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23 April 2004

Chairman Samuel, Deputy Chair Sylvan, Commissioners Martin, McNeil, Willett,
Australian Competition and Consumer Commission
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Mr Chairman, Ladies and Gentlemen,

Draft Decision-Review of the Regulatory Test for Network Augmentations

In October 2002, I wrote the Minority decision (www.netribunal.net.au) in the National Electricity Tribunal's assessment of the application for review by Murraylink of NEMMCO's SNI decision. As you know, appeal against the Majority decision (at same URL) was subsequently upheld in the Victorian Supreme Court. Various aspects of my decision involving the welfare-economic and theoretical bases of the Test and the NEMMCO decision were included in the arguments of the appeal. The case involved detailed discussion and interpretation of the Commission's Regulatory Test.

I retired from the Tribunal in early January 2003, and have not been involved with the NEM since then. On 20 March of that year, I learnt that a review of the Test had started in February and wrote to your Mr Roberts of the Electricity Group offering my assistance. I had no further submission to make beyond my NET decision. I received no reply to that letter and have not followed later developments. However, a former colleague yesterday sent me your Draft Decision document, responses to which are due today. I have thus had the opportunity for a brief reading only, but would like to make the following points:

1. In my decision, and with the help of its various appendices, I outlined the basis upon which the economic assessment method of cost benefit analysis (CBA) is justified as an appropriate basis for a decision on the *public welfare aspects* of an infrastructure investment such as a network augmentation, and the logic of *the terms and processes used in CBA techniques*. It was common ground among the parties that the case did involve an application of CBA. I also specified, with authorities, the expert meanings accepted in the discipline of economics for key terms, 'terms of art', in the legal phrase, included in various aspects of the CBA techniques relevant to the case, and including the phrase "cost benefit analysis". Some of these terms had not been well formulated or referenced in the Regulatory Test. I note that a number of the changes

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made in the present draft attempt to clarify some of the terms and meanings to which I drew attention. One of the reasons I detailed these matters was to establish that important terms used in the Test and in CBA are, indeed, 'terms of art, of the economic art', as I said in my decision, that they have precisely defined meanings well understood in the discipline, and that they should, therefore, be used in those ways. In the Majority decision, my colleagues, Messrs Cripps and Williamson, both lawyers with extensive judicial experience, used several terms of the analyses in ways inconsistent with their meanings as terms of art but consonant with their use by NEMMCO. I cannot here canvass this in detail, but it was largely because of this that they arrived at key aspects of their decision. In the Victorian Supreme Court decision on the appeal (www.austlii.edu.au/au/cases/vic/VSC/2003/265.html),
His Honour Justice Nettle dismissed arguments of the appellant based on this distinction. I quote:

'7. The appellant embraces Professor McDonnell's (sic) analysis and says that the failure of the Tribunal to apply the regulatory test as Professor McDonnell said that it should have been applied has resulted in an improper failure to consider taxes and transfers; shadow prices; and optimisation of project characteristics, especially in relation to scale and timing; and risk and uncertainty.'

'8. In my opinion this is not a question of law. It is a question of fact (here the references *Collector of Customs v Agfa-Gevaert* (1996) 186 CLR 386 at p.394; *Vetter v Lake Macquarie* CC (2001) 202 CLR 439 at pp.450-452, are cited by His Honour). There is no dispute that the test to be applied is the test promulgated by the ACCC. There is also no dispute that the test modifies what Professor McDonnell terms "the usual dimensions of a CBA". The debate is about the ways to go about a cost benefit analysis of that kind. Say that quickly and it may sound as though it involves a question of construction of the Code, or at least the construction of the test imported by the Code. But it does not. The difference between the majority and Professor McDonnell *is about no more than the application of economic criteria to the facts of the matter* (italics added).'

2. In short, His Honour did not accept that the terms in question were terms of art, with expert meanings, and that their use should be determined by those meanings, including both technical and welfare associations of those meanings, given to them in the economics discipline. Further, His Honour concluded that my position was a personal one, rather than one exposing, on the basis of cited economic authorities which have not been disputed, the rationale of the expert discipline in this area. My point was, of course, that NEMMCO's processes in question *did not* conform to economic criteria. With respect, His Honour, in my view, erred in both these respects.

QUESTION 1: Be that as it may, are you satisfied that the terms, including the numerous expert terms, of the Draft Test as now reformulated would be able to withstand that sort of legal interpretation?

3. There is a closely related matter. The intention of the regulation encapsulated in the Test is, in accordance with the Code, to further economic efficiency. This is its welfare basis, as I explained in my decision. It was to establish the conceptual

underpinnings of economic efficiency and thus of the regulatory intent that I traversed the relevant principles. Economic efficiency would not, however, have followed from the interpretations of NEMMCO's processes adopted in the Majority decision, as I explained. The foundation, in principled economic argument, of the regulatory intent of the Test, and of the meanings of the terms used in that Test, was not, apparently, a matter which concerned the Majority. Further, it seems also not to have been an issue for Justice Nettle: his decision was that the reading of NEMMCO's processes taken by the Majority, except in regard to the matters dealt with in **Ground 3** of his judgment, was of equal value with the view I derived from economic principles. As I showed, NEMMCO's processes, including those accepted by the Majority, would not have furthered the regulatory intention-far from it.

4. Paras 7 to 16 of His Honour's judgment refer. Thus, for example, at para.13 he says:

'…the majority did not wrongly exclude considerations of relevant general economic principle. What they said was that the "cost benefit analysis is to be applied conformably with the particular criteria specified in the regulatory test, rather than by reference to cost benefit principles at large". In principle there is no difference between that and, as Professor McDonnell would have it, a 'formal traditional cost benefit analysis within a partial equilibrium setting, with the specified, and only the specified, delimitations to be used for the particular application, and the applicability of the usual dimensions of a CBA taken for granted". Semantics aside, the two are the same.'

5. I demur that, semantically, "the particular criteria specified in the regulatory test" were *not* distinct from, but *could only be understood with reference to*, "cost benefit principles at large", as I explained in my decision.
6. I note that in your commentary on the current Draft Test, under "Option 3: Competition benefits", the point is now made, presumably to clarify regulatory intent, that the test must be consistent with the principles of Chapter 6 of the National Electricity Code, i.e., with the pursuit, in particular, of economic efficiency. I note also that little weight was given by either the Tribunal Majority or Justice Nettle to the commentary accompanying the then Test.

QUESTION 2: Are you satisfied that, as presently expressed, the proposed Draft Test's regulatory intent, and *its basis in the formal theory and practice of CBA*, is sufficiently clear and fortified?

7. In the Tribunal decision, I explained the adjustments required in order to prepare economically valid comparisons of investments of differing sizes. The Net Present Value rule must be appropriately qualified to allow this. From my brief reading of the Draft Test it is not clear to me that this matter has been adequately attended to.
8. In the Tribunal decision, I also dealt extensively with issues of risk and uncertainty, notably in connection with the high proportion of residual value within the sum of the benefits i.e. of mainly unused capital arising from the short review period; and also with the lesser confidence to be placed in late occurring benefits and costs. In the SNI case the failure to deal with these issues strongly skewed the assessment. Again, from my brief reading of the current Draft it is not clear to me that these have been adequately attended to.

9. Again, in the decision I drew attention to the need in CBA to make incremental analyses of the productivity of individual capital components of the proposed investment package. As I showed, and as Professor Stephen Littlechild has commented (www.econ.cam.ac.uk/electricity/publications/wp/ep376.pdf) in a recent paper on the SNI case, this sort of analysis would have revealed the inadequacy of the SNI proposal. I do not think that this issue has been dealt with in the Draft Test.

QUESTION 3: Are you satisfied that the issues in 7., 8. and 9. above have been sufficiently clarified to protect the regulatory intent?

There are two other issues which extend beyond the specifics of the Draft Test. Firstly, as I explained in my decision, CBA was originally derived for dealing with the " market failure" situations attendant upon adding investments in large, government owned, monopolistic infrastructure systems-dams, hydro plants, airports, roads, etc-and where the proposed investment is a small proportion of total system investment. It has been used, with varying usefulness, in other contexts, such as in various types of *ex ante* and *ex post* assessments of policy instruments. However, I know of no other example of CBA being used as a discriminator in a highly market-dynamic situation such as the NEM. I noted this reservation in my decision. In the NEM case the economic effects of proposed 'monopolistic' or regulated investments, even largish ones such as interconnectors, are small in relation to those of the other market-based investments. Also, new investments and system modifications, right across the NEM, are constantly being mobilised and can affect the proposed investment, whether or not they are, in the terms of the current Draft, "substitutes".

This changing situation will also affect the attempt now proposed to measure "competition benefits", since the bases for measuring the effects of the "market power" of a network element, and other inefficiencies, are likely to be rapidly changing. I have not had the time to address the issue systematically, but think there might well be theoretical issues relating to this situation which need to be clarified. But, apart from such considerations, the practical problems of obtaining a "snapshot" of the proposed situation, and assessing that as if it were a realistic representation of the incremental effects due to an augmentation within a mobile, complex market, seems likely, at least, to present unrealisable demands on data availability and modelling coherence. Perhaps it is the crucial and much vexed question of network investment frameworks that your Supplementary Discussion Paper addresses. I shall read it with interest.

Finally, the present review has now taken almost fifteen months, after the years of delay beginning with the original SANI proposal. The sense of regulatory uncertainty, and even of dismay, in the industry is strong. We might recall that the adopted model of the NEM was specifically recommended by the Industry Commission because it was to be regulatorily 'light-handed'. In my view, this was, in fact, never on the cards, because of the Industry Commission's failure to grasp the network issues. But I think few expected the intractabilities of the present situation.

It is very important that the outcome of your review and associated steps bring greater confidence to one of the most complex and certainly one of the most essential national industries. The performance of the Commission has not been above comment. Many point to the extraordinarily damaging episode of the Customers Benefits Test, with

its theoretical vacancy, and wonder how the ACCC could have accepted it in the first place. The Commission has never sought to explain that. The Commission's pronouncements in this sector have been, in terms of economic argument, of varying quality and sometimes wrong. Doubts linger. The policy and analytical questions involved, especially for developing responsive networks in a market environment, are extremely formidable and nowhere have they been satisfactorily resolved. They are being tackled in other countries with heavy commitments of expertise and investment. Yet neither NECA nor the ACCC has ever sponsored a serious research effort to address network issues, or, indeed, market design, but have relied instead on occasional consultancy reports and on necessary, valuable, but diffuse and not always well informed, public consultation.

I have been involved with the electricity reform process for a long time, having directed the 1985-86 Commission of Enquiry into NSW Electricity Generation Planning. The results of that, along with a later Victorian Enquiry, established preconditions for national policy reform, and much of the agenda. The improvements effected in several jurisdictions in the pre-market period, plus gains since NEM start, economised the use of generation assets. But conditions of supply are now tightening, and the networks are getting older. It is a critical time. Many issues in the NEM require resolution, but it is strategically important that the present review bring clarity and responsiveness to network regulation. For that, strong intellectual foundations are a prerequisite. I don't believe your proposals have that.

Allow me to suggest that an independent scholarly assessment be obtained as soon as possible from an established authority in the fields of cost benefit analysis and welfare/resource economics: I have not spoken to any of them, and they might not thank me for mentioning them, but Professor Peter Forsyth, of Monash University, Dr Michael Common, of ANU, and Emeritus Professor Ted Kolsen, of Queensland University, are all such people, and there are others.

I am sending copies of this letter to the Chairmen of NECA, NEMMCO and NET. I am also sending it by email to your Electricity Group with the request that it be treated as a response in your consultation process and be published on your website.

Yours sincerely,

Gavan McDonell