The Water Industry: Why It Should Adopt the Mutual Society Model

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There is widespread discontent with the performance of regulation in the water industry following privatisation. In an article in the September *Journal*, John Kay proposed a solution in the form of new public interest companies with statutory obligations. I shall argue that this solution is not adequate to the task and Kay was wrong to reject a more radical reform, namely mutualisation.

In his article, Kay drew attention to the low initial sale price of water companies and the subsequent super-normal returns for shareholders and he identified two problems that still beset the industry. The first is that there are only implicit and very weak mechanisms for securing a good share of on-going efficiency gains for customers. The second, and related, problem is that, in the public mind, the system lacks legitimacy. The public persists in regarding water as an essential public service. A system that encourages managers to believe that water companies are capital market vehicles to be manipulated to maximise shareholder value, and opposes that viewpoint only with a regulator supposed to defend the consumer interest, will never achieve acceptability. The problems of asymmetric information and regulatory capture are obvious and endemic. The present system dooms the industry to an adversarial relationship between companies and regulator. Both sides will play games, the companies to protect profits and the regulator to protect his political position.

Ultimately, this is not a good situation even for the companies. The great gain from privatisation was to give managers freedom to manage without unnecessary bureaucracy or political interference. But company success now always looks like regulatory failure and sets up political pressures. Political feedback then creates perverse incentives.

That is John Kay's diagnosis of the situation. He points out that the current situation is supposed to incentivize shareholders and, through them, managers. Normally that is appropriate; in

a competitive product market it is possible to serve shareholder interests only by serving consumer interests. There is no necessary conflict between the two. In a monopoly, of course, that is not so. There is a potential conflict of interest. Despite the ingenuity of the government and regulator, over ninety per cent of water will continue to be supplied under monopoly conditions.

Now, given a potential conflict of interest, water companies are not in a position to exploit shareholders since they face a competitive capital market. They have to make and pay adequate returns if they are to attract new capital, be it equity or debt. They can, however, take advantage of consumers. Ideally, therefore, managers should be incentivized to serve the consumer interest. They can only do so if the company stays solvent, invests and is able to attract funds to do so. Given the structures of the markets, the shareholder interest will look after itself in a way that the consumer interest cannot.

Having seen that clearly, and argued it cogently, John Kay proposes the following solution. He wants to define a new kind of company, the customer corporation, subject to a statutory duty to provide customers with what they need at the best price and quality possible. He believes that is what managers want to do anyway and, given that statutory obligation, the present system of appointing boards would be serviceable. Directors would have to balance the statutory duty with the traditional duty to look after shareholder interests but nothing else need change.

His customer corporation could be owned by an ordinary plc but its accounts, balance sheet and cash flow would be ring-fenced. It could only undertake activities covered by its licence. The regulator would, Kay assumes, have much less to do but one duty would be to police the ring fence and to ensure that plcs were not appropriating the customer corporation's assets or revenue stream.

Kay does not think consumer ownership or representation on boards is a good idea. The only arguments he adduces against these things, however, is the risk of boards divided among themselves and the competitive failure of co-operative retail and wholesale societies in the UK.

In my opinion, Kay runs a great race but stumbles at the last fence. He wants managers to believe it is their primary job to serve the customers but there is nothing in the governance

structure of the public interest company he proposes to encourage that. He is trusting to a cultural hang-over from nationalisation when water utility managers regarded themselves as public servants. It seems a frail reed to lean on so strongly. On the other hand, managers would behave as he wants if the governance structure of the company reflected his priority, if, in other words, the board was ultimately responsible to the consumer. John Kay resists this conclusion out of a general wish to de-emphasise the importance of shareholders. All companies, he believes, are a coalition of interests in which managers have to balance the interests of different stakeholders. He believes that a supposed management wish, in the water industry, to think more about customers is being thwarted by the excessive power of one stakeholder, namely the shareholder. He wants to counter that but has no wish to buttress what he sees as the false doctrine of shareholder primacy by protecting consumers through the device of making them shareholders.

However, if we are not fighting a shareholder versus stakeholder battle on a wide front but are concerned merely with the good governance of the water industry, mutualisation or the creation of consumer co-ops is the obvious solution. This would resolve the inappropriate incentives in the current structure and reduce the importance of the regulator without opening the door to increased political interference and all the consequences of government failure.

Despite Kay's reference to the failure of wholesale and retail co-ops, the empirical evidence is not against mutualisation. The governance structure of retail co-ops was complicated, politicised and slow-moving but that is not inevitable. Building society boards work much more like those of plcs, and on most measures of efficiency, mutuals have outperformed plcs in the UK financial sector. Over the past ten years, the ten cheapest lenders in the financial sector have all been mutual building societies. Bank of England data show savers have enjoyed higher returns in building societies than in banks for similar term deposits and borrowers have, on average, borrowed more cheaply from building societies. Yet no such society has ever gone bust and no depositor has ever lost money. The current fashion for demutualisation in the sector has more to do with the benefits that current members and management can obtain at the expense of potential future members than with considerations of

efficiency.

The United States also provides an interesting comparison since its electricity utilities include plcs, publicly-owned companies and consumer co-operatives. Some 60 studies have been carried out comparing the different forms in terms of costs and returns, measures of static efficiency, and rates of innovation. In a survey of all this work, Lon L Peters found there was no significant difference in the efficiency of plcs and co-ops. Of the 60 studies, 25 found plcs better in someway, 19 found non-plcs better in some way and 16 found no difference. Findings that one or other type of company was better were generally not robust to small changes in method.

The evidence seems to be that we can switch the incentives that managers face, to the general advantage, without suffering any necessary loss of efficiency. Yet the common objection that mutuals or consumer co-operatives are somehow less efficient than plcs is based less on evidence than theoretical arguments. The following propositions are typical:

- if customers get equal shares in the mutual (one member one vote), all shareholders are "small" and the absence of large shareholders weakens practical accountability;
- it may not be worth the while of any shareholder or member to exercise control, given the costs of doing so and the limited benefits;
- there is no real market in company control and so no take-over threat.

However, none of those arguments is particularly strong. Members can appoint a company senate or remuneration committee to set the incentives for managers and these can be as strong as they like in terms of bonuses for meeting performance criteria. Other management teams can offer themselves to members and bid for a franchise to run the company, promising better performance or accepting weaker incentives. Large customers may only have one vote but their commercial exposure to the water company should give them an adequate incentive to lead and organise consumer representation in order to maintain accountability. Representatives of smaller consumers would surely become active if it appeared the larger members were taking advantage of them. Since no-one would have the

ability to "exit" - everyone needs water - the right to "voice" would be exercised.

While there are theoretical problems in the principal/agent relationship of members of a mutual and its management, the same is true of a plc - recall the many recent debates about corporate governance to which Kay is a distinguished contributor. If anything, economic theory tends to support the view that the mutual form is likely to lead to more socially efficient outcomes where there is monopoly. Oliver Hart and John Moore analysed the case of a stock exchange and asked whether it should be owned by its members or by an outside capitalist. The structure of their argument applies to other forms of enterprise too - they also apply it to a golf club. They find that, so long as all customers are treated similarly (eg all customers are charged the same price), outside ownership becomes more efficient in allocating resources, relative to a mutual structure, as the market becomes more competitive. When there is monopoly, the mutual structure is likely to be better.

In the case of water, so long as the consumer interest was clearly predominant, it would not be necessary to go all the way to full mutuality. A consumer majority holding that left some shares in individual or institutional hands would do. The private shares would fetch a lower price since they could never confer control of the company. Pure equity would therefore be somewhat more expensive for the quasi-mutual water company, but that would simply incline it to raise more of necessary capital by issuance of preference shares or debt. Since the water business is a very low-risk, stable and mature business it is appropriate for companies to carry more long-term debt than they typically now do. US electricity co-ops are 100 per cent debt financed.

Private holdings would enable plc companies to continue to hold shares in water companies but, in that case, separate accounts and balance sheets would be obligatory just as in the case of Kay's public interest corporation. Another common advantage would be a considerable reduction in the scope of regulation. Price control would not be required. The regulator would merely police the operation of the quasi-mutuals, their relationship with any plc shareholders, and publish comparative data on the performance of different companies. However, I believe a structure of the type I propose would more surely resolve the current problem that customers do not stand to gain

from efficiency gains and would improve the distribution of benefits between customers and shareholders.

Mutualisation could be brought about gradually if water companies used cash flow to repurchase their own shares, which could then be placed in trust for consumers. Given the difference in return on debentures and water company shares, it would be appropriate to issue debt for share repurchase - a leveraged buy-out on behalf of customers. Over time a rising proportion of the company would be owned by the consumers. Dividends accruing to shares in the trust would be paid out to consumers annually as a rebate on water bills. Consumers would be encouraged to develop representative structures so that they could vote the block of shares. There is no obvious reason why companies should do this voluntarily so the government should apply fiscal incentives or penalties to set the ball rolling.

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References

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