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Carl Hanson
Chief Executive
Electricity Authority
2 Hunter Street
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By email: submissions@ea.govt.nz

Dear Carl

Changes are needed for the CBA framework to provide credible results

Genesis Energy Limited welcomes the opportunity to provide a submission to the Electricity Authority (“the Authority”) on the working paper “Transmission Pricing Methodology: CBA” dated 3 September 2013 (“the CBA working paper”).

Genesis Energy is pleased to see that the Authority has responded positively to the industry discussion related to the original Cost Benefit Analysis (“CBA”) framework. In particular, we support the Authority’s proposal to move away from a “top down” approach to evaluating benefits of reform and to apply a “bottom-up” methodology that directly estimates the impacts of any change. However, further work is required for Genesis Energy to be confident that the Authority’s CBA framework will produce credible results – results that should provide certainty and confidence to not only the sector, but for end consumers as well.

The CBA working paper produced does respond in part to submitter concerns by recognizing the link between CBA and problem definition. But it falls short of establishing a best-practice framework for developing a revised TPM. This is because the Authority’s working paper, although moving in the right direction, does not address important framework issues in the problem definition and does not describe how reform options will be identified.

Benefits of a good decision making/CBA framework

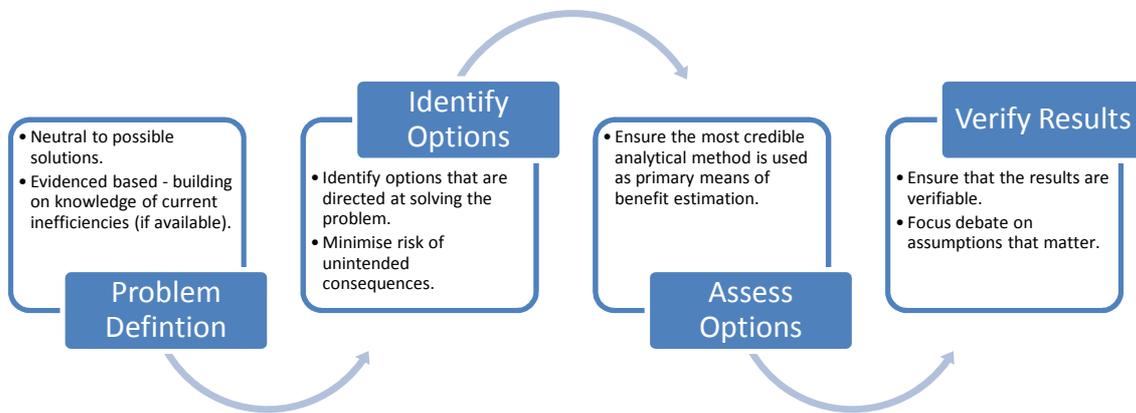
Genesis Energy considers that it is critical that stakeholders have confidence in the decision making framework, particularly the CBA framework used to assess likely impacts of any proposed change. Regulatory decisions on transmission pricing will inevitably have significant impacts on affected parties. A transparent and verifiable CBA methodology allows parties to satisfy themselves that the impacts of change are fully understood, and that the decision is likely to lead to better outcomes overall (even if the impacts on particular parties are negative). A further advantage of a credible CBA framework is that it enables affected parties to anticipate and prepare for regulatory change. This is critical for early and efficient transition to any new regulatory settings.

We note that the Authority has recognised the importance of credible CBA frameworks in its own internal processes for making Code Change decisions, and has publicly emphasized the importance of quantifying costs in its criticism of the Labour/Greens single-buyer proposal. However, in our view, the Authority has failed, to date, to establish a best practice CBA framework for the review of the TPM. This consultation provides an opportunity for the Authority to develop such a best practice approach. Developing a credible, best practice, CBA framework will have wider benefits than just the TPM review. It would also be a useful benchmark for evaluating the costs and benefits of regulatory change, an approach that can be applied consistently across the Authority's future activities.

Features of a credible CBA framework

A credible CBA framework is more than just how costs and benefits of a proposed option are evaluated. It requires clear principles for defining the problem and identifying likely (and credible) options for evaluation. These two steps are fundamental inputs into the traditional CBA assessment. Poor problem definition and identification of options will undermine any analytical assessment of benefits, no matter how credible the methodology used. In addition, any robust policy decision requires CBA results to be tested and verified.

In our view, a credible CBA framework includes a specific problem definition, clear identification of a narrow set of options, the assessment methodology for those options, and finally the verification of results. The interrelationship and key principles for each of these steps is shown below.



The CBA working paper reflects many of these key steps including a focus on the analytical method for assessing options, and includes a brief discussion of verifying results. However, the CBA working paper omits any discussion on the identification of options. Although we agree that a framework paper should avoid discussion of any actual options at this stage, there are key principles that need to be outlined for the identification of options as part of the conceptual framework.

Improving the CBA framework to a best-practice model

Genesis Energy has asked Castalia Limited (“Castalia”) to review the CBA working paper and assess it against best practice. Castalia’s review, attached in full, identifies four key areas where improvements are required to provide stakeholders with confidence in the CBA:

- **Use of evidence to support the problem definition.** The current problem definition (as described in the CBA working paper) lacks a sufficient level of credibility. This is because it is not supported by evidence, does not provide a sense of the scale of the problem, and does not distinguish between symptoms and underlying causes. As a solution, Castalia suggests that the problem definition should be framed in a way that builds on existing work and evidence of the impacts of transmission pricing. The Authority must also ensure that its problem definition is neutral to any one proposed solution and does not create a predetermined outcome.

- **Establish principles for deciding on options.** As noted above, the CBA working paper does not clearly set out principles for identifying options. The CBA framework should describe how a set of options will be identified that are most likely to deliver improvements, most likely to be convincingly assessed against each other, and least likely to cause unintended consequences. Critical to good option selection is ensuring that the options are commensurate with the scale of problem identified.
- **Use a primarily bottom-up approach.** The Authority has made progress in developing its approach to analysing the costs and benefits of changing the TPM. However, based on the information now available to the Authority through the submission and TPM conference, it is clear that a bottom-up approach is the most appropriate methodology for assessing costs and benefits of any proposed reform.
- **Follow a process that generates verifiable results.** The TPM review is a very contentious issue. Any solution is likely to include the transfer of wealth between stakeholders, and will therefore be hotly contested. For this reason, the TPM review is a good example of why it is critical for the result of any CBA analysis to be verifiable, and why this should be a stand-alone step in the process. For example, as recognised by the Authority, a good sensitivity analysis will allow stakeholders to identify specific areas of disagreement, and provide input to the regulatory process that improves decision-making.

Next steps

If the Authority's desire is to create a TPM that is enduring it is essential that the CBA be able to withstand the highest level of scrutiny. Genesis Energy considers that this working paper is a step in the right direction, but a good CBA framework will be instrumental as the Authority considers the complex issues to be discussed in future working papers, in particular for the discussion of alternatives and options for the residual charge (interconnection) and beneficiaries pays methodology. Therefore, we ask that the Authority responds to submitters' suggestions and comments on the CBA working paper *before* releasing any further working papers on options or components of a new TPM. This will enable submitters to provide evidence that is more useful for the Authority's ultimate evaluation of the options.

We also consider that the Authority's proposed process is missing a critical working paper that properly considers alternatives in the context of overall improvements to the TPM. We understand that the proposed working papers on beneficiary pays and residual charges will, in effect, be options papers. But it is clear that these papers could inadvertently pre-determine the range of options

that the Authority will consider. This, in turn, has the potential to erode confidence in the TPM review process

If you would like to discuss any of these matters further, please contact me on 04 495 3340.

Yours sincerely



Jeremy Stevenson-Wright
Regulatory Affairs Manager