Benchmarking and its Applications

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Introduction

Regulators worldwide are increasingly looking at economic benchmarking techniques to characterise and predict the efficiency levels of the utilities they are called to regulate by law. Regulatory agencies who have to tackle the difficult issue of mimicking market interaction in such industry subsets when natural monopoly is present as transmission and distribution of electricity or gas, generally prefer to adopt rigorous techniques to establish relative efficiency advancements by natural monopolists.

In order to evaluate the efficiency of indirectly competing monopolists, regulators can impose discipline on them by comparing their operations. When done on the basis of economic principles as opposed to process-based engineering checks, this is known as 'economic benchmarking'. Economic bench-marking techniques abound. We will concentrate in this article on those two techniques that, by academic pedigree and practical application, look like the most appealing ones to regulators worldwide, and as such have been applied in a number of jurisdictions.

The paper is strongly relevant for the upcoming energy regulation in Germany. In September this year the Ministry of Economy (BMWA) in Germany presented its findings about the status of the electricity market opening in Germany. Although the report conclu-ded that the Association Agreement was relatively successful and lead to a reasonable quick and effective opening of the German electricity market a number of critical areas have been indicated. Development of an effective network price control mechanism belongs to these areas. The Ministry leaves open, if such price control mechanism shall be similar to the incentive systems developed and implemented in many other countries. However, the new price control mechanism shall ensure that only efficient costs for provision of network service are covered. The application of efficiency assessment techniques and integration of efficiency scores into the price control design is a fundamental question that will need to be addressed by the future German regulator.

The article is structured as follows. Section 2 illustrates the mainly used non-statistical benchmarking technique, Data Envelopment Analysis (DEA). Section 3 describes the statistical counterpart of DEA, which builds up from simple econometric regression analysis with a series of non-trivial complications: this is known as Stochastic Frontier Analysis (Estimation) or SFA/SFE. Section 4 compares the two techniques. Section 5 finally provides a master example of economic benchmarking from the real world, with a focus upon Europe: the fundamental experience of electricity networks' regulation in the Netherlands, with its pros and cons as now observable from an ex-post perspective. Section 6 provides some policy conclusions. A comprehensive list of academic and practical references for the interested reader concludes the piece.

Microeconomic Efficiency Measurement and DEA: a Theoretical Summary

Economic efficiency analysis is a concept much used in the industrial organisation literature and has its origins in the microeconomic theory of production and cost. The applied use of comparative efficiency analysis is just a by-product of the typical microeconomic problem of the measurement of efficient cost and production levels, and of the separation between different types of inefficiency in production.

This paper outlines a number of commonly used efficiency measures and discusses how they may be calculated relative to an efficient technology, which is generally represented by some frontier function. Frontiers have been

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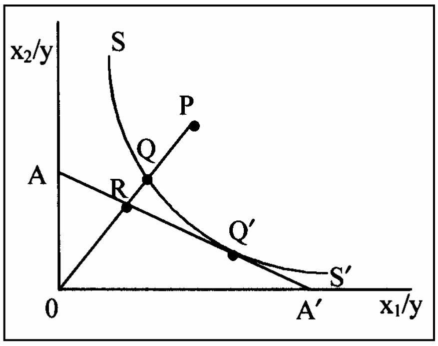
Figure 1: Technical and input-allocative inefficiency



estimated by applied economists and econometricians using many different techniques over the past forty years. If we ignore the simple averaged estimation that Ordinary Least Squares (OLS) and its variants provide, the two principal methods[1] which provide some degree of 'best practice' – and not simple central-tendency - outcomes are the following:

Stochastic Frontier Estimation (SFE), also known in the regulatory practice as Stochastic Frontier Analysis (SFA); and Data Envelopment Analysis (DEA), which is the focus of much regulatory practice in the field of electric utilities.

The two methodologies involve econometric and mathematical programming methods, respectively. The discussion in this Section provides a brief introduction to modern efficiency measurement. A more detailed treatment is provided by Fare, Grosskopf, and Lovell (1985, 1994), and Fried, Lovell, and Schmidt (1993). An interesting overview of DEA is in Seiford and Thrall (1990), whereas the two basic DEA models being developed in the late Seventies and early Eighties - to which most applied papers still refer - are those by Charnes, Cooper, and Rhodes (1978) for constant returns to scale (CRS) DEA, and by Banker, Charnes, and Cooper (1982, 1984) for variable returns to scale (VRS) DEA. A new perspective on DEA in principal-agent theory terms has been provided by Bogetoft (1994) and in more recent applied papers written by this author, sometimes in co-operation with Agrell, on applied regulatory topics in Scandinavia.

Modern efficiency measurement begins with Farrell (1957), who drew upon the work of Debreu (1951) and Koopmans (1951), to define a simple measure of firm efficiency that could account for multiple inputs, and easily generalise to multiple outputs. He claimed that the efficiency of a firm consists of two components:

- technical efficiency, which reflects the ability of a firm to obtain maximal output from a given set of inputs, and
- input-allocative efficiency, which reflects the ability of a firm to use the inputs in optimal proportions, given their respective prices.

These two measures are then combined to provide a measure of total economic efficiency[2]. The following discussion begins with Farrell's original ideas, which were illustrated by the author in input-input space and hence had an input-saving focus (i.e., they assumed that firms should minimise input usage for a given set of outputs). These are usually termed input-orientated measures, as opposed to output-maximising (or output-orientated) ones, which assume that firms maximise output(s) for a given set of inputs.

Farrell (1957) illustrated his ideas by using a simple example involving firms which utilise two inputs (to make up the input vector, **X**) to produce a single output (**Y**), under the assumption of constant returns to scale (CRS)[3]. Knowledge of the unit isoquant of the fully efficient firm[4], represented by SS' in Figure 1, permits the measurement of technical efficiency. If a given firm uses quantities of inputs, defined by point P, to produce a unit of output, technical inefficiency for that firm is represented by the distance QP, i.e. the amount by which all inputs could be proportionally reduced without a reduction in output. This is usually expressed by the ratio QP/OP, which represents the percentage by which all inputs could be reduced. The technical efficiency level (TE) of a firm is most commonly measured by the ratio

$$TE_i = OQ/OP \qquad (1)$$

which is equal to one minus QP/OP. It will take a value between zero and one, and hence provides an indicator of the degree of technical (in)efficiency of the firm. A value of one indicates that the firm is fully technically efficient. For example, point Q is technically efficient because it lies on the efficient unit isoquant (Figure 1).

If the input price ratio, represented by the line AA' in Figure 1, is also known, allocative efficiency may also be calculated. The allocative efficiency level (AE) of the firm[5] operating at point P is defined by the ratio

$$AE_i = OR/OQ, \qquad (2)$$

since the distance RQ represents the reduction in production costs that would occur if production were to take place at the allocatively (and technically) efficient point Q', instead of the technically efficient, but allocatively inefficient, point Q[6]. To sum up, the total

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[1] See Pollitt (1995).

[2] Some of Farrell's terminology differed from the current one. He used the term price efficiency instead of 'input-allocative' efficiency, and the term overall efficiency instead of 'economic' efficiency.

[3] The CRS assumption simplifies the analysis by allowing the use of unit isoquants. Furthermore, Farrell also discussed the extension of his method so as to accommodate more than two inputs, multiple outputs, and non-constant returns to scale.

[4] The production function of the fully efficient firm is not known in practice, and thus must be estimated from observations on a sample of firms in the industry concerned. In this paper, DEA is meant to estimate the efficient production, or 'best-practice', frontier.

[5] More generally, data points are for 'decision-making units' (DMUs), which can also be branches of a single company.

[6] One could illustrate this by drawing two isocost lines through Q and Q'. Irrespective of the slope of these two parallel lines (which is determined by the input price ratio, or relative price), the ratio RQ/OQ would represent the percentage reduction in costs associated with movement from Q to Q'.

economic efficiency level (EE) for the *i*-th decision-making unit will be defined as

$$EE_i = OR/OP, \qquad (3)$$

where the distance RP can also be interpreted in terms of a cost reduction. Notice that the product of technical and allocative efficiency provides the overall economic efficiency level (multiplicatively separable), which is also known as 'Farrell efficiency':

$$TE_i \cdot AE_i = \frac{OQ}{OP} \cdot \frac{OR}{OQ} = \frac{OR}{OP} \equiv EE_i. \qquad (4)$$

Notice that all measures are bounded by zero and one, and that overall (Farrell) efficiency has the nice property of multiplicative separability into input-allocative and technical efficiencies. Separability may also be exploited in order to decompose technical efficiency into scale, congestion, and 'purely technical' efficiency, as in Fare et al. (1985). These efficiency measures assume that the production function of the fully efficient, or 'best-practice', firm is known. However, this is rarely the case, so that the best-practice unit isoquant must be estimated from sample data. Farrell suggested the use of either:

- a non-parametric piecewise-linear convex isoquant constructed such that no observed point should lie to the left or below it (refer to Figure 2), or
- a parametric function, such as the Cobb-Douglas, CES, generalised Leontief (Diewert), or translog[7] forms being fitted to the data, again such that no observed point should lie to the left or below it (Figure 2).

Figure 2: The Data Envelope

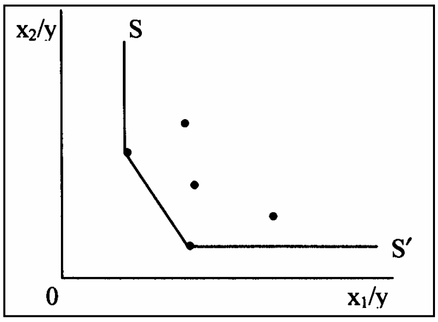


Figure 3 (a, b): Input- and output-orientated efficiency measures.

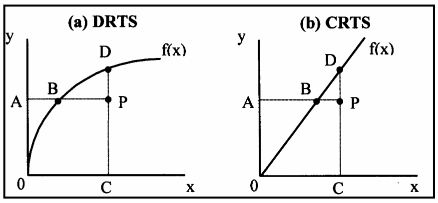
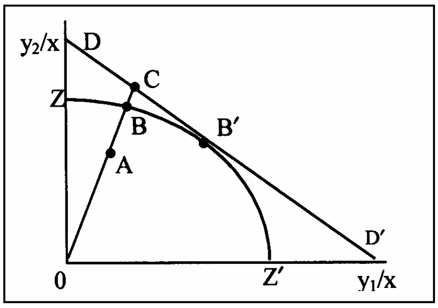


Figure 4: Relative efficiency measurement in output-output space.



Farrell provided an illustration of his methods using agricultural data for the 48 continental states of the US. The radial nature of Farrell's geometric efficiency measure makes it particularly appealing, given its multiplicative separability property. However, radial measures do encounter consistency problems whenever input reduction has to be measured along segments which are parallel to one of the axes. In those cases, 'input slacks' are found, and alternative, non-radial efficiency measures should be used[8].

If one wishes to know by how much output quantities can be proportionally expanded without altering the input quantities being used, then an 'output-orientated' measure must be introduced. The difference between the output and input-orientated measures can be illustrated by using a simple example involving one input and one output. This is depicted in Figure 3a, where we have a decreasing returns to scale technology represented by *f*(*x*), and an inefficient firm operating at point P. The Farrell input-orientated measure of TE is AB/AP, while the output-oriented measure of TE is CP/CD. The output and input-oriented measures will only provide equivalent technical efficiency values when constant returns to scale (CRS) are assumed, but will be unequal when either increasing or decreasing returns to scale are encountered[9].

The case where production involves two outputs (making up the output vector **Y**), a single input (say, *x*), and constant returns to scale is depicted in Figure 4, where the line ZZ' is the unit production possibility curve, and point A corresponds to an inefficient DMU. Notice that the inefficient point (A) lies below the curve in this case, because ZZ' represents the upper bound of production possibilities.

The Farrell output-oriented efficiency measures are defined as follows. In Figure 4 above, the AB distance represents technical inefficiency (that is, the amount by which outputs could be increased without requiring extra inputs). Hence, a measure of output-oriented technical efficiency will be the following ratio:

$$TE\ (output) = OA/OB. \qquad (5)$$

If we have price information, then we can draw the iso-revenue line DD', and define allocative efficiency to be equal to

$$AE\ (output) = OB/OC. \qquad (6)$$

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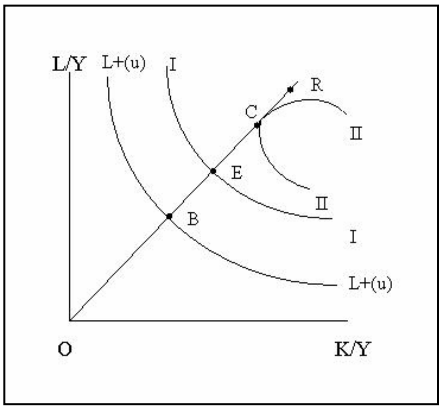
[7] Translog functional forms were first introduced by Christensen, Jorgenson, and Lau (1971, 1973). Using Monte Carlo simulations, Guilkey, Lovell, and Sickles (1983) compare three flexible functional forms - translog, generalised Leontief (Diewert), and generalised Cobb-Douglas - and conclude that the translog form performs at least as well as the other two and "[...] provides a dependable approximation to reality, provided that reality is not too complex" (IER, page 614).

[8] See Fare et al. (1985, 1994) on the 'Russell' measure of microeconomic efficiency.

[9] Fare and Lovell (1978).

Figure 5: Decomposition of overall (technical) inefficiency into scale, congestion, and 'purely technical' components



Output-oriented allocative efficiency (AE) has now a revenue-increasing interpretation, which is similar to the cost-reducing interpretation of allocative inefficiency in the input-oriented case. Furthermore, one may define overall output-oriented economic efficiency as the product of TE and AE (again, notice multiplicative separability), that is

$$EE_{output} = \frac{OA}{OC} = \frac{OA}{OB} \cdot \frac{OB}{OC} = TE_{output} \cdot AE_{output}. \tag{7}$$

Again, all of these three measures are bounded by zero and one. Before we jump to more detailed decompositions of technical efficiency[10] and to the theoretical treatment of DEA[11], two quick points should be made regarding the six efficiency measures which were previously defined:

- all the above efficiency measures are computed along a ray from the origin of axes to the observed production point. Hence, they hold the relative proportions of inputs (or outputs) constant. One advantage of these radial efficiency measures is that they are invariant to the choice of measurement units. A non-radial measure, such as the shortest distance from the production point to the production surface, may be argued for, but this measure will not be invariant to the units of measurement being chosen. Changing the units of measurement in this case could result in the identification of a different 'nearest' point. This issue will be tackled when we come to consider the treatment of 'input slacks' (or 'excesses') in DEA;
- the Farrell input and output-oriented technical efficiency measures may be shown to be equal to the input and output distance functions discussed in Shephard[12] (1970). This observation becomes important when one considers the use of DEA methods in calculating Malmquist indices of Total Factor Productivity (TFP) change[13].

Fare, Grosskopf, and Logan (1983) analysed the efficiency of a sample of Illinois electric utilities. They decomposed global economic efficiency (EE) into three further measures:

$$EE = AE \cdot TE = AE \cdot (SE \cdot CE \cdot PTE), \tag{8}$$

where *AE* = input-allocative efficiency, *SE* = scale efficiency, *CE* = congestion efficiency, and *PTE* = purely technical efficiency. The calculation of these three measures is illustrated in Figure 5. Technical inefficiency is decomposed into three further multiplicative elements. Scale efficiency (*SE*) relates to the fact that the DMU might not operate at optimal scale. If one assumes that an 'ideal' unit isoquant for CRS may be drawn, then the radial distance between such isoquant and the 'real' (VRS) one will give a measure for 'scale inefficiency' - that is, inefficiency stemming from the firm operating on a non-flat region of the AC curve, where returns to scale are either increasing (IRS) or decreasing (DRS). Whereas scale efficiency assumes that the initial CRS assumption of Charnes, Cooper, and Rhodes (1978) is dropped, congestion efficiency (*CE*) may be computed provided that the assumption of strong (i.e., free) disposability of inputs is ignored by the linear program. This allows the unit isoquant to bend backwards, indicating that as the quantity of one input (say, *K*) is increased, the output produced falls. Finally, purely technical (in)efficiency (*PTE*) is residually defined as the measure of how much inefficiency is solely due to merely technical gap between the DMU under consideration and the best-practice DMU, or best-practice 'peer', to which the current unit is being compared. In other words, PTE is 'pure' inefficiency after that both scale (VRS/CRS) and congestion inefficiencies have been extracted from the global *TE* (technical efficiency) measure. All *SE*, *CE*, and *PTE* are bounded by zero and one, and multiplicatively recover the *TE* measure, so that *PTE* may be computed residually, after knowing *TE*, *CE*, and *SE*.

In Figure 5 - drawn in (*K*, *L*) unit space - the above efficiency measures are

$$SE = OB/OE;\ CE = OE/OC; \tag{9}$$
$$PTE = OC/OR, \text{ so that}$$

$$TE = SE \cdot CE \cdot PTE = \frac{OB}{OE} \cdot \frac{OE}{OC} \cdot \frac{OC}{OR} = \frac{OB}{OR} \in (0,1]. \tag{10}$$

Whereas congestion inefficiency originates from the fact that **C** falls on a backward bending section of the **II** isoquant, so that inputs are congesting, scale inefficiency is due to the fact that, in the long run, DMUs in competitive equilibrium should be operating at a minimum of the U-shaped AC curve. Therefore, the DMU under examination in the short run might adjust its scale and produce its current output level with fewer inputs. The 'best-practice' unit isoquant **L+(u)**, where all efficient 'peers' are located, is the relevant isoquant for comparison as it incorporates the twin, 'ideal' assumptions of strong (free) input disposability (leading to CE = 1) and con-

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[10] See Fare et al. (1985).

[11] Charnes, Cooper, and Rhodes (1978) is the seminal paper.

[12] For more on this, see Lovell (1993).

[13] Refer to Forsund and Kittelsen (1997) for Norwegian electricity distribution over the Eighties and Nineties. Burns and Weyman-Jones (1994b) provide an empirical application to regional electricity distributors in England and Wales.

stant returns to scale (leading to SE = 1). It is obvious that, under the above assumptions, both scale and congestion inefficiencies will disappear, thus making TE ≡ PTE, and EE = AE · PTE. The details of the linear programs required for the above three measures of technical efficiency (SE, CE, and PTE) are given in Fare et al. (1985, 1994), and Pollitt (1995). It is also possible to identify whether a DMU showing scale inefficiency is exhibiting constant, increasing, or decreasing returns to scale, and thus classify it as CRS, IRS, or DRS. Modern DEA computer packages are able to compute the above efficiency measures for each DMU in the sample, and also tell whether DMUs are operating on the decreasing (IRS), flat (CRS), or increasing (DRS) region of the U-shaped average cost curve.

Data Envelopment Analysis (DEA) is the non-parametric mathematical programming approach to frontier estimation. The discussion of DEA models being presented here is brief, with relatively little technical detail[14]. The piecewise linear convex hull approach to frontier estimation, proposed by Farrell (1957), was considered by only a handful of authors in the two decades following Farrell's paper. Authors such as Boles (1966) and Afriat (1972) suggested mathematical programming methods which could achieve the task, but their method did not receive wide attention until a paper by Charnes, Cooper, and Rhodes (CCR, 1978) inserted Afriat's methodology within a standard operations research framework, and coined the term 'Data Envelopment Analysis' (DEA). Since then, there have been a large number of papers extending and applying the DEA methodology. CCR proposed a model which had an input orientation and assumed constant returns to scale (CRS). Subsequent papers have considered alternative sets of assumptions, such as Banker, Charnes, and Cooper (BCC, 1984), who proposed a variable returns to scale (VRS) model.

Stochastic Frontier Estimation: a Theoretical Summary

Deterministic frontier analyses have been most used in the Sixties and early Seventies[15]. The need for separating efficiency errors - i.e., those due to the firm erroneously shifting within its production possibilities set - from purely random noise led theoretical researchers in production econometrics to devise a brand-new framework which was capable of dealing with 'efficiency errors' (one-sided), as separated from either noise or imperfect information[16].

The stochastic frontier production function was independently proposed by Aigner, Lovell, and Schmidt (1977), and Meeusen and van den Broeck (1977). The original specification involved a production function for cross-sectional analysis, featuring an error term which had two components, the first one to account for random effects (a traditional, two-sided disturbance term), with the second one accounting for technical inefficiency (a one-sided error). This model can be expressed in the following form: (11)

$$
\begin{aligned}
&Y_i = X_i\beta + (v_i + u_i), \qquad i = 1,\ldots,N,\\
&\textit{where}:\\
&Y_i = \text{production (possibly logged) of the } i\text{-th firm;}\\
&X_i = \text{a } k \times 1 \text{ vector of (transformations of the) input quantities of the } i\text{-th firm;}\\
&\beta = \text{a vector of unknown parameters;}\\
&v, u = \text{two separate random variables.}
\end{aligned}
$$

The two-sided random error (v) is assumed to be identically and independently distributed as a normal, with zero mean and constant variance. In particular, such a traditional two-sided random disturbance is independent of u, which is assumed to be a non-positive random variable accounting for technical inefficiency in production. The 'efficiency error' u is often assumed to have a truncated normal, half-normal, gamma, or exponential distribution[17]. If a cost function is used instead of a production relationship, the one-sided error will be non-negative, thus reflecting efficiency errors leading the firm to shift above its cost-minimising contour.

The original stochastic frontier specification has been used in a vast number of empirical applications over the past two decades. The above, standard specification has also been altered and extended in a number of ways. These extensions include the specification of more general distributional assumptions for the efficiency error (u), such as the two-parameter gamma distribution; the consideration of panel data and time-varying technical efficiencies; the extension of the methodology to cost functions and also to the estimation of equation systems. A number of comprehensive reviews of this literature are available, such as those proposed by Forsund, Lovell, and Schmidt (1980), Schmidt (1986), Bauer (1990), and Greene (1993b).

Going back to the one-sided or 'efficiency' error, it must be emphasised that the (in)efficiency component cannot be observed directly. In fact, it must be inferred from the composite error

$$\varepsilon_i = v_i + u_i. \tag{12}$$

Jondrow, Lovell, Materov, and Schmidt (1982) derived an explicit form that decomposes the total error term. The in-

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[14] More detailed reviews of the methodology are presented by Seiford and Thrall (1990), Lovell (1993), Ali and Seiford (1993), Lovell (1994), Charnes et al. (1994, 1995), Pollitt (1993, 1995), and Seiford (1996). Theoretical perspectives on DEA are also outlined, within a principal-agent relationship, by Bogetoft (1994).

[15] Nerlove (1963), in Zellner (1968); Christensen and Greene (1976).

[16] Hebden (1983); McElroy (1987).

[17] See also Greene (1990).

terested reader is referred to their paper and also to Battese and Coelli (1988, pg. 392-393).

Cost efficiency in SFA is simply given by[18]

$$EFF_i = \exp(u_i) \overset{\le}{\ge} 1, \qquad (13)$$

depending on the main relationship being either a production or a cost function, respectively. Notice that, if the dependent variable is not expressed in natural logs, the above expression will not be valid. The following one should be used instead:

$$\boxed{EFF_i(linear) = \frac{X_i\beta + u_i}{X_i\beta} \begin{cases} \in (0,1] \text{ for a stochastic production frontier;} \\ \in [1,+\infty) \text{ for a stochastic total cost frontier.} \end{cases}} \qquad (14)$$

Jondrow et al. (1982) also derived similar expressions for exponentially-distributed efficiency errors, whereas Stevenson (1980) did the same for the truncated model. Moreover, Schmidt and Sickles (1984) identified three shortcomings of the cross-sectional estimation of stochastic frontiers: first, the assumption that firm-specific inefficiency is uncorrelated with the explanatory variables can be violated; secondly, the error term may not always be normally distributed; finally, the estimate of u, the efficiency error, may not be consistent. Panel data estimation of stochastic frontier models, which is able to overcome the above limitations, is reviewed and implemented by Burns and Weyman-Jones (1994a). Battese and Coelli (1988) provided a panel data counterpart to the above reported cross-sectional decomposition of the error term. As it will be clarified later, estimation of both cross-sectional and panel data stochastic frontier models is carried out by Maximum Likelihood Estimation (MLE) techniques.

Battese and Coelli (1992) propose a stochastic frontier production function for (unbalanced) panel data which has firm-specific efficiency effects being distributed as truncated normal random variables. Such firm-specific efficiency errors are also permitted to vary systematically with time. A cost-function alternative to more traditional production functions is also provided by the authors. There are obviously a large number of model choices that could be considered for any particular application. For example, a half-normal distribution for the (in)efficiency effects might be assumed, instead of the more general truncated normal distribution. Furthermore, provided that panel data is available, one could assume either time-invariant or time-varying inefficiencies. One could even revert to deterministic OLS estimation if she believes that the u term is not significant, and should then be removed from the model altogether.

Traditionally, a number of empirical studies[19] have estimated stochastic frontiers and predicted firm-level efficiencies by using these estimated functions. Then, they regressed predicted efficiency scores on environmental variables (including ownership types) in an attempt to identify some of the reasons for differences in predicted efficiency scores among firms in a given industry. This has long been recognised as a useful exercise. Lovell (1993, pg. 53), with reference to both stochastic frontier and DEA analyses, points out that "[...] It is worth thinking hard about what variables are inputs and outputs that belong in the first stage [i.e., either production/cost estimation or first-stage DEA], and what variables are explanatory variables that belong in the second stage. This must be done on a case-by-case basis, of course. The only general guideline I have to offer is that variables under the control of the decision-maker during the time period under consideration belong in the first stage. Variables over which the decision-maker has no control during the time period under consideration belong in the second stage. Candidates for second-stage variables include quasi-fixed variables, site-specific characteristics, socio-economic and demographic characteristics, the weather, and so on". The author also discusses the possibility of estimating efficiency scores by limited-dependent variables techniques (e.g., Tobit) because of the censoring problem resulting from the 0/1 scale.

However, as Coelli (1996a) observes, the two-stage estimation procedure has also been long recognised as one which is inconsistent in its implicit assumption regarding the independence of the inefficiency effects (the us) in the two estimation stages. The two-stage estimation procedure is unlikely to provide estimates which are as efficient as those that could be obtained by using a single-stage estimation procedure. This issue was addressed by Kumbhakar, Ghosh, and McGuckin (1991), and Reifschneider and Stevenson (1991), who proposed stochastic frontier models in which the inefficiency effects (*u*) are expressed as an explicit function of a vector of firm-specific variables plus a random error.

A Comparison Between DEA and Stochastic Frontier Estimation

In this chapter we sketch the main pros and cons which should be taken into consideration when comparing DEA efficiency results with those stemming from stochastic frontier analysis, an econometric technique often used by regulators as a cross-check on DEA[20]. In order for methodological cross-checking to be fully understood, the following differences between DEA

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[18] This is computed by software packages in order to construct efficiency scores for every firm in the sample, being used to build up a final 'efficiency ranking' of all observed units.

[19] E.g., see Pitt and Lee (1981).

[20] The Austrian regulator E-Control has recently announced that both DEA and stochastic frontiers will be used in its comparative efficiency exercise for price regulation purposes, but the econometric technique will only be used as a cross-check.

and Stochastic Frontier Estimation (SFE) must be kept in mind:

- the DEA technique does not require the specification of a functional form for the production function. Such flexible functional forms as the translog definitely improve the situation, but are not able to clarify how different components of efficiency might be separated within SFE. As noticed in the previous Sections, stochastic frontier methods are generally unable to effectively distinguish between input-allocative and technical efficiency. Battese and Coelli's (1995) 'Technical Efficiency Effects' model, for instance, sorts out the problem by simply assuming that allocative efficiency is *ex ante* full ($AE \equiv 1$), thus ascribing all deviations from best-practice efficiency to technical effects (apart from random noise, of course). In general, SFE encounters serious problems with input-allocative efficiency computations;
- the DEA technique is non-stochastic[21] and does not take errors (random noise, measurement error) into consideration, unlike the SFE technique. Empirical work always involves some degree of measurement error, data handling errors, stochastic shocks, et similia. On the other hand, the ability of SFE to handle errors only comes at the expense of either the imposition of a functional form for the errors themselves[22], or the use of panel data[23];
- DEA scores are heavily affected by specification and variable selection errors. On the contrary, SFE frontiers give rise to standard errors and *t*-values for each of the parameters (e.g., in a translog total cost function). It is also true that sophisticated sensitivity analysis of DEA scores might be a possible solution to this problem, but it would be indeed complex and time-consuming;
- from a computational point of view, differences between DEA and SFE are now negligible, as a consequence of modern computing power. SFE involves econometric estimation of either a production or a cost function (plus share equations, if feasible), whereas DEA implies a separate linear program for each DMU in the sample. The most recent DEA software is capable of accommodating thousands of simultaneous linear problems automatically, so that computer programming skills are no more essential;
- DEA allows easy extension to multiple outputs in a production frontier context, and can also accommodate non-discretionary variables into the analysis in a direct way. On the contrary, SFE may only be extended to multiple outputs within a cost frontier setting. However, an excessive number of outputs (or inputs) in DEA will rapidly give rise to an excessive number of best-practice DMUs. This may result in a tighter constraint on the number of inputs/outputs which can be inserted in DEA - as opposed to SFE – without saturating the model[24].

Real-world regulatory usage of economic benchmarking

– lessons from the Norwegian and Dutch experience with electricity networks' benchmarking –

Norway

The transmission and distribution of electricity in Norway is carried out by a large number of companies operating three different networks: main transmission network, regional transmission networks and local distribution networks. Statnett SF, a state-owned enterprise, owns by far the largest part of the main network and is responsible for tariffs, system operations, and the development of the main network system. The main transmission network includes 400 kV, 300 kV and 132 kV. Statnett owns about 77 % of the Transmission Network and leases the remaining 23 %. Some 40 other network companies (regional companies and producers) each own small sections of the main network. Statnett SF has a leasing agreement with these 40 companies, and the lease costs historically are passed on to consumers. Between 50 and 60 companies are involved in the transmission of electricity at the regional level. These companies are often vertically integrated in the sense that they also produce and sell electricity. They are also often involved in the distribution of electricity at the local level. The regional networks are often owned by local and/or regional authorities. Electricity is distributed locally by around 200 companies, often owned by the local municipalities. These companies vary greatly in size and other characteristics. The average distribution company has around 5000 customers. Some of the distribution companies feature local production. The majority of the distribution companies are also engaged in the sale of electricity, mostly to local customers.

NVE applies revenue cap regulation with profit-sharing component for electricity networks. In the cap formula the need for increased revenue due to grid expansions in the Norwegian model is based on the parameter load growth multiplied by a scale factor of 0.5. This implies that if a grid company had a revenue cap of $1 million the previous year, and load increase of 2% is expected, the revenue cap will be increased by $10,000 to cover for necessary grid expansions caused by the 2% load growth. Losses are added to the

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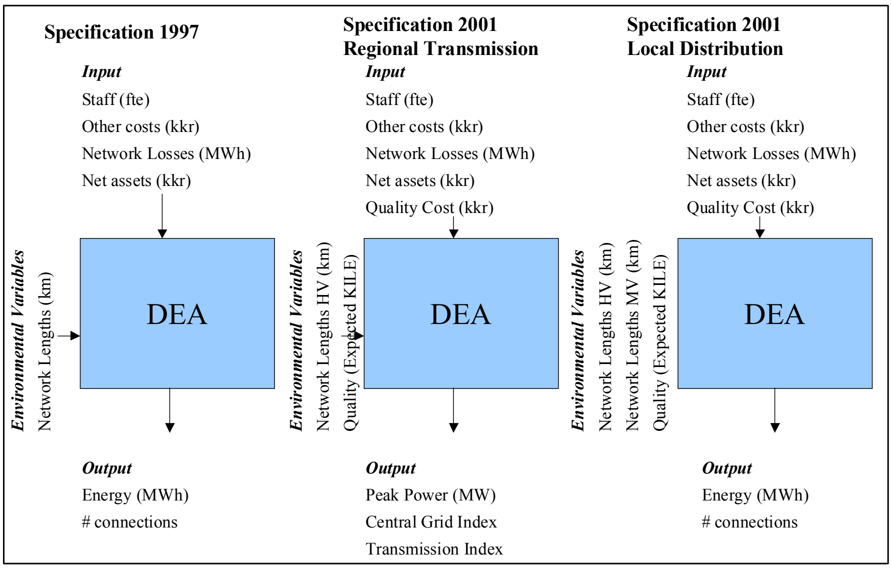
[21] Some researchers have tried to develop a stochastic version of DEA (see Land, Lovell, and Thore, 1988, and Lovell, 1993), but those models are by no means complete, and require massive data information regarding expected values, variance-covariance matrices, probability levels, and so on. Stochastic DEA would solve the main methodological problem with Data Envelopment Analysis, and is therefore worth investigating to a larger extent in the future.

[22] See Jondrow, Lovell, Materov, and Schmidt (1982), and Greene (1993b).

[23] See Burns and Weyman-Jones (1994a).

[24] On the 'parsimony' requirement for DEA, see Ferrier and Lovell (1990).

Figure 6: Overview of efficiency analysis undertaken by NVE



formula through multiplying the physical losses by the spot market price. Hence, losses are by definition not adjusted by the inflation factor. However, losses are adjusted for productivity improvement factor as well as the growth factor.

The revenue cap is adjusted using an efficiency factor X that comprises a 'general' (common X factor) and a 'utility-specific' (additional stretch X factor) component. The utility specific X-factor is calculated from DEA (Data Envelopment Analysis) of the distribution utilities while for Statnett the X-factor is calculated from Value Chain Method and comparison with the Swedish utility Svenska Kraftnät.[25] The same general X factor applies to all network companies and was determined based on a study made by consultants according to which the general productivity improvement of the Norwegian network utilities is 1.5 – 2 percent.

The original NVE benchmarking model (see the figure below) is an input-minimizing cost efficiency model, run under variable returns to scale assumption. The environmental variable is treated as an additional output. The input operating costs (*opex*) is calculated from staff hours (fulltime equivalents), physical network losses, costs for materials and services and the regulatory asset base in accounting and replacement value. The conversion was made for 1994/95 using a set of a priori prices for all but capital costs, where an individual calculation has been made. Accounting unbundling for activated staff costs has been made by the firms, as well as the allocation of joint costs for distribution and regional transmission grids. In the 1999 run, actual staff costs were used, leaving the net losses as the only item with estimated price. The outputs represent the number of connection and the energy distributed (Figure 6).

Two revised models for distribution and regional transmission were presented in NVE (2001). The distribution model, illustrated in Figure …, includes the a priori estimated cost of non-delivered energy, to account for quality differentces among firms. The actual cost of non-delivered energy is added to the operating cost, whereas the anticipated cost is added to the exogenous variables as an indicator of operating quality. The problem of the underlying stochastic behaviour was addressed by using a four-year average.

The model for regional transmission draws on the 1996/99distribution model for inputs and environmental factors, but is fundamentally different in its output definition. Except for the peak power variable, the two other outputs are essentially weighted assets indices for transforming equipment and central grid installations, respectively. The indices are determined using the 1994/95 weights.

The first regulation period beginning from 1997 introduced individual efficiency targets for distribution networks from 1998, based on DEA production runs using average values for 1994/1995. The reference set was formed of 198 firms after elimination of 38 regional grids and 11 distribution utilities. The average score for the distribution utilities was 86% and 34 units were ranked as fully efficient.

The NVE's analysis produced DEA scores that spanned the range 60-100 per cent.[26] NVE established a common X-Factor of 1.5 per cent per annum[27], and augmented it by a "stretch factor" related to DEA scores of 0 to 3 per[28] cent per annum, giving overall x-factors between 1.5 and 4.5 per cent per annum at most (see Table 1).[29] [30]

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[25] Tooraj Jamasb (Department of Applied Economics, University of Cambridge), Michael Pollitt (Judge Institute of Management Studies, University of Cambridge), 2000: Benchmarking and Regulation of Electricity Transmission and Distribution Utilities: Lessons Learned from International Experience.

[26] NVE (Sep 1999), Regulation of electricity monopolies, Efficiency analysis of transmission and distribution, Presentation by Thor Martin Neurauter.

[27] It is determined based on a study made by Førsund and Kittelsen according to which the general productivity improvement of the Norwegian network utilities is 1.5 – 2 percent.

[28] The average required individual efficiency improvement was therefore 1.4 percent a year.

[29] In 1997, a general efficiency requirement of 2% applied to all utilities and no utility-specific X-requirement. In 1998, the general X-factor was set at 1.5% while the weighted average of utility-specific X-factors was 0.6%. The corresponding figures from 1999 to 2001 are 1.5 and 1.1% respectively.

[30] In 1999, the total revenue cap for the utilities amounted to 14,360 million NKr. In comparison, the total efficiency improvement requirement for the same year was 370 million NKr. The utility-specific efficient requirement amounted to 157 million NKr, of which 70

Table 1: Overview of Efficiency Zones applied by NVE in Norway

Number of companies	Efficiency Range	Common X factor	Additional Stretch Factor
45	Below 70 %	1,5 %	3,0 %
68	70 % - 80 %	1,5 %	2,0 %
42	80 % - 90 %	1,5 %	1,0 %
43	90 % - 100 %	1,5 %	0,0 %

Table 2: DEA benchmark model specification

Input factor	Total Costs [NLG]
Output factors	Energy delivered [kWh] Number of small customers (distribution) Number of large customers (transmission) Peak demand at distribution level [MW] Peak demand at transmission level [MW]
Environmental factors	Number of transformers Network route length [km]

The subsequent run on averaged 1996-1999 data to set 2002-2007 targets was made on 171 (6 excluded) distribution utilities and 83 (21 excluded) regional grid companies and resulted in average cost efficiencies of 90% and 95% for distribution and regional network operations, respectively. The total number of efficient units were (25% of reference set) and 48 (58% of reference set) for distribution and regional network operations, respectively. The results were implemented for regional grids in 1999. A dynamic Malmquist analysis was made on 1995/98 data to provide data for the general productivity development parameter X.[31]

In the new price control period (2002-2006) the common X factor was kept at 1,5 %, however the range of the additional stretch factors changed from 0-3% to 0-5,2%.

A particular feature in the NVE implementation of scores is the floor at 70% (1994/95) and 50% (1996/99) to which all score inferior to the floor are truncated. The determination of the floor was based on regulatory discretion, likely to avoid outliers from being overly penalized. The lowered floor in the model runs with 1996/99 data can then be interpreted as a tougher policy under improved data quality.

The Netherlands

The Dutch energy regulator DTe is responsible for setting tariffs for electricity transmission and distribution networks. This is done on the basis of a price cap system according to a CPI-X formula. DTe published its first decision on the X factors for electricity transmission and distribution networks in September 2000. These X factors were strongly driven by the results of a DEA benchmark report. Three separate DEA benchmarks were carried out: For the national transmission grid (TenneT), for a regional transmission grid (TZH), and for the regional network companies. The DEA benchmarks for TenneT and TZH were later discarded by DTe. In the remainder of this paper, we will focus on the DEA benchmark for the regional networks (Table 2).

The DEA benchmark was applied to the sample of 20 Dutch local network companies. The model specification is shown in table 1. DTe used a single input factor, which was the total cost of each network company. This total cost was the sum of operating expenditure, depreciation, and a standard return on assets. Certain cost elements, which were considered to be uncontrollable by the network company, were not included in the benchmark analysis and were remunerated separately on the basis of actual costs. A peculiar feature of DTe's model is its total cost approach.

A special feature of the Dutch regulation system is that both operating and capital costs were considered in the DEA efficiency analysis (DTE 2002). Operating expenditure is associated with personnel, maintenance etc. while capital expenditure is made up of depreciation plus a fair rate of return on investment. As far as known to the authors, no other regulator directly includes capital costs in the efficiency analysis. In other regulatory cases, the calculation of the X-factor also includes capital costs but these are not directly benchmarked. Benchmarking analysis is restricted to operating costs whilst (scrutinised) capital costs are simply added on a cost-plus basis when setting the tariffs. Traditionally, DEA benchmarks are carried out either for operating expenditure alone, or when capital expenditure is included, this is usually through the use of proxy parameters such as the number of installed transformers, network length, etc.

The DTe approach is different in that cost data, rather than technical inputs, were used and that operating and capital costs were considered simultaneously. DTe's motivation for this approach was that it is the company's responsibility to trade-off between short and long-term costs. Insofar as this trade-off had any effect on the overall efficiency of the company, it should be reflected in the efficiency analysis. By simultaneously considering operating and capital expenditure in the efficiency analysis, DTe bypassed the regulatory problem of investment appraisal. Experience shows that this is one of the main difficulties faced by regulators. Under a total cost model, this problem was simply bypassed as there was no explicit requirement anymore to consi-

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million NKr applied to distribution utilities and 87 million NKr to regional networks.

[31] Agrell / Bogetoft (2003), Benchmarking for Regulation, Final Report for NVE.

der CAPEX projections in the X factor calculations. In principle, a total cost approach is therefore preferable because it creates incentives to improve efficiency in the short as well as the long term. Given that capital forms a significant portion of total cost, the effectiveness of regulation can be greatly enhanced. However, benchmarking capital costs is extremely difficult due to data problems. Capital costs reflect the investment process and exhibit long- term characteristics that imply multi-period determinations of depreciation and of the return on assets. For instance, different companies may use different depreciation profiles (asset valuation, asset life, depreciation path) as allowed by national accounting rules. DTe aimed to eliminate such monetary effects resulting from bookkeeping practice by performing a backward calculation of book and depreciation values. In doing so, however, a number of assumptions and approximations had to be made. Due to the lack of detailed data, the standardisation was performed on an aggregate basis, thereby ignoring the differences in lifetime and age across asset categories. Also, as historical investment profiles were not available, a virtual annual investment profile was assumed when recalculating the asset and depreciation values.

DTe used three types of outputs, namely energy delivered, number of custommers, and peak load. For the latter two outputs, a distinction was made between distribution and transmission. While some companies had only distribution activities, others had a mix of transmission and distribution. To accommodate these differences, the data on customers and peak load was split between distribution and transmission. In addition to the total of five output factors, DTe included two environmental factors in the benchmark. Network route length was used as a proxy for the size of the network, while the number of transformers acted as a proxy for complexity.

The September 2000 decisions on the X factors led to a wave of protest and formal appeals by the industry. Their main critique was aimed at the use of benchmarking as a way to set tariffs, the mechanical translation of efficiency scores into X factors, and the use of limited and flawed data – in particular, the standardisation of capital costs. Additionally, the fact that DTe widely published the benchmarking results did not help in this regard. As a result, the relationship between regulator and industry became increasingly hostile: on the one hand, DTe confirmed its decisions; on the other hand, the network companies refused to accept the – in their eyes unjust and erroneous – X factor decisions. The appeals led DTe to publish revised decisions in September 2001. The main difference with the initial decisions was an increase in the quality of data. An independent audit was performed to verify and improve the output factor data, while the CAPEX standardisation was refined by considering each individual asset and the actual historical investment profile. The data improvement led to higher efficiency scores and lower X factors. However, the companies' main critique points were still not thoroughly met, and there still remained problems with the data. DTe responded to this by initiating a special project with the objective to remove any remaining data problems. As a result, a second revision of the benchmark analysis and X factors was published in August 2002. But this did not prevent the network companies from confirming their appeals, as they did not consider DTe's corrections to be sufficient. Eventually, in October 2002, the Courts overruled the X factor decisions. However, this was just a legally-motivated decision. It was taken not (only) on the basis of the benchmark analysis, but mainly because according to the Dutch Electricity Act, DTe should have applied a uniform X factor (instead of an individual X factor for each company) in the first place.

Conclusions

The informational asymmetry problem between the regulator and its regulated agents has been widely discussed in the literature. Lack of information about the network companies' efficiency potential prevents the regulator from setting optimal prices and performance standards. Benchmarking is a powerful tool to reduce this informational asymmetry. In this paper, we have discussed two popular benchmarking techniques.

Data Envelopment Analysis (DEA) is a linear programming technique and calculates efficiency instead of estimating it. This exposes the technique to a host of problems and difficulties relating to the absence of a stochastic component that differentiates between genuine inefficiency and random noise. On the other hand, DEA makes life (apparently) easy to monopoly regulators.

Stochastic Frontier Estimation (or Analysis) is a statistically-based technique that attempts at drawing a line between inefficiency and random effects. It does so at the expense of imposing a functional structure upon the production or cost process. This introduces a number of complications in the analysis, and may result in the diminished appeal of this technique for realword applications. However, regulators are now tending to re-use statistical techniques to cross-check DEA results. This has recently been observed, for instance, in Austria and in a number of Central and Eastern European countries.

Benchmarking techniques should be used cautiously, and their limitations should be recognised. Benchmark studies do not generate the absolute truth, but rather an indication and ranking of relative efficiency levels. Its re-sults will depend strongly on the choice of model, model specification, and the quality of the data. From a regulated company's point of view, it is very difficult to accept the results of an efficiency analysis if changes in data or model specification result into totally different results. In the Dutch case, the results from the benchmarking analysis were directly translated into X factors. This ‘linked’ approach made the regulatory process extremely sensitive to data errors. A change in the data for a single company might have potentially led to a change in efficiency scores for the whole sample. This also created an op for companies to strategically influence the regulatory process, as each subsequent correction in the. regulatory decisions will reduce overall credibility The main lesson from the Dutch experience is perhaps that regulators should take into account the limitations of benchmarking. Efficiency scores should be considered as an indication, rather than a confirmation, of (in)efficiency. Given the large degree of uncertainty in the results of a benchmarking study, its outcomes should be used with a grain of salt. Rather than feeding directly into the X factor process, they should be considered as precious pieces of information to strengthen the regulator’s position in the discussions with network operators. Benchmarking results are not the solution, but merely the starting point in sorting out the information asymmetry problem.

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