

Accounting Separation Methodology Statement

Contents

| | |
|--|---|
| 1. Introduction..... | 2 |
| 2. Change in methodology from previous year..... | 2 |
| 3. Use of the Company’s accounting system..... | 3 |
| 4. Analysis of expenditure into Accounting Separation units..... | 4 |
| 4.1. Directly attributed operating costs | 5 |
| 4.2. Cost subject to allocation - General & Support..... | 5 |
| 5. Wholesale costs – further detail on Accounting Separation unit allocations..... | 7 |
| 5.1. Power costs | 7 |
| 5.2. Abstraction charges | 7 |
| 5.3. Cumulo and local authorities’ rates..... | 7 |
| 5.4. General support functions (mentioned in Section 3.2)..... | 8 |
| 5.5. Capital Expenditure (Capex) | 8 |
| 5.6. Grants and contributions..... | 8 |
| 6. Retail costs..... | 8 |
| 7. Asset Methodology..... | 9 |

1. Introduction

This Accounting Separation Methodology Statement (the “Statement” or “Methodology”) details SES Water’s (trading name of Sutton and East Surrey Water plc or the ‘Company’) analysis of costs between the respective binding price controls (Wholesale and Household Retail) for the relevant tables in the Company’s 2020/21 Regulatory Accounts. This Statement, and the related regulatory tables, are prepared in accordance with Ofwat’s (the Water Services Regulatory Authority) Regulatory Accounting Guidelines (RAGs). In specific cases where the RAG does not provide sufficient detailed guidance, the allocations are conducted using the reasonable cost drivers, for which data are available. The assumption for allocation of general support cost is based on the proportion of each business unit or price control unit in the total number of full-time equivalent staff and total floor area, whichever applicable.

Specifically, this Statement is produced to meet the requirements of Ofwat’s guidelines for accounting information, as published in RAGs 1.09, 2.08, 3.12, 4.09 and 5.07 and associated materials including Information Notice 13/01 (Revised regulatory accounting guidelines and regulatory accounts reporting requirements for 2012-13 and onwards) and the most recent Information Notice 21/01 issued by Ofwat in April 2021.

Tables 1A-20 have been audited by the Company’s external auditors (PwC), based on the accounting policies set out in pages 98 to 105 in the Company’s 2021 Annual Report and in this Statement.

In accordance with Ofwat’s requirements Section 4’s Tables are not subject to an audit opinion. However, these tables have been subject to proportionate assurance activity, including review and approval by relevant senior management and Directors to ensure that they have been completed appropriately.

It should be noted that SES Water is a water only company and has disposed of its Non-household retail business. Therefore, there is no Wholesale Wastewater or Non-household Retail information to be provided.

2. Change in methodology from previous year

The allocation of general labour and network related costs is based on full-time equivalent (FTE) staff this year, instead of manpower cost. The use of FTE better reflects the proportion of general support cost used by each business unit.

The IT software platform for customer service, known as transformation programme, to be recharged from retail to wholesale, is allocated based on FTE this year, instead of directly attributed. The change is made to reflect the phasing out of this cost in its second year of application. The large cost incurred in the previous year at the installation stage was more

directly linked to each unit, while the maintenance and operation cost in the current year is more aligned to a general support function.

3. Use of the Company's accounting system

The general ledger in the Company's accounting system (Navision) is the source for all the expenditure reflected in the operating cost analyses for the accounting separation tables. Transactions in the General Ledger all have cost centres and expense type account codes allocated at the time of their initial capture. The Company's trial balance consists of around 3,500 of these cost centre and account combinations and so is readily manageable for calculation in Excel to produce these accounting separation tables. Operating costs combinations make up around 3,000 lines of the trial balance.

Cost centres - For most operational areas, the cost centre is purpose (first two digits) and location (last 4 numbers) specific.

Accounts – there are a number of specific accounts which support the cost allocation process. For example, there is a specific account for abstraction costs.

Therefore, the cost centre and account code combination make it possible to attribute a significant portion of costs directly to the relevant accounting separation unit.

Operational costs which do not lend themselves to such direct attribution – typically covering site-wide, centralised, support, or management costs - are allocated using appropriate cost drivers.

A mapping table is maintained showing how the cost centre and account combination is mapped, either directly to an accounting separation unit, or to a “bucket” for further allocation using an appropriate cost driver.

This approach enables over 90% of total operating costs to be directly attributed to the appropriate Accounting Separation unit in the “Totex Analysis – Wholesale” and “Operating Cost Analysis – Retail” tables in this initial step.

The remaining costs are related to general functions that serve the whole company, hence need to be allocated appropriately to each Accounting Separation unit, depending on what specific activities actually involved.

4. Analysis of expenditure into Accounting Separation units

The Company's operating expenditure requires to be analysed into the following categories, and then categorised across the Accounting Separation units:

- Power
- Abstraction charges and discharges
- Cumulo and local authorities' rates
- Manpower
- Hired and contracted
- Materials and consumables
- Other costs
- Other employment costs

The first two items are related to the wholesale Accounting Separation units only and are allocated by using a separate method (see more details in Wholesale section).

The remaining five items are either *directly attributed* to Accounting Separation unit or *proportionately allocated and recharged to retail* for the general support functions. Table 1 below presents the methodology applied to each cost category.

Table 1

| Cost items | Methodology | Wholesale | Retail |
|-------------------------------------|------------------------|-----------|--------|
| Power | Direct and apportioned | Yes | No |
| Abstraction charges and discharges | Direct | Yes | No |
| Cumulo and local authorities' rates | Direct and Apportioned | Yes | Yes |
| Manpower | Direct and apportioned | Yes | Yes |
| Hired and contracted | Direct and apportioned | Yes | Yes |
| Materials and consumables | Direct and apportioned | Yes | Yes |
| Other costs | Direct and apportioned | Yes | Yes |
| Other employment | Direct and apportioned | Yes | Yes |

4.1. Directly attributed operating costs

This represents operating expenditure by departments that serve a specific and unique purposes or function that belong to a price control unit and is not shared. These include both labour and non-labour costs incurred by departments, for activities at sites and locations that can be allocated to one price control unit only. For example, a water treatment works directly attributed costs include its direct labour, chemicals used in water treatment, other materials and consumables that serve water treatment function only.

As explained in Section 2, the cost centre codes within the accounting system already provide the information to categorise these directly attributed costs into the requisite Accounting Separation units. For example, groups of cost centres exist for Resources (wholesale),

Treatment (wholesale), Distribution (wholesale), Customer service (retail) and General Support (supporting functions for both wholesale and retail).

In addition, a number of the direct attributions to Accounting Separation units are relatively straightforward given the size and the nature of SES Water, namely:

- All abstraction charges are in a specific account and are allocated to water resources abstraction charges.
- There are no bulk supply or bulk discharge costs.
- No renewals expensed in the year (no longer use renewals accounting under IFRS/FRS101).
- All income from National Grid's Short-Term Operating Regime (STOR income) is allocated to Water Treatment. This is an income from charge for use of the appointed business standby generators to assist with peak electricity demand - treated as revenue in the statutory accounts, but as negative operating expenditure in the regulatory accounts.
- All third-party services relate to Treated Water Distribution.

4.2. Cost subject to allocation - General & Support

As noted above, General Support costs for functions that serve the company as a whole and across the Price Control and Accounting Separation units and subject to allocation using appropriate cost drivers, given the available information. Functions that are subject to allocation and recharge include the followings:

- Cumulo and local authorities' rates
- IT platform (transformation) for customer services and other management functions
- Scientific research by the lab for quality compliance
- Economic regulation
- Non-operational buildings
- Procurement

- General labour
- General network related cost
- Other general support functions

In terms of cost categories, all of the items listed above are within the operating expenditures classifications required under the RAGs (manpower, hired and contracted, materials and consumables, other costs, other employments). However, in terms of cost centre (the departments that cause the costs), these costs serve general functions that benefit the whole company and across price control unit, both wholesale and retail. Therefore, all the operating expenditures by these departments and functions are allocated using appropriate cost drivers (see Sections 4.4 and 5). Table 2 provides more details about cost drivers used for allocation.

Table 2. Other opex allocation method

| Cost categories | Cost drivers | Cost drivers |
|--|---|---|
| | 31 March 2021 | 31 March 2020 |
| General labour costs | FTE adjusted for actual serving time (*) | FTE |
| Network related costs | FTE adjusted for actual serving time (*) | FTE |
| Economic regulation | FTE adjusted for actual serving time (*) | Equal across AS units |
| Non-operational building | FTE adjusted for actual serving time (*) | Floor share |
| Procurement | FTE adjusted for actual serving time (*) | FTE |
| Transformation recharged from retail | FTE adjusted for actual serving time (*) | FTE |
| General support cost from: Central cost, Corporate Service, Communication, IT, Executive, Finance, Human Resources | FTE adjusted for actual serving time (*) | FTE |
| Scientific Research | Activity based model | Activity based model |
| Cumulo and local authorities' rates | Direct cost and FTE within price controls groups (Wholesale & Retail) | Apportioned by Fixed Asset values for Cumulo rates and floor space for Local authority rates. |

*) We conducted a sample estimation of the actual time that general support staff uses to serve each price control unit to make it more cost reflective.

The above sections explain the attribution and allocation of operating costs across the operating expenditure categories and between price control units and – to an extent where directly attributable – to the required Accounting Separation units.

The following sections provide further details of allocation of costs to Accounting Separation units. Section 5 provides details of wholesale cost allocation to water resource, water treatment and water distribution. Section 6 explains cost allocation between measured and unmeasured customers in retail.

5. Wholesale costs – further detail on Accounting Separation unit allocations

Wholesale costs as reported in Table 4J of the Regulatory Accounts include power cost, abstraction charges, local authorities' rates, and other operating expenditures. All these costs should be allocated to water resources, raw water distribution, water treatment, and treated water distribution.

5.1. Power costs

Power consumption includes two parts:

- direct consumption by each business unit, as calculated from management surveys, with accurate meter reading from the sites (99%).
- general supporting consumption by cross-cutting services such as non-operational building (eg Redhill office), infrastructures that serve the whole company or more than one specific function, etc.

The general supporting consumption of power are allocated to each business unit based on their proportion to total direct power consumption as measured in kWh.

5.2. Abstraction charges

These charges are paid to the Environment Agency for raw water abstraction from the environment. These costs apply to water abstraction from the environment only, and have no relation to any other activities. Therefore, these costs are fully allocated to water resources.

5.3. Cumulo and local authorities' rates

Cumulo rates relate to the wholesale operations and as such have been directly allocated to wholesale with proportion of FTE used to split within wholesale.

Local authority rates mainly relate to the Redhill office and have been apportioned based on floor area occupied by each department. Wholesale and Retail received direct allocations for the floor space they occupy with support departments being allocated to Wholesale and Retail based on FTE. Within Wholesale and Retail, FTE is used to allocate costs to the operational units.

5.4. General support functions (mentioned in Section 3.2)

As seen in *Table 2*, a number of the drivers have been updated for the year ended 31 March 2021 to enhance accuracy of allocations. All cost items in *Table 1* are allocated across water resources, water treatment, water distribution, and retail.

Depending on the functions and their scope of service they provide, the following cost drivers are used to allocate general support cost:

Number of full-time equivalent staff

FTE is a good driver of operating costs for both labour and non-labour costs. This is used as cost driver to allocate network-related costs, and general support costs.

5.5. Capital Expenditure (Capex)

Similar to opex, capex is also composed of the directly attributed and the general expenditure to be allocated. The majority of capex is directly attributed from the jobs and departments that serve the relevant price control unit. More details are provided in Section 6 on Asset Methodology. The general expenditure includes general supporting functions and salaries of project managers who serve these various capex projects. These indirectly incurred capital expenditures are allocated to each business unit in proportion to their share in the directly attributed capex.

5.6. Grants and contributions

These expenditures are directly attributed to treated water distribution only as this is completely network related activity.

6. Retail costs

Except for meter reading, all other cost items are allocated between measured and unmeasured household customers which is based on number of billed properties.

Sub-categories of operating cost as required to be presented in *Table 2C* for retail include:

- Customer service
- Debt management
- Doubtful debt
- Meter reading, and
- Other operating expenditures

Some of the general functions in retail and wholesale serve the whole business, therefore need to be recharged or allocated appropriately. The allocation is done as follows:

- Retail payroll function. This activity services retail business only, therefore subject to be split between different retail functions, but not to wholesale. This expenditure is split between customer service and debt management, based on the number of full-time equivalent staff (See Table 3)
- Doubtful debt. Total doubtful debt analysis provides information about source of debt by customer type. The debt is then allocated in the accounting system to wholesale and retail.
- General support functions that serve the whole company. These expenditures are allocated based on FTE as explained in details in *Table 2* for wholesale.

Table 3. Retail function for payroll cost allocation

| Retail function | Category | Description |
|------------------------|------------------|--|
| Billing | Customer service | Customer billing operation |
| Payment handling | Customer service | Processing all payments |
| Contract | Customer service | Managing contracts with customers |
| Other customer service | Customer service | Call centre, correspondence, revolving claims, etc. |
| Debt management | Debt management | Contact and follow-up with delinquencies, payment plan, etc. |

7. Asset Methodology

A Company engineer has reviewed the asset database used for statutory and regulatory accounts purposes and an additional code has been added to each operational asset to indicate either its business unit, or that it is a General and Support or Scientific Services asset. Assets are classified into price control unit as follows:

- Water resources: water abstraction from the environment only;
- Water treatment: treatment plants and facilities that turn raw water into treated;
- Raw water distribution: networks and pipes that transport water from the source to the treatment works;
- Treated water distribution: networks, pipe, pumping stations that bring water from the treatment plants to the customers.

Other tangible assets are already coded by their cost centre codes within the database, and each cost centre is allocated to a business unit, where possible. Where a cost centre spans business units, the asset is split in the same way as the operating expenditure for that cost centre has been split, for example by direct costs, direct employment costs, modern equivalent asset (MEA) asset values, etc.

The information is separated into Water Resources, Raw Water Distribution, Water Treatment, Treated Water Distribution, Retail, General and Support and Scientific Services.



General and Support assets are allocated to the Wholesale business unit and the capital costs are recharged using the same drivers as used for operating expenditure.

The Scientific Services assets are allocated across Water Resources, Raw Water Distribution and Water Treatment pro rata to the Scientific Services operating expenditure.

The Retail assets are allocated to Household.