

CORPORATE CONTROL AND THE PUBLIC INTEREST;
THEORY AND CASES

By

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ABSTRACT

This thesis contains two lines of research. The first applies the strategic decision-making theory of the firm to the issue of corporate governance. We find that preferences vary over strategy but not all interests are currently being represented, resulting in a failure to govern in the public interest. As solutions, we consider membership of the company and also more immediate ways forward, focusing on regulation and democratically controlled public agencies, but stressing the fundamental significance of active, effective citizens. Throughout, our arguments are illustrated using utility companies as our primary examples. It includes discussion of electricity privatisation in Mexico and, to demonstrate that the theory is widely applicable, we also consider governance of corporate universities. The second line of research builds upon earlier analysis by considering aspects of British electricity privatisation. We consider the role of independent power producers, finding that they have not significantly increased competition as intended but have adversely affected the future viability of the system. The affect of privatisation on electricity prices is also considered via the use of a counterfactual model for continued state ownership. Observed prices are found to have been significantly higher than those that would have been charged had the industry remained in the public sector.

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The responsibility for errors, however, is entirely my own.

DECLARATION OF COLLABORATIVE WORK

I do hereby declare that the material contained within this thesis draws upon the following pieces of collaborative work, and that my proportional contribution to these is given in parenthesis:

BRANSTON, J.R. and SUGDEN, R. (2002). “Educated Servants? The Corporate Governance of the Corporate University and Their Masters (the Modern Corporation)”, *mimeo*, University of Bath. (50%).

BRANSTON, J.R. and SUGDEN, R. (2001). “Healthy Governance: Participation and Democracy in the Health Industry”, *mimeo*, The University of Birmingham. (50%).

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BRANSTON, J.R., SUGDEN, R., VALDEZ, P. and WILSON, J.R. (2001). “Creating Participation: Electricity Reform in Mexico”, *L’institute* Discussion Paper 17, Universities of Birmingham, Ferrara and Wisconsin-Milwaukee. (25%).

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DECLARATION OF PREVIOUSLY PUBLISHED WORK

I do hereby declare that the material contained within this thesis draws upon the following pieces of previously published work:

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NB *This journal article builds upon work previously presented as part of the MSc dissertation referenced below, although significant and considerable differences exist between these two publications. When compared with the MSc dissertation, the journal article and the material in this thesis are based around an extended and enhanced methodology, utilise a different data set, include greater evidence, have a slightly different country focus and differ considerably in their scope.*

BRANSTON, J.R. (1998). "Electricity Privatisation in England and Wales: A Counterfactual Price Analysis", MSc Dissertation, Department of Economics, The University of Warwick.

TABLE OF CONTENTS

ABSTRACT	I
ACKNOWLEDGEMENTS	II
DECLARATION OF COLLABORATIVE WORK	III
DECLARATION OF PREVIOUSLY PUBLISHED WORK	IV
TABLE OF CONTENTS	V
LIST OF ILLUSTRATIONS	VIII
LIST OF TABLES	VIII
LIST OF EQUATIONS	VIII
GLOSSARY	IX

INTRODUCTION	1-13
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INTRODUCTORY COMMENTS	2-13
I. Context, Motivation and Focus	2
II. Organisation and Chapter Overview	4
III. Methodology	8
<i>III.i Overview</i>	8
<i>III.ii Telephonic Interviews</i>	9
<i>III.iii The Risk of Bias and Other Potential Deficiencies</i>	11

PART ONE: Public Interest Decision-Making	14-142
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CHAPTER ONE: Strategic Decision-Making and Corporate Governance	15-47
I. Introduction	15
II. Strategic Decision-Making	16
<i>II.i Origins in The Literature</i>	16
<i>II.ii Implication of Strategic Decisions</i>	19
III. Corporate Governance	20
<i>III.i Ownership Concentration</i>	22
<i>III.ii Alternative Anglo-US Mechanisms</i>	27
<i>III.iii Anglo-US Direct Contact and Influence</i>	31
<i>III.iv Other Facets of The Concentration of Power</i>	33
<i>III.v Exit and Voice</i>	36
<i>III.vi Concentrated Shareholder Power</i>	40
<i>III.vii Control of The Modern Corporation</i>	41
IV. Implications of the Corporate Governance Debate	42
V. Concluding Comments	45

CHAPTER TWO: The Public Interest in Public Utilities	48-87
I. Introduction	48
II. Strategic Decision-Making and the Public Interest	50
<i>II.i Strategic Decisions</i>	50
<i>II.ii Variation of Interests</i>	52
<i>II.iii The Challenge For Public Policy</i>	57
<i>II.iv Market Failure versus Strategic Failure</i>	60
III. Governance in the Public Interest	65

III.i	<i>A Reformed Legal Framework</i>	66
III.ii	<i>More Immediate Ways Forward</i>	77
IV.	Concluding Comments	85
CHAPTER THREE: Creating Public Interest Decision-Making: The Case of Electricity Industry Privatisation In Mexico		88-116
I.	Introduction	88
II.	Privatisation and Democracy	90
II.i	<i>The Drive Towards Privatisation</i>	90
II.ii	<i>The Dangers of Privatisation</i>	91
II.iii	<i>Privatisation, Democracy and Development</i>	96
III.	Mexican Electricity	98
III.i	<i>The Current Structure</i>	98
III.ii	<i>Democratic Privatisation Using Mexican Pension Funds</i>	99
IV.	Implementation, Funding and Governance	103
IV.i	<i>A Potential Industry Structure</i>	103
IV.ii	<i>Ownership, Funding and Control</i>	104
IV.iii	<i>Pension Fund Governance</i>	107
IV.iv	<i>A Balanced Governance Structure</i>	111
V.	Concluding Comments	115
CHAPTER FOUR: The Wider Application of Public Interest Decision-Making: The Case of Corporate Universities		117-142
I.	Introduction	117
II.	The Corporate University	120
II.i	<i>The Corporate University Defined</i>	120
II.ii	<i>Decision-Making within The Corporate University</i>	122
III.	The British Corporate University	125
III.i	<i>The Rationale</i>	127
III.ii	<i>Governance Mechanisms</i>	130
III.iii	<i>Corporate University Governance and Strategic Failure</i>	132
IV.	The Implications of Strategic Failure	134
IV.i	<i>A Cause For Concern</i>	134
IV.ii	<i>How To React?</i>	137
V.	Concluding Comments	140
PART TWO: British Electricity Privatisation		143-210
CHAPTER FIVE: The Issue of Independent Power Producers in England and Wales		144-178
I.	Introduction	144
II.	The Background	146
II.i	<i>Electricity Sector Privatisation</i>	146
II.ii	<i>Dominance in Generation</i>	149
II.iii	<i>How New Entrants Were Encouraged</i>	151
III.	The 'Independents'; Who, How And Why?	153
IV.	The Consequences of Entry	162
IV.i	<i>Competition</i>	162

IV.ii	<i>Damage to Coal</i>	169
IV.iii	<i>System Viability</i>	170
V.	Concluding Comments	176
CHAPTER SIX: Privatisation and Electricity Prices		179-210
I.	Introduction	179
II.	Overview Of Some Existing Literature	180
III.	Theoretical Framework	184
IV.	Counterfactual Data Used	188
IV.i	<i>Fossil Fuel Costs</i>	190
IV.ii	<i>Profits</i>	196
IV.iii	<i>Non Fossil Fuel Costs</i>	198
V.	Results	202
V.i	<i>Domestic Prices</i>	203
V.ii	<i>Industrial Prices</i>	204
V.iii	<i>Price Ratio</i>	205
V.iv	<i>Sensitivity Analysis</i>	206
V.v	<i>Beyond the Study</i>	208
VI.	Concluding Comments	208
CONCLUSION		211-222
CONCLUDING COMMENTS		212-222
I.	Overview and Summary	212
I.i	<i>Part One: Public Interest Decision-Making</i>	212
I.ii	<i>Part Two: British Electricity Privatisation</i>	214
II.	Future Research Possibilities	215
II.i	<i>Immediate Concerns</i>	215
II.ii	<i>Strategic Decision-Making Beyond the Modern Corporation</i>	216
II.iii	<i>The Health Industry</i>	217
II.iv	<i>Electricity Privatisation</i>	221
III.	Final Thoughts	221
APPENDIX A: Defining a Corporate University		223
APPENDIX B: Corporate University Interviews		224
APPENDIX C: Electricity Privatisation Interviews		234
APPENDIX D: Plant Margin		242
APPENDIX E: The Counterfactual Model		243
APPENDIX F: The Breakdown of Profit Between Industrial and Domestic Sales		245
APPENDIX G: The Pessimistic Counterfactual		248
APPENDIX H: The Optimistic Counterfactual		249
REFERENCES		250

LIST OF ILLUSTRATIONS

Figure 1: Electricity Production and Access in Mexico	95
Figure 2: Potential Control Structure	113

LIST OF TABLES

Table 1: The Plant Margin of the UK Electricity System	171
Table 2: Domestic Electricity Prices	203
Table 3: Industrial Electricity Prices	204
Table 4: Ratio of Industrial to Domestic Prices	206
Table 5: Domestic Electricity Price Counterfactual Comparisons	207
Table A1: Differences Between a Training Department and a Corporate University ..	223
Table A2: Meister's Organisational Principles and Goals for a Corporate University	223
Table B1: Core Interview Questions	224
Table C1: Core Interview Questions	234
Table E1: Counterfactual Assumptions	243
Table F1: 1993/94 Electricity Price and Typical Bill Breakdown	245
Table F2: 1993/94 Electricity Sector Profits	247
Table G1: Pessimistic Counterfactual Assumptions	248
Table H1: Optimistic Counterfactual Assumptions	249

LIST OF EQUATIONS

Equation 1	181
Equation 2	182
Equation 3	185
Equation 4	186
Equation 5	186
Equation 6	187
Equation D1 (Appendix D)	242

GLOSSARY

APP	Affiliated Power Producers
BG	British Gas
CCGT	Combined Cycle Gas Turbine
CEGB	Central Electricity Generating Board
CfD	Contract for Differences
CFE	Comisión Federal de Electricidad
CU	Corporate University
FFL	Fossil Fuel Levy
FGD	Flue Gas Desulphurisation
IPP	Independent Power Producer
LFC	Luz y Fuerza del Centro
NE	Nuclear Electric
NETA	New Electricity Trading Arrangements
NGC	National Grid Company
NP	National Power
OFFER	Office of Electricity Regulation
OFGEM	Office of Gas and Electricity Markets
PG	PowerGen
REC	Regional Electricity Company
SMP	System Marginal Price
VAT	Value Added Tax

INTRODUCTORY COMMENTS

I. CONTEXT, MOTIVATION AND FOCUS

Ever since Berle and Means (1932) first introduced the possibility of US corporations being controlled by their management, there has been much attention focussed on how corporations are governed, and by whom. This debate has recently been given fresh impetus by the collapse of the giant US based transnational energy corporation, Enron, amid a web of accounting irregularities, fraud and dubious business practices on a massive scale.¹ These events prompted serious questions as to how shareholders had been blind toward, and powerless to prevent, the managers of *their* corporation from pursuing such questionable and illegal policies that had such disastrous effects. Moreover, such interest in governance was further fuelled by subsequent revelations of more cases of fraud and/or accounting irregularities within the US corporate sector, as companies such as Worldcom,² Qwest,³ Tyco⁴ and Xerox⁵ also admitted to wrong doing. The issue of corporate control has therefore been brought back onto the main agenda, both in the USA and elsewhere.

The US and UK response to these corporate scandals seems to have focussed on shareholders being wronged by the criminal or otherwise dubious activities of the managers/directors of the various companies, and thus what might be done to prevent such actions in the future. Such a shareholder focus implicitly suggests that governance of corporations is only (or at least mainly) about the relationship between shareholders and managers. However, we would take issue with this, as we would suggest (and will later argue) that governance should not be limited to the relationship between these two groups,

¹ See <http://news.bbc.co.uk/1/hi/business/2517389.stm> (accessed on 3rd December 2002).

² See <http://news.bbc.co.uk/1/hi/business/2407991.stm> (accessed on 3rd December 2002).

³ See <http://news.bbc.co.uk/1/hi/business/2275318.stm> (accessed on 3rd December 2002).

⁴ See <http://news.bbc.co.uk/1/hi/business/2254125.stm> (accessed on 3rd December 2002).

but should instead be concerned about all of those groups who have an interest in the activities of a particular corporation. Only when all groups have the ability to assert influence on governance, can outcomes be framed as truly representing the ‘public interest’, which we would argue must be the goal of any democratic society.

It is therefore our intention to conceptually, theoretically and empirically re-visit the issue of governance, examining not only the debate as to who actually controls the modern corporation, but also the possible implications of this control configuration and therefore the potential policy responses required if the public interest is to be achieved.

A second, but related, line of research has also been pursued: that on privatisation. Whilst there is some tension between these two avenues, privatisation is fundamentally about governance since it is the transfer of activities from the public sector into the private sector, and therefore from public to private control. Moreover, privatisation is a process during which many changes often occur, and therefore it presents a natural opportunity in which to make the fundamental governance changes that our work on the public interest suggests may be required.

It is often argued that the change in governance inherent to privatisation is needed in order to gain greater economic efficiency (because of the higher emphasis usually placed on profits by the private sector). However, our initial focus on governance of the modern corporation and the public interest considers a broader notion of efficiency, and therefore points to the possibility of ‘strategic failure’ within the governance of the modern corporation. We would

⁵ See <http://news.bbc.co.uk/1/hi/business/2277753.stm> (accessed on 3rd December 2002).

therefore suggest that, privatisation via the simple transfer of assets into the private sector does nothing to address such concerns. Conversely, we submit that this need not be the case by presenting a practical illustration to demonstrate that privatisation, if implemented appropriately, does have the possibility to address both economic efficiency and broader concerns. In doing so, lessons from existing privatisations (both on economic efficiency and on other aspects) need to be learned, and it is this that is the focus of the later analysis in the thesis.

Our concern with governance of the modern corporation draws heavily upon the case of utility companies (especially electricity companies) in order to illustrate the ideas and concepts that we investigate. Our discussions of some lessons to be learned from existing privatisation are therefore similarly based around the electricity industry, specifically the privatisation of the sector in Britain.

II. ORGANISATION AND CHAPTER OVERVIEW

In order to pursue these arguments this thesis is split into two parts, each of which focuses on the different lines of research as mentioned above. Part One, entitled ‘Public Interest Decision-Making’, uses the strategic decision-making perspective of the firm to focus attention on the governance of the modern corporation, within which our specific concern is the attainment of the ‘public interest’.

Chapter One starts by introducing the notion of strategic decisions, and suggests that because these decisions determine a corporation’s broad direction, to control them is in essence to control the firm. In light of this, control of the strategic decision-making process is then

examined in a review of corporate governance, in order to explore how control of the modern corporation is currently conceptualised in the world's major economies. We find that although there are significant differences within the corporate governance systems observed, the core result is the same; shareholder power rests with a relatively small group of shareholders. Together with higher management and the board of directors, we suggest that they form an elite, a select few, who control the strategic decision-making process and therefore exercise control of the corporation.

The significance of elite control is explored in Chapter Two, which uses the example of utility companies to illustrate this in a practical context. We propose that preferences over potential strategic decisions vary between those who have an interest in the activities of a particular corporation. This variation is then used to suggest that having control of the modern corporation in the hands of a subset of those who have an interest in its activities leads to decisions being taken in the interest of that elite, and thus perhaps not in the interests of the wider public; that decision-making is not taken in the public interest. In light of this, we examine what measures might be taken in order to ensure that utility companies, and thus companies more generally, are controlled so as to serve the wider public interest. We advocate that companies be controlled by their members, where members consist of all of those different groups who have a specific interest in the activities of a particular company. Practical and immediate ways forward are also addressed.

To give an illustration of how such ideas of economic democracy might be implemented in practice, Chapter Three examines the topical case of electricity reform in Mexico. After discussing why privatisation is a particularly attractive and likely option for a publicly

owned electricity system in a 'less-developed country' such as Mexico, the chapter presents one possible avenue for privatisation which seeks to incorporate the aim of economic efficiency together with principles of democratic decision-making. We suggest that Mexican pension funds have the potential to play a key role in such a process, although direct input from ordinary Mexican citizens via a variety of mechanisms and channels, is also required.

Given the focus on utility companies in the preceding chapters, Chapter Four purposely digresses from this sector by considering corporate universities. This is done in order to provide a significantly different illustration of the broadly applicable nature of our previous conclusions on governance and the public interest. After initially discussing the issue of what constitutes a corporate university, we establish the possibility of elite control of such organisations and thus the affects this may have. Drawing upon original telephone interviews, we conduct an investigation of the corporate universities of the FTSE 100 companies in order to investigate how this theoretical possibility relates to reality. Our findings suggest that British corporate universities are controlled by a subset of those with an interest in their activities and therefore that policies are needed to address this issue.

Part Two of the thesis, entitled 'British Electricity Privatisation', concentrates on the reorganisation, privatisation and subsequent development of the British electricity sector. In doing so, it aims to add to the debate on the success or failure of this particular privatisation process, firstly by considering the structure adopted and some of the subsequent changes this induced, and secondly by considering the issue of electricity prices.

To this end, Chapter Five introduces the 1990 restructuring and privatisation of the electricity sector in Great Britain before considering the specific issue of the emergence of the so called ‘independent power producers’ in the market of England and Wales. The reason behind their emergence and the nature of these companies is addressed, as is their effect on the market for electricity. Original telephone interviews with those involved with the independent power producers are heavily utilised in order to provide fresh (and often unexpected) insight into these issues. The evidence collected suggests that the independents have not done the job they were originally intended for, and that they have had a number of unforeseen consequences.

Chapter Six considers the issue of electricity prices, suggesting that privatisation should not be regarded as a success simply because electricity prices have fallen in real terms, since other industry structures might have resulted in more significant price cuts. The Chapter therefore develops a counterfactual scenario for the likely decision of a publicly owned industry in order to assess whether privatisation resulted in these price cuts or if they would have happened anyway. This counterfactual is developed around the context of an identity that splits the price of electricity into three elements, and draws upon the previous work of Yarrow (1992), and Newbery and Pollitt (1997). The conclusion is that observed electricity prices are significantly higher than would have been charged had the industry remained in public ownership. Moreover, we find that domestic consumers are particularly disadvantaged when compared with industrial users, suggesting that it is domestic consumers who bear the biggest burden of privatisation.

Finally, our concluding comments are then presented in the last Chapter. A brief summary of the thesis is presented, where the key findings are highlighted and distilled in order to reach some conclusions on our central theme of governance. The implications of the work contained herein are then discussed, together with suggestions for possible extensions or future research to be conducted.

III. METHODOLOGY

III.i Overview

As Hussey and Hussey (1997, p.54) outline, “methodology refers to the overall approach to the research process, from the theoretical underpinning to the collection and analysis of data.” Furthermore, as Silverman (1993, p.2) suggests, “like theories, methodology cannot be true or false, only more or less useful.” The methodology utilised herein has therefore been chosen to closely reflect and facilitate the themes, aims, scope and motivations inherent to this thesis.

To that end, the chosen methodology employed during the researching and writing of this thesis utilised most of the research techniques commonly used in the social sciences when conducting such research. Specifically, we have used: literature searches (both academic and non-academic sources); telephone based interviews; data analysis; surveys of, and correspondence with, those involved in sectors of interest; and communication/dialogue with those with expertise in related fields. Each of these techniques was chosen after careful thought and consideration in order to be the most appropriate for the issues in question. In the majority (if not all) of cases, several methods were utilised during the investigation of particular issues in order to verify, support and give rise to robust findings.

Throughout, the thesis utilises many actual company examples to illustrate the theory or idea being explained. Some of these examples are relatively short in nature whilst others are addressed in much more detail, acting as recurring themes throughout the thesis and/or as in-depth case studies. Whilst in one sense the choice of the specific examples is somewhat arbitrary, generally reflecting our own research interests, they have also been chosen for their topicality, their scope to raise a variety of relevant issues, their relevance to a re-occurring (utilities) theme, and their complementarity (due to either similarities or differences).

III.ii Telephonic Interviews

Chapters Four, Five and Six all make use of original telephone interviews conducted specially for this thesis. These interviews were all of the ‘semi-structured’ type in which the interviewer (J. Robert Branston in all cases) had a list of themes and questions to be addressed that formed a general but flexible guide (Saunders *et al.*, 2000).⁶ Each interview was therefore free to develop its own character in that the interviewer could respond to the specific conditions encountered by, for example, varying the order that the questions were given in, occasionally omitting specific questions where appropriate, or supplementing the pre-determined questions with additional queries (Saunders *et al.*, 2000; Hussey and Hussey, 1997).

⁶ This ‘semi-structure’ type of interview can be compared with the other two types as discussed in the literature: ‘structured’ and ‘unstructured’. A structured interview consists of a rigid set of questions that are read out, with responses generally being recorded using pre-coded answers. Unstructured interviews have no predetermined questions to work through although clear ideas as to the aspects to be explored are required - see Saunders *et al.* (2000) for further details.

This method of interviewing was chosen because it was identified as the most appropriate for the research issues to be addressed. As Saunders *et al.* (2000, p.245) put it, “semi-structured ... interviews are used in qualitative research in order to conduct exploratory discussions not only to reveal and understand the ‘what’ and the ‘how’ but also to place more emphasis on exploring the ‘why’”. These are the exact issues that are explored within Chapters Four, Five and Six. Moreover, semi-structured interviews allow “the opportunity to ‘probe’ answers” and thereby to get “the interviewees to explain, or build on, their responses ... add[ing] significance and depth to the data obtained” (Saunders *et al.*, 2000, p.247). Indeed, such probing often led the discussion into areas that were not previously considered but which proved to be of significant benefit to our understanding of the issues.

Other research methods, such as questionnaires or face-to-face interviews, were actively considered but, given the issues to be investigated and experiences reported in the research literature, it was felt that telephone interviews would be superior on a number of grounds. For example, interviews (as against questionnaires) are said to “undoubtedly be the most advantageous approach...where the questions are either complex or open-ended [or] where the order and logic of questioning may need to be varied” (Saunders *et al.*, 2000, p.248 building upon the work of Easterby-Smith *et al.*, 1991; Healey, 1991 and Jankowicz, 1995). Furthermore, it was felt that given the busy nature of the relatively high-ranking individuals to be interviewed, the more flexible approach offered by a telephone interview (as opposed to the planning required for a face-to-face interview) was more likely to engender participation.⁷

⁷ See Saunders *et al.* (2000), Hussey and Hussey (1997), or Jankowicz (1995) for further details on the advantages/disadvantages of interviews of the type utilised herein.

III.iii The Risk of Bias and Other Potential Deficiencies

Inherent in any methodological approach is the potential for bias, and/or other forms of deficiency. The most obvious areas where accusations of weaknesses in the methodology adopted herein might be placed, are the telephonic interviews and the incorporation of significant examples during Part One of the thesis.

The potential for bias and other weaknesses relating to interviewing originate for several factors. For example, bias could occur because of the actions of the interviewer, such as the way in which the questions were asked or the tone in which they were delivered. There would also be a danger of interviewee bias, which may occur because of the nature of the individuals who agreed to be interviewed, or due to the interviewee not wishing to reveal all aspects of the chosen topic. Indeed, where permission was granted, the telephone interviews were also tape-recorded which may have increased the possibility of the interviewees giving inhibited responses (Saunders *et al.*, 2000; Hussey and Hussey, 1997).

However, following the findings of the literature, great care was taken in the preparation and conducting of the interviews in order to minimise the impact of such potential problems. To this end, the interviews were generally arranged in advance rather than done on a 'cold-call' basis, and prior to the interviews, the following steps were taken: background information on the company in question was researched; interviewees were provided with appropriate information (both background to the research and the broad content of the interview); careful thought and consideration was given to the opening of the interview and the wording of the questions; permission was obtained for the recording of the interviews once the strict confidentiality and the purpose of this was carefully explained. In addition to these steps,

summaries of the interviewees' responses were utilised to check that a full and unbiased understanding was reached (Saunders *et al.*, 2000; Hussey and Hussey, 1997, Jankowicz, 1995). Given these measures, we are therefore reasonably confident that the possibility for bias in or a lack of validity from the interviews has been minimised.

The second main area where criticism of our methodology might be directed is our use of extended discussions on the examples of utility (especially electricity) companies and corporate universities. Yin (1994, p.13) defines "a case study as an empirical inquiry that investigates a contemporary phenomenon within its real-life context", and as such, it is clear that at least some of our discussions on the aforementioned topics do conform to this definition, and might therefore be called case studies.

One of the major concerns surrounding the use of case studies is the problem of generalising from a single or small number of detailed cases, towards broader theory. However, this criticism is explicitly addressed and questioned by Yin (1994, p.10), who suggests that "case studies, like experiments, are generalisable to theoretical propositions". The cases utilised herein have been incorporated in order to enrich and illustrate developments in governance theory, and thereby give a practical demonstration of how the policies we advocate as being required, might be implemented in practice. This type of use is in keeping with the suggestion by Yin (1994, p.1) that "case studies are the preferred strategy when 'how' or 'why' questions are being posed ... and when the focus is on ... some real-life context".

We therefore believe that the use of such illustrative examples should not be seen as a methodological weakness, but rather as a particular strength.⁸

⁸ Yin (1994) also suggests that there are often two other common concerns regarding the use of case studies as a means of academic inquiry, although neither of these is a particularly appropriate criticism of the case studies used within the context of this thesis. The first is that there is a perception that case studies are a less desirable approach than other alternatives (such as experiments or surveys), which Yin believes may in part be due to many previous case study enquiries lacking rigor, incorporating biased information or being the result of sloppy investigation. However, such potential problems are in no way limited to the case study approach to research. Furthermore there is no reason to suppose that the adoption of such methodology herein would mean this thesis suffers from such problems. The second potential problem Yin (p.10) identified is that case studies “take too long, and they result in massive, unreadable documents”. Given the nature of a PhD thesis, the potential length and depth of a case study is not a significant issue, especially given the way that case studies have only been used as an illustration of the underlying governance theory, rather than as the defining rigorous case study used to generalise a new theory.

PART ONE
PUBLIC INTEREST DECISION-MAKING

CHAPTER ONE

STRATEGIC DECISION-MAKING AND CORPORATE GOVERNANCE

I. INTRODUCTION

The issue of corporate control is once again a topical issue, with interest having been reinvigorated following recent scandals in corporate America. Our particular interest in the control of corporations is to incorporate recent developments in understanding the theory of the firm, and it is our contention that such an approach provides fresh insight into the implications of the modern corporation. Specifically we will focus on the strategic decision-making approach to the theory of the firm and the implications that this has for corporate governance.

In order to pursue these ideas, Section II introduces the notion of strategic decisions, tracing the development of the strategic decision-making literature from its origins, and establishes why this is of relevance to corporate governance. Section III moves the discussion forward by centring attention on corporate governance, examining who controls the modern corporation and the mechanisms utilised to exert control. The arguments are made by particular reference to the corporate governance systems of Japan and the continental European and Anglo-US economies. The Chapter finds that although these systems are different in many respects, the adoption of the strategic decision-making approach leads to a common conclusion on corporate governance. The implications of this approach are then addressed in Section IV. Finally our concluding comments are presented in Section V. Throughout, the Chapter draws upon the evidence of a number of different topical examples in order to practically illustrate several points of theory. The choice of the examples chosen

are somewhat arbitrary and necessarily reasonably brief but nevertheless give practical insight into the theory.

II. STRATEGIC DECISION-MAKING

Within the economics literature, there have been many contributions to the debate on the theory of the firm. One of the more recent theories to emerge as to the nature of the modern (transnational) corporation is the strategic decision-making approach, which is particularly (but not exclusively) associated with the work of Keith Cowling and Roger Sugden. Cowling and Sugden (1998, p.61) take the view that a corporation is “a nexus of strategic decision-making” and so they define “a modern, large corporation [as] the means of co-ordinating production from one centre of strategic decision-making” (Cowling and Sugden, 1998, p.67). The significance of this approach to the nature of a corporation becomes apparent when one considers the nature of strategic decisions and the analysis of the impact of a corporation that this approach leads to. Associated with this view of the impact of a corporation will (amongst other things) be an alternative analysis of appropriate public policy. Whilst these issues are covered later in this Chapter, or in subsequent Chapters of this thesis, it is first necessary to consider the origins of the strategic decision-making approach if its implications are to be fully explored and understood.

II.i Origins in The Literature¹

The strategic decision-making approach to the theory of the firm, as advanced by Cowling and Sugden (1987a, 1994, 1998), has two principal foundations: firstly, the seminal work by

¹ For a more in-depth analysis of the origins of strategic decision-making, the essence of the modern corporation and other literature contributions on the theory of the firm, see Cowling and Sugden (1998).

Coase (1937) as to the nature of the firm; and secondly, the literature on corporate governance, in particular the contribution by Zeitlin (1974).

The basis for the majority, if not all, economic analysis on the theory of the firm, is the seminal work by Coase (1937), which is typically seen as being a pillar supporting a market-centred approach. Coase (1937, p.388) suggested that ‘firms’ and ‘markets’ represent alternative means of co-ordinating production. To this end, Coase saw a firm as a unit where “market transactions are eliminated” in its’ internal operation, in favour of an “entrepreneur-co-ordinator who directs production” (p.388). Coase (1937, p.387) illustrated this through an example, suggesting that when a workman is redeployed from one department to another within a firm, it is not because the market has caused price differentials in the rewards of factors of production, but because he is ordered to do so by those with positions of authority within the company.² Coase therefore founded his analysis on planning, although as Cowling and Sugden point out, this is not something that is widely recognised. This is not planning in the sense of the former centrally planned economies, which might be termed macroeconomic planning, but rather planning on a microeconomic scale.

Coase (1937, p.387) argued that under the market system there is “planning by individuals” who “exercise foresight and choose between alternatives” based around the co-ordination provided by the price mechanism. However, he suggested there to be another type of “planning within our economic system which is quite different from ... individual planning ... and which is akin to what is normally called economic planning” (Coase, 1937, pp.387-388).

² Those in authority taking the decision to redeploy the workman may themselves be responding to market signals, but the crucial point is that the market is not operating *within* the firm.

It is this type of planning that he argued occurs within firms, and which thus allows them to form an alternative to the co-ordination provided by the market mechanism.

This idea of firms as units of planning leads to the more recent notion of strategy. If firms are units of planning, then they must include long-term broad plans aimed at ensuring a successful future for the firm. Such long-term plans are otherwise known as strategies, and the choice over which strategy to adopt has been termed strategic decision-making. In the context of the modern corporation, strategic decisions can be thought of as those decisions that give rise to the broad corporate plans that are the crucial determinants of the activities with which the corporation is associated. The essence of a strategic decision is to plan the general route that the firm takes with regard to the activities with which it is associated.

The importance of strategy was crucially raised by Zeitlin (1974), which brings the concept into the wider debate on corporate governance. Zeitlin saw the ability to control a corporation as actually being the capacity to determine “the broad policies guiding a corporation and not ... the actual influence on the day to day affairs of an enterprise” (Goldsmith and Parmelee, 1940, quoted in Zeitlin, 1974, pp.1089-1090). Such broad policies can thus be thought of as being the strategic decisions already defined above. Therefore, following Zeitlin and Coase, it can be said that to control the strategic decision-making process is, in essence, to control a corporation. Building upon Zietlin (1974, pp.1091-1092), examples of strategic decisions might be the power to decide where a corporation locates its facilities, the relationships it develops with workers and Governments in such locations, how it interacts with rival corporations, or how it sources any required raw materials. (Examples of real world strategic

decisions are given in the later Chapters of this thesis that examine a number of specific industry cases).

II.ii Implication of Strategic Decisions

The focus on strategy points to the modern corporation being viewed as a centre of strategic decision-making, and although it is not suggested that whatever is done in a corporation is determined solely by strategic decisions, it is suggested that these decisions are especially important because, by definition, they determine a corporation's broad direction.³

The importance of this strategic decision-making approach to the theory of the firm is that different approaches are associated with different analyses of the impact of corporations and thus with different analyses of public policy, including policy towards corporate governance. A market-centred approach to the theory of the firm is a foundation for a market-centred analysis of impact and policy but, in contrast, a strategy-centred approach leads to an understanding of impact and policy based on strategic decision-making. For the latter, the impact of corporations depends crucially on who governs and on what basis they make their decisions.

Different strategic decisions for a corporation will be associated with differing impacts of that corporation upon society. The choice of where to locate a new production facility, for example, could have a dramatic effect on the various different locations under consideration. Thus to choose a corporation's strategy, is to choose the impact of that corporation upon

³ In line with this Pitelis and Sugden (1986) outline two further layers of decision-making within the firm: operational decisions and working decisions. They argue that all three types of decision shape what actually occurs within a corporation but strategic decisions are the crucial ones since they determine the scope available when making operational and working decisions.

society. A widely used assumption in economics is that decisions are made to be in the interests of those who make the decisions. Accepting this assumption, we expect a corporation's strategy to be designed and implemented in the interests of those making its strategic decisions. It therefore follows that the affects of a corporation are determined by which group has the ability to take such decisions. Consequently, it is important to know who, or which group of individuals, control the strategic decision-making process so that the impact of the modern corporation can be more fully understood. It is to this that we now turn to in the next Section of this Chapter, where corporate governance of the modern corporation is analysed.⁴

III. CORPORATE GOVERNANCE

The notion of corporate governance has been defined in numerous ways by different commentators, and has therefore come to mean many things to many people. Nevertheless, one thing that unites most definitions of corporate governance is the concept of control over a corporation, and the overwhelming focus placed upon the relationship between shareholders and management. Implicit within all of this debate is the notion that it is shareholders who are the owners of a corporation in the eyes of the law, and the majority of existing contributions take this to imply that shareholders should ultimately determine how a

⁴ Cowling and Sugden (1987a, 1994, 1998) suggest that a corporation should be thought of as more than just a legal entity. They argue a corporation to an economist should be a wider concept in order to incorporate the nature, scope and influence of strategic decisions beyond the strictly legal boundaries of the conventionally defined corporation. In other words to view a corporation as a centre of strategic decision-making, and thus include those activities which are influenced, but not necessarily owned, by the legal body making the strategic decisions. That is to say, to include, for example, the activities of sub-contractors where their operations are controlled by the strategic decisions of the 'parent firm'. This thesis is not focused on the definition of the modern corporation but rather focuses on the strategic decision-making that occurs in such institutions. As such it does not matter if one chooses to define a corporation as something akin to the narrower legal definition, or the broader definition as suggested by Cowling and Sugden.

corporation is run.⁵ Corporate governance has therefore come to represent the concept of how shareholders exert their influence in order to be sure that it is their (and not the managers') agenda that their company follows in situations where the ownership and management of a corporation are in separate hands. In short, how shareholders, rather than managers, exercise control over a corporation.

Many authors (for example: Jenkinson and Mayer, 1992; Franks and Mayer, 1995; Shleifer and Vishny, 1997; Becht and Röell, 1998; Scott, 1999; Yafeh, 2000) highlight the differences that exist between the types of corporate governance that is observed across the major economic systems of the world. These differences have the potential to lead to different conclusions regarding who controls a corporation and as such may have profound implications for the affects of that corporation on the societies in which it operates. To this end we present a description and analysis of the different ownership systems that can be observed across different economies and the implications these differences have for corporate governance. In doing so we follow the established convention and make the distinction between three types of governance systems: Anglo-US, Japanese and continental European. These three have been chosen since they represent the largest amount of previous research contributions, perhaps because they represent some of the worlds major economies, although this is not to deny that other distinctions could have been made. However, as this Section will later suggest, although these corporate governance structures differ in many regards they ultimately give rise to the same broad conclusions; *de facto* control of the modern corporation

⁵ That is not to deny the acceptance that there will be legal (and other) restrictions on the ability of shareholders to determine the way in which 'their' corporation is run.

rests with a subset of those who have an interest in its activities.⁶ In this respect the choice of the three ‘different’ systems under consideration is somewhat arbitrary.

III.i Ownership Concentration

Concentration of share ownership is said to be one of the key factors in corporate governance because it usually leads to the concentration of shareholder power in the hands of a relatively small number of agents. This gives each of those agents significant influence over management, often by virtue of the fact that these large shareholders are also members of the board of directors. It also gives rise to strong incentives for those agents to be proactively involved with management in order to ensure that it is their agenda (and not the managers’) that is followed by the corporation, due to the significant financial interest they have in the operations of that particular corporation. Therefore, although the cost of monitoring and proactively engaging with management may be high, the rewards the agent will get from such action are more likely to be significant due to their large financial stake in the enterprise.

Conversely, where ownership concentration is low, each shareholder has little power since they control only a small amount of the enterprise, and the incentive to be actively involved is therefore low because the costs of such action are high relative to the potential rewards. This leads to the problem of ‘free-riding’. If any one individual or institution expends resources in an effort to monitor and/or control the management of a specific corporation in which they are shareholders, the benefits do not accrue solely to them. All investors will benefit, even those who have contributed nothing to the costs of such action. There is therefore a great incentive

⁶ Cowling and Tomlinson (2000, 2002) present a related argument in that they attribute the present weakness in the Japanese economy to the concentration of strategic decision-making within the *keiretsu* networks of firms. They go on to say that, in this respect, the Japanese economy shares a fundamental symmetry with recent crises

to free-ride on the efforts of other investors, by doing nothing/less oneself, relying instead on the efforts of the active participant(s) to reduce the risk of management failure. However, because such incentives apply to all shareholders, there is a significant danger that all investors will wait for someone else to do the job due to the high costs involved relative to the expected benefits, and thus that nothing gets done, resulting in managers gaining a high degree of autonomy (Blair, 1995; Jenkinson and Mayer, 1992).

The problem of free-riding leading to shareholders suffering from little or no influence over managers is therefore easier to solve when the number of parties is smaller, and/or where ownership is more concentrated. In this case the benefits accruing to one shareholder who acts are so much greater, it is worth their expending significant resources on monitoring/controlling the management of a specific company irrespective of the actions of the other shareholders. By the very nature of the concentrated ownership, more of the benefits from such action will accrue to the party responsible and thus the expected payoff from such action is greater (Blair, 1995; Jenkinson and Mayer, 1992).⁷ It would therefore seem that ownership concentration has the potential to have a significant influence on corporate governance and it is therefore appropriate to consider the ownership concentration in the different governance systems.

In Japan and many continental European countries, corporate ownership is concentrated in the hands of a relatively small number of other firms, banks, families or individuals. In contrast, ownership in the Anglo-US economies is perceived as being far more diverse. Franks and

in other forms of industrial organisation, such as the Anglo-US type of corporation. They do not however, given an in-depth investigation of the exact nature or mechanisms behind this concentration of decision-making.

Mayer (1995, pp.174-176), for example, report that of the approximately 170 largest quoted companies, the proportion in which there was at least one shareholder who owned more than 25% of the equity of the firm, was 85% for Germany and 79% for France. This situation can be compared with that in the UK, where just 16% of the top 170 quoted companies had at least one shareholder who owned more than 25% of the equity of the firm. Furthermore, Prowse (1990, p.45) reports that commercial banks hold over 20% of all outstanding corporate equity in Japan, compared with 0% in the USA.⁸ The differing levels of concentration are again illustrated by Prowse (1994), who highlights the differences in the average percentage of outstanding shares in large non-financial corporations that are owned by the largest five shareholders. He reports (p.35) that in Germany, the top five shareholders on average account for 41.5% of the outstanding shares, indicating concentrated corporate ownership. A similar, but less extreme picture can be observed in Japan, where the figure is 33.1%. These statistics can be compared with the more diversely owned US and UK economies, where the figures are just 25.4% and 20.9% respectively.

Becht and Röell (1998, p.1049) show empirically that ownership concentration in continental Europe is reflected in voting power; they highlight the “extraordinarily high degree of concentration of shareholder voting power in continental Europe relative to the USA and the UK” as their most salient finding. It would seem that the concentrated ownership (and hence voting rights) in the continental European system has been a significant factor resulting in shareholders being more directly involved in the management of these corporations than in

⁷ Even where ownership concentration is high there may well be free-riding because small shareholders will still have an incentive to let the larger shareholders get involved and thus bear the cost. The difference is that this is less likely to lead to a situation where nothing gets done and thus managers are very autonomous.

⁸ See also the report in Yafeh (2000).

the Anglo-US system. Shareholders are therefore able to exert a greater degree of direct control.⁹

The Japanese system might be seen as having a similar result to that of the continental European system, since they are both characterised by high ownership concentration levels. However, the Japanese system also has a number of individual features which differentiate it and which may therefore lead to a distinctive and unique outcome. Japanese corporations typically operate within networks – the so called *keiretsu* - which contain many other firms who are inter-related transaction partners, and who have long-term, established relationships with each other.¹⁰ Sheard (1994, p.310) notes that the “prevalence of interlocking shareholdings is one of the most striking features of the large Japanese firm. A typical listed firm has ... extensive interlocking shareholdings with transaction partners (banks, insurance companies, suppliers, customers, trading companies)”. Whilst each of these shareholdings is likely to be individually small, collective ownership within the network constitutes a majority holding. Sheard (1994, p.313) goes on to say that the interlocking nature of share ownership within such networks of firms results in “a relatively small number of shareholders being in a position to exercise joint control over any given company. Ownership is both dispersed and concentrated: a listed firm has on average 12,910 shareholders, but between ten and twenty of these could exercise joint control”.

⁹ That is not to suggest that factors other than concentrated share ownership have not contributed to the process of how shareholders are directly involved in the management of a corporation. An example of another factor that might have contributed to this process would be the German two-tier board system in which shareholder nominees play a significant part of the *Aufsichtsrat* - the supervisory board (Davies, 1999, pp.51-53).

¹⁰ See Cowling and Tomlinson (2000, 2002) for more detail on the nature of the Japanese firm and the *Keiretsu* networks.

Cowling and Tomlinson (2002), drawing upon Ruigrok and Van Tulder (1995), indicate that this process of the concentration of shareholder power inside the Japanese corporate grouping, is re-enforced by the habit of leading firms within the networks appointing former executives to key positions in lower ranked firms within the same group. This facilitates the dissemination of corporate strategy, giving the leading firms (who are often shareholders) greater influence and thus power. A similar situation is also reported by Kester (1992), who sees the habit of temporarily seconding managers to other group companies within the *keiretsu* as having a similar affect.

It would therefore seem that although significant differences exist, the Japanese and continental European models yield similar results in terms of who has the power to control a corporation; shareholder power is concentrated in the hands of a small group, which therefore have a significant degree of control over, and are actively involved with, management. Unlike the continental European or Japanese systems discussed above, the Anglo-US economies are characterised by relatively low ownership concentration rates. This not only gives shareholders less individual power, reflecting their smaller ownership stake, but also reduces the incentive for shareholders to be actively involved in the (monitoring of) management of their corporations. The costs of engaging in such action will be relatively high compared with the potential benefits of doing so, due to the small financial stake in question, and thus other corporate governance mechanisms are said to have been adopted in order to help over-come the risk of managerial failure.

III.ii Alternative Anglo-US Mechanisms

In 1997, 75% of the British stock market was owned by institutions (MacLean, 1999), and such institutional investors are said to rely on take-over to reduce management failure and diverse portfolio holdings to spread the risk of management failure in any one corporation (Jenkinson and Mayer, 1992). Investors manage portfolios that contain a large number of investments in many different corporations. Each stake is relatively small in terms of the percentage of equity owned, even though collectively the funds can be very large, reflecting their majority ownership of the stock market. The risk of managerial failure in any one corporation is therefore small to such investors since they have spread their risk via their diverse investment portfolio, and so any financial costs incurred due to managerial failure in one corporation is going to be relatively insignificant next to their total investments.

Take-over is without doubt a very significant aspect of economic activity, and is very much integral to corporate governance since the process of buying or merging a corporation impacts upon who controls, or can control, that corporation. In the year 2000, the value of worldwide mergers and acquisitions was US\$3.5 trillion, up from US\$3.3 trillion in 1999 (Economist, 2001, p.83). One of the most highlighted and commented upon differences observed in the world's various economic systems, is the extremely strong prevalence of take-over activity that exists in the Anglo-US economies. This is in stark contrast to what is observed in other economies, where take-over is much less common, and hence plays a far smaller role in the economic system. Franks and Mayer (1990), for example, document that in the UK there are approximately double the number of take-overs as there are in France or Germany. Comparable financial data on this area is hard to establish, but Prowse (1994, p.47) reports that over the period 1985-1989, the average value of completed domestic mergers and

corporate transactions with disclosed value was far higher in the Anglo-US economies than in either Japan or Germany. Normalising the data as a percentage of total market capitalisation, Prowse indicates that the average annual value of such activity as being 41.1% and 18.7% of the value of the US and UK stock markets respectively, compared with just 3.1% and 2.3% for Japan and Germany.¹¹ Even allowing for the inherent dangers when examining cross-country data of this type, the size of the difference in these figures clearly indicates that take-over activity is of a completely different magnitude in the Anglo-Saxon world.

Another noticeable difference of the Anglo-US economies is the way that this take-over activity takes place. Hostile bids are commonplace in the USA and UK, but are far more uncommon in the Japanese or continental European economies.¹² Franks and Mayer (1998), for example, report that there have only been three hostile take-overs in Germany in the post war period. Furthermore, Prowse (1994, p.49) reports that of all attempted transactions in the period 1985-1989, 37.1% of these were hostile take-overs in the UK, compared with just 9.6% for the rest of Europe.¹³ It is therefore evident that there are more take-overs in the Anglo-US economies, and more of these bids are hostile, than is the case in the Japanese or continental European economies

¹¹ The data was normalised as a percentage of stock market capitalisation to reflect the larger number of companies listed on the stock markets in the US and UK. For example, Franks and Mayer (1995, p.175) indicate there were 2,006,000 domestic listed companies on the stock market in the UK, compared with 649,000 in Germany or just 443,000 in France. This difference in the number of firms on the respective stock markets is also a significant since it further illustrates the different approach to corporate ownership adopted in these different economies.

¹² It was said by some that Vodafone's take-over of Mannesmann in 2000, the first successful hostile bid for a Germany firm by a foreign predator, was the start of a new era. However, it would seem that so far, the prediction of such profound changes has not been observed, and thus that the *status quo* has not been significantly altered – see The Economist (2001, p.84).

¹³ One might also include leveraged buyouts as being 'hostile'. Taking this wider definition of what constitutes hostile, the adjusted figures would be 43% for the UK, and just 12.3% for Germany.

It has been argued by many authors (for example, Shleifer and Vishny, 1997; MacLean, 1999; Davies 1999; Franks and Mayer 1995; Prowse, 1994) that this high level of take-over activity is an important and integral aspect of the Anglo-US system of corporate governance. It is suggested that the threat of take-over will provide management with a large incentive to adhere to shareholders wishes and where mis-management does occur, take-over will facilitate change.

The threat of take-over action will have the effect of disciplining management and encouraging them to focus on 'shareholder value', rather than pursuing their own interests. If shareholders are not happy with the efforts of management, they can engage in the so called 'Wall Street walk' and simply sell their shares (Brancato, 1997, p.xi/23). When many shareholders sell their shares, the value will fall, making the company a more attractive take-over target. The management of a company must therefore make it attractive for shareholders to maintain their holdings. This would, at least in part, involve the managers creating shareholder value, and following the course of action that the shareholders would choose. In other words, the share price is acting as a signal to management (Blair, 1995, p.68).

Take-overs are also important because where managerial failure actually occurs, take-overs are said to facilitate the replacement of poor management. A corporation that is perceived as being mis-managed would be the target of a bid, because a corporation or individual making a bid must believe that they could change the firms operations and make (greater) profits. The replacement of poor management and the alteration of corporate strategy would be believed to facilitate the return of the firm to the 'right track' of increased profitability (Roe, 1993, p.322). Franks and Mayer (1992), cited in Jenkinson and Mayer (1992, p.3), report that in the

two years following a hostile take-over in the UK, nearly 90% of directors (both executive and non-executive) will have been replaced.¹⁴

The disparity of take-over activity might therefore initially suggest that there is greater pressure on management in the Anglo-US economies to follow the agenda of the shareholders. However, various authors (see for example, Kester, 1992; or Schneider-Lenné, 1992) suggest that the take-over market is not so vigorous outside the Anglo-US economies because it is not needed. By their direct and official involvement, large shareholders in Japanese and continental European firms have sufficient control over their corporation. In contrast, it is often argued that in Anglo-US corporations, the real threat of take-over is needed to ensure that the management is effective.

These differences in corporate governance systems have led to many commentators (for example, Franks and Mayer, 1995 or Blair, 1995) labelling the corporate governance systems of Japan and continental Europe, as 'insider' systems, and that of the Anglo-US economies as 'outsider' systems. Insider systems are said to be characterised by more concentrated share ownership, where shareholders are often key 'stakeholders' such as banks, supplier or customer firms, which enables the relatively close observation of the working of the corporation. These stakeholders are also likely to be on the board of directors, enabling them to exercise control from inside the corporation via their direct involvement.¹⁵ Conversely, outsider systems are characterised by diverse share ownership and a board of directors

¹⁴ The ability for the new owners to change the way the corporation is run and hence make (higher) profits, presumably explains, at least in part, why the bidding party is willing to pay a bid premium over the traded value of the shares. They see the potential of the corporation and its future value, not simply what it is worth today. Jensen (1988, p.22) indicates that premiums in hostile bids have historically average approximately 30% although have been known to average as high as 50% at times.

dominated by outsiders who have little or no personal stake in the performance of the corporation. In these systems, control of the corporation is said to be determined outside the corporation through the methods discussed in the Section above (Blair, 1995, p.283-284). However, the use of the terms insider and outsider might be taken to imply that shareowners in the Anglo-US economies solely utilise the outsider methods of corporate governance. Whilst these instruments are clearly important, there are also other aspects to Anglo-US corporate governance.

III.iii Anglo-US Direct Contact and Influence

Diverse ownership portfolios and the adoption of take-over as methods of corporate governance do not, however, mean that the larger shareholders in the Anglo-US system have no means of direct influence over the corporations in which they invest. Whilst discussing the British system, Holland (1995, p.28) highlights the fact that “institutional influence and intervention is normally conducted through co-operative relationships with investee companies. Much of this process of influence and intervention ... [is] conducted away from the public gaze”. As Pitelis and Sugden (1986, p.75) put it, “the well-timed business lunch should not be underestimated”. These inter-organisational contacts, which also take place in the US, are often termed ‘relationship investing’; the building of long-term co-operative communications based associations between an organisation’s owners and management (Rubach, 1999; Blair, 1995).¹⁶ When taken together with more traditional mechanisms of shareholder influence like filing shareholder proposals, and voting at the AGM, this forms the notion of ‘institutional shareholder activism’, i.e. institutional shareholders having an active

¹⁵ Not only are (some of these) stakeholders likely to own significant shareholding in corporations and thus have influence via this, but they are often also involved through other channels such as the German two-tier board system which gives groups such as employees significant influence.

interest in their holdings (Rubach, 1999, pp.1-5). These concepts have spawned a growing literature looking at how widespread these are, and how effective they are in practice (see for example: Rubach, 1999; Brancato, 1997; Holland, 1995). Rubach (1999, p.34) reports a survey of equity fund managers and institutional owners in the US by Russell Reynolds Associates. It found the practice of relationship investing to be widespread; nearly half of the surveyed “managers conveyed their organisation's point of view to a board of directors, either verbally or in written form”.¹⁷ Indeed, Rubach (1999, p.101) observes that “institutional owners have a major ownership presence in United States corporate governance”. It therefore seems that, although less obvious, the Anglo-US system functions along similar lines to the Japanese and continental European models, albeit at a lower level of intensity. Large shareholders can and do have contact with, and influence over, the boards of modern corporations.

The influence of large shareholders over Anglo-US corporations is often explicitly recognised in the companies’ annual reports. To pick one of countless examples, Severn Trent Plc (one of the privatised British water companies) report that “the company attaches considerable importance to the effectiveness of its communications with shareholders ... Regular communication is maintained with institutional shareholders and fund managers through meetings and presentations” (Severn Trent, 2001, p.22). Indeed, some corporations take these contacts even further, introducing measures such as those observed at The Coca-Cola Company, which has a special telephone inquiry line for institutional investors (Coca-Cola Company, 2001, p.72).

¹⁶ Rubach (1999, p.5) reports that this process is also sometimes known as ‘relational investing’ but there tends to be some confusion as to what this actually encompasses.

¹⁷ See also Rubach (1999), chapter 4, which contains a good summary of the major literature on institutional activism.

These institutional links with the management of a corporation are given increased weight and importance as a consequence of the way that the process of such contacts interacts with the aforementioned take-over threat mechanism. Although the largest shareholders are smaller and therefore less powerful than in the Japanese or continental European systems, they can off-set this (at least in part) by utilising the possible vulnerability of the corporation to take-over. Large shareholders can threaten to sell their holdings, thereby making the corporation a potential target if managers do not pay real attention to their wishes as communicated via these direct contacts. In other words, to use the interaction of the various methods of corporate governance to their advantage. (This interaction between different types of corporate governance mechanism is discussed in more detail in Section III.v of this Chapter).

III.iv Other Facets of The Concentration of Power

As the above Sections have illustrated, concentrated share ownership, direct contact between management and the larger share owners and active take-over markets tend to concentrate shareholder power in the hands of the largest shareholders. This concentration of shareholder power within the modern corporation is further increased by the preference in many continental European countries for dual-class shares, where the different classes carry different voting rights. In Denmark, for example, class 'B' shares cannot have less than one-tenth of the voting rights of class 'A' shares whilst in Italy, France and Germany only 50% of equity need have any voting rights (Rydqvist, 1992, p.47). In many countries this habit has become the norm; approximately 75% of quoted firms in Denmark and Sweden have dual-class shares, with Switzerland being only slightly lower at 68% (Rydqvist, 1992, p.48). Where dual-class shares exist, a subset of shareholders will control a disproportionately high

percentage of the company voting rights, giving these shareholders a correspondingly high degree of control. Indeed, this predilection for dual-class shares is most likely one of the factors behind the concentration of shareholder voting power in continental Europe, as reported by Becht and Röell (1999) in Section III.i of this Chapter.¹⁸

In other countries, such as the UK, Japan or the USA, the one-share/one-vote system is favoured. Rydqvist (1992, p.48), for example, reports that only approximately 1% of companies in the UK or Japan have dual-class shares, whilst it is only slightly more common in the USA, with 4% of companies having dual-class shares. Equal voting rights per share, however, is still not enough to ensure that influence over the strategic decisions of a corporation is widely spread amongst shareholders. Tricker (1997, p.49) argues that “information has always been central to the exercise of power, and so it is with governance power”, yet Russell Reynolds Associates (1998, p.67) reports that “investors say they do not have enough information”. Without the general availability of genuine and appropriate information, the majority of shareholders cannot effectively monitor management, giving them little or no corporate control.

As Jenkinson and Mayer (1992, p.7) report, this problem is compounded by widely dispersed shareholding because “there is little incentive for a shareholder to devote much attention to the monitoring and control of a company if only a minute fraction of the total shareholdings in a firm is held”. Given a relatively small shareholding, the cost of such action could be expected to be high, relative to the benefits that might accrue from such actions. Indeed, as

¹⁸ It might be argued that the existence of dual-class shares with different voting rights doesn't matter so long as it is clear as to exactly what is being bought when each class of share is purchased. Whilst this may be true for some matters of share ownership, to argue this in regard to corporate control would be incongruous in that it

the start of the Section outlined, this also gives rise to the problem of free-riding amongst the smaller shareholders, since they have a significant incentive to rely upon the efforts of the larger shareholders to prevent managerial failure, which further distances the smaller shareholder from positions of influence. Only larger shareholders have a financial interest of a size that delivers sufficient returns to justify the costs of taking the time, effort and resources of monitoring and actively engaging in measures to control a corporation.

The combination of these features therefore means that the large shareowners that regularly meet management are typically the only groups with the incentive and opportunity to access the information needed to effectively monitor management. Consequently the annual general meeting, where all shareholders are in theory supposed to be able to exert some influence over corporate control, fails to provide an appropriate forum for achieving, as Tricker (1997, p.50) puts it, “real democratic shareholder control”.

Tricker (1997, p.49) indicates that there is “a widespread and growing demand for disclosure, transparency, and access to corporate information”. In Britain, the 1992 Cadbury Committee Report touched upon this broad issue, when it addressed the issue of non-executive directors. Its findings, together with other more recent events, have resulted in an increased role for, as O’Sullivan and Wong (1998, p.92) put it, “non-executive directors who are expected to critically evaluate the policies and strategies of their executive colleagues”. Davies (1999) cites a 1997 MORI poll that showed that only five companies out of 305 respondents had no non-executive directors, with there being an average of four such directors for all companies. The 2003 Higgs report again addressed the issue of non-executive directors in light of events

misses the point made herein that by issuing shares with different voting rights, shareholder power is further concentrated.

surrounding Enron and proposed a number of measures to refine their role in governing the corporation. Amongst other things, it proposed that independent non-executive directors should be encouraged to work closely with major shareholders (Higgs, 2003).¹⁹

In one sense, non-executive directors might be seen to reduce the requirement for shareholders to have access to information, since these directors are (at least in theory) acting to ensure that management/the board are acting in the best interests of the shareholders. However, despite this, there is still the problem of delegation; it is not the shareholders themselves being able to exert influence and monitor management. In short, there does not appear to have been (or will be in the near future) any significant changes to the information being provided to the general shareholder and so the *status quo* has yet to be fundamentally altered; shareholder power rests with a subset, a privileged few.

III.v Exit and Voice

As Rubach (1999, p.45) and Blair (1995, p.68) allude, the essence of corporate governance, and thus the differences in the various systems observed, might be seen as revolving around the choice of Hirschman's (1970) seminal notion of exit and voice. Hirschman focused on the behaviour of consumers in relation to the firms from which they purchase goods or services, but he pointed out that such theories are applicable to other situations. Moreover, his ideas are readily applicable to corporate governance and indeed, he does, if very briefly, touch upon aspects of this.

¹⁹ See also summary at <http://news.bbc.co.uk/1/hi/business/2674007.stm> (accessed on 14th February 2003).

To Hirschman (p.74), weak management has two ways of finding out about its failure: customers can stop buying the firm's product, revenues drop and so the management is compelled to search for ways to correct the faults that have led to this exit; or customers can express their dissatisfaction directly to management, that is exercise voice, highlighting to management the causes and cures for such dissatisfaction. As Hirschman himself put it, voice might therefore be defined "as any attempt at all to change, rather than to escape from, an objectionable state of affairs" (Hirschman, 1970, p.30). It is interest articulation.

In terms of corporate governance, exit and voice might be seen as describing the options open to shareholders who are not satisfied with their corporation's managers. Shareholders can either exit when they are dissatisfied with the operation of the corporation by selling their shares, or they can exert their influence over management (and perhaps other shareholders) by choosing voice and making their views known on the future direction of the corporation; they "can 'kick up a fuss' and thereby force improve[ment] ... upon delinquent management" (Hirschman, 1970, p.30).

Hirschman's contribution on exit and voice also allows a better understanding of the way the exit option works in corporate governance. According to Hirschman (p.24), if in general exit is to be successful, it is best to have a mixture of alert and inert customers in order to give management time to correct its failures. In a corporate governance context, alert shareholders who are not satisfied with management and sell their shares provide a feedback mechanism (i.e. the drop in share price) which alerts management to their failing from a shareholder's point of view. The inert shareholders, by retaining their shares, help to provide stability thereby allowing management time to identify and make the necessary adjustments required

by shareholders. The exit option, therefore, need not to be taken to the extreme of making the firm vulnerable to take-over in order to work, but can serve as both a signal to existing management, and as a last resort, to replace failing management via take-over.²⁰

However, corporate governance cannot be viewed as being such a simple ‘either/or’ type of choice, since exit and voice will interact with each other. In other words, corporate governance might be more accurately viewed as a balance between the two mechanisms. As the previous Sections of this Chapter have illustrated, both exit (take-over) and voice (direct contact with management) are used in the corporate governance systems of the Anglo-US economies, and in the continental European and Japanese systems. Indeed, Hirschman recognised that exit and voice could be part of a balance when he said that they “come into play alongside, or in lieu of” each other (p.30). Shareholders may not be able to successfully use voice if they have no threat of exit to add weight to their voice, whilst the choice of exit may involve costs (e.g. selling (potentially) valuable shares) and so some attempts may first be made to use voice in order to avoid these costs. In the extreme, the costs of exit might be such that it is no longer a viable alternative and thus voice is the only sensible option available to the shareholder.²¹ Such examples are in keeping with the views of Hirschman (p.83), who noted that “the *effectiveness* of the voice mechanism is strengthened by the possibility of exit. The willingness to develop and use the voice mechanism is reduced by exit but the ability to use [voice] with effect is increased by [exit]”. Earlier in his work, Hirschman (p.34)

²⁰ As Hirschman (p.26) points out the use of exit to alert management to cases of failure may break-down in situations where many firms are suffering from the same problem and thus the exit by existing customers is offset by the acquisition of new customers. In a corporate governance context this would be those selling shares to illustrate dissatisfaction would be replaced by new shareholders without the loss in value of the shares required to send the appropriate signal to management. The new shareholders might be equally unhappy with management but cannot find a better investment opportunity that does not suffer from the same problems.

²¹ Example of such an extreme cost precluding exit might be a massive loss on the value of the shares held, should they be sold at the currently available low price, or their sale would adversely affect the image, reputation or standing of the share owner.

commented that “the role of voice would increase as the opportunities for exit decline, up to the point where, with exit wholly unavailable, voice must carry the entire burden of alerting management to its failings.”

Whilst corporate governance might be seen to consist of a balance between exit and voice, the balance would seem to be different in the distinct governance systems that have been examined in this thesis. Hirschman (p.74) himself noted that “different organisations are differentially sensitive to voice and exit and that the optimal mix of voice and exit will therefore differ from one type of organisation to another.” This not only suggests that differences will exist across countries, but that differences could also exist in the balance between exit and voice within countries.

In the Anglo-US model, exit seems to be a powerful facet of corporate governance due to the prominence of take-over in those economies. That does mean to say that voice is not utilised, but rather that the widely dispersed share ownership that characterises this system results in it being used in a less intense or formal manner. However, the strong take-over markets and corresponding threat of exit results in voice, albeit limited in scope relative to the ‘insider’ systems, being taken seriously because of the real threat behind it. Conversely, continental European or Japanese shareowners are generally far more able to utilise voice without having to resort to the threat of exit due to the more concentrated share ownership in these economies. That does not mean to say that exit is never used in these economies but rather that it is not as common as in the Anglo-US.²²

²² Hirschman’s concept of exit and voice in relation to consumer and other groups who have an interest in the activities of a corporation is further illustrated in chapter three of this thesis.

Implicit within this discussion of exit and voice, and thus the balance between their use in the various systems of corporate governance, is the conjecture that it is only large (or relatively large) shareholders who are in a position to exert real control over a corporation. A small shareholder opting to use exit is likely to have little or no effect on the corporation as a whole and, likewise, a similarly small shareholder opting to use voice is unlikely to be able to ‘kick up much of a fuss’ on its own. Generally, only larger shareholders are successfully able to use exit and/or voice because only they have a noticeable effect by utilising such mechanisms.

III.vi Concentrated Shareholder Power

The governance systems that have been characterised as Anglo-US, continental European and Japanese differ in many respects, but in terms of shareholder power they seem to yield the same end result. Although most clearly and extensively observable in the continental European and Japanese cases, it is only the larger shareholders that have direct access to, and thus influence over, a corporation’s management. The smaller shareholders are often excluded from these links, which serve to concentrate shareholder power in the hands of the privileged few. Indeed, this is implicitly recognised in parts of the existing corporate governance literature. La Porta *et al.* (2000, p.15) summarise the arguments of Shleifer and Vishy (1997), when they frame the agency problem of corporate governance in terms of the relationship between “controlling shareholders and outside investors”, instead of the more conventional Berle and Means (1932) conflict involving “outside investors and managers” (La Porta *et al.*, 2000, p.15).

The reasons for this concentration of shareholder power vary from country to country, reflecting their respective corporate governance systems, but the end result is the same.

Concentrated share ownership, restricted voting practices, restricted corporate information and active take-over markets all contribute to the concentration of power with a relatively small group of shareholders.

III.vii Control of The Modern Corporation

As the whole debate on corporate governance illustrates, managers are (in theory) delegated agents, acting on behalf of, and for, shareholders who are the legal owners of the modern corporation. However, as Tirole (2001, p.17) puts it “the allocation of formal control ... cannot be the full story.” We have already seen that shareholder power is concentrated in the hands of the larger owners. Furthermore, the modern corporation is an immensely complicated, not to mention large, entity that requires that many strategic decisions are taken. It is unrealistic to expect that all of these decisions are, or could possibly be, made with the understanding of the *controlling* shareholders. This would seem to indicate that, as Tirole (2001, p.17) again puts it, “players without formal control rights actually enjoy substantial control over their organisation”. In other words, it appears that (large) shareholders are only involved (both directly and indirectly) with what they regard as the most important strategic decisions. This leaves senior management with a high degree of autonomy and thus a high degree of *de facto* control over the corporation. Only when management deviates significantly from the controlling shareholders’ wishes, will they be pulled back into line as the shareholders exercise their formal control powers. It would therefore seem likely that *de facto* control of strategic decision-making process, and thus control of the modern corporation, rests somewhere between a subset of (large) shareholders and the company’s senior management.

IV. IMPLICATIONS OF THE CORPORATE GOVERNANCE DEBATE

Whilst there are various answers and much debate within the corporate governance literature as to the exact balance of power between these two constituents, there is also consensus; control is clearly perceived as resting with a subset of those having an interest in a corporation's activities. A group of (relatively) large shareholders and the company's senior management are seen as being the only groups able to influence the strategic decision-making process. Other groups with an interest in the activities of a corporation, such as employees or customers, are excluded from this process. Strategic decision-making might therefore be characterised as being the preserve of a select few of those with an interest in the activities of a particular corporation, or as Cowling and Sugden (1994, p.42), and Zeitlin (1974, p.1075) label it, an "elite".

The identification of the existence of this controlling elite should be seen as the important contribution made by the corporate governance literature. This is far more profound than working out the exact nature of the relationship between shareholder and manager, or such things as the effects this has on company financial performance. These are mere details and minutiae when compared to the existence of this controlling elite, which, as will be explained in Chapter Two, is of fundamental importance to the way that corporations operate.²³

The exact make-up of this controlling elite is almost certain to differ from country to country, and from company to company within a given locality; it is likely that no two controlling elites will be exactly the same. Each country or particular corporation is likely going to have

²³ That is not to deny that the controlling elites are going to have limitations on their knowledge, and that this may impinge upon their ability to take all strategic decisions. In such cases they may need to seek outside council or employ advisors in order to gain specific knowledge or insight into particular issues – ultimately the decision will still rest with the elite, even if their decision is based on the advice of an expert.

a number of particular features that give rise to a unique balance between the relative strength of the larger shareholders and the top management. The fundamental issue is that some form of controlling elite exists, and as introduced above, that they consist of subset of those who have an interest in the actions of a particular corporation.

It is important, however, to note that just because controlling elites exist across companies and countries, it does not mean that they will all necessarily act in exactly the same way, even when presented with exactly the same situation. There is no given blueprint as to the exact composition of the controlling elite in any given situation, or how this elite should react when faced with a certain opportunity or problem. The balance between shareholders and managers within the group will differ, for example, yielding different outcomes in terms of the goals of elite as a whole. Moreover, large shareholders or managers are not homogenous groups who have exactly the same aims, goals and desires; each manager or shareholder is potentially different, having their own opinions on the future. Sometimes these opinions will coincide and so commonalities will exist between the members of the elite, on other occasions there will be differences. It is the co-existence of these commonalities and differences that allows many different elites to be in control of the worlds many different corporations, without all acting in exactly the same manner.

Take, for example, the British banking industry. HSBC and Lloyds TSB (two of the largest British banking corporations) although similar in many regards, have in some circumstances acted in different ways and adopted different policies, indicating that those in charge of the two companies have made different strategic decisions. For instance, in the late 1980s HSBC made the decision to create its branchless First Direct subsidiary, which is designed to be

innovative and technologically driven, making use such things as telephone and internet banking.²⁴ By contrast Lloyds TSB did not create, and does not own such a specialist subsidiary.²⁵ Such differing decisions reflect the different preferences, and the different balance of interests, that exist within the elite groups controlling these particular corporations.

As well as differing in their composition and aims, elites controlling corporations will also differ in the constraints they face. The policy space available to an elite, for example, is likely to differ depending on the company or locality involved, and by the nature of the decision to be made. These constraints upon decision-making might be legally binding and enforceable laws, such as the German two-board system, but they could also be wider, less tangible considerations, such as the public perception of the company or mass community action.

Witness the differing reactions across countries to the news in March 2001 that British retailer Marks and Spencer was closing its continental European operations by the end of the year.²⁶ In France, where the company's entire portfolio of 18 stores was due to be closed with the loss of 1,650 jobs, the decision created, as *The Times* newspaper puts it, "a bitter confrontation with unions and politicians".²⁷ As early as April 2001, more than 1,000 people took to the street in Paris as a protest against this action²⁸ and a legal challenge resulted in the suspension of the closures to enable a "full consultation and information process" with its workers.²⁹ Indeed, in July 2001, Marks and Spencer was forced into announcing that it was suspending these mandatory consultations whilst it attempted to sell the business as a going

²⁴ See www.firstdirect.com and www.hsbc.com (accessed on 21st January 2003).

²⁵ See www.lloydstsb.com (accessed on 21st January 2003).

²⁶ "Strike Threatens M&S Closure", *The Times*, Saturday June 23rd 2001.

²⁷ "M&S Try To Sell 18 French Stores", *The Times*, Wednesday July 25th 2001.

²⁸ "M&S Protests To Come To London", *The Times*, Saturday May 5th 2001.

²⁹ "EU Will Back France Against Brutal M&S", *The Times*, Tuesday April 24th 2001.

concern. Compare this reaction where workers, politicians and the general public were united against the closure plans, to that in Belgium, where the closure of the country's four stores was already agreed by the time of the attempt to find a buyer for the French stores.³⁰ This example clearly illustrates how the elite controlling Marks and Spencer faced far more constraints on their decision-making ability in France than they did in Belgium, where the closure of stores was more easily arranged.

V. CONCLUDING COMMENTS

This Chapter sought to investigate how corporations are controlled, and which groups are able to use these mechanisms to exert control. In order to do this, the Chapter rooted its arguments in the economic literature on strategic decision-making. Strategic decisions were defined as those important decisions that give rise to corporate strategies, the broad plans that are the crucial determinants of the activities with which corporations are associated. It was therefore argued that to control the decision-making process was, in essence, the ability to control a corporation. Consequently the Chapter then turned its attention towards investigating those who are in a position to influence strategic decision-making, by examining the existing corporate governance literature.

Corporate governance, however, is not a uniquely acknowledged concept but is a more vague idea representing the notion of control over a corporation. Given this rather blurred definition, there is considerable debate around what is, or what should be, included in the topic of corporate governance, and indeed the conclusions that are reached as to the nature of control within the modern corporation. Many focus on the relationship between shareholders

³⁰ "M&S Try To Sell 18 French Stores", *The Times*, Wednesday July 25th 2001.

and managers, often examining developments as to which of these has the power to control the direction of the corporation, and/or examining the effects of control on corporate financial performance.

Furthermore, many commentators make much of the differences in the systems of corporate governance that are found in Japan, continental European countries and the Anglo-US economies. Such differences are the source of great debate within the literature, but as this Chapter has argued, these differences are in a sense superficial. Differences only exist in so far as contributions generally concentrate on the notion of shareholders competing against management for control of a corporation. It is to the extent that one or other group controls a corporation, or the effects of differing balances in control across countries, where commentators generally disagree. Despite this disagreement, on a fundamental basis, the literature on corporate governance is extremely consistent, in that nearly all contributions seem to agree on one vital point. Control of the modern corporation is not seen as being widely dispersed, democratic, or open to all, but rather the preserve of a subset of those with an interest; an elite.

The exact make-up of this controlling elite is likely to change from country to country, and thus the behaviour of this elite will also vary, reflecting the individual conditions that exist in each locality. Constraints on the strategy space available are likely to vary from country to country and indeed the influences that exist within the elites themselves will also vary, reflecting the differing constituents of the elite. Nevertheless, the fundamental characteristic across countries is that controlling elites exist.

This is of profound importance because different groups have different preferences about the strategy the corporation should pursue. The impact upon society of a corporation will therefore differ depending on which strategy is adopted, and so the ability to select the path of a corporation is the crucial determinant in shaping its influence upon society. It is to this fundamental issue, and to the implications of corporate control being in the hands of an elite, that we now explore in Chapter Two. In order to make this theory accessible, we examine the issues by considering the specific example of utility companies and the provision of utility services.

CHAPTER TWO

THE PUBLIC INTEREST IN PUBLIC UTILITIES

I. INTRODUCTION

A public utility company, by definition, is the provider of important (one might say essential) basic services (such as electricity, water or gas) to the general public. It is often said that because the services that utility companies provide are so important to everyday life, they should be given special consideration, and consequently that the governance of utility companies should be treated differently from other, less ‘essential’ companies. This is not our view; in this Chapter we use the case of public utilities to explore the wider issues of elite control of the modern corporation. Our findings will therefore be relevant and applicable to the governance of corporations more generally.¹

Chapter One explored the strategic decision-making approach to the theory of the firm and the implications this has for corporate governance. It concluded that control of the modern corporation resides with an elite; a subset of those who have an interest in its activities. Standard economic thinking would suggest that members of such an elite (like all individuals) would exercise their control so as to further their own interests. In this Chapter we argue that it is desirable that public utilities – and hence other corporations more widely – are run, and thus governed, in the interest of the public they serve. To do otherwise, is to allow strategic failure. To that end practical steps to avoid the enduring strategic failure of elite control are outlined and examined.

¹ The exact definition of a public utility is relatively unimportant in this context since utility companies are just being used as an example to illustrate our theories of company control. For the sake of clarity, public utilities have been defined herein as including corporations that supply services such as gas, electricity, telephone, water and major transport links (such as rail or bus facilities).

In order to pursue these ideas, Section II initially positions itself by illustrating how strategic decisions, and thus the strategic decision-making approach to the theory of the firm, can be applied to utility industries. These practical illustrations are then utilised to establish how preferences over potential strategic decisions can vary between those who have an interest in the activities of a particular corporation. This varying of preferences is then used to suggest that having control of the modern corporation in the hands of a subset of those who have an interest in its activities, leads to decisions being taken in the interests of that elite, and thus perhaps not in the interests of the wider public; that decision-making is not taken in the public interest.

In light of these findings, Section III examines what might be changed to ensure that utility companies are controlled so as to serve the wider public interest. In other words, how the governance of such companies could be constructed around a more inclusive and democratic structure. We propose the notion that companies should be controlled by their members, where members consist of all those different groups who have a specific interest in the activities of a particular company. This is strikingly different from current practice where the only members are shareholders. The analysis is completed by examining practical and immediate ways forward that might address these issues in the utility sector. Our concluding comments are then presented in Section IV.

II. STRATEGIC DECISION-MAKING AND THE PUBLIC INTEREST

II.i Strategic Decisions

Chapter One argued that to control the strategic decision-making process of a corporation is in essence to control the corporation. It was suggested that strategic decisions are the important decisions that give rise to corporate strategies, the broad plans that are the crucial determinates of the activities with which a corporation is associated. Following Zeitlin (1974, pp.1091-1092), we proffered that such policies could be conceptualised in broad terms as things like the power to decide where a corporation locates its facilities, the relationships it develops with workers and governments in those locations, how it interacts with rival corporations, or how it sources the required raw materials. However, such relatively abstract strategic decisions can be readily illustrated in a more meaningful way by reference to the utility sector.

This sector, especially in regards those corporations involved with water, electricity or telecommunications, often has extensive overseas activities. In many cases, former monopoly corporations were privatised and/or liberalised prior to the expansion of the overseas operations. Expansion into overseas markets reflects a strategic decision on the part of those in control of the utility company to diversify away from their historical base. Indeed, as well as expanding the span of their geographical interests, many corporations have also diversified into new areas, thus expanding the number of activities with which they are associated. This is again a strategic decision.

Consider the specific example of ScottishPower. The company was privatised in 1991 as an integrated electricity company, providing generation, transmission, distribution and supply of

electricity in its historical franchise area of Scotland (Thomas, 1996a).² Since this time, a series of strategic decisions have been taken which have considerably altered the business. The company now operates in the USA as well as in the UK (as opposed to just Scotland), having electricity generation, transmission, distribution, and supply activities in both countries, as well as coal mining and gas storage/hub services in the US, and gas supply interests in the UK.³ In the years following privatisation, the group also developed significant interests in telecommunications although these have subsequently been demerged into the THUS Group Plc.⁴ The decision to demerge these telecommunication interests, just like the initial decision to develop them or the other activities and/or countries added since privatisation, is an example of a strategic decision taken by those who control the ScottishPower group.

Furthermore, those in charge of ScottishPower will have also taken many other strategic decisions, such as the location and technical type of new generating plant to be built or acquired. In early 2001, for example, ScottishPower acquired the Combined Cycle Gas Turbine (CCGT) Rye House power station from PowerGen (another UK based power group created during the privatisation process). Indeed, the decision of ScottishPower to purchase the Rye House power station was possible because those in a position to exercise control over Powergen had decided to sell the plant and had taken a number of strategic decisions in the

² The company was actually created when the industry was reorganised in 1990. See Chapter Five for further details of electricity reorganisation and privatisation in Great Britain.

³ See http://www.scottishpower.com/pages/aboutus_companyprofile (accessed on 13th August 2002).

⁴ See http://www.thus.net/index_2.htm, About Thus, Company History section. (accessed on 13th August 2002).

early 1990s when they decided to build a power station at that location, and chose the CCGT technology.⁵

II.ii Variation of Interests

To be able to exert corporate control is of profound importance because the actions of corporations are widely felt within society, especially when those corporations are involved with the utility sector. Each strategic decision will impact upon communities in a different way (both good and bad) and so to control a corporation is to determine its impact upon society. The significance of this lies in the fact that interests vary across those concerned about, and affected by, a corporation's activities; not everyone with an interest draws equal benefit, or bears an equal burden.

This variation would inevitably entail different strategic decisions being preferred because each potential decision each would yield differing effects in the ways in which corporations influence economies and hence societies. Zeitlin (1974, p.1091) implicitly recognised this variation in interests when he argued that controlling a corporation actually implies the ability to determine broad corporate objectives “despite resistance from others” - such resistance can only exist if there is disagreement concerning the decisions to be taken. Indeed, Brancato (1997) also recognises the fact that interests vary within corporate governance when she comments that “it is crucial to remember that creating shareholder value means different things to different shareholders” (Brancato, 1997, p.xiv). Furthermore, this concept can be illustrated in the specific case of the utility sector.

⁵ See Rye House section of http://www.scottishpower.com/pages/aboutus_scottishpowerbusinesses_ukdivision_powergeneration?nav=about_us_scottishpowerbusinesses_ukdivision_powergeneration (accessed on 13th August 2002).

Shareholders currently dominate systems of corporate governance, and because of their financial stake, they clearly have a particular interest in ensuring that the corporation, and thus their shareholding, remains profitable. Consider the troubled British railway network infrastructure company, Railtrack, which was placed in administration during October 2001.⁶ In an effort to resurrect Britain's railway infrastructure, the assets of Railtrack were sold to a new 'not-for-dividend' company, Network Rail.⁷ The decision to enter into this sale, however, was not universally welcomed by all Railtrack shareholders. Many smaller shareholders objected to the sale but it was nevertheless passed at the extraordinary meeting thanks to institutional investors who voted in favour. Indeed, 1,000 small shareholders registered their protest at the sale during the meeting via three-and-a-half hours of attacks on the board,⁸ but ultimately 97% of votes were cast in favour of the sale.⁹ That this was not totally unanimous illustrates that shareholders are not one homogenous group who agree on every issue.

Subsets of shareholders are not the only groups to have an interest in the activities of a particular utility company. Such companies are, by their nature, companies with large numbers of employees. At the extreme, for example, the Deutsche Telekom Group workforce on 30th September 2001 stood at 246,192 (Deutsche Telekom, 2001, p.2), whilst the BT Group's workforce stood at 108,600 on 31st March 2002,¹⁰ and Vivendi Environnement (A

⁶ See <http://news.bbc.co.uk/1/hi/uk/scotland/1586086.stm> (accessed on 14th August 2002).

⁷ Network Rail has no shareholders but is run along commercial lines, with any operating surplus being re-invested in the rail network. The company board is held accountable for its performance by 115 members who are individuals and organisations with an interest in the future of the rail sector (Network Rail, 2002a). The issue of membership of Network Rail is discussed later in this Chapter.

⁸ See <http://www.guardian.co.uk/business/story/0,3604,762181,00.html> (accessed on 14th August 2002).

⁹ See <http://www.railtrack-group.co.uk/news/article.cfm?id=1251> (accessed on 14th August 2002).

¹⁰ <http://www.groupbt.com/Corporateinformation/Chartingourprogress/charts2/charts.pdf> (accessed on 13th August 2002).

France based environmental services company) employed approximately 239,000 people in 2001.¹¹ Whilst companies with such high employee numbers are relatively few in number, many of the smaller utility companies still employ significant numbers of workers. British Energy (UK based energy company), for instance, employs approximately 8,200 workers, whilst Severn Trent Plc (UK based environmental services group) employs over 14,000 people.¹² It is inconceivable to believe that all of the employees in such companies share exactly the same vision for the company's strategic decisions or, for that matter, agree with all the strategic decisions taken by those in control.

Consider, for example, the decision of British Telecom to demerge its mobile phone business in 2001. Members of the Communication Workers Union opposed this action as they were said to believe that it would lead to a take-over and then job losses.¹³ This clearly illustrates that those in control of British Telecom's strategic decision-making process, and (at least some of) the workers held different preferences concerning the future of the mobile phone division. Furthermore, in the summer of 2002, rail members of the Rail Maritime and Transport (RMT) Union voted on industrial action concerning a pay dispute with train operator First North Western. The fact that only approximately 85% backed industrial action illustrates that workers are not one homogenous group that agree on every issue.¹⁴

Moreover, there are other groups who have an interest in the activities of the various utility concerns. Given the nature of utility companies, one of the most important amongst these

¹¹ The key figures section of; www.vivendienvironnement.com/en/services/infos/index.htm?garde=/en/services/infos/historique/garde.htm, (accessed on 13th August 2002).

¹² See <http://www.british-energy.com/media/information/index.html> and Employment section of <http://www.severn-trent.com/obop/index.htm> respectively (Both accessed on 14th August 2002).

¹³ See <http://news.bbc.co.uk/1/hi/business/1615100.stm> (accessed on 14th August 2002).

might be said to be consumers. Consider the example of the coming of age of the Internet, which has started a revolution in the way in which telephony services are viewed, provided and utilised. Many consumers (both household and business) would like improved access to the next generation of technology, which should provide cheap and quick access to the Internet. However, as the *Financial Times* reported, “in the US and Europe, telecommunication operators (like BT) have been reluctant to deploy new broadband access technologies ... because of their concerns that it would cannibalise their highly lucrative ISDN and leased line services” which are based on older (and hence slower) technologies.¹⁵ In this respect the interests of consumers and those in control of the telecommunication operators do not seem to coincide. This does not mean, however, that consumers are a uniform group; there will be a multitude of subsets who hold diverging views on what they expect from a particular utility company. Looking more widely, this might be in terms of the level of service they receive, such as the level of water quality or packages which include equipment rental and servicing. Consumers would also differ in other ways, such as in preference on the type of tariff structures, methods of payment or the ability of companies to offer discounts when they bundle utility services, like gas and electricity.

Special interest groups, such as environmental pressure groups, would also have their own, and most likely distinct, opinions on company strategy. In this case placing a heavier weight on environmental concerns than might other interest groups, such as shareholders or consumers. Take, for instance, the case of power generation. Organisations such as Greenpeace or Friends of the Earth object to the use of certain types of fuel or technology (i.e.

¹⁴ See <http://news.bbc.co.uk/1/hi/wales/2159512.stm> (accessed on 14th August 2002).

¹⁵ *Financial Times*, 7th April 1999, ‘Survey - Financial Times Information Technology: Speedier access Broad Band Access by Paul Taylor: Livelier content and improved services with transform the internet when users are no longer constrained by slow access’.

nuclear or fossil fuels) on the grounds of environmental desecration.¹⁶ For example, because of these views, such environmentalists were bitterly opposed to the plans for the construction of a new nuclear power station in Finland that was finally approved in May 2002 by the Finnish parliament.¹⁷

Other identifiable interest groups are those involved with related firms, both direct competitors and utility companies in general, as they will also have an interest in the strategic decision of a specific company. The strategic decisions of one firm may have potentially damaging or lucrative spillover effects on other utility companies. In Britain, for example, the decision of Telewest (a cable company) to offer a 'reasonable' flat rate tariff for unlimited Internet access inclusive of phone charges put great pressure on other providers of telephony services to offer similar unmetered tariffs.¹⁸ A few days after Telewest made their announcement, NTL (another cable company) followed suit by offering free and unmetered Internet access, conditional on switching to the company's telephone service and spending a minimum of £10 a month on ordinary voice calls. Such moves applied enormous pressure to BT (the former monopoly telephony company), forcing it to respond with several unmetered Internet access¹⁹ packages.²⁰

¹⁶ See <http://www.greenpeace.org/> for more information on the stance of Greenpeace, and <http://www.foei.org/> for information on Friends of the Earth (both accessed on 13th August 2002).

¹⁷ See <http://news.bbc.co.uk/1/hi/world/europe/2006191.stm> (accessed on 13th August 2002).

¹⁸ *The Times*, 6th March 2000, 'Blair Set to back calls for lower Net fees'.

¹⁹ *The Times*, 9th March 2000, 'BT seeks leeway to compete in Net war'.

²⁰ This type of pressure has already been seen in the market for Internet Service Providers (ISPs) when Freeserve pioneered subscription-free Internet access (i.e. no monthly fee) in Europe. Freeserve was so successful after its launch, that many other ISPs were forced to follow its example and offer subscription-free access. - see the *Financial Times*, 17th March 2000, 'Companies and Finance: UK Early fame brings pitfalls and suits in the wings: Freeserve will need to rebrand itself to gain long term success, says Caroline Daniel'.

Another group that may be seen to have an interest in the activities of utility companies is Governments.²¹ Many, for example, regulate the price and quality of services that such companies provide, clearly illustrating that government has a different view of such strategic decisions from that of the companies. One such case is the Office of Telecommunications, which is the regulator of the UK telecommunications industry and has thus set various price controls in place, leading to significant cuts in the real price of telephone charges. The fact that these controls were needed to obtain lower telephone charges illustrates how government and corporations each have their own views.

This does not mean, however, that Government is an identical or uniform group that agrees on every issue. For example, the aforementioned Finnish decision to approve construction of a new nuclear power station was in no way unanimous since the idea had previously been voted down in the Finnish Parliament during 1993, and the May 2002 bill was only narrowly passed with 107 voting for, and 92 against.²² Indeed, it would seem that the issue of power generation is a divisive one since the ruling Norwegian coalition government collapsed in March 2000 after being defeated in a confidence vote surrounding the policy of building gas fired electricity power stations. The Prime Minister lost the parliamentary vote 71-81 which again intimates that there were considerable differences of opinion.²³

II.iii The Challenge For Public Policy

In short, many different groups can be identified, each with their own particular interest in the activities of a specific utility corporation. These differing interests will lead to individual

²¹ It could be argued that government does not have an interest itself, but is rather the representative of other interest groups such as consumers or employees. Whilst this view is appealing in many respects, it doesn't really account for the fact that government has a specific function and this may give rise to a unique interest.

²² See <http://news.bbc.co.uk/1/hi/world/europe/2006191.stm> (accessed on 14th August 2002).

preferences for the strategic decisions to be taken, and thus by extension, the impact of the corporation upon society. Sometimes these interests and preferences will coincide or overlap, whilst in other situations, they will be conflicting or opposing. However, as this thesis has already suggested, control of the strategic decision-making process typically lies with an elite, a subset of those who have an interest in the activities of a particular corporation. Economic theory suggests that individuals take decisions in their own self-interest, and so when taken in combination, these findings would seem to indicate a fundamental problem with the current system of corporate governance.

The ability of an elite to take the strategic-decisions of the modern corporation (such as a utility company) suggests they do so in a way that best serves the interests of that specific group. This is a serious problem if it is seen as desirable that corporations' activities serve the interests of all people or interest groups, and thus the community in general; if it is considered desirable that corporations serve the public interest. The problem is that elite decision-making in such a manner negates the ability of the community to determine the strategic path of production in its own best interest. Therefore, current decision-making, as seen from a community level, might be seen to be sub-optimal. As Cowling and Sugden (1999, p.361) put it, elite decision-making means there is "strategic failure" in the current system of corporate governance. Branco (1997, p.xxi) implicitly recognises this strategic failure from a shareholder perspective when she says that "corporations cannot create *shareholder value* through one all-purpose strategy. They must define which shareholders they intend to create value for and design strategies accordingly". Furthermore, Tirole (2001, p.23) identifies this failure when he comments upon the "various externalities imposed by profit maximising

²³ *The Times*, 10th March 2000, 'Norway's coalition falls in dispute over gas pollution.'

choices on other stakeholders”, and later concludes that “undivided control ... creates biased decision-making” (Tirole, 2001, p.30).

To avoid such strategic failure, an obvious possibility is to follow the suggestion of Cowling and Sugden (1999, p.366) and search “for ways of appropriately involving more and more people affected by strategic decisions in the actual process of making those decisions; to design ways” of democratising governance. A key aspect of this is to seek more participation and an effective democracy within the strategic decision-making processes of corporations. This is significantly different from the view presented in Tirole (2001, p.24) that “the firm should internalise the *externalities* [imposed] on the various stakeholders” and thus that “incentives should be designed that induce management to account for” these. Whilst such a suggestion goes some way to accommodating the interests of wider groups, it is still lacking. To put in place the managerial incentives required to account for the externalities, there has to be some ‘guessing’ as to the interests of different interests groups and the extent to which they were affected by firm created externalities. Furthermore, it would be impossible to identify, and therefore take account of, all the externalities imposed by the firm. The internalisation of externalities would therefore be an inferior way of incorporating different viewpoints and interests, when compared with the introduction of democratic control. (In many ways, the internalisation of externalities suffers from similar problems to regulation, a topic which is addressed in Section III.ii).

One feature of the current system of corporate control is that shareholders are usually seen as the corporate risk takers, since they bear a financial risk for which they receive financial benefits in the form of dividends or capital growth. However, we would argue that other

groups such as employees or specific localities also bear risks associated with a corporation, including for example, the risk of unemployment (if the corporation were to move its facilities to a different location) or pollution (if the corporation was careless, or its facilities suffered an accident). In line with this, Tirole (2001, p.23) suggests that other stakeholders such as “management and workers ... [invest] their human capital as well as off-work related capital (housing, spouse employment, schools, social relationship, etc.) in the employment relation”. The democratisation of decision-making may therefore also serve to address this issue in that those groups that currently bear risk may be able to gain a greater degree of control over the risk they face.

It would be unrealistic, however, to assume that all (if any) of the controlling elite would be willing to voluntarily relinquish, or even diminish, their control of the corporation so that democratic control can be introduced.²⁴ This therefore suggests that corporate governance needs to be made a central issue for public policy if strategic failure is to be meaningfully addressed.²⁵

II.iv Market Failure versus Strategic Failure

The strategic decision-making approach to the theory of the firm thus gives rise to the notion that public policy should seek to address the issue of strategic failure in corporate governance. By contrast, the theories on economic welfare centred around markets suggest that the basis for public policy is market failure rather than strategic failure, and the public interest may still

²⁴ See Pitelis and Sugden (1986) for further discussion of control groups voluntarily relinquishing control.

²⁵ Indeed, not only would such policies address the fundamental issues concerning the current strategic failure of decision-making, but evidence also suggests that widening involvement in strategic decision-making might be welfare enhancing in its own right. Frey and Stutzer (2000, p.918) report that interview data in Switzerland indicates “individuals are *ceteris paribus* happier, the better developed the institutions of direct democracy are in their area of residence”. Therefore, by addressing the strategic failure of corporate governance as a matter of

be served even if corporations are governed by sectional interests which are left 'free' from Government 'interference'. An argument underlying such a view can be seen in extreme form in an Arrow-Debreu type general equilibrium model (see, for example, Debreu, 1959; and Arrow and Hahn, 1971). In this case, the presence of ubiquitous perfect competition ensures Pareto optimal outcomes in situations where producers and indeed all actors pursue their own interests. Less extreme would be the situation where a corporation is governed by sectional interests but where those with other interests can make take-over bids in a competitive capital market or can establish new, competing corporations. The strategic failure analysis, in contrast, is founded on the significance of imperfect competition.

The justification for this foundation can easily be illustrated in the case of utility companies with regard to the possibility of new entry. It is not always possible for at least some of those with an interest in a particular utility company to establish a new, competing firm. In many situations utility companies are natural monopolies, which by definition make it inefficient and hence impractical to create new companies with competing infrastructure. The services provided by these companies have become essential, which means consumers are locked-in to this natural monopoly firm from which they have no possible means of escape.

Even where natural monopolies do not exist, inertia on the part of the consuming public puts new ventures at an immediate disadvantage; the public has a great tendency to remain with their historical supplier. For example, in Britain from September 1998, the market for electricity supply was fully liberalised so that all customers could choose which company supplied their electricity (OFFER, 1998, p.17). Prior to this date, a number of companies had

purposive public policy, individuals will potentially benefit from the welfare enhancing effects of feeling involved with decision-making *per se* as well as from the public interest decision-making it implies.

enjoyed regional monopolies in their franchise areas (see Chapter Five of this thesis for a more detailed explanation of the liberalisation and privatisation of the British electricity sector). As of February 28th 2002, only 35% of customers in Great Britain had switched electricity supplier from the former monopoly, even though in doing so the consumer could significantly reduce their bill.²⁶ This leaves new ventures on the margin, fighting for involvement in a smaller market, serving the small number of consumers who are willing to actively seek alternatives.

In addition to this inertia, utility companies often provide their services using expensive infrastructures (e.g. electricity grids or networks of water pipes) which exclude all but the most committed and wealthy from being potential entrants. Those most in need of influence over the strategic decision-making process are those that currently have no or extremely little power, and it is unlikely that such wealthy individuals capable of creating an entrant could be described as such. As we established in Chapter One, significant wealth leads to power through the ownership of significant shareholdings, and thus participation in the controlling elite. Furthermore, even if the wealthy were not currently part of the controlling elite, the financial resources needed to start a competing firm might instead be used to bring their owners into the existing firm's strategic decision-making process thereby removing the need to create an entrant. By contrast, those groups lacking wealth are most likely excluded from the current decision-making structures because they are unlikely to be large shareholders or senior management. Consequently the representation of wider concerns in corporate

²⁶ Source: <http://www.ofgem.gov.uk/prices/switching.htm#elec>, accessed on 7th August 2002. A typical example of a significant saving might be what Energywatch classifies as a medium user (3,300kWh consumption) who pays by direct debit and lives in the region of England where SWEB was the former monopoly supplier. As of August 2002, such a customer being supplied by SWEB would face a bill of £261, which is 16.5% higher than if they were supplied by the cheapest company, Basic Power who charge £224 – calculated from information presented in Energywatch (2002).

governance requires new policies to enable all interests groups to have some bearing on a firm's strategic decision-making process. This is the challenge faced by public policy.

One of the implications of the differing perspectives of the market-centred and strategic failure approaches toward the nature of competition, is their respective emphases on Hirschman's (1970) forces of exit and voice. This has important implications for the nature of the purposive public policies we are advocating, as will become apparent later in this Chapter. The nature of the market centred approach is such that it focuses upon the idea of exit. Any problems encountered are because the market is not able to function freely; there are constraints acting upon entry and exist decisions. In light of this, appropriate public policies (when adopting a market centred approach) would concentrate on achieving (or at least mimicking the effects of) contestibility to free up the natural operation of the market, and thus correct any problems encountered. In other words, a market centred approach leads to public policy focusing upon the free operation of markets, and such an approach can be equated with Hirshman's concept of exit.

The strategic failure approach, by contrast, is built upon the assumption of imperfect competition and thus recognises the importance of *both* exit and voice in addressing problems. It recognises that exit (or entry) is not always a viable option and thus voice, the expressing and articulation of ones opinions or preferences, is therefore crucial. That is not to suggest that policies toward exit have no place in a strategic failure approach, but rather that they only form part (instead of the entirety) of appropriate public policy. This is quite a departure for the justification behind, and thus the nature and scope of, appropriate public

policy, especially since the concept of voice is so much less precise than exit. As Hirshman (1970, pp.15-16) observes, exit is

“the sort of mechanism economics thrives on. It is neat – one either exits or one does not; it is impersonal – any face-to-face confrontation between customer and firm with its imponderable and unpredictable elements is avoided and success and failure of the organisation are communicated to it by a set of statistics; and it is indirect – any recovery on the part of the declining firm comes by courtesy of the Invisible Hand, as an unintended by-product of the customer’s decision to shift. In all these respects voice is just the opposite of exit. It is a far more ‘messy’ concept because it can be graduated, all the way from faint grumbling to violent protest; it implies articulation of one’s critical opinions rather than a private, ‘secret’ vote in the anonymity of the supermarket; and finally, it is direct and straightforward rather than roundabout”.

Consequently, voice is at the very heart of public interest decision-making; the democratic process at the core of its essence entails “the digging, the use, and hopefully the slow improvement” (Hirschman, 1970, p.17) of channels of voice, and “while exit requires nothing but a clearcut either-or decision, voice is essentially an *art* constantly evolving in new directions” (Hirschman, 1970, p.43). The challenge is to design specific policies that recognise and nurture this constantly evolving art (and that maintain an appropriate mix and balance of voice and exit processes). It is to the design of such specific policies that we now turn in the next Section of this Chapter. Whilst these discussions are focussed upon the utility sector, the ideas are still broadly applicable to other sectors.

III. GOVERNANCE IN THE PUBLIC INTEREST

As the previous Section outlined, governance in the public interest requires that governance be democratised so that all of those with an interest in the activities of a particular utility corporation can have a voice in determining its strategy, and thus its impact upon society. The organisation of production in this manner would be a deep-seated, fundamental change which requires an alteration to the very nature of the shareholder focussed system currently in place. We do not suggest that such a fundamental transformation towards an inclusive, democratic system of governance could, or indeed, should be achieved immediately. Rather, we suggest that it should be society's long-term aim and objective.

The attainment of such an objective requires that long-term plans be adopted which seek to implement the more fundamental changes required to the current system. However, these long-term plans, by their very nature, may extend deep into the future and thus may mean fundamental change will take a significant amount of time. Such policies therefore need to be supported and supplemented by more short-term measures which can more immediately start to address concerns with the exclusion of many interest groups from strategic decision-making. To that end, we first turn to some potential long-term policies in Sub-Section III.i before addressing more immediate measures and initiatives that might be taken in Sub-Section III.ii.

The policies we discuss in the following Sub-Sections are not about imposing or forcing our view of appropriate governance mechanisms upon society. They are designed to facilitate society's use of governance instruments, and are about enabling and awakening the power that is currently dormant within us. As Wheatley (2002, pp.48-49) observes, "there is no

power for change greater than a community discovering what it cares about". We are therefore seeking to proffer policies that may facilitate and help utilise the power that exists within all of the diverse and varied aspects of society. Furthermore, policies based around the idea of the empowerment of society allow individuals to decide for themselves what issues (and thus decision-making processes) they care enough about to become involved with, instead of merely allowing participation in a number of externally decided decisions, which may or may not be appropriate.

III.i A Reformed Legal Framework

One vital possibility that might be a step in the appropriate direction is to consider the provisions of company law to introduce changes that would widen involvement in strategic decision-making. To pursue this we examine English experience as an illustration.²⁷

In Chapter One, we argued that the existing corporate governance literature places *de facto* control of the typical large, modern corporation between an elite group of (large) shareholders and senior managers/the company board. Drawing upon the law literature, Branston *et al.* (2001a) identify that this is reflected in English company law in the notion that certain shareholders are a company's 'members' who elect and in theory monitor the board of directors. Furthermore, they highlight that the prime duty of directors is to act in the interests of the company, but that this is essentially equated with the shareholders' interests. Whilst secondary duties towards company creditors and employees are highlighted, these are said to be of little consequence.

Branston *et al.* (2001a) go on to characterise the US legal situation as being broadly similar although they highlight that there are contrasts with other systems such as Japan or Germany, where companies are seen as serving both shareholders and employees. This is not to contradict the argument in Chapter One that *economic* control rests with an elite in Japan and Germany, rather it is to comment upon the formal *legal* duties of those elite and on the *legal* constraints that the elites face. Whilst these formalities and constraints need not be irrelevant, our focus is the possibilities for democratising governance, for moving away from governance by an elite towards effective participation by all interested parties. An English *legal* system in which directors owe a duty to shareholders does not mean that all shareholders are effectively participating in *economic* governance. Similarly, a Japanese or German *legal* system serving employees does not necessarily mean that employees have *economic* control.

One possibility for change in England to increase participation in a corporation's strategic decision-making is to build on the concept of membership of a company and the requirement that senior management must act in the interest of members. The idea is to reform company law in order to widen membership beyond shareholders, including as members others with an interest in the corporation's activities.

This sort of development has been discussed in earlier literature, see for example Farrar and Hannigan (1998), and Mayson *et al.* (1999) on the debate regarding the interests of 'stakeholders', also Sternberg (1997) and Tirole (2001) on the definition and use of this concept. Indeed, these contributions together with that of Kelly *et al.* (1997), clearly reveal

²⁷ Examination of one country is not to deny the possibility of countries co-operating with each other to pursue change. This option might be interesting in the European Union, building on the history of the Vredeling directive, see European Commission (1980).

the very narrow conceptualisation of stakeholding that is adhered to by many.²⁸ Moreover, the prospect of senior management having a duty towards all of those interest groups with a stake in a company has recently been rejected by the Hampel Committee on Corporate Governance, which concluded that :

“to redefine the director’s responsibilities in terms of the shareholders would mean identifying all the various stakeholder groups; and deciding the nature and extent of the director’s responsibility to each. The result would be that the directors were not effectively accountable to anyone since there would be no clear yardstick for judging their performance. This is a recipe neither for good governance nor for corporate success” (Hampel Committee Report, 1998, paragraph 1.17).

However, it would seem to us that, in the light of the economic argument outlined herein, this issue is far from closed. In addition, it is curious that whilst some consider it appropriate for a corporation to be governed in the interests of only one group amongst a set of stakeholders, the same is not considered appropriate for a nation. According to the Hampel Committee, the directors of a particular utility company would not be accountable to anyone if they owed significant duties to shareholders and to others. Yet it is commonly argued that the British Government, for instance, is in some sense accountable to the British electorate, an electorate made up of many varied and diverse interests. Furthermore, existing English company law means that buying shares generally means the buying of votes and hence a degree of control

²⁸ Will Hutton (who has made a number of contributions to the stakeholder debate) argues that “shareholders property rights are not absolute, that those shareholders live in society too, and the exercise of their rights is subject to the claims of others”. To this end he suggests that “corporate law should widen the number of stakeholders who have a legitimate claim on decision-making” (*The Observer*, 9th April 2000). Hutton is also a contributor to Kelly *et al.* (1997). He favours social and economic inclusion but then argues that the big question is where the market should end and the relationships of inclusion begin. Our analysis does not recognise

over the strategic decision-making process. This is again strikingly different from what is widely perceived as being appropriate for the governance of a country; the use of money to buy votes in British parliamentary elections (and indeed in countries more widely) was eradicated in the nineteenth century, even though a similar system still persists in the governance structure of publicly owned corporations.²⁹

The exact way the widening of membership is achieved and how company directors are bestowed with attainable duties towards all those members is something that would need imaginative consideration, and it is likely something that would need to be developed and evolved over time, learning from experience. The same process could not be uniformly applied to every corporation; each sector, and perhaps corporation, has unique considerations that need to be taken into account. In general, however, it would be infeasible to attempt to provide all interests with an appropriate voice in the strategic decision-making process simultaneously, and one option is to focus attention consecutively on particular sectors and groups. In the case of utility companies, we have identified different groups of shareholders, of people working for the companies, special interest groups and of customers, as all having an interest. One possibility might be to focus in the first instance on the feasibility of employees being made company members, or perhaps the nature of such companies suggests the initial focus should be on customers. Within this there could be further focussing; perhaps on customers who take more than one service from the utility company, for example where the company acts as the supplier of both gas and electricity services. Another illustration might be railway season ticket holders who use the train for their daily commute. Both of

this border, instead suggesting that inclusion needs to be the fundamental determinant of the nature and form of all relationships, *including market relationships*.

²⁹ In practice, the buying of votes in national elections implicitly continues via the use of lobbyists, publicity and spin doctors.

these examples might be seen as implying a level of commitment and dependence towards a particular company and hence a corresponding interest that stands such people apart from others.

When deciding which interest group to make the focus of the initial process to widen membership, it would not be appropriate to make this focus on larger interest groups, such as large customers. These are the groups that are more likely to have influence over the existing strategic decision-making process and are thus less in need of policy intervention to improve their influence over the strategic decision-making process. It should be the smaller interest groups, the ones with the least influence over the existing strategic decision-making process that are made the initial focus. This way, membership would be widened significantly from the start of the process, making a real difference to corporate governance.³⁰

In widening membership of companies there would be difficulties in developing a practical system that allows effective corporate governance. One of the most important of these difficulties being the allocation of votes for electing the board of directors, since this needs to be done in a way that enables real power sharing whilst also maintaining a practical and workable system. For example, to have a situation where each customer member has a vote together with one vote per share would give a significantly different result to a system with one member one vote. Indeed it could be the case in both situations that either shareholder or customer members were capable of swamping the other, depending on the numbers involved.

³⁰ Here we use size as a way of distinguishing between the existing power of different interest groups, although this might equally be done on other grounds such as financial resources (as mentioned earlier).

Another practical problem that would need to be addressed is how new company members are to be identified. If, for example, customers are to be company members, criteria will be required in order to define those able to become a ‘customer member’. Such an identification process would not be an easy one. By their very nature, utility companies are service providers and so the ability to easily identify suitable groups will vary from company to company, but this is a problem with many potential solutions; a significant membership fee might be considered as one desirable option as this might imply that only customers with a significant dependency on the utility company would incur the cost of becoming members. This fee could take many different forms but a one-time fee, returnable on the decision to cease being a member presents an attractive possibility. To reduce the exclusion of those financially constrained, such a fee might be paid over time, perhaps via a monthly salary contribution. The fee could then be placed in some form of interest bearing trust to act like a bank account, giving a guaranteed return disparate from company performance and profits. In this situation, the fee is acting as a bond between the new member and company, whilst maintaining the distinction between shareholders and other company members. The fee might also be returnable if, for example, the member decided they no longer wished to be involved in the governance process.³¹

Conversely, it might be deemed appropriate to automatically give such membership rights to certain types of customers, such as rail season ticket holders, or as mentioned earlier, those

³¹ On first impression, requiring a membership fee might be seen as little different to defining company membership exclusively in terms of those buying a share in the company; if both customer and shareholder members are defined (in part) by their willingness to make a financial commitment, why not simplify matters by requiring all company members to have a shareholding, whether or not those members be customers? The reason why not is that customers have interests as customers and as distinct from shareholders; if customers are to qualify as members by virtue of a shareholding, the significance of customers qua customers is in danger of being lost. By having a fee that is separated from company performance, this distinction is not lost. There is a similar argument against the view that employees who are also shareholders are appropriately accounted for

who take more than one utility service from the same company. To ensure only committed individuals claimed such rights, membership could be made conditional on their participation in some active and perhaps time-consuming registration process, to ensure there is some ‘cost’ of becoming such a member and thus that it is not entered into lightly.

It is, however, unrealistic to assume that every consumer (or other interest group) would immediately want to become a member of the company. Although the numbers would differ from sector to sector, in many cases it would only be those few who have a special interest that would exercise their right. This might be seen to imply broad satisfaction, or at least low levels of dissatisfaction, with the company existing strategic decisions and hence governance. In times of (extreme) public dissatisfaction we envisage the right to become members being more highly utilised, changing the governance balance between shareholders and other members. This shifting balance would therefore be a process that helps affect change.

Such thinking is inline with the views of Hirschman (1970, p.32), who suggested that “a mixture of alert and inert citizens, or even an alternation of involvement and withdrawal, may actually serve democracy better than either total, permanent activism or total apathy”. Hirschman (1970, p.32) went on to explain that “one reason ... is that the ordinary failure, on the part of most citizens, to use their potential political forces to the full makes it possible for them to react with unexpected vigour – by using normally unused reserves of political power and influence – whenever their vital interests are directly threatened”. Furthermore, it was also suggested that the use of voice needs to be followed by a period in which representatives

merely by reason of their shareholdings. See Knight and Sugden (1990) for more details on this and related issues.

of the corporation have time to “respond to the pressures that have been brought to bear on it” (Hirschman, 1970, p.33).

The ability to become a member is therefore important for giving a voice to those who currently have none, even if it appears (at least superficially) that it is not always (fully) utilised. For example, it is unlikely that many customers would become members of British electricity supply companies at this time, since there are low levels of public dissatisfaction with their service; there were just 0.05 complaints (customer account complaints excluding direct selling and transfer complaints) per 100,000 customers in December 2001.³² However, given the same rights, customers of the private rail companies in Britain are far more likely to be active in seeking membership, reflecting the almost universal public dissatisfaction with the performance of these companies; Train Operating Companies registered 126 complaints per 100,000 passenger journeys in the fourth quarter of 2001-2002 (Strategic Rail Authority, 2002, Table 2.2, p.18).

It may also be the case that the choice to become a member would be influenced by the quantity and quality of available ‘performance’ indicators. Consider the examples used above. Electricity consumers mainly rely on price and the reliability of service but for rail travellers there are far more criteria on which to judge (and hence be dissatisfied with) - price, delays, cleanliness of rolling stock, journey times and so on. On this basis, electricity customers in California, who have recently faced uncertain supplies, power cuts and steep price rises, would be highly likely to be actively seeking membership.

³² http://www.energywatch.org.uk/uploads/Electricity_Customer_Account_Complaints_December_2001.doc accessed on 9th August 2002.

This example highlights the fundamental issue of information. We see information as being central for effective corporate governance, as it is unrealistic to assume that members can exert proper control if they are blindfolded and handicapped by lack of information. Indeed, in Chapter One we reported the view that existing members (i.e. shareholders) lack sufficient information, which is a well-known problem that needs to be resolved. Membership cannot be truly widened if information is restricted. Interest groups need information so that they can appropriately assess the existing strategic decision-making process. By giving interest groups more information, the company is making accessible more grounds on which it can be judged. In this respect, policy therefore needs to be directed to actively ensure that the appropriate information is more widely available to all actual and potential members. Such a policy would have to balance these concerns against the need to guarantee that the companies' most sensitive information is not freely given to rival organisations. However, the even application of such a policy to all firms would go a long way towards mitigating potential secrecy concerns. Moreover such a process could be seen as a good thing; reducing the secret nature of society would help to build trust, changing the relationship between customer (or other interest group) and company from antagonism, suspicion and distrust, to one of engagement and proactive involvement.

One policy possibility in line with this thinking is suggested by Bailey *et al.* (1994, 1999), who propose the idea of 'transnational corporation monitoring units' - units "designed to collect information on transnationals' performance and impact, to prepare accounts and to use these to influence economic policy and attitudes of and towards transnationals" (Bailey *et al.*, 1994, p.316). Although the focus of the argument in Bailey *et al.* (1994) is to aid governments with their dealings with transnational corporations, Bailey *et al.* (1999) suggests

that the monitoring unit could act like a ‘clearing house’, where various interest groups could pool any information they have, allowing the widespread dissemination of information. Such a system could be readily adapted to the utility sector (especially since many of the groups are now transnational corporations) and would be invaluable in helping the various interest groups gain the necessary information that they would need in order to have a real voice in the corporate governance process of utility companies.

The deficit of appropriate information illustrates that introducing new interest groups into the membership of companies is not enough. For such action to really start the process of democratising strategic decision-making, such groups need to have real power within the corporation. In the existing structure of companies, this equates to the ability to monitor, and indeed elect, the board of directors. Furthermore, the whole nature of company directors would have to change. At present, a company director might be said to be only truly responsible to the corporation's shareholders, who are themselves the only form of company ‘member’ that currently exist. However, we have seen that in the case of utility companies that there are in fact a significant number of groups who might like to be members. For this to happen, the nature of company director would have to evolve from being responsible to just this one type of company member, to being answerable to a multitude of different members. In doing so, the role of company director would evolve from being one of almost *de facto* direct company control, to one of arbitration and negotiation; to mediate between the interests of all members. With the many varying interests of a large number of company members, many of these views will be conflicting. It might even be said that directors specific duty should be to facilitate, and to provide a forum where such opposing views could be presented, discussed, debated, and eventually to explicate an acceptable agreement. Such a change

would be a significant step in broadening, and hence democratising, the strategic decision-making process.³³

Whilst being a considerable departure from the current system, the policies advocated above are not so radically different from current practice as to be totally infeasible, and indeed not without some precedence in the UK. Consider once again the case of Network Rail, the ‘not-for-dividend’ company that assumed control of Britain’s railway infrastructure in October 2002. This company has no shareholders, but has instead 115 ‘members’ who are supposed to “ensure independent oversight, strong accountability and high standards of corporate governance” (Network Rail, 2002a, p.1). These members were appointed following a nationwide advertising campaign to which virtually anybody could apply, and include individual public members, members “drawn from a wide variety of stakeholder organisations including passenger authorities, regional transport executives, disabled access groups and business representatives” (Network Rail, 2002a, p.2), and industry members. The latter two categories include representative from both the public and private sectors. See Network Rail (2002a) for further details on membership. Whilst it still remains to be seen if these members are public interest members as we see them, or indeed how much (if any) power they possess, the fact that such a concept is being talked about and implemented, illustrates that our ideas are not so far from current practice as to be obviously out of place.³⁴

³³ It is interesting to note that this system would endogenise preferences to decision-making, since preferences would be evolving within the system as the negotiations between all the different interest groups took place. This is in stark contrast to the exogeneity assumption characterising Arrow's (1951) impossibility theorem, once again emphasising the difference between the market failure and the strategic failure reasoning behind public policy.

³⁴ Whilst Network Rail is moving in the general direction we are advocating, there are still issues to be addressed. Most significant amongst these is a potential conflict of interests for the board of directors since they have ultimate power over the appointment or removal of the members; the very group supposed to hold the board accountable. There is therefore an incentive and mechanism to remove those members who make life difficult for the directors, and appoint those who won't, as Hirschmann (1970, p.30) put it, “kick a fuss”. See Network Rail (2002b) for further details.

III.ii More Immediate Ways Forward

We have briefly indicated some of the issues in (English) company law that must be addressed if there is to be effective economic democracy and in so doing have commented on some of the fundamental requirements of reform. The complexity of the issues, however, is indicative of the need for a long-run project that addresses a wide range of considerations if strategic failures are to be overcome, and new ways forward are to be found. Meanwhile, it is necessary to ensure that economies progress in the (immediate) future in ways which ideally facilitate, but which certainly do not undermine this long-run, fundamental change towards effective democracy.

With this in mind, one obvious and practical step is to ensure that democratically controlled public agencies have the responsibility and ability to monitor firms' strategic activity. Using this knowledge, such agencies might then act to ensure more effective representation of the public interest in the strategic decision-making process of corporations. Even where a utility company is otherwise under the control of an elite few pursuing their own agenda, the welfare interests of others groups could be represented by appropriate public agencies acting on their behalf. It is, however, unrealistic to assume that such an agency would have an all-encompassing effect; public agencies cannot costlessly monitor all of the strategic decisions that occur in a particular economy. The costs of such actions dictate that it could have a limited effect. Indeed, it is unlikely that a public agency could successfully represent all the varying interests of those currently excluded from the strategic decision-making process. Nevertheless, such an organisation would provide a limited, but definite, increase in participation of the strategic decision-making process.

It is important to reiterate that such a regulatory agency is not a substitute for the introduction of direct and genuine democracy, but rather an intermediate step to be taken whilst the long-term measures are put in place. Whilst discussing network utilities, Newbery (1997, p.357) argues that “regulation is inevitably inefficient” because it cannot replicate the effects of competition, although we propose that the limits of regulation extend significantly beyond this simple competition focus. Regulation is essentially an arms-length response to failures in arms-length relationships, whereas the very essence of economic democracy entails inclusive, dynamic processes for shaping preferences and possibilities. When Hirschman (1970) refers to the development of democracy as a constantly evolving art, he is identifying a process that cannot be attained via regulation of an undemocratic process. The democratic process itself implies evolution, change and consequently different outcomes. No arms-length regulation of an undemocratic process could mirror this, not least because, in its absence, there is no way to know what the democratic process would yield.

Public agencies currently in existence are already given roles which are, to some degree, in line with our suggestion. In Britain, for example, many of the privatised utility industries are subject to industry specific regulation. These regulatory agencies have set the precedent that public intervention can exist to actively restrain a company's strategic decisions but thus far they have only had a competition focus; the broader concerns that we are advocating have not been emphasised. Indeed MacKerron and Boira-Segarra (1996, p.95) comment that:

“In the privatised British system, regulation has been rather narrowly focused: apart from protection against monopoly abuses, it has concerned itself almost

entirely with issues of economic efficiency, which are themselves held always to be advanced by the promotion of competition”.

Nevertheless, the existence of these regulators represents a platform from which future developments can occur. The remit of regulatory agencies needs to be extended to include the responsibility (and the ability) to monitor the strategic activity of corporations and their controllers, and to act to secure effective representation of the public interest when important strategic decisions are made. For such a measure to widen involvement in strategic decision making with real effect, it is important that the public interest be explicitly identified in terms of different sub-groups of the public having varied concerns in the strategic direction of a company, where that strategic direction is recognised as the central issue. Serving the public interest needs to be seen in terms of the different interests being represented effectively; whilst each interest in isolation might prefer a different strategic direction, taking account of all interests requires the search for compromise and consensus, thus a concern with promoting mutual awareness and with mediating a suitable development path.

Such action needs to take place within a framework of democratising the regulatory agencies themselves, to ensure that it is the public interest that is followed, as there are concerns as to how democratic these existing regulatory agencies are in practice. While discussing the agency for the electricity sector (the Office of Electricity Regulation, OFFER³⁵), MacKerron and Boira-Segarra (1996, pp.96/97) go on to say:

“OFFER is an agency of the state but is not directly responsible to any Government department: it is a non-departmental agency If OFFER is not really

³⁵ The electricity regulator has now been merged with the gas regulator to form the Office of Gas and Electricity markets (OFGEM).

responsible to Government, the question remains as to whom or what it is accountable.”

Recent Government legislation, the Utilities Act 2000, presents a possibility for more public interest involvement although it has so far failed in this regard. However, prior to the legislation being adopted into law in the summer of 2000, Stephen Littlechild, the former Director General of Electricity Supply (the person heading the electricity regulator), commented that the (then proposed) legislation

“would undermine the priority given to competition and give the Government much more control over supposedly independent regulators.”³⁶

These comments clearly indicate that Littlechild believed the new Bill would give the regulators wider responsibilities when regulating the utility firms, replacing the previous focus on competition. Whilst this has not happened, the reasoning behind these views can be explicitly seen in the Act, which states that

“the principle objective of Secretary of State and the Gas and Electricity Markets Authority in carrying out their respective functions ... is to protect the interests of consumers in relation to electricity conveyed by distribution systems, wherever appropriate by promoting effective competition ...” (UK Parliament, 2000, Part II, section 12, subsection 1).

But it goes on to say that

“...the Secretary of State or the Authority (i.e. the regulatory agency) shall have regard to the interests of -

(a) individuals who are disabled or chronically sick;

³⁶ “Littlechild criticises Bill”, *The Times*, Monday 8th February 2000.

- (b) individuals of pensionable age;
- (c) individuals with low incomes; and
- (d) individuals residing in rural areas.

but that is not to be taken as implying that regard may not be had to the interests of other descriptions of consumer.” (UK Parliament, 2000, Part II, section 12, subsection 3).

This piece of legislation (at least in theory) therefore requires that the regulator explicitly consider these different interest groups, and not simply assume that competition is sufficient to ensure that the diverse concerns of different interest groups are met. Furthermore, the Act should also give the Government more control over the regulators, which ought to make them more accountable to the public, via their democratically elected Government.

Drawing upon Branston *et al.* (2001a), we have already noted that existing company law imposes a duty on company directors to take account of the interests of employees, but in practice this is dominated by the duty to shareholders to such an extent that it is virtually meaningless. Unfortunately, it would seem that the Utilities Act 2000 is similarly ineffective in securing the public interest in that it has made no noticeable difference to the way in which industry specific regulation occurs. Indeed during the time the act has been in force, OFGEM (the gas and electricity regulator) has removed direct price controls on domestic gas and electricity supply, thus relying totally on competition to ensure a public interest outcome in this sector (OFGEM, 2002, p.38).

Nevertheless, the very existence of the Utilities Act 2000 is something on which more can be built; whilst it focuses on the interests of consumers and not those required for the public interest more widely, it does provide a way in which interest groups can quickly start to be more explicitly considered in regulation. It is far from being the inclusive piece of legislation that we would ultimately envisage, but the Utilities Act 2000, together with the existence of the current regulators, does show that our proposals are not so radically different from current practice as to be utterly infeasible in the immediate future.

It would be naïve to suggest that such democratic public interest regulators should be established for every individual sector of the economy; cost considerations alone would make this inappropriate. However, it is crucial for the particularly important sectors of an economy, such as utilities since such a policy has the potential to make a real difference in the immediate future.³⁷

Furthermore, the evolution of an effective organisation for take-over and merger control would be the ideal complement to the reformed regulatory agencies that we are advocating. In this regard, regulators are not the only precedent for public agencies intervening in the strategic decisions of companies. Britain, like many other countries, has for many years had an organisation that has responsibility for take-over and merger control (the Competition Commission which succeeded the Monopolies and Mergers Commission on 1st April 1999).³⁸ Unfortunately, in practice this body, like the existing industry regulators, sees the public

³⁷ As we have already indicated, the effective democratisation of governance requires appropriate communication amongst interested parties, which itself necessitates a communications sector that is democratically controlled. Perhaps communications should therefore also be a priority sector, both in terms of a public interest regulator, but also in terms of a long-run reform project. Democratisation of communications is explored in Cowling (1985).

³⁸ This is a result of Section 45 of the 1998 Competition Act. For more details see Keenan (2000).

interest to be invariably represented by promoting competition, and not the wider interests that we have already identified.³⁹

In practical terms, only certain cases qualify for reference since “the principal objective of the reference policy is the control of mergers that would have adverse effects on competition in the UK” (Farrar and Hannigan, 1998, p.615).⁴⁰ However, whilst investigating, the Commission

“must take into account all matters that appear to be relevant in considering the public interest but in particular it must have regard to the desirability of maintaining and promoting competition in the UK, of promoting the interests of consumers, purchasers and other users of goods and services in the UK in respect of prices, quality and variety of goods and services; efficiency and innovation, the balanced distribution of industry and employment, and exports” (Farrar and Hannigan, 1998, p.615).⁴¹

Competition is thus clearly given priority but, at least in theory, public interest is explicitly framed to be wider than this one issue.

The actual operation of the Commission can be clearly seen in the British utility sector, where much of the take-over and merger activity of the privatised companies was referred to the Competition Commission (or rather the MMC as it was then). For example, the 1996 report on the take-over of South West Water Plc by Wessex Water Plc concluded that the acquisition “may be expected to operate against the public interest” as it would impinge upon the ability

³⁹ Mergers that impact on other European Union member-states must also take into account European Union rules, see Keenan (2000).

⁴⁰ Farrar and Hannigan are actually referring to the Monopolies and Mergers Commission which is the precursor of the current organisation the Competition Commission.

of the regulator to make comparisons between different water companies and reduce future opportunities for competition (Monopolies and Mergers Commission, 1996, summary section). There are many other examples of reports written on Utility companies, and indeed many other companies, all of which share a common thread; the Commission (like the MMC before it) has adopted a narrow interpretation of its existence and what constitutes the public interest, resulting in competition being particularly emphasised.⁴² Indeed, policy surrounding the likes of the Commission is nowadays typically labelled ‘competition policy’.

A preoccupation with competition is more in line with the market failure, market-centred approach to policy, and insofar as the Commission has an economic rationale, it is rooted in the market failure perspective. Nevertheless, its terms of reference appear quite broad and flexible, the concern with public interest apparently allowing a strategic decision-making approach to economic welfare to be pursued, if there is the necessary political will. The existing institutions would not need drastic reform to be able to follow a broader and hence inclusive definition of what constitutes the public interest. Indeed, although a slight diversion from our utilities focus, this is illustrated by the Commission itself during its 1998/9 investigation of the BSkyB proposal to take-over the football club Manchester United:

“many of the points put to us went well beyond the competition and consumer concerns that normally arise in merger enquiries. However, in considering this merger we are directed by section 84 of the [Fair Trading Act] to take into account when assessing the public interest ‘all matters which appear to [us] to be relevant’. We have therefore looked at these wider football issues” (Monopolies and Mergers Commission, 1999, point 2.184, p.42).

⁴¹ Farrar and Hannigan are actually referring to the Monopolies and Mergers Commission.

This has therefore established the precedent of a wider definition of what constitutes the public interest, which again illustrates that our proposals are not so different from current practice as to be unworkable. Indeed, the British government is currently in the process of bringing in new legislation (the Enterprise Bill) which may affect Competition Commission investigations as it amongst other things contains specific provisions for “Public Interest Cases” (UK Parliament, 2002).

The offices that we are advocating (reformed take-over body and regulatory agencies) could be charged with safeguarding the public interest in all strategic decision-making (albeit control of the public agencies in the public interest would also need to be ensured, itself no foregone conclusion). On occasions there might be tension between a public body concerned with mergers and the public interest, versus one concerned with strategic decisions more generally and the public interest. We suggest that such tension could be creative and fruitful, if appropriately managed, and should neither be feared nor necessarily avoided; its presence, accommodation and deliberate stimulation could be a positive dimension in a process for promoting mutual awareness and for drawing out a suitable development path.

IV. CONCLUDING COMMENTS.

Building upon the foundations established in Chapter One, this Chapter has taken that analysis further by examining the implications of our conclusions on strategic decision-making and corporate governance. We illustrate that interests vary between (and within) all of the groups that have an interest in the activities of a particular corporation, and that this varying interest will result in differing preferences over strategic decisions. Given that

⁴² This presumably explains (at least in part) transference of the responsibilities of the Monopolies and Mergers Commission to the newly formed Competition Commission.

individuals take decisions in their own best interest, corporations controlled by an elite implies that strategic decisions are taken in the interests of that elite and not in the interests of the wider public; that decision-making is not taken in the public interest.

In order to avoid this strategic failure, one possibility is to reform the governance of the modern corporation so that it is constructed around a more inclusive and democratic structure. Using English company law as an example, we suggested that one possibility in line with this thinking is to reform company law so that shareholders no longer dominate as the only 'members' of corporation. Other 'members' could also be included so that all of those with an interest in the activities of a corporation have a real voice in the decision-making process.

Given that this is fundamentally different from the current system, we also examined more immediate ways forward which might address such issues in the near future. These included amongst other things, the use of existing public agencies such as the Competition Commission or the industry specific utility regulators, in order to incorporate wider interests in decision-making, and thus help secure more public interest outcomes in the immediate future.

In short, this Chapter sought to investigate the implications of corporations being controlled by an elite, and the requirements of public policy if this was to be avoided in the future. In order to do this, the Chapter utilised the specific example of utility companies and the provision of utility services. The choice of this particular case was not intended to imply that the theory or potential mechanisms it helped highlight were only applicable in this way to this

case, but it was rather chosen as an interesting and topical application of a more widely applicable theory.

The next Chapter of this thesis further extends the use of this example in that it applies the broad theoretical analysis to the debate surrounding the proposed reform of the electricity sector in Mexico. This practical application illustrates how measures to address concerns surrounding public interest decision-making can be implemented in the real world, even in such a situation as that which exists in Mexico, where the policy space available is constrained by numerous internal and external factors. Specifically, we suggest one avenue for consideration that aims to amalgamate economic (and other forms of) efficiency with concerns surrounding the need for economic democracy. It is to this that we now turn.

CHAPTER THREE

CREATING PUBLIC INTEREST DECISION-MAKING: THE CASE OF ELECTRICITY PRIVATISATION IN MEXICO

I. INTRODUCTION

One of the major implications of privatisation is the transfer of ownership, and as we have previously outlined, current governance systems mean that there are associations between ownership and the notion of company control. Furthermore, governance is not the only thing to change during privatisation, as it is a process during which industry re-organisation and other changes often occur. It therefore presents an opportunity in which to make the sort of fundamental governance changes that the previous Chapters have suggested are required if the public interest is to be achieved.

Moreover, the nature of privatisation as the transfer of activities from the public sector into the private sector implies a change from public to private control. Such a change could be argued to be a backward step for public interest decision-making in that it may be a move that furthers the elite control that we have suggested exists within the private corporation.¹ Privatisation might therefore be regarded as a particularly important policy if elite control of the corporation is to be fundamentally addressed.

The previous discussions in this thesis surrounding what might be done to address the strategic failure associated with elite control of the modern corporation has in many respects been rather general and theoretical, insofar as it has focussed on broad policies that might be

¹ Elite control of publicly owned industries is still a distinct possibility, but given that government is the ultimate owner (and often has a high degree of influence over the running of the corporations in question), the possibility of more public interest type decisions being arrived upon might be seen to be greater.

applied in the utilities sector, and hence elsewhere. Privatisation, however, is a very specific policy that has to take account of the unique industry and company settings to which it is being directed, and this makes such broad generalisation problematic. Therefore, our discussions for the possibilities that privatisation presents for introducing economic democracy are based around the indicative example of the proposed electricity reform in Mexico.

Whilst the choice of this specific case is rather arbitrary (and thus other examples could have been chosen), it is an especially interesting practical example because of the forces at work within and upon Mexico, the importance of the electricity sector in such a ‘developing country’ setting, and thus the constrained nature of the available policy space. Whilst this means that we are going to be dealing with a constrained solution (i.e. not the first best) from the point of view of attaining economic democracy, this specific example has (at least in part) been chosen because it illustrates how a long-term project is needed to reform the essence of the broad economic system, so that the policy space available is not so constrained.

In order to pursue this examination of privatisation, the Chapter is organised as follows. Section II examines the attractiveness of, and drive towards, privatisation in ‘developing country’ situations such as Mexico, and goes on to highlight some of the concerns with privatisation, especially those surrounding governance. The link between democratic governance and the process of development is also highlighted. In Section III we then outline the current structure of the Mexican electricity sector, and suggest one possible avenue for its privatisation based around principles of democratic decision-making and involving Mexican

pension funds as a key actor. Section IV discusses this possibility in more practical detail, and finally our concluding comments are presented in Section V.

II. PRIVATISATION AND DEMOCRACY

II.i The Drive Towards Privatisation

The reform of the electricity sector in Mexico is currently a topical issue, and one that is mirrored in many other ‘less developed’ countries across the world. Within this debate, there is a particular focus on the possibilities for privatisation.² Privatisation in some form may be an attractive option for countries such as Mexico, both in terms of the flow of funds that can be generated by government to boost spending in other important areas, and in terms of the ideological credence that the process gives them with important donor and investment partners.

Many less developed countries are characterised by public industries that are in dire need of investment, while the governments’ spending ability is severely limited, and priorities are often in other areas such as education and healthcare, or servicing government debt (Tenenbaum *et al.*, 1992). It is estimated, for example, that \$25 billion of investment is required in the electricity sector in Mexico over the next six years to provide the capacity needed to meet growth in demand, which is expected to be not less than six percent per annum (Ministry of Energy, 1999, p.4/17). Private investment, through encouraging private ownership, is often perceived as a desirable solution to this investment gap. Moreover, the use of markets in organising production (of which privatisation is thought to be a necessary component) arguably has the potential to bring significant economic efficiency gains. From

the perspective of government, therefore, longer-term efficiency savings can potentially be made in the funds that need to be set aside to subsidise public services. In Mexico the potential for savings may be large, as general subsidies for electricity tariffs amounted to around US\$3.1 billion in 1998 (Ministry of Energy, 1999, p.53).

In addition to these perceived benefits, Branston *et al.* (2001b) suggest that there is strong ideological pressure that reform in such situations includes privatisation. Influences in the British experiences were identified and, more generally, in the drive towards an integrated capitalist system, organised around transnational capital. Such an agenda was seen as having been actively pursued by the Washington institutions³ through their influence on the policies adopted by less developed countries, and in particular through emphasis on privatisation in the structural adjustment programmes of the International Monetary Fund (IMF). Indeed, Branston *et al.* (2001b) go on to intimate that the overall international environment under the so-called ‘Washington consensus’ places significant pressure on less developed countries to accelerate the transfer of public industries to the private sector, and allows very little room to manoeuvre policy in alternative directions.⁴

II.ii The Dangers of Privatisation

There is a danger that, in being swept along by this tide, insufficient attention is given to key concerns around privatisation. There is a commonly held perception that privatisation is

² See, for example: Islas and Jerónimo (2000); “Propone senador revisar esquema de subsidios a tarifas eléctricas”, *El Economista*, 15th October 2001; and “La apertura del sector eléctrico, una trampa: Ortega”, *La Jornada*, 20th August 2001.

³ The two key Washington institutions are the International Monetary Fund (IMF) and the World Bank.

⁴ A good example cited in Branston *et al.* (2001b) is the case of Argentina where Nochteff and Abeles (2000, p.69), argue that “the government was faced with a sort of desperate political and ideological urgency to privatise and deregulate... ushered in by its seeking to gain the confidence of both the “Washington Consensus overconfident investors” and the international organisations (IMF, World Bank); (and)... by the intellectual pressure of neoliberalism (and its prestige as the “only conceivable economic wisdom””.

automatically associated with gains in economic efficiency, but this is being challenged in a growing literature. In a review of earlier evidence on privatisation, Kay and Thompson (1986, p.23) argue that “it does not seem that there is anything intrinsically superior about performance under private ownership”. Similarly, Parker and Willner (2000, p.4) conclude that several studies have reported “no statistically significant differences” between public and private ownership and go on to reject “any simplistic and axiomatic relationship between private and public ownership” (p.10). Furthermore, Parker and Saal (2001, p.62) cite a number of studies that suggest, “performance improvement is by no means guaranteed and that efficiency may be related to product market competition rather than ownership *per se*”.⁵

More fundamental, however, is the issue of governance in the privatisation process. The simple transfer of government run organisations into the (international) private sector may facilitate elite control of the resulting corporations. Whilst these corporations might be subject to (industry specific) regulation, as we have already argued, this would only serve to constrain the policy space available to the controlling elite, and thus do little to incorporate the variation of interests inherent to such an industry. Indeed, the variation in interests in a setting such as Mexico is likely to especially great because of the developing nature of the Mexican economy.

Take, for example, the issue of pricing. Prices have been heavily subsidised, such that in 2000 the average price per kWh was US\$0.07, but varied from US\$0.028 for agriculture to US\$0.13 for commercial/general uses (Office of the President, 2000). In 1998, for example, the total subsidy was US\$3.1 billion (Ministry of Energy, 1999, p.53). It is clear that such

⁵ See also the work on British electricity privatisation contained within Part Two of this thesis.

tariffs did not fully reflect costs, and hence it is highly likely that reform would bring pricing revision.⁶ Different groups, however, will have separate interests in the nature of such revisions. While industrial consumers might favour low tariffs for high users, for instance, domestic consumers might prefer discounts for the smaller user, as might small or micro firms. Moreover, the owners of the electricity industry would no doubt prefer to be free to set profit maximising prices from the outset. Such views themselves might be misaligned with those of the Mexican government, or with poorer communities, who might prefer pricing strategies that are geared towards facilitating development. Indeed, in February 2002 the pricing structure in Mexico was modified,⁷ and the subsequent debate across groups within the country clearly reflects the variation of interests around such decisions.

For different sectors and groups within the economy there are other relevant strategic decisions where interests vary. For instance, domestic fuel suppliers (such as *Petróleos Mexicanos*) would have a particular interest in decisions taken regarding the choice of fuel for future power stations, or indeed how the existing generating plant is used to generate electricity. Such opinions may well be in conflict with the views of other interested groups, such as environmentalists, employees or affected local communities, who may prefer a different strategy. Employees within the industry have a particular interest in strategic decisions concerning all aspects of the industry, given that this is the source of their livelihood and dominates their waking hours. Again, their interests on particular decisions may differ from those of other groups.

⁶ In most international experience of privatisation modifications to tariffs have been observed. For the case of Britain, see for example Clarke (1993) or the work presented in Part Two of this thesis.

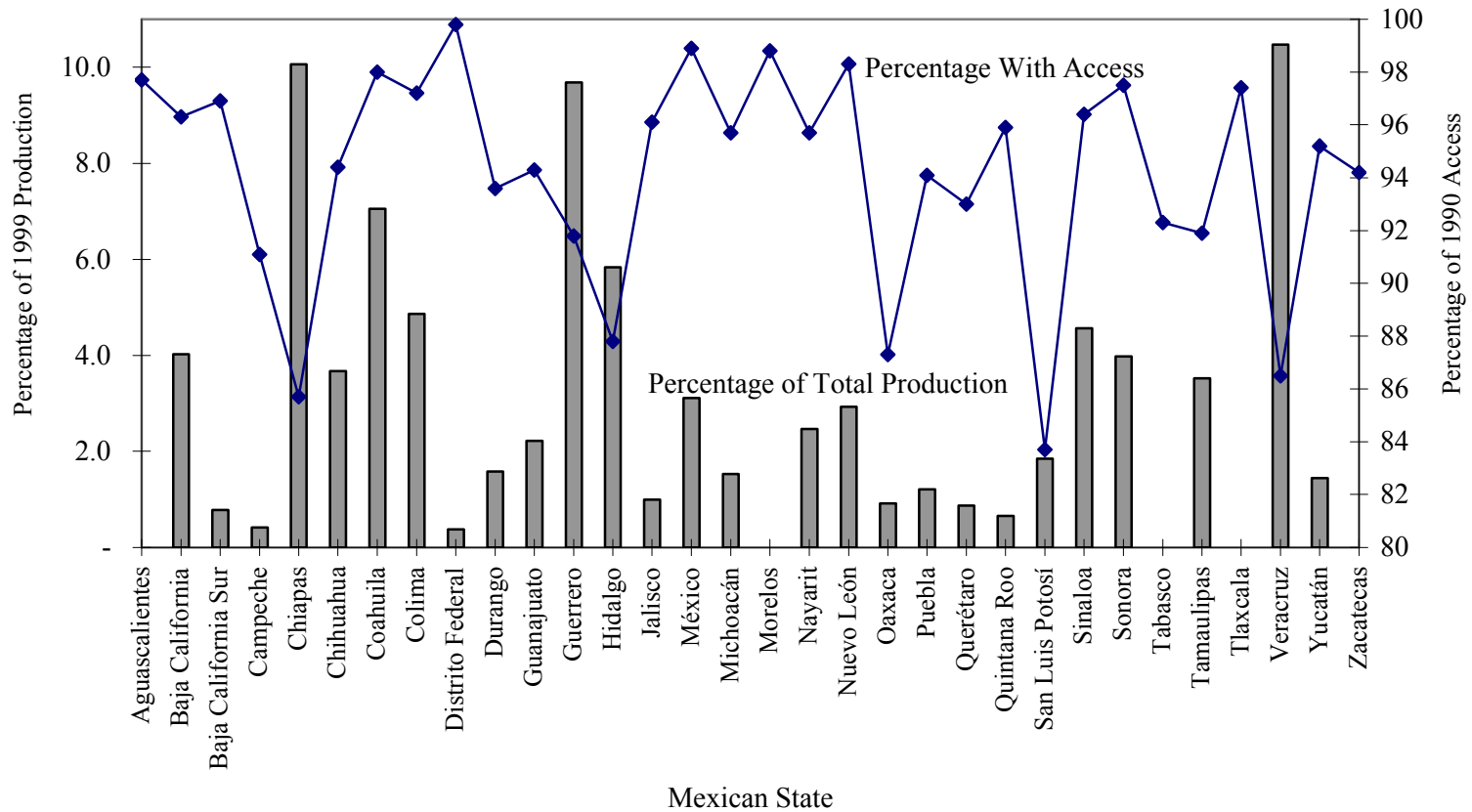
An area where significant variation of interests may exist in a developing country such as Mexico is the extent of electricity availability within the community, as currently not all of the population has access to the electricity system. Approximately 94% of households had access in 1997, representing an increment of 7 percentage points from 1990. However, the progress has not been equally distributed; in rural areas the access is as low as 87%, compared to almost 100% in urban areas (INEGI, 2000). This inequality reflects the great difficulty inherent in providing services in a large country where 26% of the total population live in rural areas (INEGI, 2000).⁸

Figure One (overleaf) illustrates both the percentage of people with access to electricity in the different states of Mexico (line) and the individual states' share of the total electricity production (bar). The states of *Chiapas* and *Veracruz* demonstrate clearly the current disparate nature of electricity production and supply. *Chiapas*, for example, contributes 10% of the country's output, and yet almost 15% of its households do not have access to the service. This is in stark comparison to the conditions that exist in cities, such as *Distrito Federal* (Mexico City), where there is virtually no production but almost universal access to electricity.

⁷ See *Diario de la Federación*, 7th February 2002.

⁸ Approximately 32% of the population lives in communities with less than 5,000 inhabitants. (INEGI, 2000)

Figure One
Electricity Production and Access in Mexico



Data sources: Access data from INEGI (2000) and production data from Office of the President (2000)

Situations such as this provide further evidence of the need for more active participation of the various different interest groups in the strategic decision-making of the sector. Potential consumers in *Chiapas* or *Veracruz*, for example, will have a separate interest that is distinct from existing customers in *Distrito Federal*; existing customers might prefer a strategic decision to make the current system cheap and reliable, whilst potential customers might prefer to use such resources to expand the network so that they can become customers. It is therefore imperative to find ways of giving such groups an effective voice in the decision-making process underlying the electricity sector.

In line with this, in Chapter Two we discussed some measures that might be taken to democratise decision-making. Privatisation, if implemented in a suitable manner, might be a complimentary policy that helps to achieve this. Our argument here is not one for or against privatisation. What we are suggesting is that if privatisation is to take place, it presents an opportunity to address governance concerns, but if nothing is done about governance, then privatisation could perpetuate and expand strategic failure.

II.iii Privatisation, Democracy and Development

Furthermore, the electricity sector of a ‘developing’ country such as Mexico is arguably a particularly critical sector because of the role it plays in the more general development of the economy. Provision of electricity is fundamentally linked to the development aspirations of a country, and those of individual communities within that country. A commonly used ‘development’ indicator, for example, is the number of households that have access to electricity, and therefore to important welfare enhancing goods such as electric lights, radios and refrigerators. Moreover, there are vital links between the provision of reliable and

appropriately priced electricity and the development of local economies and industries, which in turn provide employment for local people. Indeed, the strategic importance of the electricity sector for the overall development of communities implies that its privatisation be implemented in a way that is sensitive to the sector's role in development. In the case of Mexico such concerns were highlighted by the Ministry of Energy, who stated in 1999 (p.4, emphasis added) that “the indicators of quality and reliability of service, especially in the centre of the country, are *below those required for proper development.*”

The democratisation of strategic decision-making in the electricity sector may serve to help in the development process, especially if the view of development advocated in Sugden and Wilson (2002) is adopted. They suggest that development should not be viewed as in the conventional sense of the attainment of a specific set of externally set indicators, but should rather be conceptualised and defined as the attainment of the aims and objectives of those seeking to develop. If different interest groups are able to have a real voice in the decision-making process, their views on the electricity sector and its significance to the development of Mexico can be taken into consideration. Decisions may then be taken which amongst other things help facilitate, or at least do not undermine, the development aims of the communities within Mexico. This potential outcome is in stark contrast to that which would follow if the sector were simply transferred to a group of international investors who were free to pursue their own interests, which are unlikely to be fully aligned with Mexican communities. Such a privatisation would potentially limit the development of these communities and certain sectors within the economy. For example, isolated communities where service provision is (relatively) unprofitable or unduly risky may be excluded or marginalised. This can be seen, for example, from the South African experience with water privatisation, where, in the town

of Stutterheim, a large foreign firm ‘cherry-picked’ the lucrative areas, leaving many others unconnected (Mncwabeni and Bond, 1999).

We therefore now turn to the situation that currently exists within Mexico, and proffer a potential privatisation structure that moves in the direction of the principles we have advocated. It is recognised, however, that such concerns must be balanced with practical considerations over issues such as funding, which may, for example, be reliant on international capital markets, and thus strongly influenced by prevailing attitudes in the international community. As such our suggestion is at best a second best result.

III. MEXICAN ELECTRICITY

III.i The Current Structure

The electricity system in Mexico is currently focused around two vertically integrated public entities, the *Comisión Federal de Electricidad* (CFE) and *Luz y Fuerza del Centro* (LFC). Together, these are responsible for the transmission, distribution and supply of electricity for public service,⁹ and generate the vast majority of electricity.¹⁰ In 1999 they accounted for more than 92% of Mexican generating capacity (Ministry of Energy, 1999, p.14). The remaining generating capacity was owned by private self-generators, co-generators and, following an amendment to the law in December 1992, several independent power producers (IPPs).¹¹ However, in the absence of a market for electricity, self-generators and co-generators only satisfied their own needs. IPP involvement was also low, accounting for only

⁹ Transmission refers to the use of the high voltage national electricity grid, distribution refers to the low voltage local electricity lines and supply refers to the sale of electricity to the final consumer.

¹⁰ CFE covers the entire national territory with the exception of the *Distrito Federal* and parts of the states of *Morelos*, *Hidalgo* and *Puebla* (i.e. the central area), where LFC has responsibility.

¹¹ Co-generation refers to electricity that is generated simultaneously with steam or other types of thermal energy used in an industrial process, or generation from the waste heat of an industrial process. Self-generation refers to

3.3% of generating capacity in 1999 (Ministry of Energy, 1999, p.17), reflecting the unattractiveness of selling under long-term contract in a monopsony market where CFE is the only buyer.

The current structure is characterised by significant inefficiencies that have arisen due to lack of investment. The transmission grid has high electrical losses, with some sections experiencing capacity and reliability problems. These constraints impinge upon the efficient operation of the system because some low cost generating plant is unable to operate at full capacity, increasing the total cost of electricity production. A similar picture can be observed in the distribution sector, which experiences technical losses equivalent to 10% of low voltage sales due to overloading, and further losses caused by shortages of meters and other equipment (Ministry of Energy, 1999, p.18). In short, the current system is vertically integrated, relatively technically inefficient, and one which the Ministry of Energy (1999, p.18) identified as needing significant investment in generation, transmission and distribution.¹²

III.ii Democratic Privatisation Using Mexican Pension Funds

The implication of our conceptual analysis and of the current state of the Mexican electricity industry is that successful privatisation of the sector would (at least) need to combine two goals: the infusion of democracy and an increase in investment. A typical argument would be that foreign capital could solve the investment problem, but as we have already suggested, privatising to a small elite of international investors does not to address concerns over the

the generation of energy to meet a producer's own physical or contractual needs (Ministry of Energy, 1999, pp.71-73).

¹² More recent concerns over the urgent need for investment are reflected in "México dependerá más del capital privado por la limitación del presupuesto", *La Jornada*, 14th May 2001.

strategic failure of governance. Moreover, it would most likely to a backward step in this regard.

Branston *et al.* (2001b), drawing upon Clarke and Pitelis (1993), and Reed and Anthony (1993), suggest that previous international experience in privatisation has made much of the desire to expand ‘popular capitalism’, by widening share ownership. While such sentiments are broadly in line with our principles of democracy, they are identified as being superficial by Cowling and Sugden (1993). Investments in shares are just that; simple, financial investments designed to make financial returns. In line with this, Branston *et al.* (2001b), again drawing upon Clarke and Pitelis (1993), highlight the example of British experience, where mechanisms to widen share ownership failed to encourage long-term small investors, and most of the time only promoted speculation by foreign investors. Moreover, we have already seen in Chapter One that small shareholders are excluded from governance and so in many ways this failure to secure long-term investment in shares is a moot point. Nothing fundamental has changed; interest groups continue to remain excluded from decision-making. Learning from this experience, it is imperative to find alternative ways of introducing economic democracy; thus reducing speculation and encouraging active community participation.

Given the constraints in place, one potentially attractive alternative is to introduce institutional investors, such as domestic pension funds. This possibility has been voiced by various high-profile figures in Mexico, including Antonio Dávila, Secretary of the Commission for Energy in the House of Representatives.¹³ Pension funds are in essence ‘delegated monitors’ of

¹³ See “Propone diputado usar recursos de Afores en electricidad”, *La Economista*, 16th October 2001. Recently it has been suggested that the resources of the pension funds could be used by private investors as a source of

millions of workers. Therefore, if they are incorporated in a privatisation solution, the participation of a major part of society is automatically guaranteed, most likely in a long-term relationship.¹⁴ Moreover, Branston *et al.* (2001b) identify that pension fund investments have already been involved in privatisations in other Latin American countries, and elsewhere.

The potential for using pension funds in Mexico is clearly significant. In the mid 1990s, the Mexican government undertook a reform of the pension system.¹⁵ This reform created a group of new institutional investors within the financial system, and in the near future these funds are likely to become the largest institutional investors in Mexico. At the end of 2000 the value of the funds stood at around US\$10.4 billion (CONSAR, 2001), and considerable growth is expected in future years. As such they have a key role in expanding asset holdings within Mexican society, but also in promoting development, using pension savings to finance sound economic activities. One way of doing this is for them to play a major role in electricity privatisation.

The pension funds began with a very restrictive investment regime. Amongst the 17 active pension funds in Mexico only approximately three percent of their portfolios are invested in shares, with the remainder held in government debt instruments and high-rated private debt (CONSAR, 2001). However, government debt has been declining in the last 10 years, while the funds are continuously growing, and thus there are large pressures to relax the present investment regime. The reality is that the funds may grow faster than the available

finance for electricity projects ("Indispensables, los cambios constitucionales en energia", *El Financiero*, 28th May 2002).

¹⁴ There are other alternatives, such as facilitating the participation of municipalities. However, in Mexico (and many other countries) there is currently no market for municipal debt, and so their avenues for providing the required funding are limited.

investment opportunities in relatively safe assets. Some solutions to this dilemma point towards a liberalisation of the investment regime, including allowing overseas investments (Srinivas and Yermo, 2000; Mitchell, 1999; Vittas, 1996).¹⁶ Other Latin American countries, such as Chile, Argentina and Peru already allow investment in foreign securities. Although Chile sets a maximum limit, this is as high as 20% of the total portfolio (Srinivas and Yermo, 2000). The potential problem is that outward foreign investment is an export of domestic capital; resources that could otherwise be used to nurture development of the local economy.

Participation by pension funds in the reform of the electricity sector could form an attractive option for new investment strategies given the funds they have available. It might seem that there exists a trade-off between maintaining the security of the pension funds and investing long-term in potentially higher-risk Mexican firms. However, the Ministry of Energy recognised in 1999 (p.62) that “electricity companies are considered to have low risk in a growing industry” and therefore suggested that “pension funds will be able to participate in ownership of these companies, either as direct shareholders or through financial markets.” Indeed, it could be argued that the high-growth electricity sector constitutes a potentially lower risk than investment in currently volatile international securities.

Moreover, there is an inherent meeting of interests in such a solution. Mexicans owning pension funds have interests both in their private savings and as individual consumers (or potential consumers) of electricity. More generally, they also have an interest in the development of the economy, which we have suggested is strongly influenced by a key sector

¹⁵ There are large social and fiscal implications from this reform that are beyond the scope of this analysis. For a brief summary of the Mexican pension reforms see Branston *et al.* (2001b), or for a more detailed background and discussion see Sales-Sarrapy *et al.* (1998).

such as electricity. This provides strong incentives for the type of involvement in decision-making that we have previously identified as important. Together, these arguments provide a compelling case for analysing the feasibility of involving pension funds in the privatisation.

IV. IMPLEMENTATION, FUNDING AND GOVERNANCE

The industry structure put in place during the restructuring and privatisation process will have profound consequences for the subsequent ability of the industry to meet the goals we have set in terms of technical efficiency and participation in the strategic decision-making process. This does not mean to say that technical efficiency and economic democracy are incompatible goals.¹⁷ They should instead be viewed as two issues that need to be successfully combined in any privatisation process. It is, however, by no means certain that this will be the case, since under certain circumstances one may serve to exclude the other. Thus the choice of structure is crucial in order to allow both goals to be realistically achieved.¹⁸

IV.i A Potential Industry Structure

One potential structure that could achieve these goals is that which was proposed by the Mexican Ministry of Energy in 1999. This resembled the structure of the industry in England and Wales when that was reorganised and privatised in 1990 (see Part Two of this thesis for further details).¹⁹ The proposed structure would have separated generation into multiple units to encourage competition and hence economic efficiency. Electricity generated by these

¹⁶ The arguments of these authors are mainly sustained on diversification gains and the lack of safe investment opportunities in developing countries.

¹⁷ Economic democracy could be argued to lead to social efficiency as opposed to a more narrow (technical) conceptualisation of economic efficiency.

¹⁸ Learning from experiences in Britain and elsewhere, it would seem optimal for reorganisation to take place significantly prior to privatisation so that the new structures and companies would be able to establish themselves, and efficient system operations verified, before the system is transferred to the private sector - see Tenenbaum *et al.* (1992) and the work in Part Two of this thesis.

companies would then be sold via a co-ordinated market mechanism and transmitted by a national transmission grid, owned by a single company. Finally, a number of regional companies would then distribute and supply this electricity to end-users.

We would, however, advocate that this structure be supplemented via the creation of an additional body to ensure that there exists co-ordination between these different companies. Indeed, such a body could also assume the role of industry regulator to ensure that the natural monopolies (transmission and distribution) do not unfairly exploit their position. Whilst the system proposed by the Ministry of Energy in 1999 does allow for a new body overseeing system operation and dispatch, this seems to be limited to day-to-day operation. Provision is made separately to strengthen regulation, currently undertaken by the *Comisión Reguladora de Energía*. We suggest that it would be better to combine both of these in a single body, which could also take a long term view, co-ordinating the efforts of the various companies as they seek to expand and consolidate the industry.²⁰ It is important that such a body itself incorporates means of democratic control, so that it does not undermine our stated privatisation aim of increased participation in decision-making.

IV.ii Ownership, Funding And Control

Within such a general structure, we then propose an ownership and control configuration that contains three key participants: Mexican pension funds; other financial investors; and Mexican citizens. Pension funds, as mentioned previously, present a way of raising private

¹⁹ There are currently constitutional barriers to introducing such changes in Mexico, but they do offer an analytical starting point for the more fundamental points we seek to raise via the use of this example.

²⁰ Such a body might resemble the Strategic Rail Authority of the UK, which has the role of guiding the industry towards a 'bigger, better, safer railway'. This does not however, have responsibility for regulation which is carried out by a separate body and so differs from our proposal in this respect – see <http://www.sra.gov.uk/sra/> for more details (accessed on 16th August 2002).

capital for the necessary investment, while still achieving a degree of community based control. Pension funds could therefore be given preferential treatment, for example in terms of first refusal on any shares sold (both now and in the future), so as to maximise their involvement. Although the current size of pension funds is not sufficient to provide all (or even a majority) of the required funds, as low risk and expanding institutions they could borrow at preferential rates using as collateral the value of future contributions. We also recognise, however, that other financial investors (domestic companies, transnational corporations, etc.) will also be required to play an important role in providing both financial and operational backing, and expertise.

Given concern with the undemocratic nature of strategic decision-making, the rights of these two investors need to be balanced further against the interests of communities within Mexico. Although pension funds provide a great many Mexicans with a potential for voice in key decisions, they are by no means wholly inclusive institutions. Indeed, CONSAR (the pension funds supervisory authority) estimated in December 2000 that there were 17.8 million workers registered with the funds,²¹ representing only a fraction of the Mexican labour force of around 38 million. There is a danger, therefore, that decision-making structures would exclude a large segment of the population. Crucially, those Mexicans not linked to the pension system, and therefore excluded from decision-making, would be likely to correspond to the poorer, rural groups in society, and the majority of those currently without access to electricity. In order to balance this tendency, a third control group could be formulated to involve all Mexicans. Specifically, this could take the form of an in-built right, realised at birth and relinquished upon death, for all citizens of Mexico to have some level of

²¹ Only 89.1% of these made at least one payment (contribution).

participation in decision-making within the electricity sector. It is unlikely that this participation could be in the form of a financial stake, given the imperative of raising the \$25 billion of required investment (i.e. the granting of shares to all Mexican citizens). However, there is no reason why this should be necessary for effective participation in decision-making, as our discussions in Chapter Two on broadening company membership illustrated.

An industry structure along the lines of that outlined in Section IV.i above, would enable the level of participation (or indeed balance of ownership) to vary across different parts of the industry, and thus to reflect the importance given to decision-making in each different part. It may be considered, for example, that in generation there are fewer grounds for community involvement in decision-making, as one of the key imperatives is simply to generate electricity as efficiently as possible; although this is not to deny that groups such as workers would require decision-making channels. Given a sufficiently large number of companies to ensure competition, and given democratic channels through which workers can input into key decisions, it might not be inappropriate for each company to be owned by a particular group (e.g. pension fund, transnational corporation). The third control group would then be essentially a safeguard to the system, acting where particular and uncommon issues/tensions arise.²² However, in sectors that are seen to have greater strategic importance, such as transmission or distribution, more care may need to be taken. This might mean a more balanced ownership and control system, perhaps implying that pension funds hold a larger amount of equity in the companies responsible, and that the potential for community involvement through the third control group is more fully utilised. The exact balance of

²² For example over decisions such as location and type of power plant, in which local communities may wish to be involved.

ownership and voting rights is something that would need to be adjusted and refined, learning from experience, varying from company to company, and from sector to sector.

One potential criticism of this type of system would be that private investors who actually own shares in the companies could be put off by the possibility of being held ‘hostage’ by the voice of the community. However, current practice shows that this need not be the case. In Britain, many of the privatisation experiences incorporated the idea of a ‘golden share’ for many years. These were held by the government to enable them to exert a disproportionate degree of control in unusual circumstances, such as at times of potential foreign take-over (Thomas, 1996b). Moreover, German companies are legally bound to have a second board, which contains worker representatives. This board has to approve all high level decisions, which means it can actively restrain the activities of the company (Davies, 1999). These examples are from systems that functioned, and indeed thrived, suggesting that the idea of giving communities a voice in decision-making is not so far from current practice as to be unworkable.

For such a structure and control configuration to effectively enhance democratic decision-making, it is necessary to address the practical issues of participation and governance. To this end, we first examine the governance of the pension funds, and before looking at the electricity sector more widely.

IV.iii Pension Fund Governance

If pension funds are to play a meaningful role in a privatisation process designed to enhance economic democracy, the governance of these pension funds must also be addressed and

integrated into the governance of the electricity sector. Pension fund ownership of a significant proportion of the electricity sector could create a large number of ways for participation in the decision-making process. As owners, pension funds would essentially supervise management within the electricity sector, and thus have input into key decisions around economic and financial strategy. Indeed, pension funds essentially concentrate ownership, which, as described by Stiglitz (1985), is probably the most effective method of reducing agency problems. If pension funds have a significant shareholding, they will have incentives to produce and analyse information for monitoring; the size of their investments will allow them to have dedicated resources for analysis and strategy evaluation.

In realising this element of control, pension funds can be seen as having two distinct duties. The first, more conventional duty, is to assure a certain balance of risk and return for their contributors. In this sense they are simply ‘delegated investors’, searching for an attractive rate of return. However, pension funds are also ‘delegated monitors’ of workers’ interests. It must be recognised in this regard that workers have interests that are wider than the financial status of their pension. As consumers of electricity they are concerned with quality of service and fair prices from the sector, and as citizens they have interests in the wider development of their communities, of which the electricity sector is a key component. In this regard contributors to pension funds face inter-temporal, and often conflicting, decisions. Fund managers could thus have a duty to balance these interests in a process of mediation, in order to elicit compromise and agreement. Indeed, from the perspective of government, this balance is also crucial. While pension fund returns are important to negate the need for pensioner assistance in the future, government also has strong interests in the development of the economy, and how this is influenced by key decisions in the electricity sector.

There are therefore two main challenges for strategic decision-making. Firstly, pension fund managers will be required to participate intensively in the strategic decisions of electricity firms, in order to look after the investments and to transmit the desires of the people that they represent. These could involve, among others, the technology for new power stations, new services, new tariff structures, and grid extensions. The second challenge is to create an adequate way of transmitting community aims and desires to pension fund managers.

As Chapter One highlighted, the direct involvement of institutional investors, such as pension funds, in the decision-making of firms is a widely known phenomenon.²³ Branston *et al.* (2001b) highlight the example of Chile where the participation of domestic pension funds in privatised firms during the 1980s, helped them to create the infrastructure and knowledge to participate in share ownership. Indeed, fund managers are said to now be able to vote for independent directors (Vittas, 1996). The challenge in Mexico, therefore, is to improve the role of fund managers in corporate decision-making along similar lines. This will involve cultural changes and a learning process, which might be stimulated by the chance to become involved in the electricity privatisation, and nurtured by the pension fund regulatory authority.

However, what is not clear from existing work or experience is how the challenge of transmitting the different, and often conflicting, interests of pension fund contributors might be met. In order to give a flavour of such an idea, we suggest a number of ways in which this might take place. Ballots and elections of fund managers could be instituted, allowing contributors to express their opinions on how funds should be managed, a concept not

²³ See, for example, Rubach (1999) or Faccio and Lasfer (2000).

dissimilar from the way in which the electorate determine the path of a country (or how senior management might be accountable to the members of a corporation). In exceptional circumstances referenda might be called, perhaps if a certain number of contributors can be gathered to support a particular proposition. More generally the pension funds might be invested with a duty to actively consult and seek the opinions of its members. This might take the form of local meetings with participants, or greater opportunities for feedback regarding key decisions. Indeed, the role of fund managers could evolve; to mediate across different interest groups, to elicit compromise, and to negotiate agreements on the way forward. It may also be possible for each pension fund to evolve a particular niche in terms of policy. Individuals would then be able to self-select the fund that best represents their interests. Given their pioneering nature, all of these mechanisms would need to be considered and reformed overtime, learning from experience, and refined in light of success or failure.

There will undoubtedly be limits to the practical feasibility of such schemes to increase involvement in the decision-making of the pension funds, especially in developing countries such as Mexico. Particular concern may be expressed, for example, at the cost of the monitoring and consultation that is required. This is something that must clearly be considered, but what is important is that there exist *some* ways in which contributors can have their opinions heard and considered. Indeed multiple avenues are important so that if one method is unavailable to a certain groups then others are. In this way, pension fund contributors have the opportunity to become involved in decisions where they feel that they have an interest, but the choice to remain passive at other times. As we have previously suggested, following Hirschman (1970), a mixture of active and inactive members might actually serve the system more effectively than total activism.

A similar opportunity should not be denied, however, to the large proportion of the population that do not contribute to pension funds. This was indeed the principle behind our earlier proposition of a third tier of governance, in addition to pension funds and other private investors. With this in mind, we now turn to consider a balanced governance structure for the whole industry, incorporating a general citizen's right to participation.

IV.iv A Balanced Governance Structure

The idea of a balanced governance structure is to ensure that decision-making becomes more democratic with the implementation of privatisation; that all actors have a voice. To this end, it is important that all Mexican citizens have access to channels of participation in decisions where they have interests, although it is unrealistic to envisage that this be in terms of a financial stake.²⁴ The fundamental principle is that one group (i.e. pension funds, other investors or Mexican citizens) does not hold all the power; democracy implies the balancing of interests. In practical terms, the balance of different governance powers will require continual adjustment, learning from experience of what works and what does not.

A number of different avenues are required to facilitate this process of incorporation of wider interests, many of which will share a fundamental symmetry with the measures we have already outlined when discussing the governance of pension funds. There will, however, need to be differences, and expansions upon the ideas already outlined, reflecting the different situations. An example of one such method would be the creation of a body that could help

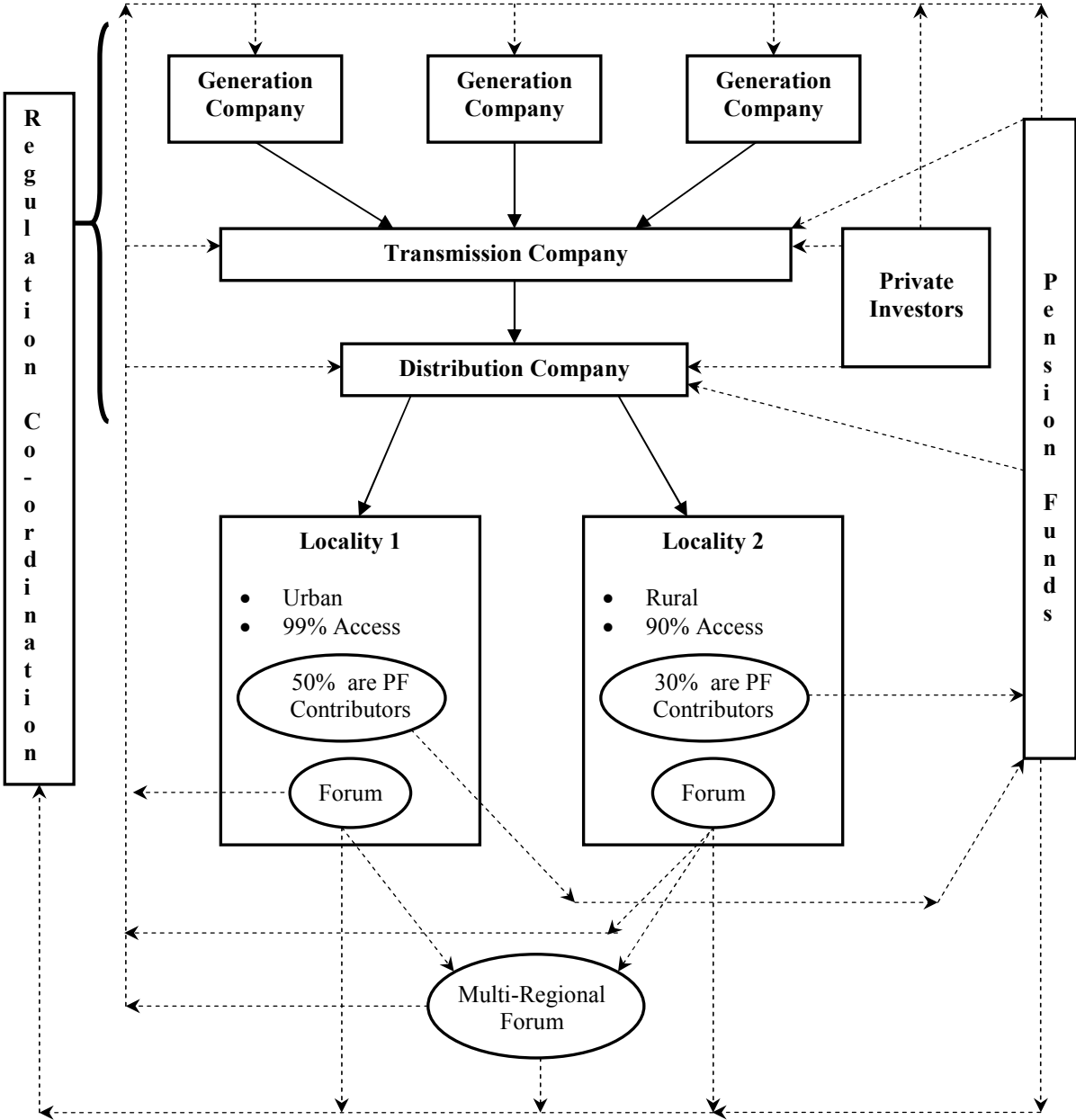
²⁴ If shares in the electricity companies were floated on the stock market, any individual could buy shares, thus giving them some form of representation in the conventional sense of corporate control. The point here, however, is to give representation to all, and not simply those in a position to obtain some measure of control




form groups of like-minded individuals; to facilitate the formation of interest groups. These could be more conventional consumer pressure groups lobbying over specific issues, or, more fundamentally, locally based groups that have the interests of that locality as their prime concern. Such local groups could act as fora for thinking, analysing and discussing issues of importance to that locality, one of which may involve electricity. These local groups might then feed into a larger process whereby many different local groups get together to express and debate their concerns, and then make representations to the electricity companies when and where issues of importance arise.

We therefore see that a balanced governance structure for the privatised electricity sector would look something along the lines of that outlined in Figure Two (overleaf). The top half of the diagram shows the electricity sector, split into its three core elements, while the bottom half represents localities within Mexico. For purposes of illustration, we have depicted two such localities, one urban and one rural, with different characteristics in terms of access to electricity and pension fund contributions. Represented in solid arrows are electricity flows; from the generators to the local distribution companies, via the transmission company, and finally to the localities themselves. Around this we have illustrated our proposed flows of decision-making input and control (dashed lines), incorporating the three distinct groups outlined above.

through share ownership. Moreover, there is strong debate around the ability of small shareholders to effectively exercise their control rights – see Chapter One.

Figure Two
Potential Control Structure



- Key**
-  Electricity Flow
 -  Decision-Making Input Flow
 -  Remit of Regulator/Co-ordination Body

The first, and most traditional, control group are the private investors, who have direct input into the three different types of company through their share ownership. The second group are the pension funds, who also have direct control through their ownership. The control exerted by this group, however, is linked explicitly back to the localities through the subsection of each locality that are contributors to these funds. Finally, the third tier of control is that implied by the right for all Mexican citizens to participate in the governance of the key electricity sector. This control differs from the other groups in that there is no element of financial ownership, and input is thus shown on the opposite side of the diagram.

We have represented the input of this third group in relation to local fora (which may be informal or formal), where issues of concern can be aired among local actors. Where these concerns are influenced by the activities of electricity companies, it is envisaged that representations can be made to these companies, either directly or through a broader layer where distinct localities can co-ordinate their representations. The precise form of these channels for representation to the companies is an important consideration. In particular, there is a danger that the non-financial status of this group implies, in practice, a comparative lack of voice. It may be necessary, for example, to formalise this participation on the board of the company, perhaps through allowing these local channels to elect representatives to the board. In this way, the channel becomes effective, but will only be utilised where there is a divergence of interests. This solution will be particularly appropriate for local distribution companies, which play more of a role in specific localities, especially in terms of widening access and expanding the system. This is not to deny, however, that there may (or should) be other channels through which localities can exert their voice in the decision-making process. Indeed, one of these could be through the regulatory/co-ordination body, which we have also

included on the left side of the diagram. Individuals or localities could input into this body, either directly or through the multi-regional fora, and thus influence the way in which this body interacts with, and guides, the electricity sector as a whole.

V. CONCLUDING COMMENTS

As a practical real-world application of the principles and types of broad policies we have indicated as being required to correct strategic failure in governance, we argued that the impending reform of the Mexican electricity sector is a step that should be afforded great care. In particular, our emphasis has been on the possibility of privatisation and the opportunity that this process would present for enhancing participation, and hence democracy, in a key sector of the economy that has major implications for the development of the localities that comprise Mexico.

Given the constraints that exist for Mexico and the nature of the electricity sector, our preferred solution, as outlined in Chapter Two, of simply putting in place a variety of mechanisms to allow different interest groups to participate in the current decision-making processes is not a viable option. We have therefore had to consider alternative solutions. Specifically, we have suggested an ownership and control structure that aims to balance the interests of the required private investors against those of other interest groups. A primary mechanism for this is to allow Mexican pension funds to play a leading role in the reform, thus linking investment in the sector back to individuals and groups with interests wider than those traditionally associated with external investors. While this moves towards the guiding principles we established in the earlier parts of this thesis, it falls short of being the fully inclusive economic democracy we advocate. We have therefore also proposed a more direct

incorporation of Mexican citizens in decision-making, through a formal right to participation. Finally, we have debated various governance mechanisms that would allow this participation to be realised, although we acknowledge that these require further debate, refinement and learning from what works, and what does not.

The use of Mexican electricity reform as a specific application of how economic democracy can be made a reality, should not be interpreted to mean that this is a special case and thus that (many of) the conclusions are not applicable more widely. The case of Mexico was adopted because of it allowed discussion of the governance implications of privatisation, its topical nature, the fit with the previous wider utility focus, and the fact that the forces acting within and upon Mexico meant that the policy space available was severely limited. To that end, other industry examples might also have been chosen. This is pursued in Chapter Four, which further extends the analysis of elite decision-making by focussing attention on the considerably different example of the corporate university. It is therefore to this that we now turn.

CHAPTER FOUR

THE WIDER APPLICATION OF PUBLIC INTEREST DECISION- MAKING: THE CASE OF CORPORATE UNIVERSITIES

I. INTRODUCTION

The focus placed upon utility companies in the preceding Chapters gives rise to a possible danger in that some readers might take this to imply the requirement for public interest decision-making is only applicable to these specific sectors. This was not our intention, nor our view; other industry or sector examples to illustrate the application of the theory might easily have been chosen. To demonstrate this, a further application of our approach is therefore now considered; we examine the case of corporate universities. This example is a considerable departure from our previous utility company focus but this is a deliberate choice in order to give the broadest possible illustration of the generality of the theory. Furthermore, at another level, corporate universities are significant in their own right and therefore discussion of the sector provides further insight.

Education and the acquisition of new skills have always played a significant role in economic development and thus the expansion of the productive capacity of an economy. In the age of the so called ‘knowledge’ economy, a highly skilled workforce and consequently the means by which these skills are nurtured – education/training - are seen to have a central role in creating economic prosperity (Sugden and Wilson, 2003; Dunning, 2000; World Bank, 1998; Stiglitz, 1998). As an aspect of this, corporations see an appropriately educated workforce as one of the key determinants of their ability to thrive and expand. In line with this, recent years have seen many become involved with the phenomena of the so-called ‘corporate university’.

Dealtry (2000, p.171) reports that there are more than 1,600 such institutions now listed, and Meister (1998a, p.38) comments that in the USA, at their current rate of growth, their number could surpass that of traditional universities by the year 2010. A survey of the FTSE 100 index companies conducted in the Spring of 2002 for this PhD, revealed that 23 out of the 100 companies identified themselves as having created, or having been in the process of creating, a corporate university for their organisation.

The decision to create such institutions is of particular interest in the current business climate, where many corporations are downsizing and focusing their activities on 'core areas'. Such behaviour gives rise to an apparent paradox: it is hard to reconcile retrenching and the narrowing of focus, with the corporate move to provide education via the creation of corporate universities.¹ In this Chapter we therefore seek to analyse why so many corporations are embracing the idea of the corporate university, by investigating the aims of the companies that have created them, and then by exploring the implications of these institutions. Specifically we are concerned with some of the affects of these bodies on the governance and control of education, and on the provision of education in the economies in which they operate.

The basis for our analysis is our previous understanding of, and therefore a comparison with, governance of the modern corporation. This is of relevance to corporate universities since these are institutions specifically created and controlled by a corporation, dedicated to serving

¹ It could be argued that if the education and training corresponds to these 'core areas' then it might be a natural deepening of the corporate focus. However, even in this situation, a conflict could be still seen to arise because the provision of such training/education is most likely not a core area in itself but rather one of many services

its needs. The implication is that decision-making within the parent organisation will likely impact upon the way it operates. More specifically, with a corporation being controlled by a subset of those with an interest, we are left with the potential result that the corporate university may in turn be governed by this minority group, thus granting them the potential to exert a significant degree of control over education in the economies with which their corporations are associated. Such a situation may be incompatible with a truly democratic society, where institutions such as companies and universities might be argued to exist to serve the communities with which they are associated, not the significantly different result, which the creation of corporate universities might imply.

In order to pursue these arguments, this Chapter is organised as follows. Our starting point in Section II is the issue of what exactly a corporate university is, and thus how it might be defined. We then position this discussion in terms of the possibilities of strategic decision-making within such organisations. Section III then introduces the British corporate university sector, drawing upon a survey of their number in the corporations of the FTSE 100 index, and a series of interviews conducted for this thesis. The key findings on the rationale and governance mechanisms of these corporate universities are examined, and then this evidence is used to draw conclusions in terms of the control of corporate universities and the possibility of strategic failure. Section IV highlights the implications and significance of our findings for governance. Finally our conclusions are presented in Section V.

that helps facilitate the operation of the corporation. It is therefore unclear why it wouldn't be outsourced like other support services such as housekeeping.

II. THE CORPORATE UNIVERSITY

II.i The Corporate University Defined

Encountering the term ‘corporate university’ for the first time, it immediately raises connotations of an organisation that is an academic institution run on corporate lines. That is to say, a university that operates as a business by providing a service (research, education and the granting of degrees) from which it raises revenue, and thus makes a profit; i.e. a for-profit private university run like a corporation. In fact this is not the case. Defining what constitutes a corporate university, however, and thus what is and is not such an organisation, is something upon which there is no definitive answer within the literature. Several authors proffer consistent, if somewhat vague, definitions for this relatively abstract concept, but the difficulty remains in defining a corporate university in a definitive, meaningful way.

A good starting point for a broad but robust definition is that proffered by Blass (2001, p.153), who sees corporate universities as “wholly owned training/education/learning/knowledge management facilities providing education and services for members of their organisations”. However, whilst this definition does not contradict the other contributions in this area, it does seem lacking when compared with the views of other commentators. Greenberg (1998, p.37), for example, gives a good summary of the general feeling within the literature when he defines a corporate university as “a centralised, proactive organisation that is responsible for all training and education at a given company – and sometimes beyond.” It is the structural and behavioural element that is the key difference from Blass, the notion of “centralised” and “proactive” suggesting the relevance of strategy to the operation of a corporate university. This Greenberg definition is more consistent with the views of Meister, one of the most

prominent and prolific writers in this subject area. She defines a corporate university as a “strategic umbrella for developing and educating employees, customers, and suppliers in order to meet an organisation’s business strategies” (Meister, 1998b, p.29). Therefore, according to Meister, such an institution must be strategic as well as being aligned closely with the needs of the parent corporation. However, what is still unclear is exactly what ‘corporate university’ actually means in practice, and how it differs from a more traditional training department or function.

According to Meister, there are some very real and tangible differences between a training department and a corporate university, some of which are illustrated in Appendix A. It reports Meister’s comparison of some of the differing features, and the ten clear-cut goals and principles around which she suggests that corporate universities tend to organise themselves. Whilst this is again instructive in giving a broad insight into a corporate university, it is still not a definitive or really meaningful definition.

One of the key factors that make it so difficult to robustly define a corporate university in a meaningful way is that there is not a fixed model for such an organisation. The corporate universities that exist today vary considerably in their operation and scope, making a ‘one-size-fit-all’ definition problematic. Some are entirely virtual, relying solely on the Internet and other new technologies, whilst others are in a more traditional university mould, having bricks and mortar campuses. Moreover, some corporate universities observed in the real world neither fulfil all of the criteria for being different from a training department, or subscribe to all of the guiding principles identified by Meister, but they are nevertheless widely regarded as being corporate universities. It would therefore seem that the term

‘corporate university’ should be regarded as an overarching nomenclature to describe the activities of branded, centralised and strategic training organisations of corporations, rather than as a rigidly definable particular type of entity that is readily, clearly and easily identifiable. It is this view that is adopted for the purposes of this thesis. It is a view in line with the observations of Prince and Beaver (2001, p.18) who see the term corporate university as being “little more than that a convenient label or language construct”.

We have not, however, addressed whether these institutions can be appropriately described as universities in the traditional and conventional use of that word. This has been covered fairly extensively in the existing literature and is not our central concern. Our focus is the governance of such entities. The broad view of existing research is that the traditional (or academic) university and the corporate university are quite different and distinct things. Moreover, a common thread running through many, if not all, of the interviews conducted for this work was the ready acceptance that the corporate universities in question were not actually universities in the broadly accepted sense of the word. For further information on this issue see Beaver and Prince (2001), Blass (2001), Craig *et al.* (1999) or Walton (1999).

II.ii Decision-Making Within The Corporate University

Irrespective of the debate as to how to define a corporate university or whether they are or are not a university in the traditional sense of the word, one thing is clear: a corporate university is some form of corporate organisation and, as such, governance is required. Chapters One and Two earlier established the existence and significance of strategic decision-making within corporate governance. However, strategic decision-making is not confined to traditional production activities. Many different types of corporate institutions and organisations give

rise to strategic decisions as a habitual part of their activities and/or operations. Without such decisions to (amongst other things) establish the broad plans to guide them, such institutions and organisations would lack focus and direction, given that they could not have any clear aims or goals for the activities with which they are associated. Strategic decisions are therefore readily observable in many different fields of economic activity, and corporate universities are no exception. Strategic choices are made concerning the courses the corporate university is to offer (including any accreditation), what bodies (if any) are to accredit the courses, how to deliver those courses (using a physical facility or via virtual technologies), who are to be the instructors (internal or external), who is the target audience, and how to position the corporate university in relation to other educational providers, such as traditional universities.

By their very nature, such strategic decisions are fundamental in determining the nature and shape of corporate universities, and are therefore the key determinants of their impact and affects. There will inevitably exist different preferences over the potential strategic decisions amongst all of those groups or individuals that have an interest in the activities of that corporate university. This variation in interest can easily be illustrated.

Differences of opinion may exist, for example, on the corporate university offering (externally) accredited courses. Corporate employees completing courses taught by the corporate university may prefer that widely recognised bodies externally accredit these courses so that their qualification is 'portable', providing cachet in the eyes of potential employers. Conversely, those controlling the corporation may prefer that courses are more basic, only covering material relevant to the firm (and not the wider generic material that

would most likely be required for a formal qualification). This would mean the corporate university does not devote resources to something for which the parent corporation would receive little benefit.²

However, that does not mean that all the employees of a corporation with its own corporate university will have exactly the same views on all of the possible strategic decisions. It could be the case, for example, that middle ranking managers prefer that their junior colleagues do not take accredited course because these may take longer to finish, thus requiring more time away from the business needs of their job, and which may then make the jobs of middle ranking managers more difficult. Conversely, the junior colleagues may prefer to take accredited courses because they may help to secure promotion (perhaps at a rival firm) in the future. There are also likely to be differences of opinion over the availability of courses. Some may prefer that courses are freely available to all, whereas others might prefer restrictions in order to protect the exclusivity of the courses and qualifications.

Interests may also differ between those involved with a corporate university and those involved in the wider educational sector, such as a traditional university, or more broadly, government. More traditional universities may question the ability of a corporate university to act independently given the nature of the relationship with its parent, and may see such an organisation as a threat to the traditional educational and research role of universities. Indeed, traditional universities may well prefer that corporations train their staff via the use of closer partnerships with existing educational institutions, rather than by creating their own corporate universities. On the other hand, many of those controlling the corporations clearly

² The interviews conducted for this Section of the thesis highlighted cases where corporate universities identified the requirement to expand the generic material taught on their courses (which was not of relevance to their

prefer to create their own corporate university (given the number that have been created thus far).

Given this variation in interests and the usual economic assumption that individuals take decisions in their own best interests, the question then becomes: who is able to exert control over the decision-making process, and thus determine the impact and affects of the corporate university?

Our previous discussions on control of the modern corporation are again instructive in this regard. Corporations controlled by a subset of those with an interest in their activities raises the possibility that a corporate university, controlled by a particular corporation, may also be controlled by a subset of those with an interest in its activities. If this is the case, a corporate university may not be governed in a way that is acceptable to all of those with an interest in its activities. In other words, the corporate university may also suffer from strategic failure. This is a particularly alarming result given the importance of education, and thus an investigation upon the nature of the corporate university is required if their impact and consequences are to be properly assessed. We therefore now turn to investigate the corporate universities of the largest British based publicly floated companies in order to do this.

III. THE BRITISH CORPORATE UNIVERSITY

A survey conducted between January and March 2002 of the FTSE 100 companies revealed that 23 out of the 100 companies contacted (via telephone and email) identified themselves as

parent organisation) if they were to gain accreditation from external bodies.

having created, or having been in the process of creating, some form of corporate university.³ In reality the true number of corporate universities in Britain is likely to be significantly higher than this figure would suggest; several companies identified themselves as not having such an institution but an alternative view is that they have a *de facto* corporate university, it is just not branded as such.⁴ Moreover, several companies outside the FTSE 100 have created their own corporate universities, or have access to their parent organisation's corporate university. Arkin (2000, p.43), for example, reports that there are around 200 corporate universities in the UK, and that this number is likely to increase over the next few years. The suggestion is therefore that the influence of the corporate university in the UK is reasonably strong, and is getting stronger.

The evidence presented in the following Section is based around a series of semi-structured telephonic interviews that were conducted in February and March 2002 with relatively senior representatives of a number of FTSE 100 companies. Building upon the foundations of the survey mentioned above, these representatives were identified as working in the areas of those companies that are associated with corporate universities. This included those involved with corporations that already operate a corporate university, those in the process of creating one, and those to whom the idea is still some distance away. Whilst the parent corporations and the corporate universities in question vary considerably, a number of key themes and findings were common to most interviews. Unless highlighted otherwise, the quotes in the remainder of this Section have been taken directly from these interviews. The companies' names have

³ The FTSE 100 was taken to be that as outlined in *The Sunday Times* on December 16th 2001. Where the term 'corporate university' was not known, the simple definition of Blass (2001) was adopted.

⁴ Similarly some of those companies which identified themselves as having a corporate university may not in fact have such an organisation in the eyes of those involved with the corporate university sector elsewhere, although the effect of this over representation is likely to be relatively small due to the multi-contact approach adopted by this survey.

been omitted to ensure anonymity (of both the companies and the individuals who took part). See Appendix B for the list of core questions utilised in these interviews, and a sample transcript of one of the interviews.

III.i The Rationale

In order to understand the role, impact and implications of the corporate university, it is first necessary to understand the rationale behind the corporate decision that they be created. The most commonly cited explanation in the interviews for why corporations are becoming increasingly involved with the corporate university was that they sought “to align learning with group and business strategies”. A corporate university was seen as the best means to train and educate a workforce in a way that “responds to the corporate strategy of [the particular corporation]” and thus ensure “a closer link between learning available and the needs of the business”. In other words, as one interviewee put it, to ensure that “the learning agenda of [the particular corporation] is entirely driven by the business agenda of [the particular corporation].” The parent corporations seem to believe that a corporate university is the best way to educate and train their workforces in a way that facilitates the successful operation of those corporations. This appears to encourage the view that a corporate university is just a means to an end; a tool to aid and assist a corporation in its activities.

Viewing corporate universities as such a tool is consistent with the fact that virtually none of the companies interviewed used their corporate universities as revenue generators. Broadly speaking, they were internally focussed, seeing their customers as solely the employees of the parent organisation. They typically did not offer any of their courses to external agents. However, the major exceptions to this were when a limited number of courses were offered to

some of the business partners of the parent corporation. Generally speaking these were only a small number of specialist courses that would enable their relationship to function better (for example, by providing specialist information on the understanding of the nature of the business), or that would be difficult for the partner to run by itself but were nevertheless required for their business operation (e.g. safety courses).⁵ It did not appear to be the case that these courses were offered outside the parent corporation in order to make a profit. It seemed to be in the parent's interest to aid its business partners in this way because it facilitated successful business relationships. This is consistent with viewing the corporate university as something that has been created to aid and assist the parent corporation.⁶

The interviews also indicated that one of the major reasons for the move into the corporate university field was to get the best value from the money being put into the education/training area. In other words, to gain “the greatest possible benefit for the greatest number of people”, or to get the biggest “bang for your buck”, as one interviewee said. Companies indicated that by centralising training in such an organisation they were able to cut out wasteful duplication of effort amongst their different business units, gain economies of scale and scope, and offer consistent courses across the whole business group. Indeed one interviewee working within a corporate university said that they “have a business model according to which the considerable investment that [the parent corporation] is making into [the particular corporation] is matched by savings that [accrue] by just centralising training.” A corporate university is therefore partially about the cost of training and education to corporations.

⁵ The courses may be difficult to run for a whole host of reasons, for example, because the partner in question was relatively small.

⁶ There were a very small number of other exceptions to this where companies did provide training to external agents, which for the most part seemed to be done for historical reasons. For example, they were the worlds largest company with expertise in a particular area and so had always made their training available to external

A significant number of the interviews also highlighted the idea that a corporate university was created in order to make learning and education more accessible, and to give employees “access to top quality learning”. By centralising all training, corporations are “opening up the best [of the] existing courses to people right across” the parent corporation, increasing the scope and raising the standard of training within the corporation.

Improving the access, quality and ‘value for money’ of training is especially important for a number of corporations as they are under dual forms of pressure to educate their workforce. Firstly, from a compliance point of view, both service and more traditional manufacturing or related sector corporations are now obliged to have employees in certain positions with specific external qualifications. They are thus having to train more of their staff to such levels; they are under pressure to create “fit for purpose people in the organisation”. Secondly, corporations were also said to be under increasing pressure from their shareholders to manage and invest in their “intangible assets, [their] intellectual capital”, which is the company employees. Such a view parallels and compliments the findings of a small number of the interviews suggesting that a significant reason for the move into a corporate university was to change the business culture; “to turn [the particular corporation] into the kind of organisation where learning is part of the culture...to get all [of the parent corporation’s] employees interested in learning”. The move into a corporate university was seen as being a “cultural change project” to help the organisation adopt a more learning/training friendly approach.

agents, even prior to the creation of a corporate university. The provision of this training is therefore unconnected with the decision to create a corporate university.

Changing the business culture regarding training and education would also have a positive impact upon another one of the reasons highlighted, that of the beneficial affect on the attraction and retention of staff. A corporate university to provide access to training and qualifications was seen as a positive factor when recruiting new staff or striving to keep existing staff; “a lot of people would rather work for an organisation that is going to give them development than for an organisation that isn’t.” Moreover, “people would prefer to work in an organisation where morale and motivation is high, and [they] are highest in organisations that put a lot of time, effort and money into developing people”.⁷

III.ii Governance Mechanisms

As outlined, one of the major reasons that corporations moved into the area of corporate universities was “to align learning with group and business strategies”. If a corporation is to successfully achieve this goal, it needs to be able to exert control over the corporate university so that it can govern what is going on within that organisation; it needs to be in a position to influence strategic decision-making within the corporate university. This was very evident in the interviews. Many interviewees outlined governance mechanisms in corporate universities that were apparently envisaged to ensure that “learning is very much guided by the direction in which the business is going”. Broadly speaking this seems to be operationalised by integrating high-ranking leaders of the parent corporations into positions of responsibility and decision-making power within the corporate universities. In many cases the corporate universities have a council, board or senate which sits at the top of the organisation to control

⁷ It is interesting to note that these later reasons for why corporations have created corporate universities might be seen to be general arguments as to why corporations invest in education rather than why they created corporate universities *per se*. It would, however, be dangerous to take one argument in isolation since it is likely that all of the reasons mentioned above would interact with each other when the decision to create a corporate university is taken. It could, for example, be the case that whilst a corporation was required to have certain employees with specific qualifications, it wanted to ensure that any learning done within the guise of that

its operation, and these are dominated by senior representatives of the parent corporation. For example, “the person who chairs the executive committee [of the particular corporate university] is the group chief executive, and he is also the chair of the university council”. Similarly “the strategy board ... consists of half a dozen directors who are either on the main [company] board or one stop removed from the main board and they are there as a business representative to make sure that we have an overall university and learning strategy and agenda that meets what the business wants”.

In addition to having supervisory type-boards at the top of the corporate universities, many were also divided into several faculties for different types of learning/education. These were also generally headed by a senior member of the parent corporation, and such managers were often on the supervisory boards as well. As one of the interviewees highlighted, “the four faculties of [the particular corporate university] are all chaired by a dean who is a member of the executive committee of [the particular corporation], in other words the top top business leaders, and those four deans are accountable for the learning agenda of [the particular corporate university] so they drive it absolutely at the centre”. Whilst discussing the issue of how they maintain governance, one interviewee highlighted that this was done by “subdividing ... all the key learning areas into what we call faculties and then appointing again a senior director as a head of each of those faculties.” In other words, “the learning agenda is right up there with the business agenda because it is exactly the same people driving both”.

qualification was as relevant to its specific business needs as possible, a situation facilitated if the corporation was responsible for the teaching associated with that qualification via its own corporate university.

As well as controlling the corporate university by formal governance mechanisms, a number of the interviewees outlined several other ways in which the parent corporations exert their influence. Whilst much of the corporate university's teaching/instruction is done by external providers or professional trainers within the organisation, a significant amount is said to be done by "those people who actually work in the line, in functions out in the [operations of the business]". Indeed one corporation was said to run a course through its corporate university "...for [its] high potential senior leaders and the chairman of the company always contributes to it in terms of the final session".

Such involvement by those so closely associated with the parent organisation cannot help but transfer the strategic direction of the parent corporation onto the operations of the corporate university. The transfer of influence is further re-enforced by other factors that help close integration with the parent corporation. One such example might be the decision on where to locate any physical infrastructure associated with the corporate university. One interviewee revealed that "the reason why we have decided to build our leadership development centre in [a particular city] is that we will actually build it into the core of our head office in [the same city] ... we want senior leaders who are based in head office to easily be able to contribute to its programmes ...we are taking the learning centre right into the heart of head office".

III.iii Corporate University Governance and Strategic Failure

It is clear that the evidence presented significantly validates the hypothesis that corporate universities, like their parent corporations, suffer from strategic failure in that they are controlled by a subset of those with an interest in their activities. Not all of those with an interest in the activities of the corporate university are able to contribute in a meaningful way

to strategic decision-making. The evidence collected overwhelmingly suggests that everything about the British corporate university is controlled by the parent corporation. We have seen they control its physical location, its scope, the nature of its teaching, its syllabus and even provide much of its personnel. Furthermore, the identification of this subset controlling the corporate universities is unmistakable. It is senior individuals within the parent company who seem to be taking such strategic decisions, and as Chapter One suggested, it is these individuals who are going to be closely involved with the strategic decision-making of the parent company. Decision-making within the corporation and corporate university are therefore extremely closely integrated, something that was explicitly admitted during many of the interviews.

Given this control structure, it is no surprise that as one interviewee put it, corporate universities “are driven by an overriding business agenda rather than by a general academic agenda”. Likewise, another admitted that “courses that happen in [the particular corporate university] are usually very business focused” and “any value we [the corporate university] have within [the particular parent corporation] is about delivering things for and as part of [the particular parent corporation]”. We would expect such findings given that theory suggests decision makers take those decisions in their own best interests, and the previous conclusion that control of the corporate university strategic decision-making process is the preserve of those controlling the parent corporation.

In one sense this result is unsurprising and in no way unexpected given previous contributions as to the nature of a corporate universities, their function and the fact they were created by their parent corporations. At another level, however, the extent to which those in charge of

the strategic decision-making process of the parent corporation seem to utterly dominate the activities and decision-making of the corporate university is extremely revealing. This close association means that those controlling the modern corporation are not only able to control production, but are also able to exert significant influence upon the provision of education. The significance and implications of this are addressed in the next Section.⁸

IV. THE IMPLICATIONS OF STRATEGIC FAILURE

IV.i A Cause for Concern

A practical illustration of one of the problems caused by strategic failure within the corporate university, and one of the much highlighted dangers in the existing literature, is the existence of a potential for conflicts between a corporate centred agenda and scholarly independence and impartiality – as one of the interviewees puts it, “we are driven by an overriding business agenda rather than by a general academic agenda”. As Craig *et al.* (1999, p.513) comment,

“in the corporate university one might well imagine conflict between what scholars consider ought to be enquired into, and what the corporate strategy dictates to be the current action plan. Consider, for example, the obvious conflicts between corporate strategies in the tobacco industry and the conduct of research into the health effects of smoking.”

A similar argument can also be made for the academic content of educational courses offered

⁸ Our findings on the control of the corporate university have implications for the issue as to whether or not a corporate university can be treated as anything other than a subsidiary of the parent corporation. The close relationship we have documented between the corporate university and the parent corporation, both in terms of the decision makers and supporting role of the corporate university, certainly adds weight to the argument that the corporate university cannot be treated as anything other than a subsidiary. Indeed, this view is further reinforced by adopting the Cowling and Sugden (1987a, 1994, 1998) view of a corporation as a centre of strategic decision-making. This broad perspective as to the nature of the corporation would therefore suggest that a corporate university could be treated as being part of the parent given that the strategic decision-making is closely integrated. Whilst the veracity of this argument is appealing in many regards, the matter is still open to debate because of the differences that exist between the two organisations. For example, the purpose of the parent corporation is making profit via the provision of good and services, whilst the corporate university is

by the corporate university.

Whilst the possibility for conflict in teaching is significant, the extent to which a research conflict exists within the corporate university is in all probability reasonably limited, given that the corporate universities examined in this study were essentially training centred organisations and as such did little or no research.⁹ Where research was conducted, it seemed to be focused on operational aspects, aimed at improving the operation of the corporate university itself rather than developing new knowledge of the form required from research conducted in a more traditional university. Much of the corporate university research process was done by benchmarking and interacting with other corporate universities, either directly or by one of the many organisations that seem to have been created to facilitate such activity. One surprising feature the interviews did raise, however, was that those involved with corporate universities were generally not prohibited from researching or writing articles for publication, although that they were said to be “accountable” for their time and employed in a certain function. If this responsibility were neglected to pursue other interests then action would be taken, but so long as this was not the case, individuals were free to pursue any matters that arose. In practice it seemed to be the case that the vast majority of those who this might apply to would not have the time to take advantage of this potential freedom. They were *de facto* constrained.

The aforementioned constraint of the academic freedoms of those involved with corporate universities highlights the significance of strategic failure within the governance of the corporate university. A corporate university controlled by, and therefore run in the interests

about providing education and training.

of, those in control of the parent corporation implies that the education/training is given because it is the interests of the corporation to do so. It is not given for altruistic reasons or because it is beneficial to society. It will likewise be given in a manner, and containing the content that is most suitable for the needs of the corporation in question. Whilst this sounds like the basic economic principle of self-interest leading to mutually beneficial outcomes, this is in fact not the case. Such a view is based on the notion of ubiquitous perfectly competitive markets, but it is universally acknowledged that markets are imperfect. Such market imperfection therefore suggests that corporations are free to pursue their own self-interest but that it may no longer lead to mutually beneficial outcomes.¹⁰ Hence, it points to the significance of strategic failure.

Consequently we view the provision of education via the corporate university as a serious cause for concern because, as the previous potential research conflict illustration has demonstrated, the interests of the corporation may not conform to the broad academic principles, standards, ideals or impartiality that society may regard as desirable. Furthermore, by providing a (potentially) biased or sub-standard education with limited content, the corporate university may also stifle future possibilities and knowledge creation. Such a situation is not optimal for society as a whole, and therefore the education and other services provided by the corporate university might be done in a sub-optimal way.

Moreover, as well as controlling the education given to their employees via their own corporate university, corporations are also extending their influence into other parts of the

⁹ This clearly has implications as to whether these institutions can be accurately be known as universities although as already stated, this question is beyond the confines of this study.

¹⁰ Chapter Three used its focus on utilities to give some examples of how the absence of perfect competition results in the breakdown of the self-interest principle.

educational sector. Our interviews revealed that corporate universities tend to form a number of partnerships with existing traditional universities and other educational institutions, in order to take advantage of existing expertise and award particular degrees or qualifications. As several authors have already highlighted (Craig *et al.*, 1999; Jarvis, 2000; Sugden, 2000), by engaging in such processes they raise the possibility of their having an immediate and direct influence over the activities of these partners. This might therefore give their parent corporations even more control over education than might first be apparent, thus exacerbating the costs to society of the corporate university. It might even extend the strategic failure of the corporate university into education more generally.

IV.ii How To React?

In response to the strategic failure surrounding the corporate university (and perhaps therefore education more broadly), some schools of thought are sure to argue that appropriate regulation could be used solve any problems. This regulation could, for example, take the form of nationally set curricula for corporate universities, or stipulations as to outside (i.e. none corporate) or academic members of any corporate university governance board, or the sheer number/strength of their positive features. We would, however, contest the view that regulation could be fully effective since, as we have previously argued, regulation is a mechanistic, arms length response to address a specific set of observed 'symptoms'. Not only does it fail to address the underlying governance concern of the dominance of the parent corporation, it will inevitably be found wanting given that it seeks to use (an admittedly developing but) fixed set of rules to limit a fundamentally dynamic and often unseen/unobserved process.

We therefore suggest that active measures need to be taken to restrain the activities of corporations within the educational sector. The exact nature of these measures is beyond the confines of this thesis and requires input from those with specific pedagogical expertise, drawing lessons from what works and what does not. One possibility would be dilution or control of the corporate influence within a corporate university, but that might still give the parent a (significant) degree of control, thereby not removing the possibility of strategic failure within the corporate university. In practice it may, however, prove extremely difficult, if not impossible, to separate a corporate university from its parent corporation. It may therefore be necessary to take the extreme step of banning the existence of corporate universities and instead require corporations to reassign education/training resources to support their employees in other education/training possibilities that do not suffer from strategic failure (or at least not to such an extent).

Opponents of the view that restraint of corporate universities (or at least restraint of direct corporate involvement with them) is a necessity might argue that corporate universities have a number of positive features that justify their continued existence in their present form. Such positive features might be seen to include the fact that they are organisations that promote education/training, encourage a corporate learning ethos or are quite innovative in their teaching methods when compared to the traditional university.¹¹ If these arguments are adhered to, then it is logical to encourage corporate universities instead of seeking to restrain (or indeed ban) them as we are advocating.

¹¹ These 'positive features' were all goals or features of the corporate university identified during the interviews conducted.

However, to make such an argument would fundamentally miss the governance focus of the arguments we have been making. The issue as to whether or not a corporate university has specific (educational or other) benefits is beyond the confines of this thesis. However, for the sake of argument, let us assume that the corporate university does have some benefits, at least some of which are unique and thus cannot be replicated by another form of educational establishment.

In this situation, the extent to which these potential benefits of the corporate university accrue to society depends upon the way in which it is governed. Any benefits from a corporate university that accrue to society will originate from those issues where the interests of the elite running the corporate university overlap, coincide or approximate the broader interests of society. Therefore, the benefits actually derived from a corporate university controlled by an elite are certain to be equal or less than would be the case if there were the application of public interest decision-making (if such a thing is possible in this context). This is evident from the following extreme situations that serve to bound the possibilities of the outcomes of elite decision-making, and thus the potential benefits of the corporate university.

A best-case scenario under strategic failure would have the interests of the decision-making elite coinciding with those of society on every issue, and on every occasion. In this situation, elite decision-making would result in the same outcomes as public interest decision-making, and thus all the possible benefits of the corporate university would be gained by society. At the other extreme, a worst-case scenario would have polar opinions on strategic decision-making between the controlling elite and society in general, and thus there would be no overlap or even similarity in preferences. In these circumstances, elite decision-making

would result in outcomes diametrically opposed to those that would have been achieved under public interest decision-making. Therefore, none of the potential benefits of the corporate university would accrue to society.

The above scenarios show that only in an extreme situation did elite control of the corporate university result in the same outcomes that would have occurred had there been public interest decision-making. This extreme scenario is exceedingly unlikely to occur in reality given the variation of interests that we have already illustrated exist surrounding the corporate university. Therefore, it is more realistic to assume that preferences over decisions will differ (for at least some of the time) and thus that elite control of the corporate university results in a less than optimum outcome for society. Only some (if any) of the possible benefits of the corporate university will accrue to society. Furthermore, this loss to society may be further increased by the influence of the corporations, either via their corporate universities or other means, upon more traditional forms of educations/training such as universities.

In short, we suggest that society needs to think carefully about the consequences of corporate universities before we rush to embrace and encourage them, which seems to be the current trend, at least in the UK. Education is far too important to allow it be provided in a manner which does not take account of the public interest, and consequently we suggest that measures need to be taken that address the strategic failure of corporate universities.

IV. CONCLUDING COMMENTS

Building upon the utility corporation centred foundations of the preceding work, this Chapter examined the considerably different example of examining the emerging corporate

universities phenomena. Defining these bodies as the branded, centralised and strategic training organisations of corporations, we hypothesised that because corporations suffer from strategic failure, a corporate university may likewise be controlled by a subset of those with an interest in its activities. In order to test this view, we illustrated the presence of strategic decision-making and then presented an investigation of the corporate universities of the corporations in the FTSE 100 stock market, examining why such corporations decided to create these institutions and how they were governed. The findings indicated that these institutions have been created, are controlled and are run so as to serve the interests of their parent corporations, and therefore perhaps not in the interests of society more widely. We therefore suggested that measures need to be taken to address this strategic failure, and that perhaps even banning such institutions is required given the importance of education. Criticisms of this interventionist approach were also addressed.

In short, this Chapter sought to extend the application of the strategic decision-making approach to governance, and thus illustrate its broadly applicable nature. In order to do this we considered an in-depth analysis of the corporate university. Other illustrations might also have been chosen. To mention a few out of any number of possibilities: given the dominance of Microsoft in computer operating systems and elsewhere, there are questions to be addressed, for example, into the governance of Microsoft, its and other companies influence upon the Internet or simply computing in general; given the risk inherent in the consumption of tobacco products, there are questions to be addressed into the governance of this sector; or given the particular nature of the entertainment they provide, there are questions regarding the governance of sports teams such as football clubs.

These possibilities we leave for future investigations. We will instead conclude our governance investigation by returning to the topic of privatisation. As Chapter Three outlined, privatisation has important implications for corporate control whilst also presenting a opportunity in which to make the fundamental changes that our earlier work on public interest decision-making suggested may be required. In utilising privatisation in such a manner, lessons need to be drawn from existing experience so that (organisational) mistakes are not repeated. In Part Two we therefore continue our previous focus on the electricity sector by examining several features of British electricity privatisation in order to highlight such lessons to be learned.

PART TWO

BRITISH ELECTRICITY PRIVATISATION

CHAPTER FIVE

THE ISSUE OF INDEPENDENT POWER PRODUCERS IN ENGLAND AND WALES

I. INTRODUCTION

The aim of this Chapter is to evaluate the policy of encouraging new entry into the market for electricity generation in England and Wales. This issue has been largely ignored in the existing literature inasmuch as encouraging new ‘independent power producers’ (IPPs) is often (implicitly) assumed to be a logical progression of a newly liberalised and privatised market. Where the existing literature does look at these ‘independents’, it is as an aside to what are perceived to be larger issues, and/or from the point of view of a different subject. Green (1999), for example, mentions IPPs in the context of the reform of electricity trading arrangements, whilst Watson (1997) and Winskel (1998) do so from the perspective of technological change within the industry. Furthermore, Thomas (1999) comments upon IPPs when conducting a broad analysis of whether privatisation has reduced electricity prices.

Our view is that the policy of encouraging independents should not simply be regarded as an aside to other events, but is instead an important and deliberate attempt to correct a mistake that was created by an embroiled privatisation process. As such it should be evaluated on its effectiveness in this respect. That is our goal, and by doing so, it is hoped that lessons can be learned for the design of future privatisations and for the policies that are implemented once privatisation has occurred. This issue is especially relevant for our previous decisions on electricity privatisation in Mexico, given that IPPs are already operating in the publicly owned system in Mexico (see Section III.i, Chapter Three). Moreover, entry by new firms is about competition, and as Sugden (1990) has suggested, competition is an aspect of democratic

governance in that it can prevent the exercise of monopoly or monopsony power which may constrain the freedom of a publicly controlled corporation.

In order to pursue these arguments, the Chapter is organised as follows. After initially positioning itself within the context of privatisation of the British electricity sector, Section II highlights why such a policy on entry was required and how this policy was implemented in practice. Section III provides some insight into which companies responded to the incentives on offer, why these companies got involved, what factors influenced their decisions to enter and how they became involved with generation. The issues of what these companies are independent of and whether they can in fact be called independent are also addressed. To do this, the Chapter draws heavily upon original information gained from telephone interviews conducted with many of those involved with the so called ‘independent power producers.’ These interviews provide fresh insight on many issues, with some of the information being completely unexpected in the context of the existing electricity literature. The interviews also provide evidence to support theories that have already been mentioned in the existing literature concerning IPPs.

In the light of, and drawing from, the information provided in the interviews and existing literature, Section IV then analyses the effects of this entry. We suggest that the policy objectives have not been met, since the independents have not done the job that they were originally intended for. The unforeseen consequences of this policy are also examined, with newly calculated figures for the plant margin (the amount by which installed capacity exceeds peak demand) leading the Chapter to highlight serious concerns about the future viability of the electricity system. We then conclude by using the experiences of the policy of

encouraging entry to draw some overall lessons on the design of privatisation in England and Wales, and hence more widely.

II. THE BACKGROUND

II.i Electricity Sector Privatisation

Consider first a brief overview of the restructuring and privatisation process of the electricity sector in Great Britain. The British system consists of one market for England and Wales, and a separate, significantly smaller, Scottish market. Prior to reorganisation and privatisation (henceforth privatisation for simplicity) the market in England and Wales consisted of twelve regional Area Boards who were responsible for the local distribution and supply of electricity to consumers. These Area Boards purchased electricity directly from the CEGB (Central Electricity Generating Board), which was responsible for the generation and transmission of electricity via a countrywide electricity grid (Chesshire, 1996).

In 1990 the British Government restructured and then subsequently privatised the electricity sector of England and Wales. The transmission grid of the CEGB was transferred to a new company (National Grid Company - NGC) and the 12 Area Boards were essentially unchanged and became known as Regional Electricity Companies (RECs). The NGC and the RECs were seen as natural monopolies and were therefore governed by a new industry regulator, the Office for Electricity Regulation (OFFER), which employed RPI-X style regulation.¹

¹ On 16th June 1999, OFFER merged with the gas regulator to form OFGEM, the Office of Gas and Electricity Markets.

The government's initial plans (as outlined in the February 1998 white paper) were to include all generating plant in the privatisation, including the nuclear plant. To achieve this whilst also including competition in generation, it was planned that the CEGB's generation assets would be split into two companies; the nuclear facilities being combined with 60% of the conventional stations to form National Power (NP), while the remaining conventional stations were to be placed in a smaller company (PowerGen). This asymmetric duopoly structure was chosen as it was felt that a large company was required to 'shelter' the nuclear plant; to bear the sizeable risks associated with their construction and pay the extensive back end costs of the contaminated power stations (Newbery and Green, 1996).

As the privatisation process progressed, it became increasingly obvious that nuclear generated power was far more costly than had been previously thought and that the market was unwilling to shoulder the massive liabilities associated with this plant. The government had no real alternative but to withdraw the nuclear stations from the sale midway through the process in 1989. By this stage the privatisation process was already very seriously delayed and so there was no time to change the structure of conventional generation. Thus the only alteration was that the nuclear assets were removed from NP and placed in a company, Nuclear Electric, which was to remain in the public sector (Thomas, 1996a).²

As well as restructuring the industry, the government also changed the way in which the market worked. The main result of this was the creation of the Power Pool, a spot market designed to secure a merit order of plant operation. Generating companies made bids into the Pool with the price of electricity from their individual power stations. A combination of plant

² The nuclear plant remained in the public sector until 1996, when the newer plant was privatised as British Energy. At the time of writing this company was facing significant financial difficulties.

was then chosen, such that expected demand was satisfied at minimum cost. All the power stations chosen received the bid price of the marginal plant selected to run; the System Marginal Price (SMP). In addition to this payment, all plant that bid into the Pool received a variable capacity payment for each unit of capacity bid, regardless of whether this capacity was actually used to generate electricity at that time. This payment was inversely related to the amount of surplus capacity (i.e. the greater the surplus capacity, the lower the payment). The objective was to ensure that the system had sufficient capacity (Newbery and Green, 1996).

Since privatisation, the industry has witnessed the so called 'dash for gas' - the building of large amounts of new generation capacity using the relatively new Combined Cycle Gas Turbine (CCGT) technology. Much of this new capacity has been built by the independent power producers that are the focus of this Chapter.

The electricity system in Scotland is separate to that which exists in England and Wales, although both systems are physically linked and industry reorganisation in both systems took place on the same day (31st March 1990). Prior to privatisation two vertically integrated companies (The South of Scotland Electricity Board and the North of Scotland Hydro-Electric Board) provided all electricity services in the regions of Scotland in which they operated. Reorganisation and privatisation of the industry in Scotland was less radical than that in England and Wales. The two vertically integrated companies were essentially transferred into the private sector with the only major change being that the nuclear assets were transferred into a new publicly owned company, Scottish Nuclear. Like their counterparts in

England and Wales, the new Scottish electricity companies were regulated by OFFER on transmission, distribution and supply (Thomas, 1996a).

II.ii Dominance in Generation

It quickly became apparent that the structure of the industry in England and Wales that eventually emerged from the embroiled privatisation process had some significant defects. Most important amongst these was the severe lack of competition in the generation sector, a situation that was particularly acute since the government did not believe generation to be a natural monopoly if entry was possible, and had therefore made no provision for detailed regulation of this sector.³ National Power (NP) and PowerGen (PG) had inherited all the existing fossil fuel capacity, including the ‘mid-merit’ and ‘peaking’ plant that set SMP virtually all the time, giving these companies effective control of the Pool. Even in 1994, after NP and PG had come under pressure from the regulator for controlling the Pool and significant amounts of entry had occurred, NP and PG still set SMP 85% of the time (Thomas, 1996b, p.73).

If the Pool had been competitive, a profit maximising generator owning a single plant would bid into the Pool at the marginal cost of its plant; if it bid above marginal cost, the generator would risk being asked to produce less often. Since there would be a large number of different generators bidding into the Pool, each generator would have no real opportunity to act strategically and increase profits (Green, 1996). In this situation the Pool might be an admirable system, providing electricity at the marginal cost of production.

³ The government believed that competition from the existing generators and the threat of potential competition from new entrants would suffice (Newbery and Green, 1996).

However, in reality the market was dominated by two large companies who owned numerous generating plants. In this situation the large companies have an incentive to act strategically by raising the bid price of some of their stations. Although these stations would be used less, the higher bids would raise the overall system marginal price (SMP) which all operating plants receive. The firm's remaining stations would then receive this higher SMP, making it possible for the firm to raise its overall profits (Green, 1996).

Indeed, the evidence suggests that both PG and NP have engaged in such activities to manipulate the Pool to their own advantage. The OFFER (1991, p.1) report on the Pool price inquiry cites that average Pool prices for the first half of 1991/92 were 29% higher than the corresponding period of 1990/91, which it attributes to rises in SMP. The report goes on to say that "PowerGen followed a policy of declaring some plant unavailable which was subsequently redeclared available. This policy increased Pool prices it represented an abuse of the company's dominant market position" (OFFER, 1991, p.3). This gaming within the Pool allowed the company to increase the capacity payments that generators receive. Indeed the report also notes that "there is no doubt that the two major generators (PG and NP) have recently been able to increase Pool prices significantly" (OFFER, 1991, p.2).

It is interesting to note that the Power Pool provides a practical illustration of the theories of Baran and Sweezy (1966), and Scherer and Ross (1990), in which firms recognise that they are mutually dependent. Cowling (1982) and Cowling and Sugden (1987b) take this idea further, with the notion of the coexistence of rivalry and collusion. A firm will follow the course of action from which it derives the most benefit; retaliatory power on the part of rivals leads to a collusive outcome since it is the avoidance of mutually damaging behaviour. In the

Power Pool, neither of the two dominant conventional generators had any incentive to act competitively by cutting price, since any price reductions on the part of one company would have necessitated an immediate and similar response by the other so that it would maintain its market share. Consequently the threat of mutual aggression forced the companies to compete in other ways, since aggressive action would ultimately hurt both companies. Indeed the firms could increase the benefits from strategic action if they worked together. If both firms acted strategically, for example, by increasing the bid price of several stations each, they would have increased the benefits of this course of action. The stations with the more expensive bids would have set the SMP on a greater number of occasions, benefiting all the plant selected to run.

Assessing the situation, Parker (1996a, p.127) sees that there was little choice on what could be done to increase competition in generation:

“It was politically unthinkable for the government to contemplate breaking up National Power and PowerGen so soon after setting them up, or even at that stage requiring them to divest themselves of plant. The only way the market share of National Power and PowerGen could be reduced was through the construction of new generating plant not owned by either of these companies.”

The crucial issue is therefore to understand how new companies could be persuaded to enter the market for electricity generation, in order to ‘correct’ for this domination.

II.iii How New Entrants Were Encouraged

One of the responsibilities of the regulator, as set out in the 1989 Electricity Act, was to promote competition wherever possible (MacKerron and Boira-Segarra, 1996). It was

therefore the regulator's responsibility to pursue a policy that encouraged new entrants into electricity generation.

The RECs had generally only been involved in the public distribution and supply of electricity prior to privatisation.⁴ However, one of the conditions of their supply licences was that each REC was now given a limit on the amount of generation capacity that they could own; either wholly owned generation sets, or plants in which they had an accountable interest. These were fixed limits in terms of the number of megawatts (MW) allowed by each company, which translated to approximately 15% of the electricity each individual company supplied (House of Commons, 1992/93, p.25).

As OFFER (1992, p.4) describes, the Pool had been organised to “facilitate the freedom (of) generators and suppliers to enter into contractual arrangements around the Pool.” This allowed new entrants to sign fixed price electricity contracts with customers (Contracts for Differences - CfDs), circumventing the risks of relying on the variable price associated with the Pool. Removing this uncertainty would allow new entrants to predict their revenue streams, reducing the risks associated with entry. The regulator also encouraged entry into power generation by allowing the RECs who signed power purchase agreements with IPPs to ‘pass through’ any additional costs of these contracts into their prices (Parker, 1996a). This cost ‘pass through’ was seen as being important since the new entrants were looking for the security of long-term power purchase contracts. The long duration of these contracts would be a risk to the RECs as they might be left with an expensive contract if the price of electricity were to fall. The ability of the RECs to ‘pass through’ the cost of these contracts was

⁴ A small minority of the RECs (Area Boards) had some involvement with small power projects prior to privatisation.

contingent upon their ability to show that they had met the economic purchasing obligation of their licence when they signed these agreements (Parker, 1996a). The REC's licences contained an obligation on economic purchasing, but the wording of this left considerable scope for interpretation, since it stipulated that electricity should be purchased at the "best effective price" (OFGEM, 1999b, p.146). This licence clause "specifies factors which may be relevant – such as diversity, reliability and security of supply. Each company may have regard to the future effect on price, and on those other factors of its purchasing decisions" (OFFER, 1992, p.2). The RECs were therefore presented with a number of grounds on which they could justify signing such contracts.

III. THE 'INDEPENDENTS'; WHO, HOW AND WHY?

The incentives for getting involved with the market for generation and the general nature of the privatisation had the effect of encouraging a large amount of entry. At the end of May 2001, total capacity of generating plant commissioned since privatisation and owned by new entrants stood at 17,045 MW, out of a total capacity of 74,220MW in the United Kingdom⁵ (approximately 23% of total capacity).⁶ With the encouragements on offer, virtually all the RECs became involved with generation to varying degrees. This usually took the form of a joint venture between one or more of the RECs (or one of the Scottish companies) and a company already involved in electricity generation elsewhere, often a transnational power

⁵ This section focuses on the electricity sector in England and Wales, since the other parts of the United Kingdom have different structures. Statistics often refer to the UK as a whole, but should reflect events of England and Wales since this is by far the biggest element of the UK – see Section IV, Chapter Six for statistical evidence of this.

⁶ Figures calculated using the list of power stations in the UK, presented as Table 5.13 in DTI (2001, pp.156-159). This list includes all power stations of more than 1MW capacity that were operational in the UK at the end of May 2001, with the exception of several renewable stations. In calculating this figure, the time of privatisation is assumed to be the time of reorganisation and privatisation of the industry in England and Wales, i.e. 1990. New entrants refers to all the companies that entered new markets by constructing new generation capacity, and to this end includes the capacity constructed in England and Wales by the two incumbent Scottish

group. The 1,875MW Teeside power station, for example, was built and part owned by Enron. This venture was also a partnership between four of the RECs: MEB; Northern Electric; Southern Electric; and SWALEC.⁷

The evidence presented in this section is based around telephone interviews conducted in January/February 1999 with those involved with the new entrants into electricity generation. This included senior figures within several of the transnational power groups who became involved with generation in England and Wales, high level managers within the RECs, and those involved with the IPPs directly. Unless otherwise highlighted, the quotes in this and the following sections have been taken directly from these interviews. The company and individual names have been removed from any quotes to ensure anonymity to those taking part in the interviews. See Appendix C for the list of core questions utilised in these interviews, and a sample transcript of one of the interviews.

The form that entry took was particularly interesting since there has been little difference between the various independent projects. The most obvious pattern is in the type of plant used; virtually all of the new plants constructed since privatisation have used the new Combined Cycle Gas Turbine (CCGT) technology. The interviews highlighted a number of technical reasons as to why this particular type plant had been chosen. This was a relatively new technology that had been proven in other countries to be a reliable generator of electricity. CCGT plants are a lot quicker to build, the interviews providing the illustration of a CCGT plant taking around 3 years to construct, compared with 4.5 to 5 years for a coal fired plant (Thomas, 1996b, p.75, cites these as typically being 2-3 and 6-8 years respectively).

electricity companies. Total generating capacity owned by new entrants (i.e. capacity newly constructed and existing capacity purchased) was 36,982 MW, representing approximately 50% of total generating capacity.

The capital costs per unit installed are approaching half of those for a coal fired plant; the interviews revealed that capital costs of one of the early CCGT plants was around £500 per kW installed, compared with an average coal station without FGD (flue gas desulphurisation - an emissions cleaning technology) of £800 to £1,000 per kW. The CCGT plants also operate at much higher thermal efficiency levels (CCGT plant in the UK averaged 49.8% in 2000, compared with 36.2% for coal fired plant - DTI, 2001, Table 5.9, p.151), which means less fuel is required per unit of electricity generated. This helps to make gas a relatively 'clean' fossil fuel. Not only is less fossil fuel required per unit of electricity generated, but each unit of gas produces significantly less of the emissions that cause acid rain and global warming. The environmental risks of using gas as a fuel were therefore seen as being considerably less than the more polluting coal, which was likely to suffer from tighter future environmental legislation.

The plants were mainly built on an 'off balance sheet basis' using project finance; the companies involved borrowed the money to build the power station. To finance the project the banks required the parties concerned to remove as much of the uncertainty as possible so that there was little risk of the bank not receiving its money back. To this end, the IPPs hedged as much of the risk as they possibly could; they "let other companies who were better placed bear the risk." This involved 'back-to-back' fixed price contracts, usually of at least 15 years duration, which made the projects very secure. For example, the IPPs bought gas on a fixed real price basis and then signed contracts for virtually all their output that allowed them to pass through these gas costs. These output contracts have become known as 'sweetheart' contracts since the majority of output was usually taken by the RECs who had an

⁷ Source: Teeside Power Ltd

equity interest in the project, casting doubts on the independence of the entrants.⁸ The set of contracts surrounding the investment was such that the only risk the IPP was actually left with was the operation of the plant; the availability and reliability risk. These risks were minimal since gas is a uniform fuel with few impurities and therefore does not require a large amount of expertise for plant operation. This means there was little scope for operator errors leading to breakdowns and the factory produced technology had been proven to be reliable in other countries.

CCGT plants were particularly attractive in respect to finance. The lower capital costs meant that borrowing was low, and the smaller build time allowed the plant to start generating electricity and obtain revenue at the earliest opportunity. The overwhelming conclusion drawn from the interviews was that everything about these ‘independent’ projects concerned the stripping out of all risks. Without this cover against all the uncertainties, the vast majority of these projects would not have gone ahead.⁹

This pattern of entry has been followed for the majority of the independent plants that have been constructed since privatisation. However, more recent years witnessed a change in this pattern. The Pool had by then been in operation for several years and so the banks had become more comfortable with its operation and how it actually worked; those involved had a view on what the price was going to be, and why prices were what they were. That meant that the risk removing ‘cradle to grave’ contractual structures of earlier projects were no longer required. More recent entry into generation has been carried out on a more ‘merchant plant’

⁸ There were also a limited number of contracts signed with large industrial users of electricity.

⁹ The findings of the interviews presented in the previous part of the section have some degree of overlap with the findings of some of the interviews that contribute to Winskel (1998). Where overlaps exist, the results of the

basis. Essentially this is buying the gas required for generation short term on the open market and selling electricity via the banks who act as brokers. However, a virtual moratorium was put in place on the construction of new gas fired capacity in 1998 because the government was worried about the rapid increase in gas capacity (predicted to exceed 60% by 2003 if nothing was done) and the distortion that this ‘dash for gas’ was having on the market (DTI, 1998b).¹⁰ Whilst the moratorium was lifted in November 2000 (DTI, 2000), it had stifled the development of new merchant type plants since its imposition coincided with the beginnings of this type of development.¹¹ Nevertheless, this is a very significant development that will be discussed in section IV.

Although the CCGT technology offered several distinct advantages over other types of plant, technological reasons were not the sole guide for the RECs. The interviews with one of the transnational power groups revealed some unexpected information on this subject: “We started developing a coal project with one of the RECs but they pulled out we offered them a long term contract and pricing on coal plant that were competitive but they preferred the gas.....The RECs behaved like sheep – once one had gone for CCGT they all wanted to go (for) it they don’t want to be out on their own on a whim.” The choice of plant would therefore seem in part to be a logical continuation of the new entrants policy of stripping away risk. The fixed contract would mean the REC had no risk in terms of the technology. However, by a particular REC using a different type of plant from the others, they would stand alone. They would therefore lose their strength in numbers which they

two different sets of interviews are consistent even though they were undertaken completely independently and without prior knowledge of the other interview series.

¹⁰ The moratorium took the form of a stricter consents policy which only gave permission to environmentally friendly projects such as combined heat and power (CHP), or renewable schemes - see DTI (1998b).

would have enjoyed had they followed all the other RECs. This strength might be for a regulatory reason; for example, if such fixed price contracts were to incur problems in the future. Problems with fuel supply might also arise (e.g. due to strikes or technological problems), but by being the same as the other RECs, the company would not be singled out or lose an advantage. Knickerbocker (1973) raised the possibility of firms following an investment matching strategy as a means of cutting risks and preventing one company from gaining an advantage, and it would seem that the REC's behaviour is in line with this approach.

The convention in the existing literature is to call the new entrants into power generation 'independent power producers' (IPPs). In reality, many of these companies are not truly independent. The RECs have equity stakes in the majority of these power generation projects from whom they purchase electricity. This is too close a relationship to be termed independent. Tenenbaum *et al.* (1992, p.1134) suggest a more accurate way of describing these generators:

“.....many of the new generators are affiliated with their buyers, the RECs. Therefore, it is probably more accurate to describe them as affiliated power producers (APPs).”

The distinction between independent and affiliate is crucial. By recognising that the RECs have a vested interest in these new generating companies, we start to accept that there are few truly independent generators. Indeed, one could argue that these “affiliates” have just created a new power bloc opposing the big established generators, and have really done little to shape the market to be of a truly competitive nature. This, and the wider implications of being an

¹¹ It could be argued that the moratorium effectively ended the construction of new plant on a merchant basis due to the very strong contractual nature of the New Electricity trading arrangements - NETA (which are discussed

affiliate, will be dealt with in section IV. (For the sake of clarity we will continue to follow the existing convention, however, and refer to all the new entrants as IPPs.)

But why did the RECs and the other companies deem it to be in their interest to enter the market for electricity generation? Again the interviews revealed a great deal of information on this subject. One of the most commonly cited reasons for the RECs involvement in generation was the dominance of National Power (NP) and PowerGen (PG). The RECs resented this dominance and were “very worried that they were going to be squeezed between PG and NP.” Direct involvement in generation allowed them some shelter from this dominance and to some extent to compete. This finding is in line with that of Watson (1997) and Winskel (1998). Indeed OFFER (1992, p.16) cites the RECs as seeing “long-term contracts to support IPPs as providing an important countervailing power to the market power of the (big two) generators and hence in their longer interest.”

The interviews also revealed that another major reason why the RECs entered the market for electricity generation was to get to know that market; they very much wanted to understand electricity generation. When it came to negotiating with the big generators for supply contracts, they wanted to be in the position of understanding generation costs and the various mechanisms; they wanted to know what they should pay and why. As one of the interviewees highlighted, “this immediately gave value to a REC entering into the market for electricity generation.” Even if the IPP were to make no direct profits, the REC would benefit by gaining knowledge of generation and thus hopefully the ability to save money on its fixed contracts with the existing generators. This knowledge of the market for power generation

later in more detail).

will be of great use in the current market for electricity generation, because in March 2001, the Pool was replaced with a new way of trading electricity, NETA, a topic addressed in the next section.

Another insight revealed by the interviews was that following privatisation, the RECs “became very interested in assuring that there was sufficient capacity in the system.”¹² The RECs could not easily compel the existing generators to invest in new capacity or keep a sufficient stock of existing plant to meet an acceptable safety margin. Whilst it was true that the Pool had been created with a capacity element to encourage entry, this mechanism was still untested and so an element of doubt existed. Direct investment in generation on the part of RECs allowed new capacity to be built, giving those RECs who signed contracts a greater degree of security of supply.

National Power, in the House of Commons report into the market for coal, claimed that IPPs “provide a mechanism whereby (REC) profits can be transferred from regulated to unregulated businesses” (House of Commons, 1992/93, p.48). Several of the interviews were broadly supportive of this view, in that they indicated that the RECs wanted to diversify from their traditional roles of electricity distribution and supply. The RECs had lots of money which they were “terrified that the regulator would make them return to their customers.” Entering into generation was one such opportunity of diversification, which was particularly attractive since it was “an opportunity to earn unregulated profits.”¹³ This view on

¹² It is in the RECs interest to ensure that there is sufficient generating capacity, because their businesses can not function efficiently if they are unable to sell electricity to fulfil demand, i.e. demand unfulfilled is a lost profit opportunity.

¹³ That does not mean that profits earned on generation were seen as being unregulated. The interviewee suggested that profits on generation were relatively unregulated, a stark contrast to the very tight, RPI-X regulation in electricity supply/distribution.

diversification is in line with the findings of Winskel (1998), who also makes use of interviews with those involved in the sector.

In addition to diversifying, a REC also took out a form of profit hedge on the electricity price when they signed a 'sweetheart' contract with an IPP affiliated to them. If the electricity price rises, the fixed contract will allow the REC to purchase cheaper electricity and hence make high profits on the sale of this to the final consumer. If the electricity price were to fall, then the REC would be buying electricity at premium rates from the affiliate which would be making high profits from these and other contracted sales. Since the affiliate would be part owned by the REC, some of these unregulated profits would accrue to the REC. The electricity regulator has also allowed the REC to pass through the costs of these contracts to the final consumers. The REC is therefore still able to make reasonable profits on these sales in its own right. In this respect the REC could not lose by entering into a deal with an IPP.

The partners of the RECs in these new power generators became involved with power generation for a far more fundamental reason. These companies were established transnational power groups and so it was a logical progression for them to expand by getting involved in the newly privatised market in England and Wales. In terms of the specific factors that influenced them to choose the UK, the interviews again provided information. When considering entering a "new market, (a transnational power group) look for a legal basis to do it, a political will, a way of financing the project and a requirement for power." While it is true that there was no real requirement for power in the UK, the political will for encouraging competition was such that this did not really matter. Although electricity is somewhat different from most foreign investments in that it cannot be readily exported around

the world, this information would seem to be in tune with the views of Caves (1996) and Dunning (1993) on foreign investment. Caves (1996, p.60) says companies “picked foreign markets so as to minimise the information and transaction costs associated with foreign investment.” The newly privatised market in the UK was particularly attractive since it was now reasonably similar to the US market where most of these companies were based. It therefore presented an opportunity, as Caves (1996, p.60) puts it, of “acquiring knowledge that reduces the cost (or risk) of future expansion into more alien territory.” With other European countries starting to privatise, the entry into the UK market would give it experience of working in Europe.

IV. THE CONSEQUENCES OF ENTRY

IV.i Competition

Such a large amount of entry into the market for power generation was clearly going to have a significant impact. However, it was not certain that it would necessarily solve the problem of lack of competition in generation, the reason that the policy was created.

The nature of IPP entry was such that the majority of their output had already been sold via long-term power purchase agreements - CfDs. These contracts meant the IPPs were operating on ‘baseload’ (i.e. that part of demand that does not change with time). To make sure these IPPs were selected to be run by the Pool, they placed bids at very low prices (Green, 1999). The IPPs could do this because the price they would receive was set in advance by their power contracts and was not the price set by the Pool.¹⁴ In this respect, entry by IPPs had

¹⁴ As Green (1999) highlights, the actual problem was that these IPP contracts were ‘non-firm’ CfDs which means that that the power station in question only receives payments when it generates, receiving nothing if it does not run. It was therefore always in the interest of the station to bid a low price into the Pool so that it would be chosen to run, and would thus get the payments set under its CfD. An alternative contract would have been a

very little effect on the way the overall Pool price was set, other than to change which group of plant would set the Pool price.¹⁵

The entrants had contracts for virtually all their output. However, the interviews revealed that some of the IPPs had a very limited amount of uncontracted capacity at the ‘top end’ of their plants i.e. that part of capacity that requires 100% plant operation. When the SMP was high enough, it was worth the IPP bidding this part of its capacity into the Pool. On these occasions IPPs did have some effect on the Pool and could have set SMP on occasion. However, this would have been only when SMP was reasonably high and therefore did little to make the Pool a source of cheap electricity. For example, in 1998/99 CCGT plant set the Pool price on only 3% of occasions (OFGEM, 1999a, p.13), although this figure will include the CCGT plant of the CEGB successor companies as well as the IPPs. Indeed the ability of the IPP to bid this way into the Pool was curtailed by the nature of the gas contracts the majority of the IPPs agreed. The contracts signed were such that British Gas can ‘interrupt’ gas supplies at times when the gas capacity is required to ensure that the demands of the domestic market are met (Thomas, 1996b). Pool prices were likely to be high when demand for all forms of energy was high, but it was (and still is) at these times that gas supplies for electricity generation were most likely to be unavailable, thus restricting the ability of the IPPs to bid their uncontracted capacity into the Pool.

‘two-way’ CfD which specifies a purchase price and payments are made irrespective of whether the particular station runs. If the Pool price is below the price of the contract, the buyer pays the seller the difference. On the other hand, if the Pool price is above the price of the CfD, the generator refunds the buyer the difference. A ‘two-way’ CfD would not have caused the IPPs to bid at very low prices because it would be more efficient for the station not to bid into the Pool at price below its marginal cost - at these price levels, the station would be better off not running, and simply collecting the contract payments.

¹⁵ It could be argued that SMP would therefore be set by a cheaper station and thus the price of electricity would fall. Whilst there is an element of truth in this, it does not take into account the cost of the IPP plant which received a set price which was separate from the Pool.

In more recent years, new plant was starting to be built on a more ‘merchant’ basis. This type of plant would have significantly increased competition since it was not tied down by a set of ‘back-to-back’ contracts and could compete directly. However, before many of this type of plant could be developed, the moratorium on new gas plant was put in place. This moratorium meant the policy of encouraging entry as a way of increasing competition was cut off just when it had the belated potential to work and the number of companies bidding into the Pool was increasing. At the time of privatisation only 8 generators bid into the Pool but this had increased to 38 in 1999 (OFGEM, 1999a, p.13).

Despite this, in respect of increasing competition in electricity generation, one must look at the policy to encourage new entrants as an overall failure. Although competition in generation has increased in the period since privatisation, in part due to the increased number of companies bidding into the Pool, the changes have not been enough. Even as late as 1998/99, SMP was set on 86% of occasions by just three operators of conventional plant (OFGEM, 1999a, p.14)

The fundamental problem was that the policy of encouraging entrants did little to widen ownership of the ‘mid-merit’ and ‘peaking’ plants that set SMP the majority of the time. Indeed, it could be argued that more progress was made in this area via other means, such as applying pressure to NP and PG to dispose of significant amounts of plant; the capacity of NP and PG accounted for approximately 78% of total capacity in England and Wales on 1st April 1990, and this had fallen to approximately 42% on 1st October 1999.¹⁶ Changes to the rules of

¹⁶ Information provided by OFFER.

the Pool also changed to make it harder for companies to manipulate Pool prices (OFGEM, 1999a).

However, despite these changes, in 1999 OFGEM (1999a, p.7) reported that “the history of the Pool in the ten years or so since vesting (i.e. reorganisation) has demonstrated the continuing market power of a number of generators and their willingness to exercise that market power at the expense of customers, which is facilitated by” the Pool. The government/regulator therefore concluded that changes needed to be made to the way electricity was traded if competition in generation was to increase. To that end, the New Electricity Trading Arrangements (NETA) became live on the 27th March 2001. If the new entrants had done the job they were intended for, competition in the Pool would have been greater and thus these wholesale changes would not have been required. What is, however, interesting to note is that NETA is based around bilateral power purchase agreements such that it is estimated that around 90% of trading will take place on forward contract markets (OFGEM, 2001, p.1). This is effectively extending the contract based system employed by the IPPs, to the rest of the market.

But what of the unforeseen effects of this policy to encourage entry into generation?

Tenenbaum *et al.* (1992, p.1154) raise the issue of a REC favouring its own affiliate:

“When a regulated buyer has captive customers, it has the incentive to purchase from its unregulated affiliate at a price that is higher than the market price. Unless the regulator is able to detect and eliminate these the captive customers will be harmed.”

To the consumers it matters little if the high price of electricity is caused by the dominance of the big generators or ‘sweetheart’ contracts between RECs and their affiliates. The emergence of IPPs therefore created a trade off between curtailing the power of the big generators and the RECs incentive to buy expensive electricity (Tenenbaum *et al.*, 1992). The interviews revealed that many of the RECs have struck deals that, although reasonably attractive in terms of price at the time of signing the contracts, now look less impressive. One REC, for example, signed a contract with an affiliate based around the gas contract price of 20p a therm. At the time of the interview, gas was said to be available on the spot market at 10p a therm and so as the interviewee put it, “from (the RECs) point of view it isn’t such a good deal at the moment....but as a shareholder of (the affiliate) we are doing very well thank you (since) companies who buy from (the affiliate) are buying at premium rates.” This REC is not alone in this position. Therefore the entrant has locked the REC into buying expensive electricity due to the contracts it required to get involved in generation. In this respect, entry just replaced one cause of high electricity prices with another.

The effects of this change are not equal in terms of which consumer group bears the burden. The market for supplying large users was open to competition straight from privatisation. The size of the market open to competition was gradually increased until 1998 when the RECs lost their monopoly position in the small, domestic market. Up to this point, the RECs could exploit their captive customers and so it was these who paid the high price for the electricity they received from their affiliates. The large users were free to choose their suppliers and so the REC had to offer them competitive prices. This supports the material presented in the next Chapter which suggests that in terms of price, privatisation was hardest on domestic consumers, while the larger industrial users bore a relatively light burden. Indeed, Thomas

(1999, Generation Section) highlights this issue by including some statistics from the regulator, which show that in 1996/97 captive customers were charged about 22% more for generation than non-captive customers.

Whilst it is true that the supply companies of the RECs have now lost their legal monopoly in supply, they still retain a great deal of their former monopoly power. Inertia on the part of consumers means that very few consumers actually change supplier. As of September 15th 2001, only approximately 30% of customers in Great Britain had switched electricity supplier.¹⁷ As Thomas (1999, Conclusion) puts it, “consumers do not want to sit down regularly with a confusing selection of advertising material trying to work out what is the best deal for them. They have better things to do with their time.” The incumbent supply companies of the RECs know that many consumers will not switch supplier and use this to exploit their position as the former monopolist - a fact that is obvious when tariffs are compared. In the area where the RECs used to enjoy a monopoly, they are amongst the companies offering the highest charges. Although the supply company of the REC will lose some customers, they will still retain the majority. However, in other regions the same company offers cheaper tariffs in an attempt to win new consumers.

For example, in October 2001, in the Midlands region, Npower (the successor supply company of the former REC - MEB)¹⁸ offered a standard rate tariff such that the typical bill for the use of 3,300kWh of electricity (classed as medium electricity use by Energywatch) would be £236 paying by Direct Debit. All of the competing supply companies in this region offered tariffs which would result in savings ranging from £8 to £33 on the same bill using the

¹⁷ See <http://www.ofgem.gov.uk/prices/switching.htm#elec> - accessed on 15th November 2001.

same payment method (Energywatch, 2001a). Similarly, in the East Midlands region, PowerGen (the successor supply company of the former monopoly REC - East Midlands Electricity) charged customers paying by Direct Debit £226 for the same amount of electricity on the standard rate tariff scheme. All of the competing supply companies in this region offered tariffs which would result in savings ranging from £6 to £28. Npower, one of the rival supply companies in the East Midland region, offered a tariff structure such that the charges for the same service and payment method would result in a saving of £22 (Energywatch, 2001b). This means that Npower charged customers in its own historic region £32 more for the same amount of electricity on a standard rate tariff using the same method of payment. There is no reason why significant cost differences should exist between these adjoining regions, suggesting a strategic reason for the price differential.

It is therefore clear that the RECs still have a large amount of *de facto* captive customers who they can exploit by passing on the high costs of the fixed price IPP contracts they signed some years ago. The ability of the REC to pass on these costs will slowly decline over time as more customers decide to switch electricity supplier. Nevertheless, there will still be a great deal of people who remain with the historic supplier of that region for the foreseeable future and who will thus continue to pay for these expensive contracts. OFGEM (2000) studies show that ‘disadvantaged customers’, such as low income groups, are less likely to have knowledge of competition in supply, or change supplier. It is these groups that are therefore most likely to suffer from the RECs’ expensive IPP contracts.

¹⁸ Many RECs have separated the supply and distribution parts of their business, often selling either or both of these businesses.

IV.ii Damage to Coal

The actual effects of the new gas fired stations with respect to coal are two fold. First, the large building programme has caused the premature closing of the older coal fired stations. The second effect is that the remaining coal stations have been utilised less intensively. During the Hinckley Point enquiry, the CEGB presented its central forecast of its future power requirements. It estimated that by the end of the century, 5.5GW of ageing coal plant would need replacing (Barnes, 1990; Newbery and Pollitt, 1997). However, by 1995 more than 5.5GW of coal plant had already been retired. These stations had not yet reached the end of the technical working period and so this new wave of investment was precipitate. They were essentially forced out of the market because the new gas stations operated on ‘baseload’ due to the contracts the entrants signed. Parker (1996b, p.220) sees that the attempt to introduce competition in this way created a market distortion since “the avoidable costs (of the coal stations) were lower than the total costs, including capital charges, of many of the new CCGTs”, a finding that is supported by the work of Winskel (1998) and by the government in its white paper on Energy sources for Power Generation (DTI, 1998c). From a theoretical viewpoint, the effect of this entry has been to raise the price at which electricity might be charged. These new stations have now to be paid for, whereas the older coal stations could have provided the same power at a lower total cost, a view shared by Green (1999). Not only has the policy of entry failed to increase competition in electricity generation, but it has also raised the industry’s cost base. This means that if any future policy is successful at lowering electricity prices, they will not be reduced by as much as they might have been had this policy not been pursued.¹⁹

Following privatisation, the utilisation of coal plant has fallen dramatically as independent gas fired stations started to operate on long-term ‘baseload’ contracts, which resulted in high utilisation levels. These contracts distorted the marginal cost based merit order of the Pool which should have determined the combination of plant to be used, since gas plant was contracted to operate, even when it was not the cheapest plant to fulfil demand. For example, data on the UK shows that the utilisation of coal plant fell from 54.1% in 1993/93 to 44.8% in 1997, while the utilisation of CCGT plants rose from 60.5% in 1993/94 to 81% in 1997 (DTI, 1998a, p.164).²⁰

IV.iii System Viability

The telephone interviews conducted highlighted the fact that one of the factors that influenced the RECs’ decision to enter the market for electricity generation was the desire to ensure that there was sufficient capacity in the system. This does, however, seem to be at odds with the way this entry took place. The ability of the system to keep the lights on is most likely to be in jeopardy when demand for energy is at its highest. This is when the IPP plants are least likely to be available, due to the interruptible nature of their gas contracts.

This problem of system viability has been exacerbated because as mention above, the entrants have resulted in a large amount of the older coal plant being closed prematurely, which has put severe strain on the ability on the system to cope with demand. Indeed, in several of the years since privatisation, entry by IPPs was more than off set by the closure of existing coal fired generating capacity. For example, data for the UK shows that between March 1992 and

¹⁹ Since virtually all new entrants have been gas fired, there will have been significant effects on this industry and on the coal industry which it has displaced. These effects have been covered elsewhere and as such do not need to be explored here.

March 1993, the capacity of coal stations declined by 2,163MW, whilst new CCGT capacity was rated at only 900MW (DTI, 1995, Table 50, p105).²¹

Plant margin statistics measure the amount by which installed generating plant exceeds peak demand, and this is presented as a percentage of that peak demand (appendix D shows the formula how plant margin is calculated). The building of large amounts of new CCGT plant associated with the entry by IPPs might lead one to expect an increase in plant margin. However, the actual situation as seen in Table 1, reveals that in fact plant margin declined following privatisation, stabilising at approximately 20%.

Table 1
Plant Margin of the UK Electricity system
(see Appendix B for formula used)

Year	Plant Margin (%) ^{a,b}
1989/90	31.66
1990/91	28.21
1991/92	21.78
1992/93	22.67
1993/94	17.65
1994/95	23.46
1995/96	19.05
1996/97	21.61
1997/98	19.88
1998/99	21.45
1999/2000	21.10
2000/01	23.23

^a Calculated using data presented in DTI, *Digest of United Kingdom Energy statistics*, various issues, London: Government Statistical Service.

^b From 1996/97, data for generation capacity (required to calculate plant margin) is published as it stood at the end of the December of the period of interest. Prior to this time, generation capacity had been measured as it stood at the end of the March of the period of interest. According to Mike Janes, head of

²⁰ 1997 data has been used because after this date, coal stations are no longer explicitly listed, but rather included in the broad category of “conventional steam stations” which will include other fossil fuels.

²¹ Presumably the signing of contracts with IPPs reduced the size of the market available to other generators, reducing the incentive to maintain/build plant on a merchant basis

coal, gas and electricity statistics at the DTI, this change was made so that the generation statistics can more accurately reflect the capacity which was available at the time of peak demand. It was estimated that had capacity been measured in March 1997, instead of December 1996, capacity would have been 80MW higher, which is a 0.12% increase in total generating capacity. The effect of this change is therefore likely to be small. Maximum load (the other statistic required to calculate plant margin) is measured for years ending in March throughout, so that the winter maximum load might be accurately reflected, regardless of which calendar year it falls in.

An initial look at the plant margin figures might indicate that the electricity system still has a high degree of excess capacity, with the rapid reduction in the plant margin following privatisation representing the increased efficiency and cost reduction measures of the private sector. However, what is not apparent from the figures is that generating units are not available 100% of the time; CEGB experience suggests that only 85% of generating stock could be predicted to be available at times of winter peak demand several years ahead, which means it is necessary to plan to meet demand with only 85% of generation capacity. In this case it means that installed capacity must be equivalent to 118% of peak demand (i.e. a plant margin of 18%), although this does not take into account other factors, such as the risk of adverse weather conditions which might be worse than the average weather assumed under the forecast (National Grid Company, 2000, Chapter 4, Plant margin terminology section, point 4.5). Plant margin is therefore not surplus or excess capacity but necessary for the security of electricity supply (National Grid Company, 2000, Chapter 4, Plant margin terminology section). The ability of the system to keep the lights on was therefore more in doubt than might first be apparent from the figures present in Table 1.

A minimum plant margin of 18% (as suggested by the paragraph above) is very close to the actual plant margins observed in the UK following privatisation, which indicates that the system has had very little spare capacity, should unforeseen events have occurred. Indeed, the CEGB aimed to have a plant margin of 24% several years ahead and large world-wide utilities

plan on a similar basis to have plant margins of up to 30% (National Grid Company, 2000, Chapter 4, Plant margin terminology section, point 4.6), presumably so that the electricity systems are able to cope in times of unexpected events, such as severe weather.

Whilst the rules of the Power Pool can be said to be most at fault for failing to secure an adequate plant margin, the IPPs do make a significant contribution to such concerns. The plant margins observed in Table 1 are somewhat misleading, in that at times of peak demand, available capacity is likely to be less than that indicated by the figures. As previously mentioned, gas supplies to the IPPs might be interrupted and so some of the installed capacity would be unavailable. Recent estimates suggest that if Britain experiences a '1 in 50 winter' (the coldest winter expected in a 50 year period), gas stocks would run out in six days, which would require the implementation of emergency measures to reduce consumption, with power stations being the first to be cut off.²² Any removal of (some) of the IPP capacity could be expected to be in addition to the 15% of capacity that the CEGB experience suggested would be unavailable, since the CEGB had no CCGT stations that could have been made unavailable due to gas interruptions. The IPPs are therefore potentially exacerbating the situation.

Indeed Thomas (1996b) cites several incidents since the industry was privatised, where the viability of the system has been placed in severe risk. In December 1994, two nuclear power plants broke down which is said to have diminished the margin of spare plant down to minimum levels. As Thomas (1996b, p.84) puts it, "had demand been as high as the previous year, the lights might well have dimmed or gone out." Thomas goes on to report that in December 1995, the coincidence of cold weather, breakdowns at a number of nuclear stations

²² "UK faces threats of winter power cuts", *The Times*, Monday April 23rd April 2001.

and strikes in France resulting in the loss of imports, were said to have again caused problems. Most interestingly, Thomas (1996b, p.84) explicitly comments that in January 1996 there was “serious concern” that there would not be sufficient capacity in the system due to the availability of IPP being curtailed by the unavailability of gas supplies. It would therefore seem that there are significant doubts about the ability of the system to keep the lights on, an issue which, although not wholly attributable, is still very much related to the large amounts of IPP entry, the nature of this entry and the effect this entry had on the existing generating capacity.

It remains to be seen what will happen to the plant margin and hence system viability in the future. When the moratorium on the construction of new gas fired plant was revoked in November 2000, 6 new IPP projects were given approval (DTI, 2000) representing over 4,800MW of new capacity²³, and further projects have been approved since then. However, this new capacity is gas fired and so it may well be liable to the same constraints on fuel supply as the current gas fired stations, adding to concerns over the viability of the system, especially if this new capacity results in the closure of existing, none gas fired, capacity.

Such significant entry by IPPs using CCGT technology also raises the question of security of fuel supply. In recent years there has been steep increases in the amounts of natural gas consumed in the UK, both for electricity generation and more widely. For example, total natural gas and colliery methane available for consumption in the UK (i.e. consumption) has increased from 597,046GWh in 1990 to 1,103,508 GWh in 2000, with gas used by the

²³ Information provided by the DTI.

electricity generators rising from 6,513 GWh in 1990 to 312,695 GWh in 1999 (DTI, 2001, Table 4.4, pp.126-127).

Demand for natural gas is now such that Britain is no longer self-sufficient, having to import gas during the winter months, and the situation is expected to worsen in the near future. John Wybrew, a director of Lattice Group (the company that owns Britain's gas pipeline network), was quoted during March 2001, as saying that "we already expect the UK to be dependent in winter on (gas) imports and we will be importing more than we export within three years".²⁴ In the recent government white paper on Energy Sources for Power Generation, figures were presented which predict that gas imports would constitute between 55% and 90% of consumption by 2020 (DTI, 1998c, p.6). Although Norway might provide a solution to these import requirements in the short term, Russia is likely to be the biggest gas supplier in the long term due to its massive reserves. Gas in Russia is dominated by the company Gazprom, a monster company which accounts for 8% of Russia's GDP, controls 25% of the world's gas production and is said to have almost unlimited gas reserves of 35 billion cubic metres.²⁵ Jacek Palasinski, of *Wpost* magazine (which has been tracking the company) was quoted as saying that "Gazprom has become the most important instrument of Russian foreign policy."²⁶ If these predictions prove to be correct, Britain, like much of Western Europe, will be heavily reliant for much of its energy requirements on a relatively unstable country, which has a proven record of exploiting its dominant position as a major energy supplier. To have such a reliance on one country would give Russia and the companies that control these energy supplies, enormous power over Britain. In this way the IPPs have contributed to the possibility of energy problems in the future, since they have helped reduce the use of coal, a

²⁴ "UK may be net importer of gas 'within three years'", *The Times*, Friday March 23rd 2001.

²⁵ "Even big Ted Turner will avoid igniting Gazprom", *The Independent on Sunday*, 15th April 2001.

fuel that is plentiful in Britain. Whilst this does not preclude a return to power stations designed to burn coal in the future, it has set back the development of the associated technologies which will be of disadvantage in the future should this line of power generation be required. Indeed, Watson (1997) highlights the rise of CCGT technology, and its widespread uptake, as one of the key reasons for the failure of the fluidised bed technology that uses coal as its fuel.

It might therefore be said that entry by IPPs has made a potentially significant contribution to the concerns surrounding the viability of the electricity system, both now, and potentially in the future, which was perversely one of the reasons why they were said to have entered the market!

V. CONCLUDING COMMENTS

The policy of encouraging entrants into electricity generation can be traced back to the deficiencies in the market that were created when the industry was reorganised and privatised in 1990. The government's desire to include its nuclear assets in the privatisation led to an embroiled process, which eventually resulted in a system that was dominated by two conventionally fired generators.

Post-privatisation policy towards electricity generation has been very much dominated by the need to correct this early mistake. This Chapter has illustrated how the policy of encouraging entry has had little effect on increasing competition but has created further distortions in the

²⁶ "Russia's New Power Game", *The Times*, Monday March 26th 2001.

market which may have serious affects in the future, confirming the view of Tenenbaum *et al.* (1992, pp.1155-1156):

“We think the best approach..... is to put the industry and regulatory structures in place prior to privatisation. In other words – restructure first and privatise later. If this is politically infeasible, the alternative is to do as the British did – restructure and privatise at the same time. However, the problem with this approach is that major mistakes are often made in the rush to privatise and once the structure is in place, it is difficult to correct these mistakes. The reality is that it is infinitely easier to make changes before privatisation than to do so afterwards”.

The policy of encouraging entry is an excellent example of how it is difficult to correct mistakes made during a rushed privatisation. Had the government taken the time before privatisation to ensure that its restructuring was optimal, the subsequent problems might well have been avoided. If any flaws did exist in the reorganised system, the government would have been able to address these problems without any issues of hurting private firm’s property rights. In the case of England and Wales, the government would have had no need to implement the policy of encouraging entry; instead they would have been able to split conventionally fired generation into more companies, reducing the ability of any one firm to control the market. Not only might there have existed a cheaper, more efficient electrical system, but the government could have received a greater income. By allowing the new industry structure to establish itself for a reasonable period of time in the public sector, the markets could observe it operating in practice. This would have reduced the doubt as to how the market system operated and so allowed the government to increase its proceeds from

privatisation. Since this was not the case, successive governments have been unsuccessfully playing catch-up, attempting to correct the earlier mistakes built into the market. Future privatisations in England and Wales, or elsewhere, take note.

CHAPTER SIX

PRIVATISATION AND ELECTRICITY PRICES

I. INTRODUCTION

There seems to be a general acceptance that electricity privatisation in England, Wales and Scotland (henceforth, Great Britain) has been a success, simply because real electricity prices have subsequently fallen, and thus that it is a model for elsewhere. However, it is the contention of this Chapter that British electricity privatisation should not be viewed as a success for this reason, as other industry structures might have resulted in more significant price cuts.

Consequently we investigate the privatisation process in an attempt to see if it did indeed result in lower real electricity prices, or if these price cuts would have happened anyway. This is accomplished by comparing the observed electricity prices with those that might have been charged had the industry remained publicly owned. In this Chapter we therefore develop a counterfactual scenario for the likely decisions that the publicly owned industry would have taken, drawing heavily on the existing counterfactual work of Yarrow (1992) and Newbery and Pollitt (1997). The counterfactual is developed within the context of an identity, which splits the price of electricity into fossil fuel costs, profits and other costs. Each of these elements is then modelled in terms of the likely effects of a publicly owned industry.

In the course of developing the counterfactual model, the Chapter apportions aggregate industry profits between industrial and domestic sales with some startling results. The calculations presented indicate that domestic sales account for the majority of aggregate

industry profits, even though they make-up only 35% of total sales.¹ This bias against the domestic consumer is also born out in the analysis of final electricity price, which indicates that both domestic and industrial prices would have been lower had privatisation not occurred. Moreover, the results presented imply that domestic prices with privatisation are higher by relatively more than industrial prices, intimating that the domestic consumer has suffered the most from privatisation.

In order to pursue these arguments, the Chapter is organised as follows. Section II considers existing literature contributions in this area, enabling Section III to build upon these foundations by developing a theoretical model of electricity prices. Section IV uses this model to construct a counterfactual analysis of the industry had it not been privatised. Our results are then presented in Section V, followed by our concluding comments in Section VI.

II. OVERVIEW OF SOME EXISTING LITERATURE

Much has been written about the privatisation of electricity in Britain, with the vast majority of the literature (implicitly) assuming that the resulting structure was beneficial. A large amount of this literature has focused on specific elements of privatisation, such as modelling the operations of the pool or the extent of competition in generation. These articles often conclude that specific elements of privatisation could have been carried out more effectively; for example, competition in the pool would have increased had the CEGB's generating capacity been split into at least five companies (Green and Newbery, 1992).² However, the focus of this literature seems to be that these flaws in privatisation have been a gain lost,

¹ The breakdown of electricity sales by sector was provided by Andrew Walker, Director of price control at the Office of Electricity Regulation (OFFER).

² See also Green (1996) and Armstrong *et al.* (1994).

rather than an outright cost. Thereby privatisation is still seen as a good thing, just that it could have been done better.

Nevertheless, there has been a limited amount of work seeking to evaluate whether or not privatisation was beneficial, primarily the contributions of Yarrow (1992), and Newbery and Pollitt (1997). Yarrow uses the basic benchmark of privatisation, that of electricity price, to evaluate whether the process was advantageous. This is carried out by comparing the actual electricity prices observed with those that might have been charged had privatisation not occurred. To accomplish this, Yarrow developed a counterfactual scenario which assumes that the CEGB had not been privatised but that instead the government continued with the policies it established in the 1980's.³

The counterfactual was constructed within the context of the price identity shown below:

$$P_t = X_t + Y_t \qquad \text{Equation 1}$$

Where P_t is the relevant price (per kWh) of electricity in year t
 Y_t is the unit (per kWh) cost of coal inputs in year t
 X_t comprises unit 'non-coal costs' in year t

Yarrow (p.11) accounts for the use of this identity because he believed that for the period of interest (i.e. 1988 to 1991)⁴ "bulk prices of electricity have been driven by the unit costs of generation of conventional steam turbine technologies." Since coal costs accounted for in excess of 80% of the CEGB total fuel costs up to early 1992, it would seem reasonable to

³ In the late 1970's/1980's, the government progressively introduced the use of financial/performance targets and reduced entry barriers to encourage the development of private power stations and hence competitive pressures.

⁴ Yarrow assumes privatisation would first have had an effect when the specific details were first announced in 1988.

separate out the cost of coal as a major determinant of price (Yarrow, 1992, p.12). In order to calculate the ‘unit cost of coal’, Yarrow uses the following formula:

$$Y_t = \frac{PC_t \times QC_t}{QE_t} \qquad \text{Equation 2}$$

Where Y_t is the unit (per kWh) cost of coal inputs in year t
 PC_t is the unit price of coal to the generators in year t
 QC_t is the quantity of coal used in year t
 QE_t is the quantity of electricity supplied in year t

The counterfactual position developed by Yarrow is carefully explained by detailing the specific assumptions made regarding each variable, since privatisation would have affected many of the factors included.

Yarrow defines the ‘non-coal costs’ component of price in very broad terms, which means it would include all the remaining determinants such as capital costs, taxation, profits or labour costs. This is calculated as a residual, i.e. price minus coal costs, and so the counterfactual makes predictions using the observed long-term trend. This is perhaps the main weakness of the paper because this ‘non-coal costs’ element is so broad that it includes many unknown factors. It contains not only the residual costs of generation, but also the various factors that affect distribution, transmission and supply.

The counterfactual ‘story’ for the likely CEGB actions in the absence of privatisation allows Yarrow to separately calculate the two elements of price. These are then combined to find that in 1991, domestic prices are 25% higher than they would have been without privatisation (Yarrow, 1992, p.23). The counterfactual assumptions used are well justified, but the author also develops a more ‘pessimistic’ case for ‘non-coal costs’ (due to the large amount of

unknown factors this includes) which still shows a 15.6% difference in price (Yarrow, 1992, p.31). Both of these results are used by Yarrow to undermine the supposed success of privatisation.

Newbery and Pollitt (1997) take a more complex view by attempting a comparative social cost-benefit analysis of the CEGB restructuring/privatisation process, between the years 1988 to 2010.⁵ The main aim of the article is to investigate the size of the efficiency gains from privatisation, although there is limited discussion about the resulting effects on price.⁶

To carry out such an analysis, Newbery and Pollitt need to compare the actual efficiency of the industry with that which would have existed had privatisation not taken place. They therefore develop a counterfactual position for the likely actions of the CEGB if it continued in its pre-privatisation form. This takes the form of two 'extreme' scenarios: the 'pro-privatisation' case, which is pessimistic in terms of the CEGB performance and consequently favourable to privatisation; and the 'pro-CEGB' case, which takes a more optimistic view of the CEGB, thereby more supportive towards continued public ownership. These counterfactual positions were derived by forecasting the CEGB's actions if it had faced the same conditions as the privatised industry. For example, the changing sulphur limits imposed by Brussels, or the 1991 lifting of the EC prohibition on the burning of gas in electricity generation. Since these factors were not experienced by the CEGB when it was publicly owned, Newbery and Pollitt rely on evidence of the CEGB's view of the future and its plans

⁵ 2010 was chosen since the majority of the current plant will have been replaced by then. This time frame has not been adopted here due to the great uncertainties about predicting future events.

⁶ In carrying out the analysis they focus on the impact of competition in generation and so they therefore exclude electricity distribution and supply from their study, reasoning that it has been regulated and essentially unchanged in structure.

for the 1990's. The majority of this information was presented to a commission of inquiry in 1990, when the CEGB proposed to construct a new nuclear station at Hinkley Point.

Newbery and Pollitt then use this counterfactual, together with predictions for the future performance of the industry, to look at the various effects of restructuring and privatisation. Efficiency savings (e.g. due to lower labour use) together with changing plant mix and input costs are all modelled. They find that benefits accrue from four areas: efficiency gains in the use of inputs (offset partly by restructuring costs); the switch in fuel use and investment; and the consequential environmental benefits. The main costs arise from higher prices for imported French electricity, the cost of restructuring, and premature investment in new gas-fired generating plant. Combining all their calculations, Newbery and Pollitt obtain a central estimate that privatisation has resulted in a permanent cost reduction of 5% per annum over continued public ownership. However, they find these cost savings have not been passed on to the consumer in the form of lower prices, but have instead been taken as higher profits by the electricity companies. Indeed they find that it is only these companies who have benefited from privatisation, since profits have risen by more than the cost reductions made. They therefore conclude that electricity prices in the privatised industry are higher than those predicted for the CEGB, indicating that it is the consumer who has borne the burden of the privatisation process.

III. THEORETICAL FRAMEWORK

Earlier assessments of the potential costs of privatisation (in terms of electricity prices) indicate that there may exist substantial costs to the consumer from the restructuring and privatisation of the British electricity system. It would therefore be useful to verify this view

with a more up to date analysis, especially since Newbery and Pollitt reach their conclusions on price movements as an aside to their main work. Moreover, Yarrow's work was written in 1992 and as such it only includes the performance of the private companies for one year. The effect on price may therefore be substantially altered since this time. Consequently we use a modified version of the model presented by Yarrow, together with elements of the Newbery and Pollitt article, to judge the success of privatisation with respect to the price of electricity.

Since Yarrow, electricity generation in Britain has witnessed significant changes, which implies that Yarrow's approach cannot simply be duplicated with updated data. The model must be revised to take account of changing technologies and alteration in the effects that the privatised companies have had on the nature of electricity generation. On this basis, a similar approach to Yarrow has been used, where the cost of electricity has now been split into the three components shown in equation 3:

$$P_t = F_t + N_t + \Pi_t \quad \text{Equation 3}$$

Where P_t is the relevant price (per kWh) of electricity in year t .
 F_t is the 'fossil fuel costs' per unit (kWh) of electricity sold in year t .
 N_t comprises 'non fossil fuel costs' (per kWh) in year t .
 Π_t are the 'profits' (per kWh) in year t .

The price identity now includes the more general term 'fossil fuel costs', which replaces Yarrow's 'unit cost of coal'. This has been done to incorporate the 'dash for gas' (and the associated changes in the mix of fossil fuels required for generation), as discussed in the previous chapter. It also provides a better estimate of overall fuel costs, since it now incorporates the use of oil in generation. 'Profits' have also been separated from Yarrow's 'non-coal costs' so that the massive increases in profit levels after privatisation can be

explicitly modelled. This leaves the remaining factors bundled in the residual term, ‘non fossil fuel costs.’

Yarrow does not model the different potential mix of fuels used to generate electricity but rather assumes that 75% of “bulk electricity produced by the generating companies was from coal-fired stations” (Yarrow, 1992, p.17). This assumption, while reasonably valid for the time period examined, can no longer be supported due to the changes that have occurred in the fuel mix used for generation. Consequently equation 4 utilises the weighted unit costs of coal, gas and oil generated electricity to calculate an estimate of the cost of fossil fuels per unit of fossil fuel generated electricity.

$$FF_t = (X_t \times C_t) + (Y_t \times G_t) + (Z_t + O_t) \quad \text{Equation 4}$$

Where FF_t is the fossil fuel costs per unit (kWh) of electricity sold in year t which was generated using fossil fuels

X_t is the proportion of electricity sold in year t , generated using coal.

C_t is the unit (per kWh) fuel cost of coal generated electricity in year t .

Y_t is the proportion of electricity sold in year t , generated using gas.

G_t is the unit (per kWh) fuel cost of gas generated electricity in year t .

Z_t is the proportion of electricity sold in year t , generated using oil.

O_t is the unit (per kWh) fuel cost of oil generated electricity in year t .

To calculate the unit fuel cost of electricity generated from the different fossil fuels, the formula Yarrow used (as outlined in equation 5) can be applied to each of the fuels:

$$I_{it} = \frac{P_{it} \times Q_{it}}{QE_{it}} \quad \text{Equation 5}$$

Where I_{it} is the unit fuel cost of electricity generated using fossil fuel i in year t .

P_{it} is the unit price of fuel i in year t .

Q_{it} is the quantity of the fuel i used in year t .

QE_{it} is the quantity of electricity generated using fuel i in year t .

However, equation 4 does not take into account electricity generated from other, non fossil fuel sources such as nuclear or hydro, and thus just works out the costs of the fossil fuels per unit of electricity generated using fossil fuels. Therefore, an additional equation is required to spread the costs of the fossil fuels over the total amount of electricity sold, in order to calculate the cost of fossil fuels per unit of all electricity sold. This is done in equation 6.

$$F_t = \frac{FF_t \times QEF_t}{QET_t} \quad \text{Equation 6}$$

Where F_t is the fossil fuel costs per unit (kWh) of electricity sold in year t
 FF_t is the fossil fuel costs per unit (kWh) of electricity sold in year t which was generated using fossil fuels
 QEF_t is the number of units of electricity (kWh) sold in year t which was generated using fossil fuels
 QET_t is the number of units of electricity (kWh) sold in year t

When combined, equations 4, 5 and 6 should provide a good estimate of ‘fossil fuel costs’ per unit of electricity sold, since they incorporate virtually all of the fossil fuel used. The structure of the equations also allows the changing importance of each fossil fuel to be modelled on a yearly basis.

Although the price identity is an updated version of Yarrow, the general methodology employed in this Chapter draws heavily upon that of both Yarrow, and Newbery and Pollitt. Following Yarrow, we look at the price of both domestic and industrial electricity and make similar assumptions regarding the CEGBs structure without privatisation (i.e. further reductions in entry barriers to encourage competition, together with slightly more aggressive financial/performance targets). We also follow Yarrow’s assumption that the first effects of privatisation would be felt in the financial year 1988/89, since the governments specific proposals had already been published by then. Newbery and Pollitt's influence on this

Chapter is mainly discernible in terms of the counterfactual developed (see next section), but a similar approach is adopted to the way in which they deal with the different domains within the electricity sector.⁷ The focus is predominantly on generation since this contains the most important cost drivers, while the structure of the remaining parts of the industry is generally unchanged and has been subject to government regulation.⁸ This essentially means we concentrate on the activities of the CEGB (and its successor companies) as this accounted for the vast majority of British generation cost drivers, especially given that the Scottish market was more heavily based on nuclear and hydro generated electricity (Thomas, 1996a, p.59).

IV. COUNTERFACTUAL DATA USED

In order to compare prices, a counterfactual alternative must be developed for the individual elements that form the price identity. Newbery and Pollitt present an assiduously developed counterfactual ‘story’ for likely CEGB actions in the absence of privatisation. Although this Chapter incorporates differing assumptions and structure, Newbery and Pollitt has been utilised as a foundation for the counterfactual developed here, due to the vast amount of information it contains. (N.B. a brief summary of the counterfactual used can be seen in appendix E).

In line with Yarrow, and Newbery and Pollitt, the counterfactual analysis starts in the financial year 1998/89, as this is the first year after which the specific privatisation proposals were announced and thus changes might have reasonably started to occur within the electricity industry. It has, however, been decided to limit the extent of our study such that it finishes with the 1997/98 financial year. With any counterfactual type analysis the

⁷ *i.e.* Generation, transmission, distribution and supply.

probability of accurately predicting what might have been, slowly diminishes as the number of years increases, and thus the number of decisions that have to be estimated multiply, and assumptions built upon assumptions start to grow. To this end, we felt that a ten-year study would give a strong indication of the real effects of privatisation upon price, whilst after this time the electricity market had grown sufficiently different to make robust counterfactual predictions problematic. For example, in 1998 the market for electricity supply was fully liberalised, which resulted in all electricity consumers being able to choose their electricity supplier. This therefore meant that amongst other things, it would no longer be appropriate to concentrate entirely on generation as the main driver of electricity price. Moreover, given the changes in the industry (e.g. fuel used for generation) consistently defined data series were also becoming more difficult to obtain or calculate as the length of the counterfactual increased.

The data used to construct this counterfactual (and the actual data it contrasts) has been collected from several specialised publications,⁹ and from telephone interviews we conducted with senior people within the industry. However, some of the published information refers to the United Kingdom (UK) as a whole and thus is not specific to the markets of England and Wales, and Scotland (i.e. the markets that make up Great Britain). This is not a serious problem since the electricity system for Northern Ireland (the UK consists of Great Britain and Northern Ireland) is tiny in comparison to the markets of Great Britain, and so data for the

⁸ This line is supported by the fact that, for example, in 1993/94, 77% of industrial electricity cost was attributable to generation, which shows it to be by far the most important domain (CRI, 1994/95 edition, p.xi).

⁹ These include: the Digest of United Kingdom Energy Statistics, and Energy trends, both published by the Department of Energy and then the DTI; Handbook of Electricity Supply Statistics, and Annual Report and Accounts, both published by the Electricity Council; Energy Prices and Taxes from the International Energy Agency; The UK Electricity Industry: Charges for Electricity Services, The UK Electricity Industry: Electricity Services and Costs, and The UK Electricity Industry: Financial and Operating Review, all published by the CRI; the Statistical Yearbook from the CEEGB and the Annual Report and Accounts of the privatised companies.

UK should still provide a reasonable estimate for Great Britain.¹⁰ For example, in 1998 7,174GWh of electricity were distributed by public electricity suppliers in Northern Ireland, which is just 2.4% of the 299,387GWh distributed in the UK as a whole (DTI, 1999, p.151).

IV.i Fossil Fuel Costs

When looking at ‘fossil fuel costs’ it is first necessary to examine the fuels used in the generation process, as this is said to be a direct consequence of the industry structure. As the previous Chapter indicated, there has been a significant shift in fuel use since privatisation, with the new independent CCGT plant replacing the coal fired plant of the CEGB successor companies.¹¹ During the Hinckley Point Enquiry the CEGB presented its central forecast of its future power requirements. It estimated that by the end of the century 5.5GW of ageing coal plant would need replacing (Barnes, 1990, Newbery and Pollitt, 1997). However, by 1995 more than 5.5GW of coal plant had already been replaced by the IPPs new gas fired plant, which had caused the premature closure of the older coal stations.

Telephone interviews that we carried out with senior people within these independent companies during January/February 1999 suggested that limited entry by IPPs might still have been possible in the absence of privatisation, if the environment were right (see report in Chapter Five, and appendix C for the list of core questions utilised in these interviews, and a sample transcript of one of the interview). For this entry to take place, our interviewees indicated that the independent companies would have been looking for specific conditions, such as long-term purchase contracts, which are likely to have been less favourable or

¹⁰ The electricity system of Northern Ireland has not been included in this analysis because much of the information required was unavailable for the period of interest.

forthcoming under public ownership. Therefore, the counterfactual developed in this Chapter takes the view that independent entry would have been approximately 50% of that actually witnessed under privatisation, reflecting the reduced willingness of the independents to enter.¹² Thus in the counterfactual scenario there is a lower amount of gas capacity (3.5GW less by 1998). Consequently the retirement of ageing coal plant would have been more gradually phased in and would not have been completed until the end of the century, as was originally forecast.

The analysis of capacity does not show how the assumed plant mix would be used to generate electricity, and so plant utilisation must also be modelled. One of the features of privatisation was that the utilisation of coal plant fell dramatically as independent gas fired stations started to operate on long-term ‘baseload’ contracts, which resulted in high utilisation. These contracts distorted the marginal cost based merit order which should determine the combination of plants to be used, since these gas plants were contracted to operate, even if they were not the cheapest plant to fulfil demand. For example, the utilisation of coal plant fell from 54.1% in 1993/93 to 44.8% in 1997, while the utilisation of CCGT plants rose from 60.5% in 1993/94 to 81% in 1997. (DTI, 1998a, Table 6.7, p.164). Since the counterfactual assumes lower entry by IPPs, there would have been less use of gas for ‘baseload’ operations and so gas fired plants would have been used less intensively. In order to model plant utilisation this Chapter uses the established trends (both pre- and post-privatisation) to

¹¹ In dealing with this issue it has been assumed that the electricity production/capacity for nuclear, hydro, oil and imported electricity remain unchanged, due to the time taken to build new plant and to the nature of the demand these sources satisfy.

¹² 50% has been used due to the information gained from the interviews conducted.

estimate the rates for the counterfactual. This results in higher utilisation of coal plants and reduced utilisation for gas plants.¹³

To calculate 'fossil fuel costs' it is also necessary to make assumptions regarding the technical efficiency (i.e. the amount of fuel required to generate one unit of electricity) of the power stations, which will then allow fuel requirements to be calculated.¹⁴ The observed trend shows that there were steady improvements in the efficiency of coal fired plant from 1980 to the end of the study, with privatisation making no difference to the trend. For example, in 1987 approximately 0.000435 tonnes of coal were required to generate one unit of electricity (kWh), which had declined to 0.000419 tonnes by 1992 and 0.000396 by 1997. Such a trend suggests that the CEGB was as efficient as the privatised industry in terms of the technical operation of coal fired plant. This is a contention that is supported by Armstrong *et al.* (1994, p.320), who report in their conclusion: "In terms of short-run operating efficiency, the CEGB's performance appears to have been reasonably good, except (as is now apparent) for over-staffing". However, since the CEGB had no CCGT stations, there is no pre-privatisation record to study, and so there are fewer facts to guide the counterfactual estimation of the efficiency of the gas fired stations. What is known is that the technical efficiency of CCGT fired plants is virtually unchanged during their limited period of use. This is unsurprising since CCGT is a new technology and there has been little time for improvement. It might therefore be reasonably assumed that the CEGB would have run its CCGT stations with the same ability as it did its coal stations. Consequently the

¹³ When modelling utilisation it has been assumed that the total amount of electricity sold would remain the same *i.e. own price elasticity of electricity is zero*, since simultaneous modelling of price and quantity would be prohibitively complicated due to the many effects it would have. Research conducted on the own price elasticity of demand shows that in the short run it is actually likely to be in the region of -0.7 for small changes (Brenton, 1997).

counterfactual assumes that technical efficiency for both coal and gas would have been the same as that observed under privatisation. (i.e. the amount of fuel required to generate one unit of electricity is the same for the counterfactual as that actually observed).¹⁵

Privatisation is also likely to have had an effect on the prices of coal and gas used in electricity generation,¹⁶ especially since the quantities required would differ (due to the assumptions made on available capacity). Prior to electricity privatisation the Government owned both the coal and electricity industries. To protect domestic coal production, it forced the CEGB to purchase expensive British coal. However, in the 1980's government policy changed towards a more market orientated approach, which included a policy of cost reductions in order to move British coal prices more in line with world prices.

Government influence in the price of coal continued to be felt in the years immediately after privatisation. In 1990, prior to privatisation, the new generating companies signed three-year contracts with British coal, which were effectively government imposed. These contracts specified large quantities of coal (only slightly lower than the quantity in 1989/90) whilst continuing previous government policy of gradually moving British coal to world prices.¹⁷ The counterfactual used in this assumes that the coal prices up to 1993 were the same as those

¹⁴ This is different from thermal efficiency, which measures the efficiency with which heat energy contained in the fuel is converted into electrical energy - see the DTI (1998a,1999).

¹⁵ It has been assumed that the efficiency costs to coal stations of being fitted with the additional FGD equipment required to clean emissions is offset by the efficiency increases derived from higher load factors (i.e. increased use).

¹⁶ It has been assumed that the oil price would not change in the counterfactual since the market for oil is a global one.

¹⁷ Since the government had such strong links with the coal price Yarrow made the assumption that coal prices would have been the same had privatisation not occurred.

actually observed, with small adjustments to take account of quantity differences.¹⁸ This approach has been chosen as it seems to represent the most likely conditions the CEGB would have faced, inasmuch as the actual price was effectively set by the government.¹⁹

Once these contracts expired, the privatised electricity companies were able to negotiate their own contracts for coal. They could now exert considerable pressure on British Coal, since their newly constructed port capacity meant they had the viable alternative of cheaper imported coal. This resulted in a considerable gulf between what British Coal was willing to accept as reasonable and what the generators were willing to offer. The government acted as a negotiator and applied considerable pressure to reach an agreement. The contract stipulated significantly lower quantities (reflecting the reduced demand caused by the CCGT stations) while continuing the previous downward trend in the real price, which had started in the mid-1980s when the CEGB was still publicly owned. Given this government involvement, it is likely that a publicly owned CEGB would also have followed a similar path. Therefore, the counterfactual in this uses the observed price from 1994 to 1998 as a base, with the appropriate adjustments for quantity differences.²⁰

The effect of privatisation on gas price is more difficult to estimate since there were no CCGT stations operating before privatisation. Newbery and Pollitt, in their 'pro-CEGB' case use the same price actually observed under privatisation. In their 'pro-privatisation' case they argue that gas prices might actually have risen by 10% without privatisation, due to the monopsony

¹⁸ Newbery and Pollitt use the marginal cost curve presented in the House of Commons *Inquiry into the Market for Coal* as a means of adjusting the price of coal for quantity changes. A similar approach has been adopted in this , using the cost curve presented in House of Commons (1992/93, p.24) .

¹⁹ Newbery and Pollitt in their 'pro-CEGB' case assume coal costs were the same as with privatisation.

²⁰ See Parker (1996a) and House of Commons report (1992/93) for a more comprehensive account of the relationship between the coal industry and electricity generation.

power of the CEGB deterring the rapid expansion in North Sea gas production, which is said to have resulted in the decline of gas prices. However, this does not allow for any entry by IPPs or other avenues for gas production (e.g. exports into Europe), and hence it is unlikely that the North Sea boom would be as severely affected as Newbery and Pollitt suggest.

Newbery and Pollitt's contention is opposed by the House of Commons 1992/93 report 'British Energy Policy and the Market for Coal', which partially attributes the 'dash for gas' in electricity generation to the "realisation that more gas was available at competitive prices than had previously been thought" (House of Commons, 1992/93, point 77, pp.46-47). This would seem to reverse the causality between the 'dash for gas' in the North Sea and that in the electricity generation sector, from that proposed by Newbery and Pollitt.

This argument is supported by developments in the gas market, where regulatory bodies had effectively removed British Gas's monopoly control of the market. For example, between 1989 and 1993, 36 new gas fields were made available but only 9 of these went to British Gas (BG), the remainder going to 18 different organisations. Previously, new gas fields had only been brought on line when BG required them, either to replace existing fields or to meet the extra demand within its existing markets. This had allowed BG to restrict gas supply to forecast demand, but competition has resulted in a great deal more gas seeking buyers and hence lower prices (Parker, 1996a, p.128). Consequently it might be that the falling gas price, and its plentiful availability helped to encourage the use of gas fired plant. In that case, the ownership of the power station is an inconsequential fact.

In this situation, lower entry into gas fired generation (as is assumed under the counterfactual) might lead to over supply and thus to even lower gas prices. This lower price contention

might be supported by the view that monopsony buying power of the CEGB could also lead to lower prices. Therefore, in the face of such great uncertainty, the CEGB counterfactual assumes a gas price which is the same as the one actually observed with privatisation.²¹

IV.ii Profits

Electricity prices are generally presented in two forms: the price to domestic consumers and the price to industrial users. Following Yarrow's example, we use the same separation of price. However, this presents a problem due to the explicit incorporation of profits into the identity employed. The statistical data does not include the profits made from each category of sale, but instead gives total industry profits.²² The profit figures cannot be simply divided by the number of units sold each year, because this makes the implicit assumption that industrial and domestic sales generate the same profit per unit. It is rather unrealistic to assume that domestic and industrial sales would produce the same profit per unit, given the higher levels of competition for industrial sales during the period of interest and the cost differences. It is therefore better to estimate explicitly the profit distribution, using the limited amount of data that is available.²³ (A full transcript of the calculations can be seen in Appendix F).

The calculations indicate that in 1993/94, 61.65% of profits in the electricity sector were earned on domestic electricity sales, with only 38.35% coming from the larger industrial

²¹ This is the same line that Newbery and Pollitt take in their 'pro-CEGB' counterfactual.

²² We contacted several companies to get this information but they proved unwilling to share this confidential data.

²³ The calculation is based on the idea that to generate one unit of electricity costs the same irrespective of final destination. Therefore, information on the breakdown of typical industrial and domestic bills between the different domains in 1993/94 allows the calculation of the profit differential earned in generation between the two types of sale (i.e. industrial/domestic). This profit rate was then applied to the other domains and hence the per unit profits for the two sale types can be calculated.

sector.²⁴ This result is very significant since it shows that domestic electricity sales provide a disproportionately large percentage of aggregate profits (only 35% of sales are to domestic customers). It may also indicate that industry specific regulation has failed to protect the domestic consumer from the interests of big business, if the profits on domestic electricity sales represent more than a reasonable return on capital employed.

The key piece of information used to calculate this profit distribution (the breakdown of typical electricity bills) was only available for the financial year 1993/94, when the industry was privately owned. It is most likely that this profit distribution would have been different had the industry still been publicly owned, and indeed changed over time for both the public or private industry. However, given the lack of regular information, there is no way that reasonable predictions can be made for this changing profit distribution. It has therefore been assumed that the division of profits remains at the 1993/94 level, for all the years examined and for both the public and private industry.

Throughout the 1980's, the electricity industry in the Great Britain faced a series of financial targets that determined the individual company's return on capital (i.e. profit). It is the position of this that the government would have continued with this targeting policy, setting financial targets for the CEGB, the various Area Boards, and the Scottish companies.²⁵ In the last few years of public ownership, these financial targets were increased significantly (e.g. in

²⁴ Initially these calculations were carried out using earlier information from OFFER that indicated the market for electricity was split evenly between domestic and industrial sales. The use of this information gives the conclusion that 79.29% of profits originate in the domestic sector, with only 20.71% earned from industrial sector sales. However, these have not been used because when sent details of the provisional results, OFFER replied with scepticism, citing as evidence 'new' information on the proportion of electricity sold to domestic/industrial consumers (i.e. 65% industrial, 35% domestic). This 'new' evidence, being the most up to date, has therefore been used in the remainder of this, although in either case the results are startling.

England and Wales, the target increased from a 2.7% return on assets in 1987/88 to a 4.75% return in 1989/90 - see Electricity Council, 1988/89). Since this was a time when the industry was being prepared for privatisation, the counterfactual assumes that a target under continued public ownership would have been set slightly above those set for the period in the mid 1980's. Moreover, in the later years of the counterfactual, the profit target has been increased slightly to reflect a more aggressive approach to targeting and the entry by IPPs, who would have the higher profit margins associated with private businesses. (It has been assumed that financial targets would be met - see Appendix E for the actual profit targets).²⁶

The counterfactual profits estimation has resulted in the observed profits trend of the 1980's continuing into the 1990's. However, in reality profits exploded since privatisation. Therefore the profits predicted by the counterfactual are significantly below those actually observed.²⁷

IV.iii Non Fossil Fuel Costs

The biggest element of price is what we term 'non fossil fuel costs', which are determined by the multitude of factors not covered by the 'profit' or 'fossil fuel costs' terms. When analysing the actual data on privatisation, 'non fossil fuel costs' are calculated as the residual of price; i.e. by subtracting 'profits' and 'fossil fuel costs' from the price. However, the counterfactual requires it to be modelled explicitly so that the estimate of the counterfactual price can be achieved. To accomplish this Yarrow simply assumes the series would have followed the same downward trend as was observed from the middle of the 1980's. While

²⁵ The industry in England and Wales faced a joint financial target. From this, each Area Board faced its own target, reflecting the different circumstance of each, while the CEGB aimed to achieve the industry target. The two Scottish companies had a separate target.

²⁶ Newbery and Pollitt do not make any explicit predictions regarding yearly profits, but give a discounted figure for total profits in the time frame they use. They account for this by the continued use of the CEGB's 1989 financial target.

this might appear reasonable up to 1991, it is unlikely that this trend would have continued unchanged, due to the large amount of variables included. We therefore examine the main constituents of this broad category, examining how each might have been altered. The nature of the elements included in this term mean there are often severe data limitations and so the established trends (both pre- and post-privatisation) are important indicators for the counterfactual.

One of the main elements expected to be included in the ‘non fossil fuel costs’ division since privatisation, is the fossil fuel levy (FFL).²⁸ This was a flat rate tax of around 10% on all retail sales of electricity in England and Wales, which was introduced during industry restructuring in 1990 (it was phased out in 1996/97 when the newer nuclear stations were privatised as British Energy). The exact purpose of the FFL has been the source of much confusion, with many authors and even government ministers often reporting its purpose inaccurately. The primary aim of the levy was to finance the excessive costs of nuclear generated electricity over conventionally generated electricity.²⁹ Money generated by the FFL was paid to Nuclear Electric (NE) who treated these payments as a large component of its turnover. The levy payments were not reserved to pay for inherited liabilities as is widely reported (MacKerron, 1996, pp.151-154). The Chairman of NE told the House of Commons Trade and Industry Committee that “basically the Levy is taken in to add cash flow.” The finance director added that the FFL “.. was specifically described as to ensure that Nuclear Electric remained cash-positive” (House of Commons, 1992-93, p.62).

²⁷ For example, actual industry profits were £2013.3M in 1990/1, rising to £4,737.6M by 1996/7 (CRI, 1996/97), where as the counterfactual estimates profits in 1996/7 at £2,360M.

²⁸ This does not mean that the fossil fuel levy is a cost - just something that one might expect to be included in this section due to the way it is calculated as a residual.

²⁹ A very small amount of the levy was used to support energy generated from renewable sources.

The majority of NE's expenditure since privatisation would have occurred regardless of whether NE received any money from the FFL; investment in plant under construction would have continued, whilst nuclear plants and waste materials would still have needed to be made safe. In this respect the only effect of the levy has been to boost Nuclear Electric's revenue, and hence profits. The levy will therefore already be included in the 'profits' section (since NE's profits include the levy payments) and consequentially will not constitute part of the 'non fossil fuel costs' division of the privatisation scenario.

The manner in which nuclear liabilities were handled did not change following industry restructuring. As a liability became due, it was paid out of current revenue. The CEGB's policy on the backend costs of nuclear power was that the assets were reduced in value to take account of these future costs, which were to be met from future revenues. Privatisation separated the nuclear assets from the conventional plants that were to provide much of this future revenue, creating the need for the FFL. If privatisation had not occurred, there would have been no need for the levy since the backend costs of nuclear power would have been met in the planned way. Since 'profits' are calculated using an appropriate return on assets employed, and total costs are accounted for using the 'fossil fuel costs' and 'non fossil fuel costs' series, the counterfactual for continued public ownership does not need to include a fossil fuel levy.

The capital costs of building the power stations (in the form of depreciation) are another important factor, since approximately 25% of the non-fuel costs of the CEGB in the 1980's were depreciation costs (See Electricity Council, handbook of electricity supply statistics).

After privatisation, the ‘dash for gas’ resulted in the building of many new power stations which would have boosted this depreciation charge. In the counterfactual scenario it is assumed that there would be less new CCGT capacity (nearly 3.5GW less by 1998), which would reduce the depreciation charge, since old plant would already have been written down.³⁰

Although the CEGB had been reducing its workforce throughout the 1980's, labour still accounted for approximately 27% of the CEGB's non-fuel costs in the 1980's (see Electricity Council, handbook of electricity supply statistics). Since privatisation, the rate of job losses within the industry has increased significantly, and it is unlikely that the CEGB would have matched the privatised companies in this respect.³¹ We therefore take the view that the observed CEGB trend of labour reduction in the 1980's would have continued in the absence of privatisation, with a slight increase in the mid 1990's reflecting the number of IPPs and associated competition.

There were significant costs associated with the whole reorganisation and privatisation process - Newbery and Pollitt estimate the cost of restructuring the CEGB at approximately £3 billion (Newbery and Pollitt, 1997, p.291). If the industry had not been privatised these costs would not have been incurred. However, the counterfactual does assume that some reforms would have occurred within the public sector (e.g. more performance targets, the

³⁰ Some of the savings in depreciation charges from fewer new stations would be offset by the need to install FGD emission cleaning equipment in some of the coal plants to meet emission targets.

³¹ Interviews with industry insiders show that the CEGB did not know how much ‘fat’ it contained, and so they report that it really needed the aggressive approach of the private sector to fully trim this excess labour fully.

introduction of independently owned generating capacity) and therefore takes account of a £2 billion cost saving from not privatising.³²

Clearly many other factors would be included in such a broad category, the majority of which are not known. Thus it is rather difficult to predict the effect that privatisation had upon these costs. However, some were classed by the government as being ‘non-controllable’ before privatisation, so it seems reasonable to assume that the remaining ‘non fossil fuel costs’ would not have been significantly changed for the counterfactual (Yarrow, 1992, p.11).³³ This view is supported by the fact that ‘non fossil fuel costs’ also include the costs of electricity generated from other sources (e.g. nuclear, imports or hydro), which have already assumed to be constant in terms of volume and price. For example the improved performance of the nuclear power industry would be included in this part of the analysis. The counterfactual assumes that this improvement would have happened even if privatisation had not occurred, since much of the improvement can be attributed to the solving of technical problems and the nuclear part of the industry was in public ownership for much of this improvement.³⁴

V. RESULTS

Combining the various elements of the counterfactual with equations 3, 4, 5 and 6, allows us to estimate the predicted electricity prices for continued public ownership.

³² This is a very conservative estimate of the cost savings that would have been achieved, but detailed information on the costs of privatisation was not available and hence a conservative figure was taken.

³³ Some costs would have risen but these might be offset by the cost elements that had fallen.

³⁴ In 1988, salaries, depreciation and local rates accounted for over 60% of non fuel costs, and this figure would rise when the other factors already mentioned are included (Electricity Council, handbook of electricity supply). Therefore, it would seem that the assumption on ‘non fossil fuel costs’ is a reasonable first approximation.

V.i Domestic Prices

Table 2
Domestic Electricity Prices, pence per kWh[†]

Year	Actual*	Predicted	% Difference
1988/89	6.17	6.06	1.73
1989/90	6.67	6.49	2.64
1990/91	7.34	6.75	7.97
1991/92	7.72	7.16	7.27
1992/93	7.70	7.09	7.92
1993/94	7.50	6.73	10.29
1994/95	7.46	6.31	15.47
1995/96	7.44	6.27	15.70
1996/97	7.14	5.68	20.51
1997/98	6.94	6.13	11.64

[†] In April 1994 VAT (Value Added Tax) was imposed on domestic electricity sales. This tax has been excluded for consistency.

* Source: International Energy Agency, *Energy Prices and Taxes*, various issues

Table 2 shows that privatisation has led to significant increases in the price of domestic electricity compared with those predicted for continued public ownership. Consumers have been paying significantly higher prices since 1988/89, which indicates that the privatisation process has had a large cumulative cost (in terms of price) to domestic consumers.

The size of the difference is particularly interesting because it suggests that the results presented in Yarrow over-estimated the price-increasing effect of privatisation. For example, Yarrow projected that without privatisation, domestic electricity prices would have been 25% lower in 1991 (Yarrow, 1992, p.23). The results in this estimate the cost for 1990/91 at only 7.97%. Moreover, Yarrow's less optimistic counterfactual estimates the cost at only 15.6%, which are still significantly higher than this has found (Yarrow, 1992, p.31). Another interesting observation is that the price differential peaks in 1996/97 and starts to fall after this time. This is because the actual price of domestic electricity continued its downward trend, while the predicted price of electricity actually broke its downward trend and started to rise.

Nevertheless with a difference still in the region of 11.64% in 1997/98, the results show that privatisation has had a substantial negative impact on consumer prices.

The results presented above (and in the rest of this section) are nominal prices. A second set of results were calculated using real prices, but these are not presented in this section because the nature of the results was not altered. The aim of this is to give an indication of the relative changes in prices caused by privatisation. To present results using real prices might imply a level of accuracy in terms of the absolute level of real prices, which would be unwise given the nature of the methodology employed.

V.ii Industrial Prices

Industrial electricity prices show a similar story to domestic prices although the price differential is lower.

Table 3
Industrial Electricity Prices, pence per kWh

	Actual*	Predicted	% Difference
1988/89	3.73	3.62	2.86
1989/90	3.98	3.81	4.33
1990/91	4.11	3.68	10.41
1991/92	4.32	3.93	9.14
1992/93	4.55	4.12	9.36
1993/94	4.38	3.95	9.85
1994/95	4.34	3.80	12.52
1995/96	4.19	3.65	12.88
1996/97	3.95	3.39	14.26
1997/98	3.91	3.66	6.48

* Source: International Energy Agency, *Energy Prices and Taxes*, various issues

It is interesting to note that the difference between the actual and predicted price in the industrial sector has a flatter distribution than domestic prices, peaking at only 14.26% compared with 20.51% for domestic prices. This might reflect the fact that the market to

supply large users was open to competition from the beginning, reducing the market power of individual firms. The results for industrial prices are closer to those of Yarrow's preferred counterfactual. For example, Yarrow's main prediction is that industrial prices would be 18.9% lower in 1991 (Yarrow, 1992, p.23), while his alternative set of results indicated they would be 7.9% lower (Yarrow, 1992, p.31). Table 3 shows that our model predicts that industrial prices would have been 10.41% lower in the 1990/91. It is also interesting to observe that the price differential peaks in 1996/97, the same year as the peak in the domestic price differential. The price differential has also fallen substantially in 1997/98, to 6.48%, which is nevertheless a significant amount. The predicted figure for 1990/91 seems to dip in comparison to the surrounding years, which leads to an unexpectedly large differential. The reason behind this is a dip in the 'non fossil fuel costs' and the cause appears to be a quirk of the methodology and its interpretation of events.

V.iii Price Ratio

It is also interesting to compare the ratio of industrial to domestic prices, as this shows how privatisation has affected the relative price of electricity, and thus which group bore the most burden.

From Table 4 (overleaf) it can be seen that the predicted results follow roughly the same pattern as was actually observed under privatisation; i.e. industrial price falls as a proportion of domestic price. It is interesting to note that the predicted ratio is slightly below the actual ratio for the first half of the period of interest, although it closely follows the general pattern actually observed. This indicates that the predicted series has lower industrial prices relative to domestic prices than were actually observed. After the first few years following

privatisation, the pattern is reversed so the actual ratio shows industrial prices falling relative to domestic prices, whilst the predicted series suggests that relative prices would remain roughly constant. These results indicate that domestic consumers suffered the most from privatisation, since the price they faced increased by relatively more than industrial prices. This is consistent with the structure of privatisation, as it created a competitive market to supply larger (industrial) consumers but retained the Area Boards' local monopoly over supply to small (domestic) consumers during the period of interest.

Table 4
Ratio of Industrial to Domestic Prices (i.e. Industrial/Domestic Price)[†]

	Actual	Predicted	% Difference
1988/89	0.6045	0.5976	-1.15
1989/90	0.5967	0.5864	-1.73
1990/91	0.5599	0.5451	-2.65
1991/92	0.5596	0.5483	-2.01
1992/93	0.5909	0.5817	-1.56
1993/94	0.5840	0.5869	0.49
1994/95	0.5818	0.6021	3.50
1995/96	0.5632	0.5820	3.35
1996/97	0.5532	0.5967	7.86
1997/98	0.5634	0.5963	5.85

[†] Domestic prices exclude the effect of VAT which was imposed in April 1994 on domestic electricity sales.

V.iv Sensitivity Analysis

When dealing with methodology such as that used in this Chapter, the exact results calculated will, to some extent, depend upon the author's individual interpretation of the specific events investigated. It is therefore desirable to proffer the preferred results within the context of a potential range, in order to show how sensitive these results are to differing assumptions. In order to accomplish this, the preferred results for domestic electricity (as presented in Tables 2 and 3 above) have been calculated together with two, more extreme scenarios. The 'pessimistic' series assumes a counterfactual that takes a more negative view of CEGB performance and events. This includes factors such as slower reductions in employee

numbers, higher fossil fuel prices and a higher profit target. The ‘optimistic’ series takes a more positive view of CEGB performance and events, so includes factors like lower fossil fuel prices, more aggressive reductions in the labour force and lower profit targets. (N.B. a brief summary of the key differences of the ‘pessimistic’ and ‘optimistic’ counterfactuals can be seen in Appendices G and H respectively).

Table 5

Domestic Electricity Price Counterfactual Comparisons (in pence per kWh - % difference to actual in parentheses)[†]

	Actual*	Preferred	Pessimistic	Optimistic
1988/89	6.17	6.06 (1.73)	6.13 (0.61)	6.01 (2.61)
1989/90	6.67	6.49 (2.64)	6.61 (0.87)	6.43 (3.58)
1990/91	7.34	6.75 (7.97)	7.04 (4.13)	6.59 (10.22)
1991/92	7.72	7.16 (7.27)	7.48 (3.10)	7.02 (9.13)
1992/93	7.70	7.09 (7.92)	7.49 (2.73)	6.95 (9.69)
1993/94	7.50	6.73 (10.29)	7.12 (5.04)	6.49 (13.45)
1994/95	7.46	6.31 (15.47)	6.70 (10.19)	6.06 (18.73)
1995/96	7.44	6.27 (15.70)	6.75 (9.30)	6.03 (19.01)
1996/97	7.14	5.68 (20.51)	6.14 (14.0)	5.42 (24.14)
1997/98	6.94	6.13 (11.64)	6.60 (4.86)	5.85 (15.66)

[†] Prices exclude the effect of VAT which was imposed in April 1994 on domestic electricity sales.

* Source: International Energy Agency, *Energy Prices and Taxes*, various editions.

Table 5 shows that differing assumptions within the counterfactual can produce substantial differences in the results. The contrasting extreme counterfactuals show a similar trend and distribution to the author’s preferred counterfactual, without changing the indication of the results. The main difference between the series is the size of the differential achieved during the period of interest.

However, by calculating this analysis of the domestic price, we have illustrated that even when using an extremely pessimistic view of possible CEGB performance, prices in the privatised industry would seem significantly higher than those that might have been charged by a publicly owned industry. Indeed, the extremely optimistic series shows the differences

to peak at a massive 24.14% in 1996/97, although the results of the preferred series (e.g. 20.51% for 1996/97) are favoured by the author. A similar sensitivity analysis was also conducted on industrial electricity prices, but this showed similar results to the analysis on domestic prices and so was felt to be of little value.

V.v Beyond the Study

The results presented above indicate that the differential between actual prices and those predicated for the counterfactual narrowed in the last year of the study. We believe that it is likely that this process would continue after the sample period for a number of reasons. The price controls for the years after the study are significantly stronger than those imposed in the early part of the 1990's, which should ensure that the actual price of electricity continues to fall. In addition, in September 1998 the market for electricity supply was fully opened to competition (OFFER, 1998, p.17), which should provide additional downward pressure on actual electricity prices in future years. The counterfactual price of electricity might be expected to fare less well since some of the older coal fired stations would have to be replaced with new gas fired plant. It would therefore be expected that the actual price of electricity will decline relative to the price that might be charged by a publicly owned industry. Indeed, it is not impossible that the situation will be reversed, and that the privatised industry would provide the cheaper electricity.

VI. CONCLUDING COMMENTS

Building a counterfactual for likely actions of a publicly owned electricity sector, we have shown that privatisation has resulted in prices significantly above those that might have been charged had the industry remained in public ownership. By concentrating on price alone, this

Chapter restricts its analysis to consumer surplus, while welfare as a whole is constituted by consumer and producer surplus. Since it has been assumed that the amount of electricity sold remains the same (i.e. own price elasticity of electricity is zero), the effect of privatisation has been to reduce consumer surplus while the effect on producer surplus, and hence total surplus, is indeterminate. However, it is observed that profits have increased dramatically since privatisation, while at the same time a significant part of the industry has been sold to foreign utility companies, transferring a notable amount of these profits out of the country. When the producers were domestically owned, some of the profits and hence producer surplus would be transferred back to the consumer in the form of dividends, but now any dividends would accrue to the foreign owners.

The result might have been different had we not assumed that the own price elasticity of electricity was zero, but instead allowed both price and quantity to vary. For example Brenton's (1997) estimate of an elasticity of -0.7 for rich countries, together with decreased domestic prices of 20.51% (1996/97) would have resulted in demand increasing by 14.36%.³⁵ This changing price and demand would clearly have affected the size of total surplus and thus would have given a better indication of the desirability of privatisation.

This Chapter also concentrates entirely on the electricity sector when evaluating privatisation and thus does not take into account any spillover effects on other markets. For example, electricity privatisation has had a considerable impact on the British coal mining industry, since it has caused a precipitous decline that might otherwise have been avoided. Therefore

³⁵ Although elasticity estimates, and hence quantity changes, are not likely to be stable for such large changes

electricity prices should only be one element of a wider picture when analysing the success or failure of privatisation.

However, despite their limited scope, the results presented clearly indicate that privatisation may well have resulted in prices that are significantly in excess of the prices that might have been charged with continued public ownership. This would imply that privatisation has failed to live-up to the promises of successive governments, who have stated that consumers have benefited from this process. Indeed the results also intimate that it is the domestic consumers who have born the heaviest burden, since they have endured the higher relative price rises. This bias is also borne out in the analysis of industry profits, which reveals that sales to domestic consumers account for 61.65% of total profits but only 35% of sales.

Since electricity prices appear to have been ‘excessive’ since the late 1980’s, the cumulative cost to both consumer groups of this privatisation inadequacy is significant. Calculations using the results presented indicate that by 1997/98 consumers have paid an additional £16,134 million in electricity charges.³⁶ It would seem that the cause of these high prices can be broadly attributed to the specific structure of privatisation and the subsequent operation of the market it created. Future privatisations in Great Britain, or elsewhere, take note.

³⁶ This figure is calculated by using the yearly price differential indicated by the preferred counterfactual series multiplied by the amount of electricity sold in each year.

CONCLUSION

CONCLUDING COMMENTS

I. OVERVIEW AND SUMMARY

In light of recent corporate scandals surrounding the likes of Enron, Worldcom and Tyco, we sought to add to the debate first started by Berle and Means (1932) as to how corporations are governed and by whom. Our core premise was that only when all interested groups have the ability to assert influence on governance, might outcomes be framed as truly representing the public interest. The central concern of Part One was therefore the current governance mechanisms of corporations, whether these lead to public interest outcomes, and thus appropriate public policy responses.

Part Two pursued a related line of research on privatisation. Whilst there was some tension between these two avenues, privatisation is fundamentally about governance since it is the transfer of activities from the public sector into the private sector, and therefore from public to private control. Moreover, privatisation is a process during which many changes often occur. As we have demonstrated by reference to electricity reform in Mexico, it therefore presents an opportunity to make the fundamental governance changes as suggested by the first line of our research. In making such fundamental changes, lessons need to be learned from existing or recent privatisations, and it is this that was the second focus of our research.

I.i Part One: Public Interest Decision-Making

After introducing the concept of strategic decisions, we suggested that because these decisions determine the broad direction of a corporation, to control them is in essence to control the firm. This result was then positioned within the context of existing literature on the nature of corporate control as conceptualised in the world's major economies. We concluded that even

though significant differences exist between the corporate governance systems examined, the central result is the same. Shareholder power rests with a small group of inordinately powerful shareholders, who together with higher management and the board of directors, form a select few who control the strategic decision-making process, and by extension, the corporation.

Using utility companies as a practical illustration, we then explored the significance of the modern corporation being controlled by an elite. We suggested that preferences over strategic decisions vary between those who have an interest in the activities of a particular company, and given self-interested decision-making, this implies that the elite will take decisions in their own best interests and thus not those of the wider public; that strategic failure exists.

To address this concern, we examined a number of policy measures that might be taken to ensure companies serve the public interest. Our main suggestion was to increase participation in the decision-making process; to democratise decision-making. One possibility raised was that companies be controlled by their members, where members consist of all of those different groups who have a specific interest in the activities of a particular company. More immediate ways forward were also considered.

As a practical illustration of these ideas on economic democracy, we then considered the topical case of electricity reform in Mexico. One avenue for privatisation was presented which sought to marry economic efficiency with principles of democratic decision-making. Our specific idea was that Mexican pension funds have the potential to play a key role in such

a process, although direct input from ordinary citizens via a variety of channels and mechanisms, is also vital.

In order to provide a contrasting illustration of our conclusions on governance and the public interest, we then switched focus from the example of utility companies, to consider corporate universities. After investigating the nature of these organisations, we drew upon an original survey and telephone interviews concerning the corporate universities of the FTSE 100 companies in order to investigate the possibility of their elite control. Our findings suggested British corporate universities are controlled by a subset of those with an interest in their activities and that this subset is closely associated with the elite controlling their parent company.

In short, Part One utilised the strategic decision-making approach to the theory of the firm to re-visit the topic of corporate control so as to gain new insight into the nature of appropriate public policy.

II.ii Part Two: British Electricity Privatisation

In Part Two, we turned our attention to the reorganisation and privatisation of the electricity sector in Britain, in order to explore some practical lessons to be learned from past privatisations. After introducing the British electricity sector, we considered a number of aspects surrounding the emergence of the so-called independent power producers (IPPs) in the market of England and Wales. Original telephone interviews with those closely involved with the IPPs were heavily utilised within this investigation. The evidence presented suggested

that these IPPs have not done the job that they were originally intended for, but have instead had a number of unforeseen consequences.

In order to investigate the issue of privatisation and electricity pricing, we then developed a counterfactual scenario for the likely decisions of a publicly owned industry. This counterfactual allowed comparisons between the prices actually observed and those that might have been charged had the industry not been privatised. Our conclusion was that observed electricity prices are significantly higher than those that would have been charged had the industry remained in public ownership. Furthermore, we found that domestic consumers were especially unfortunate in that the cost differentials in this category were significantly greater than for industrial users.

In short, Part Two examined aspects of electricity reorganisation and privatisation in Britain, in order to gain lessons for future reforms in this sector. The issue of independent power producers in England and Wales was investigated, as was the effect of privatisation upon the electricity prices charged to final users.

II. FUTURE RESEARCH POSSIBILITIES

II.i Immediate Concerns

The application of the strategic decision-making theory of the firm has given new insights into the control of modern corporations, and thus their impact upon society. The possibilities for future research in this area are therefore numerous. Most obviously, further sector specific investigations are required in order to develop our understanding of the exact nature of elite control in different contexts, countries or industries, or to explore how principles of

democratic decision-making might be practically implemented in different contexts. Consequently, additional policies might be devised which will more effectively engender democratic decision-making (either in those specific contexts, or for application more widely).

Furthermore, investigations into the success (or failure) of implemented measures to broaden the governance of corporations are also warranted so that lessons can be learned as to what policies work and what do not. In this regard the future of the British not-for-profit railway infrastructure company, Network Rail, is especially interesting given that it includes public interest members (although it remains to be seen what their function will be in practice). Investigations of similar examples in other countries is also an attractive possibility.

These two extensions to the work contained herein are our immediate concern, but one attractive possibility is to explore the boundaries and extent of strategic decisions, the process by which such decisions are made in these contexts, and thus their wider impact upon society.

II.ii Strategic Decision-Making Beyond the Modern Corporation

The focus of this dissertation has been on strategic decision-making within the modern corporation. However, we believe that strategic decision-making is neither confined to the modern corporation nor merely to the traditional concern of production, since all forms of organisation require governance. We therefore suggest that many non-corporate institutions and organisations will take strategic decisions as a habitual part of their activities. Without such decisions to (amongst other things) establish the broad plans to guide them, such institutions and organisations would lack focus and direction, given that they could not have

any clear aims or goals for activities with which they are associated. For example, charities have to decide upon which causes to support and how to generate the associated funds, publicly funded schools and universities have to decide how to best use their limited resources, and foundations have to decide upon how to invest their endowments.

The significance of strategic decisions within the non-corporate sector would seem to be very similar to their connotation within the corporate sector. Different interested groups will be differently affected by all the possible strategic decisions, and will therefore have their own preferences over which should be taken. Given the standard economic assumption of self-interested behaviour, to control the strategic decision-making process of a non-corporate entity is to control the impact of that organisation upon society. Strategic failure may therefore not be confined to the corporate sector but could instead extend to any organisation or institution that habitually takes strategic decisions.

The investigation of the decision-making structures of non-corporate entities is therefore a natural extension of the work contained herein. Furthermore, situations where corporate and non-corporate organisations or institutions interact may have additional significance. In line with these ideas, one potentially interesting avenue for further study that we aim to pursue is the specific case of the Health Industry.

II.iii The Health Industry

Personal health, or indeed the health of a society more generally, might be seen as being fundamental to life, given that without it, individuals are unable to fulfil their economic or social potential. Consequently, healthcare provision is integral to positive freedom - the

ability to be a someone, a do-er deciding, not an individual being decided for (Berlin, 1969). It might therefore be regarded as a particularly important sector, and accordingly, one that merits immediate consideration in terms of democratic decision-making.¹

Following Di Tommasso and Schweitzer (2001), the health industry might be viewed as consisting of all the corporations and other institutions or organisations that are in some way involved in healthcare related activities. Our previous conclusions as to the governance of corporations are therefore of relevance, but they need to be supplemented by investigations in to the strategic decision-making processes of the non-corporate elements, such as public or not-for-profit hospitals, private trusts and charitable foundations. The interaction of the corporate and non-corporate elements might also warrant further investigation.

The possibility of applying a strategic decision-making approach to the governance of this sector is evident, given the number of corporations involved and the fact that strategic decisions are readily observable in the non-corporate settings. For example, in countries where the university sector is state funded, the decision as to how many doctor, nurse or other medical training places to support is a strategic decision that takes place outside a corporation. The number of staff trained will have a significant impact upon the ability of the health industry as a whole to provide appropriate medical services. Without a continuous supply of new staff, the industry would be unable to fulfil its obligation of providing medical care to local communities. Indeed, a similar situation also exists in hospitals where various different types of appointments exist. The number of appointments available, and the balance between medical professionals who are continuing their education and those who have special skills to

¹ The amount of resources devoted to healthcare also highlights the significance and importance of this sector. The United States, for example, spent 13% of GDP on health in 2000, whilst the same figure was 10.6% in

teach, again determines how the industry is able to provide its services both now and in the future. Other examples of strategic decision-making in the corporate and non-corporate parts of the health industry are also easily discernible.

The variation in interests surrounding the choice of strategic decisions is also readily observable in the (corporate and non-corporate parts of the) health industry. Consider, for example, the election of Richard Taylor to the British parliament, for the constituency of Wyre Forest. Taylor, standing for the Independent Kidderminster Hospital and Health Concern Party, was protesting against the downgrading of the public hospital in Kidderminster, and the relocation of its accident and emergency unit to a hospital 12 miles away. Dr Taylor's unhappiness with this strategic decision was clearly widely felt in the local community, because the incumbent Labour party (which formed the national government, in turn controlling the hospital in question) saw its 26,843 votes in the previous election in 1997 (which gave labour a majority of 6,946) collapse to just 10,857 votes, giving Dr Taylor a massive majority of 17,630.² A significant number of local people clearly held a view of the strategic decision to downgrade Kidderminster hospital, a view at odds with that of the actual decision-makers.

Within a broad topic such as the governance of the health industry, the detailed analysis of particular features or aspects might be seen as being appropriate. Current evidence suggests that one potentially interesting option would be an investigation of the governance of the healthcare sector of England and Wales. Hutton (2000, p.1) reports on a survey carried out in March 2000, which indicates that 63% of people questioned thought Britain's National Health

Germany, 9.3% in France and 7.3% in the UK (OECD, 2002).

² See "Doctor wins by healthy margin in Wyre Forest", *The Times*, June 8th 2001.

Service (NHS) to be the ‘most valuable institution’ in the country.³ However, only 4% of people thought that the NHS provides a good service that cannot be improved, whilst 62% believed that it requires to be improved ‘quite a lot’ or ‘needs a great deal of improvement’ (Hutton, 2000, p.3).

The relevance of this to our focus on control and decision-making is that for such a treasured national institution, only 36% of the people surveyed believed that the NHS was run ‘in an open way and consults the public’ (Hutton, 2000, p.126). This indicates that strategic decision-making within the NHS might not be democratic, but could rather be the preserve of an elite. Indeed, 77% of people thought they had little or no power over their medical treatment, whilst 55% of people thought they should have a lot of power in this respect, and only 3% of people thought they should have no power at all (Hutton, 2000, p.5, p.126/127). These apparent concerns with governance, and the fact that the British government has committed itself to a period of reform and increasing NHS spending by 6.1% in real terms (Hutton, 2000, p.3), make this an especially interesting and topical case for investigation. Comparisons with other countries might also be beneficial. In line with this, specific research possibilities exist surrounding the success or failure of the proposed ‘foundation hospitals’ in England and Wales, which will be independent not-for-profit organisations accountable to the communities in which they operate.⁴

³ As Hutton (2000, p.1) outlines “the NHS is tasked to provide equal care to every British citizen on the basis of their equal need, irrespective of where they live or how much they earn. The service is publicly owned and accountable, and is almost wholly financed by general taxation.” Moreover, it is interesting to note that the next highest institution after the NHS in this poll was Parliament, with only 12% of people voting this the most valuable.

⁴ See <http://news.bbc.co.uk/1/hi/health/2564281.stm>

II.iv Electricity Privatisation

Given the importance of a privatisation as a policy (both in terms of a mechanism to increase democratic control but also as a widely implemented current industrial policy), further investigations and analysis of past or proposed privatisations are also an attractive possibility for future research. Similar investigations to those contained herein could be conducted on electricity privatisations in other countries, or within the contexts of other (utility) industries, both within the UK and in other countries. Furthermore, given the continuing changes and evolution of the British electricity industry since privatisation, other research possibilities exist within this sector. To name two out of any number of possibilities, the effects of NETA (New Electricity Trading Arrangements) needs to be further analysed (perhaps within the context of possible democratic privatisation solutions), or the current difficulties experienced by the nuclear generation sector suggest the need for a focussed investigation.

III. FINAL THOUGHTS

We have raised a number of crucial issues herein, and the implications of these are both significant and numerous. Most prominent amongst these is the nature of elite control of the corporation and perhaps other organisations, and the need to address this by broadening participation in the governance process. Whilst we have suggested some ways that this might be achieved, it is imperative that they are developed further, and other avenues and possibilities be explored. This exploration needs imagination and originality if it is to be the innovative and iconoclastic process required to make public interest decision-making a reality. Hopefully we have provided the foundations for such a process, or at the very least, highlighted the need for it.

While many of the issues and/or implications raised by the work contained herein are important and might be discussed at some length, one that warrants special and immediate comment is the implied importance of education. Citizens need to be appropriately educated, encouraged and nurtured so that they can think about, develop and penetrate the governance processes that impinge upon their lives. It would be relatively meaningless at best, or counterproductive at worst, if civic society were to (be allowed to) participate in governance processes if they did not have the education required to make a meaningful contribution.

The enablement of society should therefore not be seen as simply extending the right to participate. It also needs to include the provision of appropriate (formal and informal) mass education and learning, based around the intelligence of each and every person, on the nurturing of active citizens with the ability to think about and therefore participate fully in the governance processes. Recognising this, new potential may be unlocked, leading to unexpected possibilities and new outcomes, not only for corporations but also for individuals and for society. Only such appropriately educated and active citizens can demand and assure that good governance prevails. They are the key to a free economy, to an economy governed in the public interest.

APPENDIX A

Defining a Corporate University

Table A1

A Summary of Meister's View of the Key Differences Between a Training Department and a Corporate University

Training Department		Corporate University
Reactive	Focus	Proactive
Fragmented & Decentralised	Organisation	Cohesive and Centralised
Tactical	Scope	Strategic
Little/ None	Buy-In	Management and Employee
Instructor-Led	Delivery	Experience with Various Technologies
Training Director	Owner	Business Unit Managers
Wide Audience/ Limited Depth	Audience	Customised Curricula for Job Families
Open Enrolment	Enrolment	Just-In-Time Learning
Increase in Job Skills	Outcome	Increase in Performance On-The-Job
Operates as a Staff Function	Operation	Operates as a Business Unit
"Go Get Trained"	Image	"University as Metaphor for Learning"
Trainer Dictated	Marketing	Consultative Selling

Source: Meister (1998b), p.23

Table A2

Meister's General Organisational Principles and Goals for a Corporate University

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|--|
| <ol style="list-style-type: none"> 1. Provide learning opportunities that support the organisation's critical business issues. 2. Consider the corporate university model a process rather than a place of learning. 3. Design a curriculum to incorporate the three Cs: Corporate citizenship. Contextual framework, and Core competencies. 4. Train the value chain, including customers, distributors, product suppliers, and the universities that provide tomorrow's workers. 5. Move from instructor-led training to multiple formats of delivering learning. 6. Encourage leaders to be involved with and facilitate learning. 7. Move from a corporate allocation funding model to one 'self-funded' by the business units. 8. Assume a global focus in developing learning solutions. 9. Create a measurement system to evaluate outputs as well as inputs 10. Utilise the corporate university for competitive advantage and entry into new markets. |
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Source: Meister (1998b), pp.30/31

APPENDIX B

Corporate University Interviews

Table B1

The Core Questions used in the Semi-Structured Telephone Interviews

- Can you tell me what your company does in the area of Corporate Universities (CU)? How long has your Corporate University (CU) been in operation?
- What was the thinking behind your company's decision to create a CU?
- Why not use an existing university to provide the training needs of your organisation?
- Is your CU run totally separately from the parent organisation?
- What is the structure of the CU?
- Is it simply to provide training, or is it directly integrated with the company strategy, implementing this in the way it is organised, and executes training and/or research?
- Who is your CU aimed at?
- Does your CU accept students from outside your organisation?
- How does your CU work? What sorts of courses does it offer?
- Does your CU provide any widely recognised qualifications, e.g. BSc, MBA?
- If so, by whom are these certified?
- How are the contents of these (or other) courses agreed upon?
- Who teaches on the courses run by the CU?
- Does your CU engage in active research? If so, who determines the research agenda?
- Are researchers allowed to publish/make known the results of research conducted, in the normal academic way?
- Is there any significance to the name you have chosen for your CU?

Transcript of Interview with John Smith of XYZ Group plc¹

Rob = Interviewer

John = Interviewee

Greeting, introductions and permission to tape interview received.

Rob OK, if we can just sort of start off with the focus of the university. In that handout you said it was just for [company name] – is it the case that it is literally just the staff of the group or can any partners as it were join in?

John At the moment it has to be – one of the rules if you like by which we are allowed to call ourselves a university is that we are not allowed to trade as a university which means we can't offer our services outside those who work for [company name].

Rob You said the rule – whose rule is that?

¹ The names of the interviewee and company have been changed in order to protect the identity of those concerned.

John Governmental rule. We spoke at some length with the department for education as it was at the same and said look, this is what we want to do, are there any rules..... because actually the use of the term university is quite jealously guarded by the universities. They are scared of young whipper snappers coming in and sort of calling themselves universities when they are not. In order to do that, we had to confirm that one, we would only make things available to people working within [company name] and secondly that we wouldn't issue any qualifications in our own name, so you can't get a degree from the University for [company name].

Rob OK, but you do do courses where you get a qualifications from external

John We will work with academic universities to produce courses, yeah.

Rob When you say work with them, does that mean you have a partnership with a particular one, and they just accredit or are they involved with the teaching and delivery?

John They can be involved with the teaching and delivery. With the University of Warwick for example, Warwick Business School, we do quite a lot of work with them on the operations area and they are a very good – that is not your university is it?

Rob No, I am at Birmingham but I was at Warwick before actually.

John Ahh, right, OK. They are very good on the operations –they are one the best operations management universities that we have got in Britain. Between us and them we have worked an operations management course together which does involve some teaching from Warwick and some teaching from our own people and some access to web based learning etc. etc. But ultimately it produces a University of Warwick and University for [company name], if you like, a shared qualification but it is in the name of Warwick University.

Rob OK, I have got you. That seems like quite a high level qualification...

John Yeah that is an operational management certificate. It is really horses for courses Rob. We will work with any awarding body if we think it is appropriate. We don't need to work with an awarding body. We are big enough as we are to We can produce certification or a certificate of learning to confirm that someone has been through a University for [company name] course, but it is not something that you quote on your CV as such. But we work with for example, City and Guilds to produce a customer service qualification, we work with the institute of financial services and chartered insurance institute to produce some of our sales financial consultant qualifications – those are externally qualifications that any financial consultant working in any financial arena has to have. We have worked with Sheffield Hallam University to produce a coaching qualifications, so there is a lot of them but we don't feel that we have to. It is actually quite an expensive way to go about it, and we need to be sure that the money we are spending is – the greatest possible benefit for the greatest number of people type of approach.

Rob So it is getting, as the Americans would say, “as much bang for your buck” as you can as it were?

John Yes absolutely.

Rob In a sense I can see that is one of the objectives and I can see that on the sheet, and the second one you said was to develop a closer link between learning etc. and the needs of the business. Were they the only two goals behind the decision?

John Essentially yeah. What happened, to slightly go back a bit in the history which we perhaps didn't go into in the sheet, when [company] and [name] bolted themselves together in, well it started in 1995 but it really happened in 1997/98, we decided that we needed a new training strategy for the new merged group and we needed a training strategy that was new and different and vibrant and didn't really look back in either direction to old [company] or old [name]. At the time the University for Industry was just setting up and the whole concept of life long learning and the learning age document which presumably you are aware of and have had a look at, and the Corporate University movement, if you like, was just beginning to get a foothold in the UK. There were about 4 or 5 of them in those days – they were places like British Aerospace, Unisys and Motorola, and Unipart, so there weren't very many. We had a look at them and we decided that this was the way that we wanted to go and we were adamant that wanted to call ourselves a university because it was different and because we did want to make a stamp. The term university was more about the fact that it was universal - it was using the term university in its widest sense so it was a university that everybody could go to. So from someone coming into the bank as a brand new entrant, I think it is quite a powerful message for them to hear that the first they are going to receive is some development through something called the University for [company name].

Rob OK, so in a sense you could perhaps put a third point on the objectives, to show this to your staff as a positive thing?

John Well, there is something around profile. There is also something around managing and developing talent. That sort of got added on afterwards – on the sheet you got some details around the centre for career management and career management activities that we sort of got involved in.

Rob I guess going back to the point about the business needs - how are they reflected in the University then? You mention there was a close link but how was that close link fostered?

John I think the thing that articulates that the best is the way we govern the university, and that is the strategy board which consists of half a dozen directors who are either on the main board or one stop removed from the main board and they are there as a business representation to make sure that we have an overall university and learning strategy and agenda that meets what the business wants.

Rob OK, so the learning is very much guided by what the business needs....

John so the learning is very much guided by the direction in which the business is going, and then developing and subdividing if you like, all the key learning areas into what we call faculties and then appointing again a senior director as a head of each of those faculties in a sort of honorary capacity but we do expect them to work for the money. Well we don't pay them any money but they do have to work for the title.

Rob OK, so they have to integrate what their business needs into

John So they then have to be aware of the needs of the business but it is the group wide needs of the business not just the function they serve. So for example, we have a faculty of IT because we can see that the need to be able to develop IT skills and capabilities is important for us going forward. The head of the that faculty is the chap who is the director of group IT, so again one stop off the board really, but we have to be careful to make sure that he doesn't develop, or try to develop, that faculty only to suit his own people, i.e. the people that are specialists working in IT. It is as much there for – we keep sort of referring to this poor lady, Betty, in Banbury. She must be incredibly busy because she keeps getting all the training we are forever talking about, but we have got to be as aware for poor old Betty that she needs IT skills as somebody who is sitting in an IT department needing to develop programming or architectural skills.

Rob OK, I see. So is this strategy board the head or is there a single figurehead of the university?

John There is a head of the University.

Rob OK, who do they report to?

John They report to the group HR business director, who is effectively the group HR Operations director in most other parlance.

Rob OK, so basically the head guy is very senior

John Yeah.

Rob You mention there about having faculties and so on. That is sort of seems to be the normal phrases for what I would call a more traditional university. Would you say the it is set-up is fairly traditionally university orientated or is it quite business perhaps

John There are reflections of an academic university in that as I say, we have faculties, we have a curriculum framework that we operate, but in some respects that is pretty much there are the top level for the way we choose to govern the university. We try very hard not to use those terms if we can help it when we are talking to Betty in Banbury because she has probably never been anywhere near a university and probably doesn't actually feel comfortable using that terminology. So when it is actually made manifest

to her, what she will still see is – it is still called University for [company name] but she will see learn about IT or learn about operations, or something like that. It will make some, maybe oblique reference to the fact that there is a faculty of operations that is running all this, but it is actually learn about what operations is all about and how operations is required in your job and how you can get better at it.

Rob OK, got you. I am fairly curious then as to what you see as the main difference between an academic university as you have just described it and your university? You said you were keen to use this term.....

John I would say that there are two main differences. One is the ability to award qualifications in your own right, and the other is probably around research. We do an element of research but we certainly don't...., I wouldn't say, where as a academic university would sort of exist for the furtherance of the theoretical of research into learning, we don't indulge too much into that other than where it is a by product of what we are doing anyway.

Rob OK, so the research is the real perhaps difference as it were?

John Yes, I would say so. We link in to pieces of research and in order to stay ahead of the field we need to keep pretty much abreast of what the big issues are but you wouldn't find us, for example, setting up a piece of work specifically researching into, I don't know, the way people learn or something like that. What we will do is maybe found out what the research is about the way people learn and then we may then use that as a catalyst as the way we develop things internally, but ultimately we have to bear in mind that we are hear to make people in [company name] better at what they do.

Rob So it is more of a training function as it were than a knowledge generator?

John No I wouldn't say it is a learning function because we are making many more things that are available to our people than pure training.

Rob OK, yeah, but it is generally improving the skill level of your staff?

John Yes, in that respect, yes.

Rob You said you do, do a little bit of research, I was just curious, generally speaking, as someone who works in an academic university there is quite a bit of freedom into how you pursue that research. Would you say that people involved in your university have that same freedom or is it very much

John To an extent. It depends on the role I think. I am probably more involved with that then most and I can probably choose the bits that I go for but I have to justify what I am doing. No one is going to ask me why are you going to that meeting, but if I spend a lot of time..... one of the ways I do research is by looking at what other organisations are doing. I am not so fussed about what is coming out of academic universities but I am interested in what British Aerospace University are doing. I am interesting in how Rolls Royce are doing some of the things that they are doing, and I

am interested in getting around a table and talking to other users and other corporates who have got the same problems as I have, and finding out how they get around them. 9 times out of 10 I don't get much out of it but every now and then I get a little nugget that says, yeah actually if Rolls Royce are doing it that way and we are very close to doing that, then there is a very small step between us being where we are, and really taking things on a stage further.

Rob So it is very much focussed research, perhaps, on relevant on things that you can perhaps

John Yeah, we certainly wouldn't just follow a whimsy as it were in terms of our research. It would pretty much be something we would agree in conjunction with the faculty head or internally within the university as something we wanted to look at.

Rob So there is very much an accountability in your actions?

John I think so. I mean, one of the things we are looking at at the moment is the concept of learning to learn, for example. You know, how individuals, not just how they learn, but how they learn to be able to learn because there are so many different ways of learning now. Far more ways of learning than there were 5- 10 years ago. Web and even M learning, mobile telephone learning coming up and experiential learning is there more than ever and there is huge value in informal learning that people probably don't actually manage to realise quite how much of that they are doing.

Rob You mentioned about learning for learning – I remember that I talked to someone else who is involved in a Corporate University and they said they actually arranged for one of their staff to do a bricklaying course, not because that was particularly relevant to their business, but because they wanted to foster the whole learning ethos. Does your University subscribe to that?

John We don't to be honest. We've sort of danced around that. Ford and Rover are the two that come to my mind, particularly when Rover many years ago said right we are going to give all of our staff whatever it was, £200, and they can go off and learning basket weaving if they want to, and Ford did something similar a few years back. Now I don't know, maybe I am bit too hard nosed on this, but my view is that if they want to learn basket weaving they can go and do that at college in their own time but what I want to do is to make people better at their jobs and also more employable. There is a bit of me who says there is a lot of people at ford who went out and learned how to play golf – well now they have got an awful lot more time to play golf in and I bet they're perhaps wishing they had developed a few business skills because now they are out of a job, it might have made it slightly easier to get back into one. So, we have adopted, we have slightly bastardised the term lifelong learning and we use the term career-long learning within [company name], on the basis that we can't give you learning for life because you don't necessarily touch us for all your life. You know we have people who come in and stay with us for 6 months sometimes, you know, in a call centre environments and then go out. We don't want them to – we would like them to stay a bit longer but that is the nature of things. We have some people who are with us for 40 years, an entire career, so what we need to be able to do is to make

sure that as and when they do touch us, we provide them with the best quality development that a) makes them better at the jobs they are doing, but also gives them something to feel they have bettered themselves because they have touched us.

Rob It was interesting there that you talked about people dipping in and out and leaving or what have you. If you were giving people dipping in and out as it were, or leaving and what have you, if you are giving people accredited skills externally, those skills are fairly portable, I mean is there any way you try to lock those staff into you to make them stay as it were, as opposed to using the qualifications they get through you to move to a 'rival company (named)'?

John No not really. To be honest it is a frequent question that if you develop your staff that you are developing them up to leave, and no I am not actually. My view is that if you develop people up so that they could leave you, actually they won't, because a lot of people would rather work for an organisation that is going to give them development than for an organisation that isn't. So actually yes you are always going to find some people who go, but on the whole, people would prefer to work in an organisation where moral and motivation is high, and moral and motivation is highest in organisations that put a lot of time effort and money into developing the people.

Rob I guess I am taking quite a lot of your time here, but one final question. Going back to the very beginning you said about the term university and how hard it was for you to get that. I am just kind of interested in why you decided to go for that term as opposed to say, College for [company name]?

John We looked at all of them. We looked at College, we looked at academy, we looked at School. I don't know, I guess it was in a way flavour of the month. In some respects you know, in hindsight, was it a mistake and there are still some people within the organisation that still think the university is there only for the people at the top of the organisation. But it was really a case of making a statement of something that was very different, and college to me, or academy, they don't say anything different. I mean, BT set-up their university as an academy and to me BT academy doesn't say anything different to me from University for [company name] in terms of its connotations and I would rather be called a University than an Academy, so on that basis it felt, and still feels the best of the possible descriptions.

Rob So in a sense it is a branding issue?

John I think it is a branding issue and there was initially a lot of sniping even from within the organisation, in other words all you have done is re-branded training and development, and actually yeah we did and I don't apologise for the fact that it was to some extent a re-badging exercise but it was more than that. It need to be re-badged because actually what you had got out there at the time was a whole load of individual training departments in business units doing a whole load of things that were all branded differently, they all talked in a different language, they all looked different. So if you went out to a branch, and we did a bit of this when we did the initial research, and we asked people in the branches what did they think of the training you get, and they said we don't get much of it to be honest. Well why is that then? Well

we don't seem to get much – we were spending £30m on training people at that time. We are spending more now. The fact was that every time that training came down to them it looked different, and it didn't necessarily look like training. What is this then? That is not training, that is just to help me do my job properly. Well isn't that training? It was produced by the training department but because it came down looking just like a communication, it wasn't considered to be training. And they were saying that unless I am off my seat and in some sort of residential training centre, I don't consider it to be training. Well we can't train everyone like that – we have got 80,000 people and we can not put 80,000 through some sort of face to face residential training programme each year. We just don't have the money or resource to do it, and there are better ways of doing it, because you don't need to give people face to face training for certain types of development particularly if it is just around knowledge, so what is the case now is that everything they receive looks It doesn't look the same because we do make little subtle changes to it, but on the whole it will all have the overall branding pattern of the University for [company name].

Rob so it is presented in a way which makes people

John so it is all consistently presented so when you go to then now and say tell me about the University of [company name] they have usually got something they can point to and say it does that or does that. They may still not be using it, but a lot of them are – usage is very good and certainly the feedback we get through staff attitude surveys shows us that staff perception and understanding of a) of training available to them, of b) of accessibility of learning and c) in terms of something to manage their careers is significantly better than back in 1999 before we launched the thing.

Rob One final, final question here. You sort of just mention there the way the training comes through. I was just curious as to how it was delivered – before you said some of it was delivered by traditional university partners, but I mean is ever any of training ever delivered by managers working in the line or people already working in that job function?

John Very occasionally. In the main – we have reduced the number of instructional trainers, face to face trainers, over the last 2 or 3 years because we have been putting a lot of things through different routes. We have got multimedia PCs which are out there now, we have got around 2,000 of those that people can go and learn from a CD-ROM, probably without having to leave their branch, or certainly if they do, they would only have to travel for about 10 minutes to get to one, which compares to maybe leaving the office for a whole day to go to a face to face event. Both the staff and the managers are happy with that because they are not losing their staff for significant lengths of time. We have got a corporate intranet which we put a lot of e-knowledge really rather than e-learning down, or e-reference – it is little bite-sized pieces of learning that are just there. I am not sure I understand such and such. Well it is there and you can go on to the website and find out about it. You don't then to find a training course to learn that little bit. We are looking at a buzz word which I don't particularly like is blended solution which is taking what was originally a week long face to face intervention and saying well right OK, how much of that could we be doing in a different way. So we will say there is an awful lot of knowledge up front

and there is stuff at the end that is just reflecting and revising the stuff you have learned and that can be taken out. That can be done at the branch. That can be done over the web, it can be done through a work book, it can be done through CD-ROM or whatever, and you can say right so what we need then is a two day course for people to go away to that just looks at the behavioural side of things and gives people the chance to practice some of the behavioural skills and maybe a follow up workshop 2 or 3 weeks later just to check that these things are being embedded. So it reduces your face to face intervention from 5 days to 3 days or even 2 days sometimes, which means we can through-put more people because if you have got a 90 bed college, and we have got 3 of those, if you have got 1, 1 week course running your throughput is 90 people but if you can manage to put two courses at 2 days through each week and then suddenly your through put doubles so we are able to touch twice as many people by changing the way we deliver the learning.

Rob Interesting. How do you see the University developing in the future? Has it reached its plateau for the time being, or ...?

John No, I don't think it has. I think there is an element of consolidation that we do need to do but I think we need to – I still don't think that we have completely harnessed what technology can do for us. I still think there is something we can significantly work on in terms of managing the knowledge that we have available to us and reporting that information back to the business. There is an awful lot more we can do in terms of providing information, not just knowledge management but providing information to those that are governing the university. I don't think we have quite got that right yet so there is some sort of house-keeping bits we can improve. I think we can certainly look at One of the things we are having to do at the moment is integrate more parts of the group into the university because we have done it gradually so 2 or 3 big parts of the University for [a group company] for example is just coming in so that is a big piece of activity. So one of the things we are needing to do now is to have a better approach to our product management strategy because very time you integrate some more parts of the university you get all of the learning products that they have suddenly come into the central pot. Now we rationalise and rationalise and rationalise and then suddenly we get another lot and so we are going to have to go through another rationalisation. We are managing something like 400 products right now. I would personally want to get that down significantly – probably to halve it actually over the next 12 to 18 months into much more modular based programmes that fit with the way we develop the curriculum better.

Rob This really is my last question now – I know that [company name] isn't a purely UK based thing. Do you extend the facilities as it were to subsidiaries based overseas?

John Yeah we do. It is not a huge international organisation in the way that [rival company name] is, for example, but yeah the multimedia PCs we have got those available in Most of the international – certainly in S. America which is probably our biggest international presence. The Internet and group intranet are both available internationally. We very, very rarely will send a face to face trainer overseas because usually if it is face to face it is cheaper then frankly to purchase that thing locally and it probably has to be done in the local language anyway, because we employ quite a

lot of local workers. We don't have too many trainers who are fluent in Spanish or Portuguese to be frank to send them over to Argentina or Brazil.

Rob So there is some but not much?

John There is some but it is not considered a priority. Our priority is probably to get the 50 odd thousand people who work in the UK better at their jobs.

Thanks and goodbye

APPENDIX C

Electricity Privatisation Interviews

Table C1

The Core Questions used in the Semi-Structured Telephone Interviews

- How important was the structure of the electricity sector in your company's decision to enter the market for generation?
- Would your company still have considered entering the market if the structure had been different? If so, might have the size/nature of the involvement changed? (If possible, give a rough idea of how)
- More specifically consider privatisation with the following structures and indicate your company's possible response;
 - If generation had been privatised with 5 conventional generators?
 - If generation had been privatised with more than 20 conventional generators?
 - Generation structure privatised as the existing CEGB but with moves to make it easier for Independents to sell electricity into the system?
 - Generation unchanged with CEGB but National Grid separated and formation of electricity pool/spot market?
 - If the privatisation of the other electricity sectors had been different in some way e.g. The National Grid owned transmission and distribution networks?
- How would your answers to the previous 5 questions be affected if the same structure was used but the industry remained in public ownership?
- What about if direct bulk electricity contracts with the RECs were not allowed?
- What about if generation ownership by the RECs was prohibited?
- What about if there were limits on the capacity each firm could own?
- Was technology a factor in your decision to enter? What other factors were there?

Transcript of Interview with James Smith of PQR Electric Group¹

Rob = Interviewer

James = Interviewee

Greeting, introductions and permission to tape interview received.

Rob How important do you think the structure of the electricity sector was in your company's decision to enter the market for generation?

James Well I can tell you precisely why the company enter the generation market and it was down to the structure. The industry was split and the area boards evolved into the RECs, the CEGB was split into its numerous components of generators and transmission companies and the obligation to keep the lights on went to the RECs. The security standard as it was called was the obligation of the CEGB in the public

¹ The names of the interviewee and company have been changed in order to protect the identity of those concerned.

sector and this obligation transferred to the RECs. For that reason we became very interested in assuring that there was sufficient capacity in the system but also they wanted to ensure there was competitive pressure on the generators because at the time when the industry was privatised there were only two sources you could go to for your energy, NP and PG and so that structure made it important to the RECs to ensure that competitive pressures were brought to bear on them.

Rob Do you think this was the only factor or were there others such as new technologies making it easier to enter? Or was that just 'by-the-by'?

James The new evolving technology of CCGT made it easier for the RECs to enter having said that, most of the REC that went into generation entered it in partnership and probably at least one member of the partnership consortium would be an experienced operator of power plant. There is no doubt the gas fired plant is a lot simpler and made the technological decision a lot easier.

Rob Obviously that is coupled with the long term gas contracts which reduce the risk etc. to the individuals?

James Yes the long-term gas contracts were all part and parcel of making the projects financially - that was really driven by financing considerations.

Rob If that was unavailable would you think they would have not gone ahead if they could not have been financed on this loan basis?

James If the finance had not been available that would have made it much more difficult indeed.

Rob If the structure of the privatisation had been different would that have affected your decision; For example say there had been 5 conventional generators (instead of the 2) or 20 generators would that have reduced in your view the need to have this independent presence because potentially there would have been more competition in the generation sector?

James I think that in essence yes. 20 generators would probably be too many - there is just not enough plant to go around as it were or enough viable plant with a long-term future. If there had been more generators it may actually have precipitated a much more significant change in the structure of the industry. You may have found that instead of the RECs being privatised as RECs they may well have been combined with the remnants of the CEGB to form power boards.

Rob Like the situation in Scotland with Scottish Power and Hydro Electric, which are more vertically integrated?

James Yes that right vertically integrated. What you may have got in that situation, is from day one the structure we now see the industry is now moving towards. Eastern has generation has generation plant and was a REC, PowerGen has got East Midlands, National Power has bought the supply business of MEB so there is a number of

power boards creating themselves just through the market forces that have evolved over time. So I think your question needs to acknowledge the fact that if it had been 5 generators that had been created you would probably have caused the industry to be structured quite differently and for it to be 5 power boards. The number 5 is interesting because the CEGB had 5 regions.

Rob I did not know that.

James Yes it did: North East, North West, Midlands, South East and South West.

Rob So how did they operate - were they just centrally controlled?

James There was a central control with a senior man in each region/division and they were pretty powerful regions in their own right but of course it was co-ordinated centrally by the CEGB.

Rob So it was a means of controlling the system?

James Well the problem with that system is that there were 12 area boards at the time and so it would mean splitting the CEGB a single entity into 5 but it already had structure of 5 which that possibly wasn't going to be a problem. Area boards would need to be condensed down from 12 to 5 and those merged in with the CEGB regions and that would have involved a lot of redrawing of maps. It may have involved some re-jigging of the generation assets because each of the regions did not have an even mix of plant in them, so some regions might have had more nuclear than others some may have had more coal and some may have been dominated by oil and so there were asset split issues in that as well. And all those complications may have been part of the deciding factor that made it privatised the way it was.

Rob What do you think would have happened if they decided to sell it just like the CEGB as it was, with no restructuring at all so the RECs would have had to go to the CEGB for electricity - would that have encouraged you even more so to enter generation?

James I think it would have had other consequences first. I think it would have had necessitated the generation side to be price regulated. Now if that was price regulated that would then impact on whether we felt the need to go and invest in generation because the pressures are there - you have a regulator saying drive costs out of your business - it would probably have been an RPI-X formula.

Rob That would have perhaps have been the same if the national grid had been spun off or would you perhaps view that as the national grid is separate therefore we have better access to transmit electricity to everywhere and therefore it might be worthwhile us entering.

James It would have been the same answer really - if the CEGB had remained intact I think you would have found a different regulatory structure with price control on the CEGB. Whether we would then have felt the need to enter into generation is debatable even if we had access to the national grid or not.

Rob How about if the National grid owned all the overhead lines, so the national grid as it is now and also the distribution networks that you (i.e. the RECs) own now?

James That is an interesting one that. I think what that would have probably have done and it would have pushed generation and supply much closer from day one. The businesses in the electricity industry are essentially supply, distribution, transmission and generation. Transmission is the high voltages, 275 and above, distribution is the local networks so imagine its likes motorways right down to the 'B' roads, generation is obvious and supply is an odd one. It almost like an admin function - it's the billing and all that stuff that takes a wholesale price and converts it into a retail price for the customer. So in going through the supply side it has a basic electricity costs from generation, has the transmission costs added, the distribution costs added to it, IT costs, Billing costs and that converts it into a retail price. Now it's a very low margin business supply but a very high turnover. Now [company name]'s supply business probably turns over in excess of £1.5 billion but profits are measured in a few £10's of millions.

Rob So it perhaps would not have been viable to separate distribution and supply then?

James It would have been perceived as a very risky business and so if the wires business had been stripped out from the RECs, what remained (i.e. supply) probably could not have been floated on its own, so again it would have pushed you towards bringing together of generation and supply which is what we are seeing now.

Rob OK - could you not have argued that if you are going to combine supply with gas supply etc, just having one entity that does all the billing for the various companies would that not have been viable or would that again been too early?

James Again the gas market was not mature at that time - it wasn't open to viable and extensive competition at that particular juncture so the infrastructure was not there to bring those two things together but you are right and that is why they are coming together now. That is why you see the merger of the various companies as they try and reduce costs and get critical mass. Certainly in supply where margins are very low, critical mass is important.

Rob What about if all this still remained within the public sector, apart from the RECs which were floated off and the CEGB etc. remained within the public sector. Would it again be the case that you perceived the electricity to be cheap enough for you coming from the public sector so that you would not have had to worry about entering the market?

James Well I am not sure where competitive forces would arise from then.

Rob There would be no competitive forces but the view being that the government would keep electricity prices lower without the need for regulation by being the government and the need to be seen to be popular?

James Governments have never really pushed prices down in their nationalised industries and that was the driving force for them all being privatised in the first instance and so I am not sure that would have actually work.

Rob So are you saying there might have been more entry because you think you could generate electricity cheaper so as long as you had access to the grid to transmit this electricity to wherever?

James Yes the danger is how you can get your capacity on to the network so you would need open access and secondly how is the price of electricity determined in that new marketplace. Now the CEGB has sufficient capacity to meet the needs of the nation and if someone else built some capacity who is going to close the power station. If you are single power station developers you have only got one plant so who is going to close their power station so electricity prices remain viable so unless there is a closure programme, building a new power station, so OK it introduces competition and price will fall but without closure you are going to drive prices to such a level that new entrants are totally not viable. Now a big government backed entity could sustain that because it has got the treasury behind it and so there need to be some understanding to remove the slack from the system.

Rob Which would obviously have to be the government.

James They would need to have a undertaking that indeed the slack would come from them.

Rob so in a sense they are privatising new plant, since new plant will be done by the independents?

James Yes but if there was an edict that said the CEGB couldn't build new plant there would be a big fight over that because they had the obligation to keep the lights on and now if they were no longer allowed to build new capacity they would say you can't leave the responsibility with us to keep the lights on if we are not allowed to build new power stations. So where that responsibility goes would cause a big debate.

Rob What do you think would have happened if they had outlawed direct bulk electricity contract with the RECs? (i.e. they have to buy direct from the pool and not 15 year agreements with the IPPs)

James I think what you would find is that the IPP build programme either would not have happened at all or would have been a lot more sluggish to take-off. Its all about financing - to get the money from the banks they needed to know that the revenue was secure and that the costs were secure and they could only do that with a suite of contracts surrounding the investment.

Rob So it's all about getting rid of the risk element?

James Yes that's right - so as to make it bankable.

Rob What about if the RECs themselves were not allowed to hold stakes in those companies - do you think this would have stopped them happening as well?

James Very much so because the players who would be coming into the market would see a generation sector dominated by the CEGB and would have no on going route to market for their output and they would not be sure that they could sell to the area board and at the price they might receive for it. As new capacity comes onto the system its just going to drive down price and unless they saw some undertaking by the CEGB to remove the slack they would see price falling and so their investments would become non-viable.

Rob so they need this security of the contracts and ownership to reduce the risk?

James There is now a move towards more merchant plant which don't have this cradle to grave contractual structures but they are only occurring almost 10 years after the industry was privatised and people are much more comfortable with how it works and what is happening and so on and so forth.

Rob Do you think the actual operating of the pool has had any thing to do with the independents and the way it which it has been manipulated by the big 2 - do you think that is a disincentive for this sort of investment?

James Yes it's a shame that they are introducing new trading arrangements because the only reason the pool has come into disrepute is because there has been far to few generators with plant that can set price in the pool. In my mind the pool is actually a very neat system and it would work really quite well if it had an adequate number of generators bidding prices into the pool. It has suffered from having too few and therefore there has been market influence has been possible.

Rob Do you not think a system where by each plant would bid in a fee and they would receive the fee that they have bid rather than the current system where they bid in MC and then receive the highest price?

Brain No because doing it the way it has been done on supposedly MC basis is the economic optimum way of doing it as it basically means you cover your fuel costs, you bid that price and it is worth you running and the capacity payment, combined with any extra you make over and above your fuel price allows you to recover your fixed costs. Now that system, as any economist will tell you is the optimum way to run.

Rob Do you not think that although this might be the best system in theory but as you say it has been manipulated so much that perhaps it is better to take a step back and take the second best option as it might work better?

James It's a shame - I think its all unfortunate that the timing as just as we are getting further plant divestment and getting more generators in the marketplace with plant that can set price and therefore could make the pool become effective and operate in the way that it should operate - is the very time that we are about to throw it in the ditch.

Rob So would you advocate that when it was first created to have split up National Power and PowerGen?

James Yes I would have gone for 5 companies as the number you already suggested.

Rob Is this because of the CEGB having 5 regions or do you see 5 as enough?

James I think that 5 is enough to get competitive juices flowing.

Rob but still having the size to get the economies of scale and that sort of thing?

James That's right.

Rob What do you think would have happened if there had been some government effort to limit the size of firms - they said OK each firm can only have a maximum of 2,000MW of capacity or something - would that have been a really big disincentive to get involved knowing that you could not expand if you were successful?

James In actual fact there is such a limit on us.

Rob I don't just mean on the RECs but I mean companies generally. Is the limit on RECs not just a percentage on electricity you sell and so you could get around this by just selling more electricity?

James It's a percentage of our equity interest in generation, so if we have a 10% equity interest in a 1,000MW plant then 100MW counts towards our limit. If we have a 50% interest, 100% of that power station contribute towards our limit.

Rob Ah because they are saying you control the company or something?

James Yes that's right and so after a certain point the whole amount counts towards our limit. So basically what you are saying is should the CEGB have been split into virtually about 20 companies?

Rob Well I mean not 20 - I just want to know if in an effort to increase competition in the pool they had this limit so if they didn't cut PG and NP they would tell them to get rid of capacity by the same token I can see if that if they were privatised with 20 these firms would start to predate and take over each other and so get big again?

James I think limiting the size to 2,000MW is probably too small but a larger size - I don't think there is a need to do that at the moment and it might be something that the regulator keeps his eye on and it is something the regulatory authorities do keep their eye on through the offices of the OFT and I think the size that attracts their interest is 25% of the market and then they will say you are of a significant size and you potentially have market influencing capabilities - you are getting too big. So the processes are there to limit the size of companies and now indeed the merger that we have just gone through with [partner company name] it went right through the OFT to

see whether the merger of [company name] with [partner company name] was going to have an impact of the competitive position of the market.

Rob Are you going to fully integrate with [partner company name] - I mean with all their English generation interests be pooled with your interests or will you still differentiate between the two?

James Part of the conditions of the merger is that the regulator wants all generation brought under a subsidiary company of [partner company name]. Our generation assets are held in a special purpose vehicle which is called [company division name] and that is where I am based, and this is going to be taken out of [company name] and put under [partner company name].

Rob Will that not reduce competition where as I would have though it would be the other way around and they try and keep them separate and not encourage you to join them together.

James No - what they are trying to do is separate generation from distribution and supply and so they are lumping the various businesses together.

Thanks and explanation of interview programme.

James Its interesting that you have interviews someone from [partner company name] as we are now one entity so you might be able to draw something out from that, getting the different perspectives.

Goodbyes and further thanks.

APPENDIX D Plant Margin

The formula used to calculate plant margin is as follows:

$$\frac{C - ML}{ML} \times 100 = PM$$

Equation D1

Where

C = Capacity
ML = Maximum Load
PM = Plant Margin

APPENDIX E

The Counterfactual Model

Table E1

A Summary of the Key Counterfactual Assumptions Used

General

- CEGB structure as before privatisation with further reductions in entry barriers and use of slightly more aggressive financial/performance targets.

Fossil-Fuel costs

- Capacity of coal and gas the only fuels to be affected by privatisation.
- Less new gas capacity constructed (as entry by IPPs 50% lower) and older coal capacity utilised for longer – results in nearly 3.5GW lower gas capacity by 1998.
- Gas capacity utilised less intensively and coal used more intensively than with privatisation, resulting in a larger share for coal generated electricity.
- Coal prices assumed to be the same, with small adjustments reflecting the different quantities purchased.
- Gas and Oil prices assumed to be the same.
- All generation plant assumed to operate with the same efficiency levels, in terms of the quantity of fuel required to generate one unit of electricity.

Profits

- Industry profits divided 61.65% to domestic and 38.35% to industrial. This is assumed constant over the period of interest for the both the counterfactual and the actual results.
- Profits continue with the financial targets for the return on current cost (CC) assets (CC assets are taken to be the same as the ones actually observed). Industry target for England and Wales of 3% return from 1988/89 to 1992/93 and 3.25% from 1993/94 to 1997/98. Target for Scotland of 2.7% for 1988/89, 3% from 1989/90 to 1992/93 and 3.25% from 1993/94 to 1997/98.

Continued overleaf

Non Fossil-Fuel costs

- No *fossil fuel levy* in the counterfactual - decommissioning paid out of future income.
- Savings in capital costs from 1993/94 to 1997/98 reflecting the lower amounts of new gas capacity.
- Labour costs higher due to slower reductions in the workforce.
- Cost savings from not privatising the industry - savings of £2,000m taken over the years 1988/89 to 1990/91.

APPENDIX F

The Breakdown of Profit Between Industrial and Domestic Sales

Table F1
The Price of Electricity and the Breakdown of Typical Bills in 1993/94

	Domestic	Industrial
Price of Electricity ¹ (£/kWh)	0.0750	0.0438
Percentage breakdown of Typical Bills in 1993/94 ²		
Generation	0.52	0.69
Transmission	0.05	0.05
Distribution	0.26	0.15
Supply	0.07	0.01
Fossil Fuel Levy	0.10	0.10
Generation Price (£/kWh)	0.03900	0.03022

¹ *Energy Prices and Taxes from the OECD, 1999, First Quarter Edition.*

² *The UK Electricity Industry: Electricity Services and Costs from the Centre for the Study of Regulated Industries, Table 2, p.xi. 1994/95 edition.*

Using the final price of electricity and the proportion of this accounted for by the generation companies, allows the generation price to be calculated. This is the amount of money that is passed to the generators per unit of electricity sold.

(Generation price = Price of electricity x Proportion of the bill that goes to the generators)

Assuming each unit (kWh) costs the same to generate, then the difference between the two generation prices will be the additional profits that domestic electricity sales make over industrial sales for the generation companies.

Additional profit from domestic sales = domestic generation price – industrial generation price
 = 0.0390 – 0.03022
 = 0.00878 (£/kWh)

This means that 22.51% of the generation price for domestic electricity is additional profits (i.e. [0.00878/0.03900] x 100)

Assuming the mark-up is the same for all electricity sectors, not just generation, then additional profit on 1 kWh of electricity sold to the domestic sector is given by:

Additional Profit per unit = Unit Price x Profit Rate

However, the final price quoted above includes the *fossil fuel levy*, which accounts for 10% of the final price (see table); this will not have generated industry profits and so should be excluded from the profit calculations at this point. Therefore

$$\begin{aligned} \text{Unit Price} &= \text{Bill price} \quad \times \text{Proportion accounted for by electricity firms} \\ &= 0.0750 \quad \times 0.9 \\ &= 0.06136 \end{aligned}$$

$$\begin{aligned} \text{thus} \quad \text{Additional Profit per unit} &= 0.06136 \quad \times 0.2251 \\ &= 0.01381 \text{ (£/kWh)} \end{aligned}$$

Since domestic electricity accounts for approximately 35% of electricity sold, total additional profits on domestic electricity sales can be calculated by multiplying the additional profit per kWh by the number sold to domestic users, i.e.

$$\begin{aligned} \text{Domestic sales} &= 0.35 \times \text{Total Sales} \\ &= 0.35 \times (3.0878 \times 10^{11}) \\ &= 1.08073 \times 10^{11} \end{aligned}$$

$$\begin{aligned} \text{Additional Profits in domestic sector} &= \text{Additional Profit per unit} \quad \times \text{Domestic Sales} \\ &= 0.01381 \quad \times (1.08073 \times 10^{11}) \\ &= \text{£1,493 million} \end{aligned}$$

This therefore leaves profits of £2,148,193,987.73 (see below) unaccounted for by the difference between domestic and industrial profit rates. This must be the profits earned equally on all units of electricity sold. i.e.

$$\begin{aligned} \text{Base profits} &= \text{Total profits} \quad - \text{additional profits in the domestic sector} \\ &= \text{£3,641 million} \quad - \text{£1,493 million} \\ &= \text{£2,148 million} \end{aligned}$$

This profit can then be split equally over the total units sold (since the differential between the two types of sales has already been accounted for).

$$\begin{aligned} \text{Base profits per unit} &= \text{Base profits} \quad / \text{Units sold} \\ &= \text{£2,148 million} \quad / 3.0878 \times 10^{11} \\ &= 0.00696 \text{ (£/kWh)} \end{aligned}$$

Therefore total profits per unit sold in 1993/94 are:

Domestic

$$\begin{aligned} &= \text{Base Profits} \quad + \text{additional domestic profits} \\ &= 0.006957 \quad + 0.01381 \\ &= 0.02077 \text{ (£/kWh)} \end{aligned}$$

Industrial

$$\begin{aligned} &= \text{Base Profits} \\ &= 0.006957 \text{ (£/kWh)} \end{aligned}$$

Combining the above information allows the distribution of industry profits:

Table F2
1993/94 Electricity Sector Profits, Broken Down by Class of Sale

	Domestic	Industrial
Profit per unit sold (£/kWh)	0.02077	0.006957
Units sold (kWh)	1.08073×10^{11}	2.00707×10^{11}
Sector Profits (£)	2,244 million	1,396 million
% of Total Profits	61.65	38.35

APPENDIX G The Pessimistic Counterfactual

Table G1

A Summary of the Key Assumptions Used in the 'Pessimistic' Counterfactual

As the Preferred Counterfactual as outlined in Appendix E except

Fossil-Fuel costs

- From 1990/91, coal prices 5% higher than those assumed under the preferred counterfactual (and actually observed).
- From 1990/91, gas prices 10% higher than those assumed under the preferred counterfactual (and actually observed).

Profits

- Profits continue with the financial targets for the return on current cost (CC) assets (CC assets are taken to be the same as the ones actually observed). Industry target for England and Wales of 3% return from 1988/89 to 1989/90, 3.75% from 1990/91 to 1991/92, 4.25% from 1992/93 to 1994/95 and 4.75% 1995/96 to 1997/98.
- Target for Scotland of 2.7% for 1988/89, 3% for 1989/90, 3.25% from 1990/91 to 1992/93 and 3.75% from 1993/94 to 1997/98.

Non Fossil-Fuel costs

- Savings in capital costs from 1993/94 to 1997/98 reflecting the lower amounts of new gas capacity. Assumed to be the same as under the preferred counterfactual.
- Additional £750m charge applied evenly from 1991/92 until 1997/98 for general higher costs of operation and other inefficiencies.
- Labour costs higher due to slower reductions in the workforce. By 1997/98 10% higher cost increase than that assumed under preferred counterfactual.
- Cost savings from not privatising the industry - savings of £2,150m taken over the years 1988/89 to 1990/91.

APPENDIX H

The Optimistic Counterfactual

Table H1

A Summary of the Key Assumptions Used in the 'Optimistic' Counterfactual

As the Preferred Counterfactual as outlined in Appendix E except

Fossil-Fuel costs

- From 1990/91, coal prices 5% lower than those assumed under the preferred counterfactual (and those actually observed).
- From 1990/91, gas prices 10% lower than those assumed under the preferred counterfactual (and those actually observed).

Profits

- Profits continue with the financial targets for the return on current cost (CC) assets (CC assets are taken to be the same as the ones actually observed). Industry target for England and Wales of 2.7% return from 1988/89 to 1997/98.
- Target for Scotland of 2.7% from 1988/89 to 1997/98.

Non Fossil-Fuel costs

- Savings in capital costs from 1993/94 to 1997/98 reflecting the lower amounts of new gas capacity. 11% higher capital saving than assumed under preferred counterfactual.
- Labour costs higher due to slower reductions in the workforce. By 1997/98 10% lower cost increase than that assumed under preferred counterfactual.
- Cost savings from not privatising the industry - savings of £1,850m taken over the years 1988/89 to 1990/91.

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