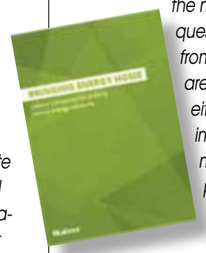
## INDUSTRY COMMENT

# CLEAR WATER CLARIFICATIONS?

## What can we learn from last month's Bringing Energy Home publication about Labour's plans for water (re)nationalisation? By Colm Gibson and Adam Mantzos.


*It's two years since Labour pledged in its 2017 election manifesto to "bring key utilities back into public ownership", and "replace our dysfunctional water system with a network of regional publicly-owned water companies". It's around nine months since the Labour Party published its conference leaflet Clear Water explaining its plans to nationalise English and Welsh water companies in some detail.*

*As reported in the FT (on 29 May 2019), Labour fully understands that the Regulatory Capital Value (RCV) reflects the amount that investors have put in that customers have not yet compensated them for. So for those strongly in favour of re-nationalisation, the RCV is a natural place to start as the basis for calculating compensation due to investors, as it can be thought of as refunding investors everything that they could legitimately expect. Similarly, for those same people that strongly favour re-nationalisation, it will only seem fair to make deductions to compensation on the basis of "pension fund deficits; asset stripping since privatisation; state subsidies given to the privatised water companies since privatisation" and the like, as Labour set out in its conference leaflet, even if the logic for these deductions isn't always clear.*

*None of the above is all that new, nor is the knowledge that Labour has committed to ensure that "existing debts of the companies will be carried over with the companies under public ownership and honoured in full", and that the whole process (including taking on this debt) would be "cost neutral to the public purse".*

*The many investors that we have met recently feel that their legitimate expectations for compensation are more centred around market value than RCV – and they have a point. In circumstances where compensation for re-nationalisation is unreasonably low, those investors protected by Bilateral Investment Treaties (BITs) have the right to an international arbitration to determine a "fair value" for their investment and receive additional compensation accordingly. Such determinations would be legally binding on a UK government. Our experience is that arbitral tribunals are very much at the "market value" end of the spectrum and are unlikely to place much weight on a regulatory construct such as the RCV, provided there is robust contemporaneous evidence of what a fair market value would be.*

*Whilst the Clear Water document did include far more detail than the election manifesto, in many ways, it was far from "clear", potentially raising many more questions than it answered. It is clear, however, that Labour's thinking has evolved since that publication. Some of the more intriguing questions arising from Clear Water are answered either explicitly or implicitly in the more recent publication Bringing Energy Home.*

### HoldCo v OpCo

*Is it definitely holding companies that are being nationalised along with all the group debt, or might it be only the operating companies that are transferred with the OpCo debt, leaving the HoldCo and its debts in place?*

*Many regulated companies, particularly securitised ones, have been accused of having overly complex structures. Given that the "1 x RCV minus" approach generates largely the same level of compensation irrespective of whether the regulated operating company itself is transferred to public ownership or whether the top level holding company is transferred, it may have seemed superficially attractive to Labour (or at least better value for the taxpayer) if the group holding company and everything below it was transferred.*

*There is, however, a material problem with this approach that arises when the "1 x RCV minus" calculation results in a figure below the overall group debt. This would happen, for example, if a holding company is over 80% geared (as several are) and the "minus" bit is 20% of the RCV, i.e. the compensation is assessed at 80% of the RCV. In these cases, the net debt figures that hit the government's balance sheet outweigh the compensation available, resulting (obviously) in a total loss for equity investors and a significant a problem for Labour – doing this deal would breach its electoral promise that the re-nationalisation process would be "cost neutral to the public purse" after taking on responsibility for paying off debt.*

*The solution for Labour lies in the Bringing Energy Home document. This notes in several places that it is possible to target companies that "can be precisely identified by sets of accounts relating solely to the regulated … business", i.e. the licence holding Operating Company and its subsidiaries.*

*So it seems that Labour is quite prepared to forego claiming the group company and all that group level debt, and chose the OpCo and net off the OpCo debt against the "1 x RCV minus" calculation. As the debt held at OpCo level is lower than the overall group debt, it is this smaller amount that is netted off the compensation price meaning that some compensation will be paid, (probably) even for the most indebted companies. This has an additional advantage for Labour, paying nothing for a company's equity was surely going to be easier to challenge than paying something. It does, however, create a new problem for the Group holding company. This company will have lost its main (or sole) operating asset, albeit with most of the debt, in return for some government bonds, whilst retaining all the debt obligations higher up the structure (see diagrams).*

*Where Labour selects the OpCo to avoid the government taking on more debt than the compensation value, then, as a matter of mathematical certainty, the compensation payment (paid in government bonds) must be of lesser value than the residual HoldCo debt.*

*Ofwat's recent stance on obtaining covenants from companies' "ultimate controllers" may have exacerbated the problem, as this has often resulted in numerous parties providing such undertakings for any given licence holder. This might be viewed as handing Labour a list of companies in the ownership chain, any of which it might view as legitimate to select as the appropriate company to nationalise.*

### Only the WASCs?

*Is it only the English WaSCs who were privatised that need to worry, or does it also include water only companies and/or Tideway and/or NAVs (even though they were never previously nationalised)?*

*The Clear Water document isn't completely clear on this question. In some places it refers to "The nine regional water companies in England" (as in "The nine regional water companies in England have between them received almost £164 million more in tax credits than they paid in tax despite pre-tax profits of over £16 billion"). In others it simply refers to "The existing companies" (as in "The existing companies will be acquired through a new act of parliament that: nationalises the companies; creates the RWAs and sets out their structure and responsibilities; transfers the ownership of the companies to the new RWAs and protects them from future privatisation in statute").*

*Our guess is that the thinking at the point the Clear Water document emerged focussed on the WaSCs. There are signs, however, that if that was the case, the thinking has moved on. In particular, Bringing Energy Home includes a comprehensive list of British energy networks (but curiously not many Northern Irish ones?). Unsurprisingly, this includes the four companies that own the privatised transmission grids (that used to belong to British Gas and the CEGB), the 14 companies that own the privatised regional electricity distribution grids, and the five companies that own what was once British Gas' distribution system. Everything on the list so far counts as re-nationalisation.*

*What is perhaps more surprising is that the document then goes on to list a further 11 companies whose assets were never publicly owned, albeit that some might be mutual companies. This suggests that the net is to be cast wide and may well include WoCs and Tideway. Indeed, as the plan for the nationalised water industry announced by "weownit.org.uk" covers "every village, town and city", it is not clear how Labour's Regional Water Authority model can work as envisaged if the major WoCs, and indeed Tideway, are not merged into it.*

*This then begs the question about whether Insets and NAVs are covered. The Bringing Energy Home document is silent about the smaller independent electricity and gas networks, and Clear Water is equally silent about Insets and NAVs. Our suspicion is that this silence simply means that Labour hasn't yet turned its thoughts to those areas. It will be important for companies to consider this in order to make the relevant preparations.*

### Be prepared

*What should investors and companies do? Investors should check whether they have access to the protection of a Bilateral Investment Treaty and to the extent that they are covered, ensure that they have undertaken at least the basic steps to secure the contemporaneous, externally verified evidence needed to make a claim, in the form and to the level of rigour required by arbitration tribunals.*

*Investors not protected by Bilateral Investment Treaties need to ensure that their companies secure the maximum possible compensation under the proposed compensation calculation. Indeed, even those investors that are protected will need to ensure that they have taken reasonable steps to mitigate their losses. This will entail:*

- *Minimising the scope for deductions from the level of compensation.*
- *Being able to present the requisite evidence persuasively.*
- *Being in a position to challenge the compensation level using whatever mechanism is available.*

*This will also require evidence to be marshalled in the form and to the level of rigour required for these processes.*

*Companies themselves might also want to:*

- *Understand the implications of OpCo vs HoldCo (or even MidCo) nationalisation.*
- *Understand how the areas they currently serve map onto the likely Regional Water Authority boundaries, and the extent to which this implies they will need to "demerge" areas and/or merge with other company areas.*
- *Understand how investment and financing decisions will need to be made, potentially learning lessons from the existing nationalised companies where appropriate.*
- *Identify the extent to which it would be in the interests of customers to take preparatory steps, and the cost of these steps, so that they can be dealt with at PR19.*

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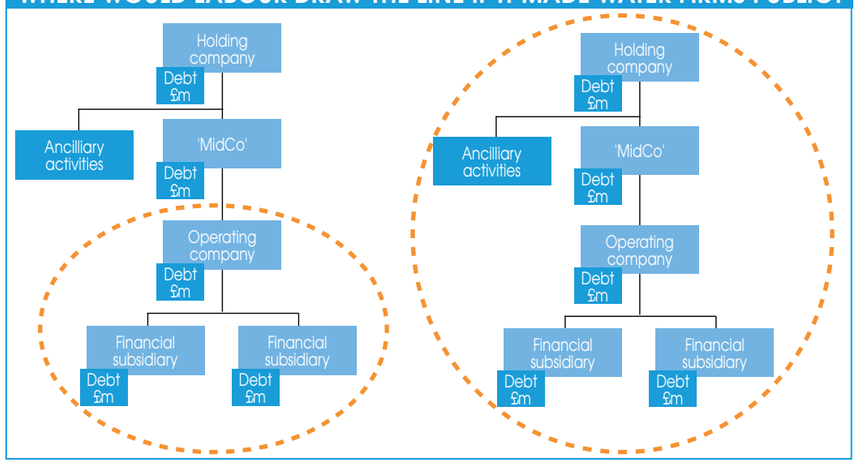
**WHERE WOULD LABOUR DRAW THE LINE IF IT MADE WATER FIRMS PUBLIC?**

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