

# RAG 2.05 – Guideline for classification of costs across the price controls

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## 1. Introduction

### 1.1 Introduction

Cost attribution and allocation are the means by which costs are divided between specific products and services. Costs can be considered as:

- direct costs of activities (for example materials and wages); and
- indirect costs which are directly consumed or allocated to activities (for example space occupied, IT resource used by an activity) and those not related to activities (for example management fees).

Costs should be attributed and allocated in relation to the way in which resources are consumed. This provides a means of building up service and product costs. This approach views a business as a series of activities, each of which consumes activities and, therefore, generates costs. An activity based approach should result in the majority of total costs being attributed or allocated on a meaningful basis. Although a significant proportion of costs can be attributed or allocated in relation to the way resources are consumed, it is recognised that a point of diminishing returns will be reached where the cost of further attribution or allocation outweighs the benefit. In addition, it is recognised that some costs will not be driven by activities and that some subjective allocation will be necessary to arrive at the full cost. All costs must ultimately be attributed or allocated including, where appropriate, depreciation charges.

### 1.2 Scope

This regulatory accounting guideline (RAG) covers the principles and cost drivers to be used to attribute and allocate capital and operating costs in pro forma tables 1A to 1D, 2B, 2C, 2D, 4D, 4E and 4F of the annual performance report between:

- Appointed and non-appointed activities within the appointee;
- Retail and wholesale services;
- Household and non-household retail services; and
- Services for measured and unmeasured customers.

### 1.3 Objectives

The key objectives of this guidance are as follows:

- to strike an appropriate balance between the need for comparability and cost reflectivity so that informed decisions can be made and the report is useful to all stakeholders;
- to ensure that companies' revenue and cost splits are aligned and that they report revenues and costs at a sufficiently disaggregated level to be able to

demonstrate compliance with the separate price limits that have been set for 2015-20 for wholesale water, wholesale wastewater, household retail and non-household retail; and

- to ensure that there is a level playing field for companies and customers when non-household retail markets open and also potentially upstream markets develop.

## 1.4 Licence authority

Condition F, paragraph 5, sets out the analysis of operating costs which appointees are required to provide. This guideline sets out those requirements.

## 2. Cost allocation

### 2.1 Cost allocation principles

The following principles underpin the attribution and allocation of companies' costs between appointed and non-appointed activities, retail and wholesale, household and non-household retail and measured and unmeasured customers in preparing regulatory accounting statements:

- **Transparency**

The cost attribution and allocation methods applied to allocate costs within the Annual Performance Report need to be transparent. This means that the costs and revenues apportioned to each service or segment should be clearly identifiable. The cost and revenue drivers used within the system should be clearly explained to enable robust assurance against this guidance.

- **Causality**

Cost causality requires that costs (and revenues) are attributed or allocated to those activities and services that cause the cost (or revenue) to be incurred. This requires that the attribution or allocation of costs and revenues to activities and services should be performed at as granular a level as possible. Allocating costs in relation to the way resources are consumed provides a means of building up service and product costs. This approach views a business as a series of activities, each of which consumes resources and, therefore, generates costs. An activity based approach should result in the majority of the total costs being attributed or allocated on a meaningful basis. All costs must ultimately be attributed or allocated, including, where appropriate, depreciation charges on assets.

- **Non-discrimination**

Companies should ensure that no undue preference or discrimination is shown by water undertakers and sewerage undertakers in relation to the provision of services by themselves or other service providers (this is consistent with the new duty in section 2 of the Water Industry Act 1991 that has been (or, in relation to Welsh water companies, will be) inserted by section 23 of the Water Act 2014). Therefore the attribution or allocation of costs and revenues should not favour any business unit or service within the regulated company and it should be possible to demonstrate that internal transfer charges are consistent with the prices charged to external third parties.

- **No cross subsidy between price controls**

Following the introduction of separate binding price controls at the 2014 price review, companies cannot transfer costs between the price control units in setting prices and preparing regulatory accounting statements. The revenue allowance for each price control is determined by the costs specific to that particular price control. Therefore companies should also ensure that there is no cross subsidy between price control units. In accordance with RAG 5, transfer prices for transactions between price control units should be based on market price unless no market exists, in which case transfer prices should be based on cost. There will also be instances where the transfer price for some internal services and activities should be based on cost, even though a market may exist, for example activities such as treasury, legal or payroll etc. Provided the service or activity is company specific and is being provided internally to all of the price control units, or being provided solely to both the appointed and non-appointed business then the transfer price should be based on cost.

- **Objectivity**

The cost and revenue attribution criteria need to be objective and should not intend to benefit any business unit or service. Cost allocation must be fair and reasonable and there must be consistent treatment of costs for appointed and non-appointed activities.

- **Consistency**

Costs should be allocated consistently by each company from year to year to ensure:

- meaningful comparison of information across the sector and over time;
- that regulatory incentives from comparative analysis apply fairly across companies; and
- to enable monitoring of companies' performance against final determinations for 2015-20.

Any changes to the attribution and allocation methodology from year to year should be clearly justified and documented in the Accounting Separation Methodology Statement.

- **Principal use**

Where possible, capital expenditures and associated depreciation should be directly attributed to one of the four services for which price limits have been set for 2015-20; that is to wholesale water, wholesale wastewater, household retail or non-household retail. Where this is not possible as the asset is used by more than one service, it should be reported in the service of principal use with recharges made to the others services that use the asset reflecting the proportion of the asset used by the other services.

## **2.2 Cost allocation guidance**

Appointees should use the above principles when determining how to attribute or allocate costs. The onus is on companies to ensure that all costs are ultimately allocated in accordance with these principles. The only exception is where we have provided further guidance on the use of cost drivers for the allocation of operating costs between retail and wholesale and between household and non-household retail in paragraphs 2.4 and 2.5 of this RAG.

## **2.3 Capital costs**

This guidance applies to capital costs for all assets, including general and support and management and general assets, in pro forma tables 2A to 2D and 4D to 4F.

### **2.3.1 Allocation of capital costs between appointed and non-appointed business**

The allocation of capital costs and depreciation between appointed and non-appointed activities is covered in RAG 5.

### **2.3.2 Allocation of capital costs between price control units**

Where possible, capital expenditure and associated depreciation should be directly attributed to one of the price control units comprising the service groups subject to separate price controls – wholesale water, wholesale wastewater, household retail or non-household retail.

Where an asset is used by more than one of these price control units, it should be reported in the price control unit where the service of principal use occurs (wholesale water, wholesale wastewater, household retail or non-household retail). In most cases we would expect that wholesale (water or wastewater) would be the principal user, and so the capital expenditure and depreciation costs should be recorded in

wholesale (water or wastewater) with a recharge being made to the other services reflecting the proportion of the asset used by those services. Where this is the case, the cost of the recharge will be reported as an operating cost within the other services under “Recharges from other segments” in pro forma 2A. The corresponding income will be reported as a negative operating cost within wholesale (water or wastewater) under “Recharges to other segments” in pro forma 2A.

Where retail (household or non-household) is the principal user, the capital expenditure and depreciation costs should be recorded in retail (household or non-household) with a recharge being made to the other services reflecting the proportion of the asset used by those services. The cost of the recharge will be reported as an operating cost within the other services under “Recharges from other segments” in pro forma 2A. The corresponding income will be reported as a negative operating cost within retail (household or non-household) under “Recharges to other segments” in pro forma 2A.

The basis for recharges between services (wholesale water, wholesale wastewater, household retail and non-household retail) should reflect the nature of the asset being recharged. For example, the number of licences would be an appropriate basis for recharging finance software, floor space would be an appropriate basis for recharging leasehold and freehold property and use or area would be an appropriate basis for recharging land.

### **2.3.3 Allocation of capital costs between business units**

We have not prescribed how companies should attribute or allocate capital expenditure and depreciation between the business units or services within water and wastewater in pro forma 4D and 4E. The onus is on companies to determine the most appropriate means of attributing or allocating these costs. In doing so companies must ensure that their attributions or allocations are in accordance with the principles set out in paragraph 2.1 of this RAG.

### **2.3.4 Treatment of developer services**

Part of developer services should be accounted for in retail and part in wholesale in line with the basis on which separate price controls have been set. The part of developer services included in retail is providing developer information and administration for new connections. This should be reported as operating expenditure. It should not be capitalised as there is no relevant asset in retail against which to capitalise the expenditure. The wholesale part of developer services includes all other developer services, that is those not in retail. Companies may capitalise the wholesale element of developer services if it meets the capitalisation criteria set out in UK GAAP.

## **2.4 Allocation of operating costs between retail and wholesale**

This guidance applies to the attribution or allocation of operating costs between retail and wholesale (water and wastewater) in pro forma 2B and 2C of the annual performance report. Where possible, operating costs should be directly attributed between retail and wholesale (water or wastewater). Where this is not possible, companies must use the cost drivers set out in table 2.4.1 to allocate their operating costs between retail and wholesale (water and wastewater).

Where there is a choice of cost driver for any cost in table 2.4.1, companies must explain in their Accounting Separation Methodology Statement relevant to the reporting year concerned why they have selected the cost driver that they have used for that year. For some of the costs in table 2.4.1 below, it may be possible to directly attribute some but not all of the costs. Where this is the case, the costs that can be directly attributed should be directly attributed to retail or wholesale (water or wastewater), with the remainder of the costs allocated between retail and wholesale (water and / or wastewater) using the cost drivers in table 2.4.1.

The guidance for actual cost attribution and allocation builds on the bases used for setting allowed revenues in the price review. It seeks to strike a balance between cost reflectivity, comparability and proportionality.

Table 2.4.1 Cost drivers for allocating operating costs between retail and wholesale

Heading per Pro forma 2C	Cost	Wholly or partly in retail	Part in retail	Part in wholesale	Cost driver to be used (where cost cannot be directly attributed)
Customer services	Billing	Wholly in retail	n/a	n/a	n/a
Customer services	Payment handling, remittance and cash handling	Wholly in retail	n/a	n/a	n/a
Customer services	Charitable trust donations	Wholly in retail	n/a	n/a	n/a
Customer services	Vulnerable customer schemes	Wholly in retail	n/a	n/a	n/a
Customer services	Non-network customer enquiries and complaints	Wholly in retail	n/a	n/a	n/a
Customer services	Network customer enquiries and complaints (as defined in paragraph 3.1)	Wholly in retail	n/a	n/a	n/a

Heading per Pro forma 2C	Cost	Wholly or partly in retail	Part in retail	Part in wholesale	Cost driver to be used (where cost cannot be directly attributed)
<b>Customer services</b>	Investigatory visits / first visit to the customer  (as defined in paragraph 3.1)  (see Note 3)	Partly in retail	Where the cause of investigation is not a network issue.  This means that there isn't a fault or the fault is on the customer's property up to the emergency stop tap.	Where the cause of the investigation is a network issue.  This means that there is a fault on the network at or beyond the emergency stop tap. This includes jobs requiring follow up work.	n/a – direct attribution to retail or wholesale
<b>Customer services</b>	Other customer services	Wholly in retail	n/a	n/a	n/a
<b>Debt management</b>	Debt management	Wholly in retail	n/a	n/a	n/a
<b>Doubtful debts</b>	Doubtful debts  (see Note 3)	Partly in retail	Customer doubtful debts	Wholesale doubtful debts eg. bulk supplies, third party	n/a – direct attribution to retail or wholesale
<b>Meter reading</b>	Meter reading	Wholly in retail	n/a	n/a	n/a
<b>Services to developers</b>	Services to developers	Partly in retail	Providing developer information and administration for new connections	All other developer services (that is, those not in retail)	n/a – direct attribution to retail or wholesale
<b>Other operating expenditure</b>	Disconnections and reconnections	Partly in retail	Decision and administration of disconnections and reconnections	Physical activity of disconnections and reconnections	n/a – direct attribution to retail or wholesale

Heading per Pro forma 2C	Cost	Wholly or partly in retail	Part in retail	Part in wholesale	Cost driver to be used (where cost cannot be directly attributed)
Other operating expenditure	Demand-side water efficiency initiatives  (see Note 3)	Partly in retail	All expenditure in retail except where there is expenditure to meet wholesale outcomes	Expenditure to meet wholesale outcomes	n/a – direct attribution to retail or wholesale
Other operating expenditure	Customer side leaks  (see Note 3)	Partly in retail	All expenditure in retail except where there is expenditure to meet wholesale outcomes	Expenditure to meet wholesale outcomes	n/a – direct attribution to retail or wholesale
Other operating expenditure	Other direct costs	Partly in retail	Other direct costs which are retail in nature  (ie. those not covered under the other headings)	Other direct costs which are wholesale in nature	n/a – direct attribution to retail or wholesale
Other operating expenditure	General and support – IT costs	Partly in retail	See Note 1	See Note 1	In order of preference:  1. An appropriate cost driver depending on the nature of IT costs. 2. Number of computers and mobile devices (where there is not an appropriate cost driver)
Other operating expenditure	General and support – motor vehicles	Partly in retail	See Note 1	See Note 1	Number of motor vehicles

Heading per Pro forma 2C	Cost	Wholly or partly in retail	Part in retail	Part in wholesale	Cost driver to be used (where cost cannot be directly attributed)
Other operating expenditure	General and support - Finance, HR, payroll, general management	Partly in retail	See Note 1	See Note 1	In order of preference:  1. Time (based on timesheets) 2. FTEs
Other operating expenditure	Executive directors' remuneration  (as defined in paragraph 3.1)  (see Note 3)	Partly in retail	See Note 1	See Note 1	In order of preference:  1. Time (based on timesheets). 2. Management estimate (with supporting commentary)
Other operating expenditure	Non-executive directors' remuneration  (see Note 3)	Partly in retail	See Note 1	See Note 1	In order of preference:  1. Time (based on timesheets). 2. Management estimate (with supporting commentary ie time spent to board meetings)
Other operating expenditure	General and support - Facilities, building / grounds maintenance  (see Note 3)	Partly in retail	See Note 1	See Note 1	In order of preference:  1. Floor space 2. FTEs

Heading per Pro forma 2C	Cost	Wholly or partly in retail	Part in retail	Part in wholesale	Cost driver to be used (where cost cannot be directly attributed)
Other operating expenditure	General and support - insurance	Partly in retail	See Note 1	See Note 1	FTEs for employers / employees liability or more appropriate cost driver for other types of insurance
Other operating expenditure	Other general and support costs	Partly in retail	See Note 1	See Note 1	In order of preference: <ol style="list-style-type: none"> <li>1. Time (based on timesheets).</li> <li>2. Appropriate cost driver (based on nature of cost)</li> <li>3. FTEs (where there is not an appropriate cost driver)</li> </ol>
Other operating expenditure	Other business activities (regulation costs)	Partly in retail	See Note 1	See Note 1	1/9th to retail for water and sewerage companies  1/5th to retail for water only companies
Other operating expenditure	Local authority rates  (see Note 3)	Partly in retail	See Note 1	See Note 1	In order of preference: <ol style="list-style-type: none"> <li>1. Floor space</li> <li>2. FTEs</li> </ol>
Third party services	Third party services  (see Note 3)	See Note 2			Direct attribution where possible. Otherwise appropriate cost driver based on nature of cost.

Heading per Pro forma 2C	Cost	Wholly or partly in retail	Part in retail	Part in wholesale	Cost driver to be used (where cost cannot be directly attributed)
Depreciation	Depreciation	Partly in retail	See section 2.3		

**Note 1**

Many of the costs in this cost category are unlikely to be directly attributable to retail or wholesale and will need to be allocated between retail and wholesale using the cost drivers prescribed in Table 2.4.1.

**Note 2**

The extent to which these costs are wholly or partly in retail and can be directly attributed or need to be allocated using a cost driver will depend on the nature of the specific cost.

**Note 3**

Guidance has been refined / is new or has changed since the cost allocation guidance for the 2015-20 price review.

## 2.5 Allocation of retail operating costs between household and non-household

This guidance applies to the allocation of retail operating costs between household and non-household retail in pro forma 2C of the annual performance statement. Where possible, retail operating costs should be directly attributed between household and non-household retail. Where this is not possible, companies must use the cost drivers set out in table 2.5.1 to allocate their operating costs between household and non-household retail. Where there is a choice of cost driver for any cost in table 2.5.1, companies must explain in their Accounting Separation Methodology Statement why they have selected the cost driver that they have used.

For some of the costs in table 2.5.1 below, it may be possible to directly attribute some but not all of the costs. Where this is the case, the costs that can be directly attributed should be directly attributed to household or non-household retail, with the remainder of the costs allocated using the cost drivers in table 2.5.1.

**Table 2.5.1 Cost drivers for allocating retail operating costs between household and non-household**

Heading per Pro forma 2C	Cost	Entirely in household / non-household or split between household / non-household?	Cost driver to be used (where cost cannot be directly attributed)
Customer services	Billing	Split	Number of bills raised
Customer services	Payment handling, remittance and cash handling	Split	Number of payments received
Customer services	Charitable trust donations	Entirely in household	n/a
Customer services	Vulnerable customer schemes	Entirely in household	n/a
Customer services	Non-network customer enquiries and complaints	Split	In order of preference: <ol style="list-style-type: none"> <li>1. Time spent on non-network customer enquiries and complaints</li> <li>2. Volume of non-network customer enquiries and complaints</li> </ol>

Heading per Pro forma 2C	Cost	Entirely in household / non-household or split between household / non-household?	Cost driver to be used (where cost cannot be directly attributed)
<b>Customer services</b>	Network customer enquiries and complaints  (as defined in paragraph 3.1)	Split	In order of preference:  1. Time spent on network customer enquiries and complaints 2. Volume of network customer enquiries and complaints
<b>Customer services</b>	Investigatory visits / first visit to the customer  (as defined in paragraph 3.1)  (see Note 4)	Split	In order of preference:  1. Time spent on investigatory visits 2. Volume of investigatory visits
<b>Customer services</b>	Other customer services	Split	In order of preference:  1. Time (based on timesheets). 2. Appropriate cost driver (based on nature of cost) 3. Customer numbers
<b>Debt management</b>	Debt management	Split	Debt outstanding for more than 30 days (that is, not current debt)
<b>Doubtful debts</b>	Customer doubtful debts  (see Note 4)	Split	n/a – direct attribution on a customer type (meaning household or non-household) specific basis
<b>Meter reading</b>	Meter reading	Split	In order of preference:  1. Time (based on timesheets) 2. Number of meter reads factored by scheduling an allowance for average time taken 3. Number of meter reads
<b>Services to developers</b>	Services to developers	Entirely in non-household	n/a – direct attribution to non-household
<b>Other operating expenditure</b>	Disconnections and reconnections	Entirely in non-household	n/a – direct attribution to non-household

Heading per Pro forma 2C	Cost	Entirely in household / non-household or split between household / non-household?	Cost driver to be used (where cost cannot be directly attributed)
Other operating expenditure	Demand-side water efficiency initiatives	Split	Direct allocation where initiatives are specific to household or non-household, otherwise customer numbers.
Other operating expenditure	Customer side leaks	Split	Directly attributable on a job specific basis
Other operating expenditure	Other direct costs	Split	In order of preference: <ol style="list-style-type: none"> <li>1. Time (based on timesheets).</li> <li>2. Appropriate cost driver (based on nature of cost) where time basis is not possible and there is not an obvious cost driver.</li> </ol>
Other operating expenditure	General and support – IT costs  (see Note 4)	Split	In order of preference: <ol style="list-style-type: none"> <li>1. An appropriate cost driver depending on the nature of IT costs.</li> <li>2. Number of computers and mobile devices (where there is not an appropriate cost driver)</li> </ol>
Other operating expenditure	General and support – motor vehicles  (see Note 4)	Split	In order of preference: <ol style="list-style-type: none"> <li>1. Number of motor vehicles</li> <li>2. Customer numbers</li> </ol>
Other operating expenditure	General and support - Finance, HR, payroll, general management  (see Note 4)	Split	In order of preference: <ol style="list-style-type: none"> <li>1. Time (based on timesheets)</li> <li>2. FTEs</li> <li>3. Customer numbers</li> </ol>
Other operating expenditure	Executive directors' remuneration  (as defined in paragraph 3.1)  (see Note 4)	Split	In order of preference <ol style="list-style-type: none"> <li>1. Time (based on timesheets).</li> <li>2. Management estimate (with supporting commentary)</li> </ol>

Heading per Pro forma 2C	Cost	Entirely in household / non-household or split between household / non-household?	Cost driver to be used (where cost cannot be directly attributed)
Other operating expenditure	Non-executive directors' remuneration  (see Note 4)	Split	In order of preference  1. Time (based on timesheets). 2. Management estimate (with supporting commentary ie time spent to board meetings)
Other operating expenditure	General and support - Facilities, building / grounds maintenance  (see Note 4)	Split	In order of preference:  1. Floor space 2. FTEs 3. Customer numbers
Other operating expenditure	General and support – insurance (see Note 4)	Split	FTEs for employers / employees liability or more appropriate cost driver for other types of insurance.
Other operating expenditure	Other general and support costs	Split	In order of preference:
Other operating expenditure	Other business activities (regulation costs)	Split	1. Appropriate cost driver (based on nature of cost) where there is not an obvious cost driver. 2. Customer numbers
Other operating expenditure	Local authority rates  (see Note 4)	Split	In order of preference:  1. Floor space 2. FTEs 3. Customer numbers
Third party services	Third party services  (see Note 4)	Dependent on nature of cost	Direct attribution where possible. Otherwise appropriate cost driver based on nature of cost.
Depreciation	Depreciation	See section 2.3	

**Note 4**

Guidance has been refined / is new or has changed since the cost allocation guidance for the 2015-20 price review.

## 2.6 Allocation of household retail operating costs between measured and unmeasured services

This guidance applies to the allocation of household operating costs between the following customer types in pro forma 4F of the annual performance report:

- Unmeasured water only;
- Unmeasured wastewater only;
- Unmeasured water and wastewater;
- Measured water only;
- Measured wastewater only;
- Measured water and wastewater

Where possible, household retail operating costs should be directly attributed to one of the categories above. Where direct attribution is not possible, an appropriate allocation should be made using a cost driver consistent with the allocation principles in paragraph 2.1 above. In order to assist companies with the process of allocating costs between different household retail customer types we have included further guidance on cost allocation. This includes a list of possible cost drivers for each type of activity/cost. **These are only to be used as a guide and the onus is on companies to identify the most appropriate cost driver.** Companies should explain the reasons for their choice in their Accounting Separation Methodology Statement.

**Table 2.6.1 Possible cost drivers for allocating household retail operating costs between measured and unmeasured**

Heading per pro forma 4F	Cost	Possible cost driver to be used
Customer services	Billing	Number of bills raised to each of the 6 customer types (unmeasured water only, unmeasured wastewater only, unmeasured water and wastewater, measured water only, measured wastewater only, measured water and wastewater)
Customer services	Payment handling, remittance and cash handling	Number of payments received from each of the 6 customer types
Customer services	Charitable trust donations	Number of customers in each of the 6 customer types
Customer services	Vulnerable customer schemes	Number of customers from each of the 6 customer types in vulnerable customer schemes
Customer services	Non-network customer enquiries and complaints	Number of non-network customer enquiries made by each of the 6 customer types

<b>Heading per pro forma 4F</b>	<b>Cost</b>	<b>Possible cost driver to be used</b>
<b>Customer services</b>	Network customer enquiries and complaints  (as defined in paragraph 3.1)	Number of network customer enquiries made by each of the 6 customer types
<b>Customer services</b>	Investigatory visits / first visit to the customer  (as defined in paragraph 3.1)	Number of investigatory visits made to each of the 6 customer types
<b>Customer services</b>	Other customer services	Number of customers in each of the 6 customer types
<b>Debt management</b>	Debt management	Debt outstanding for more than 30 days (that is, not current debt) for measured and unmeasured then allocation between the 3 measured and unmeasured customer types using an appropriate cost driver
<b>Doubtful debts</b>	Customer doubtful debts	Direct attribution to measured and unmeasured then allocation between the 3 measured and unmeasured customer types using an appropriate cost driver
<b>Meter reading</b>	Meter reading	Direct attribution to measured then allocated between the three measured customer types based on customer numbers
<b>Other operating expenditure</b>	Demand-side water efficiency initiatives	Directly attributable to measured or unmeasured where initiatives are specific to measured or unmeasured customers.  Then allocation between water only and water and sewerage measured and water only and water and sewerage unmeasured based on customer numbers in each of the customer types.
<b>Other operating expenditure</b>	Customer side leaks	Number of customer-side leaks in measured water only, measured water and sewerage, unmeasured water only and unmeasured water and sewerage properties
<b>Other operating expenditure</b>	Other direct costs	Number of customers in each of the 6 customer types
<b>Other operating expenditure</b>	General and support costs (excluding motor vehicles)	
<b>Other operating expenditure</b>	General and support – motor vehicles	Costs relating to vehicles used for meter reading directly attributable to measured then allocated between the three measured customer types based on customer numbers  Other costs allocated based on number of customers in each of the 6 customer types
<b>Other operating expenditure</b>	Other business activities (regulation costs)	Number of customers in each of the 6 customer types
<b>Other operating expenditure</b>	Local authority rates	

Heading per pro forma 4F	Cost	Possible cost driver to be used
Depreciation	Depreciation	<p>Directly attributable to measured for vehicles used for meter reading and IT used for meter reading then allocated between the three measured customer types based on the number of meter readings</p> <p>Allocation of other assets based on the nature of asset, for example billing system based on number of bills raised to each of the 6 customer types</p>

## 3. Definitions

### 3.1 Additional guidance on definitions

A number of terms have been used throughout these guidelines. To avoid confusion, they are defined as follows:

#### Customer numbers

To ensure consistency with the way in which price controls have been set for 2015-20, customer numbers when used as a cost allocation metric as referred to in Table 2.5.1 above is equal to 1.0 for single-service (water or wastewater only) customers and 1.3 for dual-service (water and wastewater) customers.

#### Household and non-household

The definition to be used for household and non-household for the purposes of separating retail costs in the annual performance report is set out below. This definition is consistent with the definition that we have used for distinguishing between household and non-household services, costs and revenues when setting price controls for 2015-20.

- **Households**

These are properties used as single domestic dwellings (normally occupied), receiving water for domestic purposes which are not factories, offices or commercial premises. These include cases where a single aggregate bill is issued to cover separate dwellings having individual standing charges. (In some instances, the standing charge may be zero.) The number of dwellings attracting an individual standing charge and not the number of bills should be counted. Mixed/commercial properties and multiple household properties – for example, blocks of flats having only one standing charge – should be excluded.

- **Non-households**

These are properties receiving water for domestic purposes but which are not occupied as domestic premises, or where domestic dwellings are combined with

other properties, or where properties are in multiple occupation but only have one standing charge. In this case, it is the number of bills that should be counted.

### **Measured and unmeasured**

The definition to be used for measured and unmeasured retail services for the purposes of separating retail costs in the annual performance report is set out below.

- **Measured**

These are properties where some or all of the charges for supplies are based on measured quantities of volumes.

- **Unmeasured**

These are properties where none of the charges for supplies are based on measured quantities of volumes. These include properties which receive an assessed charge because metering is not possible or economic.

### **FTEs**

For the purposes of cost allocation, FTEs (or ‘full-time equivalents’) should include all full-time staff, and contractors/temporary staff directly employed (average in service during the year). Where there is an existing contractual arrangement in place with an associate or third party for example a third party billing arrangement, FTEs will include all full-time staff, and contractors/temporary staff directly employed by the associate or third party involved in providing that service to the appointee.

### **Network customer enquiries and complaints**

This includes the following activities:

- receiving and passing on a phone call, email or letter;
- scheduling jobs where they are triggered by a customer call; and
- internally generated calls to the retail call centre to enable the customer call to be resolved

It does not include investigatory visits / first visits to the customer.

### **Investigatory visits / first visit to the customer**

Undertaking an investigation (that is, a site visit) on account of a network customer enquiry or complaint

### **Water only customer**

A ‘single service customer’ to whom the appointee provides a water service.

### **Wastewater only customer**

A 'single service customer' to whom the appointee provides a wastewater / sewerage service.

### **Water and wastewater customer**

A 'dual service customer' to whom the appointee provides both water and a wastewater / sewerage service.

### **Cost**

The actual cost to the supplier, of the goods, works or services, including a reasonable rate of return on capital employed. Unless the circumstances of the transaction provide a convincing case for the use of an alternative measure, the return on capital should be consistent with the cost of capital/net retail margin as set out in Ofwat's final determination of 12 December 2014. (or any other determination applicable in the 2015-20 period).

### **Cost allocation**

Cost allocation is the means by which all costs are allocated to appointed and non-appointed businesses, price control units, or specific supplies, works and services, ensuring a fair share of overheads, even where costs cannot be directly attributed to specific activities and associated services.

### **Cost driver**

A cost driver is the factor or factors which cause cost to occur. This can be further divided between the driver that causes an activity to occur, and a driver that determines how often it occurs. Costs may vary in relation to the cost driver over the short or longer term, depending on the nature of cost concerned.

### **Cross-subsidy**

Cross-subsidy in this context is monetary aid or contributions from the appointee to the associate, or between price control units, which does not reflect the value of the services received. It also relates to services provided by the appointee to associate companies where there has been an under-recovery of costs incurred by the appointee.

### **Market price**

The price of a good, service or supply as determined by market-testing.

### **Market-testing**

Market-testing is the process of determining a market price for a particular supply, works or service.

### **Executive Directors' Remuneration**

The total remuneration received by executive directors for services provided to the appointee. This includes any form of payment (including bonuses), consideration or

other benefit (including pension benefit) received. Where possible, the total remuneration should be directly attributed to wholesale water, wholesale wastewater, household or non-household retail. Where this not possible it should be allocated in accordance with paragraphs 2.4 and 2.5 of this RAG.

### **Activity**

A logical grouping of tasks (undertaken to provide a service covered by these guidelines). An activity based approach views a business as a series of activities, each of which consumes resources, and therefore generates costs.

### **Appointee**

The company appointed to be the water undertaker or sewerage undertaker for any area of England and Wales, as set out in the Water Industry Act 1991.

### **Appointed business**

The appointed business comprises the regulated activities of the appointee which are activities necessary in order for an appointee to fulfil the function and duties of a water or sewerage undertaker under the Water Industry Act 1991.

### **Arm's length trading**

Arm's length trading is where the appointee treats the associate on the same basis as external third parties.

### **Associate company**

Any "Group Company" or a "Related Company" as defined in licence conditions. For the purposes of compliance with these guidelines and to ensure complete transparency, any associate determined in accordance with 'Financial Reporting Standard 102 (FRS 102) should be treated as a Related Company for the purposes of this guideline. Any exceptions to this must be agreed with Ofwat.

### **Competitive letting**

Letting contracts as a result of a tendering process.

### **Economically advantageous price**

The economically advantageous price is the net cost to the appointee after taking account of all factors including the contract price, contractor management time, cash flow impact of the payment schedule, completion date, quality, after sales service, technical merit, aesthetics, security of supply, effectiveness, whole life cost, capability, etc.

### **Marginal costing**

Marginal costing is the additional variable cost of the production of the next unit. Short-run marginal costing merely includes the short-term costs involved in producing the additional unit, whereas long-run marginal costs include the additional costs, including a capital element, involved in the sustained production of the next unit over the long term.

### **Price control units**

At the 2014 price review Ofwat introduced separate binding price controls. These include wholesale water, wholesale waste water, retail household and retail non household.

### **Transaction**

For the purposes of RAG5, a transaction occurs where the appointee and its associates supply goods, works or services to each other, directly or indirectly via a third party. A transaction also occurs where price control units supply goods, works or services to each other.

### **Transfer pricing**

A transfer price is the price paid by one group company to another for transactions between the two companies or for transactions within the appointee between price control units or between appointed and non-appointed business.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a leading economic regulator, trusted and respected, challenging ourselves and others to build trust and confidence in water.



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Printed on 75% minimum de-inked post-consumer waste paper.  
February 2015

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