

Case Study— Kiskun-Viz, Hungary

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Key Characteristics of Aggregation Case Study

KISKUN-VIZ, HUNGARY	
Context	<ul style="list-style-type: none"> • High-income country • Aggregation covering urban and rural areas • High level of water supply and sanitation (WSS) performance
Purpose	Economic efficiency, performance, professionalization
Scope	WSS functions and services
Scale	<ul style="list-style-type: none"> • Administrative boundaries • Localities covered: 54 for water and 35 for wastewater • Population covered: 161,000 inhabitants for water and 141,000 for wastewater • Coverage: 100% for water; 87% for wastewater • Connections: 63,670 for water and 43,658 for wastewater • Network length: 1,377 km for water and 906 km for wastewater
Process	Top-down
Governance	<ul style="list-style-type: none"> • Merger • Public company • Decision making: municipalities and the Hungarian state are the utility's shareholders • Asset transfer: assets remain the property of municipalities and are managed by the operator as part of the merger agreement • Liability: liabilities and debts from previous operators are taken on by aggregated utility • Staff transfer: all staff was transferred • Clear entry and exit rules
Outcome	Positive, with decreased operating expenses
Findings	Political resistance when choosing utility headquarters location and nominating CEOs; difficulty retaining skilled staff because of financial constraints; accountability mechanisms toward employees; harmonization of operating practices among aggregated entities on the basis of best practice; accountability toward customers (satisfaction survey); aggregation appears beneficial, especially for service quality and sustainability in small municipalities

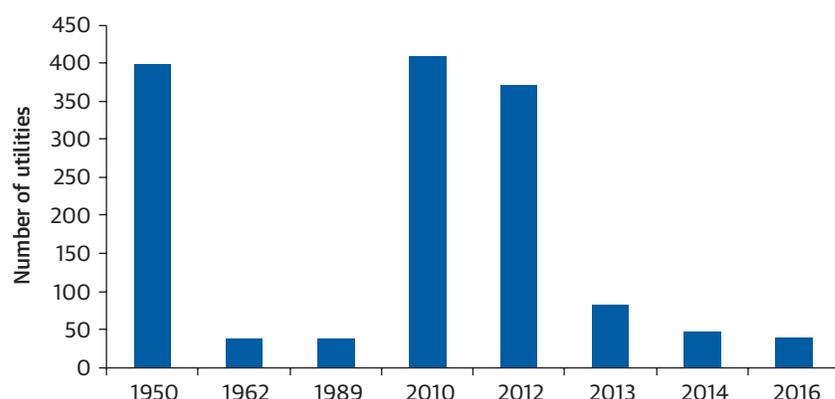
In 2011, when the Hungarian parliament voted on the Act on Water Utility Services, the three water utilities of Halasvíz, Kalocsavíz, and Kőrösvíz—which had previously worked together—quickly decided to merge. This corporate merger is the only example of its kind in Hungary following the mandatory aggregation reform. Although the merger negotiations and the design of the aggregation were quick and smooth, implementation of the aggregation triggered challenges among the merging partners. Those challenges were overcome, and the aggregation delivered benefits to all partners, with reduced operating costs and with a limited increase in performance.

From Fragmentation to Aggregation of Hungary's WSS Utilities

After World War II, during the Communist era, Hungary's water sector was highly fragmented. There were more than 400 water utilities, most of which were owned by local councils. The aim in the 1950s was to halt and reverse fragmentation by connecting the neighboring water utility systems in the country. A number of state-owned water utilities were then created, and small water utilities were merged. That process resulted in the integration of water services into 34 water utilities. Those companies were operating predominantly at the county level and in larger towns. After the 1989 change of regime, Act LXV of 1990 on Local Governments declared that local governments were responsible for providing

water and sanitation services. Act XXXIII of 1991 stipulated that the assets of state-owned companies were to be transferred to local governments. The former companies that had been operating on a county level split into several smaller water utility companies, driven by the municipalities' desire to achieve independence in local service provision to match their obligations of supplying services. Some municipalities contracted with private operators through management contracts or concessions, but most settlements continued to be supplied by municipally owned water utility companies. In 1989, there were 38 water utilities, and by 2010 there were more than 400, predominantly owned by local governments. However, in 2012, the 33 largest companies were providing drinking water for 85 percent of the Hungarian population. Nevertheless, the large number of water utilities meant that there were huge differences in service levels, prices, cost recovery, and operating efficiency, as well as in sustainability. Recognizing that situation, the Hungarian Parliament adopted Act CCIX of 2011 on Water Utility Services. That act reflected a new vision for the sector, including national regulation through a regulatory agency, uniform tariff-setting procedures, and achievement of major aggregation within the sector. As a result, a wave of aggregation swept the country, triggered by a regulatory requirement on the minimum size required to obtain an operating license. From January 1, 2017 onward, water utility companies have to serve at least 150,000 consumer equivalents (CE) to be allowed to operate. The number of utilities fell from more than 400 in 2010 to 41 by 2017 (figure 1).

FIGURE 1. Water Utilities in Hungary



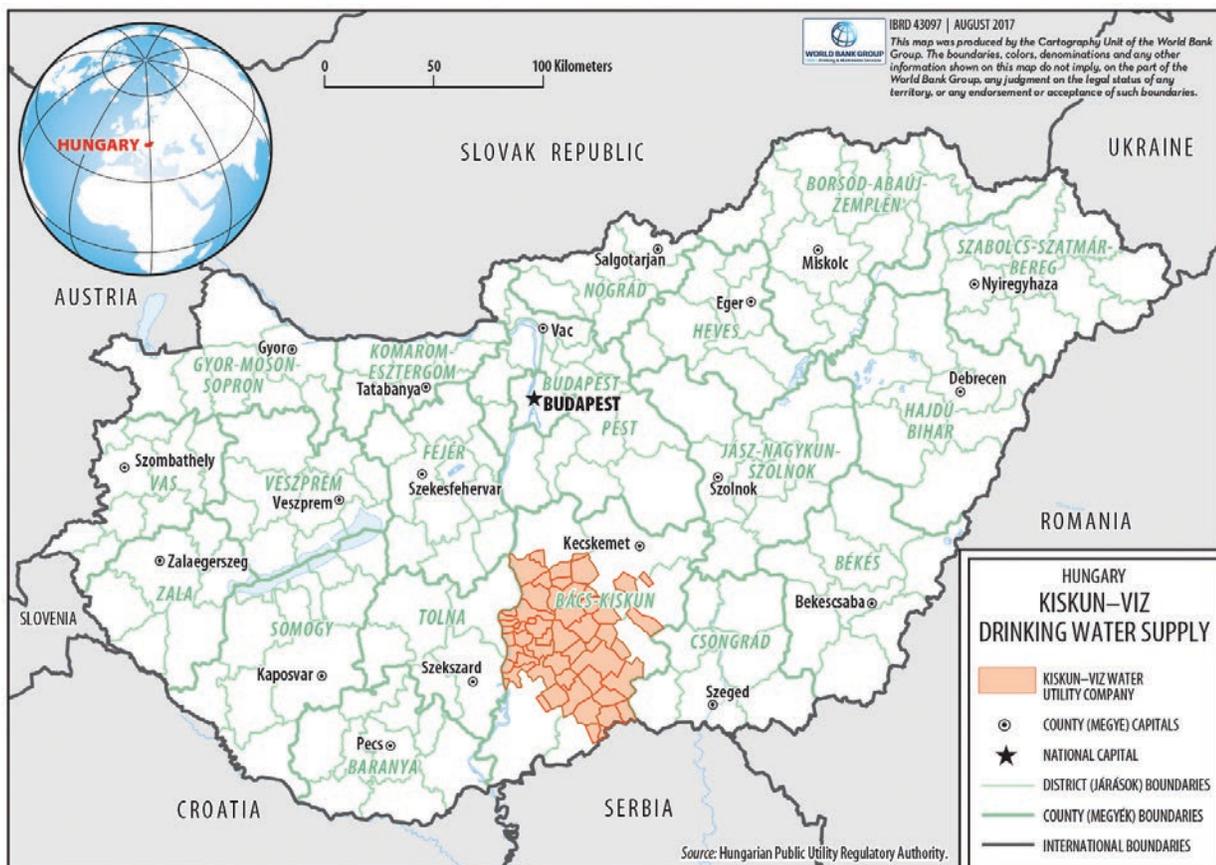
A Merger between Three Utilities that Were Used to Working Together

Before 1993, the Dél-Bács-Kiskun Megyei Vízmű Vállalat utility (South Bács-Kiskun County Water Utility Company) supplied services in southern Bács-Kiskun County. But after a water

sector reform, the utility was disaggregated into four medium-size utilities (each serving between 10 and 20 municipalities) and several small utilities (each serving only 1 or 2 municipalities), all owned by the municipalities they serve. Even though the disaggregated utilities started operating individually and independently from one another, the four medium-size companies (Halasvíz, Kalocsavíz, Bajavíz, and Kőrösvíz) continued to cooperate either formally or informally. Those companies were used to borrowing equipment from one another, sharing information, and organizing events together. Hence, when the Act on Water Utility Services was passed in 2011, it appeared natural to the four utilities' directors to start merger discussions. They received approval and support from their municipal councils to do so. After a short while, the Bajavíz utility

decided to reach the regulatory size threshold on its own, and it quit the negotiations. The other three utilities continued to discuss the merger (see map 1). That preparatory phase lasted through 2012, and in September 2013 the three utilities signed a merger agreement that stipulated clear entry and exit rules. The capital of the aggregated utility is owned by the Hungarian state (8.35 percent) and the municipalities served by the utility. The name of the aggregated utility was changed to Kiskun-Víz, and by 2013 the utility had already reached its final aggregated size, four years ahead of the legal deadline. This merger has been managed by the top management of the three companies because no external consultant was hired to help with the process and no dedicated merger team was set up. Kiskun-Víz took over all contractual obligations of the three former companies.

MAP 1. Kiskun-Víz Kft. Drinking Water Supply in January 2017



Those liabilities usually did not extend beyond 1.5 to 2 years post-merger. When those supplying contracts were not advantageous, Kiskun-Víz did not renew them upon expiration. At the time of the merger, all 320 employees from the merging companies were offered continued employment at their current salary. The initial discrepancy between job descriptions and associated wages was gradually addressed. By 2017, uniform job descriptions had been created and the salary gap had been closed by raising lower salaries to the level of the highest ones for similar jobs. This adjustment represented an average salary increase of 8.5 percent over three and a half years. Transitioning was also facilitated by the fact that about one-third of the 320 employees had previously worked together at Dél-Bács-Kiskun Megyei Vízmű Vállalat until 1993. Familiarity among employees led to increased cooperation and teamwork in the new, larger company.

Challenges between Merging Partners during the Implementation Phase

Although the merger negotiations and the design of the aggregation were quick and smooth, implementing the aggregation triggered challenges regarding (a) harmonization of administrative practices and IT systems and (b) the selection of the headquarters location.

To ensure balanced representation of the municipalities previously supplied by the three merging companies, each of the merging companies appointed a managing director to be responsible for the service area that its company used to cover. As a result, Kiskun-Víz had four managing directors: a general chief executive officer and three regional managing directors. This structure did not work very well, and in January 2015, about 16 months after the merger, the management structure was reorganized. At present, Kiskun-Víz has three directors: a chief executive officer, a technical director, and a finance director. (It should be noted that one director comes from each of the areas represented by the three former companies.)

A specific IT-related challenge arose after merger—namely, the integration of the three companies' IT services. The aggregated utility of Kiskun-Víz selected the IT customer databases and invoicing systems from Halasvíz to be used going forward, and data were migrated from the other aggregating companies. This migration created a one-off cost for the years 2012 and 2013. Customer service operations were suspended for one day because of the transition. Kiskun-Víz issued its first post-merger invoice in November 2013. The consolidated system for managing outstanding invoices was ready in 2015. A central customer service office was supplemented by two new local offices open three days a week and by a number of small “customer service points” that are available once a week in some of the smallest settlements. The three merging companies (Halasvíz, Kalocsavíz, and Kőrösvíz) also brought different operating practices into the merged company. In each instance, Kiskun-Víz selected the best practice and implemented it companywide. For example, Kalocsavíz had an efficient system for the management of unpaid invoices, which was adopted throughout the aggregated utility. The frequency of meter reading was also reduced, and electronic payments have been implemented for all customers, while cash payments are no longer accepted.

Another challenge concerned the location of the new company's headquarters. Each of the merging companies feared that it would have less control over company operations if the headquarters was located in another company's territory. Therefore, Kiskun-Víz decided to set up the new headquarters in Kecel, a minor town in the geometric center of the merged service areas. This seemingly neutral location turned out to be an unsatisfactory compromise: the headquarters building itself was unsuitable and too small, and a large share of the administrative staff had to endure a long daily commute. During 2014, all the merging partners realized that the new company was working well, and mutual trust was strengthened. As a result, in January 2015 the headquarters was moved to

Kiskunhalas, which is the biggest town within the service area and is the original headquarters of one of the merged companies (Halasvíz). Many employees have a shorter commute, and the utility sponsors a free mini-bus service for commuters.

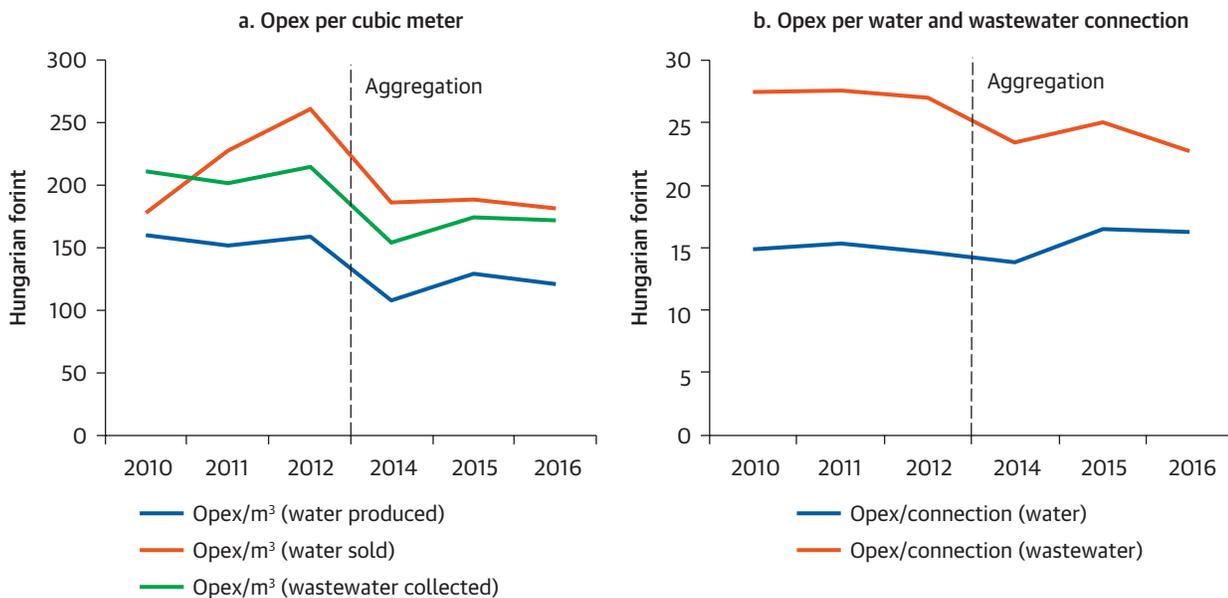
Increased Economic Efficiency and Slightly Improved Performance

Economic efficiency has been improved through the merger for both water and wastewater services. Operating costs of both the drinking water service and the wastewater service decreased after aggregation (see figure 2). The management of Kiskun-Víz stated that procurement costs for inputs such as energy, fuel, chemicals, and work clothes declined slightly as a result of volume purchasing. The unit cost of central administration, including company management and customer service, also declined following the consolidation of those tasks within the merged company. However, some costs increased,

most notably the travel costs of specialized personnel serving a larger operating area and the cost of employees' daily commute to the headquarters, which is subsidized by the utility. In addition, some new cost items appeared because of legal obligations set by the 2011 water utility regulation. Those costs, which encompass items such as energy audit and invoicing audit, are not directly linked to the aggregation process.

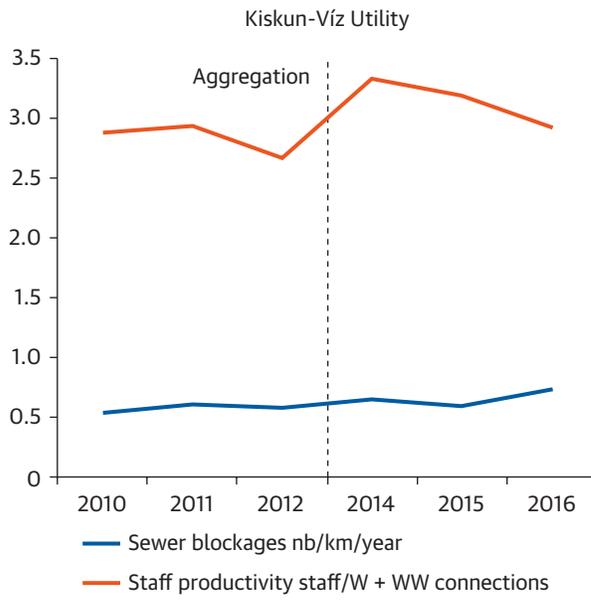
Sewer blockages slightly increased after aggregation, possibly because of limited resources available for reconstruction and regular maintenance. Staff productivity per connection first increased and then declined, probably as a result of the increasing number of wastewater connections in 2016. (See figure 3.) On more qualitative grounds, a customer satisfaction survey is now in use in Kiskun-Víz, whereas this was not the case in the three companies before the merger. The quality of drinking water has clearly improved, as has

FIGURE 2. Economic Efficiency of Kiskun-Víz Utility



Note: Opex = operating expenses.

FIGURE 3. Efficiency of Kiskun-Víz Utility



Note: nb = number, W = water, WW = wastewater.

effluent treatment; however, those achievements cannot be totally attributed to the merger because they are the result of a European Union-funded program that started before 2013.

Overall, Kiskun-Víz succeeded in managing transaction costs (related to staff transfer, IT systems integration, and harmonization of administrative practices), which did not increase costs in the long run. In addition, service performance improved, especially in rural areas where quality standards are now as good as those in urban areas.

Aggregation Case Study at a Glance

Key Lessons Learned from the Aggregation Case Study

Lesson 1: Defining Principles but Allowing Flexibility in Implementation Ensures Local Ownership

National reforms are more likely to be successful when they follow the principle of subsidiarity and allow flexibility for local stakeholders to own the aggregation process and adapt it to their local context. In Hungary,

the Water Utility Services act, passed in 2011, states that water licenses shall be issued to providers reaching a certain level of aggregation, expressed in consumer equivalent. But no administrative limits such as watershed or regional boundaries were set. The utility of Kiskun-Víz opted for a quick implementation of aggregation and reached its final aggregated size by 2013, four years ahead of the legal deadline.

Lesson 2: Harmonization of Administrative Practices has Increased Performance Without Generating Cost Increase

When the scope of aggregation includes consolidation of functions, a harmonization of administrative practices across aggregating service providers is necessary. In the best-case scenario, this harmonization leads to elevating standards to those of best practices. In Hungary, the three merging companies—Halasvíz, Kalocsavíz, and Kőrösvíz—brought different operating practices into the merged company, Kiskun-Víz. Those practices were harmonized by selecting the best practice in each case and implementing it companywide. For example, Kalocsavíz had an efficient system for the management of unpaid invoices, and that system was adopted throughout the aggregated utility. As a result, the overall level of unpaid bills was halved.

Lesson 3: Transaction Costs can Hamper Aggregation Success

Transaction costs occurring before, during, and after aggregation can hamper aggregation success or limit and delay the benefits of aggregation. Transaction costs can take many forms.

Labor costs

In Hungary, following aggregation, human resources policies have focused on training programs and wage increases to attract and retain skilled staff. At Kiskun-Víz, the salary gap among the staffs of the three merged companies was gradually closed by raising lower salaries to the highest level of those for similar jobs, with an average increase of salaries representing 8.5 percent

over three and a half years. Other labor-related costs also increased, most notably the travel costs of specialized personnel serving a larger service area and the cost of employees' daily commute to the headquarters, which is subsidized by the utility.

IT systems

Transaction costs related to the merger of IT systems between aggregating entities occur during aggregation implementation. In Hungary, Kiskun-Víz selected the

customer databases and invoicing systems from Halasvíz, one of the three companies that merged, to be used companywide, and data were migrated from the other aggregating companies. This migration created a one-off cost for the years 2012 and 2013. Customer service operations were suspended for only one day because of the transition. Kiskun-Víz issued its first post-merger invoice in November 2013. The consolidated system for managing outstanding invoices was ready in 2015.

