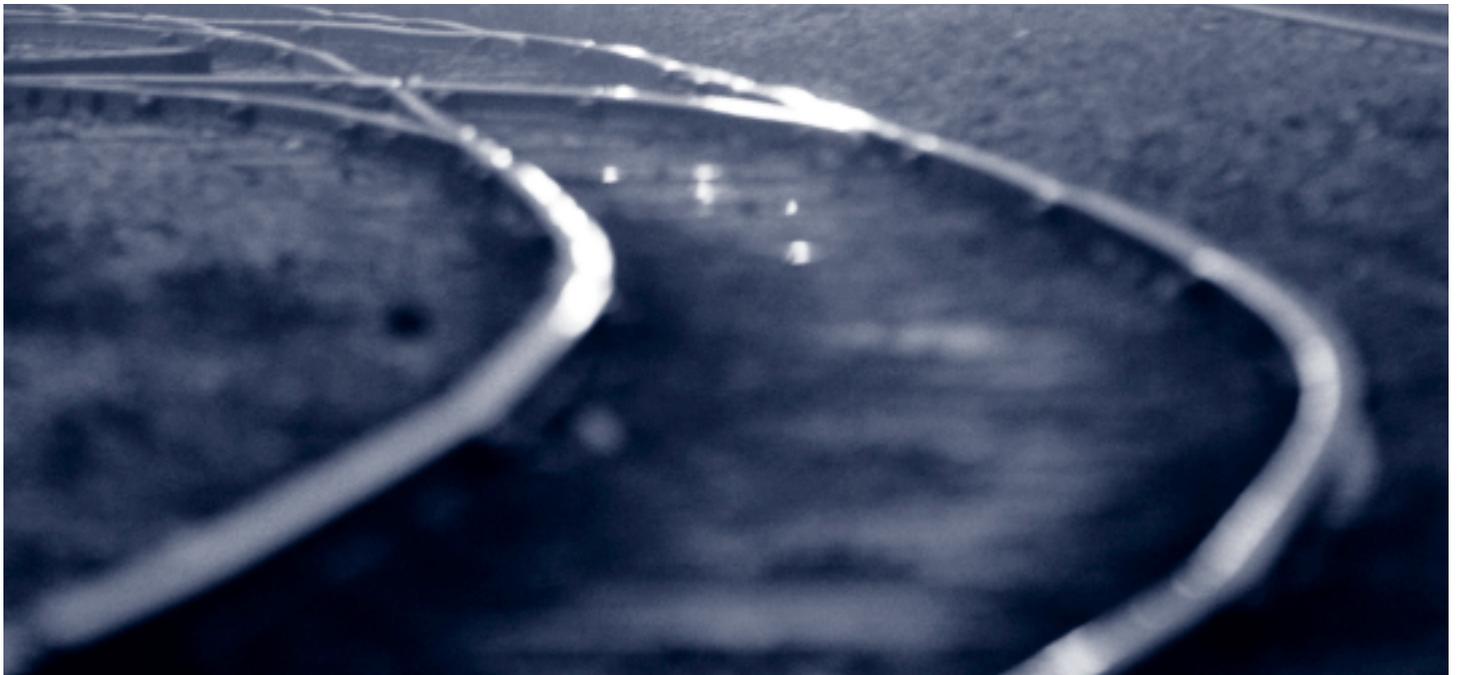


# A Mutual Trend: How to run rail and water in the public interest

by Johnston Birchall

The mutual state in action 1



## About the author

Johnston Birchall is a Senior Lecturer in Social Policy at Stirling University and a Senior Associate of the New Economics Foundation. He is currently running a three-year research project into what motivates public service users and co-operative members to participate (ESRC-funded, with Richard Simmons), and writing a book on *The Sociology of Co-operation*. Some relevant publications include *Building Communities, the Co-operative Way* (1988, Routledge); *Co-op: the People's Business* (1994, Manchester University Press), *The International Co-operative Movement* (1997, MUP), *Decentralising Public Service Management* (with C Pollitt, 1988, Macmillan), and *The New Mutualism in Public Policy* (edited, 2001, Routledge).

## The mutual state in action 1

*A Mutual Trend: How to run rail and water in the public interest* is the first in a series of publications which will build on and develop the ideas presented in *The Mutual State* – the report of a collaborative programme by the New Economics and Mutuo which invited contributions from a broad range of organisations to explore the potential for the mutualisation of public services. The Mutual State aims to put the public back into public services. Through user participation, accountability to the local community or recasting public services as self-governing social enterprises, a new mutuality could refresh and reinvigorate our public services.

## Contents

1	Summary	17	The costs and benefits of membership
2	Introduction	19	Arguments against excluding shareholders from ownership
4	From private to public and back again: the ownership of natural monopolies	20	What motivates people to become active members?
6	Has privatisation failed?	25	Who should own the water industry?
7	Has regulation failed?	26	How should Network Rail be organised?
10	From privatisation to mutualisation?	27	Other developments
11	What form should 'mutualisation' take?	28	Conclusion
16	Two-stage governance structures		



# Summary



Recently, a lively debate has begun about alternative models for the ownership of industries that are currently in either the public or for-profit private sectors. A ‘public interest company’ form has been suggested for the water industry, rail network and local education authority,<sup>1</sup> and for the London Underground and health trusts.<sup>2</sup> Social enterprises have been suggested as a way of running public services,<sup>3</sup> tackling social exclusion and modernising local government.<sup>4</sup> The authors of a New Economics Foundation report advise that:

*It is worth approaching the debate from the point of view of looking at the desired goals and outcomes in particular industries for customers and for the wider public interest, and then considering what mix of organisational forms would best achieve these.<sup>5</sup>*

That is what this report does in relation to the water industry and rail transport. It begins by looking at how the ownership of natural monopolies has evolved over time, with its move from private forms to public and back to private again, and with a continuing search for ways of regulating private interests so that they serve public purposes. Then it examines the record of the privatised water and rail industries and finds that they have failed to deliver what they promised. It finds that regulation has also failed because it is inherently unstable; either the interests of consumers and other key stakeholders are sacrificed or the profitability of the company is undermined.

The report then shows how opportunities have arisen for a new form of organisation to own water and rail track assets that would put the customers and the wider public interest back into the centre of the business. It analyses in some depth the various elements that would go into the design of a new utility mutual or non-profit, finding that there are three key elements: membership, ownership rights and representation. It defines the difference between non-profits and mutuals in terms of whether the organisation gives individuals ownership rights to governance and the financial surplus. Working through the theoretical permutations of the three elements, it finds five types of organisation: a non-member non-profit, a single stakeholder non-profit, multi-stakeholder non-profit, single stakeholder mutual and multi-stakeholder mutual. It then subjects these to various tests:

- Will the costs of member participation exceed the benefits?
- What are the consequences for risk and capital-raising from taking investor-owners out of the business?
- Would consumer members be motivated to participate over time?
- Could the organisation be captured by an interest group or by its managers?

Four key questions are asked of what sort of organisation should take over water and rail infrastructures:

- Should there be a genuine membership?
- If so, which stakeholder group or groups should be members?
- Should they be given full ownership rights (a mutual rather than a non-profit) or just the right to take part in governance?
- If a multi-stakeholder option is chosen, how will the rights of each stakeholder be determined?

The recommendations in relation to water are:

- Water companies that want to sell their assets should be given a clear lead by OFWAT as to what sort of successor organisation is acceptable. This should be along the lines of a multi-stakeholder non-profit.
- The new companies should be designed by a working group made up of representatives of the key stakeholders (including consumers) and endorsed by OFWAT.
- They should consider the merits of having a two-tier structure of a management board and a stakeholder council.<sup>6</sup>
- The constitution of the new companies should include direct election of consumer representatives by customers. At first, the consumer board members should be appointed by the OFWAT National Customer Council, but as soon as is practical board members elected by the members in a postal ballot should replace them.
- The new National Consumer Council for water should be a more participatory form of organisation than its predecessor. It should have a regional structure, with each regional water company setting up a consumer council that is directly elected by residential and business customers in a postal ballot, and that has reserved places on the board.

The recommendations in relation to the governance of a new model for Railtrack (or the proposed Network Rail) are:

- The assets of Railtrack should be transferred to a new company, set up as a multi-stakeholder non-profit.
- The new company should be designed by a working group made up of representatives of the key stakeholders, and endorsed by the Rail Regulator.
- Key stakeholders should include the train operating companies, the workforce trade unions, the government, and consumer representatives.
- Again, it should consider not having a unitary board but a two-tier structure of a management board and a stakeholder council.
- The constitution of the new company should include direct election of consumer representatives by customers. At first, the boards should be appointed from existing national and regional chairs of the Rail Passengers Council but, as soon as is practical, board members elected by the members in a postal ballot should replace them.
- The Rail Passengers Council and its regional committees should become democratically elected bodies, with a membership of regular travellers and local voluntary rail groups. It should be charged with developing a membership strategy to achieve this, and then to sustain members' interest. It would then elect consumer members of the board of Network Rail.

In addition to these, there are recommendations about how the National Air Traffic Control System and the Train Operating Companies could be opened up to consumer stakeholding through the issue of shares in a consumer mutual. In particular, like football supporters, regular travellers could buy shares in the companies and dedicate the resulting governance rights to a passenger trust. This would give them direct access to and, over time, some control over, the way that train services are provided.

The conclusion suggests that there is a need to:

- design governance structures and member relations' strategies that work and are sustainable over time.
- design new forms of multi-stakeholder governance structures so as to bring more than one stakeholder into the business.
- recognise that members may benefit just as much from the more diffuse ownership structure of a non-profit as from a mutual.



How do we harness private interests for public purposes? This is one of the big questions faced by British society over the last 250 years – ever since the industrial revolution began forcing people off the land and into the cities, out of their workshops and into the factories – making us face up to the complexities and dangers of modernity. First the question was resolved in favour of private interests, then public, then in the 1980s back to private again. It has not yet been satisfactorily resolved and it is the purpose of this paper to suggest another way of resolving it, that puts the consumers or users of services at the centre of the business.

There are strong arguments in favour of letting the private sector get on with providing services, with as little interference from government as possible. When Adam Smith wrote: 'It is not from the benevolence of the butcher, the brewer or the baker that we expect our dinner, but from their regard to their own interest',<sup>7</sup> he was setting up the most persuasive argument yet invented for preferring market exchange to other ways of meeting human needs. What Smith was saying was that we live in a complex society where the division of labour has been taken so far that we cannot hope to produce all we need to live on independently of others. We need 'the co-operation and assistance of great multitudes', but we cannot rely only on altruism; we have to appeal to people's self-interest if we are to survive. The main way to ensure that people meet each other's needs is to let them exchange goods and services in a free market. All that state regulation does is to distort prices and, in the long run, make everyone worse off.

When, in the 1980s and 1990s, the Conservative government sold off most of the public utilities – gas, electricity, telecommunications, railways, water and so on – to the private sector, they justified their actions by appealing to arguments that, at their core, derive directly from Adam Smith's 'invisible hand'. It is important, then, to prise open his argument to see if there is any room for an alternative interpretation. There are two important leverage points. First, Smith qualified his viewpoint when he said: 'It is by treaty, by barter and by purchase that we obtain from one another the *greater part* of those mutual good offices which we stand in need of.'<sup>8</sup> There are some goods and services – the *lesser part* – that are not so easily obtained in a market. For instance, Smith recommended that: 'Good roads, canals and navigable rivers ... are the greatest of all improvements' in breaking

up monopolies and enabling markets to expand, and he commended the Turnpike Trusts that at the time were beginning to lay out a national road network.<sup>9</sup> These were private trusts, but they were virtually what we would call 'non-profits' (raising money by fixed interest bonds), having their maximum toll prices regulated by Acts of Parliament. After their job of improvement was done, their time expired and the roads became free again. This kind of public-private partnership lasted until the late nineteenth century, by which time local government had developed the capacity to deliver such goods itself.

There are two types of public good. One type – such as public parks or clean air – is indivisible and non-excludable, meaning it cannot be divided between users and they cannot be prevented from using it. This means it cannot easily be charged for. If the market cannot charge for something it has to be provided free and so, unless the state intervenes and provides through tax revenue, it will be under-provided. The second type is a natural monopoly, such as water, roads or rail transport. It has the characteristic that it requires a large investment in the means of delivering the good (water and sewage pipes, rail track), but once it has been provided the owner can then charge a monopoly price. The costs of entry to that market are so high that nobody can afford to compete. In such a situation, only government regulation or a public buyout can protect the consumer.

The second point to be made about Smith's argument is that there is more than one way of organising 'self-interest'. It would be anachronistic to assume that his argument applies without qualification to the dominant modern form of trading – the joint stock company – when at the time he was writing (1776) this had still to be invented.<sup>10</sup> In fact, around that time an entirely different form of business was being developed, one that put the consumer rather than the investor of capital at its centre.

While being generally in favour of free markets, Smith had also realised that, at every opportunity, dealers would form cartels, fix prices and exact excess profits that he called a 'tax' on the public. This is what happened in the corn milling and baking industries and, in the 1760s, dockyard workers at Woolwich and Chatham decided to buy their own corn mills and begin baking bread for themselves. They started a consumer co-operative movement that would, after some trials and errors, become a major force in British retailing that, at

its peak, in the 1950s, would capture around 11 per cent of the entire retail trade. Again, at around the same time as Smith was writing, people began to set up friendly societies that offered them some insurance against the financial consequences of illness and death. By 1910 these societies were insuring the majority of the male working class population. They became a kind of embryonic 'welfare state' (not so fanciful a description, since, when the state first began compulsory social insurance, it was heavily reliant on the friendly societies to deliver it). Also around the time that Smith was writing his book, the first building societies were founded. By the end of the nineteenth century these had become the main means by which people saved and financed the buying of a home. Together, these mutual sectors have the common characteristic that they offer membership rights and return dividends to the consumer rather than the investor in the business. Their strategy has always been, explicitly, to find a mechanism by which people on low to moderate incomes can increase their power in the market by working together. They do not rely on altruism, but appeal directly to people's self-interest, expressed in a collective form.

Right from the beginning of the industrial revolution there has therefore been a third alternative to either for-profit investor ownership or public ownership. Its growth, in several directions and with more or less vigour, can be plotted in every country that industrialised after Britain, including most of Europe, Russia, Japan and the USA.<sup>11</sup> It is an alternative way of doing business that may have something to offer when we come to the question of who should own and control natural monopolies such as water and transport.

## From private to public and back again: the ownership of natural monopolies

### The Skye Bridge affair

In 1995 a bridge was completed, linking the island of Skye to the Scottish mainland. It was the first of the public-private partnerships that are now being used by the UK government to finance new hospitals, schools, roads and prisons. Like the Turnpike Trusts of old, it attempts to harness private interests to public purposes. Accurate figures are difficult to obtain, but one account says the bridge cost £25m to build, plus government subsidies of £16m, and that if the toll lasts for the maximum 27 years the investors will extract £88m from the deal.<sup>12</sup> Like the Turnpike Trusts, the bank that owns it pays a toll-collector a fixed annual rate, though at £770,000 a year this dwarfs the earnings a nineteenth century toll booth would bring in (and, unlike the turnpikes, the job is not put out annually to auction).

As soon as the bridge was opened it became a 'natural monopoly'; the ferry service to the island was discontinued. Local people have never got used to the idea that the Bank of America should control access to their island home (though, like the turnpikes, the tolls are capped by government, and the owner receives a subsidy to keep prices down for regular users). They have campaigned for a free crossing ever since. While their protests have been more good-natured and non-violent than those made against the turnpikes, the government's decision to treat those who refuse to pay the tolls under criminal rather than civil law is reminiscent of that time (though the protestors of 200 years ago faced the death penalty for destroying a toll gate). However, the government has refused to buy out the private interest because it would be too expensive. The old Turnpike Trusts had to apply for an annual extension to their licence after 21 years; here, the tolls will be ended some time between 14 and 27 years, but it is unclear on what criteria the Scottish Office will make the decision.

In the early stages of the industrial revolution, private interests provided all natural, monopoly-type activities. There were few public bodies and the ones that existed – magistrates, local poor law commissioners, and boards of health – were fragmented and lacked credibility. The companies needed some public sanction for their activities, such as to obtain limited liability. In order to have the power to compulsorily purchase land (crucial for canals and railways), an Act of Parliament was necessary. Water companies needed local government's sanction to operate in a particular area and there was 'political infighting of a squalid and expensive kind'<sup>13</sup> about who would get hold of the monopoly. In contrast to the earlier burst of activity of the turnpike trusts, there was no attempt by government to regulate prices (though eventually the railways were subject to statutory limits on ticket prices). There were fines for dangerous behaviour such as drawing water from a polluted source, but generally regulation was not so much light as non-existent. On the canals and railways, one result was a damaging lack of co-ordination; eight different gauges of railway track, narrow and wide beam barge widths on the canals, led to loss of profits all round. It was not long before companies in both sectors ran into financial trouble. The water companies failed to deliver to any but the wealthier areas. In 1844 the Commissioners on the State of Large Towns said 'all stop short of ... carrying supplies ... into the habitations of the poorer consumers'. After the Sanitary Act of 1866, the authorities were supposed to ensure that water was provided, but by 1885 another Commission, on the Housing of the Working Classes, showed there had been little change. The companies charged for water at a yearly rate. By the time it reached the poor it was charged by the jugful. The common people of the cities were reliant on standpipes, wells and water butts until local authorities started supplying water towards the end of the nineteenth century.<sup>14</sup>

What happened in Birmingham was typical. The Birmingham Water Works Company had been founded in 1826 and was not badly run, but its coverage was still inadequate; the poor were still dependent on water from wells.<sup>15</sup> Joseph Chamberlain argued for municipalisation, declaring:

*All regulated monopolies, sustained by the state, in the interests of the inhabitants generally, should be controlled by the representatives of the people, and not left in the hands of private speculators.<sup>16</sup>*

## From private to public and back again: the ownership of natural monopolies

He argued that all profit should go towards a reduction in the price of water, and, most dramatically: 'The power of life and death should not be left in private hands'. In 1875 his Bill passed through Parliament. Within eight years, more than 3000 wells, used by 60,000 people, were condemned as dangerously contaminated. The death rate fell from 25.2 per thousand in 1871-5 to 20.7 in 1880-5. The public takeover of the industry was unstoppable; by 1913 local authorities provided 80 per cent of the water supply.

In 1974, local government was reorganised and central government took water out of their control; creating 10 regional water authorities in England and Wales and three in Scotland, each covering a river basin area. Though local accountability was lost, these regional bodies made considerable efficiency gains; the English and Welsh ones had, by 1989, reduced the number of employees from 80,000 to 50,000. In 1990, the 10 regional bodies in England and Wales were privatised (joining 29 much smaller water-only companies that had always been private). They were given ownership of the infrastructure, and 25-year monopolies. Protected for five years from takeover, half are now owned by multi-nationals, only one of which is a water company, the rest being energy companies keen to diversify into the water industry.

The historical trajectory of the railways was similar, but with public takeover being achieved much later – not until 1948. Calls for the nationalisation of the railways began early on, but were unsuccessful until, after their virtual takeover by the state and the exhaustion of the infrastructure brought about by the Second World War, in 1948 the Labour Government created British Rail. By then, such was the clamour for public ownership that an interesting suggestion by the North Eastern Railway Company that the government nationalise the infrastructure while franchising out the lines to the four big railway companies, met with little sympathy. Over the next thirty years, British Rail gained a reputation for needing ever-larger subsidies and for over-manning and inflexible work practices (though the main cause of its decline was competition from growing car ownership and the new motorways). It was an instant target for the radical Conservative government of the 1980s, and by 1984 British Transport Hotels and the Sealink fleet had been sold off. In 1996 the rail infrastructure was sold to Railtrack, and passenger franchises began to be let to train operating companies.

### **A call for the nationalisation of the railways**

F Keddell, writing in 1887:

'The monopoly was granted under the middle-class sophism that it would always be to the interests of the railway companies to serve the community well, in as much as their profits would increase if they did their work well, and would decrease if they did it badly. But being companies started with the main object of making profit, they have steadily kept that aim in view, and have constantly neglected the interests of the community as much as they dared.

The greatest ingenuity is shown by railway managers in their efforts to keep up high dividends, especially in times of crisis and depression. This national concern is run for profit and not for use, and every nerve is strained to show the most profit, even when the means adopted are such as to prejudice future interests ... to give a show of prosperity they will starve the permanent way, and will keep down necessary expenses to a dangerously low level ... In practice the companies have used their monopoly, as all monopolies have been used, namely for their own benefit.'<sup>17</sup>

# Has privatisation failed?



In the space of a hundred years in the case of water, fifty years in the case of railways, natural monopolies have gone from private to public and back to private again. What has been lost and what gained through this re-privatisation? It could be argued that the disadvantages of private, for-profit monopolies – the costs of regulation, the exploitation of consumers – can be justified if they can demonstrate that they are more efficient and effective than any other way of delivering the service, or if they are able to raise capital more easily to upgrade the infrastructure without being restricted by public sector borrowing requirements. Certainly, these were the kinds of arguments used by the Conservative government in the run up to privatisation.<sup>18</sup> However, the means to greater efficiency was increased competition, and it was generally accepted that this could not apply in the water and rail industries in the way that it could in telecoms, electricity and gas. The difficulty of sharing the delivery system – water pipes, rail tracks – between competing companies was beyond their means (though it is a problem that might be solved eventually in the water industry).

The record of the water companies on efficiency savings is patchy. They were set a difficult task because the previous public corporations had themselves made significant efficiency gains. At first, they out-performed OFWAT's expectations, but then they were allowed to set up these expectations in the first place. It was in their interests to minimise the efficiency savings they might make in order to secure a high price cap. Then, it was in their interest to make greater than expected efficiency savings, with the resulting cash surplus used to boost profits.

Leakage targets for water distribution were not set until after the 1995 drought. Since then leakage has fallen from 31 per cent to 22 per cent of the supply, though, like all efficiency measures, this relies on the companies' own figures. There was little improvement on sewer flooding and water quality and little concern shown for improving the quality of water in sites of special scientific interest. Eight out of ten of the companies have been prosecuted for a total of 22 pollution offences. There was little attention paid to the capacity of the industry to supply water, until the disastrous supply failure of the summer of 1995 when Yorkshire consumers had to queue up at road tankers for their water.

Efficiency is only one important criterion. Another is the extent to which the companies guarantee to provide water to the poor. In the first five years after privatisation, the number of disconnections for non-payment tripled. The alternative to disconnection that they developed – pre-payment meters – amounted to a hidden disconnection when people could not afford to pay for the payment cards. In the 1998 Water Act, these practices were made illegal.

On the capital side, the initial expectations were that large amounts of money would be raised to meet the industry's obligations to the European Union; an estimate of £28 billion was made. One economist found that: 'Capital expenditure started accelerating before privatisation, rose to a peak in 1991-2, and then levelled off and even fell, although the companies had projected that it would continue to rise at the same rate.'<sup>19</sup> This meant that, by under performing against the regulator's expectations, this was another way they could make a surplus to boost profits. Again, after the 1994 price review, a number of companies revised their capital expenditure plans downwards, but the resulting savings were not used to cut prices. OFWAT was satisfied, but a Parliamentary Committee was severely critical of the lack of improvement, particularly in the underground network.<sup>20</sup> On one estimate, sewers are expected by the companies to last for an average of 280 years.<sup>21</sup> It will take over a hundred years to reline or replace water mains, and several centuries to renew the sewers. On another estimate, over the first six years the companies should have spent 6-12 per cent of their infrastructure asset values on renewals, but they actually spent only 1.5 per cent.<sup>22</sup> They displayed a short-termism that boosted profits but was actually running down the asset base. Even worse, because of their diversification into other businesses that did not perform well, some of the water companies began to get into debt and their parent companies have had to provide them with loans (thus finding another way to make money out of water).

Railtrack is an even starker example of a privatised company whose management has been worse than that of its public predecessor, even though the shortcomings of British Rail are generally acknowledged. There are at least two distinct causes for Railtrack's failure. The first was the way in which the railway system was fragmented at privatisation, leading to an adversarial and buck-passing relationship between Railtrack and the train

operating companies that did nothing to improve the reliability of the system. The second was the way in which Railtrack's management performed. It was weak on engineering skills, and overemphasised the financial aspect of the business at the expense of safety and reliability. It replaced skilled direct labour teams with a labyrinthine system of contracts and sub-contracts, changing the incentive structures so that co-operation was replaced by mutual suspicion and avoidance of responsibility. When it was discovered that a broken rail track at Hatfield had been known about for two years before the crash, a criminal investigation began. The consequences of the crash and its exposing of management weaknesses were huge financial losses, decline in the share price and, most crucial of all, a loss of credibility in the financial markets.

The railways had been privatised out of a belief that private management is always better than public, and that the private sector can be left to raise the funds needed for improvements to the system. Both beliefs had, within four years, been proved wrong. Railtrack's alternative was that, in order to retain the confidence of the market, the government should take a 15 per cent stake in the company. However, this would still leave private shareholders in control. There was an even more fundamental problem. When a private industry needs large amounts of state subsidy, yet needs to keep its shareholders satisfied, some of that subsidy is bound to leak out into dividends. In Railtrack's case, this was illustrated when in May 2001 it used £138 million of a £1.5 billion government grant to pay shareholders dividends, despite having made a £500m loss. The only way to avoid this 'leaky bucket' effect is to convert the company to some kind of non-profit ownership structure.

## Has regulation failed?



If private monopolies have failed, then who is to blame, the industry or the regulators? Is the task of regulating just too difficult? There is no avoiding the need for regulation of a private monopoly. Since it gives market power to one group – investors – who can then impose significant market contracting costs on another – the consumers – the only answer is price regulation by government on behalf of customers.<sup>23</sup> But the task is a difficult one. Price-based regulation involves calculating how much more efficient a company can become, and then dividing the costs and profits between customers and shareholders, weighing prices against quality. Designed to provide reasonable prices to consumers while preserving efficiency incentives for firms, it means estimating what costs ought to be, by comparing one company with another. The process imposes its own costs, both on government in comparing the performance of different utilities, and on the utilities in providing the information.

Some commentators believe that with a privatised monopoly the regulatory process is unworkable, as the relationship between the provider and the regulator is inherently antagonistic. As Holtham says of the water industry: 'The present system dooms the industry to an adversarial relationship between companies and regulator'.<sup>24</sup> There is permanent information asymmetry, because the regulator is dependent on the utility for comparative information needed for the setting of prices, targets for improvements, and so on. The provider has an incentive to hide or distort the information the regulator relies on. The rational response of companies is to maintain some inefficiency, so as to mitigate the effects of each price determination. On the other hand, a determined regulator can impose price cuts, can fine companies for poor performance, and set stringent targets. But where the industry needs continuing subsidies from government – in transport, but not in water or air traffic control – the threat to withdraw support can make the provider company unviable. The balance of power between provider and regulator depends as much on the political conditions of the time as on economic arguments.

Another way of putting this dilemma is in terms of claims on the added value generated by the industry. Economists who analysed the first five years of operation of the private companies, concluded that the regulator had sufficient powers, but that in practice it was impossible to

## Has regulation failed?

satisfy all the claims on the surplus without increasing prices. Conflicts between the claimants mean it is 'virtually impossible to regulate the water industry by any standards'.<sup>25</sup>

All of these points can be illustrated by the examples of water and Railtrack over the last few years. Take the water industry; in the mid 1990s it looked as if the water companies were winning. As Kay described the situation: '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'.<sup>26</sup> Then, when in 2000 the regulator imposed a severe price regime, the pendulum swung the other way and investors wanted to get out of ownership of water infrastructure altogether. In public transport, the initial regulatory regime was soft on Railtrack. However, with the election of a New Labour government in 1997 the mood changed, a new regulator was appointed who imposed record fines and made government funding dependent on stringent new targets.

In the rail industry, the task of regulation has been even more difficult. First, there has only been one provider of track and signal infrastructure, Railtrack, and so no comparisons can be made with similar companies; comparisons have had to rely on improvements relative to the previous performance of British Rail. Second, safety aspects of regulation were, until recently, the duty of a division within Railtrack rather than an independent regulator; in the light of several rail crashes this was simply a mistake. Third, unlike the water companies that deal directly with end-users, Railtrack's customers have been the train operating companies, and so there are two layers of regulation, one of the infrastructure provider, and another of the operators. Such a complex structure has required complex regulation, with the Rail regulator, the Strategic Rail Authority and the Health and Safety Executive, all involved in various ways.

The 'bottom line' in the case for regulation is that the regulator prevents the exploitation of the consumer. What evidence is there from water and Railtrack that the consumer has been protected? First, consider the water industry. Over the first ten-year period since privatisation, consumers experienced a doubling of water bills, while the companies made £16 billion in profit, of which £9.5 billion was transferred as dividends to their parent companies. The National Consumer Council estimates

that consumers overpaid by £6bn, around £300 each.<sup>27</sup> Shaoul estimates that the share of the value-added going to profits over the 11 year period was a staggering 51 per cent.<sup>28</sup> While customers might have thought they were paying for improvements, in the first ten years nearly the entire increase in their charges went towards operating profit.<sup>29</sup> Researchers from Greenwich University have calculated that pre-tax profits doubled in the first year of privatisation, and rose by 142 per cent in real terms in eight years, and that the profit margins in England and Wales are typically three or four times greater than in four other European countries.<sup>30</sup> In a seven-year period, the highest paid directors' pay increased by between 50 and 200 per cent. The privatised companies in England and Wales charge roughly twice as much as the public sector water companies in Scotland. It is not surprising that they have become deeply unpopular with consumers.

Kelda, the owner of Yorkshire Water, provides a graphic example of the failure of regulation to protect the consumer. The highest profits were made in the first few years; by 1994, shareholders had made an annual return of between 25 and 34 per cent in real terms, after paying income tax. In the first ten years, profits more than doubled, and the return on capital employed averaged 10 per cent.<sup>31</sup> Prices set by the regulator were more than enough to cover the cost of investment and a return to the investors; consumers had effectively funded both. Dividends to the parent company totalled £954m, more than double the £471m price paid for the shares at flotation in 1989.<sup>32</sup> As a result, there was a negative cash flow in the subsidiary company that had to be offset by increased debt.

Consider also the record of Railtrack. After privatisation, its flotation price of £3.80 soared to £15. For the next three years it made record profits, paying generous dividends, despite growing evidence of a lack of investment and poor management of the track. We have already noted how, having lost £534m after the Hatfield crash, it paid its shareholders the same dividend as the year before, effectively finding the money from the latest government grant.

There are ways in which the system can be reformed. For instance, there are too many regulators, and some rationalisation would help.<sup>33</sup> The technical capacity of regulators to set standards, to monitor performance, to use their powers of enforcement, could all be improved.<sup>34</sup>

Has regulation failed?

The amount of profit made can be restricted if the regulator adopts a 'rate of return' system, such as is practiced in the USA (and was used in Britain with private water-only companies before the regional water system was privatised). Under this system, the regulator calculates how much capital a company has invested, how much the delivery of water is likely to cost, and then fixes prices so as to deliver an acceptable rate of return on the capital. In 1989, this was rejected for the privatisation of water in England and Wales because it gives little incentive to contain costs, and a strong incentive to invest too much capital. Instead, price-capping was thought to provide greater incentives to efficiency even though it did not give the regulator much financial control; if the companies made too much profit, it was hoped this could be clawed back in the next price round.

The duty to protect the consumer can be made more central to the work of the regulator, and the current UK Government intends to do this in relation to water. Accountability can be improved by turning current consumer councils into independent, statutory bodies.<sup>36</sup> At present, they are heavily dependent on the regulators. For instance, all 10 chairs of the customer service committees and the chair of the National Consumer Council for water are appointed by the Director-General of OFWAT, and are serviced by an OFWAT customer services division services. The Rail Passengers Council and the network of regional Rail Passengers Committees, funded by the Strategic Rail Authority, seem more independent and are certainly more outspoken. But again, the national and regional chairs are appointed by the Secretary of State for Transport (in Scotland, by the Scottish Minister for Transport and the Environment), and the rest of the Council are appointed by the Strategic Rail Authority. It is doubtful whether these kinds of bodies could ever make a significant impact. They remain at one remove both from the ownership and control structure of the industry and from consumers.

The system cannot be reformed enough. It is inherently unstable; either the regulator will be too soft or too hard, and the companies will make extra profits or be in danger of being driven out of business. The problem is well stated by some advice given by the World Bank. It admits that firms' actual costs can be concealed by 'clever accountants', and with imprecise cost estimates 'there is always a risk that the regulator will set the price too high,

hurting consumers and unnecessarily discouraging water use, or too low, encouraging the wasteful use of water and discouraging investment by water companies'.<sup>37</sup> The Bank's solution is to auction water provision rights once every 20 years, but this means that price regulation is still needed in the years in between auctions.

Is there another alternative, a third way between public and private that might avoid these insoluble problems? There are, in fact, at least three alternatives being promoted, all of them situated somewhere between public and private for-profit models, and with various advantages and disadvantages. But before we submit these to scrutiny, we need to know just how and why the opportunity has arisen for mutual forms of business to be advocated for natural monopolies such as water and transport.

# From privatisation to mutualisation?



In the water industry in England and Wales the opportunity for an alternative has been presented by the industry itself. At privatisation, the Government gave the industry a kick-start. It set aside over £5 billion of existing debt, gave the new companies a 'green dowry' of £1.6 billion and offered the companies for sale at a substantial discount.<sup>38</sup> During the first ten years, the regulator, OFWAT, allowed the companies to raise prices so as to tackle a backlog in essential maintenance and an urgent need to improve water quality and sewage treatment in order to comply with European directives on standards. Then, deep price cuts were demanded over the period from 2000 to 2005. These provoked a crisis in the industry, leading companies to want to divest themselves of the water assets and to concentrate on providing the service under contract. At Yorkshire Water, for instance, the regulator demanded a 14 per cent cut in prices and a £1.5 billion spending programme over the five years. Share prices fell by around 40 per cent. The board of the parent company, Kelda, responded with a plan to create a Registered Community Asset Mutual that would buy the assets of Yorkshire Water for their current regulated value, and would initially contract with Kelda, and then after five years tender competitively for the management of its operations.<sup>39</sup> Welsh Water, faced with a cut of 10.5 per cent in 2000, followed by 0.5 per cent and then small rises over the next three years, proposed that its assets be acquired by a new non-profit company, Glas Cymru. This would realise £1.8 billion for current investors, to be financed almost wholly by the sale of bonds. It was promised that, because bonds are cheaper to service than shares, the buyout would result in reductions in water bills to consumers. Both companies needed permission from the regulator to go ahead. In the end, Yorkshire Water was turned down, but Welsh Water (Glas Cymru), was given permission to transfer its assets to a non-profit company and to this end has successfully raised £2bn on the bond market. It is likely that, if the regulator allows it, others will follow this example.

In Scotland, the Scottish Parliament had to restructure the publicly owned water industry in order to make it competitive. Mutualisation to a consumer co-operative form was considered briefly, but rejected in favour of the amalgamation of the three existing public corporations into one, with representation of consumers taking the form of statutory regional consumer councils. The Scottish Co-operative Party campaigned to reopen the debate, claiming that the Scottish Executive was unable

'to understand the case for the mutual method of public ownership', but it seems that, for the moment, this form will not be pursued.<sup>40</sup>

In the public transport sector the opportunity has been provided by the failure of Railtrack. Sold for under £2 billion in 1996 (when its value was reckoned to be £5 billion) and with guaranteed annual revenue of £2.5bn of which over 90 per cent was in fees paid by train operating companies, it had a very easy start in life. However, the backlog of maintenance and modernisation that were needed to track and signals, and the huge cost of upgrading the West Coast Main Line, meant it was going to have to seek enormous sums from both the state and the private sector; its own estimate was £27 billion. Over the next five years a series of disastrous train crashes, and the disruption and financial penalties which followed, led to the company becoming unsustainable without massive and continuing injections of government funding. In October 2001 it was put into receivership. The Government has signalled its intention to turn it into a non-profit company, Network Rail, and has offered it a £3 billion subsidy to buy out existing shareholders. Despite there being other commercial bidders for Railtrack, it is likely that this plan will go ahead. The company will be governed by a panel of 'members' picked from stakeholder groups such as the train operating companies, trade unions, passenger groups and representatives of the disabled. A former chief of Ford UK will chair it, and the current Railtrack chief executive will remain in post.<sup>41</sup>

The idea of a mutual alternative for the London Tube has arisen for similar reasons, and has been strengthened by the example of Railtrack. The Government's plan was for three (later reduced to two) contracts to be let to different consortia of private companies to take control of the Tube infrastructure, while the public sector would run the trains. It faced strong opposition from the London Mayor, Ken Livingstone and his appointed commissioner for transport, Bob Kylie, whose alternative was for the Treasury to allow London Underground to stay in the public sector, raising capital through issuing bonds. However, the idea of a non-profit solution for Railtrack has led some commentators to suggest the same for the Tube. From a governance point of view, both the public corporation and the non-profit trust models could be made accountable to key stakeholders, the main difference being that the latter could more easily

circumvent the Treasury Public Sector Borrowing Requirement. This is a rule that makes public bodies have to seek permission to borrow, and makes their borrowing count as public expenditure. Non-profits, being private, escape this rule and can borrow as and when they need to. However, it is unlikely that the Government will allow the London Tube to be turned into a non-profit or a mutual. The plans for a public-private partnership are too far advanced and the view, emanating from the Treasury, that this is the best alternative, seems to be remaining firm.

#### **Air Traffic Control – towards a multi-stakeholder mutual?**

Air traffic control was, after a long period of political controversy, partially privatised, with a group of airlines taking a 46 per cent stake, employees another 5 per cent and the state retaining a 'golden share' of 49 per cent. Although the resulting enterprise takes a conventional investor-owned form, the airlines have made a commitment to a non-profit strategy, with surpluses being reinvested or used to reduce the airlines' fees rather than distributed in dividends. It could be seen as a kind of multi-stakeholder mutual, in that the interests of customers, workers, and the general public are represented. There is, however, a complication in that the immediate customers (the airlines) have a different, if overlapping, interest with end-user customers (air passengers).<sup>42</sup> Recent losses made by the airlines as a result of the terrorist attack of September 11th have resulted in government and banks each pledging an extra £30 million. If the company continues to be in financial difficulty, then a restructuring of the shareholding could change the balance of power, and consumers could be more directly involved, perhaps through a trust that owns shares on their behalf.

## **What form should 'mutualisation' take?**



Non-profit company, consumer co-operative, multi-stakeholder mutual, are all terms being used to describe alternatives to for-profit, shareholder-owned private companies. As if this were not complicated enough, the Public Management Foundation has also been developing a new model, the 'Public Interest Company' (PIC), for ownership of water, the rail network and local education authorities.<sup>43</sup> Also, in the current policy debate, all of these forms have been referred to rather loosely as 'mutual' solutions, and we shall have to be more precise. The subject can be simplified if we keep separate two very different discussions that are often held at the same time. One concerns the relative merits of existing and proposed legal forms, while the other identifies key features that may be common to more than one form, and that need to be blended together carefully to ensure that any alternative to private for-profit companies would work.

There are at least four distinctions that are made in choosing a legal form that turn out on closer inspection not to be as important as one might expect. We mention them now in order to dispense with them so we can get down to more serious issues. First, should such an organisation have charitable status? Organisations that are registered as charities gain tax advantages, but they are restricted in their ability to trade in different markets, and sometimes they set up non-charitable trading arms to overcome this. The important point is that a charity is not a legal person, and so organisations have to be something else as well – under UK law a company limited by guarantee or a 'bencom' (industrial and provident society for public benefit). So charitable status is something to be added if it gives tax advantages and does not restrict the organisation too much. Second, should such an organisation have public purposes built into it? The advocates of the public interest company would like to see this enshrined in one legal form, but bencoms and companies limited by guarantee can also write public purposes into their constitutions. Third, should such an organisation be able to make surpluses? This is sometimes referred to as the difference between a 'non-profit' and a 'not-for-profit'. In practice, all organisations make some surpluses on their trading accounts, unless they can foresee in advance exactly how much a 'cost price' might be for their goods or services. It is what they do with the surpluses that matter, crucially, whether or not they distribute them to individual members. Last, there is the ability to demutualise. This is an important point. At present, all non-charitable,

## What form should 'mutualisation' take?

membership-based forms of organisation are subject to the risk of being demutualised. The proposed legal form of the PIC would bar it from being converted to another form, and if it were wound up it would have to transfer its assets to another PIC. However, amendments to Industrial and Provident Society law currently going through Parliament would make it much harder for members to demutualise industrial and provident societies.

Now we are ready to ask three really important questions. First, *does the organisation give membership rights, and if so, to which stakeholders?* In some organisations there are no members, just trustees or self-appointing boards. In others, membership is based on the use that one stakeholder group makes of it (consumers, workers or suppliers). In yet others, more than one stakeholder group is able to take up membership. This gives us three types:

1. non-member organisation (eg charitable trust).
2. single stakeholder member organisation (eg consumer mutual or an association).
3. multi-stakeholder member organisation (eg the Eroski co-op in Spain, that has consumer and worker members, or a company limited by guarantee that has specified members).

Second, *what do we mean by membership?* It is possible for any organisation to offer 'membership', simply as a means of associating people with itself, or signalling that some customers have earned bonuses or privileges. It may be clearer if we restrict its use to include only those situations where some kind of ownership or governance right is being offered. Ownership generally means two things: that members have the right to take part in governance and to share in any surpluses the organisation makes. If the organisation is a traditional non-profit, it tends not to offer any such rights. Nobody owns the business and trustees (in the case of trusts) or boards of directors (in the case of companies limited by guarantee) merely look after it on behalf of others. It is barred by legal or constitutional restraints from distributing surpluses. If it has members, it will usually give them some rights over governance, such as the right to vote on who is elected to a board of directors or management committee. If the organisation is a mutual, it will generally give both kinds of rights. This gives us three types:<sup>44</sup>

1. no ownership rights (eg traditional charitable trust).
2. members have rights over governance (eg member-based non-profit, or bencom).
3. members have rights over both governance and distribution of surpluses (eg consumer co-ops, financial mutuals).

Third, *what kind of representation is there?* It is useful to place the different types on a ladder of representation. At the top is the direct representation of members by elected individual members; each person has one vote, and the candidate that gets the most votes takes a place on the governing board or committee. Then comes indirect representation through membership organisations. This applies when a second-tier mutual is set up and its members are elected by other mutuals. Then comes indirect representation by organisations that are not themselves membership based, or whose boards appoint representatives without asking their members to vote. Finally, we have proxy representation, in which a non-member organisation claims to represent a particular class of people without giving them governance rights. In this class we include organisations that have a nominal membership but do not offer membership rights to all consumers. Here, the co-operative principle of open membership is a useful test: does an organisation offer membership to all people who are in the appropriate relation to it (eg a class of consumer) or not? If not, then we treat it as a non-member organisation. This gives four types:

1. direct representation of members by members (eg consumer mutuals).
2. indirect representation of members through member-organisations (eg a secondary co-op).
3. indirect representation of interests by organisations (eg consumer council).
4. proxy representation (eg self-appointing board, consumer committee appointed by government).

At this stage, if we try to make sense of all this by simply multiplying all the variables we will end up with far too many types of organisation. Happily, there are only a few combinations that work. The most important distinction is between *non-profits and mutuals*. Suppose we label as *non-profits* organisations that either have no members or members who do not share in the distribution of surpluses, and label as *mutuals* organisations that give their members full ownership rights to both governance

What form should 'mutualisation' take?

and surpluses. Then, we combine this with membership to give five types:

1. non-member non-profit (eg charitable trust).
2. single stakeholder-member non-profit (eg National Trust, campaigning organisations).
3. single stakeholder-member mutual (eg consumer co-op, building society).
4. multi-stakeholder-member non-profit (eg community housing association).
5. multi-stakeholder-member mutual (eg the Mondragon co-operative system in Spain). Then, comparing these types with the ladder of representation shown in Figure 1, we find that the five types of organisation divide into four that are democratic (in theory at least), and one much less democratic.

### **The strange case of Letchworth Garden City**

Ebenezer Howard was a visionary who, in his book *Garden Cities of Tomorrow*, set out a plan for the rehousing of the British people in garden cities that would combine the best of both country and town living, but leaving behind the overcrowding, insanitary housing, lack of open space, pollution and alienation of the industrial city.

He was adamant that this could be provided through private funding, and was against the state taking any part. His supporters included some 'plutocrats', seriously rich aristocrats and industrialists who were prepared to invest money at a fixed rate of interest, leaving any surpluses made by the company to be paid out to the community. In this way, citizens would gradually buy out the investors so that the city would be owned by a community co-operative. This would then, using the freehold income from land, begin to provide local welfare services.

Letchworth was gradually built, but the company struggled financially and Howard's ideas were only partly realised. In 1947 the Labour Government passed a new Town and Country Planning Act that made all changes in land use subject to planning permission. The 'planning gain' that resulted from change of use would be taxed at 100 per cent. However, when a Conservative government abolished the tax, speculators began to take an interest in Letchworth, and in 1961 a company called Hotel York bought a controlling portion of the original shares. With the prospect of their town being privatised from under them, residents supported a Private Member's Bill that wrested back control to a Town Corporation. Eventually, Howard's faith was partly vindicated; in 1973 the company finally went into surplus, and now pays for local NHS patients to be treated free at a private hospital, as well as providing leisure and community centres.<sup>45</sup> In 1995, another Act gave Letchworth the co-operative Howard had always wanted: a Heritage Foundation registered as an Industrial and Provident Society.

Figure 1: Ladder of representation by types of organisation

		Non-member non-profit	Single stakeholder non-profit	Single stakeholder mutual	Multi-stakeholder non-profit	Single stakeholder mutual
4	Direct member representatives	No	Yes	Yes (eg building society)	Yes (eg community housing association)	Yes (eg Mondragon's Eroski chain)
3	Indirect member representatives	No	Yes	Yes (eg secondary co-op)	Yes (eg development trusts)	Yes (eg the Phone Co-op, Poptel)
2	Organisational representatives	Yes (eg many charities)	Sometimes	No	No	No
1	Proxy representatives	Yes	No	No	No	No

Armed with these important distinctions, we can now attempt to evaluate the different options that have been proposed for the takeover of water and rail infrastructures.

The *non-member non-profit* form is the one that has been chosen for the one water company that has successfully transferred its assets. Glas Cymru has been designed with an undemocratic governance structure. The chairman will initially appoint four to six non-executive directors and three executive directors. Membership will be restricted to 50 people (rising to a maximum of 200), also appointed by the chairman following nomination by an independent panel. They will undergo a pre-selection process to make sure that one group of interests does not

dominate, and will not be elected by or be responsible to consumers. Because we define membership strictly in terms of the 'open membership' principle, in the ladder Glas can be described as a non-member non-profit, though its defenders might want to describe it as a multi-stakeholder non-profit with proxy representation.

However, it would not be difficult to open up this structure towards a *multi-stakeholder non-profit*. Glas is already under pressure from the National Assembly for Wales, which has commissioned work to develop a more democratic constitution. As the housing association movement has shown, the non-profit model is capable of being adapted to more community-based and democratic

## What form should 'mutualisation' take?

forms of governance, if it takes advantage of the ability to issue membership shares. The wider the membership, the more it begins to resemble a mutual. Ownership remains nominal but membership confers some control rights which give the opportunity to get involved in governance. What such a model does not do is to give members the right to a personal share in any surpluses made. However, where the business is run in such a way that it either sets prices so as to avoid making a surplus, or uses the surplus to lower future prices (as Glas Cymru is doing), this is not much of a disadvantage. Advocates of the new PIC form expect it to be a multi-stakeholder non-profit, with governance by representatives of the public and staff and 'with different types of election appointment for different directors'.<sup>46</sup> In relation to water, they describe a 'board representing a diverse range of stakeholder interests', who could either be appointed (as in public quangos) or could come from elected bodies, including customer representatives.<sup>47</sup> In relation to the proposed model for Railtrack – Network Rail – they describe a board 'made up of those with an interest in rail services: passengers, the train operating companies, government, unions'.<sup>48</sup> However, there is some uncertainty about how far up the ladder of representation they wish to go. For local education authorities that move to a PIC model, they advocate either election from local organisations or from the whole electorate. And they are still working under the assumption that there will be a unitary board.

The New Economics Foundation, particularly through the work of Shann Turnbull, has been exploring the inadequacies of a single board of directors. A unitary board model creates a top-down control system that can suffer from centralised power which may be corrupt and can create inefficient and ineffective decision-making. The directors are both poachers and gamekeepers – in other words – they are only accountable to themselves. Non-executive directors, presumed to be able to hold management to account, faces difficulties in accessing independent sources of information from key stakeholders. There is a need to explore alternative governance models which at the very least incorporate an additional stakeholder council which would involve key strategic stakeholders providing independent sources of information and scrutinising management behaviour.<sup>49</sup>

The *single stakeholder mutual* has also been advocated for the water industry.<sup>50</sup> At first sight this is the simplest

and best option, because it replaces investor-owners with consumers. Since all households are water consumers, and they have an interest in low prices and good quality, they ought to be put at the centre of the business. However, just because an organisation is called a mutual, it does not always mean that it is a genuine consumer co-operative. The proposal by Kelda for the mutualisation of Yorkshire Water was for a board of five non-executive directors and two executives. The customer-members would directly elect only two of the non-executive directors. The Director General of Water Services turned down the idea on the grounds that it was skewed in shareholders' favour, the benefits to consumers were hard to identify, and it did not demonstrate independence from Kelda.<sup>51</sup>

Finally, the *multi-stakeholder mutual* is a logical extension of the consumer co-operative idea, to include other stakeholders such as workers or the wider community. Currently, UK consumer co-ops are considering moving towards a more inclusive model of governance, bringing workers onto the board. It is becoming harder to argue for just consumers to be involved; stakeholder theory is moving towards a more sophisticated understanding of who has a claim on the business, and how the 'control architecture can be designed so as to encourage all stakeholders to take part'.<sup>52</sup>

## Two-stage governance structures



In a relatively simple form of organisation such as the single stakeholder mutual, relationships with other organisations are governed by contract, by partnership agreement, or by a more formal agreement to set up a federation. None of these kinds of relationships affect the governance structure, because they do not cross the boundary between the organisation and its environment. In a multi-stakeholder organisation, the governance structure is dependent on a set of relationships with stakeholders that often involve other organisations being given membership rights. For instance, if workers have places on a board they can elect these through a trade union or works council. If consumers have board members they can elect these directly through their own consumer council or indirectly through other consumer-based organisations or by proxy through having board members appointed to represent them (as laid out on the ladder of representation).

If a multi-stakeholder form is advocated for water and Railtrack, then a new set of questions arises as to how the stakeholders' representatives are appointed. All the usual arguments about representative democracy apply. Consumer representatives should only be found from among consumers, and then by majority vote, with mechanisms for their being called to account for their actions or inaction. Since all consumers have to pay for the service, all should be eligible for membership in the organisation that gives voting rights, and all should be eligible to vote. This means that the task of organisational design does not stop at the owner of the water or rail assets, but continues into the question of how stakeholders will be represented.

In order for stakeholders to be able to take part in governance, two innovations have to occur. First, there has to be a genuine member-based organisation that overcomes the 'collective action' costs faced by individuals and organises their democratic representation on the board of the service provider. This means creating new, or reforming existing, consumer councils, staffing them and funding them so they can operate effectively. For other stakeholders, such as suppliers or the workforce, it means having stakeholder panels, that feed into a stakeholder council that is 'capable of bringing together the different stakeholders into one forum'.<sup>53</sup> Second, once representatives are on the board, they have to be supported by training and independent sources of information, and have to gain the trust and loyalty of the

people they represent. The stakeholder council adopts roughly the role of shareholders scrutinising the separate board of management and providing strategic information.

# The costs and benefits of membership



Having set out the options for ‘mutualisation’, we are now able to begin to weigh up the advantages and disadvantages of each. First, let us consider arguments about the costs and benefits of membership-based organisations. The benefits from participation have to be weighed against the costs. If the net cost of participation becomes too high, other models that might be less participatory might become more efficient, or we might be satisfied with a minimal-participation version of a mutual/non-profit. On this view, we should advocate whichever model has the best trade-off between benefits and costs from member participation.

In order to understand better what we mean by costs and benefits, we begin with the work of Hansmann on governance costs. Then we open up the argument further by considering the benefits of participation to the boards, managers and members of mutuals/non profits and the ways in which a business strategy of maximising participation can provide a ‘co-operative advantage’. Hansmann argues that ‘costs will be minimised if ownership is assigned to the class of patrons for whom the problems of market contracting – that is, the costs of market imperfections – are most severe’.<sup>54</sup> He suggests that with a natural monopoly the costs are minimised by having the firm owned by its customers. In our terms, he advocates a *single-stakeholder mutual*. On balance, those who have the best claim on grounds of efficiency, then, must be domestic consumers. However, this only remains true if the governance costs – making collective decisions, monitoring managers, and the costs of failing to do these – are not too high. It is not clear that consumers have the incentive to take on the governance costs, or that managers can be persuaded to develop a participatory culture and member relations’ strategy. As Leadbeater and Christie note, while member participation is the main strength of a mutual, in practice it is often its main weakness.<sup>55</sup> It is time-consuming and difficult for managers and for members, decision-making procedures are ‘hard to devise and maintain’, and the membership can become too large and dispersed to maintain incentives for participation, or too inward-looking and dominated by sectional interests.

We can see evidence of these kinds of costs from the history of the retail consumer co-operative sector. During the period of rapid change in retailing from the 1950s onwards, co-ops in retailing have been much slower at reacting to market signals than their multiple chain

competitors. Across Western Europe they have been unwilling to make structural changes, and have either gone out of business or had their market share severely reduced. They have been held back partly by a defensive, industrial working class culture combined with highly oligarchic decision-making leading to some spectacular failures in corporate governance.<sup>56</sup>

However, Hansmann goes on to argue that, despite these costs, a consumer-owned but not controlled mutual may still be an efficient option. Paraphrasing his argument, we can say that a non-participatory mutual is better than investor ownership if it:

- avoids the costs of wide participation;
- by not encouraging participation, avoids costly conflicts between different types of member;
- will still stop others from exploiting the consumer in a monopoly situation (ie blocks less efficient forms of ownership); and
- returns the net profits to the consumer rather than investors.

A mutual might, then, be the least-costly ownership option, even if it falls short of the participatory governance implicit in its constitution (though in such a case it might be better to set the organisation up as a non-profit run in the public interest rather than a ‘pseudo-mutual’). Also, consumer control need not be all that costly. Modern methods of communication such as the Internet and email groups cut down on the costs. Some costs will be covered by the kinds of regular contact with consumers that the utility would have anyway: annual bills can be accompanied by a newsletter or a voting card, for example, and market research can be turned into a more participatory exercise.

The more homogeneous the owners are, the lower the costs will be. Where mutuals work best – as in US rural electricity co-ops or Australian irrigation mutuals – the consumer owners of water are a relatively homogeneous group. In the UK water industry, there would be clear differences of interest between business and domestic users; one group would hardly want to subsidise the other. Then within the business sector there would be differences between large industrial users and smaller businesses. Already, in the publicly owned Scottish water industry, there is controversy over the likely impact of the industrial users being allowed to contract with alternative suppliers. Then within the domestic sector there would

be some tension between rich and poor users and between large and small households over, for instance, the use of meters and treatment of debtors. There might be a difference between those who take a long and short-term view, trading off lower prices against investment that minimises the impact on the environment. If these differences of interest are likely to be large and persistent, and if agreement cannot be reached over the weighting of membership rights to reflect and balance these interests, then a *non-member non-profit* alternative would be less costly.

On the other hand, a lack of consumer control can also be costly. Before the 1986 Act, building societies could avoid involving members because the environment was highly regulated and not very competitive; there were not many important decisions to make. With no pressure to distribute surpluses, a low-risk strategy of building up large reserves was followed. The costs of this minimal participation strategy only appeared with deregulation, when the members were able to demutualise and take the surpluses for themselves. In the mutual insurance sector, the costs have been even higher: the misselling of endowment mortgages pensions, and now the failure of one of the most successful mutuals – Equitable Life – show what can happen when members are not consulted. Of course, we can never know exactly what difference consultation would have made; it is possible that without adequate information members would have allowed managers to continue unchecked. However, had members had a strong, independent voice and access to information, it is much less likely that these failures would have happened in the first place.

Third, consumer control can also bring competitive benefits. It could be argued that in sectors where some attempt has been made to open up governance to members – friendly societies, credit unions, housing co-ops and some consumer co-ops – the benefits have been outweighed by the costs. Encouraging participation by members can provide for an information rich environment and for trust relations to build up, important benefits that make the costs to boards and managers worthwhile.<sup>57</sup> Some people go further, arguing that member participation provides the necessary conditions for a ‘co-operative advantage’ to be gained, that will show up positively in the trading results. The aim is to promote social goals and ethical practices that are implicit in co-operative principles, in such a way that the

incorporation of these goals and practices into the business strategy gives a commercial advantage over one’s competitors. The return of benefits to members completes a virtuous circle, demonstrating both the ethical and commercial superiority of co-operatives.<sup>58</sup>

A related argument against single stakeholder mutuals is that, if they do not maintain the interest of the members and participation is low, their governance may be captured by a narrower interest group. One of the reasons the regulator turned down the idea of a mutual for Kelda was because of a concern that undue influence might be gained by sectional interests. One of the reasons why the Glas Cymru case was accepted was because the vehicle of ownership was a company limited by guarantee rather than a mutual registered as an Industrial and Provident Society. The customers would not be the owners, but ownership would be entrusted to the board of the company on their behalf. However, the argument can be overstated. Other forms of business organisation are just as susceptible to capture by minority interests. The remedy is not to take away democratic control but to make sure it works properly to represent different viewpoints. But this points not to pure consumer ownership but at the minimum to some form of multi-stakeholder governance and at the maximum multi-stakeholder ownership.

## Arguments against excluding shareholders from ownership

### Building mutuality back in – the case of the life insurance sector

One of the ironies of demutualisation in the UK life insurance sector is that supervisory boards representing policy-holders are likely to be imposed on the companies by the regulator, the Financial Services Authority. Appointed actuaries will be replaced by a committee of externally appointed experts, policyholder representatives and non-executive directors. This is because the £30 billion of 'orphan assets' – money not allocated to meet the immediate obligations to policyholders – in the companies will, otherwise, be stolen by the shareholders. The problem has affected mutuals as well, because the existing arrangements, whereby actuaries sit on boards to represent member interests, did not prevent the crisis in Equitable Life which has been caused by one kind of member being privileged at the expense of another. The lesson to be learned by both mutual and investor-owned insurance companies is that someone has to look after the interests of the customers from within the boardroom.

The arguments outlined above concerning the failure of water companies and Railtrack to perform lead to a view that shareholder-owned businesses are inappropriate. They do not necessarily lead to the view that shareholders should not be involved at all. One argument against taking shareholders out of ownership is that, because debt markets do not provide as strong a pressure as do investor-owners, managers and directors face fewer pressures to perform. The regulator made this argument in relation to Glas Cymru, but it concluded that performance indicators, statements of intent to provide customer rebates, and market competition for operations, would have to suffice.<sup>59</sup> This is not so much an argument against consumer ownership as against inadequate governance structures. It reinforces the view that Glas should have a wider membership base and a stronger set of procedures for election of directors. It is also an argument that flies in the face of some very strong evidence that in investor-owned businesses the shareholders do not have much influence over managers anyway.

Another argument against excluding shareholders altogether is that other stakeholders then have to take the burden of risk. The water industry is not very risky, yet the prospect of customers taking on large amounts of debt led to criticism of Kelda's proposal for a consumer buyout. It is significant that the idea of a mutual came in Kelda's case from a 'board decision to focus aggressively on shareholder value', in particular to return to investors the capital received from sale of the water assets, and to concentrate on developing the provision of (non-regulated) services to the wider water industry. It was about getting out of an unprofitable area into a more profitable one. In this respect it resembles some employee share ownership schemes that also look on the surface to be about empowering workers but are really about finding an exit strategy for investors.<sup>60</sup> Critics argued that the taking on of a massive debt burden of 100 per cent of the cost of around £2.4 billion was not fair on consumers. One analyst estimated a cash shortfall of £151m per year, an affordability gap that meant a poor deal for consumers, who will be owners without being beneficiaries and therefore that the: 'members will own the debts and the banks will own the revenue stream'.<sup>61</sup> On the other hand, it was claimed that the plan would have had benefits to consumers: lowering the relative cost of capital (debt taken out by consumers being cheaper to service than shares); providing the

## What motivates people to become active members?



security of customer ownership; and providing a means by which surpluses could be used on their behalf.

In the case of Railtrack, there is concern that the new non-profit company will be taking on the risk of large-scale enterprises such as the West Coast rail route, whose costs have already quadrupled. In this case, having the diffused ownership of a non-profit spreads the risk. In practical terms, since Network Rail cannot be allowed to go bankrupt, this leaves the risk with the government of the day. One alternative that is being explored is to take high-risk engineering schemes outside the business and form public-private partnerships to deliver them instead. Another is to allow a proportion of the shares in a company to be taken up by investors. A Social Market Foundation report recently suggested that a 20 per cent investment would lower the risk for other stakeholders in the Glas Cymru model.<sup>62</sup> This would point to the need for a company limited by shares rather than a non-profit, because the former has identifiable share capital to apportion between stakeholders. A mutual also has identifiable shareholders, but these are limited to people who make use of the business rather than merely investors.

Mutuals and co-operatives have always been reluctant to dilute their control by issuing voting shares. Usually they raise capital by issuing loan stock (in industrial and provident societies) or preference shares (in companies limited by guarantee) rather than full voting stock. It is difficult to combine ownership and control by shareholders with that of other stakeholders whose interests are diametrically opposed. It has been tried in Irish agricultural co-ops, and the experience has not been a very happy one. The message seems to be that it is not a good idea to bring investor-owners into a business owned by consumers, even if the latter remain in the majority. It is better to form new joint ventures, or a looser form of partnership.<sup>63</sup>

This concern about risk led the water regulator to insist that Kelda give customers the chance to vote on the proposal, on the basis that substantial financial burdens should not be put on them without their informed consent. This points to another advantage of the non-member non-profit form, that it does not need such consent. On the other hand, it also lacks the legitimacy of a company in which stakeholder interest is more identifiable.

Perhaps the strongest argument against mutualisation is that the consumers will not be interested enough to take part in governance to ensure that the organisation is run for their benefit. The Scottish government decided against mutualisation for Scotland's water, on the ground that customers do not have sufficient incentive to become active members. It is important that this issue be addressed. At Stirling University, this author and his colleague, Richard Simmons, are developing a *mutual incentives model* of participation that shows whether or not people are likely to want to participate under different circumstances. We begin by identifying the characteristics of the relationship between consumer and producer, which varies by sector in at least four ways:

1. the degree of *continuity* of need (from occasional through intermittent to continuing).
2. the degree of *intensity* of the need (on a hierarchy of needs from frivolous through important to life-saving).
3. the degree of *financial involvement* of individual consumers (from no involvement, ie publicly funded, through means-tested to market-based).
4. the degree of *consumer competence* in assessing the quality of the product or service (from consumer-driven through to professionally dominated).

We can generalise that, other things being equal, the greater the continuity, intensity, financial involvement and consumer competence in a particular sector, the more likely people will be to participate. For instance, the National Health Service in the UK is professionally dominated, publicly funded, and the relationship of patients is often intermittent. Participation of patients is always proved difficult to organise. However, the intensity of their need makes up for this to some extent. Education has some continuity, with parents being involved over at least 12 years of a child's life. They are often intensely interested in the outcomes for a particular child, can assess the competence of teaching by its results. This compensates for lack of financial involvement (in state schooling). Council tenants also have a continuing involvement with their landlord, their home matters to them, and there is no mystery to housing management. However, where a high percentage of households have their rent paid fully by the benefits system, this may undermine their motivation to seek value for money in estate management. In water utilities there is a continuous need, but it is not a very intense one (except when the supply fails or the water quality goes down),

## What motivates people to become active members?

nor will consumers be particularly interested in the technical questions of how it is supplied (though environmental concerns are growing among some consumers). They will, however, be interested in obtaining value for money as well as a voice in the running of a monopoly service that they need, but from which they cannot exit. In transport, the main problem is that journeys are often occasional or intermittent, and so only season-ticket holders might expect to be involved as members, though they would be more interested in influencing the train operating companies directly, rather than indirectly through governance of the track. The technical questions of safety and timeliness are of great interest to travellers, their need is intense, and they are financially committed. Once people have made a decision about where to live and to work, they are locked into a monopoly-like situation in which they often have no choice about which route to travel. This is shown in the fact that many passengers are already involved both in regional rail user committees and in voluntary groupings based around a station or branch line.

The analysis then moves on to consider three background conditions for participation:

1. prior member resources;
2. opportunities to participate; and
3. an organisational participation strategy.

First, the civic voluntarism model of citizen participation has found that the best predictor of whether people will participate in voluntary situations is the *resources* they bring to it. In particular, they bring 'civic skills' derived from their involvement with institutions that have taught them how to participate. Not surprisingly, higher income and educational level correlate well with participation. Added to their resources, participators bring a psychological engagement with politics.<sup>64</sup> What this means for participation in mutuals is that, other things being equal, we should expect lower participation levels in those mutuals whose members have lower incomes and educational levels, and have developed less of a 'taste' for politics (credit unions, consumer co-ops) than in those whose members have more of these resources (life insurance mutuals and building societies). This was demonstrated recently when three groups of Equitable Life members set up websites to deal with the insurer's financial crisis (Equitable specialises in pensions for people on high incomes).

In the case of water and transport, since all citizens are customers, we can expect a large minority to have the required resources, but there would be a bias towards higher social classes that might have to be compensated for in the design of governance structures.

Second, it is self-evident that *opportunities* are needed if there is to be participation. In many mutuals, the lack of publicity for annual meetings, of contested elections, of contact with members, have meant there has been almost no opportunity for participation. It is ironic that the vote for demutualisation has often been the first time members have been made aware of their status as owners. The large size of modern mutuals also restricts opportunities, since only a very small proportion of members can be involved at the top level. As a recent report on building society governance concludes, there is a need for federal structures designed to connect people up to large mutuals, and electoral college systems that reward active participation.<sup>65</sup> In rail transport there is an active national consumer council and regional committees, funded by government through the Strategic Rail Authority. These structures could be built on to provide a means by which consumers could be represented on a multi-stakeholder service provider. In water, there used to be a consumer council but it has lapsed. There is 'proxy' consumer representation, not directly with the companies but with the regulator. In this case some rapid institution-building would be necessary if consumers were either to take control in a single-stakeholder mutual, or be represented in a multi-stakeholder body.

Third, it follows that there has to be an *organisational strategy* for participation. It cannot be left to itself, in the way it could in the small-scale, locally based co-ops, friendly societies and building societies of the Victorian age. Managers have to be charged with setting up and staffing participatory structures such as area or regional committees or forums, with organising an information-rich environment in which members are listened to and their views collated, and with providing supports for participants such as training, office facilities, and expense budgets. Such a strategy is beginning to be established in some UK consumer co-ops and building societies. The difficulty with designing an organisational strategy for water is that the companies operate over large areas, and have no clear local focus such as a shop or branch on the high street. Transport is better focused – there are already

## What motivates people to become active members?

over 200 voluntary rail user groups around the country, focused on particular travel to work areas.

Assuming the structures are in place to provide opportunities, and that there is a management strategy to maximise participation, the question now becomes – will people be motivated to participate? The idea that people need incentives to participate has been used successfully to explain membership of political parties.<sup>66</sup> Our *mutual incentives theory* assumes that people are motivated by a mixture of both individual and collective incentives. Individual self-interest is easier to deal with, as it is the basis of exchange and rational choice theories that provide some detailed generalisations. The term ‘collective’ refers to a process by which individuals come to see their own aims and values in terms of a wider community, and so find it difficult to account for their motives entirely in terms of self-interest.

At the *individual* level, people calculate the costs and benefits of taking part. The costs to members are the opportunity-costs of giving their time and energy to this rather than to other activities, and the psychological costs of engagement; the risk that participation may not give the expected benefits, leading to frustration, anger or apathy.<sup>67</sup> The literature on rational choice makes gloomy reading on this subject. Taking its starting point that people do not have a reasonable incentive to vote in elections, it attempts to find ways of overcoming this built-in disincentive in order to explain why so many people do, in practice, vote. There are two problems participants have to overcome: a temptation to free ride on other people’s participation and a calculation that one’s own participation will not have any noticeable effect on the outcome. There are several possible ways of minimising the ‘collective action’ problem that results. First, participation may not be all that costly. Some types, such as voting, take little effort such as filling in a voting card. Second, in certain circumstances (such as local rather than national political participation) a person’s participation does have an effect. Third, participants may find that the ‘expressive’ aspect, making one’s views and feelings known, is itself a benefit.

Benefits can be classified into material and non-material. The material benefits include immediate benefits from taking part and longer term ones from maximising the return from the business. In terms of immediate benefits, it is often assumed that participants should not be paid,

but attendance allowances and annual ‘honorariums’ are often used for customer panels or focus groups, and expenses can be budgeted for. The longer-term benefits can be substantial, providing the members have real control over the business and over how surpluses are allocated. One of the main incentives for participation in consumer co-ops used to be that they declared an annual dividend on purchases; there was intense speculation among ordinary members about the rate, and much holding to account of directors when dividends were lower than expected.<sup>68</sup> The problem with water and transport is that dividends are more likely to be returned in lower prices in the future rather than cash payments, and members face the collective action problem of not knowing how much their personal participation has counted.

Non-material benefits include increased self-confidence, a social life, increased knowledge, a sense of personal efficacy, increased employability, and so on. Preliminary results from the current study show that these are very important, and, for activists, far outweigh the costs. Particularly valued is the ‘chance to have a say’ in how a service is run. The benefits only follow if the quality of the relationship between the participant and the organisation’s managers and board members is good. The terms of the relationship have to be made clear, time must be taken to build up trust, and the managers have to demonstrate their effectiveness in responding to the demands made by the participants.

One important non-material benefit is that participants enjoy taking part because the subject is an interesting one. A problem for water utilities is that their product, while so important for sustaining life, is also rather mundane. Apart from concerns with water quality and the environment, members might not have much to interest them. However, it can be made interesting: some water companies in England have developed interactive displays at reservoirs and pumping stations that attract large numbers of visitors. The environmental interest is growing, especially among young people. In transport, the subject attracts a minority of dedicated fans, so much so that the term ‘train spotter’ is used to denote anyone who has a narrow or pedantic interest in something. Again, a management strategy can make it more interesting to potential participants, and the sheer complexity of running a railway or tube system could be appealing. It also depends on what participants are being

## What motivates people to become active members?

asked to do. Members of a utility mutual may be interested enough to read an annual report, or voting information from a candidate for the board, or even to browse a website, even if they never serve on a committee. When people do join a decision-making group, providing it is seen to be effective, they tend to find that their interest grows over time.

Participants often say they will participate even if they do not continue to receive these individual benefits. This seems contradictory, but they are saying they have *collective incentives* that outweigh the individual ones. Again, results from a study of council housing and social care services show that we can expect active participants rapidly to build up collective commitments that far outweigh considerations of personal benefit or cost. We distinguish three types: shared goals, shared beliefs, and a sense of community. The sharing of goals that one values highly is a major source of commitment. Council tenants who want decent housing and a clean and safe environment for their children, people with learning difficulties who want the local authority to provide the support services they need, day care centre users who want to improve the quality of food, are expressing a mutual need which translates into common goals.

The difficulty with a water mutual might be that, though everyone values the product, it is hard to see how collective action by members can improve it. Transport is more complex, and more amenable to actions at a local level to improve parts of the service. Shared beliefs are important for participants in campaigning organisations, political parties and churches. In water provision, the main motivation might be a belief in the environment, but this could lead to an attempt by well-motivated interest groups to take control, a scenario that has led OFWAT to prefer a non-profit to a single-stakeholder mutual form. The sense of community motivates people because they care about other people who either live in the same area, or people who are like them in some respect (the elderly, the disabled, local commuters). Community is a major motivator on council estates, where residents either want to preserve or to rebuild it. It is difficult to see how this would motivate members of a water mutual, as no one identifies strongly with a water catchment area (though water did engender strong loyalties when it was owned by local authorities). There may be a small incentive effect in relation to regional or national feelings; Glas Cymru has been

strongly supported by people in Wales, because it is seen to be restoring ownership to 'the people'. In transport, because rail and bus lines link people's home and work lives, the sense of community may be strong. This is shown particularly when a line is threatened with closure.

Preliminary results from a comparison of participation by public service users and active members of retail co-operatives shows that those who have been participating longer are much more committed to collective values than newly active members. This means that in any new rail or water mutual it would take time for active members to build up mutual sentiments. It is probably that they would eventually do so, but their participation would need to be nurtured.

The generalisations applied so far predict quite low levels of participation among potential members. At this point it is worth asking what types and levels of participation are needed? For effective governance, all members need to be kept informed, and a large minority need to be sufficiently interested to vote for board members. A small minority of activists is needed to provide monitoring of the board's performance, to replace board members when their term is ended, and to represent important interest groups on a broader-based body such as a stakeholder council or consumer advisory group. Mass participation can only be expected when things go badly wrong (though the opportunity presented by a mutual for members to take action when things do go wrong is a major advantage).

What motivates people to become active members?

#### **Mutual water utilities have been shown to work**

In the USA, there are around 1000 electricity utility co-ops and 244 telephone co-ops, based in rural areas, though the water industry is split between investor-owned and municipal firms.<sup>69</sup> The electricity co-ops supply power to 10 per cent of the population, including half of all farm households. They are partially vertically integrated, in that they draw around 45 per cent of their power from co-operative generators in which they are members. Like water, these are homogeneous commodities, with a relatively homogeneous consumer interest. Like the proposed water mutuals, their assets are financed mainly by debt.

#### **Water mutuals in Australia**

In 1995, the water industry in Australia began to be privatised, but not just to conventional investor-owned corporations. The assets of South West Irrigation were transferred to an irrigator-owned mutual, SWIMCO, which has 2300 members. Its operations business was transferred to a co-operative. Since then, four other mutuals have been formed on similar lines. They have 'proven to be highly robust and efficient', they now operate multi-million dollar sinking funds, the working structure is highly consumer-focused, and there is a corporate emphasis on the long-term financial and engineering feasibility of the system.<sup>70</sup>

#### **A water co-operative for a large city?**

SAGUAPAC is a co-operative that, since 1979, has been providing water supply and sewerage services to the one million inhabitants of the largest city in Bolivia, Santa Cruz. All 96,000 domestic customers are automatically members of the co-op. They elect members of the administrative board from nine water districts. They also elect a separate supervisory board that monitors the performance of the administrative board. A study undertaken by Birmingham University economists has found that it is one of the best run water companies in Latin America, with a low level of water leakage, a 96 per cent bill payment rate, and 80 per cent water coverage, despite rapid population growth. Its co-operative structure shields managers from the political interference that weakens municipal water companies, and it can implement new investment projects faster than other companies. The model is being copied elsewhere in Bolivia, in the towns of Tarija (1988) and Trinidad (1991). One report has found that, though it is highly regarded by the World Bank, the model is not being promoted actively because of pressure from powerful international water companies wishing to sell their services in developing countries.<sup>71</sup>

#### **Mutuality on the railways**

Mutuality is already being practised at the edges of the railway system. In rural areas, on long-neglected branch lines, community-rail partnerships are being formed. Bringing together train operators, local authorities, parish councils, community groups and local businesses, they aim to support a particular line by connecting it up with buses, improving the environment of stations, increasing the frequency of services, preparing local transport plans, advocating

local residents' rail cards, and so on. There are 30 such partnerships, federated in the Association of Community-Rail Partnerships. The Association is developing the idea of 'micro-franchising'; if local rail services were put out to tender, as they are in Germany, local multi-stakeholder mutuals could bid to run them.<sup>72</sup>

# Who should own the water industry?



We are now at the stage where we can make some recommendations about the relative merits of the four different organisational forms outlined above in relation to water and rail infrastructure. We have some useful generalisations about how costly and how risky member participation is likely to be, and whether or not people will participate. There are four key questions:

1. Should there be a genuine membership?
2. If so, which stakeholder group or groups should be members?
3. Should they be given full ownership rights (a mutual rather than a non-profit) or just the right to take part in governance?
4. If a multi-stakeholder option is chosen, how will the rights of each stakeholder be determined?

The idea of a mutual to own the assets of the water industry came from the private companies themselves. It is no wonder that both the Glas and Kelda proposals stayed on the lower rungs of the ladder of representation, because shareholders wanted to offload the less profitable part of the business while keeping the contract for operations. For this they needed a fairly cosy relationship between the new board and the contractor. The result was one successful bid to set up a limited-member (arguably in the terms being used here, non-member) non-profit and one failed bid to set up a not very convincing single stakeholder mutual. The Scottish Parliament rejected this idea, because they were not convinced that consumers would want to participate in the long run. Yet the water industry has one simple asset – it has a known, relatively stable and relatively homogeneous set of customers. It would be quite easy to offer them membership in a single-stakeholder consumer mutual. Shares could be weighted so that domestic customers get one each and business customers more, on a formula that would recognise the latter's greater use of the business. In the usual way that Industrial and Provident societies work, it could cap the number of shares any one customer could hold at say 200, so that no one business or group of businesses could dominate. Then the shareholders could vote their representatives directly on to the board. The participation costs would be low, because information-giving and voting could be linked to the regular bills that are sent out to customers, and much of the organising of interests could be done on websites and email groups.

There are three problems with this suggestion. First, it would require that management and the board have a continuing strategy for involving members in governance, otherwise it could easily slip into a routine endorsement of a governor/manager oligarchy. It might not provide as rigorous a check on managerial complacency as other forms of governance; its record in the financial services mutuals and consumer co-ops in this respect is not very good. The interest of a mass membership in such a mundane activity as water delivery would be difficult to keep up. It might be in danger of capture by an interest group that has the motivation to become organised. Second, it would not represent all the stakeholders that need to be represented. Someone should represent the environment, the long-term needs of consumers who are not yet members, and the interests of the workforce. Third, it would leave any financial surpluses to be divided among users in whatever way they want. This looks like an advantage, but it could be a source of conflict between different types of user, and could discount the environment or future users against immediate gains. All of these problems point to the need for some strong public interest in the governance of the industry, either through continued regulation or a public stake in the business.

A multi-stakeholder water mutual could add board level representation by other interests such as local authorities, environmental groups and the workforce. This would almost certainly avoid the problems identified above. But this raises another important point. Would it need to be a mutual? The main advantages of a mutual are that it defines a set of owners and gives them rights to any surpluses. In the case of water, the infrastructure includes human-made assets such as pumping stations, water treatment plants and so on. But it also includes natural assets such as aquifers, watersheds and rain. There is a strong argument that this should not be owned by anyone in particular, but by the public and that environmental issues also need to be taken more strongly into account. These arguments point towards a multi-stakeholder non-profit with a clearly remit outlined in the constitution.

The main question then becomes how the various stakeholders would be given a collective identity and then represented. There is no need to slip down the ladder and accept either proxy representation by self-appointed governors or representation by the

## How should Network Rail be organised?



professional staff of existing organisations. Local authorities already have the means democratically to elect their representatives, as do trade unions. Consumers could be organised to elect their representatives directly through postal voting. In fact, all the strengths of the consumer mutual option could be built into this with none of the weaknesses. If consumer participation proves to be too costly, then they can be represented less directly by a statutory consumer council. But if the members of this are not themselves elected by consumers, we are back to proxy representation and the opportunity for direct involvement of customers will have been lost.

The main recommendations in relation to water are therefore:

1. Water companies that want to sell their assets should be given a clear lead by OFWAT as to what sort of successor organisation is acceptable. This should be along the lines of a multi-stakeholder non-profit.
2. The new companies should be designed by a working group made up of representatives of the key stakeholders (including consumers), and endorsed by OFWAT.
3. They should consider the merits of having a two-tier structure of a management board and a stakeholder council.
4. The constitution of the new companies should include direct election of consumer representatives by customers. At first, the consumer board members should be appointed by the OFWAT National Customer Council, but as soon as is practical board members elected by the members in a postal ballot should replace them
5. The new National Consumer Council for water should be a more participatory form of organisation than its predecessor. It should have a regional structure, with each regional water company setting up a consumer council that is directly elected by residential and small business customers in a postal ballot, and that has reserved places on the board.

In public transport, the nature of the relationship between customers and providers is quite different. Not all householders are customers, and if they are their involvement is often intermittent. Only regular travellers, particularly season-ticket holders, would have the incentive to become members of something. As we have seen, they have stronger incentives than water consumers to participate. It looks as if the two industries have much in common; it is the infrastructural assets that are to be transferred, leaving operations to be contracted out. But the similarities are superficial. Rail services are much more complex than water delivery. The infrastructure owner is also responsible for maintaining and upgrading the track. Operators are responsible for making sure there are trains that run on time. Customer members would probably be more interested in the latter which has a more immediate payoff. Also, the arguments for multi-stakeholder involvement are compelling; given the amount of public subsidy going into the business, there should be a strong public interest presence. These (and other) good reasons make the decision to set up Network Rail as a multi-stakeholder organisation rather than a consumer mutual an inevitable one.

The decision to make it a non-profit rather than a mutual is less self-evident. It could issue shares to different stakeholder interests, and link these to voting rights as has been done in the privatisation of air traffic control. This has the advantage that stakeholders know that their governance rights cannot later be changed or over-ridden. The proportion of shares given to each interest could be balanced carefully to ensure that the public interest has a 'golden share'. It also has the advantage that any financial surpluses made can be distributed in an explicit way in lower operating charges or increased investment. However, the prospect of rail infrastructure ever making a surplus remains remote. A non-profit is therefore the simpler option.

Again, this does not mean that there is an excuse for slipping down the ladder of representation towards proxy representation or the filling of places by the 'great and the good'. Given the complexity of the stakeholder interests, representation by individuals is unlikely and representation through existing organisations is inevitable. However, these organisations should be challenged to develop membership rights that allow their members directly to elect representatives to Network Rail's stakeholder council. This would mean, for instance,

turning the Rail Passengers Council and its committees into a more member-owned organisation. The analysis of what motivates people to participate shows that there would be no problems in fostering member participation.

The main recommendations in relation to the proposed new model for Railtrack – Network Rail – are:

1. The assets of Railtrack should be transferred to a new company, set up as a multi-stakeholder non-profit.
2. The new company should be designed by a working group made up of representatives of the key stakeholders, and endorsed by the Rail Regulator.
3. Key stakeholders should include the train operating companies, the workforce trade unions, the government, and consumer representatives.
4. Again, it should consider not having a unitary board but a two-tier structure of management board and a stakeholder council.
5. The constitution of the new company should include direct election of consumer representatives by customers. At first, the boards should be appointed from existing national and regional chairs of the Rail Passengers Council, but as soon as is practical board members elected by the members in a postal ballot should replace them.
6. The Rail Passengers Council and its regional committees should become democratically elected bodies, with a membership of regular travellers and local voluntary rail groups. It should be charged with developing a membership strategy to achieve this, and then to sustain members' interest. It would then elect consumer members of the board of Network Rail.



The National Air Traffic Control System (NATS) is an interesting case of a company that is investor-owned but because of the structure of the share ownership looks more like a multi-stakeholder mutual. The fact that the airlines that own a 46 per cent stake have pledged not to take surpluses for commercial gain reinforces this impression. It is more like a mutual than a non-profit because ownership is clearly assigned, and the shareholders can still use the surpluses to lower prices to the consumer. However, the involvement of travellers is very indirect; we have to accept that their interests are being protected either by the public stake or by the airlines. The company recently got into financial difficulties and has had to be bailed out with a £30 million cash injection from the UK Government, matched by the banks. When it was under public ownership, NATS had a consumer council, and there are proposals to revive this. If the company needs any further help from public funds it would be easy for government to issue new shares directly to such a consumer council. Again, this could be a genuine member organisation if it offers membership to regular travellers, perhaps using the services of airline customer clubs.

The train operating companies are currently entirely investor-owned. Some of them have developed airline-type clubs for regular travellers. They have influence only through the Rail Passengers Council, whose members are currently appointed by the Strategic Rail Authority. There is another way they can gain direct access to governance. Like football supporters, they could buy shares in the companies and dedicate the resulting governance rights to a passenger trust. This would give them direct access to and, over time, some control over, the way the train services are provided.

# Conclusion



A decade ago, nobody would have predicted that the idea of ‘mutuality’ would have become so fashionable. In the last few decades of the twentieth century, the mutual sector had lost its collective nerve. Consumer co-ops tried to be just like other retailers, closing their small, local shops and opening superstores. Mutual insurers mis-sold pensions with as much enthusiasm as did their investor-owned competitors. Building societies were as ruthless as banks in evicting mortgage defaulters. Friendly societies continued the decline that had begun when state social security was established in the 1940s. Then, just before the turn of the century, something remarkable happened. They began to get their nerve back. Co-ops began to concentrate on their small stores and brought back the dividend, becoming what they had always claimed to be – community retailers. Those building societies that resisted demutualisation began to pay attention to their membership, offering loyalty bonuses and emphasising the benefits of not having a separate group of investors with whom to share profits. Now, the pendulum is in danger of swinging the other way, so that mutuality is seen as a panacea for all ills, offering social inclusion, an alternative means of delivering public services, and an ethical alternative to global capitalism. It could be these things, but there is much work to be done. First, we have to design governance structures and member relations strategies that work, and are sustainable over time. Then we have to face up to the need to bring more than one stakeholder into the business – the old consumer co-op model is not enough. Then we have to ask whether or not members need full rights of ownership, or whether in some cases the more diffuse ownership structure of a non-profit might be better.

But unless ‘mutuality’ (in the broader sense of the term) is given a chance to work – and to evolve through practice – its potential will not be realised. In relation to water and rail it could become a viable alternative to private, profit-making companies that will always, by their very nature, put the interests of their investors before the interests of the consumers, the workers and the wider community.

# References

- <sup>1</sup>Corrigan, P, Steele, J and Parston, G (2001) *The Case for the Public Interest Company*, Public Management Foundation, London.
- <sup>2</sup>Brecher, C (2002) *The Public Interest Company as a Mechanism to Improve Service Delivery*, Public Management Foundation, London.
- <sup>3</sup>Mayo, E and Moore, H (2001) *The Mutual State: How local communities can run public services*, New Economics Foundation, London.
- <sup>4</sup>Westall, A (2001) *Value Led, Market Driven: Social enterprise solutions to public policy goals*, Institute for Public Policy Research, London.
- <sup>5</sup>Westall, A and Mayo, E (2001) *Social Ownership: Beyond public or private*, a discussion paper for the National Consumer Council, New Economics Foundation, London, p4.
- <sup>6</sup>See the arguments for this by Turnbull, S (2002) *A New Way to Govern: Organisations and society after Enron*, New Economics Foundation, London.
- <sup>7</sup>Smith, A (1982) *The Wealth of Nations*, Penguin, p.119, Harmondsworth.
- <sup>8</sup>Smith, op cit, p119 (italics are mine).
- <sup>9</sup>Smith, op cit, p251.
- <sup>10</sup>At the time when Smith was writing (1776), the only way to set up a joint stock company with limited liability for the shareholders was through an Act of Parliament, and then only for a narrow range of purposes. It was only from 1861 that the modern form of the Limited Liability Company was allowed.
- <sup>11</sup>See Birchall, J (1997) *The International Co-operative Movement*, Manchester University Press.
- <sup>12</sup>Monbiot, G (2000) *The Captive State: the corporate takeover of Britain*, Macmillan, p30, London.
- <sup>13</sup>Gauldie, E (1974) *Cruel Habitations: a history of working class housing 1780-1918*, George Allen and Unwin, London.
- <sup>14</sup>Gauldie, op cit.
- <sup>15</sup>Briggs, A (1963) *Victorian Cities*, Odhams Press, London.
- <sup>16</sup>Gauldie, op cit p227.
- <sup>17</sup>F Keddell, (1887) *The Nationalisation of our Railway System: its justice and advantages*, The Modern Press, London.
- <sup>18</sup>Summarised by Shaoul, J (1997) 'A critical financial analysis of the performance of privatised industries: the case of the water industry in England and Wales', in *Critical Perspectives on Accounting* 8, 479-505.
- <sup>19</sup>Lobina and Hall, op cit, p9.
- <sup>20</sup>House of Commons Select Committee on the Environment (2000) Seventh Report: *Water Prices and the Environment*, HC597, HMSO.
- <sup>21</sup>Lobina and Hall, op cit.
- <sup>22</sup>Shaoul (1997) op cit, p493.
- <sup>23</sup>Morse, L B (2000) 'A case for water utilities as cooperatives, and the UK experience', *Annals of Public and Cooperative Economics*, 71.3, 467-493.
- <sup>24</sup>Holtham, G (1997) 'The water industry: why it should adopt the mutual society model', *Journal of Co-operative Studies*, 29.3, 3-8
- <sup>25</sup>Schofield, R and Shaoul, J (1997) 'Regulating the water industry: by any standards?' *Utility Law Review* 8 (2), Mar-Apr, 56-70.
- <sup>26</sup>Kay, J (1996) 'Regulating private utilities: the customer corporation', *Journal of Co-operative Studies*, 29.2, 28-46.
- <sup>27</sup>Bradley, A (1999) Supplement: 'The Water Industry', *The New Statesman*, London, 26 July 1999.
- <sup>28</sup>Shaoul (1997) op cit, p493.
- <sup>29</sup>OFWAT (1999) *Draft determinations – Future water and sewerage charges 2000-2005*, 19-26.
- <sup>30</sup>Lobina and Hall, op cit, p13.
- <sup>31</sup>Shaoul, J (2000) *Water mutualisation: the financial reality of the new form of ownership*, Response to Kelda plc's proposal, Manchester University, p11.
- <sup>32</sup>Shaoul (2000), op cit.
- <sup>33</sup>There are three regulators for water: the Drinking Water Inspectorate monitoring water quality, the Environment Agency monitoring river and environmental pollution, and OFWAT setting prices. There are two regulators for railways: the Office of the Rail Regulator and a more recently set up Strategic Rail Authority. The Government is proposing to amalgamate the last two.
- <sup>34</sup>For a discussion, see Shaoul, J (1998) *Water clean up and transparency: the accountability of the regulatory process in the water industry*, Public Interest Report, Manchester University.
- <sup>35</sup>This proposal is under consideration by the Government, in relation to OFWAT.
- <sup>36</sup>A commitment made in Dept of Trade and Industry White Paper (1999) *Modern Markets, Confident Consumers*, HMSO.
- <sup>37</sup>World Bank (1996) *Regulating Water Companies*, Public Policy for the Private Sector Note 77, May, p3.
- <sup>38</sup>Lobina, E and Hall, D (2001) *UK Water Privatisation: a Briefing*, University of Greenwich, Public Services International Research Unit.
- <sup>39</sup>Kelda Group (2000) *Strategy Review Conclusions*, press release 14 June.
- <sup>40</sup>Hill, J (2001) 'Opinion', *New Mutualism* magazine, Co-operative Party, Autumn.
- <sup>41</sup>Clark, A (2002) 'Railtrack rescuer pledges more punctual trains soon', *The Guardian*, 26 March 2002.
- <sup>42</sup>The same would be true if an integrated railways mutual were set up and if train operators remained separate from the infrastructure provider.
- <sup>43</sup>Public Management Foundation (2001) *The Case for the Public Interest Company*, PMF, London.
- <sup>44</sup>There are also some companies limited by shares that have social purposes (eg Day Chocolate) or choose not to distribute surpluses to shareholders (eg National Air Traffic Control System). In such cases, they operate like mutuals though they have a structure that is normally designed to reward shareholders.
- <sup>45</sup>James, M (undated) *Letchworth, the First Garden City*, <http://mondodesigno.com/letch.htr>.
- <sup>46</sup>Public Management Foundation, op cit, p19.
- <sup>47</sup>Op cit, p25.
- <sup>48</sup>Op cit, p32.
- <sup>49</sup>Turnbull, op cit.
- <sup>50</sup>See eg Morse, L B (2000) 'A case for water utilities as cooperatives, and the UK experience', *Annals of Public and Cooperative Economics*, 71.3, pp467-493, and Holtham, G (1997) 'The water industry: why it should adopt the mutual society model', *Journal of Co-operative Studies*, 29.3: pp3-8.
- <sup>51</sup>OFWAT (2000a) *The Proposed Restructuring of the Kelda Group*, consultation document, June.
- <sup>52</sup>Turnbull, op cit.
- <sup>53</sup>Turnbull, op cit.
- <sup>54</sup>Hansmann, H (1996) *The Ownership of Enterprise*, Cambridge MA, Bellknapp Press, p21.
- <sup>55</sup>Leadbeater, C and Christie, I (1999) *To Our Mutual Advantage*, DEMOS, p23, London.
- <sup>56</sup>See Birchall, J (1997) *The International Co-operative Movement*, Manchester University Press, and Brazda, J and Schediwy, R (1989) *Consumer Co-operatives in a Changing World*, Geneva: International Co-operative Alliance.
- <sup>57</sup>Birchall, J and Simmons, R (2001) 'Member participation in mutuals: a theoretical model', in Birchall, J (ed) *The New Mutualism in Public Policy*, Routledge, London.
- <sup>58</sup>Co-operative Commission (2001) Report, *The Co-operative Advantage*, London.
- <sup>59</sup>OFWAT (2000b) *The Proposed Acquisition of Dwr Cymru Cyfyngedig by Glas Cymru Cyfyngedig*, consultation paper, November.
- <sup>60</sup>Gates, J (1999) *The Ownership Solution*, Penguin, Harmondsworth.
- <sup>61</sup>Shaoul (2000) op cit.
- <sup>62</sup>Stones, C (2001) *Changes in the pipeline: Economic and public policy implications of water industry restructuring*, Social Market Foundation.
- <sup>63</sup>See Nilsson, J 'Farmer co-operatives: organisational models and their business environment' in Birchall (ed) (2001).
- <sup>64</sup>Verba, S, Schlozman, K, L, Brady, H, E (1995) *Voice and Equality: Civic Voluntarism in American Politics*, Cambridge Massachusetts: Harvard University Press.
- <sup>65</sup>Cook, J, Deakin, S, Hughes, A (2001) *The Governance of Mutuality: Building Societies, Property Rights and Corporate Governance*, Report to the Building Societies Association and Norwich and Peterborough Building Society, p77.
- <sup>66</sup>Whiteley, P and Seyd, P *New Labour At the Grassroots*, Palgrave, forthcoming 2002.
- <sup>67</sup>Homans, G (1974) *Social Behaviour, its Elementary Forms* (2nd ed), Harcourt Brace Jovanovich, New York.
- <sup>68</sup>Birchall, J (1994) *Co-op: the People's Business*, Manchester University Press.
- <sup>69</sup>See Hansmann, 1996, Ch9; Birchall, 1997.
- <sup>70</sup>Information received from the solicitor who devised the corporate structure for the water mutuals, Jenni Mattila.
- <sup>71</sup>Nickson, A (1999) findings summarised at [www.thewaterpage.com/ppp\\_debate](http://www.thewaterpage.com/ppp_debate).
- <sup>72</sup>Salveson, P (2001) 'Crisis on the railways: an opportunity for co-operation', in *Journal of Co-operative Studies*, 34.3, December, 182-187.

## A Mutual Trend: How to run rail and water in the public interest

Key public interest industries such as water and rail have swung between public and private ownership since the beginning of the industrial revolution over 250 years ago. Johnston Birchall charts the change in ownership over time and the struggle to harness the private sector for public ends. He argues that we have not learned the lessons of history – the current models and regulation have failed to deliver. Either the interests of consumers and other key stakeholders are sacrificed or the profitability of the company is undermined.

However, current initiatives in water and rail, such as the new not-for-profit model for Railtrack – Network Rail - and Glas Cymru – a not-for-profit water company – present opportunities to put customers and the wider public interest back into the centre of the business. Birchall sets out the potential for radical new models for not-for-profits with multistakeholder governance which address the democratic deficit in our public interest companies and public services. He argues that we can

create 'ladders of participation' for the general public to become involved in such organisations through a range of innovative ways of engaging with consumers.

This book will appeal to policy-makers, and anyone interested in future change in our public services. The report is also the first in a series of publications which will further develop the ideas expressed in the New Economics Foundation pamphlet – The Mutual State – which aims to put the 'public' back into public services.



The New Economics Foundation (NEF) was founded in 1986 by the leaders of The Other Economic Summit (TOES), which has forced issues such as international debt onto the agenda of the G7/G8 summit meetings. It has taken a lead in helping establish new coalitions and organisations, such as the Jubilee 2000 debt campaign, the Ethical Trading Initiative, backed by the Government and leading retailers, the UK Social Investment Forum and the Green Gauge 'alternative' indicators of social and environmental progress.

NEF is a registered charity, funded by individual supporters, trusts, business, public finance and international donors, and acting through policy, research, training and practical initiatives to promote a 'new' economy – one which is people-centred, delivers quality of life and respects environmental limits. It's strategic areas currently include the global economy, corporate accountability, community finance and participative democracy. It is now recognised as one of the UK's leading think-tanks.

**To become a NEF supporter and receive its publications at a discount, contact us at the following address:**

New Economics Foundation  
Cinnamon House,  
6-8 Cole Street,  
London,  
SE1 4YH,  
United Kingdom,

Tel: ++ 44 (0)20 7089 2800

Fax: ++ 44 (0)20 7407 6473

Email: [info@neweconomics.org](mailto:info@neweconomics.org)

[www.neweconomics.org](http://www.neweconomics.org)

Registered charity number 1055254

© New Economics Foundation

ISBN 1-899407-51-0