



Hawkesbury City Council

Attachment 1
to
item 190

Retailer of Last Resort and Operator of
Last Resort Arrangements Under the
Water Industry Competition Act 2006
Discussion Paper - June 2011

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Finance
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Retailer of Last Resort and Operator of Last Resort arrangements under the *Water Industry Competition Act 2006*

Discussion paper

July 2011

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Abbreviations

AER	Australian Energy Regulator
ESC	Essential Services Commission, Victoria
DFS	Department of Finance and Services
IPART	Independent Pricing and Regulatory Tribunal
NECF	National Energy Customer Framework
NOW	NSW Office of Water
NSW	New South Wales
OoLR	Operator of Last Resort
RoLR	Retailer of Last Resort
WIC Act	Water Industry Competition Act 2006

Acknowledgements: In late 2009 the Independent Pricing and Regulatory Tribunal (IPART) prepared an internal scoping brief on the issue of RoLR and OoLR under the WIC Act (IPART 2009). IPART's brief has formed the basis of this discussion paper.

1. Introduction

A key component of the New South Wales (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. Regulatory reform has formed a key component of this strategy with the introduction of the *Water Industry Competition Act 2006* (WIC Act) in August 2008. The WIC Act seeks to promote innovative solutions to the water supply and demand balance, particularly the development of infrastructure for the production and reticulation of recycled water. The WIC Act introduced a number of reforms to the water industry, including a licensing regime for private entrants seeking to provide water or sewerage services within the NSW water industry.

Along with measures to protect public health and the environment, there are also provisions that seek to protect customers in the event that a retail supplier licensed under the WIC Act fails or becomes unviable – these are referred to as retailer of last resort (RoLR) arrangements. This review will examine the adequacy of the current arrangements.

While the WIC Act does include broad provisions for a retail supplier licensee failure, it does not have any arrangements in place that would respond to a licensed network operator failure – operator of last resort (OoLR) arrangements. Therefore this review will also consider arrangements that should be in place to address a network operator failure.

1.1. Five yearly review of the WIC Act

It should be noted that section 104 of the WIC Act provides that the Minister is to review the Act, as soon as possible after a period of five years, to determine whether the policy objectives of the Act remain valid and whether the terms of reference of the Act remain appropriate for securing those objectives. Therefore, in addition to the RoLR and OoLR review, a broader review of the WIC Act will commence in 2011.

1.2. Purpose of the review and terms of reference

The purpose of this review is twofold:

- 1 to review the adequacy of the RoLR provisions and identify a preferred set of arrangements
- 2 to identify a preferred option for OoLR arrangements.

The terms of reference in relation to each are as follows:

Review RoLR arrangements under the *Water Industry Competition Act 2006* and the *Water Industry Competition (General) Regulation 2008*

In consultation with stakeholders:

- review the adequacy of the RoLR arrangements under the *Water Industry Competition Act 2006* and the *Water Industry Competition (General) Regulation 2008*
- identify the key issues and problems to be addressed in relation to these arrangements
- examine RoLR arrangements for gas and electricity in NSW and other Australian jurisdictions
- identify and examine possible options for RoLR arrangements that will safeguard customers in the event of a retail supply failure

- identify a preferred set of RoLR arrangements.

Identification of OoLR arrangements

In consultation with stakeholders:

- identify the key issues to be addressed in developing OoLR arrangements
- examine OoLR arrangements in other jurisdictions (where applicable)
- identify and examine possible options for OoLR arrangements that will safeguard customers in the event of a network operator failure or a combined retail supplier and network operator failure
- identify a preferred option for OoLR arrangements.

1.3. Purpose of the discussion paper

With regard to the RoLR component of the review, the aim of this paper is to facilitate discussion in relation to the existing RoLR arrangements under the WIC Act and seek stakeholder input on the key issues the current regime does not address.

With regard to the OoLR component of the review, this paper identifies the key issues that need to be considered in developing an OoLR regime and seeks stakeholder views on how these should be most appropriately dealt with.

1.4. How to have your say

The Department of Finance and Services (DFS) is seeking comments on the issues raised in this paper. Specific questions are identified in relevant sections.

Interested persons are invited to read this discussion paper and to provide written submissions responding to the numbered questions in this paper.

Post: WIC Act RoLR and OoLR review
Metropolitan Water Directorate
McKell Building 2-24 Rawson Place
Sydney NSW 2000

Email: wica@waterforlife.nsw.gov.au
Subject line - WICA – RoLR and OoLR

All submissions will be made publicly available on the Water for Life website, unless requested otherwise. Please indicate if you want your submission to be treated as private and confidential.

1.5. Next steps

Once submissions have been received, the feedback will inform the development of detailed provisions for proposed RoLR arrangements and a preferred option for OoLR arrangements.

A recommendations report on the most appropriate model for NSW will then be provided to Government for its consideration. The Government will then determine how these recommendations will be acted upon in order to achieve the objectives of this review.

1.6. Structure of the discussion paper

The structure of this paper is as follows:

Section 2 sets out the broader legislative and policy context for the review. It provides an overview of the WIC Act and its policy objectives, as well as the key issues driving this review.

Section 3 examines the proposed policy intent of RoLR and OoLR arrangements, putting forward a set of principles and objectives. These principles and objectives draw on the outcomes of a national review of energy RoLR arrangements.

Section 4 defines the scope and intent of RoLR and OoLR schemes as a service continuity measure and how other regulatory mechanisms also play a role in ensuring service continuity.

Section 5 describes current RoLR arrangements under the WIC Act and identifies possible areas for improvement.

Section 6 gives consideration to OoLR arrangements. It identifies the issues that need to be addressed in developing detailed provisions for an OoLR regime.

2. Water Industry Competition in NSW

This section sets out the legislative and policy context for the review. It provides an overview of the WIC Act and its policy objectives, as well as the key issues driving this review.

2.1. The *Water Industry Competition Act 2006*

The WIC Act and the Regulations supporting its implementation (the Water Industry Competition (General) Regulation 2008 and the Water Industry Competition (Access to Infrastructure Services) Regulation 2007) commenced on 8 August 2008. The objectives of the Act and supporting Regulations 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, while protecting public health, the environment and consumer rights.

The core reforms introduced by the WIC Act are:

- the establishment of a new licensing regime for private sector providers of reticulated drinking water, recycled water and sewerage services
- provisions to authorise Independent Pricing and Regulatory Tribunal (IPART) to arbitrate certain sewer mining disputes
- the establishment of a third-party access regime for water and sewerage infrastructure.

The WIC Act encourages competition and investment through:

- promoting new recycling businesses
- establishing a comprehensive access regime to help new suppliers negotiate arrangements for the transportation and storage of water and sewerage using existing water networks
- ensuring new entrants and the public water utilities face similar obligations, where like services are provided
- providing equality between independent and public water utilities for things such as laying pipes in public roads and reading meters.

2.1.1. Licensing regime

The WIC Act establishes a licensing regime for private entrants seeking to provide water or sewerage services within the NSW water industry. 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 WIC Act, a person must not construct, maintain or operate any water industry infrastructure or supply water (potable or non-potable) or provide sewerage services by means of any water industry infrastructure otherwise than under the authority of a licence under the WIC Act.

There are two categories of licence the Minister can grant under the WIC Act:

- a **network operator's licence**: this authorises the licence holder to construct, maintain and operate specified water industry infrastructure for the purposes identified in the licence
- a **retail supplier's licence**: this authorises the licence holder to supply water or provide sewerage services by means of water industry infrastructure.

In granting a licence the Minister must have regard to four core principles:

- the protection of public health
- encouraging competition in the provision of water supply and sewerage services
- ensuring the sustainability of water resources
- promoting the production and use of recycled water.

The WIC Act sets out the functions and responsibilities given to the Minister for Finance and Services (the Minister) and IPART in relation to the licensing regime. The Minister's functions include determining whether to grant a licence, determining licence conditions, setting licence fees and enforcing licences. IPART's functions include considering licence applications, recommending the terms or conditions of a licence to the Minister, and auditing and enforcing licences. The Minister also has a range of functions to ensure the integrity of the licensing regime, such as giving emergency directions to deal with a risk to public health or safety, declaring specified persons as retailers of last resort, and declaring supply failure in relation to a licensed retail supplier.

2.1.2. Retailer of last resort provisions

Similar to the energy industry, to protect consumers, the WIC Act includes provisions to ensure the continued supply of water and sewerage services in the event of a retail supplier failure.

Under the WIC Act, the Minister can declare a public utility or a licensed retailer a RoLR. In the event that the Minister declares a supply failure, the RoLR must start supplying water or providing sewerage services when the Minister declares a supply failure in relation to a licensed retail supplier. Under the current arrangements the Minister is not able to declare a supply failure in relation to a licensed network operator. The Minister can declare a supply failure if, for example, the licensee is declared insolvent or elects to terminate its licence. The former retailer's customers then become the customers of the RoLR for these services.

Adequacy of Retailer of Last Resort provisions

The key issue in relation to the current arrangement is that, compared to other RoLR schemes (e.g. for the energy sector), the legislation only provides for a broad framework and lacks considerable detail in some key areas. To ensure there are adequate arrangements in place to support a RoLR event, the existing provisions need to be strengthened. This is addressed in detail in section 5.

2.1.3. Operator of last resort arrangements

As noted in section 1, while the RoLR provisions address the possibility of a retail supply failure, there are no provisions that would respond to a network operator failure (OoLR event) or the failure of a combined network operator and retail supplier. OoLR provisions are important for ensuring continued operation of network infrastructure in the event of a network operator failure.

It is important there are adequate safeguards to deal with the possible failure of retail and network functions. This is a central component of the overall integrity of the licensing regime.

3. Policy intent of RoLR and OoLR arrangements

The Australian energy sector has well established separate RoLR schemes for each State and Territory. However, a National Energy Customer Framework (NECF) is proposed that includes a single national RoLR scheme for electricity and gas. It is anticipated that the NECF will come into effect in all States and Territories (except Western Australia and the Northern Territory) between mid-2011 and mid-2013. Although the energy and water industries are not entirely analogous, the considerable experience and work undertaken to date in the energy sector provides a useful basis on which a RoLR and OoLR scheme can be developed and discussed. Therefore, the proposed NECF RoLR scheme has been used in this paper as a framework for identifying and discussing the key policy issues both a RoLR and an OoLR scheme will need to address.

This section puts forward a set of principles and objectives that can be applied to both RoLR and OoLR schemes.

3.1. Principles and objectives

As part of the development of the NECF, the Ministerial Council on Energy (MCE) engaged NERA Economic Consulting and Allens Arthur Robinson (2009) to undertake a review of Australian and international RoLR jurisdictional arrangements and recommend a single national RoLR policy framework for gas and electricity. As part of its review, a set of objectives common to RoLR regimes nationally and internationally were identified.

Although a broad RoLR framework currently exists under the WIC Act, principles and objectives have not been defined. While the RoLR and OoLR arrangements will be developed as two separate schemes there is considerable crossover in the issues that are fundamental to each of these schemes. Informed by the outcomes of the national review of energy RoLR arrangements, the following principles and objectives are proposed for both RoLR and OoLR schemes under the WIC Act.

It is proposed that a RoLR and an OoLR scheme should:

1 Be flexible to ensure the most practical and efficient response to licensee failure

- It is difficult to predict the full range of possible licensing arrangements under the WIC Act and possible licensee failure scenarios. The circumstances (such as the type of service provided, infrastructure, small or large customers¹) surrounding a licensee failure may vary considerably. The Minister needs to have a reasonable level of flexibility to ensure he or she is able to implement the most appropriate and efficient response to a licensee failure. Therefore the RoLR and OoLR arrangements should not be overly prescriptive in terms of the circumstances under which they can and can not be applied.
- The appointment of a RoLR or OoLR should not be the default response to all licensee failure scenarios. Depending on the circumstances surrounding the licensee failure, appointing a RoLR or OoLR may not always be the most practical or efficient response. For example, if a network operator of a sewer mining project in the basement of a multi-storey building was to fail, it may be more practical to connect to the public water utility mains rather than appointing an OoLR to operate the infrastructure.

¹ The WIC Regulation defines a small retail customer is less than 15 mega litres per year for water supply and less than 10.5 mega litres per year for sewerage services.

- It is likely that the appointment of a RoLR or OoLR would be the most appropriate response in relation to the provision of essential services (drinking water, sewerage services), and where those essential services form part of an integrated service providing both essential and non essential services (e.g. where recycled water is used for toilet flushing and general wash down purposes).
- OoLR arrangements should have the flexibility to apply where there is network operator failure or a combined network operator and retail supplier failure.
- OoLR arrangements should have the flexibility to continue until a permanent solution is found (either sale of the assets or connection to a surrounding network).

2 Encourage good industry practice

- The RoLR and OoLR scheme should form part of a broader commercial and regulatory framework that places primary responsibility for risk management and contingency planning on the licensee. It is therefore important that the RoLR and OoLR schemes not provide a disincentive for licensees to exercise good industry practice (i.e. maintain infrastructure and ensure contingency plans are in place).
- Equally, RoLR and OoLR arrangements should not discourage customers of their responsibility to be aware of potential issues associated with becoming a customer of a WIC Act licensee. For example, it is important that customers fully assess the risks associated with purchasing a property that is serviced by a stand alone system operated by a WIC Act licensee.
- On this basis, the RoLR and OoLR scheme should be specifically designed to respond to situations where the licensee is no longer viable and therefore unable (either voluntarily or involuntarily) to provide water or sewerage services. The rationale for this principle is explained in section 4.

3 Ensure continuity of service provision

- The RoLR and OoLR arrangements should form part of an overall suite of regulatory mechanisms designed to protect service continuity.
- RoLR and OoLR arrangements should, where possible, ensure continuity of water supply and/or sewerage services to customers.

4 Ensure quality of service provision

- The quality of service provision (e.g. water quality, infrastructure management) as required under the WIC Act licensing regime should continue to apply in a RoLR or OoLR event. This is central to ensuring the continued protection of public health and the environment.

5 Not impede competition

- The RoLR and OoLR arrangements should not, where possible, create any barriers to competition while at the same time ensuring the protection of customers, the environment and public health.

6 Protect customers

- The RoLR arrangements should protect customer interests with respect to prices, terms and conditions of supply and ensure customers receive timely, accurate information to enable informed decisions.

- The OoLR arrangements should safeguard customers in the event of a network operator failure or a combined retail supplier and network operator failure.

7 Ensure the continuity of payments and information to affected parties

- Relevant parties affected by the failure of a licensee should be protected.
- The RoLR arrangements should ensure the continuity of payments to suppliers of network operation and other ancillary services and ensure they receive timely, accurate information to enable informed decisions.
- The OoLR arrangements should protect retail suppliers, including mechanisms that allow for retail suppliers to continue to access network infrastructure.

8 Include cost recovery mechanisms

- The RoLR and OoLR arrangements should provide RoLRs and OoLRs a reasonable opportunity to recover the efficient costs it incurs in complying with its regulatory RoLR and OoLR obligations.

9 Be compatible with broader legislative and commercial arrangements

- Given that RoLR and OoLR schemes are specifically designed to respond to licensee failure, each scheme should be clear in terms of how it will interact with Chapter 5 of the *Corporations Act 2001* (insolvency regime). That is, RoLR and OoLR provisions need to not only address the rights and responsibilities of the RoLR and the OoLR, they will also need to specifically address the rights and responsibilities of insolvency officials. This is important as the roles and responsibilities of an insolvency official under the *Corporations Act* may not be consistent with the policy objectives of a RoLR and OoLR regime. Having clarity regarding these respective roles and responsibilities is essential to ensuring continuity of supply in a RoLR or OoLR event.

Question:

- 1. Are the above principles and objectives appropriate for RoLR and OoLR arrangements?**

4. RoLR and OoLR as a service continuity measure

As noted in the proposed principles, RoLR and OoLR arrangements should be designed to form part of an *overall suite of regulatory mechanisms* designed to protect service continuity – they should not be the only regulatory measure in place to protect service continuity. This section explains the specific role of RoLR and OoLR arrangements and what other mechanisms are in place to protect service continuity.

4.1. Factors that can lead to service failure

Service continuity can be threatened by a range of factors. These can be broadly categorised as factors that relate to the failure of a licensee and those that relate to the physical failure of infrastructure or physical failure of a supply source.

Licensee failure: Situations where the licensee is no longer viable and therefore unable (either voluntarily or involuntarily) to provide water or sewerage services. For example:

- Commercial failure of a licensed retailer and/or licensed network operator
- Licensee elects to terminate services (under Cl. 17 of the WIC Regulation)
- Licensee is no longer authorised to supply water or sewerage services (i.e. no longer licensed).

Physical failure: Situations where the licensee is still viable but the continuity of service is impacted by problems with infrastructure or supply source. For example:

- Physical supply failure or disruption (e.g. lack of supply or insufficient source of water, health concerns in relation to water quality, contamination of supply).
- Physical infrastructure failure (e.g. network infrastructure fails which would either disrupt or lead to complete failure of water or sewerage services).

There will be occasions where licensee failure is connected with a physical failure event. For example, a licensee may become unviable as a result of costs incurred to address a physical infrastructure failure. However, while a physical failure may impact on the viability of a licensee, there are other mechanisms in place under the WIC Act that are specifically designed to manage the risk of physical failure in situations where the licensee is still viable.

These are detailed below.

4.2. What provisions are in place to deal with physical failure?

4.2.1. WIC Act licensing measures

It is important to note that this review is predominantly focused on what arrangements should be in place to respond to licensee failure. It will not examine in detail the process that is undertaken and factors that are considered before a licence is granted to a network operator or retail supplier and the extent to which this process considers RoLR or OoLR related issues. A more detailed review of the licensing process will be undertaken as part of the five yearly review of the WIC Act late in 2011.

The licensing requirements under the WIC Act include a number of mechanisms for managing the risk of physical supply or physical infrastructure failure.

At the licence application stage applicants are required to identify:

- the events or circumstances that could adversely affect their ability to carry out the proposed activity

- the probability of these events occurring; and
- measures that can be implemented to prevent or minimise the likelihood of any such event or circumstance (contingency measures).

Once licensed, retail suppliers and network operators can not commence commercial operations until they have management and operation plans in place that include contingency measures in the case of a service failure.

Retail suppliers are required to have a retail supply management plan. This plan must outline arrangements in relation to:

- the events and circumstances that could adversely affect the licensee's ability to supply water or sewerage services
- the probability of the occurrence of any such event or circumstance
- the measures to be taken by the licensee:
 - ⇒ to prevent the occurrence, or minimise the effect, of any such event or circumstance, and
 - ⇒ to arrange for alternative supplies of water or sewerage services in response to any such event or circumstance.

(Clause 9 Water Industry Competition Regulation (General) 2008).

Network operators are required to have an infrastructure operating plan and a water quality plan. The infrastructure operating plans must indicate:

- the arrangements in relation to the continued safe and reliable performance of the infrastructure;
- the continuity of water supply or sewerage services
- alternative water supply or sewerage services when the infrastructure is inoperable.

(Clause 13 Water Industry Competition Regulation (General) 2008).

Water quality plans must outline how the water supplied from the infrastructure meets Australian Drinking Water Guidelines and the Australian Guidelines for Water Recycling (where relevant).

4.2.2. Emergency direction provisions

There are emergency directions provisions under the WIC Act (section 18) that allow the Minister to direct licensees to undertake certain actions to address a risk to public health or public safety arising from the construction, maintenance or operation of water industry infrastructure or the supply of water or the provision of sewerage services.

There are a number of safeguards built into the licensing regime that seek to manage the risk of physical failure and ensure that there are contingency plans in place that can respond to a physical supply or infrastructure failure.

4.2.3. Other relevant regulatory mechanisms

There are regulatory mechanisms outside of the WIC Act licensing framework that play an important role in protecting service continuity and quality. The WIC Act works in conjunction with other legislation including the *Public Health Act 1991*, the *Protection of the Environment Operations Act 1997*, and the *Environmental Planning and Assessment Act 1979*. The WIC Act does not override the requirements of

these Acts. For example, the *Public Health Act 1991* defines the powers of NSW Health in relation to drinking water supplies. These include powers to require:

- testing of drinking water
- production of information including the results of testing
- rectification or closure of a water supply that is a risk to public health.

In addition, under the *Essential Services Act 1988*, the Government has the ability to declare a state of emergency in relation to the provision of sewerage services or the supply and distribution of water, and to direct the activities of any person in relation to the provision of the supply of water or sewerage services during the state of emergency.

Question:

2. Are these provisions adequate to manage the risk of physical failure?

4.3. What is the role of RoLR and OoLR arrangements in the event of a physical failure?

RoLR and OoLR arrangements are not intended, nor an appropriate mechanism, to respond to physical failure where the licensee remains viable. Replacing a retailer because of an infrastructure or physical supply failure is unlikely, by itself, to resolve the problem. Similarly, replacing a network operator would also be unlikely to resolve the problem.

If RoLR and OoLR arrangements were designed to specifically respond to a physical supply failure or physical infrastructure failure, this could create a disincentive for licensees to maintain infrastructure or ensure contingency measures are in place. It would also mean that WIC Act licensees would have an unfair advantage over public utilities as WIC Act licensees would be treated differently in a supply failure scenario.

If a public utility's water supply was to fail or to be interrupted, a third party would not take over operation of its infrastructure or retail supply services. Public utilities would have contingency measures in place for accessing alternative water sources or sewerage services to ensure continuity of service. For example, during extended drought periods, many local water utilities developed drought management plans that included contingency measures for accessing alternative drinking water sources (e.g. carting of water) in the event of primary drinking water supply failure.

Therefore, it is important that RoLR and OoLR arrangements do not perform the role of a quasi-contingency measure that licensees can rely on as a back-up.

4.4. Managing the risk of licensee failure

RoLR and OoLR arrangements are intended to be the last resort regulatory responses to the failure of a licensee. They are not the only measures in place to manage this risk. The licensing regime under the WIC Act plays a role in managing the risk of licensee failure by assessing the organisational and financial capacity of applicants to undertake the activities proposed to be licensed. In applying for a WIC Act licence, applicants are required to submit information regarding the applicant's financial history, the

projected financial performance of the proposed activities, how it will finance the proposed activity, insurance arrangements, and any events that could affect its future financial capacity.

However, any financial capacity assessment has limitations. It is undertaken at a particular point in time and may not be valid if economic and other conditions change. The assessments are based on a number of assumptions, some of which are difficult to verify and may also change over time. As such financial capacity assessment provides no guarantee that a company will remain viable especially in a competitive market. Other regulatory measures need to be developed to ensure the continuation of essential services (i.e. RoLR and OoLR arrangements).

It should be noted that the broader WIC Act review will provide an opportunity to review the licensing process in detail, including what role it plays to establish RoLR and OoLR arrangements for individual licences.

Question:

3. Are the existing licensing requirements adequate to manage the risk of licensee failure?

5. Retailer of last resort

This section describes the current RoLR arrangements under the WIC Act, including some scenarios where RoLR arrangements would be triggered. Drawing on the findings of a national review of energy RoLR frameworks, the current RoLR provisions are examined and areas lacking detail are identified.

5.1. Possible RoLR scenarios

While it is impossible to predict every retail supplier failure scenario, the following scenarios provide an indication of the types of situations RoLR arrangements may need to address. They also demonstrate the range of schemes that can potentially be licensed under the WIC Act.

There are three key factors that impact on the complexity of supply/service arrangements, and therefore the complexity of a RoLR scenario:

- The nature of the infrastructure: whether or not services are provided via a stand alone network or via an existing utility's infrastructure. Unlike the energy sector, a retail supplier can operate on an existing network or on a 'stand alone' network. A stand alone network is a privately owned network that is not connected to existing water and sewerage infrastructure.
- The nature of the services provided: drinking water, sewerage services, recycled water services for a range of purposes.
- The licensing arrangements: if it is a 'bundled' supplier (i.e. retail supplier and network operator are the same entity) or separate entities providing a retail supplier function or a network operator function.

Scenario 1: Retailer fails on privately owned network where service is still viable and another retailer is operating on the network

Context: A 5,000 lot housing development is located in a greenfield development site on the outskirts of Sydney. A recycled water plant is located on-site. Recycled water is used for toilet flushing, irrigation and general wash down purposes. Small retail customers are supplied with drinking water via public utility owned and operated infrastructure, and sewerage and recycled water services via a privately owned stand alone network.

Licensing arrangements: Yellow Corporation holds a network operator's licence to operate and maintain the recycled water and sewerage infrastructure. Red Corporation and Green Corporation both hold a retail supplier's licence to supply recycled water and sewerage services respectively to small retail customers. Red Corporation and Green Corporation have a network access agreement with Yellow Corporation.

RoLR scenario: Green Corporation is declared insolvent and the Minister declares a supply failure in relation to Green Corporation. Given the underlying supply service is still viable, there is a need only for continuity of retail functions by the RoLR. Supporting arrangements would be necessary to ensure the RoLR could access the relevant network assets. It would be possible for the Minister to appoint a public utility or another licensed retail supplier (e.g. Red Corporation) as the RoLR. Alternatively, the network operator could apply for a retail supplier's licence and take over the retail function.

Likelihood: This scenario is unlikely in the short term. This is because, in the current early stages of competition reform, it is unlikely there will be more than one retailer supplying on small private networks. Simultaneous network operator and retailer failure is more likely given the retailer will usually be the

same or a related party to the network operator, resulting in an OoLR event. It is proposed that where there is a combined failure, this should be addressed through the OoLR arrangements. This scenario is included in section 6.2.

Scenario 2: Retailer fails on existing public water utility's network

Context: A public water utility owns and operates drinking water and sewerage infrastructure that services an infill residential development in the Sydney Metropolitan area.

Licensing arrangements: The public water utility is also the retailer of drinking water to residential customers. Blue Corporation holds a retail supplier licence to provide sewerage services to residential customers. Blue Corporation has an agreement with the public utility to access sewerage infrastructure.

RoLR scenario: Blue Corporation provides notice to the Minister and IPART of its intention to cease services. The Minister declares a supply failure in relation to Blue Corporation. Given that the public utility owns and operates the sewerage infrastructure it is likely that the public utility would become the RoLR and take over the retail functions. In this scenario there would be no network access issues.

Likelihood: Based on the nature of licensed schemes to date and the current state of water competition within the water industry, this scenario is unlikely.

5.2. Key elements of RoLR arrangements

In its review, NERA and Allens Arthur Robinson (2009) used a set of broad categories to describe RoLR arrangements across different jurisdictions. These categories highlight the key elements of a RoLR scheme and the questions that must be considered in relation to each of these elements. It also provides a useful framework to examine the existing RoLR arrangements under the WIC Act (see section 5.4):

Table 1: Elements of RoLR arrangements

Element	Key questions/issues
The appointment of a RoLR	Who can be appointed a RoLR and how? Who is able to make this appointment? When is an appointment made? Should RoLR appointments be reviewed?
Trigger events	Under what circumstances can a supply failure be declared resulting in a RoLR being obliged to supply customers of another retailer?
Preliminary obligations	Includes the process for determining the terms of supply by a RoLR, establishment of systems and management processes, and promoting customer awareness of the RoLR scheme and its consequences.
Obligation to supply	The nature and extent of the RoLR obligation to supply, including the customers to be supplied by the RoLR and the duration of that obligation.
Commercial parameters	Tariffs, terms and conditions on which the RoLR's obligation to supply customers is based.
Legal consequences when a RoLR's supply obligation is triggered	Legal and contractual effects and consequences when a RoLR's supply obligation is triggered.
Market consequences of a RoLR event	Including the process by which financial responsibility for affected customer supply points is transferred to the RoLR.
Information transfer	Provisions facilitating access by the RoLR to up to date customer information when a RoLR event occurs.

5.3. Overview of RoLR provisions under the WIC Act

Under the WIC Act, the Minister can declare a public utility or a licensed retailer a RoLR. Once the Minister declares a supply failure, the RoLR must start supplying water or providing sewerage services when the Minister declares a supply failure in relation to a licensed retail supplier.

The legislation prescribes a number of matters relating to the RoLR arrangements. In summary these are:

- **RoLR triggers:** The circumstances in which a “supply failure” may be declared by the Minister – i.e. the triggers for a RoLR event. The Minister can declare a supply failure if, for example, the licensee is unable to supply water or provide sewerage services to some or all of its customers. This could occur due to the commercial failure of the retailer or the retailer electing to terminate its licence. The former retailer’s customers then become the customers of the RoLR for these services.
- **The appointment of a RoLR:** The Minister can declare any licensed retailer or a public water utility a RoLR. This RoLR appointment can be made in relation to the supply of water or sewerage services and within the whole or any specified part of the RoLR’s operations.
- **RoLR contingency plans:** The matters which must be included in the contingency plan prepared by the RoLR. The contingency plan must address the infrastructure from which it proposes to supply customers subject of the supply failure, the arrangements it has or will make with the service provider for that infrastructure, the additional costs that it is likely to incur if it has to supply ‘supply failure’ customers, and any limitations on its ability to supply ‘supply failure’ customers.

- **Special circumstances contract:** When a RoLR event occurs, the customers and relevant RoLR are taken to have entered into a special circumstances contract. After a person becomes a customer of a RoLR, the RoLR must provide notice to the customer and a copy of the special circumstances contract.
- **Last resort supply fee to be charged by the RoLR:** This fee is determined by the Minister on the recommendation of IPART.

5.4. Gap analysis of RoLR arrangements under the WIC Act

There are a number of issues surrounding the adequacy of current RoLR arrangements. Compared to other RoLR schemes (e.g. for the energy sector), the legislation only provides for a broad framework and lacks considerable detail in some key areas, namely:

- **RoLR appointment process:** specific requirements in terms of the process that must be undertaken and the timing of an appointment.
- **Commercial parameters:** required terms and conditions of special circumstances contracts (between the RoLR and customers), including tariffs and charges and termination of a RoLR's supply obligation.
- **Customer transfer:** detail around the transfer of customers from a failed retailer to the RoLR, including access to and communication and collection of customer information and apportionment of financial responsibility between the failed retailer and RoLR.
- **Cost recovery mechanisms:** cost recovery determination of the retailer of last resort supply fee (determined by the Minister on the recommendation of IPART).
- **Access arrangements:** supporting arrangements to ensure a RoLR can access the relevant network assets.

The scenarios set out in section 5.1 have been used to describe and analyse the current RoLR arrangements under the WIC Act. The analysis includes identification of key outstanding issues that need to be considered as part of this review.

5.4.1. Appointment of a RoLR

Although the legislation does provide some broad provisions for the appointment of a RoLR, the current provisions lack considerable detail, particularly in relation to the timing and process of a RoLR appointment.

Currently, the Minister can appoint any licensed retailer or a public water utility a RoLR. This RoLR appointment can be made in relation to the supply of water or sewerage services and within the whole or any specified part of the RoLR's operations.

No requirement to appoint a RoLR

The legislation does not specifically require the Minister to declare a RoLR in relation to a retail supplier licence; rather it provides that the Minister *may* appoint a RoLR. By comparison, the proposed NECF RoLR framework provides for the registration of a RoLR and the subsequent appointment of default RoLRs and designated RoLRs. A retailer must first be registered as a RoLR in order for the Australian Energy Regulator (AER) to appoint it as a default RoLR or a designated RoLR. The AER is required to appoint at least one retailer as a default RoLR for each jurisdiction and ensure there is a default RoLR

for each jurisdiction at all times. The AER is also able to appoint *designated RoLRs* in response to a specific RoLR event.

The absence of any requirement under the WIC Act to appoint a RoLR and the timing of such an appointment means that potential RoLRs and customers operate in a very uncertain environment. There is no certainty as to how or when the Minister may or may not appoint a RoLR. This has implications for a RoLR's ability and capacity to undertake appropriate contingency planning.

The existing provisions could be strengthened to provide greater certainty both for potential RoLRs and customers. For example, the legislation could require the Minister to appoint RoLRs. Such a provision would need to specify the nature and timing of this appointment. Options include:

- mirror the proposed NECF RoLR scheme where the Minister is required to appoint a 'default' RoLR for an area of operations but is also able to appoint a RoLR in response to a specific RoLR event; or
- require the Minister to appoint a RoLR in relation to each individual retail supplier licence within a specified time period of the licence being issued (e.g. 30 days, 3 months or 6 months); or
- the existing public utility automatically becomes the RoLR for failed retailers in its area of operations. For example, Sydney Water would be appointed as the RoLR for retailers in its area of operations and Hunter Water for retailers in its area of operations and council water authorities in their local government areas etc. The disadvantage of this is that it would not provide an opportunity for other licensed retailers to become RoLRs and therefore could be seen to be anti-competitive; or
- recognising that appointing a RoLR may not always be the most practical or efficient response to every licensee failure scenario, at the time of granting a licence the Minister could be required to determine if it is necessary to nominate a RoLR in relation to that scheme (this would mean that the Minister would be able to take into account contextual factors, such as the location of the scheme, whether or not it is an essential service, capacity of the surrounding network etc) and assess on a case by case basis whether or not the nature of a scheme warrants a RoLR.

Questions:

4. What provisions should the scheme include with regard to the RoLR appointment process:

- a. Should the RoLR scheme require the appointment of a RoLR? If so, on what basis should the appointment be made? For example, should it be a requirement that all retail supplier licences granted under the WIC Act have an appointed RoLR from the date the licence is granted? What should be the timing requirements of this appointment?***
- b. Alternatively, at the point a licence is issued, should the scheme require that the Minister first determine if it is necessary to nominate a RoLR in relation to that scheme? Should there be a minimum timeframe in which the Minister must make the determination?***

Responsibility for appointment

Consideration also needs to be given to the responsibility for appointing a RoLR. A possible alternative to the current arrangement where the Minister has the power to appoint a RoLR, is to require licence applicants to have an agreement in place with a retailer to be the RoLR before a retail supplier's licence can be issued. This approach would be based on the principle that the licensee should take full responsibility for ensuring there are appropriate measures in place (not just contingency plans in the event of a physical failure). However, the disadvantage of this approach is that given the current lack of competition in the market, the applicant would have very little bargaining power relative to potential RoLRs (i.e. public water utilities). Unless there was a clear commercial benefit for the public water utility to be a RoLR, it could be difficult for the applicant to seek the agreement from a public water utility to be a RoLR.

Question:

5. Should the Minister or the licence applicant have the responsibility for appointing a RoLR?

Pre-appointment process requirements

The WIC Act is also silent on steps the Minister must take or factors she or he must consider before appointing a RoLR. For example, the proposed NECF RoLR scheme requires that in determining whether to register a RoLR (that may or may not be subsequently appointed as a *designated* RoLR), the regulator must give consideration to the organisation and technical capacity of the retailer, its financial resources and whether the retailer is a 'suitable person to be a RoLR' taking into consideration the number of customers the retailer has, the class or classes of customers the retailer has, and the area or areas the retailer currently services. Before a registered RoLR can be appointed as a designated RoLR, the regulator must also consider the above criteria as well as whether the registered RoLR has a cost recovery scheme and, if so, what costs are recoverable under the scheme and the amount or likely amount of those costs.

The WIC Act also does not include any requirements for the Minister to consult with retailers before appointing them as a RoLR. Under the proposed NECF RoLR scheme, the AER must consult with a registered RoLR before appointing it as a designated or default RoLR. However, the registered RoLR's consent is not required for appointment. In addition, if the AER has reason to believe that there is a risk of a RoLR event, the AER may inquire of one or more registered RoLR's as to whether it wants to be appointed designated RoLR for that event.

Questions:

6. Should the RoLR arrangements include provisions that:

- a. prescribe criteria that must be considered before making a RoLR appointment? If so, what should these criteria include?**
- b. require the retailer to be consulted before being appointed as a RoLR?**
- c. require the retailer's concurrence before being appointed a RoLR?**

5.4.2. Trigger events

The WIC Act sets out the circumstances under which the Minister can declare a “supply failure”. Under the Act, a “supply failure” relates to a failed retail supplier and not necessarily the failure of a physical supply. The Minister declares a “supply failure” to trigger RoLR arrangements.

When a supply failure is declared the licensed retail supplier must cease supplying water or providing sewerage services and the RoLR must start providing these services. The former retailer’s customers then become the customers of the RoLR. The Minister serves the order of a supply failure in writing to the relevant licensed retail supplier and RoLR.

The Minister may declare a supply failure in relation to a licensed retail supplier in the following circumstances:

- the licensee is no longer authorised to supply water or provide sewerage services (e.g. the licensee is found to be in breach of its licence and the licence is revoked)
- the licensee has refused to supply water or provide sewerage services to its small retail customers without having made adequate arrangements for the transfer of these services to another licensed retail supplier or public water utility
- a licensee has given written notice to the Minister of its intention to terminate the supply of water or sewerage services to some or all of its customers (e.g. as a result of commercial failure of the retail supplier)
- where the licensee is unable, or the Minister is satisfied that it is imminently likely to become unable, to supply water or provide sewerage services to its customers (e.g. if the licensee has indicated to the Minister that they are experiencing financial difficulty).

It should be noted that these are not automatic triggers as the Minister has ultimate discretion in declaring a supply failure.

These triggers are in keeping with the overall policy intent of the RoLR scheme – i.e. to respond to situations where the licensee is no longer viable and therefore unable (either voluntarily or involuntarily) to provide water or sewerage services.

The proposed NECF RoLR scheme includes similar triggers:

- the revocation of the retailer's retailer authorisation or the right of the retailer to acquire gas or electricity from the wholesale market is suspended
- the retailer ceases to be a registered participant in relation to the purchase of electricity directly through a wholesale exchange
- in the case of gas, the retailer's registration as a registered participant under the NGR is revoked
- an insolvency official is appointed in respect of the retailer or any property of the retailer
- an application or order is made for the winding up or dissolution or resolution for the winding up or dissolution of the retailer
- the cessation of the sale of energy by the retailer to customers.

Question:

7. *Are the existing triggers for declaring a supply failure in relation to a licensed retail supplier appropriate?*

Notification requirements

Licensed retailers are not required under the WIC Act to notify the Minister or IPART if it is likely that a RoLR event will be triggered (e.g. if it is experiencing financial difficulty and it is likely to become insolvent). Under the proposed NECF RoLR scheme the Australian Energy Market Operator and retailers are required to notify the AER of any event that they believe may give rise to a RoLR event. In addition, the contingency provisions under the scheme give the AER power to request financial information from a retailer.

Question:

8. *Should licensed retail suppliers be required to notify the Minister or IPART if it is likely that a RoLR event will be triggered?*

Reversal of a RoLR event

The WIC Act is currently unclear as to whether or not a RoLR appointment is permanent and if it is possible for a failed retailer to be reinstated.

The advantage of RoLR arrangements being permanent is that it would provide greater certainty to potential RoLRs, as well as discouraging retailers from engaging in overly speculative or high risk activities. To be consistent with the overall policy intent, RoLR provisions should not be seen by retailers as a mechanism that can be used to temporarily 'park' customers.

While the proposed NECF RoLR scheme does not include specific provisions to allow for the reinstatement of a failed retailer, it does not oblige customers of a RoLR to remain with the RoLR for any minimum period of time. Therefore, assuming there was a choice of retailers, a customer could at any time after the RoLR transfer date choose to enter into a contract with another retailer.

Question:

- 9. Once appointed, should the RoLR arrangements be permanent or should the failed licensee have an opportunity to be reinstated?**

5.4.3. Preliminary obligations

Planning for a RoLR event

A RoLR is required to prepare a contingency plan for the Minister's approval. The contingency plan must address the following in relation to the supply of water or sewerage services to failed licensee customers:

- the water and sewerage infrastructure from which it proposes supply of water or sewerage services
- the arrangements it has, or proposes to make, with the service provider for that infrastructure
- any limitations (such as limitations as to capacity and reliability) in its ability to supply water or provide sewerage services
- the additional costs that it is likely to incur if it has to supply water or provide sewerage services to supply failure customers
- consequential effects on its ability to supply water or provide sewerage services to supply failure customers.

The Minister may approve the plan or require the RoLR to amend the plan and resubmit for approval.

The proposed NECF RoLR scheme does not provide for a 'contingency' plan as such but requires a RoLR plan to be developed in consultation with the Australian Energy Market Operator, the nominated RoLR(s) and other relevant parties nominated by the AER (such as nominated distributors). These plans must outline the procedures that are to be followed in the event of an anticipated or actual RoLR event. The plans aim to ensure all the necessary information is provided by the relevant parties in a RoLR event. The plans must include:

- exercises to be held on at least an annual basis and a report on the conduct of each exercise be included on the AER's website
- strategies for communicating relevant information to the affected parties, including small and large customers, relevant Ministers and departmental officers, energy ombudsman, the failed retailer and any insolvency official of the failed retailer, the Australian Energy Market Operator and designated RoLR(s).

The matters that must be addressed in the proposed energy RoLR plan are different to the contingency planning requirements under the WIC Act. Under the WIC Act, there are no specific requirements with regard to the procedures that must be followed in a RoLR event or that these procedures are 'exercised' on an annual basis. These procedures would be essential to ensuring that, for example, there would be efficient processes in place to transfer customer data from the failed retailer to the RoLR.

Responsibility for developing contingency plan

There is also the question of the most appropriate agency/organisation that should be responsible for preparing a contingency plan and if there should be specific consultation requirements for its development. Under the current arrangements it is the RoLR (once appointed) that is responsible for preparing the contingency plan. However an alternative would be for the licensee to be required to complete the contingency plan in consultation with the RoLR and that the plan be approved by the Minister. This option assumes that the RoLR is nominated in advance of a RoLR event.

Questions:

10. *Are the existing contingency planning requirements adequate?*

11. *Should the contingency planning requirements include procedures and information communication requirements?*

12. *Who should have the responsibility for preparing the contingency plan?*

5.4.4. Obligation to supply

The supply obligation commences on the RoLR being served with the order of declaration of a supply failure.

The WIC Act does not specify a minimum period a customer must remain with a RoLR. This means that customers of a failed retailer can opt out of being a customer of the RoLR and move to another retailer at any time. This may have implications for a RoLR's ability to recover its costs. If a RoLR was to incur substantial costs in accepting new customers, there would be little certainty under the current arrangements that the RoLR could fully recover these costs, particularly if they are recovering the costs through instalments over more than one billing period.

The WIC Act does not include provisions governing the termination of a supply obligation and/or a RoLR appointment. The proposed NECF RoLR scheme provides that the AER may terminate a default RoLR's appointment and registration at any time, however it is under no obligation to do so.

A registered RoLR (that is not a default RoLR) is able to apply to the AER for termination of its registration as a RoLR. Before deciding whether to grant or refuse an application, the AER may seek further information from the applicant and must publish a copy of the application on its web site inviting written submissions. After considering these submissions, the AER must publish a copy of its decision on its website.

Questions:

13. Should the RoLR arrangements set a maximum period within which a customer of a RoLR must decide whether or not they want to remain a customer of the RoLR or switch to another retailer? If so, what should this maximum period be?

14. Should the RoLR arrangements include provisions that govern the termination of a RoLR's supply obligation/appointment? If so:

- a. should a RoLR have the ability to seek a termination of its appointment; and/or**
- b. should the Minister have the ability to terminate a RoLR appointment?**

5.4.5. Commercial parameters

Special circumstances contract

When a RoLR event occurs, the customers and relevant RoLR are taken to have entered into a special circumstances contract. After a person becomes a customer of a RoLR, the RoLR must provide notice to the customer and a copy of the special circumstances contract.

The WIC Act does not prescribe any minimum conditions to be included in special circumstances contracts. For example, in relation to tariffs, charges and termination of a RoLR's supply obligation.

The items that might be included in a special circumstances contract include:

- account payment provisions - who to pay, overcharging/undercharging arrangements and payment options
- additional charges to be levied on customers and the basis on which these can be levied, including the duration of the charge
- customer protection provisions for small or vulnerable customers including hardship provisions (provisions that apply if a customer is unable to pay, account dispute processes, ombudsman processes)
- details regarding rebates and concessions
- if relevant, the minimum period of time the customer must remain with the RoLR
- provisions relating to the termination of the contract and transferring to another retailer (if available).

An alternative to a separate contract could be 'special circumstance conditions'. These conditions would be additional to any existing contract conditions with the failed retailer (regardless of whether it is a deemed or specific contract) and, where conflicting with any existing conditions, the special circumstances conditions could take precedence.

The WIC Act is generally unclear with regard to any differences in terms, conditions or tariffs that might apply to different classes of customers. While the special circumstances contract provisions do specifically refer to 'small retail customers' (including the possibility of 'different small retail customers' being under different contracts), there is no reference to 'large customers'.

For small customers under the proposed NCEF RoLR scheme, the terms and conditions of the deemed arrangement are the terms and conditions of the designated RoLR's standard retail contract. For large customers the terms and conditions of the deemed arrangement are the terms and conditions published by the designated RoLR. These terms and conditions must be 'fair and reasonable'.

Questions:

15. With regard to the special circumstances contract:

- a. Should the RoLR arrangements specify a minimum set of conditions to be included in the contract? If so, what should these include?**
- b. Should the terms and conditions be the same for small retail and large customers?**

RoLR tariff and cost recovery

There are a range of costs that could be incurred by a RoLR both in planning for a RoLR event and assuming the role of a RoLR. For example, RoLRs would incur costs associated with developing a contingency plan and ensuring the appropriate systems are in place to facilitate the transfer of customers in a RoLR event. Similarly, there would be costs incurred in implementing this contingency plan. The fundamental questions from a cost recovery perspective are: who should pay for the cost of a RoLR event? What mechanisms should be used to recover these costs? How should the cost be determined?

The current provisions do include a cost recovery mechanism – a RoLR tariff. A RoLR can impose a RoLR tariff on a transferred customer. The tariff is determined by the Minister on the recommendation of IPART. The legislation does not specify the basis on which the tariff is determined and what sort of costs it is intended to cover. There is no distinction made between costs incurred as a result of *planning* for a RoLR event as opposed to those incurred *once a RoLR assumes its role*. In the energy sector however, a 'RoLR tariff' is generally a relatively low fee intended to cover basic administration costs in a RoLR event.

Therefore consideration needs to be given to:

- whether or not the existing cost recovery mechanism is adequate and, if so, what the specific process should be for determining the RoLR tariff and the sorts of costs this tariff should cover
- if it is determined that the existing RoLR tariff on its own is not an adequate cost recovery mechanism, what other cost recovery mechanisms could be included under the RoLR arrangements.

The proposed NCEF RoLR scheme provides for a cost recovery scheme. The AER is required, on application by a registered RoLR, to determine a RoLR cost recovery scheme for the RoLR. A RoLR can only recover costs in accordance with this scheme. Only default RoLR cost recovery schemes can include costs incurred in preparing for a RoLR event. Designated RoLRs (i.e. RoLRs that are appointed in a RoLR event) are able to include costs incurred on and after a RoLR event. This includes costs paid to insolvency officials and costs paid to gas distributors that are not recoverable from the failed retailer or their customers. Under the provisions, distributors are required to make a financial contribution to the cost recovery scheme and this contribution is determined by the AER in consultation with relevant

distributors. The scheme does not, however, provide detail regarding the specific basis on which the AER would determine a cost recovery scheme.

For electricity in NSW, the RoLR fee is set by the Minister on a recommendation from IPART. The maximum amount that impacted customers of a failed retailer can be charged is \$50. The RoLR fee covers costs associated with customer transfer, account establishment and notification requirements. In NSW there have been two RoLR events in the electricity sector since retail contestability was introduced.

One option would be for the current approach for RoLR cost recovery for electricity in NSW to be adopted. Another possible option would be to have two separate cost recovery mechanisms – one for contingency planning costs and one for the costs of assuming the role of a RoLR:

Contingency planning cost recovery mechanism

A RoLR's contingency planning related costs could be recovered by imposing either an upfront fee or annual fee on the licensed retailer.

- Upfront fee: A RoLR's contingency planning related costs could be met by an upfront fee charged on the new retailer. This could be set by negotiation between the retailer and the appointed RoLR, or by IPART, as a standard establishment charge that is levied on a new retailer at the time a licence is granted. This could then be passed on to the appointed RoLR to cover contingency planning costs. The fee could be determined based on the estimated number of customers the retailer expects to be using the service. The advantage of this would be that the licensee would only need to pay a one off fee, however the potential disadvantage is that the retailer may not provide an accurate estimate of customer numbers and therefore the charge may not be an accurate reflection of all costs incurred. It may also not take into account the costs incurred by the RoLR to review or update contingency plans over time.
- Annual fee: A RoLR event may not occur until some time after the date a licence is issued and contingency plans should be reviewed on a regular basis to ensure they account for changes that may have occurred overtime (e.g. number and type of customers, changes to the infrastructure from which it proposes supply of water or sewerage services). On this basis, it could be argued that an annual fee would be more appropriate to cover planning costs. There are factors other than the number of customers, such as the geographic area or the merging of incompatible customer data bases, that may determine contingency planning costs. The advantage of this approach is that it would reflect the actual cost of contingency planning. However it may result in the licensee having less certainty of the RoLR contingency costs it would be incurring.

RoLR event cost recovery mechanism

Under the current provisions, the RoLR tariff is levied on the customer of the failed retailer. One option would be for this fee to cover the costs relating to the transfer of the customers and other administrative costs associated with managing new customers. The tariff could be established after the date of transfer and determined by IPART on the basis of the actual costs incurred by the RoLR. The tariff could then be determined on a per connection basis or (meter equivalent) as for Sydney Water's and Hunter Water's fixed charges. If necessary, IPART could review this cost allocation to ensure the derivation of the charge is fair.

These example mechanisms do not include the option of spreading the RoLR related costs across the existing customer base of an appointed RoLR. While this would enable the costs to be spread over a larger customer base, it may not be a very equitable arrangement to expect the existing customers of

the RoLR to cover these costs. In circumstances where RoLR related expenses were very high, these could be recovered from the failed retailer's customer's in affordable instalments (i.e. allow the RoLR a period of time over which the costs can be recovered).

Questions:

16. *Is the existing RoLR tariff provision an adequate cost recovery mechanism for RoLRs? Are there other cost recovery mechanisms that should be considered?*

17. *Should the RoLR arrangements include provisions allowing RoLR's to recover additional costs incurred as a result of its appointment as a RoLR prior to the occurrence of the RoLR event?*

18. *Should RoLR costs be recovered as an upfront or annual fee?*

5.4.6. Legal consequences when a RoLR's supply obligation is triggered

As noted above, a 'special circumstances' contract is deemed to have been entered into at the point the Minister makes the order declaring the supply failure in relation to a licensed retail supplier.

Notification obligations

In a RoLR event, the Regulation requires that the RoLR must give the customer notice that the customer has become a customer of the RoLR, together with a copy of the special circumstances contract.

Under the proposed NECF RoLR scheme, all customer retail contracts for small customers must include a notice explaining what will happen to the customer's arrangements for the purchase of energy if a RoLR event occurs.

Question:

19. *Are there additional customer notification or information requirements that should be imposed in a RoLR event?*

20. *Should there be communication with customers explaining what will happen if a RoLR event occurs in the future?*

RoLR access to network assets

The current RoLR framework does not include provisions that ensure a RoLR is able to access the network assets (and therefore ensure continuity of supply to customers).

The RoLR arrangements could, for example, provide that when a RoLR event is triggered, the existing agreement between the licensed network operator and the failed retail supplier automatically applies to the RoLR. An alternative could be that, as part of its contingency planning requirements, the RoLR is

also required to have a 'special circumstances' contract negotiated with the relevant network operator. This contract could then apply when the RoLR event is triggered.

Questions:

21. Should the RoLR be required to have a network assets access agreement in place with the network operator as part of its contingency planning obligations?

22. Or, should the existing agreement between the licensed network operator and the failed retail supplier automatically apply to the RoLR?

5.4.7. Market consequences of a RoLR event

The market consequences of a RoLR event principally relate to the transfer of financial responsibility for affected customers from a failed retailer to a RoLR. These sorts of provisions could include the following:

- arrangements for the Minister to transfer financial responsibility for a failed retailer's customers to a RoLR automatically process by which financial responsibility for affected customers is transferred to the RoLR
- how financial liability is apportioned between the failed retailer and the RoLR (e.g. based on estimated consumption).

The Regulation provides that the Minister may gazette a Transfer Code of Conduct. While it would primarily deal with the transfer of customers from one retailer to another as a result of customer choice, this could include these types of RoLR specific provisions outlined above.

There are no specific provisions under the proposed NECF RoLR scheme that deal with the process of transfer of financial responsibility however there are generic provisions concerning customer transfer. Any customer that was a customer of a failed retailer immediately before the transfer date ceases to be a customer of the failed retailer on the transfer date and becomes a customer of the designated RoLR. The designated RoLR assumes no financial or other liabilities of the failed retailer where that liability accrues before the transfer date. The customer retail contracts between the failed retailer and affected customers in existence before the transfer date are terminated.

5.4.8. Information transfer

It is important that the process for the transfer of customers from a failed retailer to a RoLR is clearly regulated to ensure a timely and seamless transfer in a RoLR event. The RoLR regime would need to specifically address:

- rights and obligations of retailers and other participants (i.e. network operators) to collect and maintain up-to-date customer information
- obligations for customer information to be provided to the RoLR for identification and billing purposes

- provisions facilitating access by the RoLR to up to date customer information when a RoLR event occurs (including if the customer is eligible for rebates or is a dialysis patient etc)
- requirements for regular testing of systems for the transfer of customer information.

The proposed NECF RoLR scheme includes specific provisions that allow the AER to service a 'RoLR regulatory information notice' on a retailer (or its insolvency official) that requires the retailer to provide information to a registered RoLR. On being served with the notice, the retailer or insolvency official must comply with the notice by providing the required information. This includes customer information (such as names, billing address, meter identifier, whether the customer is a hardship customer, details of the customer's actual consumption of energy etc). These provisions are in place to ensure that in a RoLR event, all necessary information is transferred to the RoLR.

Question:

23. Are there additional matters regarding information transfer in a RoLR event that should be addressed under the RoLR regime?

6. Operator of last resort

Operator of last resort (OoLR) arrangements refer to the arrangements designed to respond to a network operator failure. The WIC Act does not currently include such arrangements. Network operator failure may occur as a result of, for example, financial failure of the network operator or if a network operator elects to terminate its operations.

This section considers possible scenarios that might trigger OoLR arrangements and the key issues an OoLR regime should address.

6.1. Introduction

The implications of a network operator failure are considerably more complex than a retail supplier failure. Retail suppliers are not responsible for the operation and maintenance of water infrastructure (although they do rely on this infrastructure to supply water or sewerage services to its customers). While it may be the case that the licensed retail supplier and the licensed network operator are the same entity, the technical skills and capacity required to operate and maintain infrastructure are quite different to those required to sell water to customers.

OoLR events can be complicated by a range of factors.

- The nature of the infrastructure: Services may be provided via a stand alone network or via an existing utility's infrastructure. There are complex risks to manage for stand alone schemes to ensure service continuity. For stand alone schemes, customers are completely reliant on the on-site water supply and/or sewerage systems. These customers' access to a secure, reliable water and/or sewerage services could be threatened by the failure of the network operator.
- The standard of infrastructure: Infrastructure may be designed and constructed to a different standard than the OoLR's other infrastructure or the infrastructure may treat from a source not previously used by the OoLR (e.g. groundwater).
- The age of the infrastructure: Infrastructure may be nearing the end of its operating life and require significant and costly upgrade.
- The capacity of the OoLR or utility that acquires the infrastructure: Infrastructure may be different to the technology the OoLR normally manages. For example, if a connection is required of a stand alone network to an existing network, the OoLR may need to be resourced to handle that expansion. It may also take significant time to connect to existing infrastructure.
- The capacity of the OoLR's infrastructure: If an OoLR is replacing recycled water or drinking water from an alternative water source (that does not feed into the OoLR's system) with drinking water from its system, the OoLR would require sufficient capacity in its potable water system for continuous supply. An OoLR may have to undertake costly upgrades to ensure that the water system has sufficient capacity.
- The ownership of the infrastructure: The failed network operator may not own the water/sewerage infrastructure which they operate. Any OoLR arrangement will need to be flexible to take account of the rights of the owners of the assets.

Unlike RoLR, there is also little precedent for OoLR arrangements. OoLR provisions are not needed in the energy sector because networks are connected to a national grid. The failure of an energy retail supplier is unlikely to result in the cessation of supply to customers. RoLR provisions are adequate to

ensure the interests of network operators and generators are protected. For schemes licensed under the WIC Act however, OoLR arrangements are essential to ensure continued supply of water or sewerage services that may otherwise cease in the case of network operator failure.

6.2. OoLR scenarios

Scenario 1: Retail and network functions are performed by the same entity and that entity fails

Context: A 5,000 lot housing development is located in a greenfield development site on the outskirts of Sydney. A recycled water plant is located on site. Recycled water is used for toilet flushing, irrigation and general wash down purposes. Small retail customers are supplied with drinking water via public utility owned and operated infrastructure and sewerage and recycled water services via a privately owned stand alone network.

Licensing arrangements: The White Corporation holds a network operator's licence to operate and maintain the recycled water and sewerage infrastructure as well as a retail supplier's licence to supply recycled water and sewerage services to small retail customers (i.e. a bundled supplier).

OoLR scenario: The White Corporation is declared insolvent and an OoLR is appointed to continue operation of the recycled water and sewerage infrastructure as well as take over retail supply functions. In the longer term, the public water utility (or a private operator) could acquire the infrastructure from the failed licensee. Another alternative long term arrangement could be that the utility disconnects the stand alone recycled water infrastructure and connects to its existing potable water system. If the assets were not owned by the failed licensee, another private operator could be contracted by the owner to operate the assets and this would result in the end of the OoLR arrangements.

Scenario 2: Retail and network functions are performed by separate entities

Context: A 60 lot residential property development is located on the outskirts of a town in regional NSW. Drinking water is provided via the public water utility's drinking water infrastructure, and sewerage services are provided via a stand alone network.

Licensing arrangements: The Brown Corporation holds a network operator's licence to operate and maintain the sewerage infrastructure. The Orange Corporation holds a retail supplier's licence to provide sewerage services to residential customers.

OoLR scenario:

a) The failure of the network operator results in the failure of the retail supplier

The Brown Corporation is declared insolvent. This results in the insolvency of the Orange Corporation. An OoLR is appointed to take over the retail and network operator functions. The OoLR could either continue to operate the stand alone network or extend its own network to service the area.

b) Only the network operator fails

The Brown Corporation is declared insolvent and an OoLR takes over the network operator functions. The Orange Corporation continues as the retail supplier. The same long-term options as described in (a) could also apply.

Scenario 3: Retailer and network operator fails where alternative services are readily available via existing water utility's network

Context: A high-rise commercial building located in Sydney’s CBD has a recycled water treatment plant in its basement. The recycled water plant is connected to Sydney Water’s sewer mains for the purpose of sewer mining and discharge for sludge and brine. Treated water from the plant is used for toilet flushing, irrigation and cooling tower applications. Drinking water services are provided by Sydney Water.

Licensing arrangements: Purple Corporation has a network operator’s licence to construct, operate and maintain the recycled water treatment plant as well as a retail supplier’s licence to supply recycled water by means of this infrastructure to customers.

OoLR scenario: Purple Corporation provides written notice to the Minister of its intention to terminate the supply of recycled water to its customers and terminate operation of the recycled water plant. Sydney Water has indicated that it does not have adequate capacity in its system to replace recycled water services with drinking water. Therefore it is not possible to switch to the Sydney Water mains in this scenario. The Minister would then appoint an OoLR to continue retail supply and network operation.

Likelihood: There are two recycled water schemes located in the CBD currently licensed under the WIC Act. For these schemes it is unlikely that Sydney Water would lack capacity to replace recycled water services with drinking water in the event of a licensee failure. If this were the case, Sydney Water would not be performing the role of an OoLR as it would not be taking over operation of the recycled water plant. Therefore, based on the nature of the schemes currently licensed, it is unlikely that an OoLR would need to be appointed in this scenario.

6.3. Key elements of OoLR arrangements

Keeping in mind that OoLR arrangements will need to be flexible to respond to a range of scenarios, it is likely that OoLR arrangements would need to consider the following:

Table 2: Elements of OoLR arrangements

Element	Key questions/issues
The appointment of an OoLR	Who can be appointed an OoLR and how? Who is able to make this appointment? Can an OoLR also perform the role of a RoLR in a combined retail supplier and network operator failure? How long will an OoLR need to be appointed for?
Trigger events	Under what circumstances can an OoLR be appointed?
Preliminary obligations	What are the contingency planning requirements of the nominated OoLR.
Cost recovery mechanisms	Mechanisms for OoLRs to recover costs incurred to plan and or assume the duties of an OoLR.

6.4. Key issues to be addressed

There are a range of issues that the OoLR regulatory framework will need to address to ensure continued supply of essential services to customers. As noted in relation to possible OoLR scenarios, these issues can be very complex.

6.4.1. Appointment of OoLRs

The issues that need to be considered with regard to the appointment of OoLRs are very similar to the appointment of a RoLR. Having clarity as to the timing and process of an OoLR appointment is essential if potential OoLRs are to have a degree of certainty and the ability to undertake contingency planning.

Requirement to appoint an OoLR?

If the OoLR scheme was to include a requirement that the Minister appoint an OoLR in relation to each network operator licence, consideration would need to be given to the nature and timing of this appointment. Options could include:

- the Minister is required to appoint an OoLR in relation to each individual network operator licence within a specified time period of the licence being issued (e.g. 30 days, 3 months or 6 months); or
- the existing public utility automatically becomes the OoLR for failed retailers in its area of operations; or
- recognising that appointing an OoLR may not always be the most practical or efficient response to every licensee failure scenario, at the time of granting a licence the Minister could be required to determine if it is necessary to nominate an OoLR in relation to that scheme (this would mean that the Minister would be able to take into account contextual factors, such as the location of the scheme, whether or not it is an essential service, capacity of the surrounding network etc) and determine on a case by case basis whether or not the nature of a scheme warrants an OoLR.

Questions:

24. What provisions should the scheme include with regard to the OoLR appointment process:

- a. Should the OoLR scheme require the appointment of a OoLR? If so, on what basis should the appointment be made? E.g. should it be a requirement that all network operator licences granted under the WIC Act have an appointed OoLR from the date the licence is granted? What should be the timing requirements of this appointment?***
- b. Alternatively, at the point a licence is issued, should the scheme require that the Minister first determine if it is necessary to nominate an OoLR in relation to that scheme? Should there be a minimum timeframe in which the Minister must make the determination?***

Responsibility for appointment

If the existing RoLR provisions were to be mirrored, the Minister would have the responsibility for appointing an OoLR. However an alternative could be to require licence applicants to have an agreement in place with a network operator to be an OoLR before a network operator's licence can be issued. As noted in the RoLR discussion, it would be very difficult for a network operator to negotiate such an agreement.

Question:

25. Should the Minister or the licence applicant have the responsibility for appointing an OoLR?

Process for appointment

Consideration needs to be given to the process undertaken in order for an OoLR appointment to be made. For example:

- Factors that should be taken into account in making an appointment: e.g. the organisational and technical capacity of the operator, the location of the failed operator, the technical capacity of surrounding networks (see factors outlined in section 6.1), the willingness of other operators to take on the role of OoLR.
- Steps that should be undertaken before an appointment is made: e.g. requirement to consult with potential OoLRs before they are appointed.

Questions:

26. Should the OoLR arrangements include provisions that:

- a. prescribe criteria that must be considered before making an OoLR appointment? If so, what should these criteria include?***
- b. require the operator to be consulted before being appointed as an OoLR?***
- c. require the operator's concurrence before being appointed an OoLR?***

Length of OoLR appointment

The occurrence of a network operator failure will, in most cases, require a longer-term solution (such as the sale of network assets) in addition to arrangements to ensure continued supply in the short term. Therefore, OoLR arrangements need to be in place long enough for a permanent solution to be found to ownership and operation of the network. This may involve allowing sufficient time for:

- negotiating the sale or transfer of network assets
- licensing a new operator or varying an existing operator's licence.

Given the time taken to process and assess a licence application, even if a buyer is found quickly, OoLR arrangements may need to be in place for an extended period of time. Where it takes longer to find a buyer, OoLR arrangements need to be flexible enough to continue during this time.

While having this flexibility is important, another consideration is providing some certainty to the appointed OoLR regarding the period for which it will be responsible for operations. For example, the OoLR may need to be appointed for an initial period, towards the end of which the Minister reviews the

arrangement and any progress made towards a permanent solution, and decides whether to extend or terminate the OoLR arrangement.

Complexities may arise in the event a buyer can not be found. A potential solution in these circumstances could be to transfer the assets to another operator prepared to maintain the essential service.

Another complicating factor is that the network operator licence holder will not always own the relevant infrastructure.

Questions:

27. Should the OoLR arrangements have the flexibility of being either a temporary or permanent arrangement?

28. Should the OoLR scheme include a provision that allows the Minister to review OoLR arrangements and progress made towards a permanent solution and decide whether to extend or terminate the OoLR arrangement?

Relationship between the ownership of network assets and the failed licensee

Under the WIC Act the owner of the network assets (for example a community title, a developer, a superannuation fund) may not necessarily be the holder of a network operator licence. In some circumstances specialist private water utility operators could be granted a licence to construct, operate and maintain water infrastructure they do not own. As a consequence, any OoLR arrangements that are developed must be flexible enough to deal with situations where the failed licensee is not the owner of the assets. For example, a small community title development may not have the financial and/or technical capacity to quickly find another network operator and may need an OoLR to be appointed to maintain essential services.

In the absence of a public utility taking over the essential service, arrangements may need to be made to allow another private operator to continue to provide the service even if they do not hold a network operator licence for that particular site. This could include an option for temporary licensing arrangements (e.g. until the owner of the asset is able to find another network operator to permanently operate the infrastructure or until the normal licensing requirements were met by the new operator). A temporary licensing process would involve a relatively fast assessment process (to ensure continuity of service).

Questions:

- 29. Where a public utility is unable to take over an essential service, should there be provisions that would allow for a private operator (licensed under the WIC Act for a separate scheme) to continue to provide that service on a temporary basis?**
- 30. If a temporary licensing provisions were to exist:**
- a. Should the circumstances under which a temporary licence could be granted be prescribed? If so, what should these prescriptions be?**
 - b. What should be the maximum period of time a network operator could operate under a temporary licence before it would be required to obtain a full licence under the WIC Act for that scheme?**
- 31. Where a private operator (who is already licensed under the WIC Act) continues to provide services they are not licensed for, when would it be appropriate for the operator to:**
- a. seek a variation to its existing licence to operate the new service?**
 - b. be required to apply for another licence under the WIC Act for the new service?**

Potential to address a combined RoLR and OoLR scenario

A RoLR event results in the permanent transfer of customers away from the failed business, while the appointment of an OoLR is envisaged as a temporary arrangement that continues until either the assets and business are sold or premises are connected to an available network. Where a bundled supplier fails, retaining the bundled service through an OoLR period may be desirable to protect the value of the business for the purposes of sale, rather than transferring its customers to a RoLR and effectively stripping the business of its retail function.

Question:

- 32. In the event of a bundled supplier (the retail supplier and network operator are the same entity) failure, should the OoLR regime have the ability to also appoint an OoLR to continue the retail supply functions?**

6.4.2. OoLR trigger events

The OoLR regime will need to specify the circumstances under which the Minister can declare a network operator failure and therefore trigger the OoLR arrangements.

The trigger events prescribed by the WIC Regulation also appear appropriate for OoLR events, as follows:

- where, as a consequence of enforcement action or variation of licence condition, a licensee is no longer authorised to operate in the whole or any part of its area of operations
- where a licensee has refused to operate in the whole or any part of its area of operations without having made adequate arrangements for the transfer of its operations to some other licensed network operator or public water utility
- where a licensee has given written notice to the Minister of its intention to terminate operations, affecting some or all of its customers
- where the licensee is unable, or the Minister is satisfied that it is imminently likely to become unable, to operate in the whole or any part of its area of operations
- where a licensee has failed to meet the criteria necessary to hold the relevant WIC Act licence, or
- where a licensee has lost its licence due to a breach of a condition of its licence.

Question:

33. Are there other events that should trigger an OoLR event?

6.4.3. Preliminary obligations

Planning for OoLR events

Just as RoLRs are required to prepare contingency plans and maintain the arrangements in these plans, OoLRs will need to plan for OoLR events. This could involve considerable investment of time and resources. As currently applies to RoLRs, these plans could be reviewed and approved by the Minister/regulator.

Under the WIC Act, a RoLR is required to prepare a contingency plan for the Minister's approval. There are requirements as to what the contingency plan must address. If this was to be used as a basis for developing OoLR contingency requirements, it would need to address:

- the arrangements it has, or proposes to make, with the retail supplier to provide services
- any limitations (such as limitations as to capacity and reliability) in its ability to operate network infrastructure
- the additional costs the OoLR is likely to incur if it has to operate water infrastructure
- consequential effects on its ability to operate network infrastructure in the event of a network operator failure.

Questions:

34. Should nominated OoLRs be required to have a contingency plan?

35. If so, should these planning requirements mirror those required for RoLRs?

36. Are there additional matters that should be addressed in an OoLR contingency plan?

6.4.4. Cost recovery

The costs an OoLR could face in planning for an OoLR event and in carrying out its role as an OoLR during an event include:

- the costs involved in planning and maintaining the capacity for a OoLR event, such as developing a contingency plan and ensuring measures are in place to continue supply to customers of a failed network operator
- costs involved in operating the failed network operator's infrastructure, including any insurance required during the OoLR period
- capital costs necessary to ensure continued safe operation of the network during the OoLR period (this would be impacted by the ownership of the asset).

While an OoLR should be able to recover some of its operating costs through income from operating the network, there may be a shortfall that needs to be recovered. This could be because the prices charged by the failed operator were too low to cover its costs, or because infrastructure needs to be upgraded.

There is a wide range of cost scenarios an OoLR could face. In some circumstances the costs could be high. In other cases they could be relatively minor, for example:

- Public utilities appointed as an OoLR may be able to avoid costs. For example being appointed an OoLR of a stand alone sewerage treatment plant and network servicing a greenfield site that is built, operated and maintained by a licensee under the WIC Act may mean that the a public water utility does not need to extend its existing network to provide sewerage services to that area, thereby deferring capital investment.
- The OoLR could also face significant unplanned costs. For example, the average life of a filtration membrane unit is three to seven years. If a licensed network operator is unable to meet the cost of replacing a membrane unit and chooses to cease operation or go into administration, there would be a significant capital cost of ensuring the continued safe operation of the system. A cost recovery mechanism would be needed to meet these costs. This raises different issues depending on whether the OoLR is a major public utility owned by the State Government, a local council or another private operator. Asset ownership (i.e. whether the failed licensee owns the infrastructure) may also be a factor that further impacts on the capital costs necessary to ensure continued operation.

Question:

37. Are there additional costs an OoLR is likely to incur?

Cost recovery issues

In terms of the mechanisms of cost recovery, there are several broad issues to consider when deciding how additional costs incurred by an OoLR should be recovered. These include:

- who should bear the risk of failure of a new network operation – the operator, its customers, the broader community or others?
- how the costs of an OoLR event should be distributed – who are the beneficiaries and who should bear the costs in the event of a failure?
- what are the costs to be recovered and how do they relate to the income from the failed network operation?
- what pricing mechanisms should be used to recover the costs?
- when should charges be paid and costs recovered – before an OoLR event or after?
- how should cost recovery mechanisms be determined and regulated?

Cost recovery principles

Cost recovery mechanisms should be informed by a clear set of principles. A proposed set of principles is outlined below.

OoLR cost recovery mechanisms should:

- Account for full efficient costs: The full efficient costs of providing the services should be taken into account when determining the costs to be recovered.
- Be fair and equitable: Cost recovery should be equitable and protect customers from sudden price increases and ensure there are no perverse incentives for potential OoLRs.
- Be transparent: Cross subsidies should be limited, but if they exist should be transparent.
- Easy to administer: Cost recovery by an OoLR should be simple to administer and understand.
- Distribute risks evenly: Any mechanism should appropriately distribute risks across network operators, customers and the broader community.

These principles could be equally applied to RoLR cost recovery mechanisms.

Question:

38. Are these appropriate principles of OoLR cost recovery?

39. Are there other principles that need to be applied?

Possible cost recovery mechanisms

There are a number of possible cost recovery mechanisms that could be used in an OoLR event, including:

- an upfront charge to network operators to cover the preliminary costs of establishing an OoLR for their networks
- upfront bonds from network operators
- an industry wide fund
- a charge to customers affected by the OoLR event
- costs spread over OoLR's entire customer base
- a combination of the above.

These mechanisms are discussed below.

1. A charge on network operators to cover the costs of establishing the OoLR

An OoLR would need to incur the costs of developing a contingency plan regardless of whether an OoLR event is triggered. One option to cover these costs would be to charge the licensed network operator fee either as an upfront or annual fee, which is not allowed to be recovered through prices. This charge could be negotiated between the network operator and the OoLR, or set by IPART to be included as fees associated with the licence.

Upfront charge

This could be charged as an establishment fee when the licence is issued. Possible advantages of this mechanism include:

- it ensures the new operator incorporates some of the risk of potential business failure in its business planning
- it reflects the costs of planning for an OoLR event and avoids these costs being subsidised by the OoLR or its customers.

Possible disadvantages of this approach are:

- the actual cost may not be able to be accurately estimated at the licence application stage
- it may represent a barrier to competition
- there may be an incentive for operators to underestimate the costs to minimise the fee.

Annual charge

An OoLR event may not occur until some time after the date a licence is issued and contingency plans should be reviewed on a regular basis to ensure they account for changes to network infrastructure overtime. On this basis, it could be argued that an annual fee would be more appropriate to cover planning costs. For public water utilities that have avoided capital investment as a result of the licensed scheme, the annual contingency planning fee they would charge the licensee could be offset by any avoided costs.

The advantage of this approach is that it would reflect the actual cost of contingency planning and does not rely on a network operator's estimate.

Questions

40. Should the costs incurred by an OoLR be recoverable from newly licensed network operators?

41. Should these costs be recovered upfront or annually?

42. Should such a charge be established by IPART or negotiated between the OoLR and the network provider?

2. Upfront bonds from network operators

This option could involve payment of an upfront bond from new network operators to contribute to the OoLR costs in the event of business failure. There could be provision for returning all or part of the bond to the network operator if the network was sold, or under other conditions, such as achieving a lower risk profile over time.

IPART has considered this mechanism in relation to islanded energy networks (i.e. electricity networks that are not connected to the Grid). IPART concluded that bonds from applicants were not necessary given that only projects that could satisfy the financial indicators relating to viability of the project would be licensed. However, water and sewerage networks may require significant, “lumpy” capital investments over time and if planning is not adequate, these could cause the business to fail.

An issue to be addressed under this type of cost recovery mechanism would be setting the bond amount, which would probably be based on the risk profile of the network provider/operation.

Possible advantages of this option are that it would:

- ensure that network operators incorporate risk into their planning and pricing
- protect customers from sudden price increases in the case of an OoLR event
- provide a source of funds to cover the costs to the OoLR of stepping in to operate the failed provider’s network.

Possible disadvantages of this option are:

- it could place an overly high financial burden on a new network operator, particularly small operators, and therefore act as a barrier to entry
- the higher the bond (or more strict the requirements) the more risk is borne by the network operator
- it would be difficult to estimate the appropriate bond amount to recover costs in the event of an OoLR event
- if the bond amount was passed onto the network operator’s customers, they would bear the business risk and may end up paying a premium for the service.

Questions:

43. Under this option, is there a need to limit the amount passed through into prices paid by customers of a private network operator?

44. What risk management considerations are involved in determining a bond amount?

45. Are there any other issues associated with this approach?

3. An industry-wide fund

Operators could pay into a fund to be drawn on in case of an OoLR event. Similar to the option of a bond payment, this could be an upfront charge to operators at the time the licence is granted. It could be determined based on the level of financial risk and/or the size of each operation. The questions of who would manage the fund and how much network operators would pay need to be addressed. Also, a methodology for calculating the amount paid to an OoLR in case of an OoLR event would need to be developed.

Possible advantages of this approach are:

- this type of risk-based approach is likely to more equitably manage the risks associated with new operators, as incumbent operators (including OoLR) would have a lower risk of failure and therefore pay a lower amount into the fund
- there would be an opportunity for allowing this cost to be passed through into prices, meaning that the OoLR could recover some or all of its contribution.

Possible disadvantages of this approach:

- it may be financially prohibitive to small projects that would otherwise be efficient, and therefore act as a barrier to competition
- what would monies from the fund be used for if there are no OoLR events
- it would be difficult to determine the appropriate contribution of each operator.

Question:

46. Are there any other issues associated with this approach?

4. Additional charge to affected customers

This would involve making provision for a fee payable by customers transferred to the OoLR to cover some or all of the costs associated with an OoLR event. Potential customers would need to be made aware of this charge when purchasing or moving into a property.

This fee could be specified in the last resort contingency plan, including the amount of the fee, the method used to calculate it and when it would be payable. This charge could be designed to cover some or all the costs incurred by the OoLR when a last resort event is triggered.

The calculation of such a charge would need to take into account any benefits the OoLR would receive from taking on the new customers, as well as costs the OoLR would incur under a last resort event. This charge could be calculated using a methodology that allows for what are likely to be significant differences in costs across different OoLR trigger events. It may also be desirable to provide for flexibility in the payment mechanism, to allow for either a one-off fee, or an ongoing charge, depending on the magnitude of the costs and the length of time the OoLR would be operating the network. If the network operator's prices were not regulated, there would need to be some regulatory oversight to ensure that the charges did not over-recover costs.

Possible advantages of this approach are that it would:

- provide a more accurate reflection of the magnitude of costs of providing services to this customer group if the failure was due to the new network operator charging prices that did not cover its costs
- reflect a user pays approach because the customers of the failed provider would not be subsidised by the OoLR's other customers
- provide a mechanism for the OoLR to recover costs associated with an OoLR event in excess of those able to be recovered through the regulated tariff it charges its existing customers.

Possible disadvantages of this approach:

- if the customer base of the failed operator is small (e.g. a small development area using recycled water in an isolated network), additional costs to each customer may be significant
- it would transfer the business risk from the operator to its customers and penalise the customers if there was a failure event
- customers could not easily switch to a different network operator to avoid this price increase, as there would usually be only one network (i.e. they cannot exercise market choice)
- it is likely to be difficult to estimate the costs associated with an OoLR event, as these are unique to each OoLR event and could vary significantly.

Given that customers of the failed retailer would be bearing the cost of licensee failure under this option, consideration would need to be given to the following additional factors:

- ensuring that potential land purchasers/tenants within a WIC Act scheme are aware of the costs that may be passed onto them in the event of a licensee failure – i.e. buyer beware
- whether the risk management/contingency planning requirements for licence applicants under the WIC Act should be strengthened (without creating unnecessary barriers to entry).

Question:

- 47. Should the costs incurred by an OoLR be recoverable from affected customers?**
- 48. Are there any other issues associated with charging affected customers to recover the costs of an OoLR event?**
- 49. Given that customers would be bearing the cost of licensee failure:**
- a. what measures, if any, should be in place to ensure potential purchasers/tenants are aware of the costs associated with licensee failure?**
 - b. should the risk management/contingency planning requirements for licence applicants under the WIC Act be strengthened? If so, how?**
 - c. What are some key considerations in developing a methodology to recover costs from affected customers?**

5. Costs spread over operator of last resort's customer base

Under this approach, the additional costs to the OoLR of operating the new network would be recovered across the whole of the OoLR's customer base through the price path. This would involve calculating the net cost incurred by the OoLR during the failure event and incorporating it into broader water and/or sewerage prices.

Possible advantages of this approach are:

- the additional cost per customer would be lower, as it would be shared across a greater number of customers
- the true costs of network provision would be incorporated into prices, which may not have been the case if the network operator failed because prices did not cover its costs
- it would protect affected customers from a price spike, which may have affordability impacts.

Possible disadvantages of this approach are:

- the OoLR's customers would be subsidising the failed network operator's customers (who would potentially be paying an artificially low price for the service)
- if another private provider is the OoLR, there may be no additional customer base (i.e. it would be paid by affected customers) or the existing customer base may be small and therefore cost could be significant to customers
- the risk of business failure would be borne by a third party, limiting the accountability of the failed network operator
- it could lead to intergenerational equity issues if costs are recovered over a long period of time – future generations could bear the cost of failed network providers

- there is a possible incentive for an OoLR to build excess capacity in infrastructure in case of an OoLR event. If passed through in prices, this would not result in efficient investment.

Questions:

50. Should the costs incurred by OoLR be recoverable from an OoLR's customer base?

51. How should the price/charge be calculated if incorporated in the price path? Should this calculation be different if the OoLR was a regulated water authority versus a local council or a private operator?

52. Are there any other issues associated with charging affected customers to recover the costs of an OoLR event?

6. A combination of the above

This option could include separating the OoLR cost recovery between two or more of the above options.

One combination could involve an up front charge to new operators to cover OoLR establishment costs (Option 1) and allowing the OoLR to recover the net costs of operating the system across its customer base in an OoLR event.

Alternatively, if a bond payment approach or an industry fund approach was adopted, there would be flexibility to allow recovery of part of this amount across either the affected customers of the failed operator, or across the broader customer base of the OoLR, depending on the magnitude of costs and to fulfil equity objectives.

Questions:

53. How could options be combined to achieve appropriate cost recovery, risk management and equity outcomes?

7. Conclusion

In summary, developing RoLR and OoLR arrangements raises a number of complex policy issues. This paper is intended to provide a framework for considering these issues and facilitate stakeholder comment on how these issues could be addressed.

The questions included in this discussion paper seek to generate stakeholder views in relation to two key areas:

1. the principles and objectives that should underpin a RoLR and OoLR scheme
2. the issues that must be addressed in developing the detailed provisions that will make up the RoLR and OoLR scheme.

Stakeholder input generated from this paper will inform the next stage of the review process which is to develop proposed detailed provisions for a RoLR and an OoLR scheme. Further consultation will be undertaken in relation to an appropriate regulatory framework to give effect to each scheme.

How to have your say

The Department of Finance and Services invites interested parties to make written submissions in relation to the discussion paper.

Post: WIC Act RoLR and OoLR review
Metropolitan Water Directorate
McKell Building 2-24 Rawson Place
Sydney NSW 2000

Email: WICA@waterforlife.nsw.gov.au
Subject line - WICA – RoLR and OoLR

All submissions will be made publicly available through the Water for Life website, unless requested otherwise. Please indicate if you want your submission to be treated as private and confidential.

8. References

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Appendix A:

Service continuity measures in England and Wales

The following provides an overview of the service continuity regulatory arrangements in place in England and Wales under the water industry competition legislation (Ofwat 2003; 2005; 2006).

1.1 The Water Supply Licensing system

Regional and local water boards in England and Wales were privatised in 1989. Water and sewerage services are delivered to customers by appointed water and sewerage companies which effectively operate as regional and local monopoly service providers.

- The overall framework for competition within the water industry is set out in the *Water Industry Act 1991*. The Water Supply Licensing (WSL) regime was introduced in England and Wales in December 2005, under the *Water Act 2003*. Unlike NSW, the WSL regime opened up a specific sub set of the water market to competition. Under the regime, another company can replace the appointed water and/sewerage company for a specific geographic area if one of the following criteria is met:
- the customer is a large water user (consumes at least 50 megalitres a year in England and at least 250 megalitres a year in Wales)
- the site is currently unserved (i.e. a Greenfield site)
- by incumbent consent.

Under this framework, two types of water supply licenses can be granted:

- A retail licence: this authorises the licensee to purchase a wholesale supply of water from an appointed water company and to use the appointed water company's supply system for the purpose of supplying water to the premises of the licensee's customers.
- A combined licence: in addition to the retail authorisation, this authorises the licensee to develop its own water source and use the supply systems of appointed water companies to supply water to customer's premises.

1.2 Managing the risk of licensee failure

There is no legal obligation on an appointed water company to act as a retailer of last resort in the event of licensee insolvency or withdrawal from the market. However, the legislation does include 'interim supply duty', 'strategic supply designation' and 'special administration' provisions that are designed to protect customers in the event of a licensee failure. These provisions are outlined below.

At the time of writing this paper, seven licences had been issued under the WSL scheme; however no customers had transferred from an appointed water company to a licensee. Therefore, these provisions are yet to be tested.

1.2.1 Interim supply duty

Under the *Water Industry Act 1991*, if a customer is supplied with water from a licensee and the licensee or the supply subsequently fails, the appointed water company is required to supply water to the customer. However, this provision does not apply in all cases. The appointed water company is not required to supply water to customers of the failed licensee if this would put at risk the appointed

water company's ability to meet its existing supply obligations and its probable future obligations to supply water for domestic purposes or require unreasonable expenditure to do so.

In the event that an appointed water company considers that it would not be able to meet its requirements of the interim supply duty, it can apply for a strategic supply designation.

1.2.2 Strategic supply designation

The *Water Industry Act 1991* allows Ofwat to designate as 'strategic' one or more introductions of certain water supplies by a licensee into a nominated water company's supply system. Introductions are classified as 'strategic' where, in the event of the licensee failure, the appointed water company would be unable to supply its own customers and the domestic needs of the licensee's customers.

An appointed water company is able to request Ofwat to make a determination that an introduction constitutes a strategic supply. A request for a determination can be made at any time. Ofwat also has the power to make a determination without a request from the appointed water company (e.g. Ofwat may give consideration to making a determination in response to a licensee or customer asking them to do so).

If a licensee's water introduction is dedicated as a strategic supply by Ofwat and the licensee is no longer able to supply water to its customers (e.g. as a result of its conduct or insolvency), the licensee will be subject to the special administration procedure.

1.2.3 Special Administration

The special administration provisions are important for ensuring customers receive continuity of service in the event of licensee failure. The purpose of a special administration order is to transfer to another company as much of the licensee's undertaking as it is necessary to ensure supply continuity.

Once a licensee's water supply is designated as 'strategic', special administration licence conditions are imposed on the licence. These conditions require the licensee to have sufficient rights and assets to enable the special administrator to manage the affairs, business and property of the licensee.

A special administration order is made by the High Court. Ofwat is able to apply to the High Court for a special administration order where the qualifying licensee:

- has been or is likely to be in a sufficiently serious contravention of a licence condition or a statutory requirement imposed on it in consequence of its licence as to make it inappropriate for the licensee to continue to hold its licence; or
- has been, or is likely to be, in a sufficiently serious contravention of an enforcement order as to make it inappropriate for the licensee to continue to hold its licence.

Under this order, the High Court appoints a person responsible for managing the affairs, business and property of the qualifying licensee. The making of a special administration order has no effect on the validity of the qualifying licensee's agreements. For example, access agreements and agreements between qualifying licensees and customers remain valid.