Regulating Private Utilities: the Customer Corporation

John Kay

The regulation of privatised utilities in Britain is widely criticised today. The criticism comes from many quarters. Customers resent their money being handed out in excessive salaries and dividends. Academics are now widely critical of the price fixing formula (RPI-x) which was once a proud British innovation. A curious alliance of politicians and senior industry executives is concerned to suggest that the regulatory process is insufficiently accountable. Much of this criticism of regulators is misconceived. On balance, regulators have done a better job than could reasonably have been expected. The problems of utility regulation are mostly not the fault of the regulators. They arise directly from the failure to address a range of fundamental structural issues about the management of utilities at the time of privatisation. If people are trying to push water up hill, the correct response is not to berate them for incompetence or to look for ingenious devices to help; it is to point the finger at those who gave them the job to do in the first place. We should address our criticisms to the politicians who devised the framework rather than at the regulators who struggle to operate within it.

The deficiencies of that framework are of three main kinds, and they have been cumulative in their effect. All have a common fundamental cause, which is that the principal concern in all privatisations (with the partial exception of electricity and buses) was to achieve a successful flotation. That was largely perceived as an end in itself. To the extent that the architects of the programme thought beyond that, it was simply assumed that the change in ownership would bring about the desired results. The first weakness is that the terms on which utilities were privatised were much too favourable to firms and their shareholders and gave insufficient attention to the interests of customers. The second is that no explicit mechanism was put in place for securing a substantial share of the expected efficiency gains for customers. Even if - as can be argued - such a

mechanism was implicit, the absence of a clear relationship was bound to leave customers dissatisfied. The third, and deepest, of the problems is that the privatised utilities lack what political theorists term legitimacy - a popularly acceptable basis for the power they exercise. Much concern has recently been expressed over the accountability of the regulators; the man in the street is not concerned with this but with the accountability of the companies themselves, and he is right. It is this absence of legitimacy which explains why privatisation remains unpopular with the public even as it has started to deliver benefits to them in the form of lower prices. It is also why attempts to extend privatisation further - in post and railways, in health and education - have ground to a halt.

This paper develops these propositions and argues that attempts to add bells and whistles, or more accurately balls and chains, to the current regulatory system are certain to fail. They will increase rather than reduce dissatisfaction with the current structure. The right answer is a partial retreat from privatisation. It is an acceptance that the governance structure of the plc is not suitable for the governance of monopoly utilities even if it is appropriate for firms which operate in competitive markets (it is not clear it is appropriate for them either, but that is a matter for another article).

The basic reform proposal developed here is a very simple one, though far-reaching. At present, the conventional view is that the primary duty of corporate boards is to the shareholders of the company, and its obligations to customers arise incidentally to the fulfilment of that obligation. In a competitive market, the interests of shareholders can only be achieved by meeting the expectations of customers. But this is not true for a firm which does not face a competitive market, such as a monopoly utility. For such a company, the legal position should be the other way around. The purpose of a privatised utility should be to serve its customers, and its obligations to shareholders exist only to the extent necessary to ensure that the company can meet that primary purpose. This change would have implications for the appointment and conduct of Boards, for the financing of companies, and for the role of the regulator.

From my knowledge of the managers of privatised utilities, I believe that this change would reflect the ways in which the vast

majority wish to behave and the ways in which they, in the main, do behave. To remove the tension between their aspirations and the expectations of the capital market would be to the long run benefit of everyone. Some utility executives will see this as a major erosion of the management freedom which privatisation has given to them. The intention, and the effect, would be precisely the reverse. The only hope of maintaining that freedom, and the efficiency gains which have been derived from it, is to find a structure which legitimises it more effectively. Decisions as to what level of renewal investment is necessary, which new activities will benefit customers, how improvements in service quality should be balanced against price increases, are all best taken not by politicians, or regulators, or referenda among customers, but by utility managers themselves. What we need is a framework that both encourages and allows them to make these decisions in an environment which focuses unambiguously on the interests of customers. The alternative, which is already in progress, will be a continued erosion of management autonomy through expansion of the scale and scope of regulation and from increasing direct political intervention.

The Achievements of Privatisation

Before turning to the supposed failures of regulation, it is well to begin with the successes of privatisation. There have been substantial improvements in efficiency in all those firms which were publicly owned when the privatisation experiment began in the early 1980s. Most of this improvement, possibly all of it, has come from reductions in manning levels. The most remarkable achievements have been from those formerly state-owned firms operating in a competitive environment: steel, airways, the two electricity generating companies. Telecom and gas were slower to slim their workforce, but have begun to do so as competition has become more effective. The pace of change has been less marked in water and electricity distribution, and in these industries there are probably large improvements yet to come.

In broad terms, these changes have been achieved without loss of output or service levels. To a much greater extent than had been realised, nationalised industries had become employers

of large amounts of unnecessary unskilled labour. The Central Electricity Generating Board (CEGB), widely regarded as one of the most efficient of nationalised industries, can now be seen to have been grossly over-manned. Other countries have had similar experiences in the restructuring of their public sectors. It is, however, important to recognise that competition, rather than ownership as such, seems to have been the key element. Not only have changes happened more quickly in competitive environments than in others, but substantial productivity gains have also been made in the same period in other industries, such as the Post Office, which remained in state ownership.

These efficiency gains have revealed clearly the negative effects of traditional 'accountability' which takes the form of detailed supervision of management actions and of firms' investment plans and operating activities. Such accountability had, in practice, undermined the responsibility of the managers of the businesses concerned for the consequences of their actions without effectively transferring it to the supervisory civil servants or politicians. The recent fracas over prison management is an unambiguous reminder of the weaknesses of this structure as a means of organising industrial activities or, for that matter, anything else. Greater freedom to manage has everywhere led to improvements in morale and performance.

Almost all utilities have become more customer focused, in terms of attention to service quality and relationships with customers. British Telecom's redesignation of 'subscribers' as 'customers' is in a sense only symbolic, but represents a real change; customers may now have a choice, and even those utilities which remain monopolies are more inclined to treat customers as if they did have a choice. The influence of employees on British nationalised industries was substantial, but implicit rather than explicit, and hence essentially negative. It operated to prevent change in the structure of organisations, in working practices, and in the range and nature of services provided. There was also an excessive emphasis on technical issues relative to those of marketing and finance, reflecting political love of the grandiose and the wide influence of equipment suppliers. Electricity generation illustrates the nature of change here. The CEGB focused on large, state of the art generating sets, few of which were ever built to time or budget. Since privatisation, all

new capacity (apart from Sizewell B, an overhang from the old days) has taken the form of small, combined cycle gas turbines, which can be built rapidly on well-established principles.

Privatisation has given utilities more investment freedom. The results of this have been more mixed. Most have taken the opportunity to diversify, either internationally, or outside the core business. Since utilities see limited prospects for growth within the core business, internal and external pressures to do this have been substantial. Very few of these diversifications have been in any way successful. Companies have also been able to invest far more in their core businesses, and this has been particularly true in telecommunications and in water. Arguably, a systematic bias towards under-investment has been replaced by a systematic bias towards over-investment. And the problem of monitoring investment, and securing effective discipline without depriving consumers of necessary capital expenditure, has been changed in form but not in substance. In water, in particular, the appraisal of investment programmes by the regulator, at once detailed and arbitrary, comes more and more to resemble the methods of Treasury scrutiny and control which were applied in public ownership. No better answers have been found in gas and electricity.

There is a substantial positive balance to be recorded. It is possible that many of the gains which have occurred in the last decade could have been made without privatisation. It is, however, a matter of historical record that they were not made without privatisation, and that they now have been realised. It is also possible that the effect of reducing manpower levels, which is by far the most important consequence of the programme, has been to replace disguised unemployment by actual unemployment. Nevertheless, there is no going back, nor should there be.

Has Regulation Failed?

Criticism of the current regulatory structure comes both from those who applaud the developments described above and from those who remain hostile to privatisation. One line of attack that unites both is the alleged lack of accountability of the regulators. The various Acts prescribing their duties do so only in rather

general terms. The details vary from industry to industry, but the model has substantial common elements. Each utility operates under a licence awarded to it at privatisation. This licence imposes detailed requirements in respect of behaviour and the supply of information to the regulator. Amendment to the licence, or modification or renewal of the price cap which limits prices, may be made by agreement with the firm concerned. In the absence of such agreement the Monopolies and Mergers Commission (MMC) adjudicates.

While the role of the MMC is confined to major issues involving licence changes, judicial review offers a second mechanism for challenging regulatory decisions. This latter procedure is a common law remedy which has grown explosively since the mid-1970s. One unfortunate effect of judicial review on the regulatory process has been that it has increased the reluctance of regulators to provide detailed rationale for their decisions. It is easier to mount legal challenges to the steps of an argument than to the simple exercise of a general discretion which statute undoubtedly confers on the regulator. That discretion is itself the subject of criticism. It is easy to sympathise with the argument that what is needed is clarity and transparency of regulatory procedures and formulae, and that management should then be free to operate within the framework so prescribed. But the sought for clarity and transparency is largely illusory.

Consider some of the issues which are central to utility regulation. What is the cost of capital in electricity distribution? When is price discrimination pro-competitive and when is it anti-competitive in effect? What level of efficiency savings can a water company be expected to achieve? Decisions on each of these can only be made by the exercise of informed judgement. It is certainly possible to construct mathematical formulae, but their operation would be arbitrary and unfair. My preference is for giving discretion and autonomy to informed individuals capable of balancing conflicting duties and interests, rather than for the prescription of detailed rules. This applies both to regulators and to the managers of regulated companies.

(RPI-x)

The (RPI-x) formula is the distinctive British contribution to the

regulatory debate. The concept behind price cap regulation is that it provides reasonable prices to customers while preserving efficiency incentives for regulated firms. It is essential that prices should be based not on what costs are but on what they ought to be. The best source for this would be knowledge of what has been achieved by other firms, in the UK or overseas. In practice, almost no use has been made of international comparisons in British regulation, and there is little sign of any sustained attempt to develop them. Another source is the cost levels achieved by other companies. The opportunity for yardstick or comparative competition of this kind provided a specific rationale for the maintenance of ten separate water and sewerage companies and twelve regional electricity companies. But the failure to make comparative competition effective has been one of the major disappointments of the UK regulatory regime. The agencies have not been successful in developing robust measures of relative performance, and have not been able to get beyond broad qualitative groupings of those above and below average.

In practice, price caps are based on forecast costs adjusted by reference to an efficiency target. The incentives established by this regime are not particularly attractive, and in some respects perverse. The regulator cannot, after the event, distinguish between cost savings which arise because cost forecasts were unduly pessimistic and those which arise because the firm has done better than could reasonably have been expected. The regulated firm has therefore very strong incentives to pad out its forecasts of operating costs and investment needs. Since the regulator knows less than the company about what is necessary, he or she is inevitably forced to make arbitrary reductions in the levels of cost and capital spending planned by firms, and such reductions will, on average, be justified. But these will affect all firms, not just those which most exaggerated their expected costs; and that means that all firms must play the game of proffering inflated estimates of operating costs and investment needs, even if they would rather be frank and open with the regulator.

The game which results is one which the regulator must inevitably lose, because the regulator can never know as well as the company what costs and capital programmes are really required. At the same time, it undermines any rational process of investment evaluation, and it diminishes incentives to control

operating costs. The rational response of companies is to maintain a reserve of inefficiency, some of which can be eliminated in the aftermath of each regulatory review, hence ensuring that each target can be met or outperformed without either eroding too much the capacity to meet future efficiency targets or encouraging these targets to be set at even more optimistic levels. These are not theoretical or hypothetical concerns. Elements of this behaviour are apparent from the recent regulatory reviews in water and electricity. The fundamental problem is that regulator and company management have different objectives, and the regulator never has enough information.

There is a further problem which was not widely recognised at privatisation, and which has become evident as the system has operated in practice. It is that 'success' for a company means doing better than the regulator had anticipated when he set the price cap. It inescapably follows that such 'success' appears as a failure of regulation. Customer dissatisfaction is simply inherent in the structure, and paradoxically, the better companies perform in managing it the greater such dissatisfaction is likely to be. Such dissatisfaction had been building up steadily since privatisation. When the golden shares in electricity and water expired in 1995, the emergence of hostile bids forced companies to be explicit about their success in beating the regulatory system. At that point, dissatisfaction boiled over.

The Problem of Legitimacy

Privatisation is, and has remained, an unpopular policy. A recent opinion poll showed that the proportion of the electorate which disapproved of water privatisation had risen from 71% at flotation to 75% now. In its early stages, the main popular attraction of privatisation was the quick and generally substantial gains which small investors made on the shares and there were few, if any, customer benefits. In electricity and water, the process of preparing the industry for privatisation led to higher prices than would otherwise have been imposed. With longer experience of privatisation, the combination of efficiency gains by the industries and a tighter regulatory regime has led to significant price reductions. Increases in the x factors in telecoms and gas have led to lower consumer prices in nominal terms in the second

five year phase of price regulation. Competition in electricity generation led rapidly to falling prices, and substantial reductions in distribution charges are now in progress. Although water costs will continue to increase in real terms in the second five-year period the rise will be much less than in the first quinquennium.

Although these things might have been expected to win more support for the framework of privatisation and regulation, criticism has grown rather than diminished. Coincident developments have not helped. The share options which were awarded at flotation have produced unacceptably large gains for senior executives of privatised utilities. Although the salaries of these executives are not high by the - admittedly generous - standards of private industry generally, many people still remember that the same jobs were done only a short time ago, often by the same people, for relatively modest remuneration. The fundamental problem which privatised utilities face is that which political scientists recognise as the issue of legitimacy: 'What gives them the right to do that?'. Legitimacy can stem from many sources: traditional authority, direct election, proper and accepted delegation from those whose authority is itself legitimate. Unsatisfactory though the performance of nationalised industries was in many respects, their legitimacy was not in doubt. But this is not true of their successors. Legitimacy is rarely a problem for institutions which are seen to be doing a good job. But, as Fukuyama puts it, 'The strength of legitimate government is that it enjoys a reserve of goodwill which protects it when things go badly'. The weakness of privatised industries is that they enjoy no such goodwill.

The drought of summer 1995 illustrated precisely that. No reasonable person could blame either privatisation or the managers of water companies for the absence of rain. Yet the result of water shortages was to unleash a further wave of hostility against the privatised industry. That hostility was not confined to newspapers, or politicians, but widely felt and expressed. In earlier droughts, such as that of 1976, there was a general perception of common cause between water suppliers and their customers. Under the current structure, that perception no longer exists although the actual behaviour of the suppliers is virtually unchanged.

An instructive demonstration of these issues of legitimacy was provided at the recent annual general meeting of British Gas. An ill-timed announcement of a substantial pay rise for the company's chief executive provoked controversy. The AGM provoked a barrage of hostile criticism of the company and its management. In the end, the chairman used institutional proxies, overwhelmingly supportive of the management, to defeat all critical resolutions by large majorities. In a real sense, the institution of the AGM - a meeting of the company's shareholders - was being abused. The representatives of the shareholders included, for example, Ken Livingstone, a left-wing Labour MP purportedly representing an American institutional shareholder. Livingstone was not, in fact, there to express concern for the interests of shareholders, and nor were most of those present at the AGM. He was there to make a political speech on what he considered a matter of public interest.

But it is difficult to argue that Livingstone's interest was not a proper one. It is not a good answer to the criticism levied at the company, and at its relative treatment of its own managers, employees and customers, to say that these things are a private matter between the company and its shareholders - they are not. It is a better answer to say that the regulator is the vehicle through which the public interest in these questions is expressed. But the regulator, correctly, argued that few of the matters in dispute lay within her jurisdiction.

And the vote which vindicated British Gas management turns out, under scrutiny, to be an unsatisfactory affair. The billions of votes which supported the board were in fact cast by a small group - well under one hundred - of city investment managers, who had been assiduously cultivated by the British Gas chairman in the weeks preceding the AGM. These individuals were not themselves beneficial owners of claims against British Gas, and insofar as they had proper authority to act on behalf of those who were, it is not at all clear that such authority extended to matters such as these. It is very likely that the views of the beneficial owners - pensioners and holders of life policies - were closer to those which were expressed at the meeting than to the votes that were cast on their behalf. But even if it were practical to canvass the opinions of those who directly or indirectly owned the shares, no one can seriously believe that seeking these

opinions would be a good way to run the company. The whole procedure might be from Alice in Wonderland: nothing is what it seems, no-one is what they say they are.

In the early years of privatisation, it could be argued that the unpopularity of privatised industries was a transitional issue, and that once the structure was properly understood it would be more widely accepted. The moral of the British Gas fiasco is that it is wrong to think that the problem is one of education and explanation. On the contrary, the more closely the structure is studied, the less defensible it becomes.

Incentives for Whom?

One of the advantages generally claimed for price cap regulation is the incentive which it offers for greater efficiency in the firms concerned. This argument deserves more careful attention than it has received. The incentives provided under the system are incentives to shareholders. To the extent that firms do better than the efficiency targets set with the price cap regime, earnings will be higher than anticipated. The importance of incentivising shareholders assumes, however, that shareholders are in a position to bring about improvements in the efficiency of the companies concerned or, alternatively, that unless so incentivised they would wish to obstruct such improvements. There seems to be no reason to believe either proposition. The annual general meetings at which small shareholders are represented are a farce, and almost wholly irrelevant to the operational management of the businesses. If large institutional shareholders have played an active role in demanding efficiency improvements in some of the worse run utilities, this role has been a very low key one.

The simple, obvious point is that the substantial efficiency improvements described have not been brought about by shareholders, but by managers. If it is necessary and desirable to provide incentives to improve the efficiency of utilities, and it is, then the important people to incentivise are managers, not shareholders. Now the interests of managers and shareholders are to some degree aligned. There are two main elements in this: share options and the threat of take-over. It is paradoxical that management share options, which are the most criticised single element of privatisation and its consequences, are also the main

mechanism for improving the efficiency of privatised companies. They are not, however, a very good mechanism. If we accept for a moment the widely publicised estimate that the managers of privatised utilities have received £25 million in profits on the exercise of share options, we might observe that this amounts to less than 0.1% of the capital gains made by shareholders since flotation. Put another way, each £1 that is used to incentivise managers costs the company's customers £1,000 to provide. That figure might be easier to defend if there was a clear connection between the incentive and the efficiency improvements. But there is not. There is no correlation whatever between the size of the gains which managers have made from stock options and their assiduity in promoting efficiency. If the executives of some English electricity companies have done particularly well, and the Scottish electricity companies and British Gas relatively badly, it is because of the way the cards fell rather than as a result of the effectiveness with which these managers fulfilled their functions.

Several of the privatised companies - such as BT or British Gas - are in practice immune from take-over. Most of the water and electricity companies were subject to a five year moratorium on bids which has now lapsed. So far, the record of take-over threat as a spur to efficiency inspires little confidence. In only one of the bids so far made or threatened - that of Scottish Power for Manweb - has the suggestion that an alternative management team could do a better job been a central issue. In others, such as Trafalgar House's offer for Northern Electricity, the bidder has no relevant skills or experience and does not profess them. In most, the bidder has promised - whether credibly or not - that he will not change the operations of the firm he is buying in any material way. If the objective is to give the managers of utilities incentives to provide better service at lower cost, then the best, simplest and cheapest way to do it is to give them incentives to provide better service at lower cost. If bonuses given to executives were based on performance relative to demanding efficiency targets or, better still, directly tied to reductions in charges to customers and improvements in the quality of services offered, then the indignation which has been provoked by the exercise of share options would largely disappear. The reason there is much less hostility to option schemes in other companies is that profits

earned in competitive markets are, at least in broad terms, related to the effectiveness of the company. By contrast, the public thinks that profits are easy to earn in monopoly industries and that profits have often increased for reasons which are unrelated to improvements in efficiency or service. And again, the public is right.

Profit Sharing

It is essential that the link between firm performance and customer benefit be clearly established. At present, the utility retains all benefits up to the time of the next periodic review, at which time an indeterminate fraction of efficiency gains is passed on to customers. It is essential that the lag be shortened and the connection made explicit. The most obvious method of achieving this is a mechanism for sharing profits between shareholders and customers. The attraction of a system of profit sharing is that it represents a relatively modest reform which appears to answer some of the central criticisms of the current regime. On closer examination, however, the scope of the reform is wider than it appears at first sight, and its effectiveness in defusing customer criticism of the current arrangements more doubtful. The measures adopted by several water companies, and the industry-wide agreement on a programme of leakage control, are examples of voluntary profit sharing arrangements, and both represent constructive responses to recent customer criticism. But the limitations of voluntary arrangements are obvious. Unless very modest in scale, they create tensions between companies which choose to behave in this way and those which do not, and they put the managers of companies faced with hostile take-over in an untenable position. Unless very limited in amount, profit-sharing is only possible within the framework of broadly agreed industry parameters. That leads directly to the need to design a profit sharing formula. There are two main alternatives. The simplest method is that a fraction of all profits in excess of today's level be allocated, not to dividends, but to lower customer charges; the great advantage of such a scheme is its simplicity. Another approach involves sharing of profits in excess of the levels provided for in price-setting. This would demand that the regulator be more explicit about the basis of his calculations

than has generally been the case in past reviews.

However, the attractions of a general profit sharing mechanism diminish on closer examination. Such a scheme is likely to aggravate the problem of gaming between regulator and regulatee, and to lead to a significant increase in the instrusiveness of regulation. It is also likely to provide disputes which may take us further from the fundamental objective of strengthening customer involvement in the present system. The issue is therefore whether the basic objectives - of preserving and enhancing management autonomy while clarifying and increasing commitment to customers -can be achieved by a different path of reform.

The Customer Corporation

An alternative mechanism of profit sharing is one which creates a link between dividends paid to shareholders and charges to customers. The merit of this proposal is that it creates an automatic alignment of the interests of customers, investors and the regulator. The adversarial system described above, in which the regulator's concern for customers is pitched against the company's concern for shareholders, neither generates the quality of information needed for regulation nor provides adequate incentives to efficiency or protection to customers. But a share whose dividend entitlement depends on charges to customers, rather than on the earnings of the company, is fundamentally different in character from a conventional equity.

The conventional view is that a company exists to maximise profits for its shareholders. Of course, a company which considered exclusively the interests of its shareholders would not survive for long. For a firm which operates in a competitive market, the only way in which it can serve the interests of its shareholders is by identifying and meeting the interests of its customers. But a monopoly utility is different. A firm with a monopoly of electricity distribution can do well for its shareholders whether it satisfies its customers or not, and that is why the profits earned by utilities are inevitably a matter of controversy. We therefore suggest that the ordering be reversed. The customer corporation is one whose primary objective is to produce services of the quality demanded by its customers at

the lowest possible prices. But since it will operate in a competitive capital market, it will be obliged to consider the interests of investors in doing so. It is important to understand that putting customers first is the natural instinct of the vast majority of managers of privatised utilities. Few of them leap out of bed looking forward to the prospect of another day enhancing shareholder value; but the motivation to do a good job for customers is generally extremely strong. Many such managers will volunteer that the opportunity to give priority to customer interests, with greater freedom from union influence and political restriction, has been the principal benefit of privatisation.

It is an extraordinary feature of current arrangements that, far from encouraging this emphasis on the consumer, the structure invites managers of utilities to fight against it. It encourages, even requires, that they pursue shareholder value, with the regulator as customer advocate, in the essentially adversarial relationship between companies and regulator described above. It presupposes a priority of shareholder interests which would not necessarily be defended even by the shareholders of these companies themselves. If we truly believed that a water company put the interests of its shareholders ahead of its customers, we would prefer not to have to drink their water. The companies often do not behave as the model would have them behave, but why do we encourage this futile tension in the first place? The customer corporation leaves managers free to do what they mostly want to do and what we want them to do. It removes an apparent divergence of interest between companies and the public which is quite unnecessary and which has created much of the discontent with the performance of privatisation and regulation.

In advocating customer corporations, I emphatically do not propose either that management should be elected by customers or that customers should 'own' the business. It is essential that these firms are run by teams with common interests, values and identity. Although Yorkshire Water's response was heavy-handed and inept, the election to the Board of Diana Scott (the vocal chair of the company's Customer Service Committee who subsequently sought election to the Board) would not have served the best long-term interests of that company's customers. If the

board of a company is not united in purpose and objective, it rarely functions effectively, and the practical consequence is that substantive decisions are made outside it. The customer interest is likely to be better served by professional managers committed to that interest, and accountable for it, than by representatives of consumers (who are, in the main, rendered unrepresentative by their very willingness to undertake the task). We should learn from the competitive failure of the co-operative movement. Much of the problem was that customers were not, in fact, interested in exercising control, which reverted to employees and politicans. The present method of Board selection and election of public companies generally is considerably less than ideal, but it functions tolerably well in practice, and thre is no urgent need to change it. The Board of a customer corporation should however, be encouraged to be widely representative of the community in which it operates (such a requirement should be part of the customer corporation statute). The following activities are some of those which would be appropriate for customer corporations:

- Water and sewerage services
- Electricity distribution
- The National Grid
- British Gas Transco
- Airport non-trading functions
- Railtrack
- The Post Office
- British Telecom Network Services
- The BBC

There is no reason why a customer corporation could not be owned by a plc. And given the current starting point we visualise that most customer corporations would; Eastern electricity Customer Corporation might be wholly 'owned' by Hanson plc or by Eastern Group plc. 'Ownership' would, however, only relate to the securities of the customer corporation concerned. The plc would not 'own' the assets or revenue streams of the customer corporation and would not be able to use these as security for its own borrowings. The customer corporation would not be permitted to undertake any activities other than those

prescribed in its licence. This would imply ring fencing the monopoly utility activities of the customer corporation, and any transactions between the customer corporation and its plc parent would be the subject of specific regulatory approval. Arrangements of this kind already exist in the water industry, but would need to be introduced into other utilities.

The Financial Structure of a Customer Corporation

I expect to be told that no one would invest in a customer corporation, and certainly at first sight it would seem that a move to order interests of customers ahead of shareholders would make it more difficult to raise money from shareholders. This view is superficial. Customer corporations would certainly attract investment, and because of their low risk character it is likely that they would do so more cheaply than do privatised utilities under the current system of regulation. Uncertainty about the earnings streams of activities such as water and electricity distribution arises from two main sources. One is the possibility of divergence between the regulator's efficiency target and the actual outcome. The other is uncertainty about the evolution of the regulatory regime itself. If these sources of uncertainty were removed or reduced - as would be true for a customer corporation - than the cost of capital would be reduced correspondingly.

What does this mean in practice for the capital structure? A customer corporation could be expected to carry considerably more debt in its balance sheet than do the existing utility plcs. The debt of these companies might be provided by the parent plc or raised directly by the customer corporation. The equity of customer corporations might take two forms: indexed preferred stock (IPS), and ordinary shares. IPS would carry a dividend coupon linked to the Retail Price Index, and would have priority over the payment of any ordinary dividend and the holders would acquire voting rights over the company if dividends were not paid on the due date. The ordinary securities might be directly held by individuals and institutions, or wholly owned by a plc whose shares were in turn owned by individuals and institutions. In either case, the ordinary shareholders would enjoy the usual voting rights attached to such shares and would be entitled to

a stream of dividends.

How would dividends be determined? One possibility is that the ordinary shares might themselves have indexed dividends. The attraction of this is that it is simple and minimises the need for regulatory oversight. The weakness is that ordinary shareholders have little incentive to take an interest in the company's efficiency. An alternative is that the directors might set dividends by reference to what they consider prudent; this is exactly how dividend policies of plcs are determined today. The interests of customers would be protected by the statutory obligations of the company and the ultimate ability of the regulator or of the customers themselves to seek legal enforcement of them. The interests of shareholders would be protected by the company's need to secure continued access to the capital markets.

Regulating the Customer Corporation

The essence of these proposals is that many of the duties of the regulator are taken over by the board of the customer corporation itself. The intention is to replace a regime based on a battle between managers representing shareholders and a regulator representing customers with one in which a customer-oriented management makes the trade-offs for itself. There are overwhelming advantages from a shift from a relationship between regulator and regulatee which is fundamentally adversarial to one in which both parties are pursuing broadly similar objectives. The result would be a much more light-handed system of regulation than we currently have. The regulator would publish information on the comparative performance of firms, police the ring fence between the customer corporation and the owners of its securities, and provide an important buffer between political influence and operational management of utilities.

Conclusions

On balance, the credit ledger of privatisation far exceeds the debits. The task for the next decade is to find a structure which preserves these gains while meeting the criticisms which are fairly levelled at the existing arrangements. I have argued that

the key to this is to move to a structure which entrenches clear priority for consumer interests in monopoly utilities while maintaining and in general enhancing the freedom of operational management which has been the most valuable product of the last decade of privatisation and regulation. The customer corporation is a vehicle for achieving that. It recognises fully the consumer interest, while minimising the need for politicians and regulator to second guess what are best taken as managerial decisions. It is less novel than it sounds. It is, in reality, a modernisation of the statutory water company framework, which was by no means unsuccessful in Britain for over a century; the companies were, on average, more efficient than their public sector counterparts but suffered none of the problems of legitimacy which have dogged their privatised successors. There are other historical and institutional parallels. Indeed, one of the attractions of the customer corporation framework is its relevance to schools, hospitals and other state activities for which full privatisation is inconceivable but a dilution of unproductive structures of political and bureaucratic control essential.

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