



Best Practice Utility Licensing

Draft for Consultation

24 October 2006

Introduction

Prior to the establishment of the Economic Regulation Authority (Authority) in January 2004, providers of gas and water services were licensed by two separate regulators: the Office of Energy and the Office of Water Regulation. These licensing functions were transferred to the Authority as the economic regulator for the State, offering an opportunity for consistency and best practice licensing across all types of licences.

By proclamation, the licensing functions of the Authority were extended on 1 January 2005 to include transmission, distribution and generation of electricity taking the total number of licences administered by the Authority to around 100.

The Authority is currently undertaking a review of gas trading and distribution licences (see www.era.wa.gov.au) pursuant to the *Energy Coordination Act 1994* and early in 2007 is intending to undertake a review of water licences pursuant to the *Water Services Licensing Act 1995*.

The review of gas and water licences will be undertaken within the Authority's view on best practice licensing. The purpose of this paper is to present, for discussion, an overview of what might constitute best practice licensing. The principles in the final paper will be reflected in the reviews of licensing arrangements such as those proposed for gas trading and distribution licences and water licences.

How to Make a Submission

Submissions on any matters raised in this paper should be in written form and electronic form (where possible) and addressed to:

Best Practice Utility Licensing
Economic Regulation Authority
PO Box 8469
Perth Business Centre
PERTH WA 6849

Email: licensing@era.wa.gov.au
Fax: (08) 9213 1999

Submissions must be received by 23 November 2006.

In general, submissions from interested parties will be treated as in the public domain and placed on the Authority's website. Where an interested party wishes to make a confidential submission, it should clearly indicate the parts of the submission that are confidential. For more information about the Authority's submissions policy, see the Authority's website.

The receipt and publication of a submission shall not be taken as indicating that the Authority has knowledge either actual or constructive of the contents of a particular submission and, in particular, whether the submission in whole or in part contains information of a confidential nature and no duty of confidence will arise for the Authority in these circumstances.

Further information regarding this inquiry can be obtained from:

Mr Adam Phillips
Assistant Director, Monitoring
Economic Regulation Authority
Ph (08) 9213 1900

Background

The Functions and Role of the Authority

The Authority was established by Government on 1 January 2004 as an independent regulatory agency with two principal functions. The first is as the State's independent economic regulator, involving the administration of industry-specific legislation in the areas of water, gas, electricity, and rail. The Authority is responsible for regulating the terms and conditions of access (including prices) to rail track infrastructure, gas transmission and distribution pipelines, and electricity transmission and distribution networks. The Authority is responsible for the licensing and monitoring of water, gas and electricity service providers and from 21 September 2006, assumed responsibility for several new functions relating to the Western Australian Wholesale Electricity Market. These include determining the allowable revenue for the Independent Market Operator and Western Power's System Management, the annual approval of price limits for reserve capacity and energy and, with the assistance of the Independent Market Operator, monitoring the short-term electricity market.

The second function of the Authority is to undertake inquiries referred by the Government concerning matters relating to regulated and non-regulated industries. This second function is similar to that of the Productivity Commission at the federal level.

In performing these various functions, the Authority seeks to produce outcomes that promote fair prices, quality services and choice for the long-term benefit of all Western Australians.

The Authority's Licensing Functions

Licensing is the conferring of a right by Government to undertake a specified activity (or activities) in exchange generally for a fee as well as compliance with certain conditions. In the case of utility licensing, the conditions are largely specified by Government with the licensing system generally administered by an independent regulator.

The Authority's licensing role includes:

- Determining various customer protection arrangements, such as standard form contracts, customer service charters and supplier of last resort provisions.
- Designing licences that apply the Government's service standards.
- Assessing whether prospective licensees conform to the eligibility provisions in the relevant legislation.
- Issuing licences to suppliers that are eligible to hold a licence.
- Monitoring licensees' compliance with their licence conditions.
- Informing the relevant responsible Minister(s) about any failure by a licensee to meet performance criteria or other requirements of its licence.
- Enforcing compliance with licence obligations.
- Reporting to the relevant responsible Minister(s) on the operation of the licensing schemes.

The Authority's statutory power to carry out its functions is provided in the following legislation:

- *Economic Regulation Authority Act 2003*;
- *Energy Coordination Act 1994*;

- *Electricity Industry Act 2004*; and
- *Water Services Licensing Act 1995*.

The number of organisations licensed by the Authority has increased from 30 to around 100 with the addition of electricity licensing.

Best Practice Utility Licensing

The Authority, in currently undertaking a review of gas trading and distribution licences, and in the future, in undertaking a review of water licensing, seeks to adopt the principles of best practice utility licensing. This requires an understanding of the objectives of the licensing regime, the characteristics of an effective licensor (i.e., the licensing entity) and the characteristics of effective licensing (i.e. how the licensor undertakes its functions). While for completeness this section discusses all three of these elements of licensing, the Authority is seeking comments from interested parties only on the characteristics of effective licensing as this is the matter over which the Authority has direct control.

Licensing Objectives

Licensing should only be implemented where it is the most appropriate form of intervention to meet a clearly identified market failure and where the benefits of licensing outweigh its costs.

Market failure occurs where markets can not be relied upon to produce outcomes that are in the long-term interests of consumers. The common sources of market failure relevant to utility licensing are natural monopoly and asymmetric information.

Natural monopoly occurs when it is less costly for one firm to service the market than two firms. This is usually the case with large interconnected infrastructure associated with public utilities like water, electricity and gas where it is uneconomic to duplicate the pipelines or networks. If industries with natural monopoly elements are not regulated it can lead to sub-optimal outcomes such as suppliers providing poor levels of service, charging high prices, using obsolete technology and not maintaining existing infrastructure or operating systems. In the case of utilities that provide essential services, licensing can reduce the risk of a supply disruption and can ensure minimum standards are met (such as minimum drinking water standards or standards for electricity and gas services).

Asymmetric information occurs where parties to a transaction cannot make fully informed decisions due to a lack of information, which often exists when there is market power. Usually the seller has better information than the buyer and regulation can help to protect the under-informed party. Asymmetric information is the justification for licensing organisations that do not have natural monopoly characteristics but may have a degree of market power, such as organisations providing electricity generation and retailing services. Licensing in this manner can ensure that customers, particularly small use customers, are treated fairly and efficiently through the application of a customer protection regime.

Characteristics of an Effective Licensor

An effective and credible licensing regime is administered by an entity that is independent and accountable.

Independence is important because regulatory decisions should be free from inappropriate influences that compromise regulatory outcomes. The ACCC published a discussion paper on Best Practice Utility Regulation in July 1999, which referred to the need for the utility regulators' decisions being "free from undue influences that could compromise regulatory outcomes"¹. According to the ACCC, the principle of independence is "a necessary element

¹ Utility Regulators Forum (July 1999) *Best Practice Utility Regulation*, ACCC.

in providing stakeholders with confidence in the regulatory system, and is linked to achieving the principles of consistency and predictability".

The principle of independence in the regulation of utilities may be compromised where the licensing and policy setting functions both reside in a Government agency. There is a greater risk of licensing decisions being influenced by irrelevant or inappropriate considerations where the licensing entity is not an independent, accountable and transparent statutory authority. Stakeholders are likely to view any licensing arrangements that lack the consistency and predictability of independent regulation as high risk which impact on regulatory certainty (i.e. which impact on any decisions to invest capital into the market). This is particularly the case where governments might use the licensing framework as a tool to implement short and medium term policy objectives rather than objectives that are consistent with the long-term interests of consumers.

If both the policy and licensing functions reside in a Government agency then existing and potential participants will have less assurance that any information they provide in support of a licence application will be used for only that purpose. This risk is much reduced where the information is provided to a regulator that is independent of Government and is subject to strict legislative provisions concerning the use of licensing information.

The risk of inappropriate influence in licensing decisions is further reduced where regulatory decisions are made by an entity with licensing responsibilities across a number of industries. This reduces the risk of regulatory capture by any one industry group. It also assists the licensor to compare claims as between industry groups.

Other jurisdictions have separated the roles of licensing and subordinate regulation setting in the utilities sector by establishing independent regulatory authorities such as IPART (NSW), ESC (Victoria) and ESCOSA (SA) to licence utilities and monitor compliance. These regulators are required to transparently apply the principles mandated by the relevant legislation to the regulation of their markets. In certain circumstances, regulators are permitted to make subordinate regulation decisions. The ESC, for example, is responsible for developing codes. While the legislation is generally prescriptive about what the Authority must take into account when performing its licensing functions, the Authority has also been given some discretion in making subordinate regulation:

- The inclusion of terms and conditions into licences. These terms and conditions are included in Schedule 1A of the *Energy Coordination Act 1994*, Schedule 1 of the *Water Services Licensing Act 1995* and Schedule 1 of the *Electricity Industry Act 2004*. Note that the Authority may include any of the terms and conditions set out in the schedules of the relevant legislation but it has the discretion to choose not to do so. For example, the Authority has the ability to require electricity licensees to prepare and implement strategies for the management of greenhouse gas emissions and also to require them to implement strategies to encourage the use of renewable energy.
- The amendment of the Code of Conduct (for the Supply of Electricity to Small Use Customers) under the *Electricity Industry Act 2004*.
- The Authority has the power under the *Energy Coordination Act 1994* to amend, repeal or replace the Gas Marketing Code of Conduct.

It should be noted that the extent of subordinate regulation discretion given to the Authority can be refined over time depending on the degree to which Government wishes to prescribe the Authority's functions.

In addition to the importance of impartiality as an essential characteristic of an effective licensor, the licensor also needs to be accountable for its decisions. Accountability is generally achieved by making the licensor's decisions subject to review by an appropriate independent appeals body. The Authority's licensing decisions on gas and water can be appealed to the State Administrative Tribunal and on electricity to the Energy (Gas) Review

Board. It should also be noted that it is the Governor, on advice from the Minister, who revokes a licence, not the Authority.

Characteristics of Effective Licensing

Licensors typically have some degree of discretion in how they perform their prescribed functions. An effective licensing approach is one that ensures that service standards to customers are maintained, does not adversely influence investment decisions (often referred to as regulatory risk) and minimises compliance costs. The pursuit of these objectives may involve trade-offs. The overall goal, however, is to licence in a manner that is consistent with the long-term interests of consumers. To this end the licensor should regularly review its operations.

The discussion below considers the licensing principles relevant to each of the three objectives noted above. The principles are based on the Authority's experience and the views of others, such as the Organisation of Economic Cooperation and Development, Australian Competition and Consumer Commission and Taskforce on Reducing Regulatory Burdens on Business².

Maintaining Service Standards

A licensing regime should include processes that maintain the licensor's focus on service standards to customers. To maintain service standards, a licensor should ensure its processes are consumer focussed, consistent across industries and based on consultation with consumer representatives.

Consumer focussed processes

The licensor should implement procedures that ensure customer service standards are met and maintained.

- Examples of the Authority's consumer-focussed processes include:
 - focusing auditors on high risk areas;
 - requiring licensees to provide the Authority a post-audit implementation plan as part of the audit report so as to ensure that auditor's recommendations are implemented;
 - developing customer service charter guidelines that set out the criteria by which the Authority will approve water customer service charters and review electricity customer service charters (e.g. that the licensee consults with customers during the development of their customers service charter)³; and
 - a Memorandum of Understanding with the Energy Ombudsman, which includes a requirement on their part for regular reporting on electricity and gas complaints and the exchange of other relevant information.

Consistency

Service standards and customer protection measures should be, where appropriate, consistent across industries.

- The Authority's audit approach has been standardised across industries.

² Regulation Taskforce (2006), *Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business*, Report to the Prime Minister and the Treasurer, Canberra.

³ The Authority does not have a review or approval role of gas customer service charters because there is no legislative or licence requirement for the Authority to do so.

- The Authority is working toward standardising licences across industries (particularly the gas and electricity industries).
- As a licensing entity with responsibility across a number of industries, the Authority is less likely to make decisions that do not adequately balance the interests of industry and consumers.

Consultation

Consumer representatives should be consulted during the decision making process.

- The Authority ensures that an appropriate range of consumer views are represented on the consultative committees that are required under legislation (Electricity Code Consultative Committee and Gas Marketing Code Consultative Committee).
- The Economic Regulation Authority Consumer Consultative Committee⁴, which meets regularly, has been established to provide input into all of the Authority's functions, including licensing decisions.
- Outside of the formal committees, consumer representatives are consulted as required (e.g. the Gas Industry Reference Group has been established for the gas licensing review).
- The Authority has published public consultation guidelines for electricity, gas and water licences and electricity and gas standard form contracts. These guidelines describe the process used by the Authority to gather input from all stakeholders, including consumers (as discussed above in the discussion of minimising regulatory risk).

Minimising Regulatory Risk

To minimise regulatory risk, a licensor should ensure its decisions are predictable, consistent, timely, transparent and based on effective consultation.

Predictability

The licensor's decisions should be predictable so that industry participants can invest with confidence and certainty.

- The Authority, for example, has published guidelines for licence applications⁵.

Consistency

The licensor's decisions should be consistent over time, across industries and across businesses within industries.

- For example, licences and the procedures for assessing licence applications and audits are being standardised, where possible, across the gas and electricity industry to reduce the costs associated with investment.

⁴ The ERACCC membership includes the Chamber of Minerals and Energy WA (Inc), Chamber of Commerce and Industry of WA, Property Council of Australia, Country Women's Association of WA, WA Farmers Federation, Pastoralists and Graziers Association of WA (Inc), State Ombudsman's Office, WA Council of Social Service, Department of Consumer and Employment Protection, Consumers Association of WA, Consumer Credit Legal Service (WA) and WA Local Government Authority. The ERACCC is chaired by member of the Authority, Chris Field.

⁵ For example, ERA Guidelines for Electricity Licensing Applications (November 2005) and ERA Application Guide for a Water Services Operating Licence (August 2004).

Timeliness

Decisions should be made as quickly as practically possible.

- The Authority has a legislative requirement under the *Electricity Industry Act 2004* which states that the Authority "...must take all reasonable steps to make a decision in respect of an application...within 90 days after the application is made." Although there is no time constraint on the Authority's decision making for gas and water licence applications, the Authority does endeavour to make a decision as soon as practicable after a licence application has been received. This includes allowing for stakeholder consultation.

Transparency

The licensor's decisions should be transparent, which requires the reasons for the final decisions to be published and notified to relevant stakeholders.

- A decision by the Authority sets out both the decision and the reasons for the decision. The decision and a notice which explains the nature of the decision are published on the Authority's website and are emailed to the registered interested parties.

Consultation

All interested parties should have the opportunity to participate in the decision making process by providing information to the licensor.

- Stakeholder and public comment is integral to the Authority's decision making process and requires the Authority to build effective relationships with its stakeholders, based on mutual trust and respect. The Authority has recently released a public consultation guideline which endeavours to clearly set out the steps for public consultation for its licensing processes⁶.
 - On receipt of a licence application, the Authority publishes a notice which explains the nature of the application and provides the public with 15 business days to comment on the application. The Authority provides the notice by email to any persons that have registered an interest in licensing matters on the Authority's website.
 - All public comments provided to the Authority are published on the Authority's website as soon as is practicable after the closing date.
 - After the closing date, the Authority reviews submissions and determines if the issues raised are significant and relevant. If the Authority decides that the issues raised about the application are significant and relevant, then the Authority prepares an Issues Paper or a Draft Decision. The Issues Paper or Draft Decision is then published on the website for public comment of at least 15 business days.
 - Following consideration and review of comments received a Final Decision is published on the website. A notice advising interested parties of the publication of the Final Decision is then emailed to all those registered to receive such information.

⁶ Public Consultation Guidelines - For Electricity, Gas & Water Licences and Electricity & Gas Standard Form Contracts (July 2006).

Minimising Compliance Costs

A licensing regime should aim to achieve its policy objectives at least cost to the licensee. To minimise compliance costs, a licensor should ensure its processes incorporate simple and targeted language, are consistent with other laws and integrated across jurisdictions, are flexible and are formulated with input from interested parties. Further, licensing requirements should be proportionate to the problems that exist, not unduly prescriptive and the minimum necessary to achieve the objective.

Simple and targeted language

Licensing requirements should be simple, clear, drafted in plain English and readily accessible.

- In addition to attempting to write clearly, the Authority publishes general guidelines to clarify regulatory obligations⁷; and also publishes specific guidelines, for example to signal the Authority's expectations of asset management (these guidelines are based on improved corporate knowledge of asset management as a result of comparing asset management systems from different industries)⁸;
- The Authority is currently developing guidelines that will inform licensees of the Authority's process for investigating incidents of non-compliance.

Consistency with other laws and integrated across jurisdictions

The licensor's decisions should be consistent with other laws to minimise the regulatory burden on licensees and decisions that apply to one industry should be consistent with decisions that apply to another.

- The Authority is standardising the licence and monitoring frameworks that apply across industries.
- The Authority is adopting national models of licensing and monitoring so that licensees are treated consistently throughout Australia.
- Consistency across industries is enhanced by the Authority being a cross-industry utility licensor.

Flexibility

Licences should remain as flexible as possible so as to minimise the compliance costs associated with the licensing regime.

- The Authority considers that it is preferable to have the detailed requirements on performance reporting set out in a manual and to have the manual referenced in the licence rather than encompassed within the licence⁹. A manual also provides a "one-stop-shop" approach to performance reporting.
- The Authority's experience in administering electricity licensing has indicated that licence standards are best presented in the form of a regulation or code that is referenced by the licensing scheme as a licence condition.
- The Authority rewards licensees for maintaining and improving their service standards by extending the time between audits.

⁷ ERA (September 2006), *Audit Guidelines for Electricity, Gas and Water Licences*.

⁸ ERA (September 2006), *Guide for Preparing the Financial Component of an Asset Management Plan*.

⁹ ERA (July 2006), *Draft Electricity Compliance Manual*.

Consultation

Consultation with licensees ensures that opportunities for minimising compliance costs are identified.

- The Authority periodically holds forums with the regulatory managers of the organisations that are licensed. The forums are used to discuss the Authority's licensing functions, processes and procedures.
- The Authority ensures that licensees are represented on consultative committees that are required under legislation (Electricity Code Consultative Committee, Gas Marketing Code Consultative Committee). These committees have as one of their guiding principles the reduction of compliance costs.
- Licensees are also consulted individually and collectively to ensure that their views are considered as the licensing approach is progressed (e.g. for the gas licensing review).

Conclusion

Best practice utility licensing aims to deliver a licensing regime that is in the best long-term interests of consumers. Licensing should only be implemented where it is the most appropriate form of intervention to meet a clearly identified market failure and where the benefits of licensing outweigh the costs.

A best practice licensing regime will have the following features: it will address clearly identified objectives; the licensor will be independent and accountable; and the licensor will perform its functions in a manner that ensures service standards are maintained while minimising regulatory risk and compliance costs.



Glossary

ACCC: Australian Competition and Consumer Commission

ESC: Essential Services Commission of Victoria

ESCOSA: Essential Services Commission of South Australia

IPART: Independent Pricing and Regulatory Tribunal of New South Wales