

Best Practice Utility Licensing

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Economic Regulation Authority

 WESTERN AUSTRALIA

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1 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 currently administered by the Authority to 81 licences (around 60 organisations).

The Authority is currently undertaking a review of gas trading and distribution licences¹ 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. This paper presents an overview of best practice licensing which has been informed by a public consultation process on an earlier draft. The principles in this paper are being reflected in the reviews of licensing arrangements, such as those proposed for gas trading and distribution licences and water licences.

1.1 Consultation Process

The Authority published a draft paper for consultation on 24 October 2006 and invited submissions from interested parties. Three submissions were received in response to the draft report. The overall principles set out in the original draft paper were generally supported. Accordingly, this final paper represents a redrafting of the original paper to reflect and respond to the comments that have been received as part of the consultation process.

The draft paper, submissions and this final report are available on the Authority's web site, www.era.wa.gov.au.²

2 Background

2.1 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.

¹ See *Recommendation Report - Review of Gas Trading and Distribution Licences* <http://www.era.wa.gov.au/licensingAndAuth.cfm>

² Draft Paper: <http://www.era.wa.gov.au/electricity/noticesDrafts.cfm>

Submissions: <http://erastyle2006.dev4.ibc.com.au/electricity/noticesDrafts.cfm>

These new functions 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 in the short term electricity market 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.

2.2 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; and
- 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*.

3 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 licensing entity and effective licensing. While for completeness this section discusses all three of these elements of licensing, the Authority

only sought comments from interested parties on the characteristics of effective licensing as this is the matter over which the Authority has direct control.

3.1 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 characteristics and asymmetric information.

Natural monopoly occurs when it is less costly for one firm to service the market than two or more 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 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.

All submissions support the objective that licensing should be implemented to address identified market failure where benefits outweigh costs.

In addition, WACOSS³ agrees that:

licensing can be used as an important tool for ensuring that consumers are well informed of their rights and obligations. Publicly reporting on the performance of licensees is also a critical element in the framework for ensuring consumer protection.

In their submission, the Office of Energy raises the issue of using licence exemptions for incidental distributors in the energy industry (e.g. owners of group housing facilities).

3.2 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 influences that can compromise regulatory outcomes. The Australian Competition and Consumer Commission (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".⁴ According to the ACCC, the

³ Western Australian Council of Social Services (WACOSS)

⁴ Utility Regulators Forum (1999), *Best Practice Utility Regulation*, ACCC.

principle of independence is "a necessary element 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 both the licensing and policy setting functions 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 higher risk, which then impacts on regulatory certainty (and in turn, impacts on decisions to invest capital into the market).

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 in comparing claims, as between industry groups.

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)⁵ 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 regulatory 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 discretion given to the Authority by the making of subordinate regulation 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 a 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 the Governor, on advice from the Minister, may revoke a licence, not the Authority.

All the submissions acknowledge the importance of an independent, accountable regulator. The submissions indicate a preference for a clear delineation of responsibilities, with the

⁵ Independent Pricing and Regulatory Tribunal (IPART), Essential Services Commission (ESC), Essential Services Commission of South Australia (ESCOSA).

Government being responsible for regulation/licensing policy and the Authority responsible for implementing licensing policy.

WACOSS notes that an independent regulator with a clear separation of powers, that is, with licence conditions largely specified by Government and the licensing system generally administered by a regulator, as their preferred model.

Synergy states that:

the Authority has sought to define what is considered regulation management opposed to regulatory policy, which is supported.

The Office of Energy notes that:

where there is a need to develop policy ... the appropriate course would be for the regulator to advise the Government that there is a need for policy clarification or regulatory amendment.

3.3 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 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 (OECD), ACCC and the Federal Government's Taskforce on Reducing Regulatory Burdens on Business.⁶

3.3.1 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.

3.3.1.1 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

⁶ Regulation Taskforce (2006), *Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business*, Report to the Prime Minister and the Treasurer, Canberra.

customer service charters (e.g. that the licensee consults with customers during the development of their customers service charter)⁷; 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.

All the submissions acknowledge the importance of licensing functions in maintaining service standards for consumers, with WACOSS noting their agreement with the framework detailed by the Authority for maintaining service standards.

The Office of Energy noted that, in undertaking its licensing function, the Authority seeks to act in the long-term interests of consumers, but questioned:

how these interests are determined or by whom?

The Office of Energy also noted that the determination of what is in the long-term interest of consumers should be the responsibility of Executive Government, which is able to balance competing objectives to achieve a net public benefit.

The Authority notes that in practice the responsibility for the long-term interests of consumers is shared across Executive Government, its agencies and regulators. Through its mandate, the Authority also has this responsibility. The ERA Act (s26) provides that, in making decisions regarding electricity, gas and water licences, the Authority must have regard to:

- the need to promote regulatory outcomes that are in the public interest;
- the long-term interests of consumers in relation to the price, quality and reliability of goods and services provided in relevant markets;
- the need to encourage investment in relevant markets;

The Authority undertakes its assessments and decisions taking into consideration the information provided by applicants, submissions received during public consultation periods from consumers and interested parties and its own independent research where required.

In addition to the general matters the Authority must have regard to, as outlined above, the Authority is also guided by industry-specific legislation which provides a framework specifically for matters concerning the grant, amendment, renewal or transfer of a licence.

For example, the Electricity Act provides matters which the Authority **must** take into account, including:

- environmental considerations;
- social welfare and equity considerations, including community service obligations;
- the interests of customers generally or of a class of customers;
- the policy objectives of Government in relation to the supply of electricity.

The Gas and Water Acts provide similar provisions to the Electricity Act, with a comparable list of matters that the Authority **may** take into account.⁸

In coming to a balanced position, taking into consideration the matters prescribed in legislation, the Authority is guided by an overarching objective to achieve outcomes that are in the long-term interests of consumers. In this context, these interests are taken to mean a

⁷ 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.

⁸ Economic Regulation Authority [ERA] (2006), Public Consultation Guidelines - For Electricity, Gas & Water Licences and Electricity & Gas Standard Form Contracts

balancing of the prescribed matters in a way that achieves the highest level of economic efficiency. In this context, economic efficiency is understood to have three principal limbs, namely productive, allocative, and dynamic efficiency:

- *Productive efficiency* - is achieved when goods and services are produced using the most efficient combination of inputs thereby minimising the cost of production.
- *Allocative efficiency* - is achieved when the choices, as between goods and services and in what quantities, produce the highest level of satisfaction for the community as a whole.
- *Dynamic efficiency* - is achieved when both productive and allocative efficiencies are achieved over time.

In effect, and to the extent that Executive Government delegates discretion to the Authority, regulatory decisions are guided by the matters prescribed to be taken into consideration, public consultation and economic efficiency criteria (reflecting the long-term interests of consumers).

3.3.1.2 Consistency

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

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

All submissions agreed that consistency in the licensing framework was desirable with WACOSS stating:

consistent utility licensing processes should be facilitated by a consistent regulatory and legislative approach.

3.3.1.3 Consultation

Consumer representatives should be consulted during the decision making process.

The Authority ensures that an appropriate range of consumer and other 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 Committee⁹, 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).

⁹ 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.

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).

All submissions agreed that it was essential to consult market participants, including consumers, and supported the Authority's endeavours in this regard.

3.3.2 Minimising Regulatory Risk

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

3.3.2.1 Predictability

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

- For example, the Authority has published guidelines for licence applications.¹⁰

3.3.2.2 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.

3.3.2.3 Timeliness

Decisions should be made as quickly as practically possible.

- For example, 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 seeks to make a decision as soon as practicable after a licence application has been received. This includes allowing for stakeholder consultation.

3.3.2.4 Transparency

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

- For example, 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 web site and are emailed to registered interested parties.

3.3.2.5 Consultation

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

- For example, stakeholder and public comment is integral to the Authority's decision making process and requires the Authority to build effective relationships with its

¹⁰ For example, ERA (2005) *Guidelines for Electricity Licensing Applications* and ERA (2004) *Application Guide for a Water Services Operating Licence*.

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 processes.¹¹

- 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 web site.
- All public comments provided to the Authority are published on the Authority's web site 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 web site for public comment of at least 15 business days.
- Following consideration and review of comments received a Final Decision is published on the web site. A notice advising interested parties of the publication of the Final Decision is then emailed to all those registered to receive such information.

In its submission, WACOSS and Synergy agreed that minimising regulatory risk is an essential consideration and that a licensing process needs to be consistent and transparent, be based on public consultation and deliver decisions in a timely manner.

3.3.3 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 market issues, not be unduly prescriptive and be the minimum necessary to achieve licensing objectives.

3.3.3.1 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 obligations¹²; 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)¹³.
- The Authority is currently developing guidelines that will inform licensees of the Authority's process for investigating incidents of non-compliance.

¹¹ ERA (2006), op. cit.

¹² ERA (2006a), *Audit Guidelines for Electricity, Gas and Water Licences*.

¹³ ERA (2006b), *Guide for Preparing the Financial Component of an Asset Management Plan*.

3.3.3.2 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.

3.3.3.3 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 specifying detailed requirements in a licence.¹⁴ 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.

3.3.4 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 in any further development of a licensing arrangement (e.g. for the gas licensing review).

In their submissions, WACOSS and Synergy agree that compliance costs should be minimised.

The Office of Energy states that licence fees should be cost reflective, and that:

there should not be cross-subsidy between one industry and another with respect to licensing administration costs.

WACOSS also stated their support for the use of a reporting manual in that it:

¹⁴ ERA (2006c), *Draft Electricity Compliance Manual*.

supports calling up compliance and performance criteria in a reporting manual ...and aligning those criteria with national best practice for performance.

Synergy considered that the Authority has:

demonstrated a preparedness to reduce regulation where demonstrable reasons exist"...and considers this to be consistent with best practice regulation.

4 Conclusion

Best practice utility licensing aims to deliver a licensing regime that is in the 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 optimised while minimising regulatory risk and compliance costs.

5 Further Information

If further information regarding Best Practice Utility Licensing is required, please contact the Authority, as follows:

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