Assessing the Effectiveness and Future Viability of Trusts in the New Competitive Market

Electricity Industry Reform Conference

This paper was presented by Peter McKinlay, executive director of MDL, to the Electricity Industry Reform Conference, Wellington, 4 & 5 July 2000.

1.0 Introduction

The brief for this paper is to present a reassessment of the role of energy trusts in the context of current concerns about the development of the competitive market and how (if) the long drawn out process of reform will finally deliver tangible benefits for consumers. Here the emphasis, particularly given the inevitably political context of electricity reform, is that as a minimum benefits for consumers means worthwhile benefits for residential consumers.

To address the brief I want first to look briefly at the origins of energy trusts and then to consider their present situation from three different perspectives:

- Legal and constitutional issues
- Trust ownership and industry efficiency
- The impact of regulation

2.0 Origins

The Energy Companies Act 1992 can be seen as a product of government frustration with or inability to resolve the extraordinarily vexed question of finding an acceptable ownership form for the companies which would result from corporatisation of power boards. The Act followed several years of often acrimonious debate between advocates of privatisation, supporters of continuing but stand-alone public ownership and a minority who believed that ownership should vest in local authorities as the best available representatives of the communities served by the former power boards.

The process provided for in the Act for determining ownership was unique, not just in New Zealand's experience of restructuring publicly owned trading assets but internationally. It was driven by the people who had been selected in 1990 to

be the directors of the future corporatised distributors (the then Labour government had intended to create companies run by commercial directors but owned by community trusts; it got as far as selecting the future directors, putting them in place as members of the to be corporatised power boards, and sidelining the then board members as "interim trustees" pending creation of community trusts before it lost the 1990 election).

The future directors were required to prepare an establishment plan including a share allocation plan. They had complete discretion as to how share ownership should be allocated subject to:

- going to public consultation as though they were a local authority subject to section 716A of the Local Government Act
- obtaining the agreement (by majority) of the interim trustees
- obtaining the consent of the Minister of Energy.

Although the then Minister initially suggested that trust ownership would not be seen as compatible with the Government's objectives, in practice he accepted whatever proposals were placed before him provided that the future directors could show that they had the agreement of a majority of interim trustees and had addressed (but not necessarily acted on) any issues raised in public consultation.

The majority of power boards opted for at least some trust ownership with a significant number preferring 100 percent trust ownership. The detail of these arrangements differed quite substantially. The majority chose a trust structure which gave trustees considerable influence, at least in theory, over the company but others were restricted in various ways the most notable example being the Auckland Energy Consumer Trust which received 100 percent beneficial ownership of Mercury Energy Limited but under a complex arrangement which effectively left control of the company with the directors.

With hindsight, there is much about that process which could be criticised from a public policy perspective. For example, it is clear that the section 716A special consultative procedure is far from satisfactory as a means of determining public preferences -- especially as its focus in electricity restructuring was on responding to a specific proposal with no or very limited ability to research alternatives.

Perhaps the major defect, though, was the failure on the part of the government to put in place any statutory framework regulating the governance or accountability of the trusts. A reading of the various policy papers considered by Ministers suggests that one reason for this failure was a confident expectation that trusts would have a very short-lived existence. Against that expectation putting in place a statutory framework for the governance, management and accountability of energy trusts may have been seen as both unnecessary and likely to create the impression that trusts would be around for the long haul, something which was clearly not the Minister's objective.

Whatever the explanation, the reality is that energy trusts stand in stark contrast to other holders of local public wealth in their lack of any of the normal controls on public bodies. The community trusts which resulted from the restructuring of regional trust banks are subject to quite tight ministerial control -- trustees are appointed by the Minister of Finance and any changes to their trust deeds require ministerial approval. Local authorities face an extraordinarily detailed set of requirements governing their financial management, reporting and accountability.

In practical terms, energy trusts are part of the governing structure of the local community. Accordingly, it should be seen as simply plain common sense that they should be subject to the same comprehensive statutory standards as apply to their senior "partner" in that governance, local authorities.

3.0 Legal and constitutional issues

Constitutional

The constitutional position of energy trusts is somewhat peculiar. Their present status seems to be thought of as public bodies somewhat analogous to special purpose local authorities. The reality is quite different. To quote from the report of the Inquiry Into the Electricity Industry, "Trusts are private bodies established under a trust deed and subject to the Trustee Act 1956". In practice, they are legally no different from a typical discretionary private trust.

Accordingly, they have none of the reporting or accountability requirements usual for public bodies, hold their meetings in private, and have no obligation to explain the nature of their decisions or the basis on which they are taken. The one connection which they have to any kind of public accountability is the fact that typically they are elected by their consumer beneficiaries.

This in itself is capable of creating a great deal of confusion. It is common for people seeking election to campaign on the basis of what they believe public expectations might be and make commitments accordingly. In a trust context however, electoral "commitments" have a quite different significance than they do for the typical public body. Election in a trust is a means of selecting persons who then become trustees subject to the full burden of trustee responsibility with its emphasis on prudent management of the trust fund. The potential for conflict is very real as trustees learn that implementing the promises on which they were elected may involve a breach of trust.

Perhaps more importantly, the idea that election will result in an effective mandate for trustees, or act as a means of holding individual trustees to account for past performance, is something of a myth. Reasons for this include:

- Effective electoral accountability requires that electors have available to them information on which they can make judgements about the performance of the persons standing for election. The fact that trusts as private bodies conduct most of their activities in private and make relatively little information available publicly denies electors the very information they need in order to make informed judgements on the performance of trustees

- The interest which the typical elector takes in the electoral process is normally a function of the significance of the electoral outcome -- what difference is it likely to make to you personally -- and of the ease of getting information on which to make your judgement. Regrettably, the practical reality for bodies such as energy trusts is that it is simply not worthwhile for the individual elector to go to the time and trouble needed to cast an informed vote, especially given the difficulty of getting adequate information.

This is an issue which could have been addressed by the Inquiry Into the Electricity Industry but this is clearly one area in which it has "dropped the ball" (perhaps because it considered that the ownership, governance and accountability of trusts themselves was outside its terms of reference). There are recommendations in place regarding trust owned energy companies but these are

extremely unlikely to have any significant impact (recognising that the measure of impact is the extent to which companies actually change their behaviour as a consequence of those recommendations in a way which they would not otherwise have done).

The Inquiry proposes that:

- All distribution companies that are majority owned by trusts and local bodies be required to have a Statement of Corporate Intent modelled on Transpower's
- Those Statements of Corporate Intent should include the substantive provisions of Transpower's SCI in relation to service quality, costs and prices; and
- The directors of those companies should be required to undertake to operate in accordance with those SCIs.

These recommendations assume that the key governance relationship is between the trustees and the company. This assumption is quite wrong. The critical relationship is between trustees and their beneficiaries -- the public whom they serve. Unless trustees are required to be accountable to their beneficiaries for the nature and quality of the decisions they take and the performance they require of their energy company then little is likely to change. Typically, companies have a much greater capacity to analyse and review activity than their associated trusts. In the absence of compelling reasons for challenging company views on what should be done and what is possible, it will be extremely difficult even for those trustees who may want to do so to achieve change.

There is a more fundamental issue as well. The recommendations in the Inquiry's report assume continuing trust ownership of the related energy company whilst acknowledging the possibility that, following an ownership review, a trust might elect to sell or otherwise dispose of part or all of its holding. In practice the interests of the beneficiaries, at least at the level of the collective, will not be confined to the sell and distribute/don't sell option. There will be a number of instances in which the optimal use of the wealth represented by energy company ownership may be some other form of investment in the interests of the community. Without effective accountability to trust beneficiaries, there is no real way in which these issues can be raised -- and periodic ownership reviews are not the vehicle for this kind of questioning as they focus on a rather different set of issues.

There is a further problem with the Inquiry's recommendation for the adoption of an SCI modelled on that for Tranpower. This would require trust owned companies to target earning a full weighted average cost of capital on the seeming assumption that only through full economic pricing can productive and allocative efficiency be best achieved. This is a doubtful proposition for a business such as this. Typically, the decision which consumers face is to connect or not to connect rather than the more normal purchase case of making judgements about the precise quantity to purchase or the use of different suppliers in order to get some comparison.

The reasoning in support of this recommendation is sparse but part from the implicit economic rationale may also reflect an Inquiry view on the meaning of section 36 of the Energy Companies Act which provides:

> (1) The principal objective of an energy company shall be to operate

as a successful business.

(2) In seeking to attain its principal objective, an energy company shall have regard, among other things, to the desirability of ensuring the efficient use of energy.

It is common to argue that in order to be a successful business it is necessary to earn at least your cost of capital. The argument is based on:

- the fact that most businesses are owned by investors for whom return on their invested capital is their principal concern
- the view that earning at least your cost of capital is an essential element in achieving productive efficiency.

If the interests of the owner are different, then surely the measure of success should also be different? It seems likely that the main interest which consumers have in the operation of a trust owned energy company is that it is able to achieve least cost efficient service delivery. This might suggest earning a surplus as a means of funding new investment (if depreciation is not sufficient for that purpose) but there is no logical reason why it should require the company to target a normal rate of return on capital; after all, trust owned companies are much more analogous to co-operatives than they are to conventional companies. For the same reasons consumers may reasonably take the view as "owners" that there are better performance requirements for targeting efficiency than earning a full cost of capital.

It would seem to me to make better sense to develop means of incentivising company managements so that their returns were at least partly dependent on demonstrating that they had achieved least cost efficient delivery having regard to the need to maintain the capability of the network including security of supply at whatever standard was deemed appropriate.

In summary, the constitutional situation of trusts is anomalous and in my judgement one of the more significant policy issues which the present government needs to resolve. My informal inquiries suggest that the present government is following the "hands off" approach of its predecessor in this area in the belief that interfering with trusts inevitably means privatisation. If that is the situation, then the government has clearly misunderstood the nature of the problem. The question which needs to be dealt with is the lack of proper governance and accountability to the beneficiaries of the trusts themselves and not the now somewhat outdated question of whether trusts should be forced to divest.

Legal

This area is a real mine field. The problem for trustees is that trusts were not designed as a vehicle for owning major business enterprises operating under conditions of risk. Trustees are bound by the so-called prudent person rules in contrast to directors who face a business conduct rule. Trustees are expected to place their primary emphasis on protecting the corpus of the trust fund; whilst directors are not expected to be reckless, there is a recognition that their role inevitably involves risk-taking.

There is some limited recognition of this in the typical trust deed for an energy trust. The investment powers will usually include a provision to the effect that "no trustee shall be liable for any breach of trust... merely because the investments of the trust fund are not diversified." However, as section 13E of the Trustee Act

1956 makes clear, diversification is only one of the matters which trustees should take into account:

> Without limiting the matters that a trustee may take into account, a trustee exercising any power of investment may have regard to the following matters so far as they are appropriate to the circumstances of the trust:
> (a) The desirability of diversifying trust investments:
> (b) The nature of existing trust investments and other trust property:
> (c) The need to maintain the real value of the capital or income of the trust:
> (d) The risk of capital loss or depreciation:
> (e) The potential for capital appreciation:
> (f) The likely income return:
> (g) The length of the term of the proposed investment:
> (h) The probable duration of the trust:
> (i) The marketability of the proposed investment during, and on the determination of, the term of the proposed investment:
> (j) The aggregate value of the trust estate:
> (k) The effect of the proposed investment in relation to the tax liability of the trust:
> (l) The likelihood of inflation affecting the value of the proposed investment or other trust property.

Of particular importance is the need to consider the risk of capital loss or depreciation. Over the past few years this has probably not been seen as much of an issue. In the years immediately following restructuring, the value of energy companies increased quite significantly as the market understood the relationship between earnings and ODV. More recently, I suspect that trustees have been comforted by the belief that a lines owning energy company is a natural monopoly and thus capable of maintaining its earnings stream and value into the foreseeable future.

Such a view is now, at best, complacent. There is a growing acceptance that deregulation of the electricity industry not just in New Zealand but in major developed countries is for the first time creating an environment in which it makes economic sense for entrepreneurs to pursue alternatives to the traditional model of the large-scale generating set distributing its power through major networks. Arguably, we may be at about the same stage in developing alternatives as the personal computer industry was in the early 1980s.

Some trust owned companies are clearly aware of this potential as the following quotation taken from a submission to the Inquiry shows:

> "Rapid technological development of small-scale distributed generation and storage devices will create real competitive tensions in distribution and transmission markets over the next decade."

The assumption here is of the real possibility for a decline, possibly very significant, in the value of trust investments to the extent that value is governed by the economic value of lines businesses. It is doubtful that the exception for non-diversification will be sufficient of itself to protect trustees against actions for negligence if they are not proactive in managing the risk to the value of their investment (it would be fascinating to know what advice the directors of the companies concerned have given their trustee owners on this issue, if any).

The main protection which trustees have enjoyed so far is a very pragmatic one; the rather adverse cost:benefit assessment of the worth of suing. If you assume

that your interest as a beneficiary is pro rata to the number of beneficiaries then the maximum value of your interest is probably less than $5000 and in most cases significantly less than that. If this is the case, then even if you think that the trustees of your energy trust have been grossly negligent, there is probably little merit in suing them especially as their resources would typically be sufficient for them to appeal any adverse decision as far as the Privy Council if necessary.

There are signs that this is changing. The Auckland local authorities currently engaged in legal action against Vector and the Auckland Energy Consumer Trust are admittedly in a somewhat unusual situation (they are capital beneficiaries suing over the question of whether a proposed distribution is from income or capital). However what they are doing is staking a claim that as representatives of their communities it is appropriate for them to intervene when another entity, serving those same communities, appears to be acting in what they regard as an unlawful or inappropriate way.

The issues traversed in the last two paragraphs suggest that, in their own interests, the trustees of energy trusts should be re-considering the appropriateness of those structures. The issue which they need to resolve is how to develop a structure which can reconcile the interests of public ownership with the need to be able to act commercially. Their dilemma is that the kinds of decisions which they might need to take to protect the value of their investment against technological change are not the kinds of decisions which trustees are normally called upon to make, but, if they fail to act to manage technological risk they may nonetheless face personal liability.

Again, what I am looking at here is a direct consequence of the failure of those responsible for the Energy Companies Act to consider the likely operating issues which energy companies and trusts might face. Had they done so it seems inevitable that they would have put in place a statutory framework giving trustees somewhat better protection and somewhat wider powers than they currently have but undoubtedly in return for more robust provisions regulating governance, management and accountability.

4.0 Trust ownership and industry efficiency

In this section I want to consider three separate matters:

- reconciling social and commercial objectives;
- the relationship between trust ownership and industry rationalisation and efficiency;
- are there constraints on finance for supply security and asset growth.

Social and Commercial Objectives

This issue could have been discussed when dealing with legal and constitutional concerns as there is a question over whether trustees have the power to use their energy company ownership to pursue social objectives, at least if this was seen as likely to have an adverse impact on the value of their investment.

This has been a source of frustration both for a number of trustees and for those of their beneficiaries who have taken an interest in what they seek to do. From a purely common sense perspective it seems logical that a public body owning a monopoly infrastructure business should have not just the ability but an obligation

to take social objectives into account.

The reality is that conventional private trusts are not intended to be vehicles for the pursuit of social objectives. Instead, they are intended to be prudent custodians of wealth in the interests of beneficiaries. This situation was capable of being addressed by including suitable provisions in the terms of individual trust deeds. This did happen in some cases -- most notably with the Rotorua Energy Charitable Trust which was quite specifically established for charitable purposes and thus with an overriding social purpose. In the majority of instances, though, trustees may find that they have to get quite creative in exercising their powers if they are indeed to pursue social purposes. A common way of doing this is to rely on the powers to distribute income for the benefit of consumers as a means of funding activities with a social purpose.

I turn now to the question of whether there is an inherent conflict between social and commercial objectives arising out of trust ownership of energy companies and, if there is, how to manage that. My starting proposition is that, all too often, what might appear to be conflicts between social and commercial objectives turn out to be lack of proper definition and allocation of roles where they belong. The recent fracas over the disconnection policy of Metro Water Limited in Auckland seems to be a good example. The company chose to disconnect water supply to certain residential consumers who had failed to pay their accounts. This caused the council considerable embarrassment as it appeared to confirm public criticism that corporatisation of the water supply would result in the profit motive overriding any sense of service obligation to consumers to the particular disadvantage of low income households.

My assessment of this particular event is that it need not have happened. First, it seems that the Council took no steps to ensure that the statement of corporate intent for Metro Water Limited included the Council's expectations of how the company would deal with instances of non-payment. The Council could have specified a number of options in the statement of corporate intent including:

- The means of enforcement which, as shareholder, it regarded as consistent with public ownership
- The steps which the Council might want the company to go through -- which could include referring non-payers to agencies which might be able to assist
- The "best practice" practices which the Council expected the company would follow in managing its reputation as a good corporate citizen.

As an example of this latter point, the Council might decide that it wished to see the company set up an effective and properly resourced customer advisory board as a means, amongst other things, of identifying customer concerns before they get to a crisis in individual cases. This is a practice which I would recommend to any company managing a natural monopoly such as a lines or water distribution network. Provided that it is probably established, a customer advisory board can offer the very real benefit of independent legitimation of company policy.

Secondly, the company itself may not have thought through the implications of what it was doing. It is simply good commercial business practice to be aware of the potential sensitivities associated with the decisions you might be required to take and ensure that those sensitivities are properly understood and managed.

More generally, conflicts between social and commercial objectives most often arise when one or both of the parties involved are trying to avoid confronting an

issue. I recall an instance of a city councillor on the board of a council owned energy company feeling totally frustrated because of what she felt was her inability to look after the interests of low income consumers. The former MED, like many of the old supply authorities, priced electricity to residential consumers below cost and cross-subsidised from (particularly) commercial consumers. The new energy company was re-balancing its tariffs so that each category of consumer was required to pay the full economic cost of supply.

The councillor, as a director of the company, was arguing against this change. The company's response was threefold:

- · As a director of the company she had a primary obligation to act in good faith in its best interests. This did not include arguing that a particular tariff should be set at less than full economic cost for what were claimed to be social reasons
- An across the board subsidy was extremely inefficient; the bulk of residential electricity sales were to households which were not low income so that the principal effect of holding down prices for "social" reasons was to subsidise the already well off. The obvious answer, if assisting low income consumers was a priority, was to find some means of targeting them. Directors and management of the company made the point that they had been appointed for their commercial skills and lacked the knowledge and background required to make social judgements
- The Council was the proper body to decide whether subsidy for low income consumers should continue and, if it should, to develop and implement the means of delivering that subsidy. The subsidy could be funded out of the Council's income from the company which would be pleased to work with Council in delivering the subsidy to entitled consumers.

The Council concerned decided not to get involved in the payment of subsidy to low income electricity consumers. Its main reason seemed to be an unwillingness to become involved in overt income redistribution, partly because this had not been a traditional local government role and partly because it did not want itself have the responsibility of deciding who should be entitled to receive a subsidy and who should miss out.

From my perspective, the question of social vs. commercial objectives is not really one of conflict. Rather, it is either one of a lack of knowledge of the available instruments (for example, how to use the statement of corporate intent to influence the way in which the company does its business), a lack of good commercial understanding about how to manage the sensitivities associated with a natural monopoly or what amounts to a wish for owners " to have their cake and eat it too". In the situation which I have just outlined, it seemed clear that the Council had been perfectly happy with under pricing residential electricity for "social" reasons but was far less happy to develop a policy on explicit targeted subsidy. I suspect similar considerations underpin most of those cases where there are complaints that corporatisation of public facilities will make it difficult to reconcile social and commercial objectives.

In summary, my view is that when people complain that there is a conflict between social and commercial objectives in a public ownership situation, such as we have with trusts or local authorities (or for that matter central government) what we really have is one or more of the following:

- A failure in organisational design with the result that it is not clear how

responsibilities are divided between public owners and commercial managers

- Public owners are looking for a "free lunch" solution, trying to pretend that there is no economic cost associated with pursuing their social objectives.

The Relationship Between Trust Ownership and Industry Rationalisation and Efficiency

Perhaps the first point to make is that efficiency is a measure of the resource cost involved in achieving a particular objective or objectives. Clearly, it is only possible to make a judgement about efficiency when you understand what the objectives actually are. There is substantial evidence that many of the communities whose networks are trust owned place a positive value on this form of ownership. In part, that is simply a reflection of a quite wide spread community opposition to privatisation of what are regarded as "essential services". It seems to me however that there are other reasons as well. Many communities seem to place quite strong value on local ownership and the sense this may give them of accountability and of having available to them local management responsible for the maintenance of the network, especially under emergency situations. You may lack the information which you need to make a judgement on the quality of trustees' commercial decisions but, if you have a prolonged power outage, that itself is the information which local communities will use to call trustees to account.

It may be that in an ideal world theoretical least cost operation, with its implication of a number of networks coming under common management, would be consistent with the concerns underlining a belief in the merits of local ownership and control. I suspect that we are still some distance away from that outcome. There are still too many anecdotal stories of people ringing a call centre to get attention to a local emergency to find that the operator has no idea where they are. Admittedly, that is happening in an environment of local ownership of the network but with the customer relationship in many cases being with an energy trader whose operational base is hundred of miles away. At least, from that frustrated customer's perspective, there is still the possibility of holding the network owner to account to ensure that it exercises leverage over energy traders using its network to provide proper service.

That said there may well be a number of barriers but also some potential levers in favour of rationalisation. The most significant barrier is that the people who would be required to promote rationalisation will most commonly be those who are likely to become redundant as a consequence. The incentives on current network managers to recommend to their owners that they should look for some form of rationalisation are not strong and, in the absence of contestability in the provision of network services, their owners have no particularly strong incentive to get independent advice.

It is interesting to look at what is happening in a parallel area, water and waste water services. There is a growing view, which has been promoted by a number of people currently engaged in the management of individual water and waste water systems, that the case for rationalisation, at least of management if not of ownership, is extremely strong. It is difficult to see why the case should be strong in that sector and not in electricity distribution. My expectation is that we will see a growing acceptance that looking at options for management is a reasonable and appropriate thing to do. Like much else which I have commented on in this paper, I think that progress would be much faster if we had a proper accountability regime for energy trusts and they were required (as local authorities are by statute) to consider the costs and benefits of different means of undertaking

significant activity.

So much for barriers. What about influences which might encourage rationalisation? To my mind the strongest is the potential impact on trustees as they begin to realise that the natural monopoly characteristic of networks is under considerable threat from technological change. As trustees start to look at this issue, and what it implies for their trustee responsibilities, I would not be all surprised to see a growing interest in options for rationalisation. The trick, especially for commercial interests with an interest in promoting this approach, will lie in finding ways of giving confidence to trustees and their communities that rationalisation will not place consumers at risk of exploitation or of a lower quality of service.

Constraints on Finance for Supply Security and Asset Growth

To my mind the answer is the question of whether trust ownership would make it more difficult to raise finance for security of supply or asset growth is a straightforward no. The critical question is surely whether or not the capital expenditure concerned can be included in the ODV. If it can, then the company is entitled to recover its weighted average cost capital on the investment which should be sufficient to support any necessary borrowing. If it cannot, then it is difficult to see why a company required to act commercially would want to make that investment, regardless of its ownership.

The are two qualifications to this judgement. The first is that the company might have such a high proportion of debt financing on its balance sheet that, regardless of its ability to include the investment in its ODV, financiers might be unwilling to lend to it. I am not aware that any trust owned network operator is in this situation. The second qualification is that the customer or customers on whom the company would rely for payment might not be a good business risk for the amount involved; this may be a particular issue for large customer specific investments whose value is simply scrap if the activity fails.

5.0 Regulation

I have some very real reservations about the regulatory proposals which have been made in the Inquiry's report. My starting point is that the regulator, under a system of government imposed regulation, always starts on the back foot. Anyone who has spoken with some of the American companies which have invested in, or looked at the possibility of investing in, the New Zealand distribution sector will know the level of comfort they have with operating under heavy-handed regulation. In practice, they tend to regard this as more a guarantee of profit than a restraint. Amongst the reasons which give rise to this outcome are such things as:

- The power imbalance between the regulator and the regulated. The regulator's resources depend on appropriation by a normally tight fisted government[1]. In contrast, for the regulator maintaining as favourable a regulatory environment as possible is absolute core business; you will spend what it takes and the good news is that the regulatory regime will almost certainly ensure that you can pass this cost on to your customers so that the cost to your owners of defending your position is essentially zero.

- Particularly in an environment such as New Zealand's, it may be far more difficult for the regulator to engage the number and quality of staff required to discharge the regulatory function effectively than it is for the industry to recruit or allocate the resources to protect its position.

- At the end of the day government, and the regulator, needs to maintain an environment which will not discourage future investment.

I have already commented on the failure of the Inquiry to look at the governance and accountability of energy trusts. In my view unless this issue is addressed directly and comprehensively, then the prospects of an effective regulatory regime for electricity distribution, if by this is meant a regime which produces least cost efficient outcomes for consumers, are virtually zero.

One of the arguments advanced in favour of trust ownership is that trustees will naturally have an incentive to represent the interests of their consumer beneficiaries. The argument is an attractive one but it needs close examination. In practice, incentives are only effective if the people whose interests are to be protected have available to them clear and timely information about how their representatives have responded and this is coupled with the ability to impose sanctions if they have not performed as the incentive framework suggests.

Consider what this would require. First, trustees would need to give consumers clear information about the different options for management of the network in order to achieve their desired objectives. This would have to be more than simply bland statements that the trustees were satisfied that it was in the best interests of consumers that the status quo persist. Consumers would need chapter and verse about the options which had been considered and the financial and other variables which had been compared. The same should be required for other operational variables such as security of supply.

Ideally, the trustees would also act to ensure that consumers had independent and reliable information on the different options available to them for energy supply. This would see trustees acting, in effect, as a form of consumer watchdog over the supply companies.

This is regulation working effectively with the incentives probably aligned and the obligation placed on people who genuinely have the necessary access to information and who can take whatever steps are appropriate in the circumstances of the particular company and set of customers to get the right outcomes. It should also avoid the problem of the company gaming the regulator, especially if trustees were able to ensure that the remuneration arrangements for key company management were dependent on achieving least cost efficient and effective supply.

This could extend to establishing customer advisory boards or other mechanisms such as customer charters but with the weight of the owner behind them.

The "price" for trustees would be a relatively comprehensive governance and accountability framework over their own activities. The reward should be the ability to appear effective in acting on behalf of consumers and thus potentially improving their own credibility, an opportunity which the present lack of accountability ironically denies them.

6.0 Conclusion

Here I restate the main points made in the paper with the intention that they should be seen as matters which the present government should address, urgently, as part of its response to the recommendations of the Inquiry Into the Electricity Industry.

Origins

Trusts were accepted as part of a political compromise by a government which did not expect that form of ownership to continue long-term. Now that it is clear they will, it is imperative that their governance and accountability arrangements be placed on the same footing as those for other significant local public bodies -- the obvious parallel is the accountability and reporting regime for local government

Constitution

The Inquiry has wrongly identified the relationship between energy trusts and their energy companies as the key governance relationship. In practice, the key governance relationship is between energy trusts and their consumer beneficiaries. In order to make that relationship effective, consumer beneficiaries require adequate and timely information on such things as the objectives which trustees have set for the operation of the energy company, how those objectives are monitored and the rewards/sanctions in place for performance.

If, as informal inquiries suggest, the present government is continuing the "hands off" approach of the previous government in the belief that intervention with energy trusts means privatisation, and needs to recognise that the issue is no longer divestment but governance and accountability requirements that measure up to what we require of other public bodies.

Legal

Energy trusts are private trusts. This is not a structure which was designed for the purpose of holding the ownership of major commercial trading assets in a time of potentially rapid technological change. Again, the mismatch between structure role reflects the lack of consideration of the operating environment for trusts at the time of the original restructuring.

The dilemma for trustees is that they may now face significant personal risk which they might find extremely difficult to manage given the difficulties of doing so within a trust structure which also carries with it the expectation of continuing network ownership.

Efficiency issues

(1) Social vs. Commercial Objectives

My own view is that there is no inherent conflict. Rather, in cases where there appears to be a difficulty the cause is normally one or more of the following:

A failure to properly specify using the available instruments such as the statement of corporate intent how the owner expects the company to act

The company itself paying in adequate attention to the proper management of customer relations, both at the level of the individual customer and with customers generally

The owner wishing to avoid facing up to the what is actually involved in implementing measures to achieve its desired social objectives.

(2) Industry Rationalisation

The first question is efficiency for what purpose? Clearly, many communities place at least some value on local public ownership and what they regard as direct

accountability for performance. To the extent that is the case, that objective needs to be factored into any efficiency measure.

That said, the present structure is unlikely to promote rationalisation as the personal incentives are not aligned with this outcome -- there is still an element of self sacrifice in recommending that your own employment is no longer necessary. The high level of interest within the publicly owned water and wastewater industry in rationalisation of management begs the question of why similar changes are not being actively explored by energy trusts.

A possible explanation is that energy trusts, unlike local authorities, do not face a statutory obligation requiring them to review the costs and benefits of different ways of undertaking activity. Such a change should be part of a new statutory framework for trusts.

Finally, as trustees consider the risks to their own personal position from technological change, there may be an attitude shift on rationalisation.

(3) Constraints on Finance

These should be minimal so long as any new investment can be included within the ODV. There will be exceptions, for example if there are doubts that an expected user of a major dedicated investment can meet the long-term commitment involved, but this would be just as much an issue for an investor owned network.

Regulation

I have very real concerns about the effectiveness of the proposed regulatory environment. Regulatory frameworks function best when the incentives of the parties are aligned with the objectives of the regulation. At least for trust owned companies, this suggests using ownership rather than government intervention as the means of regulation. Again, this would require putting in place a suitable governance and accountability regime for trusts which, amongst other things, required the trustees to give consumers clear and timely information about the different options for management of the network in order to achieve their desired objectives.

It also seem appropriate for energy trusts to take a role in protecting their consumers interests as purchasers of energy.

FOOTNOTES

1. Government does have the alternative of funding the regulator by a levy on the industry. In practice, this does not avoid the problem as the industry will pass the cost onto the consumer thus leaving the government in the politically unpalatable position of taxing consumers.

Copyright © 1995-2000 McKinlay Douglas Limited