

Northern Ireland Water Ltd
Annual Information Return 2009
To the
Northern Ireland Authority for Utility Regulation



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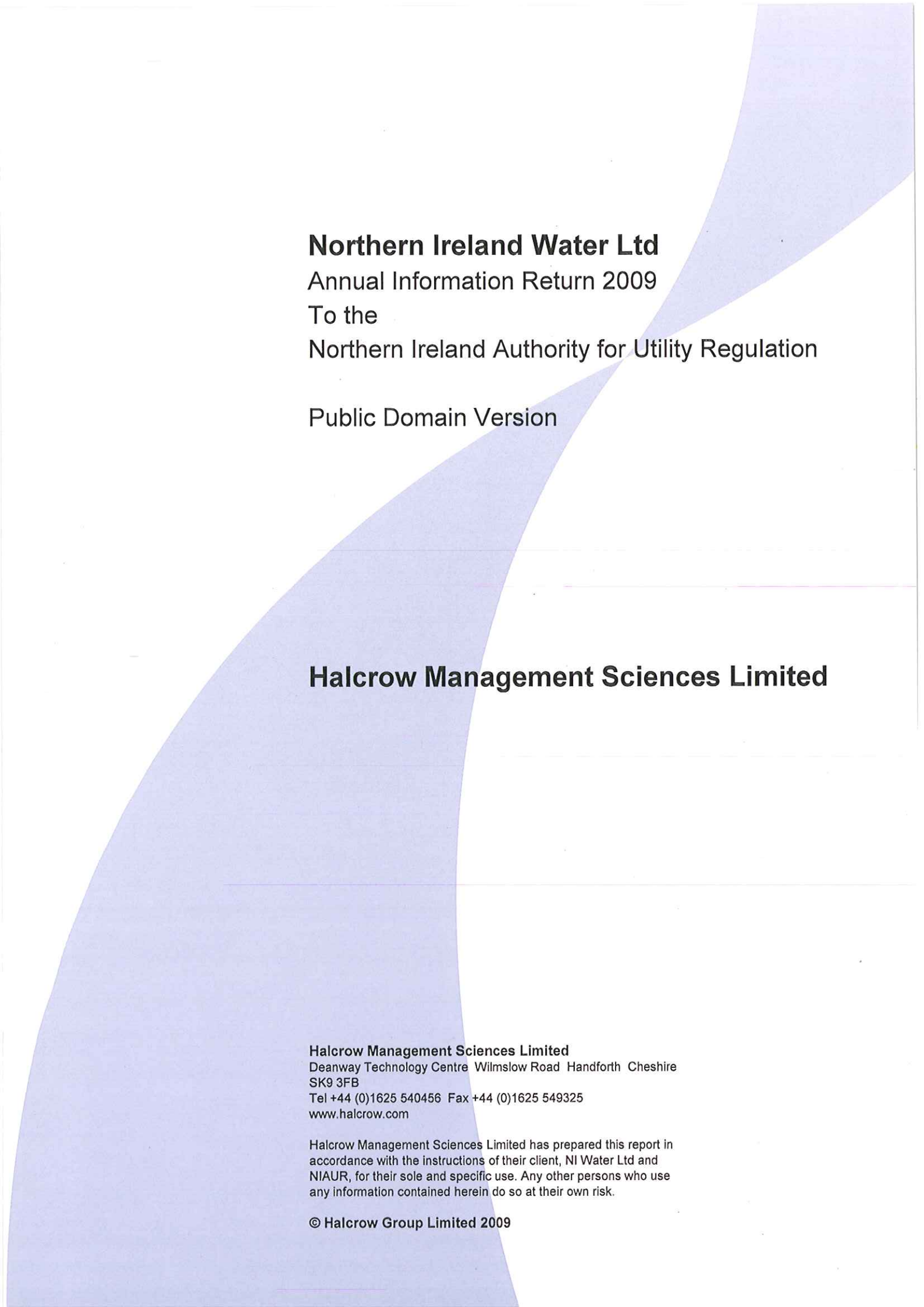
Part 5 of 7 containing:
Regulatory Accounts - commentaries for tables 21, 22 and 25

Reporter's Submission

By

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Halcrow Management Sciences Ltd

Halcrow



Northern Ireland Water Ltd
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Northern Ireland Water Ltd – AIR2009 Submission

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Items mark (x) have been excised as they are considered commercially confidential or of sensitive nature.

Table 21 and 22 – Activity Costing Analysis**Commentary by REPORTER****1. Background**

These tables collect information on operating costs and maintenance costs. The information from this table is used to identify trends in operating costs and also to derive annual unit cost comparisons

2. Key Findings

- The Company has applied a revised method to the completion of these tables for AIR09 compared to AIR08 in a number of cases. A major difference is the treatment of General and Support expenditure. In AIR08 it reported General and Support expenditure of £50 million, whilst for AIR09, this has reduced to less than £14 million.
- The revised method makes it particularly difficult to compare trends between two periods related to direct costs. This is because expenditure was coded differently for General and Support in AIR08. This means that General and Support expenditure between AIR08 and AIR09 totalling in the region of £36 million has been reallocated across the direct costs portion of tables 21 and 22. In order to undertake the comparison correctly it would be necessary to repopulate tables 21 and 22 for AIR08, with the method used for AIR09.
- The revised method involved a review of General and Support costs in February 2009 and subsequent reallocation of costs across different direct cost categories. The reallocation was a manual approach which relied on responsibility codes and discussions with appropriate managers. Because the reallocation process was largely manual we believe that this could impact on the robustness of the data reported.
- For the current year the proportion of General and Support costs make up 9% of functional expenditure whilst direct costs make up 91% of functional expenditure. This is substantial greater than the total England and Wales value where General and Support costs accounted for 31% of functional expenditure in 2003/04 and 29% of functional expenditure in 2007/08. This suggests that too much cost have been transferred from General and Support costs to direct costs for Northern Ireland Water. The Company advised that the allocation of the General & Support costs was a result of recommendations from the reporter in AIR08. The Company advised that it is keen to clarify exact requirements with the current reporter. We believe that comment related to the actual coding of transactions falls within the domain of the financial auditors as tables 21 and 22 form part of the regulatory accounts submission.
- The Company has reported a number of atypical costs. These are discussed in more detail below.
- The Company has not disclosed in its commentary details of donations to

charitable trusts or fines and provisions made against Section 74 of the Roads and Street Works Act. The Company advised that it has agreed to include this in AIR10.

- The data relies on a combination of service activity code, expense code and responsibility code. In the majority of cases this should be sufficient to report data for the purposes of tables 21 and 22. However, it is possible that some costs will not neatly fit into the coding structure. We have not reviewed the materiality of this in the current year. We will review this in more detail or AIR10.
- The system relies on the correct coding of invoice and time costs.
- The process for completion of this table is documented at a high level. We received this document at the time of our audit.

3. Audit Approach

During our audit we reviewed the Company explanations for variations in costings. The Company has not limited its comment to the thresholds of 2% total opex and 30% sub-line opex being exceeded compared to the previous year as requested by the reporting requirements. In addition we have commented on the procedures used for cost allocation. We have not audited the application of the procedures described to us. The overall comment on the correctness of table 21 and 22 falls within the domain of the financial auditors.

4. Audit Findings

4.1 NI Water Data

Method Non-PPP

As advised in the Company commentary a £3,000 de minimus figure is used for capitalisation.

Data in tables 21 and 22 is based on information extracted from the General Ledger System. All transactions within the General Ledger are coded to a cost centre with an associated Service Activity Code, Expense Type Code and Responsibility Code. Together these allow for the reporting of information contained in table 21 and 22. The Company advised that the activity code and expense type code together allow for the identification of the majority of expenditure to lines in either tables 21 and 22. The responsibility code is used to split expenditure in cases where costs are general costs such as customer services or scientific services.

The approach relies on the correct coding of expenditure to expense, activity and responsibility codes.

Direct Operations staff are required to complete a weekly timesheet. The Company advised that these types of staff form approximately 40% of the workforce. Non direct

operations industrial staff do not complete a timesheet. Their time is allocated on the basis of responsibility codes. The responsibility codes are described below.

For common costs the Company uses a method to apportion these based on direct costs.

The function of each of the codes, as well as the codes available is described below:

Service Activity Code. The service activity code determines the type of work being carried out. It distinguishes between the water and sewerage service activities. Within the water service it distinguishes between distribution and water treatment and resources. Within the wastewater service it distinguishes between sewerage, sewage treatment and sludge treatment. Further division of the service activity code within these subservice areas allows the Company to identify costs of particular activities. Particular Service Activity codes are used to capture costs of management, administration and support functions.

The service activity codes are shown below:

| NIW Service Activity | Service Activity description | Table 21/22 Mapping |
|----------------------|---|--|
| 310 | Pumping (Inc Highlift at WTW) | Water - Distribution |
| 311 | Service Resv Wat Tower Tanks | |
| 312 | Service Resv cleaning | |
| 313 | Distribution and Water Operations | |
| 320 | Repair and Maintenance (Mains Repair) | |
| 321 | Repair and Maintenance (Service Repair) | |
| 322 | Repair and Maintenance (Hydrant & Valve Repairs) | |
| 324 | Repair and Maintenance (Mains Cleansing) | |
| 326 | Repair and Maintenance (Lead Replacement) | |
| 331 | Repair and Maintenance of 'Street Furniture' (Water) | |
| 340 | Leakage - Monitoring | |
| 341 | Leakage - Detection | |
| 351 | Consumer Meter Repair & Maintenance | |
| 360 | Investigations | |
| 362 | Customer Contacts excluding meter query | |
| 363 | Regulatory Plumbing Inspection | |
| 380 | 'In House' Investigations and Attendance | |
| 385 | Health & Safety - Networks | |
| 391 | Networks Function Activity -Query | |
| 399 | Networks Stores | |
| 920 | Connection (Water) | |
| 110 | Impounding Reservoir | Water - Resource & Treatment |
| 111 | Loughs | |
| 112 | River Intakes | |
| 113 | Boreholes, Springs & Wells | |
| 120 | Repairs & Maint A/duct/Main | |
| 140 | Recreation & Amenity | |
| 150 | Water Treatment | |
| 151 | Water Sludge Treatment | |
| 152 | Water Sludge Disposal | |
| 185 | Health & Safety - Supply | |
| 190 | Supply Function Activity | |
| 191 | Supply Function Activity - Query | |
| 822 | Instrumental Control Activity M & E Water Supply | |
| 410 | Repair & Maintenance of Sewers | Sewerage - Sewerage |
| 411 | Blockage | |
| 412 | Desilting | |
| 413 | Inspection of Sewers | |
| 414 | Repair and Maintenance of 'Street Furniture' (Sewerage) | |
| 415 | Sewerage Tankering | |
| 430 | Pumping (Foul & Combined) | |
| 431 | Pumping (Surface Water) | |
| 460 | 'In House' Investigations and Attendance | |
| 462 | Rodent Control | |
| 940 | Rechargeable (Sewerage) | |
| 950 | Connection (Sewerage) | |
| 510 | Sewage Treatment | Sewerage - Sewage Treatment |
| 591 | Waste Water Function Activity - Query | |
| 620 | Sludge Treatment - Tankering Between Works | Sewerage - Sludge Treatment |
| 621 | Sludge Treatment | |
| 630 | Sludge Disposal to Agricultural Land Transportation | |
| 631 | Instrumental Control Activity M & E WasteWater | |
| 632 | Sludge Cake Transportation to Landfill | |
| 633 | Sludge Cake Disposal to Landfill | |
| 635 | Sludge Logger Maintenance (Contract) | |
| 636 | Incinerator Sludge Treatment | |
| 637 | Sludge Disposal Tankering from Strategic Collection Centres to Dewatering Centres | |
| 638 | Sludge Cake Disposal to Incinerator | |
| 639 | Incinerator Ash Disposal to Landfill | |
| 640 | Private Septic Tank Desludging | Customer Services |
| 710 | General | |
| 711 | Customer Services (Meter Read & Customer Queries) | |
| 712 | Disconnection / Reconnection | |
| 714 | Consumer Meters Repair And Maintenance | |
| 790 | 790 | |
| 730 | Water Analysis | Scientific Services |
| 731 | Sewerage General | |
| 732 | Labs Water & Sewerage General | |
| 733 | Sampling | |
| 734 | Labs Sewage Sampling | |
| 003 | Rates DRC - Water | Rates |
| 013 | Rates DRC - Sewerage | |
| 910 | Rechargeable Work | Third Party Opex |
| 000 | Default | Overhead Pot 1 - General |
| 021 | GAE | |
| 023 | Invest to Save Revenue | |
| 810 | Vehicle & Plant Maintenance | |
| 811 | Vehicle & Plant Accident Repair | |
| 812 | Garage Overheads | |
| 813 | Roads Service | |
| 820 | Telemetry | |
| 890 | TMG Function Activity | |
| 050 | Ops & Maint General (Water) | |
| 055 | Ops & Maint General (Sewerage) | Overhead Pot 2 - Water |
| 585 | Health & Safety - WW | Overhead Pot 2 - Sewerage |
| 590 | Waste Water Function Activity | |
| 735 | Trade Effluent | |
| 821 | Radio & Monitoring Wastewater | |
| 390 | Networks Function Activity | Overhead Pot 3 - Networks Water & Sewerage |

Expense Code: These identify the type of expenditure such as wages, power, hired and contracted services, etc. The expense groups underlie the mapping of costs to the various lines in Tables 21 and 22, particularly the direct cost lines.

| Expense Group | Description | Table 21 & 22 mapping |
|---------------|-----------------------------------|------------------------------|
| 511X | Industrial Wages | 1 Employment |
| 513X | Other Wage Costs | 1 Employment |
| 514X | Other Costs of Employment | 1 Employment |
| 515X | Salaries | 1 Employment |
| 516X | Non-Industrial Expenses | 1 Employment |
| 517X | Temporary Support Staff | 1 Employment |
| 611X | Costed Wages Charge | 1 Employment |
| 612X | Wages Overheads | 1 Employment |
| 613X | Costed Wages Recovery | 1 Employment |
| 614X | Costed Wages Overhead Recovery | 1 Employment |
| 521X | Power | 2 Power |
| 531X | Operational Contractors | 4 Hired and Contracted |
| 532X | Other Contractors | 4 Hired and Contracted |
| 534X | Out sourcing | 4 Hired and Contracted |
| 538X | Consultants Fees | 4 Hired and Contracted |
| 541X | Materials and Equipment | 6 Materials & consumables |
| 544X | Non Operations Materials | 6 Materials & consumables |
| 547X | Stock Adjustments | 6 Materials & consumables |
| 548X | Chemicals | 6 Materials & consumables |
| 536X | Office and Computer Services | 9 other direct costs |
| 537X | Legal and other professional fees | 9 other direct costs |
| 551X | Accommodation | 9 other direct costs |
| 553X | Insurance - Premiums | 9 other direct costs |
| 553Y | Insurance - Claims | 9 other direct costs |
| 554X | Public Liability | 9 other direct costs |
| 555X | Employer's Liability | 9 other direct costs |
| 616X | Vehicle and Plant Charges | 9 other direct costs |
| 695X | Management Task | 9 other direct costs |
| 759X | Overheads Capitalised | 9 other direct costs |
| 518X | Staff Training & Hospitality | 11 General & support |
| 533X | V&P repairs | 11 General & support |
| 539X | Audit | 11 General & support |
| 546X | Mobile V&P Charges | 11 General & support |
| 552X | Communication | 11 General & support |
| 556X | Other Grants and Subscriptions | 11 General & support |
| 557X | Advertising and Publicity | 11 General & support |
| 641X | Intra Departmental Notionals | 11 General & support |
| 651X | Inter Departmental Notionals | 11 General & support |
| 775X | Discount Allowed | 13 Customer services |
| 556Y | Regulatory Costs | 15 Other Business Activities |
| 558X | Rates | 17 Rates |
| 772X | Bad Debts | 18 Doubtful debts |
| 534Y | PPP | 20/21a PPP unitary charge |

Responsibility Code: The Company advised that all cost centres within the general ledger system have responsibility codes associated with them. Thus all transactions within the system have responsibility codes assigned. Responsibility codes relate individual cost centres to individual employers with NI Water who are responsible for them. The Company advises the responsibility codes are used to identify customer services, scientific services and Other business activities (regulatory costs) spend.

Responsibility codes are structured into directorates. Each directorate has separate areas of responsibility within the company. We challenged the Company in relation to whether management responsibility is clearly defined and specific to customer services, scientific services and other business activities and whether the schemes assigned to them were truly specific to that service area. The Company advised that all costs in the GL were coded to an appropriate manager and all managers could be mapped to service areas for the purposes of reporting data for customer services, scientific services and other business activities.

The Company advises that personnel are advised immediately after an individual receives revised responsibilities or job specification.

We believe that the above could impact on the robustness of data reported. Nevertheless in the absence of other information the process above is appropriate to split expenditure between service types (water and sewerage) and we believe will give an overall allocation of costs that is broadly reflective of the actual position.

We did however challenge the Company on the use of the responsibility coding process, as the Company has service activity descriptions that relate to customer service and scientific services. We challenged the Company as follows:

‘Your service activity descriptions provide for data to be coded to both scientific services and customer services. Why then is it necessary to report customer services and scientific services costs on the basis of responsibility codes?’

The Company advised that *‘There are generic service activities which can be used by Customer Services, Scientific Services and Other areas of the Business, therefore the responsibility code is necessary to specifically isolate the CS and SS costs.’*

4.2 Allocations by Line – NI Water

Employment Costs

The process relies on the completion of timesheets that use a mix of service activity and expense code for direct operations staff. For non-direct operations staff expenditure is assigned on the basis of responsibility codes.

Remaining Direct Costs

The process relies on the correct coding of invoices to a mixture service activity code and expense code.

General and Support Expenditure

The coding does not allow for the direct coding of General and Support expenditure in all cases. For example service activity 390 relates to network activities for both water and sewerage.

For AIR08 the Company had reported in excess of £50 million for General and Support costs. For AIR09 the Company advised that it considered the £50 million to be an inflated view of the actual costs that should be General and Support. For the AIR09 the Company undertook a review of the costs allocated to the General and Support codes (Overhead pots 1, 2 and 3). This review was undertaken in February 09. The Company then reallocated a large portion of costs that were already coded to these General and Support pots to other parts of the business. As a result, for the current year the Company has reported a total of £13.4m for General and Support Costs. The reallocations have been done on a manual basis and have been done on the basis of responsibility codes and with consultation with managers. Compared to England and Wales this seems to be a relatively low level of General and Support expenditure as a percentage of functional expenditure.

In order to improve the quality of reported data and ensure data is reported consistently between years the Company should include appropriate procedures to ensure a minimal amount of expenditure information is miscoded and requires reallocation.

The remaining General and Support costs have been split on the following basis:

| Allocation of General and Support | | Water | | Sewerage | | |
|-----------------------------------|-------------|-------|--------------|----------|------------------|-------------------------|
| Description | Total £ | R&T | Distribution | Sewerage | Sewage Treatment | Sludge Treatment & Disp |
| BASIS - Total Direct Costs | 143,419,702 | 22.2% | 24.2% | 21.3% | 19.5% | 12.8% |
| G&S Overhead Pot 1 | 7,783,193 | 22.2% | 24.2% | 21.3% | 19.5% | 12.8% |
| G&S Overhead Pot 2a - Water | 3,443,147 | 47.8% | 52.2% | 0.0% | 0.0% | 0.0% |
| G&S Overhead Pot 2b - Sewerage | 300,947 | 0.0% | 0.0% | 39.7% | 36.4% | 23.9% |
| G&S Overhead Pot 3 | 531,869 | 22.2% | 24.2% | 21.3% | 19.5% | 12.8% |

Overhead pot 1 relates to non-specific General and Support costs. These have been split across the service activities and by service on the basis of calculated total direct costs. Overhead Pot 2a and 2b relate to overheads for water and sewerage spend. These costs have been pro-rated on the basis of total direct costs within each of water and sewerage cost categories. Overhead Pot 3 relates specifically to networks functions activity. Again, the Company has split this against each service activity on the basis of total direct costs. As these overheads relate specifically to network activities it may be more appropriate to split this expenditure against distribution and sewerage. We challenged the Company as follows:

As the overheads under Pot 3 relate specifically to network functions, would it not be more appropriate to code this expenditure solely to water distribution and sewerage? The Company advised *'The overhead to Pot 3 were all transferred to Water Distribution and Sewerage with the exception of General & Support which came to £,500k.'*

The Company further assigns a number of unallocated costs to General and Support costs. These are shown below:

| Description | Amount | Table 21/22 location |
|--|---------------|--|
| Unallocated Employment Costs | £5.2M | Included in General & Support (Removed from Employment Costs) |
| Unallocated Hired & Contracted Costs | £0.8M | Included in General & Support (Removed from Hired & Contracted) |
| Unallocated Materials & Consumables | £0.1M | Included in General & Support (Removed from Materials & Consumables) |
| Unallocated Other Direct Costs | £1.4M | Included in General & Support (Removed from Other Direct Costs) |
| Communication | £1.6M | General & Support |
| Mobile V&P Charges & Repairs | £1.9M | General & Support |
| Staff Training | £0.6M | General & Support |
| Audit & Environmental Regulatory Costs | £1.4M | General & Support |
| Other | £0.7M | General & Support |
| Total | £13.7M | £8.9M Table 21 and £4.8M Table 22 |

The Company advised that this is the remaining costs included in General & Support after a detailed review process.

Customer Services

The process relies on the correct coding of invoices and the appropriateness of responsibility codes for service activities. In order to report this data the Company considers responsibility codes and assigns costs to customer services based on these responsibility codes.

The split between water and sewerage is based on total direct costs reported in tables 21 and 22.

We challenged the Company in relation to the possibility of service managers sharing responsibility across different areas such as customer services and debt recovery for example, or customer services and other business activities such as regulatory services. The Company advised that *'There is a possibility, but the financial implications are deemed to be immaterial.'*

Scientific Services

As for customer services the process relies on the correct coding of invoices and the appropriateness of responsibility codes for service activities.

Other business activities

The Company advised that this is regulatory costs. These are identified by responsibility code H160. The total cost for water and sewerage for other business activities is reported as £3.2 million. The Company advised that this is the cost of Reporter activities and the fees imposed by the regulatory authority. In addition the Company advised that the size of the regulatory team within NI Water has increased from 12 to 16. The costs of the NI Water regulatory team has been stripped out of employment costs and reported under regulatory reporting services. In addition we note that the Company has applied a different approach to last year in relation to Reporter costs. Last year Reporter costs were reported under General and Support costs.

In order to report this data the Company uses responsibility codes.

Rates

The Company advised that rates are based on actual information based on rates paid. The process again relies on the correct coding and recording of these costs within the General Ledger system. However, we would expect this to be relatively straight forward as the number of such invoices is likely to be limited.

Doubtful Debts

The Company has applied all doubtful debts to water as it advised that these debts relate largely to water Test Meters. The Company advised that the Test meters are predominately for water. It advised that there is a small element for sewerage circa £80k. However, for AIR09 the Company has reported all these costs under water.

The assessment is based on a professional judgement rather than specific analysis to support this assumption for the current year. The Company advised that it will review the method for AIR10.

Exceptional Items

The Company has not reported any exceptional items. A number of items have been recorded as atypical. These are described in the Company commentary.

Third Party Service - Opex

As for other costs reported the process relies on the correct coding of invoices.

Total PPP Unitary Charges

This is based on actual invoices received.

Reactive and Planned Maintenance Infrastructure

As for other costs reported the process relies on the correct coding of invoices.

Reactive and Planned Maintenance Non-Infrastructure

As for other costs reported the process relies on the correct coding of invoices.

4.3 Allocation of costs to un-appointed activities

The Company advised that these activities are either charged on a full cost recovery basis, and thus costs broadly mirror income generated, or the income does not give rise to any additional operational costs (e.g. rents received or fishing rights). The Company advised that this is consistent with the basis of the 2007/08 return. We have not checked the application of this but the assumption seems reasonable.

4.4 Reorganisation costs

The Company has provided the following split related to re-organisation costs.

| Description | Amount | Table 21/22 location |
|--|---------------|------------------------------|
| Business Improvement programme | £8.4M | Lines 1-10 where appropriate |
| Steria Contract Termination | £2.7M | Customer Services |
| Voluntary Early Retirement Scheme \ Voluntary Severance (VER \ VS) | £11.7M | Employment Costs |
| Total | £22.8M | |

We challenged the Company as follows:

- 1) How did you assign the Business Improvement Costs across direct costs?
- 2) What was the Steria Contract and why was it terminated?
- 3) Have any of the Voluntary Early Retirement Scheme or Voluntary Severance costs been applied to customer services or scientific services?

The Company advised as follows:

- 1) *Business Improvement Costs were assigned across water and sewerage as per the BAU split within that particular directorate. For example, Business Improvement costs in the F&R directorate were split as per the water/sewerage split used in F&R. In addition, Business Improvement costs in Operations were split as per the functional split for each project. Finally, the costs of the Programme Office were split between water and sewerage as per the total split of all the projects. The BI costs are captured in the same expense lines as the BAU costs and*

mapped to the Table 21 & 22 cost lines as per Appendix 1 to the Commentary.

- 2) *In January 2009, Northern Ireland Water announced plans to change the contractual arrangements with the [X] led Crystal Alliance consortium, which provides support in customer contact, billing and mobile work management services. The change in contractual arrangements was to allow NI Water to take direct management control of the specialist sub-contractors who perform the core customer service support activities, achieving financial savings and providing opportunities for further service development.*
- 3) *No VER/VIS in Customer Services in 0809*

4.5 Fines and Donations

NRSWA Fines

The Company has not made any comment in its commentary related to fines. The Company advised that it will provide comment related to this in AIR10.

Donations to charitable trusts or other funds assisting customers with payment difficulty

The Company has not made any donations to charitable funds for the current report year.

4.6 Exceptional Items

The Company has not reported any exceptional items for 2008/09.

4.7 Atypical Costs

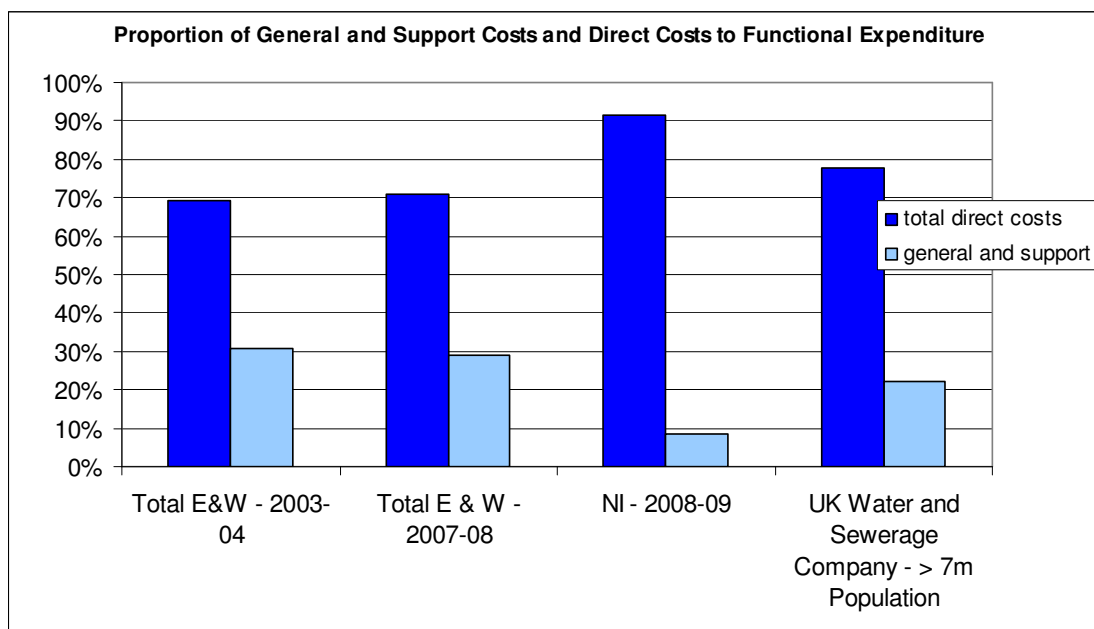
The Company has reported a number of atypical costs in relation to tables 21 and 22. The categories are as follows:

- Decrease in flooding provision: The Company advised that it released a provision of £170k. It advised this was split 51% water and 49% sewerage.
- Reorganisation costs: These are discussed above.
- Business Improvement Programme: These are discussed above.
- Steria Contract Termination: This is discussed above.
- Voluntary Early Retirement: This is discussed above.

4.8 AIR09 Key Cost Drivers

By in large the largest explanatory factor of cost variation is the revised method employed this year compared to the previous year. The current method has resulted in a revised General and Support figure of 13.4 million. This is substantially less than the General and Support figure that was reported in 2007/08. This revised method will in many cases be a significant factor in the explanation of cost variations between the two years. In order to correctly identify drivers of costs between AIR08 and AIR09, tables 21 and 22 should be repopulated using the method for AIR09. The actual coding of transactions and physical allocation of costs has not been audited by Halcrow. As table 21 and table 22 form part of the regulatory accounts we understand that this table has been audited by the financial auditors, [X].

We reviewed the proportion of General and Support costs compared to total functional expenditure for the whole industry for 2003/04 and 2007-08 in England and Wales. In addition we reviewed the proportion of General and Support costs compared to total functional expenditure for a large Water and Sewerage Company in the UK on the basis that a large Company can obtain economies of scale in relation to General and Support costs. We compared this data with data from NI Water. We noted a substantial variation in the proportion of General and Supports costs compared to direct costs. The data is shown below:



1

¹ Source: Ofwat and Halcrow

This suggests that the Company may have over-allocated General and Support costs to direct costs. The Company advised that it is keen to clarify the exact requirements with the Reporter. The Company advised that the approach to reallocation was a detailed review of responsibility codes and service activities.

We did notice in our review of tables 17a-17g some evidence of over allocation of General and Support costs to direct costs. Please refer to our commentary related to tables 17a-17g for further information.

4.9 Table 21 Specific Lines

The Company approach has been to analyse all impacts rather than provide a specific variance analysis that considers the difference. The Company should focus its commentary on those variations that meet the variation targets as described in the Company guidelines.

A – Direct Costs

Line 1

The Company report that there has been an increase in Employment costs related to Water Resources & Treatment (WRT) by £4M and Water Distribution by £7M. The overall increase compared to 2007-08 is in excess of £10M. The Company advised that this is due partly to the improved allocation of costs from other directorates and in particular the reallocation of costs from the General and Supports costs category. We are aware of the Voluntary Early Retirement Scheme and Voluntary Severance scheme which has been included in employment costs. These costs together amount to £11.7million and would seem to account for the majority of the increase in Employment costs. A corresponding reduction due to a reduced headcount would also be present in the data.

Line 2

The Company advised that it has experienced an increase in the unit cost of electricity for the current year, resulting in an increase in costs of 30% compared to 2007/08.

Line 3

The Company has not reported any costs in relation to Agencies.

Line 4

The variation in Hired and Contracted service is £4m. This is split equally between Water Resources Treatment and Water Distribution. The Company advised that these costs are those that were incorrectly coded to General and Support expenditure in the

previous year.

Line 5

The Company has not reported any costs for associated companies.

Line 6

There is no material variation between last year and AIR09.

Line 7

The Company has not reported any costs in this line.

Line 8

The Company has not reported any costs in this line.

Line 9

The Company advised that other direct costs have increased by circa £2M. The Company further advised that this is due to the improved allocation of costs to other directorates which were captured in the General and Support pot in previous years.

[X]

Line 11

Line 11 relates to General & Support expenditure. As the Company advises in its commentary this has significantly reduced as compared to AIR08. The figure here has fallen from £31.1M to £8.9M. The Company advises that this is due to a more accurate view of the NI Water costs by individual area. This has resulted in the revised and reduced expenditure allocated to General and Support and is a key explanatory factor for other variances across table 21.

[X]

[X]

B - Operating Expenditure

These lines are not affected by the revised method used to reallocate General and Support costs.

Line 13

The Company advised that Customer Services costs have fallen by circa £1M compared to AIR08. As the Company advises this is due to the transfer of some functions, namely Communications. In addition the Company has applied a revised approach to apportion costs between water and sewerage services. In AIR08 the proportion of costs allocated to between water and sewerage was 50% in each area based on direct labour costs. For the current year the Company has allocated costs on the basis of direct costs. The percentage of total direct costs, (lines 10 and 9 for water and sewerage respectively) is shown below:

| Service Area | Percentage |
|--------------|------------|
| Water | 46.6% |
| Sewerage | 53.3% |

We believe that the use of total direct costs is appropriate in order to split this expenditure between water and sewerage services. We also note that the Company has reported severance costs under Employment Costs in its totality rather than split these costs between consumer services and scientific services.

Line 14

Line 14 relates to Scientific Services costs. The Company advise that it has experienced a reduction in scientific costs in relation to staff numbers as well as the revised apportionment method used to split between water and sewerage. We challenged the Company in relation to whether any severance costs had been included. The Company advised that *'No severance costs have been included within this line as these were internal transfers as a result of reorganisation.'*

The revised split between water and sewerage is based on direct costs. The Company advised that in the previous year it had allocated scientific services costs equally between water and sewerage services. However, for the current year it has split the costs 47% water and 53% sewerage. This is based on direct costs as it is for customer services.

Line 15

Line 15 relates to other business activities. The Company has advised that the following cost categories exist here:

- Utility Regulator Fees;
- Increased Staff within NI Water undertaken the regulatory function, from 12 to 18;
- Reporter costs were included in General and Support in AIR08. They have now moved to line 14.

The Company has again used a 47% - 53% split between water and sewerage respectively on the basis on total direct costs incurred for water and sewerage services. We believe that it is appropriate to use this to split costs against water and sewerage services.

[X]

Line 17

This relates to local authority rates. The Company advised that local authority rates have increased in AIR09. The Company advised that it has taken actual payment data specific to water which can be identified from the rates bill. The Company advised that the process is the same as that used for AIR08.

Line 18

This relates to doubtful debts payments. The Company has identified a number of reasons related to the increase. The main contributor here was a one-off write-off in respect of bills issued on test meters. In addition to this the Company advised that a negative adjustment was made to bad debts in 2007/08 to reflect postponement in implementation of domestic billing.

Bad debt policy and the allocation of provisions falls within the domain of the financial auditors. The reasons for the variation are accounting rather than changes in underlying trends except for test meters. We challenged the Company in relation to why it has decided to write off the cost of test meters? The Company advised that *'We provided against 75% of the test meter income as we were invoicing 3 years in arrears and anticipate high levels of bad debt.'*

We further challenged the Company in relation to whether this cost would ultimately be paid for by the taxpayer as it would ultimately translate into an increased subsidy requirement. The Company advised that *NIW has not requested nor is it due to receive any additional funding from Government. The company will absorb the loss through reduction in its costs.*

[X]

Line 20

This is a calculated line.

Line 21

Third party services is rechargeable works. The Company advise that this has fallen slightly due to a reduction in rechargeable works.

[X]

[X]

.

C Reactive & Planned Maintenance

Line 23

This line relates to infrastructure maintenance. The Company has advised that this figure has reduced due to significantly improved coding by the operational staff throughout the Networks Water Function. We challenged the Company in relation to where these costs now reside and what specific initiative it followed in order to improve the quality of data coding. The Company advised *'The costs have been coded to the correct service activity for the work being carried out, across networks. This is a result of better education of budget holders.'*

Line 24

This line relates to non-infrastructure maintenance. The Company advised that the increase is due to maintenance costs for water treatment works. The Company advised that this was not included in last year's return. The Company advises that no specific

service activity for building and grounds maintenance exists for line 24. It has therefore failed to include these costs in the assessment.

4.10 Table 22 Specific Lines

Line 1

Line 1 relates to employment costs. The Company advises that these costs have increased in Sewerage (circa £7M), Sewage Treatment (circa £5M) and in Sludge Treatment and Disposal (circa £1M). The overall increase of circa £13M is due to the improved allocation of costs from all other directorates and the subsequent reduction in the General & Support costs (line 10).

We note the £11.7 million was incurred due to severance costs. We challenged the Company in relation to how this had been split between water and sewerage services. The Company advised that 'These were split based on where the staff who left on VS/VER worked.'

A corresponding reduction due to a reduced headcount would also be present in the current year.

Line 2

The Company advised that it has experienced an increase in cost per unit of 30% in electricity prices. This compares with similar increases in other parts of the UK water industry with some companies reporting an increase of up to 50% in unit costs.

The Company has advised that it has made a more appropriate allocation of power costs for the current year. It advised that previously power costs reported under sludge treatment included all power costs related to Waste Water Treatment Works, excluding Belfast, whilst costs reported under Sludge Treatment and Disposal (Column 3) included all costs for the incinerator plus Belfast. This is because these sites shared a common meter connection. However, for AIR09 it has allocated power costs based on Wastewater Field Managers information related to percentage estimates of power costs between sewage treatment and sludge treatment at each of the WWTWs where both activities exist. The views are based on an internal judgement. However, we believe that this will provide an improvement in the quality of data reported compared to AIR08.

Line 3

The Company has not reported any costs in relation to Agencies.

Line 4

The variation in Hired and Contracted service is £8m. This is split £2M to Sewerage,

circa £2M to Sewage Treatment and circa £4M to Sludge Treatment & Disposal. The Company advised that the increase in Sewerage and Sewerage treatment can be attributed directly to the improved allocation of costs from other directorates and the subsequent reduction in General and Support costs in line 10.

In relation to the Sludge Treatment and Disposal the Company advised that the majority of these costs are due to an increase in contractor rates. The Company advised that this was an increase in contractor rates of up to 40% in the year. We challenged the Company in relation to the drivers for this change. The Company advised that this was largely due to cost pass through from the contractor to NI Water. This is because disposal routes are now significantly more expensive due to revised legislation. The Company advised that it is sometimes necessary to transport sludge to the mainland UK for disposal.

In addition the Company advised that there are several new WWTWs that have come on line during the year. The Company advised that these WWTWs will have a negligible overall impact on costs.

Line 5

The Company has not reported any costs for associated companies.

Line 6

This line relates to Materials & Consumables. The Company advised that these costs have increased by circa £1M. The increase in Sewerage and Sewage Treatment is largely attributed to the revised method for cost allocations. The increase in the year due related to Sludge Disposal and Treatment is attributed to an increase in Chemical expenditure. We challenged the Company in relation to whether it had tried to source chemicals from elsewhere. The Company advised that it had sourced chemicals locally for a short time, however the quality was insufficient to treat the sludge adequately so now it has reverted to sourcing chemicals from Mainland UK.

Line 7

The Company has not reported any costs in this line.

Line 8

This line relates to Other Direct Costs. These have increased by circa £2M. Again the Company advised that this is largely due to the improved allocation of costs from all other directorates and the reduction in General and Support costs.

[X]

Line 10

Line 10 relates to General & Support expenditure. As the Company advises in its commentary this has significantly reduced as compared to AIR08. The figure here has fallen from £21M to £5M. The Company advises that this is due to a more accurate view of the NI Water costs by individual area. This has resulted in the revised and reduced expenditure allocated to General and Support and is a key explanatory factor for other variances across table 22.

[X]

[X]

B - Operating Expenditure

These lines are not affected by the revised methodology used to reallocate General and Support costs.

Line 12

The Company advised that Customer Services costs are broadly consistent with AIR08. The Company has applied a revised approach to apportion costs between water and sewerage services. In AIR08 the proportion of costs allocated to between water and sewerage was 50% in each area based on direct labour costs. For the current year the Company has allocated costs on the basis of direct costs. The percentage of total direct costs, (lines 10 and 9 for water and sewerage respectively) is shown below:

| Service Area | Percentage |
|--------------|------------|
| Water | 46.6% |
| Sewerage | 53.3% |

We believe that the use of total direct costs is appropriate in order to split this expenditure between water and sewerage services. We also note that the Company has reported severance costs under employment costs in its totality rather than split these costs between customer services as well.

Line 13

Line 13 relates to Scientific Services costs. The Company advised us that it has experienced a slight reduction in scientific services costs in relation to staff numbers. We also note that the approach to allocating costs has changed. The revised split is based on direct costs. The Company advised that in the previous year it had allocated scientific services costs equally between water and sewerage services. However, for the current year it has split the costs 47% water and 53% sewerage. This is based on direct costs as it is for customer services. In addition no severance costs have been included under this line.

Line 14

Line 14 relates to other business activities. The Company has advised that the following cost categories exist here:

- Utility Regulator Fees;
- Increased Staff within NI Water undertaking the regulatory function, from 12 to 18;
- Reporter costs were included in General and Support in AIR08. They have now moved to line 14.

The Company has again used a 47% - 53% split between water and sewerage respectively on the basis on total direct costs incurred for water and sewerage services. We believe that it is appropriate to use this to split.

[X]

Line 16

This relates to local authority rates. The Company advised that the rates have remained broadly the same as AIR08. It should be noted that £0.3 million has been removed from the data as this is paid by NI Water on behalf of the private contractor. As the PPP table does not request this data the data is not present in the total NI Water + PPP table. The

reconciliation as provided by the Company is as follows:

| | |
|---------------------------------------|-------------------------------------|
| NIW Only | <input checked="" type="checkbox"/> |
| PPP Only | <input checked="" type="checkbox"/> |
| Plus PPP Kinnegar Rates (paid by NIW) | <input checked="" type="checkbox"/> |
| Total NIW | <input checked="" type="checkbox"/> |

The Company advised that it has taken actual payment data specific to waste which can be identified from the rates bill. The Company advised that the process is the same as that used for AIR08.

Line 17

This relates to doubtful debts payments. Doubtful debt payments have been entirely coded to table 21. We challenged the Company in relation to this allocation. The Company advised that the allocation was based on a high level assessment undertaken for the current year. The Company advised that it would review this position for AIR10. The Company has therefore reported zero in this line.

Line 18

The Company has reported zero in line 18 for exceptional items.

Line 20

Third party services is rechargeable works. The Company has not reported any costs in this line.

[X]

C Reactive & Planned Maintenance

Line 22

This line relates to infrastructure maintenance. The Company has advised that this figure has reduced due to significantly improved coding by the operational staff throughout the Networks Water Function. We challenged the Company in relation to where these costs now reside and what specific initiative it followed in order to improve the quality of data coding.

Line 23

This line relates to non-infrastructure maintenance. The Company advised that the increase is due to maintenance costs for sewage treatment works by the M & E function. The Company advised that this was not included in last year's return.

5. Infrastructure Renewals Charge (IRC)

See Commentary for Table 33.

6. System Controls

The Company advised that an internal audit carried out an audit on AIR08 during the 2008/09 financial year and came up with recommendations regarding sign offs, password protection of files and process notes. The Company advised that it has incorporated these procedures where possible.

7. PPP Data Table

General

This is the first year that the regulator has collected information in relation to the PPP service providers in the Table 21 and Table 22 formats. The Company advised that it has agreed with the Regulator to report only data for the North Down WwTW Facility for Project Omega, along with the existing Kinnegar contract (where data is available). The Company advised that the reason being that the remainder of the developments

were unlikely to have achieved Service Commencement until late in the reporting year and hence were not operating for a complete year. For Project Alpha, the Company advised that the Regulator agreed that data should be provided for all Facilities in Service.

Method PPP

The PPP data being reported in tables 21 and 22 is incomplete. The Company advised that it has sought to obtain data on a best endeavours basis. However, it advised that not all the PPP contractors are obliged to report data to the regulator. NI Water advised that:

- The Kinnegar contract was designed in the 1990s. It was designed prior to any consideration for a Government Company. As a result no clause exists for the provision of regulatory information. Thus the Kinnegar contractor is not obliged to provide any information in addition to that defined in the contract, which does not include information for regulatory returns. In addition it should be noted that the contractor for Kinnegar is responsible for all operating expenditure, including electricity;
- For the Alpha contract there is an implicit requirement to provide this information. The Company advise that any information requirements are discussed in relation to whether or not it falls within the scope of the contract. NI Water pays the operating costs for electricity for the Alpha contract;
- For the Omega contract the obligation for regulatory reporting data is explicit. The Company advised that the contractor has been supportive in any requests for information that have been made. NI Water pays the operating costs for electricity on the Omega contract.

From the above it is clear that not all information was available to NI Water to provide a complete return for tables 21 and 22 for the PPP contractors.

Variation from Previous Years

The value for previous years was zero. Therefore a variation from previous years exists in all cases. The reason for the variations is that the PPP providers are beginning to provide outputs as agreed.

7.1 Table 21 – Specific Lines

[X]

[X]

Line 11

The Company has reported a total of £74,000 in this line. The Company advised that the £74,000 is based on 3.5 FTE which it will use to manage the PPP contracts once the contracts are live. The Company advised that the Alpha contract was only active for 58% of the year. This is based on it being active for 7 of the 12 months under consideration. The Company then assesses that out of a total of 36 months for which the 3 PPP schemes could have been active as a whole, the Alpha scheme has only been active for 7. This gives $58\%/300\% = 19.33\%$. Therefore the total number of resources that would have been consumed by project Alpha are $19.33\% * 3.5 = 0.67$ FTE. We note that this is payroll costs, however we feel that the £74,000 of 0.67 FTE is excessive and would not be truly reflective of the payroll costs for 0.67 FTE at the grades being considered. In addition the calculation assumes that time of the 3.5 FTE would be divided equally between the three projects.

[X]

[X]

7.2 Table 22 – Specific Lines

[X]

[X]

Line 10

The Company has reported a total of £158,000 in this line. The Company advised that the £158,000 is based on 3.5 FTE which it will use to manage the PPP contracts once the contracts are live. The Company advised that the Omega and Kinnegar contracts were using 100% and 18% of the necessary full time resources. It has therefore assessed that they are currently operating at 1.37 FTEs. Based on an assessment it has then determined that the total payroll costs are £158,000. We believe that the approach applied is generally appropriate. However, the £158,000 payroll costs for 1.37 FTE seems excessive.

[X]

[X]

[X]

[X]

[X]

Date: 10 August 2009

Table 25 - Analysis of fixed assets by asset type

Commentary by REPORTER

1. Key Findings

The Company advised that it has not made any AMP adjustments in this table for AIR09.

Date: 10 August 2009