Irish Water

Response to CER/15/096, CER Discussion Paper on Irish Water's Interim Revenue Control 2 (2017-2018)

6 July 2015

Introduction

Irish Water (IW) welcomes this opportunity to respond to the Commission for Energy Regulation's (CER) discussion paper on the next interim revenue control for Irish Water (IRC2). With the transition from the initial revenue control, which runs from 1 October 2014 to 31 December 2016, into the next control period on 1 January 2017, it is important to confirm the adopted approach on a number of key aspects.

As outlined in our response to the CER consultation paper (CER/13/246) – 'Economic Regulatory Framework for the public Irish Water services sector', IW is fully supportive of the economic framework put in place by the CER. This framework has worked well in the Irish energy sector to date and has led to:

- A very strong focus on customer service and significant improvements in service quality;
- The delivery of operational and efficiency improvements to the Irish energy sector, such that it is now in line with some of the most modern and efficient systems in Europe;
- Delivery of investment in the renewal of, and extension to, critical Irish energy infrastructure, as a platform for stable economic growth to the country; and
- The structure and certainty to allow Irish utility companies to have access to substantial levels of external debt financing at the lowest cost.

IW believes that the IW customer will similarly benefit from the extension of a regulatory framework, that is stable, predictable, transparent, and that the results in the energy sector, outlined above, can be mirrored in the water services sector. By confirming a number of key aspects for IRC2 the CER is promoting such stability, predictability and transparency. The remainder of this response details our views on the key aspects raised in CER/15/106.

Duration of the Revenue Control

IW agrees with the proposed duration of two years for the next revenue control period. We acknowledge that the length of the control should be determined by the extent that costs are predictable. Without complete asset information at this point it is challenging for IW to accurately predict our costs. We welcome the CER's understanding of this difficulty. IW since its establishment has been collecting more robust data on the water services network. This will facilitate future revenue controls that can be longer and more robust.

However, it is important to point out that a shorter revenue control period of two years reduces the flexibility of IW to move along an efficiency glidepath in a consistent manner. We suggest that this is recognised by the CER in the forthcoming review and that reasonable efficiency challenges are set.

Suitability of the Capital Asset Pricing Model (CAPM)

We support the use of CAPM in deriving the cost of equity for the purposes of setting the allowed Weighted Average Cost of Capital (WACC). IW recognises that CAPM is not perfect, but is a model understood well by investors worldwide. Its continued use will add to the stability of the regulatory framework.

At this stage in its formation, it is difficult to compare IW to other Irish utilities. This is especially the case when considering WACC parameters, such as the cost of debt and the asset beta. IW is a new national utility, with a regulatory framework still in its infancy. It also has a very significant capital investment programme, which is needed to ensure compliance with EU Directives, as well as address the legacy of many years of under-investment in water services assets. As a fledgling utility, IW will need market confidence in order to access 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.

The factors used to determine the WACC of other utilities such as ESB Network's (ESBN) reflects the fact that they are long-established mature companies with a well-established regulatory framework. ESBN has modern infrastructure that has seen significant investment in recent years, based on a Capex programme that was moderate relative to the organisation's Regulatory Asset Base (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 believes that the CER must take these differences into account in the upcoming IRC2 review.

Revenue Cap and the CPI-X model

IW agrees with the use of a revenue cap and the CPI-X regulatory model with a rolling retention element. This regulatory regime provides strong incentives for the company to perform efficiently. It is recognised that this approach has worked well in other regulated utilities, with the inclusion of the 'X' factor and retention mechanism successfully resulting in benefits for the end customer in both the electricity and gas sectors.

IW is committed to achieving the efficiency cost reduction targets set by the CER, whilst also improving the service provided to our customers. IW would caution against the setting of efficiency challenges that are unrealistic which ultimately may detrimentally affect customer service levels.

Asset Value and Depreciation Methodology

IW supports the continued use of indexed historic cost as a proxy for replacement cost when valuing assets being added to the IW RAB. We also support these assets being depreciated on a straight line basis and that average lifetimes, based on appropriate international benchmarks, are used to calculate asset lives.

IW submitted, as part of the first interim review, its Capital Investment Plan (CIP) for the 3 year calendar period, 1 January 2014 to 31 December 2016. The CIP detailed programmes of expenditure determined largely by their primary investment driver, such as Major Capital - Drinking Water Quality, Major Capital - Waste Water Compliance or Health & Safety. The CIP was not broken down into particular asset classes on which specific asset lives could have been applied. This was because the CIP represented the transition between the capital programmes previously overseen and largely funded by the DECLG, and the investment plans reviewed by the CER under the Water Service Act No.2 2013.

As a result the CER allocated IW's allowed capex for the first interim period (€1.383bn) based on the latest available data on capital programmes for Northern Ireland Water and Scottish Water. For example, 5% of the €1.383bn was allocated to a 'Very Short' asset life of 5 years, 7% was allocated to a 'Short' asset life of 10 years etc. This does not actually reflect the asset class breakdown of the 2014-2016 CIP. IW is currently developing its Investment Plan for submission to the CER as part of the IRC2 review, which will contain a more structured asset class breakdown. We ask that the allocation methodology is examined again as part of the IRC2 review.

Inflation

IW agrees with the proposal to use the Irish Harmonised Index of Consumer Prices (HICP) to index values where appropriate for IRC2. We agree with the CER that a consumer focused inflation index is appropriate and recognise the likelihood that the HICP will exhibit less volatility. From the perspective of both the end customer and the utility stable revenues are important.

There is an inherent risk when using a consumer focused inflation index that input costs could rise more than the rate of inflation. We suggest that in this scenario the regulatory model would allow that these costs be treated as pass through, a supplementary real cost of inflation is allowed for specific items or IW ultimately having the option to apply for a re-opener to the revenue control decision.

Incentives

IW supports the implementation of effectively focused incentives.

Rolling Retention of efficiency savings
The proposal by the CER to utilise a rolling retention mechanism is welcomed by IW. We recognise that this is appropriate to incentivise the utility to outperform against the efficiency challenges set by the regulator, and welcome the chance to improve service delivery to our customers. We agree that the use of the rolling retention incentive can, in the medium term, produce a benefit to the end customer in the form of improved service delivery at less cost.

Performance-based incentives
IW agrees that performance based incentives are an important component of economic regulation. The CER have placed incentives of this nature on energy companies to date and we support the intention to apply a similar approach to IW, while recognising that IW is a new utility and in a sector which has suffered from decades of under-investment. IW believes that a stable baseline of data is required to appropriately apply incentives. Incentives are only successful in the instance where the utility has the ability to exert control over the outcome. Incentivising performance in an area that is outside the control of the company is of no benefit to the customer, or the utility.

Conclusion

IW welcomes the commitment made by the CER in CER/15/106 to continue with a regulatory framework that provides stability and predictability for the water service sector. This is a pre-requisite for IW to be able to invest efficiently in the system, improve customer service and quality standards. We ask that the CER consider the points made in this response. We look forward to working with the CER, and other stakeholders, during the IRC2 review for the benefit of the customer.