

Public ownership, benefits and compensation I: benefits of nationalisation of UK water and energy grids and legal and economic issues in determining compensation

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Contents

1. INTRODUCTION	2
2. BENEFITS OF PUBLIC OWNERSHIP	3
3. UK LEGAL FRAMEWORK: PARLIAMENT DECIDES EACH CASE	3
4. ERRORS IN COMPENSATION CLAIMS BY CBI AND OTHERS	5
5. COMPENSATION ISSUES AND PRINCIPLES	6
A. NO FUTURE CONTINUATION OF EXCESSIVE MONOPOLY PROFITS.....	6
B. NO COMPENSATION FOR EARNINGS DEPENDENT ON REGULATORY REGIME	7
C. NO COMPENSATION FOR VALUE DERIVED FROM PUBLIC SERVICE SYSTEM	8
D. NO COMPENSATION FOR RISKS OR 'HOPE VALUE'	9
E. CONCLUSION: BALANCE OF INTERESTS.....	10
6. ANNUAL SAVINGS AND COMPENSATION	10
ANNEXE A: COMPANIES TO BE NATIONALISED UNDER LABOUR PARTY PLANS AS AT OCTOBER 2019	13
ANNEXE B: UK PRACTICE IN COMPENSATION FOR EXPROPRIATION	14
ANNEXE C: LEGAL FRAMEWORK AND CASES IN OTHER COUNTRIES	17
➤ USA	17
➤ GERMANY	19
BIBLIOGRAPHY	21
NOTES	24

1. Introduction

The potential cost of compensation is a significant factor in political decisions to nationalise or municipalise. The legal framework now includes not only national law, but also international treaties relating to investment and trade which provide for investor-state dispute settlement (ISDS) which may enable foreign investors to seek compensation through arbitration

In the 2017 election in the UK the Labour Party announced plans to renationalise water, energy, rail and postal companies - the first time that a major political party has done so since the government of Mrs Thatcher privatised large parts of UK utilities. During the election campaign and subsequently these proposals proved to be immensely popular, with a major survey by a (right-wing) think-tank finding huge majorities supporting public ownership of water (83%), energy systems (77%), railways (77%) (Legatum Institute 2017, Labour Party 2019). This has led to a public debate on the benefits and advantages of public ownership of companies providing public services, of the desirability of ending PPPs, and of returning outsourced services to inhouse direct provision.

The main issue raised by investors and their advisors in this debate, by contrast, has been the question of how much compensation would have to be paid to the current private owners, and thus how much the policies would cost. The discussion concerns what is required or permitted under UK law, and the possibilities for using BITs or the Energy Charter Treaty (ECT) to claim higher compensation. (Clifford Chance 2019, Macquarie 2018). [These issues are discussed fully in a separate paper: Hall and Wegmann (2019E)] These claims should be seen as part of the process of political debate, rather than detached analysis of legal entitlements.

Within the legal framework, the key arguments about the benefits of public ownership and the appropriate level of compensation are economic questions, both in the assessment of the benefits of, and in particular the economic consequences of adopting different formulations for compensation. This paper addresses these economic issues and arguments, within the actual UK legal framework, under which parliament has to determine the basis for compensation. It is thus both an analysis of the issues and a contribution to the process of debate around the approach which parliament should adopt.

It is focussed on the water and energy grid sectors, and is structured as follows.

- Section 1: Introduction
- Section 2 Benefits of public ownership
- Section 3 UK legal framework on compensation
- Section 4 Errors in compensation claims by CBI and others
- Section 5: Compensation issues and principles
- Section 6: Annual savings and compensation

2. Benefits of public ownership

The roles of public and private sector in producing goods and services, including infrastructure, is a policy issue which is constantly debated by governments and public authorities in relation to many sectors and public service systems. This is recognised for example in the EU treaty which includes a simple clause that “The Treaties shall in no way prejudice the rules in Member States governing the system of property ownership.” (article 345 TFEU). Public ownership is normal and widespread in these sectors, with 90% of water services worldwide provided by the public sector (including in the USA), and many energy grids across Europe owned and run by public sector companies. The debate requires attention to the benefits which are expected from public ownership in any particular case, not merely the costs.

In the cases of the water and energy grid companies in the UK, the benefits can be summarised as follows.

- Firstly, it would end the extraction of monopoly profits by these companies, through dividends and high interest payments, and enable investment capital to be financed more cheaply through raising debt at the much lower interest rates which can be achieved by governments and the public sector. A study of the water sector found that over £50 billion has been extracted in dividends in 30 years, and a report on the energy grid companies found that consumers are overpaying by £7.5 billions over the current 8-year price period alone.¹ The gains from this are quantifiable, and are very large, as set out in section 6.
- Secondly, it would enable these systems of public infrastructure to be subject to a transparent system of public accountability, rather than through the autonomous, obscure practices of the current regulators, who have failed to protect consumers effectively or ensure the delivery of services. The failings of the current regulatory system have been recently highlighted by a NAO report which noted: “a range of issues, including long-term above-inflation price rises in utilities [and] poor quality of services...”, and a 2017 report to government by Prof Dieter Helm which concluded in favour of state-owned system operators and the effective elimination of the regulator OFGEM’s current role.²
- Thirdly, it provides for greater public control over the implementation of public policy, which in these sectors include core environmental issues, including transition to renewable energy and sustainable management of water resources.
- Fourthly, it will enable these public interest objectives to be achieved more efficiently, by reducing the ‘transaction costs’ involved in constantly attempting to create incentives for profit-maximising firms. There is no reason to expect any fall in operating efficiency: contrary to a common assumption, dozens of empirical studies comparing worldwide, across these and other sectors, have found no significant differences in public and private efficiency (Hall and Nguyen 2018), and have resulted in higher prices to consumers (Fiorio and Florio 2013). Evidence on the performance of UK privatisations, including these sectors, confirms that the private companies here have not significantly improved efficiency, and may even have performed worse than the previous state-owned companies (Florio 2004, Saal and Parker 2001)

3. UK legal framework: parliament decides each case

An October 2017 research note by Moody’s Investor Services outlines the legal framework as follows:

“ if Labour campaigned on nationalisation, won a majority in the House of Commons and chose to carry through the policy, Britain's parliamentary and legal structures would give it great flexibility in how it did so. ... It would be necessary for parliament to determine the compensation payable for any assets or companies that are nationalised or transferred to a new form of ownership. However, the level of compensation would fall within the wide discretion of parliament..... Although the process of nationalisation and the level of compensation could be subject to judicial review, primary legislation cannot be overturned by UK courts. If an Act of Parliament was found to be incompatible with the European Convention of Human Rights, which protects against deprivation of property, the courts could issue a declaration of incompatibility but not overturn the legislation. Investors could also appeal to the ECHR, as they did in the nationalisation of Northern Rock, but the Convention allows states to act in the “general interest” and the ECHR has previously taken the view that national authorities are better placed than an international judge “to appreciate what is ‘in the public interest’”. (Moody's 2017) ³

This summary accurately reflects UK law, which allows and requires parliament to set its own rules for compensation in each specific case, taking account of public interest considerations, as determined by the democratic process. In each case there is an act of parliament which, firstly, takes the relevant entities into public ownership and then “set out the terms of compensation for the property transfers and how this would be paid” (HoC 2018, Cairns 1951). Unlike the USA, there is no general right to compensation still less to compensation based on a specific formula or formulation, such as ‘market value’, and the London stock exchange rules for takeover bids have no relevance: “in England an owner is entitled only to what is accorded him by statute” (FRD 1949). It is thus not only possible but necessary for parliament to provide specifically for compensation in each case. Moreover, UK courts cannot overrule a decision of parliament: “the UK Supreme Court does not have the power to ‘strike down’ legislation passed by the UK Parliament.” ⁴

The only relevant court cases have been those brought under the European Convention on Human Rights, but none have been successful. Both the UK courts and the Strasbourg court have refused claims by investors that the amount of compensation was too low.

The basic principle was confirmed most recently in 2012 by the UK Court of Appeal and the European Court of Human Rights (ECHR), in relation to the rescue of Northern Rock in 2008, where the shareholders were awarded zero compensation. Some shareholders brought cases arguing that this was unfair, because the share price was £0.90, not zero. However, these cases were unsuccessful: the evaluation process used by the UK government was validated as entirely legitimate by the High Court, the Court of Appeal ⁵, and, for the same reasons, by the European Court of Human Rights. ⁶

The reasons for the rejection of the claims was not, however, peculiar to Northern Rock, nor restricted to nationalisations rescuing bankrupt companies. The two basic principles apply to all nationalisations in the UK.

The first was stated by the UK Court of Appeal:

“the court would only interfere if it were to conclude that the State's judgment as to what is in the public interest is manifestly without reasonable foundation” ⁷

The ECHR re-stated the second principle, that there is no general right to full market value compensation if public interest objectives, including social justice and economic reform, lead to a different conclusion:

‘Legitimate objectives in the “public interest”, such as those pursued in measures of economic reform or measures designed to achieve greater social justice, may call for less than reimbursement of the full market value.’⁸

This is not a new doctrine. The same principle was stated by the English courts and the ECHR over 20 years previously, in rejecting claims for higher compensation by former shareholders of the shipbuilding and aerospace companies in 1977:

“A decision to enact nationalisation legislation will commonly involve consideration of various issues on which opinions within a democratic society may reasonably differ widely. Because of their direct knowledge of their society and its needs and resources, the national authorities are in principle better placed than the international judge to appreciate what measures are appropriate in this area and consequently the margin of appreciation available to them should be a wide one. It would, in the Court's view, be artificial in this respect to divorce the decision as to the compensation terms from the actual decision to nationalise, since the factors influencing the latter will of necessity also influence the former.” (*Lithgow and Others v. the United Kingdom* (1986) 8 EHRR 329).⁹

It was also used to reject a claim by the Duke of Westminster, the largest landowner in Britain, against a new law introduced by a Labour government in 1967 allowing leaseholders to buy freeholds at much less than the market value. The courts noted that:

“such legislation had been part of Labour Party policy for some years. It was regarded as a necessary social reform, required to right an injustice....”

and again, that, with ownership of property as well as with shares,

“Legitimate objectives of ‘public interest’, such as pursued in measures of economic reform or measures designed to achieve greater social justice, may call for less than reimbursement of the full market value”. (*James and Others v UK* [1986] 8 EHRR 123)¹⁰

Three key points emerge:

- The basis for compensating shareholders is decided by government and parliament on a case by case basis, taking account of a range of relevant matters, including public interest objectives, and the particular circumstances of each case.
- the courts have consistently confirmed that public policy considerations are paramount, and that there is no general right for investors to be paid full market value as compensation.¹¹
- It is not true that compensation to shareholders must be based on the stock market value of the shares, or the enterprise value, or reflect stock exchange rules on private takeovers.

4. Errors in compensation claims by CBI and others

As part of the political debate, since 2016 a number of organisations have published estimates of the possible cost of compensation for nationalising these companies.¹² Most recently, in October 2019 the CBI published a claim that compensation for the Labour Party’s nationalisations would cost £196billion in

compensation, which it claims represents ‘true market value’.¹³ The CBI subsequently admitted it had included some companies which Labour did not have plans to nationalise, the railway rolling stock companies, and reduced their estimate for water and energy to £179billion.¹⁴ It also failed to acknowledge publicly that the government would acquire assets worth the same amount, and so would be no worse off in normal accountancy terms, although its background paper noted this.¹⁵

But there was a more fundamental flaw in these figures. The CBI say that for energy and water they have used Regulatory Capital Value (RCV) and Regulated Asset Value (RAV) – notional figures estimated by the regulators as part of their incentive regulation scheme – which are then increased by 30% as proxies for current market value. The CBI replicated the mistaken methodology of a SMF report financed by the water companies, which also used RCV/RAV, plus a 30% markup. But this estimate has been long discredited, and tacitly abandoned by the SMF, because RCV/RAV includes not only the shareholders capital – about a quarter of the total – but also the companies’ debts, which would simply be carried over in the companies. An analysis by the FT in April 2019 quoted the economist Dieter Helm, formerly a supporter of privatisation and an adviser to the Theresa May government, as saying that the SMF report had “virtually no intellectual substance and the figure was wrong”. The FT also reported that the SMF itself now acknowledged that “a nationalising government does not need to buy out the debt of the water companies [£46billion], and would only need to buy out the equity”, and that the SMF itself now estimated that the “implied market value” of the shareholders equity in the sector was £34bn.¹⁶ The gratuitous addition of a notional ‘acquisition premium of 20 to 30 per cent’, removes the estimate even further from reality.

As the next section explains, there are good economic reasons for not basing compensation on market value, but rather basing it on the value of the actual shareholders’ capital invested in the companies, as measured by the book value of net assets, or ‘shareholders’ equity. But even as a measure of market value the SMF/CBI methodology fails, which can be seen from the known value of shares of companies listed on the stock market: the total value of Severn Trent shares this year has varied around £4.5billion, whereas the SMF/CBI methodology of RCV +30% has the ludicrous result that Severn Trent’s ‘true’ value is somehow over £11billion.

These and other estimates should nevertheless be seen as early and legitimate interventions in the political debate on behalf of private interests.

5. Compensation issues and principles

Under UK law, the proper level of compensation must be decided by parliament in each case. The legal framework places no constraints on this (other than ‘reasonableness’), and so the key issues to be taken into account are not legal entitlements but economic issues. The CBI and others have attempted to do this on behalf of investors’ economic interests. This section sets out issues and principles based on delivering the public interest by obtaining the benefits of public ownership and avoiding economically damaging approaches to compensation.

It is assumed throughout this discussion that nationalisation will involve taking public ownership of the water and energy grid companies by effectively taking the shares and compensating shareholders, but that the bonds and loans held by other debt-holders of the companies will be transferred with the companies into public ownership and be honoured in full.

A. No future continuation of excessive monopoly profits

A key objective is to avoid paying compensation which enables the shareholders to continue to enjoy the same excessive returns which they have done during the period of privatisation. This would just

perpetuate these excessive returns at the taxpayers expense through interest payments on the bonds used to finance the compensation.

This is a central reason for not paying compensation based on market value, which is normally higher than the book value of shareholder equity, because it is based on future expected returns, which are in turn based on current returns. The market values thus incorporate a future which is not going to happen, because of the nationalisation, a core objective of which is to stop the current returns being extracted : “the problem arises because current value is a function of expected future values”.¹⁷

Indeed, paying market value as compensation would perpetuate, at the expense of taxpayers and ratepayers, the current excessive returns extracted by shareholders. In accounting terms: “market value is assumed to equal the net present value of expected future dividends”;¹⁸ In practical terms, it means that, even after nationalisation, former private shareholders will hold public sector bonds on which consumers or taxpayers would have to pay interest equivalent to the dividends which we now have to pay under private ownership, **in addition to** the financial and operating costs of the future public water and energy companies. There is a bitter historical experience of this mistake in the 1902 municipalisation of the private water companies in London to form the Metropolitan Water Board. One of the main reasons for the municipalisation was “the desire to eliminate the avoidable costs of private ownership” in the shape of the dividends paid to private owners, which had risen steadily to a quarter of total revenues or more. But the cost of compensation was calculated to preserve the previous returns of the shareholders, and the debt to finance this compensation was then placed on the books of the MWB, which thus had to charge Londoners to cover the cost for a long time:

“based on the cost of reinvestment to achieve a similar return... [which was]... almost double the total capital on the company books... The MWB used its borrowing powers as a public-sector entity to replace equity paying 10 per cent with long-term debt paying 3 per cent, but the amount of compensation was so huge that the Board started its life with a “*millstone around its neck*” which burdened the new public company, and thus its customers, with paying the same excessive profits as before”. (Goldsmith and Carter 2015)¹⁹ (see annexe)

There is an earlier example of the problem. The principle behind such preservation of returns at public expense had first been imposed in 1833, when slaveowners – controversially – were given government compensation for being deprived of their property rights as a result of the abolition of slavery in the UK. The slave-owners submitted claims in respect of 800,000 slaves, valued according to market prices over the previous 8 years, and received compensation totalling £20million in the form of ‘perpetual annuities’ and undated government bonds paying 4%. These bonds continued to pay interest until 2015, by which time the descendants of slaves, as tax-payers, were paying compensation to the heirs of the slave-owners – though the slaves and their descendants had received no compensation at all. (see annexe)

To avoid these mistakes, compensation should be based on the principle of returning to shareholders their actual investment in the company, as reflected by the value of net assets/shareholder equity on the company balance sheet.

B. No compensation for earnings dependent on regulatory regime

In criticising the CBI claim, Carys Roberts of IPPR argued against paying market premia in compensation, on the grounds that: “as essential services, they effectively enjoy a guarantee from government, as well as the value of economic rents that can be generated in monopolistic industries. This would not be a fair price. There is no reason why the government would pay for its own guarantee – nor should it pay for the rent extraction that nationalisation seeks to stop”²⁰

The regulatory regime for both the water and energy grid companies has been crucial to their profitability. It should be remembered that from the start, the regulators had: “a statutory duty, under the Water Industry Act 1991, to make sure that companies are able (in particular by securing a reasonable return on their capital) to finance the proper carrying out of their functions”²¹, and as the data on dividends shows, the regulators have been extremely generous in doing so. It would have been, and still is, possible to have a different regulatory regime under which prices were limited to costs plus a minimal ‘risk-free’ dividend (similar to that which existed for the few small private companies before the 1989 privatisation), and/or a regime which required investors to maintain the companies debt-free, as they had been at the point of privatisation: under such regimes the value of the companies would be infinitely smaller.

This principle of discounting any value flowing from government regulation is also implicit in the Northern Rock judgment, where the court ruled that “... if the assumptions indeed produce a nil value, that can only be because the business is shown to be worthless without the support put in by government”²².

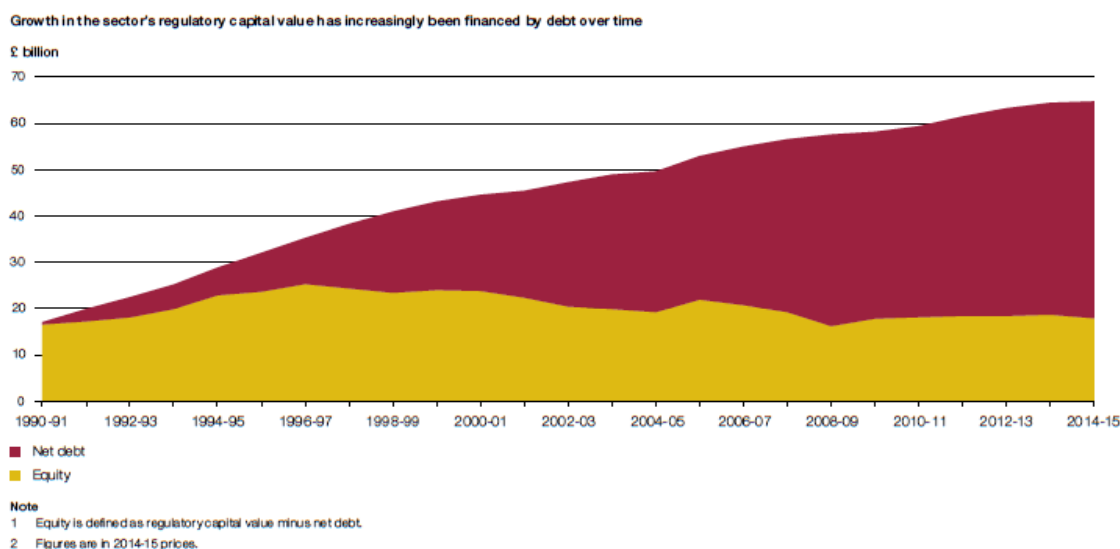
Private shareholders should not be entitled to compensation for loss of any returns which derive from the regulatory regime set up by parliament and governments.

C. No compensation for value derived from public service system

The companies in parts of mature public service systems which have been privatised are not comparable to companies operating in other spheres. Their business is entirely framed by the requirements and licenses structured by the state and its democratic structures, which determine the public objectives of the system and its economic framework, including requirements such as universal service and the standards to be met. The water, electricity, and gas networks privatised in the 1980s had already established effectively universal connections, and so the companies inherited a comprehensive and monopolistic customer base. They have not built up the business through their own initiative, nor had to compete in a consumer market with other companies, and their investments are not made on the basis of entrepreneurial risk in consumer markets. The new private shareholders paid for the network assets and their monopoly licenses in the privatisation processes of 1989/1990, but since then the real value of the shareholder investment on the books of the companies has fallen rather than risen, so the financial data suggest that the shareholders (as opposed to the debt-holders) have contributed very little to the companies.²³

Shareholders in the privatised water and energy companies should not be treated as entrepreneurs who have built up the value of the business by risk-taking in competitive markets.

Chart A. Equity and debt in the water sector 1990-2015



Source: NAO 2015 <https://www.nao.org.uk/report/the-economic-regulation-of-the-water-sector/>

D. No compensation for risks or 'hope value'

Nationalisation is one of the risks that investors face, and so investors should provide for it themselves, through insurance, or by consciously carrying the risk themselves. Investors clearly do so, as risk of nationalisation is explicitly discussed in company annual reports to shareholders. It is for the investors to assess that risk, like others, and to carry that risk if they make mistaken judgments. In these particular cases, investors have been aware for over 2 years of Labour nationalisation policies, and made their own assessment of the probability of such events. As with other risk assessments, they may be right or they may be wrong, but this is normal with all risk assessments.

The payment of any compensation should thus at most cover that part of the investment which can be considered 'risk-free', that is the basic shareholders equity on the books of the company, which could otherwise be invested at a risk-free rate, normally reckoned to be the rate paid by government gilts. Any market value over and above represents hoped-for returns which can no longer come from the water or energy grids, but investors may take their basic capital and either receive the minimal 'risk-free' return, or seek higher returns by making risky investments elsewhere.

Using the book value as the basis for compensation in this way is in line with accountancy analysis which treats the book value as the accurate measure of the "owners' equity", whereas the market value includes "expected future *abnormal earnings*... Market value is assumed to equal the net present value of expected future dividends"²⁴. So the difference between book value and market value is also a measure of the 'abnormal earnings' currently enjoyed by the private companies

A similar issue arises in the currently debate over compensation payable by local authorities to developers for land for public housing. Current law on CPOs provides for compensation for 'hope value', which is the value of the land developers are hoping for in the future if they develop it – rather than the actual value of the land itself. This rule rewards speculative hoarding, and obstructs using the land for greater public value (and Labour is expected to change it so that land can be compulsorily purchased for public housing at its basic 'agricultural' value, which is far lower).²⁵

The USA rules on 'regulatory' compensation, and indeed the payment of any compensation for expropriation, have been criticised for similar reasons: "The risk of loss from government action resembles many other risks that investors face and mitigate through insurance, such as the threat of fire....[whereas] compensation imposes costs on all taxpayers, who must pay the award." ²⁶

Compensation should not be used to protect private investors from failures to assess risks correctly.

E. Conclusion: balance of interests

In determining compensation, the UK parliament should be balancing public and private interests, paying attention to the benefits of nationalisation and the protection of future public interests, set against the claims of investors. According to a legal commentator, this was the general principle underlying the compensation awarded in the post-WWII nationalisations:

"to express, in payment, an accurate equilibration between the rights of owners and the needs of the public..... It must be remembered that in estimating the "fairness" of compensation there must not be an identification of *fairness* with some absolute idea of what owners are entitled to receive for their property under all conditions." (F. R. D. 1949) (see annexe)

The basic principles proposed here can be summarised as:

- **giving the shareholders their money back: that is, they will receive back the money they have actually invested in the company.**
- **but they should not get compensation for any future profit they expected or hoped to make in a privatised future, because the future will be public.**

These principles mean that **the market value of the company shares is not the correct measure of the compensation due, because the share price reflects the value of expected future profits**, and thus builds in the expectation of continuing to get the excessive returns of the era of privatisation. Compensation for money actually invested in the company should rather **start with the actual value of shareholders' equity in the companies, as measured by the book value of equity on the balance sheets of the regulated companies.**

The next section sets out the relevant calculations.

As discussed above, there is no reason to expect that legal action could be successfully taken under UK law, or the ECHR, if future nationalisations provide compensation based on returning to shareholders the actual amount invested by them in the companies, as measured by the book value of equity. The estimates of 'market value' which have been published by stockbrokers and commercial lawyers and others should thus be seen as an opening negotiating position by investors in a dynamic political process, rather than a serious attempt to forecast the final result of a legal challenge in the UK. Since additional compensation cannot be obtained through UK courts, the attention has switched to the potential for investors to take action under international treaties. This is discussed in the separate paper on international treaties, which concludes that the eligibility for such action is limited to a few investors, and the potential impact of such claims is unlikely to be significant.

6. Annual savings and compensation

This section sets out estimates for both the benefits and the costs of Labour’s public ownership plans. The tables below shows both the savings to be made through reducing the cost of capital under public ownership, and the cost of compensation based on the book value of equity. Data is taken from company annual reports and reports by the regulators OFWAT and OFGEM.

Table 1 Future savings from public ownership (£m.)

	Annual dividends (£m.)	Annual net interest (£m.)	Annual net savings (£m.) after refinancing at govt rates (1.81%)	Annual savings £ per household
Water companies	1922	1813	2537	113
Energy grid companies	3711	1332	3734	142
Royal Mail	242	18	171	7
PFI's	n/a	n/a	1400	53
Total	5876	3164	7842	315

Sources: see text

The savings are calculated by comparing the current cost of dividends and interest paid by the private companies with the cost of refinancing the current equity and debt with debt raised by issuing government bonds. They also serve as an indicator of the very large scale of extraction of money from the system by current owners.

The government rate is taken from OFGEM’s current estimate of the rate on government gilts. The savings would be greater in real terms as the current real rate of interest on government debt is negative, as assessed by all the regulatory bodies (UKRN Sept 2019 Cost of Capital – Annual Update Report)²⁷.

The savings are a net figure after taking into account the interest payable on gilts, including the interest on the bonds issued to compensate shareholders. The public companies would in effect cover all the future interest costs of the nationalisation, as well as delivering savings equivalent to about a 25% reduction in the costs to consumers.

The savings are quantified on a per household basis to indicate the value gained by each household, whether it is used to reduce prices or improve services through investment.

The savings from the ending of dividends would be delivered immediately on public ownership, the savings on debt interest would be realised as existing debt is refinanced by public sector debt.

Table 2: Estimated compensation payable to owners of companies to be nationalised (£bn.)

	No. of companies	Book value of equity 2019 £bn	est. Market value July 2019
Water companies	15	14.7	36.2
Energy grid companies	26	27.9	41.1

Royal Mail	1	4.6	2.2
PFI's	294	2.5	n/a
Total		49.7	79.5

Sources: see text

The general principle proposed for compensation is to return to investors the money they actually have invested in the company. The simplest indicator of the money actually invested in the company by its owners is 'net assets' or 'shareholder equity' as shown on company balance sheets. The results accord with the estimates made by ratings agency Moodys for the Financial Times (FT April 2019).

This principle for compensation avoids using values, such as actual or estimated market value, which are based on expected future earnings, as these expectations are derived from the regulatory regime of the government. Paying compensation on this basis would effectively guarantee to current private owners the perpetuation of their existing excessive returns.

As a corrective to incorrect and inflated figures advanced by lobbying organisations including the CBI and the Social Market Foundation, estimates of market value are shown, based on actual market values of shares of listed companies, in line with normal practice for valuing investments: no investment manager would use the methodology of the CBI/SMF.

As detailed in other reports by PSIRU, the actual impact on UK pension funds and pensioners is negligible. The prospect of legal action by foreign investors under international treaties is also unlikely to have a significant impact on the level of compensation payable.

Data sources

- The data on book value of equity, dividends and net interest are taken from the latest ARs of each company (and for water companies the reports by Bayliss/Hall 2017 and Yearwood 2018: dividends are average of last 13 years for WASCs, of last 2 years for WOCs and energy grids, and latest year for Royal Mail).
- Data on net debt is taken from OFWAT and OFGEM reports
- Market value data is taken from the FT: for energy and water companies the portion of market value attributable to regulated UK water or energy grid business is taken, and the sectoral estimate is then based on the proportion of RAV represented by the listed companies.
- The figure of £2.5bn for nationalising SPVs of PFI schemes, and the estimate of annual savings of £1.4bn., is taken from Mercer and Whitfield (2018)
- Household numbers are from [ONS data for England \(for water companies\) and for England, Wales and Scotland](#) for the energy grids, post office, and PFI savings
- Figure of 1.81% for refinancing at government rates is taken from latest OFGEM estimate of risk-free rate

Annexe A: Companies to be nationalised under Labour party plans as at October 2019

The companies to be nationalised in are the operating companies water and energy, not the parent groups - such as Pennon Group plc - which may also own other subsidiaries. In water that is 9 regional WASCs plus 6 smaller WOCs; in energy the 4 licensed electricity and gas transmission companies, and the 22 licensed gas and electricity regional distribution companies. For PFI it is the SPV companies at the heart of each PFI deal.

Water:

Anglian Water Services Limited
Northumbrian Water Limited
Severn Trent Water Limited
Southern Water Services Limited
South West Water Limited
Thames Water Utilities Limited
United Utilities Water Limited
Wessex Water Services Limited
Yorkshire Water Services Limited
Affinity Water Limited
Bristol Water plc
Portsmouth Water Limited
South East Water Limited
South Staffordshire Water plc
Sutton and East Surrey Water plc

Energy:

National Grid Gas Plc
National Grid Electricity Transmission Plc
Scottish Hydro Electric Transmission Plc
SP Transmission Plc
Cadent Gas
Scotland Gas Networks
Southern Gas Networks
Wales & West
Electricity North West Limited
Eastern Power Networks Plc
London Power Networks Plc
South Eastern Power Networks Plc
Northern Powergrid (Northeast) Limited
Northern Powergrid (Yorkshire) Plc
Scottish Hydro Electric Power Distribution Plc
Southern Electric Power Distribution Plc
SP Distribution Plc
SP Manweb Plc
Western Power Distribution (East Midlands) Plc
Western Power Distribution (South Wales) Plc
Western Power Distribution (South West) Plc
Western Power Distribution (West Midlands) Plc

Post:

Royal Mail plc

Annexe B: UK practice in compensation for expropriation

There is a long history in the UK of expropriation and nationalisation used as an instrument of economic, social and colonial policy, even before the nationalisations of the 20th century. Indeed, all property rights in the UK originate from the seizure by king William I of all land in 1066, and its subsequent distribution; and property rights in the USA derive from similar seizure of lands by the USA government, mainly without compensation (Singer 2011). Major historical events involving expropriation include the dissolution of the monasteries, the enclosure of the commons, the abolition of slavery, and the takeover of India by the British state from the East India Company.

The dissolution of the monasteries by Henry VIII in the 16th century involved the expropriation of the monasteries themselves and their sale or assignment to private individuals. No compensation was paid to the multinational monastic orders which owned the monasteries, but the state did provide pensions to thousands of monks, nuns and other workers (Pound 1986)²⁸.

The enclosure of common land in the 17th, 18th and 19th centuries was carried out mainly under a series of acts of parliament, which authorised the enclosure by individuals of previously common lands totalling 2.8million hectares, about one-fifth of the entire land area of England. These acts authorised the enclosure but made no provision for people who lost their rights to the commons, despite campaigns for such protection which failed to overcome: “the obduracy of Parliament in refusing compensation” (Pound 1986, Neeson 1993).

The Abolition of Slavery Act 1833²⁹ ended slavery in the UK and colonies (after 6 years of forced labour for existing slaves), and provided for public expenditure to compensate the slave-owners for their loss. The preamble of the Act combines the two objectives: “it is just and expedient that all [slaves] should be manumitted and set free, and that a reasonable Compensation should be made to the Persons hitherto entitled to the Services of such Slaves for the Loss which they will incur by being deprived of their Right to such Services”. There was nevertheless “substantial disagreement ... as to the mode and the amount of compensation” (Draper 2007). The Act specified that the total amount of compensation available would be £20million – equivalent to 40% of all government expenditure in that year, and to about £2.3billion in current values. Slave-owners submitted claims in respect of 800,000 slaves, valued according to market prices over the previous 8 years, and received compensation in the form of ‘perpetual annuities’ and undated government bonds paying 4%. These bonds continued to pay interest until 2015, by which time the descendants of slaves, as tax-payers, were paying compensation to the heirs of the slave-owners – though the slaves and their descendants received no compensation at all. (HM Treasury 2018)

In 1858 the UK government took direct control of India by expropriating the powers, territories, armed forces, rights and revenues of the East India Company, which had ruled India for the previous 250 years under a crown charter, but with a series of abuses. The company however continued to exist under the generous regulation of its charter of 1833, which included a government guarantee for the payment of dividends of 10.5% for 40 years, financed by the tax revenues from India. It was finally wound up by act of parliament in 1874, in which the government paid £200 for every £100 of shares, as had been guaranteed by the 1833 Act. Payment was made in cash or in government bonds paying 3%-4%, so that even after the company’s collapse, the shareholders could still enjoy a return of 8% on their original investment for the indefinite future – not far below the 10.5% which had been guaranteed by government since 1833. The payments totalled £12million (about £1.3billion at 2018 prices), and the bonds issued to pay the compensation were added to the debt of India, so that the interest on that debt continued to be paid by the people of India for another 70 years: “the Indian people are virtually paying dividends to this day on the stock of an extinct company in the shape of interest on debt”. (Robins 2012, quoting R.C. Dutt)³⁰

Two features of these episodes are of relevance for understanding later practice, current policy, and the political economy of compensation.

Firstly, the weakest groups do worst in terms of compensation. The nationalisation of India was accompanied by compensation for the former private owners, but not for the Indians who had suffered at their hands; the abolition of slavery compensated the slave-owners but not the slaves. In relation to the enclosures too, the commoners are given no rights to compensation for their losses. Parliament could have required such compensation, given that the purpose of the nationalisations in the slavery and India cases was to end abuses, but chose not to.

Secondly, the Slave-owners and East India cases introduce a striking new policy, that is the provision of compensation to property-owners which preserves their previous returns into the future, financed by taxpayers through public debt. Again, there was no compulsion to be so generous, and considerable controversy over the awards, but the political strength of the slave-owners and the company shareholders prevailed.

The series of 'modern' nationalisations starts in the 1870s, but, consistent with the legal framework, the actual compensation has been determined by parliament in a political process in which owners and investors have pressed hard for whatever approach would maximise their compensation. This has not necessarily meant supporting a simple formula, such as the share price: e.g. the shareholders of an aircraft company taken over by the government in World War II argued that the actual share price of their company was the *wrong* basis for valuation, and the owners of steel companies renationalised in 1968 similarly argued that the share price woefully understated the value of their companies. (Cairns 1951).³¹

- The telegraph companies were nationalised by the Conservative government under Disraeli 1870, which then made them part of the Post Office. The private telegraph companies were operating a cartel, disliked by businesses and by the press who paid for transmission of news, whereas the post office, which had already diversified into running a savings bank was seen as a model efficient bureaucracy by Gladstone and others. Compensation was paid on the basis of 20 years of profits – implying the perpetuation of a 5% return - which was criticised as unnecessarily high, but still worthwhile because of the public benefits (Perry 1997)
- In 1912 the telephone networks were also nationalised under the post office, this time by a Liberal government, for similar reasons to improve efficiency and remove problems of oligopoly. The Post Office already regulated the sector and under an agreement of 1901 “had the right to purchase the assets of the private companies without any additional payment for goodwill when their licences expired in 1911”, when the assets, rather than the companies, were duly purchased for £12.5m. and the sector taken under the control of the post office (Scott 2011).
- The creation of a public water company for London, the Metropolitan Water Board, in 1902 was also carried out by parliament, taking over the eight existing private water companies. After more public controversy, the act itself adopted the slave-owners’ formula, that compensation had to be

“based on the cost of reinvestment to achieve a similar return... [which was]... almost double the total capital on the company books... The MWB used its borrowing powers as a public-sector entity to replace equity paying 10 per cent with long-term debt paying 3 per cent, but the amount of compensation was so huge that the Board started its life with a *“millstone around its neck”*... which burdened the new public company, and thus its customers, with paying the same excessive profits as before”. (Goldsmith and Carter 2015)

This episode is especially illuminating, as it shows the continuation of the rule adopted for the slave-owners and the East India stockholders in achieving long-term perpetuation of their pre-nationalisation profits at the expense of the public ratepayer. It also draws attention to the long-term cost consequences of this policy.

- The nationalisation of industries following World War II adopted various methodologies, surveyed by two contemporary review articles and a more recent parliamentary report (Cairns 1951, FRD 1949, HoC 2018). In each case there was an act of parliament authorising the specific nationalisation, and containing specific provisions for compensation to authorise the public expenditure involved. Owners were compensated with government bonds, which then became debt of the new publicly owned entities, but the amount was determined in various ways:
 - Where companies were listed on the stock exchange, as with some electricity, gas, and transport companies, the value was based on the share price in the immediately preceding period.
 - The act nationalising the Bank of England specified that shareholders should receive the amount necessary to give the same return as the dividends previously enjoyed by shareholders – roughly four times as great as the face value of the shares (Cairns 1951)
 - with the nationalisation of the coal mines, which were largely privately owned, the assets themselves were nationalised, a single total figure of £165million was fixed for compensation, and then allocated to the owners according to comparative valuations of the assets
 - Local authorities were compensated with a lump sum reflecting the debt they had taken on to finance their undertakings such as in electricity and gas, and for recent capital expenditure, plus a total of £5million for loss of revenues,
- The survey by FRD summarised the various methods and outcomes as an attempt:

“to express, in payment, an accurate equilibration between the rights of owners and the needs of the public..... The novel and varied measures adopted in making compensation for nationalization may be said to represent legislative decisions as to what extent the public interest justifies less (or more) advantageous terms of payment than might have been accorded under former principles.... It must be remembered that in estimating the "fairness" of compensation there must not be an identification of *fairness* with some absolute idea of what owners are entitled to receive for their property under all conditions. Rather it should be considered whether the legislature, in coming to its conclusion, gave the proper importance to each of the relevant factors.” (F. R. D. 1949)

A number of conclusions can be drawn in relation to UK law and practice on compensation

Firstly, any act of parliament passed under a future Labour government nationalising any companies would include a section providing for compensation, and this is exactly in accordance with UK law and practice on how compensation is determined. It is misleading for corporate lawyers to claim that “any nationalisation would be subject to legal frameworks that did not exist in the 1940s or 1970s. Legal challenges are therefore inevitable, particularly over the amount of compensation.” (Clifford Chance 2019) UK law has not changed at all, and it provides no role for the courts, apart from the ECHR cases, which have always been unsuccessful because the courts will not even consider interfering unless the decision can be shown to be “manifestly without reasonable foundation”. The decision-making process for compensation in the UK is, simply, the political machinery of parliamentary democracy, as part of

which owners make their case – with a remarkable degree of success, historically. Indeed, the booklets published by corporate lawyers, stockbrokers and right-wing think-tanks clearly represent early participation by investors attempting to influence this political decision-making process. The potential use of arbitration by foreign investors under BITs or the ECT is a separate issue, which is considered in a later section.

Secondly, the corporate lawyers' claim that there is an 'international norm' in OECD countries for paying what investors claim to be 'market value' is also a misleading picture. The next part of this section examines the law and practice in Germany - where a very recent and high profile case has resulted in a parliamentary decision to offer compensation on an utterly different basis from the 'market value' claimed by three multinationals – and the USA, where even the constitutional right to 'just compensation' is mediated through political processes and contested evaluations.

Thirdly, the arguments about the level of compensation must be conducted on their own merits. Nothing in UK law states otherwise, and there are multiple reasons why basing compensation on 'market value', or the preservation of past returns, is both economically harmful and inappropriate for re-nationalisations. The appropriate basis for compensation in these cases should rather be to return to shareholders the equity they have actually invested in the companies, enabling them to re-invest elsewhere exactly the same money that they have invested in the companies being re-nationalised. The final part of this section sets out such an approach in more detail.

Annexe C: Legal framework and cases in other countries

➤ USA

The law and practice on compensation for nationalisation or municipalisation in the USA³² is not a straightforward matter of rigorous application of a simple formula for 'full market value', and the determination of compensation is invariably settled through political mechanisms following procedural rules. The 5th amendment of the US constitution states: "nor shall private property be taken for public use, without **just** compensation", which provides a basis for legal action over compensation, and the courts have ruled that "the general standard is the market value of the property, *i.e.*, what a willing buyer would pay a willing seller". This is a significant difference from the UK, where there is no such basis for legal action. But the courts have recognised that there is no simple objective way of calculating 'fair market value' – especially in cases where a business, as opposed to land, is being expropriated. This allows for a wide range of different approaches to be used, and the states have created procedures to be followed in determining compensation when entities are taken into public ownership. (Legal Information Institute 2019)

This is not just a theoretical issue in the USA. Contrary to common assumptions, public ownership is widespread, at municipal, state and federal level. Indeed, in the sectors targeted by the UK Labour Party – water, energy, rail, and postal services - the USA has a higher level of public ownership in 2019 than the UK. About 87% of water supply services are owned and run by municipalities; there are about 2000 municipally owned electricity utilities – including cities such as Los Angeles - serving about 49million people, or 15% of the population, as well as the federally owned Tennessee Valley Authority, which supplies 9 million people. There are hundreds of municipally owned ports, airports and public transport systems, a thriving bank owned and run by the state of North Dakota, and more than 750 publicly owned internet networks with speeds, service levels, and costs as good as or better than commercial systems. At federal (national) the US Postal Service remains 100% owned by the government – unlike in the UK and some other European countries – as well as the passenger railway system Amtrak and various financial institutions such as the

mortgage financiers known as Fannie Mae and Freddie Mac, which are both in the top 10 largest financial corporations in the USA by revenue (Hanna 2018 , APPA 2019 , Fortune 500 2019).

As elsewhere, there have been trends towards re-municipalisation, and so the question of compensation arises regularly. There have been over 70 cases of re-municipalisation of water supply since 2003, most of which have taken the form of recreating a municipal service after the expiry of a private concession, but at least nine were cases of municipalisation by 'eminent domain' of existing private companies, including the case of Missoula discussed below. There are fewer cases in energy, but this may change: in 2019 the city of San Francisco published a report which concluded that "public ownership of San Francisco's electric grid has the potential for significant long-term benefits relative to investment costs and risks"; city councillors in Chicago have called for a feasibility study on municipalisation of energy when the current 28 year old concession expires in 2020; and, amidst multiple failures in the private electricity supply to New York City, the mayor warned that "we need to think about some kind of public approach". (Ulmer and Gerlak. 2019 ; San Francisco PUC 2019 , APPA 2019)

A 2012 survey of the laws on the process and methodology for fixing compensation in relation to the municipalisation of electricity utilities shows wide variation in procedures, and acceptance of multiple methods of calculating value of compensation, both between states and even within states. With regard to the process, the great majority of states expect the amount to be fixed 'by agreement', with various other mechanisms available if no agreement is reached. Many states refer the decision to the Public Services Commission (the regulatory body in most US states), but some allow the use of citizen juries, including Alaska, Florida, Idaho, Louisiana, Michigan, North Carolina, Tennessee, Utah, and West Virginia, which emphasises the political nature of the process. Where valuation methods are referenced, they vary widely, as in Alaska, where: "Courts have accepted multiple valuation methods in eminent domain proceedings to determine just compensation, including fair market value, replacement value, and reproduction value". (Briggerman et al 2012)

There are two important ways in which USA practice does not follow the investors ideal . Firstly, some states depart sharply from corporate notions of market value (and some of the UK practice) by explicitly excluding any account of future earnings. In Massachusetts "the Department of Public Utilities (DPU) is required to determine what price should be paid, having in view the cost of the property less a reasonable allowance for depreciation and obsolescence, and any other element which may enter into a determination of a fair value of the property so purchased, **but such value shall be estimated without enhancement on account of future earning capacity or good will, or of exclusive privileges derived from rights in the public ways**"; in Alabama, the PSC "determines the fair value of the assets based on cost less depreciation, plus severance damages, **but not taking into account future earnings, good will or certain real estate rights**, and deducting or withholding the value of encumbrances, pending discharge thereof". Secondly, the constitutional right to just compensation does not enable investors to endlessly repeat the same arguments in the hope that the judges will award a more favourable formula than the political process. If compensation has been determined by following the due process of the relevant state "in some appropriate way, before some properly constituted tribunal"³³ then "its findings as to the amount of damages will not be overturned on appeal"³⁴ to the Supreme Court. (Legal Information Institute 2019A)

Some states reference other valuations made for other public purposes. In Idaho the court, jury or referee is expected to take account of "assessed value for property tax", and in Florida the PSC is expected to take account of "other items which are normally included in valuations of electric utility assets". This refers to the valuations of a company which are carried out under the USA system for regulating the rates that private utilities can charge to customers, where the valuation is used to calculate what kind of return is reasonable. In this field too, the myth of a precise formula has been rejected by the courts: "For almost fifty years the [Supreme] Court wandered through a maze of conflicting formulas and factors for valuing public

service corporation property.....only to emerge by holding in *FPC v. Natural Gas Pipeline Co.*¹⁸⁵ that “[t]he Constitution does not bind rate-making bodies to the service of any single formula or combination of formulas”. Indeed the Supreme court adopted a principle of non-interference - similar to the view of the UK courts and the ECHR - that the courts will not overturn a valuation unless the objector can prove it is manifestly unreasonable in its effects: “it is the result reached not the method employed which is controlling, . . .it is not the theory but the impact of the rate order which counts, ...and if the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry ... is at an end” and “he who would upset the rate order . . . carries the heavy burden of making a convincing showing that it is invalid because it is unjust and unreasonable in its consequences.”³⁵ (Legal Information Institute 2019; Merrill 2002 ; Briggerman et al 2012; Legal Information Institute 2019B)

The recent case of Missoula illustrates the political dynamics of the USA process (Mann and Warner 2019). In 2017, the City of Missoula, Montana, in the western United States, used its powers of eminent domain to take ownership of its water system from The Carlyle Group. The process involved a series of public sector actors - the mayor, judge, and Public Services Commission (PSC) – with a key role being played by 70% public support for “ending the flow of money to corporate owners in California and regaining control of their future” on the one hand, and information asymmetries, legal resources and effective ‘capture’ of the regulatory PSC favouring the company on the other hand. The city had to initiate a court case, which ultimately went up to the supreme court of Montana, in which it had to demonstrate that there would be better value for the public from the takeover, as well as arguing for its proposed level of compensation. The city argued in court that it should be \$46million, Carlyle argued for \$143million, and the final settlement was for \$88.6million. Mann and Warner conclude that: “Power asymmetries place municipalities at a disadvantage at every stage of the negotiation... Missoula’s experience seems to point to an inevitable collision between private equity firms and the public, whose interests are nearly diametrically opposed.”

These are clearly political processes whose outcome reflects the balance of economic and political power between the two parties. There is no golden formula at the end of the rainbow. As summarised by Merrill (2002):

“as astute observers have long recognized, the concept of fair market value is essentially a fiction in [this] context.... What actually happens in a case in which there is a dispute about the measure of compensation? Basically, the condemning [public] authority introduces evidence, often through the testimony of expert witnesses, which tends to show that the property has a relatively low value. The owner then introduces evidence, often using rival expert witnesses, which follows one or more of these techniques and tends to show that the property has a relatively high value. The tribunal, which may include a jury depending on the jurisdiction, will then have to determine which evidence is most persuasive...; often, it will reach a compromise between the positions of the two parties. The number picked by the tribunal is deemed to be the "fair market value".

➤ Germany

German law on compensation is also based on its constitution, but the principles are significantly different from those in the US constitution. Article 14 (3) of the German constitution rules that expropriation is only permissible ‘for the public good’ and that it can only be done by a law which also “determines the nature and extent of compensation”. It does not however specify any unilateral rights for investors to receive ‘market value’ or even ‘just compensation’. Its only requirement is for a balance between public and private interests:

“Such compensation shall be determined by establishing an equitable balance between the public interest and the interests of those affected.”

It also specifies that, like the USA but unlike the UK: “In case of dispute concerning the amount of compensation, recourse may be had to the ordinary courts”. The centrality of ‘balance’, however, means that the fixing of compensation is not centred solely on perceived investor losses, let alone some notion of market value, but also on the impact on the public interest (German Constitution 2019).

The application of this principle was recently tested by the electricity companies who sued the German government for compensation over the decision in 2011 to compel closure of all nuclear plants. Germany had previously adopted this policy of nuclear phase-out in 2003, but intensive lobbying by the companies resulted in a decision in October 2010 for indefinite postponement of the closures, a decision in which “Important aspects of the law were negotiated rather than founded in fact” (Polk 2011). Then, following the Fukushima nuclear disaster in Japan, the original decision to phase out by 2020 was reinstated in March 2011.

The electricity companies with nuclear generators - E.on, RWE and Vattenfall - sued for compensation in the German federal constitutional court (FCC) in November 2011, arguing that the government’s action was unconstitutional and that they were entitled to a sum as large as €19 billion Euros in compensation.³⁶ The court ruled in 2016 that, firstly, the nuclear phase out is constitutional; but, secondly, it was subject to article 14 of the constitution and so compensation should be provided; thirdly, however, the FCC refused to decide the value of compensation itself, and instead ruled that the parliament had to pass a bill by 2018 to regulate the compensation payable. In 2018 the parliament passed an amendment of the nuclear law allowing for ‘adequate financial compensation for so-called frustrated investments the companies made in nuclear power plants between 28 October 2010 and 16 March 2011’, but without specifying a precise sum, arguing that it will not be possible before 2023 to decide on an amount of compensation as only then will the amount of electricity not produced as a result of the frustration of those investments be clear enough to calculate the lost profits of the companies.³⁷

However, the actual investments made in the 5 month period were probably close to zero, and so, even after a ruling by the constitutional court and a legislative amendment as required by the court, compensation could be close to zero and still meet the constitutional requirement for balance: “can be considered proportional even without compensation provided to the affected operators” (Bernasconi-Osterwalder and Hoffmann 2012). It also notes a number of other factors that may mitigate against the companies’ claim: the fact that the companies capital has been almost fully amortized “reduces the need for protection of the operators”; that article 14 “does not protect the expected profits of the operators”; that state subsidies for the nuclear power stations, worth €203.7 billion between 1950 and 2010, could be taken into account; that the operators had to expect at least a very high risk of nuclear plants being closed from 2003 onwards, and so the risk was already factored into their business. (Bernasconi-Osterwalder and Hoffmann 2012). As the only foreign-owned company, Vattenfall is also seeking to use the Energy Charter Treaty to sue for compensation in front of an arbitration tribunal in New York. This ECT case is discussed below in section 5.

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²⁷ <https://www.ukrn.org.uk/wp-content/uploads/2019/09/2019-UKRN-Annual-Cost-of-Capital-Report-Final-1.pdf>

²⁸ See also for an example of actual pensions awarded <https://www.dhi.ac.uk/cistercians/fountains/history/app3.php>

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³² In USA legal terminology, the power of governments to expropriate property is known as 'eminent domain', and the act of nationalisation or municipalisation is known as 'takings' or, confusingly, 'condemnation'.

³³ Backus v. Fort Street Union Depot Co., [169 U.S. 557](#)

³⁴ McGovern v. City of New York, [229 U.S. 363](#),

³⁵ FPC v Hope 320 US 591, 602 1944 <https://www.law.cornell.edu/supremecourt/text/320/591> ; Kelo v. City of New London (545 U.S. 469, 2005

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