

Accounting Separation Methodology Statement

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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 2022/23 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, 2.09, 3.12, 3.14, 4.10, 4.11 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 22/01 issued by Ofwat in March 2021.

Tables 1A-20 have been audited by the Company’s external auditors (PwC), based on the accounting policies set out in pages 127 to 136 in the Company’s 2023 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

When allocating operating costs, RAG 2 has been used as a guidance, same approach as the previous year. Majority of the methodology has stayed consistent. The largest change is coming through Local and business rates whereby rather than apportioning the cost for the national non-domestic rates (NNDR) using floor space or FTE, this has wholly been allocated to treated water distribution.

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 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	
	31 March 2023	31 March 2022
General labour costs	FTE adjusted for actual serving time (*)	FTE adjusted for actual serving time (*)
Network related costs	FTE adjusted for actual serving time (*)	FTE adjusted for actual serving time (*)
Economic regulation	Per RAG 2.09 1/6th Retail 5/6ths Wholesale	Per RAG 2.09 1/6th Retail 5/6ths Wholesale
Non-operational building	FTE adjusted for actual serving time (*)	FTE adjusted for actual serving time (*)
Procurement	FTE adjusted for actual serving time (*)	FTE adjusted for actual serving time (*)
Transformation recharged from retail	FTE adjusted for actual serving time (*)	FTE adjusted for actual serving time (*)
General support cost from: Central cost, Corporate Service, Communication, IT, Executive, Finance, Human Resources	FTE adjusted for actual serving time (*)	FTE adjusted for actual serving time (*)
Scientific Research	Activity based model	Activity based model
Cumulo and local authorities' rates	Direct cost and floor space (Wholesale & Retail)	Direct cost and floor space (Wholesale & Retail)

*) 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. Sections 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 business operations and as such have been directly allocated to wholesale based on floor space for direct price control categories, and with a proportion of FTE used to split floor space related to general support services.

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.

The national non-domestic rates (NNDR) makes up for over 95% of the local and cumulo rates, there has been a large shift this year from previous years as it was identified that all costs for the NNDR should be allocated to treated water distribution (TWD) as oppose to allocating between wholesale and retail using the FTE/floor space method.

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 2023 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

The asset database is 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.