Pointmaker

THE COST OF NATIONALISATION

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SUMMARY

- Labour intends to embark on a mass nationalisation programme in the energy, water, rail and mail sectors, as well as buying out some PFI deals. They are, however, refusing to cost their plans, arguing that the profitable nature of assets will cover the cost of borrowing.

- In fact, the cost of these plans is a matter of overwhelming public concern.

- It is impossible to come to a definitive total. But independent estimates suggest that the upfront cost would be at least £176bn. This represents around 10 per cent of the UK's national debt or £6,471 for every household – or central government's contribution to the cost of 2.93 million new homes [See Annex].

- This estimate assumes that, in the case of the energy sector, Labour only seeks to nationalise transmission and distribution. Nationalising the wider sector could see the cost increase to £306bn.

- Labour has indicated that it would save money by refusing to pay the full market price. But this could end up being even more damaging to the UK economy, via a slump in business investment and collapsing confidence in the government.

- After nationalisation, there would be greater competition for capital within the public sector, with private capital locked out. Pension funds, which are heavily invested in utilities, would suffer both from the cut-price buyout and reduced options for investment.

- Labour has promised that the profits of nationalised firms will be used to cut household bills by £220. Yet at the same time, it has argued that nationalisation will be cost-free because the profits will be used to pay debt interest. It is hard to see how the two can be squared.

- While there are substantial risks with nationalising utilities, there is little evidence to suggest that consumers have much to gain, or that the firms in question will become more efficient or productive. In fact, productivity would in all likelihood end up declining.

1. INTRODUCTION

The Labour Party has put nationalisation at the heart of its economic strategy. It has promised to take some or all of the energy, water and rail sectors back into government ownership, as well as Royal Mail and an unknown number of Private Finance Initiative (PFI) contracts.

This is by no means the limit of Labour's nationalisation plans. An official document entitled "Alternative Models of Ownership", published after the 2017 general election, blames private property and corporate ownership for many of Britain's economic ills. It mentions health and social care, infrastructure, telecommunications, the digital economy and data as areas that would function better outside of private ownership. The document also repeatedly refers to capturing the fruits of automation for public rather than private benefit, for example by requiring newly listed companies to give up a proportion of their stock to a sovereign wealth fund.

Despite its official imprimatur, and publication on the Labour Party website, the report claims that it should not be taken to represent party policy. But it does indicate that the party's commitment to nationalisation is whole-hearted – and that the sectors mentioned in their 2017 manifesto may represent the start, rather than the limit, of its ambitions.

Given this, it is clearly in the public interest that Labour's nationalisation plans receive close scrutiny, in terms of both their impact on the sectors concerned and the cost to the taxpayer. To date, John McDonnell, the Shadow Chancellor, has claimed that there is no need to cost these plans, arguing that the profitable nature of the assets will cover the cost of borrowing. But this is logically flawed. If Labour refuse to say how much their nationalisation plans will cost up front, then it will be impossible to calculate whether the borrowing costs will indeed be covered by the diverted profits.

This, in turn, raises another key point. Labour has promised that it will use the promised savings from nationalisation to cut household bills by £220 – while refusing to spell out how this would be achieved, which particular bills would fall, when this would happen by, and how such a uniform reduction could be achieved for every household.

Yet at the same time, Labour has also argued that nationalisation will be cost-free, because the cash generated by these assets can be used to pay the debt costs.

The problem, self-evidently, is that if the profits are going to repay the borrowing costs, they cannot be used to drive down prices for consumers. And however the profits are deployed, there will be a heavy opportunity cost to the taxpayer, in terms of what the capital used could have accomplished if deployed elsewhere in the economy. Moreover, the yields on UK government bonds will inevitably increase due to the risks associated with Labour's plans, meaning that government borrowing costs will go up even further. And, of course, the nationalised industries will in all likelihood become less efficient than they currently are.

The purpose of this paper, therefore, is to put a preliminary estimate on the upfront cost of the Labour nationalisation programme – that is, to calculate the immediate expense to the taxpayer. It does

not argue that this would be the final cost of nationalisation: merely the down payment.

Given the lack of detail provided by the Labour Party, any attempt to calculate this upfront bill will be highly uncertain. But rigorous, independent evaluations of the cost of nationalisation have been undertaken in many of these sectors.

Taken together, they suggest that the upfront capital cost of Jeremy Corbyn's nationalisation programme could be in the region of £176bn: £55.4bn for energy (this is based on a floor price for nationalising the transmission and distribution networks; nationalisation of the whole energy industry would come to around £185bn); £86.25bn for the water sector; £4.5bn for Royal Mail; and a potential £30bn for PFI nationalisation (although this estimate is particularly uncertain). It should be noted that, if Labour sought to nationalise the whole energy sector rather than just the networks, the overall cost of nationalisation would rise to £306bn.

Even taking the lower estimate of £176bn, this is an enormous amount of money: equivalent to 19.3 years of the UK's defence equipment budget, or the cost of building 2.93 million council houses. The amount also represents around 10 per cent of the national debt or £6,471 for every household.

And this only represents the upfront cost. Rail nationalisation, for example, could be accomplished "on the cheap" if franchises were taken back by the state as they lapsed. But there would be ongoing costs in terms of new rolling stock and other investments; likewise in the energy and water sectors. That is without considering ancillary costs such as the accrued pension obligations of the various firms, or the impact on the Government's debt repayments – particularly if bond yields rise due to a market reaction to these measures.

When confronted with estimates for components of its nationalisation programme, Labour has insisted that this does not represent the price that will actually be paid. Party spokesman have repeatedly suggested that it would seek to pay prices well below commercial values: the Shadow Chancellor, for example, told Andrew Marr that "it will be Parliament who sets the price on any of those nationalisations". An alternative approach would be to use the power of government, or simply the pulpit it affords, to artificially drive down the value of the assets.

Yet overall, this would almost certainly be more expensive, given the impact on business investment and confidence, and the potential for capital flight. Also, many of the shareholders who would lose out are UK pension funds, meaning that taxpayers would be paying twice over. Similarly, Labour's suggestion that it might pay "differential compensation" rates for shares owned in countries deemed tax havens opens up the prospect of legal wrangling for years to come.

The puzzling thing here is that while there are substantial risks associated with nationalising utilities, there is little evidence – as this paper will make clear – to suggest that consumers have anything to gain. UK domestic electricity prices, for example, are roughly average for Europe. Consumers in Ireland and Germany – where there is a high degree of government ownership in the energy sector – pay higher prices than those in the UK.

This paper, therefore, will undertake a sector by sector analysis, exploring both the likely costs of Labour's nationalisation programme and the justifications offered for it.

2. ENERGY

2.1 What does Labour what to nationalise?

The Labour Party's 2017 manifesto committed it to "regain[ing] control of energy supply networks through the alteration of operator licence conditions, and transition[ing] to a publicly owned decentralised energy system".[1] It is clear that, at the very least, this would involve nationalising National Grid and the distribution networks, bringing transmission and distribution of energy back into government ownership.

What it means for the generation and retail energy market is less clear, but it appears that Labour have every intention of intervening in these areas. Jeremy Corbyn is on record saying that he would personally like to see the Big Six energy suppliers brought back into the Government's hands.[2] This would not amount to a wholesale nationalisation of the sector – there are many generating assets that are not owned by the Big Six – but would still represent an extraordinary, and extraordinarily expensive, shift in the industry. Alternatively, a Labour Government may seek to bring back the system that prevailed until the 1980s, in which all of the UK's power generation was operated by the State-run Central Electricity Generating Board – although this is not currently official Labour Party policy.

2.2 The economic rationale for nationalisation of energy

There are democratic and social arguments offered for government ownership of the UK's energy system. But from an economic perspective, there are three reasons that are commonly given:

1) There is a widespread perception that private suppliers of energy are making excess profits.

2) The assets are "income generating" and these profits should be used for the benefit of customers, rather than being paid out as dividends to shareholders or interest payments to creditors.

3) The Government can borrow at lower interest rates than commercial companies, which would lead to reduced debt-financing costs.

2.3 What would the upfront cost be?

Responsibility for Great Britain's energy networks lies with National Grid (transmission)[3] and a series of electricity and gas distribution networks (distribution), all of which are in private hands. Private companies handle the generation of energy and retail services to customers. The Big Six energy companies are important players in both of these areas, accounting for just over 80% of the electricity retail market[4] and 65% of GB electricity generation.[5]

Existing cost estimates of nationalising the energy sector are highly uncertain. The

[1] Labour Party Manifesto, *For the Many Not the Few*, 2017

[2] *Independent*, 'Labour leadership: Jeremy Corbyn pledges to renationalise the Big Six energy firms', August 2015

[3] Note that National Grid runs the gas transmission system across Great Britain but only the electricity transmission network across England and Wales.

[4] Ofgem

[5] Ofgem

scale of nationalisation, as well as the way in which companies' value is determined, will be critical in formulating an accurate total borrowing requirement for Labour's plans.

In 2015, the City of London analysts Jeffries argued that wholesale nationalisation of the energy sector in the UK could cost £185bn (see Table 1).[6] This figure falls to £124bn if calculated on the assumption that a future Labour administration would restrict itself to acquiring National Grid and the Big Six. These estimates were calculated on the basis of an enterprise value (market capitalisation + debt), where shares would be bought at current prices for listed companies and the price paid for companies not listed, such as EDF and EON, would be correlated to the valuation of their UK operations.[7]

If the Labour Party sought to simply nationalise the electricity and gas networks, this would have a considerably lower up-front cost. It is estimated that the Regulated Asset Value (RAV) of energy networks is around £55bn, according to analysis conducted by Moodys (see Table 1). The RAV is effectively the value of net invested capital for regulatory purposes.

However, some academics have questioned whether these figures are an overestimate. A study published by Greenwich University argues that Labour could pay just £24bn[8] for their nationalisation plans. The report claims that the Jeffries estimate does not adequately discount the international activities of some of the companies. It also disagrees with the notion that a Labour Government would need to cover the cost of shareholder value, claiming that share prices are merely a "negotiating position" for shareholders and that the final purchase would be much lower.

Of course, an incoming Labour administration might seek to reduce the share price value of energy companies to lower the cost of government ownership. The prospect of Labour's plans would in themselves likely have a detrimental impact on share prices and punitive regulations could be used to artificially reduce them further. Doing this, or paying just £24bn as suggested by the University of Greenwich study, would certainly decrease the up-front borrowing requirement for nationalisation. But as outlined later in this paper, there would be a series of detrimental consequences.

Using statements in the Labour manifesto and Jeremy Corbyn's previous pronouncements, we can assume with confidence that a Labour Government would seek to nationalise the energy networks.

Corbyn has also previously talked up the possibility of nationalising the Big Six – although this was not stated in the Labour Party manifesto of 2017.

For the purposes of our calculations, we make a lower estimate based on the Labour Party simply nationalising energy networks, and a higher estimate using the assumption that the cost of government ownership relates to a wholesale nationalisation of the energy sector. In reality, the figure is likely to be somewhere in between these estimates.

[6] *Daily Telegraph*, 'Jeremy Corbyn's plans to renationalise UK power sector could cost taxpayer billions', 7 August 2015

[7] For full breakdown see Guardian, 'Jeremy Corbyn's bill for nationalising energy sector costed by City at £185bn', 7 August 2015

[8] University of Greenwich, *Public ownership of UK energy system – benefits, costs and processes*, 2016

Table 1: Estimates of costs for Labour's planned energy nationalisation

HIGH ESTIMATE	Jeffries (enterprise value for nationalisation of energy sector)	Up to £185bn
LOW ESTIMATE	Regulated asset value of energy networks*	£55.4bn

* Data comes from Ofwat, Ofgem and Moody's. Value correct as of March 2017. RAV of gas transmission = £5.5bn, Electricity transmission = £17.6bn, Gas distribution = £12bn, Electricity distribution = £20.3bn

The RAV of the energy networks is £55.4bn (see Table 1, above). This is below the commercial value of the listed companies involved and prices paid in recent transactions, meaning that the figure should be treated as an absolute minimum cost for Labour's energy nationalisation plans.

For the upper estimate, the appropriate figure to use is that of the enterprise value of the energy sector. For example, many of the Big Six are owned – or part owned – by foreign governments, who are unlikely to accept the UK Government seizing assets below their true value, even if a Labour administration was able to deliberately manipulate share prices downwards. And if companies owned by foreign governments demanded a good price for a sale, it would be inevitable, not least for legal reasons, that other shareholders would be treated in the same way.

We also assume that, in such a scenario, a Labour Government would have to take full ownership of the Big Six energy companies rather than just obtaining a controlling stake. As pointed out in the Jeffries report, under Stock Exchange rules, once a shareholding hits 30%, an offer for the whole company must be made.[9] Moreover, there would be little appetite for any private shareholders to maintain their stake in a majority-owned Government-run energy company.

Therefore, the Jeffries estimate of £185bn, suitably updated, would seem to be the best guess for an upper estimate of Labour's energy nationalisation plans (see Table 1).

2.4 Would nationalisation be worth it?

Government ownership of energy companies does exist in many European countries – in the shape of firms such as Dong, EDF, ESB, Fortum, Engie, RWE and Vatenfall[10] – and some of these firms already own parts of the UK electricity system. This raises the question: would the UK, under Labour, not simply be replicating the energy ownership structures of other European countries?

If it did so, the only legitimate rationale would be to reduce prices paid by consumers. However, there appears to be no evidence that state ownership in the energy sector would achieve this.

[9] *Daily Telegraph*, 'Jeremy Corbyn's plans to renationalise UK power sector could cost taxpayer billions', August 2015

[10] University of Greenwich, *Public ownership of UK energy system – benefits, costs and processes*, 2016

Table 2: International electricity prices for medium domestic consumers (Jan to Jun 2017) Figures are in p/kwh

	Exc. taxes and levies	Inc. taxes and levies
Denmark	8.63	26.25
Finland	9.03	13.61
France	9.37	14.55
Sweden	10.82	16.67
Germany	11.96	26.24
Ireland	15.89	19.84
UK	11.57	15.2
EU-15	10.51	16.79

Source: Department for Business, Energy and Industrial Strategy

Table 2 outlines the prices paid by domestic consumers in EU countries that have state-run energy firms operating in the UK. French and Swedish consumers fare slightly better than the UK in terms of prices before and after taxes, but Germany and Ireland fare considerably worse on both measures. This is particularly significant given that Germany is sometimes cited as an energy model that the UK should follow.

International evidence also suggests that privately run energy assets are more efficient than those under government ownership. For example, on a cost-per-customer basis, privately owned electricity distributors in Australia operate their assets between 15 to 33 per cent more cheaply than equivalent assets that are in government ownership.[11]

This appears to suggest that, while the risks of nationalisation are substantial, there is no evidence to show that creating government ownership models similar to those in many European countries would lead to any benefits in terms of prices paid by consumers.

2.5 What should be done?

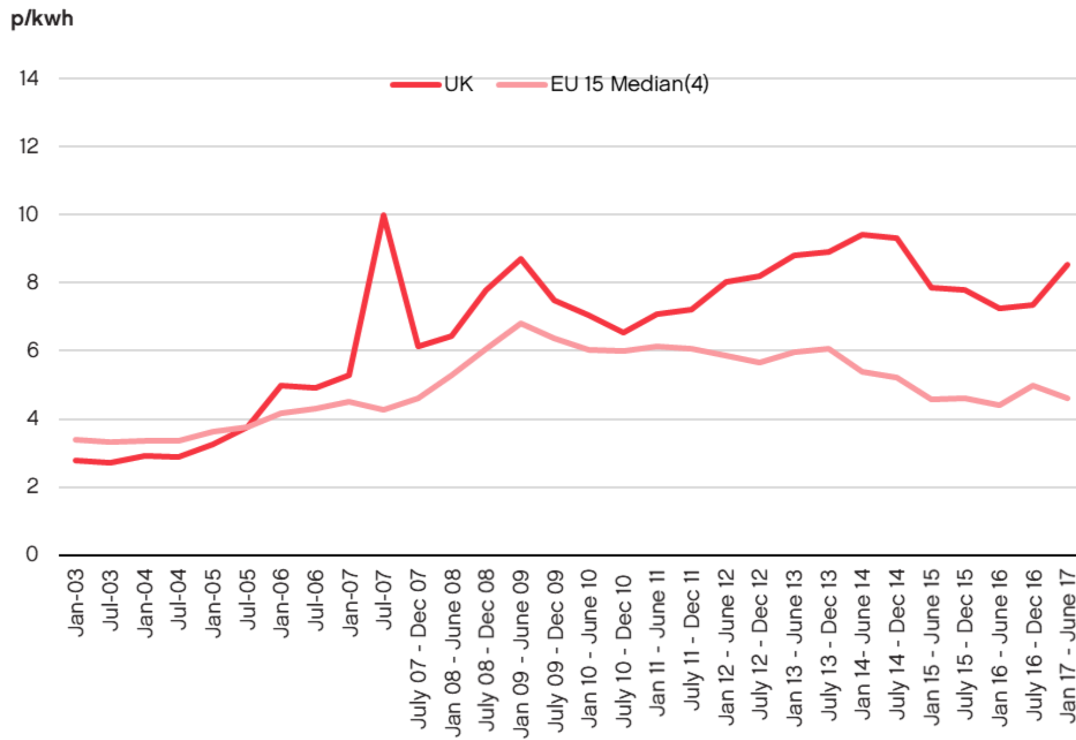
There are undoubtedly serious problems relating to the UK's energy market. While domestic households receive electricity prices that are roughly around the EU average (see Table 2), the same cannot be said of industrial electricity prices, which are estimated to be some of the highest in Europe.[12] Some of this can be attributable to unilateral green levies such as the Carbon Price Floor (CPF). However there are other reasons, too.

When examining electricity prices exclusive of taxes and levies (which strips out the impact of measures such as the CPF), it is clear that UK prices were competitive in the early 2000s (see Figures 1 and 2). The UK's energy market was liberalised at this stage and faced little government intervention.

[11] PWC, *The case for change – privatisation of Western Australia's electricity networks*, Oct 2016

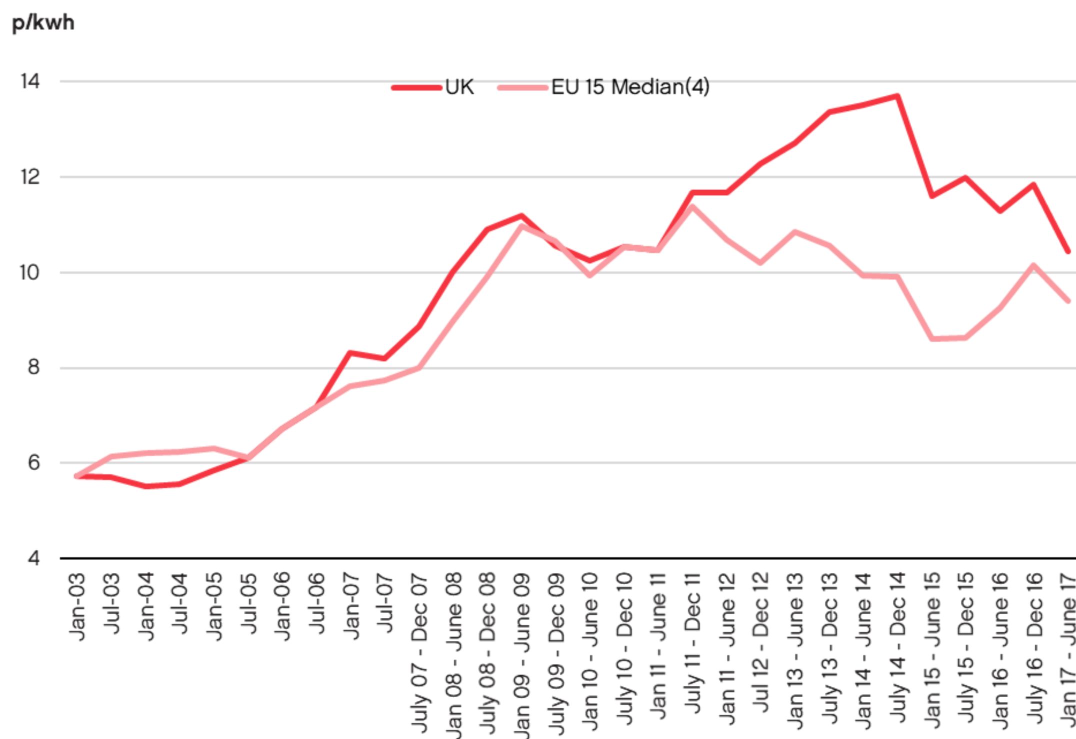
[12] House of Lords Economic Affairs Committee, *The Price of Power: Reforming the electricity market*, February 2017

Figure 1: Industrial electricity prices for large consumers exc. taxes and levies (2003 to 2017)



Source: Department for Business, Energy and Industrial Strategy

Figure 2: Domestic electricity prices for large consumers exc. taxes and levies (2003 to 2017)



Source: Department for Business, Energy and Industrial Strategy

Since then, however, the UK's industrial electricity prices, and to some extent domestic electricity prices, have become much less competitive. But this has corresponded with ***increased*** state intervention in the energy market, not further liberalisation.

This has been confirmed by a recent government-commissioned review into the costs of energy in the UK.[13] It concluded that the cost of energy is significantly higher than it needs to be to meet the government's objectives of ensuring energy security and hitting climate change targets. According to the report's author, Professor Dieter Helm, this has arisen from the state moving away from mainly market-determined investments towards a situation in which all new electricity investments are chosen through technology-specific contracts.

Nationalisation would further increase state intervention and squeeze out the remaining market mechanisms in place, leading to even worse outcomes for customers. The best way of fixing the energy market would be to promote competition in the energy retail market, bear down on the cost of environmental levies and re-introduce market mechanisms on the generation side of the market.

[13] Dieter Helm, *Cost of Energy Review*, 2017

3. WATER

3.1 What does Labour want to nationalise?

Labour's 2017 manifesto called for the water system in England to be replaced with a network of regional publicly-owned water companies. This would effectively reverse the privatisations that occurred in 1989.

3.2 The economic rationale for nationalisation

As with the energy sector, there are three reasons that are commonly given from an economic point of view:

1) There is a widespread perception that private firms are making excess profits. This has been blamed by some for the 40% real terms increase in water bills since privatisation in 1989.[14]

2) The assets are "income generating" and these profits should be used for the benefit of customers, rather than being paid out as dividends to shareholders or interest payments to creditors.

3) The Government can borrow at lower interest rates than commercial companies, which would lead to reduced debt-financing costs.

3.3 What would the upfront cost be?

Private water companies in England (as well as a not-for-profit company in Wales and a nationalised company in Scotland) are responsible for water supply and wastewater management.

[14] National Audit Office, *The economic regulation of the water sector*, 2015

Table 3: Estimates of upfront cost to nationalising English and Welsh water companies

Macquarie Research estimate	£100bn
Regulatory capital value +25%*	£86.25bn
Regulatory capital value (Ofwat)	£69bn
University of Greenwich estimate	£14.3-£37bn

* Uses the Credit Suisse assumption that market value has a 25% premium to the RAC
Sources: Ofwat, Macquarie and University of Greenwich

The Regulatory Capital Value (RCV) of these water companies in England and Wales is estimated to be in the region of £69bn.[15] RCV is a measure used by the regulator Ofwat to help determine the prices the water firms can charge: it effectively represents the value of the capital base of companies.

Many commentators assume that this would be the cost of nationalisation. But it is notable that this is far less than the value of the industry as determined by its share prices, leading to a study by Macquarie Research concluding that the cost of government ownership would be £100bn.[16]

As former owners of Thames Water, Macquarie are not wholly impartial. But other estimates do suggest that these firms' market value is much higher than the RCV. For example, Credit Suisse concludes that United Utilities trades at a 25% premium to its Regulatory Asset Base.[17] We have therefore assumed that the commercial value of the water sector is the RCV of £69bn plus an estimated 25% premium.

As with our estimates for the energy networks, this figure should be viewed as conservative. The water companies have debts of around £49bn and it has been suggested that these may need to be paid off immediately in the event of nationalisation.[18] The estimates in Table 3 do not account for this possibility.

An alternative report, again from the University of Greenwich, argues that a Labour government could, in fact, pay much less than the regulatory capital value.[19] However, doing so would have serious knock-on consequences, as outlined later. So we have chosen to use the £86.25bn figure as coming closest to a likely final total.

3.4 Would nationalisation be worth it?

As with the energy sector, it is highly unlikely. In particular, it is misleading to claim that recent increases in water bills are due to privatisation.

By 1989, which is when the water companies were privatised, the water system was suffering from chronic underinvestment. Since then, there have been significant improvements. Customers are now five times

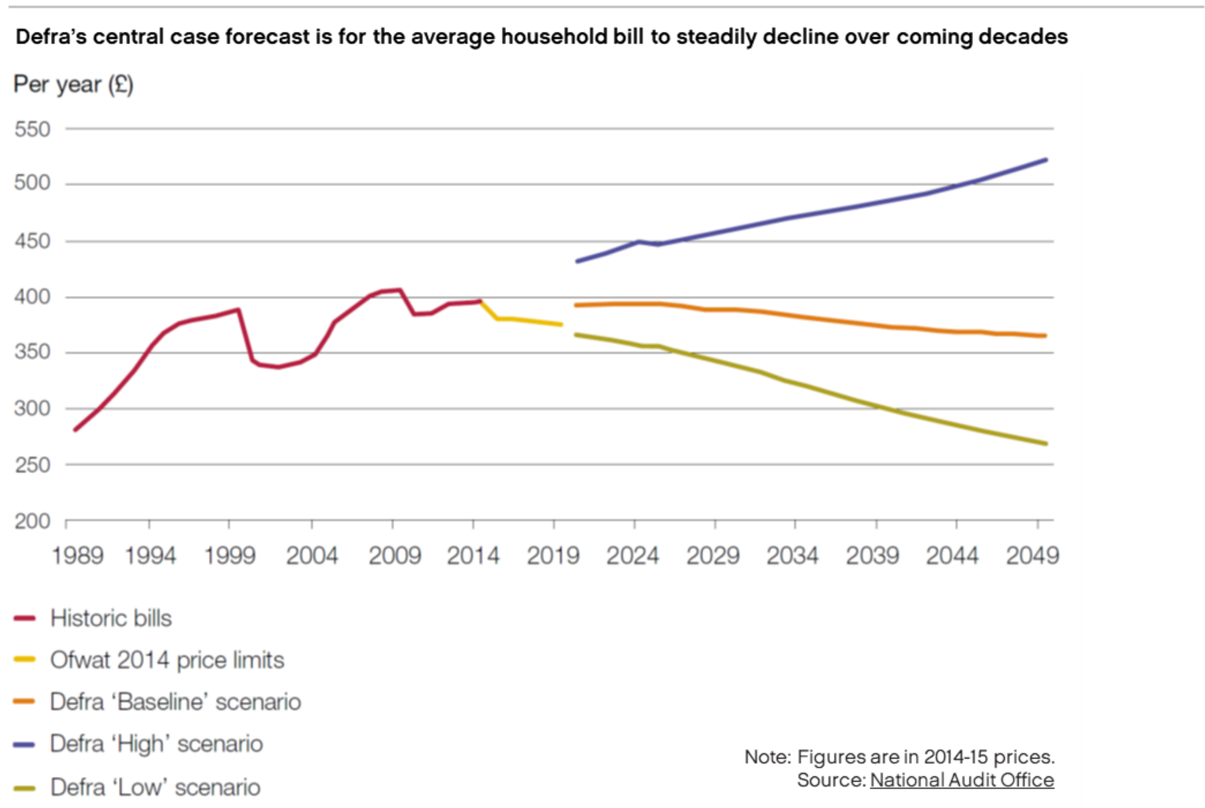
[15] Ofwat, *Regulatory capital values*, 2017
[16] Macquarie Research, *UK Water: buy the best*, 2017
[17] Credit Suisse, *UK Water: Revisiting the equity risk*, 2016
[18] For example, see Nils Pratley for the Guardian, 2017
[19] University of Greenwich, *Bringing water into public ownership: costs and benefits*, 2017

less likely to experience unplanned supply interruptions and water companies have reduced leakage by a third.[20] The water companies are also now 64% more productive than they were under nationalisation, according to Frontier Economics.[21]

This has only happened because the newly formed private companies were able to boost investment in water infrastructure. For example, in the six years after privatisation, the water companies invested £17bn, compared to £9.3bn in the six years prior to privatisation.[22] Indeed, in the 15 years since privatisation, water and sewerage companies had to invest £50bn to catch up for past under-investment, leading to an increase in customer bills of 35% in real terms by 2005-06.[23] Bills have subsequently increased by a further five percentage points in real terms.

As pointed out by former chief executive of Ofwat, Cathryn Ross, there has been more than £140bn of total investment in the water sector since privatisation. Despite this customers, on average, now pay less than a penny per litre of water delivered.[24] Ross describes this as “a great story”.

Figure 3: Projected pathway of average household water bills in England and Wales



20 Discoverwater.co.uk
21 Frontier Economics, *Frontier report assesses productivity changes in the English water sector*, 2017
22 World Bank, *Water privatisation and regulation in England and Wales*, 1997
23 Ofwat, *The development of the water industry in England and Wales*, 2006
24 Ofwat, *Cathryn Ross speaking notes – Moody’s 2017 UK Water Sector Conference*, October 2017

Looking at the current situation, there is a wide spread of charges set by the private water companies in England, ranging from a low of £341 per year in Severn Trent area to £491 per year in the South West. These charges tend to reflect the varying amounts of investment that have been required since privatisation – not least because Ofwat sets price limits accordingly. The average charge in England and Wales was £395.[25]

Encouragingly, it is projected that the current system – under which the water companies are privatised but heavily regulated by Ofwat – will soon lead to falling prices for customers (see Figure 3).

The history of the water industry also raises the issue – which applies to other sectors as well – of competition for capital. Within the public sector, all of the newly nationalised industries would be competing, along with all of Labour's other priorities, for available capital on an ongoing basis. The need to inject capital into nationalised industries that had long been starved of it was one of the major justifications for the privatisation programme in the first place – and the example of the water industry shows its success.

3.5 What should be done?

While the privatised water companies have successfully upgraded infrastructure and delivered a more reliable and higher quality service to customers, the industry lacks innovation and entrepreneurial dynamism. In many respects, nationalised monopolies have been replaced by a series of regional private monopolies, to the extent that the water companies are somewhat reminiscent of the old utilities in the 1970s and 1980s.

[25] Discoverwater.co.uk

Michael Gove has recently highlighted issues associated with some of the UK's water companies, particularly with the use of offshore tax havens.[26] There is also evidence that some water companies are paying out high dividends, while increasing borrowing.[27] Yet the threat of nationalisation is actually a major incentive for firms to continue this behaviour, or even to ramp it up – particularly since Labour is indicating that it will not pay proper commercial value for their assets.

The solution to these problems is not to re-nationalise the water companies. This would simply cost large amounts of money, create an uncertain business environment and produce the conditions for no competition. Instead, the Government should pursue measures that increase transparency as well as competitive pressures on the water companies.

This could be done by promoting greater competition in the supply of water, or by introducing retail competition into the industry. Ofwat argues that offering retail competition to residential customers could, among other things, produce benefits worth £2.9bn over 30 years, deliver new offers and choice to customers, and lead retailers to challenge wholesalers to become more efficient.[28] Moreover, Ofwat already has the ability to scrutinise the practices of water companies to ensure value for money, without exercising the expensive option of nationalisation.

[26] Sunday Times, *Gove turns hose on water bosses' use of tax havens*, Jan 2018

[27] Financial Times, *'Thames Water: the murky structure of a utility company'*, 2017

[28] Ofwat, *Costs and benefits of introducing competition to residential customers in England – summary of findings*, 2016

4. ROYAL MAIL

4.1 What does Labour want to nationalise?

In 2013, the Coalition sold 60% of the state's shares in Royal Mail – which operates across the United Kingdom – to its employees along with private investors. While the Post Office network has remained in control of the state, Royal Mail is now fully owned by private interests and subject to regulation by Ofcom. Labour is essentially seeking to reverse the privatisation of Royal Mail and bring it back into full government ownership.

4.2 How much would it cost?

As of 2 January 2017, Royal Mail had a market capitalisation of roughly £4.5bn.[29] This figure is, of course, subject to change. As is the case with the value of other companies, the share price may fall after the election of a Labour Government. A McDonnell-led Treasury might even argue that shares should be bought back at the price they were initially sold to private investors.

4.3 The economic rationale for nationalisation

There has been disgruntlement about:

1) Dividends paid to shareholders.
2) The price that shares were sold off at.
3) The fact that, as Royal Mail was profitable in the year before privatisation, there was no need to take it out of state hands.

4.4 Was the sale price too low?

The former Department for Business, Innovation and Skills sold 60% of the government's shares in Royal Mail at a price of £3.30 each in October 2013. The share price then increased by 38% on the first day of trading, leading the National Audit Office (NAO) to investigate whether the sale represented value for money.[30] Further share sales, concluding in October 2015, saw the state's shareholding completely disposed of, raising a total of £3.3bn for the Exchequer.

In evaluating the initial share sale, the NAO did conclude that ministers should consider whether new methods should be used to get better value from future privatisations. But there was no evidence to suggest that a much higher price could have been achieved. Lord Myners, a Labour Peer who oversaw an informal review of the sale, said: "For the avoidance of doubt, we do not believe that a price anywhere near the levels seen in the aftermath could have been achieved."[31]

4.5 Royal Mail's former track record

The argument that Royal Mail was a thriving business before privatisation is a hard one to make.

It was generally recognised that Royal Mail's efficiency was very poor. Despite shedding 50,000 jobs in the four years from 2003, the company admitted that it was still 40% less efficient than its competitors by 2007.[32] When Richard Hooper CBE was asked to undertake an independent review of the UK postal services sector in 2008, the expert consensus was that the position of the company was unsustainable.

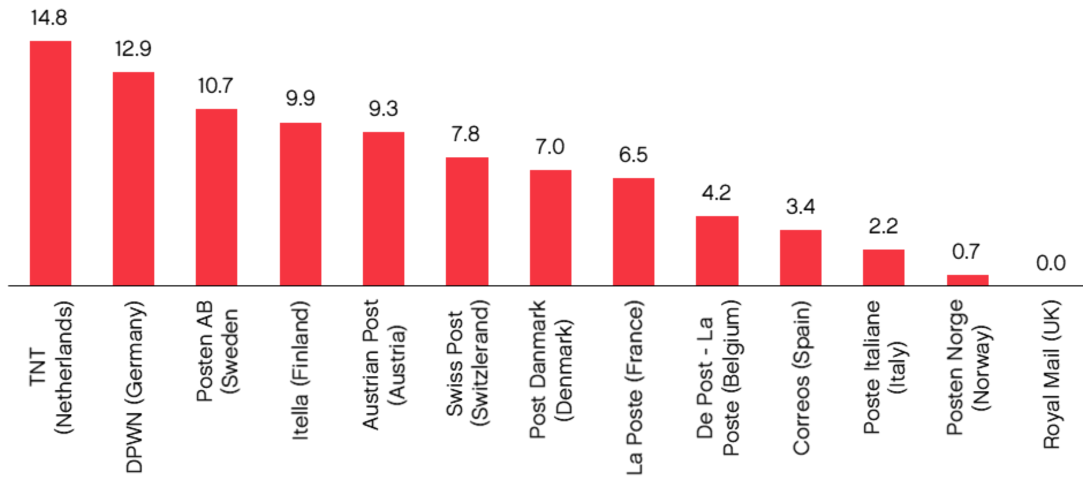
[29] Bloomberg Markets (correct as of 2 Jan 2018)

[30] National Audit Office, *The Privatisation of Royal Mail,* April 2014

[31] House of Commons Library, *Privatisation of Royal Mail*, 2016

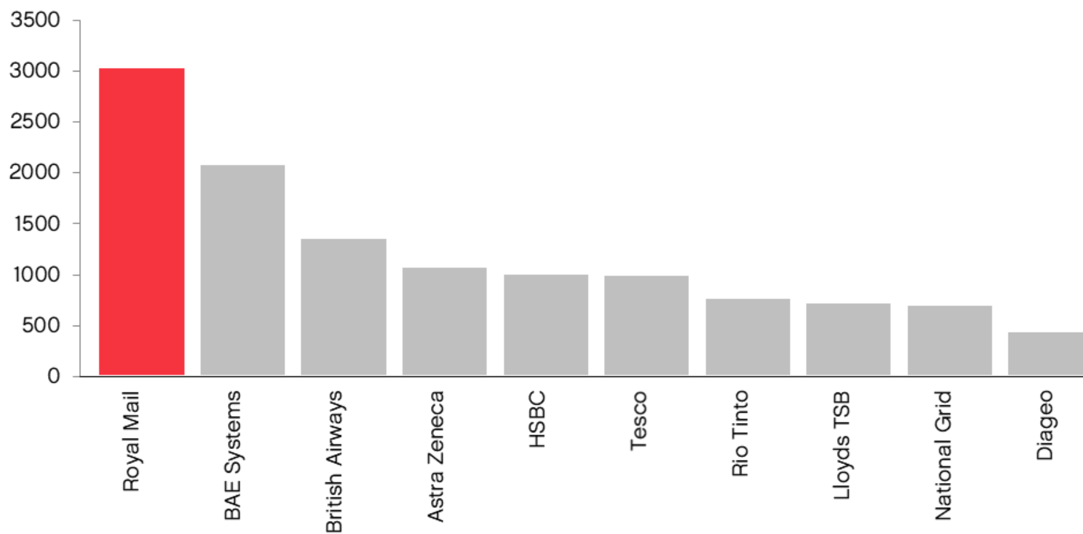
[32] Postal & Logistics Consulting Worldwide, *Review of the impact of competition in the postal market on consumers*, 2015

Figure 4: Operating profit margins of Western European postal companies, 2007 (%)



Source: "Modernise Or Decline: Policies to Maintain the Universal Postal Service in the United Kingdom: an Independent Review of the UK Postal Services Sector" Richard Hooper, Deirdre Hutton, Ian R. Smith, 2008

Figure 5: Royal Mail's pension deficit vs selected FTSE 100 companies, 2007 (£ million)



Source: "Modernise Or Decline: Policies to Maintain the Universal Postal Service in the United Kingdom: an Independent Review of the UK Postal Services Sector" Richard Hooper, Deirdre Hutton, Ian R. Smith, 2008

Particularly striking was that while private mail companies in Germany and the Netherlands were facing greater end-to-end competition than Royal Mail, they were achieving high profit margins from their mail operations. By contrast, Royal Mail's financial position was becoming increasingly precarious, making an operating loss in 2007 (see Figure 4). There were also a range of other issues: for example, it had one of the largest pension deficits in the UK.

The Hooper Review argued that, in order to sustain the universal service provided by Royal Mail, this inefficiency had to be tackled urgently.[33] This included calls for the injection of private sector money and expertise. The Coalition Government accepted this and went ahead with privatisation.

4.6 Record post-privatisation

Since privatisation, £1.5bn of much-needed investment has been ploughed into modernising Royal Mail's IT and delivery office network.[34] The company now also appears to be on a sustainable footing, delivering more parcels each year than all of its competitors combined.[35] And employee relations appear to have improved. Employee engagement, measured by independent surveys, has risen from 20% in 2010/11 to 57% in 2016/17.[36] It is also notable that many Royal Mail employees are now stakeholders in the business, which further brings into question the wisdom of pursing nationalisation.

The renationalisation of Royal Mail would, in comparison with Labour's plans for the energy and water sectors, be relatively inexpensive – if a multi-billion-pound price tag can ever be called inexpensive. But as with the utilities, it is hard to see the rationale, given that the service is performing better in private hands.

5. PFI

The Private Finance Initiative (PFI), introduced in 1992, was used as a mechanism to fund major capital investments, under which private firms would handle the upfront costs on the condition that the Government would make annual payments to the companies, typically across 30 years. It was greatly expanded under New Labour, under whom total debts incurred through PFI projects rose dramatically.[37]

John McDonnell has committed to there being no new PFI contracts. This is relatively uncontroversial. But he is also planning to take action on existing deals, pledging to bring existing PFI contracts back in-house.[38] However, in the immediate aftermath of the party conference speech in which the announcement was made, the Labour Party clarified that this would not (as McDonnell had appeared to suggest) apply to all PFI contracts, but only to some.

This uncertainty makes it extremely difficult to calculate the cost of this proposal. Nationalising all existing contracts could amount to around £200bn, according to some estimates.[39] In the wake of the announcement, John Appleby, chief

[33] Richard Hooper CBE, *Modernise or decline*, 2008

[34] Royal Mail, 16th November 2017

[35] Royal Mail, 'Annual Report and Financial Statements 2016-17 '

[36] Ibid and Royal Mail, 'Annual Report and Financial Statements 2010-11'

[37] Centre for Policy Studies, *After PFI*, 2012

[38] *The Architects' Journal*, 'Labour will scrap PFI', 2017

[39] *Wacomms*, 'PF Why? Analysing Labour's PFI announcement', Oct 2017

economist of the Nuffield Trust, suggests that ending NHS PFI contracts alone could cost in the region of £50bn.[40] Robert Peston of ITV put the total cost of Labour's plans at between £30bn and £40bn – an amount Peter Dowd, McDonnell's deputy, agreed was "sensible".[41]

The truth is that, as Appleby argued in a later briefing note for the Nuffield Trust, there is no way of coming up with a definitive figure without more detail on how many contracts would be bought out by the state, and how the process would work.[42] Bearing that in mind, we shall be generous to Labour and take the low point of Peston's estimate, as one which Labour figures have themselves endorsed.

Of course, there is no way to defend many of the PFI deals signed since the 1990s, which have been some of the costliest experiments in public policy-making and infrastructure investment. As highlighted in a Centre for Policy Studies pamphlet by Jesse Norman MP,[43] there have been a series of problems associated with these contracts. Public sector institutions have often been poor clients; the procurement process was flawed; and there was an asymmetry of negotiating power between individual hospitals, schools or councils on the one hand and contractors on the other.

The result – thanks primarily to Gordon Brown's enthusiasm for PFI – has been a huge level of liabilities for the taxpayer. So, it is easy to see the case for terminating these contracts.

The problem, however, is that as these contracts have now been entered into, there would be huge penalties to pay for terminating their provisions. Moreover, nationalising the contracts at a discounted rate could damage investor confidence if previous agreements are not abided by. Responding to McDonnell's PFI announcement and other nationalisation proposals, the British Chambers of Commerce warned that his proposals "would put business investment in the deep freeze at precisely the time that it is needed most".

PFI is an ugly mess, and one largely of Labour's own making. But any mass buying-out of contracts – rather than simply winding down the most egregious examples – would make an already bad situation even worse.

6. RAIL

In the 1990s, Britain's rail system was privatised. Part of the industry was, however, re-nationalised shortly afterwards. The result is that responsibility for maintaining the track lies with the state-owned Network Rail, but train services are delivered by private operators via franchise agreements.

There are currently 18 franchises in England, Scotland and Wales. It is these that an incoming Labour Government would seek to bring these back into public ownership.

The upfront cost would depend on the pathway chosen to achieve government ownership of rail services. If a Labour Government sought to terminate the contracts of current franchise holders, this could lead to considerable compensation costs. A less expensive route would be to simply allow each franchise to expire and phase in government ownership one-by-one.

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[40] *Financial Times*, 'Labour Party Threatens to nationalise PFI contracts', 2017
[41] *ITV,* 'The death of PFI is no free lunch', 2017
[42] Nuffield Trust, *Making sense of PFI*, 2017
[43] Centre for Policy Studies, *After PFI*, 2012

Although Labour might indeed seek to nationalise some franchises before their expiry date, we have charitably assumed that they would phase in nationalisation on one-by-one basis. This means that the costs would not be part of the immediate bill which this paper attempts to calculate.

That is not to say, however, that this option would be cost-free. For example, a new rolling stock company would be needed to buy trains from the private sector, or build new ones. In 2015/16, the train operating companies paid £1.4bn in rolling stock charges[44] – some 12 per cent of their total expenditure. That is a cost which would be taken on by the public sector under a nationalisation scenario. It is also worth noting that much of the train operating companies' income goes to the Government already, either in the form of franchise payments to central government or access payments to Network Rail.

It is also far from clear, as with the other markets considered, how any savings would be generated post-nationalisation, or passed on to consumers. Indeed, Labour have committed to increased spending, for example on staffing levels, which would tend to drive costs (and therefore ticket prices) up rather than down.

This could be covered by increasing the amount of subsidy, but this would simply end up benefitting the wealthy at the expense of the less well-off: it is estimated that the households in the top fifth of the income distribution do four times as many rail journeys and travel six times as far as those in the bottom 20% of the population.[45]

As with water and energy, the rail market is far from perfect. In some respects, nationalised monopolies have been replaced by a series of private monopolies, which only face competition when bidding for contracts.

Yet there are various ways of reforming this system without going down the route of nationalisation, which would likely make the situation worse by squeezing all competition out of the system. For example, allowing more on-track competition could be a way forward. Indeed, where open access operates (ie multiple providers competing over similar routes), UK passenger satisfaction is at its highest.[46]

And it is important to note that despite the rail industry's problems, there have been some significant improvements since privatisation. The UK is now among the safest countries for rail travel in Europe. Passenger numbers have more than doubled since the late 1990s and customer satisfaction has also seen improvements over the same time period.[47] In fact, overall satisfaction with the UK's railways is the second highest in Europe.[48]

It is true that fares are high in the UK. But that is because of a deliberate policy decision to make passengers pay more of the actual cost of their fares. The reason why many other European countries have lower

[44] House of Commons Library, *Railway rolling stock (trains),* 2017

[45] Department for Transport, *National Travel Survey: England 2016*, 2017

[46] Centre for Policy Studies, *Get Rail Competition Back on Track,* December 2016

[47] Rail Delivery Group, *Partnership railway's transformation in numbers*, 2017

[48] European Commission, *Fourth report on monitoring development of the rail market*, 2014

train ticket prices is simply due to much higher levels of state subsidy.

A move towards a fully-nationalised rail system with bigger government handouts would be the worst of both worlds. The UK's comparatively high satisfaction levels with the railways would be at risk, given that all competition would be removed from the system. And greater taxpayer support for rail fares would be a costly and regressive step, privileging wealthy South-Eastern commuters over other taxpayers.

7. THE BROADER CONSEQUENCES OF NATIONALISATION

Taken together, the calculations above suggest that the upfront capital cost of Jeremy Corbyn's nationalisation programme could be in the region of **£176bn**: £55.4bn for energy (based on a floor price for nationalising the transmission and distribution networks); £86.25bn for the water sector; £4.5bn for Royal Mail; and a potential £30bn for PFI nationalisation (although this estimate is particularly uncertain).

It should be noted that, if Labour sought to nationalise the whole energy sector rather than just the networks, the overall cost of nationalisation would rise to **£306bn**.

Even taking the lower estimate of £176bn, the opportunity cost of spending this on nationalisation would be substantial. It would represent around 10 per cent of the national debt or £6,471 for every household. It is also equivalent to 19.3 years of the UK's defence equipment budget, or could theoretically be used to help build 2.93m council homes [See Annex].

Labour will, of course, argue that it would use the power of Government to ensure that it pays less. Yet this would likely have an even worse outcome.

By the Labour Party's own admission, investors are likely to take a very negative view of its nationalisation plans. Indeed, John McDonnell has admitted that Labour figures are preparing for a run on the pound if he becomes Chancellor of the Exchequer.[49] This admission about the real possibility of capital flight under an administration led by Jeremy Corbyn raises the question of what measures they would turn to in order to preserve the stability of the UK economy.

Paying below market value for energy and water companies – either via "negotiation" or pushing down the price through regulatory means – may on the face of it seem like the Government ensuring taxpayer value. Labour has floated the idea of giving shareholders government bonds at a value determined by Parliament, which would suggest that this is their preference.

However, such moves would lead to huge consequences for the public, for business investment and for confidence in the UK Government.

7.1 Business Investment

Some impacts arising from Labour's nationalisation plans may occur across the short to medium term. The seizure of assets and shares from investors in various industries would dampen business confidence – especially if the compensation was below the commercial value. Investors could become fearful of further non-voluntary purchases of private businesses or the introduction of regulatory rules that

[49] John McDonnell at Labour Party Conference 2017

would damage the competitiveness of UK industry. This would encourage capital flight (hence McDonnell's concern about a run on the pound), reduce foreign direct investment and reduce business investment to even lower levels than is currently the case (despite recent improvements, the UK still has the G7's lowest level of gross fixed capital formation as a % of GDP[50]).

Moreover, Labour's plans would hamper the UK in areas where it is currently punching above its weight. For example, the UK currently leads Europe in attracting foreign direct investment[51], but this would undoubtedly be at risk after Labour's nationalisation plans.

7.2 Confidence in government

Confidence in the Government is broadly represented by the yield on gilts. The lower the yield, the more willing investors are to put their money into UK government debt. There is therefore every reason to assume that bond yields, and therefore debt interest payments, would rise significantly following nationalisation.

Debt interest payments would rise considerably for the following reasons:

a) The additional interest payments arising from borrowing to finance nationalisation.

b) Investors in gilts will likely demand a premium for the big risks associated with such a large-scale nationalisation programme – especially if Labour seizes assets below their commercial value. By spooking the markets, borrowing costs for Labour's other planned spending will increase. And the Bank of England's ability to use the Quantitative Easing programme to purchase gilts has been almost exhausted, meaning that this mechanism will probably not be able to hold down yields.

c) The rise in gilt yields will not just make servicing Labour's nationalisation plans more expensive. It will also make debt financing for the UK's existing budget deficit and Labour's other spending pledges more costly for the Exchequer.

This also undermines the argument that current company profits would be used for the benefit of customers under a nationalisation scenario – that promised reduction of £220 in household bills (a figure seemingly plucked from the air, given Labour's refusal to explain its composition). In fact, if the companies remained profitable, the money would simply be used to pay off debt interest – something which John McDonnell appears to have conceded.[52]

Labour may argue that they can have their cake and eat it: that the increased borrowing costs and the £220 bill cut can both be paid for from the profits that these firms make. But how can this be tested? For that claim to stand up, we would need to know how much borrowing there will be, which is impossible to know without an idea of how much Labour plan to pay for nationalisation – something Labour refuses to tell us.

There is another argument to make, of course. It is that set out in "Alternative Models of Ownership", the document produced for the Labour hierarchy before the election. It tries to argue that public

[50] ONS, *An International comparison of gross fixed capital formulation*, Nov 2017

[51] EY, *EY's Attractiveness Survey UK*, May 2017

[52] John McDonnell has said "what I am saying is the cost is always covered because these are profitable industries and that will cover the cost of borrowing": Daily Telegraph, 19th November

ownership is superior to private ownership, meaning that these firms would be become models of efficiency and industrial harmony.

Yet it is highly questionable that newly nationalised companies would maintain their efficiency levels, let alone improve them. The water companies, as mentioned above, are now 64% more productive than when they were under state control. Moreover, overall productivity in the market (ie private) sector has long outstripped that of the economy as a whole. Public sector productivity actually fell in the decade before the financial crisis[53] when the UK was experiencing growth in output per capita of roughly 2% per annum overall.[54]

Whatever the pathway of nationalisation chosen by Labour, it will involve a series of ongoing costs to the taxpayer. This will come from the additional interest payments on extra borrowing as well as the costs arising from higher bond yields.

7.3 Pension funds

An added complication to Labour's plans is that reducing the value of energy companies, assets in the energy sector and the water companies may hit pension funds, which invest heavily in utilities.

Pension funds have been particularly attracted towards investment in the UK's water sector due to the guaranteed returns that it can generate. Just recently, a handful of local authority pension funds teamed up in an attempt to obtain a 15% shareholding in Anglian Water Group.[55] Moreover, 32.9% of the company is owned by the Canada Pension Plan Investment Board and 19.8% is owned by IFM investors (which is operated by 30 Australian pension funds).[56] And across Europe, the Middle East and Africa more broadly, it is estimated that 47% of pension fund equity has been invested in the energy and utilities sector in the decade from 2006 to 2016.[57]

A cut-price nationalisation strategy would therefore reduce the savings and future wealth of millions of British pensioners. It would also restrict those funds' investment options in the future. It is also notable that concern about the impact of Labour's nationalisation plans on pension funds has been expressed by some Labour figures, including Chris Leslie[58], shadow Chief Secretary to the Treasury under Ed Miliband. He argued, during the Labour leadership contest in 2015, that nationalisation would have an adverse impact on thousands of investors, including charities.

8. CONCLUSION

As this paper suggests, the upfront costs of nationalisation would – even under a relatively generous set of assumptions – be truly daunting. To cause minimal disruption to business confidence, Labour would likely have to pay an upfront cost in the region of £176bn, representing around 10 per cent of the current national debt,[59] or £6,471 per household[60].

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[53] From 1997 to 2007, public sector productivity fell by 1.1 percentage points (See: ONS, Growth rates and indices for total public service output, inputs and productivity, February 2016)

[54] House of Commons Library, *Productivity in the UK*, 2017

[55] *Sky News*, 'Council pension funds team up to buy £500m Anglian Water stage', 2017

[56] Anglian Water Group

[57] UBS, *A long-term perspective: Pension Fund Indicators*, 2017

[58] Twitter, 23 August 2015

[59] Public sector net debt was £1,734.8bn at the end of November 2017 – see ONS

[60] 27.2m households in the UK in 2017 – see ONS

And this figure may well be an underestimate, given the higher totals suggested in many of the sectors examined. For example, the estimate of £176bn assumes that a Labour Government would, in the case of energy sector, only nationalise the transmission and distribution networks. If, instead, they sought to bring the whole energy sector into government hands, the overall cost of Labour's nationalisation plans would increase to £306bn (see Table 4).

Yes, there are issues in many of the industries that Labour plans to nationalise, particularly in the energy and water sectors. But government ownership would simply exacerbate them – while requiring large amounts of borrowing.

The truth is that the implications of nationalisation will have far more wide-ranging consequences. Businesses are already raising the alarm. Late last year, a director on the boards of two financial services companies claimed that "the UK would be bust in three years" after the election of a Labour Government.[61]

This shows that the nationalisation plans in themselves would cause markets to become nervous. But there is every indication that Corbyn and McDonnell would try to seize assets at a lower price.

McDonnell has repeatedly claimed that Parliament will set the price of nationalisation, suggesting that the Labour Party has no intention of paying a commercial value. The consequences for taxpayers might actually be even worse in the medium-term than forking out large amounts of upfront borrowing. Business investment would slump, confidence in the government would likely collapse, leading to a spike in bond yields, and pension funds that have invested heavily in utilities would suffer losses. This could explain why John McDonnell is planning for a run on the pound if Labour is elected to power.

Moreover, the plans would no doubt be subject to legal challenge – particularly if Labour went down the path of "differential compensation rates". A programme of mass nationalisation would also lock out private capital from these industries, and lead to an increase in competition for capital within the public sector. This would lead to the industries becoming less efficient and could also result in resources being diverted away from areas such as schools and hospitals.

Many argue that nationalisation of "profit-yielding" assets is sensible when interest rates on government bonds are much lower than commercial rates of borrowing. This is mistaken in two key respects.

First, this argument could be used to justify nationalising any profitable companies, rather than simply those which happened to be in state hands back in 1979. Indeed, Labour's "Alternative Models of Ownership" paper tries to argue that private ownership – not of nationalised industries, but in general – makes for lower productivity and a lack of long-term investment.[62] This endorsement of the state's ability to provide "patient capital" of course ignores a long history of government mis-investment – and the fact that productivity in the "market sector" has long outstripped that in the economy as a whole.

[61] *The Times*, 'Businesses fear Corbyn's Britain would go bust in three years', 2017

[62] Labour, 'Alternative Models of Ownership document'

Table 4: Upfront cost of Labour's nationalisation plans over one parliamentary term (exc. rail)

Energy*	£55.4bn / £185bn
Water**	£86.25bn
Royal Mail***	£4.5bn
PFI****	£30bn
Total***	**£176bn / £306bn**

* Lower estimate is the RAV of UK energy networks. The higher estimate is Jeffries' figure for nationalising the whole energy sector.
** Ofwat's estimate of the water companies' regulatory capital value +25%.
*** Market capitalisation value of Royal Mail as at 2 Jan 2018.
**** Uses the lower end of Peston/Dowd estimate of PFI contract nationalisation cost.
***** Rounded to the nearest £bn.

Note: Nationalisation of the UK's railways would involve up-front capital costs for the taxpayer. For example, it would become the government's responsibility to buy or lease rolling stock, and the Labour Party would likely increase taxpayer support for the railways. However, if Labour sought to nationalise the franchises as they expired, this process would take more than one parliamentary term. Up-front costs associated with rail nationalisation have therefore been excluded from this table.

Furthermore, the very prospect of Labour's nationalisation plans would lead to gilt yields rising considerably, making it more expensive to service the UK's existing borrowing and Labour's other pledges.

And while there are substantial risks associated with nationalising utilities, there is little evidence to suggest that consumers have anything to gain. For example, Britain's domestic electricity prices are roughly average for Europe, and consumers in Ireland and Germany – where there is large-scale government ownership in the energy sector – pay much higher prices. Moreover, under the current system water bills are set to fall over the coming decade.

Labour's nationalisation programme appears, in other words, to be ideological in its underpinnings rather than pragmatic. It will divert an enormous amount of capital from more productive uses, in order to accomplish – at best – no improvement in the quality of those services or in the costs paid by consumers, not least because if the industries remain profitable, the profits will, as John McDonnell has admitted, have to be used to cover borrowing costs.

Nationalisation would be hugely disruptive to the UK economy, hugely risky – and is unlikely to result in any material improvement in performance. Yes, many of these industries have problems. But Labour's solutions are precisely the wrong ones.

We have tried, in totalling the cost of the Corbyn nationalisation programme, to be as fair-minded as possible, erring on the side of the lower figure when presented with multiple costing scenarios. If Labour disputes the figures, we would be only too happy for them to come forward with their own – not least because, in doing so, we might finally get some idea of how they can justify a programme which, on the face of it, appears to be a triumph of dogmatic ideology over financial prudence.

Daniel Mahoney

ANNEX: COST OF NATIONALISATION & COMPARISON FIGURES

Lower capital cost of nationalisation: £176bn
Upper capital cost: £306bn

(Figures rounded to the nearest £bn)

The lower capital cost estimate assumes that a Labour Government would, in the case of the energy industry, only nationalise the networks. The upper estimate makes the assumption that a Labour Government would nationalise the whole energy industry.

Annual cost of defence equipment programme: £9.1bn
Public sector net debt: £1,735bn (rounded to nearest £bn)
Number of UK households: 27.2m
Central government contribution per unit of social housing: £60,000

The cost of the MoD's 10-year equipment plan is £91bn from 2016 to 2026 – see NAO

Public sector net debt was £1,734.8bn at the end of November 2017 – see ONS

There are 27.2m households in the UK in 2017 – see ONS

John Healy MP, Labour's former shadow housing minister, estimates at £60,000 per house the grant from central government required to assist councils and housing associations to build new homes – See John Healey, The Smith Institute, September 2015

Applying these figures, we get the following:

Number of years of defence equipment (low estimate): 19.3
Number of years of defence equipment (high estimate): 33.6
Number of social homes (low): 2.93m [2.d.p]
Number of social homes (high): 5.1m
% of public sector net debt (low): 10.1
% of public sector net debt (high): 17.6
£s per household (low): £6,470.6
£s per household (high): £11,250.0

(Figures are rounded to 1.d.p)

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