

# Accounting Separation Commentary 2016



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# OVERVIEW

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- 1.1. Bournemouth Water's (BW) appointed activities are analysed in the Regulatory Accounts between certain 'Retail' and "Wholesale" business units in respect of specific activities and cost categories<sup>1</sup> in the following areas:
  - Operating cost
  - Current cost capital maintenance charges
  - Current cost fixed asset values.
- 1.2. The purpose of this report is to provide an explanation of the key movements in costs during the year, and where appropriate highlighting changes in allocations or approach in the year as required.
- 1.3. During 2015/16 BW incurred £0.1m costs on restructuring which have been included in the tables.
- 1.4. The tables have been prepared in accordance with Regulatory Accounting Guidelines ("RAG's") issued in February 2013 (updated February 2014) effective for the financial year ended 31 March 2016. This means that the tables for 2015/16 have been prepared on an IFRS basis compared to 2014/15 which were prepared on a UK GAAP basis. This has increased Opex costs in the tables by £0.4m.
- 1.5. Total appointed business operating costs reduced by £0.6m from £22.3m to £21.7m. The key movements were:
  - £0.4m Moving to IFRS from UK GAAP
  - £0.2m - Cost increases including general inflation 1%.
  - £0.2m- Operating cost increases associated with new capital schemes
  - £0.2m – Costs in preparation for market opening

The above increases have been off-set by:

- £(0.3)m - A refund of abstraction licence fees
- £(0.2)m – Reduction in doubtful debt charges.
- £(0.5)m - Synergy savings arising from sharing costs with SWW
- £(0.1)m – Net non-recurring and atypical cost movements
- £(0.5)m – Net other efficiencies

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<sup>1</sup> Appendix A shows a summary of business units, services and activity examples.

- 1.6. The impact of the net cost increases varies across the business units and is dependent on activities and operational factors. The key operational impacts in the year have been:
- inflationary cost increases, for example power costs at 8.10%, increased by a higher proportion than some other third party costs.
- 1.7. The cost allocations between wholesale and retail have been reviewed. As a result we have changed how we allocate the majority of management overhead costs. These costs are now allocated in the same manner as staff costs, whereas previously we used Gross Modern Equivalent Asset (GMEA) values to allocate these costs. (Allocation of insurance costs for assets has remained unchanged, being based on GMEA.) This change more closely aligns our overhead cost allocation with allocation methods used for the recent Price Review, although we are using estimated activity drivers rather than FTE numbers to base allocations on.

Other cost allocation methodologies remain unchanged. In particular:

- Scientific services** – all costs (including sampling at customer tap) are considered a wholesale activity
  - Regulation** – costs for regulation are specifically required to be allocated equally between the 5 business units (four water and one retail)
  - Household / Non-household drivers** – the allocation of costs between household and non-households are based on the same series of metrics as last year but updated for current year actual results.
- 1.8. The table below highlights the total water and retail costs as per Table 2B and 2C for 2014/15 and 2015/16.

	Total	Wholesale	Retail	
		Water	HH	NHH
Operating Costs	£m	£m	£m	£m
2014/15	22.308	17.958	3.795	0.555
2015/16*	21.676	16.820	4.008	0.847
<b>Cost decrease</b>	<b>(0.632)</b>	<b>(1.138)</b>	<b>0.213</b>	<b>0.292</b>

\* 2015/16 costs shown on IFRS basis

- 1.9. Whilst direct operational cost impacts are separately identified within each unit, the corporate costs (whether directly charged or allocated through an appropriate metric) impact differently across all business units depending on the nature of activity.

# CORPORATE COSTS

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- 2.1. Corporate costs include:
- Health & safety management and central costs
  - Facilities and accommodation
  - HR and employee support
  - Information Services (IS) costs where not directly attributable
  - Finance and procurement
  - Corporate costs (including BW Board) and Pennon group charges (including legal, treasury and internal audit)
  - Insurance.
- 2.2. As outlined in our methodology, some corporate costs (for example insurance, specific IS charges) can be directly allocated between wholesale and retail units. Other corporate costs (for example HR, accommodation and Finance support and Executive management costs) are required to be allocated based on a key metric.
- 2.3. Key metrics (such as Management Estimates and IS User Accounts) are updated each year and therefore can result in movements between business units depending on activity in the year. Overall general corporate costs (G&S) are broadly constant at £4.3m.
- 2.4. This is driven by the following key movements:

	<b>Total</b>
<b>Corporate costs</b>	<b>2015/16</b>
	<b>£m</b>
2014/15	4.262
Inflationary increases (average of 1%)	0.042
IFRS GAAP changes re pensions	0.202
Regulatory reform costs	0.206
Timing on Director's change of Office	0.197
Synergies	(0.539)
Other cost movements and efficiencies	(0.056)
<b>2015/16</b>	<b>4.314</b>

- 2.5. Bournemouth Water has sought to maintain a consistent approach in accordance with the latest guidance but, as well as cost increases in corporate departments, the allocations between business units may have changed as a result of updating for 2015/16 actual metrics.
- 2.6. The key change in allocations has been that management overhead support costs are now allocated on the same basis as management time. Instead of allocating these costs by GMEA, which uses asset values to allocate costs, we now use our estimate of staff activity in the year to allocate overheads. This is more consistent with the FD, whilst still being activity based. The impact of this change is set out below:
- Impact of Change in Allocation of Corporate Overheads

	Wholesale	Retail		Non Regulated
	Water	HH	NHH	
	£m	£m	£m	£m
G & S allocation	(0.531)	0.258	0.127	0.146

2.7. The allocation of corporate costs in each area has resulted in the following movements from last year, including the movements above:

	Total	Water	Retail
Corporate Costs	£m	£m	£m
2014/15	4.262	3.298	0.964
2015/16	4.314	2.636	1.678
<b>Cost increase</b>	<b>0.052</b>	<b>(0.662)</b>	<b>0.714</b>

### **Regulation Costs**

2.8. Regulation costs have increased by £0.1m. A reduction in licence fees £0.1m has been offset by increased cost associated with Open Water £0.2m. In accordance with guidance from Ofwat all regulation costs are allocated evenly across the 5 business units. (Retail is then split by customer numbers between household/non-household). The allocation of costs are shown below:

	Total	Wholesale	Retail
		Water	HH & NHH
Regulation costs	£m	£m	£m
2014/15	0.390	0.312	0.078
2015/16	0.505	0.404	0.101
<b>Cost increase</b>	<b>0.115</b>	<b>0.092</b>	<b>0.023</b>

# WHOLESALE WATER

		Water Total					
DESCRIPTION	2013/14	2014/15	2015/16	Movment 2014/15 - 2015/16	% Movment 2014/15 - 2015/16	Comments	
SERVICE ANALYSIS	£m	£m	£m	£m	%		
<b>OPERATING EXPEDITRUE</b>							
1	Power	3.107	3.378	3.560	0.182	5.39%	
2	Income treted as negative expenditure	-	-	-	-	-	
3	Service charges	0.997	1.015	0.724	(0.291)	(28.67%)	
4	Bulk supply imports	-	-	-	-	-	
5	Other operating expenditure	9.300	10.131	9.009	(1.122)	(11.07%)	
6	Local authority rates	3.344	3.421	3.500	0.079	2.31%	
7	Total operating expenditure excluding third party services	16.748	17.945	16.793	(1.152)	(6.42%)	
8	Third party services	0.020	0.013	0.027	0.014	107.69%	
9	Total operating expenditure	16.768	17.958	16.820	(1.138)	(6.34%)	

## 3.1. Key movements within water are:

- **Power** cost increase primarily results from our new ultra violet treatment processes, which improve the quality of the water but are energy intensive, and a price change. Additionally, there were increases arising from Carbon Reduction Credits (CRC).
- **Service charges** relate to abstraction licences in the water business. The decrease is due to a one-off refund 15 relating to the Environmental Improvement Unit Charge.
- **Other operating expenditure** includes:
  - Direct manpower £2.2m and contractors costs of £1.8m
  - Materials £0.6m
  - Scientific Services £0.6m
  - Other direct costs £0.5m and an allocation of corporate costs and regulation as noted above £3.0m.
  - £0.1m of exceptional restructuring costs.
  - £0.2m increase for IFRS opex relating to maintenance.

Overall, these costs have reduced, largely as a result of more efficient use of labour and contractors £(0.4)m and the change in corporate services allocation £(0.5)m

- **Local authority rates** refer to water cumulo charges which have been allocated to business units based on the GMEAV of the assets within each area. The increase over 2014/15 of 2.3% reflects inflation.

Line description	Units	Water resources		Raw water distribution		Water treatment	Treated water distribution	Total
		Abstraction licences	Raw water abstraction	Raw water transport	Raw water storage			
<b>A Operating expenditure</b>								
1 Power	£m	0.000	0.895	0.526	0.092	1.240	0.807	3.560
2 Income treated as negative expenditure	£m	0.000	0.000	0.000	0.000	0.000	0.000	0.000
3 Service charges/ discharge consents	£m	0.724	0.000	0.000	0.000	0.000	0.000	0.724
4 Bulk supply/ Bulk discharge	£m	0.000	0.000	0.000	0.000	0.000	0.000	0.000
5 Other operating expenditure	£m	0.000	0.624	0.267	0.046	3.469	4.603	9.009
6 Local authority rates	£m	0.000	0.082	0.078	0.014	0.917	2.409	3.500
7 Total operating expenditure excluding third party services	£m	0.724	1.601	0.871	0.152	5.626	7.819	16.793
8 Third party services	£m	0.000	0.000	0.000	0.000	0.000	0.027	0.027
9 Total operating expenditure	£m	0.724	1.601	0.871	0.152	5.626	7.846	16.820
Total operating expenditure 2014/15		1.015	1.612	0.807	0.098	5.682	8.744	17.958
Movement 2014/15-2015-16		(0.291)	(0.011)	0.064	0.054	(0.056)	(0.898)	(1.138)

**Water resources** – The overall movement is largely due to a refund of abstraction charges of £0.3m which is reflected within service charges.

**Raw water distribution** – key movements include an increase in power costs of £0.1m, which arose from switching between sources of water in 2015/16.

**Water treatment** – There are no significant movements in the year.

**Treated water distribution** – key movements include restructuring costs £0.1m reduced power costs (£0.2m), and IFRS opex maintainance costs £0.2m a reduction in corporate service costs of £0.5m and lower employment and contractor costs of £0.5m.

## Unit costs

Line description	Units	Water resources		Raw water distribution		Water treatment	Treated water distribution
		Abstraction licences	Raw water abstraction	Raw water transport	Raw water storage		
<b>Unit cost information (operating expenditure)</b>							
Licensed volume available	Ml	84056					
Volume abstracted	Ml		56554				
Volume transported	Ml			24908			
Average volume stored	Tonnes				928065		
Distribution input from water treatment	Tonnes					52405740	
Distribution input treated water	m3						52405740
Unit cost	ttcds	8.61	28.31	34.97	0.16	0.11	0.15



# RETAIL

- 4.1. The metrics used for the allocation of costs between Household and Non-households has remained unchanged in 2015/16 compared to 2014/15 but the underlying data has been updated to reflect the 2015/16 information. The table below shows the metric used to allocate costs:

Cost Activity	Cost Driver
Manage customer data	Number of bills issued
Manage property data	Number of bills issued
Payment Handling General	Number of payments
Investigate billing and payment enquiries & complaints	Non-Network No. of Contacts
Investigate metering queries & complaints	Non-Network No. of Contacts
Non network customer enquiries and complaints General	Non-Network No. of Contacts
Network customer enquiries and complaints General	Network No. of Contacts
Debt Management General	Debt >30days
Administration of disconnections and reconnections	Number of customers
Demand side water efficiency initiatives General	Number of customers
Customer side leaks General	Number of customers
Other direct costs General	Number of customers

- 4.2. Retail operating cost analysis – table 2C

Line description	Units	House hold	Non-house hold	Total
<b>Operating expenditure</b>				
1 Customer services	£k	1,583	200	1,783
2 Debt management	£k	583	34	617
3 Doubtful debts	£k	159	15	174
4 Meter reading	£k	95	10	105
5 Services to developers	£k	0	60	60
6 Other operating expenditure	£k	1,589	460	2,049
7 Total operating expenditure excluding third party services	£k	4,009	779	4,788
8 Third party services operating expenditure	£k	0	68	68
9 Total operating expenditure	£k	4,009	847	4,856
10 Depreciation	£k	400	33	433
11 Total operating costs	£k	4,409	880	5,289
12 Debt written off	£k	216	15	231

5. Commentary on retail numbers is included in the household and non household sections show below

# RETAIL HOUSEHOLD

5.1 Overall retail household costs show an increase of £0.214m (5.6%)

	Retail Household			
	2014/15 £m	2015/16 £m	Variance £m	%
Customer Services	1.632	1.583	(0.049)	3.0%
Debt Management	0.522	0.583	0.061	11.7%
Doubtful Debt Charges	0.328	0.159	(0.169)	(51.5%)
Meter Reading	0.200	0.095	(0.105)	(52.5%)
Other Operating Expenditure	1.101	1.576	0.475	43.1%
Rates	0.012	0.012	0	-
<b>Total operating expenditure</b>	<b>3.795</b>	<b>4.008</b>	<b>0.213</b>	<b>5.6%</b>

5.2 Key movements within household retail are:

- *Customer services* – inflationary increases particularly on employee costs offset by staff being transferred to NHH
- *Debt management* – cost increases particularly for employees to retain our industry leading debt performance.
- *Doubtful debt charge* – has reduced from the prior year reflecting the release of a general provision no longer required (£0.1m) and improvements arising from the new billing system.
- *Meter reading* – the decrease reflects a fairer allocation of meter reading costs to the non- regulated business.
- *Other operating expenditure* – cost increases were largely as a result of changing the allocation methodology for non- labour support costs from GMEA to Management Estimate £(0.26)m. and the new billing system causing more of IT general support costs to be allocated to retail £(0.15)m

# RETAIL NON-HOUSEHOLD

6.1. Overall retail non-household costs show a decrease of £0.012m (2.16%) compared to 2014/15.

	Retail Non-Household			
	2014/15 £m	2015/16 £m	Variance £m	%
Customer Services	0.164	0.200	0.036	22.0%
Debt Management	0.026	0.034	0.008	30.8%
Doubtful Debt Charges	0.032	0.015	(0.017)	(31.3%)
Meter Reading	0.024	0.010	(0.014)	(58.3%)
Other Operating Expenditure	0.269	0.459	0.190	70.6%
Rates	0.001	0.001	0	-
Developer & third party services	0.039	0.128	0.089	228.2%
<b>Total operating expenditure</b>	<b>0.555</b>	<b>0.847</b>	<b>0.291</b>	<b>52.4%</b>

6.2. Key movements within Non-household retail are:

- *Customer services* – additional costs associated with increased focus on customer retention, including dedicated account managers.
- *Doubtful debt charge* – has decreased from the prior year reflecting improved focus on debt recovery process for business customers and a decrease in write-offs.
- *Meter reading* – the decrease reflects a fairer allocation of meter reading costs to the non-regulated business.
- *Other operating expenditure* – cost increases were largely as a result of changing the allocation methodology for non-labour support costs from GMEA to Management Estimate £(0.12)m. In addition more IT costs have been allocated to non-household as a result of the new billing system
- *Developer services* – increase reflects the additional activity in this area during the year.

# FIXED ASSETS & DEPRECIATION including CURRENT COST DEPRECIATION

- 7.1. The methodology for allocating most assets and associated depreciation has not changed in the year. Assets that are used wholly within one area are directly allocated to that unit. General and support assets which are used across the business are allocated using an appropriate driver.
- 7.2. In accordance with instructions from Ofwat, general and support (management and general assets) used principally for wholesale activities have been allocated in full to the wholesale business units with the previous allocation of depreciation replaced by a recharge of the same amount.
- 7.3. The reporting requirements for the Regulatory Accounts were changed in the year with the IFRS fixed assets Table 2D replacing the fixed asset table at note 14 and the current cost fixed asset tables by business unit (Tables C and D). There is also a separate table, Table 2E, providing a full analysis of grants and contributions. These changes reflect reduced emphasis on CCA reporting together with the new emphasis on total expenditure (Totex) reporting.

## Fixed Assets

- 7.4. Total appointed capital expenditure in the year (after deducting contribution) was £8.4m (2014/15 £11.0m). The reduction is explained by the change from AMP5 (K5) to AMP6 (K6) with the completion of major projects in 2014/15. The key areas of investment during the year were:
- Continued expenditure on our pipework network (£3.7m net of contributions)
  - Completion of 2 new Ultra Violet disinfection plants (£0.8m)
  - Continued expenditure on meters both as replacements and for customers opting to change to a metered supply (£1.4m).
- 7.5. Additions to retail related to improvements in the customer service and billing systems.
- 7.6. The mix of assets between business units has remained consistent year on year. These values have been changed to an IFRS basis and include infrastructure assets. The stable picture reflects the long-term nature of the asset base which results in changes due to investment having a limited effect on the asset profile for each business unit.

		Wholesale	Retail	
	Total	Water	HH	NHH
NBV	£m	£m	£m	£m
2014/15	140.9	139.2	1.6	0.1
2015/16	141.2	139.7	1.4	0.1
% of total assets				
2014/15	100%	98.8%	1.1%	0.1%
2015/16	100%	98.9%	1.0%	0.01%

7.7 In accordance with the revised Regulatory Accounts guidelines the more detailed analysis by business unit set out below is not currently published. The analysis, which has been revised to an IFRS historical cost basis, continues to provide a useful guide to fixed asset investment in the relevant business units.

7.8 Historical cost accounting understates the replacement costs of all assets after periods of inflation particularly long-life assets such as infrastructure assets. Current inflation rates are low but with asset lives typically of 60 to 80 years past inflation has been significant. In addition most costs other than materials relevant to infrastructure assets have increased at rates above general inflation due to UK labour costs, and to the benefits of increased automation being offset by increased costs of working in urban areas in the presence of other services.

### Water Analysis

	Water Resources		Raw Water Distribution		Water Treatment		Treated Water Distribution	
	Non-Infra £m	Infra £m	Non-Infra £m	Infra £m	Non-Infra £m	Infra £m	Non-Infra £m	Infra £m
NBV 2014/15	1.0	1.1	12.1	9.4	46.4	-	5.3	63.9
NBV 2015/16	0.9	1.1	12.6	9.4	44.5	-	5.5	65.7
<b>Movement</b>	<b>(0.1)</b>	<b>0</b>	<b>0.5</b>	<b>0</b>	<b>(0.6)</b>	<b>-</b>	<b>0.2</b>	<b>1.8</b>

### Current Cost Depreciation & IRC

7.9. The approach to calculating the current cost depreciation and infrastructure renewals charge (IRC) has not changed this year. In due course the IRC will be affected by the changes in relevant expenditure. The IRC charge takes account of both past and forecast future expenditure on maintaining infrastructure assets. The relevant expenditure is all expenditure on maintaining infrastructure generally referred to as Infrastructure Revenue Expenditure (IRE).

	Total £m	Wholesale	Retail	
		Water £m	HH £m	NHH £m
<b>Depreciation</b>				
2014/15	8.1	8.1	0	0
2015/16	8.8	8.1	0.6	0.1
<b>IRC</b>				
2014/15	3.0	3.0	-	-
2015/16	3.0	3.0	-	-

7.7. Current cost depreciation has increased reflecting the growth in the asset base.

7.8. 2015/16 disposals in current cost terms have offset the expected increase in charge in the year. The retail depreciation increase reflects the new billing system being depreciated in 2015/16.

7.9. As an interim measure, pending a full review of the calculation and use of IRC charges, the IRC charge for 2015/16 has been kept at the level charged in 2014/15. This explains why the numbers are the same.