Note on Beneficiary-pays approach

Dr Graham Scott, TPAG chair

I undertook to elaborate TPAG's response to the request in the letter to me from the EA for comment on Biggar's criticisms on our use of the principle of beneficiary pays. Specifically, this is our response to the direction in the letter from the EA that "TPAG should reconsider the arguments for the 'beneficiary pays' concept, but only to the extent that the considerations are material to TPAG's analysis."

Biggar's report is critical of TPAG's use of beneficiary pays on both a theoretical and practical level. To explain our response to his criticism we need first to comment on the perspective from which he makes his criticism. He argues that TPAG has not identified properly the problem to which it is applying its efficiency principles, because TPAG did not use a methodology based on searching for departures from a hypothetical perfect model of a market and trying to correct for those departures, by creating a world that behaves as much like one of voluntary contracting for transmission as possible.

This is a static world. TPAG did not employ such a methodology because it would have been impractical and inconsistent with the CAPs. Instead, TPAG's approach was to take the status quo as given and evaluate proposed changes in terms of their probable impact on dynamic efficiency measured in terms of expected efficiency gains over time. This approach does not treat every departure from an idealised benchmark as a market failure, nor seek to force reality towards a perfect benchmark. It searches for incremental efficiency gains in the long term interests of consumers using cost benefit analysis and is thereby consistent with the requirements of the CAPs. By implication, the basis for the present range of regulations in the industry was the identification of fundamental market and regulatory failures which these current arrangements and decisions were designed to address. It is beyond TPAG's scope to delve into the reasons for the current arrangements. We take them as given.

Given his theoretical perspective, it is not surprising that Biggar is critical of the requirements of the CAPs, and also critical of the efficiency criteria TPAG uses to operationalise those requirements. This includes the criterion of beneficiary pays, in respect of which Biggar states "beneficiary pays has no foundation in traditional neoclassical economic theory". One could agree or disagree, depending on what the statement is taken to mean and on one's view of the relevance of neoclassical theory to the deep regulation of the NZ electricity industry.

But when proposing what should be done, Biggar does not actually use the framework he proposes, but shifts ground to propose a set of principles that are not far off those used by TPAG, as noted in the final report. He deploys these for the purpose of achieving the goals of regulation, which he says should be to "re-create the long term contract the customers *would* have negotiated with the service provider prior to either party making any sunk investments". This is no easy thing to do, as it assumes away all the actual market behaviour and gaming with the regulator that would occur in reality. What a customer *would* have negotiated under hypothetical circumstances can never be known. It is more practical to analyse what a customer *should* rationally have been willing to pay, assuming the data are available to support the analysis. This is broadly what TPAG tried to do with the beneficiary pays principle. Generally the benefit of the principle is seen to be in enhancing investment decision making and also promoting stability in pricing practices. But in relation to the HVDC, TPAG has not been able to provide analysis that has been able to facilitate consensus among the members of TPAG on who the beneficiaries are and what benefits they get.

Rather, its analysis centred on the potential efficiency gain from changing the status quo through the removal of a bias between and amongst existing and new investors in SI generation. Had there been agreement about the beneficiaries, this would likely have affected the advice as to how to avoid the inefficiency. But, because of disagreement over who the beneficiaries are, there is also disagreement over whether and how to solve the problem.

Coming to the practical implications of Biggar's opinion about beneficiary pays, he focuses on the references in the TPAG report to the value of the principle in incentivising participants to engage in the investment planning processes. There was more besides this that our report invokes the principle for.

He made a useful point that the incentives to participate in consultations about investment are not as simple as our discussion document stated, which he illustrated with examples of what might happen if the goal of encouraging customers to engage in investment consultations were over-emphasised. On this specific point, we have extended the report to respond to his criticism.

The beneficiary pays principle does not stand in isolation as an absolute in our analysis. The general idea is that beneficiaries can only be identified up to the point where further attempts do not justify the costs. Beneficiaries should not be charged beyond the benefits they receive and the residual then has to be recovered in a way that minimises the efficiency losses that may be caused, but cannot be measured. It is a criterion in the search for efficiency improvements as evidenced in better investment decisions and must be balanced against other criteria.