

# STRATEGIES FOR SAFEGUARDING PUBLIC VALUES IN LIBERALIZED UTILITY SECTORS

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In the utility sectors, public values such as affordability, safety, and protection of the environment, require safeguarding. In the last 15 years, most utilities have been either liberalized or privatized. In an attempt to protect public values under these new conditions, this shift has been accompanied by an emphasis on tight regulations and strict norms. These are examples of hierarchical safeguarding mechanisms. This mechanism can cause adverse effects, such as an increase in transaction costs, which diminish or even outweigh the supposed advantages of liberalization and privatization.

In addition to hierarchical safeguarding, this article describes two mechanisms used to safeguard public values: network mechanisms and market mechanisms. We suggest that smart combinations of network and hierarchy on the one hand, and market and hierarchy on the other, will lead to more effective and efficient safeguarding of public values than relying on hierarchy alone.

## INTRODUCTION

Recent years have seen a great deal of debate about the safeguarding of public values in the liberalized utility sectors. Examples of public values are reliability, safety and affordability of the service. The Californian electricity crisis in January 2001 sparked off the debate in the United States. Did the profit-seeking private companies do enough to safeguard the supply of such a primary necessity of life? The same question arose after two major rail accidents in the United Kingdom in October 1999 and March 2000. In a situation where private companies now plied the rails, did the regulators actually have a grip on safety? A third example is the major power outages in the Nordic countries (2003), Italy (2003), London (2003) and New York (2003). The list of incidents and crises continues to grow. The debate is being conducted everywhere.

In the ensuing public debate, these crises were blamed on liberalization. According to Ken Livingstone, London's mayor, 'that great wave of privatization that went round the world' was to blame for the problem since the result was 'the lack of investment, [which] is bordering on the criminal' (Livingstone 2003). Among academics, we hear similar voices. Jørgensen and Bozeman, for example, argue that 'privatization and contracting out often have the effect of eroding public values' (2002, p. 65).

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The debate about whether public values are safe in private hands is the logical consequence of liberalization and privatization in the utility sectors. These tendencies have major impacts on traditional safeguarding mechanisms. In terms of infrastructure, governments used to be the sole producers and distributors in almost all cases. Consequently, it was felt that there was no need for a tight regulatory framework. Public actors, in whose ethics these public values played a key role, protected them, even if they were not always explicitly identified (Van Wart 1998; Kernaghan 2003).

Liberalization and privatization have made production, distribution and supply the responsibility of several public and private actors. This has created a network of interdependent actors. Targets and procedures that used to remain implicit in one single public body now need to be stated explicitly between different contract partners. Thus, unavoidably, complex legal provisions accompany the liberalization of utility sectors. These provisions help to identify, allocate and mitigate the various risks involved, risks that did not exist under conditions of public ownership (Lobina and Gall 2003, p. 22).

This article seeks to set out the safeguarding arrangements that are necessary in a liberalized or privatized context in order to protect public values while mitigating the adverse effects associated with tight regulation. Under conditions of liberalization and privatization of utilities, it is clear that both laws and regulation are necessary. However, given the disadvantages of strictly defined targets and regulations that are too strict, how can laws and regulations be combined with other safeguarding mechanisms so as to leave room for the operator as well as power for the regulator?

In the section that follows, we give a brief overview of the discourse about public values and we discuss the relativeness of the concept of 'public value'. We then outline three types of safeguarding mechanisms: hierarchical, market-like and network-like. We then discuss smart combinations of the different mechanisms. The article's conclusion briefly discusses the conditions under which the different combinations can be successful.

## DEFINING PUBLIC VALUES

The literature on public values is a broad one. An immense landscape of theories and terminologies can be unfolded, especially when we incorporate perspectives used in institutional economics, law and public administration. There are services of general interest (see, for example, EC 2004), public values (see, for example, Moore 1995; Jørgensen and Bozeman 2002), public objectives (see, for example, Noam 1996), public interests (see, for example, Blumstein 1999; Raad voor Verkeer en Waterstaat 2003), externalities (see, for example, Michie 1997; Ostrom *et al.* 1999), and public norms (see, for example, ECN SEO 2004), to name only a few of these. It should be remembered also that even when authors use the same concepts, they can mean very different things.

In making an inventory of the literature from three important disciplines that study the safeguarding of public values in utility sectors, that is, law, economics and public administration, we can find a number of observations on public values that are relevant to the debate on liberalization and privatization in the utility sectors. A summary of these observations is given below.

### **Procedural values versus substantive values**

In the discourse on public values given in this paper, process is separated from and contrasted with content. Procedural public values refer to the way the public sector should act and to standards that the process of government action should meet. These are procedural values like 'honesty, probity, impartiality, serving public interests, political accountability, regime stability, transparency, social cohesion, user orientation and efficiency' (Jørgensen and Bozeman 2002, p. 64). This discourse is undoubtedly powerful. Several governments have established offices for ensuring 'ethical conduct.' For example, Canada has the Office of Values and Ethics (see Kernaghan 2003, p. 714) and several governments have formulated Codes of Conduct (for example, New Zealand, the UK and Australia). In this discourse, it is argued that basic (procedural) public values should be taken into account when producing goods and services that are collective goods or common goods (for example, Jørgensen and Bozeman 2002, p. 64). Theories within this category stress different aspects of public values. Their main concern is how citizenship, equity, justice, ethics and responsiveness can be enhanced (Frederickson 1997).

This article focuses on substantive public values rather than these procedural public values. In the discourse on public values in the context of utility sectors, the central idea is that the state is responsible, either directly or indirectly, for safeguarding substantive public values such as universal services, continuity, quality of service, affordability, user and consumer protection. These values can be specified for each utility sector (for example, Schmitter 1988; Netherlands Scientific Council for Government Policy 2000; Netherlands Ministry of Economic Affairs 2002, p. 6; EC 2002, 2003; Dubash 2003, p. 149; Nyfer 2003; Encore 2004). Other authors have chosen terms such as 'public goals' (Encore 2004); 'public works values' (Tonn 2000) or 'public interests' (PIER 2001, p. 2). Of course, it is impossible to make a clear-cut distinction between procedural values and substantive public values. In this article, we will demonstrate that the substantive public values can be ambiguous.

### **Public values versus private values: public benefit versus private interests**

What qualifies a value as a 'public' value as opposed to a 'private' one? For a value to be called 'public', there has to be a collectivity, an aggregation level that can benefit from the protection of this value. 'Private' values are

equated with private interests. These private values can be contrasted with collective benefit (Weintraub 1997, p. 5). The opposite of 'public' is that which pertains only to an individual. This implicit or explicit reasoning that a value is public only if a collectivity benefits from it is common to all analyses of public values.

In the political debate, the concept of 'public values' is often used without the term being questioned. Public values are 'condensation symbols': 'symbolic forms that merge diverse anxieties and emotions with a shared expectation about the time, the place, and the action that will evoke common support and a common perception of the enemy' (Edelman 1971, p. 135). However, in the utility sectors, we see a highly contested notion emerging. How the line between public values and private ones is drawn precisely in practice differs widely. What is defined as a public value in a utility sector in one country may be labelled as 'private' in the same sector in another country. Or what is labelled as a public value in one period of time may be defined as private in another decade. An example of the blurring of public and private labels are the water companies in the UK. These companies are called 'public companies' in daily parlance, although they are completely privatized. This picture becomes even more blurred when we speak of the 'safeguarding' of public values. Public values might be protected by private actions. Take, for example, the protection of captive consumers, as in the telecommunications industry, where this value is protected by private actions. Given the many operators and the many modalities (fixed and mobile telephony, telephone via Internet) consumers have many choices and it is extremely difficult, if not impossible, for operators to keep them captive.

### **Public values and efficiency**

Another observation is that the protection of public values brings costs, and public values always require a trade-off between their own values and the value of efficiency. This seems to be a rather trivial observation, but the point is that liberalization has made the costs of privatization and liberalization visible. The more visible these costs are, the stronger the need to make a trade-off between public values and efficiency. An example here is the public value of reliability of supply in the electricity sector. This reliability of supply may be improved by making the system of electricity supply extremely redundant (for example, in the event of a power interruption on part of the grid, the electricity can always reach the consumers by another route), but this makes it prohibitively expensive. The question therefore is not how to guarantee reliability of supply, but how to guarantee a cost-effective reliability of supply. This may be a reason not to invest any further in reliability of the grid: The Netherlands Bureau for Economic Policy Analysis argued that it might be cheaper for customers to face the occasional outage, or the risk of an outage, than to invest in further reliability of the grid (CPB 2004). One may doubt whether this issue would have come up if generation, transport, distribution and supply were still in the hands of one bundled

public organization. The question therefore is not: 'How do we guarantee absolute reliability of supply, or absolute safety?' but 'How much is the government, or are the customers, prepared to pay for a unit of extra reliability of supply?'

### **Competing values**

The relative nature of public values also appears from the fact that they may be conflicting. The quality of service provision and the safety of passengers, for example, may compete in the aviation industry. Checks on passengers following 11 September 2001, may cause delays. We find another example in the drinking-water sector. A particular way of building the water mains benefits public health: 'ramifying', which keeps the water in the water supply system as short a time as possible. However, 'meshing' is better for the reliability of supply. Although it enables water to reach consumers by several mains, the water stays in the system longer. Here we see that the public values not only compete, but also show interdependencies with the technical infrastructure.

The fact that public values compete and always require a trade-off – on some occasions between different public values, but on other occasions even within one and the same public value – implies that the judgement about this trade-off tends to be subjective. Different parties (for example, governments, private companies, citizens, network managers, service providers) may choose different trade-offs. This deprives the public value even more of its absolute connotation.

### **The dynamic trade-off between public values**

In cases where public values require a trade-off – as in the examples given below – they are, by definition, never static. Views as to what protection a public value merits in relation to another (public) value are constantly in motion and are influenced by all sorts of factors. We mention two examples below:

1. Incidents: constant checks on gas pipes in homes where the risk of accident is small cause irritation among citizens because of the inconvenience; thus they bring social costs. A gas explosion as a result of inadequately maintained gas mains leads to immediate calls for more safety and checks.
2. Technological developments: a company that is highly dependent on its computer infrastructure becomes technically capable of saving all information in 'real time'. Such a company is probably less willing to pay more for a few seconds less power of interruption per year.

The essence of the above examples is that trade-offs can always be retabled as the need arises.

### THREE TYPES OF SAFEGUARDING MECHANISM

Public values are inherently relative. It is difficult, if not impossible, to define them unambiguously: trade-offs are required between public values and efficiency and between public values mutually and these trade-offs can change with time. The inherently relative nature of public values has instrumental consequences. We distinguish three types of safeguarding mechanisms:

1. Hierarchy: imposing public values, for example, by regulation
2. Network: interacting about public values
3. Market: competing on public values

We will show the essence of these mechanisms and the differences between the three and their ability to cope with the relative nature of public values. In the section that follows, we will present examples of the use of combinations of these safeguarding mechanisms.

#### **Hierarchy: imposing public values**

There are plenty of examples of hierarchical safeguarding mechanisms. Governments can impose fines in the event of failing reliability of supply. In the United Kingdom, Ofgem, the electricity regulator, obliges electricity companies to innovate (Ofgem 2003). In the Belgian electricity market, public values have been translated into highly detailed norms. For example, the public value of social inclusion has been translated into the obligation for operators to have uniform prices. Equality, another public value, has been translated into 'uniform conditions' and the obligation for a 'guaranteed supply', which means that 500 kWh (500 kilowatt-hours) a year should be supplied free of charge (Ministerie van Economische Zaken (Ministry of Economic Affairs) 2002).

We should point out that public values are by no means always regulated by public organizations. As Scott (2003) has shown, there is great organizational variety in 'regulatory governance'. In most OECD countries, there is a certain degree of implicit regulation and self-regulation. Only countries such as Japan and South Korea continue to place emphasis on powerful ministerial departments. But even here, regulation is coupled with self-regulation by powerful trade associations (Scott 2003, p. 302).

Given the relative nature of public values as set out above, it is remarkable that one solution dominates in the instrumental reflections on how these values can be protected: a strong government translates the values into clearly delineated standards and formulates clear rules for the protection of these standards. An example here is the authoritative report of The Netherlands Scientific Council for Government Policy, which literally advocates 'tight government control' (2000, p. 12), or the advice given by Price Waterhouse Coopers about this subject, together with a plea for 'definition and delineation of public values' (Price Waterhouse Coopers 2001, p. 8).

These proposals assume a situation in which there is a hierarchical relation between the government and the supplier and/or the producer of the service, and in which the government is apparently able to *enforce* the safeguarding of public values ('tight control', 'strict regulation'). They also assume that public values can be defined unambiguously ('clear definitions'). As we have sought to substantiate above, these assumptions can be problematized due to the relative nature of public values. Besides this principal reason for the incongruence between public values and hierarchical mechanisms, there are more practical reasons for prudence in using hierarchical instruments. These well-known reasons stem mainly from anti-bureaucracy theories and we will summarize them only briefly.

***Does hierarchy lead to undesirable and static prioritization of values?***

One risk of tight regulation is that it cannot cope with the ambiguous nature of public values. Instead, the choice is between a particular definition of a public value or a particular trade-off between a public value and efficiency or between public values. As observed above, public values and the trade-off between public values may change in the course of time. For the most part, hierarchy is unable to cope with this dynamic. This is the essence of the Californian crisis: the state government wanted to prevent electricity prices rising too quickly after liberalization took place and for that reason imposed price caps on the industry. This one-sided accent on the public value of accessibility and the inability to respond to changing circumstances led to interruptions and, consequently, to the neglect of the value of reliability of supply (Ten Heuvelhof *et al.* 2003, p. 145).

***Do hierarchical instruments reach the operational level?***

In many cases that involve public values, the government lays down a framework of requirements and profit-maximizing companies are contracted to deliver what is agreed. As Kay (2002) rightly concluded, this arrangement either works insufficiently well or does not work at all (Dicke 2001, p. 64). The erroneous assumption in this arrangement is that rules and agreements about public values steer operational execution more or less unambiguously. However, in the technically complex utility sectors, this tends not to be the case (Van Eeten and Roe 2002). The rules, drawn up by the government, have to be interpreted in thousands of individual decisions taken each day as part of 'everyday' operational management. In all those decisions, a balance has to be struck between conflicting values that are public and sector-specific and company-specific.

***Do hierarchical instruments incentivize strategic behaviour?***

Laying down the exact formulation of a controversial operationalization also tends to spark off various forms of strategic behaviour by people at the operational level (Kuit 2002; de Bruijn 2002). In the case of The Netherlands, an example of strategic behaviour arising from such regulation of operational

variables can be found in Dutch Rail. The Dutch government set out to check whether trains ran on time. Counting how many trains were delayed for how long seemed an unambiguous and relatively easy task. The opposite proved to be the case. Since the advent of a punctuality contract for Dutch Rail, the relevant consumer organization and Dutch Rail have disagreed about the exact way in which the counting should take place. Dutch Rail counted the delays of trains that arrived late, not cancelled trains. Consequently, the punctuality rate only showed data about the trains that actually ran. Data on non-running trains, however, is important, since cancelling trains causes serious delay and annoyance to would-be passengers (ROVER 2001).

*Do hierarchical instruments juridify the relation between government and other actors?*

Hierarchy may juridify the relation between the government and other actors (Habermas 1984). This may be problematic, because juridification makes the supply of information to the government selective: a company provides the government with the information that it has to provide from a legal point of view, but does not provide other information, which may also be relevant.

The above discussion does not suggest that hierarchical safeguarding mechanisms are meaningless. In the utility sectors, safeguarding public values is an important social issue: where would a society be without reliable and affordable drinking water; how could a contemporary society function if power failures occurred continually? From a constitutional perspective, there is every reason to safeguard them in laws and regulations. This is a form of institutionalizing of public values. Thanks to such institutionalization, regulation may have the following instrumental functions.

1. It creates a common frame of reference as to what public values are, demonstrating that they are important. Such a frame of reference can be important in interactions between government, companies and consumers.
2. It constitutes a legal basis for further action, for example, for concluding performance contracts.
3. Once public values have been identified, they can play an important role in societal debate. This, too, may have a steering effect, for example, in negotiations about a performance contract or when companies have to answer for their conduct to consumers. Such negotiations take place in 'the shadow of the law', which might be an incentive for negotiating parties to reach an agreement.
4. It affords an important option to fall back on. When companies protect public values insufficiently and voluntary consultations produce inadequate results, a government can rely on laws and regulations to enable it to intervene unilaterally.

### **Network: negotiating about public values**

Under conditions of privatization and liberalization, service provision by utility companies takes place in a network of highly interdependent parties. Such partners include producers, distributors, governments, various types of customers and societal organizations. These interdependencies imply that no one party is able to impose its own views on others. Consequently, decision-making results from interaction (for example, consultations, negotiations) between these parties (Giddens 1994; De Bruijn and Ten Heuvelhof 1999; Klijn and Koppenjan 2000; Webler *et al.* 2001; Halvorsen 2001).

In order that public values can be safeguarded in a process of consultation and negotiation, a government must create conditions for this to happen. Government may facilitate the creation of an institutional structure for these negotiations – for example, by promoting efforts to encourage consumers to organize themselves in representative bodies. From an instrumental perspective, government might design procedures or rules of the game for these negotiations. Such rules of the game might, for instance, stipulate who is to take part in the negotiations, when the negotiations are to take place, how the agenda will be drawn up, and so on. A government can itself carry out the design of these processes, have them designed, or invite the negotiating parties to make a proposal for their design. What is of the essence here is that all parties agree about the rules of the game to be observed, thus creating a ‘negotiated environment’.

There is an analogy here with interactive decision-making processes, something which has been on the increase over the past two decades. A government designs a process in which societal parties are involved in public decision-making. The question of how the outcome of societal decision-making relates to the special position and responsibility of a government is an important aspect of such a process. This same question will be an important aspect of processes to protect public values. A government should therefore indicate how the outcome of the negotiating process between companies and consumers relates to the formal decision-making: (1) under what conditions will it corroborate the outcome of the negotiations; and (2) under what conditions does it want to be able to deviate from this outcome?

### **Market: competing on public values**

The essence of putting in place market arrangements to protect public values is that companies differentiate themselves from their rivals by presenting themselves as safeguarding public values. From a hierarchical perspective, it is for the government itself to protect public values. One of the reasons for this is that companies have strong incentives to endanger such values. From a market perspective, a different situation arises. Governments use market forces to protect public values rather than opposing and trying to mitigate such forces. Thus companies compete on public values, trying to win the

favour of consumers by considering the protection of public values to be of paramount importance.

One example of this mechanism is that of energy producers who are able to differentiate themselves from their rivals by offering 'sustainable' energy. Privatization, then, tends to be accompanied by increased visibility for the companies involved and an increase in the overall transparency of the sector (Dicke 2001). Thus companies act in order to realize the protection of the public value 'environment', the first value likely to be abandoned because of liberalization and privatization. E-commerce companies provide another illustration of this mechanism. In terms of the security of financial data, for instance, these companies, each of which are the others' competitors, have strong incentives to maximize the security of credit card data. The more security a company can guarantee, the more attractive the company is to consumers.

How can government ensure the promotion of competition between companies on public values? The institutional part of this question seems easy to answer. The introduction of competition means that companies have to differentiate themselves from each other more than they used to do, so the incentive for competition on public values is already present in principle.

From an instrumental perspective, there is a range of possibilities for the government to activate competition on public values.

1. When there are auctions or tenders, a government can lay down special conditions regarding public values. For example, when auctioning the license to operate part of the railway system, it can formulate quality, affordability and innovation standards.
2. A government can stipulate conditions as to the transparency of a sector. For example, it may stipulate that all electricity providers must offer clarity on a number of public values: price (affordability), the number of interruptions per year (reliability) or the origin of the electricity (sustainability). All of this in turn promotes the transparency of the market. It improves consumer insight into the degree to which the various providers protect public values, allowing them to base their choice on this insight.
3. A government can subsidize companies who propagate public values. Energy companies in Belgium, for example, can offer free energy because the government partly subsidizes it. In The Netherlands, the government subsidizes those companies who offer energy derived from sustainable sources.

The objection to hierarchical instruments is that they 'set' public values, that they are static, that they fail to reach the operational level and that they provide juridify the relationship between government and companies. When public values are protected by negotiation or competition, these objections either do not apply or they apply to a lesser extent for the following reasons:

1. Networks and the market offer room for both governments and companies and set the trade-offs between public values and efficiency and between public values themselves far less than hierarchical safeguarding mechanisms. With network-like safeguarding mechanisms, the parties can negotiate an agreement on the desired trade-off, something which leads to a negotiated trade-off. If the parties feel that it should be possible in the future to adapt this trade-off to changing circumstances, they can make agreements about this also. With market-like safeguarding mechanisms, companies compete on public values and will therefore always offer the trade-off that is the most attractive to consumers. If there is any dynamic in the competition, companies – or competitors – can offer a different trade-off.
2. Hierarchical mechanisms by definition try to protect public values in a top-down manner. As a result, there is a risk that such mechanisms will fail to reach the ‘bottom’ so to speak, that is, the operational level. In network and market arrangements, on the other hand, the protection of public values evolves from the bottom up. The parties either adopt a stand about protecting public interests and start negotiating about it (network) or they examine how they can protect public interests (and what public interests they can protect) and they then make an offer to consumers or to the government (market).
3. Hierarchical instruments juridify relations. This differs from the relations in networks where the parties negotiate about public values and are therefore partners. It also differs from the relations in the market where companies compete on public values and therefore have to be as transparent as possible about how they protect these values.

### **SMART COMBINATIONS OF SAFEGUARDING MECHANISMS: HOW TO ‘BLEND IN’ HIERARCHY**

As has been discussed above, there are good reasons for developing a strong set of hierarchical safeguarding mechanisms (see also de Bruijn 2005). Under conditions of liberalization and privatization, utilities are increasingly embedded in a structure marked not only by hierarchy but also by network and market. As a result, therefore, there should also be additional network-contingent and market-contingent safeguarding mechanisms. The intriguing question here is whether such hybrids are possible: can hierarchical protection of public values improve the functioning of network and market mechanisms? The discussion that follows focuses on one hybrid of network and hierarchy and one of market and hierarchy.

#### **Network and hierarchy**

In 2002, Dutch Rail proposed implementing two fare increases: one on 1 January 2003, to be followed by another on 1 June. These fare increases came as a surprise, both to the government and to consumer organizations

since they were contrary to earlier agreements between the government, consumer organizations and Dutch Rail. Because of what was agreed to be the deplorable service delivered, the fare increases would be limited in nature.

The Ministry of Transport, urged by the Dutch Parliament, reacted with a hierarchical intervention: it blocked the fare increases, brought a court action (which was joined by consumer organizations) and won the case. After this court judgment, a negotiating process followed between Dutch Rail and the consumer organizations. The threat of more court actions brought Dutch Rail to the negotiating table. A number of negotiating sessions followed in the summer of 2003 (ROVER 2004). The consumer organizations were keen to negotiate, because the court ruling had given them (...) a weapon to press home their demands for Dutch Rail to back down (ROVER 2004). The Ministry of Transport, however, decided not to participate in the negotiating process, leaving the matter to the operator and the consumer organizations. The outcome of these negotiations was that Dutch Rail would be allowed to increase fares if it satisfied a number of quality standards. Quality was expressed in three variables. As regards punctuality, percentages of 84.4 and 86.8 were established. Dutch Rail also had to improve in terms of both customer satisfaction and number of train cancellations.

To monitor these values, both existing and new measuring systems were put into place. The 'quality of service provision' would be measured by means additional to the counting of trains. The quality of service provision was measured, for the first time, by qualitative interviews and the qualitative judgements of the consumers, something which made avoidance less probable. This can be seen as a new answer to the strategic behaviour already shown by the operator, that is, by dropping train services altogether, since this was previously not included in either the measurement or the 'quality of the service' criteria (see above). The outcomes have been satisfactory for both the operator and consumer organizations.

The case described above is clearly a hybrid, using hierarchical and network-like mechanisms to protect public interests. There were prior negotiations about public values such as 'affordability', 'accessibility' and 'quality of service'. The outcome of these negotiations was a trade-off between these public values. Price increases (which affect affordability) were permitted if there was a substantial improvement in both accessibility and quality of service.

However, hierarchical interventions were crucial to the success of these negotiations in at least three ways:

1. Negotiations took place about public values; hierarchy was used as an incentive at the start of these negotiations. There would have been no negotiations between Dutch Rail and consumer organizations but for the hierarchical intervention of the ministry as well as the court action. Leaving everything to the stakeholders involved without the use of any

- hierarchical mechanisms would not have been an option. Thus, if the parties involved do not feel a sense of urgency to start the negotiations or to reach consensus, the network mechanism is bound to fail.
2. The shadow of hierarchy boosted the progress of the negotiations. Remarkably, the ministry was not involved in the negotiations. Nevertheless, it was present in the background: for example, it threatened to bring further court action if Dutch Rail failed to reach agreement with the consumer organizations. This represents the shadow of hierarchy: hierarchical interventions are used to put pressure on the negotiations. However, these hierarchical interventions will not take place if the parties reach agreement. If they fail to reach agreement, hierarchical interventions will follow. The ministry was able to play this role because it did not take part in the negotiations. Had it done so, it might in the process have become committed to a result that it might have found less acceptable.
  3. Hierarchy was combined with room to manoeuvre, that is, negotiating space. Had the hierarchical intervention limited itself to the two elements mentioned above, Dutch Rail's position would have scarcely been an attractive one: hierarchy was used to enforce negotiations and the threat of hierarchical interventions was used during them. The third important element of the strategy is, however, that there was something to gain for Dutch Rail. The ministry was prepared to accept the outcome of the negotiations, even if it did deviate on a number of points from earlier agreements or from the letter of the court ruling. This made the negotiations attractive to Dutch Rail: negotiating meant that it could water down a number of agreements that were binding upon it. We would call this a 'Janus-faced' strategy: on the one hand, hierarchy was used to put pressure on the negotiations and force them into a particular direction; on the other hand, Dutch Rail was offered room to manoeuvre, which implied the prospect of gain.

Hierarchical safeguarding mechanisms have three major disadvantages: they are static, they fail to reach the operational level and they juridify the relationship between the government and private parties. The hybrid contains these disadvantages either not at all or it contains them to a lesser degree, because hierarchy serves to incentivize and facilitate negotiations on public values rather than to determine what public values are and how they should be safeguarded.

### **Market and hierarchy**

In the utility sectors, there are good reasons to rely on market mechanisms for the protection of public values. The greatest benefit is efficiency gains, resulting in a tariff reduction for the consumer. However, institutional economists have long tried to convince us of the adverse effects associated with an increase in transaction costs (Williamson 1981). How can laws and

regulations be combined with market mechanisms so as to leave space for the operator and power for the regulator?

An illustration of a mixed market and hierarchy strategy can be found in the case of Welsh Water in the UK. Extremely strict regulation on public values is carried out by Ofwat, the water regulator. The drinking water sector in the UK is completely privatized. Like all water companies, Welsh Water was privatized in 1989 and its shares traded on the stock market. This situation changed in 2001. Welsh Water was acquired by Glas Cymru, a 'not for profit' company limited by guarantee and bond financed. The company was 'de-risked': that is, most aspects that investors found risky were eliminated. This resulted in a water-only company (the former owner of Welsh Water, the multi-utility company Hyder, went bankrupt), a policy of no foreign investments and as much outsourcing as possible. A total of 14 contracts are in place, as follows:

1. One contract for Asset Operation covering all water supply and wastewater treatment, plus some sewage pumping stations;
2. Four contracts covering sewerage operations;
3. Three contracts covering sewage pumping stations;
4. Six contracts covering Asset Investment.

How are public values protected in this market? Ofwat, the UK water regulator, conducts an Overall Performance Assessment. This assessment is operationalized into 23 key performance indicators. These indicators are used in the overall performance assessment of the drinking water companies in the UK. They reflect the different public values involved: the quality of drinking water, customer service and protection of the environment and the trade-off between these values. Illustrations of these indicators are customer service (for example, billing contact, written complaints); water service (for example, inadequate pressure, supply interruptions, drinking water quality); sewerage service (for example, internal flooding from sewers, environmental impact); compensation (e.g. operation of the guaranteed standards scheme) and information quality.

Ofwat's overall performance assessment is an example of strict hierarchical safeguarding of public values. Ofwat's indicators are imposed upon Welsh Water and are translated *directly* into the contracts with the sub-contractors. The bidders have to show how they expect to perform on the indicators laid down by the regulator. This process ensures that the contract will go to the sub-contractor who performs well on all public values, not just on efficiency.

The performance of Welsh Water and its subcontractors is monitored. The subcontractor who outperforms the Ofwat indicators receives a percentage of the profit that Welsh Water is allowed to keep under the terms of Ofwat's price cap. This is a strong incentive to perform well, not just on efficiency but on all public values. The score on the indicators is extremely important. It results in a five-yearly benchmarking of all water companies on the overall

performance assessment. This is ultimately used – by means of a price cap – to determine how much profit the company is allowed to make.

Again, the above represents a mixture of two safeguarding mechanisms, in this case, hierarchy and market. But there is also a major role for hierarchical mechanisms, as can be seen from the following:

1. Public values are in the hands of the market, but public values are safeguarded hierarchically. Welsh Water is a privatized company operating in a market and with a number of potential subcontractors. But the regulator, Ofwat, defines what public values are and what the performance of Welsh Water should be. This seems the best of two worlds: competition between subcontractors (market) and unilateral regulation of public values. In their bids, subcontractors have to set out how they will safeguard public values. In other words, they compete on public values.
2. Hierarchical mechanisms strengthen the position of Welsh Water in the market. Because of Ofwat's performance standards, Welsh Water holds a strong position *vis-à-vis* the other parties. There is limited room for them to negotiate – that is, only on performance standards – since Welsh Water can refer to a third party, one which imposes the requirements unilaterally. This puts Welsh Water in an extremely comfortable position. Had there not been a third party, the subcontractors would have been induced to discuss the required performance.
3. Hierarchy is combined with room to manoeuvre. There is breathing space for the market parties: over-performance is attractive to them because it brings in money. It is also attractive to Ofwat, the regulator, because every five years it can translate over-performance into new and stricter performance standards. This reduces the risk of congealing of public values – a risk with hierarchical mechanisms.

In this example, too, hierarchy is 'blended in' rather than being limited to imposing public values on the market parties involved. Hierarchy facilitates the normal market processes of bidding and concluding contracts. As has been said, one major disadvantage of hierarchy is that it is static while the hybrid described above leaves negotiating space for the parties involved.

## CONCLUSION

The liberalization and privatization of the utility sectors prompt the question of how public values in these sectors can be safeguarded. On the basis of this article, three conclusions are important. The first is that public values are ambiguous. They are difficult to objectivize; they change with time; they require trade-offs with other (public) values, values which may be different each time. This presents a government with a difficult challenge. On the one hand, public interests need protecting; on the other hand, such public values cannot be formulated unambiguously.

The second conclusion is that hierarchical safeguarding mechanisms find it difficult to deal with the ambiguous nature of public values. This is why other safeguarding mechanisms are also important here: market mechanisms (competition on public values) and network mechanisms (interaction/negotiations on public values). These safeguarding mechanisms either do not contain the disadvantages of exclusively hierarchical safeguarding mechanisms (hierarchy is static; hierarchy fails to reach the operational level; hierarchy juridifies) or they contain them to a lesser degree.

The third conclusion is that hybrid strategies are eminently possible. Although hybrids do not safeguard public values hierarchically, hierarchy is used to increase the chance of success of both market and network mechanisms. Hierarchy becomes an incentive not only for negotiations on public values but also for competition on public values.

## ACKNOWLEDGEMENT

This article was written with the help of Bauke Steenhuisen. We would like to thank Nigel Annett, Executive Director of Glas Cymru, and Richard Curtis, Company Secretary, and others from Glas Cymru and Welsh Water, for their time and effort to explain the Glas Cymru Model. This research is part of the Next Generation Infrastructures Programme.

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*Date received 24 October 2004. Date accepted 30 December 2005.*