Nationalisation: navigating political risk in the utility sector

By Matthew Franklin, Senior Credit Analyst

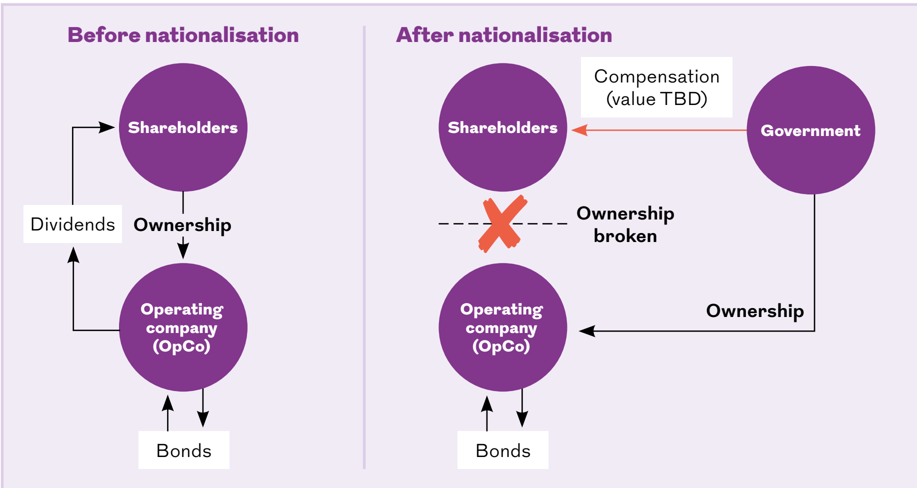
Once again political risk is on the rise in the UK. With Boris Johnson becoming Prime Minister and facing the same Brexit impasse that defeated Theresa May, attention once again has begun to turn to what a Labour government could mean for investors.

One particular focus for bondholders is the Opposition's commitment to nationalise large parts of the utilities industry – the regulated electricity, gas and water networks. Labour has in recent weeks restated its nationalisation position, perhaps anticipating a general election sooner than the May 2022 date prescribed by the Fixed-term Parliaments Act 2011. But what could nationalisation mean for lenders? And should bondholders fear it?

Bondholders of the world unite

Labour initially made broad policy commitments about nationalisation in the run up to the 2017 general election, and since then has published papers – 'Clear Water' and 'Bringing Energy Home' – providing some detail behind its policy. They would seek to legislate to acquire regulated utilities operating companies (OpCos), with any debt "carried over with the companies under public ownership and honoured in full"[1] (figure 1).

Figure 1



Basic operating company structure before and after nationalisation. Despite the break in ownership, the OpCo bonds remain with the operating assets.

[1] 'Bringing Energy Home' – Labour's proposals for publicly-owned energy networks (May 2019)

ROYAL LONDON
ASSET MANAGEMENT

If enacted this way, it could be argued that nationalisation could in fact be a positive outcome for OpCo bondholders. While it is not our base case – as credit investors we are pre-conditioned to expect the worst – these lenders would arguably gain implicit UK government support, and could even see rating upgrades and spreads tighten as a result.

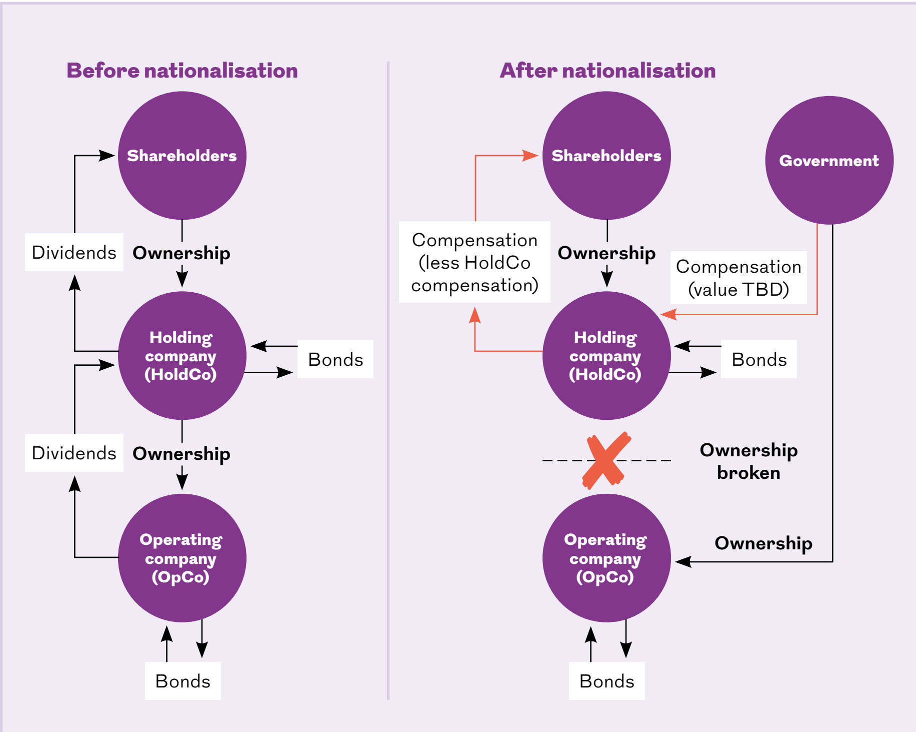
So far, so good. But for many regulated utilities the story does not end there. This is because some companies have also issued extra debt outside their OpCo. Several have borrowed out of a holding company (HoldCo) – this debt sits between shareholders and the OpCo, and relies on dividends from the OpCo to pay its coupons (figure 2). In this sense risks at HoldCo are far more aligned with ultimate shareholders; if the operating asset is nationalised, lenders at this level will be reliant upon the level of compensation paid, and could potentially face losses if it is insufficient.

Can't pay, won't pay?

Compensation paid for nationalisation is the main area of contention at present, with Labour recently indicating that it will renationalise the water sector for less than their £15bn book value. To put this in context, last year the companies involved published a study arguing that their market value would be £44bn.

Theoretically, any valuation and approach is possible as the government sets the law by passing parliamentary legislation. However, any attempt to appropriate assets without fair compensation for investors would likely lead to serious parliamentary resistance and/or legal challenge. While not providing definitive protections to HoldCo lenders, both precedent and international frameworks are instructive.

Figure 2



More complex structure with holding and operating companies before and after nationalisation. Despite the break in ownership, the OpCo bonds remain with the operating assets. However, the HoldCo bonds are no longer supported by cash flow and their value is therefore dependent on the level of compensation paid by the government.

According to research by Clifford Chance[2], every nationalisation under British law since 1945 has been at market value (or probably more in the cases of Rolls-Royce and British Leyland). Indeed, this has been the case in all nationalisations in OECD countries analysed in its report.

Labour has cited Northern Rock as a precedent for sub-market levels of compensation as the bank's ordinary shareholders received nothing, but at the time the government argued this was fair market value compensation as the bank was no longer viable. Instead of Northern Rock, Clifford Chance identifies the 1977 nationalisation of the aerospace and shipping industries as a better precedent as the companies were profitable and the takeover was opposed by many of the companies' shareholders. In this case, the process was long-winded and resulted in significant friction with investors seeking legal redress for inadequate levels of compensation.

The point is that any attempt to appropriate assets without market value compensation will struggle to receive parliamentary approval and/or could tie up the government in the courts for years. Neither will be appealing for a government that would presumably prefer to pass its bold new legislation quickly and demonstrate the merits of public sector ownership.

Furthermore, international treaties provide protection for shareholders in certain jurisdictions to ensure fair market value is paid – would any future government want to favour international investors over UK pension funds?

Our approach

Ultimately, predicting the political future is incredibly difficult; working this through to outcomes for investments is even harder. While factors such as potential redress under UK or EU law, or even international investment treaties, are reassuring, they can only guide our thinking about what could happen were a Labour government to be elected and implement its manifesto around nationalisation.

We instead focus our investment decisions on areas where we can have higher conviction, such as our position within a company's capital structure. When lending in a junior way, such as through HoldCo bonds, we need to ensure we recognise the increased risk and severity our clients face, and ensure that we are appropriately compensated. Above all, what's key is to manage this exposure and risk by holding them in widely-diversified funds.

This is an extremely complex issue with many ifs, buts and maybes. Knee-jerk thinking is unlikely to produce the optimal outcome. Instead, we aim to understand fully the protections on those bonds we own and know exactly where we are lending into the issuer's capital structure. There can be no short cuts from our long standing approach. Diligent research and rigorous risk management of our exposures, both at the bond and portfolio level, remains the way to best serve our clients' interests.

[2] 'UK Nationalisation: The Law and the Cost – 2019 update' – Clifford Chance (May 2019)

Contact us

For more information about our range of products and services, please contact us.

Royal London Asset Management

55 Gracechurch Street, London EC3V 0RL

020 7506 6500

communications@rlam.co.uk

www.rlam.co.uk

Past performance is not a reliable indicator of future results. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.

For more information on the fund or the risks of investing, please refer to the fund factsheet, Prospectus or Key Investor Information Document (KIID), available via the relevant Fund Price page on www.rlam.co.uk

Ref: AL RLAM PD 0021

59204 06 2019