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# Public Interest Companies

## Fad or permanent fixture?

Over the last year a new phrase has entered the policy lexicon: the Public Interest Company (PIC). The Government, or rather parts of it, appears interested in exploring this new idea. In the cases of Network Rail, National Air Traffic Services (NATS) and Foundation Hospitals, they have already created such organisations or are in the process of doing so. There are dissenting voices, most notably in the Treasury, but also on the Labour back benches where distrust in all types of Public Private Partnerships is widespread.

To date there has been little understanding of what Public Interest Companies are, what they might offer, and what problems they may bring. They have three key defining features. They:

- do not usually have shareholders; where they do they are restricted in their ability to profit from the organisation, or they have

another key interest in the organisation besides profit

- are independent from the state
- deliver a public service

These organisations are sometimes referred to as 'not for profits'. Such a term is misleading and inaccurate; managers in Public Interest Companies will typically want to retain a surplus, but the key difference is that this surplus will not be distributed to owners.

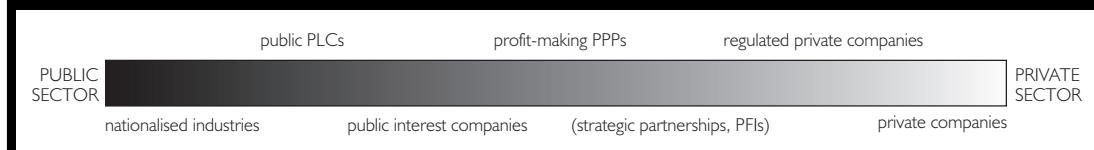
*"Despite the recent interest, the concept of Public Interest Companies is not a new one"*

### *PICs in context*

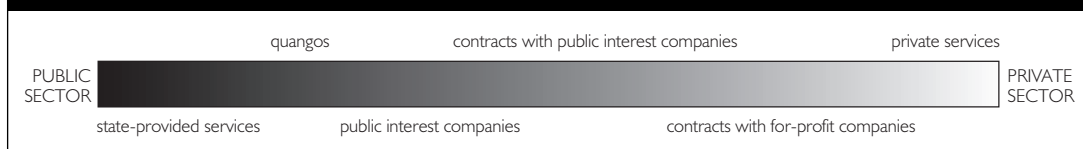
It is helpful to consider Public Interest Companies as a type of Public Private Partnership (PPP), albeit one

rather different from the Private Finance Initiative (PFI), one of the most common forms of PPP. It is also useful to place PICs in the context of other organisational forms available to public managers. These encompass full public sector control, through to complete privatisation.

### Box 1 The public enterprise continuum



### Box 2 The general public services continuum



It is important to make the distinction between two types of public services: the revenue generating public enterprises including the privatised utilities and most public transport services; and the more general tax-funded public services such as the NHS and schools. The existence of user charges mean the public enterprises have a more obvious route to access private finance than other services wholly reliant on Government grants.

They have often been granted more organisational independence than other forms of public services, and have frequently been the focus of privatisations. The more general public services have rarely moved along the public service continuum.

### A multiplicity of PICs

Despite the recent interest, the concept of Public Interest Companies is not a new one.

Type of PIC	Key features	Examples
Company limited by guarantee	Management answer to appointed 'members' who carry out the same role as shareholders, but who cannot profit from the company.	This is the most popular form of PIC. Examples range in size from small Development Trusts to large utilities such as Network Rail.
Industrial and provident society	Can be either bona fide mutuals, owned by their members for their members or 'Benefit of the community societies', which provide services for people other than just their members.	Examples include organisations set up to run ex-local authority leisure services in Bristol and Greenwich, and the majority of Housing Associations.
Public or private limited company owned by users of a service	If a limited company or a PLC is owned by the users of the service then the owners have a different relationship to the company from typical shareholders. These organisations could be labelled Consumer Service Corporations.	The joint venture PPP for National Air Traffic Services (NATS) is owned by the Government, staff, and a consortia of airline companies who have a controlling stake.
Public or private limited company wholly owned by government	In some circumstances the Government may wish to provide public enterprises with the freedoms of a typical company, but for public interest reasons may want to retain all shares and control.	Examples include the Post Office and British Nuclear Fuels Ltd.
Share trust	A PIC organised as a private limited company with nominal share capital held in trust. The holding company owns 100% of the operating company, which in turn is operated as a PLC. The trust is established in favour of a not-for-profit or charitable purpose, and independent trustees are obliged to act in accordance with these instructions.	An example is the Housing Finance Corporation, the funding intermediary for social housing.
Trust or special organisation	Bodies that do not use existing company models, but which have specially created bodies that conform to PIC definitions.	Examples include the Trust Ports, Higher Education Corporations (the majority of Universities set up after 1992), and the older universities either set up under Royal Charter or under their own Acts of Parliament as Chartered Corporations.
Charity	Charitable status is not in itself a form of incorporation; it is granted in addition to an organisation's basic legal status. Charities are usually organised as either companies, trusts, or they are unincorporated or 'exempt' (ie incorporated as Industrial and Provident Societies, by Royal Charter, or otherwise by statute).	Organisations which are well known for being charities (such as Help the Aged, or the Children's Society) deliver many public services, especially in areas such as personal social services, hospice care and home/school links.

Housing associations have delivered social housing for over a century using the same basic model. Nor is there one simple type of Public Interest Company; one of the sector's strengths is the variety of organisational forms that can be employed.

### ***A new legal form is not necessary***

The Prime Minister's Strategy Unit has suggested adding a new legal form – a 'Community Interest Company' – to this list of possible organisational forms. The main justification for this is the difficulty of preventing demutualisation in Companies Limited by Guarantee and Industrial and Provident Societies. Demutualisation is rightly seen as problematic when significant assets (potentially such as the rail network or hospitals) are at risk of being transferred from public to private control without the approval of Government. The current array of options is also seen as making the promotion of Public Interest Companies more complex.

Helping to prevent the possibility of demutualisation is clearly an important consideration, although there are ways of preventing this without recourse to a new legal form. However, it is not clear that adding a new legal form will help promote Public Interest Companies: the additional public benefit tests and regulation might make the new legal form appear less attractive than existing well-tried alternatives.

### **PICs and incomplete contracts**

One of the main benefits of Public Interest Companies arises from a desire to provide public managers with clarity about what is expected of them and with management freedoms to help achieve those ends. Currently, too many public sector managers have little clarity about who bears what responsibilities.

There is little devolution of power to front-line operatives and a culture of risk aversion tends to dominate.

Putting in place a purchaser-provider split, for example through the Private Finance Initiative, has been seen as a useful way to clarify the desired outcomes of public service provision. For relatively simple public services it is easy to specify what needs to be delivered in a contract. However, contracts are by their nature incomplete. Where a service is complex and safety or the public interest is paramount, contracting alone is unlikely to protect the public interest.

Public Interest Companies offer a possible advantage in such complex circumstances by replacing shareholders with a stakeholder membership (which could include government) so that the profit-maximising pressure from shareholders is diluted. For

this reason Public Interest Companies could provide an adequate safeguard when contracting for services such as clinical care in a major NHS hospital.

### **Finance and risk**

Issues of finance and risk should be central to any debate about the usefulness of Public Interest Companies. Some of the presumed advantages of the model are centred around finance: that Public Interest Companies are presumed not to appear on the Government's accounts; that they have lower costs of borrowing, and that they can take a more long-term management view without the presence of shareholder pressure. However, to date, few of these issues have received adequate analysis.

### ***Illusory finance arguments for PICs***

When supported by taxation, the off-balance sheet arguments in favour of Public Interest Companies are entirely illusory, as they are

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with the Private Finance Initiative and other types of Public Private Partnerships (IPPR, 2001). The logic of the argument is that if Public Interest Companies are accounted for as private companies and do not appear on the Government's balance sheet, they can borrow freely from the private finance markets because it will not count towards departmental expenditure limits. As a result, government departments can invest in alternative schemes, increasing the overall level of investment.

This argument is wrong. Although the *financing* for this investment comes via the private sector, in many Public Interest Companies all the *funding* comes from taxpayers. It remains a public liability and there can be no 'extra' investment. Government should focus on questions such as whether these bodies provide more appropriate management structures and whether they are more likely to improve services to the public. Only when the optimal solution has been reached should the Government consider how the organisation should be accounted for.

### ***PICs do not generally deliver lower costs of capital***

Another often-stated advantage of Public Interest Companies is that they can achieve lower costs of borrowing. This argument arises because in typically financed companies that use a mixture of equity (shares) and debt (lending), the cost of debt is significantly lower than the cost of equity. In a Public Interest Company there are usually no shareholders, so 100 per cent of any private finance has to be debt. However the cost of finance is a function of how much risk that finance bears (Modigliani and Miller, 1958). Financial markets will price the overall risk of an organisation and so the absence of equity will not lower the overall costs of finance.

However, there are two exceptions to this rule. The first concerns tax treatment; interest payments on debt are tax deductible, but

dividends on equity are paid after tax. This is one of the reasons why Glas Cymru, the Welsh water utility which is a Public Interest Company, achieves a lower cost of finance than other companies in the water industry. The second occurs when the nature of the business changes. An example is when a Public Interest Company owned by the users of its services (a Consumer Service Corporation) permits a fundamental change in the regulatory structure of an essential monopoly service. For example, Nav Canada, the Canadian air traffic control company, which is organised as a Public Interest Company, has achieved a lower cost of capital than would otherwise be the case because the users of the service, the airlines, have rights over appointing the board and the company is then free to set prices. This avoids the need for risky price regulation.

### ***Short-term nature of equity***

Although equity is a tried and tested method of dealing with risk in private companies the horizons of institutional equity investors are notoriously short-term. Companies' concerns about falls in their share price can have a distorting short-term influence on business decisions. Lenders, however, have longer investment horizons and so a 100 per cent debt-financed company may be more suitable for the needs of a public service, where horizons might be measured more in decades than months.

### ***Alternative ways to deal with risk***

As risk-bearing capital, equity plays a vital role as a financial buffer in typical companies. Public Interest Companies that do not have shareholders must replicate this flexibility if they are to be successful and stable organisations. There are at least six ways in which risk can be dealt with in the absence of equity:

- Debt issuers could bear the risks
- Sufficient cash reserves could be built up over the short term to absorb expected

future risks

- Financial support could be obtained as a substitute for risk capital
- Risks could be transferred on to the users of the service
- Risks could be absorbed within the operational performance of the company
- Risks could be externalised, through outsourced contracts or insurance

Few of these alternative methods are as satisfactory at dealing with financial risks as equity. As a result Public Interest Companies are probably more suited to low-risk situations and to circumstances where a combination of these different methods can be employed.

#### ***Attraction of prudential borrowing frameworks***

When considering finance and risk, it should be remembered that not all Public Interest Companies will require capital. In addition, those that do require capital do not necessarily need to access private finance markets; in fact in the case of taxpayer-funded services, there is no obvious benefit from doing so. Prudential borrowing frameworks, similar to those being considered for local government and the Northern Ireland Assembly, may be a better way of allowing organisational independence and appropriate borrowing powers through accessing finance direct from the Government.

#### **Governance and accountability**

Besides providing risk capital, shareholders also fulfil another vital role in typical companies; that of governance. In theory at least, shareholders provide managers with a clear target of increasing shareholder value, and if managers fail to deliver this increased value they can be dismissed. The absence of shareholders in most types of Public Interest Company mean that corporate governance has to be organised differently. Alternatives, such as stakeholder members without a financial interest in the organisation, are considered by

critics as too unfocussed and unwilling to take tough financial decisions. Yet supporters of Public Interest Companies claim that stakeholder governance, particularly if it includes direct public involvement, can increase the accountability of public services.

#### ***Facing up to the criticisms of stakeholder membership***

The criticisms of the governance arrangements found in Companies Limited by Guarantee have some validity. It is possible for there to be little incentive for effective corporate governance and too often members are chosen because they are 'the great and the good', rather than because they will provide effective scrutiny. Members can also become defenders of the status quo rather than agents for change, and there are many industries (including rail) where groups such as trades unions, user representatives and industry representatives all have radically different views concerning the priorities of the Public Interest Company in question. Critics are also able to point to examples of where stakeholder governance has not performed well.

#### ***Potential benefits of PIC corporate governance***

In some cases, however, the governance arrangements of Public Interest Companies could provide advantages. The myth that managers need share options (and hence the company needs shares) in order to perform well has been overturned in the case of Glas Cymru, where managers are rewarded bonuses not simply on the basis of the short-term share price, but on a range of customer-focussed, environmental and financial indicators. Consumer Service Corporations might also be expected to deliver particularly effective corporate governance. Yet there are other circumstances where appointed members might be expected to deliver particularly effective scrutiny; given the history and passions aroused by the rail

network in the UK, the appointed public members of Network Rail are likely to ask much tougher questions about management performance than the institutional investors behind Railtrack ever did.

Although there are both pros and cons of using stakeholder membership in the place of shareholders, what is clear is that in order to be successful Public Interest Companies will want to pay particular attention to how their corporate governance is organised and to the quality and experience of appointed members.

### ***Lenders and corporate governance***

Another possibility for governance of Public Interest Companies is giving lenders a key role. Normally, lenders take little interest in corporate governance as their money is likely to be repaid regardless of the day-to-day fortunes of the company. In the absence of shareholders, lenders might be expected to fulfil governance duties in PICs.

However, if lenders are given a role in a Public Interest Company's corporate governance it should be done with caution. Even in PICs lenders are unlikely to take on financial risk, so other methods of dealing with risk will probably need to be found. If this is the case, lenders will in theory continue to have little financial interest in the company and should be less effective than shareholders in carrying out corporate governance tasks.

### ***Separation between accountability and governance***

The stakeholder membership system possible in Public Interest Companies offers the possibility of a radical change in the way in which the public interacts with those responsible for delivering public services. If the public can become good corporate governors of a company delivering public services then we would have a new form of accountability in public services that might be better than many current arrangements in public private partnerships and which might even

be more focussed than traditional ballot box accountability.

Public involvement in stakeholder membership can be particularly useful where increasing social capital is a principal aim of the organisation (such as in the many Development Trusts) or where using existing community organisations can help a public authority reach out to many vulnerable minority groups (for example, Tower Hamlets is establishing a new procurement regime to increase the proportion of service delivery by charities and other types of Public Interest Companies).

However, too often the principles of accountability and governance are unnecessarily conflated. A public service is not necessarily more responsive, efficient or of a higher quality if there are weekly community meetings attended only by unrepresentative activists. This is being recognised by some housing associations who believe that they can determine their tenant's needs and views more effectively through polling and focus groups than they could by organising tenant meetings. Openness and accountability in public services are important principles. However, the best way to achieve these ends might not be through user representation on formal governance structures. Indeed, in areas such as health there is a distinct danger that these community representatives could be captured by professional groups.

### **Conclusion**

It seems that Public Interest Companies have a role to play in three key areas of public service delivery:

- in public enterprises that are monopoly essential services where users are organised and have a significant interest in the performance of the organisation. In these circumstances users can be given some control over the governance of the company, helping avoid the natural pricing

conflict generally found between owners and users of a monopoly service. These Consumer Service Corporations can also modify the need for price regulation.

- when contracting for a service is desirable but the complexity of a service means the public interest can not be guaranteed solely through a contract. In these situations Public Interest Companies can help avoid the profit maximising behaviour of shareholder-owned companies that might unhelpfully exploit incomplete contracts.
- where a key aim of the service is the involvement of stakeholders in the organisation's governance. This is particularly useful for smaller organisations where building social capital is the key policy aim.

However, Public Interest Companies are no panacea. There are a number of points that need to be understood before a Public Interest Company should be considered for a public service:

- PICs are probably more suitable to low-risk ventures, and there needs to be clarity over how financial risk can be dealt with before a project goes ahead.
- For taxpayer-funded services public borrowing via prudential borrowing regimes may provide a more suitable route of finance. Off-balance sheet arguments in favour of taxpayer-funded PICs are erroneous.
- 100 per cent debt-financed organisations such as PICs generally do not have cheaper costs of borrowing.
- Public Interest Companies need to think

carefully about how they provide good corporate governance. Involving a wide range of stakeholders in corporate governance might not be the best way to provide responsive and accountable services to users.

- Public Interest Companies should not be seen as 'not-for-profit' or 'nice' PPPs. Particular caution should be exercised when they are used when there is no fundamental problem with other contracting processes; for example, in the 'not-for-profit PFIs' currently being considered in Scotland.

Whilst Public Interest Companies can offer a way forward for public services, choosing the appropriate organisational structure is clearly only one way in which public services can be improved. And even then, other organisational forms such as joint ventures between the state and private companies may achieve similar results.

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*"Public Interest Companies offer the possibility of bringing some additional diversity of provision to key public services, but the danger is that they become the latest policy fad and are used in situations where they are not appropriate"*

policy fad and are used in situations where they are not appropriate. Government needs to pay serious attention to PICs and should routinely consider them alongside other organisational forms when planning the future of public services. If used wisely PICs could become a permanent fixture in the public services; just as those original Public Interest Companies – the Housing Associations – have managed to adapt and survive for over a hundred years ●