

RAG 4.01

LICENCE CONDITION F: ACCOUNTS AND ACCOUNTING INFORMATION

SECTIONS 5.1 (1) AND 5.1 (3)

GUIDELINE FOR THE ANALYSIS OF OPERATING COSTS AND ASSETS

Operative: Financial Year 1992-93

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RAG 4.01
GUIDELINE FOR THE ANALYSIS OF OPERATING COSTS AND ASSETS
(Issued 5 June 1992)

PART 1 - EXPLANATORY NOTE

1.1 Introduction

- 1.1.1 This Regulatory Accounting Guideline covers the form, content and principles of the analysis of operating costs to be produced as part of the current cost accounts in the water industry. It also defines the analysis of assets required for the calculation of total costs.
- 1.1.2 This explanatory note describes the objectives of the analysis, and outlines the approach adopted. Part 2 defines terms used in the guideline. Part 3 - the guideline itself - describes activity and subjective categories, defines the required analysis of assets, and specifies the policy to be adopted with respect to allocations and apportionments. Appendix 1 comprises pro-formas; Appendix 2 worked examples.
- 1.1.3 A more complete detailing of the items to be included under each heading is provided in the manual "Activity Costing for the Water Industry", issued as an annex to this Guideline.

1.2 Objectives

- 1.2.1 The analysis of operating costs and tangible fixed assets detailed in this document is designed to facilitate:
- the comparison of both the total costs and the operating costs incurred in fulfilling the functions of water companies and water & sewerage companies;
 - the explanation of cost variations.
- 1.2.2 The first objective requires the specification of a procedure to ensure that operating costs and total costs are calculated consistently, the second a disaggregation that permits an exploration of the relationship of the cost components to companies' operating environments.

1.3 Format

1.3.1 The analysis will form part of the current cost regulatory accounts submitted to the Director General under Condition F of the Licence.

1.3.2 The basic format of the analysis is of a subjective disaggregation of the operating costs directly incurred under a range of activities, together with an associated analysis of tangible fixed assets. Note that the definitions of the subjective cost components are different from those originally specified in the Licence, and that the full subjective analysis is not required for each activity. The format for water only companies is illustrated in figure 1.

Figure 1 Operating Cost Analysis - Water Company

£000s	Resource & Treatment	Distribution	Water Supply Subtotal	Customer Services	Scientific Services	Cost of Regulation
Direct Costs						
Employment Costs						
Power						
Hired and Cont. Services						
Associated Companies						
Materials and Consumables						
Service Charges						
Other Direct Costs						
Total Direct Costs						
General & Support Exp.						
Functional Expenditure						
Capital Costs						
CC Depreciation						
Infrastructure Ren. Exp.						
Inf. Ren. Accrual/Prepayment						
Functional Cost						
Total (from above)						
Rates						
Doubtful Debts						
Exceptional						
Intangible Assets						
Business Acts. Cap. Costs						
Service Cost						

- 1.3.3 Each of the activities identified as a column represents a primary "function" performed by the company. The direct operating costs of General and Support Activities are allocated to these functions.
- 1.3.4 The structure is designed to facilitate comparisons both including and excluding certain subjective elements. The totals excluding capital-related items are termed "functional expenditures"; when these items are included, the totals are termed "functional costs". Certain subjective elements (rates, bad and doubtful debts, exceptional items and the write-off of intangible assets) are included only at the service level. (Note that the totals brought down in order to calculate service costs comprise the sum of the functional costs for the service activities plus the relevant portions of the functional expenditures for the individually identified business activities.)
- 1.3.5 The format is more fully demonstrated by the pro formas in the appendix. (Separate pro formas are provided for water companies and for water and sewerage companies.)
- 1.3.6 It would be helpful if all companies were to exercise the option to analyse fully the costs of transactions with associated companies, even where the extent of such transactions falls below the 20% threshold established in RAG 3. A requirement to do so may follow from the work being undertaken on transfer pricing.
- 1.3.7 Particularly in the short term, some companies may find it difficult to comply with the requirements as indicated in the pro formas. In such cases, and subject to agreement with Ofwat, alternative procedures may be followed.

1.4 Licence Authority

- 1.4.1 Condition F, paragraph 5, sets out the analysis of operating costs which Appointees are required to provide. This guideline will replace those requirements. The Director General will seek to agree an amendment to Condition F in due course.

PART 2 - DEFINITION OF TERMS

Services

Water supply and sewerage services.

Service Activities

The individually identified activities which must be pursued separately in order to provide water and sewerage services, namely Water Resources & Treatment, Water Distribution, Sewerage, Sewage Treatment, and Sludge Treatment & Disposal.

Business Activities

The activities which can be pursued collectively in order to provide water and sewerage services. The individually identified business activities are Customer Services, Scientific Services and the Cost of Regulation. General and Support Activities are identified collectively as a group.

Direct Costs

The costs directly attributable to each of the individually identified service and business activities and to General and Support Activities as a group. Such costs should include apportionments, where such apportionments are necessitated by operational considerations (for example where mobile gangs are used to operate both sewerage and water facilities, or where small sewage treatment works are not separately costed for sewage and sludge treatment).

Functional Expenditure

The direct costs incurred in the provision of each of the individually identified service and business activities, plus in each case an allocation of the direct costs incurred in the provision of General & Support Activities.

Functional Cost

The functional expenditure of each of the service activities, plus in each case "current cost depreciation", "the write-off of intangible assets", Infrastructure renewals expenditure", and the "change in the infrastructure renewals prepayment or accrual".

Service Cost

For each service, the sum of the functional costs for each of the service activities, plus the sum of the appropriate portions of the functional expenditures of the individually identified business activities, plus the appropriate portions of the costs of rates, doubtful debts, exceptional items, the write-off of intangible assets, and of general & support costs.

(In the case of the Water & Sewerage Companies, this will necessitate the allocation or apportionment of the functional expenditures associated with Customer Services, Scientific Services, and the Cost of Regulation, and the allocation or apportionment of the costs of rates, doubtful debts, exceptional items, the write-off of intangible assets, and of General & Support costs.)

Other Terms

Other terms are as defined in sections 3 and 4, or in other Regulatory Guidelines (RAGs 1 - 3).

PART 3 - ACCOUNTING GUIDELINE

3.1 INTRODUCTION

3.1.1 For the 1992-93 regulatory accounts, and subsequently, companies will be required to analyse operating costs in the manner described in sections 3.2 and 3.3, and to analyse assets in the manner described in section 3.4. This analysis will form part of the current cost regulatory accounts; no analysis of operating costs will be required as part of the historical cost accounts.

3.2 ANALYSIS OF INDIVIDUALLY IDENTIFIED ACTIVITIES

3.2.1 The operating costs incurred by the appointed business should be analysed under the headings listed in sections 3.2.4 to 3.2.7. Include under each heading the direct costs attributable to the relevant activity, but exclude those costs which are only to be recorded at service level - namely rates, bad and doubtful debts, exceptional items and the write-off of intangible- assets. All costs that are capitalised should be excluded; the infrastructure renewals charge to the profit and loss account should be split between infrastructure renewals expenditure" and the "change in the infrastructure renewals accrual/prepayment", in line with the requirements of RAG 2.

3.2.2 Companies should include the costs of management, supervision and administration within the individually identified activities in so far as such costs can be directly attributed to the activity in question.

3.2.3 Companies should identify all the costs of general and support activities within the separate activity as defined.

3.2.4 Service Activities - Water Supply

Water resources and treatment

All direct costs associated with the abstraction, conveyance and treatment of raw water, including routine maintenance. (Non routine maintenance should be charged to General and Support Activities.) Include the cost of bulk water supplies purchased, but exclude the functional costs of bulk water supplied to third parties and of non-potable water.

For these purposes, the latter costs should be estimated, and adjustments made to the appropriate subjective lines (including depreciation and infrastructure renewals expenditure/prepayment/accrual). Compensating adjustments should be made under "Services Provided for Third Parties". Where pumps serve a dual abstraction/distribution function, an assessment must be made of the costs of each function based on relative pumping head.

Distribution of Treated Water

All direct costs associated with the pumping, storage and conveyance of treated water, including the operation, control and monitoring of the distribution system, including routine maintenance. (Non-routine maintenance should be charged to General and Support Activities.) Where pumps serve a dual abstraction/distribution function, an assessment must be made of the costs of each function based on relative pumping head. The costs of distributing non-potable water should be excluded. Include here the installation, removal, and replacement of consumer meters (except where capitalised or rechargeable), but not meter reading. Where distribution employees are employed on work related to tariff matters, and charging and billing enquiries, they should be charged to Customer Services.

3.2.5 Service Activities - Sewerage Service

Sewerage

Include all direct costs associated with sewerage, including agency costs, and routine maintenance. (Non-routine maintenance should be charged to General and Support Activities.) Exclude all costs associated with sea outfalls. Exclude terminal pumping costs (ie costs incurred in pumping to treatment works).

Sewage Treatment

Include all direct costs associated with sewage treatment, including terminal pumping costs, and routine maintenance. (Non-routine maintenance should be charged to General and Support Activities.) Include the cost of sewage exports, but exclude the cost of treating imported sewage. For these purposes, the latter cost should be estimated, and adjustments made to the appropriate subjective lines (and compensating adjustments, made under "Services Provided for Third Parties").

Include all costs associated with sea outfalls, except the costs of sludge disposal where sea outfalls discharge treated effluent, and sludge is disposed of separately.

Sludge Treatment and Disposal

Include all direct costs associated with sludge treatment and disposal, including routine maintenance. (Non-routine maintenance should be charged to General & Support Activities.) Include the cost of sludge exported, but exclude the cost of treating and disposing of imported sludge. For these purposes, the latter cost should be estimated, and adjustments made to the appropriate subjective lines (and compensating adjustments made under "Services Provided for Third Parties").

3.2.6 Business Activities

Companies should identify all of the costs directly associated with each of the remaining individually identified activities, except for current cost depreciation, infrastructure renewals expenditure, and the change in the infrastructure renewals prepayment or accrual.

Customer Services

Include customer accounting, the reading of meters, debt recovery and the costs of cut-offs, customer enquiries relating to tariff matters and charging/billing, and complaints handling. (The costs incurred within the water distribution and sewerage activities in dealing with complaints about matters, other than those related to tariff changes and charging/billing should be recorded within those activities.) The cost of billing services purchased should be included, the costs of services provided for third parties excluded. For these purposes, the latter cost should be estimated, and adjustments made to the appropriate subjective lines (and compensating adjustments made under "Services Provided for Third Parties").

Scientific Services

Include the costs of scientific and laboratory services, and of the monitoring of quality. The cost of such services purchased should be included, the costs of services provided for third parties excluded. For these purposes, the latter cost should be estimated, and adjustments made to the appropriate subjective lines (and compensating adjustments made, under "Services Provided for Third Parties").

Cost of Regulation

Include all incremental managerial costs of regulation, viz licence fees payable to Ofwat and MAFF in respect of regulation; certification fees associated with the Licence requirements; staff and associated costs incurred in the preparation of submissions to, and liaison with, regulators. (Note: NRA service charges are included under the operational activities.)

3.2.7 Services Provided for Third Parties

Include the cost of bulk supplies of raw or treated water supplied to other companies, the cost of producing and delivering non-potable water, the cost of treating and disposing of imported sewage and sludge, and all rechargeable works.

3.3 SUBJECTIVE ANALYSIS

3.3.1 Subjective Categories - Analysis of Direct Costs

Companies should provide, under each of the service activity heads defined in sections 3.2.4 and 3.2.5, a subjective analysis of the direct costs incurred according to the following definitions. For each of the individually identified business activity heads identified in section 3.2.6, companies should provide the total direct costs. Appendix 1 contains pro formas which identify those elements of the subjective analysis which are to be completed for each activity.

Employment Costs

The gross salaries and wages of all employees within the relevant activity, including payments resulting from bonus and profit-related payment schemes, employers National Insurance Contributions, superannuation, unfunded pension liabilities, sick pay, sickness benefits, private health insurance, retirement awards, death in service benefits, paid leave, subsistence, travel, entertaining and conference expenses.

Power

All energy costs other than energy used for transport and energy costs associated with the provision of depots and offices, which are included in General and Support Activities.

Local authority sewerage agencies

All section 73 costs of subcontracting sewerage services to local authorities. All other subcontracted sewerage services are included in Hired and Contracted Services.

Hired and contracted services

All hired and contracted equipment and services. Hired services includes the hire of machinery, office and general equipment, and transport (but excludes the hire of vehicles and plant, which is included in General & Support Activities). Contracted services includes all contracted labour; professional advice (such as lawyers and consultants) computer software; and local authority contracts for the collection of water and sewerage charges. (The provision of services by associated companies is dealt with below.)

Associated Companies

If the total cost of all hired and contracted services from associated companies (excluding services that are capitalised or included in infrastructure renewals expenditure or prepayment/accrual) exceeds 20% of the total operating costs of the Appointed Business, before interest and tax, then such costs must be analysed across the headings of the segmental analysis, as if the sub-contracted activities were carried out by the Appointee. If the total costs of such subcontracted services fall below this limit then companies may, instead of the foregoing analysis, identify their total cost as a separate and additional line of the segmental analysis. (Such transactions with associated companies are also subject to the general requirements of Paragraph 6 of Condition F of the Licence, as described in Part 3 of RAG 3.02)

Materials and consumables

All materials and consumables that are not in "Hired and Contracted Services". This category of cost includes equipment (such as small tools and clothing), provisions, tarmac and backfill materials, but excludes all items capitalised or included within infrastructure renewals expenditure. (Most if not all stock items fall into this category.)

Service Charges

- Water: Payments to the NRA for water abstraction and payments for bulk supplies.
- Sewerage: Payments to the NRA for discharge consents.

Other direct costs

Any other operating costs, but excluding interest and taxation, on an aggregated basis, including costs associated with the provision of depots and offices, and insurance premiums. (Where such costs exceed 5% of total operating costs, an analysis should be provided.)

3.3.2 General and Support Expenditure

The aggregate direct cost of General and Support Activities is termed "General and Support Expenditure".

"General and Support Activities" include all centrally provided services, except for any items specifically covered under the individually identified activities. The following services should be included:

- Provision of Administrative Services
- Provision of Personnel Services
- Provision of Financial Services
- Provision of Legal and Property Management Services
- Research and Development
- Policy Determination, Implementation and Monitoring
- Provision of Audit Services
- Provision of Public and Employee Relations Services
- Provision of Data Processing Facilities
- Planning Liaison
- Provision of Vehicle and Plant (including hired vehicles and plant, and leased company cars)
- Provision of Electrical and Mechanical Maintenance Facilities
- Provision of Land and Property Maintenance
- Storage of Materials - Operational and Technical Support
- Provision of General and Support Buildings

Where such services are provided by an associated company, the relevant charge should be included.

The direct costs of General and Support Activities are not required to be separately identified for publication, but must be allocated across service activities and the individually identified business activities as "General and Support Expenditure". Companies should normally adopt the format shown in the pro forma tables in the Appendix. (Subject to agreement with Ofwat, where compliance with this requirement is impractical, alternative procedures may be adopted.)

3.3.3 Subjective Categories - Analysis of Capital Costs

Companies should provide, under each of the service activity heads defined in sections 3.2.4 and 3.2.5, a subjective analysis of the capital costs incurred according to the following definitions.

Depreciation and amortisation (where charged)

The current cost depreciation charge on tangible fixed assets, less the amortisation of grants and third party contributions relating to non-infrastructure assets.

Infrastructure renewals expenditure

Expenditure incurred in maintaining the operating capability of infrastructure assets.

Infrastructure renewals accrual/prepayment

The difference between the infrastructure renewals charge (as determined at initial K setting or at Periodic Reviews on the basis of the company's Asset Management Plans) and the infrastructure renewals expenditure.

3.3.4 Subjective Categories - Analysis of Service Costs

Companies should provide, at the aggregate level for cash service (ie for "water supply" and "sewerage services" separately), a subjective analysis of the costs incurred according to the following definitions.

Local authority rates

General and business rates including cumulo rates for water supply.

Charges for bad and doubtful debts

The charge/credit to the profit and loss account for bad and doubtful debts.

Exceptional items

Exceptional items are defined as in SSAP 6.

Write-off of intangible assets

Any amortisation or other reduction in the balance sheet valuation of intangible assets such as goodwill.

3.3.5 Capital Costs of Business Activities

Companies should identify, at the aggregate level for each service, the capital costs attributable to the business activities. This will comprise the aggregate cost for General and Support Activities of depreciation, infrastructure renewals expenditure and the change in the prepayment/accrual, plus the cost of these same items for the individually identified business activities.

3.4 TANGIBLE FIXED ASSETS

3.4.1 Companies are to identify the assets (including land) associated with each of the following activities (or groups of activities):

- Water Supply - Resources and Treatment
- Water Supply - Distribution
- Sewerage
- Sewage Treatment
- Sludge Treatment and Disposal
- General and Support (including Business Activities) - Water Supply
- General and Support (including Business Activities) - Sewerage Service

3.4.2 The meaning of these terms is as defined in section 3.2.

3.4.2 The asset values are to be at current cost, calculated according to the Modern Equivalent Asset principle as explained in RAG 1.02.

3.4.3 Adjustments should be made to the asset values identified for each activity in order to reflect the use of assets in the provision of services for third parties, and in the production and delivery of non-potable water. Compensating adjustments should be made in the column headed "Services for Third Parties".

3.5 ALLOCATIONS AND APPORTIONMENTS

3.5.1 The provisions of Licence Condition F paragraph 7 shall apply to all allocations and apportionments of costs required to achieve the inputs required under the headings detailed in sections 3.2 to 3.4.

3.5.2 Where allocations or apportionments are required in order to complete the remaining lines in the pro formas (ie, allocations and apportionments of the costs of General and Support Activities, Business Activities, and the analysis of assets) the basis should be stated.

APPENDIX 1

Published Activity Cost Table - Water Companies

Appointed Business - Revenue Account Only

£000s	Service Analysis			Business Analysis		
	Resource & Treatment	Distribution	Water Supply Subtotal	Customer Services	Scientific Services	Cost of Regulation
Direct Costs						
Employment Costs	I	I	C			
Power	I	I	C			
Hired and Cont. Services	I	I	C			
Associated Companies	I	I	C			
Materials and Consumables	I	I	C			
Service Charges	I	I	C			
Other Direct Costs	I	I	C			
Total Direct Costs	C	C	C	I	I	I
General & Support Exp.	I	I	C	I	I	I
Functional Expenditure	C	C	C	C	C	C
Capital Costs						
CC Depreciation	I	I	C			
Infrastructure Ren. Exp.	I	I	C			
Inf. Ren. Accrual/Prepayment	I	I	C			
Functional Cost	C	C	C			
Total (from above)			C			
Rates			I			
Doubtful Debts			I			
Exceptional			I			
Intangible Assets			I			
Business Acts. Cap. Costs			I			
Service Cost			C			
Service for Third Parties			I			
Total			C			
CCA (MEA) Values						
Service Activities	I	I	C			
Business Activities			I			
Water Supply Total			C			
Services for the Third Parties			I			
Total			C			

I = Input

C = Calculation

Published Activity Cost Table - Water and Sewerage Companies

Appointed Business - Revenue Account Only

£000s	Service Analysis								Business Analysis		
	Water Supply			Sewerage Services							
	Resource & treatment	Distribution	Water Supply Subtotal	Sewerage	Sewage Treatment	Sludge T&D Subtotal	Sewage T&D Subtotal	Sewerage Service Subtotal	Customer Services	Scientific Services	Cost of Regulation
Direct Costs											
Employment Costs	I	I	C	I	I	I	C	C			
Power	I	I	C	I	I	I	C	C			
Agencies				I			C	C			
Hired and Cont. Services	I	I	C	I	I	I	C	C			
Associated Companies	I	I	C	I	I	I	C	C			
Materials and Consumables	I	I	C	I	I	I	C	C			
Service Charges	I		C	I	I	I	C	C			
Other Direct Costs	I	I	C	I	I	I	C	C			
Total Direct Costs	C	C	C	C	C	C	C	C	I	I	I
General & Support Exp.	I	I	C	I	I	I	C	C	I	I	I
Functional Expenditure	C	C	C	C	C	C	C	C	C	C	C
Capital Costs											
CC Depreciation	I	I	C	I	I	I	C	C			
Infrastructure Ren. Exp.	I	I	C	I	I	I	C	C			
Inf. Ren. Accrual/Prepayment	I	I	C	I	I	I	C	C			
Functional Cost	C	C	C	C	C	C	C	C			
Total (from above)			I					I			
Rates			I					I			
Doubtful Debts			I					I			
Exceptional			I					I			
Intangible Assets			I					I			
Business Acts. Cap. Costs			I					I			
Service Cost			C					C			
Services for Third Parties			I					I			
Total			C					C			
CCA (MEA) Values											
Service Activities	I	I	C	I	I	I	C	C			
Business Activities			I	I			I	C			
Service Totals			C	I			C	C			
Services for the Third Parties			I					I			
Total			C					C			

I = Input

C Calculation

APPENDIX 2

Published Activity Cost Table - Water Companies

Appointed Business - Revenue Account Only

£000s	Service Analysis			Business Analysis		
	Resource & Treatment	Distribution	Water Supply Subtotal	Customer Services	Scientific Services	Cost of Regulation
Direct Costs						
Employment Costs	35	48	83			
Power	12	9	21			
Hired and Cont. Services	14	18	32			
Associated Companies	0	0	0			
Materials and Consumables	18	12	30			
Service Charges	5	0	5			
Other Direct Costs	0	0	0			
Total Direct Costs	84	87	171	29	10	6
General & Support Exp.	38	39	77	6	5	4
Functional Expenditure	122	126	248	35	15	10
Capital Costs						
CC Depreciation	13	8	21			
Infrastructure Ren. Exp.	20	10	30			
Inf. Ren. Accrual/Prepayment	4	-3	1			
Functional Cost	159	141	300			
Total (from above)			360			
Rates			47			
Doubtful Debts			23			
Exceptional			0			
Intangible Assets			0			
Business Acts. Cap. Costs			4			
Service Cost			434			
Service for Third Parties			46			
Total			480			
CCA (MEA) Values						
Service Activities	78000	97000	175000			
Business Activities			22000			
Water Supply Total			197000			
Services for the Third Parties			13500			
Total			210500			

Published Activity Cost Table - Water and Sewerage Companies

Appointed Business - Revenue Account Only

£000s	Service Analysis								Business Analysis		
	Water Supply			Sewerage Services					Custo mer Servic es	Scientifi c Services	Cost of Regul aton
	Resou rce & treatm ent	Distrib ution	Water Supply Subtotal	Sewer age	Sewag e Treat ment	Sludge T&D Subtotal	Sewag e T&D Subtot al	Sewerag e Service Subtotal			
Direct Costs											
Employment Costs	35	48	83	18	25	10	35	53			
Power	12	9	21	14	9	3	12	26			
Hired and Cont. Services				33				33			
Associated Companies	14	18	32	5	10	4	14	19			
Materials and Consumables	0	0	0	0	0	0	0	0			
Service Charges	18	12	30	9	13	5	18	27			
Other Direct Costs	5	0	5	2	3	2	5	7			
	0	0	0	0	0	0	0	0			
Total Direct Costs	84	87	171	81	60	24	84	165	69	21	13
General & Support Exp.	38	39	77	23	14	9	23	46	13	11	9
Functional Expenditure	122	126	248	104	74	33	107	211	82	32	22
Capital Costs											
CC Depreciation	13	8	21	12	16	4	20	32			
Infrastructure Ren. Exp.	20	10	30	12	0		0	12			
Inf. Ren. Accrual/Prepayment	4	-3	1	-2	0		0	-2			
Functional Cost	159	141	300	126	90	37	127	253			
Total (from above)			360					329			
Rates			47					58			
Doubtful Debts			23					46			
Exceptional			0					0			
Intangible Assets			0					0			
Business Acts. Cap. Costs			4					4			
Service Cost			434					437			
Services for Third Parties			46					32			
Total			480					469			
CCA (MEA) Values	78000	97000	175000	88000	95000	45000	14000	228000			
Service Activities			22000	8000			8000	16000			
Business Activities			197000	96000			14800	244000			
Service Totals							0				
Services for the Third Parties								11000			
Total								255000			