



FINAL REPORT

## **Proposed NEM objectives**

### **Consideration of economic properties**

PREPARED FOR  
ENERGYAUSTRALIA

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# 1 Introduction

The Network Economics Consulting Group (NECG) has been asked by EnergyAustralia to review the proposed National Electricity Market (NEM) objective and advise on whether it is rigorous and testable from an economic perspective given the number of important functions it will serve under the National Electricity Market Framework.

## 1.1 Background

The following NEM objective has been proposed in the current exposure draft of the National Electricity Law:

...to promote efficient investment in, and use of, electricity services for the long term interests of consumers of electricity with respect to price, quality, reliability, safety and security.

This objective is to replace the following market objectives set out in section 1.3 (b) of the National Electricity Code (the Code)

The objectives of the national electricity market (called “market objectives”) are as follows:

- (1) the market should be competitive;
- (2) customers should be able to choose which supplier (including generators and retailers) they will trade with;
- (3) any person wishing to do so should be able to gain access to the interconnected transmission and distribution network;
- (4) a person wishing to enter the market should not be treated more favourably or less favourably than if that person were already participating in the market;
- (5) a particular energy source or technology should not be treated more favourably or less favourably than another energy source or technology; and
- (6) the provisions regulating trading of electricity in the market should not treat intrastate trading more favourably or less favourably than interstate trading of electricity.

The proposed change involves streamlining these objectives into a single overarching objective, and changing the focus towards efficient investment and explicit recognition of the long-term interests of consumers of electricity.

In its explanation of the proposed objective, the Ministerial Council on Energy (MCE) argues that the objective will provide clear guidance in the following areas:<sup>1</sup>

- the AEMC may only make Rules which will or are likely to contribute to the achievement of the national electricity market objective, and must make a Rule if it will or is likely to contribute to that achievement;
- the AEMC must have regard to the national electricity market objective when performing its functions; and
- the MCE statements of policy principles must be consistent with the national electricity market objective.

Furthermore, it argues that the single objective will be more legally robust and represents a more “economically testable statement” than the objectives in the current Code:<sup>2</sup>

“Accordingly, the generalized single national electricity market objective in the new NEL provides a more legally robust and economically testable statement of the national electricity market objective for the purpose of Rule making than the specific objectives listed in the original formulation of the current Code.”

In the following sections we consider whether the proposed NEM objective will provide clear guidance and represent an “economically testable statement”. First, we consider the appropriate role for objectives within a regulatory framework. Second, we assess the proposed NEM objectives against accepted standards of what constitutes effective objectives. Finally we set out our conclusions.

## 2 Role of objectives

Objectives, or “objects clauses” within legislation serve to provide guidance as to the meaning and intention of the relevant provisions. In particular, they seek to set out the overarching aims of the legislation and assist in achieving the goals of regulation by reducing the potential for parties to subsequently reach decisions that are in conflict with the initial intentions of policy makers.

The need for an objects clause reflects the fact that most statutes, and regulatory statutes perhaps especially so, are to some degree ‘open ended’. Because the precise circumstances regulators will face in taking decisions cannot be fully anticipated and because coming to a decision in the circumstances that do occur will involve some degree of judgement, the statutes invariably confer on the regulator discretionary powers. One way of placing

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<sup>1</sup> MCE, National electricity market objective - an explanation, Energy Market Reform Bulletin No32, December 2004.

<sup>2</sup> Ibid, page 2.

bounds on those discretionary powers is by articulating a more general standard, in the form of an over-riding objective, to guide the exercise of that discretion. This more general standard should inform the interpretation of uncertain or ambiguous elements in the statute, as the regulator is bound to interpret those elements in a manner consistent with that standard. In practice, this means that the regulator, in exercising the discretion that arises from the open-ended nature of the statute's specific provisions, and faced with a situation where one interpretation of those provisions is more conducive to the achievement of the statute's objectives than are others, must choose that interpretation over the alternatives. This can enhance the effectiveness of the regulatory framework by helping to address principal-agent problems as between the Parliament as the principal and the regulator as its agent;<sup>3</sup> additionally and related, by providing guidance as to the manner in which the regulator will behave, it grants a greater degree of certainty to parties likely to be affected by the statute, and hence allows them to better adapt their plans to the statute's overall effects.

That said, there are limits to what can be achieved by means of an objects or purpose clause. Importantly, where the specific provisions in a statute are not open-ended, the mere fact that they conflict with the objects clause does not allow them to be over-ridden. Additionally, where the objects clause is limited in its coverage relative to the scope of the statute (say because there are elements in the statute that are unrelated to the stated purpose), the clause will not assist in their interpretation. Finally, the objects clause may itself be too ambiguous or open-ended to provide practical guidance and hence to achieve its purpose. As a result, the precise wording of the objects clause can be crucial in determining whether it is ultimately effective.

## 2.1 What constitutes an effective objects clause?

Whether any particular objects clause meets these aims will depend on a number of factors. It is now widely accepted that an effective objects clause is likely to meet the following conditions:

- **The objectives should be appropriate to the regulated industry.** In particular, the objective should explicitly reference economic efficiency. This is because an increase in economic efficiency should be a fundamental requirement of economic regulation. As there are a number of aspects to economic efficiency, the objects clause should not restrict overall efficiency gains to a subset of potential efficiency gains (for example allocative efficiency gains or dynamic efficiency gains in isolation).

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<sup>3</sup> Principal agent issue arise whenever one person seeks to motivate another to pursue a particular course of action. There is extensive literature on the issue supporting this approach. See, for example, Laffont and Tirole, 1993, *The Theory of Incentives and Procurement*, MIT Press and Vickers and Yarrow ((1988) *Privatisation: An Economic Analysis*, MIT Press.

- **The clause should be relatively simple and easy to interpret.** Objects clauses are designed to provide guidance to parties, and thus should be readily interpreted in a consistent manner. The mere act of including an objects clause does not imply consistency in interpretation, as a very large range of interpretations may validly be placed upon general expressions of objectives.
- **Conflicting objectives should be avoided.** Where objectives of numerous parts of legislation overlap, it is important to ensure that there is consistency between objectives.
- **Sub-objectives should only be included where they assist in interpretation of the key objectives.** Historically, the path chosen to address divergent interpretations has been to include specific sub-objectives. However, specification of sub-objectives without an indication as to whether all these need to be met, or their relative importance tends to reduce regulatory transparency. Moreover, given the potential for conflict between sub-objectives, where these are used they should be accompanied by a requirement that *all* sub-objectives need to be met or they are given a specified relative importance.<sup>4</sup>

## 2.2 Review considerations

In recent years, there has been considerable examination of the application of objects clauses in Australia. Various Productivity Commission inquiries in relation to access regimes in Australia have focused on the important role that objects clauses can play in promoting effective and transparent regulation.

In its Inquiry Report into the Gas Access Regime, the Commission considered there were considerable benefits in clearly specifying the objectives of legislation when this can narrow the extent of regulatory discretion:<sup>5</sup>

The more clearly specified the objectives, the more effective is the guidance to regulators... Decision makers facing conflicting objectives need to exercise discretion to assess the tradeoffs... the larger the number of conflicting objectives, the greater is the discretionary element involved in their resolution. As this tends to increase the potential for inconsistent judgements, there are advantages in narrowing the range of, and clearly specifying objectives.

The Commission also supported the role of objects clauses in its Inquiry Report into Part IIIA, arguing its effectiveness is enhanced where appropriate, providing appropriate policy guidance is provided as to the purpose of the legislation. It noted:<sup>6</sup>

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<sup>4</sup> The rationale for this is explored in subsequent sections.

<sup>5</sup> Productivity Commission 2004, Review of the Gas Access Regime, pp. 161-162.

An objects clause is a first stage espousal of the purpose of legislation. As a general statement of principle, an objects clause, of itself, does not provide regulators with all of the guidance necessary to ascertain the balance between the interests of current and prospective infrastructure providers, access seekers, end users and, more broadly, on how best to improve efficiency of resource use.

The Commission thus concluded that it would be useful for the Government to elaborate on the intent of the objects clause in any Explanatory Memorandum accompanying a Bill inserting an objects clause.

In its response to the Part IIIA inquiry reports, Government accepted the need for an objects clause, proposing the following clauses:<sup>7</sup>

- a) promote the economically efficient operation and use of, and investment in, essential infrastructure services, thereby promoting effective competition in upstream and downstream markets; and
- b) provide a framework and guiding principles to encourage a consistent approach to access regulation in each industry.

As in the future the National Electricity Rules may operate under the auspices of Part IIIA, any objects clause applying to Part IIIA may be applicable to the new Rules. As yet this issue is still to be decided.

### **3 Assessment of proposed NEM objectives against key features of effective objects clauses**

In this section we assess the proposed NEM objective against the key conditions of an effective object clause set out in section 2.1.

#### **3.1 Relevance**

The proposed definition contains a number of features that are widely accepted as beneficial for a system of regulation, such as the need to promote efficient investment and the need to consider price, quality, reliability, safety and security of supply in any regulatory decision.

However, a narrow definition of promoting economic efficiency has been adopted. In particular, it is not clear that promoting the “long-term interests of consumers of

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<sup>6</sup> Productivity Commission 2002, National Access Regime, pp. 135-16.

<sup>7</sup> <http://www.treasurer.gov.au/tsr/content/publications/NationalAccessRegime.asp>

electricity” provides the best approach to maximising social welfare, as the subset of electricity customers is potentially narrower than the general public. For example, higher prices may not be in the interests of consumers of electricity, but may well be desirable in terms of economic efficiency overall.

A similar issue has arisen in the Australian telecommunications sector, where the Productivity Commission examined the effectiveness of the objects clause in Part XIC of the Trade Practices Act, which is focused around a similar provision, namely the promotion of the “long term interest of end users” (LTIE). In its inquiry into the telecommunications sector, the Commission argued that application of the LTIE test would not necessarily produce the same outcome as a public benefit test.<sup>8</sup>

... in applying the LTIE objects clause, Part XIC takes a slightly more restrictive approach than the rest of Australian trade practices law... [t]his suggests that the application of the LTIE objects clause would not necessarily produce the same outcomes as one aiming at the public benefit. It is generally appropriate to seek the overall public benefit, rather than that of particular subgroups.

The PC recommended changes to the objects clause in Part XIC, proposing that the objects clause be changed from focusing on the LTIE to:<sup>9</sup>

*‘The object of this Part is to promote economically efficient use of, and investment in, telecommunications services...’*

Thus the PC recommended that the focus on the LTIE be removed in favour of a more explicitly efficiency based clause. Importantly, it considered that its recommendation would not result in a dilution of protection for consumers:

Consumer organisations claimed that the proposed objects clause in the draft report would represent an apparent dilution of a commitment to protect consumer interests... [h]owever, an explicit focus on preserving incentive for investment and innovation may better serve their long-term interests.<sup>10</sup>

The relevance of promoting the interests of consumers is further highlighted by outcomes in New Zealand where similar provisions are evident. Here, the focus on the promotion of the interests of consumers (or ‘acquirers’ under certain Commerce Act provisions) has led to outcomes that may be unjustifiable on economic efficiency grounds.

In particular, it appears that the objectives of the New Zealand legislation allow for consideration of wealth transfers between suppliers and consumers as part of the promotion of their interests. These wealth transfers are zero net welfare gains, and their

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<sup>8</sup> Productivity Commission 2001, Telecommunications Competition Regulation, p. 257.

<sup>9</sup> *ibid*, p. 259.

<sup>10</sup> *Ibid*, p. 259.

impact on efficiency is not necessarily positive. Indeed, allowing the use of regulation to effect wealth transfers may result in socially wasteful investment in rent-seeking behaviour by potential beneficiaries of those transfers. Setting the promotion of the interests of one section of the community as the object of a regulatory scheme may therefore lead to outcomes inconsistent with economic efficiency as a whole.

## 3.2 Simplicity and ease of interpretation

There is a significant risk that the proposed NEM objective may be interpreted in a number of different ways. This is due to problems in defining the “long term interests of consumers of electricity” and the inconsistency between the proposed objective and that proposed by Government for Part IIIA. These are considered in turn.

### 3.2.1 Ease of interpretation of “long term interests of consumers of electricity”

Precedent from the telecommunications sector suggests that there may be significant divergence in interpretation in what constitutes the “long term interest of consumers of electricity”.

The telecommunications specific regime under Part XIC of the Act set out various matters that need to be taken into account in considering the promotion of LTIE. These are set out in Box 1.

#### Box 1 Objectives of telecommunications regime under Part XIC

The object of Part XIC is centred around the LTIE, and is set out in section 152AB(1) as follows:

(1) Object

The object of this Part is to promote the long-term interests of end-users of carriage services or of services provided by means of carriage services.

When considering the promotion of the LTIE, regard must be had to the matters outlined in section 152AB(2), which are set out as follows:

(2) Promotion of the long-term interests of end-users

For the purposes of this Part, in determining whether a particular thing promotes the long-term interests of end-users... regard must be had to the extent to which the thing is likely to result in the achievement of the following objectives:

(c) the objective of promoting competition in markets for listed services;

(d) the objective of achieving any-to-any connectivity in relation to carriage services that involve communication between end-users;

(e) the objective of encouraging the economically efficient use of, and the economically efficient investment in, the infrastructure by which listed services are supplied.

However, as there is little guidance as to how these factors are to be taken into account, the ACCC has been granted significant freedom in interpreting the objectives in a manner that has been contentious. With regard to the three objectives involved in promoting the LTIE, the ACCC has stated that:<sup>11</sup>

In the Commission's view, these objectives are essentially 'secondary objectives'. They are not ends in themselves but are the means by which the primary objective (of promoting the long-term interests of end-users) is to be realised.

Where declaration is likely to result in the achievement of one or more of these objectives, it will generally promote the long-term interests of end-users.

Thus the ACCC considers these objectives to be subordinate to the overall consideration of the LTIE. As such, where declaration may have conflicting effects on one or more of these objectives, the ACCC has formed its own judgemental position when considering: whether to declare a service; arbitrating for a declared service; and accepting or rejecting an undertaking on the terms and conditions of supply of a declared service. In relation to the benefits of declaration the ACCC has stated:<sup>12</sup>

Where declaration is likely to have mixed effects in terms of one or more objectives, the Commission will seek to form a view about the net impact upon end-users... Forming a view about the net impact on end-users is likely to be a qualitative assessment involving judgements about the benefits and costs arising from declaration, and the spread of those costs and benefits.

This declaration process clearly differs from the declaration criteria set out under Part IIIA, where all declaration criteria must be satisfied before a declaration is made. It also confers upon the ACCC significant discretionary power in determining whether or not to declare a service. The fact that the Commission acknowledges the role that "the spread of ..costs and benefits" plays in its evaluation highlights the scope the LTIE test creates for distributional concerns to play a role.

As a consequence of both the legislative provisions of the LTIE test and the ACCC's approach to assessing declarations with respect to it, numerous concerns have been raised about its operation. The subordinate nature of the economic efficiency objective in the construction of the declaration provisions of Part XIC clearly allows for economic efficiency considerations to be over-ruled by qualitative and/or subjective judgements relating to the perceived promotion of competition. By its exclusion of any reference to economic efficiency, and focus on a subjective interpretation of the "long-term interest of consumers of electricity" the proposed NEM objective is susceptible to similar costly misinterpretation.

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<sup>11</sup> ACCC 1999, Telecommunications services – Declaration provisions, p. 35.

<sup>12</sup> *ibid*, p. 37.

### 3.2.2 Consistency with the objectives underpinning Part IIIA

The relevant part of Government's proposed objects clause for Part IIIA, set out in section 2.2 is:

“..promote the economically efficient operation and use of, and investment in, essential infrastructure services, thereby promoting effective competition in upstream and downstream markets”

While the proposed NEM objective adopts in part the wording related to the promotion of investment, it is largely inconsistent with the remainder of the proposed Part IIIA objects clause. In particular, the proposed Part IIIA objects clause makes no reference to the “long-term interests of consumers of electricity” while the proposed NEM objective does not explicitly reference the need to promote upstream and downstream competition.

These inconsistencies are likely to significantly increase regulatory risk and the number of disputes due to differences in interpretation should the revised Rules operate under the auspices of Part IIIA. At best, the NEM objective introduces unnecessary complication. The promotion of the economically efficient use of, and investment in, electricity services does not need to be qualified, as any regulatory decisions made to promote this objective should act to improve overall welfare. Introducing the qualification of the “long term interests of consumers of electricity” is both unnecessary, and as highlighted in relation to telecommunications conflicts may arise between this provision and economic efficiency, providing undesirable discretion to the regulator and increasing regulatory uncertainty and risk.

### 3.3 Avoidance of conflicting objectives

By streamlining the current market objectives into a single over-riding objective, the proposed amendments largely reduce the potential for conflicts. However, as noted in the previous sub-section, the introduction of the “long term interest of consumers of electricity” appears an unnecessary inclusion at best, and potentially conflicting complication – in terms of interpretation – at worst. The inclusion of this term is also contrary to the Productivity Commission's findings in relation to the LTIE in the telecommunications sector, and inconsistent with the proposed objective for Part IIIA.

Should a provision similar to the LTIE provision in telecommunications be included, it is likely to function more effectively if it is part of provision relating broadly to enhancing long-term economic efficiency. If the overarching objective of the regime is one of economic efficiency, then it is more likely that a regulator or Court would see competition as the most efficient competitors being the ones that ultimately stand in the market with less efficient competitors being driven out. This contrasts with the ACCC's apparent view

under the LTIE provisions that competitors of all shapes and sizes should be able to “make a go of it”, provided they are in some way “efficient” given what they are.

### 3.4 Only inclusion of relevant sub-objectives

The proposed NEM objective includes a number of sub-objectives relating to price, quality, reliability, safety and security. In any dispute, the regulator will necessarily have to place weights on each of these factors, even if it is only in a subjective manner, a point noted by the Productivity Commission:<sup>13</sup>

Regulators not only need to interpret the meaning of the objectives, but also implicitly or explicitly attach weights to them.

The inclusion of sub-objectives in telecommunications regulation and the subsequent interpretation and application of these objectives by the ACCC has been contentious. In particular, while all the sub-objectives need to be considered, not all sub-objectives are required to be met in the ACCC’s regulatory decisions. Furthermore, it is left to the regulator to determine what weight will be given to the various objectives – including whether any weight at all is given to individual sub-objectives. This provides the ACCC with scope to trade-off particular objectives – in particular, economically efficient usage and investment may be traded off against the promotion of other objectives – and ignore others. In this regard, these sub-objectives do not meet the criteria expressed above – they provide scope for regulatory discretion, decreasing transparency and requiring trade-offs between potentially conflicting sub-objectives on a qualitative basis by the regulator.

It is not clear to what extent the inclusion of the considerations in relation to price, quality, reliability, safety and security improve the guidance that the proposed NEM objective provides. Further, it is not clear the extent to which these considerations may or may not conflict with the general efficiency objectives of the objects clause, and if so, how any conflicts would be resolved. As a result it may be more beneficial to separate out the economic elements from the non-economic elements. The economic elements such as price and quality are all part of the same “value for money” concept addressed by efficiency. Therefore, it is questionable whether they require a separate explicit listing. On the other hand, while issues such as safety and security may be best addressed primarily by technical regulation, it could be appropriate for the regulator to be required to exercise its mandate subject to those goals being met. The regulator would not, in this approach, have the scope to interpret the explicitly economic objective in a manner that undermined the safety, security and reliability of the system. This would plainly be especially important were the “long term interests of consumers of electricity” formulation, with the discretion it creates, retained.

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<sup>13</sup> Productivity Commission 2004, Review of the Gas Access Regime, p. 168.

## 4 Implications and conclusions

Based on precedent in the telecommunications sector in particular, the proposed NEM objective will confer significant discretion on decision makers such as the AEMC when carrying out its functions and where such decisions are the subject of challenge or dispute, give rise to considerable controversy or uncertainty. This is largely due to the inclusion of the “long term interests of consumers of electricity” in the definition rather than a wider provision relating to long-term economic efficiency. However, the inclusion of separate reference to price, quality, reliability, safety and security also allows significant discretion to the regulator by allowing it to make subjective judgements on the relative importance of each of these factors.

Regulatory precedent in Australia and New Zealand suggests that decision makers may use this discretion as a mechanism to unduly focus on reducing price and/or increasing entry into regulated (or competitive) sectors. This may be at the expense of overall economic efficiency and may additionally conflict with reliability and security in supply.

Adopting a definition consistent with that proposed for Part IIIA can alleviate many of the problems associated with the proposed NEM objective. In particular, there is no reason why the objective should not take the “promote the economically efficient operation and use of, and investment in, essential infrastructure [electricity] services” component of the proposed Part IIIA objective. This would be more beneficial as:

- The terms are relevant to the electricity sector and do not unduly restrict economic efficiency;
- The terms are well established and subject to less misinterpretation than the “long term interests of consumers”;
- There are no conflicting objectives; and
- Confusing sub-objectives are removed.

Should MCE decide that it is necessary to include explicit reference to the “long term interest of consumers of electricity” it is likely to function more effectively if it is part of provision relating broadly to economic efficiency. If the overarching objective of the regime is one of economic efficiency, then it is more likely that a decision maker would see competition as the most efficient competitors being the ones that ultimately stand in the market with less efficient competitors being driven out.



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