

28th August 2014

Mr. Paul McGowan,
Commissioner,
Commission for Energy Regulation,
The Exchange,
Belgard Square North,
Tallaght,
Dublin 24.

Re: CER/14/366 – Water Charges Plan Consultation

Dear Paul,

Irish Water (IW) welcomes the publication of the Water Charges Plan (WCP) consultation paper (CER/14/366) by the Commission for Energy Regulation (CER). The consultation paper sets out the CER's proposed allowed revenue for IW within the context of the Minister's policy direction and funding available from the Exchequer. IW has reviewed the paper and would like to raise a number of points which we believe should be addressed by the CER before a final decision is made.

In summary, IW would make the following comments:

- IW recognises that the publication of the first WCP consultation paper is a significant step in the reform programme of the water services sector.
- IW recognises the critical importance of driving efficiency and cost reduction, improving customer service and operational performance in the sector and is fully committed to delivering this as quickly as possible.
- IW welcomes the CER acknowledgement concerning a two-year IPC period that *"[the CER] must be reasonable in its approach to setting targets for the review and what is achievable by Irish Water in that period"*.
- However, IW is concerned that a number of proposals outlined in the consultation document will affect the work that IW needs to undertake over the IPC period for improved customer service, and the longer term drive for efficiency and investment.
- IW understands the benefits of comparing its performance with UK Water and Waste Water companies, where significant improvements in both service and operational efficiency have been achieved over the last 25 years. However, the comparison that the CER uses focuses on a simple unadjusted measure of output – 'per population served', which ignores significant differences between IW and the UK comparators and distorts the performance gap. For example, the difference between the number of wastewater treatment plants and their geographical spread in Ireland and the UK needs to be fully taken into account in the CER benchmarking exercise. Furthermore, it will take many years for IW to achieve the same level of performance as today's UK water utilities.

- IW welcomes the acknowledgement by the CER that the vast majority of the Irish Water Programme (IWP) Establishment costs were efficiently incurred. However, IW believes that the CER's position, in relation to programme management costs, does not recognise the complexity and compressed timeframe of the programme.
- IW believes that CER's proposal to impose an average annual efficiency challenge of 7% on Opex, so early in the establishment of the utility, will affect IW's ability to deliver investment, service and quality improvements for customers over the IPC period.
- IW believes that its ability is limited, in the short-term, to meet the proposed Capex challenge through changing or re-scoping of IPC projects.
- IW accepts the CER proposal for the inclusion of a mechanism to re-set the allowed WACC, which IW believes will allow us to demonstrate in due course that CER's proposals will need to be amended to allow it to efficiently finance its activities.

Detailed Comments

Background

It is worth outlining the scale of the challenge that faces IW over the Interim Price Control (IPC) period and beyond. The previous framework was fragmented and dispersed on a LA basis across the country. As a result, and despite the best efforts of LAs, water services in Ireland suffered from a lack of adequate investment for several decades. In addition, the network has suffered from very poor data collection, inconsistent asset analysis, differing local application of policies and standards, ad-hoc investment planning and limited application of true risk metrics over many years. The net result is that it will take time for many water service customers to receive the service levels that should be expected in a modern economy. IW outlines in its revenue submission to the CER that there is a critical requirement for several years of increased and sustained investment, and a need for radical transformation in how we deliver water services in Ireland. This will be needed to meet environmental standards, support economic growth and meet customer expectations.

IW understands the benefits of comparing its performance with UK Water and Waste Water companies, where significant improvements in both service and operational efficiency have been achieved over the last 25 years. However, IW is establishing a new national utility within a short time frame (18 months) and is faced with very significant legacy challenges as briefly outlined above. It has also been tasked with installing approximately 1 million water meters and implementing a new domestic billing system. It is clear therefore that IW cannot be expected to achieve the same level of performance as today's UK water utilities for several years.

CER's proposal – IWP Establishment Costs

IW welcomes the acknowledgement by the CER that the vast majority of the Irish Water Programme (IWP) establishment costs were efficiently incurred.

Given the above, IW considers the CER's position, in relation to programme management costs, to be inconsistent. Furthermore, it does not recognise the complexity and compressed timeframe of the programme, which necessitated strong programme management to ensure delivery. IW has provided detailed comparators to the CER on the scale and complexity of this programme and comparative programme management costs. These comparators all indicate that a programme management cost range of 10% to 15% is appropriate for the

successful delivery of these types of programmes, and where that is not present, significant scope, time and cost overruns can be incurred.

IW will have to manage the remaining IWP expenditure to stay within the CER's decision on allowable efficient costs. There are critical milestones yet to be met within the programme and the cuts to the establishment programme costs may impact on remaining milestone delivery.

CER's proposal – Opex challenge

IW acknowledges that one of the conditions of Exchequer funding is that IW be classified as a Market Corporation under Eurostat rules. Under the DECLG's policy direction to the CER, the CER has to comply with these conditions of funding in setting IW's allowed revenues.

However, IW believes that CER's proposal to impose an efficiency cut on Opex so early in the establishment of the utility (10.5% in 2015, followed by a further 3.5% in 2016) will directly affect IW's ability to deliver investment, service and quality improvements for customers over the IPC period. It will also affect IW's ability to drive the longer term objectives of Opex and Capex efficiency gains in the sector.

By comparison, Opex in the England and Wales water companies rose in the early years of regulation, driven primarily by (a) the investment needed to achieve regulatory and legal standards for drinking water quality and wastewater treatment discharges and (b) expenditure to deliver future Opex efficiencies. Similar investment is needed in IW's operational assets over the coming years.

The CER's benchmarking focuses heavily on unit cost comparisons, which are supplemented with econometric analysis. This comparison has focused on a simple unadjusted measure of output – 'per population served', which ignores significant differences between IW and the UK comparators. For example, the difference between the number of wastewater treatment plants and their geographical spread in Ireland and the UK needs to be fully taken into account in the CER benchmarking exercise. The effect of using the 'per population served' comparison is to overstate the performance gap of IW versus the comparators.

IW has undertaken a comprehensive review of each role within the target operating model for the new organisation, with the support of an independent expert firm. IW would be happy to engage with the CER and its advisors over the coming IPC period to review labour costs within the IW organisation. IW is confident that such a review will support our position that IW's labour costs are appropriate and reflect IW's organisational needs to deliver investment, service and quality improvements for water service customers.

As noted above, IW recognises that there is scope for efficiency in industry Opex costs. In response, we have invested considerable time in understanding how efficiencies can best be implemented, whilst maintaining an appropriate balance between improving quality and sustainability of service and reducing costs. IW considers that the efficiency savings outlined in our IPC submission on controllable Opex are deliverable. These savings are considered to be a start on the glide-path to building the future efficiencies needed in the sector, while delivering for the water services customer.

CER's proposal – Capex challenge

IW welcomes the CER's statement that the proposed projects under the Capital Investment Plan 2014-2016 (CIP) 'are reasonable, showing demonstrable need'. The recognition that 'IW has largely inherited the CIP already established by the LAs, with a significant proportion of committed expenditure' is further welcomed. However, IW is concerned with the CER's proposal to reduce all non-committed capital expenditure, excluding capital maintenance, by 7% per annum, or by 14% by the end of the IPC period.

The consultation document outlines the expectation that IW can deliver efficiencies over the IPC period in a number of areas as "*IW plans to standardise technical design solutions, purchasing processes and incentivise the supply chain*". As detailed in our CIP, each project has been assigned into one of three statuses depending on where it is in the project lifecycle (A – continue in construction, B – review scope and continue in construction, or C – continue planning and business case review). Although a significant number of projects have been assigned to categories B and C (approx. €800m of the CIP), these projects are sufficiently advanced that they will either reach construction during the IPC period or are projects addressing urgent national or regional priorities over a longer timeframe. The ability of IW to meet the proposed Capex challenge through changing or re-scoping these projects in the short-term is therefore limited.

CER's proposal – WACC and Financing Arrangements

IW has concerns regarding the use of the same factors to determine the WACC for IW, as that used to determine the appropriate WACC for ESB Networks (ESBN) in February of this year. This has resulted in a proposed WACC of 5.1% for IW, compared to an ESBN WACC of 5.2%.

The factors used to determine ESBN's WACC reflects the fact that it is a long-established mature utility with a well-established regulatory framework. ESBN has relatively modern infrastructure that has seen significant investment in recent years, based on a Capex programme that was moderate relative to the organisation's RAB. These factors also reflect the fact that ESBN has a track record of borrowing, delivering infrastructure and repaying investors, and has proven revenue streams.

IW, on the other hand, is a new national utility, with a regulatory framework which is in its infancy. It also has a significant capital investment programme, which is needed to ensure compliance with EU Directives, as well as make up for many years of under-investment in assets. Despite being a fledgling utility, IW will need access to significant commercial funding to deliver this investment. It also faces wider uncertainties, with an initial reliance on Government subvention and the introduction of domestic tariffs.

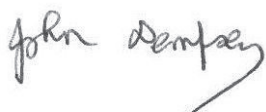
However, we note that the CER do recognise that there is a degree of uncertainty in relation to future financing costs, in particular debt costs. In response, the CER propose the inclusion of a mechanism to re-set the allowed WACC, which we believe will allow IW to demonstrate in due course that CER's proposals are insufficient to allow it to efficiently finance its activities.

Conclusion

The publication of the first WCP consultation paper is a significant step in the reform programme of the water services sector and the bedding down of the new regulatory framework. It is clear that there are many challenges ahead for IW and key to meeting these challenges is a balanced and stable regulatory framework. This is especially the case when such a framework is in its early stages. IW is fully committed to reducing costs as quickly as is feasible and to achieving, in the longer term, an efficient level of service costs. However, such an approach must be underpinned by the need to balance cost reduction against the ability to continue to deliver and improve the service.

IW acknowledges the constraints of the MCT. However, IW is concerned that a number of proposals outlined in the consultation document will affect the work that IW needs to undertake over the IPC period to improve service for the water services customer and the longer term drive for efficiency and investment. Nevertheless, IW looks forward to working with the CER over the coming IPC period, and beyond, to deliver efficiencies and to meet the needs of our customers, ensure environmental compliance and be in a position to support the Irish economy.

Yours Sincerely

A handwritten signature in black ink, appearing to read 'John Dempsey', with a stylized flourish at the end.

John Dempsey
Head of Finance
Irish Water

