an idea in progress

The Case for the Public Interest Company:

a new form of enterprise for public service delivery

Public Management FOUNDATION

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a Public Management Foundation discussion paper

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Preface and acknowledgements

Many people have contributed to the development of this paper, but it is the authors who take full responsibility for the ideas presented here. In beginning the process of making a case for a public interest company, our aim is to move a debate along, but not to close it. We recognise that there is a lot more work still to be done on the topic.

The Public Management Foundation (PMF) has long been interested in the issue of appropriate organisational forms for different types of public and private enterprise. PMF was set up by the Office for Public Management, a consultancy organisation, whose founders, Greg Parston and Laurie McMahon, drawing on the example of the American public benefit corporation, wanted to establish a genuine not-for-profit, charitable trading organisation. They found that the only legal way to do this was to develop two organisations, a trading company (OPM) and a charity (PMF) to whom the company's profit has been covenanted.

Over the years, PMF has studied the ways in which public service delivery can be improved and it was this concern for social outcomes that brought us back to the question of organisational form for effective public service delivery.

The distinction between public sector and private sector delivery has been a crucial, but limited, part of the debates about public service modernisation. Over the summer of 2000 we looked into different institutional and sectoral possibilities, drawing again on the model of the 'public benefit corporation' (PBC) and thinking through how something along those lines might work in the UK. At the same time, we talked to a number of people whom we knew were thinking innovatively about the nature of public service organisations. The process was encouraged during discussions at a T&GWU sponsored-conference where we learned that the Union was interested in developing different kinds of organisations that could provide public services that look to the public as customers, perhaps through a variety of mutuals.

We also discussed our forming ideas with Roger Warren Evans who has spent many years pushing the boundaries of organisational forms – and not just in theory but by creating a range of different public service and charitable organisations. Our work also brought us into contact with a number of public sector organisations who were interested in creating new vehicles for service provision. At the same time, we started to talk with colleagues at the New Economics Foundation (NEF), especially about ways in which organisations might be developed to produce finance for other community organisations.

In the autumn of 2000 year we discussed our ideas with many other people who were frustrated with the way current organisational structures had limited their service delivery possibilities. In particular, we began discussions with people at the Centre for Civil Society at the London School of Economics and Politics (LSE).

We then moved on to a systematic exploration of the constraints imposed by current organisational forms. This involved talking to people working in many fields, including: Mike Tebbutt at Aquaterra; John Stewart at the Wellcome Trust; Joss Saunders at Oxfam; Helen Barber at ICOM; John Bird and Craig Pickering at the Big Issue; Tim Emmett at CfBT; Barbara Ainger, Peter Impey and Howard Webb at the Housing Finance Corporation; and Margaret Bolton at NCVO.

In February 2001 we held a very useful seminar with Tom Cannon from Respect London; Richard Fries from the Centre for Civil Society at the LSE; Teresa Graham, a partner from Baker Tilly; Ed Mayo from the New Economics Foundation (NEF); Sylvie Pierce from Capital and Provident and Julia Unwin from the Charity Commission. We took away from that seminar some very helpful advice on the structure of our research and this paper.

All the above, and many others, have been very generous in discussing their own work and ideas with us. We would particularly like to mention David Leam at the Social Market Foundation; Tony Grayling at IPPR; Peter Hunt at the Co-operative Party; Bill Shannon at the Co-operative Group and Cliff Mills at Cobbetts Solicitors.

Two grants we received at the end of 2000 from Gordon Roddick and from the Calouste Gulbenkian Foundation have enabled us to complete the research and publish this pamphlet.

As well as wanting to thank all these individuals, we have mentioned them for another important reason. This pamphlet is very definitely an 'idea in progress' that is emerging from the combined thoughts and work of very many people. So, indeed, is the PIC debate itself: an idea in progress towards becoming a reality. This will take time, and PMF will carry out some of the work, but so too will others. Equally, some of the people we have worked with are trying to develop other new models of public service delivery organisation – most notably within the mutuals movement. Nothing we say here in favour of a PIC detracts from their work to develop other organisational forms as well.

Our collective point is that the way in which the British system allows organisations to deliver public services has been too restrictive and a far wider variety of organisational forms for public service delivery needs to be encouraged. The public interest company will be just one of these.

Paul Corrigan, Executive Director,
Jane Steele, Director of Research
Greg Parston, Chairman

Public Management Foundation
June 2001

Introduction

The politics of the recent election have centred on the nature of public services. Whilst some of that debate has been about how much public money is being invested in those services, most of it has been about the ability of public service organisations to deliver. Unfortunately, a good deal of the debate has been simplified into an either/or choice between the public and private sectors. This pamphlet suggests a different way into this discussion, proposing a new organisational form for delivering public services – the public interest company (PIC).

The Public Management Foundation takes a close interest in the development of public services. Each year, for several years, we have published a report of our investigations into the public value of public services[1] and looked into ways of improving the organisations providing those services. Our work with a wide variety of public, voluntary and private organisations has demonstrated that people are often frustrated with the limitations of existing organisational forms. In a number of areas, these frustrations are now restricting the possibilities for public value to be added through public service.

At the moment, there are restrictions on what is a public sector organisation can do. We have found public sector organisations that wanted to develop into a different form; they are interested in institutions that try to make a surplus and see their resources as coming through trade.

‘How important,’ one might ask, ‘is the question of organisational form, compared to that of outcomes for the public? And, apart from those whose work involves organisational maintenance rather than service development, who cares anyway?’ Yet, time and again, we have found that people are forced to take an interest in pushing the boundaries of organisational form simply to improve service delivery.

Last summer, urged on by the frustrations we were witnessing within many and very different organisations, we began to look seriously at the US model of a ‘public

1. All endnotes are found on pages 46–47

benefit corporation' (PBC). This proved useful but, as is often the case with international comparisons, it presented us with problems of cultural transference. In the US, the PBC had been shaped by American organisational and cultural interactions. Simply transferring it across the Atlantic would not work.

Also, it is difficult enough to persuade official institutions in the UK that there needs to be a new structure without labelling that structure an American import. We therefore intend to demonstrate that, whilst some of the ideas inherent in the model we are proposing here may be owed to the history of the American PBC, it is essentially a UK model, developed to meet our national need at this time.

We are calling our model a 'public interest company' (PIC).

Indeed the phrase 'public interest company' entered the parlance of the British General Election on 21 May when the Liberal Democrats made a case for such an organisation to take over the existing PLC, Railtrack.

What we are arguing for is a small and limited addition to the company form, one that will meet the growing and varied needs of the different public services that we outline in the rest of this paper.

Chapter 1. The problem with existing organisational structures

Not all public services can be provided by the forms of public sector organisation that presently exist in the UK.

The public sector ethos is still strong, especially in distinction from the different ethos of 'private for-profit organisations'. In this country there is a prevailing sense that public sector organisations are not just different from 'profit' organisations, but in some way opposed to them.

However, three sorts of problems immediately arise.

First, as PMF's recent research[2] shows, both the public and 'experts' alike are very confused about exactly what makes a public service 'public'.

'*People came back again and again to the idea that a public service involves public money and government authority, but were unable to fit this together with a belief that public services should benefit society. Changes in the role and delivery of public services, including a blurring of public/private boundaries, seem to have contributed to the confusion. New experiences of public services also overlay persistent historical and received definitions.*'[3]

Many people in our '*What makes …*' survey contended that 'public organisations are those that don't make a profit'; beyond this, however, their understanding of the related ethos was confused. Historically, public accountability has been a cornerstone of the public sector organisation and its unique selling point. But people's understanding of the term varies. The public want accountability but are not very keen on the fact that the responsibility for it lies with elected politicians whom they don't altogether trust.

'Forty six percent of those who said they distrusted elected people to make decisions about public services nevertheless agreed that public services should be controlled by elected people. About half of those who disagreed that public services should be controlled by elected people, nevertheless wanted government to do more to control public service organisations.'[4]

Second, in terms of developing new ways of working, the existing public sector organisational form is problematic. Most people do not regard public services as being at the cutting edge of organisational innovation. On the contrary, many people believe that public services have problems with service delivery and with customer focus. And this perception is largely accurate: public organisations have a specific remit and are limited by statute to undertaking specific activities; developing dynamically beyond that – for example, innovating radically different services – is difficult.

However, even more significantly, people do not find it easy to develop a dynamic relationship with different markets. There is a strong tendency to define the market as one that is producer-oriented rather than one that is customer-oriented.

It has proved very difficult for public sector organisations to develop efficiently so as to drive costs down. Whilst some organisations try to develop this ethos – with cost centres and attempts at internal markets – most of this is a bit like 'playing at shops' where the money and the consequences are not real. For most of the public sector, 'businesslike' is synonymous with 'profit' and therefore 'not something we do'.

Thirdly, there have been real problems in relation to resources. Most money comes from revenue raised from public taxes: resources are regarded as there to be spent rather than 'earned'. Generally, any pressures for change to this ethos come from outside the sector. It will be a long time before we see a change from the norm of obtaining resources for public sector organisations from taxation alone.

For the most part, the idea of making a surplus from a budget is anathema to the public sector. In the recent past, accounting procedures have been such that an end-of-year surplus was to be avoided, or would be grabbed back by any superior organisation, so spending everything was vital. The new three-year cycle seeks to dampen that effect.

There are even greater problems with regard to the raising of capital. There are severe restrictions on raising capital in the markets. The spectre of the 'public sector borrowing requirement' hangs over the public sector's capacity to raise capital. This has contributed to the complexity and the difficulty of PFI.

Concerning relationships with the public, then, the difficulties involved in developing entrepreneurial capacity and the way in which resources are gathered and spent will continue to cause systemic problems as long as the current public sector model is the only way in which public services are provided.

Over the last few years, one of the most systematic attempts to change things has come through privatisation and the outsourcing of public services to private companies. In Chapter 3 we go on to discuss at some length the problems with this. Suffice to say here that if this had completely worked – and had been seen to work by the public – then there would be no need to be making a case for a different organisational form.

As we shall see with the examples of the water industry and Railtrack in Chapter 4, the privatisation of public services is now disclosing real problems with raising capital for investment, the very reason for privatisation in the first place.

And we shall also see that there are severe problems with the other organisational forms available for service delivery. People do not like it when public money leads to private shareholder profit.

Nevertheless, people do want to see alternatives to the existing public sector form. In Chapter 2, we will look at the three main alternatives: the private sector company – politically, the most important – and charities and mutuals.

What does a new public service organisation need to achieve?

This critique of the way in which traditional public sector organisations deliver public services is complemented in the next chapter by critiques of the way in which other existing organisations can deliver services.

Modern public services need organisations where managers are encouraged to act in an entrepreneurial way, where they are encouraged to develop new services and products to meet customer needs. This can come about when senior managers have to earn the public money that they are spending and recognise that extra resources can come in from successful trading and successful capital formation.

However, we do not believe that such organisations have to be governed by the profit motive nor driven by the need to deliver resources to shareholders. Whilst the public would like public services to be more entrepreneurial, they are unhappy about the idea of diverting any public money from public services through profit into the hands of private shareholders.

The existing company form is also problematic in that any organisation can be taken over by another bigger, richer organisation. So, for instance, a public service, delivered by a small local company dedicated to both the locality and the service, could be taken over by, or sold to, an international concern with little regard for local needs. We argue that public service organisations, providing as they do such crucial services, need a firmer basis to develop over time. An alternative organisation would need to be able to develop new services for a new market but it would need to do so within the drive for the particular public service it is dedicated to.

For some of those who run private companies, such an organisation is contradictory: their experience of being entrepreneurial is driven by returns to shareholders and they see that as the only driver for such activity. But this view of managerial motivation is too limited. Whilst the commercial world has a powerful sway over organisational drivers, there is strong evidence that other forms of motivation exist too.

The worlds of charity and public service are affected by the commercial world but the motivations of people within them are not dominated by commercial concerns. PMF has carried out extensive work into the motivation of public service managers, and finance comes a long way down the list of effective drivers. These people are primarily motivated by improving services to their public. We believe that the current organisational framework of the public sector does not allow that motivation to develop.

Our argument for a PIC is that we need to create an organisational form that is based upon entrepreneurial trading for public service, but that will do so without the need to generate profit for external distribution.

Chapter 2. Existing alternative models

Before looking at the characteristics of a public service company that can deliver innovative, effective and efficient public services, we want to explore the suitability of current alternative forms of organisation for the not-for-profit delivery of these services. These are: companies; charities; and mutuals and co-operatives.

The company form

The company form is clearly not identifiable as a method of meeting public interest. In fact, the reverse is true. Companies cannot have a purely public benefit outcome while they are firmly based within a model which necessitates the making of a profit for shareholders. Companies that are labelled 'not-for-profit' are mistrusted because they run counter to the overall aims of the organisational form. The private sector organisation makes money for itself and for the people who own it. This is its principal benefit. This presents almost insuperable difficulties for any organisation that wants to be 'a company' and also to create public benefit.

The success of the company form lies in the further fact that it can be turned into a very wide variety of 'off-the-shelf' organisational forms. It was created and has developed in such a way as to be transformable to meet different needs. On the one hand, it can develop itself into any product line or service as economic and market conditions dictate. On the other, being 'taken over' by another company with very different core business and aims is also a normal part of the life of a company. It is therefore impossible to develop an existing company in such a way as to guarantee anything very much into the future. No company can guarantee to the public that it will have the same organisational form in five years time that it has today. Any guarantee depends upon the existing board members keeping to their pledge and since they can be 'bought out' at any time by others, the 'not-for-profit' organisational form is unsafe for our purposes.

Profit is usually distributed to owners or to shareholders. In fact, the company form is so securely a 'for-profit' form, that attaching the phrase 'not-for-profit' to it tends to confuse rather than clarify. Any private company that provide public services would have to, at the very least, have a dual aim of both making profit and providing that public service. Yet it is the former that must dominate.

This confusion does not sit easily with the public who mistrust the idea of making a profit out of public service and this limits the extent to which the company form is allowed to provide public service.

Company law reform has looked at company accountability and seems certain to maintain the very strong accountability to shareholders. However, there will almost certainly continue to be a range of other stakeholders who will claim various kinds of accountability. In the next few years, the accountability to stakeholders – and the debate about this – will not go away and it is likely that the company form may find itself assailed by them. The accountability to shareholders rather than to the public (of whatever form) also diminishes the attractiveness of this form of organisation to deliver public services.

But there are issues on the plus side. First, companies are 'free' from direct political interference from government and are therefore an independent part of civil society. This independence will allow them to develop a public interest free from political control.

Second, companies are dynamic, with a wide variety of possibilities of organic change involving the development of new products and markets. In fact, as history has shown, it is only by being dynamic and developing different products that private companies can survive in the modern market. Companies that fail to create and maintain this approach fail. Trading generates nearly all their income and a failure to trade successfully will mean they fail.

Third, companies raise capital on the equity markets and financial markets with ease, and the financial markets feel 'safe' with this form. Provided they are profitable and have assets, they will attract finance in the normal way.

The charity form

'Charity' is not actually an organisational form. The distinction is important because, for voluntary organisations, one of the difficulties with charitable status is that it does not provide a legal personality.[5] Trustees of a charity that do not form any other organisation are held individually and severally responsible. For this reason, most charitable organisations of any size are also companies limited by guarantee, or industrial and provident societies.

However, a charity has a very clear organisational identity, and is identifiable as an organisation that seeks to provide a public benefit. This makes it a natural organisation to deliver public services. People believe in and have expectations of a charity and the word has a strong historical resonance. Sometimes that resonance is at odds with what the charities actually do, for example when they trade and charge for services. But history provides the charity form with some clear strengths including the commitment of people and resources to the public benefit purpose and an independence that allows scope for innovation. The form encourages people to donate time and money to causes about which they feel strongly. Since it is so strongly linked to public benefit, it appears to be a useful way of delivering public service.

As a form of organisation, charities operate outside of the profit motive and have been successful at maintaining this powerful distinction from profit-making companies. The distinction is not only maintained by the Charity Commission and the law, but is very strongly policed by the media and the public. When anyone 'makes any money out of charities' there is a very powerful public reaction. In fact, this restriction can lead to problems when paying senior staff market-rate salaries.

Charities also provide an important guarantee of public benefit over time. This is reinforced by the Charity Commissioners. The governance structure ensures this through an independent board of trustees (who must not benefit personally). They will be in breach of trust if they act outside their objects or fail to pursue them with proper care.

Charities have a very well established independence from government. Indeed, one of the problems they experience in the new contract culture, where they may provide services for central or local government, is that they are anxious about losing that independence from government. They are regulated by an organisation which has considerable public credibility (although some may complain about the extent and nature of that regulation).

There are four major problems with the use of charities to deliver public services.

The first relates to the ability to trade. Certain charities can trade, within certain primary purposes. But donations from the public and income derived from previous donations are the major source of many charities' income and they rely on their charitable status to raise it. The difference between this mode of 'earned' income and the business mode can creates a real clash of ethos and lead charities to feel 'opposed' to private, market-oriented organisational forms. This can be especially problematic as charitable organisations move into the world of trading as, for example, some housing associations and children's charities have done. Such developments still draw cries of 'inappropriate!' from within the charity world. The weakness of the charity form is that it may somehow be seen as wrong to create a surplus.

Under charity law there is the restriction to trade within one's defined primary purposes. This causes problems for many organisations that want to trade outside of that established charitable purpose.

A current example of this is the case of charitable housing associations that want to provide housing for key workers at market rent (a secondary purpose), as well as continuing with their primary purpose of providing low cost housing for others; the worry is that this will contravene their charitable status. They also fear that the Inland Revenue may tax this part of their income as it will be commercial activity. The housing associations' view is that the restriction to work within their primary purpose undermines their aim to create mixed, sustainable communities.

The second major problem with the use of charities to deliver public services is the difficulty they have in developing new products. The relationship between primary and secondary purpose for the charity will always restrict any organic development within an organisation, especially when compared to the way in which a company can react to a dynamic market. Markets may drive product development horizontally and vertically into different sets of relationships between new and old products. Each of these products could fit in with a 'public benefit' purpose. However they may be very different types of products and each may necessitate a return to the Charity Commissioners before the organisation can begin to develop it.

This is a major constriction for a charity and makes it difficult to develop new products and services organically.

The third problem is raising capital in the money markets. This has not historically been the norm with charities. Their relationship with money markets has not been one where the markets feel it is easy to lend equity. This is mainly because of the ethos (outlined above) of an organisational form that in some way opposes making money and other businesslike activity. This has become a cultural problem, in that – as is the case with Aquaterra (a trust established to take over a local government leisure service) for instance – there is a real problem for those trading charities as long as the word 'charity' remains unattractive to the money markets.

Housing associations are an important development in this area. Many of them are now treated as very good risks by financial markets (obviously because of their extensive asset base) and they are an orthodox part of the financial market. Equally, these charities have developed a businesslike approach to their work. We need to explore the way in which this different form of charity makes possible this financial relationship.

The fourth problem for charities relates specifically to notions of 'the public' they serve and provide benefit to. Most charities have very specific publics and construct their boards of trustees to ensure they focus on that. Charities have a form of accountability to their trustees and through the trustees to the Charity Commissioners.

Charitable status historically brings considerable taxation benefits with it. Indeed, some people regard this as the defining aspect of the organisational form, with 'public benefit' simply being that which you aim for in order to get tax relief. This is also one of the main reasons for such close regulation. The NCVO report we referred to earlier (see endnote 5) concludes that the main benefit of charitable status for charities is public credibility (which encourages the donation of time and money) rather than tax relief. However, it is hard to imagine charities foregoing their current tax advantages by, for instance, setting up trading arms.

The co-operative and mutual enterprises forms

Compared to other European countries, the identity of the mutual is weak in the UK. Co-operative and mutuals have a collective identity that has a number of stronger sub-identities. Building societies probably touch the largest number of people, but for most borrowers and lenders the mutual nature of the form is not a strong selling point. The Co-op as a retail service has a strong identity amongst older people. Mutual producing organisations are a much smaller part of the productive sector in the UK than in mainland Europe.

If the objects of a 'benefit of the community society' are 'charitable in law', it can register with the Inland Revenue as an exempt charity and receive the same fiscal benefits as a registered charity.

Historically, there is a very strong accountability to members. The image is that a mutual will benefit you if you are a member, not if you are just a member of the public. This could limit the capacity of the mutual form to be seen as benefiting the public in general. If the aim of the mutual is to benefit members, and some of the public are excluded, then a general public benefit is problematic.

Developing industrial and provident societies

According to the Registrar of Friendly Societies, industrial and provident societies are organisations 'conducting an industry, business or trade either as a bona fide co-operative or for the benefit of the community'.

The Registrar goes on to explain that:

'*Bona fide co-operative societies are for the mutual benefit of their members, with any surplus being ploughed back into the organisation to provide better services and facilities. Each member has at least one share in the society and control is vested in the members equally.*'[6]

Benefit of the community societies provide services for people other than their members. They must have special reasons for registering as industrial and provident societies rather than companies.

There is considerable interest in exploring and developing this model. Work is being done within the co-operative movement to develop 'new mutuals'. This work flows from a recent report by the Co-operative Commission which recommends that something similar to the Company Law Review 'should be established to develop the future legal framework of the social enterprise and mutual sectors as a whole. The aim of such a review should be to develop a simple, modern and cost-effective legal framework for carrying out business activity and meeting the social goals of these sectors.'[7]

In the proposed 'new mutual' or 'community mutual' service, users are members, but they are members on behalf of the whole community, not all of whom are signed-up members. Some people on the board are co-opted; others are elected by the whole membership. For the form to be relaunched as a public benefit organisation, the relationship between 'the membership' and 'the public' would need to be clarified.

If we are looking for a public service delivery organisation with an organisational authenticity that commits it to public benefit in perpetuity, then we need to note that there are both pluses and minuses with the mutual organisation.

The 'bona fide co-ops' and the 'benefit of the community societies' are different in this respect. In the former, the members can decide to change their organisational form or to sell their organisation to another organisational form. For some organisations this may be unlikely, but when a mutual is 'successful' it is not unlikely for predatory companies to make 'offers' to members to change the form. For example, a successful mutual making a considerable surplus would be very attractive to a private company who might make an offer to members based upon market value. And, given the socioeconomic background of many typical members, this offer may be very appealing. Thus the potential for a successful mutual to be bought out is high. However, the Co-operative Commission report makes recommendations about this and seems to have got some government support for change.

Benefit of the community societies must have rules that do not allow profits or assets to be distributed to members. Thus, an incentive to sell is removed. Also, the society's rules must not allow assets to be distributed to members on dissolution. At that point, assets should be transferred to another body with similar objects or working for similar charitable, philanthropic or benevolent purposes.

This approach towards the distribution of profit to external shareholders means that it will not fall foul of a public which is wary of distributing any public service surplus to external shareholders. Given the fact that some mutuals are mutual producer organisations, the drive to make a large surplus is unlikely since, after some time, the producers may want this to be translated into increased wages and salaries. The same is true with mutual distributors with lower prices being the *quid pro quo* for a low surplus.

Benefit of the community societies are not allowed to distribute profits or assets to members. Profits must generally be used to further the objects of the society by being ploughed back into the business or used for another purpose that is similar to the main object of the society. This may prevent there being a problem with the distinction between those members of the public who are members and those who are not.

All of the above issues provide a secure basis for mutuals and co-operatives to provide public services. However, in practice, mutuals face difficulties as public service providers.

The first is their ability to work within a competitive market to gain trade. The 19th century co-operative and mutual form was created in order to trade within a different ethos. While there has often been a struggle to develop a different ethos around trading than that of profit, trading remains one of the one of the main reasons for this organisational form.

Trading mutuals that provide a public service have to trade successfully otherwise their ability to provide that service is compromised. Success at trade can be seen as a pre-requisite for mutuals that hope to provide public services.

But there is contradictory evidence here. For some mutuals there is a pride in making a small surplus so that it can be distributed to members to demonstrate the different principle of distribution than within the company form. However, the drive to make a large surplus to distribute has not been strong. The Co-operative Commission recommends that organisations should set challenging targets for commercial and social performance and that reinvestment in the business must always have first claim on the profits. It also discusses the 'virtuous circle' of strong commercial performance, membership and social performance.[8]

Guidance from the Registrar of Friendly Societies says that benefit of the community societies will usually be 'charitable, philanthropic or benevolent in character'. But this already encompasses organisations with a wide range of types of business activity.[9]

Another difficulty lies in attempting to develop within the organisation an entrepreneurial activity that develops new sets of products. This has not been a traditional strength of mutuals that have tended to develop within their original and specific aims rather than pursue and develop market opportunities. There are structural difficulties in quickly developing aims away from the original core business, but these are not insuperable.

Third, there are issues about the ability to raise capital. Some difficulties here arise because the problems with profit that we have described appear odd to the money markets. But there is also the problem, for most financial organisations, with the identity of mutuals. There is work being carried out by NEF and others on this.

Chapter 3. The main elements of the public interest company (PIC)

Having explored the issues with the public sector as the main institution that provides public services, and having looked at the alternative organisational forms that currently exist, we are now in a position to explore the characteristics of the PIC we are proposing. We can identify nine main characteristics.

1. An organisation for specific public benefit

The new organisational form must be clearly and publicly identifiable as a public benefit or public interest organisation. Given the current debate that poses 'public' versus 'private' interest, the organisation must be seen as one that aims for a public good and not one that creates a profit for shareholders or directors out of that public good. The public interest needs to be transparent and organised around a specific set of public interest outcomes; furthermore, these outcomes would have to be agreed as being public interest outcomes by the Registrar of Companies. Gaining – and keeping – public trust to deliver a public interest would be an essential part of this organisational identity.

2. A public benefit organisation over time

A guarantee must be given that the organisation cannot be transformed into another type of organisation that does not provide public benefit. More than an assurance is required: there needs to be an unalterable 'lock' on the organisation, tying it in perpetuity to working towards a specific set of public benefit outcomes. This also needs to preclude the distribution of profits to shareholders or any external body and any possible future privatisation. If the organisation is to be wound up, all assets must go to a similar PIC.

3. A trading organisation

Income and resources need to be generated as far as possible from trading for the delivery of services. For some PICs, the majority of this trading will take place through contracts with government commissioners, won in competition with both private companies and other public sector organisations. Given the importance of 'best value', this will increasingly become the way in which services are delivered. Whilst the PIC may gain some resources from taxation or donations, its success will depend upon its ability to trade.

4. A cost-efficient organisation

The organisation must include incentives to promote efficiency and effectiveness in meeting its public interest. This will be assisted by the fact that the bulk of its resources will have been gained through trade, and that trade will have been won in competition with others, including for-profit companies. An inefficient PIC is bound to fail.

5. An entrepreneurial organisation

Within these secure public benefit constraints, each organisation must be allowed to develop dynamically its approach to its particular public benefit. In the modern world, the way in which an organisation reaches its goals is likely to change in line with rapidly changing markets and customers' expectations and needs. The PIC must be able to develop new products and vehicles of delivery to meet its stated public interest outcomes. For this reason, its managers need to be encouraged to develop an entrepreneurial attitude to the marketplace, constantly reviewing different possibilities. As long as new products and services work towards the original public benefit, this would obviate having to 'apply' to the High Court or the Charity Commission for the right to develop a 'new product'.

6. A secure not-for-profit organisation

Profits cannot be distributed to people outside the organisation. Any surpluses must be reinvested – and transparently – for the particular public benefit that the organisation is working towards.[10] Recognising that the public are at least ambivalent and potentially hostile about the distribution of any public service profit to private sources, the PIC must have amongst it aims that it could could not distribute profits. Loans, both for the start-up and continuation of the company, could be raised and repaid as bonds and the ownership of the bond would grant ownership of the company. Directors would have limited liability, and could be salaried if this was desired.

7. An organisation that can raise capital from the money markets

It will be normal practice for the organisation to raise finance from within one or more forms of money market.[11] The ability to raise capital outside of the equity market is crucial for the PIC. In the US, bond markets have provided a mainstay of capital finance for PBCs.

8. An accountable organisation

The organisation must have some form of accountability to different stakeholders, including the public who are the recipients of its services. As well as limited liability for directors, accountability would cover a range of issues about ownership, with different types of election appointment for different directors. This could include representation from staff and from the public. As there will be no shareholders, accountability will be very different from other company forms.

9. An organisation independent of direct political control

Like charities and companies, the PIC needs to be free of direct political control by government and other vested interests, but it will also have to be regulated.

Defining 'public interest'

Throughout this whole debate about public service, the question of what is and what is not a 'benefit to the public' is a vital one. Philosophers, sociologists and economists have all applied themselves to what this might mean. There is no simple answer.

However, we are lucky in that, at the moment, an important debate is in progress about how public benefit should be defined when organisations apply for charitable registration. We summarise it briefly below, without attempting to be definitive.

1. The NCVO report on charity law reform recommends that the current four 'heads' of charity (the first three are education, religion and relief of the poor) should be replaced by the current fourth: 'purposes beneficial to the community'. In other words, all charities would have to meet the conditions of being beneficial to the community and this would supersede the current arrangements for charities with purposes in education, religion and the relief of poverty. Indirect as well as direct benefit would be allowed. For example, society as a whole benefits from educating or training a small number of people, therefore a small-scale educational project could register as a charity. The

well off, as a part of the community, are allowed to benefit: benefit does not have to be limited to poor people.

2. Another definition comes from the Registrar of Friendly Societies. To register as an industrial and provident society that is established for the benefit of the community (rather than a 'bona fide co-operative') organisations have to show that there is a good reason why they should not be a company. There is no statutory definition of 'special reasons' or of 'benefit of the community' although the Registrar gives the examples of economies of scale or financial/tax advantage.

3. The Co-operative Commission Report addresses this problem with regard to mutuals. It recommends various steps to prevent co-ops being demutualised and taken over by other companies:

- all mutuals should adopt rules to set high turnout thresholds as a defence against takeover or demutualisation and/or to secure the transfer of assets to another co-op organisation;
- work needs to be done on the possibility of a co-op setting up a trust to hold its assets and thus protect it;
- the government should introduce legislation to secure co-op assets for the future. This Government has indicated that it intends to take this very seriously.

There is need for further study on this issue. For example, how appropriate would it be to confine an organisation to a particular public benefit? Would a water company be able to provide gas and electricity? Might a regeneration project encompass a large range of products and activities? Or could a school provide breakfasts? We would want to avoid confining organisations too closely, so defining public benefit purpose would be more practical and flexible than defining products or activities. Might it be possible, and desirable, to define public benefit purpose generically (in terms of not-for-private-profit, for example) without specifying a type of outcome (such as health)?

There is a further concern which is important to mention but on which we do not at the moment have a firm opinion: the issue of tax status. Tax advantages and relief on business rates for PBCs in the United States and charities in the UK are major characteristics of those organisational forms. There are two contrasting arguments about taxation for a PIC. The first is that since the PIC is providing a public benefit, any taxation of surplus would tax that public benefit. The alternative argument is that since a PIC would be in competition with private, for-profit companies for much of its trade, it should not have a tax advantage over those for-profit companies. We are seeking people's opinions and ideas about this.[12]

Chapter 4. How a PIC could develop service delivery: three examples

In this chapter we apply the nine components of a PIC to three different public services. Two of them are utilities, both of which have had a long track record of public sector provision and both of which have recently been privatised: the water industry and the rail network. The third is a public sector organisation where alternative models are currently being canvassed: the local education authority.

Of course, converting the current forms of these organisations into PICs would be problematic. Private sector organisations would require public purchase of their assets, for example; while public sector organisations would require allocation of public assets into new separate capital accounts. We do not explore these here (although this needs to be done) but focus on how these organisations could operative as innovative, effective and efficient public services within the structure of a PIC.

1. The water industry

Introduction

The major case for the privatisation of the water industry and its delivery through the creation of public limited companies (PLCs) was to create a series of organisations that could bring long-term investment into the industry. The PLC was believed to be the ideal vehicle for this.

Given the monopoly nature of the industry, there was to be strict regulation of prices: this was intended to stop water companies from making excessive profits. At the beginning, there was considerable investment in the industry and charges to customers were reduced following intervention by Ofwat.

However, the industry is now finding that, in a heavily regulated field, where the charges that can be made to customers are limited and environmental objectives are also set by regulators, it is becoming difficult to raise money for further investment and to provide an attractive return to shareholders.

Within a year, two parts of the water industry found themselves so frustrated with their existing organisational forms that they looked into creating new organisations. In the summer of 2000, Yorkshire Water, with others, looked closely at the possibility of changing their organisational form to that of a mutual. There were various reasons but one of the strongest was to try to establish the financial basis for the organisation on a much longer-term basis. The idea proved not to be feasible.

And in the spring of 2001, Glas Cymru was launched as a 'not-for-profit company' which was established to take over the functions of Welsh Water. At the time of writing, they have succeeded in developing sufficient finance to take over the previous suppliers.

What would a water PIC look like and how would it run the public service of water supply?

A PIC would clarify the public's relationship with water industries. Since it would clearly not be able to distribute profits to shareholders, it could not be classified as 'profit making'. For a water industry organised by PICs, there would be no need for a regulator to limit the amount of profit that would be distributed since PICs could not distribute profit. Whilst the organisation would have to charge to meet its costs, removing the need to distribute profits to members – or to directors and shareholders – would clarify its role and objectives. A water company that became a PIC would be irrevocably tied to a specific public interest concerning the delivery of water services to the public. As such, having the identity of a PIC would emphasise the sole importance of public service outcomes.

On occasions, and where necessary, this would allow money from taxation to be given to the PIC without any worry over the creation of private profit out of public money.

A PIC would lock the long term public benefit aim of service delivery into the organisational structure. The organisation could not be 'taken over' by any other organisation which had different goals or a belief in private profit. If the organisation wanted to stop trading, it would have to give any assets to another PIC that had similar aims and a clear public interest at heart. This 'lock' on the transfer of resources would change the public's perception of the organisation.

In contrast, whilst Glas Cymru styles itself a 'not-for-profit company', it cannot legally guarantee that it will maintain this position over time. If it is successful in extending its asset base, it could find itself under very heavy pressure to realise those assets either through its own organisational form or by being 'taken over' by another organisation.

A PIC would still allow the water industry to develop a range of new, market-oriented products, so long as these met public benefit outcomes. This would encourage an entrepreneurial capacity within the organisation. While diversification could take place, it could only do so within the original goals of the organisation, ensuring that public benefit remained the core business of the organisation.

The surplus that would be generated would, by law, have to be used in the pursuit of the particular public interest in question. This would encourage the organisation to develop a surplus and therefore encourage businesslike activity.

PBCs in the US raise billions of dollars through the bond market. Following Glas Cymru's success in raising £2 billion through the bond market, there is now a British example where considerable sums of money have been raised by a not-for-profit company. This took place at a time when the rest of the water industry was finding it hard to raise capital through bonds. Something significant had happened here: the bond market felt safer with a longer-term, not-for-profit company than it did with comparable PLCs.

Given the international nature of the financial markets, and since American financial institutions are used to providing bonds for PBCs, it is likely that a water industry PIC, with its developed revenue stream, would also be successful in raising money through the bond market.

A PIC for the water industry could have a board representing a diverse range of stakeholder interests. These could either be appointed under Nolan principles, as with public quangos, or they could even come from elected bodies and include representatives of the organisation's customers. Crucially, everyone on the board would have to strive towards the public benefit aims of the organisation.

PICs would be set up to be clearly independent of the government. The creation of PICs would provide the opportunity to bring the water industry ‘back into the public sector’ but without tying it into the political control of the government.

The prime regulation of a PIC would be within the legislation creating such a company form. All PICs would have to register a specific public benefit and they would be regulated by the High Court to meet that benefit.

The issue of public service and private profit

We have discovered from other recent PMF research[13] that people get confused about the objectives of a service like water when it is run by a PLC. They see water as something clearly of public use and value, but the company form sits uneasily with the development of that public value. This confusion complicates all the relationships involved – to which we will return below – accountability, stakeholder involvement, and regulation.

As a PLC, a water company has to put the interests of shareholders first, and this can be a source of tension with its other objectives: to serve consumers and to care for the environment. These two objectives can also appear incompatible unless an overall objective of sustainability is adopted. Sustainability must necessarily be something that takes a long-term perspective – perhaps very long-term – and is not something that normally fits well with annual shareholders’ interests.

Because the distribution of profits to shareholders produces a contradictory set of goals for a public service, this can lead to a political demand to use the regulator to limit the amount of profit that can be made. We have already seen a review of water prices by the regulator, leading to a cut in charges to customers, which was followed by a fall in share prices.

The organisation that represents the water industry, Water UK, says that the restructuring of the industry through mergers and special purpose vehicles is being driven primarily by the need to deliver value to shareholders. In other words, the organisation through which water is being delivered is being driven by contradictory drivers, some working towards public benefit and some towards meeting shareholders’ needs.

The creation of new organisational

forms in 2000 and 2001

The changes attempted by Yorkshire Water to become Kelda, and carried out by Welsh Water to become Glas Cymru, stem from some of these conflicts. Water, as an industry, needs very long-term investment, which may come into conflict with the short-term demands of equity shareholders. Meanwhile, the public are, at the very least, confused by the delivery of a public service through a private company.

Glas Cymru, styling itself a not-for-profit company, has raised £2bn on the bond market. It says that using this form of capital is much less expensive than equity financing, enabling it to build up reserves and pass savings on to customers. It managed to gain Triple A rating for the bond issue.

It also says that investors were attracted by low-risk returns: Glas Cymru assured them that it would not diversify and that it would outsource operations, with contractors being penalised for any performance failures. As some of its contractors are other water companies, presumably its own shareholders will bear the cost of any failures.

Other water companies have found it difficult to raise much smaller sums through bonds. This reflects a wider crisis in finding investment for the water industry. It would appear that tight regulation can scare off equity finance.

Yet Glas Cymru's success suggests that, apart from the risk of regulators' intervention, water is a low-risk business. It has a stable and pretty much guaranteed revenue, and low technology risks. It would appear to be the regulator that is making the raising of finance difficult, but equally the regulator is playing a major role because of the profit motive driving the industry.

The integration of British water companies into multinationals

Other companies from outside the UK have bought a number of water companies, which are also involved in a range of businesses, mainly utilities. This means that these companies are subject to the control and influence of interests other than those of UK water consumers and citizens (citizens' interests might include environmental concerns, for example). This stretches still further public confusion about what these industries are.

It is a part of the structure of a PLC to be able to be taken over by other companies. For a water supplier, these may or may not be companies which also specialise in the delivery of water services. They may be companies who specialise in property development and they might come from any part of the world.

In terms of the delivery of services this may not matter. It will, however, very considerably restrict the public's agreement about putting any public monies into the service. The public will ask whether such public money is contributing to public good or is being delivered to overseas shareholders.

The existing PLC structure allows water industries to diversify into any form of product. This does encourage an entrepreneurial approach which allows the companies to develop newer markets within their overall business.. However it does so within an organisational context that can cause the public anxiety over whether public service is still the main focus of the organisation's activity.

Different sorts of monopolies or oligopolies take place in a wide variety of different public services, whether these are provided by public or private organisations. In these services, the consumer power of choice is limited and therefore the classic 'market mechanism' is also limited. The traditional way in which competition strips out unnecessary costs and creates innovation does not necessarily work in these areas.

There has been an ongoing debate between government and Water UK, which represents the industry, about whether and how to increase competition in the sector. The industry thinks competition would encourage innovation and improve efficiency, but competition is clearly difficult to introduce in a sector where geographical monopolies seem to be unavoidable.

Regulation and competition

The regulator plays an important role in determining activity within the water industry, sometimes limiting prices and sometimes determining environmental investment. Compared to the market mechanism of competition, this is limited. Nevertheless, a straightforward, unregulated competition could leave long-term environmental concerns unexpressed.

The regulator is thought to be opposed to mergers between water companies as a way of increasing efficiency because he wants to be able to benchmark different companies against each other.

We would be concerned about reconciling the need for environmental protection with the drive for greater efficiency in a situation where prices cannot be increased: this suggests cutting costs and possibly damaging the environment.

Competition does not seem to be the route for creating a more businesslike ethos. The entrepreneurial drive must therefore come from a different quarter, perhaps from the involvement of different stakeholders who want to balance customer service with environmental goals.

A businesslike approach might also include competing on a 'best value' basis for various parts of the operation, such as billing. Glas Cymru is doing this.

The regulator plays a major role in the development of the water industry partly because of the fears that a pure private company model, with its overriding emphasis on developing a surplus for shareholders, would not develop the industry within the public interest. Even if it were possible to develop a pure market model of competition, the effect on the water industry, as a public service, may not be helpful: costs could be driven down to beneath that which is compatible with environmental health.

It is clear then that there can be no unregulated market in water and therefore no pure market model. Within a private market company but without a pure market model, a businesslike ethos is just as likely to be absent from a private company as as it is often assumed to be from a public organisation.

Accountability

At the moment, accountability is apparently simple: through the shareholders of the water companies. But in real terms it is complex and full of conflict since the regulator represents a different accountability. At present Ofwat has a number of 'customer services committees' who provide accountability on behalf of the public. However this puts consumer and citizen interests externally to the heart of the business.

Those interested in the reform of the water industry have discussed different options concerning accountability. The key struggle is to ensure that there are no separate shareholders owning the organisation, since it is likely that these will come into conflict with other stakeholders. Glas Cymru is to have a group of 50 individuals, appointed according to Nolan principles, who will represent stakeholders.

As an alternative, the mutual option proposes that any customer can become a member, with the membership electing non-executive board members while other non-executives are appointed by the board, which also contains the executives who run the business day to day.

At present, the water industry has a very complex relationship with the government, brought about by the initial decision to privatise through PLCs. At the moment, because of the need to ensure that companies do not simply make high profits for shareholders without a view to the long term environment, the water industry has been given a number of regulators: Ofwat, the Environment Agency and the Drinking Water Inspectorate. A long-term strategy for sustainability might help to reconcile the demands of different regulators, but it will still be difficult to reconcile sustainability with shareholders' interests.[14]

2. The rail network

Introduction

The railways of Great Britain were nationalised by the Transport Act, 1947. In the 1980s, a programme of privatisation of state assets by the then Conservative government included the privatisation of the railways. The Railways Act received the royal assent in 1993.

The old British Rail was split up and Railtrack was established to control, develop and maintain the network. It was floated on the London Stock Exchange in 1996 and became a PLC, accountable to its shareholders.

Twenty five train operating companies were established to run passenger services and various other companies were formed to run freight and other services.

What would a rail PIC look like and how would it run the public service of rail networks?

If it were a PIC, Railtrack would have clear goals and compatible priorities concerning the specific public benefit of providing the railways as a public service.

Most people see the railways – whoever provides them – as a public service. But people find it confusing when the railways are expected to develop a profit for the shareholder as well. In the US, a number of public transportation services are PBCs, expected both to operate as a business and to provide a public service: a similar organisational form applied to Railtrack would help to clear up the public's confusion. Furthermore, our work on the motivation of public managers[15] suggests that the managers of a public service like Railtrack would be more motivated if they were working for an organisation clearly aimed at public benefit. Again, a PIC would achieve this.

Turning Railtrack into a PIC would provide the opportunity of 'bringing railways back into the public sector' but this would not mean bringing them into government through nationalisation. Railtrack as a PIC would primarily be regulated through the High Court to which it would have to show that it was meeting (or not) the public benefit it was set up to meet.

If and when profits were generated, these would be available for re-investment in the railways network. This is not the case at present, as is clear from a recent announcement about a re-organisation. In May 2001, Railtrack announced it was being re-organised into three divisions: one to operate and renew the network; the second to carry out major developments (such as the West Coast mainline); and the third to develop property and new business.

The third division is expected to generate profits from Railtrack's extensive landholdings. The regulator will claw back £1bn of any profit for re-investment over the next five years.

If it had been a PIC, the full amount of any profit would have been available for investment in the railway network.

If Railtrack were a PIC, it would gain most of its finance through charges for the use of the railway and public subsidy. At the moment, there is public anger at any subsidy that is given to Railtrack at the same time as shareholders receive a dividend. This current position is inherently unstable. Within a PIC, the relationship between these two different forms of income could be discussed without the usual public backlash. People would not feel that actions such as cost cutting were being carried out in order to meet the interests of shareholders.

If it were a PIC, Railtrack's board members would have no possibility of agreeing to a sale or take-over, and no incentive to do so. If any public assets had been put into the organisation these would be 'safe' in perpetuity to meet the particular public benefit the original organisation was intended to meet.

A railway organisation committed to public benefit could develop a number of products in partnership with other public or PIC organisations. Railtrack PIC could work with other PICs in the transport industry to meet its specific and wider public benefit goals such as developing an integrated local or national transport system.

Also, as a PIC, the drive for efficiency and entrepreneurial development would come from the motivation of its staff, led by the senior managers and the board, to serve the public interest.

Railtrack PIC would not sell shares but it would have access to the bond market, and this has been suggested as a strong alternative to shares as a way of raising finance. Railtrack was created as a PLC in order to raise capital, but it is precisely that activity which, in the summer of 2001, it is finding impossible to achieve.

To be financed through bonds it would still be necessary for Railtrack to satisfy financial institutions that it could keep up interest payments. In reality, with a monopoly over an infrastructure that is vital to the nation, Railtrack could be attractive to those seeking a low risk, moderate return on loans. The income from train operating companies is a reliable source of revenue. A clear commitment from government on the amount of public subsidy to be provided in the coming years would help to attract investors. The credit rating would also be improved by a government guarantee, as was used in the case of the Channel Tunnel.

Obviously we have no modern experience of bond issues for railways in this country (although see above with the water industry and Glas Cymru), but we do have the example of the Metropolitan Transport Authority of New York to look to: the MTA is a PBC and raises its capital finance through bonds.

As a PIC, Railtrack could have a board made up of those with an interest in rail services: passengers, the train operating companies, government, unions. The business plan would reflect their interests, not those of shareholders. All would want the operation of the network to be as efficient – and as safe – as possible.[16] Legally, they would have to work towards the specific public interest of providing a railway system as a public service, or however their public benefit was expressed.

There would obviously still be the need to balance the demands for current performance with maintenance and development work, but the need to make a return for distribution, rather than reinvestment, would not cloud the issue. This could contribute to a fundamental culture shift within the organisation.

The regulation of Railtrack is complex. Given that some of this concerns the anxieties caused by having a profit-making institution as a publicly-subsidised monopoly provider, regulation could be made a lot simpler. A PIC would have its prime regulation carried out by the Registrar of Companies who would ensure that it kept to its specific public interest.

The issue of public service and private profit

Public concern about Railtrack's priorities and competence has been rising as a result of three serious rail accidents between 1997 and 2000, in which a total of 42 people died. Questions have been asked about whether Railtrack was investing enough in maintenance and about whether it was single-minded in its pursuit of public safety, given the importance of controlling costs and returning a dividend to shareholders.

Public anxiety over these accidents was, however, an overlay on existing public disquiet about the form within which Railtrack was delivering a railway.

An ICM poll of a representative sample of 1001 adults in March 2001 found that 76% of people thought the railways should be brought back into the public sector.[17] Some of these concerns seem to be echoed by Lord Macdonald, Minister for Transport, when he said, at a conference in February 2000, that Railtrack was not an ordinary company but 'the custodian of a national asset' for whom 'the pursuit of profit is not a viable option'.[18]

Much of the recent discussion about Railtrack's future and financial difficulties has focused on the fact that it is a PLC which needs to make a return for shareholders. Railway accidents, particularly Hatfield in October 2000, have resulted in enormously expensive safety and repair programmes and compensation payments to train operating companies for the loss of revenue.

They have also raised questions about the underlying causes of the problems brought to light by the Hatfield crash and its aftermath. Some of these seem to lie with the structure of Railtrack as a PLC.

It can be assumed that any private company will seek to maximise profits and that shareholders are interested, on the whole, in fairly short-term returns. The options for Railtrack are to increase its revenues, to cut costs or to expand into new business. There is little possibility of increasing revenues, since charges for access to the network are set by the regulator.

Expansion into new areas is limited by the terms of the licence from the regulator. However, where Railtrack is involved in major infrastructure projects, the regulator allows a higher profit margin, because of the increased financial risk. Again, the interests of shareholders have to be accommodated.

This leaves the option of cutting costs as the only real possibility, leading to anxiety that this concern with cost cutting can and does jeopardise safety.

Railtrack has been accused of endangering public safety by adopting a strategy of reducing maintenance costs by renewing equipment as and when necessary, rather than at fixed intervals. The problem with this lies with Railtrack's inadequate records and knowledge about its assets and their condition, making it very difficult to assess the need for repair or replacement. It has also been criticised for employing layers of contractors, many of whom themselves used subcontractors, in efforts to save costs. Local knowledge and co-ordination about the state of the track was lost as a result.[19]

It is clear that, at least in the public eye, there is a clear link between cost cutting in order to gain profit for distribution, and issues of public safety: the two are seen to be in contradiction. In all, the public is distrustful about the idea of making private profits out of the railways.

The problem of public subsidy and private profit

Railtrack is heavily dependent on government grants for investment in the network, but its major source of revenue is payments made by the train operating companies for use of the network. The regulator sets these access charges. Clearly, the level of charges is of critical importance to Railtrack's profitability and investment programme.

In May 2001, Railtrack announced a loss of £534m for the previous financial year and asked for further public subsidy. Passenger groups and trades unions protested when it also announced that it was maintaining a dividend payment to shareholders, saying this was necessary to maintain access to the capital markets for future investment.[20]

It seems unlikely however that Railtrack could ever 'break even' without some form of public subsidy. The financial future, therefore, must be one of mixed public subsidy and income from charges: a problematic scenario, given public disquiet about Railtrack distributing profits to its shareholders at the same time as expecting an increase in subsidy. As a long term way of running a railways, this is not feasible.

The problem of capital formation in a failing PLC

The value of Railtrack's shares has fallen considerably since its launch as a PLC in 1996, facing the company with considerable difficulties in raising capital from the money markets.[21] It appears that shareholders would not support a rights issue for the time being.[22] Since one of the main aims of creating the PLC was to be able to bring capital finance into the industry this is a serious problem.

The recent IPPR commission report on public/private makes some important points here. As Martin Taylor the commission's chairman puts it in a foreword to the report, 'If the private sector is to play a greater role in public sector activities, it cannot do this on the basis of the very high returns earned in the highly leveraged structures erected by the venture capital industry. … They cannot form the general model for outsourced public services.'[23]

Further, various commentators have remarked on low morale and lack of trust amongst Railtrack staff, attributing this to years of uncertainty during the privatisation process and then increasing political and public criticism as performance appeared to deteriorate.[24]

At present, it is difficult to imagine the circumstances in which Railtrack might be bought by another organisation. It does not seem to offer an attractive business opportunity to other companies or investors. However, it is possible for other major investors or companies to acquire large holdings and exercise an influence on Railtrack's business.

If Railtrack were to become economically successful (perhaps through the provision of public subsidy) then it would be possible for them to be taken over.

The activities of Railtrack are defined by its licence from the regulator, which also prohibits it from conducting business other than that which is permitted by the licence.

The competition between Railtrack and, for example, some long term bus companies sometimes precludes the development of a local integrated transport system since the bus companies do not see it as in their interests to take passengers to the stations that connect them with their potential competition.

Railtrack is a monopoly organisation. One of the arguments put forward at the time of privatisation was that the need to make a return to shareholders would give the organisation and its staff an incentive to operate more efficiently. Would it therefore become less efficient without this driver?

Can a PLC be accountable for a public service?

Current difficulties financing Railtrack have illustrated the problems of accountability that are inherent in a having a PLC operating a public service. Following recent concerns about whether Railtrack was working wholly in the public interest, the Government announced that it would require Railtrack to have an additional director, to represent the public interest. This was announced as part of a package involving financial help from public funds.[25] In response, Railtrack commented that, under current legislation, the new non-executive director, would be required to look after the interest of shareholders, not those of taxpayers or passengers.[26]

This is obviously the law for a PLC but poses considerable problems for any form of accountability which goes beyond shareholders. This has to be developed through the different regulators.

When the railways were privatised, they were made into PLCs to demonstrate that they were independent of government. Indeed, the experience of a nationalised industry had made that independence one of the main selling points for privatisation.

However, given the monopoly status of the service and the profit making nature of the PLC, public regulation became essential.

Regulation of the railway industry is so complex because it needs to provide the PLCs with their public accountability.

The rail regulator, heading the Office of Rail Regulation, has a number of responsibilities encompassing the control of the railway industry. He has to promote efficiency and competition in the provision of railway services. He sets charges that Railtrack can make to the train operating companies, aiming for a balance between making a reasonable return on its capital assets but not abusing its monopoly by making excessive profits.

Without shareholders, different interests would have to be juggled: a reasonable level of charges for the train operating companies against the need to generate surplus for investment in the network.

The Strategic Rail Authority grants franchises to the train operating companies, imposes minimum standards on them, and is responsible for protecting passengers' interests.

(We have not gone into the possibility of the train operating companies themselves also operating as PICs, or being incorporated into Railtrack, but such changes would obviously change the role of the regulators still further).

3. The local education authority (LEA)

Introduction

Since the 1870 Education Act, local authorities of one form or another have played a role in education. Over the following 108 years, this role grew considerably so that it covered nearly every aspect of education provision at pre-school, school, further and adult education levels (and, in those local authorities with polytechnics, higher education). This was an extensive set of statutory powers, and most of the debate that took place concerned the way in which these powers could be extended.

With the 1988 Education Reform Act this changed dramatically. And with the introduction of local management of schools the role was dramatically diminished so that the day-to-day 'running' of schools and, later, further education colleges by LEAs was stopped.

The decade since has seen a powerful debate about the role of the modern LEA. This has continued under both the Conservative administration of 1992 and the Labour administration of 1997 through the challenge of 'fair funding' (increasing the percentage of resources that the local education authority has to deliver straight to schools).

The 1998 Education Standards Act gave the power to the Secretary of State for Education to intervene if there was evidence that an LEA was failing, the main criteria of which was receiving an unfavourable report on an OFSTED inspection. At that point, the Secretary of State and the LEA would bring in a firm of consultants who, together with the LEA, would draw up an action plan for improvement. It was made clear from the beginning that this action plan might involve outsourcing the LEA's functions to other organisations.

In 1999 and 2000 some 15 authorities had such an action plan and they developed a wide range of different approaches to the provision of LEA services. For many of them, there was some discussion of 'outsourcing' all the LEA functions to another organisation, mostly one or other private company, which led to the charge that education was being 'privatised' and that companies were 'making a profit out of children's education'.

Towards the end of 2000 the DfEE encouraged local authorities to develop different models of education authorities and actively encouraged radical thinking in this regard. Yet the organisational forms open to them were restricted to the charity, the public company or the traditional public service organisation.

For many this was a limited choice: if they moved away from the traditional public service model they would usually be forced into working within the existing company model. The public resistance to ‘making a profit’ out of public money for children’s education meant that many local authorities would not go down that path. This left the charity model. But this was also problematic since an LEA provides a wide range of services for schools which would fall outside of the charity’s primary purpose.

This has brought the debate about the future of local education authorities into the arena of our research on PICs. How would a PIC operate an LEA within the standards we have outlined?

How would a PIC develop an LEA as a public service?

If a PIC were to take over the duties of an LEA they would be set up to meet a specific public interest outcome for education services. They would have to have that aim and could clearly be held to account for working towards that interest. There would be no shareholders to confuse this. A local authority could create a contract with a PIC, with the same success or penalty clauses – detailing extra money for success – as a contract with a private company would have, but the local authority would know that these extra ‘success resources’ would not go to external shareholders.

All surpluses would go back to the pursuit of the original public interest. If the PIC was able to cut costs, this would not be seen as a strategy to meet shareholder goals but would, rather, be part of creating a businesslike ethos and producing surplus for the original public benefit.

The directors would have to work towards the specific public interest aims. If these were a nationally-based set of educational aims it would be possible to have directors appointed from national education bodies that represent parents, teachers and governors associations. Or, as is more likely, if we had local PICs providing education services in a specific locality, then representatives could be elected from local organisations or even from the whole local electorate. If the company were to fail, its assets would have to be rolled into an organisation with a similar public interest. This would provide some important safety for the local authority as client. The creation of PICs would allow education services to be provided 'within the public sector', but not under direct political control.

A PIC providing local education services would be able to develop new products and services as long as they were within the public benefit aims of the original organisation. This would ensure that they would be able to meet the shifting markets needs of a local education service without changing their overall goals. Over the last few years, for example, it has become clear that for some schools, breakfasts for the children and after-school clubs demand different products which a PIC could meet. Such a relationship could operate through a long-term partnership contract, which would allow contractor and client to develop new products for new needs without having to specify the nature and level of all these services in the original contract.

A PIC that provided local education services would be expected to develop those services within a businesslike ethos. For some services, trade would be gained in competition with private companies. The managers, director and staff of a PIC could be paid publicly-transparent bonuses for creating surpluses for the original public benefit.

A PIC providing education services would only gain any income if its successfully traded for services from LEAs. It might gain small sums of money from other public or charitable subsidies, but its major source of income would come from trading.

We have no British experience of organisations such as PICs raising capital for educational services on the British financial markets. However, in the United States this is an established way of financing capital for education services: all of the schools in New York have their capital financed through PBCs. And it is probable that the US bond market would be a useful first lender for any British PICs providing education services.

Problems with existing organisational alternatives to the LEA

At the moment there is a clear identity for nearly all LEAs with the public sector: they are seen as public organisations providing public services. Any alternative LEA run by a private company brings real problems. Those private companies that provide education services are mainly larger companies who are making a profit and this clouds the public service relationship.

'We profiled 16 service providers currently providing education services to LEAs. The majority of those services we identified were large, national companies with high levels of turnover. In terms of staffing levels, the majority of providers had well over 100 members of staff. Every company we profiled worked nationally across the UK and a significant number worked internationally.'[27]

National or international private companies cannot claim that they are providing education solely as a public interest. They are providing it as both a public interest and as a benefit to their shareholders. The public sees this as, at the very least, a confusion and, at the most, an opportunity for their money to go to shareholders rather than into education.

LEAs as public institutions do not make a profit. But the fact that the only present alternative to them are private companies who do make profit is a major drawback to the development of alternatives to LEAs and causes the debate to be stuck in a very simple either/or between public and private service delivery models. The distribution of profit – and the possibility of 'losing' that money from education itself – is one of the single biggest reasons why so few alternatives to public LEAs are in place.

This potential confusion of goals may appear to be sorted out by the creation of a contract which links the two. Thus a company will only be given any profit if it meets certain educational goals (usually educational standards). Such a contract may have an internal logic but, as far as the public is concerned, the shareholder interest confuses the public interest.

At present, if an LEA outsources its work to a company, that company risks being taken over by another which may not have education as its core business: there is no 'lock' within the company model to stop this. If a local authority is thinking of developing a new organisation to deliver the services of an LEA, it will need to anticipate the possibility of such a takeover and the consequences. Will the original contract still be important to any new, probably larger and possibly international organisation? If all you have is a contract, this could be of very little importance to a company run from the other side of the world with no real long term interest in education.

The limits of entrepreneurialism in the existing LEA structure

LEAs have traditionally been limited in their ability to trade beyond their boundaries and beyond the specific products that statute allows them to provide. Historically, when a new product has been necessary, it has come about through new legislation: for example school meals in the first decade of the 20th century. Over the last few years a number of LEAS have successfully 'sold' existing services to other local authorities, most notably inspection and advice services, but have not been allowed to trade in new forms of service. With the new 'power of community well being' contained in the Local Government Act 2000, this may be eased.

The history of local authorities as entrepreneurial developers of new products has not been good. Within their localities, LEAs are public monopolies. Historically, most have very little experience of operating in a businesslike atmosphere. The creation of locally managed schools with their own budgets has changed this for a number of services which now have to compete with external traded services and, therefore, to work within a very different market ethos.

Interestingly, for some local services, this has led to the creation of mutuals within the local authority service sector. In Newcastle-upon-Tyne, the musical instrument and training service – which used to be a part of the LEA – has become a co-operative and has succeeded in developing and selling music services to other LEAs. This demonstrates the need for some local education services to move towards adopting a different organisational form in order to construct a clear business operation.

Education is a charitable purpose with a long history and many charities already exist to provide education services. Each one is, however, specifically tied to its original aims. While it is possible for each to apply for an extension to these aims whenever they have in mind to develop a new product, having to do so hardly encourages a spirit of entrepreneurialism.

The public sector's lack of experience of trading

An LEA within the public sector has historically gained nearly all of its finances through national and local taxation. This has not encouraged LEAs to look for others sources of income and in the past they have been forbidden to trade.

Following local management of schools, some parts of local education services have learnt that they must trade to survive, and they have traded with the schools that now have the bulk of the money. This has changed the ethos of those parts of the LEA. However, the LEA as a whole – with its director of education and lead member for education at its helm – still sees the vast majority of its resources coming from public taxation and is essentially *not* a trading organisation looking to fund itself from the goods and services it provides.

The problem of raising capital

Traditionally the LEA has raised capital finance through credit, as central government has allowed it to do, although this has been restricted by the Treasury to certain sums. In recent years this has been supplemented by the possibility of extra private finance through the Private Finance Initiative (PFI) which, at least for some LEAs, has increased the opportunity to create capital for larger projects. Considerable controversy exists about this proposal amongst public sector providers, however, because of short- and long-term costs and fears of losing control to the private sector. Whilst PFI has grown as an alternative for the provision of public services, it has done so because there is currently no other alternative.

At the moment private companies who deliver education services have no problem in obtaining capital finance as these activities are profitable. If that profitability were to dip because of ideological factors, this might change.

Accountability

LEAs' accountability exists through a number of different platforms. Most obviously, electors vote for the councillors who, in turn, elect the lead member for education. They are also accountable for national standards to OFSTED.

Accountability through electors is a classic cornerstone of public accountability. It is, however, questionable whether this provides the public with a real experience of being able to hold education providers accountable.[28]

Private companies providing education services are only felt to be accountable through the contracts that they work through. The local authority provides them with a contract for a set of services and they are accountable for the provision of those services alone; there is no wider accountability for the organisation as a whole. Historically, the accountability of private organisations providing public education services has not been a matter of concern to the public, but increasingly it is becoming so.

Conclusion: Carrying forward the case for a public interest company

As an idea in progress, *The Case for the Public Interest Company* raises many possibilities and many questions. Each needs exploration. We believe that many of the next steps in making the case for a new form of public service organisation need to be taken from within public services themselves. In education, crime prevention and health the new government has committed itself to a programme of reform. Sometimes that reform will mean having private sector organisations running public services and, because these organisations must be committed to distributing a dividend to shareholders, this is likely to raise considerable problems.

In this paper we have suggested the PIC as an alternative both to the existing public sector organisation and to the private company. Over the next several months PMF will be exploring with different public service organisations how a PIC could be used as a vehicle to deliver their own services. As we succeed in constructing a strong case for the reform of each separate area of public service, we will be adding that to the areas we have already covered, thereby building the overall case for reform. We encourage other organisations to do the same. When, together, we have a powerful enough ‘critical mass’ of public services recognising how they could use a PIC, we will turn our attention to a more detailed technical and financial examination of the organisational form.

As we said in our acknowledgments, there are others making important cases for the development of other institutions, especially new mutual forms. We believe that our case for a PIC and their case for new mutuals complement each other in our attempt to break through the either/or of public sector and private sector, that confronts the British people at present.

Better public services deserve better delivery vehicles.

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3. ibid page 3

4. ibid page 16

5. 'The status charity does not attach to a category of organisations with a particular form but rather to charitable objects managed in such a way as to maintain the integrity of the gift' NCVO For the Public Benefit, (report on charity law reform) 2001

6. see the Registrar of Friendly Societies website

7. Co-operative Commission, *The Cooperative Advantage*, January 2001, p.-8

8. ibid

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10. As a part of a particular public interest, some organisations may want to invest any surplus they make in assisting for example local social entrepreneurs or in creating new public interest organisations. For as long as there was no leakage of surplus to other sources, the surpluses could assist the future development of the number of organisations developing within that public interest.

11. The Housing Finance Corporation, despite their own role as intermediaries, thought that it was housing associations' assets and more-or-less guaranteed income from government (housing benefit) that enabled them to borrow money in the market. This was more important than organisational form in convincing lenders to do business.

12.The issue of competition and conflict between any new organisational form and companies is important. Margaret Bolton at NCVO, who was secretary to the Charity Law Reform Group spent a sabbatical at Columbia Law School studying 501(c)3 (public benefit corporations). She said the issue of unfair competition between these organisations and private sector businesses is complex, producing a mass of case law. Related to this, regulation has become very detailed e.g. on remuneration of senior staff.

13.Steele and Corrigan (2001) op. cit.

14. The Director General of Water Services (Ofwat) has primary duties and secondary duties. His primary duties are to ensure that the functions of the companies are properly carried out and that 'companies are able to finance their functions, in particular by securing a reasonable rate of return on their capital. Lenders and shareholders should be able to receive a return that is sufficient, but no more than sufficient, to induce them to make loans and hold shares, if the company operates efficiently.'

His secondary duties include protecting

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about the Public Management Foundation

The Public Management Foundation is a research centre concerned with improving the impact of services that create public value. PMF explores issues relating to the effectiveness of public, private and voluntary sector services which affect community well-being.

Much of our research is directed primarily at learning from the reflections and practices of people who are actually involved in service delivery and use: politicians, managers, service professionals and citizens.
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