Future of Gas Entry Tariff Regime – Draft Decision (CER/15/057)

Submission to Public Consultation

By: Paul Hunt[1], 8 May 2015

Via Email to Colm Ó Gormáin

Introduction

1. The publication by the CER of its draft decision on the future gas entry tariff regime is welcome. Under Gas Regulation 715/2009/EC the CER is obliged to ensure that an Entry-Exit approach is applied to derive gas transmission tariffs. Subject to the Framework Guideline on harmonised Gas Transmission Tariffs issued by the Agency for the Co-operation of Energy Regulators (ACER) and the Network Code being developed by the European National Transmission System Operators – Gas (ENTSOG), the CER has discretion to choose among various calculation methodologies that are consistent with an Entry-Exit approach. The CER has announced that it is minded to apply the Matrix methodology and, thereby, to rule out other methodologies that are consistent with an Entry-Exit approach. The CER has also advised that it has decided that transmission tariffs will be derived on a forward-looking basis and, as a result, that it is minded to decide on the values of the respective system expansion constants (expressed in Euro/GWh-km) for the onshore and offshore systems. Finally, the CER advises that it is minded to continue the current policy of the postalisation of exit charges.

2. However, the CER has identified six issues (the annuitisation factor used to derive forward-looking tariffs, the possible use of a negative expansion factor to address reverse flows, the capacity/commodity split, the entry/exit split, the tariffs to be applied to the Isle of Man and the proposal not to subject storage operators to entry charges) on

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Beginning with significant involvement in gas market liberalisation in Great Britain – including advising the gas regulator and the then Monopolies and Mergers Commission (subsequently re-configured, via the Competition Commission, as the Competition & Markets Authority) - the geographical scope of his work has expanded and he has considerable international experience throughout Europe, Africa, the Middle East, Russia and East Asia. He has provided advice to the European Commission on its gas market liberalization programme and evaluated gas interconnection and storage projects under the European Energy Programme for Recovery. He has worked for gas market participants throughout the EU in the context of gas market liberalization and is involved in the development of the EU's Gas Target Model being facilitated by the Directorate-General for Energy of the European Commission (DG ENER), the grouping of national energy regulators for the Member States (ERGEG) and the Agency for Co-operation of Energy Regulators (ACER). He has written a paper which sets out a basis for developing the mandated Entry-Exit pricing of gas transmission in the context of the EU Gas Target Model:

http://www.oxfordenergy.org/wpcms/wp-content/uploads/2010/11/NG23-Entry-ExitTransmissionPricingwithNotionalHubsCanItDeliverAPanEuropeanWholesaleMarketInGas-PaulHunt-2008.pdf

which it has not reached 'minded to' decisions. The CER asserts it encourages feedback on issues on which it is minded to decide and on those on which it has not yet reached this position.

3. The decisions which the CER is minded to make are deeply flawed, but there is no effective means of persuading the CER or of ensuring that the CER is compelled to remedy the flaws in these decisions. These flaws have been highlighted on numerous occasions by existing and prospective market participants and by other interested parties, but the CER is statutorily and administratively empowered to reject unilaterally any presentation of these flaws. And this, precisely, is what it does. To an extent, these flaws may be traced back to the approach to economic regulation developed in Great Britain and subsequently adopted and adapted throughout the EU and further afield. Appendix A presents the failings of this approach to economic regulation. However, the flaws in the decisions the CER is minded to make are more serious and damaging due to the perverse manner in which the British model of economic regulation has been applied in Ireland.

The Nature of 'Economic Regulation' in Ireland

4. If all that was required to remedy the failings of economic regulation in Ireland was to remedy the failings of the variant of the British-originated model that has been applied the task would be relatively straight forward. It is much, much more challenging both to remedy these failings and to apply effective economic regulation when the regulated firms are either in majority or total state ownership (or the regulated firms are subsidiaries of firms either in majority or total state ownership). Government ministers appoint the members of the boards of directors of the state-owned companies in their areas of ministerial responsibility that either provide monopoly services or own business units that provide monopoly services – subject to economic regulation by the NRA. The decision-making members of an NRA empowered to regulate a monopoly service provider in a particular sector are appointed by the government minister with responsibility for that sector. And ministers are empowered to issue policy directions to the NRAs regulating monopoly service providers in the sectors for which they are responsible and these policy directions can and do impact on the NRAs' decisions about allowed revenues and prices.

5. Despite being the sole or majority shareholder of these businesses, it is government policy not to invest equity, either directly or indirectly, in these companies. This blatant dereliction of the state's shareholder responsibility on behalf of all citizens, by default, imposes the responsibility on the economic regulatory bodies to set or approve charges and tariffs for the services provided by these companies to compensate for the state's failure to part-finance vitally necessary investment. The tariffs and charges set by the regulatory bodies allow the regulated companies to extract additional revenue from final service users and consumers to part-finance the investment that the state should be part-financing.[2] This is an implicit financing tax and is a more regressive tax (since it falls

[2] It is extremely rare for any government or for a government minister to reveal publicly the commitment to this wrong-headed policy in an official document. But, occasionally, a minister is forced out in to the open. The Commission for Aviation Regulation (CAR), in its review of the cap it imposes on airport passenger charges, indicated in May 2014 that it was minded to disallow the recovery of some proposed investment by the Dublin Airport Authority (DAA) when it would set the cap on these charges towards the end of 2014. Based on its projections – including disallowing the recovery of this investment - the CAR proposed to set a cap that would decline by 5% in real terms over the five-year control period from 2015. This proposed profile of capped charge allowed excessive revenue recovery by the DAA, but the Minister for Transport felt compelled to issue a policy direction to the CAR to allow the investment and to confirm long-standing government policy to avoid any part-financing by the Exchequer of investment by state-owned businesses. Not surprisingly, the CAR has

proportionately more heavily on lower income consumers than on higher ones) than if the part-financing of investment were funded by direct taxation. Precisely the same policy is applied, and an implicit financing tax extracted, in the electricity and gas sectors with the responsible NRA, the Commission for Energy Regulation (CER), being obliged to set network revenues and electricity generation payments far higher than they should be. However, since the CER was established to extract this implicit financing tax there has been no requirement for the ministers responsible for these sectors to issue policy directions to the CER.

6. The imposition of the responsibility to extract this implicit financing tax, ultimately from final consumers and service users, flies in the face of all established principles of economic regulation. NRAs in other jurisdictions seek to set the cost of capital to provide the appropriate incentive to ensure the efficient financing, using a mix of debt and equity, of investment. Many of these regulators regulating private sector firms feel compelled to set a cost of capital that is higher than it should be, because private sector firms generally prefer to minimise the requirement for new equity financing, but all are empowered, even if they rarely exercise these powers, to set revenues that in some circumstances will require new equity financing by the regulated firms. In contrast, **in Ireland, the NRAs never set revenues that require new equity financing by the state.[3] Instead they set revenues that extract an implicit financing tax from final consumers to part-finance the investment that should be part-financed by the state as a responsible shareholder. This is a fundamental failing of Irish economic regulation that goes beyond the failings of regulation in other jurisdictions applying variants of the British model and is a direct result of a combination of state ownership of the regulated firms and a dereliction of the state's shareholder responsibilities**.

The Role and Power of Special Interest Groups

7. In addition, the managements of these state-owned companies comprise formidable and influential special interests groups, as do the staff and unions in these companies. Although they exist in an environment of continuous, but generally managed, conflict, these special interest groups have no compunction (but without being seen to act in concert) about seeking to bend their own boards, governing politicians, senior civil servants and NRAs to their will – at the expense of the vast majority of citizens.[4] In this

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capitulated, has allowed recovery of the investment initially proposed by the DAA and has set a profile of capped charges higher than its proposed profile. This generates a revenue over-recovery of 18% for the DAA which means that, with a projected increase in passenger numbers, the charge per passenger will be 12.5% higher than it should be. This is the regressive financing tax which will be paid by passengers.

3 The CER consistently sets the rate of return on equity not only much higher than it should be but also much, much higher than the Government's cost of funds. However, irrespective of how large this gap is, successive governments have refused to part-finance the often huge programmes of investment being undertaken by these firms. The Government's provision of some equity financing during the establishment of Irish Water is the exception that proves the rule.

4 This involves the playing of a 'game' between the NRAs and the regulated firms– in which their retained consultants also participate. The playing of this game is forcefully denied by all of the participants, but it involves the regulated firms demanding regulated revenues in excess of what they require and would be prepared to settle for. (This game is also played in other jurisdictions.) Sometimes the regulated firms signal in advance the revenues they would be prepared to settle for, but it generally requires some 'behind-the-scenes' negotiations between the regulated firms and the NRAs to identify these revenues. This allows the NRAs to reduce the stream of revenue initially demanded by the regulated firms back to the level they would be prepared to settle for. It also allows the NRAs to blow their trumpets about the 'savings' they have made for final consumers and the regulated firms to highlight the tough settlements the NRAs have imposed on them. It is impossible to

they are supported by other private and public sector participants who often form special interest groups of their own and who profit from providing services to these state-owned entities.[5] In fact, the special interest groups rarely have to flex their muscles to secure what they desire because **governing politicians (from all of the mainstream political parties which have participated in government over the last 25 years) and senior civil servants are perfectly content that the NRAs award excessive revenues[6] to the regulated state-owned businesses since this minimises the requirement for direct or indirect (via dividends forgone) Exchequer financing of these businesses, it permits the expansion of these businesses to satisfy the ambitions of their managements and provides more than ample 'gravy' (i.e., unearned rewards and returns) for the various special interest groups participating in the sector.[7] As a result the interests of all of the parties involved coincide and are protected and advanced by the regulatory process at the expense of the majority of citizens**.

8. But it is not just the interests of the majority of citizens which are damaged by the failure of economic regulation. New or prospective entrants to the regulated sectors whose participation might curtail or reduce the unearned returns and rewards secured by any of the special interest groups in these sectors invariably find that the regulatory process is

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determine objectively whether or not these alleged 'savings' have any substance, but confecting them is a major part of the effort to project the optical illusion of economic regulation.

5 These special interest groups are perfectly entitled to seek to use whatever means are available to protect and advance their interests. It becomes a problem when these activities rely on the perpetuation of inefficiencies and the sustained capture of unearned returns and rewards at the expense of the majority of citizens and there is no effective representation and advocacy of the collective interests of final consumers to contest the activities of these special interest groups.

6 The frequency with which regulatory revenue-setting decisions are contested by regulated firms is generally a good indication of how effective the regulatory body is being in discharging its duties. This happens quite frequently in other jurisdictions, but it rarely, if ever, occurs in Ireland. This is because the 'game' described in the previous footnote almost always generates outcomes that are satisfactory to the regulated firms. However, on the rare occasions when a proposed decision is unacceptable to a regulated firm it will find a way to secure a favourable decision (cf fn 7). The ESB also found a way when it was confronted with a proposed regulatory decision it deemed unacceptable. In 2010, when the CER was setting the allowed electricity network revenues and tariffs for the period 2011-2015, it set the cost of capital (or return on investment) below what the ESB, at the time desperately accumulating funds to close out its acquisition of Northern Ireland Electricity (NIE), wanted. The ESB directed all its available fire on the CER, both publicly and behind the scenes. Not surprisingly, the CER capitulated and awarded the ESB its desired higher cost of capital. Ironically, the ESB, so used to a compliant regulator, tried the same tactics with the Northern Ireland utility regulator when the regulator cut its allowed revenue on the Northern Ireland networks. However, the utility regulator held firm and forced a reference to the UK Competition Commission. The Competition Commission subsequently found largely in favour of the regulator and actually reduced the cost of capital initially proposed by the regulator. The knock-on effect is that other sector regulators in Britain have been forced to reduce their estimates of the cost of capital in line with the decision of the Competition Commission. It is unlikely that shareholders in the regulated businesses affected are best pleased with the ESB.

7 The Government's proposed approach to manipulate the regulatory process to fund the transformation of the water sector differs from the manipulation applied in other sectors. But the intent to protect and advance the interests of favoured special interest groups is identical. In the water sector the Government is prepared to provide subventions to fund the activities of Irish Water, but these are intended to minimise the cost burden that will be imposed on households to fund the excessively costly establishment and operation of Irish Water within Bord Gáis and the equally excessively costly 12-year Service Level Agreement with the Local Authorities.

applied, or is manipulated so that it may be applied, to deter entry or to penalise entry in a discriminatory manner.[8] There is increasing evidence of this abuse of the regulatory process. And this abuse of the regulatory process is generally justified by a disingenuous conflation of a conveniently distorted definition of the public interest and the interests of the special interest groups in the relevant sector. As a result, it is difficult, if not impossible, for new or prospective entrants to secure relief from this abusive application of regulation – even if it is possible to demonstrate that the impact of their entry is unambiguously in the public interest.

The Optical Illusion of Economic Regulation

9. It could be contended that the way economic regulation is being applied in Ireland simply amplifies the fundamental failings of the British-originated model, but the reality is that **economic regulation has never been applied in Ireland in any meaningful sense – nor was there ever any intention to do so. Yes, Ireland has all of the trappings of economic regulation, but there is no substance. It is simply an optical illusion. This failure of economic regulation in Ireland and, indeed, its total lack of substance are not difficult to demonstrate (and have been demonstrated[9]), but all of the parties involved are determined to conceal this failure, to reject any consideration of it and to sustain the optical illusion of economic regulation**. It is, therefore, futile to employ the normal democratic process to seek to remedy this failure of economic regulation. Backbench politicians in all of the mainstream parties appear either to be unaware of these failings of economic regulation or, in so far as they are aware, to be unable or unwilling to raise concerns with governing and front-bench politicians. Most public representatives outside of the mainstream parties appear as eager to distract public attention from the failings of economic regulation as their mainstream counterparts are.[10] The mainstream media appear to lack the resources or

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8 In some instances new entry is tolerated – and even encouraged. These instances tend to arise when the provisions of EU law, or the functioning of competition in specific markets, require a reduction in the market share of incumbent suppliers or providers. But this generally is a managed process where the incumbents are compensated for their loss of market share by being permitted (and provided with the necessary funding) to expand their activities in other areas and there is an understanding that the new entrants will not challenge existing policy and regulatory arrangements. New entrants who might disrupt these cosy policy and regulatory arrangements are simply not tolerated.

9 In the electricity and gas sectors:
http://www.dublineconomics.com/papers/energy.pdf
In the water sector:
http://www.cer.ie/docs/000993/CER14705%282%29%20General%20Public%20Response%20to%20CER14366.pdf

10 The efforts by many of those organising the public protests to distract public attention from the antics of the special interest groups in the semi-states and local authorities have been revealing. The way the totally false allegation that Irish Water was established in the manner in which it was so as to facilitate a rapid future privatisation has been forced in to the public discourse (with demands for a constitutional amendment to forbid a future privatisation) is even more revealing. The antics of the management and staff of Irish Water are little different from those of the managements and staff in other semi-state companies. In fact they are quite restrained by comparison. But when some of the public began to take note of these antics and a degree of public disgust and anger was aroused many of those organising the public protests were fearful that the public spotlight would swivel on to the even more egregious antics of other semi-state companies and, to distract public attention, they started the rumour that the antics of Irish Water were those of a company which was structured and managed to be privatised at the earliest opportunity. The Government was unable to scotch this rumour because, apart from any comparative advantages of locating Irish Water in Bord Gáis (as opposed to in other entities), the principal reason for gifting Irish Water (and approx. €12 billion of Local Authority water system assets) was to secure the acquiescence of the management, staff and unions of Bord Gáis to the sale of its non-network business units –

willingness to investigate and report on these failings – and they may be conflicted commercially. Most academics with knowledge and competence in the area of economic regulation are constrained, compromised or conflicted in some way.

The Shattering of the Illusion

10. However, the public demonstrations rejecting the decision by the CER on the Water Charges Plan published on 30 September 2014, the Government's belated recognition of the depth and breadth of this rejection and its subsequent decision announced on 19 November 2014 to change the structure of charges set by the CER and to ensure the enactment of the necessary enabling legislation all confirm not only the failings of economic regulation but also the now total failure of economic regulation.

11. Not surprisingly, the focus of most politicians and of most media coverage and commentary has been on the political ramifications for the governing parties of the clear public rejection of the Water Charges Plan decided by the CER and on how the Government is dealing with this rejection.[11] None of the politicians involved – in particular those in the governing parties – wishes to address the failure of economic regulation and its implications.[12] But these are very real. **In more than 100 years of the increasing application of economic regulation in the advanced economies it appears to be the first time that citizens have mobilised collectively to express publicly their rejection of a decision by an economic regulatory body which has a statutory duty to protect their interests**.

12. It is, of course, necessary for an economic regulatory body to be statutorily empowered to make its determinations and to ensure they are applied. A recent High Court judgement confirms that the CER is empowered to make almost any decision it chooses

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and it had no wish to draw attention to this 'sweet-heart' deal. Similarly, the privatisation rumour distracted attention from another 'sweet-heart' deal – the 12 year Service Level Agreement with the Local Authorities which is intended to maintain an army of under-employed Local Authority water sector workers at the expense of water service users and taxpayers. Again, the Government had no wish to draw public attention to this deal. Both of these 'deals' bind this and future governments to maintain Irish Water in public ownership, but the Government was unable or unwilling to highlight this constraint. And as a result, the rumour gained unwarranted substance. It also gained substance for another reason discussed in para. 15 below.

[11] This rejection must have been particularly galling for the Government given the huge effort it has put in to minimise the inevitable political repercussions of the establishment of a charge-funded model for the water and waste water sector in compliance with one of the conditions of the EU-IMF Support Programme. Despite pandering to the powerful special interest groups with which it was dealing in the semi-state, local authority sectors and in the private sector in the transformation of the water sector – at enormous cost to final service users (both household and commercial) – the Government had made every effort, using taxpayers' funds, to minimise household charges and to use the fiscal space the establishment of Irish Water created (even if some of this space is illusionary) to fund tax cuts that would more than compensate for the imposition of water charges for a large number of higher-income households. Although the full costs of pandering to these special interest groups do not appear to be fully understood by citizens, there was sufficient evidence of this costly pandering to contribute to a widespread popular rejection of the Water Charges Plan decided by the CER.

[12] This, too, is perhaps not unsurprising. Although there is little supporting evidence, it is highly likely that most citizens view the various economic regulatory bodies as nothing other than policy-implementing bodies. It is doubtful that the relentless assertions by successive governments about the independence of these bodies have had much of an impact on a public that is becoming increasingly cynical about, and disgusted by, 'government spin'..

irrespective of the objective qualitative merits of that decision.[13] But this statutory empowerment is not sufficient. Given the statutory duty of economic regulatory bodies to protect the interests of final consumers and service users, securing the consent of these consumers and service users to abide by the determinations of the economic regulatory bodies is crucial. Once this consent is withdrawn and citizens reject a decision by an economic regulatory body then that body no longer has public or democratic legitimacy. **The CER may continue to convey the impression that it is functioning as an economic regulator – and the Government and all of the parties involved may strive to support it conveying this impression, but it has lost the public consent that ultimately legitimises its functioning. The positions of the Commissioners of the CER are untenable**.

13. The Government, however, is correct when it asserts that it has not overturned the regulatory process.[14] It would be logically impossible to overturn a process that has lost the vitally necessary public consent to function. Economic regulation of the water sector has failed and the Government has been compelled to make decisions – and to ensure the enactment of enabling legislation - to compensate for this failure. The CER stands revealed as a Government policy implementation agency and not as an independent economic regulatory body obliged to take account of Government policy. The CER was established as a policy-implementation body and many of these policies involved the protection and advancement of the various special interest groups in the electricity, gas and now the water sectors at the expense of the majority of ordinary citizens. Successive governments were able to project the optical illusion of the CER as an independent economic regulatory body that was required simply to take account of Government policy. **That illusion has now been shattered and the failure of the CER to function as an independent economic regulator has been revealed at last. What is worse for the Government is that the CER has also failed as a policy-implementation body**.

Continuing to Project the Optical Illusion

14. The Government, of course, should never have put the CER in the firing line, as it were, in this manner. The Government, arrogantly and complacently, assumed that the CER would be able to secure public acceptance of household water charges (and to distance it from the political ramifications) in the same manner that it secures a largely uninformed public acceptance of the excessive revenue it allows the regulated firms to extract ultimately from final electricity and gas consumers so as to fund the desires, ambitions and antics of the special interest groups in these sectors. The Government recognises the damage that has been done to the CER and to the practice of economic regulation across all sectors – and which it caused to be inflicted. It will seek to pretend that the illusion of economic regulation has not been shattered and it will receive the support and connivance of all of the special interest groups benefitting from the projection of this illusion. And, in most instances, it is likely to be successful in its efforts.

15. This is due to the well documented fact that elected governments in Ireland exercise excessive executive dominance over the three houses of the Oireachtas (or Parliament)

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[13] *Shannon LNG Ltd & anor v Commission for Energy Regulation & ors*, [2013] IEHC 568. Despite the comprehensive rejection of the case made in legal and qualitative terms by the applicant, this judgement includes a significant caveat that a final judgement on the merits of the applicant's case cannot be made until an assessment has been conducted of the quantitative impact on the applicant of whatever decision is finally made by the CER.

[14] Question No. 88 in Frequently Asked Questions (FAQ) document issued by the Government on 19 November 2014 and published on the CER's web-site: http://www.cer.ie/document-detail/Water-Charges-Plan/1004

directly or indirectly elected by citizens – the Dáil, the Seanad and the Presidency.[15] Between general elections, when citizens exercise their ultimate authority to decide by whom and how they are governed, very little effective scrutiny, restraint or accountability is imposed on elected governments or on the highly centralised and expansive state apparatus.[16] Some restraint may be exercised from time to time by backbench members of the party or parties in government during (closed) parliamentary party meetings, and this frequently compels governments to modify (or even abandon) the implementation of policies that could provoke widespread public opposition, but it is extremely rare that ordinary citizens feel compelled to assert their ultimate authority over government and to demonstrate publicly their rejection of the implementation of a specific policy. That is why the public demonstration of the rejection of the Water Charges Plan decided by the CER is so significant.

16. However, **having made changes to the structure of charges to compensate for the failure of economic regulation and having allocated more taxpayers' funds to reduce effective charges (and made some other changes), the Government is now hoping that it has done enough to reduce public opposition to water charges to manageable proportions – and that the failure of economic regulation can be brushed under the carpet, as it were**.

17. The irony is that, by being compelled to make these changes, the Government has ended up making a bad situation even worse. It has been forced to intervene to compensate for the failure of economic regulation and by doing so has imposed a structure of water charges that provides no incentive to households to use water efficiently. Indeed, the Water Conservation Grant of €100 that will be paid to all households (including those not supplied by the public water system) and funded by all taxpayers provides a disincentive to use water efficiently. It has also been forced to cap household water charges at the current level for five years and, with the revenue requirement of Irish Water almost certain to increase after 2016, this will require the allocation of more taxpayers' funds. The costly installation of water meters for all households will contribute little in the medium term beyond recording consumption and, in some instances, assisting the identification of leakage from the system, but the costs of installing and maintaining these meters will have to be recovered from service users and taxpayers. The excessively costly establishment and operation of Irish Water and the equally costly 12-year Service Level Agreement with the Local Authorities will continue to require funding. There is a serious risk that a sustained non-payment campaign by some households will undermine the funding model. And the possibility remains that the revised funding model will not pass Eurostat's 'Market Corporation Test',[17] so the fiscal gymnastics based on the assumption that government subventions to Irish Water would not be treated as general government expenditure may be

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15 Hardiman, N, 'Institutional Design and Irish Political Reform', Journal of the Statistical and Social Inquiry Society of Ireland, Vol. XXXIX.

16 More and more voters are expressing their discontent at the excessive dominance governments exercise over the Oireachtas. The Government's declaration that Irish Water will not be privatised was simply not believed by many voters. The way the Government forced the legislation enabling the restructuring of the water sector and the establishment of Irish Water through the Oireachtas without adequate scrutiny annoyed many voters and their suspicion that this or a future government could force legislation enabling the privatisation of Irish Water through the Oireachtas in a similar manner is reasonably based.

17 Even if Irish Water passes this test, it appears that providers of debt finance may still view it as being within the general government sector. The reported upgrading of the credit rating for Ervia, Irish Water's parent, suggests that this upgrade is based on the increased ability of the state to fund the liabilities of Irish Water in the event of it encountering financial distress: http://www.independent.ie/business/irish/taxpayer-would-have-to-bail-out-irish-water-30832714.html

prejudiced. **It would be difficult to devise a more economically inefficient system of water charging and of funding the water and waste water sector and a less cost-effective means of ameliorating the inevitably regressive impact of water charges. However, while it remains in office and retains its Dáil majority, the Government will seek to ignore this reality and to continue to project the optical illusion of a functioning process of economic regulation**.

Remedying the Failure of Economic Regulation

18. Before any consideration may be given to remedying the total failure of economic regulation in the non-financial sectors there will have to be a public acceptance by most, if not all, of the parties involved that economic regulation is simply an optical illusion and that what passes for economic regulation is simply a process that favours and benefits powerful and influential special interest groups at the expense of the vast majority of citizens. But no one should be in any doubt that none of the special interest groups, profiting so handsomely from the current arrangements, will ever willingly accept this. What is equally clear is that very few, if any, of the existing elected, or prospective, public representatives appear to have any understanding of the extent of the failure of economic regulation and of the excessive and unnecessary cost burdens this failure is imposing on the vast majority of ordinary citizens and on the domestic economy. Indeed, most appear to have their own favourites among this broad array of special interest groups and the special interest groups can rely on these politicians not advancing changes that might damage their interests. It therefore appears that it will fall to ordinary citizens to inform themselves about the excessive and unnecessary cost burdens these arrangements are imposing on them and to exert pressure to secure the necessary changes. But the difficulty of organising effective collective action by ordinary citizens is well documented.[18] It may be that some politicians will emerge who will see the potential to benefit electorally by enforcing the necessary changes in the policy and regulatory framework to reduce the unnecessary and excessive cost burdens these special interest groups impose on ordinary citizens. But this appears to be a forlorn hope.

The Role of the Judiciary and the Use of Judicial Reviews

19. There is, however, one location of power and authority that the Government will find difficult to compel to validate its projection of the optical illusion of a functioning system of economic regulation. And that is the judicial system. As we have seen, there is no effective separation of the powers of the executive and legislature in Ireland, so the only effective separation of powers is between the judiciary and the executive (with the legislature, in almost all instances, being totally dominated by the executive). And the judiciary jealously guards its exercise of this separate power and authority – though it must make its judgements taking account of the 'temper of the times'.

20. The CER published (on 5 March 2015) a revised water charges plan and associated decision. As expected, the Government and the CER appear determined to continue

[18] Mancur Olson, Jr., 1965, 2nd ed., 1971. *The Logic of Collective Action: Public Goods and the Theory of Groups*, Harvard University Press.
The public protests against the water charging regime decided by the CER (but at the behest of the Government), which stripped the CER of any remaining shred of credibility and public legitimacy and which forced the Government to change its approach and to compensate for this failure of regulation, were spectacular because it is so rare for ordinary citizens to feel compelled to act collectively to assert outside of the polling booths their ultimate authority over government. Apart from those who are irreconcilably opposed to water charges, it appears that most of the citizens who protested and those who supported the protests are prepared to bide their time patiently until they next get an opportunity to cast their judgement on this Government in the polling booths. Therefore, it is unlikely that there will be further collective action of this nature by ordinary citizens prior to the next general election.

projecting the optical illusion of economic regulation. In theory, it is open to citizens, either individually or collectively, to apply for a judicial review of the CER's revised decision on the basis that the CER has lost its public legitimacy to make decisions of this nature and that it makes decisions of this nature in a manner that favours special interest groups to the detriment of the public interest. However, it should be clear to every citizen that such a course of action would be totally futile since Ireland is not governed by the rule *of* law, but by rule *by* law – with the key provisions of many of the laws enacted being directed and influenced by powerful and influential special interest groups. Of course, the option of applying for judicial reviews remains open to new, or prospective, entrants to regulated sectors who are victims of the abusive application of regulation intended to deter entry or to penalise entry in a discriminatory manner. The demonstrable failure of economic regulation and the evidence of the extent to which regulatory decisions favour special interest groups should strengthen any applications of this nature. But the treatment of such applications demonstrates that pursuing such a course of action is both futile and costly.

Conclusion

21. The British model of economic regulation in the non-financial utility and infrastructure sectors which has been adopted and adapted in Ireland and throughout the EU has significant failings that impose excessive and unnecessary costs of final consumers and service users. These failings require remedy and the remedies require limited changes to institutional and procedural arrangements, but the failure of economic regulation in Ireland, particularly in those sectors where the principal regulated firms are state-owned, is more profound. This failure is so profound that economic regulation is little more than an optical illusion applied in a politically convenient manner to benefit favoured special interest groups at the expense of the vast majority of citizens – or, in this instance, at the expense of new or prospective gas market entrants. This failure has been highlighted by the collective mobilisation of ordinary citizens to protest against the Government's approach to the transformation and funding of the water sector and to express their rejection of the Water Charges Plan decided by the responsible economic regulatory body, the CER. As a result, the CER has lost any shred of credibility and public legitimacy it retained and the positions of the Commissioners of the CER are untenable.

22. The Government and all of the special interest groups involved appear determined to ignore this evidence of the total failure of economic regulation and to continue to project the optical illusion of economic regulation. The only possible means of compelling action by the Government to deal with this failure of economic regulation are further collective action by citizens, judicial reviews of decisions made by the CER (and other regulators) that lead to their quashing and external pressure – potentially from the EU's institutions. The probabilities of the use of any of these means leading to the necessary remedy of the system of economic regulation are vanishingly small. The failures of democratic and corporate governance and of economic regulation in the financial sector that contributed so much to the inflation and bursting of the triple fiscal, property and banking bubbles in 2008 have not been fully remedied and continue to be replicated in various ways in the non-financial sectors subject to the Irish version of economic regulation.

Appendix A: The British Model of Economic Regulation

The Adoption and Adaptation of the British Model of Economic Regulation in Ireland and throughout the EU

23. The approach to establishing and applying economic regulation in Ireland was adopted and adapted from the approach introduced and applied in Britain in the 1980s. During that decade and subsequently successive UK Governments pursued a programme of privatising vertically integrated public corporations or publicly-owned entities providing utility and infrastructure services. Examples include British Telecom, British Gas, the electricity supply industry, the water and waste water services sector and civilian airports. Although the restructuring that accompanied the privatisation process in some sectors provided the means of introducing competition in wholesale and retail supply, the monopoly characteristics of the networks and essential facilities remained intact. As a result, with the transfer of these monopoly activities from the public to the private sector, the programme of privatisation was accompanied by the establishment of economic regulatory bodies such as the Office of Communications (Ofcom), the Office of Gas Supplies (Ofgas), the Office for Electricity Regulation (Offer) – with the last two subsequently being combined in the Office for Gas and Electricity Markets (Ofgem), the Office for Water Supplies (Ofwat) and the Civil Aviation Authority (CAA).[19] These regulatory bodies have a primary responsibility to exercise control over the prices charged by firms enjoying monopoly rights (which may be *de facto* or *de jure*) to provide essential services to ensure that the firms do not exploit their monopoly rights to the detriment of the public interest. And while they are required to take account of public policy, the regulatory bodies are empowered to determine and apply these price controls (for a defined period of time) independently of government.[20]

24. During the long drawn-out process seeking to complete the internal EU market in electricity and gas (which began following the enactment of the Single European Act in 1987) successive European Commissions gradually adopted and adapted the British model of economic regulation and competition in the electricity and gas sectors. The first Electricity Directive (1996) and the first Gas Directive (1998) permitted both regulated and negotiated third party access (TPA) to electricity lines and gas pipelines. It was not until the enactment of the second electricity and gas directives in 2003 that the establishment of National Regulatory Authorities (NRAs) was mandated. The EU's institutions have adopted and adapted the British model in a similar manner in other sectors and, as a result, variations of this model have become the norm throughput the EU.

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[19] The approach applied is described variously as 'Price Control Regulation', the 'RPI-X Model' or 'Incentive Regulation' to highlight its key features and to distinguish it from the 'Cost of Service' or 'Rate of Return' regulation typically applied in the US and Canada. As is usual with all regulatory approaches that begin with simple definitions and a straight forward application, the current approach is far more complex and time and resource-consuming. It is difficult to suppress laughter as one tries to grapple with the latest approach applied by Ofgem to the electricity and gas networks – the 'Regulation = Innovations + Incentives + Outputs' (RIIO) Model – and one begins to see how nonsensical and ridiculous it is. But the mirth is tempered by the realisation that final consumers are paying more than should as a result of the application of this model.

[20] In those sectors where competition in supply is possible the relevant regulatory bodies have responsibility for the design and functioning of markets and market mechanisms (with this responsibility often being discharged concurrently with the relevant competition bodies). Over time, additional duties and responsibilities have been imposed on most of these regulatory bodies via legislation to implement various elements of public policy. This is particularly the case in the energy sector where economic regulatory bodies have become increasingly involved in the implementation of climate change policies. However, the focus in this note is on the economic regulation of firms enjoying monopoly rights to provide essential services.

25. Successive Irish governments were early adopters and adapters of this model. Historically grounded similarities in the institutions and procedures of governance facilitated the adoption and adaptation of the model. For these governments, it also had two attractive features. First, given the extent to which the EU's institutions, apparently, were adopting and adapting this model, it made sense to be an early adopter and, secondly, the establishment of economic regulatory bodies, ostensibly independent of government, would allow governing politicians to distance themselves from the repercussions of potentially politically unpalatable pricing decisions made by these regulatory bodies, but which favoured special interest groups to which they wished to pander. The result is the imposition of excessive and unnecessary costs on final consumers and service users. This is evidence of the failure of economic regulation as it is practised in Ireland, but part of this failure is the result of the contravention of some abiding principles of economic regulation. And these contraventions are common across all jurisdictions that have adopted and adapted the British model of economic regulation.

Abiding Principles of Economic Regulation

26. In its 'Hope Decision'[21] of 1944, the US Supreme Court established some abiding principles of economic regulation. It established, firstly, that the setting of regulated tariffs or prices "involves a balancing of the investor and the consumer interests";[22] secondly, that "the investor interest has a legitimate concern with the financial integrity of the company whose rates [i.e. tariffs or prices] are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock"; and, thirdly, that "the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital".

The Failings of the British Model

27. In the light of this, all NRAs (across all sectors) employing the British-originated model of economic regulation fail on the first principle. No regulator can simultaneously provide an assurance of investment recovery, properly advocate and protect the collective interests of final consumers and then strike a balance between the interests of investors and consumers. In the regulatory proceedings to determine their allowed revenues, the regulated firms have every incentive to seek to maximise their return on investment, to ensure the recovery of investment and to game any strategies developed and applied by the regulatory body to increase efficiency in investment and operations. The regulatory body, ostensibly seeking to protect the interests of final consumers, is, in effect, in a 'negotiation' with the regulated firm while suffering from an enormous asymmetry in information. The regulated firms simply know more about their businesses than any regulatory body ever could. The possibility exists, over time, of the regulatory bodies acquiring more knowledge and technical understanding of these businesses, but this rarely happens given the dynamic context in which these firms and their regulators operate. The possibility also exists that the participation of other interested firms in the regulatory process would impose some scrutiny and restraint on the demands of the regulated firms. For example, in those sectors where competition in supply is possible and retail suppliers participate in the market competing to provide services to final

[21] Federal Power Commission et al v. Hope Natural Gas Company, 320 U.S. 591 (64 S.Ct. 281, 88 L.Ed. 333)

[22] In the US and Canada this balance is achieved via adversarial hearings between the regulated firms and a statutory representative of the consumer interest. A typical example is provided by the role of the Utilities Consumers Advocate of Alberta, Canada: http://www.ucahelps.alberta.ca/regulatory-services.aspx

consumers (examples are the supply of electricity or gas) it would be reasonable to expect that these retail suppliers purchasing network services from the regulated monopoly providers would have an interest in contesting the revenues demanded by these monopoly providers in regulatory proceedings. But, in most instances, the suppliers have little interest in contesting the revenue demanded (and the associated level of prices or tariffs). They simply pass the costs of the network services through to final consumers. Their principal concern is that the structure of prices or tariffs does not discriminate against them relative to other competing suppliers.[23] It is a profound failing of the British-originated model of economic regulation that there is no effective statutory and adequately resourced representation and advocacy of the collective interests of final consumers in regulatory or competition authority proceedings.[24]

28. Most NRAs also fail on the second principle. Regulators, in theory, aim to award regulated firms enough, but just enough, revenue to invest and operate efficiently. But how much is enough? The ability of regulated firms to game any strategies developed and applied by the regulatory body to increase efficiency in investment and operations has been noted above. Indeed, the more complex the strategies employed by the regulatory bodies to incentivise increased efficiency in investment and operations the more the regulated firms claim their revenue is at risk – and this has the unintended consequence of demands for higher risk-related rates of return on investment. And the increasing complexity of the strategies employed increases the extent and cost of regulatory oversight and involves the regulatory body unnecessarily and not usefully in the inevitable conflicts among owners, managers and staff (and their trades unions).[25] The almost inevitable result is the emergence of a tacit united front on the part of these interest groups in the regulated firms to beat back (or game) the intrusions of the regulator. The frequent success of this approach is to the detriment of the interests of final consumers.

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[23] In addition, though they might be operationally separate, some of the retail suppliers may be affiliated to, or held in common ownership with, other monopoly service providers in the same or another jurisdiction. It would not be in the interests of the common owner if its retail supply business were to advocate a reduction in the allowed revenues of a non-associated monopoly service provider because these arguments could be used against its own business unit providing monopoly services.

[24] Most regulatory bodies initiate a 'public consultation' when they publish their proposed decision on the regulated revenue stream they are minded to award. However, invariably, any submissions to this process which contest the basis for this award, irrespective of how well-founded they might be on facts, evidence and analysis, are simply rejected or ignored. This process makes a total mockery of the oft-expressed, solemn declarations of regulatory bodies of their desire to engage effectively with the public who ultimately fund the activities of the regulated firms. Occasionally, the regulatory body may be encouraged to make some minor changes to its proposed decision, but these are rarely substantive. And if they are substantive, they tend to be provoked by the regulated firms. The recent public consultation of the proposed Water Charges Plan in Ireland provides an illuminating example. The regulatory body received numerous submissions from the public rejecting its plan; indeed, it appears that it received no submission from the public supporting its plan. However, the regulatory body simply rejected this evidence of public rejection, made some minor modifications which failed to address the substance of the public rejection expressed and then made a final decision which left the substance of its proposed decision intact. The public reaction to this cavalier behaviour by the regulatory body was powerfully and widely expressed and proved politically effective.

[25] Much of the complexity of regulatory strategies intended to incentivise efficiency in investment and operations is the outcome of the application of well-intentioned analytic work by the newly garlanded Nobel Laureate Jean Tirole and his academic collaborators. The evidence is mounting that final consumers who ultimately fund the antics and ambitions of regulated firms are not benefitting.

29. And most NRAs also fail on the third principle. They claim to award returns to the equity owners that are commensurate with returns on investments in other enterprises having corresponding risks, but actually award higher returns. There are numerous reasons for this. Some are more plausible and understandable than others. But the principal reason is a flawed application of the Capital Asset Pricing Model (CAPM) and of the principal proposition of the Modigliani-Miller Theorem. Exploring these flawed applications is beyond the scope of this submission, but the result is to generate revenues and prices and tariffs for monopoly services that are far higher than they should be.[26]

Remedying the Failings of the British Model

30. It is possible to remedy the common failings of the variants of the British-originated model of economic regulation which are applied throughout the EU. It would require limited changes to the existing institutions and procedures of regulation with the principal ones being the statutory representation of the collective interests of final consumers and service users in regulatory and competition body proceedings and policy and regulatory arrangements governing the amount of and auctions for service providing capacity.

[26] This outcome should not be surprising. Much of the theory and practice of corporate finance and financial economics is developed and presented for the benefit of practitioners and those who employ or retain them. It is they, as managers and owners of firms and as investors, who, in the main, fund business schools and university departments conducting this research and providing these courses. And it is they who employ the graduates of these business schools and university departments – or who second and fund staff to attend these courses. He who pays the piper calls the tune.