Chambers Ireland Submission to the Commission Regulation of Utilities on the Irish Water Revenue Control 3 Interim Review

July 2022

Overview

Chambers Ireland, the voice of business throughout Ireland, is an all-island organisation with a unique geographical reach. Our 40 members are the Chambers of Commerce in the cities and towns throughout the country – active in every constituency. Each of our member Chambers is central to their local business community and all seek to promote thriving local economies that can support sustainable cities and communities.

In September 2019, our Network pledged to advocate for and support the advancement of the Sustainable Development Goals. In doing so, we use the Goals as a framework to identify policy priorities and communicate our recommendations. We have a particular focus on five of the goals encompassing Decent Work and Economic Growth (SDG 8), Sustainable Cities and Communities (SDG 11), advancements in Gender Equality (SDG 5), viable Industries, Innovation, and Infrastructure (SDG 9) and progress in Climate Action (SDG 13).[1]

The Commission's review of the Irish Water RC3 is timely. Our members throughout the country are extremely concerned that delays in the upgrading of water infrastructure is both preventing the expansion of existing businesses, and the development of new ones. For our members, one of the greatest issues that they experience while operating their businesses is with the onboarding and retention of staff because of their difficulties in securing adequate and affordable housing. The development of Irish Water infrastructure is a key part of expanding housing supply.

Chambers Ireland is a champion of the Industry, Innovation and Infrastructure (SDG 9) goal. State bodies need to be leaders in altering our infrastructure to afford individuals the opportunity to take sustainable and environmentally friendly actions. Too much of our infrastructure channels people towards unsustainable lifestyles. This is why Chambers Ireland have been so supportive of

[1] The Chambers Ireland SDGs. Available at: https://www.chambers.ie/policy/sustainable-development-goals/chambers-ireland-sdgs/

the works which Irish Water have been planning for in RC3 – unless we get these fundamental pieces of infrastructure delivered, we will not be able to make progress in many other areas.

The existence of housing in appropriate parts of the country will be essential if we are to have Sustainable Cities and Communities (SDG 11). Creating these sustainable cities and towns will allow us to scale up the availability and utility of public transport networks so that we can reduce our transport related CO2 emissions – one of the toughest challenges we are going to have if we are to meet our climate targets. Any delay in Irish Water developing its infrastructure will undermine our chances of attaining the Climate Action (SDG 13) goal. More broadly our network recognises the enormous body of work that Irish Water have to accomplish if they are to protect Life Below Water (SDG 14) and provide Clean Water and Sanitation (SDG 6).

Our concern is that Irish Water is at the moment, very strongly affected by the supply chain pressures that are burdening all businesses. OpEx costs are soaring as a result of higher cost of power and electricity, and CapEx is rising because of shortages/increased costs in energy intensive high mass inputs like steel and cement. Our members are claiming that the costs of material inputs to building have risen by 20% in the first six months of the year, that quotes for inputs are often only valid for a period of weeks, and that often supply cannot be guaranteed. On top of these capital factor costs to construction, labour costs in the construction sector have also risen by 15% over the same time.

Irish Water is one of the largest energy consumers, and also one of the largest construction contractors in the country. Thererfore, Chambers Ireland's members are deeply concerned that if Irish Water is unable to deliver its investments, at the pace which we need them to deliver these projects, our wider economy is likely to be significantly constrained. The opportunity costs for the wider economy associated with the delays in delivering Irish Water projects on time need to be weighed against the current spike in inflation. Our sense is that there is a supply shock affecting inputs to the construction sector which has its origin in two factors outside of the Irish domestic economy. Firstly, there is the disruption to global logistics networks which is has its origins in

Covid-19. This has led to reduced output in steel and cement at the global level and the winding down of inventories. When economies reopened there was excess demand which has raised the costs of transporting goods, with large heavy products suffering considerable unit price travel cost increases[2].

The cost of transporting goods is likely to decline until the October when annual year's end cyclical factors will raise prices, but the medium-term outlook is positive, so we are anticipating that the transport related cost for materials will revert to typical prices in the next 12 months.

The second major factor in the costs of construction relate to the Russian war on Ukraine. The loss of capacity for the steel sector, and the sanctions on Russian timber and iron are likely to have a much more durable effect on supply to the sector. Secondly, our sister chamber in Ukraine estimated (26 June 2022) that 1000 bridges, 6,300 railway lines, and in excess of 44.8million square metres of housing stock will need to be rebuilt when the war is over. This suggests that there will be a very slow return to normal output post-war, and that there will be a persistent effect on prices arising from the war. At present prices for iron ore, timber & steel are at the higher end of their pre-covid ranges. We would be surprised if there was considerable downward movement from these levels in the medium to long term.

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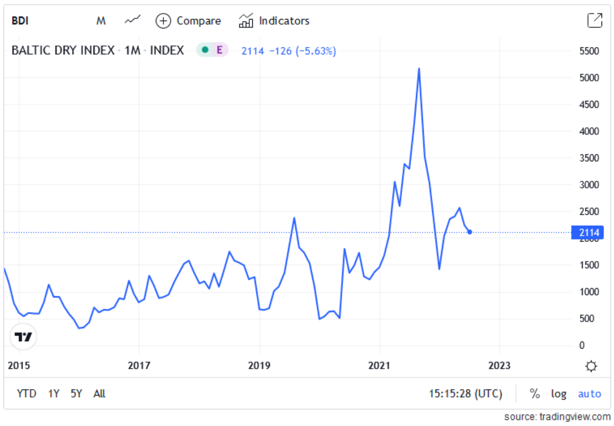
[2] Baltic Dry Index is currently (26/7/22) at €2114 is more than twice the 5-year mean for 2015-2019



The effect on fuel prices is also likely to be persistent. With the loss of much of the Russian supply to the market, and the resultant need to diversify the EU's sources of fossil fuels, considerable new costs are likely to be built into the prices consumers will need to pay, at least to 2030.

Both the short-run Covid supply shock, and the longer-run Russian shock mean that inflation is likely to run at a level that was not envisaged in RC3. Chambers Ireland's view is that while this is likely to raise the costs for delivering Irish Water infrastructure the costs for delaying the development of the much needed infrastructure (so that Irish Water CapEx can stay within the RC3 envelope) will exceed the savings within Irish Water.

Therefore, considerable alterations to the parameters which underly RC3 are necessary.

CRU Questions

1. Do you agree with the CRU's proposed framework for assessment which considers:

a. if Irish Water is facing real cost pressures that were not funded at RC3,

b. if these costs are material and outside management control, and

c. absent an adjustment to the RC3 allowance, would there be undesirable consequences from a policy perspective for water and wastewater customers?

It is clear that the assumptions that underly RC3 are no longer reasonable. There is considerably more inflation within the wider economy than was anticipated and the impact on the construction sector has been particularly strong.

Irish Water is also under pressure regarding the increase in OpEx as a result of the increased cost of energy.

As Minister Donohoe has recognised, we are living in a "shock-prone world", one was that this is translating itself into the business world is through supply shocks and price volatility. It is likely that the effects of these shocks will amplify each other and lead to higher than anticipated costs for a period that will exceed RC3.

These increases in cost are both considerable and unpredicted.

Their causes relate directly to the supply side shocks that arose from Covid-19 and the Russian invasion of Ukraine.

These are clearly externalities that were not considered when the plan, and constraints, for RC3 was being developed.

Should there not be a considerable adjustment to the RC3 allowance it is likely that substantial parts of the capital investment plan for RC3 will not be accomplished. This will make the government targets in Housing for All impossible to attain. It will also constrain the potential of the economy to grow as there are already serious difficulties in receiving planning permissions in many parts of the country which are a direct consequence of the long legacy of inadequate investment in water infrastructure.

2. Do you consider that the CRU should reset Irish Water's revenue allowances for RC3, and if so, what option do you prefer, and why?

Chambers Ireland has a strong preference for **"Option 2: HICP adjustment across RC3 period and specific differential inflation adjustment"**.

There is both a general rise in costs which can be captured by HICP, and an effect that is largely concentrated on construction sector which HICP would not adequately weight for Irish Water's activities.

With increased market volatility (largely driven by externalities that have emerged from the global economy) there is a need to take a more flexible approach.

Option 2 is strictly preferential to Option 1 as it is the more flexible approach. (Though Chambers Ireland would suggest that there may be a need for an OpEx adjustment to cover the increased cost of energy which, as we noted earlier, we expect to remain persistently beyond the expectations of the Regulator when designing RC3's parameters.)

Altering the allowances on an annual basis will allow the regulator to avoid locking in effects which are temporary in nature but will also prevent RC3 allowances from being a constraint should the Regulator misjudge the persistence of these upward pressures on prices.

The third option is weakly preferred to Option 1, but is of far lower utility than Option 2. The constraints of RC3 will continue to impact Irish Water's construction work across RC3. There is also the risk that Irish Water will defer the delivery of projects into the next period as they will not be certain that they will be compensated for their delivery as part of the ex-post review.

Chambers Ireland is also of the view that the CRU's decision-making precedents should not be significant factors in their determination of the appropriate option. Clearly the risk distribution that we are operating under has fatter tails than we expected – unlikely events are far more likely than we anticipated. Furthermore, unlikely events are correlated because of the pressures they place on other parts of the global system i.e., China's return to the global economy post-pandemic and the political reality that exists after the National Congress of the CCP in November will probably result in the commodities markets heating up, unless the impact of Covid remains high enough to continue to depress growth in China. We are in an increasingly shock-prone and volatile global economy, that the Commission has previously made decisions that were appropriate to a less volatile global business environment does not mean that it should reject the reality which businesses are currently operating in.

3. Do you think the CRU should consider other appropriate mechanisms? If yes, please explain your proposal.

No. Chambers Ireland is of the view that Option 2 will be sufficient, assuming that the Commission uses an appropriate basket of goods when creating its differential adjustment. Though we have, as noted earlier, the view that with OpEx more consideration should be applied to considering whether it would be appropriate to include an Energy Price indexation allowance to respond to the vulnerability that Irish Water has to increased energy costs.

4. Regarding the calculation of HICP, should the calculation be applied across the full five years of RC3 (incorporating outturn and forecast HICP) or just the remainder of RC3 (i.e., H2 2022 to 2024)? Please provide a rationale for your choice.

Chambers Ireland's arguments hold for the first period of RC3 as much as they do for the later period. Barring the three years from 2013-16 Ireland has been affected by crisis after crisis. For the six years that followed the Great Financial Crisis, the uncertainty regarding Brexit, the pandemic, and now a belligerent Russia, there have been a variety of forces, external to Ireland, that have had profound effects on often very narrow segments of the economy.

It would be useful if regulators better incorporated the lessons of this (that we are operating under significant volatility and that results in all players – including regulators – having imperfect information with which to make decisions) into future decision making. This would require that greater flexibility is built into their price control models to accommodate for the uncertainties that this lack of perfect information presents.

5. Do you have any comments on the CRU's proposal to allow Irish Water to draw-down on major project ringfenced money to fund additional cost pressures?

Given the delays to the Greater Dublin Drainage Project, and the Water Supply Project, using these ringfenced funds to support the construction of other capital projects is reasonable.

6. What incremental controls should be incorporated into the CRU's capital monitoring programme to ensure transparency for any incremental projects?

Chambers Ireland does not have a view about additional incremental controls.