Water Division
Commission for Energy Regulation
The Exchange
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By email: irc2@cer.ie

14th November 2016

Consultation on Irish Water Second Revenue Control (IRC2) 2017-18.

Dear Sir / Madam,

Ibec, the group that represents Irish business, wishes to offer the following comments on the CER's analysis and proposals. They should be read in conjunction with our submission on the discussion paper that was published last year.

1. Review of IRC1 Out-turn

Ibec acknowledges the considerable effort made by CER to understand and evaluate Irish Water's service delivery against agreed objectives and its actual expenditure versus approved cost items. It is encouraging to note that the utility has overall achieved the 7% annual efficiency savings that were sought by CER, albeit in a slightly different way from that originally envisaged at the outset of IRC1. In particular, Irish Water found it necessary to increase expenditure on major water and wastewater infrastructure projects, while deferring capital maintenance in order to remain within the overall spending envelope.

We note that Irish Water views insurance costs as effectively uncontrollable, but that the CER takes a different view. This is a rather complex issue. The Central Bank, as insurance regulator, is primarily concerned with solvency rather than cost competitiveness. Its recent thematic report signalled a need for insurers' premiums to increase on employer and public liability lines. Irish Water might be able to mitigate such increases by carrying a greater portion of the risk, but there is no guarantee of bucking the market.

There is a lot more for Irish Water to do in respect of becoming a fully efficient utility. In the long term, the biggest opportunity for cost savings appears to be in the area of operating cost per customer connection, which NERA found to be roughly twice as high as a typical mature water utility in Britain. Unfortunately, Irish Water's scope to reduce such costs may be hindered because of its long-term contractual obligations under Service Level Agreements. These enduring cost inefficiencies have effectively been imposed on Irish Water by its parent Department. In this regard, we would appreciate greater clarity on why the CER's first SLA review (which commenced last year) has been deferred.

2. CER proposal for IRC2

The CER proposes to continue with revenue cap regulation, including a risk-adjusted rate of return on capital determined in accordance with the Capital Asset Pricing Model. This seems reasonable, given that a similar regime is in place for gas and electricity network utilities where CER also acts as economic regulator. Although the proposed 5.2% weighted average cost of capital is far lower than what a private sector firm operating in a competitive market would require, it is broadly in line with what CER's other regulated monopoly utilities are allowed. In theory it would allow Irish Water to achieve an investment grade credit rating independently of its parent company Ervia. In practice, though, this seems unlikely while the company remains heavily reliant on state subvention, with attendant political risks.

The CER correctly acknowledges that Irish Water is best placed to identify areas with scope for cost improvement within its own operations, and that savings targets imposed by CER should be broad brush rather than specific to individual line items. It should be noted though that the company itself is still in a learning phase. The IRC1 out-turn clearly shows how changing circumstances may impact on project priorities. The remediation of Lead contamination from domestic pipes and the need to facilitate new housing developments are cases in point. Fortunately, the regulatory regime for IRC1 is sufficiently flexible to allow ex post adjustments. Such flexibility should certainly be retained in IRC2, subject to suitable safeguards. Rebalancing decisions must be based on sound analysis and should remain consistent with the company's rolling five year Capital Investment Plan (CIP).

We note the CER assessment that Irish Water will need to invest in systems and procedures to improve its service delivery capabilities, to meet higher environmental quality standards, and to meet increased customer demand. The proposal to allow some, but not all, of these additional costs in IRC2 could potentially result in a diminution of customer service. It remains to be seen whether that risk can be mitigated by the CER proposal for a somewhat slower 'glide path' towards operational efficiency during IRC2 than was the case in IRC1. We would therefore welcome greater detail on the CER's assessment of the trade-offs.

Design Build Operate contracts represent a significant portion of Irish Water's cost base, but these are excluded from the scope of the proposed 5% annual efficiency challenge. This approach seems reasonable, provided that the DBO contracts are verifiably delivering good value for money compared to what the relevant services would have cost the local authority or Irish Water to deliver in-house.

Irish Water's proposed CIP envisages a steady ramping up of expenditure over the period to 2021, with an eventual shift in emphasis from major projects to routine capital maintenance. The Forum does not have the resources or technical expertise to comment on this profile. However, we note with some concern Irish Water's recent €1.1 billion upward revision of the capital investment required by 2021. We agree with the CER's assessment that there is little if any scope for efficient deferral of key projects, and that any efficiency savings achieved on projects during IRC2 should be ring-fenced to fund additional investment.

1.3 Longer term issues

The consultation document includes a brief reference to the Expert Commission's imminent recommendations on a funding model for domestic water/wastewater services. It seems to imply that this model will help to inform Irish Water's revenue submission for IRC3. Is this interpretation correct? We had previously been led to understand that the approved opex and capex requirements will be determined by reference to customer demand and the need for environmental compliance, independently of the mix of funding sources.

The CER makes provision for Irish Water to progress several very large projects during IRC2, even though they are not yet approved. The Water Supply project for Midlands and Eastern region is the most topical example, whereby a pipeline route will shortly be selected in order to meet the region's growing water needs over the next few decades. We note that a degree of Community Gain may be deemed necessary to overcome potential resistance from the public, which would be in addition to CPO costs. Given that the disruption will be temporary, and that the end result is not visually intrusive, we would expect Irish Water's contribution to be in line with previously published guidelines.

Ibec notes that DBO projects were a key feature of the Water Services Investment Programme, which pre-dates the establishment of Irish Water. The infrastructure investment programme should be reviewed to include identification of suitable projects, including the feasibility of Irish Water securing access to external finance through the PPP mechanism. Doing so would not in any way compromise the agreed principle that Irish Water should remain a publicly owned utility.

Ibec's Environment Policy Committee members would welcome further discussions with CER and Irish Water on these issues over the coming months.

Yours sincerely

Neil Walker
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