File note on CBA meeting

2:30pm to 4:30pm, 15 May 2007, NZIER, 8 Halswell Street, Wellington

Government representatives: Roger Fairclough (Energy Information and Modeling Group, MED), Mark Pickup (Electricity Policy Group, MED) and Simon Lawrence (Energy and the Environment Group, MED)

Business representatives: Eric Hansen (Fonterra), Brent Layton (NZIER), Bryce Wilkinson (Capital Economics) and Ralph Matthes (MEUG)

1. The meeting adopted a Chatham House Rule approach. Information tabled was to be treated in confidence by the participants.

2. MED are undertaking a CBA of possible NZES, NZEECS and transport policies. The meeting provided an opportunity for an exchange of ideas on progress by MED in undertaking CBA(s).

3. This file note and the discussion at the meeting should not be viewed as being comprehensive. Only major agreed views of the business representatives are recorded. Some of the material tabled at the meeting was not thoroughly discussed because to make useful feedback would have taken considerable more time.

4. Paragraphs 5 to 15 below summarise key themes from the business representatives.

5. CBA is the centrepiece of the Regulatory Impact Statement (RIS) requirement. Conducting a CBA requires the specification and comparison of alternative responses to whatever problem the policies are intended to address. The purpose of the CBA is to establish that a preferred course of action produces greater expected net benefits for citizens than the next best course of action for addressing the problem and the policy objective. So a competent CBA should be set in the context that the RIS requirement specifies. As such, it should include a description of the policy problem to be solved and the policy objective. For the CBA work proposed by MED the RIS approach to setting policy objectives would be a good template, eg RIS require[1]:

Section title	**Required information**
Executive summary	▪ One paragraph of no more than 150 words summarising the problem, the preferred option, and the main impacts.
Adequacy statement	▪ Who has reviewed the RIS (RIAU or name of department that has reviewed RIS) and whether the RIS is adequate according to the adequacy criteria.
Status quo and Problem	▪ Brief, high-level summary of key features of the current situation – not just features of the current regulation. ▪ Summary of why government action is needed, including why the current arrangements are insufficient to address the problem. This should contain an appropriate level of detail on the status quo's costs and benefits (including compliance costs, risks and opportunities). The root cause of the problem should be identified, not just the symptoms.
Objectives	▪ The objectives that options are measured against. These should not prejustify the preferred option.

6. Any NZES, NZEECS, transport or climate change policies being considered that would lead to a change in legislation will require a RIS (and possibly a Regulatory Impact Analysis). Therefore there would be an advantage to MED at this early stage of developing a CBA methodology to align what MED were trying to achieve with the RIS/RIA requirements.

[1] This is an extract from MED, Guidelines on the Regulatory Impact Analysis Requirements, March 2007, refer table in paragraph 47, p19, http://www.med.govt.nz/upload/45766/ria-guidelines.pdf . This wasn't tabled at the meeting but its inclusion in this file note was considered useful.

7. A GDP/head policy objective was always a useful starting point as a policy objective or measure to compare alternative climate change related policies. The NPV of benefits and costs was also a standard output expected from CBA.

8. All feasible options should be considered in the context of the specific policy problem/objective, eg if the policy problem is defined as meeting NZ Kyoto obligations, then reneging on the post 2012 wash-up is a feasible option. There would be costs associated with that option (and the costs would also depend on the likelihood of other countries also reneging) but the question is whether those costs outweighed the benefits. Officials shouldn't presuppose feasible options will be discounted for political reasons; that is a decision for Ministers to make but Ministers should at least see all options.

9. Specifying the counterfactual and factual is complex because:

   a) They depend on the nature of the problem and the policy objective. For example, if the problem is that the ratification of Kyoto has led to an unexpected liability to purchase sink credits, an obvious option is to withdraw from this commitment in the manner provided for in the Kyoto Protocol. If the specified policy objective is to retain this commitment a relevant option for the CBA might be improperly (under the Cabinet Manual) excluded from the analysis. The same deficiency would apply if subsidies for energy efficiency were 'justified' by assuming that the policy objective was to increase energy efficiency.

   b) Obtaining information to adequately establish the counterfactual and therefore measure changes due to the policy change in the factual(s) isn't trivial; nevertheless this is needed to achieve a robust CBA.

   c) Interdependencies between policies need to be considered, ie should not assume policy proposals are mutually exclusive.

      eg if a policy being evaluated was to subsidise retrofitting insulation into older homes to offset a market failure (eg home owners not seeing externality value of GHG in energy bills), then the NPV of that analysis would have to take into account the possibility that soon after 2012 there would be a broad economy wide GHG price signal introduced. From that date onwards policies such as subsidising retrofitting of insulation would become redundant.

      Note that the meeting did not consider in detail if this commonly expressed "GHG externality" problem was material and if it was, whether the range of estimates for the externality were all negative or whether it might also be positive. This issue, along with others such as the pros and cons of adaptation, are more relevant to the broader CBA needed for considering all GHG and climate change policies. It is complicated because of the lack of analysis concerning:

      (1) Whether New Zealanders alive today would benefit or not from moderate warming;

      (2) The implausibility that mitigative policies by New Zealand would make any difference; and

      (3) By the problem that if the effects are negative for New Zealanders alive today then the costs of New Zealanders' emissions fall to this extent on the emitters - thereby internalising them.

      A proper analysis of the problem would identify these aspects and this would help in specifying the relevant course of action for the CBA.

10. Determining the behaviour of business under various policies isn't always straightforward and hence this needed to be carefully thought through when specifying the counterfactual and alternative factual(s),

    eg if there were a tradable emission permit regime then business would have the same incentive to lower emissions to the point that the marginal cost of emissions equals the marginal benefit of emitting whether the initial permits were granted free or purchased through an auction. Companies granted emission permits might even cash in those rights

and relocate overseas if there were a difference between the NZ and overseas climate change regimes. From a global GHG context this might be a good thing, but how should it be treated in the CBA?

11. Estimating the likely international price of C beyond 2012 was very difficult because of the thinness of existing markets. If an international market does develop then it was possible technology and innovation will drive prices down. This has been the experience in some other new markets, eg the NO_X and SO_X emissions markets where pre-market estimates of abatement costs were around USD1,500/Mt whereas the markets fairly quickly settled down to around USD 150/Mt, ie $1/10^{th}$ of the original estimates. Given this experience it may be imprudent in the MED CBA to assume C price scenarios all higher than $15/t.

12. Use of extremely low discount rates, such as those used in the Stern report, would tend to undermine the credibility of the CBA - unless robust academic literature could be found in support of the low discount rates Stern assumed.

13. The proposed MED CBA approach of focussing on economic efficiency (including deadweight losses) and excluding wealth transfers was welcomed. A consistent approach to this issue by MED was desirable.

14. There remained a need for a broader CBA to consider all GHG and the wider climate change policy options, eg a repeat of the type of work undertaken by ABARE on the economy wide effects. This is not part of the MED work.

15. The CBA(s) were likely to take another 6 to 8 weeks with possibly some external expert economic assistance or quality assurance input. Some clarity about the timing of the required RIS for the energy measures would be desirable given its potential to inform the CBA.

16. At the conclusion of the meeting MED invited further comment by email if we wished. No further meetings were planned although that option was left open for MED if needed.

Ralph Matthes
18 May 2007