Risk Management:
The Nuclear Liabilities of British Energy plc

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL
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Summary

1 British Energy is the largest electricity generator in the United Kingdom, with an annual turnover of over £2,000 million. Its eight nuclear stations generate approximately 20 per cent of the electricity used in England & Wales and half of that used in Scotland. The Company was privatised in 1996, raising £2.1 billion through a public flotation. The privatisation required British Energy to discharge its nuclear liabilities from its own resources. However, the Government is ultimately responsible for ensuring the safe management or disposal of spent nuclear fuel and for decommissioning stations.

2 A Report on the privatisation by this Office recognised that the Department created British Energy as a robust company, obtaining a high degree of assurance that British Energy would have the capacity to meet its nuclear liabilities, in the electricity market of that time. Nevertheless, that report and one by the Committee of Public Accounts raised concerns about the taxpayer's potential exposure to British Energy's large nuclear liabilities, and recommended that the Department monitor carefully the Company's ongoing ability to meet its liabilities in full without recourse to the taxpayer.[1] The Department said in response that it recognised the need to monitor these risks.

3 In September 2002 the Directors of British Energy declared that the Company was no longer clearly able to meet its liabilities, and the Government granted the Company a credit facility of up to £410 million to provide working capital for its immediate requirements and to allow it to stabilise its trading position. In October 2003 British Energy formally agreed a restructuring deal with its key creditors and the Government. The deal will only be implemented once a number of conditions are met, including approval from the European Commission, which enforces European Union restrictions on state aid to industry.

4 This report follows up our earlier report into the sale of British Energy. It covers the role of the Department for Trade and Industry in the period from privatisation in 1996 up to 5th September 2002. We intend to produce a further report on the advance of emergency aid and the terms of the restructuring of British Energy once that restructuring is completed.

1 The Sale of British Energy HC 694 Session 1997-98 8 May 1998. And Committee of Public Accounts, HC 242 1998/99.

5 The key question that this current report addresses is whether the Department effectively and in a timely manner: identified, monitored and managed the risks posed to the taxpayer by British Energy's nuclear liabilities. Our examination has shown that the Department clearly identified the risks at the time of the privatisation. The Department subsequently conducted limited evaluation of changes in the nature and scale of the risk; some of which resulted from action by the Department and other parts of government. The Department did not seek to manage the changing risk actively. The Department considers that following the transfer of British Energy's liabilities to the private sector, responsibility for these liabilities rested with the Company.

6 Whilst the Department retained residual contingent risks, it believes that it had no direct way to manage risks arising from the performance of a privatised company, and that to have tried to do so would have been in conflict with its commitments to fair markets and competition in the electricity markets. The Department believed that unless the Company qualified as 'a firm in difficulty' under European state aids regulations any financial intervention would be illegal under the rules. The Department also felt constrained by its uncertainty, shared by private sector investors and analysts, about the real extent of the Company's financial problems.

Risks to the taxpayer heightened soon after privatisation

7 The wholesale electricity market at the time of privatisation was much more favourable to generators like British Energy than is the present market. Following privatisation several significant changes took place in the electricity market in England & Wales, leading to a collapse in the level of prices received by generators from early 2000. Several of these changes had been sponsored by the Department, in line with Government policy to introduce greater competition into the electricity market for the benefit of consumers. The Department did not specifically evaluate the effect on British Energy and British Nuclear Fuels plc of major changes in the electricity industry when gathering information on the likely impact of these changes on the nuclear sector. The Department considered that price reductions of "at least 10-15 per cent" were likely, but in the event prices reached their nadir at levels some 40 per cent lower than in the previous market, a reduction not anticipated by most other commentators. Though British Energy could have coped with reductions of 10-15 per cent, it found it impossible to reduce its generating costs enough to survive the greater price falls.

8 British Energy itself did not respond effectively to the market changes. The Company had in 1997 agreed contracts with British Nuclear Fuels plc, that whilst resulting in an overall reduction of fuel management costs continued to commit it to paying prices for reprocessing its fuel linked to the Retail Prices Index, irrespective of the level of electricity prices. In 1999 it tried to acquire a large enough retail supply business to enable it to sell on most of its electricity to domestic customers. But this move towards vertical integration was too late, and with income deteriorating the strategy was quickly abandoned, whilst incomplete, leaving the Company to sell its electricity in a fiercely competitive open market. Its relatively successful ventures in North America failed to compensate for mounting losses in the core UK business. The Company reduced the payment of dividends to its shareholders from 2000, but continued to pay dividends until as late as July 2002 in order to avoid sending a negative signal to the stock market which might have precipitated a collapse in its share price.

The Department did not seek to manage the risk

9 Since privatisation the Department has had to balance three distinct roles in relation to British Energy. As the Department responsible for the electricity industry it works, with the industry regulator Ofgem, to maintain a competitive energy market for all generation and supply companies, while achieving safe, secure and sustainable energy supplies for consumers. It also accounts for nuclear safety and security to Parliament. It also had to consider what, if anything, it could do to minimise the risk that British Energy's nuclear liabilities might revert to the taxpayer as a result of British Energy becoming unable to meet its obligations. The Department considers that to have treated British Energy any differently from other electricity companies would have run counter to its objective of maintaining free and competitive markets. It was also cognisant that preferential treatment of British Energy could be vulnerable to complaints from its competitors, or to action by competition authorities in the UK or Europe.

10 A number of teams within the Department's Energy Group had responsibility for these roles. Issues relating to the safety and security of nuclear stations, and to the Segregated Fund for decommissioning them lay with the Department's Nuclear Industries Directorate. This branch was also responsible for the management of the relationship with British Nuclear Fuels plc, the Government-owned company to which British Energy was committed for providing and dealing with its Advanced Gas-cooled Reactor fuel. Separately the Electricity Directorate was responsible for electricity markets and for liaising with electricity companies including British Energy. Responsibility for issues relating to the closure of stations and fuel treatment straddled these Directorates.

11 The Company first approached the Department with concerns over its future in Spring 2000. In January 2001 the Department increased the extent of monitoring. Not until early 2002 was any single team within the Department given defined responsibility, with a specific brief, as risk manager in respect of British Energy's 'residual liabilities'. By then most of the key decisions which had contributed to the deterioration in the Company's finances had long been taken and implemented, and were hard to reverse. In any case, the Department takes the view that, for the reasons given above, it would not have sought to favour British Energy in making policy decisions in areas for which it was responsible.

12 The Department's risk management role in respect of British Energy's nuclear liabilities was a particularly challenging one for it to discharge. Given its relationship with this fully privatised Company, and Government policy objectives of a fair and competitive electricity market, it found it difficult to evaluate and mitigate properly the changing risks to the taxpayer. It had neither tools of the sort that private sector institutions like banks would use in such situations, such as formal rights of access to information, nor rights of the sort incorporated in the design of more recent Public Private Partnerships where the taxpayer retains residual risks. Also, the policies and actions of many public bodies have an effect on British Energy's business and finances. The most important such bodies are:

- **Ofgem**, which, with the Department, designed and implemented the changes to the electricity generation market and now oversees its continuing operation. Ofgem's principal duty is to protect consumers;
- **HM Treasury**, which has policy responsibility for the Climate Change Levy, an energy tax that British Energy claimed was unfairly applied to its greenhouse gas-free nuclear generation;
- **the Office of the Deputy Prime Minister**, which leads policy on business rates. British Energy believed that the rateable values applied to its stations were unfair in comparison to other generators; and
- **the Nuclear Installations Inspectorate of the Health and Safety Executive**, which regulates the safe operation of nuclear installations, which worked increasingly closely with the Department from 2002 to develop an action plan for continued safe operation of the stations in the event that British Energy became insolvent.

The Department, in discussions with these other agencies whose policies affected British Energy, did not specifically draw their attention to the risks posed to the taxpayer by British Energy's nuclear liabilities. The Department took the view that British Energy had been created as a robust company operating in the private sector, which was able to meet the cost of discharging its nuclear liabilities. As such, the Department does not consider that the existence of these liabilities would have been grounds for modifying these policies to benefit British Energy at the expense of the integrity of the overall market structure.

13 British Nuclear Fuels plc is a Government owned business, which operates as a fully commercial company. The Department has policy responsibility for British Nuclear Fuels plc. British Nuclear Fuels plc entered into lengthy discussions with British Energy on the terms of its contracts for reprocessing the Company's fuel. Discussions centred on a 'contracts for differences' arrangement worth up to £180 million to British Energy, which would limit the Company's exposure to low prices in the electricity market. In the event, the companies were not able to reach agreement, before British Energy called for Government support in September 2002. British Nuclear Fuels plc felt it should not agree to a significant revision of its contracts with British Energy in the absence of a general restructuring of British Energy to which all creditors contributed.[2]

14 From early 2000, when the likelihood of severe and sustained falls in prices became apparent, interaction between British Energy and the Department on the risks to the Company's solvency tended to be instigated by the management of British Energy, in the form of pleas for assistance. The Department stepped up its monitoring, relying mainly on publicly available documentation and in

2 *The overall gap in the Company's finances was £280 million at the time it approached the Government.*

2001, taking discrete pieces of advice from its advisers, Credit Suisse First Boston. But until early 2002 the Department did not look inside British Energy itself to help it determine whether the Company was in as severe straits as it claimed. Following discussions in early 2002, the Department accepted the Company's invitation for its advisers to examine the management accounts and other relevant records. The advisers' examination showed that the Company was highly vulnerable and could breach its financial covenants. Throughout this period the Company continued to make dividend payments. From March 2002, the Department's strategy was to avoid assisting British Energy unless it was in publicly evident distress, consistent with the government's policy not to intervene to assist individual private sector companies. Another major factor in the Department's decision to await events was the wish to reduce the risk that early Government intervention would be judged to be an illegal state aid by the European Commission.

15 The Department's management of the financial risks, to the taxpayer, from British Energy's nuclear liabilities evolved during three main phases:

- The period between privatisation and early 2000, when the Company appeared to be prospering but when the causes of its subsequent financial decline were in fact being put in place. During this phase the Department liaised with British Energy as it did with other electricity companies and its monitoring of the company tended to focus on its contribution to the Nuclear Generation Decommissioning Fund and nuclear regulatory issues. The National Audit Office considers that at this time the Department's monitoring of British Energy's ability to meet its nuclear liabilities was conducted with a light touch. The Department considers that monitoring was proportionate given the apparent success of the privatised Company during the period;
- The period from Spring 2000 to early 2002, when the Department, uncertain in the face of mixed messages from the Company therefore increased its monitoring of the risks, trying to understand the real extent of the Company's difficulties from outside, and decided to "wait and see"; and
- The period from March to September 2002, when the Department's advisers having for the first time looked inside British Energy, advised that given recent falls in electricity prices, it was indeed highly vulnerable. The Department decided not to intervene unless the Company was in a position of publicly evident distress, and prepared contingency plans to ensure nuclear safety and security of supply.

Recommendations

There are a number of lessons from this report that departments should learn to improve the way in which they handle privatisations where there are significant ongoing liabilities to the taxpayer, and the ongoing arrangements they make to manage these risks. The recommendations are consistent with previous National Audit Office Reports on risk management, and with the principles of the new Risk Management Assessment Framework that government departments have begun to apply[3].

1 Departments should ensure that their risk management plans and processes include the full cycle of proactive activities: risk identification, evaluation of the probability and impact of risks, risk mitigation, monitoring and review. They should recognise that all stages are required for an effective risk management system.

2 Where the UK has signed up to international treaties that create onerous financial obligations, performance of the obligations should be subject to formal risk management procedures. Risk assessments should include risks to the achievement of these obligations and to the taxpayers' financial interest.

3 In such cases, departments should designate a senior individual or post holder as the responsible risk manager, to ensure that responsibility is clearly allocated and effectively discharged.

4 In future transactions where performance of an obligation on Government is to be transferred to the private sector, or where there are potentially significant contingent taxpayer liabilities, departments should consider arrangements for the provision of, and access to, information on a timely basis, ideally through a written memorandum of understanding.

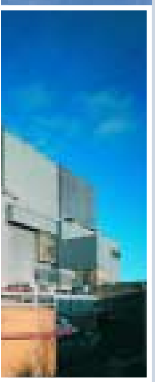
5 The case of British Energy shows that departments designing privatisations where the taxpayer will remain exposed to significant residual contingent liabilities need to consider very carefully whether such risks are likely to be better managed in the private sector.

6 If departments nevertheless proceed with privatisations where there are such significant contingent taxpayer liabilities, they should consider how far they might institute arrangements analogous to those that apply in the private sector, where firms are required to keep up to date, and periodically submit to their financial guarantors, such as banks, financial projections which demonstrate the firm's continued viability.

7 Risk Management in Government could usefully be focused on aspects that Government is most able to influence, such as the effects of major policy initiatives. The consequences of major regulatory changes can be wide-ranging, as the New Electricity Trading Arrangements and the widening of competition have shown. In making use of regulatory impact assessments for forthcoming policy initiatives, departments should, as far as possible, analyse potential significant consequences for the taxpayer. Their assessments should, where appropriate, identify possible risks to the achievement of other government objectives.

8 The Shareholder Executive, established within the Cabinet Office in 2003, should, as planned, be fully consulted in future privatisations and, where appropriate, should give advice on ongoing monitoring arrangements where the taxpayer is exposed to risk.

9 Departments undertaking privatisations should consider, on a case by case basis, whether it would be appropriate for mandatory taxpayer liabilities to have first call on the company's funds in the event of the business finding itself in financial difficulties.



3 *National Audit Office HC864 Session 1999-2000, 17th August 2000.*
Risk Management Assessment Framework HM Treasury, June 2003.