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The impact of nationalisation of utilities on taxpayers, households' savings and pensions: Update

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Overview

The UK's Labour Party has announced its intentions to nationalise public utilities if it were elected including water and energy networks, and Royal Mail, as well as announcing plans to extend public ownership in other areas, such as energy generation and retail activities.[1,2] Labour has not said how it will determine the level of compensation to shareholders, both savers and pensioners, but the press has reported that Labour will seek to acquire these assets at below market value, for example, paying only the historical value of the assets recorded in their statutory accounts (e.g. net asset value).[3]

We were commissioned by Water UK to assess the financial costs that the nationalisation of UK utilities is likely to have for taxpayers, savers and pensions, providing an update of an earlier report published in 2017.[4] We find that a future Government will need to pay at least the fair market value, at an estimated cost to the taxpayer of £193 billion for water and energy networks and Royal Mail, to avoid losses to savings and pensions. Alternatively, if the government paid less than the fair market value, say net asset value as reported in the press, the cost to the taxpayer would be £143 billion. However, the lower compensation to shareholders (i.e. savers and pensions) means a loss to them of £50 billion, i.e. the overall cost would still be £193 bn. The average loss to a UK household alone could be in the region of £400 per household.

If the taxpayer acquired the assets at no compensation to the shareholder (i.e. the Government paid only debtholders), the cost to the taxpayer would be around £97 billion, i.e. approximately half the fair market value, and there would be an equivalent loss to savers and pensions of £97 billion. The cost for each UK household is around £760 in foregone savings and pensions.

In short, either the taxpayer foots the bill or there is a hit to savings and pensions but the overall cost is £193 billion, just split in different ways.

Table 1:
The direct costs of nationalisation are £193bn, whichever way you cut it

	Cost to:		Total cost to taxpayer + savers
The Government pays:	**UK Taxpayer**	**Savings and Pensions**	
Market Value	£193 bn	-	£193 bn
Net asset value (+ debt)	£143 bn	£50 bn	£193 bn
No compensation for equity (only debt compensated)	£97 bn	£97 bn	£193 bn

Note: If the assets were acquired at regulated capital value (RCV), we estimate the total compensation to shareholders and debtholders is around £149 billion, similar to compensation at net asset value (+ debt). The cost to savers and pensioners is £45 billion, with the overall cost (to taxpayers and savers/pensions) of £193bn.

These are the direct costs. If Labour were to pay less than market value, we also estimate additional costs to savers and pensioners from losses on the holdings of other UK investments, namely UK government debt or gilts, given that investors are likely to perceive an increase in political risk for these investments too. We refer to the effect on other assets as the "contagion effect", which we estimate at around £5.3 billion or a further £200 per UK household. That is, we estimate a total potential cost to UK households from direct and indirect effects of £960 (=£760+£200), if there is no compensation for equity holders.

In addition, nationalisation could lead to international investors seeking compensation under bilateral investment treaties (BITs), leading to litigation and associated costs for all parties, and with wider implications for UK's bilateral trading relations.[5]

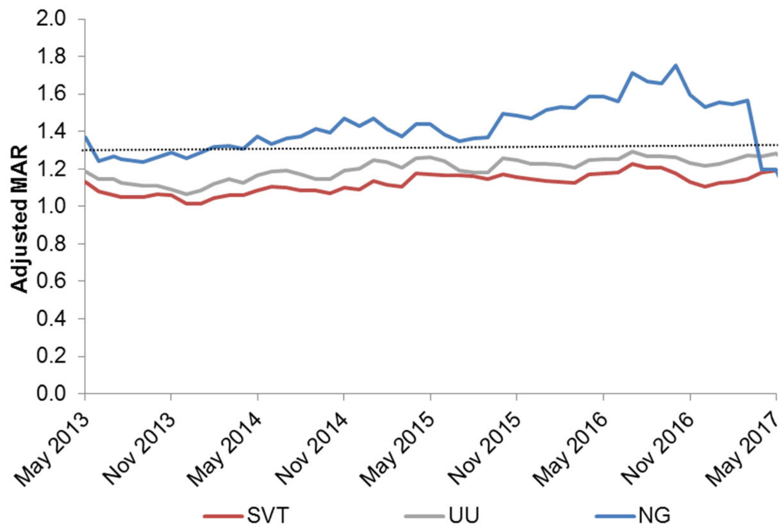
Finally, if Labour's renationalisation plans eventually included energy generation, retail and BT's Open reach, the total fair market value could be of the order of £289 billion, which would fall to the taxpayer. Likewise, if Labour were to acquire the wider set of assets at net asset value the cost to the taxpayer would fall to around £214 billion, but the reduction in cost would be offset by a loss to pensions and savings of around £75 billion globally and the average loss to a UK household would be in the region of £750 per household, including contagion effects.

We estimate a market value of £193 bn to be paid for water and energy networks and Royal Mail to avoid losses to savers and pensioners

To avoid any losses to UK pensions from the nationalisation of the water and energy networks, and Royal Mail, the compensation paid will need to reflect at least the fair market value of the assets excluding any impact of the policy announcement on the market value, which may have suppressed valuations.[6] One potential way to estimate the fair market value for the publicly quoted water and energy network companies is to examine the market-to-asset ratio (MAR) prior to the formal policy announcement in May 2017.[7] On this basis, our analysis shows that for the listed water and energy network companies, United Utilities and Severn Trent and National Grid, the market value of debt and equity were approximately

1.3 times the regulated capital value (RCV) in the period preceding the policy announcement.[8]

Figure 1:
Market to Asset Ratios for UK networks were on average around 1.3 in the period prior to the Labour policy announcement on nationalisation



We calculate the total RCV for the water and energy networks is around £149 billion, based on the most recent data published by Ofwat and Ofgem.[9] Taking the simplified approach of applying a MAR of 1.3 to the RCVs of both publicly quoted and private held regulated companies within the energy and water sector, and drawing on the current enterprise value for Royal Mail, we estimate an indicative fair market value of £193 billion.

Assuming that an incoming Labour government paid the fair market value, plus any transaction costs associated with the nationalisation, any loss to UK households in terms of savings and pension provisions should be avoided. Of course, there may be other costs to UK households and taxpayers even where savings and pensions are kept whole, such as the costs associated with early redemption of corporate debt, which are not included within the £193 billion estimate.[10,11]

If Labour's nationalisation plans included a wider set of assets, say energy generation and retail as well as BT's Openreach, then we estimate an indicative fair market value of £289 billion equivalent to around 16 per cent of Government national debt.

A compensation based on net asset value would result in £50 billion in direct losses to savers and pensions, with an average loss of around £400 for each UK household but far higher for some

If a future Government were to pay a price below market value to acquire UK utilities, investors in these companies would suffer a direct financial loss. Investors, which include individual investors, say investing through an ISA, as many as 70 per cent of employees of the publicly listed utilities, as well as public pension funds and institutional investors, would receive less money than their investment is worth in the market. In this case, direct financial losses would be equal to the difference between:

- the market value of the companies (excluding the effect of the announcement of the potential nationalisation on market price); and
- the compensation received.

We assume that the acquisition price is based on each company's net asset value, as set out in financial accounts, instead of the (higher) market value, at a cost to the taxpayer of around £143 billion. In this case, we estimate the loss of value to shareholders, or in other words savers and pensions, would be £50 billion. With UK based investors owning around 20 per cent of equity [12], the direct loss to UK savings and pensions would amount to approximately £11 billion, or £400 per UK household.[13]

However, this is the average loss per household, and some households would face far greater losses under this scenario. For example, between around half and three-quarters of staff employed by South West Water, SVT and UU own shares in their respective companies through employee share schemes. As an example, an employee that has £10,000 invested in a publicly listed UK water network would face losses of around £2,600 where the networks are nationalised at book value.[14] Similarly, some UK pension funds have substantive investments in the sector, and their members will be particularly adversely affected. Anglian Water, for example, is in part owned by the Greater Manchester Pension Fund, Lancashire County Pension Fund, London Pension Fund Authority, Merseyside Pension Fund and West Yorkshire Pension Fund.[15]

Likewise, the UK assets are widely held by pensioners overseas, e.g. with Australian and Canadian pension and infrastructure funds holding material shares in UK water and energy networks. We calculate average losses to Australian and Canadian savers and pensioners at £310 and £260 per household respectively where assets are acquired at net asset value.

If Labour's nationalisation plans were extended to energy generation and retail, and BT's Open Reach, the estimated cost to the taxpayer if acquired at net asset value is £214 billion, with a loss to savers and pensioners of around £75 billion globally. Under this scenario, the loss to UK households would be around £550 per household.

If nationalisation were to occur without compensation to shareholders, the cost to the taxpayer would be £97 billion, with approximately the same cost to savings and pensions

If the taxpayer acquired the assets at no compensation to the shareholder (i.e. only debtholders were kept whole), the cost to the taxpayer would be around £97 billion, i.e. approximately half the fair market value, and therefore with an equivalent cost to savers and pensions of £97 billion globally. Such a scenario would result in a cost for each UK household of around £760.

Table 2 summarises how the cost to the taxpayer, savers and pensioners are shared, depending on the acquisition value. We also show the cost per household in UK, and for Australian and Canadian households, with pension funds from both countries holding substantive investments in UK utilities sector.

Table 2: The direct costs will be borne taxpayers, and savings and pensions globally, with high costs for UK households as well as those in Australia and Canada

	Cost to:		**Costs to savings and pensions held in:**		
Acquisition price:	**UK Taxpayer**	**Savings and Pensions**	**UK**	**Canada**	**Australia**
Market Value	£193 bn	-	-	-	-
Net asset value (+ debt)	£143 bn	£50 bn	£11 bn (£400 hh)	£4 bn (£260 hh)	£3 bn (£310 hh)
No compensation for equity (only debt compensated)	£97 bn	£97 bn	£21 bn (£760 hh)	£8 bn (£530 hh)	£4 bn (£470 hh)

Note: If the assets were acquired at regulated capital value (RCV), then the total compensation to shareholder and debtholder is £149 billion, similar to compensation at net asset value (+ debt). The cost to savers and pensioners is £45 billion, and the overall cost is £193 bn.

We estimate the indirect effect of nationalisation on UK savers holding UK gilts at around £5.3 billion, or around £200 per household

We have also considered the potential contagion effects on the value of other assets held by UK households if nationalisation of UK utilities were to go ahead. For example, investors in UK government debt (gilts) are likely to require a higher risk premium for holding debt as a result of the increase in the Government's net debt and spending commitments, and potentially from an increase in the perceived political risk of holding UK government assets.[16]

Our indirect effect is based on the assumption that nationalisation is associated with a one-notch downgrade of UK Government debt (of £1.8 trillion), i.e. from Aa2 to Aa3, of which UK households own around 15 per cent in saving and pension funds.[17] We identify the loss based on an assumed increase in yield-to-maturity of around 12 basis points, based on market evidence of the difference in yields between Aa2 and Aa3 rated bonds, and an average tenor to maturity of approximately 16 years, which leads to a capital loss on holdings of UK gilts of around 2 per cent.

Based on these assumptions, we estimate a total indirect (or "contagion effect") effect for UK savers and pensioners in UK gilts of ca £200 per household from the reduced value of these holdings.

Conclusion

We estimate an indicative market value of £193 bn will need to be paid for the water and energy networks and Royal Mail to avoid UK households suffering losses to their savings and pensions. The Government would also need to pay any transaction costs which could be substantial.

Alternatively, if the assets were nationalised at below market value, then households' pension and saving assets would take a hit. We show that nationalisation at net asset value would result in a cost to taxpayers of £143 billion, and therefore a loss to pensions and savings of around £50 billion globally, or £400 for each UK household. In addition, households may also face losses on their holdings of UK gilts from contagion effects which we estimate at around £200 per household. Taken together, the combined effect could be an overall loss of around £600 per household. If the plans included a wider set of energy and telecoms assets, our analysis shows that the loss would be of the order of £740 per household.

Notes

[1] The Labour Party Manifesto 2017, Chapter 1, page 19; Labour Party (2018) Clear Water, Labour's Vision for a Modern and Transparent Publicly-owned Water System; Labour Party (2019) Bringing Energy Home, Labour's proposals for publicly-owned energy networks

[2] See for example, Labour (2019) Creating an Economy That Works for All. Labour states its intention to support "the creation of publicly owned, locally accountable energy companies and co-operatives to rival existing private energy suppliers. Link: https://labour.org.uk/manifesto/creating-economy-works/#eighth

[3].The Financial Times reports that the acquisition value could be at net book value, defined as assets less liabilities or alternatively at regulated capital value. FT (28 June 2019) Investors attach Labour's renationalisation plans. To estimate losses to households, and based on the above Labour publications, we assume labour will compensate investors for the net asset value reported in the companies' statutory accounts *plus* debt

[4] NERA (May 2018) The impact of nationalisation of utilities on UK households' savings and pensions

[5] See "UK Nationalisation: The Law and the Cost – 2019 update" (May 2019)

[6] Indeed, Clifford Chance identifies several constraints that may limit a Government's ability to nationalise utilities below market value. See "UK Nationalisation: The Law and the Cost" (March 2018)

[7] For the purposes of estimating an indicative fair market value for this paper, we draw on MAR evidence prior to the policy announcement for energy and network companies, and apply this to today's estimate of each company's RCV. For Royal Mail, we use the enterprise market value reported in Bloomberg as of 11 July 2019. Other approaches to estimating a fair market value include, for example, other market-based methods (such as transaction value evidence) and discounted cash-flow (DCF) modelling.

[8] See NERA Economic Consulting, "*Implications of Observed Market-to-Asset Ratios for Cost of Equity at RIIO-T2*" December 2017. We exclude Pennon, the owners of South West Water and Bournemouth Water from our MAR analysis, given the high proportion of non-regulated activities, and the greater difficulty with inferring values for the regulated businesses from market data. Other commentators have also assumed a MAR of 1.3 as a potential basis for fair market valuation. See for example, Social Market Foundation (February 2018) The cost of nationalising the water industry in England, p. 10. Estimates derived based on acquisition multiples to RCV, instead of MARs for publicly quoted companies, also support a similar fair value estimate. See for example, Ofwat (December 2017) Delivering Water 2020: Our methodology for the 2019 price review Appendix 12: Aligning risk and return, p. 51

[9] Ofwat, "*Regulatory capital values 2019*" (May 2019), available at https://www.ofwat.gov.uk/publication/regulatory-capital-values-2019/
Ofgem, "*RIIO-GT1 Price Control Financial Model*" (November 2018), available at https://www.ofgem.gov.uk/publications-and-updates/riio-gt1-financial-model-following-annual-iteration-process-2018
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[10] Associated transaction costs could be material. For example, Clifford Chance argues that in addition to acquiring the equity in utilities companies, it is likely that in many cases a future Government would also need to acquire the company's debt. Early redemption of the long term bonds issued by utilities companies is likely to trigger a "yield protection" payment, generally driven by the Spens formula, which is typically very onerous and that will ultimately increase the cost of privatisation for the tax payer. See Clifford Chance (March 2018) UK Nationalisation: The Law and the Cost

[11] There may also be longer term costs to UK households from nationalisation, e.g. in terms of lower levels of investment and poorer service levels, as well as higher operating costs and ultimately higher bills. For example, see: The Social Market Foundation (February 2018) The cost of nationalising the water industry in England

[12] Our estimate that around 20 per cent of shareholders are UK based draws on data from Bloomberg for the publicly listed companies, and a review of investors and companies' websites for non-listed companies. For the publicly listed water companies, Bloomberg reports total UK investor holdings as follows: 35%, (Pennon); 27%

(SVT); and, 28% (UU). Bloomberg also reports total pension fund holdings of 1 to 2 per cent for each company. Our estimates of shareholdings by UK based investors are conservative relative to other estimates. For example, the Social Market Foundation provides higher estimates for UK domiciled investors in the UK water sector. For example, SMF reports the following percentages for UK based shareholders: 70% (Pennon); 63% (UU); 60% (SVT). Source: SMF, op. cit., p.19.

[13] Based on 27 million UK households. Source: ONS, Families and Households dataset, available at https://www.ons.gov.uk/peoplepopulationandcommunity/birthsdeathsandmarriages/families

[14] Source for employee ownership: SMF, op. cit., p.4. The loss of £2,600 is calculated as: £10,000- [£10,000/1.36], where 1.36 is the estimated ratio between the fair market value and book value stated in the companies statutory accounts.

[15] GLIL Infrastructure LLP, the infrastructure investment joint venture between five local Government pension funds (London Pensions Fund Authority, Greater Manchester Pension Fund, Merseyside Pension Fund, West Yorkshire Pension Fund and Lancashire County Pension Fund) acquired half of 3i's stake in Anglian Water in December 2017. See: IPE (18 December 2017) Dalmore and GLIL to buy a 15% stake in Anglian Water Group from 3i.

[16] Nationalisation is likely to have a material impact on the public debt levels and spending and therefore on financial metrics considered by Credit Rating Agencies. Based on our indicative fair market value, the cost of nationalisation of water and energy networks and the Royal Mail is likely to represent more than 10 per cent of the UK's Government debt. In addition, the recurrent capital investment necessary to maintain and operate the networks also likely to have a material impact on public spending commitments. For example, the Social Market Foundation estimates expenditure to meet the water sector long-term investment requirements represents 13 per cent of all public capital expenditure.

[17] Source: HM Treasury (March 2018) "*Debt management report 2018-19*". To derive the pension funds' proportion of government debt, we assumed that this is equal to half the reported insurance companies and pension funds estimated holdings.

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