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15th October 2013

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By email: submissions@ea.govt.nz

Dear John

Working Paper - Transmission Pricing Methodology CBA

Thank you for the opportunity to comment on the working paper *TPM Cost Benefit Analysis*, published by the Electricity Authority (The Authority) on 3rd September 2013. Our interest in this consultation is as Grid Owner and administrator of the TPM.

Rethinking TPM interventions is the right thing to do

The Authority's decision to rethink its proposed TPM interventions is the right thing to do. We consider a willingness to reconsider proposals and change these to reflect a different, or enhanced information set is a characteristic of a good regulator. This can be easier said than done – as Galbraith aptly put it:

"Faced with the choice between changing one's mind and proving there is no need to do so, almost everyone gets busy on the proof."

We are encouraged by the Authority's decision to rethink its proposed TPM interventions and we remain committed to supporting the Authority and industry as changes to the TPM are considered.

CBA design needs to reflect problem definition and remedy options

With respect to the interconnection charge the Authority has not adequately defined the problem it sees with the current TPM. Apart from the 'signal strength' issues that, if established as material problems, are readily addressable the problem definition to date has essentially been a statement of faith and belief: that its preferred solution could be 'more' efficient than the status quo. This simply does not constitute a robust problem definition.

Without a robust problem definition it is not possible to sensibly identify remedies (options) or to meaningfully assess these.

Working paper represents an initial step toward developing the CBA

We agree that the "working paper represents an initial step toward developing the CBA"¹. However, while it is possible to establish a CBA framework in the abstract² it is not possible to decide the key design features without a clear problem definition and defined options – neither of which are available at this point.

¹ Paragraph 1.29 CBA working paper

² The framework outlined in the CBA working paper is essentially that described at F7 in the October 2012 paper.

We have some reservations about the process for this investigation. These concerns include the logical sequence, the subject matter and whether we are 'back to square one' as we interpret the situation to be or simply getting "busy on the proof", as Galbraith puts it.

The risk and opportunity cost is too high

Having participated fully in this process to date and from a largely 'value neutral' perspective we have been unable to convince ourselves of the case for radical change. On the contrary, as the process progresses, it has become increasingly apparent that current TPM operates well and that a stable, simple and durable TPM is highly valued. We remain extremely concerned about the risk of unintended consequences or 'collateral damage' from radical reform.

To be clear, we are not averse to change where it makes sense, and consider that the investigation process has advanced understanding of some specific problems, e.g. the HAMI charge and the strength of the UNI RCPD price signal, where there is clearly room for improvement (and potentially elsewhere). However, we simply do not think large-scale change makes sense and, rather than pursue radical departure from current arrangements, the investigation should focus on understanding and remedying the specific problems that have been identified.

This industry and the Authority face many challenges. We do not dispute that transmission pricing is important, even interesting, but we must not fixate on this when we could collectively direct our focus and resources at matters more likely to deliver benefits for consumers.

The appended submission contains our comments on the working paper under the following headings:

1. the role of cost benefit analysis (CBA) in a broader analytical framework
2. the importance of clear problem definition
3. the regulatory framework for transmission pricing
4. comments on the proposed CBA for the TPM investigation
5. other matters

Appendix A: CEG report

We trust that this submission is informative and assists the Authority's policy development process. We are available to discuss any part of this submission and remain available to assist the Authority and industry stakeholders on transmission pricing matters.

Yours sincerely

A handwritten signature in black ink, consisting of a stylized 'J' followed by a long horizontal line and a small flourish at the end.

Chief Regulatory Advisor

Transmission Pricing Methodology
Submission on Authority's Cost Benefit Analysis framework

Transpower New Zealand Limited
15th October 2013

Keeping the energy flowing



Submission by Transpower New Zealand Limited

on

Transmission Pricing Methodology:
Cost - Benefit Analysis framework

To: John Rampton
Chief Executive
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Date: 15th October 2013

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1. Introduction

We appreciate the opportunity to comment on the working paper *TPM Cost Benefit Analysis*, published by the Electricity Authority (The Authority) on 3rd September 2013.

This submission contains Transpower's comments on the Authority's TPM CBA working paper.

We note that the Authority did not pose specific consultation questions. Our submission aims to provide constructive general feedback on the proposed CBA and comment on the broader analytical framework that the CBA fits within.

Our submission comprises the following sections:

1. the role of cost benefit analysis (CBA) in a broader analytical framework
2. importance of clear problem definition
3. the regulatory framework for transmission pricing
4. comments on the proposed CBA for the TPM investigation
5. other matters

Appendix A: CEG report.

2. The role of the CBA within a broader analytical framework

This section steps back from the detail of the CBA to the broader analytical framework that it fits within and how that framework should operate.

We are not suggesting that the EA has not applied this framework; however we consider that it has applied important parts of it incorrectly. This has had a determinative effect on its subsequent analysis and conclusions.

CBA is part of a broader policy development process

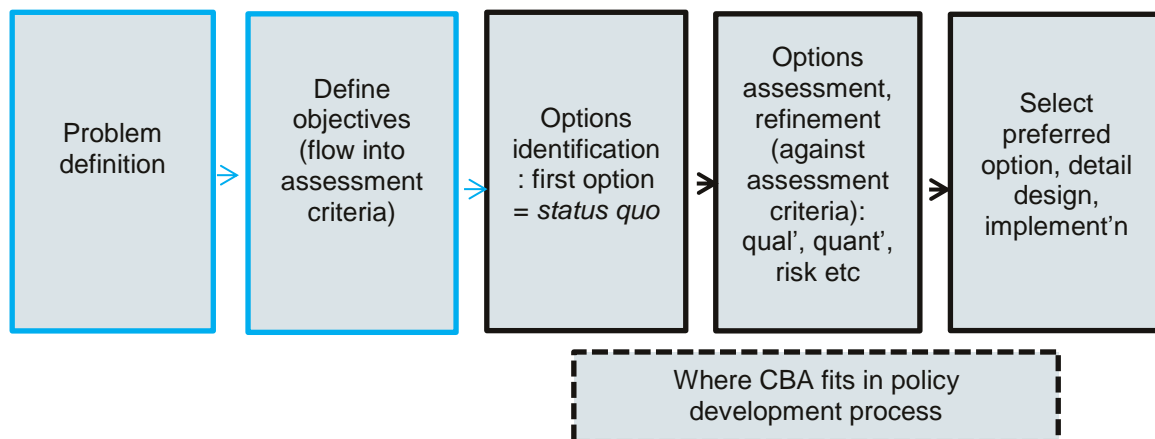
One could adopt the view that the CBA is a box to tick before finalising a decision. In our view this is the wrong approach and is unlikely to best promote the interests of end users. Rather, the role of the CBA is to inform the regulator's decision over whether change is appropriate; and, if it is established that change is appropriate then the CBA will assist the choice of which of the available options is the best remedy.

In the current context the CBA is part of a broader TPM policy development process. That process begins with establishing what, if any, problem exists, the objectives of the policy and proceeds to the identification of potential remedies (options) for addressing the problem(s) and concludes with a decision as to what, if any, change is appropriate.

It goes without saying, but is worth saying anyhow, that quality decisions depend on robust analysis. This is not necessarily volumes of complex analysis rather well structured, logical analysis that has clarity of purpose, is objective and is conducted with rigour and discipline. Rigour and discipline necessitate elimination of personal, institutional or analytical bias, checking and re-checking assumptions, striving to get to the *root cause* of the problem and challenging any 'sacred cows'.

Without these ingredients there is a good chance the policy analysis will be not be robust, the decision compromised and the outcomes sub-optimal. The high level stages in the policy development process are outlined in figure 1 below.

Figure 1: the policy development process



Missing a step or approaching the analysis out of sequence will undermine the analysis and reduce decision quality. For example, identifying a preferred option before the problem is defined. The first two stages provide the foundation from which the options identification, assessment and decision are made, and are therefore particularly critical.

The simplified diagram above may be misleading as policy analysis is hard and each of the different stages has its own challenges. Robust policy analysis requires the right institutional frameworks - including mature processes for assessing risk and making

trade-offs and decision makers who understand and are comfortable with those frameworks and processes.

The CBA evolves with the analysis

The role of the CBA is to inform the regulator's decision over whether intervention (change) is appropriate (full stop). If it is established that intervention is appropriate then the CBA will assist the assessment of which of the available remedies represents the best option.

As illustrated in Figure 1 the CBA straddles the *options identification*, *options assessment* and *selection* stages. Developing the CBA alongside options identification allows that analysis to be informed by the evolving cost benefit analysis and helps ensure the options identified are well developed. A richer set of developed options permits a more informed decision.

This will typically involve some iteration as options are refined and optimised. Once a choice has been made the CBA can also be used to fine tune the preferred option as detailed design work is done to further reduce costs or increase benefits.

By contrast (a common criticism of policy makers) the CBA can be undertaken in isolation from the policy development – potentially even at the end of the process (i.e. after the options assessment and decision). By definition this approach deprives the policy analysis and decision of the benefits of CBA and so:

- materially reduces the value of the CBA to the policy analysis
- risks the CBA being 'tailored' to suit the preferred option.

It is important that the Authority ensures its approach to and execution of CBA maximises the value of the CBA to the policy development process. This is particularly relevant for potentially contentious and far-reaching decisions as may be the case with its TPM investigation.

CBA informs the policy decision

The CBA is a key input to the decision making process but is not, of itself, determinative. This is because there inevitably are some factors that cannot be meaningfully quantified, which are materially uncertain or otherwise cannot be accounted for in a CBA. This means CBA cannot substitute for regulatory judgement and discretion.

The decision maker must balance the quantitative CBA results with a range of other factors, for example:

- risk – uncertainty or errors in the problem definition, options development and assessment translates into lower benefits or larger dis-benefits than anticipated
- the advantages of regulatory certainty over continuing uncertainty, for affected parties' long term investment decisions
- complexity – an overarching theme of regulatory failure¹
- non-financial transaction costs / opportunity cost – to the regulator and industry associated with the regulatory process and implementation of selected remedies.

The nature of the decision will vary by situation. In some cases the intervention may be clearly beneficial with few costs, be simple and low risk – in which case the need for discretion and judgement may be limited. In other cases the benefits may be smaller,

¹ See page 9, NZ Productivity Commission Review of Regulatory Institutions and : <http://www.productivity.govt.nz/sites/default/files/Regulatory%20Issues%20Paper%20final%20%28updated%2029%20August%202013%29%20LowRes%20for%20web.pdf>

less certain or far off, require complex regulation to achieve, carry large cost and involve material risk. In that scenario the decision maker will rely heavily on discretion and judgement but also the frameworks and processes referred to above for assessing risk and making trade-offs.

The notion that the option with the largest net-benefit should be selected, while intuitively attractive, should be treated with caution. It is very easy to err on the high side when estimating benefits and err on the low side when assessing cost, complexity and risk. There is much to be said for capturing benefits with low attendant cost / risk. This all goes to support that the CBA is an important element in the decision making processes but is not, of itself, determinative.

Proper consultation provides a health check

A key benefit of CBA is making the assumptions and logic that drives costs and benefits explicit and transparent and allowing these to be tested and refined through consultation. That is to say that open consultation permits the stress testing of assumptions, logic and the design of any CBA models.

From a policy perspective consultation helps iron out any errors, omissions and 'loose' assumptions. It also helps flush out some of the non-quantifiable, qualitative (judgemental) factors described above thereby enriching the decision maker's fact base. From a stakeholder perspective, while it may not result in unanimity it does provide affected parties with confidence that the range of estimated, quantifiable costs and benefits are robustly understood and reduces scope for on-going dispute and litigation. Conversely an assumed CBA will achieve the opposite.

Effective consultation necessitates publication of any models, source information and assumptions in a form that permits cost effective scrutiny. To assist cost effective and timely scrutiny, explanatory notes should be provided where necessary and any assumptions should be clearly stated with supporting rationale.

3. Importance of clear problem definition

This part of our submission explores this issue of problem definition in more detail including how the Authority might approach this stage of the analysis.

In our view the Authority is yet to adequately define the problem with the TPM that it is seeking to solve.

Clear problem definition underpins all subsequent analysis

The Authority has identified problems with the HVDC charge, the connection and interconnection charges:

The **HVDC charge problem definition** is essentially the product of the TPAG work and identifies potential inefficiencies with the HAMI charge. There appear to be reasonable grounds for considering alternative options for this charge although it is also possible that the current charge, perhaps with some de-tuning of the price signal, remains the most efficient charge.

The **connection charge problem definition** appears to have been largely debunked through the original consultation and our expectation is that the Authority will not advance its initial proposals.

The **interconnection charge problem definition** is, in our view, particularly ill-defined. Although the Authority identifies two small inefficiencies the principal driver² for change appears to be the Authority's belief that, at a fundamental level, transmission investment decisions are inefficient.

The Authority has previously defined the problem with the current TPM by reference to the hypothetical benefits of the Authority's preferred solution, and evidently proposes still to do so. Changing prices will change behaviour. This is not contested. However, the essence of the Authority's definition of the problem for the interconnection charge is that its preferred solution could be 'more' efficient than the status quo. This is a statement of faith, of belief: it is not a problem definition and simply does not permit establishment of a causal relationship between the intervention and the attainment of the stated benefit.

Please refer to the appended report from CEG for discussion of the likely efficiency of the current TPM, viewed alongside the nodal wholesale market and Capex IM, and the prospects for material efficiency gains.

Robust problem definition

At one level the problem definition can be encapsulated in a single sentence. However, before that sentence is formed, some leg work is required to ensure it correctly represents the problem. We consider that leg work, and a robust problem definition, involves the following steps.

1. *explicit definition of the problems that are perceived to exist under the status quo*: for example, if the Authority considers that transmission investments and generation location decisions have been made inefficiently in the past then it should be clear about this, or that static efficiency is compromised by the capacity factor charges (specifically HAMI and RPCD) it should state this.
2. *establishing whether the problems exist and their materiality*: to the extent the Authority has identified that problems exist under the status quo it should provide evidence of the problem that it has defined, e.g. of inefficient transmission and generation location decisions, and the materiality of these, and allow these to be tested through consultation.

² Potential for price signals to be too strong in future (and at present in LNI) and pass through

It is generally accepted that no pricing methodology will be perfect and that some inefficiencies may arise at the margin. It may be appropriate to adjust the TPM to address these inefficiencies e.g. fine tuning of price signal strength over time may be appropriate as grid and market conditions evolve. Alternatively, it may be that these inefficiencies are simply a cost of providing certainty and price signals that, on the whole, encourage efficient behaviours.

3. *establishing whether identified problems are enduring*: to the extent that there is evidence of material problems under the status quo the Authority should then establish whether these problems are likely to endure given current market conditions and regulatory settings. For example, whether perceived historic and or current problems with transmission and generation investment decision making are likely to be enduring and, if so, what their materiality is likely to be (given regulations, investment outlook etc.).

As part of this analysis we suggest that the Authority closely examine the grid investment test provisions of the Capex IM which, coupled with the nodal price signal and current TPM, we consider *already* provide the outcomes sought by the Authority.

4. *establish that the TPM is the appropriate remedy*: though not strictly part of the problem definition it is necessary, in context of a TPM investigation, to establish that the appropriate remedy for the problem is in fact the TPM not simply that the TPM is *an option*. For example, if the problem is with the policy relating to embedded generation or retail competition, the Authority should address the problem directly not indirectly through manipulation of the TPM.

If any problems are established to exist, are material, can reasonably be expected to be enduring in nature and the TPM is the appropriate vehicle for addressing them *then* the analysis can proceed to identifying and assessing policy options.

It is important that the option of *no change* remains on the table through that analysis. If, upon investigation of potential interventions, the status quo (or incremental change only) emerges as the best option then it should be adopted. Regulators need to be wary of the ‘sunk costs fallacy’ – particularly with exhaustive processes such as the TPM where considerable effort is expended and views are deeply held.

...and is worth the effort

Robust problem definition is one of the less glamorous but most important aspects of policy analysis.

Simply put, it worth the effort – it results in higher quality regulatory decisions, less dispute and better outcomes for consumers. This is because it helps mitigate the risk of incorrectly defining the problem and ‘solving’ for a problem that doesn’t exist (or solving the symptom of an unrelated problem) while potentially failing to address a real problem. Robust problem definition permits the options identification and assessment stages to be undertaken on a firm foundation.

Conversely, improperly defining the problem, for example by defining the problem by reference to a specific (preferred) solution, provides a weak foundation for subsequent analysis and undermines the quality of the policy decision. Specifically it:

- biases toward change when change may not be optimal
- skews analysis toward the ‘preferred’ option and invalidates any options analysis
- solves the wrong problem while potentially failing to address a real problem

The resultant decision will be sub-optimal, will not achieve the policy objective and is unambiguously not a feature of best practice regulatory policy making.

Problem definition warrants its own working paper

The Authority states that additional working papers may be identified as work progresses³. We encourage the Authority to consult separately on the TPM problem definition.

³ See: <http://www.ea.govt.nz/our-work/programmes/priority-projects/transmission-pricing-review/second-issues-paper/>

4. The regulatory framework for transmission pricing

In this section we reflect briefly on the regulatory journey that the TPM has been on since the Authority was established, and conclude that the development process needs specific attention in two further respects.

Our general view is that that the Authority is at once taking *too narrow a view of its objective* and *trying to do too much* through the TPM. In the process it risks failing on all counts.

The purpose of the TPM

The purpose for the TPM - as described by government policy makers in formulating the original Part F of the Electricity Governance Rules that precede the Code (schedule 12.4) - is to recover the full economic cost of provision of those services. To accomplish this, Part F included a list of pricing principles (which became code 12.79) and a guidance clause that outlined how those principles should be applied and interpreted (which became Code 12.80).

The current context

The Authority changed the framework in two major ways. First it recast the framing from a principles based approach (in effect, the value criteria *of* the methodology) to a higher level objectives based approach (the outcomes sought *by* the methodology). Second, it removed the statutory guidance of clause 12.80 about the application and interpretation of those principles. We have identified two major policy development issues arising under these framework changes.

The framing by the statutory objective: under the TPM policy development the Authority has taken the view that its statutory objective should be truncated into an ‘overarching’ objective for efficiency⁴. The options analysis is now viewed from the singular perspective of the outcomes for ‘efficiency’ and the specific considerations of outcomes for ‘competition’ and for ‘reliability’ have been disregarded. The effect of this is to greatly limit both an open-minded search for options and their full consideration against the tripartite objectives for the whole industry.

The options analysis should reveal a well-designed TPM that is supportive of, or neutral to, all three limbs and a poorly designed TPM that is unsupportive of one or more limbs. It is beholden on the Authority to explicitly surface through consultation the impact of any pricing methodology option against all three limbs of its statutory objective.

The removal of the guidance under Code 12.80: the Authority justified the removal of these guidance provisions (about practical considerations, transaction costs, and the desirability of consistency and certainty) by stating that:

“the efficient operation limb is sufficiently broad to require the Authority to consider practical considerations, transaction costs, consistency and certainty to the development and approval of the guidelines and the TPM as is currently required by clause 12.80. In any analysis of the efficient operation impacts of proposals, practical considerations, transactions costs and the costs associated with a lack of consistency and certainty are considered.”⁵

It is not apparent at this stage in the development process that this has been borne out.

Material change threshold is necessary and appropriate

⁴ TPM issues and proposals paper, page 114 – “the Authority’s objectives in relation to the TPM are to promote overall efficiency of the electricity industry for the long term benefit of consumers”

⁵ <http://www.ea.govt.nz/our-work/consultations/priority-projects/regulatory-framework-tpm/>

The threshold⁶ set by clause 12.86 is intended to provide stability for participants, to allow the regulator to resist calls for change and as a discipline for the regulator to mitigate the risk of ad hoc change or ‘tinkering’. It is not to be dispensed with lightly. In our view the Authority has yet to establish that this threshold has been met.

⁶ It is not a general requirement for Code changes

5. Comments on the proposed CBA for the TPM investigation.

In this section we comment on the proposed CBA framework. We observe that the general framework proposed is broadly fine. However, important aspects of the methodology remain at the conceptual level and cannot be sensibly critiqued at this point.

In practice this may be as far as the Authority can progress the CBA framework until it has:

- defined the problem(s) it sees with the current TPM
- identified the options for addressing any problems it identifies

This reinforces the need for a transparent and consultative approach if the Authority decides to proceed with a second 'issues and proposals' paper.

Support a different, bottom up approach to CBA

As outlined in section 2, CBA is a vital component in the policy development process. To meaningfully assist the Authority in deciding whether change is needed and if so what change is appropriate a 'bottom up' CBA is necessary. To this extent we agree with the Authority's proposal. Bottom up CBA allows the regulator's logic and assumptions to be tested and for the costs and benefits of the different options to be separately identified and updated as the proposals are refined. This is particularly important when we are seeking to understand and test the '*causes of the effects*'⁷.

A comprehensive and robust bottom up CBA does not eliminate the need for decision makers to exercise discretion and judgment to balance up the various considerations. However it does narrow the *scope* of that discretion and judgment and allows the decision maker to focus more specifically on residual areas of uncertainty, for example:

- risk – uncertainty or errors in the problem definition, options development and assessment translates into lower benefits or larger dis-benefits than anticipated
- the advantages of regulatory certainty over continuing uncertainty, for affected parties' long term investment decisions
- complexity – an overarching theme of regulatory failure
- non-financial transaction costs / opportunity cost – to the regulator and industry associated with the regulatory process and implementation of selected remedies.

Do not support Authority's use of top down methods at this point

Top down approaches can be useful in certain contexts. However, we are cautious about how top down approaches could be employed in a TPM context and find it difficult to see benchmarking adding any value to this exercise. We note that:

- benchmark countries identified in the October 2012 paper have since been discounted as meaningful comparators. Benchmarking is fraught and susceptible to misinterpretation and manipulation⁸
- 'top down' quantitative CBA approach is unlikely to be relevant or robust in this investigation given experience with the October 2012 paper. There is some wariness of assumed costs and benefits and assumed efficiency factors.

⁷ See: ACCC Evaluating infrastructure reforms and regulation—working paper no. 2, page 63
<http://transition.accc.gov.au/content/index.phtml/itemId/943318>.

⁸ Benchmarking has proven difficult even where there are many countries that are ostensibly comparable (as has been established by the Commerce Commission's benchmarking of wholesale copper and broadband access services).

We agree that a ‘treatment effects approach’⁹ (refer to comments above) is not appropriate and we also do not consider general equilibrium modelling appropriate.

Problem definition is an input to the CBA

Please refer to section 2 where we discuss problem definition.

We do not see the problem definition or options identification stages as part of the CBA, per se, rather steps in a broader analysis of which the CBA is also a component.

Should reference full statutory objective (not a truncated version)

As discussed in section 4 we consider that the Authority should develop its CBA (but also the broader analysis) with reference to the full section 15 objective. Referencing a truncated version is not necessary or appropriate and will diminish the emphasis placed on competition and reliability (the omitted limbs of the objective).

On the contrary, given the potential for material (adverse) impacts on retail competition it would seem highly relevant that this is explicitly referenced. Equally, as the benefit proposition assumes significant changes to the transmission planning outlook¹⁰ the reliability limb of the test should also be explicitly considered.

Costs and/or benefits...

We asked CEG (Competition Economists Group) to consider the Authority’s suggestion that changes to the TPM could give rise to short term static efficiency benefits. Amongst other things CEG¹¹ conclude:

“...there are unlikely to be any material static efficiency benefits to be obtained through changing the way that transmission charges are levied for existing sunk assets.”

CEG goes on to state:

“However, the potential for static inefficiency costs is clear – particularly if a variant of the “beneficiaries-pay” charge proposed by the EA in its first issues paper is implemented. These costs ... stem from reduced wholesale dispatch efficiency, amplified risk throughout the supply chain and, potentially, reduced retail competition.”

Our understanding is that the Authority’s view of, and position on, the pricing of grid assets is changing from a clearly stated preference for an “incentive free” approach to avoid price motivated grid usage decisions (generally held as inefficient) to something different, perhaps the opposite. If our understanding is correct then this would represent quite a shift both in the Authority’s own position and relative to orthodox economic thinking.

We are not absolutely clear on the Authority’s position on this issue however can observe that the cost benefit equation will be affected if actions previously considered inefficient are now deemed efficient (i.e. what were once considered costs are now deemed benefits).

Baseline scenario and cost categories

The ‘baseline scenario’ should be defined with reference to the problem definition (given it is this problem that the intervention seeks to address). The unit of measure should

⁹ Given the wealth of literature on ex ante CBA for policy development purposes it is strange that the Authority references a document focussed on ex post reviews of previous interventions.

¹⁰ Refer paragraph 6.21 CBA working paper

¹¹ See: Appendix A: CEG report - Economic review of EA CBA working paper

also be defined with reference to problem definition. Please refer to section 2 for comments on problem definition.

Our preliminary view, given the implied problem definition, is that the unit of measure should be cost (transmission and potentially generation depending on how the Authority defines the problem) although extraneous influencers will need to be isolated to ensure a sensible like for like comparison can be made.

We are encouraged that the Authority recognises that consideration should be given to the complexity and scope of reform and the attendant implementation risks. We consider that this was a deficiency of the October 2012 paper.

Cost categories should logically be defined with reference to the problem definition, baseline scenario and options identified. As these will not be established until later in this process it is not possible to comment in detail at this stage.

Notwithstanding that we note the proposal to treat costs of disputes as 'unquantifiable' and propose that, depending on the intervention eventually proposed by the Authority, this should remain as a quantifiable cost (or benefit). We also propose that costs outlined by CEG should be explicitly recognised in the CBA (see above and Appendix A) and propose that cost categories are revisited once the problem definition is undertaken and options, if appropriate, are identified.

Efficiency factor (etc.)

We are generally cautious about over-reliance upon an all-encompassing 'efficiency factor'. There is a real benefit to disaggregating different costs and benefits because it allows a more informed view of different classes of costs and benefits. For example, a cost or benefit may be immediate and certain or distant and uncertain. Each risk will have different impact, probability and proximity characteristics. Boiling multiple discrete issues with different degrees of certainty down into a single number inevitably obscures nuance and gives a false sense of security in the final number. It also relegates judgement to a function of the modelling exercise.

Applying an efficiency factor to costs/revenue beyond transmission and generation (and using final prices paid by consumers) risks unnecessarily introducing an unwarranted multiplier effect. It is clear that the Authority sees the overwhelming majority of the benefits claimed to arise from TPM reform reside in reduced transmission investment with some change in generation location decisions. Collectively these two components of the electricity system comprise ~31%¹² of the typical household bill. There is no reason why changes in these two components should affect downstream costs and prices beyond the passing through of any cost reductions. However, we observe that:

- even if there were material changes in transmission investment and generation location decisions it is unclear that cost would decline (the opposite is more likely)
- cost reductions may not be fully passed through
- competition, technology and other factors quite unrelated to this intervention will affect retail prices.

A problem with top down approaches is that they do not adequately compensate for the propensity for regulators to exaggerate benefits and to understate costs of an intervention. This consequences of getting it wrong are particularly acute when the benefits are distant, uncertain and assumed while the costs are immediate, certain and real.

Quality over quantity

¹² Source: EA Fact Sheet 2: A typical bill

The Authority produced an extraordinary amount of analysis for the October 2012 consultation and continued to publish new analysis throughout the consultation process. In practice this made the process inaccessible for many and probably detracted rather than added to the quality of the process. We consider that overly complex analysis is of less value than a simpler but well-reasoned analysis.

We outlined in section 2 the role of CBA in the policy development process and the importance of transparency and consultation to the quality of the CBA. Integral to the latter is publication of any models, source information and assumptions - in an accessible form that permits cost effective scrutiny. Explanatory notes should be provided where necessary and any assumptions should be clearly stated with supporting rationale.

As a general observation we agree with the Productivity Commission's comments that complexity is one of the overarching themes in regulatory failure¹³.

¹³ See page 9, NZ Productivity Commission Review of Regulatory Institutions and : <http://www.productivity.govt.nz/sites/default/files/Regulatory%20Issues%20Paper%20final%20%28updated%2029%20August%202013%29%20LowRes%20for%20web.pdf>

6. Other matters

In this section we discuss a few other matters that the CBA working paper has brought to mind.

Process

The Authority received feedback on its plans to radically change the TPM. It subsequently announced that it would issue a series of 'working papers' in late 2013 and issue a second 'issues and proposals paper' in 2014.

It is unclear from the sequence and subject matter of the working papers (a) exactly what the Authority is trying to achieve and (b) whether it has substantially returned to the drawing board (as one might expect given feedback to date) or not. Our view is that the Authority should substantially return to the drawing board but we have some general observations that are relevant in either case:

- sequence is important: the ability to comment meaningfully in some areas hinges on an understanding of material covered in other working papers. For example:
 - detailed CBA design can't be done without clear options (or ignorant of plans to radically change to underlying principle e.g. a potentially novel approach to the treatment of sunk costs)
 - clear options can't be done without a robust problem definition
 - a robust problem definition hasn't been done.
- ACOT is a separate policy issue: we appreciate the concerns about apparently unintended 'collateral damage' from the Authority's proposals and consider that any impacts should be captured in the TPM CBA. If the Authority is contemplating some fundamental change to the ACOT scheme, either by act or omission, then it should do this through a separate regulatory process.

We support the Authority's world class aspirations

We support the Authority's aspiration to be recognised as a world class regulator. We interpret this as a statement of intention that establishes an expectation that the Authority will adhere to best practice in its policy analysis and CBA. We support both the Authority's aspiration and its adherence to best practice.

We consider this a particularly important aspiration because of the power vested in the Authority by Parliament and the fact that its decisions can impose significant costs on participants and consumers.

More consistent approach to decision making and CBA desirable

Consistent with our support of the Authority's aspirations to be a world class regulator we consider there would be benefit in the Authority establishing:

- a set of regulatory principles that 'govern' how it operates
- a transparent CBA framework applicable to all regulatory decisions. This should recognise that different decisions require different approaches to CBA e.g. a simple mechanistic CBA may suffice for incremental operational changes to existing frameworks while a fuller policy development process and CBA will be appropriate for high impact regulatory policy changes.

References and resources

In responding to this forming our view on what constitutes best practice for policy development and CBA we have drawn on experience in New Zealand and abroad including:

- UK regulators Ofgem¹⁴ and Ofcom¹⁵: 'Impact assessment' in policy making
- The New Zealand Treasury: Regulatory Impact Analysis (RIA) Handbook, and RIA reviews¹⁶
- New Zealand Commerce Commission: *Guidelines for quantitative analysis*¹⁷
 - *The Commission ensures that the analysis can be repeated at a later date...we design and structure the process, approach and outputs before doing the quantitative analysis.*
- NZ Productivity Commission: *Regulatory Institutions and Practice*¹⁸
- UK Better Regulation Executive: *Better Regulation Task Force*¹⁹
- Commentary of CBA within submissions to the October 2012 TPM consultation²⁰.

¹⁴ See: <https://www.ofgem.gov.uk/ofgem-publications/37049/guidance-impact-assessments.pdf>

¹⁵ See: <http://www.ofcom.org.uk/about/policies-and-guidelines/better-policy-making-ofcoms-approach-to-impact-assessment/>

¹⁶ See: <http://www.treasury.govt.nz/publications/guidance/regulatory/impactanalysis>

¹⁷ See: <http://www.comcom.govt.nz/the-commission/commission-policies/guidelines-for-quantitative-analysis/>

¹⁸ See: <http://www.productivity.govt.nz/inquiry-content>

¹⁹ See: <http://www.eesc.europa.eu/resources/docs/designdelivery.pdf>

²⁰ See: <http://www.ea.govt.nz/our-work/consultations/priority-projects/tpm-issues-oct12/submissions/>



Appendix A – CEG report: Economic Review of EA CBA Working Paper

Appended separately.