

Options for adjusting £3.1m for base opex and efficiency modeling

Following discussions between Hastings and Ofwat this paper sets out the agreed practical application of the £3.1m remedy adjustment to base operating costs and the assessment of relative operating cost efficiency.

Objectives:

To ensure that £3.1m relating to opex savings related to the merger are excluded from the base 2008/9 costs for PR09.

To avoid “double-counting” of merger synergies achieved before 2009-2010.

To ensure that the opex efficiency modeling for PR09 is based on the operating costs of the merged entity.

Background:

The Competition Commission concluded that *the price reduction should be accompanied by a requirement for MKW and SEW to accept a price determination in PR09 that reflects £3.1m annual operating expenditure savings (as compared with current operating expenditure costs and projections)*¹

It is anticipated that many of the merger savings will be achieved by the end of 2008/9 but the operating costs for 2008/9 will not reflect all of the anticipated merger savings. In short, only part of the merger savings will be evident in the 2008-09 actuals.

In order to ensure that the Company complies with the Competition Commission remedy in a way that uses actual costs in relation to the £3.1 million adjustment, the method described below is recommended to be adopted. It has been discussed and agreed with Ofwat.

Method

The 2008/9 operating cost impact of merger savings actually achieved in 2008/9 or earlier will be identified and added back to the actual costs for 2008/9 to give an implied operating cost figure (restated 2008/9 opex) for the two separate entities before merger savings. The £3.1m figure for the Competition Commission remedy will then be deducted from this implied operating cost figure.

An example is shown below where the actual operating cost savings made during 2008/9 is £1.5m and actual operating costs for the merged company excluding exceptional and re-organization costs of £70.0m

¹Paragraph 8.157 (c) of Competition Commission Report on the completed water merger of South East Water Limited and Mid Kent Water Limited

	£m	£m
Actual 2008/9 opex for merged entity excluding Re-organization and exceptional costs.	X	70.0
Add back operating cost impact of merger savings achieved by March 2009	1.5	1.5
Restated 2008/9 opex	X +1.5	71.5
Adjust for CC merger savings remedy	-3.1	-3.1
Agreed base opex for 2008/9	Y	68.4

The actual 2008/9 opex will be the total operating costs reported in table 21 of the June Return on line 22 less exceptional items shown in line 19 of table 21. The re-organization costs related to the merger will be treated as exceptional or atypical costs in 2008/9 and will therefore be excluded from base costs.

Process

A record or log will be kept of the merger savings achieved during 2008/9. This will detail the following for each saving:

- Description of merger saving
- Date merger saving achieved
- Value of full year impact of merger saving
- Value of merger saving achieved up to 31st March 2009
- Cost relating to merger saving incurred in 2008/9
- Re-organization cost if any associated with the merger saving

An audit of the log of efficiency savings and the application of the process described above would be carried out by the Company Auditor (currently Price Waterhouse for SEW) as part of the Audit of the Regulatory Accounts for 2008/9. This would mean that the process of review and challenge of the merger savings was consistent with the June Return and Regulatory Accounts processes

As agreed with Ofwat the agreed base opex figure would then be used as both the base year for PR09 and the number to use for the assessment of relative operating cost efficiency (£68.4m in the example above).

It may then be necessary for Ofwat to adjust the agreed base operating figure before it is used for efficiency assessment and the base year for PR09 in accordance with Ofwat's published procedures e.g. for pensions, non-merger atypicals and transfer pricing to ensure that opex has been treated consistently across all companies

For clarity this means that the number used to assess operating cost efficiency is the number that includes the removal of the full £3.1m i.e. it includes both efficiencies made and recorded in the log before 31 March 2009 as well as future efficiencies to be realised in 2009-10 equating to a total of £3.1m.