon the type of cost or the site in question.

- **Control room**
  All costs relating to the control rooms are allocated across BUs based on the number of telemetry hits by the site that generated the hit. (Telemetry refers to automated reporting and control systems, and includes telephony costs).

- **Knapp Mill offices**
  The offices and site infrastructure at Knapp Mill cover a number of sites that are directly allocated. The cost associated with Knapp Mill have been allocated on the basis of Gross Modern Equivalent Asset (GMEA) costs of the regulated business, as we feel that the costs of offices, service roads and security etc relate directly to the amount of assets on site.

- **Inspectorate**
  The inspectorate covers a number of operational functions across both wholesale and retail BUs. Costs are allocated based on the number of inspector hours recorded in the job management system.

- **Vehicle costs**
  Commercial vehicle workshop costs are directly allocated to the non-regulated business.

  Core vehicle workshop costs, including depreciation, are charged on the basis of vehicle type and the number of vehicles assigned to each BU. The vehicles used by the non-regulated business have been excluded from this calculation as charges to these vehicles already include an overhead element. Charging costs based on vehicle usage is considered the most appropriate method of apportionment.

  Fuel costs are mostly directly allocated to sites within a BU. Where costs are not directly allocated we use a range of appropriate cost drivers to allocate costs, such as job hours.

- **Maintenance costs**
  Most maintenance costs are allocated directly to sites which fall within a single BU. Maintenance costs which are not directly allocated, such as supervision, are apportioned amongst the BU's based on the ratio of the number of jobs performed in each BU.

- **Supply Knapp Mill**
  Costs for this site have been allocated directly to the Treatment BU. This is consistent with the prior year.

- **Scientific service costs**
  Scientific service costs relate entirely to wholesale. These costs are allocated based on the number of samples taken by each BU.

- **Engineering department costs**
  Most engineering costs are allocated directly using our time management system. Any unallocated costs are allocated using the ratio of hours recorded to sites.

- **General and support**
  These have been allocated on the following bases:

Cost	Basis of allocation
IT costs	The number of IT Support calls by site weighted by software complexity for each department.
Personnel costs	Estimated management time spent on each BU.
Office costs	Office space occupied by each BU.
Insurance costs	Company GMEA, for consistency purposes. IT department insurance costs are allocated using the same method as IT costs above.
Quality & compliance costs	Estimated management time for each BU. In previous years GMEA was used to allocate costs. We no longer consider these costs to be asset linked.
Finance & general management costs	Management estimated time for labour costs and Company GMEA for other costs.

- **Other business activities (regulation)**
  Regulation costs and the Ofwat licence fees have been split equally between the BUs as per Ofwat guidance. This is a minor change from the prior year.

- **Local authority rates**
  Local authority rates are billed on a cumulo basis. Local authority rates area allocated using the GMEA of the regulated business. Rates are levied in relation to the Company turnover. Therefore allocating the costs based on the GMEA reflects the capital employed in producing the turnover.

- **Other direct costs**
  Most other direct costs, such as software maintenance, professional and legal fees, are directly allocated to the BUs. Where some costs do not fall wholly within a BU we use the most appropriate cost driver to allocate costs over other BUs.

Cost Category	2013/14 (£m)
Fuel Costs	0.173
Compensation & Penalty charge	0.072
Hire Equipment	0.002
Industrial Waste Disposal	0.077
Permit & Licence Fee	0.034
Office Supply & Stationery	0.006
Telecommunication Expenses	0.125
Professional & Legal fee	0.051
Subscription	0.032
Software Maintenance	0.051
Travel Expenses	0.007
Admin Expense - Other	0.068
Credit for internal vehicle leasing	-0.069
Commercial Vehicle	0.027
Uniforms & Accessories	0.001
Total Other Direct Costs Wholesale	**0.657**

Retail services

Row allocation

The majority of costs are allocated directly from the general ledger to the lines in the retail operating cost table. Most direct costs are initially recorded as household and are then reallocated between household and non-household.

Some costs are reallocated from wholesale BUs to both household and non-household BUs. Such costs include:

- Wholesale office costs
- Inspector costs

The company uses a payment processing agency and a bill print provider to issue customer bills. All other significant functions are managed in house.

Business unit allocation

As for the wholesale water BU allocation, activity based methods are applied to allocate costs as this is considered to most appropriately reflect where the costs should sit.

- **Customer Services**
  Customer services include customer service centre, billing, payment handling, network and non-network customer enquiries and complaints, charitable trust donations and vulnerable customer schemes. The allocation basis is as below:

Cost	Basis of allocation
Customer service centre	Costs are initially allocated to household on the different lines in the retail service table based on the numbers and types of calls received at the Company's call centre. These costs are then allocated between household and non-household using the same basis below for each line.
Billing	Number of bills raised.
Payment handling, remittance and cash handling	Number of payments received.
Network and non-network customer enquiries and complaints	Number of network call logs by customer type. However, if there is only a minor change in this (less than 2%) the prior year numbers are used for simplicity. We will always reflect with updated information even if it is a small change in future to improve the accuracy.
Charitable trust donations	All household
Vulnerable customer schemes	All household

- **Debt management**
  Costs of debt management are allocated according to the number of accounts over due for more than 30 days at the year end for household and non-household customers. This is a minor change from the prior year, which was allocated based in the total outstanding debt.

- **Doubtful debts**
  The doubtful debt charge is allocated to household and non-household in accordance with the specific customer.

- **Meter reading**
  Meter reading costs are allocated based on the number of meter readings made by customer type during the year. The number of meter connections has been used in the past.

- **Services to developers**
  The costs of a designated network service officer and a small percentage of customer service cost are allocated 100% to non-household.

- **Local authority rates**
  Local authority rates are allocated on the same basis as for wholesale water services, using the GMEA of the regulated business.

- **Third party services operating expenditure**
  These costs are directly allocated to the household and reallocated to non-household based on customer numbers by type.

- **Other operating expenditure**
  Other operating expenditure includes meter operation expenditure, demand side water efficiency, customer side leaks, other business activities, other direct costs and general support.

The allocation basis of other operating expenditure is as below:

Cost	Basis of allocation
Metering operating expenditure	Number of meter connections by customer type.
Demand side water efficiency	Number of customer where the costs are not directly attributable to the specific job.
Customer side leaks	Number of customers where the costs are not directly attributable on a job specific basis.
Other business activities (regulation)	Number of customer between household and non-household.
Scientific services	All in wholesale.
General and support	General and support basis of allocation for retail is the same as wholesale, see above.
Other direct costs	Majority of other direct costs in retail relate to inspectorate costs, which cover a number of functions across both table and BU boundaries. Costs are allocated based on the number of hours recorded in the job management system for each site between wholesale and retail. These costs then are allocated to household and non-household based on customer numbers.

The following table shows a breakdown of the other direct costs:

Cost Category	2013/14 (£m)
Fuel Costs	0.002
Employment Costs	0.076
Materials & Consumables	0.019
Compensation & Penalty Charge	0.012
Office Supplies & Stationery	0.014
Software Maintenance	0.002
Other Admin Costs	0.007
Total Other Direct Costs Retail	**0.132**

8. Sampling

No sampling has been used for the purposes of allocation either by row or by BU.

9. Asset capitalisation

Expenditure on an asset is capitalised where the cost exceeds £500 (£5,000 for computer software).

Compliance with Regulatory Accounting Guidelines (RAGs)

The asset register holds more detailed asset information and has a greater degree of granularity than is required by the RAGs. This is reviewed as part of the annual statutory and regulatory audits.

Capitalisation of overheads

Only labour and overheads that are directly attributable to a capital project are capitalised as a part of the asset. This includes current pension service costs and national insurance. General overheads are not capitalised.

Procedures and internal guidance in place

All capital projects are initially presented to the CAPEX committee. Once approved and commenced the asset is created in the fixed asset register by the financial accounting team. Costs are posted automatically to the asset using a job code. The asset register is an integral part of the finance system.

Checks to ensure compliance

The Company reviews the fixed asset register at suitable intervals and conducts a revaluation exercise as required under the RAGs. The Company's regulation manager receives any clarifications or changes to policy from Ofwat. These are passed on to the financial accounting team who ensure that the fixed asset register is in compliance. The fixed asset register is also subject to statutory, regulatory and internal audit checks.

Explanation of labour, pensions and overhead absorption

Directly attributable labour costs, including pensions and any related employment costs, are allocated on a standard labour rate basis. Indirect overheads are not capitalised.

10. Asset business unit allocation

Each asset holds a code which specifies to which BU the asset belongs. This code is used for reporting by BU. Assets also hold codes to signify whether they are additions or enhancements. The additions and enhancement list produced by the finance department is reviewed by the asset manager for appropriateness.

In the main, assets fall wholly into one of the BUs. A small number of assets will be used to service more than one area or function. In this case, we have followed guidance for the completion of tables and made a recharge based on our asset manager's assessment of the assets involved on a site. These percentages are now kept constant between asset revaluations as the Company is in a largely stable state regarding its above ground assets.

General & support assets are shared between wholesale and retail. We have allocated the depreciation of these assets equally between the five business units.

Process to ensure continued appropriateness

The fixed asset register holds more data than is required under RAG guidelines. Physical existence is confirmed on a rolling basis, and asset additions and disposals are monitored on a quarterly basis. This helps to ensure that the data is complete and accurate. Compliance with the regulatory requirements is ensured during the submission process to Ofwat.

Halcrow Group Limited, a company of independent engineers, inspected our fixed assets at 31st March 2008 and revalued assets and reported on the expected remaining lives. We included this revaluation within the Price Review (PR) 2009.

To enable the data to be brought up to date, the value for each asset in the register was created by calculating the GMEA and is adjusted for changes in the Retail Price Index (RPI) to give a current cost value.

We then compared the lives calculated by Halcrow against the current cost register to ensure that lives and depreciation charges were all still valid. The GMEA became the current cost register asset value for the Company in 2009/10. These values were transferred to a current cost register in SAP at 31 March 2012.

We maintain separate current cost and historic cost asset registers. Both are fully integrated in the financial system. Additions and disposals are recorded in the historic cost asset register, which automatically updates the current cost asset register. The system then generates the current cost depreciation based on assets' useful lives. The only entries made in the current cost asset register are to uplift the costs and depreciation for the RPI movement (as published on the Office for National Statistics website). This is performed at the end of our statutory year (31 December) and the regulatory year (31 March) using a program within the SAP SPL system. Due to the automated links between the two systems there is no need to reconcile the two asset registers.

The treatment of asset write offs and accelerated depreciation in the historic cost asset register is also automatically linked to the current cost asset register. We operate a perpetual asset review based on one third of the assets each year over three years. It is during this process that we will normally identify any adjustments that need to be applied to the asset registers. We also have a capital expenditure committee that meet quarterly. Its remit includes the above asset review and reviewing asset lives in particular, using profit and loss on disposals as a guide.

Assets allocated to Retail

Our asset registers record which BU an asset relates too, based on the entries made in the historic cost asset register when the asset is created. We allocate the shared assets using 1/5 split to five BUs (retail treats as one BU). Assets within the retail are allocated between household and non-household based on customer numbers.

The closing net book value and current cost depreciation of retail assets is split out as:

Cost	Net book value (£m)	Current cost depreciation (£m)
Billing system	0.757	0.105
Shared assets	0.574	0.113
Other assets	0.074	0.088
Total Retail Assets	**1.405**	**0.306**

A breakdown of the recharges the company paid to and received from other business units for the use of fixed assets is shown as table below. (This table does not include depreciation allocated to wholesale and retail from general and support.)

	Resources £m	Raw water distribution £m	Treatment £m	Treated distribution £m	Household £m	Non-household £m
Recharges to other business units	0.054	0.021	0.113	0.148	0.039	0.005
Recharges to other business units	0.000	0.000	-0.214	-0.166	0.000	0.000
Total Recharges	**0.054**	**0.021**	**-0.101**	**-0.018**	**0.039**	**0.005**