Commercial - in Confidence

Methodology Statement – Accounting Separation

This shows the systems in place and the sources of information used to populate the Supplementary Tables for Accounting Separation.

Methodology – Operating Cost Tables ST1 & ST2

The Company’s detailed nominal ledger management information reports allow costs to be identified for each cost centre in the company and therefore the costs of each service area (e.g. Resources /Treatment) can be built up using the reports. The management reports allow for separate identification of costs relating to both the Retail and Scientific Service functions of the business .The general and support costs of the business are not allocated by service area in the nominal ledger and it is therefore necessary to use methods of allocation to be able to provide this level of detail.

The Accounting separation guidance document has been used and followed where appropriate, in the separating of costs for the reporting of figures in tables ST1 and ST2. Where it is felt the guidance does not offer the best solution, or is inappropriate for the allocation of costs, an alternative approach has been used. A line by line brief commentary as to how costs have been split is provided below.

The capital maintenance total comprises the current cost depreciation charge and the infrastructure renewals charge for the year.

Capital expenditure comprises expenditure on overground assets plus new mains expenditure and the purchase of vehicles, computers and small plant items (including meters).

Leakage control costs are mainly allocated to operating expenditure for the day to day activities, but there are some specific projects involving the installation of PRV’s and strategic meters at certain points in the network which are charged to capital expenditure.

The allocation of indirect costs between services areas is again carried out using the Company’s management information reports as covered above. Some of the indirect costs are capable of being charged direct to service areas as the service area that uses the indirect cost centre can be identified. However, with some indirect costs centres it is necessary to make either a pro-rata allocation between the areas or to base the allocation on an assumption of cost driver (e.g. material costs for allocation of stores department cost, employees costs for allocation of personnel department costs)

The Company has followed the guidance issued by Ofwat relating to the proportional allocation of assets & costs between business units. It has followed Ofwat's hierarchy of cost drivers when deciding upon the most appropriate basis for allocation of both assets & costs. The company has opted to base the allocation of a number of assets and costs on a management estimate basis. Where it has opted to do so the Company is satisfied that this was the only valid option given the time & costs involved in the other suggested alternatives. Senior departmental managers provided the allocation bases for these items. The Business Unit descriptions were used by senior managers in their assessment of these allocation bases.

Table ST1 – Line by line treatment of costs

Direct Costs

Employment Costs: Employment costs have been treated in two separate ways for allocation into business units. Costs of employment for employees who complete timesheets have been directly allocated to the relevant business units based on this information. Employment costs of employees who do not complete timesheets have been split on the basis of a management estimate of time spent working for each business unit. Where applicable, employees that work wholly for one business unit have been charged wholly to a specific business unit for cost allocation. The majority of employees carry out work in relation to a number of business units and therefore the management estimate option has to be used as a basis for the allocation of costs.

Power: Power costs reported here mainly relate to treatment works & pumping stations, including borehole sites. Power has been allocated on the basis of the assets that consume it. Each individual location is billed separately and bills provide the data of consumption and cost by location. Each of these costs is reported by location in the nominal ledger reports. Where an asset consumes power for a dual purpose, then a split based on pumping head has been used to allocate the cost between the two functions (e.g. Abstraction and TW Distribution).

Hired and Contracted Services: As per the guidance these costs have been allocated directly.

Materials & Consumables: These costs have largely been identified as directly attributable to individual units. However, management estimates of time spent carrying out the activities of the different business units were used to enable Inspectors & Distribution Admin costs to be allocated to individual business units. This is as the activities carried out by these departments span more than one business unit.

Service Charges: This relates to abstraction charges and has therefore been allocated directly to Water Resources.

There are no direct costs relating to bulk supply imports, and no direct costs relating to associated companies.

Other direct costs were largely attributable to individual business units. However, management estimates of time spent carrying out the activities of the different business units were used to enable Inspectors & Distribution Admin costs to be allocated to individual business units. This is as the activities carried out by these departments span more than one business unit.

Operating Expenditure

General & Support Expenditure: General and support expenditure cover a range of costs that have each been identified and allocated in the following ways.

Land & Property: The nominal ledger structure allows these costs to be directly identifiable by location. Using the Activity Cost Table workings the costs that are directly attributable to individual business units have been identified. Other Associated costs not directly attributable have been allocated on a pro rata basis of those directly allocated.

Mechanical & Electrical: The nominal ledger structure allows these costs to be directly identifiable by location. Using the Activity Cost Table workings the costs that are directly attributable to individual business units have been identified. Other associated costs not directly attributable have been allocated on the basis of the management estimate of time spent working for each business unit by the employees of that department.

Supply Engineer: These represent the cost of the Supply Manager, Emergency Planner and related overheads. The costs have been split based on a management estimate of activities in each business unit.

Supply General: The supply general costs were allocated directly where possible to individual business units. Allocations of certain costs were required to be made. These costs include the running costs of the Company's Telemetry system, in order to be consistent with the treatment of the fixed assets these were allocated on the basis of the Supply Managers estimate of allocation of the telemetry system between business units.

Distribution General: Costs here were allocated between Treated Water Distribution and Retail based on the management estimate of time spent carrying out associated activities.

Personnel Services: Personnel costs have been split on a headcount basis between the 5 identified business units as per the issued table guidance.

Legal & Property: The issued guidance suggests as a third choice in the hierarchy of allocation options that a management estimate of time spent is used as a driver to split the costs for this area. This is the approach adopted.

Financial Services: Financial Services costs have been split in two separate ways. The costs of the payroll department have been split on the basis of FTE headcount. The remaining financial services costs have been split on the basis of a management estimate of time spent by the department working for each of the business units. Employees do not fill in time sheets, so this was not a valid option for allocation of costs.

Data Processing: The issued guidance advocates allocation of these costs based on the usage of the mainframe by system type. We have available a report that details the yearly usage of the mainframe computer systems, between different systems used by different business areas. (e.g. customer billing system, personnel system and the distribution work system). These can then be identified as being carried out by particular business units. It is felt that this was a most relevant method of allocation for these costs. Where activities carried out on the system are not individually applicable to business units, the costs are pro rata spread over the directly attributable system usage percentage.

Operational & Technical support: Direct allocation of costs by business unit has taken place, as per the guidance.

Vehicles & Plant: These costs, as per the table guidance have been allocated pro rata to the allocation of the vehicle and plant fixed assets, as per the table guidance.

Materials Storage: As per the guidance this has been split on the basis of a pro rata split to the direct allocation of materials and consumables.

FRS17 Pension Charge: The costs of this have been split based on the employment costs of each business unit.

National Insurance costs: Allocated on the basis of employment costs. Employment costs of salaried employees were collated by department. The NI charge was then allocated to business units using the same methods as was used for the costs of each of the individual departments. This ensures a consistent treatment with how the costs of the associated assets were allocated.

General Administration: The remaining general admin costs balance has been allocated directly to individual business units where costs are identifiable as relating to one business unit only. However there are a number of costs that cannot be allocated directly, the treatment of these is as follows:

- Head Office utilities: These have been split on the basis of floor area by business unit.
- Staff welfare: Allocation based on FTE staff headcount.
- Directors' salaries and related costs: Allocation based on an estimate of time spent per business unit.
- Secretaries' salaries and related costs: Allocation as per the split of Directors salaries and related costs.
- Slow moving stock provision: Allocated pro rata to the direct allocation of materials and consumables.
- Professional fees, subscriptions & audit costs: This has been allocated on the basis of the direct costs of the business, excluding the abstraction charges. As it is felt that this would distort the % allocation towards the Water Resource business unit, it is felt that these bases for allocation of audit costs is more appropriate than number of FTE's as per the table guidance document.
- Insurance & WRMP costs: Allocation of insurance & WRMP costs have been based on the same split as Directors Salaries and related costs. Insurance costs represent a service to the business as a whole. The time and effort spent by directors per business unit, is understood represent a good marker for the allocation of these costs.

Scientific Services: The costs of Scientific Services have been split based on a management estimate of time spent working for each business unit. The Water Quality Manager has prepared this estimation and it includes the number of water samples taken for each business unit. There is an allocation of costs to the Retail business unit.

Other Business Activities: The costs of regulation have been split on a management estimate of time basis, as per the table guidance.

Local Authority Rates: As per the table guidance the costs of local authority rates are split on the GMEA of land and buildings. This information is sourced from the supplementary fixed asset table. Not all assets were included in this calculation. Vehicles and small plant for example are considered to not be relevant for this allocation.

Exceptional Items: There are no exceptional costs to report.

Third Party Services Opex: These costs relate directly to both the bulk supply of treated water to Southern Water Services and the costs of the distribution department for rechargeable works. These have therefore been directly allocated.

Reactive & Planned Maintenance Infrastructure: This has been allocated directly to business units.

Reactive & Planned Maintenance Non-infrastructure: This has been allocated directly to business units.

Infrastructure Renewals Charge: This has been allocated directly to Treated Water Distribution.

Current Cost Depreciation: This allocation comes directly from the supplementary fixed assets table ST4.

The allocation bases above are considered the most appropriate treatment for each of the cost areas. Management has taken consideration of the cost, time and appropriateness of other possible allocation methods and has decided that the above treatments are the most appropriate for the Company to follow.

The treatment of direct costs and operating expenditure is consistent with the treatment of the relevant fixed assets for allocation purposes, reported in tables ST4 & ST6.

No Sampling has been used to populate table ST1 or ST2.

No areas requiring improvement relating to the production of the disaggregated water service and retail tables have been identified.

Table ST2 – Activity costing analysis – Retail services
Line by line treatment of costs

The retail activities described as direct costs are the same as those used in the calculation of the Company's access prices. Therefore the individual cost elements that make up the total cost of these activities are the consistent with those used in the production of the access prices tables. The costs included within each activity cover each of the process's contained in the description for each direct cost category.

Below is a line by line description as to how the cost categories have been allocated between Household & Non Household:

Billing: The total billing cost has been allocated on the basis of the number of bills issued, as per the table guidance.

Payment Handling, Remittance and Cash Handling: These costs have been allocated on the basis of the number of bills issued, as per the table guidance.

Debt Management: The allocation is based on the outstanding debt levels as reported in table 6a of JR11. Portsmouth Water does not populate table 6a until after the end of the Company's billing year on 30th July. There the data for the current year is not available to use.

Doubtful Debts: Allocation is based on the total actual debt written off during the year. These figures have been used in the calculation of the Company's bad debt provisions for the year.

Charitable Trust Donations: These costs are allocated directly to Retail household.

Vulnerable Customer Scheme: There is no material cost associated with the administration of the vulnerable group scheme.

Non-network Customer Enquiries and Complaints: Allocation is based on the number of customers in each business unit, as per the table guidance.

Meter Reading: Allocation is based on the number of metered customers in each business unit, as per the table guidance.

Meter Maintenance/Installation Non-Capex: Allocation is based on the number of metered customers in each business unit, as per the table guidance.

Network Customer Enquiries and Complaints: Allocation is based on the number of customers in each business unit, as per the table guidance.

Disconnections: These costs are allocated directly to Retail non-household.

Demand Side Water Efficiency Initiatives: Allocated as per household and non-household efficiency measures from table 1 of the June Return.

Services to Developers: These costs are allocated directly to Retail non-household.

Support for Trade Effluent Compliance: This category is aimed only at WASC'S. Therefore no entries to these lines have been made.

Customer Side Leaks: These costs are allocated directly to Retail household.

Other Direct Costs: No costs have been allocated on this line.

General & Support expenditure: This line represents the remaining costs not identified as being direct costs for the purposes of this table. They have been allocated between household and non household in two ways. The direct customer service employment costs per business unit and on the basis of customer numbers per business unit. The guidance advocates the usage of the number of FTE's. However employment costs should represent an allocation that would be similar to that of the FTE basis. As staff work for both business units in reality it would have been difficult to split these costs on the basis of FTE's. A subjective judgement would have had to have been made on either basis.

The allocation by customer numbers represents the best estimate of how costs actually relate to the general and support activities performed. A number of options in the guidance for the split of these costs could not be used as the data is not available and or the cost driver advised would not give a meaningful allocation of the costs.

The allocation of costs between the activities on lines 1-16 has been based on the following:

All general and support costs relating to employment / personnel have been allocated on the basis of the direct employment costs in each activity, as identified in the production of the direct cost figures. This is effectively management's best estimate of the allocation of these costs between activities. This is broadly in line with the guidance which advocates use of FTE and the headcount on employees.

General and support costs relating to stores and materials were only allocated between activities that would incur these costs. Pro rata allocation was used to allocate these costs over the related activities direct costs.

The remaining general and support costs were allocated on a pro rata basis against the direct costs totals already identified. As no relevant costs drivers could be identified to give an accurate allocation of these costs to activities.

Scientific Services: There are no costs identified on this line.

Other Business Activities: The costs of regulation have been split on a management estimate of time basis, as per the table guidance.

Local Authority Rates: Allocation of costs is based on the split of the GMEA of fixed assets as per table ST6 of the June Return.

Exceptional Items: There are no identified exceptional items.

Third Party Services: There are no identified third party services**.**

Infrastructure Renewals Charge: There is no entry on this line.

Current Cost Depreciation: This allocation comes directly from the supplementary fixed assets table ST4.

There are no other cost entries on table ST2.

The Company's management is satisfied that the costs and allocation methods used in table ST2 are the most appropriate. The guidance has largely been followed and on occasions where this is not the case, the Company has used its judgement to produce the most appropriate methods of cost allocation in order to give accurate cost allocations. All reasons for deviations from the guidance are explained in this methodology statement.

No sampling has been used to complete this table.

The figures reported in tables ST1 & 2 have been reconciled back to the Regulatory Accounts Activity Cost Table. The reconciliation is shown below:

Reconciliation of operating costs reported in Tables ST1 & ST2

	£000
Operating Costs as per Activity Cost Table	31,860
Less Customer Service Exp per Table 21	(3,422)
Less Doubtful Debts Provisions per Table 21	(535)
Less CCD relating to Retail Fixed Assets	(1,166)
Less increase in Other Business Activities Costs allocated to Retail	(165)
Less Local Authority Rates attributable to Retail, post allocation of costs to business units	(8)
Total Operating Expenditure reported In Table ST1:	26,564
Total Retail Operating costs reported In Table ST2:	5,296

Disaggregated current cost fixed asset tables ST4 & ST6:

Portsmouth Water keeps current cost fixed asset ledgers for all categories of fixed assets. The assets contained within these ledgers are separately identified and are updated on a regular basis.

The disaggregated fixed asset tables require the separation of assets into each of the 5 business units, with a further separation of the retail assets between Household and Non Household categories.

The current cost fixed asset registers previously maintained by the Company have been adjusted in order to classify the existing assets into the relevant Business Units for June Return reporting purposes. There was previously no system in place to determine which Business Units that assets belonged to, as there was no requirement for the Company to do so. However, now the asset additions have been assessed prior to addition to the ledger, to determine which business unit they belong to. The Ofwat business unit definitions have been used as a guide for the asset allocations.

The current cost fixed asset ledgers are maintained on excel spreadsheets and the data is therefore flexible to the specific adjustments required to populate Table ST4. Look up functions and ‘if’ statements have been used in order to produce, within excel, a version of table ST4 for each of the asset types maintained in the current cost fixed asset ledgers. Each line in the fixed asset registers are linked into a formula that looks up the asset values, depreciation and the Business Unit classification. The Individual tables created in excel are then amalgamated to produce the required inputs for Table ST4.

The Company has followed the guidance issued by Ofwat relating to the proportional allocation of assets & costs between business units. It has followed Ofwat’s hierarchy of cost drivers when deciding upon the most appropriate basis for allocation of both assets & costs. The company has opted to base the allocation of a number of assets and costs on a management estimate basis. Where it has opted to do so the Company is satisfied that this was the only valid option given the time & costs involved in the other suggested alternatives. Senior departmental managers provided, after discussion with the Management Accountant, the allocation bases for these items. The Business Unit descriptions were used by senior managers in there assessment of these allocation bases. These are described in more detail in the table commentary.

No Sampling has been used to populate the Fixed Asset Tables.

As described above, in each of the current costs accounts fixed asset registers held by the company, an individual fixed asset register by business unit is created using linked cells from the asset listings. Also created is a fixed asset register that reports the figures as they are presented in table ST4. The figures produced by the fixed asset registers are checked via formulas in the excel spreadsheets to ensure that there is a reconciliation between the disaggregated totals and the totals as per reported in table ST4.

Capitalisation Policy:

The Company classifies costs as either capital expenditure or operating expenditure based on a number of factors. These include the value, nature and purpose of the expenditure.

There is no formal procedures manual for the classification of costs to either operating expenditure or capital expenditure, due to the size of the company, the number if staff involved in the accounting process and the operating procedures that the company follows.

A detailed capital programme is drawn up each October for the coming financial year. This is approved by the Company's board and incorporated into the Company's Budget. Following Board approval individual schemes are programmed for the coming year by Project Managers responsible for delivering the schemes. The Project Managers are responsible for the control of expenditure on the schemes and authorise each individual item of expenditure incurred. The Chief Accountant reviews the scheme expenditure in order to ensure that the correct accounting treatment has been applied.

On a monthly basis the capital expenditure relating to the board approved capital schemes is reviewed by the Chief Accountant, prior to submission to the board of a monthly capital statement which shows authorised amounts. This report details the expenditure by scheme. Any material variances are investigated and resolved.

For small plant equipment and vehicles a list is drawn up and approved by the Company's Board. Purchases made are reviewed for correctness of treatment and to ensure that these are all capital items. The policy adopted by the company is that only items above £500 are capitalised.

The Management Accountant reviews the small plant and vehicle additions on a monthly basis prior to entering the additions onto the asset records. The Management Accountant ensures that only expenditure of a capital nature is capitalised in these areas by checking the details of each individual purchase invoice entered.

The treatment of Infrastructure renewals varies between the Regulatory Accounts and the Statutory Accounts of the Company. In the Statutory Accounts the Company has followed common industry practice and adopted the infrastructure renewals accounting policy as set out in FRS 15. This has not been applied in the Regulatory Accounts at the request of Ofwat.

The Company applies an on-cost rate for direct labour costs incurred on capital schemes. This rate is designed to recover the costs of non – productive time (i.e. holidays, sickness etc.) and employment related on-costs such as employer's national insurance and company pension contributions. The calculation of the rate is based on the total amount of non productive labour time and employer on costs incurred a year in relation to the total direct labour cost. The rate is applied to all types of work carried out by the direct labour force and not just to capital works staff. The calculation is reviewed annually and the appropriateness of the rate is assessed by monitoring the amount of either under or over recovery of the on-costs in comparison with the on-costs actually incurred.

The Company is also now recovering the cost of its capital works team, by allocating individual project engineers time to schemes based on time records. The costs will incorporate an hourly rate for all engineers, plus, a percentage for departmental overhead recovery.

The Executive Directors ensure that the capitalisation policies and procedures adopted by the business are being operated correctly and that they are fit for purpose by regular review of the business processes and by the reviewing of the capital scheme expenditure totals on a monthly basis. The Finance Director and Chief Accountant ensure that the company complies with the current accounting standards applicable to the Company.

No improvements in relation to the capitalisation policy have been identified as being required.

Date: 15.06.2012
Prepared By: CJ