

ACCOUNTING SEPARATION 2019/20

For inclusion in Annual Performance Report Year ended 31st March 2020

PORTSMOUTH WATER LTD METHODOLOGY STATEMENT 2019/20

Governance Process

The Accounting Separation analysis has been prepared by the Regulation Accountant and reviewed by the Financial Controller. The allocation of direct costs between Wholesale and Retail has been reviewed and agreed by senior operational management. The allocation of Retail costs between the direct activities has been reviewed and agreed by the Head of Retail. The Finance & Regulation Director has done a final review of the Accounting Separation allocations, and approved the data for inclusion in the Annual Performance Report.

Methodology Statement for Accounting Separation

This statement details the systems in place and the sources of information used to populate the Accounting Separation Tables in the Annual Performance Report.

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

Portsmouth Water was using a mainframe accounting system up until October 2016, when a new ERP system (IFS) was implemented. 18 months of P&L and Balance Sheet account balances from the mainframe were uploaded to IFS. Accounting Separation requirements for the Annual Performance Report form a fundamental basis to the new coding structure of the new system.

The Ofwat Accounting Separation guidance (RAG 2.07) has been followed, in the separation of costs for the reporting of figures in the segmental Wholesale and Retail tables. A line by line commentary as to how costs have been allocated is provided below.

The allocation of indirect costs between business unit areas is carried out by using the Company's management information reports, detailed above. Some of the indirect costs are capable of being charged directly to business units; however with some indirect costs centres it is necessary to make an allocation between business units using an appropriate cost driver. (E.g. direct material costs for the allocation of stores department costs)

The Company has followed the guidance issued by Ofwat relating to the allocation of assets and 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 and costs.

The Company has allocated a small number of costs on a management estimate basis. Where it has chosen to do so the Company is satisfied that this was the only valid option at this time. However, it is looking to minimize this further with the implementation of the new integrated asset and finance system.

See Appendix 1 for a summary of the cost allocation by business unit, and Appendix 2 and Appendix 3 for the Wholesale and Retail cost summaries.

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Wholesale Operating Cost Analysis

The Wholesale Business of the Company consists of the following Business Units: Water Resources, Raw Water Distribution, Water Treatment and Treated Water Distribution.

Management estimate percentages used in 2018/19, and referred to below, were reviewed and remain unchanged for 2019/20.

Direct Costs

Employment Costs Distribution

Costs of employment for employees who complete timesheets have been directly allocated to the relevant cost centre and work activity, and can then usually be allocated directly to a business unit. In the new IFS system, all direct employees either complete a timesheet, or if they are a supervisor or manager they will have their costs allocated to the chargeout rates of their direct reports. Direct employees also book time to specific assets, which will allow for more accurate allocation of this cost.

Direct employment costs coded to cost centres which are split between Wholesale and Retail functions have been allocated as follows:

Network Technicians

These costs are allocated to either Treated Water Distribution or Retail. Costs of debt recovery/disconnections consultations, query/complaint investigations (which turn out to be on the customer side of the network) and customer-side leaks are directly allocated by timesheets to Retail. All other direct costs, allocated by timesheets, relate to Treated Water Distribution.

In IFS Meter Readers have their own department code, and this enables their salary and administration costs to be directly allocated to Retail.

The Leakage Technicians and support staff also have their own department codes in IFS and are directly allocated to Treated Water Distribution.

Network Administration

These costs are allocated to either Treated Water Distribution or Retail. In IFS, management and supervisors have their costs added to the chargeout rates of their direct reports, so no management estimate is needed.

Water Regulations costs are allocated 100% to Treated Water Distribution. The remaining costs relate to office staff, of which 3 perform Retail activities (Network customer queries) and the rest Wholesale activities. In IFS these staff do not complete timesheets and a manual allocation still needs to be done.

Operations Centre

Costs are allocated to all business units on the basis of the activities that the operations centre performs at different times of the day. This includes a 30% allocation to Retail, which represents the service that is provided to customers who call outside normal working hours.

Network Maintenance

These costs are mainly allocated to Treated Water Distribution. However, the costs of any customer-side leak repairs are allocated to Retail.

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Power

Power costs reported here mainly relate to treatment works & pumping stations, including borehole sites, and are 100% Wholesale. Power has been allocated on the basis of the assets that consume it. Each individual location is billed, invoiced and coded separately and bills provide the data for consumption and cost by location. Each of these costs is reported by location in the nominal ledger reports.

Where a pump asset consumes power for a dual purpose, a split based on pumping head has been used to allocate the cost between the functions. These dual functions are mainly water resources abstraction and treated water distribution, but in some cases water treatment is a significant function and so consumes a proportion of the power. Where water treatment is a minor element (simple chlorination) of the asset function, then a 1% management estimate has been used to allocate costs to this business unit.

An allocation of costs for the Bulk Supply of water to Southern Water has been based on the pumping head at Slindon to Whiteways Lodge reservoir. 65% of power costs have been allocated to the Bulk Supply at this site in 2018/19.

These pumping head figures were revised and updated for 2018/19.

Pumping Head Allocation

	Distribution	Water Resources	Treatment Works	Bulk Supply	Total	Distribution %	Water Resources %	Treatment Works %	Bulk Supply %
Eastergate	38.60	14.79			53.39	72%	28%	0%	0%
Slindon	22.60	67.81			90.41	25%	75%	0%	0%
Westergate	36.21	16.29			52.50	69%	31%	0%	0%
Brickkiln	17.07	31.33			48.40	35%	65%	0%	0%
Fishbourne	72.48	14.33			86.81	83%	17%	0%	0%
Lavant	38.01	14.93			52.94	72%	28%	0%	0%
Funtington	45.37	19.23			64.60	70%	30%	0%	0%
Walderton	35.38	7.48			42.86	83%	17%	0%	0%
Lovedean	65.88	37.19	23.11		126.18	52%	29%	18%	0%
Worlds End	53.58	40.74			94.32	57%	43%	0%	0%
Woodmancote		23.67			23.67	0%	100%	0%	0%
West Meon	54.94	28.44			83.38	66%	34%	0%	0%
Northbrook	30.76	32.73			63.49	48%	52%	0%	0%
West Street	20.81	11.10			31.91	65%	35%	0%	0%
Maindell	80.16	11.52			91.68	87%	13%	0%	0%
Soberton	26.92	47.43			74.35	36%	64%	0%	0%
Havant		50.42			50.42	0%	100%	0%	0%
Bedhampton		47.63			47.63	0%	100%	0%	0%
Aldingbourne	46.21	36.09			82.30	56%	44%	0%	0%
Newtown		94.86			94.86	0%	100%	0%	0%
Lower Upham		121.30			121.30	0%	100%	0%	0%
AVERAGE PUMPING HEAD						36.4%	30.7%	2.2%	

Pumping costs from Havant and Bedhampton to Farlington Treatment Works were previously classed as Raw Water Distribution. However, following discussions with Ofwat, this is now considered to be part of the Water Resources process. Portsmouth Water does not now have any raw water transport, only raw water storage at Highwood Reservoir.

There is also an allocation of power costs at Itchen, based on pumping head, between Water Resources and Treated Water Distribution. This is the only river abstraction site for Portsmouth Water and will be the source of a new bulk supply from 2019/20.

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Employment Costs Supply

Direct Costs booked to pumping stations are allocated between the business units on a management estimate, and this reflects the high proportion of time spent at the Treatment Works. 90% of time is allocated here. Direct labour is charged to specific assets via work orders and Supervisors have been added to the chargeout rate of their direct reports.

Employment costs relating to the Farlington and Itchen sites are allocated to Water Treatment.

Hired and Contracted Services

As per the guidance these costs have been allocated directly where possible and on the basis of pumping head for costs relating to pumping stations.

Materials & Consumables

These costs have largely been identified as directly attributable to individual business units. However, management estimates of time spent carrying out the activities of the different business units were used for Network Administration and Operations Centre costs to be allocated to individual business units, and in particular between Wholesale and Retail. Meter reading is a Retail function, and 100% of materials costs relating to this have been allocated to Retail.

Materials relating to customer-side leaks are all allocated to the Retail business unit and Chemicals are all allocated to Water Treatment.

Service Charges

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

Other Direct costs

These are largely attributable to individual business units. However, a management estimate of time spent carrying out the activities of the different business units was used to enable Network Administration costs to be allocated to individual business units.

General and Support Expenditure

This covers a range of costs that have each been identified and allocated in a number of ways. Timesheets have not been introduced in most of the areas below, due to the complexity of the work and general nature of many of the activities. The exceptions are Building and Grounds Maintenance and Mechanical & Electrical activities, where timesheets are completed.

Land & Property: The nominal ledger structure allows these costs to be largely directly identifiable by location. The costs that are directly attributable to individual business units have been identified and other associated costs not directly attributable have been allocated on a pro rata basis of those directly allocated.

Retail costs have been separately identified as a percentage of those costs relating to the Head Office only. The percentage allocated to Retail is based on the floor space occupied by the Retail function at the Head Office.

Mechanical & Electrical: The nominal ledger structure allows these costs to be largely directly identifiable by location. The costs that are directly attributable to individual business units have been identified and other associated costs not directly attributable have been allocated on a pro rata basis of those directly allocated.

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Retail costs have been separately identified as a percentage of those costs relating to the Head Office only. The percentage allocated to Retail is based on the floor space occupied by the Retail function at the Head Office.

Production Engineer: These represent the cost of the Production Manager and related overheads. The costs have been split based on the same allocation as Mechanical & Electrical costs, as this covers activity at every site.

Production General: The supply general costs are allocated directly where possible to individual business units. The remaining costs include the running costs of the Company's Telemetry system, and have been split based on the same allocation as Mechanical & Electrical costs.

HR: HR costs have been split on the basis of FTE's in each business unit, as per the issued table guidance. These costs include Staff Welfare. However, any costs relating to Water Efficiency and Promotional Strategy have been directly allocated to Retail.

Company Secretary: These costs have been split on the basis of FTE's in each business unit, as per the issued table guidance.

Financial Services: Financial Services costs have been split on the basis of FTE's in each business unit, as per the issued table guidance.

IT: The allocation of costs is on the basis of number of computers and mobile devices in each Business Unit. Customer Services have a second device on their desks for the receipt of payments from customers, and these are treated as 0.5 of a device, to reflect the time that IT spend dealing with queries.

Operational & Technical support: Allocation of costs by business unit is on the GMEAV of assets additions in the year for Planning and to Treated Water Distribution for the Drawing Office.

Vehicles & Plant: These costs, as per the table guidance, have been allocated on the basis of number of vehicles. Motor vehicle insurance is included in these costs. (The motor fleet is insured through one premium with no vehicles being listed separately)

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

Pension Costs: The costs of this have been allocated directly to departments, in line with the IFS payroll system. However, these costs have been allocated on the basis of salary costs in each business unit, and included with the salary costs at each stage of the cost separation process.

National Insurance costs: These costs have been allocated directly to departments, in line with the IFS payroll system.

General Administration: The remaining general administration costs have been allocated directly to an individual business unit where possible. However there are a number of costs that cannot be allocated directly, and the treatment of these are as follows:

- Head Office utilities and costs: These have been split on the basis of floor area by business unit.

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- Directors' salaries and related costs: Allocation for the Executive Directors is based on a management estimate of time spend on activities, including an analysis of the Board Agendas during the year. Allocation for the Non-Executive Directors is based on the Board Agenda analysis only.
- General materials: Allocated on the basis of the direct allocation of materials and consumables.
- Insurance costs: Allocation of insurance costs is directly to a business unit where possible, and based on FTE's by business unit for the policies relating to employee liability and directors' and officers liability. The remainder relates to building and contents insurance and is split on the floor space allocation between Retail and Wholesale.
- Print Room: 30% of these costs have been allocated to General Business, and relate mainly to the Statutory Accounts and the Scheme of Charges booklets. These costs have then been further allocated on the basis of FTE's. 70% of the costs have been allocated to Retail and relate mainly to customer billing.

Scientific Services

The costs of Scientific Services have been split based on a management estimate of water samples taken for each business unit. The exception is Catchment Management, which is allocated entirely to Water Resources, as per the Ofwat guidance.

Other Business Activities

The costs of regulation have been allocated directly to Business Units where possible, and evenly across all business units for any remaining costs, as per the table guidance. However, with only Highwood Reservoir in Raw Water Distribution, only 1% of the costs have been allocated here.

Local Authority Rates

As per the table guidance the costs of local authority rates are split on Floor Space. This includes the Head Office site, Farlington and Itchen treatment works, Pumping Stations and Booster Stations.

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 to Treated Water Distribution.

Infrastructure Renewals Expenditure

This has been allocated directly to Treated Water Distribution.

Historic Cost Depreciation

This allocation comes directly from the IFS fixed asset data.

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 at this time.

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The treatment of direct costs and operating expenditure is consistent with the treatment of the relevant fixed assets for allocation purposes.

Retail Operating Cost Analysis

The Retail Business is located at the Head Office of the Company in Havant and consists of the following functions:

Customer Services Department (including Debt Recovery, Postage and Visiting Officers)
Print Room (70% of costs are direct Retail)
Bad Debt Provision
Meter Reading
% of Network Technicians (see Wholesale allocations)
% of Network Administration (see Wholesale allocations)
% of Operations Centre (see Wholesale allocations)
Customer-side leaks
% of Other Business Activities (Regulation)
% of Head Office costs (Land, Property and Mechanical & Electrical)
% of General and Support costs

Direct Costs

The methodology above for the Wholesale business identifies the direct costs of employment, materials and consumables and other direct costs which have been allocated between Wholesale and Retail. These relate to the costs of Inspectors, Meter Reading, Distribution Administration and Operations Centre, as well as customer-side leaks.

In addition, there are costs which are direct Retail costs and can be identified from the company nominal ledger reports. These are as follows:

Customer Services Department (including Debt Recovery and Postage)
Bad Debts Provision

Below is a line by line description as to how the direct costs have been allocated to the Retail activities. However, these are now all Household Retail costs as the Company exited the Non-Household Retail market from 2017/18. In addition, the costs within Household Retail are allocated between Measured and Unmeasured customers.

In the Annual Performance Report the operating expenditure for Retail is in a less detailed format, with one line for 'Customer Services' and another for 'Other Operating Expenditure'. The definition of these line items is in RAG 4.08 and has been followed.

Customer Services consists of the following activities:

Billing
Payment Handling, Remittance and Cash Handling
Non-network Customer Enquiries and Complaints
Network Customer Enquiries and Complaints

Other Operating Expenditure consists of the following activities:

Disconnections (customer contact only and not the physical disconnection)
Demand Side Water Efficiency Initiatives
Customer Side Leaks
General and Support expenditure

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Other Business Activities

Billing: Direct employment costs of Customer Services staff are allocated to Billing, as well as 70% of Print Room staff costs. Customer Services stationery is allocated 100% to Billing activities and Postage is allocated to Billing on the basis of number of bills sent. 33% of General Management costs are allocated here. An allocation of stationery is made from the Print Room and the Photocopy Room, as well as 25% of the software licence costs.

The total Billing cost is all household and this is allocated between Measured and Unmeasured customers on the basis of the number of bills issued in these areas, as per the table guidance.

Payment Handling, Remittance and Cash Handling: Direct employment costs of Customer Services staff are allocated to this activity, as well as a proportion of Finance Services staff. Contract repairs & maintenance is allocated here and 25% of the software licence costs.

These costs are all household are allocated between Measured and Unmeasured customers on the basis of number of bills raised, as per the guidance.

Debt Management: Employment costs of the Customer Services Debt Recovery staff have been allocated to this activity, as well as Debt Recovery Commission from third parties. Postage costs have been allocated to this activity and represent the remaining costs after the allocation to Billing. 25% of the software licence costs have been allocated here, as well as 33% of Management salaries.

The allocation of these household costs between Measured and Unmeasured customers is based on the debt outstanding > 30 days for each, at the end of March 2020.

Doubtful Debts: Costs are allocated directly to this activity and all relate to household customers.

For 2019/20 the total amount of Doubtful Debts is £535k. This is split as follows:

Unmeasured Doubtful Debts	£368k
Measured Doubtful Debts	£168k

The Measured Doubtful Debts provision amount is calculated separately from Unmeasured and reflects the risk associated with the current outstanding debt.

The remainder of the calculation relates to an allowance for the movement in total debt written off, which can also be directly allocated to measured and unmeasured customers.

Non-network Customer Enquiries and Complaints: Direct employment costs of Customer Services staff are allocated to this activity, as well as 33% of General Management, 25% of the software licence costs and a proportion of telephone costs from General and Administration.

The allocation between household Measured and Unmeasured customers is based on the number of non-network customer contacts recorded for each business unit, as per the table guidance.

Meter Reading: Direct employment costs of Meter Readers are allocated to this activity, as detailed in the Wholesale commentary above, including meter reading supervision. Associated motor transport costs are also allocated here. The costs are partially offset by Billing Commission income from Southern Water.

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All costs are allocated to measured customers.

Network Customer Enquiries and Complaints: Direct employment costs of Network Technicians, Network Administration and the Operations Centre are allocated to this activity as well as other associated direct costs.

The allocation between household measured and unmeasured customers is based on the number of network customer contacts recorded for each business unit, as per the table guidance.

Demand Side Water Efficiency Initiatives: These costs are directly identifiable and allocated to this Retail activity. The costs include Water Efficiency and Promotional Strategy.

These Household costs are allocated to Measured and Unmeasured customers on the basis of number of customers in each category.

Services to Developers: These costs are the salaries of staff who deal directly with developers, with regard to new services, and the associated supervisory costs. They were previously allocated directly to Non-Household Retail, but from 2017/18 they have been allocated to Wholesale as the Non-household Retail business was sold.

Customer Side Leaks: These costs are directly identifiable and allocated to this Retail activity as described in the Wholesale commentary above.

All costs relate to household customers only. Costs are allocated to Measured and Unmeasured customers on the basis of number of customers in each category.

General and Support expenditure: These costs represent the remaining costs not identified as being direct. Their allocation between the Wholesale and Retail business units is described above.

These Household costs have been allocated between Measured and Unmeasured customers on the basis of number of customers in each category.

Scientific Services

There is no allocation of costs to the Retail business unit.

Other Business Activities

The costs of regulation have been split evenly across all 5 business units, as per the table guidance. However, as Portsmouth Water only has one small storage reservoir in Raw Water Distribution, 24% of cost is allocated to Retail Household and 1% to Raw Water Distribution.

Local Authority Rates

These costs are allocated on the basis of floor space. This includes the Head Office site, as well as the other depots and pumping station buildings.

Third Party Services

There are no identified third party services for Retail.

Historic Cost Depreciation

This allocation comes directly from the detailed fixed asset ledgers in IFS.

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The Company's management is satisfied that the costs and allocation methods used in the Retail Operating Cost 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.

Changes in Retail Costs > 10%

As per the Ofwat guidance, below is a summary of the Retail costs which have changed by >10% since last year, and an explanation of the differences.

Overall, Retail operating expenditure has increased by 2% (£0.099m), with the movement by categories as shown below:

	<u>Change 2020 vs 2019</u>
Customer Services	-3%
Meter Reading	1%
Debt Management	448%
Doubtful Debts	-1%
Other Operating Expenditure	-7%

Debt Management is the only category with a change >10% (£0.296m) from 2018/19. The year 2018/19 included an amount of -£0.269m for the write-off of uncashed cheques. This amount was written off from the balance sheet and was a one-off item.

Other operating expenditure has decreased by 7% (0.122m) mainly due to the high professional fees in 2018/19 associated with the PR19 Business Plan submission.

Current Cost Analysis of Fixed Assets (Wholesale and Retail)

Portsmouth Water kept full current cost fixed asset ledgers, for all categories of fixed assets, up to and including 2016/17, but this is no longer an Ofwat requirement. The assets contained within these ledgers are separately identified and are now updated on an annual basis with total additions, disposals and an RPI indexation uplift. This is in line with the new Ofwat guidance. Capital expenditure comprises expenditure on overground assets plus new mains expenditure and the purchase of vehicles, computers and small plant items (including meters).

The current cost fixed asset registers have been arranged in order to classify the existing assets into the relevant business units for Accounting Separation reporting purposes. The asset additions and disposals are 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.

Where an asset has been allocated entirely to Wholesale, but provides a tangible benefit to Retail, a recharge has been calculated and is included in the total Retail operating costs, while reducing the Wholesale operating costs. In addition, within Wholesale, assets which have Treated Water Distribution or Water Treatment as their principal use business unit have some recharges to Water Resources.

Historic Fixed Asset Ledgers

New tables in the Annual Performance Report require direct Retail and Water Resources assets to be identified, and their associated depreciation. In addition, assets where there is a recharge from the principal use business unit to other business units e.g. to Retail from Wholesale (the principal

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use Business Unit) need to be identified. This has been done by copying the treatment of the assets in the Current Cost Fixed Assets Ledgers and assigning the relevant Business Units.

The new IFS system now automatically reports assets by business unit, and all future additions will be assigned a primary business unit and recharge business units for depreciation.

Household Retail assets and depreciation are allocated to the Measured and Unmeasured categories on the basis of customer numbers, except for vehicles relating to meter reading, which are all allocated to measured customers, as per the Ofwat guidance.

Asset Allocations between Business Units

Infrastructure Assets

Infrastructure Assets have been allocated directly to Treated Water Distribution or Water Resources. The assets as at 31st March 2008 had already been categorised as either Raw Water aqueducts or as Potable Water Mains as part of the PR09 process in table B7.13 of the Company's Final Business Plan submission. Infrastructure asset additions beyond this date have been assessed as to the business unit that they belong in. All additions are directly allocated.

Other Tangible Assets, Vehicles

The Fixed Asset Schedules used in the preparation of these tables itemise each vehicle by registration reference. This enables the drivers and users of these vehicles to be identified. Where applicable, the vehicles have been allocated to one single business unit. Where direct allocation of vehicles to single units was not possible then a consistent approach to allocation has been taken to that of the relevant operating costs.

Other Tangible Assets, Small Plant & Meters

The Small Plant Current Cost Fixed Asset ledger has been analysed and those plant items that were directly identifiable as being used for the purpose of only one business unit have been allocated directly to that business unit. There are a number of small plant asset types that related to company departments whose activities straddle the business units. These assets have been allocated on the same basis as the related operating costs.

Operational Assets

Operational assets have been directly allocated to a single business unit where possible. Where this was not possible assets have been allocated on bases consistent with the guidance document:

Offices & Depots

Where business activities straddle the business units the assets have been allocated on a consistent basis with that of other assets that are utilised by the same department. The Head Office has been allocated on the basis of floor area & then sub allocated either directly to a single business unit or has been proportionally allocated based on management estimates for shared service areas. All other offices and depots have been allocated either directly or on the basis of management estimates (as above).

Land

Land values have largely been identified as attributable to one business unit. Ofwat's Knowledge Management Team has provided advice regarding a number of sites and as to how they should be allocated for the purposes of asset separation. Portsmouth Water has followed this guidance. Where land is utilised for the purposes of more than one business unit, the land has been allocated accordingly. Technical drawings of the sites have been provided by the Company's

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Drawing Office and these have been used to allocate the land to each business unit necessary on the bases of floor area.

Service Reservoirs and Treatment Works

These assets have been allocated directly to individual business units.

Pumping Stations

Pumping station assets have been allocated directly to individual business units, where possible, using the asset inventory category mapping tables supplied by Ofwat. These allocations have been verified by the Supply Manager. There are only a small number of assets that required allocation to more than one business unit.

Telemetry Assets

These have been allocated to a number of business units on the basis of a Management estimate produced by the Supply Manager and the Management Accountant.

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.

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 Financial Controller 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 Financial Controller, 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 to ensure that these are all capital items. The policy adopted by the company is that only items above £500 are capitalised. Any items purchased in the year that are not on the approved capital list need to be sent to the Board for approval.

This process is audited twice a year as part of our statutory audit. Capitalised costs include contractor invoices, stores issues, direct labour charged to schemes plus on-cost recovery and the design and supervision staff costs related to project management.

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 Financial Controller ensure that the company complies with the current accounting standards applicable to the Company.

Prepared By: C Jemphrey

Date: 10.06.2020

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Appendix 1: Allocation of Operating Costs to Business Units

ANNUAL PERFORMANCE REPORT - BUSINESS UNIT TABLES

2019/20

	Water Resources £000	Raw Water Distribution £000	Water Treatment £000	Treated Water Distribution £000	Retail £000	Total £000
<u>DIRECT COSTS</u>						
Employment Costs	21	7	558	2,937	408	3,932
Power (add climate change levy)	1,010	0	83	1,468	-	2,560
Hired & Contracted Services	1	25	64	1,369	44	1,503
Materials & Consumables	-	-	297	333	11	641
Service Charges	1,322	-	-	-	-	1,322
Other Direct Costs	233	-	72	1,108	1,864	3,276
Customer Postage	-	-	-	-	127	127
Total Direct Costs	2,586	32	1,073	7,215	2,454	13,361
	0	0	0	1		
<u>GENERAL & SUPPORT ACTIVITIES</u>						
Land & Property (Direct and prorata)	86	-	41	121	18	265
Mechanical & Electrical (Direct and prorata)	285	2	366	482	29	1,165
Supply Engineer (M&E basis)	38	0	45	29	2	114
Personnel Services (FTE's)	37	0	77	214	254	582
Legal & Property (FTE's)	23	0	49	134	87	293
Financial Services (FTE's)	58	1	123	339	219	740
Directors (Activity and Board Agenda)	163	5	112	319	137	735
IT (Direct and no of devices)	84	2	192	518	299	1,096
Operational / Technical Support (GMEAV of additions)	1	-	2	339	-	341
Vehicles & Plant (Number of vehicles)	18	0	72	213	60	362
Stores (Direct value of materials)	-	-	185	207	6	398
Investments not capitalised (GMEAV of additions)	45	-	92	127		264
Havant Thicket	(3)					(3)
Rounding				(1)		(1)
<u>GENERAL ADMIN</u>						
Other General Admin (Various)	94	0	219	348	134	795
Total General & Support Costs	930	12	1,572	3,389	1,244	7,147
TOTAL OPERATING COSTS	3,516	44	2,645	10,604	3,699	20,508
OTHER BUSINESS ACTIVITIES	217	6	162	190	146	721
SCIENTIFIC SERVICES	460		374	486		1,321
DOUBTFUL DEBTS					536	536
GENERAL RATES	487	12	1,192	571	189	2,452
BULK SUPPLY				171		171
	4,680	62	4,374	12,023	4,569	25,708
<u>FUNCTIONAL EXPENDITURE</u>						
Third Party Costs (RCW)				807		807
Renewals Expensed				2,358		2,358
	4,680	62	4,374	15,187	4,569	28,872
HC Depreciation - Tangibles	293	91	1,757	3,388	86	5,615
HC Depreciation - Intangibles	9	-	2	491	4	506
Depreciation Recharges	-	-	-	(62)	62	-
TOTAL COSTS	4,982	153	6,133	19,004	4,721	34,992

ACCOUNTING SEPARATION 2019/20

Appendix 2: Wholesale Allocation of Operating Costs by Business Unit

ACTIVITY COSTING ANALYSIS - WATER SERVICE						
DESCRIPTION	Units	Water resources	Raw water distribution	Water treatment	Treated water distribution	Water Service Total
SERVICE ANALYSIS - WATER						
Direct costs						
Employment costs	£m	0.021	0.007	0.558	2.937	3.523
Power	£m	1.009	0.000	0.083	1.468	2.560
Hired and contracted services	£m	0.001	0.025	0.064	1.369	1.459
Materials and consumables	£m			0.297	0.333	0.630
Service charges	£m	1.322				1.322
Other direct costs	£m	0.233		0.071	1.108	1.412
Total direct costs	£m	2.586	0.032	1.073	7.215	10.906
Operating expenditure						
General and support expenditure	£m	0.930	0.012	1.572	3.389	5.903
Scientific services	£m	0.460		0.374	0.486	1.320
Other business activities	£m	0.217	0.006	0.162	0.190	0.575
Total business activities	£m	0.677	0.006	0.536	0.676	1.895
Local Authority rates	£m	0.487	0.012	1.193	0.571	2.263
Total opex less third party services	£m	4.680	0.062	4.374	11.851	20.967
Bulk Supply	£m				0.171	0.171
Third party services - opex	£m				0.807	0.807
Total operating expenditure	£m	4.680	0.062	4.374	12.829	21.945
Capital maintenance						
Renewals Expensed	£m				2.358	2.358
Historic cost depreciation	£m	0.293	0.091	1.757	3.388	5.529
Historic costs amortisation	£m	0.009		0.002	0.491	0.502
Depreciation Recharge to Retail	£m				-0.062	-0.062
Rounding	£m					0.000
Total capital maintenance	£m	0.302	0.091	1.759	6.175	8.327
Total operating costs	£m	4.982	0.153	6.133	19.004	30.272

Appendix 3: Retail Allocation of Operating Costs by Business Unit

ACTIVITY COSTING ANALYSIS - RETAIL SERVICES				
DESCRIPTION	Units	Retail household	Retail non-household	Retail Services Total
SERVICE ANALYSIS - RETAIL				
Direct costs				
Billing	£m	0.470		0.470
Payment handling, remittance and cash handling	£m	0.139		0.139
Debt management	£m	0.362		0.362
Doubtful debts	£m	0.536		0.536
Non network customer enquiries and complaints	£m	0.947		0.947
Meter reading	£m	0.178		0.178
Network customer enquiries and complaints	£m	0.411		0.411
Disconnections	£m			0.000
Demand side water efficiency initiatives	£m	0.116		0.116
Services to developers	£m			0.000
Customer side leaks	£m	0.075		0.075
Total direct costs	£m	3.234	0.000	3.234
Operating expenditure				
General and support expenditure	£m	1.000		1.000
Other business activities	£m	0.145		0.145
Total business activities	£m	0.145	0.000	0.145
Local Authority rates	£m	0.189		0.189
Exceptional items	£m			0.000
Total opex less third party services	£m	4.568	0.000	4.568
Third party services	£m			0.000
Total operating expenditure	£m	4.568	0.000	4.568
Capital maintenance				
Historic Cost Depreciation	£m	0.090		0.090
Depreciation Recharge from Wholesale		0.062		0.062
Total capital maintenance	£m	0.152	0.000	0.152
Total operating costs	£m	4.720	0.000	4.720

Appendix 4: Upstream Services (Wholesale Business)

Governance Process

The Upstream Accounting Separation in table 4D has been prepared by the Regulation Accountant and reviewed by the Financial Controller as part of the Annual Performance Report process. The allocation of operating expenditure between Trunk and Local Treated Water Distribution Business Units is no longer required.

The Regulation Manager has reviewed the methodology which was approved by the Engineering Director in 2016/17, and approved the data for submission to Ofwat.

Methodology Statement for Accounting Separation

This guidance details the methods used to allocate the total operating costs from the existing split of Wholesale Business Units, to the lower level split of Services, as follows:

<u>Water Resources</u>	Abstraction Licence Raw Water Abstraction
<u>Raw Water Distribution</u>	Raw Water Transport Raw Water Storage
<u>Water Treatment</u>	No further split
<u>Treated Water Distribution</u>	No further split

Operating Expenditure

Water Resources

The Abstraction Licence costs are taken from the invoice paid to the Environment Agency, relating to 2019/20. The remaining expenditure is all Raw Water Abstraction, including power, labour and an allocation of overheads.

Raw Water Distribution

Raw Water Storage relates to Highwood Reservoir at the Itchen site. The costs allocated include power and associated direct employment costs.

The Company no longer has any Raw Water Transport. The costs associated with the transport of water from Havant and Bedhampton to the Farlington Treatment works is now classified as Water Resources, and this was agreed with Ofwat.

Capital Expenditure

Water Resources

All the capital expenditure is allocated to Raw Water Abstraction.

Raw Water Distribution

Capital Expenditure for Highwood Reservoir is allocated to Raw Water Storage.

Volumes for unit cost information

Portsmouth Water collates volume and other operational data as part of the year end reporting process. This data is audited by WS Atkins for inclusion in year end reports.

For the only Raw Water Storage facility, Highwood Reservoir, there is capacity for 4 days storage.