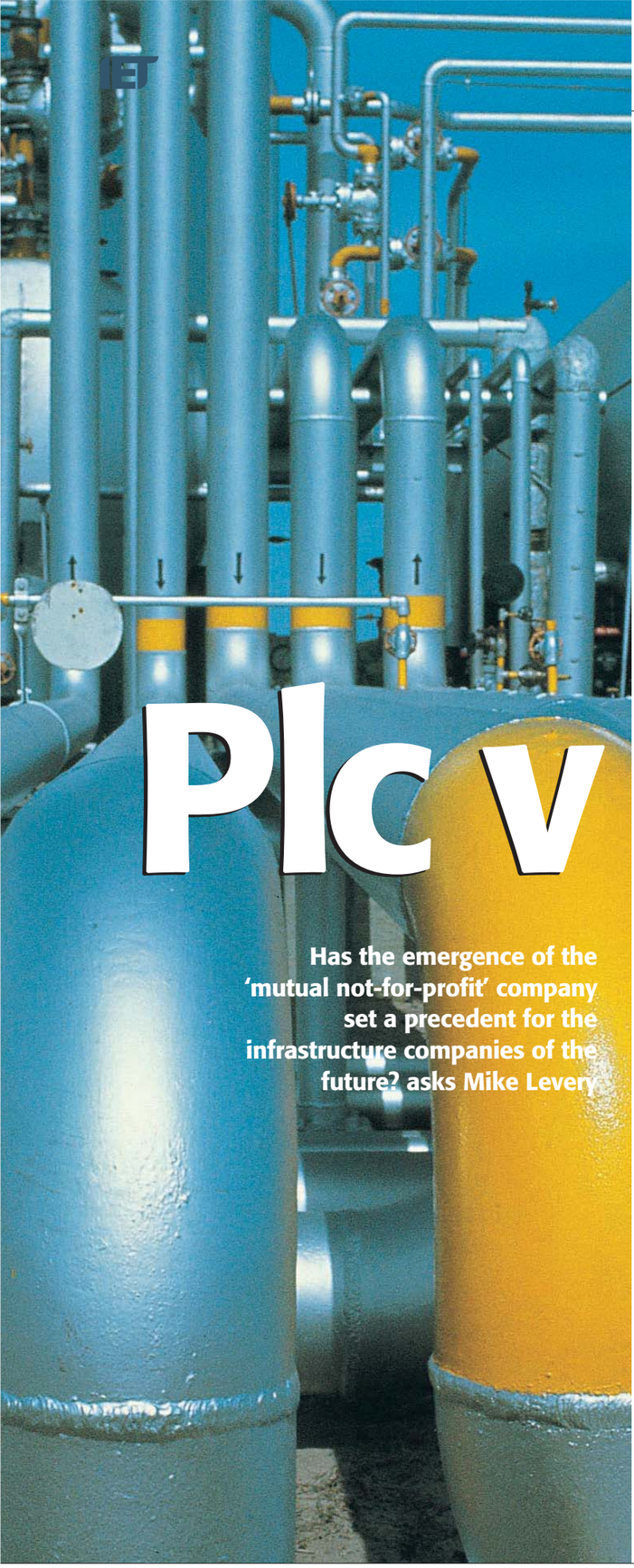


Plc v Not-for-profit

Has the emergence of the 'mutual not-for-profit' company set a precedent for the infrastructure companies of the future? asks Mike Levery

The privatisation of the rail industry followed a similar format to all other government-driven privatisations of the 1980s with public limited companies being established and the public invited to invest as shareholders in the former nationalised industries. The anticipated reversal of this policy by a subsequent Labour government never materialised as New Labour embraced the private sector and continued to support the philosophy of private companies running previously nationalised institutions.

However, when a plc fails, what should happen next? To avoid sending the wrong political messages through re-nationalisation, New Labour has adopted the 'mutual not-for-profit' company with no shareholders but members representing interested parties with any surpluses ploughed back into running the core business. The most high profile mutual company is Network Rail but they were not the first. Welsh Water was established as a 'mutual not-for-profit' company in 2000.

Can we expect to see further mutualisation for these former nationalised institutions should the plc model fail, and can infrastructure organisations in particular truly behave as private sector companies? Or is their success significantly dependant on regulatory decision making?

This article will examine the background to the establishment of two of the UK's 'mutual not-for-profit' companies and will consider whether lessons have been learnt as to why they failed and whether their business models are appropriate for organisations running infrastructure assets.

UTILITIES PRIVATISATION

Throughout the 1980s the Conservative (Tory) government privatised many of the state-run monopolies. Some of these monopolies, such as BT, British Steel and the NCB were selling their products in a competitive marketplace and were deemed to operate globally. Even British Rail was in competition with the bus industry and the motor car. Others, such as British Gas, and the water and electricity industries, were state-run monopolies that directly billed all householders for their services. In order to cushion the impact of full competition for the end user – the householder – regulation was introduced to set price controls for these newly privatised monopolies.

Since those early days the progression to full competition has varied for each market sector. BT, together with the gas and electricity industries, has seen an opening up of full competition to enable householders to choose their suppliers for these services. The rail industry has seen the introduction of franchises for the Train Operating Companies (TOCs) as a mechanism for introducing competition in passenger services. The water industry has yet to be exposed to a full competitive environment, remaining a regulated monopoly.

The assumption made by the Tory government was that all privatised state-run monopolies should adopt a plc model when privatised. While it can be argued that this model has worked effectively where direct competition is in evidence, the benefits to customers for the remaining infrastructure companies are less obvious, particularly where regulation is controlling price. Government and regulatory intervention has led to plc failure rather than the impact of direct competition. The most high profile examples of failed plcs are that of Hyder plc in 1999 and Railtrack in 2002.

Hyder plc owned two regulated companies – Welsh Water and SWALEC. Following their collapse in 1999, they were bought by American utility company Western Power Distribution, who subsequently combined SWALEC and SWEB to form a new electricity distribution company and allowed Welsh Water to become a 'mutual not-for-profit' company. The failure of Hyder plc was entirely down to the outcome of the regulatory adjudication for the Asset Management Plan (AMP3) period from April 2000 to March 2005. With government support, the regulator reduced water charges to customers by between 9.3% and 19.4% for the first year (2000/01) of the AMP3 period for the 10 largest water companies in England and Wales. For Hyder plc the effect of a 10.5% reduction in their charges to customers in 2000 for Welsh Water's services was sufficient to send their share price spiralling downwards, to such a level that the company was unable to source its capital funds to deliver the necessary investment over the five year period.

Railtrack too became Network Rail, a 'mutual not-for-profit' company as a result of the government's refusal to invest further capital beyond its already significant contribution. The outcome was as predictable as that of Hyder plc, with Railtrack being unable to fund its capital programme commitments to the Strategic Rail Authority, it was insolvent.

FINANCIAL MODELS

Why form a 'mutual not-for-profit' company when a plc fails? The collapse of Hyder plc in 1999 led to government concerns about opportunistic takeover of a failed water company. But, more importantly, did this situation provide the perfect test bed for examining an alternative to the plc for privatised utilities?

Here was the chance for the government through the water regulator OFWAT to test a new financial model in the marketplace for raising the necessary private capital to fund investment requirements, without the need to consider re-nationalisation as an option. This could be the key reason why Lord Terry Burns was appointed to set up the first 'mutual not-for-profit' company that operated in a regulated environment. There were also other political outcomes which were less obvious. Welsh Water became accountable to the Welsh Assembly, with the members of Glas Cymru appointed to represent the interests of all Welsh people. In other words, mutualisation has effectively returned control of the water assets in Wales to the pre-privatisation status, funded by private sector investment in a regulated environment.

The fact that Welsh Water comfortably raised the necessary capital to fund the 2000/05 regulatory investment requirements identified by OFWAT's five-year regulatory review gave confidence that a similar financial model would operate for a rail infrastructure company.

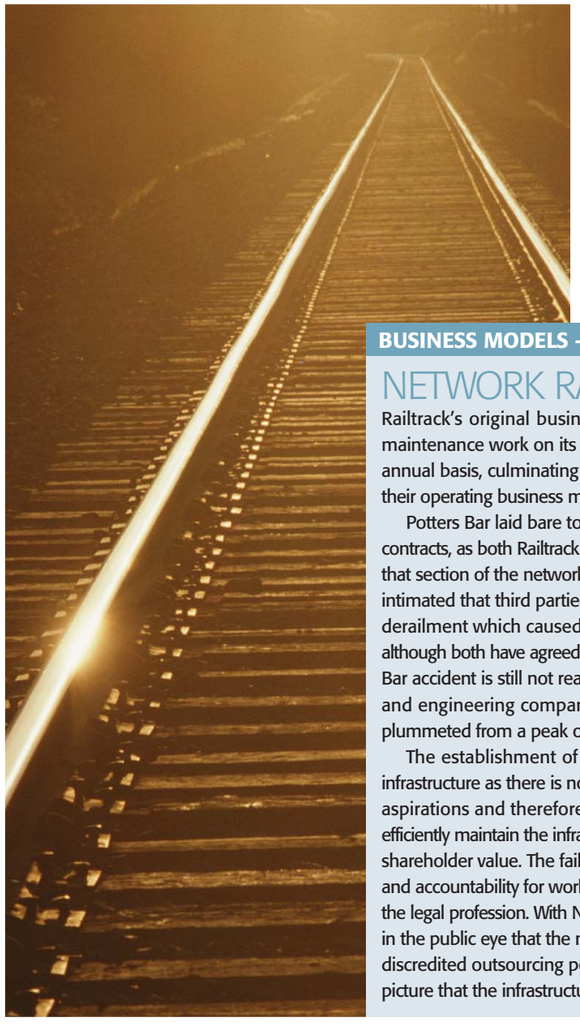
The Labour government had obvious concerns that the plc model was not working, particularly in Railtrack's case. When Railtrack turned to the government in 2002 to significantly increase their financial stake for investment in the rail infrastructure, the government acted. With the Potters Bar accident still high in the public conscience, →

> **Two 'mutual not-for-profit' infrastructure companies in the UK have adopted diametrically opposed operating philosophies**

and Railtrack's overall performance being much maligned, the government refusal of further investment made Railtrack unviable, enabling the move to the current 'mutual not-for-profit' organisation called Network Rail.

The fact that institutions are willing to invest long term in infrastructure companies without seeking a return through dividends but rather through interest on their investment set a new precedent for the future of infrastructure management companies. It gives the government the opportunity to step in with an alternative financial model with a proven track record, should a plc operating a utility fail and there be concerns about future ownership. Some regard this as re-nationalisation by another name, but capital funding in this financial model is not government sourced, and in Network Rail's case it gives the government the opportunity to reduce its investment over time to be replaced with private equity.

While the transition from plc to 'mutual not-for-profit' has proved to be relatively successful, the question as to why these companies failed as plcs requires examination of their business models and some of the key factors that led to their collapse (see Case Studies 1 and 2 below and right).



RISK AND ACCOUNTABILITY

The case studies show that the only two 'mutual not-for-profit' infrastructure companies in the UK have adopted diametrically opposed operating philosophies. Network Rail has in-sourced and is now directly managing its activities due to the calamitous approach Railtrack took in maintaining its assets through outsourced contracts. Welsh Water sees its future success through partnering contracts, with the successful contractors operating and maintaining its facilities.

Yet, have all the relevant risks and accountabilities been considered in structuring their contractual arrangements? Should a major incident occur similar to Camelford in South West Water (where a tanker driver mistakenly poured chemicals for the treatment process at a water treatment works into a potable water supply reservoir, poisoning the water supply to the town of Camelford), where will accountability lie? Surely there is little sense in having two organisations with similar drivers and objectives operating directly opposed business models.

So what is the right business model for an infrastructure company? Should infrastructure companies directly control everything that happens on their assets or can that responsibility be transferred effectively through contractual arrangements?

One thing is clear; the risk and accountability associated with transferring operational arrangements to contract are not insignificant, and traditional contractual arrangements that measure work inputs with the objective of reducing cost are highly inappropriate as Railtrack discovered.

Welsh Water sees the philosophy of partnering as the key element in ensuring that the operational contracts work in an effective environment. This is a relatively unknown and high-risk strategy. While partnering has proved effective and beneficial in the construction industry, it is operating in an environment where risks and accountabilities are well understood. Application of a partnering philosophy to an 'operate and maintain' contract in an infrastructure company is a different challenge, particularly in the water industry. There are significant numbers of stakeholders who are influential in operational decision-making, particularly customers, local councils, DWI (Water Inspectorate), EA (Environment Agency) and OFWAT (Water Regulator), together with other interest groups such as Water Watch and Surfers against Sewage.

Add to that decision making on both strategic and capital maintenance investment and the potential for difficulties to arise is significant. Has effective long term maintenance of the assets been adequately dealt with in the contract? Who is accountable for developing and delivering the asset investment policy, and how does this relate to operational performance? These are questions that Railtrack failed to address that are critical to understanding risk and accountability in 'operate and maintain' contracts.

The test of Welsh Water's business model and the partnering relationship will come when there is a crisis. Will contractual clarity in terms of risk and accountability ensure the relationship survives? Or will legal interpretation destroy trust in the relationship to the detriment of one or both of the parties?

FINALLY

Infrastructure companies throughout the UK have adopted a wide variety of business models, all driven by the continuous search for financial efficiency to meet shareholder expectations. Yet, where this driver is removed through mutualisation, there is still no consistency to identifying the most effective long term business model for an infrastructure company.

Sadly, examining the long term performance of assets and in particular the maintenance arrangements for keeping infrastructure assets well maintained is only developed as the basis for a business model when something goes wrong. When will infrastructure companies in the UK develop business models that reflect the performance of their assets rather than continuously changing to meet short term financial expediency? ■

BUSINESS MODELS – CASE STUDY 1

NETWORK RAIL

Railtrack's original business model had focused on outsourcing much of the direct maintenance work on its assets. With a succession of major accidents happening on an annual basis, culminating in the Potters Bar accident, it was only a matter of time before their operating business model would be challenged.

Potters Bar laid bare to the public the lack of accountability in Railtrack's maintenance contracts, as both Railtrack and Jarvis – the maintenance contractor responsible for work on that section of the network – attempted to avoid responsibility for the accident. Jarvis even intimated that third parties could have interfered with the track and points leading to the derailment which caused the crash. Even today, neither party will accept responsibility although both have agreed to compensate victims. The final report of the cause of the Potters Bar accident is still not ready, but the outcome for Jarvis as an infrastructure maintenance and engineering company has been catastrophic. The Jarvis Group's share price has plummeted from a peak of £5.60 in January 2002 to a fraction of that value today.

The establishment of Network Rail was, in my view, the only solution for the rail infrastructure as there is no longer the drive to reduce operating costs to meet shareholder aspirations and therefore cut costs on maintenance. Network Rail's focus is purely to efficiently maintain the infrastructure without needing to seek cost cutting initiatives to deliver shareholder value. The failure of Railtrack's maintenance contracts to properly identify risk and accountability for work done on the network was effectively an open cheque book for the legal profession. With Network Rail, an early opportunity was taken to establish credence in the public eye that the new company was in control its assets. The abandonment of the discredited outsourcing policy for maintenance assuaged public concerns and painted a picture that the infrastructure was back in safe hands.

BUSINESS MODELS – CASE STUDY 2

GLAS CYMRU

Welsh Water has got a completely different operating philosophy to Network Rail. While Glas Cymru is the owner of the assets, Welsh Water acts as asset manager, responsible for delivery of water services in Wales and controlling the capital investment programme. Crucially, however, the operation of all its facilities was transferred from in-house to an outsourcing arrangement by contract. Welsh Water is currently re-bidding the operation of its facilities from April 2005 on long term contractual arrangements of between 10 and 15 years.

Although it is the licence holder for delivering potable water and treating waste water for customers in Wales, it no longer directly operates any of its assets. Other water companies at the time Glas Cymru was established believed this was an indication of where the industry was heading, with Yorkshire Water putting proposals to the regulator to adopt a similar business model. Similarly, Anglian Water bought Morrison Construction with the intention of adopting the same business model, with Morrison providing services not just in-house, but also to other companies. The regulator made it clear that the situation in Wales was a one-off, and political accountability lay with the Welsh Assembly. Neither Yorkshire nor Anglian pursued mutualisation any further, and Anglian's share price suffered as a result of paying a premium for Morrison Construction, a situation from which they have still to recover.

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