

ACCOUNTING SEPARATION STATEMENT 2014-15

**Analysis of Operating and Fixed
Asset Costs by Business Unit**

ACCOUNTING SEPARATION STATEMENT 2014-15

1. PURPOSE OF METHODOLOGY

The purpose of this methodology statement is to explain how the accounting separation analysis tables in the Northumbrian Water Limited (NWL) Regulatory Accounts 2014-15 (the Accounts) have been produced, specifically the operating cost analysis in note 2 of Section B of the Accounts (pro forma tables A7 and A8 of Regulatory Accounting Guideline 4.04 'Guideline for the definitions for the regulatory accounts tables' (RAG4)) and the current cost analysis of fixed assets in note 3 of Section B to the Accounts (pro forma tables A9 and A10 of RAG4).

The methodology complies with the document 'Disclosure requirements for companies' accounting separation and upstream services data methodology statements 2013-14' published by Ofwat. We can confirm that guidance for PR14 or guidance contained in the new RAGS have not been used.

The methodology contains the following sections:

2. Background to NWL
3. Operating cost analysis
4. Commentary on changes to costs
5. Fixed asset analysis
6. Capitalisation policies

The methodology was last updated on 2 June 2015.

2 BACKGROUND TO NWL

NWL operates in the north east of England, providing water and wastewater services, and in Essex and Suffolk in the south east of England, providing water services only. NWL's appointed business is structured with water, wastewater and customer directorates, supported by a number of corporate support directorates and departments.

The water services directorate comprises Production (Resource & Treatment) and Distribution departments in each of the three operating areas, Northumbrian, Essex and Suffolk. There are further smaller geographic regions within each area.

The wastewater services directorate operates in the Northumbrian area only and comprises Sewerage (Collection) and Sewage Treatment departments. There are further smaller geographic regions.

The customer directorate aligns closely with the RAG4 definitions of retail services, comprising billing, payment centre, contact centre, debt recovery and meter reading teams.

Corporate support functions include Information Services (IS), Financial Services, Human Resources, Scientific Services and Facilities. All corporate support departments operate across all of NWL's operational areas. No functions are outsourced overseas.

ACCOUNTING SEPARATION STATEMENT 2014-15

3 OPERATING COST ANALYSIS

Note 2 of Section B to the Accounts analyses the operating costs and capital maintenance costs of the wholesale (water and wastewater) and retail services of the appointed business. The following section explains how the costs are allocated and apportioned to the different services.

3.1 SOURCE DATA

NWL uses Oracle financial systems, including general ledger (GL), accounts payable, accounts receivable (miscellaneous income), i-procurement and project accounting.

All operating costs are recorded in GL against an account code (expense type) and a cost centre code (department). The account codes have been directly aligned to the row headings within the operating expenditure excluding third parties of the wholesale business table of the operating cost analysis in note 2 of Section B to the Accounts. The cost centre structure in GL reflects the way the business is managed by directorate, department and location.

3.2 OVERVIEW OF PROCESS

Costs are allocated to the appropriate activity categories (table columns) by the following stages:

- Cost centres are separated between direct departments, typically operational and customer functions, and non-direct departments, typically support functions, based upon their function in the company;
- Direct departments are allocated directly to activity categories based on the nature of the function, with some exceptions which require apportionment between activities;
- Direct costs are allocated to the appropriate cost category (table rows) based upon the account code;
- A small number of support departments are apportioned directly to water, sewerage and retail activities;
- Other support departments are apportioned to operational functions based either on a specific analysis of the costs or by apportionment by an appropriate cost driver; and
- Once allocated to the operational functions the costs are then allocated to activity categories pro rata to the direct cost allocations of the operational function costs.

Sections 3.4 and 3.5 provide a more detailed explanation of these stages and of the allocation bases used for allocating costs.

3.3 CHANGES TO THE METHODOLOGY FROM 2013-14

The analysis of metering reading costs between household and non household retail services has been allocated on the number of meter reads on metered properties.

Following a departmental restructure, the Asset Information department now forms part of IS and has been included within IS allocation.

ACCOUNTING SEPARATION STATEMENT 2014-15

In the non direct department Health & Safety, individual advisors have now been assigned areas of business to provide support and this has been used as a basis for allocation.

3.4 DIRECT DEPARTMENTS

This section explains how the costs of direct departments are allocated to water service activities (water resources and treatment and water distribution), wastewater service activities (sewerage, sewage treatment, sludge treatment and disposal) and retail activities.

Most operational and customer departments can be allocated directly to a single activity reflecting their function in the company. Where this is not possible, the allocation must be calculated. The main bases for these allocations are summarised below.

3.4.1 WATER SERVICES

- Power costs are identified for each site and allocated to the appropriate service. Where the assets on a site are used for more than one activity, the cost is reviewed by operational managers to allocate between the resource, treatment and distribution categories, based on flows and lift.
- There are two main sources of income treated as negative expenditure:
 - income from short term operating reserve contracts with National Grid is allocated to water treatment;
 - income from hydro generation feed in tariffs and export is allocated to raw water distribution.
- The cost of a bulk supply agreement with Thames Water is allocated to water resources. An element of this charge relates to Environment Agency (EA) abstraction charges and is reported on the service charge line.
- Other operating expenditure comprises:
 - employment (£26.4m), hired services (£16.5m) and materials and consumables (£10.1m) costs which are mostly allocated according to their direct cost centre. A small proportion of these costs relate to more than one activity and are allocated based upon managers' estimates, whilst operational management and support costs are apportioned based upon managers' estimates;
 - scientific services costs (£6.0m) which are allocated by the number of determinants and samples. Samples taken at customers' taps are allocated to water distribution;
 - general and support costs (£22.8m), for which the basis of allocation is explained in section 3.5.
- Water cumulo rates costs are allocated between wholesale water and retail based on the gross fixed asset current cost.
- Third party services are directly attributable to business activities. The cost of supplying non-potable water to industrial customers on Teesside is reported as services to third parties and includes an element of abstraction charges and water cumulo rates.

ACCOUNTING SEPARATION STATEMENT 2014-15

3.4.2 SEWERAGE SERVICES

- The majority of sludge costs, such as dewatering, digestion and disposal at the larger sites, are identified directly at source. Some sewage treatment work costs require apportionment between sewage treatment and sludge activities. This is done using managers' estimates.
- Sludge transportation costs are captured in a separate cost centre.
- Sludge liquor costs are estimated based on average loads at the sludge treatment sites and are allocated to sludge treatment.
- Skip hire for the disposal of grit and screenings is allocated to sewage treatment.
- The costs of Bran Sands and Howdon advanced anaerobic digestion (AAD) sites are allocated as follows:
 - power generated by AAD is predominantly used on site. All of the generation is allocated to sludge treatment;
 - there is a net export of power from sludge treatment which is shown as a negative power cost;
 - the sewage treatment power cost reflects the full use on sewage treatment activities including the use of power generated by AAD;
 - all income generated from sludge digestion, which is mainly from renewable energy certificates plus occasional export, is shown as income treated as negative expenditure under sludge treatment.
- Power costs are identified by site and allocated accordingly. At sewage treatment works where there is sludge treatment, an allocation is made to sludge activities. For the two large sludge sites, Bran Sands and Howdon, the allocation uses sub-metering data. For other sites the apportionment is based on managers' estimates.
- Other operating expenditure includes the same items as the water service, described in section 3.4.1 above and is allocated on the same bases. The costs comprise employment (£17.9m), hired services (£16.4m), materials and consumables (£5.9m), scientific services (£1.9m) and general and support costs (£14.5m).
- Non-domestic rates charges are directly attributable on a site by site basis.
- Bran Sands sewage treatment works receives waste from industry on Teesside via a number of dedicated pipelines under special agreements. Operating costs are allocated between waste from special agreements and other municipal waste based on COD loads and sludge volumes. Costs associated with the waste received under special agreements are allocated to services to third parties. Other third party services are directly attributable to business activities.

3.4.3 RETAIL

Allocations to direct cost rows of the retail table are primarily captured by cost centre within the customer directorate, however, some department costs need to be apportioned.

- The debt recovery process is supported by other teams in the customer directorate, therefore, a proportion of billing and contact centre costs are allocated to line 2, debt management, based on managers' estimates.
- Customer contact centre costs are allocated between network and non-network enquiries based on the number of calls received.

ACCOUNTING SEPARATION STATEMENT 2014-15

- The cost of network calls in retail includes an allocation of scheduler and distribution technician costs for investigatory work and internally generated calls based on managers' estimates.
- The cost of proactive customer supply pipe renewals is captured directly in separate cost centres and is allocated between customer side leaks and third party services. The element covered by customers' contributions is allocated to services to third parties.
- Specific members of the development control team work full time on pre-development queries from developers, therefore, their costs have been allocated to retail services.
- The direct costs for demand side water efficiency activities are recorded within the demand planning team. The total cost includes water efficiency materials distributed to customers, value of work completed by contractors and contribution of staff time from across the demand planning teams.
- Non-domestic rates costs are allocated by location, therefore, the cost of sites where customer teams are based is allocated to retail based on full time equivalent (FTE) headcount numbers at each location. An element of water cumulo rates costs has been allocated to retail based on gross fixed asset current cost.
- Decision making and administration of disconnections and reconnections are performed by customer teams and allocated directly to retail services.

Each retail activity is allocated between household and non household services using an appropriate driver as follows:

- Billing - based on the number of bills;
- Payment handling - based on the number of receipts;
- Vulnerable customer schemes - allocated fully to household;
- Debt management costs - analysis provided by the debt recovery manager;
- Doubtful debts - based on actual debts used in calculation of the bad debt provision and customer specific write offs;
- Network customer enquiries - based on the number of network contacts;
- Non-network customer enquiries - based on the number of non-network contacts;
- Meter reading - based on number of meter reads;
- Demand side water efficiency initiatives - analysis provided by the demand planning team;
- Customer side leaks - proactive work in Essex is allocated to household and the remaining cost is allocated based on managers' estimates;
- Other direct costs - primarily comprises the customer systems team which provides support and analysis across the directorate and is allocated by the number of bills raised;
- Services to developers are allocated fully to non household services;
- Customer account management is allocated fully to non household.

NWL has agreements with a number of local authorities and housing associations to bill and collect income. The properties for each local authority are invoiced on one or two schedule bills each year. The risk of collection is transferred to the local authority and a commission is

ACCOUNTING SEPARATION STATEMENT 2014-15

paid to reflect this. Around 9.5% of income is collected in this way. The commission charge is allocated between bad debt and customer services. The billing and debt recovery costs are estimated based on NWL's own costs of billing customers directly. The balance is assumed to represent the bad debt risk and is allocated to doubtful debts.

The company does not issue bills to 'the occupier'. The company does not issue credit notes or cancel unpaid amounts where a customer has vacated a property leaving amounts unpaid.

To calculate a provision for doubtful debts, all debt is segmented into different categories, such as current and previous occupiers. All segments are profiled according to the age of the debt and a range of percentages is allocated to debt of different ages, based upon analysis of historical debt, with higher percentages applied to categories of debt which are considered to be of greater risk and to debt of greater age. The value of the bad debt provision is sensitive to the specific percentages applied. All debt outstanding for 48 months or more is fully provided for.

3.5 NON-DIRECT DEPARTMENTS

This section explains how the costs of non-direct departments are allocated across water, wastewater and retail activities.

A small number of departments can be allocated directly to activity categories, as follows:

- Regulation - costs, including the Licence fee, are allocated equally between the nine service activities, four water, four sewerage and one retail.
- Scientific Services - cost allocation based on number of determinants and samples.
- Security & Emergency Planning - a significant proportion of the cost relates to site security which is allocated directly to the department responsible for the site. The remaining costs across the business on the same basis as the maintenance allocation within direct departments.
- Insurance - premiums are allocated by applying a relevant cost driver for each premium, e.g. vehicle insurance premium by vehicle numbers.
- Logistics - costs are allocated based on value of stores issues to each department.

Where costs cannot be directly allocated to activities, departmental costs are apportioned to direct departments, based on either a specific analysis of the costs or by an appropriate cost driver, and then allocated to activity categories pro rata to the costs of the direct department. The allocation basis for each support department is outlined below. Where no appropriate cost driver can be identified, functions are classified as 'corporate overhead' and allocated as a block at the end.

- Information Services - a separate allocation model has been produced identifying all elements of costs with an appropriate driver. All costs are allocated to the various systems used or services provided and these system and service costs are then allocated on a driver such as the number of users of the system.
- Health & Safety - each advisor is assigned to different areas of the business to provide support. The direct costs for each advisor are then allocated across the departments on a FTE headcount basis. Management and admin costs are allocated on a FTE headcount basis.

ACCOUNTING SEPARATION STATEMENT 2014-15

- Facilities - costs are analysed by location and the cost of each location is allocated to departments on a FTE headcount basis.
- Human Resources - an analysis of training costs is provided by the Training manager and healthcare costs are allocated by employee. The remaining HR costs are analysed with the HR manager and, unless a better alternative is identified, allocated by FTE headcount for the relevant departments.
- Estates - rental costs are directly allocated to the responsible area of the business. The remaining departmental costs are allocated in proportion to rent, unless a specific allocation is identified.
- Finance and Technical management teams - these have separate cost centres which are allocated by person back to their areas of responsibility.
- Finance (Management Accounts) - costs are allocated in accordance with time spent on supporting internal departments.
- Procurement - the cost allocation is based on value of relevant commodities and services purchased.
- Directorate - costs are summarised by director, including an apportionment of personal assistants' costs. Each director's cost is allocated according to their areas of responsibility and the FTE headcount in each area.
- Strategic Asset Planning - costs are allocated across water and wastewater activities in line with annual impactable opex costs (impactable costs exclude Environment Agency service charges, local authority rates and bad debt charges).
- Business Process Improvement - costs are allocated across water and wastewater activities in line with annual impactable opex costs.
- Leisure - statutory recreation activities are allocated directly to water resources with the remainder of costs allocated to corporate overhead.
- Corporate overhead includes those items identified above plus the remainder of the Finance department, Conservation, Corporate Affairs, Communications and Legal and Secretariat. The total cost is allocated in proportion to the overall cost allocation for direct departments.

3.6 CAPITAL MAINTENANCE CHARGES

This section explains how capital maintenance costs are allocated between water, wastewater and retail activities.

The IRC is calculated by taking the actual IRE in the year, plus the forecast IRE for the period to 31 March 2020, in 2014-15 prices, and the value of the IRC prepayment brought forward at 31 March 2014, and calculating the annual average IRE spend. This is calculated separately for the water and wastewater services. For water, the IRC allocation to water resources and raw water distribution is the average IRE in the 2010-15 period, with the balance being allocated to distribution. The IRC allocated to sewage treatment is the average IRE in the 2010-15 period, with the balance being allocated to sewage collection.

The process and allocation for current cost depreciation (CCD) is explained below within Section 5.4.7 - CCD charge for the year.

ACCOUNTING SEPARATION STATEMENT 2014-15

Amortisation of deferred credits is captured on an individual project basis with each project being reviewed and allocated in line with business activity.

Recharges between business units relate to fixed assets utilised in more than one business unit. The asset value and current cost depreciation for these assets have been recorded in the business unit of principal use. Recharges have been made to the other units using the assets based upon the annual current cost depreciation charge and proportion of use.

3.7 REVIEW PROCESS

The cost allocation methodology and tables are prepared by a senior management accountant. They are reviewed by the management accounting manager and financial controller.

4. COMMENTARY ON CHANGES TO COSTS

Costs in the operating cost analysis table for 2014-15 have been compared to the equivalent costs for 2013-14, inflated by the average year RPI of 1.99%.

4.1 OPERATING EXPENDITURE

4.1.1 WHOLESALE WATER

Total operating expenditure excluding third party services has increased by £0.1m, in real terms, compared to 2013-14. The main changes are:

- power costs have increased by £1.7m due to 12% price increases;
- service charges include £2.6m refunds of abstraction charges paid in respect of Environmental Improvement Unit Charge in prior years.

4.1.2 WHOLESALE SEWERAGE

Total operating expenditure excluding third party services has reduced by £2.1m, in real terms, compared to 2013-14. The main changes are:

- hired services have decreased by £3.4m: sewerage contractor costs are down by £1.9m mainly due to lower reactive work and sludge contractors have decreased by £0.9m due to sludge dewatering activity being brought in-house;
- power costs have increased by £0.8m due to 12% price increases.

4.1.3 RETAIL

Total operating expenditure excluding third party services has increased by £1.9m, in real terms, compared to 2013-14. The main changes are:

- doubtful debt costs have increased by £1.1m, due to an increase in the doubtful debt provision reflecting the age and nature of the debt and specific non-household provisions;
- non-household customer services costs are up by £0.3m mainly due to increases in account management costs;

ACCOUNTING SEPARATION STATEMENT 2014-15

- non-household debt management costs have increased by £0.2m (and household debt management costs have decreased by £0.3m);
- non-household other operating expenditure has increased £0.3m, due to a higher allocation of general and support costs driven by the higher customer services and debt management costs.

Debt written off has decreased by £1.6m, due to the timing of write offs. The bad debt provision has increased.

4.2 CAPITAL MAINTENANCE CHARGES

4.2.1 CURRENT COST DEPRECIATION

Retail current cost depreciation (CCD) and recharges to and from other business units have changed, in real terms, by 8%, 14% and 20% respectively.

In 2013-14 the MEAV model assumed that IS and Building assets after reaching the end of their standard life had an extended life resulting in a lower annual CCD and recharge. This has been reviewed in 2014-15 and the model updated with assets replaced based on their standard asset life, resulting in a higher annual CCD charge than the previous year.

4.2.2 AMP ADJUSTMENT

There is a significant AMP adjustment reported in respect of sludge treatment assets in 2014-15. This relates to the impairment of sludge drying plant at Bran Sands. This plant was constructed in the 1990s as a regional centre for the treatment and disposal of the sludge generated from the company's waste water treatment process. In response to a combination of high operating costs and the emergence of new technologies, the sludge strategy was subsequently reviewed leading to the construction of two advanced anaerobic digestion (AAD) plants at Bran Sands and Howdon. The sludge drying plant was initially retained as alternative capacity, however, during 2014-15, management decided that the two AAD plants were operating to the expected standard of performance and reliability and that the sludge drying plant would be abandoned.

5. FIXED ASSETS ANALYSIS

Note 3 of Section B to the Accounts analyses the fixed assets of the wholesale and retail services of the appointed business on a current cost basis. The following section explains how the assets are allocated between the activities and how each row in the note is calculated.

5.1 SOURCE DATA

NWL does not maintain a full current cost asset register. Current cost asset data is calculated on a modelled basis according to asset type and size and, therefore, is not in a form that can be reconciled to the historical cost asset register.

5.2 ALLOCATION OF ASSETS BY ACTIVITY

Assets have been allocated to activities in accordance with the definitions in RAG4.

ACCOUNTING SEPARATION STATEMENT 2014-15

5.2.1 RETAIL ASSETS

Retail assets comprise the following:

- Billing system;
- Other retail assets, primarily comprising our Lowestoft Customer Centre, including furniture, fixtures & fittings, call centre telephone system, office equipment and IT, plus vehicles; and
- Shared assets allocated to retail principally relate to our Northumbria House Customer Centre, for which a cost is recharged to the wholesale business reflecting proportional occupation of the premises.

The financial values associated with these assets are set out in the table below:

	NBV	CCD
	£m	£m
Billing system	2.1	1.5
Other retail assets	1.9	0.2
Shared assets	22.6	1.5
Total	<u>26.6</u>	<u>3.2</u>

Retail assets are allocated between household and non household activities utilising consistent bases to those applied for the operating cost analysis.

5.3 RECHARGES

Shared assets primarily comprise offices and IT systems.

- The principal use of our Northumbria House Customer Centre is the household retail service.
- The principal use of offices at Howdon is sewage treatment.
- Other shared assets have multiple users and no single dominant user. In these cases, the largest single user has been determined as treated water distribution.

Recharges have been allocated according to proportional use, informed by relevant operating cost allocation bases.

5.4 CURRENT COST ASSET CALCULATIONS

The following section explains the basis of each row within note 3 of section B to the Accounts.

5.4.1 GROSS REPLACEMENT COST

The gross modern equivalent asset value (MEA) value is defined, in Regulatory Accounting Guideline 1.05 (RAG1) for accounting for capital maintenance charges and current costs, as 'what it would cost to replace an old asset with a technically up to date new asset with the same service capability allowing for any difference both in the quality of the output and in operating costs'. The net MEA value is the depreciated value, taking into account the

ACCOUNTING SEPARATION STATEMENT 2014-15

remaining service potential of an old asset compared with a new asset and is stated gross of third party contributions.

5.4.2 AMP ADJUSTMENT

The AMP adjustment reflects the impact of any changes to either current cost asset values or expected asset lives on both the gross MEA value and accumulated CCD values as a result of:

- asset revaluations; and
- amendments to remaining asset lives, for example:
 - a reassessment of the condition, serviceability and performance of assets with a zero net book value, or
 - a reassessment of average asset lives for a category of assets.

5.4.3 RECLASSIFICATION ADJUSTMENT

This reflects the adjustment to the gross MEA value and accumulated CCD as a result of a reclassification of assets between business units during the year due to:

- a change to Ofwat guidance on the assets to be recorded in each business unit; or
- the effect of applying a change in apportionments to opening balances.

Note, any depreciation relating to shared assets is charged fully to the primary business unit. A recharge to other business units is then calculated, using the same allocations as per operating costs for the prior year, in accordance with the principles in RAG4.

5.4.4 RPI ADJUSTMENT

This reflects inflation of both the gross book value and accumulated depreciation, by asset type, to current year prices using the year end retail price index (RPI), as follows:

$$\text{Indexation Factor} = \frac{\text{Current Year Financial Year End RPI}}{\text{Prior Year Financial Year End RPI}}$$

5.4.5 ASSET DISPOSALS

This represents the reduction in both the gross book value and the accumulated depreciation to reflect any asset disposals.

Asset disposals are recorded by various mechanisms:

- property disposals are managed by the company's Estates team who inform the Finance team when any properties are sold;
- vehicle disposals are managed by the service provider contracted to supply and maintain the vehicle fleet and they inform Finance of all disposals as they occur;
- other types of asset disposal are unusual and are captured on an individual basis;
- assets taken out of service are identified by Operations and responsibility handed over to the Estates team who maintain and manage an abandoned asset register;

ACCOUNTING SEPARATION STATEMENT 2014-15

- significant damage incurred by assets is reported to the Insurance team who manage the claims process and inform the Finance team for recognition in the accounts; and
- assets replaced as a result of capital investment are identified through monitoring of the capital program and reviewed at the asset commissioning stage.

5.4.6 ADDITIONS

This reflects the increase in the gross value of assets as a result of capital investment to either construct or purchase new assets. This comprises non-infrastructure expenditure on the base service and all enhancement expenditure, as defined in RAG 2.04 Guideline for classification of capital expenditure.

5.4.7 CCD CHARGE FOR THE YEAR

The annual depreciation charge is reported, by asset type, before the amortisation of deferred credits and intangible assets. No construction in progress is included within the depreciation calculation, as this represents assets which are not yet completed and available for use in the business.

6. CAPITALISATION POLICIES

6.1 ACCOUNTING POLICIES

The capitalisation policies applied in the regulatory accounts comply with FRS 15 Tangible Fixed Assets, other than for infrastructure renewals accounting for which FRS 15 is dis-applied in accordance with RAG1.

The key capitalisation principles within FRS 15, which are applied in NWL's capitalisation policies, are that:

- assets must have an expected useful life of greater than one year (applied as a minimum expected useful life of two years);
- the company must own the asset;
- costs can only be capitalised up to the point at which the asset is ready for use, including an initial commissioning period;
- only costs directly attributable to bringing the asset into working condition for its intended use can be capitalised.

6.2 BELOW GROUND ASSETS

The key elements of capitalisation policies for activities relating to the below-ground network are summarised below:

6.2.1 WATER NETWORK

- repair of mains using a clamp or replacement of a length of pipe not spanning a joint is charged to opex.
- replacement pipe lengths spanning at least one joint are capitalised; bends and T-joints are also considered to be individual assets and are capitalised.

ACCOUNTING SEPARATION STATEMENT 2014-15

- replacement of street furniture, such as meter chambers and stoptap covers, is capitalised.
- replacement of stoptaps and valves is capitalised.
- routine mains cleaning or flushing is charged to opex; flushing as part of the acceptability of water programme is capitalised as it is a funded regulatory output.
- service and impounding reservoir inspections are generally capitalised as they invariably lead to remedial work.

6.2.2 SEWERAGE NETWORK

- replacement of any length of sewers is capitalised.
- replacement of street furniture, such as manhole covers, is capitalised.
- repairs to sewer ancillaries are charged to opex.
- clearing sewer blockages, including sewer cleaning, jetting and root cutting, is charged to opex, unless it forms part of a larger capital rehab scheme.
- CCTV surveys are allocated to opex by default but will be capitalised if the output leads directly to a capital job.
- sewer flooding investigations are initially carried out as an opex activity and, if the cause is identified, the resolution is charged accordingly, e.g. clearing a blockage is opex, replacing a collapsed sewer is capex. If the initial investigation does not identify the problem then it is assumed to be a hydraulic problem and a full cause report and feasibility study is carried out and treated as capex.
- activities such as zonal studies or catchment studies, which are integral to the capital planning and prioritisation process, are capitalised.

6.3 ABOVE GROUND ASSETS

- the construction or purchase of new assets is capitalised.
- replacement or maintenance of existing assets is charged in accordance with FRS 15 guidelines which state that subsequent expenditure for repairs and maintenance will be opex if it is to maintain the expected standard of performance or necessary to prevent the useful life or residual value of the asset from decreasing.
- subsequent maintenance expenditure is treated as capex where it provides an enhancement of economic benefits in excess of the expected standard of performance, eg. an extension in the estimated useful life, an increase in capacity, or where the asset being replaced or overhauled has been depreciated over an appropriate asset level which reflects the maintenance requirement.
- replacement of an entire asset or a significant component of a larger asset is capitalised.
- refurbishment of an asset to extend its useful life is capitalised but given an appropriate shorter life.
- GAC media replacement is capitalised.

ACCOUNTING SEPARATION STATEMENT 2014-15

6.4 NON-CAPITALISED COSTS

All find and fix leakage costs are charged to opex.

Increases in operating costs incidental to a capital project are not capitalised, for example, higher treatment costs resulting from a treatment works being taken out of service for refurbishment.

Periodic cleaning costs of, for example, service reservoirs, filter beds or wet wells, are charged as opex.

Routine water and sewer network flushing is opex. The acceptability of water programme is an exception to this as it is a funded regulatory output associated with upgrading the serviceability of the network.

6.5 OVERHEADS AND DIRECT LABOUR RECHARGES

Capital costs are charged directly to a capital scheme wherever possible.

Direct labour costs are initially charged as operating costs and, for staff working on capital schemes, time is allocated by timesheets and recharged to the capital project based on an hourly trade rate.

Trade rates are calculated for each distinct trade group and incorporate basic pay, pension costs, national insurance, transport, personal equipment and direct supervision costs. The rates are recalculated on an annual basis to reflect the annual salary review and, by exception, recalculated during the year if a significant change has occurred.

Some functions, such as asset planning and asset accounting, work entirely in support of the capital programme. However, as their activities are spread across all projects, it is not cost-effective to allocate time directly to individual projects, therefore, the full cost of these functions is charged to a separate capital overhead project.

For other functions which support the capital programme a cost allocation exercise is carried out, using appropriate activity cost drivers, to calculate the proportion to be recharged to capital. This is also charged to the capital overhead project. This allocation exercise is carried out in detail annually at the end of the financial year. Where possible a system measured physical driver such as number of invoices processed or value of stock issued is used to apportion costs. Alternatively, estimates are provided by managers but these are done per individual employee to increase their robustness.

For reporting purposes, capital overheads are proportionally allocated across all capital schemes pro rata to the annual spend.

6.6 PROCEDURES & CONTROL CHECKS

The financial systems record operating and capital expenditure separately and the allocation of costs to opex or capex is determined in the source systems and reflects the nature of the activity being carried out. Where the accounting treatment of an unusual activity cost is

ACCOUNTING SEPARATION STATEMENT 2014-15

unclear then guidance is provided by the finance department based upon interpretation of the accounting standards.

Both opex and capex are subject to monthly budgetary monitoring and control and variations from expectations are investigated. Where an incorrect allocation is identified the costs are transferred. In the event that a cost is incorrectly charged to capital and not identified through budgetary control, it will be identified when the asset is financial commissioned and the cost written off to the profit and loss account.

The capitalisation policies reflect statutory and regulatory accounting standards and therefore are only fundamentally reviewed when these standards change. However, as either new activities arise or the nature of existing activities changes, the accounting treatment of these activities is assessed taking account of the standards.