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The impact of nationalisation of utilities on UK households' savings and pensions



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Overview

In 2017, the UK Labour Party announced its intentions to nationalise public utilities if it were elected.¹ While the details of a potential nationalisation plan are still unclear, various commentators have started to consider the potential costs and benefits of nationalisation of water companies, energy networks and the Royal Mail.²

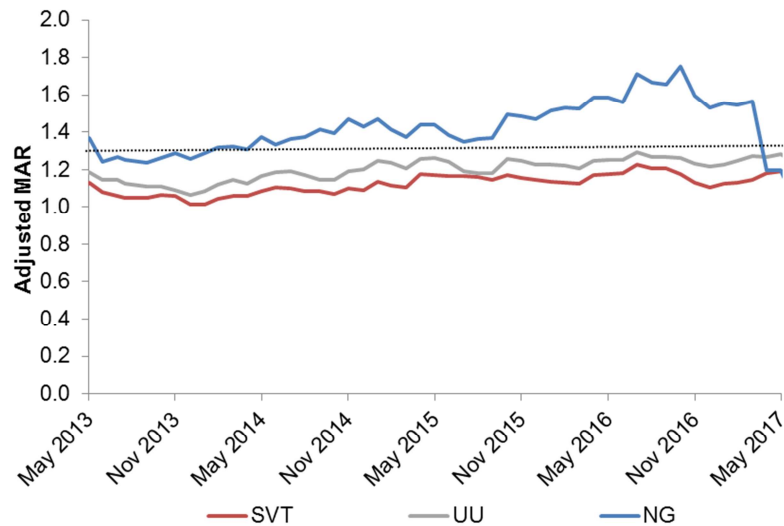
We have been commissioned by a group of water companies³ to assess the financial costs that the nationalisation of UK utilities is likely to have for UK households' savings and pensions. We find that a future Government will need to pay at least the fair market value, at a cost to the taxpayer of around £182 billion, to avoid UK households suffering losses to their savings and pensions. Alternatively, if the utilities were nationalised at below the fair market value, say for illustrative purposes, the regulatory capital value, the average loss to a UK household would be in the region of £510 per household.⁴

This is the average loss, and the loss to certain households could be much higher. As an example, an employee with a shareholding of £10,000 built up through an employee share scheme, which involves one half to three-quarters of all employees of listed water companies, would face a loss of around £2,300 where the companies are nationalised at the regulated capital value.⁵ UK local authority pension funds invested in the sector could also see their members particularly adversely affected.⁶

We estimate an indicative market value of £182 bn to be paid for the utilities to avoid UK households suffering losses to their savings and pensions

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.⁷ 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 2017.⁸ 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.⁹

**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 £140 billion, based on the most recent data published by Ofwat and Ofgem.¹⁰ Taking the simplified approach of applying a MAR of 1.3 to the RCVs of both publicly 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 £182 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 £182 billion estimate.^{11,12}

A compensation based on RCV would result in £8.4 billion in direct losses to UK households' savings and pensions, with an average loss of £310 per 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 would be receiving 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.

For illustration, we assume that the acquisition price is based on each company's RCV instead of the (higher) market value, at a cost to the taxpayer of around £140 billion. In this case, we estimate the loss of value to shareholders would be £42 billion, and with UK household ownership of equity at around 20 per cent¹³, the direct loss to UK savings and pensions would amount to approximately £8.4 billion, or £310 per UK household.¹⁴

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 £2,300 where the networks are nationalised at the regulated capital value.¹⁵ 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.¹⁶

If the acquisition value compensated only debt holders and not equity, the losses to UK savers and pensioners would be approximately £18.2 billion, or £670 per household

The larger the difference between market value and the price paid by the government to acquire UK utilities, the larger the direct financial losses suffered by UK savers and pension funds.

For example, if the nationalisation strategy involved paying no compensation to shareholders, estimated direct losses to UK savers and pensioners would amount to approximately £18.2 billion, which translates into £670 per UK household.¹⁷

The indirect effect of nationalisation on UK savers and pensioners holding UK gilts can be estimated at approximately £5.5 billion, or £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.¹⁸

Our indirect effect is based on the assumption that nationalisation is associated with a one-notch downgrade of UK Government debt (of £1.7 trillion), i.e. from Aa2 to Aa3, of which UK households own around 20 per cent in saving and pension funds¹⁹. We identify the loss based on an assumed increase in yield-to-maturity of around 10 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 15 years, which leads to a capital loss on holdings of UK gilts of around 1 per cent.²⁰

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 £182 bn will be 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 UK households' pension and saving assets would take a hit. As an illustration, we show that nationalisation at the regulated capital value would result in a loss to UK pensions and savings of £8.4 billion, or around £310 per 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 £510 per household.

Notes

¹ The Labour Party Manifesto 2017, Chapter 1, page 19.

² See for example Centre for Policy Studies "*The cost of nationalisation*" (January 2018), The Social Market Foundation "*The cost of nationalising the water industry in England*" (February 2018), Clifford Chance "*UK Nationalisation: The Law and the Cost*" (March 2018).

³ This report was commissioned by Anglian Water, Severn Trent, South West Water, and United Utilities.

⁴ This analysis focuses on potential financial losses to UK savers and pension funds holding shares in energy networks, water companies and the Royal Mail. In particular, we have not considered any potential cost and benefits to the UK tax payers.

⁵ The loss of £2,300 is calculated as: £10,000- [£10,000/1.3], where 1.3 is the assumed ratio between the fair market value and regulated asset value. See footnote 9 below for a discussion of the market-to-asset ratio (MAR).

⁶ 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.

⁷ 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).

⁸ 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 25 April 2018. 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.

⁹ 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, SMF, op. cit., 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

¹⁰ The total water sector RCV is £69 billion (Ofwat, PR14) and the total energy network sector RCV is £66 billion (Ofgem, RIIO 1), estimated as of 31 March 2017. Ofwat, "*Regulatory capital values 2017*" (May 2017), available at <https://www.ofwat.gov.uk/publication/regulatory-capital-value-2017/>

Ofgem, "*RIIO-GT1 Price Control Financial Model*" (November 2017), available at

<https://www.ofgem.gov.uk/publications-and-updates/riio-gt1-financial-model-following-annual-iteration-process-2017>

Ofgem, "*RIIO-ET1 Price Control Financial Model*" (November 2017), available at

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Ofgem, "*RIIO electricity distribution annual report 2016-17*" (December 2017), available at

<https://www.ofgem.gov.uk/publications-and-updates/riio-electricity-distribution-annual-report-2016-17>

Ofgem, "*RIIO gas distribution annual report 2016-17*" (December 2017), available at

<https://www.ofgem.gov.uk/publications-and-updates/riio-gas-distribution-annual-report-2016-17>

¹¹ 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 "*UK Nationalisation: The Law and the Cost*" (March 2018).

¹² 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 "*The cost of nationalising the water industry in England*" (February 2018).

¹³ We estimate that shareholdings in UK publicly listed networks at around 20 per cent but we acknowledge that

there is uncertainty over this estimate, and it varies over time. The proportion of shares held by UK domiciled investors and funds for UK pensions are based 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: 39%, (Pennon); 38% (SVT); and, 31% (UU). Bloomberg also reports total pension fund holdings of 1 to 2 per cent for each company. We estimate UK pension funding holdings as the product of the total pension fund holdings and the share of UK domiciled investors. Our estimates of shareholdings by UK domiciled 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 UK domiciles shareholdings: 70% (Pennon); 63% (UU); 60% (SVT). Source: SMF, op. cit., p.19.

[em.xls](#), and HM Treasury (March 2017) "*Debt management report 2017-18*", p17.

¹⁴ Calculated as 8.4 billion loss in equity value divided by around 27 million UK households. Source: ONS, Families and Households dataset, available at <https://www.ons.gov.uk/peoplepopulationandcommunity/birthsdeathsandmarriages/families>

¹⁵ See footnote 5.

¹⁶ See footnote 6

¹⁷ To estimate the acquisition value based on keeping debtholders whole, we assume actual debt levels are equal to a notional gearing of 65 per cent of regulated capital values across the industry.

¹⁸ 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.

¹⁹ Source: HM Treasury (March 2017) "*Debt management report 2017-18*". 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.

²⁰ Source: Damodaran (January 2018) "*Default Spreads for Ratings*", available at <http://www.stern.nyu.edu/~adamodar/pc/datasets/ctrypr>

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