

WATER INDUSTRY COMPETITION (GENERAL) REGULATION 2008

BETTER REGULATION STATEMENT

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Department of Water & Energy

Water Industry Competition (General) Regulation 2008
Better Regulation Statement

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Contents

Executive Summary.....	1
Need for Government Action.....	2
Objective of Government Action.....	3
Consideration of Options (Including a Qualitative Analysis of Costs and Benefits).....	4
Options	4
Method of assessment	4
Option 1 – Take no action	5
Option 2 – Address matters in the Act rather than by regulation	5
Option 3 – Industry self-regulation, co-regulation or quasi-regulation	5
Option 4 – A Regulation providing for only the minimum requirements of the Act	6
Option 5 – A Regulation that standardises and prescribes all licence obligations by way of licence conditions.....	10
Option 6 – A Regulation that provides for a combination of standard minimum obligations imposed as licence conditions (imposed via the Regulation, via subsidiary instruments developed by the Minister and via instruments developed by licensees) and Ministerial conditions applied to individual licenses.....	14
Consultation.....	21
Preferred Option	21
Evaluation and Review	22

Executive Summary

This document is the Better Regulation Statement for the *Water Industry Competition (General) Regulation 2008* (the Regulation), its purpose being to ensure the Regulation's compliance with the principles of better regulation.

The objectives of the Water Industry Competition (WIC) regime, established by the *Water Industry Competition Act 2006* (the Act), are to encourage competition in the water industry and to foster innovative recycling projects and dynamic efficiency in the provision of water and wastewater services. The Act creates a licensing framework for private sector provision of reticulated drinking water, recycled water and wastewater services. The licensing regime is designed to ensure that entities entrusted with responsibility for service delivery to private operators, public health, the environment and consumers are protected.

The Act requires Regulations to be enacted in order to give effect to the provisions relating to supply failure and the retailer of last resort. The Act also provides that the Regulations may make provisions relating to a number of other matters. Of note, the Act provides that the Regulations may impose licence conditions and may make provision with respect to the following:

- water quality and public health;
- construction and maintenance of water industry infrastructure;
- consumer protection;
- licensing administration; and
- licence conditions.

Given the content of the Act, there are three broad regulatory approaches that could be adopted:

1. A Regulation providing for only the minimum requirements of the Act;
2. A Regulation that standardises and prescribes all licence obligations by way of licence conditions; or
3. A Regulation that provides for a combination of standard minimum obligations imposed as licence conditions (imposed via the Regulation, via subsidiary instruments developed by the Minister and via instruments developed by licensees) and Ministerial conditions applied to individual licenses.

Using a qualitative analysis of the costs and benefits of each of these options, and assessing each option in relation to the key aims and objectives of the Act, it was concluded that the third option was to be preferred. This approach imposes minimum standard licence conditions (commensurate with those imposed on public water utilities where appropriate), but at the same time allows for Ministerial licence conditions to be imposed should the need arise. It also imposes licence conditions via licensee-developed Plans and codes, allowing licensees to demonstrate how they will meet key requirements of the regime (such as water quality, safety, reliability, continuity and consumer protection) in a manner specific to their activities and ensuring that licensees undertake appropriate planning and risk management.

This approach creates a degree of certainty for licensees and a desirable degree of consistency in the regulation of industry participants. This may encourage new entrants to the competitive market, increasing public confidence that adequate minimum standards are maintained and facilitating a level competitive playing field. A degree of standardisation will reduce the administrative costs of regulators and licensees. At the same time, the flexibility of the proposed regulatory regime allows it to respond

adaptively to new developments, encouraging innovation. The ability to tailor obligations ensures that the conditions imposed on licensees are appropriate to the particular activities to be undertaken, avoiding unnecessary or excessive administrative compliance costs on licensees and regulators.

Overall, this approach is considered the best way in which to achieve key objectives of the Act (such as encouraging competition and innovation, protecting public health, the environment and consumer rights) while keeping costs to all parties to a minimum. It therefore provides the greatest net benefit for all stakeholders.

This conclusion was supported by stakeholder submissions following public consultation by way of an initial consultation paper and subsequent release for public comment of the draft Regulation and a Regulatory Impact Statement.

Need for Government Action

At present the water industry in NSW is characterised by the provision of services through water utilities owned by the State and Local Government agencies. The *2006 Metropolitan Water Plan* sets out how the NSW Government will meet its priority of providing a secure supply of water that can meet the long term needs of Sydney, ensuring that there is sufficient water available over time to meet the needs of a growing city and to withstand current and future droughts and the impacts of climate change.

A key component of the NSW Government's strategy for a sustainable water future is to harness the innovation and investment potential of the private sector in the water and wastewater industries. The Act was developed to encourage competition in the water industry and to foster innovative recycling projects and dynamic efficiency in the provision of water and wastewater services.

The regime is the first of its kind in Australia. It was developed following an investigation conducted by the Independent Pricing and Regulatory Tribunal (IPART) in relation to water and sewerage provision in the greater Sydney region. The Government endorsed IPART's recommendations and subsequently released a Consultation Paper on the policy framework for the key components of the reforms. The Act was passed in October 2006, however was not commenced due to the need to draft the supporting Regulations.

The Act creates a licensing framework for private sector provision of reticulated drinking water, recycled water and wastewater services. The licensing framework is designed to ensure that where the Government entrusts responsibility for service delivery to private service providers, public health, the environment and consumers are protected.

Under the Act it is an offence, unless an exemption applies, to perform the following activities without the authority of a licence:

- to construct, maintain or operate any water industry infrastructure; or
- to supply water or provide a sewerage service by means of any water industry infrastructure.

Licences will be subject to conditions. The Act provides that licence conditions may be imposed by the Minister on a case-by-case basis or by the Regulations. The Act also provides that the Regulations may make provision with respect to the following:

- water quality and public health;
- construction and maintenance of water industry infrastructure;
- consumer protection;
- licensing administration (including the keeping, provision and publishing of records, information and statistics and the conduct of investigations by IPART); and
- licence conditions.

The Act allows for the Regulations to prescribe offences and the penalties to be applied.

The licensing regime can be seen as seeking to address potential market failures in the provision of water and sewerage services, such as the existence of market power, the difficulty for customers in making informed decisions about the quality of services being provided, and potential negative impacts on the environment.

The Act requires Regulations to be enacted in order to give effect to the provisions relating to supply failure and the retailer of last resort. In addition, while the Act provides the broad framework for the new regime, Regulations are required in order to achieve the effective implementation of the licensing regime in accordance with the licensing principles set out in the Act, namely:

- the protection of public health, the environment, public safety and consumers;
- the encouragement of competition in the supply of water and the provision of sewerage services;
- the ensuring of sustainability of water resources; and
- the promotion of production and use of recycled water.

The licence administration provisions in the Regulation, in particular those relating to information provision, are crucial to the monitoring and enforcement of compliance with licence conditions.

Objective of Government Action

The objectives of the WIC regime are to encourage competition in the water industry and to promote innovative solutions to the water supply and demand balance, particularly the development of infrastructure for the production and reticulation of recycled water, at the same time as protecting public health, the environment and consumer rights. This will assist to achieve the overall NSW Government objective of providing for a sustainable water future.

The primary objective of the Regulation is to enable the effective operation of the regime by making provisions with respect to:

- the licensing of network operators and retail suppliers to ensure the ongoing protection of public health, the environment, public safety and consumers, and the sustainability of water resources as competition develops; and
- the declaration of retailers of last resort, and the obligations of persons so declared, in order to ensure reliability and continuity of supply.

Consideration of Options (Including a Qualitative Analysis of Costs and Benefits)

Options

The following options are considered in this Report:

1. Take no action;
2. Address matters in the Act rather than by Regulation;
3. Industry self-regulation, co-regulation or quasi-regulation;
4. A Regulation providing for only the minimum requirements of the Act;
5. A Regulation that standardises and prescribes all licence obligations by way of licence conditions; and
6. A Regulation that provides for a combination of standard minimum obligations imposed as licence conditions (imposed via the Regulation, via subsidiary instruments developed by the Minister and via instruments developed by licensees) and Ministerial conditions applied to individual licenses.

Method of assessment

Given that NSW is the first Australian jurisdiction to implement such reforms, there has been little experience to date with direct competition in the water industry. Hence there is limited quantitative data on which to draw in the evaluation of alternatives. In addition, it is expected that the future participants in the industry will seek to implement a diverse range of business propositions, further limiting the capacity to estimate quantitative costs. As such, this Report relies primarily on qualitative analysis of costs and benefits. Each option is assessed in relation to the following key issues:

- The broad framework for imposing licence conditions
- The protection of water quality and public health
- Safety, reliability, continuity and standards of service
- Consumer protection
- Protection of the environment and sustainability of resources
- Licence administration
- Licence exemptions

Note that Options 1, 2 and 3 are not subject to a full impact analysis, as these options are not actually viable in light of the requirements of the Act.

Option 1 – Take no action

This option is not feasible as the Act requires the Regulation to make provisions in relation to certain specific matters. Without such provisions, the Act cannot commence.

Were this not the case, however, this option would still not be considered appropriate. While the Act provides the broad framework for the new regime, the Regulations are required to support the effective operation of licensing regime and other aspects of the Act.

Providing no further regulation of the licensing regime would, for example, mean that there would be little detail regarding licence administration and that all licensing conditions would be imposed by the Minister on a case-by-case basis. The impact of such an approach is explored in the discussion of Option 4 (a Regulation addressing the minimum requirements of the Act). On that analysis, even if possible, this approach would be undesirable.

Option 2 – Address matters in the Act rather than by regulation

This option is not feasible as the Act requires the Regulation to make provisions in relation to certain specific matters. Without such provisions, the Act cannot commence.

Were this not the case, however, this option would still not be considered appropriate. The WIC regime aims to promote new and innovative infrastructure development. As such, a wide variety of projects, innovations and arrangements for the provision of drinking water, recycled water and sewerage services may develop. Given the uncertainty over what type of projects and arrangements might emerge under the new regime, the regulatory framework needs to be sufficiently flexible to cater for a wide range of possibilities. The licensing regime must also be sufficiently flexible to minimise compliance costs and to ensure that the regime does not unnecessarily constrain competition and innovation.

Maintaining provisions in Regulations or other subsidiary instruments allows for a degree of flexibility in the regulatory framework. Should changes be required, effecting such changes to Regulations and other subsidiary instruments is a simpler and more efficient process than that involved in amending an Act.

Option 3 – Industry self-regulation, co-regulation or quasi-regulation

The Act creates a licensing regime administered by the Minister and IPART. Industry regulation of the licensing regime is therefore not an option.

Were this not the case, however, this option would still not be considered appropriate in the context of the WIC regime.

Firstly, given that the protection of public health, the environment and consumer rights are key objectives of the Act, it is considered that private service providers should be subject to mandatory obligations as opposed to voluntary codes of conduct.

Secondly, it is considered that, in the water industry context, enforcement of obligations should be carried out by an independent administrator, rather than by industry itself. Given the essential nature of the service being provided, it is imperative that acceptable standards be maintained and that the public is confident of such. This is best achieved through independent regulation and administration.

Further, concerns would be likely to arise regarding the ability of industry to monitor compliance and enforcement. Effective industry regulation relies on the existence of a cohesive industry association that is representative of the industry. Given the significance of the changes to the industry that will be brought about by the introduction of licensed competition, industry regulation would not be appropriate at this stage.

Finally, given the imperative to protect public health and the environment, it is essential that effective penalties for non-compliance be administered. Unless membership of an industry body could be made obligatory for participation in the industry, the available penalties (censure or dismissal) may have little real impact.

Option 4 – A Regulation providing for only the minimum requirements of the Act

The least prescriptive of the regulatory alternatives would be a Regulation containing only those provisions that the Act requires it to. These provisions relate to supply failure and the retailer of last resort. The Regulation would impose no standard licence conditions to supplement those contained in the Act. Licence conditions would be imposed by the Minister in respect of each individual licence. Hence each licence would be developed as a completely new and unique instrument.

The broad framework for imposing licence conditions

Benefits: The primary advantage of this approach is the flexibility it would allow in providing licence conditions that are tailored to the specific situation of the licensee. In the context of a dynamic and innovative market, the flexibility of imposing licence conditions on a case-by-case basis would enable the industry to adapt easily to new situations and arrangements. It may also increase competition by encouraging entrants who might be excluded by the imposition of standard licence conditions.

Costs: This approach has a significant number of disadvantages. It would:

- increase costs for both licence applicants and relevant government agencies. Furthermore, these costs would be incurred before it is clear whether or not the applicant will be granted a licence;
- create uncertainty for prospective licensees entering the market about the nature of the obligations likely to be imposed after completion of the licence consultation phase;
- entail the risk of inconsistent obligations applying to licensees undertaking similar activities;
- provide little transparency to consumers and the public as licences would not be comparable. Hence it would also increase the search costs of customers considering whether to change providers;
- increase the costs of licence administration by IPART and relevant government authorities;
- be likely to increase the time required to process applications and to conduct audits.

Water quality and public health

While the Act provides that licensees are subject to other legislation such as the *Public Health Act 1991*, that legislation does not comprehensively address matters related to recycled water quality or all of the matters that would otherwise be included in Water Quality Plans prepared by public water utilities. In order to address these gaps, Ministerial licence conditions would have to be imposed on each individual licensee.

Benefits: Licence conditions are likely to be highly tailored to the licence applicant's proposed activities. In turn, this may minimise any potential obstacles to the delivery of innovative infrastructure.

Costs: In addition to the general disadvantages outlined above (see the discussion regarding the costs of the broad framework for imposing licence conditions), the public would lack the information to assess water quality and evaluate standards of water being offered by different suppliers. This would be likely to undermine public confidence that consistent minimum standards will be maintained.

Safety, reliability, continuity and standards of service

The Act already provides that construction, operation and maintenance of water industry infrastructure may not be undertaken except where the person is operating under the authority of a network operator's licence. The Regulation would not directly impose any additional obligations with respect to the construction, operation, maintenance and renewal of water industry infrastructure aimed at ensuring the safe and reliable supply of water and provision of sewerage services. Therefore, Ministerial licence conditions would need to be imposed on each individual licence having regard to the licensing principles and matters to be considered in the determination of applications. These conditions would then be monitored to ensure compliance, and enforced where necessary, through systems that can adequately oversee individual or case-by-case requirements.

Benefits: This approach would allow for the development of conditions for each licence in a flexible manner.

Costs: In addition to the general disadvantages outlined above (see the discussion regarding the costs of the broad framework for imposing licence conditions), there may result in a lack of information with which to assess the adequacy of the infrastructure and operating procedures of new entrants. There may also be a higher risk of supply interruptions and public health may not be protected.

It would also mean that while the Act still provides an obligation on retailers of last resort to submit a Contingency Plan for the Minister's approval, the required content of such a Plan and the circumstances in which a supply failure can be declared would be unclear. The absence of detailed and well-understood arrangements to ensure continuity of supply in event of failure by a new supplier would pose unacceptable risks to customers and the investors / new licensees in the context of a competitive market.

Consumer protection

The Regulation would not directly impose any obligations with respect to consumer protection. This would mean relying, in the first instance, on the provisions already contained in the Act, such as the requirement for licensees to be members of an accredited ombudsman scheme, together with the commercial and market incentives for licensed retail suppliers to act in the interests of customers. Where necessary, customers may also look to existing general customer protection legislation (for example, the *Trade Practices Act 1974* and the *Fair Trading Act 1987*). In the absence of Ministerial licence conditions, consumer protection would be highly dependent on industry self-regulation.

In the new competitive environment, there are likely to be significant remaining elements of market power together with concerns about the ability of customers (particularly small retail customers) to make fully-informed decisions in the marketplace. In addition, a number of customer protection issues arise under the new regime that do not arise within the current monopoly supply model. These include the marketing practices adopted by those seeking to secure customers from incumbents or other competitors and arrangements for the transfer of customers who decide to switch suppliers.

On the basis of this analysis, the absence of licence conditions pertaining to consumer protection is considered to pose unacceptable risks to consumers, as reliance on competitive disciplines and existing consumer protection legislation is not sufficient to ensure that customer interests are protected in the context of a newly emerging market for essential services. This is particularly pertinent for small retail customers. Hence Ministerial licence conditions would be required to ensure basic customer protections.

Benefits: This approach would allow protections to be tailored to suit individual projects.

Costs: In addition to the general disadvantages outlined above (see the discussion regarding the costs of the broad framework for imposing licence conditions), it may undermine public confidence that adequate minimum customer protection standards will be maintained. In turn, this may affect the willingness of customers to transfer to a private supplier.

Protection of the environment and sustainability of resources

State agencies administer a variety of legislation relating to the planning, construction, operation and maintenance of water industry activities. In particular, the *Environmental Planning and Assessment Act 1979* provides comprehensive protection of the environment. *The Protection of the Environment Operations Act 1997* and the *Environmental Planning and Assessment Act 1979* apply to new entrants and to existing suppliers. A new supplier would therefore be required to hold an environmental protection licence under the *Protection of the Environment Operations Act 1997* where relevant. In the event that additional obligations are required to protect the environment with respect to a particular activity, this could be made the subject of a specific licence condition applicable to an individual licensee. The Act already provides that in considering whether or not to grant a licence and what conditions should be imposed on a licence, the Minister is to have regard to the protection of the environment.

Benefits: A key benefit of the 'do nothing' approach is that it ensures that additional obligations that duplicate or conflict with existing requirements are largely avoided. There are minimal benefits to be gained from the imposition of Ministerial licence conditions in this context.

Costs: The general disadvantages outlined above apply (see the discussion regarding the costs of the broad framework for imposing licence conditions). Further, by failing to provide a regulatory regime regarding environmental protection and sustainability of resources that is specific to a competitive water industry (that is, one that does not address how the licensing regime will interact with other relevant legislation) duplication of environmental regulatory approvals may occur, imposing unnecessarily high compliance costs on licensees. For example, an entity requiring a licence under the Act may also require a licence under the *Protection of the Environment Operations Act 1977*.

Under this option, a licensee would not be formally subject to water restrictions, even if the water source from which the contracted network operator takes the water is also a water source for a public water utility and the customers of that utility are subject to water restrictions. This would undermine the ability to conserve water resources at time of shortage and to ensure equitable allocation where limited resources are shared.

Licence administration

The Regulation would not directly impose any additional obligations with respect to licensing administration and related record keeping and reporting. This would mean that the administrative processes would be determined by the relevant agencies and that any record keeping and reporting obligations to be imposed on licence holders would need to be imposed by the Minister as a condition for each licence.

Benefits: No significant benefits.

Costs: The fact that administrative processes would be determined by individual agencies may reduce the efficiency, effectiveness and transparency of the licensing process. This approach would rely solely on the day-to-day practices adopted by IPART in overseeing the regime.

This approach may not ensure that information is publicly available consistently across suppliers, increasing the search costs of prospective customers and other parties with an interest in the terms and conditions of licences. It would also increase the costs to the regulator of administering the licences and potentially render difficult the monitoring of compliance.

Licence exemptions

This would mean providing no further exemptions from the requirement to be licensed than those already provided for in the Act.

Benefits: No significant benefits.

Costs: The construction, operation and maintenance of any water industry infrastructure (not already expressly excluded by the Act) or the provision of water or sewerage services without a licence would be prohibited regardless of the size or supply capacity of the infrastructure and the end-use purpose of the water supplied. The prohibition, and therefore the requirement to have a licence, would apply to infrastructure that is already subject to alternative licensing requirements (for example, under the *Water Act 1912* or the *Water Management Act 2000*). The requirement for all water industry infrastructure to be licensed immediately is likely to impose inappropriate or inefficient obligations, compliance costs and burdens in relation to certain types of infrastructure or certain services. This option would also result in unwarranted regulatory duplication and uncertainty where some water industry infrastructure will be subject to multiple licensing regimes. It also has the potential to capture

water industry infrastructure that is effectively controlled through other instruments, such as contracts with licensees or public water utilities. The costs of this approach will likely include:

- a significant frustration to the ability of public water utilities and also licensees to adopt cost-effective practices such as contracting out construction, operation and/or maintenance services to specialised corporations, as those contractors would also need to hold a licence – despite the fact that their actions would be subject to a contract with a regulated entity;
- increased costs for Government arising from the need to administer and enforce multiple (and sometimes conflicting) licensing regimes for the same infrastructure regulating the same or similar issues;
- unnecessary costs on Government and licensees where the same infrastructure is already captured in the ambit of a licence issued under this Act; and
- disruption to owners and customers of existing schemes (where no transitional provision are put in place).

Overall assessment

Imposing licence conditions on a case-by-case basis would allow a great deal of flexibility to deal with present and potential future water and sewerage service supply arrangements, and would avoid the risk of unnecessary compliance costs for licensees arising in Option 5 (which may result in the imposition of excessive or inappropriate licence conditions, whereas the present option allows licence conditions will be tailored to the particular licensee). However, it would be likely to entail high administrative costs (including time delay and financial expenditure) for Government in developing and enforcing licensing conditions on a case-by-base basis. It would also increase costs for licence applicants in the licence consultation phase, create uncertainty about the nature of the obligations likely to be imposed, and potentially result in the inconsistent application of licence conditions across licensees performing similar functions. All these factors would undermine the efficiency of the licensing regime.

Where existing regulatory frameworks are considered to be sufficiently comprehensive and Ministerial licence conditions not deemed to be required, the inability to provide a regulatory regime specific to a competitive water industry (that is, one that does not address how the licensing regime will interact with other relevant legislation) could lead to the unnecessary duplication of requirements or the imposition of contradictory requirements, imposing unnecessary compliance and administration costs for licensees and Government.

This regulatory approach is therefore is not recommended.

Option 5 – A Regulation that standardises and prescribes all licence obligations by way of licence conditions

All licence conditions would be standardised via the Regulation and there would be no scope for Ministerial licence conditions applying to individual licensees. A logical baseline for the development of standardised conditions would be to impose conditions commensurate with those imposed on public water utilities.

The broad framework for imposing licence conditions

Benefits: This would provide considerably more certainty for licence applicants regarding the conditions they are likely to be required to meet. It is also likely to be more administratively efficient for individual licence applicants and Government, once the initial investment in the development of a full

set of standardised conditions has been made. Common comprehensive obligations that cover a full range of contingencies may provide increased consumer and public confidence that all licensees are subject to minimum standard licence conditions and requirements.

Costs: The principal disadvantage of this approach is that the more prescriptive the obligations imposed, the greater the prospect that they will be inappropriate for the particular activities proposed to be undertaken by the licensee or prospective licensee. This is particularly so where a prospective licensee wishes to supply a limited range of services to a limited customer group. Key disadvantages of this approach include:

- it is a highly inflexible means of regulating a diverse and maturing market and is likely to hinder the development of innovation;
- it significantly reduces the ability of the regulatory system to deal with different types of services and sizes of operations;
- as a 'one size fits all' solution, it is likely to result in high compliance costs for many licensees;
- potential risks to public health and consumers may emerge over time given the inability to comprehensively foresee every scenario; and
- in many cases it will result in a mismatch between the 'red tape' burden and realistic risks to consumers and public health.

By imposing high compliance costs on licensees, it may discourage prospective entrants to the industry and hence reduce the potential benefits of competition to customers. It would also require a major commitment of time and resources by Government and interested stakeholders to formulate the detailed specification of obligations to address all foreseeable scenarios and to mitigate against these risks in the absence of knowledge about likely market offerings (and the risks associated with those offerings) and the future development of the market.

Given that licences are to be granted in perpetuity, this option may also unreasonably limit the ability of the Government to respond to the emergence of new risks or instances of non-compliance by licensees over time. Licence conditions will likely need to be varied as the market develops and innovation occurs.

Water quality and public health

A logical baseline for the development of standardised conditions aimed at protecting water quality and public health would be to impose conditions commensurate with those imposed on public water utilities.

Benefit: Many of the basic conditions will be appropriate for any participant in the industry. Consistency with the requirements imposed on public water utilities may bolster public confidence in the maintenance of acceptable minimum standards. It would also ensure that obligations are applied consistently across suppliers.

Costs: One disadvantage of this blanket approach is that some of the licence conditions imposed on existing public water utilities (which are based around the activities of vertically-integrated entities that undertake both infrastructure and customer supply functions) may not be applicable to the more limited activities that may be undertaken by licensees (who may be seeking to supply new services). Imposing all the licence conditions currently applied to public water utilities on all licensees may be excessively onerous and discourage new entrants to the industry. This suggests the need to modify this approach so that standardised conditions are targeted to different types of activities likely to be

undertaken by licensees. Further, a limitation of the imposition of wholly standardised conditions is that it is difficult to predict all the scenarios that may develop in the competitive market and this approach may constrain the ability of Government to address potential risks to public health and consumers that may emerge over time.

Safety, reliability, continuity and standards of service

A logical baseline for the development of standardised conditions aimed at ensuring the safe and reliable supply of water and provision of sewerage services would be to impose conditions commensurate with those imposed on public water utilities. However, these obligations could not simply be mirrored as the competitive industry will have regulatory needs that do not arise for public water utilities. For example, the Regulation needs to provide for continuity of supply in the event of commercial failure of a new retail supplier (a situation highly unlikely to arise in relation to a public water utility).

Benefits: Standard licence conditions commensurate to those applied to public water utilities could be applied across the full spectrum of schemes proposed by licensees. Consistency with the requirements imposed on public water utilities may bolster public confidence in the maintenance of acceptable minimum standards.

Costs: There are extensive requirements currently in place for public water utilities with respect to the construction, operation and maintenance of water industry infrastructure and the more onerous nature of the monitoring and reporting requirements applied to public water utilities is likely to discourage some parties (in particular small scale operators) from entry into the market. Further, the imposition of standardised conditions may result in standards that are unsuitable to the more limited activities of some private entrants, potentially resulting in inadequate and inefficient outcomes.

Consumer protection

A logical baseline for the development of standardised conditions aimed at ensuring basic customer protections would be to impose conditions commensurate with those imposed on public water utilities. However, these obligations cannot simply be mirrored as the competitive industry raises consumer protection issues that do not arise in the current market, for example marketing practices and customer transfers. Further, some provisions applying to public water utilities will not be relevant in the competitive market—for example provisions developed to mitigate against the potential for monopoly power abuse—and their application would result in unwarranted regulation.

Benefits: Consistency with the requirements imposed on public water utilities may bolster public confidence in the maintenance of acceptable minimum standards. Further, this approach would have the advantage of ensuring that customers receive the same basic protections regardless of whom they choose as their supplier.

Costs: This option may not be suitable to all types of services and may impose inappropriate or unnecessary requirements and restrictions, increasing compliance costs for licensees.

Protection of the environment and sustainability of resources

A logical baseline for the development of standardised conditions aimed at protecting the environment and sustainability of resources would be to impose conditions commensurate with those imposed on public water utilities, which are subject to a comprehensive regulatory framework. Current operating licences require Sydney Water and Hunter Water to monitor and report on environmental indicators, put in place an environmental management system to manage environmental risk, and produce and

report against an environment plan containing details of its program for environmental improvement for its water, sewerage and stormwater strategies.

Benefits: Consistency with the requirements imposed on public water utilities may bolster public confidence in the maintenance of acceptable minimum standards.

Costs: Such obligations may not be proportionate to the risks to the environment associated with the proposed activities of licensees, given differences in scale, scope and location to those of public water utilities. This approach may also result in disproportionately high monitoring and compliance costs. Further, a blanket approach may not be suitable to all types of services and may impose inappropriate or unnecessary requirements and restrictions, increasing compliance costs for licensees.

Licence exemptions

All existing water industry infrastructure would be exempt from the requirement to be licensed. The basis for this exemption would be that infrastructure already in existence may be assumed to be regulated to some extent under existing controls and hence that some minimum level of public health, consumer protection and environmental protection is already provided for.

Benefits: A blanket exemption would provide certainty for those who currently operate or maintain existing water infrastructure. It could avoid duplication and reduce the administrative costs of licensing existing infrastructure.

Costs: This approach has a number of problems. Firstly, it is not clear that the current regulatory framework governing existing water infrastructure is sufficient to ensure the effective fulfilment of public health, water quality and consumer protection objectives. Secondly, it could place new licence applicants at a competitive disadvantage. On the other hand, owners of existing infrastructure may be disadvantaged to the extent that they would not be afforded powers and rights that would be afforded to new entrants under the licensing regime. A further concern is whether a licence would be required for existing infrastructure in the event that it is modified or upgraded. If so, this might constrain innovation.

As consumer protection, resource sustainability and the promotion of competition are key objectives of the Act, the exemption of all existing water industry infrastructure from obligations in respect of these areas would likely result in a sub-optimal regulatory outcome.

Overall assessment

The principal advantages of imposing a standard set of licence conditions, with no Ministerial licence conditions, are that it would provide certainty for prospective licensees and would potentially decrease administrative costs. Where the licence obligations imposed are commensurate to those imposed on public water utilities, this may secure a degree of public confidence that adequate minimum standards are being maintained.

However, this option has a number of significant disadvantages. It provides an inflexible means of regulating a varied and dynamic industry. A wide diversity of activities will be authorised under the regime, and the one size fits all approach of this option reduces the ability of the regulatory system to deal with such diversity. It is also likely to mean that licensees are subject to inappropriate conditions and unnecessary compliance costs. Further, the inability to predict all scenarios that will require regulation means that potential risks to public health and safety may emerge over time. The regulatory system therefore needs to have the flexibility to address emerging risks and a wholly standardised approach would not have this flexibility.

In addition, the licence conditions imposed on existing public water utilities may not be applicable or appropriate to the more limited activities that may be undertaken by licensees (who may be seeking to supply new services) and would not address issues particular to the competitive market. Imposing the licence conditions currently applied to public water utilities on all licensees may be excessively onerous, resulting in high compliance costs and discouraging new entrants to the industry.

This alternative is not recommended.

Option 6 – A Regulation that provides for a combination of standard minimum obligations imposed as licence conditions (imposed via the Regulation, via subsidiary instruments developed by the Minister and via instruments developed by licensees) and Ministerial conditions applied to individual licenses

This is the preferred option and hence the approach adopted in the Regulation.

The broad framework for imposing licence conditions

The approach proposed under the Regulation involves:

- a mix of prescribed and Ministerial conditions including:
 - standard minimum obligations imposed by the Regulation directly as licence conditions on all licensees;
 - scope for Ministerial licence conditions to be imposed on individual licences if necessary;
 - obligations imposed as licence conditions via subsidiary instruments (for example, codes of conduct) to be developed by the Minister; and
 - obligations imposed as licence conditions via instruments (for example, codes of conduct and Plans) to be developed by licensees;
- licence conditions to vary depending on the nature of the licence and activity to be undertaken (for example, water supply versus sewerage services supply, drinking versus non-potable water supply); and
- obligations on licensees to be generally commensurate with existing regulatory / licence obligations imposed on public water utilities in respect of similar activities but providing for varying obligations where deemed appropriate.

Implementation and compliance

IPART is responsible for administering the licensing regime. It can recommend whether to grant a licence and what conditions should be placed on a licence. The Act provides that IPART is to monitor (and report to the Minister) on compliance with licence conditions. It can recommend to the Minister that licence conditions be varied or revoked, or that new licence conditions be imposed. The Minister and IPART have enforcement powers, including the power to issue penalties (for example, suspension or cancellation of a licence). In addition, IPART has the power to conduct investigations, to issue guidelines and to direct licence holders to keep records and to provide information. Penalties for breach of the codes of conduct devised by the Minister, which constitutes an offence and a breach of licence conditions, are specified in the codes themselves. The obligations contained in the Regulation relating to provision of information by licensees are critical to the ability of IPART and the Minister to monitor and enforce compliance with licence conditions.

Benefits: The application of minimum standard licence obligations where appropriate to the particular activities being undertaken by the licensee creates some certainty for licensees and a desirable degree of consistency in the regulation of industry participants, thereby encouraging new entrants to the competitive market, increasing public confidence that adequate minimum standards will be maintained and facilitating a level competitive playing field. The imposition of obligations commensurate with existing regulatory obligations imposed on public water utilities, where appropriate, should help ensure that new entrants will neither be able to gain a competitive advantage by reducing quality or safety of service nor be disadvantaged by the imposition of obligations that are not imposed on incumbents.

At the same time, the flexibility of such a regulatory regime allows it to respond adaptively to new developments and emerging risks, encouraging innovation and ensuring that key objectives such as the protection of public health and the environment continue to be met in the most effective way possible. The ability to tailor obligations via Ministerial licence conditions and Plans developed by licensees ensures that the conditions imposed on licensees are appropriate to the particular activities to be undertaken, avoiding unnecessary administrative and compliance costs for licensees and Government. In addition, this approach allows licensees some flexibility in how they implement the licensing principles, thereby encouraging market participation and innovation.

Overall this approach minimises compliance and administrative costs for licensees and Government, while ensuring that the key objectives of the Act and the Regulation are achieved.

Costs: The licensing regime will result in some administrative and compliance costs for licence applicants and regulators in the preparation and review of licence applications and Plans, as well as some ongoing monitoring and compliance costs. These costs will be proportionate to the complexity, scope and risk associated with the application.

Why this option is preferred: This approach ensures that minimum standard conditions are met where appropriate while providing the flexibility to tailor licence conditions to the particular licensee. Hence it provides the most efficient, adaptive and cost effective framework for imposing obligations on licensees.

Water quality and public health

Water quality and public health objectives are to be achieved by the imposition of a range of obligations including:

- requiring licence applicants to describe the comprehensive arrangements that they will implement to protect public health and water quality, including how they will implement the elements of relevant Australian Guidelines for water quality;
- requiring licensed network operators to provide more detailed information after being granted a licence in the form of a Water Quality Plan (to be lodged before commercial operation commences) that is subject to Ministerial amendment and independent audit by an IPART approved auditor;
- the establishment of a water industry code of conduct (developed by the Minister) that allocates responsibilities between licensed network operators, licensed retail suppliers and public water utilities; and
- imposing some direct constraints on the purposes for which water may or be used or supplied.

Benefits: The requirement to prepare and lodge a Water Quality Plan will ensure compliance with the Australian Drinking Water Guidelines and the Australian Guidelines for Water Recycling. It provides the most efficient and cost-effective means of ensuring that water quality and public health objectives are achieved. The requirement for licence applicants to provide a comprehensive description of their approach to addressing water quality issues provides a means for ensuring that water quality issues are addressed but avoids imposing high compliance costs on licence applicants in developing the detail of the Plan until such time as the applicant has greater certainty that its licence will be granted. Ensuring that Plans are developed and implemented in line with Australian Guidelines, rather than prescribing treatment methods, will provide greater scope for innovation and efficiency.

Imposing standard licence conditions commensurate with those faced by incumbent suppliers also maximises certainty and facilitates a level playing field to ensure fair and effective competition. Obligations based on industry-wide standards should increase public confidence that consistent minimum standard conditions are maintained. They are also sufficiently flexible to cater to different situations. While these obligations necessarily entail some compliance costs for licensees, such planning could be seen as part of normal prudent business planning and as necessary to protect water quality and avoid any risk to public health.

Costs: Compliance with the Australian Drinking Water Guidelines and the Australian Guidelines for Water Recycling and the provision of other information to IPART will entail compliance costs. The regulator will also incur monitoring and enforcement costs.

Why this option is preferred: The proposed approach of imposing a mix of standard and flexible obligations relating to water quality and public health through a variety of mechanisms would appear to maximise the ability to achieve water quality and public health objectives in a cost-effective manner while not unduly restricting innovation and competition.

Safety, reliability, continuity and standards of service

The approach proposed under the Regulation imposes a range of obligations relevant to reliability, safety, standards of service and related matters. In particular, it would:

- require all licence applicants to provide detailed information about events that could adversely affect their ability to supply the proposed services and what measures have or will be implemented to minimise this risk;
- impose a range of obligations encompassing both minimum standard licence conditions imposed on all network operators such as obligations to provide safe and reliable networks, and design and operation that is consistent with industry codes and Australian Standards;
- require all network licensees to develop an Infrastructure Operating Plan after being granted a licence (to be lodged before commercial operation commences), which is tailored to the particular infrastructure, that addresses issues of service continuity and other matters to ensure the implementation of the licensing principles and to prevent or limit impacts on public health, consumers, safety and the environment;
- require all retail suppliers to develop a Retail Supply Management Plan after being granted a licence (to be lodged before commercial operation commences), addressing measures to prevent or minimise events that could adversely affect the licensee's ability to supply water and to arrange for alternative supplies of water in such events;
- establish a water industry code of conduct (developed by the Minister) allocating responsibilities between licensed network operators, licensed retail suppliers and public water utilities;

- require an audit of all new infrastructure as part of the commissioning process; and
- impose obligations in relation to Contingency Plans in the event of supply failure by a licensed retail supplier including retailer of last resort arrangements.

Benefits: This approach allows licensees the flexibility in planning and operating infrastructure to meet the requirements of the individual business. It allows the regulator to meet health and safety policy objectives in a cost effective manner. It is also likely to improve confidence in the market as licensees are required to demonstrate that they have arrangements to safeguard reliability of supply and safety of services. It may also reduce the potential that an area of risk is overlooked.

Costs: Licence applicants and licensees will incur the costs of preparing Plans. The regulator will incur the administrative costs of reviewing, monitoring and enforcing Plans. Public water utilities will incur the costs in implementing the Retailer of Last Resort Contingency Plan in the event of a declared supply failure (although these may be recoverable through fees).

Why this option is preferred: The proposed approach to the regulation of licensed network operators provides a required degree of certainty for licence applicants on the minimum standard of design, construction, maintenance and operation of the infrastructure that will be required if a licence is granted, while allowing the licensee sufficient flexibility to develop efficient arrangements to ensure ongoing safety and reliability of infrastructure to prevent or limit impacts on public health, consumers, safety and the environment. Further it ensures that over the life of the infrastructure, licence conditions are in place to respond appropriately to developments in infrastructure design, changes in published standards, the commissioning of new infrastructure and to monitor the condition of infrastructure having regard to its licensed purpose. The proposed approach to the regulation of licensed retail suppliers also provides a required degree of certainty for licence applicants and imposes obligations that are proportionate to the need to protect customers' interest in ensuring continuity of supply of an essential service.

Consumer protection

The approach proposed under the Regulation is to require the development of a range of protections, some applying to all customers and others specific to small retail customers. These would be imposed through a combination of minimum standard licence conditions, licensee-developed codes, and industry-wide codes developed by the Minister. In particular, the Regulation:

- provides for the Minister to develop an industry-wide marketing code of conduct and customer transfer code;
- requires, as a licence condition, that all licensees must supply water and sewerage services to small retail customers under contracts that include prescribed matters to ensure transparency and information disclosure to customers, including the key provisions of that contract that must be communicated to the customer before entering into the contract;
- requires the licensee to develop a Retail Supply Management Plan after being granted a licence (to be lodged before commercial operation commences) that is subject to audit and Ministerial amendment and that includes detail on the events and circumstances that could adversely affect their ability to supply water, the probability of these events occurring, and the measures taken by the licensee to mitigate these risks;
- requires a licensee to develop a code of practice and procedure on debt recovery as a licence condition;

- requires a licensee to develop a code for complaints handling as a licence condition and also provides for details of the jurisdiction and reporting of an approved ombudsman scheme for referral of disputes and complaints;
- imposes licence conditions in the Regulation that licensees comply with Government social programs where relevant;
- requires licensees to make available details of these protections on their website; and
- requires retail suppliers to be notified of the existence of, and telephone number for, any community translation services that are available.

Benefits: The requirement to submit a Retail Supply Management Plan will help to ensure a consistent approach to the assessment of risks and that the mitigation actions put in place are proportionate to the magnitude of these risks.

The introduction of a competitive regime requires that customers receive all the information required to make an informed decision. Regulation of marketing practices is therefore justified. Given that marketing requirements are likely to change over time, the Regulation provides for the establishment of a marketing code of conduct, providing a flexible mechanism that can be developed over time. The code will provide protection against misleading conduct by marketers and assist to foster confidence in the competitive market.

The proposed regulated contract terms have been designed to protect key aspects of the supply arrangements for small retail customers. The obligations imposed on licensees under the Regulation are commensurate with those imposed on existing public water utilities. This approach ensures that customers receive similar protections regardless of the identity of their supplier. For small retail customers, standardising and simplifying the form of contracts may enable them to concentrate on key terms and conditions of difference, such as price and quality. This can also help to enhance competition. Licensees still have the capacity to negotiate with large customers.

The obligations with respect to the establishment of a code of practice for debt recovery, customer complaint handling process and dispute resolution arrangements are commensurate with those imposed on existing public water utilities. This approach ensures that customers receive similar protections regardless of the identity of their supplier and is consistent with competitive neutrality. It creates confidence in the market and protects good operators from any that engage in inappropriate market behaviours.

The establishment of industry-wide transfer code will ensure that the arrangements for transfers do not impede effective competition, while protecting privacy and other interests of customers.

Costs: There will be some costs for licensees involved in developing licensee-specific codes and complying with marketing and transfer codes.

For licensees, the inclusion of specified matters in all small retail contracts may impose some costs and to some extent constrain their market offerings to this customer segment. However, to the extent that standardised key contract terms provide confidence in the emerging market, this represents an important benefit to licensees.

Why this option is preferred: The customer protections imposed under the Regulation are considered to be the most effective means of ensuring that customers' interests are safeguarded without necessarily interfering with commercial negotiations for those customers judged able to protect their own interests in dealing with new suppliers. The development of codes for complaint handling and debt recovery ensures such basic protections are maintained without imposing arbitrary government controls (and unnecessary cost) on the ability of licensees to tailor their customer service to the needs of their targeted market and proposed commercial operations. The conditions impose compliance costs that are not excessively burdensome and are commensurate with those currently applied to public water utilities.

Protection of the environment and sustainability of resources

The approach proposed under the Regulation seeks to impose minimum standard licence obligations with respect to the protection of the environment and sustainability of resources. It does this by:

- reinforcing the existing requirements under the Act by requiring that the licence applicant has the capacity to carry out the activities that the licence would authorise in a manner that does not present a significant risk of harm to the environment;
- requiring the preparation of various Plans by the licensee (notably a Sewage Management Plan in relation to the conveyance, treatment and disposal of sewage);
- providing a standard licence condition that licensees must comply with the requirements of environmental legislation;
- allowing the Minister to impose water restrictions on private operators if they derive their water from a public water utility source in relation to which restrictions have been declared or if the circumstances leading to the imposition of water restrictions on a public water utility source apply also to the alternative source from which the operator derives supply; and
- providing that retail suppliers must not over-commit their available water source.

Benefits: This approach facilitates the achievement of water conservation, sustainability, and water quality policy objectives while avoiding the imposition of unnecessary compliance costs and the undue restriction of innovation and competition. It avoids duplication of environmental regulatory approvals where possible and minimises the application of conditions that are not proportionate to the risks associated with the project. The ability to impose water restrictions ensures conservation of water at times of shortage. The obligation not to over-commit ensures that customers are protected.

Costs: There will be administrative costs involved in reviewing, monitoring and enforcing Plans.

Why this option is preferred: The proposed approach is considered to maximise the net benefits of the Regulation in facilitating the achievement of the objectives of protection of the environment and ensuring the sustainability of resources without significantly compromising competition, innovation and market efficiency.

Licence administration

The approach proposed under the Regulation prescribes some aspects of the licensing administration process and imposes certain reporting obligations on licensees.

The Regulation makes provision for a number of licence administration matters, including licence application procedures and notification requirements, information to be included in the Register of Licences maintained by IPART and the obligation of licensees to provide and permit publication of information relating to their licences.

Benefits: The process and information provision obligations ensure that the licensing regime is administered in a manner that is efficient, transparent and accountable. It facilitates consumer buy-in by rendering information regarding licensees public. The ability of IPART and the Minister to access appropriate records, information and statistics in relation to the activities of licensees is necessary for effective monitoring of licensees' compliance with licence conditions. The monitoring of compliance is critical to the overall functioning of the regulatory regime.

Costs: Licensees will incur costs in complying with the procedures and information provision obligations. The regulator will incur some administration and monitoring costs.

Why this option is preferred: The licence administration provisions, with the exception of the record keeping and reporting requirements, largely supplement the licence application, administration and enforcement processes already established under the Act. While they necessarily impose some administrative costs, these costs are offset by the fact that they are necessary for the effective and efficient administration of the licensing regime.

Licence exemptions

This option prescribes further specified exemptions from the requirement to be licensed. The proposed approach exempts water industry infrastructure that, with regard to the licensing principles set out in the Act, are considered to be comprehensively covered by other regimes.

Benefits: This approach minimises regulatory overlap and the imposition of unnecessary compliance and administrative costs for licensees and the regulator respectively.

Costs: Minimal

Why this option is preferred: The exemption of water industry infrastructure that is considered to be adequately covered by other regimes maximises the net benefits of the Regulation whilst minimising risk as well as regulatory and compliance costs.

Overall assessment

This approach is recommended and therefore is adopted in the Regulation. For discussion see the section entitled "Preferred Option" (below).

Consultation

In November 2005, IPART completed a major investigation (including a process of public consultation) into water and sewerage service provision in the greater Sydney region. The Government endorsed the recommendations of this investigation. Recognising that similar reforms had not been implemented elsewhere in Australia, before proceeding to develop legislation, the policy frameworks for the key components of reforms were released for public comment in May 2006. Informed by the submissions of stakeholders, legislation was introduced to the Parliament and the Act was passed in October 2006.

A consultation paper on the Regulations was released in June 2007 (with submissions due in July 2007). This consultation paper explored regulatory alternatives for addressing the following issues:

- the framework for imposing licence conditions
- water quality and public health
- construction, operation and maintenance of water industry infrastructure
- consumer protection
- licensing administration
- licence exemptions

Submissions were received from a large number of stakeholders, including industry representatives, government departments (for example, the Department of Health), community groups and environmental bodies. Informed by these stakeholder submissions and the earlier consultations, the Regulation was prepared and released for public consultation in April 2008. A Regulatory Impact Statement was also released at that time. Submissions were received on the draft Regulations in May 2008. The content of these submissions was given due consideration in the further development of the Regulation.

Preferred Option

The preferred option is Option 6, a Regulation that imposes standard minimum obligations as licence conditions, while allowing for the imposition of individual licence conditions by the Minister and for the imposition of licence conditions by means of instruments such as codes of conducts and Plans.

Under this approach, where standardised licence conditions can be appropriately applied to all licence holders of a particular class, they are provided for in the Regulations. Where possible, these are commensurate with the obligations placed on incumbent suppliers. This maximises certainty, thereby encouraging new entrants to the competitive market, increases public confidence that adequate minimum standards will be maintained and facilitates a level playing field between public water utilities and new private suppliers to ensure fair and effective competition. A degree of standardisation will assist to reduce the administrative costs of the regulator and licensees.

Obligations that need to be applied with a degree of tailoring will be developed on a case-by-case basis. This ensures that conditions are imposed on licensees in a manner appropriate to the particular activities to be undertaken, allowing flexibility for licensees to adopt practices and policies appropriate to their particular activities.

The use of licensee-developed codes and Plans which are updated when necessary means that prospective licensees will undertake appropriate planning and risk management. This means that service providers will be better equipped to avoid or mitigate the negative consequences of any contingencies. This, combined with the ability to apply Ministerial licence conditions whenever necessary, means that the regulatory regime will be able to address emerging issues and risks that arise from innovation.

The proposed regulatory regime is sufficiently flexible to cater for new types of projects and arrangements, thereby encouraging new entrants to the competitive market and the development of innovative solutions to water supply and demand balance. A more rigid regime, such as that outlined in Option 4, may present a barrier to new entrants or to new innovations.

The overall flexibility of the framework for imposing licensing conditions ensures that licensees are not subject to inappropriate or excessive obligations that involve unnecessarily high administrative and compliance costs for licensees and regulators. This will ensure that competition and innovation are not unnecessarily constrained. It also allows for the most cost-effective means of achieving the public health, environmental and consumer protection objectives to be adopted in each case.

Evaluation and Review

The Regulation will be reviewed every 5 years in accordance with the *Subordinate Legislation Act 1989*. However, DWE will endeavour to keep the Regulation under continuous review, obtaining feedback from IPART and other stakeholders as to the efficacy and efficiency of the Regulation, as the Act and the Regulation operator to introduce the private sector to markets previously dominated by State-owned operators.

Furthermore, the Act is due to be reviewed approximately 5 years from the date of assent. This review will determine whether the policy objectives of the Act remain valid and whether the terms of the Act are appropriate for securing those objectives. As the broader objectives of the Act frame the objectives of the Regulation, review of the Act is likely to raise issues pertinent to the Regulation.