



Conditions for effective benchmarking in regulation

GARS Workshop

November 11, 2006

Overview

- **The regulatory problem**
- **Can benchmarking help solve it?**
- **What is needed for effective benchmarking?**
- **Implications for aviation**
- **Conclusions**



1. The regulatory problem

What should a regulatory regime achieve?

- **Deliver benefits for customers in the form of:**
 - Lower prices
 - A good quality of service
 - Improved efficiency, and hence future ongoing benefits
 - Fulfilment of certain social obligations (e.g. safety)
- **Using a regulatory regime that is:**
 - Sustainable
 - Robust (politically acceptable and economically viable)
 - Low cost

Delivery hampered by information problems

- **The regulator may observe reported costs and outputs**
 - But these may not be accurate
- **The regulator will not directly observe efficient costs and outputs**
 - ‘Buy’ accurate information – allow the business to keep the excess profits of innovation for a period; or
 - Incentivise a group of similar firms to beat each other’s efficiency (side-step the problem)

Buying information may not be sufficient

- **Provide business with incentive to achieve, and hence reveal, efficient level of costs**
 - retains profits of unexpectedly high efficiency
- **Return efficiency to customers at price review**

Advantages

- encourages some efficient behaviour
- returns benefits to customers at regular intervals

Disadvantages

- arbitrary division of gains between customers and businesses
- strategic behaviour in timing and allocation of improvements
- cost and output delivery trade-offs
- unless firms are myopic, the true efficient level of costs may never be revealed



2. Can benchmarking help solve it?

Yardstick competition – a cheaper way?

- **The prices a firm can charge are based upon a benchmark of costs**
 - Firm's own costs have limited impact (if any)

Advantages

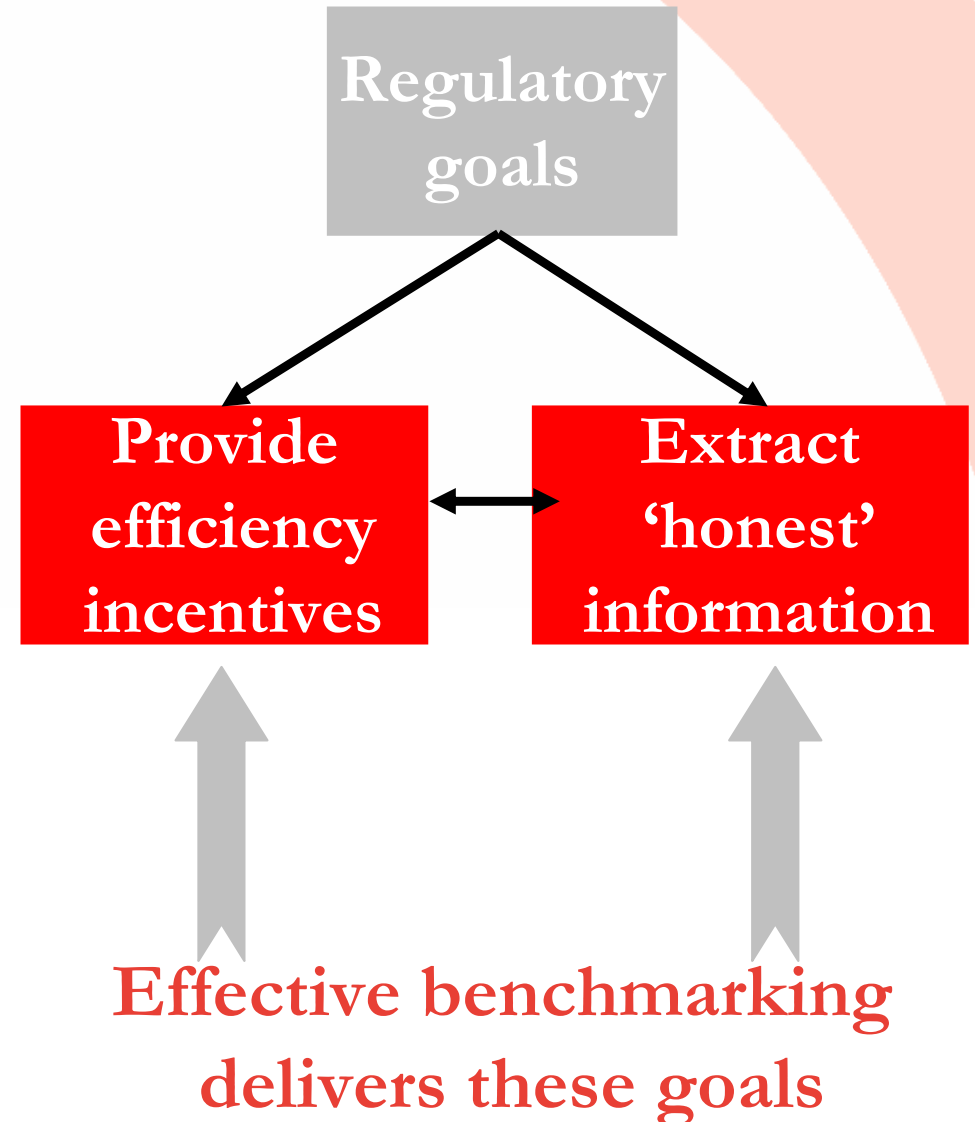
- no incentive to engage in strategic behaviour - the price is determined by other similar businesses
- encourages firms to move to the efficient level of costs as soon as possible
- natural mechanism to transfer gains to customers - not unlike in real competitive markets

Disadvantages

- circularity – need information on the efficiency relative to current benchmark to establish yardstick competition
- implementation constraints – policy framework and regulatory regime affect the effectiveness of benchmarking

Can we break out of the circularity?

- **Yes, by using benchmarking to simultaneously:**
 - incentivise firms to report costs,
 - incentivise them to monitor the costs of others; and
 - measure the efficiency of the sector





3. Conditions for effective benchmarking

When will benchmarking be effective?

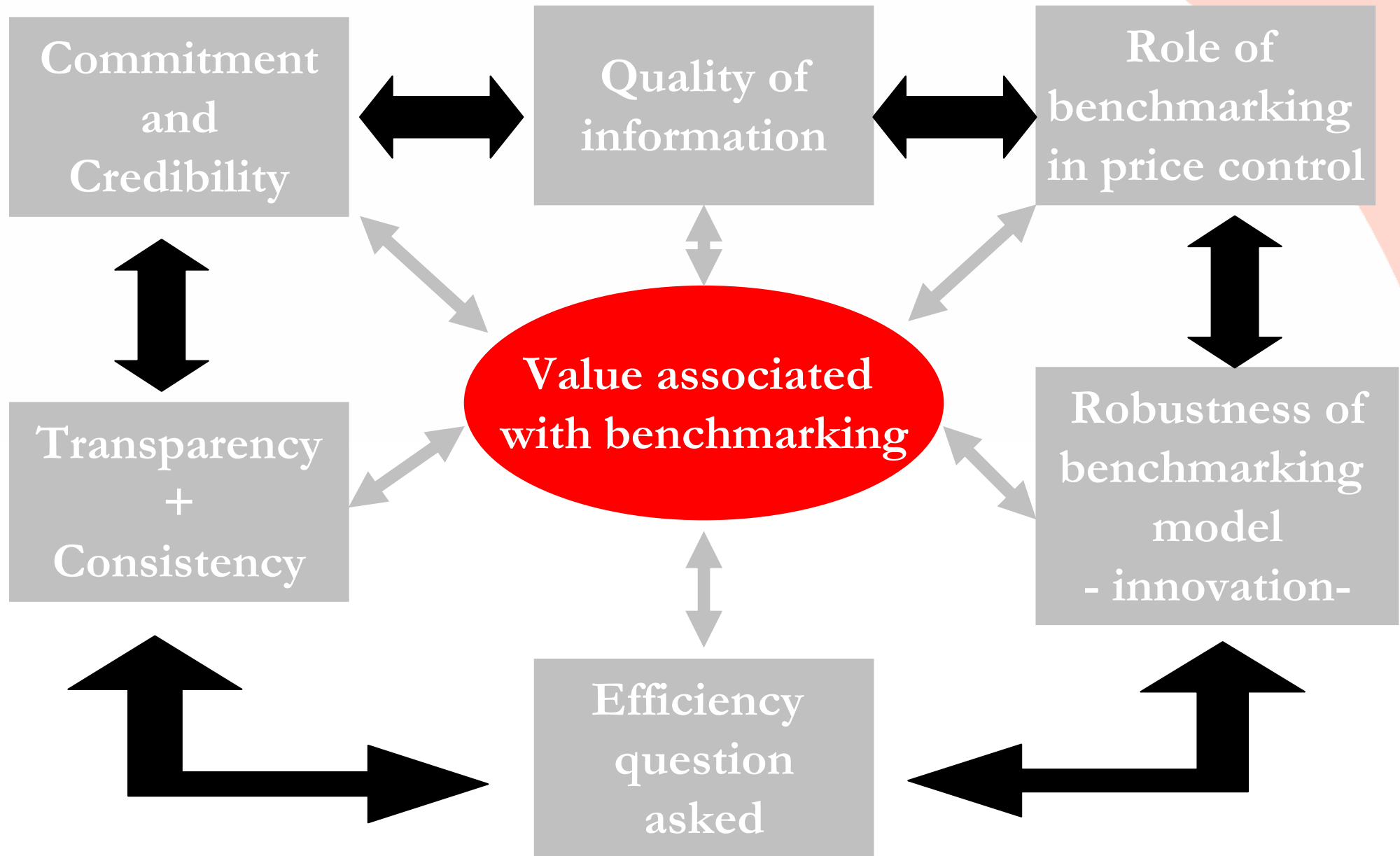
Effective benchmarking

Regime has a high impact
on company value

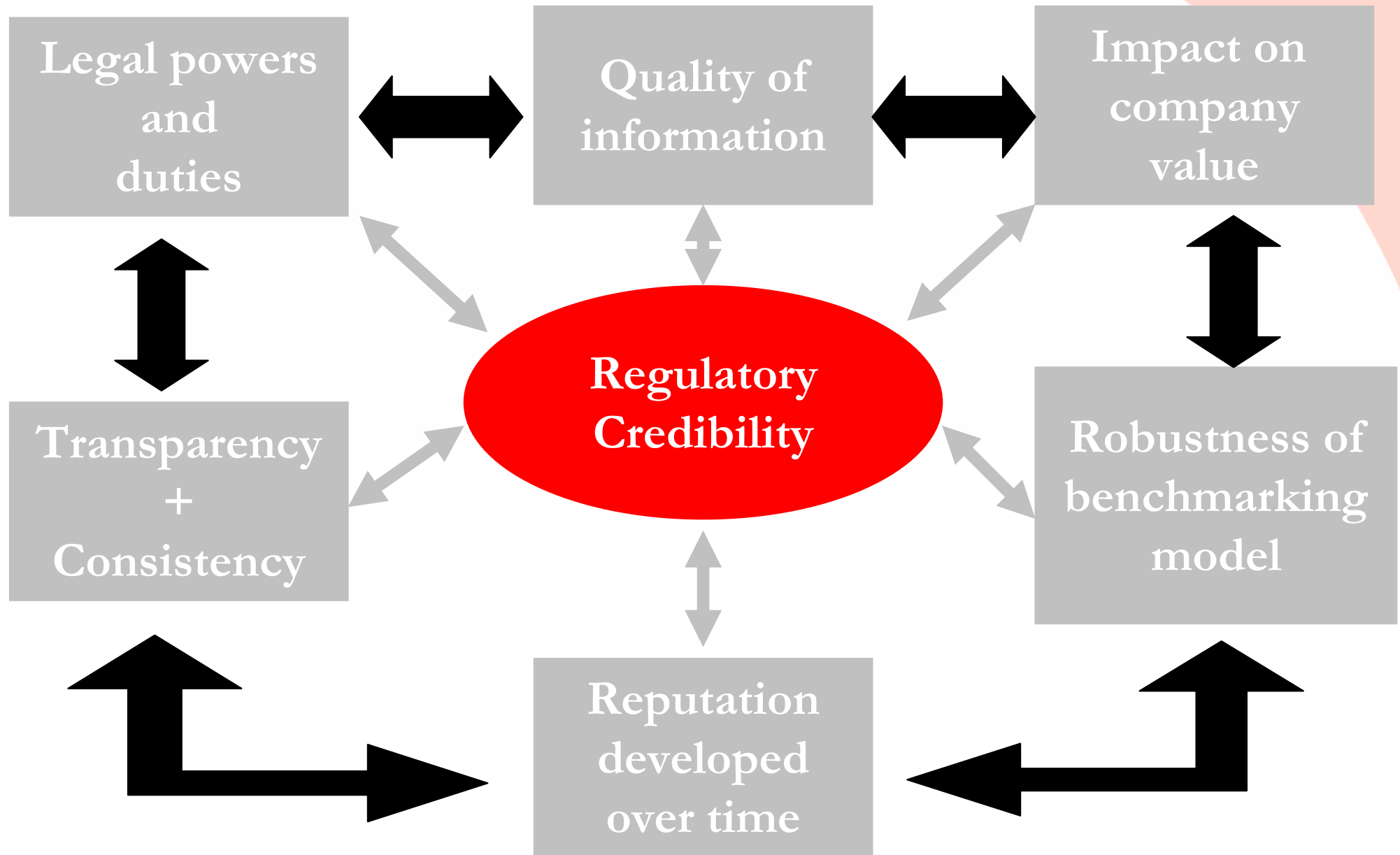
Credible regime of
yardstick competition

1. Regulator has incentive to develop robust information collection regime
2. Company has incentive to provide honest information
3. Regulator has incentive to design robust benchmarking model
4. Strong incentives to reveal information and improve efficiency
 - robust and credible model with high value implications

What affects impact on value?



What affects credibility?



Effective regulation, value and credibility

		Value	
		High	Low
Credibility	High	<p>Very effective</p> <ul style="list-style-type: none">- info collection easy- honest info revelation- robust model	<p>Middle-ground</p> <ul style="list-style-type: none">- partial models- power to extract info- limited info revelation- low incentive to get right
	Low	<p>Middle-ground</p> <ul style="list-style-type: none">- concerns about commitment- limited info revelation- strong incentive to get right- develop reputation over time	<p>Ineffective</p> <ul style="list-style-type: none">- very limited info revelation- info costly to collect- low incentive to get right- reputation not developed



4. Implications for airport regulation

Factors that affect impact on value

- **Is total cost benchmarking feasible?**
 - comparability of capex programmes for airports
- **Limitations on operating cost comparison**
 - concerns about comparability of international data
- **Design of benchmarking model**
 - little sign of innovation by regulators
(e.g. output definition; need to incorporate quality)
- **Cross-country efforts to improve information would help**

Factors that affect credibility

- **Little progress in improving information**
 - international comparisons difficult
- **Reputation has not been developed**
- **No push from policy or legislation on this**
- **Companies may push for it**
 - Airlines more aware of airport relative efficiency
 - M&A activity

Conclusions

- **Benchmarking can solve information problem in regulation *if* effective**
- **Need value affected to be high**
 - include capex benchmarking
 - quality of service aspect too
- **Need credibility**
 - international focus on data collection
 - airlines may push for improvements
- **May take time and have upfront costs**

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