

**SYMPOSIUM
ON
MARKET LIBERALISATION IN IRELAND: COMPETITION,
PRIVATISATION AND REGULATORY ISSUES**

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**Experiences from the United Kingdom in the Regulation
of Privatised Utilities**

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1. INTRODUCTION

As Ireland embarks on a programme of privatisation and liberalisation of markets, it may be informative to reflect on the experiences of the UK on competition, privatisation and regulatory issues in the utilities sector over the last two decades. The regulation of privatised utilities in Britain is widely criticised today. The criticism comes from many quarters. Customers resent their money being handed out in excessive salaries and dividends. Academics are now widely critical of the RPI-x formula for capping prices below the retail price index (RPI), which was once a proud British innovation. A curious alliance of politicians and senior industry executives is concerned to suggest that the regulatory process is insufficiently accountable.

Much of this criticism of regulators is misconceived. On balance, regulators have done a better job than could reasonably have been expected. The problems of utility regulation are mostly not the fault of the regulators. They arise directly from the failure to address a range of fundamental structural issues about the management of utilities at the time of privatisation. If people are trying to push water up hill, the correct response is not to berate them for incompetence, or to look for ingenious devices to help; it is to point the finger at those who gave them the job to do in the first place. We should address our criticisms to the politicians who devised the framework rather than at the regulators who struggle to operate within it.

The deficiencies of that framework are of three main kinds, and they have been cumulative in their effect. All have a common fundamental cause, which is that the principal concern in all privatisations, with the partial exception of electricity and buses, was to achieve a successful flotation. That was largely perceived as an end in

itself. To the extent that the architects of the programme thought beyond that, it was simply assumed that the change in ownership would bring about the desired results.

The first weakness is that the terms on which utilities were privatised were on terms which were much too favourable to firms and their shareholders, and which gave insufficient attention to the interests of customers. The second is that no explicit mechanism was put in place for securing a substantial share of the expected efficiency gains for customers. Even if - as can be argued - such a mechanism was implicit, the absence of a clear relationship was bound to leave customers dissatisfied. The third, and deepest, of the problems is that the privatised utilities lack what political theorists term legitimacy - a popularly acceptable basis for the power they exercise. Much concern has recently been expressed over the accountability of the regulators. The man in the street is not concerned with the accountability of the regulators. He is concerned with the accountability of the companies themselves, and he is right. It is this absence of legitimacy that explains why privatisation remains unpopular with the public even as it has started to deliver benefits to them, in the form of lower prices. It is also why attempts to extend privatisation further, in post and railways, in health and education, have ground to a halt.

2. THE ACHIEVEMENTS OF PRIVATISATION

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

In broad terms, these changes have been achieved without loss of output or service levels. To a much greater extent than had been realised, nationalised industries had become employers of large amounts of unnecessary unskilled labour. The Central Electricity Generating Board (CEGB), widely regarded as one of the most efficient of nationalised industries, can now be seen to have been grossly over-manned. Other countries have had similar experiences in the restructuring of their public sectors. It is, however, important to recognise that competition, rather than ownership as such, seems to have been the key element. Not only have changes happened more quickly in competitive environments than in others, but substantial productivity gains have also been made in the same period in other industries, such as the Post Office, which remained in State ownership.

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

Almost all utilities have become more customer-focused, in terms of attention to service quality and relationships with customers. British Telecom’s redesignation of “subscribers” as “customers” is in a sense only symbolic, but represents a real change; customers may now have a choice, and even those utilities which remain monopolies are more inclined to treat customers as if they did have a choice. The influence of employees on British nationalised industries was substantial, but implicit rather than explicit, and hence essentially negative. It operated to prevent change in the structure of organisations, in working practices, and in the range and nature of services provided. There was also an excessive emphasis on technical issues relative to those of marketing and finance, reflecting political love of the grandiose and the wide influence of equipment suppliers. Electricity generation illustrates the nature of change here. The CEGB focused on large, state of the art generating sets, few of which were ever built to time or budget. Since privatisation, all new capacity (apart from Sizewell B, an overhang from the old days) has taken the form of small, combined cycle gas turbines, which can be built rapidly on well-established principles.

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

There is a substantial positive balance to be recorded. It is possible that many of the

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

3. HAS REGULATION FAILED?

Criticism of the current regulatory structure comes both from those who applaud the developments described above and from those who remain hostile to privatisation. One line of attack that unites both is the alleged lack of accountability of the regulators. The various Acts prescribing their duties do so only in rather general terms. The details vary from industry to industry, but the model has substantial common elements. Each utility operates under a licence awarded to it at privatisation. This licence imposes detailed requirements in respect of behaviour and the supply of information to the regulator. Amendment to the licence, or modification or renewal of the price cap that limits prices, may be made by agreement with the firm concerned. In the absence of such agreement the Monopolies and Mergers Commission (MMC) adjudicates.

While the appellate role of the MMC is confined to major issues involving licence changes, judicial review offers a second mechanism for challenging regulatory decisions. This latter procedure is a common law remedy which has grown explosively since the mid-1970s. Although its scope is in principle confined to "Wednesbury unreasonableness" - a decision so bizarre that no reasonable person could have reached it - in practice the Courts have shown themselves more and more willing to use judicial review to explore the substantive merits of any decision reached by a public body. One unfortunate effect of judicial review on the regulatory process has been that it has increased the reluctance of regulators to provide detailed rationale for their decisions. It is easier to mount legal challenges to the steps of an argument than to the simple exercise of a general discretion which statute undoubtedly confers on the regulator.

That discretion is itself the subject of criticism. It is easy to sympathise with the argument that what is needed is clarity and transparency of regulatory procedures and formulae, and that management should then be free to operate within the framework so prescribed. But the sought for clarity and transparency is largely illusory. Consider some of the issues that are central to utility regulation. What is the cost of capital in electricity distribution? When is price discrimination pro-competitive and when is it anti-competitive in effect? What level of efficiency savings can a water company be expected to achieve? Decisions on each of these can only be made by the exercise of informed judgement. It is certainly possible to construct formulae that would, in whole or part, provide answers to these questions by arithmetic rules rather than regulatory discretion. But it is certain that the

operation of these formulae would be arbitrary and unfair and that attempts to manipulate the parameters of these formulae would have undesirable effects on the commercial behaviour of the companies affected.

The demand for greater precision and less discretion in regulation is therefore, in substance, a demand for a combination of the more extensive use of these formulae together with a much larger role for the Courts in interpreting such statutory requirements as “the proper financing of the functions” and “the promotion of effective competition”. The practical issue is therefore whether decisions on the cost of capital, the market consequences of price discrimination, and the reasonableness of efficiency targets, are better made by regulation or by judges.

The balance of argument here seems to me overwhelming. The regulator is specifically appointed for his or her balance of technical expertise and industry knowledge; the judge is not. All experience of the presentation of handling of technical economic and commercial issues of these kinds through formal legal processes suggests that the Anglo-American adversarial procedure, based on the representation of grossly exaggerated and mutually contradictory arguments by each side, succeeds in being at once extremely costly and largely ineffective in identifying and resolving substantive areas of disagreement. It is because most judges themselves perceive this that the Courts have, wisely, been very reluctant to question the exercise of regulatory discretion on matters such as these.

My preference is for giving discretion and autonomy to informed individuals capable of balancing conflicting duties and interests, rather than for the prescription of detailed rules. This applies both to regulators and to the managers of regulated companies. I am aware that this preference is unfashionable. Yet it is striking, given the criticisms of accountability and the demands for a more extensive appellate process, how little these procedures have been used. Although the threat has often been present, there has been no successful judicial review of a utility regulator’s decision and only one substantive case. Until 1992, there had been only one MMC reference on utility regulation, and that on a trivial issue. More recently, however, there has been a general review of the gas industry by the MMC, three challenges to price caps, and a further current case in telecommunications.

The central reason for the absence of challenges has been that the firms concerned did not think they would be successful. And given the generous settlements which were made at the time of privatisation, it is not surprising that the firms involved did not expect that the MMC would uphold their case or that the Courts would find that regulatory decisions were Wednesbury unreasonable. Nor does the recent experience of those utilities that have pursued MMC references provide great encouragement to others to take this route. The main reason for the demand for accountability from the utilities themselves is a belief that increased political or judicial supervision of regulatory activities would strengthen their bargaining position against the regulator.

They may be correct in this judgement. They are, however, playing with fire. The other source of demand for greater accountability is from politicians. The substantive interest which politicians have is not with the behaviour of the regulatory agency itself, but with the behaviour of the companies which are regulated. Greater political accountability for the regulator is largely seen as a route to greater accountability of the privatised companies. This demand is not altogether inappropriate, and I discuss below the problem of the legitimacy of privatised utilities, already alluded to in the introduction. But the evident and real danger is that a mechanism of direct political accountability – for example, through supervision of regulators by a select committee - would lead quite rapidly to a resumption of superficial and short-term interference in the affairs of these industries. As was true under nationalisation, this undermines the responsibility of managers for their business without effectively transferring that responsibility to anyone else; and the development of clear lines of responsibility has been a primary achievement of privatisation.

An intermediate mechanism might provide for regulation to be conducted by a board, rather than for the powers to be held by an individual. This is already the case in financial services - where the regulator is Chairman of the Securities and Investments Board (SIB) rather than Director-General of Securities and Investments - and it seems that the practical difference is very small. There have been three holders of the SIB appointment so far, and the differences among them in the style of regulation has been as great as the differences among successive utility regulators.

All three chairmen have, in different ways, been distinguished figures, and the same has generally been true of utility regulators. Two of these, in particular, have done an outstanding job. Sir Bryan Carsberg of Oftel set the style of British utility regulation. In largely uncharted seas, he managed to steer an intermediate course between the capture by the regulatees, which had too often been characteristic of British regulation, as in transport or sponsoring ministries, and the abrasive style familiar from the US. Ian Byatt at Ofwat has succeeded in sustaining a relatively tough position while maintaining almost universal respect and admiration in the industry he regulates.

This personalisation of regulation is itself another subject of, largely unjustified, criticism. If able people are to be attracted to regulatory positions, it is likely that they will become well-known public figures, if they are not already; and that they will wish to influence the style and behaviour of the organisations of which they are head. The greater danger by far is that the functions are performed by nonentities. Securing staff of appropriate calibre for regulatory agencies is already a serious problem.

This personalisation has led to differences in style among regulators. Such differences are not necessarily undesirable. In the early stages of UK utility

regulation, the adoption of different approaches has helped us learn about the process of regulation. In the recent reviews in water and electricity distribution, the very detailed requests for operating and capital cost information made by Ofwat, although burdensome, ultimately produced an outcome more satisfactory to all than the more light-handed approach of Offer. Nevertheless, as regulation matures, the case for a single body with greater commonality and consistency of approach becomes greater. Since a common agency would nevertheless continue to have different sections to deal with different industries, the practical consequence of a merger should not be exaggerated.

And, indeed, the practical consequences of any of the measures or issues discussed in this section should not be exaggerated. The key issues, and the key failings, of the existing structure of utility regulation are not to do with process. They are to do with its substantive context.

4. THE RPI-x PRICE CAP REGULATION

The RPI-x formula is the distinctive British contribution to the regulatory debate. The concept behind price cap regulation is that it provides reasonable prices to customers while preserving efficiency incentives for regulated firms. In this it has been contrasted, particularly, with price control based on actual costs plus an allowed rate of return on approved capital investment, the traditional basis of utility regulation in the US. The effectiveness of this process depends on the basis on which the price cap is determined. If the price cap is set by reference to the actual costs incurred by the firm concerned on a year-by-year basis, then price cap regulation is identical to rate of return regulation. The price cap is simply the mechanism by which the allowed rate of return is achieved.

So if price cap regulation is to differ from rate of return regulation, it is essential that prices should be based, not on what costs are, but on what they ought to be. The best source for this would be knowledge of what has been achieved by other firms, in the UK or overseas. In practice, almost no use has been made of international comparisons in British regulation, and there is little sign of any sustained attempt to develop them. One fundamental problem, which will emerge further below, is that while broad brush comparisons are possible and instructive, it is very difficult to assemble evidence of a rigorous quality which will survive appeal to the MMC or judicial view.

Another source is the cost levels achieved by other companies. The opportunity for yardstick or comparative competition of this kind provided a specific rationale for the maintenance of ten separate water and sewerage companies and twelve regional electricity companies. But the failure to make comparative competition effective has been one of the major disappointments of the UK regulatory regime. The agencies have not been successful in developing robust measures of relative performance, and have not been able to get beyond broad qualitative groupings of

those above and below average. The MMC has been particularly discouraging, treating the limited attempts to use comparative competition as matters of abstract theory. This further retreat from comparative competition was one of the most important conclusions of its recent reviews of price caps. In Scottish Hydro-Electric, the MMC substituted its estimate of the company's actual costs for Offer's calculated figures based on the distribution costs incurred by other electricity suppliers. In Portsmouth Water, the MMC explicitly rejected the suggestion that a company with costs substantially below average should earn a higher rate of return as reward for its performance.

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

The game which results is one which the regulator must inevitably lose, because the regulator can never know as well as the company what costs and capital programmes are really required. At the same time, it undermines any rational process of investment evaluation. It also diminishes incentives to control operating costs. All companies can expect to be set efficiency targets higher than would be achievable if they were already operating at the efficiency frontier. Their rational response is to maintain a reserve of inefficiency, some of which can be eliminated in the aftermath of each regulatory review. This would ensure that each target can be met or outperformed without either eroding too much the capacity to meet future efficiency targets or encouraging these targets to be set at even more optimistic levels.

These are not theoretical or hypothetical concerns. Elements of this behaviour are apparent from the recent regulatory reviews in water and electricity. Such manoeuvring between regulator and industry is likely to become worse as experience of operating this regulatory system grows. The fundamental problem is that regulator and company management can have different objectives, and also

different information. However much information the regulatory agency demands, and we can expect that it will demand more and more, it remains at a disadvantage. In the MMC's assessment of South West Water, the firm argued that only the company itself was placed to make decisions about what investment was needed to meet its obligations. The MMC held that within the current regulatory structure, such a claim could not be upheld. But both South West Water and the MMC were right in their contentions. It is impossible, or at least inappropriate, to decide from the regulator's office in Birmingham what investment should be undertaken and what not. But it is also inappropriate to allow the shareholders of a private company to invest whatever they choose and levy charges on customers to yield a return on whatever they do choose. That inconsistency between the South West Water and MMC positions demonstrates a fundamental weakness in the existing structure of regulation.

It was always appreciated by most thoughtful commentators on the RPI-x that it would, in reality, have many of the characteristics of rate of return regulation, and that much of the regulatory intrusiveness which had become familiar under that regime would arise here also. But there is a further problem, which was not widely recognised at privatisation, and which has become evident as the system has operated in practice. It is that "success" for a company operating under RPI-x means doing better than the regulator had anticipated when he set the price cap. It inescapably follows that such "success" appears as a failure of regulation and, worse still that the more effective the incentives provided by RPI-x the more inadequate the regulatory system appears to be. Customer dissatisfaction is simply inherent in the structure and, paradoxically, the better companies perform in managing it the greater such dissatisfaction is likely to be.

5. THE PROBLEM OF LEGITIMACY

Privatisation is, and has remained, an unpopular policy. A recent opinion poll showed that the proportion of the electorate which disapproved of water privatisation had risen from 71 percent at flotation to 75 percent in 2000. In its early stages, the main popular attraction of privatisation was the quick and generally substantial gains which small investors made on the shares and there were few, if any, customer benefits. In electricity and water, the process of preparing the industry for privatisation led to higher prices than would otherwise have been imposed.

With longer experience of privatisation, the combination of efficiency gains by the industries and a tighter regulatory regime has led to significant price reductions. Increases in the x (efficiency) factors in telecoms and gas have led to lower consumer prices in nominal terms in the second five-year phase of price regulation. Competition in electricity generation led rapidly to falling prices, and substantial reductions in distribution charges have been made. Although water costs will continue to increase in real terms in the second five-year period the rise will be

much less than in the first quinquennium.

Although these things might have been expected to win more support for the framework of privatisation and regulation, criticism has grown rather than diminished. Coincident developments have not helped. The share options that were awarded at flotation have produced unacceptably large gains for senior executives of privatised utilities. Although the salaries of these executives are not high by the - admittedly generous - standards of private industry generally, many people still remember that the same jobs were done only a short time ago, often by the same people, for relatively modest remuneration.

The fundamental problem which privatised utilities face is that which political scientists recognise as the issue of legitimacy: "What gives them the right to do that?". Legitimacy can stem from many sources: traditional authority, direct election, proper and accepted delegation from those whose authority is itself considered legitimate. Unsatisfactory though the performance of nationalised industries was in many respects, their legitimacy was not in doubt. But this is not true of their successors. Legitimacy is rarely a problem for institutions that are seen to be doing a good job. But, as Fukuyama puts it, "*the strength of legitimate government is that it enjoys a reserve of goodwill which protects it when things go badly*". The weakness of privatised industries is that they enjoy no such goodwill.

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

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

But it is difficult to argue that Livingstone's interest was not a proper one. It is not a good answer to the criticism levied at the company, and at its relative treatment of its own managers, employees and customers, to say that these things are a private matter between the company and its shareholders. They are not. It is a better answer to say that the regulator is the vehicle through which the public interest in these questions is expressed. But the regulator, correctly, argued that few of the matters in dispute lay within her jurisdiction. And the vote which vindicated British Gas management turns out, under scrutiny, to be an unsatisfactory affair. The billions of votes which supported the board were in fact cast by a small group - well under one hundred - of city investment managers, who had been assiduously cultivated by the British Gas chairman in the weeks preceding the AGM. These individuals were not themselves beneficial owners of claims against British Gas, and insofar as they had proper authority to act on behalf of those who were, it is not at all clear that such authority extended to matters such as these.

It is very likely that the views of the beneficial owners, pensioners and holders of life policies, were closer to those which were expressed at the meeting than to the votes that were cast on their behalf. But even if it were practical to canvass the opinions of those who directly or indirectly owned the shares, no one can seriously believe that seeking these opinions would be a good way to run the company. The whole procedure might be from Alice in Wonderland: nothing is what it seems, no-one is what they say they are.

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

6. INCENTIVES FOR WHOM?

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

been a very low key one.

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

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

If the objective is to give the managers of utilities incentives to provide better service at lower cost, then the best, simplest and cheapest way to do it is to give them incentives to provide better service at lower cost. If bonuses given to executives were based on performance relative to demanding efficiency targets or, better still, directly tied to reductions in charges to customers and improvements in the quality of services offered, then the indignation which has been provoked by the exercise of share options would largely disappear. The reason there is much less hostility to option schemes in other companies is that profits earned in competitive markets are, at least in broad terms, related to the effectiveness of the company. By contrast, the public thinks that profits are easy to earn in monopoly industries and that profits have often increased for reasons that are unrelated to improvements in efficiency or service. And again, the public is right.

7. PROFIT SHARING

If the considerable efficiency advantages which utility privatisation has brought about are to be maintained, it is essential that the link between firm performance and customer benefit is clearly established. At present, the utility retains all benefits up to the time of the next periodic review, at which time an indeterminate fraction of

efficiency gains is passed on to customers. It is essential that the lag is shortened and the connection made explicit. The most obvious method of achieving this is a mechanism for sharing profits between shareholders and customers. The attraction of a system of profit sharing is that it represents a relatively modest reform that appears to answer some of the central criticisms of the current regime.

On closer examination, however, the scope of the reform is wider than it appears at first sight, and its effectiveness in defusing customer criticism of the current arrangements more doubtful. The measures adopted by several water companies, and the industry-wide agreement on a programme of leakage control, are examples of voluntary profit sharing arrangements, and both represent constructive responses to recent customer criticism. But the limitations of voluntary arrangements are obvious. Unless very modest in scale - and the profit sharing proposals put forward so far have been very modest in scale - they create tensions between companies which choose to behave in this way and those which do not, and they put the managers of companies faced with hostile take-over in an untenable position. Unless very limited in amount, profit sharing is only possible with the framework of broadly agreed industry parameters.

That leads directly to the need to design a profit sharing formula. There are two main alternatives. One is sharing relative to the starting level. The other is sharing of profits in excess of the amount projected in the regulator's determination of price caps. Such a formula will also need to prescribe the proportions in which profits are to be shared, and also to define whether its operation is symmetric: do customers face increased charges if profits fall or are below the anticipated level? It is probably not realistic to believe that the mechanism could, in practice, operate symmetrically. But the effect of asymmetric operation is to significantly worsen the risk profile of returns faced by the company, and hence to raise its cost of capital and the overall cost of the company's activities.

The simplest method of profit sharing is to propose that a fraction of all profits in excess of today's level be allocated, not to dividends, but to lower customer charges. The great advantage of such a scheme is its simplicity. One consequence is an effective "tax" on investment by the regulated company. The source of the difficulty is that reported profit is both a return on capital employed and a return to the effectiveness with which the firm operates. This was the paradox evident in South West Water, where the obligation on the company to reinvest heavily in infrastructure improvements necessarily led, under the mechanism for price-setting, not only to steady and substantial increases in charges but also to steady and substantial rises in charges to customers. It would be possible - indeed necessary - to allow for this in the determination of price caps. There is a substantial element of illusion in this - the obligation on the firm to share profits is compensated for by an offsetting adjustment in the level of profits allowed. But the illusion may nevertheless be helpful.

A more logically coherent approach involves sharing of profits in excess of (or conceivably below) the levels provided for in price-setting. This approach would demand that the regulator be more explicit about the basis of his calculations than has generally been the case in past reviews, where elements of judgement have conditioned the final determination. Some would see this as an advantage. I believe it would be the opposite. Under the present regime, the regulator is able to make qualitative judgements about the efficiency levels achieved by companies and about the extent to which companies are taking advantage of the information asymmetry. The loss of the opportunity to do so would aggravate the gaming behaviour between regulator and regulatee described above. It would also probably increase the incidence of MMC appeal and legal challenge.

Any profit sharing proposal demands definition of the base of profits. The base should be the profits of the regulated activity. Until now, this has not been entirely clear, and a number of regulatory reviews have taken into account the overall profitability of the enterprise, and not just its profits from regulated functions. The effect of this, however, is to impose an ill-defined tax on the firm's non core functions. Not only is this undesirable, but the converse implication - that regulated customers should share the losses from unsuccessful diversification - is unacceptable. The game has been further changed, fundamentally, by the acquisition of regulated utilities by conglomerates with a wide spread of operations. There has to be a watertight boundary between Hanson's tobacco business and the activities of Eastern Electricity and this must carry over into distinctions between Eastern's first tier supply business and its other operations. Any extension of profit sharing therefore requires ring-fencing arrangements between regulated and non-regulated activities, of a kind which currently exist in water but more loosely, if at all, in other industries. Such ring-fencing inevitably involves regulatory scrutiny of all transactions which cross the ring-fence. These include, in particular, financing transactions and it will become necessary to review, and possibly to prescribe, the financial structure of the regulated business with the overall plc. Further measures of these kinds are probably now inevitable, whether or not explicit profit sharing is introduced, and would best be undertaken on a common basis across regulated industries.

The most substantial group of issues to be tackled in implementing profit sharing is that concerned with the measurement of profits. These problems concern both the base level, however defined, and the figures actually reported. The question is whether current accounting practice and standards are sufficiently robust to allow the difference between base profits and actual profits to bear the importance which it would come to enjoy under an explicit rule-based profit sharing scheme. This apparently rather technical question is in fact fundamental. Under almost any profit sharing formula, the impact of changes even in the timing of reported profitability is likely to have a significant impact on the division of gains between customers and shareholders. Issues such as the treatment of redundancy costs, pension holidays, and expenditure of a quasi-capital nature, such as computer system enhancement,

have already been the subject of extended discussion in regulatory reviews. These questions, which are at present no more than relevant background, would instead become central to the functioning of the regulatory mechanism. Worse, firms and their accountants would have every incentive to proliferate issues of this kind. It is difficult to see how a conscientious regulator could, in the final analysis, avoid employing their own auditors; not only for the historic accounts but also for the preparation of projections for the setting of price caps.

The attractions of a general profit sharing mechanism diminish on closer examination. Such a scheme is likely to aggravate the problem of gaming between regulator and regulatee, and to lead to a significant increase in the intrusiveness of regulation. It is also likely to provide friction and disputes which may take us further from, rather than closer to, the fundamental objective of strengthening customer support for, and involvement in, the present system. The basic problem is familiar from general experience of non-market based control formulae, such as the common agricultural policy, British local government finance, or more widely in East European central planning. A common, and natural, response to criticisms of the simple formula, and the distortions of behaviour created by it, is to modify the formula to meet these specific concerns. Unfortunately, the modifications simply generate new concerns, and increase incentives to sophisticated management of the formula, relative to simple management of the business. The results are ones that continue to fail to meet the underlying objectives while, at the same time, involving ever more frequent intrusion in day-to-day behaviour. This was the history of British nationalisation.