

Mr Eduardo Barredo Capelot
Director, Government Finance Statistics & Quality
European Commission, Eurostat
BECH F4/933, L-2920 Luxembourg

17 April 2015

Dear Mr Barredo Capelot

Re: Follow up of the EDP dialogue visit to Ireland at November 2014 – The classification of Irish Water

I refer to your letter of 1 April 2015 and your assessment of the sector classification of Irish Water. Firstly, as you will be aware, we have, in accordance with your email of 30 March 2015 and the conclusions of the November 2014 EDP dialogue visit to Ireland, classified Irish Water to the government sector for the purposes of the March EDP notification and this classification was reflected in the figures transmitted to Eurostat on 31 March 2015. We have flagged this classification to users as provisional, pending the final classification decision.

Having now received your response to our submission in relation to Irish Water we wish to address the following points as set out in your letter.

Autonomy of decision.

As stated in our original note we fully agree that Irish Water is under government control. Your point however appears to go so far as to imply that the level of control is such that Irish Water cannot be considered as an institutional unit. Having reviewed the structures of Irish Water we cannot accept such a conclusion. We have clearly set out how in our view Irish Water meets the essential criteria of an institutional unit. It is established as a subsidiary of Ervia, a government controlled corporation which is recognised as an institutional unit. A full set of accounts for Irish Water as a separate unit are now available for 2013. Irish Water will, like other public utilities, be in a position to own assets and incur liabilities and has already incurred liabilities to the commercial banking sector in Ireland without the support of a government guarantee. Irish Water will, again like other public controlled utilities take economic decisions about its operations, albeit within the confines of the governing legislation. The level of control exerted on Irish Water through the relevant legislation is generally in line with that of other public corporations in Ireland.

We address your point around the foundation of the pricing regime in more detail in the section on the 50% rule. On the point of control however we wish to clarify that while the charges are set out in legislation the proposal to fix revenues at a known amount for a defined period was made not by government but by Ervia on the basis of a commercial view that this was a preferred strategy to both raise revenues and to build customer confidence.

Support of the government and the service level agreement.

We now enclose the generic template used for service level agreements between Local Authorities and Irish Water. We note that these set out a clear delineation of roles and responsibilities and of the

allocation of costs between the two entities. We have also requested copies of completed SLAs and will forward these on receipt.

With regard to your comment on the role of employees of Local Authorities we are of the view that this is a pragmatic approach recognising the existing structure of the water sector in Ireland. The continued employment of existing Local Authority staff to perform the functions of the newly established utility ensures that the requisite knowledge and skill base is in place for the delivery of these services. We would also note that the European Communities (Protection of Employees on Transfer of Undertakings) Regulations 2003 applies to the employees of Local Authorities as they would to any employee under such a transfer of undertakings process.

The 50% rule

We recognise that the capped charge introduces a question around the nature of the pricing model for Irish Water and we have taken this into account in our deliberations. It may be useful here to consider the basis for these charges. In an earlier draft business plan for Irish Water a billing structure based on expected consumption and taking account of planned allowances to households to be funded by government had been approved by the Commission for Energy Regulation. However Ervia have identified a fixed price model as preferable at this stage of Irish Water's development in order to establish the utility and build customer relationships. They regard this as a long-term strategy and have pointed out that the period for which charges are fixed is short relative to the expected life of the utility. They have also commented to us that this type of pricing structure is common in other industries, e.g. mobile phone companies who sell 'bundles' comprising calls, text and data services for a fixed price. The revised charging regime results in no reduction to the forecast revenues as calculated under the original business plan. In addition the proposed charges have been calculated based on metering data available to date and reflect updated estimates of average water usage based on this new data. This clearly demonstrates that Irish Water is taking account of information on demand as it becomes available and is factoring this into their pricing considerations. Finally it should be noted that the supply to a customer of an additional unit of water has an extremely low marginal cost.

For all of these reasons and taking into account the outcome of the quantitative market/non-market criterion we have formed the view that the proposed charging structure does, in fact, represent economically significant pricing. As stated in our original submission we are of the view that our assessment is in line with the treatment proposed in MGDD 1.2.4.3 paragraph 30 which states that the assessment of whether prices are economically significant is achieved "*in practice, would be assessed if the sales of the producer cover a majority of the production costs*". In addition we would note the language of the MGDD section 1.2.4.2 paragraph 28(b) which states that "*If the public producer is the monopoly (only) supplier of its goods and services in the economy, it is presumed to be a market producer if more than 50% of its output is sold to private units*". As set out in our submission Irish Water is effectively in a monopoly position and we are of the view that we have demonstrated that more than 50% of the output of Irish Water is sold to private units.

On a point of detail, the classification proposed by us regarding the child payment was not one of a product subsidy, but rather a social transfer to households, under the ESA 2010 paragraph 4.84 definitions of social risks – i.e. 4.84(g) family. It is our view that under such a classification these payments can legitimately be regarded as sales of Irish Water.

We feel there is some confusion regarding the domestic/non-domestic charging regimes in your assessment. For domestic users there has not been any charge for water usage, so the references in your second paragraph in this section are relevant only to non-domestic charges. In this regard we would note that, as stated in our original submission, the transfer of the 'as is' scenario for non-domestic charges is an interim measure to allow time for a more standardised approach to be developed and approved by the regulator.

With regard to the elements of uncertainty which you highlight we would note the following:

- In the period up to 2018 under a fixed charge scenario the level of metering achieved does not affect the potential revenue streams.
- In the current proposal we have submitted the material as received by us as part of the Irish Water business plan. This is in line with the guidance set out in the MGDD Section I.2.4.3 para 33 which states that *“In case of new public enterprises the test may be difficult to apply immediately due to lack of results and/or because of a progressive gearing up. The classification should be based on the business plan and special attention should be given to check whether the unit becomes a market producer in a short period of time”*. Uncertainties around the materialisation of revenues and savings are an inherent part of any process which is dependent on forecast data from a business plan. We have clearly indicated in our original submission that performance against the business plan would be monitored closely by CSO over the coming years.
- The levels of revenue derived from sales to government entities are unlikely to be material to the assessment when compared to revenues from industry. This is particularly relevant in the Irish context where there are large IT, pharmaceutical and brewing plants which are high consumers of water services.
- We have grave misgivings around the proposal to record the revenues on a cash basis which is wholly at variance with the general principles of accrual recording in ESA 2010 as stated in para 1.101 *“Flows shall be recorded on an accruals basis; that is when economic value is created, transformed or extinguished, or when claims and obligations arise, are transformed or are cancelled”*. Para 1.102 further clarifies that *“Output is recorded when produced and not when paid for by a purchaser”*. An explicit exception is made in para 1.104 for taxes and social contributions only, neither of which apply in the current case. While we recognise the concerns around non-collection of revenues we are of the view that this proposal is inconsistent with the general rules applying to the calculation of the quantitative market/non-market criterion where output is clearly intended to be recorded on an accruals basis. On the issue of bad debts ESA 2010 paras 20.233-20.235 clearly indicate that debt write-down is recorded as an “other change in volume” with no impact on net lending/borrowing. In the case of debt cancellation the transaction is recorded as a capital transfer – a category of expenditure which does not enter into the definition of costs for the market/non-market test. Finally, the audited financial statements of Irish Water will be prepared on an accrual basis in accordance with international accounting standards and will contain a provision for bad debts. It is these figures that will ultimately be used to assess Irish Water’s performance in relation to the market/non-market criterion.

Mindful of the recent ESSC paper, which noted the need for statistical conclusions to be “bulletproof”, we feel that the issues in regard to the classification of Irish Water require further deliberation. We would be glad of an opportunity to discuss these points more fully before a final classification determination in respect of Irish Water is reached.

Yours sincerely

Jennifer Banim
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Central Statistics Office