Economic regulatory framework for the Irish water services sector (CER 13/246)

Response to CER's Consultation Document

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Background and Context

The Water Services Act 2013 established Irish Water (IW) as a subsidiary of Bord Gáis Éireann with the intent that IW, over time, would take over and rationalise the water and waste water services currently provided by 34 local authorities. The apparent rationale was that, since Bord Gáis already has a subsidiary, Bord Gáis Networks (BGN), which operates the public gas distribution and distribution networks, Bord Gáis had a comparative advantage over other possible candidates in the operation, maintenance and development of pipeline networks. From the Government's perspective, choosing this option also had the advantage of keeping the public water and waste water services in public ownership.

Apart from the much-touted, but often difficult-to-capture in practice, efficiencies that a single operator of the water and waste water might generate, its policy decision – and the enabling legislation which it was able to get through the Oireachtas with very limited scrutiny – generates further benefits. These are rarely considered, but they are probably the most important from the Government's perspective.

Shirking its responsibility to finance investment

The first, under-publicised and under-considered benefit is generated by a significant change in how investment in public water and waste water services will be financed. Currently, the bulk of investment is financed directly from central public funds. The Water Services Act legislates for the roll-out of water meters and the imposition of charges. The intent is to reduce dramatically, and to eliminate eventually, direct financing of investment from public funds by relying on a mix of retained earnings extracted from service users via water charges and borrowings.

Given the fiscal constraints under which the Government is operating it is perfectly legitimate for it to seek to remove this burden on central funds. But, since it refuses to dispose of this network business – or the energy network businesses, it retains a shareholder responsibility to finance investment as and when it is necessary. When it fails to do this, as it and previous governments have demonstrated consistently, it imposes an unnecessary and excessive burden on final consumers and service users. The argument that, apart from financing that may be secured from the capital market, investment financing will have to be provided either from taxation or from retained earnings extracted from final consumers does not hold water. The CER has consistently awarded a return on equity (for the energy networks) well in excess of the Government's cost of funds. The Government has a simple choice: either behave as a responsible shareholder or dispose of the businesses. Instead, successive governments have extracted sizeable dividends from the ESB and Bord Gáis at times of considerable demand for network – and other infrastructure – investment.

Imposing the burden on final consumers and service users

The second benefit is linked to this. The Water Services Act empowers the CER to regulate the provision and pricing of water and waste water services. The rationale is similar to that which encouraged the Government to establish IW as a subsidiary of Bord Gáis. The CER has been empowered, among various aspects of the electricity and gas industries, to regulate electricity networks since 1997 and gas networks since 2003. At first sight there should be a considerable 'read-across' from the regulation of electricity and gas networks to the regulation of water and waste water networks. There is some validity in this, but a lot less than most politicians, public officials and regulators assert there is when one examines the technical and economic features of these networks.

But this does not generate the key second benefit from the Government's perspective. This is the empowering of the CER to set water charges and to award sufficient revenue to IW to ensure that, following an initial transition period, there will be no further call on central funds to finance investment. The CER has form in this area. It has consistently set electricity and gas network tariffs to award sufficient revenue to the ESB and Bord Gáis so that there has never been any requirement since the CER began regulating for direct Exchequer financing of network investment. The CER, in effect, is imposing an implicit financing tax on final electricity and gas consumers. And it is a regressive tax. Previous governments have gotten away with this, initially, for the electricity networks and, then, for the gas networks. The Government is going for a hat-trick by playing the same game with the water and waste water networks.[1]

And what is even better from the Government's perspective is that it can completely insulate itself from the political repercussions of whatever service charges the CER will set. The Government will piously declare that the CER is making these decisions as an independent body, that it is legally prevented from interfering or making directions to the CER about charges and revenues, and that, in reality, these decisions have nothing to do with it.

Compensating Bord Gáis for the reduction of its energy empire

The third benefit is less significant in the overall scheme of things, but it, too, is very important from the Government's perspective. The previous government initiated an assessment of the potential to dispose of state assets and a report was prepared. Since it has been on the case, the Troika has exerted considerable pressure on the Government to develop and implement a programme of disposal. The Government has applied every stratagem and used every excuse in the book to whittle down this programme of disposal. It secured a major concession when the Troika agreed that only half of the proceeds would be applied to pay down the national debt – with the residual being applied, with some funds from other sources, to establish a Strategic Investment Fund.[2] The principal source of funds is expected to come from the sale of the energy supply business of Bord Gáis. This would involve a considerable reduction in the scale and scope of the empire which Bord Gáis has managed to build up over the years – funded to a considerable extent from overly generous awards of network revenue by the CER (at the expense of final consumers).

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1 It may be that a majority of citizens would be perfectly happy to pay this additional, implicit financing tax in prices and charges for electricity, gas, water and waste water services so as to keep the networks in public ownership, to generate dividends and to avoid any direct exchequer financing of investment. But they should be informed and their consent secured by their elected representatives. It is the responsibility of the Oireachtas to decide and authorise taxation; it most certainly should not be the responsibility of the CER to sanction the extraction of taxation covertly from the users of electricity, gas, water and waste water services without the authorisation of the Oireachtas.

2 It would not be unfair to describe this as a 're-election slush fund'.

To compensate Bord Gáis for this reduction in its energy empire it was granted IW as a new fiefdom. In this way any potentially difficult-to-surmount management, staff or union opposition to the disposal of the energy supply business would be neutralised.

This is the appropriate background and context in which to consider the Government's policy on water and waste water services, the establishment and functioning of IW and the role of the CER. The Government, departmental officials, the CER and the semi-state companies involved simply deny and dismiss the background and context presented here. [3] They are unable to rebut the evidence presented and, as result, simply refuse to engage. It is a perfect example of the arrogance that accompanies the under-scrutinised, unrestrained and unaccountable exercise of political and economic power.

However, it is impossible to ignore this background and context when it comes to considering the future role of the CER in regulating the water and waste water networks.

Introduction

On 30 October 2013 the CER published a document setting out its proposed regulatory framework for the Irish water services sector and invited responses by 29 November 2013. The CER indicates a preference for responses that are formatted in relation to the questions it has posed. These questions may be grouped under three headings:

Structure of Regulation

Q1. Do you agree with the proposed principles of the regulatory framework? If not, then please explain why.
Q2. Are there any further principles of a proper regulatory framework that the CER needs to consider / or principles that need to be removed from the above list? If so, please provide an explanation for inclusion/exclusion.
Q3. Do you agree with the CER's assessment of each of the proposed regulatory frameworks? If not, then please explain why.
Q4. Are there any advantages or disadvantages to any of the proposed frameworks that the CER has not considered? Please detail.
Q5. Do you agree with the CER's assessment that a revenue cap (RPI-X) framework should be put in place for the Irish water sector? If not, then please explain why.

Process of Regulation

Q6. Do you agree with the CER's proposed approach in each of the following areas?
The treatment of operational expenditure;
The approach to setting the opening asset value of the IW RAB
The approach valuing assets added to/within the IW RAB;
The treatment of capital expenditure;
The capitalisation policy for adding assets to the IW RAB;
The estimation of a reasonable rate of return on assets in the IW RAB;
The treatment of depreciation for assets in the IW RAB;
The use of specific revenue-based incentives;
How maximum allowable revenues are calculated; and
The form of the tariff adjustment.
If not, then please explain why for each particular section.

[3] Ample evidence of all of this is presented here: http://www.dublineconomics.com/13/papers/energy.pdf

Q7. Are there any other approaches to each of the areas detailed in this section (section 4) that the CER has not considered? Please detail why they could be considered superior to this proposed CER approach.
Q10. Do you agree with the CER's proposed approach for sharing achieved efficiency gains in one control period with customers in the next revenue control period? If not, then please explain why.

Initial and Interim Arrangements

Q8. Do you agree with the need to introduce an interim revenue control? If not, then please explain why.
Q9: Which of the three approaches to the initial valuation of the IW RAB do you consider most appropriate for the Irish water services sector? Please explain your reasoning.

The structuring of consultation documents in this way and the selection of questions for consultation is the standard approach applied by economic regulators throughout the EU to limit and channel the public debate in line with their, and their masters', agenda and to prevent engagement with substantive critiques of their structures and processes. In any event, they cheerfully ignore any critiques, irrespective of the facts, evidence and analysis presented. The process of public consultation is a farce, but it is the only means of getting any critique on the record – even if it will still be 'hidden in broad daylight'.

The structure and process of regulation set out by the CER, with relatively minor variants considered in response to specific technical and economic features of water and waste water networks before a specific proposal is advanced, has been adopted and adapted from the structures and processes of economic regulation developed in Britain during and after the programme of utility privatisation and industry restructuring undertaken during the 1980s and in to the 1990s. Ireland is not alone. These structures and process have been adopted and adapted throughout the EU as its institutions have advanced the 'liberalisation' of the markets in these commodities and services.

The next section presents a critique of these structures and processes and explains why they are fundamentally dysfunctional and are falling in to public disrepute. The following section examines the additional idiosyncratic failings and flaws of these structures and processes when applied to the regulation of the electricity and gas networks in Ireland and highlights the intention of the CER to replicate these failing and flaws in the regulation of water and waste water services. The final section presents some conclusions and recommendations.

Economic Regulation in Theory and Practice

Efficient and effective economic regulation

The structure and process of economic regulation are required when a single (or dominant) firm produces a good or provides a service. The focus, initially, is on energy networks, before considering water and waste water networks. In the absence of competitive market forces, economic regulation is required to substitute for, or mimic, the effects of these forces. In theory, economic regulators are required to strike a balance between the interests of energy network service users and the interests of the investors in (or owners of) the network business. Apart from what are generally agreed to be 'uncontrollable costs', the owners of the network business are assumed to control the costs of the materials and services they hire or acquire, so as to maximise their return of, and on, investment. If the collective interests of final consumers are adequately represented and advocated in the regulatory process, an economic regulator should

be able to secure an equitable and efficient balance between the interests of the network business owners and those of final consumers.

Failings of the British-originated system of economic regulation

But, in practice and, particularly, in the context of the British-originated system of economic regulation, economic regulation is a very poor substitute for competitive market forces. Principal-agent problems bedevil the relationship between the owners and provides of the materials and services they hire or acquire. These problems are common to all investor-owned businesses, but they have much more serious effects in investor-owned regulated businesses.

Imbalances of power and information

Competitive market forces tend to impose some discipline on investor-owned businesses that are not subject to economic regulation. But, for an investor-owned business subject to economic regulation, there is an incentive for the owners, management and staff to collude informally to hoodwink the regulator and to extract economic rents. And these economic rents are extracted from final consumers. Regulators retain the ultimate sanction of revoking the licence to operate a network, but most network owners view it as an empty threat. Fines are often ineffective. And network owners always retain a trump card by threatening an investment strike.

Totally inadequate representation and advocacy of the collective interests of final consumers

In addition, the service users operating as energy suppliers to final consumers lack clear incentives to make the case for imposing effective downward pressure on the cost base of the network business. The allowed network costs that emerge from the regulatory process are seen as a pass-through to final consumers. The principal concern of network users is to ensure that they are not discriminated against in terms of the nature and pricing of the network services they require. No individual network user has an incentive to make a case for imposing downward pressure on the cost base of the network business – even when it is clear there are inefficiencies or that economic rents are being captured which result in network tariffs being higher than would be under competitive market conditions. All network users would benefit from a successful effort by an individual user to reduce the network cost base, but this user could never be sure that the benefits it might secure, both in absolute and relative terms, would outweigh the effort and expenditure incurred.

Therefore, there is no incentive for service users to co-operate or associate to make the case to exert downward pressure on the cost base of the network business – and some incentives not to. Indeed, as businesses ostensibly competing to supply final consumers, they might justifiably fear accusations of collusion if they were to co-operate or associate to pursue this effort. Furthermore, some of these network users may have interests in network businesses in other jurisdictions and they might be reluctant to make a case for lower network costs in one jurisdiction that could be used against them in another. Finally, there may be desire to maintain good relations with both the regulator and the network business. Adversarial behaviour is generally not welcomed and, in any event, final consumers exist to be milked of revenue.

Spurious accusations of regulatory capriciousness

These deficiencies are bad enough, but if these were the only deficiencies some remedies could be crafted. But the failings and deficiencies of economic regulation as currently practised are much more deep-seated and detrimental to the interests of final consumers and service users. In theory, economic regulators, with some measure of independence and a desire to raise their public profiles, might act capriciously, ostensibly in the interests of final consumers, and seriously damage the interests of the owners of the water supply business – and ultimately

damage the industry by deterring investment - by disallowing previously agreed cost recovery. In practice, this is both unlikely and rare, but network owners are never slow to make spurious accusations about regulatory capriciousness.

Regulatory capture

What is more likely to happen is the capture of the regulator by the owners of the network business, or by a combination of the owners and the management of the business. This capture is inevitable because this process of regulation is in essence a negotiation between the regulator and the network business, with considerable asymmetry of information, with no or minimal formal representation or advocacy of the collective interests of final consumers and with a public consultation process that, effectively, is a charade. This capture generally takes place over time. As a result, inefficiencies proliferate, economic rents are captured and final prices are far higher they would be under competitive market arrangements.

Energy regulatory failings in a broader context

These regulatory failings are only part of a bigger picture of policy failings at the EU and national levels in the area for energy and climate change. The major external gas suppliers abuse their market power without an effective response from the EU. Large vertically integrated, pan European energy companies abuse their market power and are now seeking to abuse their political power to protect themselves from the inevitable consequences of their lack of strategic foresight and excessive greed. The EU ETS is in a state of disarray and is not generating the price signals it was intended to provide – despite previous colossal bribery, at the expense of final consumers, of electricity generators and large industrial consumers to secure their consent to participate. Excessive national subsidisation of renewables has increased electricity prices, imbalanced and imposed costs on electricity networks, has destroyed capital invested in efficient generation plants and has reduced the demand for skilled labour. The stupid, British-originated Entry-Exit pricing of gas transmission capacity has prevented the emergence of a genuine market in pipeline capacity – leading to the inevitable distortions of markets and under-investment.

Resolving this totally dysfunctional mess that is energy regulation and energy and climate change policy is something that must be tackled, initially, at the EU-level and, then, at the national level. However, nothing will be done until the disgust and anger of EU citizens boils over. This disgust and anger is beginning to be aroused – most notably in Britain, but also in other EU member-states.

Economic Regulation of Networks in Ireland

All of the regulatory deficiencies and failings described in the previous section are evident in Ireland.[4] And, in addition to all of these, Ireland exhibits the rare case, with the CER, of an economic regulator being established as a captured entity. This capture is enshrined in the legislation because the regulator was empowered and required to make decisions that were politically unpalatable. As we have seen, a primary requirement was to apply an implicit financing tax in network charges, so as to avoid any requirement for direct shareholder (state) financing of investment – and to ensure, ultimately, a stream of dividends.

[4] The increasing number of the CER's decisions that are being subjected to judicial review is just one symptom of the underlying regulatory dysfunction.

The CER's IW Challenge

Setting the implicit financing tax

Now that the CER is being required to regulate the water and waste water networks, it finds itself in exactly the same position as it was when it was given regulatory responsibility for the electricity networks, initially, and, then, for the gas networks. Its challenge is to set the implicit financing tax that will be collected by IW in water charges. It is very specific about this in this consultation document:

> "While State support for IW will be very important in the initial stages the CER believes that a plan needs to be put in place where over a defined period IW becomes less reliant on State support and can fund its activities from customer charges and the international debt markets." (p50)

Nothing better expresses the CER's total failure to undertake the role of an economic regulator and the extent to which it has been institutionally captured by the Government, its officials and the managements of the semi-state companies it is empowered to regulate. Now that IW has been established any funds advanced to it by the state are, by definition, shareholder equity investment and must be treated as such. But the CER is being forced to accept that, irrespective of its estimate of the Weighted Average Cost of Capital (WACC), the Government will refuse to make any direct investments.

The result is that the CER is being compelled, and is prepared to accept the compulsion, to set revenues, beyond an initial, but undefined, transition period, that are sufficiently high to finance whatever programme of investment is agreed without any recourse to direct or indirect (via dividends forgone) shareholder equity investment and relying totally on extra revenue extracted via water charges and on external borrowings. In this way, water service users will be paying, in the same way that final electricity and gas consumers are paying, to finance a portion of investment up-front and will then be required to pay the return on, and of, all investment. This is the implicit financing tax which the CER will have to set.

Making a nonsense of economic regulation

This makes a total nonsense of the time and resource-consuming effort the CER puts in to estimating the WACC. The Government appears to have made it clear, and the CER appears to accept that it has made it clear, that it or future governments will not invest equity in a business which it almost wholly owns and that provides a vital service irrespective of the demand for investment or the return on equity investment the CER is prepared to award.

The only way the CER can set revenues sufficiently high to meet this asinine Government requirement is to artificially increase the Opening Regulatory Asset Base, to set the WACC as high as possible and to opt for relatively short asset lives (to increase the depreciation charge) – or some combination of all three. Over time the WACC and the asset lives may be modified if the water charges derived are deemed to be excessive. This approach was developed by the Department for Public Enterprise for the gas transmission network prior to the establishment of the CER and it was subsequently applied by the CER to the electricity networks and then to the gas distribution network.

The CER seeks to pass up on – or water down – the poisoned chalice

There are, however, some hints in the consultation document that the CER is not entirely happy that it is being compelled, once again, to apply an implicit financing tax and, as a result, being required to impose an excessive and unjustified cost burden, on this occasion, on water service users.

> "It needs to be borne in mind that the larger the Opening IW RAB value, the larger the level of revenues accruing to IW, which in turn will ultimately mean higher bills for customers and/or Government operating subvention. Therefore, it is important that the correct balance between ensuring customers are protected (to the greatest possible extent) and the financeability of IW's investments, is met." (p48)

Of course, the CER fails to mention that the Government, as the majority shareholder, has some responsibility for the 'financeability of IW's investment' and that it should not be the CER's sole responsibility. The Government appears to be determined that even if the rate of return on equity awarded by the CER were 10 times its cost of funds it is not prepared to invest one red cent of equity in the business beyond this transition period. And the CER, apparently, feels obliged to indulge the Government's gross negligence and irresponsibility.

This highlights a crucial distinction between the regulation of networks in private ownership and the regulation of networks in public ownership. Regulators of privately owned networks are able to exert some pressure on the owners to share the responsibility for financeability without burdening final consumers or users excessively. Regulators of publicly owned networks find it almost impossible – particularly when, as in Ireland, the government is determined to impose the burden on final consumers and to shirk its responsibilities and, more crucially, the managements of the networks are able to exert pressure on government.

The CER, however, does make an attempt to pass some of the responsibility for setting the Opening RAB back to the Government where it belongs.[5]

> "The CER's current position is that the setting of the Opening IW RAB is likely to require decisions by Government and/or Ministerial Direction to the CER (to the extent that this is provided for in future legislation)." (p49)

And, given that whatever investment programme is agreed, in the absence of shareholder equity investment, it will be the major determinant of the implicit financing tax the CER will have to set, the CER is reaching out to the Government for some guidance and assistance.

> "The current water investment programme is specified in the Government medium term investment strategy entitled "Infrastructure and Capital Investment 2012-2016", which covers a five year investment cycle. Development by Government of a similar multi-annual capital investment budget, to cover the period 2016 to 2021, would be beneficial." (p50)

The investment requirement is crucial. The expectation in this instance is that the cash flow generated without imposing this implicit financing tax, and in the absence of shareholder equity injections, will not be sufficient to finance this investment. Over time, one would expect a 'steady state' situation would be achieved when the cash flow generated would be sufficient without the imposition of this implicit financing tax. However, once this tax is imposed, it will continue to be imposed, even when the demand for investment falls. Whatever residual credibility the CER retains would be obliterated if it were to alter, unilaterally, the RAB for any of the regulated network businesses. The result is that the network business will continue to generate surplus cash extracted unjustifiably from final consumers and service users even

[5] The failure of successive British governments to place values on the privatised utilities before empowering the various industry regulators caused no end of grief for these regulators. For example, the regulatory asset value of the British Gas networks wasn't finally settled until 1997, a full 11 years after the privatisation of British Gas.

when the demand for network investment falls. This surplus cash flow proved advantageous to both the ESB and Bord Gáis when they were building their empires.

Conclusions and Next Steps

It is difficult not to feel some sympathy for the CER. Previous commissioners accepted the task set by government and cheerfully made a nonsense of economic regulation. But the financing taxes they set (for both the electricity and gas networks) were imposed during the bubble period in the long run-up to September 2008. Imposing a similar financing tax on the water and waste water networks is far more challenging in these straitened times.

The consultation document hints at the CER's unease about being compelled to make regulatory decisions that will pander to the Government's irresponsibility and negligence and penalise service users unnecessarily. It makes sense to assume that these concerns are being expressed more forcefully behind the scenes. The CER simply should not be allowed to levy a blatant implicit financing tax on water service users in the same way as it has levied similar taxes on electricity and gas consumers. The commissioners may be hoping that the Government will relent, provide some continuing equity investment and, thereby, minimise the implicit financing tax the CER will be required to impose.

However, the CER will really have no choice but to plug the gap caused by the Government's irresponsibility and negligence. It is galling to observe dedicated, competent and professional public servants being forced to act against the public interest under the duress imposed by an arrogant and mendacious government. But, once it obeys its orders, the position of the CER (and its staff) is secure. The career-ending inevitability of a refusal is not really an option.

This is a matter for the TDs who either enacted the legislation that created this mess or failed to review the implementation of the legislation they, or their predecessors, have enacted (or both). The consumer protection bodies, whether statutory or voluntary, are worse than useless. It hardly seems possible, but the media are even worse again.

It is totally unreasonable to expect ordinary consumers and citizens to put in the effort to get to grips with the hugely complex edifice of policy and regulation that successive governments have put in place and authorised and to prepare and submit responses to the proposals in this document that will seriously damage their interests. And even if they were to the CER would simply ignore any that criticised or rejected what is being proposed. What is required is effective statutory representation and advocacy of the collective interests of citizens as consumers and users of utility services that are subject to economic regulation.

In the absence of such representation – or of any likelihood of the emergence of such representation, the responsibility falls on the Members of the Oireachtas, and specifically on those who are members of the relevant select committees dealing with these matters. They have a duty to the public to inform themselves of what is being proposed on foot of the legislation they have enacted, to scrutinise what is being proposed and to decide on amendments either to the enabling legislation or to the process of implementation.

It is only a matter of time before Irish electricity and gas consumers begin to express their disgust and anger with the way they are ripped off by the regulated providers of utility services.[6] It is the primary responsibility of elected public representatives both to convey and address this

[6] The current efforts by the ESB's staff and unions to extract a larger share of the largesse being awarded by the CER to the ESB at the expense of final consumers may help to arouse the public disgust and anger that will be required to have the necessary political impact.

perfectly understandable and justified anger and disgust. In the long run-up to the implosion that initiated the continuing economic crisis Irish citizens were failed repeatedly by their elected representatives. These failures continue. It is time for TDs to put a stop to this and to do the job for which they've been elected – and well-paid – to do. Stopping the damaging proposals in this document would be a perfect place to start.