National Audit Office

The Shareholder Executive and Public Sector Businesses

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL | HC 255 Session 2006-2007 | 28 February 2007

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John Bourn
Comptroller and Auditor General
National Audit Office

22 February 2007

The National Audit Office study team consisted of:

Mark Halliday, Esther Hurrell, Akhil Patel, Peter Sharpe, Mark Shearsby and Richard Wade under the direction of Patricia Leahy

This report can be found on the National Audit Office web site at www.nao.org.uk

For further information about the National Audit Office please contact:

National Audit Office
Press Office
157-197 Buckingham Palace Road
Victoria
London
SW1W 9SP

Tel: 020 7798 7400

Email: enquiries@nao.gsi.gov.uk

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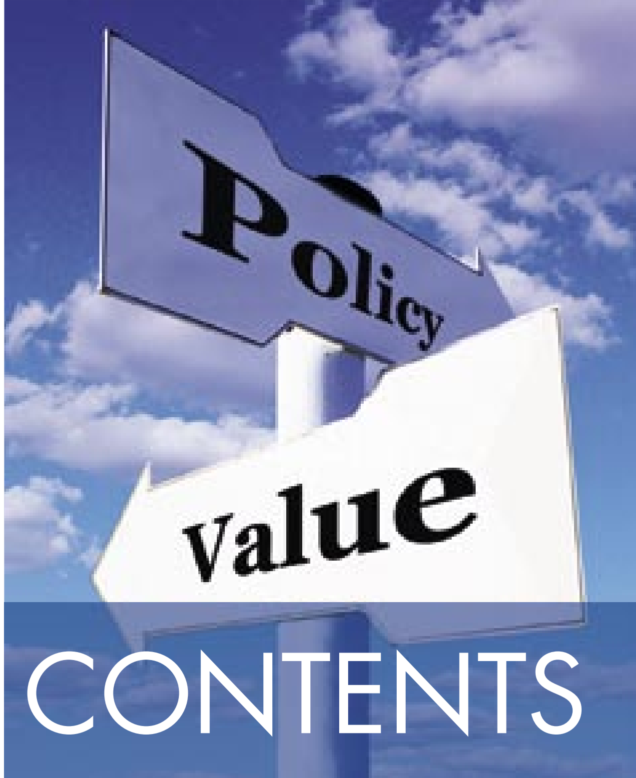

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EXECUTIVE SUMMARY

1 Despite the privatisation of many public sector businesses in the last two decades, central and local government still own or part-own a number of companies and other commercial organisations which in 2005 had a combined turnover well in excess of £25 billion. Many of these businesses are responsible for providing critical public services, such as air traffic services over national airspace and the maintenance of a postal network covering the entire population. It is crucial that these public policy objectives are achieved cost effectively. The Government, as shareholder, also has an important interest in protecting or enhancing value so that the businesses provide a satisfactory return on the public money invested in them.

2 Reconciling public policy with shareholder value objectives can be difficult because the cost of meeting the former can have a negative impact on the latter. Departmental shareholding teams often lacked the skills to achieve successful trade-offs between the two and the Government's performance as shareholder was often poor. The Public Accounts Committee and the National Audit Office have reported on instances of adverse consequences resulting from failure to manage shareholdings for value.[1] The Shareholder Executive ("the Executive") was set up in 2003 to bring a focus to shareholder issues and to improve the Government's ability to act as an effective shareholder. A key objective for the Executive was to increase the value of six of the

1 See Figure 1 and Appendix 6.

businesses[2] in its portfolio (hereafter "target" businesses) by £1 billion between 2004 and 2007. This report examines the changes to the shareholding function brought about by the Executive and whether it is on course to achieve its objectives.

3 Where the Government is a controlling shareholder, it can hold management to account for the performance of businesses by using several "shareholder levers". These are equivalent to and can be compared with the levers available to a private equity firm (Figure 3). These include: selecting the Chair and Board members; approving transparent business objectives that respect policy constraints; monitoring and rewarding performance; dealing with non-performing management; and agreeing finance for investment. Responsibility for advising Ministers on the use of most of these levers is delegated to the Executive where it has been given responsibility for looking after the Government's ownership interests.[3]

4 To date, the Executive has generally acted as an effective and intelligent shareholder by making good use of the shareholder levers. In particular, it has developed a framework which allows its skilled staff to apply the shareholder levers available to it in a consistent way. This focus on shareholder value has resulted in some notable successes. For example, in the 2006 sale of Westinghouse, the Executive, as a trusted central body within government, played a key role in the agreement to allow Westinghouse to bid to build new nuclear power plants in China. Selling Westinghouse with these contracts already negotiated helped to bring in £3 billion against initial expectations of £1 billion.

5 Important issues need to be addressed to allow the Executive to build on its early work and have a greater impact. The Executive has no statutory authority to manage government interests and has to market its services to departments in order to bring government businesses into its portfolio. Despite its success in achieving this, a number of omissions or inconsistencies still exist which can lead to inefficiencies and poor value for money. Another important issue is the range of responsibilities that the Executive has in relation to the postal market. It is responsible for DTI policy on the postal market and the Post Office network, oversight of the postal services consumer watchdog and, in some respects, the statutory regulator while also managing the shareholding in Royal Mail. These varied responsibilities mean that the Executive has to advise on how to manage the conflicting pressures and priorities. There is a risk that some judgements could be settled internally and the shareholder value case not be made clearly or transparently, a risk that will become more important as competition within the postal market increases.

6 The Executive's target – to increase the value of the target businesses by £1 billion – has brought greater attention to shareholder value within public businesses. Going forward, however, there are limitations with the target that will need to be addressed. It is difficult to link the achievement of the target with the Executive's own performance in managing the shareholdings on behalf of Government. Furthermore, the earnings of these target businesses can potentially be volatile and the performance of a single one can have a decisive influence on whether or not the financial target is achieved. Continuing with a single, portfolio-level target alone is, therefore, inappropriate.

7 The ability to access financing for investments is critical to the success of a commercial business. As long as a business is within the public sector, however, its investment needs are subject to fiscal policy constraints and compete with departmental and government-wide spending priorities. Because of these constraints decisions on whether or not to invest in a business are not considered on the basis of a sound investment return alone, as is the case with private sector businesses (some of which compete directly with public businesses). Inevitably, the current framework means that the scope for using this important shareholder lever is reduced.

8 A further consequence of this is that businesses have an incentive to build up cash reserves in case of future need, which could otherwise be passed back to departments in the form of dividends. The Executive has a generic aspiration that businesses should pay dividends but no specific business-level dividend targets.

9 This report finds that the Executive has improved the way in which Government acts as a shareholder. Taking this into account as well as its annual budget of £9.9 million and the value it has already brought to the taxpayer, for example through its role in the sale of Westinghouse, the National Audit Office concludes that the Shareholder Executive has provided value for money.

10 On the basis of the above conclusions, the report recommends the following:

2 The six businesses are: BNFL, CDC, NATS, QinetiQ, Royal Mail and Royal Mint. These businesses were selected for the target because by the beginning of the financial year 2004-05 (the first year of three year reporting period) the Executive had built close relationships with them and their sponsor departments (see paragraph 2.2). These businesses contributed approximately 75 per cent of the portfolio's turnover in 2005-06.

3 The Ministers are the Secretaries of State who, as heads of various government departments, either hold the shares in the individual businesses (for businesses which have issued share capital) or are responsible for the statutory corporations, non-departmental public bodies, executive agencies or departments which are owned by government.

A) On optimising the framework

Findings

A1 The Executive's early performance supports the case for central management of the shareholder function in Government, in line with internationally recommended best practice (paragraphs 2.13–2.15, Appendix 4).

A2 The Executive's current location in the DTI means that it is responsible for, in addition to the shareholding in Royal Mail, DTI policy on the postal market and the Post Office network and oversight of the market regulator and consumer watchdog. This could lead to the Executive advising on how to balance competing pressures rather than being able to make the shareholder case clearly and transparently (paragraphs 2.23, 3.4).

A3 As a DTI body, it operates within departmental pay and grading limits which could inhibit recruitment of appropriately skilled staff on whom the Executive's effectiveness depends (paragraphs 3.15–3.16).

A4 From 2008, the Executive's ring-fenced budget will expire and there is some uncertainty about future arrangements. This could result in either the DTI funding activities which benefit other government departments or vice versa (paragraph 3.11).

A5 A number of inconsistencies and omissions to the portfolio exist. The Executive lacks the authority to address these (paragraphs 1.4, 2.18–2.23, 3.10).

Recommendations

A1 The Executive's performance could be enhanced if it had independent status and funding, and flexibility to set remuneration, with attendant accountability arrangements and greater challenge, for example from a Board of Directors.

A2 Membership of the Stakeholder Group should be extended to include representatives from all of the shareholding departments.

A3 There should be a presumption that all publicly owned businesses should fall within the remit of the Shareholder Executive. Departments should comply with this presumption or explain the rationale for exceptions to the satisfaction of the Cabinet Office and Treasury.

A4 The Executive should not have responsibility for Royal Mail policy or oversight of PostWatch and PostComm. This will enable it to concentrate better on the case for enhancing shareholder value in Royal Mail.

B) On improving the availability of finance for investment

Findings

B1 Decisions taken by departments to invest in public businesses are subject to fiscal policy constraints and compete with other spending priorities. But the availability of finance for investment can have a major impact on the value of a business; and the ability to provide finance would increase the Executive's effectiveness in its dealings with businesses (paragraphs 2.24–2.26, 3.13).

B2 As businesses are not guaranteed to have access to financing, they have an incentive not to pay dividends to their sponsoring departments (paragraphs 2.27, 3.8).

B3 The level of dividends paid by businesses in the portfolio has increased in total since the Executive was set up, but – partly for investment reasons – has not increased as a share of operational profits (paragraphs 2.28, Figure 10).

Recommendations

B1 Finance for investment that is supported by a robust business case should be made available more consistently. There are a number of ways of achieving this, including:

- **i** Placing the Executive explicitly in the lead for the budgetary oversight of investment in businesses on behalf of sponsor departments. Responsibility for this could be delegated to the Executive by departmental Accounting Officers.
- **ii** At a minimum, requiring the Executive to report on investment planning and the impact that the current framework has on shareholder value.

B2 In these circumstances it would be reasonable to require the businesses explicitly to pay over excess cash except where the Shareholder Executive had given prior approval to investment. To increase transparency around this process, the Executive should set business-level dividend targets.

C) On improving performance and managing business risk

Findings

C1 Going forward, measuring its performance via a portfolio target alone is inappropriate because the Executive's remit does not allow it to manage its businesses as a portfolio by, for example, disposing of assets – the usual way to deal with poorly performing businesses in a portfolio (paragraphs 1.14, 3.5–3.7).

C2 The Royal Mail, British Energy and BNFL face strategic challenges over the short-term which will have an impact on their value. Each of these businesses are of such a size that an individual result can skew (up or down) the overall result – as can be seen in the last two years (paragraphs 3.2–3.3, 3.7, Figure 12).

Recommendations

C1 The Executive's target for increasing the value of its businesses should be amended to include measures that are based on the results of the individual businesses alongside an aggregated portfolio-level target.

C2 The targets must take into account the challenges facing each individual business (for example, the investment case for Royal Mail, the restructuring of BNFL, and decisions to be made regarding the equity option in British Energy).

PART ONE

The Shareholder Executive was set up to deliver a step change in the performance of Government as a shareholder

1.1 Businesses owned or part-owned by Government[4] still make an important contribution to the United Kingdom economy.[5] Their combined turnover in 2005 was well in excess of £25 billion, or over two per cent of Gross Domestic Product, and they were responsible for the delivery of a number of critical public services, such as safe and efficient air traffic services over national airspace, the clean up of nuclear waste, defence research and the universal provision of postal services.[6] Typically, the businesses provide services to the public sector and other parties to meet these public policy objectives on a commercial basis. Any business needs to generate a sufficient surplus (or profit) to cover its investment needs and the commercial risks it faces. If not run well or managed for value, businesses will not make profits, pay dividends or reinvest any surplus in improving service provision; and may require financial support in the form of debt or equity to maintain operations as a going concern. As the value of businesses in the public sector is large there is a significant public interest in avoiding such outcomes.

1.2 Balancing public policy and shareholder value objectives, however, is difficult. As a customer, the Government can sometimes benefit from the delivery of policy objectives at a price below the real cost to the business. On the other hand, the Government, as a shareholder and in most cases a lender[7] to these businesses, has an interest in their long-term value and will want to ensure that they are compensated appropriately for the public capital invested in them. Another important consideration for Government is ensuring that public expenditure remains consistent with fiscal rules and this can limit the availability of capital for investment in businesses.[8] There is a tension between these aims and in the past government departments struggled to balance these important responsibilities – often with the result that long-term shareholder value was not protected adequately. The Public Accounts Committee and the National Audit Office have previously highlighted concerns about this (Figure 1 and Appendix 6). Furthermore, between 2000 and 2003 some of the major government-owned businesses sustained large losses[9] – an indication of the challenge faced by management and departmental teams to protect shareholder value.

The creation of the Shareholder Executive

1.3 The recognition of the difficulties inherent in balancing public policy and ownership objectives and thereby ultimately in preserving and enhancing the value of public businesses led in 2003 to the creation of the Shareholder Executive ("the Executive"). **Figure 1** charts the increasing concern during the 1990s and early 2000s about shareholder value issues, both within the UK and overseas. As in other countries, the Executive was set up to centralise shareholding expertise within government, to bring a specific focus to shareholder issues and to improve government's performance as the owner of businesses. This report examines the changes brought about by the Executive operating within the policy, regulatory and fiscal constraints of central government and its performance against its objectives.

4 This includes bodies classified as UK central and local government public corporations as well executive agencies, non-departmental public bodies and statutory corporations involved in commercial activities.
5 Most of the major UK government-owned businesses were sold off during the 1980s and 1990s but a large number of public sector businesses are still owned by central and local overnment.
6 Only two public businesses are listed (QinetiQ Plc and British Energy Plc) although some have private shareholders alongside the Government (e.g. NATS, Partnerships UK and Working Links).
7 Only five businesses in the Executive's portfolio (see Figure 2) can raise third party debt: British Energy, NATS, Partnerships UK, QinetiQ and Working Links.
8 This issue is discussed more fully in paragraphs 2.24ff and 3.12-3.13.
9 "In the three (financial) years prior to the creation of the Shareholder Executive 20 [of the] businesses now within the portfolio…recorded losses of. £4.9 billion at the net income level, or £2.7 billion if losses relating to the change in BNFL's nuclear liabilities are excluded" (Shareholder Executive, 2004/05 Annual Report, p.10).

1 A number of developments, both within the UK and overseas, played a part in the establishment of the Shareholder Executive

PAC and NAO reports are in bold (see Appendix 6 for further details).

1992
- **PAC report on the Sale of Water Authorities notes insufficient separation of regulatory and selling teams**
- UK Corporate Governance: Cadbury Code of Best Practice for listed companies

1993
- New Zealand sets up Crown Companies Monitoring Advisory Unit

1994

1995
- Privatisation of British Rail Maintenance Ltd
- UK Corporate Governance: Greenbury report on directors' remuneration, in response to 'fat cats' concerns
- International Corporate Governance Network of companies, investors, and academics established

1996
- Privatisation of Railtrack
- Privatisation of British Energy

1997
- **PAC report on privatisation of British Rail Maintenance Ltd notes insufficient departmental monitoring**
- Australia establishes dedicated Unit to advise on shareholder value and business issues

1998
- **PAC report on the Sale of Her Majesty's Stationery Office criticises department's over-reliance on HMSO's Chief Executive in advising on the sale**
- Sweden centralises state business ownership to Ministry of Industry, and sets up a dedicated team
- UK: Combined Code, drawing together Cadbury Code and subsequent reports

1999
- **PAC report on the Sale of Railfreight Distribution questions whether the sale was managed to maximise value for taxpayer**
- **PAC report on Railtrack Flotation is critical of the handling of the sale, driven by policy rather than value**
- Finland revises state ownership procedures
- OECD publishes Principles of Corporate Governance

2000
- The Netherlands centralises ownership function to Ministry of Finance, late 1990's
- **NAO report on the Post Office's acquisition of German Parcel recommends departments need a team with corporate finance expertise to help appraise such acquisitions, and notes that some countries have a single department with oversight of government businesses**
- Royal Mint begins making losses
- Royal Mail (Consignia) begins making losses
- Formation of Partnerships UK to provide central government advice on PPP and PFI opportunities

2001
- Denmark transfers ownership of 11 businesses to specialist unit in Ministry of Trade and Industry

2002
- Norway consolidates ownership to unit in Ministry of Trade and Industry; Sweden's State-Owned Enterprises Division (1998) given greater powers
- USA Corporate Governance: Sarbanes Oxley Act

2003
- ***Shareholder Executive established***
- OECD produces its Survey of Corporate Governance of State-Owned Enterprises
- UK Corporate Governance: Higgs Report on non-executive directors' role; Smith review of audit committees. Combined Code revised to incorporate Higgs & Smith

2004
- Shareholder Executive moves to DTI and merges with their shareholding teams
- France sets up Agence des Participations de l'Etat

2005
- International Network of Government Ownership Agencies (INGOA) established
- OECD publishes Guidelines on Corporate Governance of State-Owned Enterprises
- HM Treasury publishes Corporate Governance in Central Government Departments: A Code of Good Practice

2006
- UK Corporate Governance: Combined Code revised

Source: National Audit Office

1.4 Although the Executive has a separate identity, it exists as an operational group within the Department of Trade and Industry ("the DTI"). It is responsible for a number of activities, the most important of which is the management of shareholdings in 17 government-owned businesses either on behalf of (in an executive capacity) or in co-operation with (in a "joint leadership" role) the sponsoring departmental shareholding team. It also plays an advisory role to the relevant team for a further 10 businesses. In each of these cases, the Executive or the departmental team are responsible for advising the relevant shareholding Ministers on decisions. These businesses are listed in **Figure 2**. It is important to note that not all bodies which have significant commercial activity, and in which the Government has an economic interest, fall within the Shareholder Executive's remit. Though its mission to improve shareholder performance is government-wide, it cannot compel departments to give it responsibility for managing their ownership interests. Examples of omissions from the remit are listed in Figure 9 on page 21.

1.5 As in the private sector, a number of "shareholder levers" exist to influence how a business is managed so that its value is protected and increased. **Figure 3 on page 12** lists these levers. As can be seen, not all of these are available to departmental shareholding teams or, through them, to the Executive. The implication of this is discussed in paragraphs 2.24–2.26 and 3.12–3.13.

1.6 In terms of its reporting arrangements, the Executive is accountable to the following in part or in full for its activities **(see Figure 4 on page 13)**:

- to the DTI Permanent Secretary for its administrative budget, covering all operational costs, and its "programme" budget which covers the cost of external advice on issues relating to BNFL, British Energy and the Royal Mail. For 2006-07 the administrative and programme budgets were £5.1 million and £4.8 million respectively;
- to the Permanent Secretaries of government departments which own businesses for the management of shareholdings and any corporate finance work (see below) carried out on behalf of that department; and
- to the Stakeholder Group, consisting of a senior official from each of the major shareholding departments (DTI, Ministry of Defence and the Department for International Development) and the Treasury: the Group monitors the Executive's performance against its objectives and its overall mission to improve shareholding across Government.

1.7 The Chief Executive also has two to three meetings a year with the Cabinet Secretary to review the Executive's delivery of its government-wide mission.[10] This reporting arrangement is in place to maintain a link to the centre of Government and because the Executive is responsible for managing shareholdings on behalf of Government. Indeed, between 2003 and 2004, the Executive sat within the Cabinet Office where it had a purely advisory role. Its move to the DTI in 2004 was a condition of it being given the opportunity to take over executive responsibilities for the DTI businesses.

1.8 The DTI teams were between them responsible for British Energy, the United Kingdom Atomic Energy Agency, BNFL, the Export Credits Guarantee Department and the Royal Mail.[11] The Royal Mail team was also responsible for policy issues relating to the postal market and the Post Office network and sponsored the market regulator, PostComm and the postal services watchdog, PostWatch, and these responsibilities were absorbed by the Executive at the same time.

1.9 The Industrial Development Unit (IDU) carries out corporate finance advisory work for central government. The IDU employs staff on fixed term contracts from the private sector with relevant professional skills (typically banking and accountancy). It appraises and negotiates financial assistance to non-government owned companies, and provides financial, analytical and negotiation support across government in its dealings with corporate bodies. In any one year the IDU can advise on projects in excess of £500 million. The IDU has the further goals of: (i) mobilising quick decision making to meet commercial timetables, and (ii) avoiding unnecessary external costs by making more efficient use of outside advisers on specific tasks. As it is now fully a part of the Executive, IDU staff are interchangeable with other professionally qualified members of the team.

10 Between November 2006 and February 2007, the Chief Executive reported to a (part-time) executive Chairman who in turn reported to the DTI Permanent Secretary and the Cabinet Secretary. The Chairman was officially in the employment of the Cabinet Office and therefore had a line managerial relationship with the Cabinet Secretary. Although the current Chairman is stepping down, it is envisaged that there will continue to be a post of part-time Chairman.

11 The responsibilities for each business were carried out by separate departmental shareholding teams within the DTI, except in the case of British Energy for which there was a restructuring team in place.

2 The Shareholder Executive's relationships

The Shareholder Executive interacts with public businesses and Government departments in a range of ways.

Role of Shareholder Executive (see paragraph 1.4 for definitions)	Government Department	Business	2005-06 turnover £ million
Executive Role	Department of Trade and Industry	Royal Mail	9,056
		British Energy	2,593
		UK Atomic Energy Authority	361
		BNFL	1,417
		ECGD	88
	HM Treasury	Partnerships UK	16
		Royal Mint	115
	Department for International Development	Actis	48
	Department of Work and Pensions	Working Links	55
Joint Leadership Role	Department for Transport	NATS	687
	Ministry of Defence	UK Hydrographic Office	75
		Met Office	170
		Qinetiq	1,052
		DSTL	353
		DARA	166
		ABRO	137
	Home Office	Forensic Science Service	158
Advisory Role	Scottish Executive	Scottish Water	1,019
	Department for International Development	CDC	387
	Department for Regional Development, NI	NI Water Service	41
	Department for Communities and Local Government	QEII Centre	11
		Fire Service College	22
		Ordnance Survey	118
	Department of the Environment, Food and Rural Affairs	Covent Garden Market Authority	11
		British Waterways	191
	Department of Culture, Media and Sport	Tote	2,208
		Channel 4	894
		Total	**21,449**

Source: National Audit Office

3 Controlling shareholders exert control over a business through various levers

	Levers available to		
	Private Equity Firm	**Cabinet Office, Treasury or Departmental Finance Director**	**Shareholder Executive/ Departmental shareholding team**
Appoint/Remove Management Team and non-Executive Directors Management Team ■ Ensures management delivers businesses and financial objectives. ■ Non-performance is scrutinised robustly and if necessary new management is appointed. Non-Executive Directors ■ Non-Executive directors have fiduciary responsibilities to act in the interests of the Board. ■ Ensures proper scrutiny of management over such issues as audit and remuneration.	Yes (and own staff may act as non-Executives)	No	Yes
Set the business objectives, investment policy and approve the business plan ■ Ensures that business and financial objectives are consistent with the shareholder's interests in long-term value. ■ Ensures investment policy is aligned with the long-term strategic health of the business. ■ Approves investment in assets where necessary.	Yes	No	Yes (after consulting other interested parties)
Link management reward to delivery of value over three to five years ■ Provides management with incentives to act in accordance with the shareholder's interests.	Yes	No[1]	Yes
Monitor Performance ■ Shareholder can intervene before problems materialise. ■ Ensures that the shareholder uses the other levers in a timely manner.	Yes	No	Yes
Set capital remuneration policy to extract surplus cash ■ This ensures that shareholder's funds are not stored up in the business but can be invested profitably elsewhere.	Yes	No	Yes[2]
Approve financing including equity contributions and/or borrowing ■ Influences business strategy.	Yes	Yes[3]	No
Exit the business by selling shares to another party ■ The ultimate signal to management that it is not performing in accordance with the shareholder's interests.	Yes	No[4]	No

Source: National Audit Office

NOTES

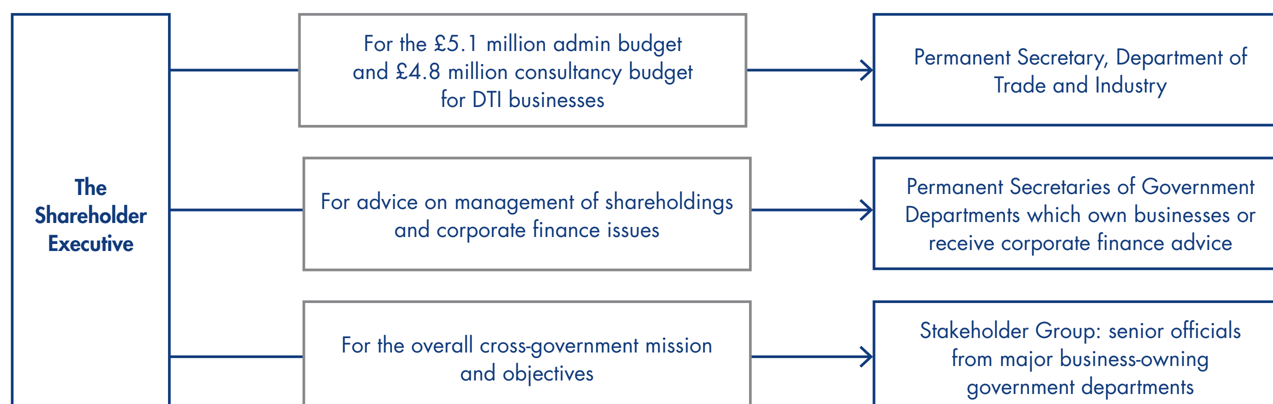
1 Management of Trading Funds are employed within the Senior Civil Service pay arrangements which are set by the Cabinet Office. The Cabinet Office has to agree any derogations to the public sector framework.

2 This lever is used within Treasury guidelines on capital remuneration.

3 The Treasury's approval is required for any investment outside the Departmental Expenditure Limit or National Loans Fund facility.

4 The Government can ultimately apply this lever if it so wishes; though generally questions of sale are considered in the context of wider public policy objectives and therefore this option is rarely applied as a shareholder lever.

4 The Shareholder Executive's accountability



Source: National Audit Office

Before the Executive was set up, there was no consistent approach to the management of Government shareholdings

1.10 As soon as it was set up in 2003, the Shareholder Executive undertook an initial assessment of the performance of Government as a shareholder to get a better understanding of prevailing practice, both domestically and internationally. The review concluded that "the overall performance of companies in Government ownership has been poor."[12] The review also found that spending on external advice between 2000 and 2003 on shareholding issues totalled approximately £70 million.

1.11 The findings of the review were consistent with previous PAC and NAO conclusions outlined in Figure 1. Two inter-related problems lay at the heart of the government's approach to shareholding at the time: there was a general lack of staff with relevant commercial and financial experience; and government's approach was fragmented because responsibility for looking after the public shareholder interest lay with individual departments. In the absence of a central co-ordinating body, this arrangement inhibited the spread of existing good practice. While there were individual pockets of good practice, the limited effectiveness of some of the shareholding teams led to declining confidence in them at the Treasury and gave rise to the need for separate checks and duplication of relationships with executive management.

The implications of policy for commercial objectives were often not made sufficiently transparent

1.12 A further, and significant, problem lay in the inability of many departmental teams to reconcile successfully competing government priorities. It is common for state-owned businesses to be required to meet a complex array of policy objectives, in addition to the standard shareholder objective, which is to protect and enhance long-term shareholder value. For example, the Royal Mail Group is required to run a network of post offices that is significantly larger than what it believes is an optimum commercially viable network of around 4,000 post offices[13] in order to meet social policy objectives. Balancing the need to increase shareholder value against these other objectives requires transparency so that they are assessed with full knowledge of their expected impact on value. This enhances decision-making.

1.13 The National Audit Office has previously highlighted the difficulties that can be faced by officials when trying to reconcile competing policy objectives. In the report *Risk Management: The Nuclear Liabilities of British Energy*, for example, the National Audit Office referred to the constraints felt by DTI officials in dealing with other departments whose policies affected British Energy. The officials did not, therefore, draw attention to the risks that might return to the taxpayer as a result of decisions affecting British Energy's business.[14]

12 Appendix 2 provides further details about the review.
13 Evidence to House of Commons Trade & Industry Select Committee, 18 July 2006.
14 *Risk management: the Nuclear liabilities of British Energy plc*, HC 264 Session 2003-2004: 6 February 2004 sub-heading on page 25, preceding the examples given in paragraphs 3.10-3.15, reads "The Department in discussions with other departments whose policies affected British Energy did not specifically draw their attention to the risks posed by British Energy's liabilities".

Managing public sector businesses consistently for value represents a step-change in the Government's approach

1.14 Ensuring that a business is run well requires effective use of the shareholder levers identified in Figure 3. Unlike shareholders in publicly-quoted businesses, the Government does not usually have the ability to sell shares as a signal to management that it is performing poorly. Equally, there is little external market scrutiny of company performance. This is often also true of private equity companies, which generally own a majority stake in an unlisted company. The Executive's position as shareholder is analogous in some ways to that of a private equity company, which provides business experience and critical oversight of management performance.[15] The latter tends, however, to take a more active role in the oversight of a company than departments did in the past, with the explicit aim of increasing the value of their investment. Ultimately private equity companies are able to "exit" the business if they feel that it will not increase in value. This option is not available to Government when management is performing poorly because its businesses are not owned solely to create value, and any question of sale is looked at within the broader context of an asset disposal strategy and wider policy objectives.

1.15 The Government has the power to appoint, incentivise and remove management, approve strategy and business objectives and monitor performance. The Government's poor record as a shareholder has been due in part to the ineffective use of these shareholder levers. The timeliness of the use of these levers has been a particular problem. There have been repeated instances of a lack of critical challenge to proposed corporate strategy, leading to poor investment decisions – BNFL's investment in nuclear waste treatment activities is one example.[16] During a period of change[17] the Royal Mail posted four consecutive annual "profit warnings" (i.e. that profits would be significantly lower than management had previously forecast) between 1998-99 and 2001-02 without immediate consequences. More timely scrutiny of the company by the departmental shareholding team would have resulted in a better awareness of business prospects and the potential scale of the losses, and earlier consideration of management changes. A loss of confidence in the management often resulted in departments second-guessing boards and executive teams, leading to a blurring of proper management accountability. In some businesses, such as trading funds, departmental pay constraints have had an adverse impact on the ability of the Executive to attract, retain and incentivise experienced management teams.

15 Private equity firms differ from the Executive in the sense that they manage their companies aggressively to ensure that they grow quickly within a three to five year horizon, beyond which they expect to sell the companies, either to a third party or through a flotation on the stock market.

16 In 1997 BNFL Inc. signed a contract with the United States Department of Energy to treat, package, and ship offsite 65,000 cubic metres of transuranic (plutonium contaminated) waste on a fixed price basis. As a result of rising costs this and other fixed price contracts proved to be loss making.

17 This change included transformation from a public corporation into a public limited company, redefining the arms length relationship with Government – see paras 1.10 to 1.15 in the C&AG's report The Acquisition of German Parcel HC 858 (Session 1999-2000).

The Shareholder Executive has made a good start, despite operating within a limited framework

2.1 Following its move to the DTI, the Executive developed the following objectives, as part of its 2004-05 to 2006-07 Corporate Plan:

- to ensure each business delivers sustained positive returns, and returns its cost of capital[18] within the policy parameters set by Government;
- to increase by £1 billion the value of a portfolio of six target businesses owned by Government, within a framework of clearly defined policy, customer and regulatory objectives;
- to provide corporate finance expertise within Government; and
- to achieve a progressive return to dividend paying.

2.2 An important part of the Executive's attempt to bring greater focus to shareholder value across government was the introduction of a shareholder value enhancement target to measure the overall change in the value of its businesses as a result of its work. The objective for the first reporting period was set at £1 billion and was applied only to six target businesses. As this was the first attempt to link performance and shareholder value, the Executive decided to apply this objective to businesses with which at that time they had a close working relationship.

2.3 Once the target was established, the Executive commissioned external consultants to develop the detailed methodological framework and advise them on the best way of measuring the £1 billion increase in shareholder value. Given the visibility of this target, we conducted a thorough analysis of the way in which it was constructed. In evaluating the target, we made reference to the Executive's aim that the target should:

- focus attention on improving shareholder value;
- be applicable across a diverse set of government owned businesses;
- attempt to measure value enhancement rather than absolute value; and
- use reported, rather than forecast, financial data.

2.4 The Executive selected an Economic Profit methodology, which uses reported results to calculate year on year changes in shareholder value for its diverse range of businesses. This methodology is used widely in the commercial sector and has the advantage that it is relatively simple to understand and apply relative to other methods (see 'box' below). Though it is applied at the level of an individual business, the Executive reports results aggregated across the target businesses. Measuring value is not an exact science and Economic Profit, like all valuation methodologies, has limitations because it relies in part on assumptions that are based on subjective judgement.[19] Where possible, the Executive has reduced the measure's reliance on assumptions to a minimum in comparison with other approaches it could have chosen. Overall, we conclude that the measure met the Executive's initial aims particularly in bringing about a greater focus on shareholder value across a range of government-owned business. The way in which this measure is applied is addressed in Part 3.

18 Government departments are required by the Treasury to provide a set level of financial return on any equity capital invested in a business. In turn, the department collects the cost of capital charge from the business: if the business is not making a profit, the department ends up covering the charge on behalf of the business.

19 For example, the cost of capital in Economic Profit methodology relies on an assessment of the risks faced by that business.

Alternative Valuation Methodologies:

Economic profit: This is a measure of value created in recent financial reporting periods. It uses published financial results to calculate a shareholder's return on investment after accounting for the risks attached to that investment. As a backwards-looking measure, it cannot be manipulated by future forecasts or by altering the timing of year-end cash-flows.

Discounted Cash Flow: This is a measure of value that a business will create in the future. The analysis uses detailed projections of a business's free cash flow (that is, the cash available after all business costs are paid). The cash flows are discounted, most often by using a measure of the cost of capital adjusted for risk: the resulting "present value" figure is a statement of the business's worth in today's money.

Multiples: This is a comparative estimate of current value - a relatively 'top down' valuation methodology based on published accounts and the proposition that, in an efficient market, similar businesses should have a similar business outlook and generate similar value based on the net cost of their sales. Therefore, the value calculation is based on gathering financial data for a comparator group of similar companies.

Note: see Appendix 3 for further details

2.5 The Economic Profit methodology measures changes in value and does not provide an absolute valuation of the Executive's target businesses. We therefore conducted a further exercise to ascertain an approximate aggregate valuation of 18 businesses in the Executive's portfolio[20] Subject to the caveats outlined in Appendix 3, we estimate the enterprise value of the Executive's portfolio to be between £17.1 billion and £20.8 billion as of 30 June 2006[21]. The businesses can be grouped into different sectors, shown in **Figure 5**.

5 The valuation range for businesses in the Shareholder Executive's portfolio, by type

Business type	Example businesses	Lower end of valuation (£ million)	Upper end of valuation (£ million)
Listed companies	British Energy	5,643	5,643
	QinetiQ		
Investment businesses	CDC	4,722	5,209
	Actis		
	ECGD		
Utilities	BNFL	5,755	8,723
	Royal Mail		
	UK Atomic Energy Authority		
	NI Water Service		
	Scottish Water		
Service businesses and others	NATS	991	1,209
	Channel 4		
	Ordnance Survey		
	Working Links		
	DSTL		
	Royal Mint		
	Covent Garden Market Authority		
	Tote		
	Total portfolio	**17,111**	**20,784**

Source: National Audit Office

NOTE

See also Appendix 3 which sets out a lower range of enterprise valuation from £4.97 billion to £8.84 billion, which excludes the lower range for Scottish Water and is, adjusted for long term liabilities considered equivalent to debt obligations. The Executive believes that its own impact on a business will show in periodic measurement of the change in value, without the distortions that can arise from very different assumptions about the most appropriate absolute valuation.

20 This exercise was carried out using a multiples-based approach and covered 18 businesses for which reasonable comparators could be found. Figures have not been adjusted for any liabilities. Appendix 3 provides further details.

21 The Executive decided not to measure the absolute value of its businesses because alternative methodologies incorporate (largely subjective) forecast financial data. In complete form, these valuations may also include legacy factors beyond the control of the current management, such as pension liabilities.

The Executive has established a good shareholding model through which it discharges the shareholder function

2.6 The shareholding model aims to implement the Executive's four shareholding principles (clarity, value, transparency and professionalism) for managing shareholdings across government. The starting point from which the Executive puts this model in place is a framework document which sets out the roles and responsibilities expected of the Executive, the sponsor department and the board of each business. This results in a separation of policy and customer roles (which are retained by the sponsor department) from the shareholder function (which is taken on by the Executive). This separation has generally been achieved for the executive businesses, though not with the Royal Mail (paragraph 2.23 and 3.4).

2.7 This framework document[22] establishes the governance arrangements that apply to a business and what is required from management in terms of the timely provision of data, and the approval of corporate strategy, proposals for Board remuneration and so on. In the case of departmental trading funds these governance arrangements have been strengthened by improving the quality of the information flow between the Executive, the department and the business and by increasing the role of non-Executive Directors. Non-Executive Directors bring a range of skills to the Boards of public businesses: they provide greater challenge to management and raise concerns with the Executive and departmental shareholding team when necessary. They are also selected to bring specialist business expertise and corporate governance skills to Boards to improve decision-making. Such improvements in the governance of public businesses can be seen in cases of the Treasury and MoD trading funds. Going forward, the Executive could consider its own staff for filling non-executive Board positions – as is the case in Sweden.

2.8 The implementation of the shareholding model has provided the Executive with the opportunity to ensure that businesses are being run effectively and to hold management to account for performance. Evidence gathered from our case study businesses[23] indicates that the Executive has made appropriate and timely use of the shareholder levers: this includes addressing poor management by the removal of Directors and/or new Board appointments.

2.9 A major part of the Executive's role is to help to articulate the value implications of policy and other objectives so that decisions on policy issues can be made with the best available information about their benefits and costs. There is some evidence of the Executive carrying out this role in the recent Energy Review[24] in relation to British Energy and the potential sites it owns (paragraph 3.3) although there is no formal mechanism for costing the impact of policy proposals in relation to shareholder value.

The Executive has attracted experienced staff with public and private sector expertise

2.10 Bringing together good quality staff with the right skills (especially investment management and corporate finance skills) within Government was one of the main drivers behind the foundation of the Executive. The role combines commercial acumen with an understanding of decision-making processes within Whitehall. To be effective, therefore, the organisation needs to draw on a mixture of public and private sector experience. In addition, the Executive needs a relatively senior team in order to be credible with the Boards and management teams of its businesses.[25]

2.11 So far, the Executive has recruited staff with a view to achieving this balance of public and private sector skills. For example, of the 12 directors in post as of December 2006 two have a background in strategy, six in investment banking or corporate finance and four largely in the civil service. Our organisational review found that bringing together staff from different backgrounds with a diverse range of skills was on the whole working well, with much sharing of knowledge and expertise.

2.12 External feedback on the Executive's staff from the businesses and departments has mainly been positive. Those interviewed said that the Executive's business experience and understanding of the individual companies have made it a credible shareholder representative. This was notably evidenced to us in the cases of Actis, CDC, NATS and the Royal Mint. In each case the director[26] we

22 In some cases the framework document takes the form of a letter written by the shareholder (either a member of the departmental shareholding team or the Executive) to the Chairman of the Board.

23 The businesses selected for closer examination were Actis, CDC, BNFL, NATS, Royal Mail and the Royal Mint. In addition, from early 2004, the Executive took shared executive responsibility for QinetiQ, the subject of a separate report to be published later in 2007.

24 The Energy Challenge Energy Review Report 2006, Department of Trade and Industry (Cm 6887).

25 This was noted in the Executive's Start-Up Review (see Appendix 2 for further details).

26 We spoke to the Chief Executive of the Royal Mail; the Senior Managing Partner of Actis; the Managing and Finance Directors of CDC; the non-executive Chairman, Chief Executive and Partnership Directors of NATS; and the non-executive Chairman of the Royal Mint.

spoke to mentioned impartiality and openness as features of the Executive's approach, and welcomed the focus it has brought on commercial rather than policy issues. Some of our interviewees also told us that these good relationships with the Executive have often benefited from staff continuity on both sides. Any tensions we identified related to negotiations over access and remit, rather than challenging professional competence.

The Executive has had early successes in bringing about beneficial change

2.13 The change in approach to the way in which Government manages its shareholdings – based on staff with relevant skills making appropriate use of the shareholder levers – has so far brought about a greater focus on shareholder value. The most tangible example of the value created by the Executive in its work to date relates to the sale of Westinghouse. The DTI and the business both agree that the Executive made an important contribution by persuading government to take advantage of favourable market conditions to increase proceeds from the sale (see the case study opposite).

2.14 In previous work the National Audit Office has been critical of the terms on which financial advisors have been appointed by public bodies.[27] An aim of the Executive was to reduce dependence and increase value for money from the use of private sector advisors. Because it is able to provide more expertise within government and through tighter specification of work the Executive estimates that it achieved savings of around £7.5 million in 2003-04, rising to a total of £12.1 million by 2007 which is approximately 17 per cent of the amount spent on advice in the three years prior to the establishment of the Executive (paragraph 1.10). We have examined the assumptions behind the 2003-04 estimate and, though it is difficult to be precise about the actual figure, we are confident that the Executive has helped achieve savings of this order of magnitude through a more timely appointment of advisors and by negotiating tighter terms of engagement.

2.15 An increased focus on value may not always be able to resolve the challenge of reconciling competing policy and shareholder objectives successfully. Without formal mechanisms to cost and recompense businesses for delivering policy objectives (something which takes place in some countries overseas – see Appendix 4 – but which does not always occur under current UK arrangements) it is difficult to predict if the improved approach to shareholding will result in a sustained improvement in the performance of businesses. Since the Executive was established, the performance of the businesses in the Executive's portfolio has generally been positive **(Figures 6 and 7)** although this indicator does not imply a causal relationship. Results have been aided by improving or stable economic conditions which have boosted the performance of some of the larger businesses **(Figure 8 on page 20)**.[28] British Energy's profits have been driven up by a large increase in wholesale energy prices since 2002 and CDC's positive results are helped by the performance of businesses in emerging markets; multi-lateral agreements on debt servicing with several major creditor countries (Brazil, Nigeria and Russia) have also improved ECGD's financial results[29]; and the performance of NATS has improved markedly under new management, but the company has also been helped by an upturn in air traffic since lows following the aftermath of 11 September 2001 and the greater stability conferred by the 2003 regulatory solution which involved contributions from different stakeholders.

2.16 Moreover, there are other reasons to be cautious about future financial performance: ten of the businesses in the portfolio did not record operating profits in each of the last three years (2003-04 to 2005-06).[30] And in the near future some major businesses (Royal Mail, British Energy and BNFL) face difficult challenges (see paragraphs 3.2 and 3.3) which could have a negative impact on financial performance.

2.17 It is therefore not yet possible to say whether the change in approach will translate into healthy financial performance on an ongoing basis, particularly given the paramount importance of ensuring that public policy objectives are met. The Executive's own internal measures back up this conclusion (see Appendix 5). They point to an improvement in the relationships with businesses and in the approach to managing shareholdings; but they also point out that most of the businesses have yet to deliver healthy financial performance on a sustainable basis.

27 See the C&AG's report *National Air Traffic Services Plc* HC 1096, Session 2001-2002, Recommendation 8. See also the C&AG's report *Central Government's Use of Consultants*, HC 122, Session 2006-2007, on the use of all types of advisors, which recommended that public bodies "should start with the presumption that their own staff are best fitted for requirements" (Recommendation ii) and that they "should make more use of different payment mechanisms such as fixed priced and incentivised contracts instead of standard time and materials" (Recommendation v).

28 This is based on the aggregate performance of all of the businesses in the portfolio, though a full (six-year) set of data was not available for New Covent Garden Authority, Fire Service College, Northern Ireland Water Service and Scottish Water.

29 The Shareholder Executive separately monitors ECGD's new business performance, excluding the legacy portfolio.

30 In the three years prior to the Executive's creation, nine out of fifteen businesses made profits in each of those three years. The twelve businesses not included in this comparison either did not exist for all three of these prior years, or data is unavailable.

CASE STUDY

The Westinghouse sale achieved £2 billion more than the initial estimate

After obtaining ministerial approval, the Board of BNFL decided on 30 June 2005 to sell Westinghouse Electric Company, its U.S.-based subsidiary providing fuel, technology and services to the commercial nuclear energy industry. The anticipated level of proceeds from the sale was thought to be approximately £1 billion. Officials at the Executive recognised that the value of the company would be much enhanced if potential buyers saw that it could win lucrative contracts in overseas markets. Initially, senior civil servants at the DTI and Treasury were unwilling to consider Westinghouse taking on commercial risk overseas as it had recently been involved in some unsuccessful ventures in the USA.

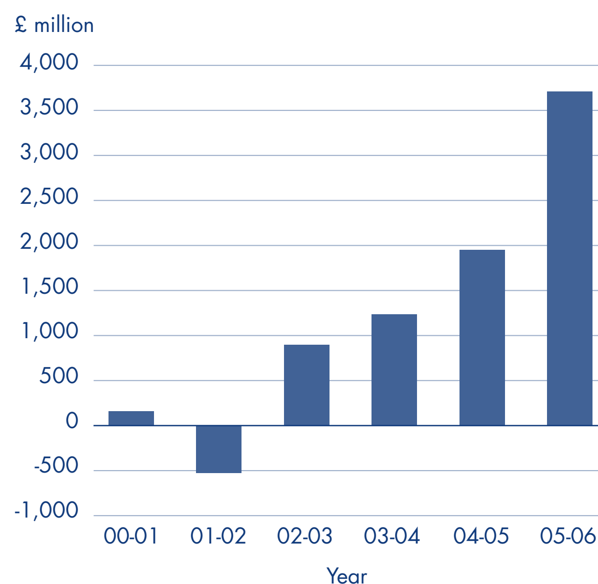
On account of its role as trusted advisor – a role that could not easily have been played by an external advisor – the Executive built a consensus in favour of allowing the company to negotiate contracts for the provision of nuclear power plants in China prior to the sale. The Executive was able to persuade officials that by getting these contracts ready, the proceeds from the sale would increase with little additional financial risk to the Government as the contracts would not become effective before the sale took place. In large measure these contracts, as evidence of the company capturing a greater share of the buoyant global nuclear energy market, were responsible for BNFL being able to sell Westinghouse in a competitive auction for £3 billion against an expected £1 billion, once the sale was completed on 16 October 2006.[1]

Source: National Audit Office

NOTE

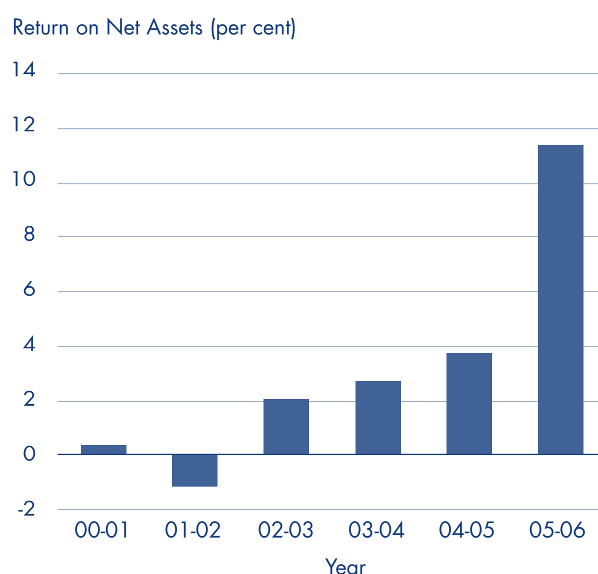
1 This is based on a conversion rate of $1.80 to £1. Westinghouse was sold for $5.4 billion against initial expectations of $1.8 billion. Other factors, such as BNFL's view on how and when to run the auction process, also contributed to the increased proceeds from the sale.

6 Operating Profits in the main businesses in the Shareholder Executive's portfolio have increased over the past three years



Source: National Audit Office

7 Return on Net Assets in the main businesses in the Shareholder Executive's portfolio have also increased over the past three years



Source: National Audit Office

The Executive's structure and remit limits its scope for realising greater benefits

2.18 The decision to move the Executive to the DTI in 2004 was a pragmatic one. This contributed to the limitations of the framework in which the Executive operates, giving rise to a number of practical barriers to further improvements.

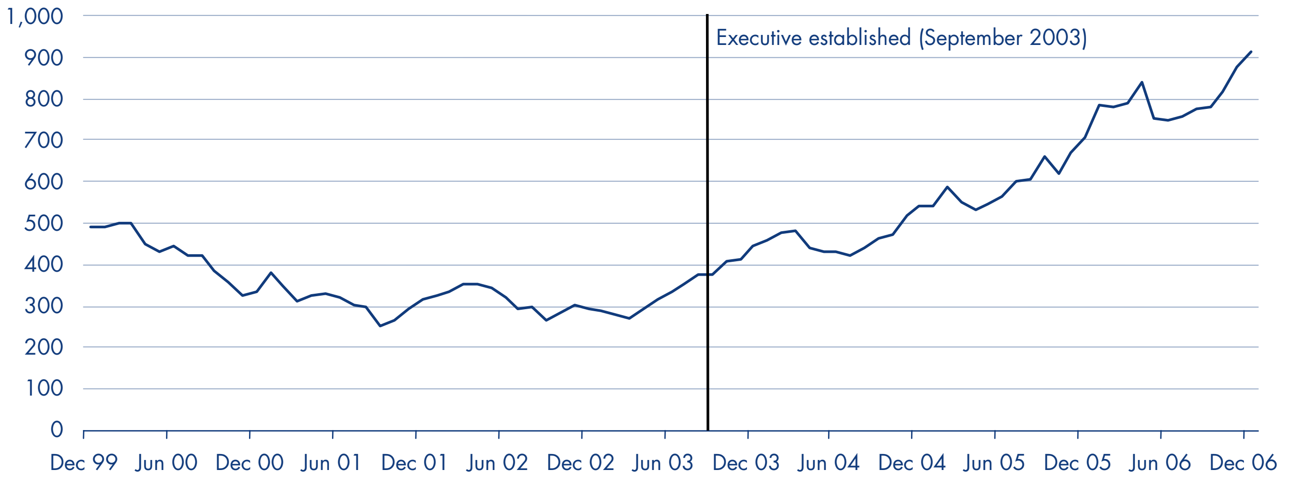
Remit

2.19 Though the Executive has a government-wide mission "to be an effective shareholder of businesses owned or part-owned by Government"[31] it cannot compel departments to give it responsibility for the management of businesses or to make use of its Industrial Development

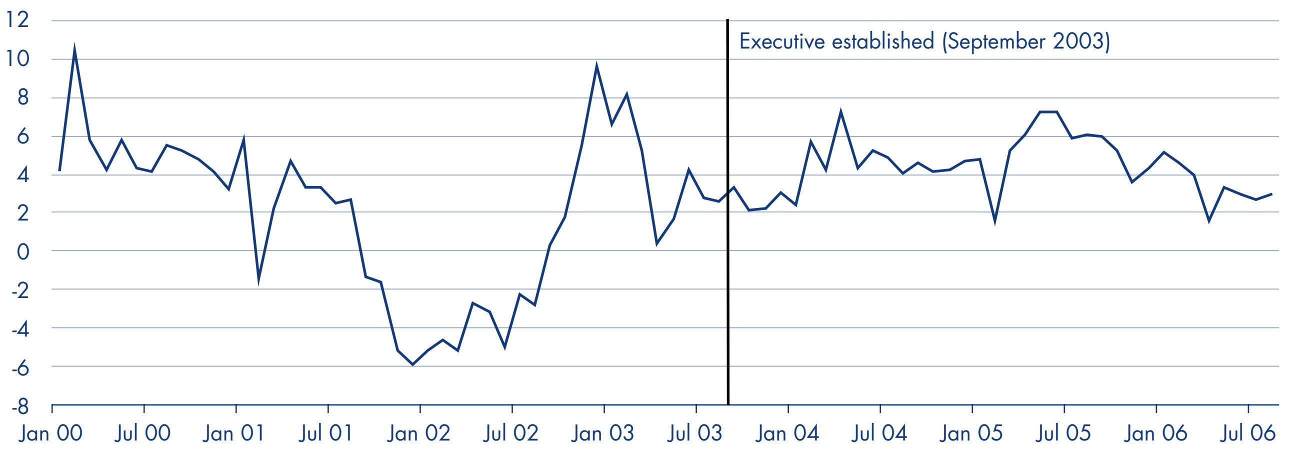
31 Source: www.shareholderexecutive.gov.uk.

8 A number of profitable businesses have competed in benign market conditions

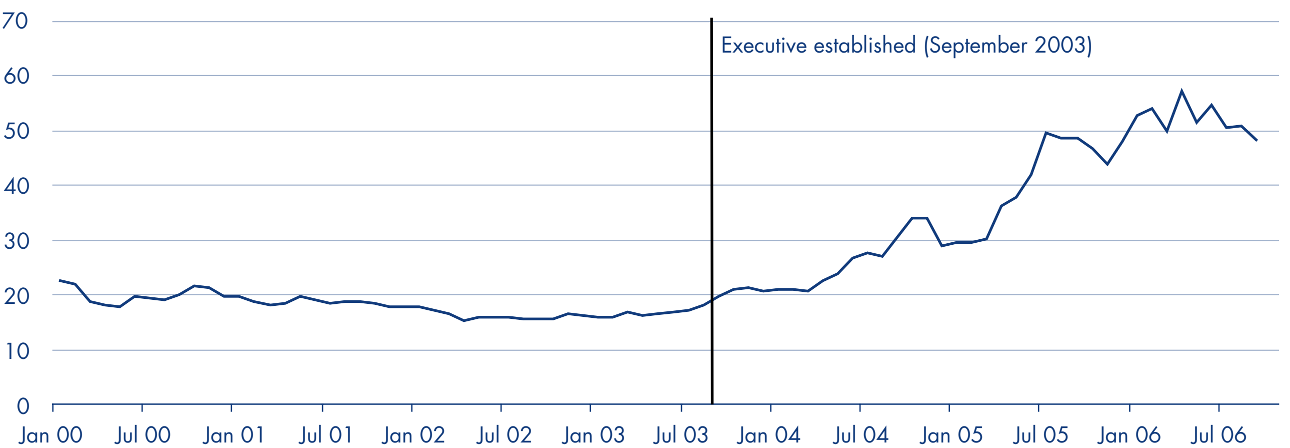
MSCI Emerging Markets Price Index



Percentage growth in number of flights per month handled by NATS



UK Wholesale Power Price £/M Wh



Source: National Audit Office

Unit for any corporate finance advisory work (see paragraph 1.9). This has meant that the Executive has relied on promoting its own brand identity through interpersonal relationships (in the absence of institutional arrangements) to engage and work with departments and businesses. The Executive has successfully negotiated a role for itself with a number of government departments. Even where its role has not been to manage shareholdings directly on behalf of the department, it has been able to work out satisfactory alternative arrangements, for example with the Ministry of Defence.[32]

2.20 This need to negotiate a role for itself can lead to problems. The limited nature of the Executive's remit slowed down the institution of framework documents (see paragraphs 2.6 and 2.7), with the Executive having to take part in a three way negotiation between the business, the owning department and the Executive. In some cases this has led to some inconsistency, with the Executive only advising the relevant departmental shareholding team. The advisory role works best where the Executive has a direct relationship with the business, is kept up to date and is actually involved in advising ministers. In some cases, such as Working Links and the Forensic Science Service, the advisory relationship has been a stepping stone to the full executive role.

2.21 In practice, however, an advisory role, or a less than full executive role, can lead to a less intensive relationship. Generally the advisory relationship is one where the Executive is not directly involved with the businesses or in advising ministers and could therefore be ignored by those departments or their businesses that claim to be able to manage commercial and financial risks adequately. For example, five of the businesses in the Executive's portfolio[33] were not included in its Annual Report 2005-06 because the Executive had typically advised on specific issues only. The advisory relationship can also lead to duplication of effort between the Executive and the shareholding department.

2.22 More importantly, there is no obligation on departments to involve the Executive at all with their shareholdings and other commercial activity. **Figure 9** provides some indication of the main omissions from the Executive's portfolio. There are cogent reasons for some omissions, but we have not found a sensible rationale behind all of them. For example, the Executive has no involvement in the commercial activities of the Department of Health and the National Audit Office has recently criticised the Department and its Information

9 A list of government-owned bodies outside the Shareholder Executive's portfolio

Examples of significant businesses, some newly created, outside the remit of the Shareholder Executive.

	2004-05 turnover £ million
Department of Trade and Industry	
Nuclear Decommissioning Authority[1]	1,211
Department for Transport	
Trust ports[2]	>100
Department of Health	
NHS Professionals	272
D.C.I. Biologicals Inc[3]	40
Partnerships for Health[4]	8
Department for Education and Skills	
Partnerships for Schools[5]	7
Devolved Regions, Greater London Authority or local authorities	
Transport for London	2,555
Manchester Airports Group	374
Blackpool Airport Ltd	353
Sianel Pedwar Cymru (S4C)	95
Caledonian MacBrayne Ltd	76
Forestry Commission	
Forest Enterprise	30

Source: National Audit Office

NOTES

1 The figure refers to the income from the NDA's commercial operations in 2005-06. The Executive has recently had some involvement with the NDA, providing advice on governance and financial analysis issues.

2 Source: Department for Transport *Focus on Ports* (2006), p.7: 14 of about 100 Trust Ports have a turnover above £3 million (eight of them above £10 million)

3 Department of Health Annual Report 2005, paragraphs 4.54 and 4.55 [and an earlier reported turnover].

4 Partnerships for Health is wholly-owned by the Department of Health. Prior to December 2006, 50 per cent of PfH was owned by Partnerships UK.

5 The Partnerships for Schools turnover covers the 14 month period to 31 March 2005. PfS is a 50:50 joint venture between the Department for Education and Skills and Partnerships UK.

32 For example the Shareholder Executive has been successful in obtaining a seat on an 'ownership council' set up to advise relevant Ministers on MoD trading funds; and it seconded a member of staff to the MoD shareholding team which has responsibility for the shareholdings in the MoD trading funds.

33 These are: Fire Service College, Northern Ireland Water Service, Ordnance Survey, QE2 Conference Centre and the Tote.

Centre's negotiations of a joint venture which it believed could have benefited from the Executive's advice.[34] Moreover, paragraph 2.14 of this report highlights the Executive's work in reducing the Government's dependence on private sector advisors: in negotiating the deal, the Information Centre incurred advisory costs of over £1.7 million which could potentially have been reduced by working more closely with the Executive. This inconsistency and lack of statutory authority to bring businesses into its portfolio is incompatible with the Executive's government-wide mission and highlights that the pragmatic decision to situate it within the DTI, with its current governance arrangements (paragraphs 1.6–1.7), has not succeeded in enabling it to deliver its mission fully.

2.23 The Executive's current remit also departs from its own principles and OECD best practice guidelines[35] in that it has multiple roles in relation to postal services. As well as a shareholder role in relation to Royal Mail, it is responsible for policy matters relating to it and oversees the work of the postal services regulator and watchdog. These conflicting roles are part of the legacy of its transfer to the DTI in 2004. This issue is also discussed in Part 3.

Financing and dividends

2.24 Our findings above concluded that the Executive has made use of the "shareholder levers" available to it to ensure that government-owned businesses are managed for value. The Executive, however, lacks the full use of an important lever which is available to investment management bodies in the private sector – the ability to arrange for the provision of financing to businesses when they have a good case for it, such as an investment that will increase the value of the business over a medium to long period of time (e.g. three years or more). Private equity firms carry out similar functions to the Executive in the private sector. They generally hold controlling shareholdings in businesses and have significant influence over management to ensure that the businesses are managed for value and growth. Their involvement in financing gives them an additional means of controlling the strategic direction of a business through approving the investments that a company makes and therefore the return – in the form of dividends and increased shareholder value – that is expected from them.

2.25 The Executive does not have this level of influence. Any financing that might be needed can come from the departments themselves in the form of debt or equity, or from the National Loans Fund: however the capital sum comes out of Departmental Expenditure Limits or Annual Managed Expenditure and therefore has to compete with other capital spending requirements within the respective departmental public spending programme and the overall fiscal framework. There is a risk that businesses will not be able to access adequate financing for investment, irrespective of the impact this could have on shareholder value.[36]

2.26 Provision of financing under the current framework is largely based on an assessment of future needs during a three year Spending Review period, with some flexibility within periods to invest from departmental savings. It is often difficult, however, for a commercial business to forecast investment needs for such a period and its investment cycle might in any case take a new direction during the period.

2.27 Given this risk, there is an incentive for management to keep cash in the business against any future investment needs (which may or may not arise) and only to pay dividends to cover the department's annual cost of capital charge within its Departmental Expenditure Limit. In some cases, the Government does not to receive dividends as part of an agreement over funding plans, debt covenants or for policy or legal reasons.[37]

2.28 Dividends paid by the portfolio businesses have increased over the last three years, but represent a decreasing proportion of operating profits – **see Figures 10 and 11**. At present any dividend proceeds above the cost of capital charge can be retained by departments and can be used for other non-investment related expenditure.[38] While this gives the department some incentive to ensure that a business regularly pays dividends, it does not necessarily address the management incentive to keep cash in the business, which could be to the detriment of overall shareholder value.

34 See the C&AG's report on *Dr Foster Intelligence: A Joint Venture between the Information Centre and Dr Foster LLP*, HC 151, Session 2006-2007, paragraph 1.45. See also paragraph 29.

35 The OECD produced its Guidelines on Corporate Governance of State-Owned Enterprises in 2005, following a number of international policy developments in the field. The first guideline in the first chapter reads "There should be a clear separation between the state's ownership function and other state functions that may influence the conditions for state-owned enterprises, *particularly with regard to market regulation*" (our italics).

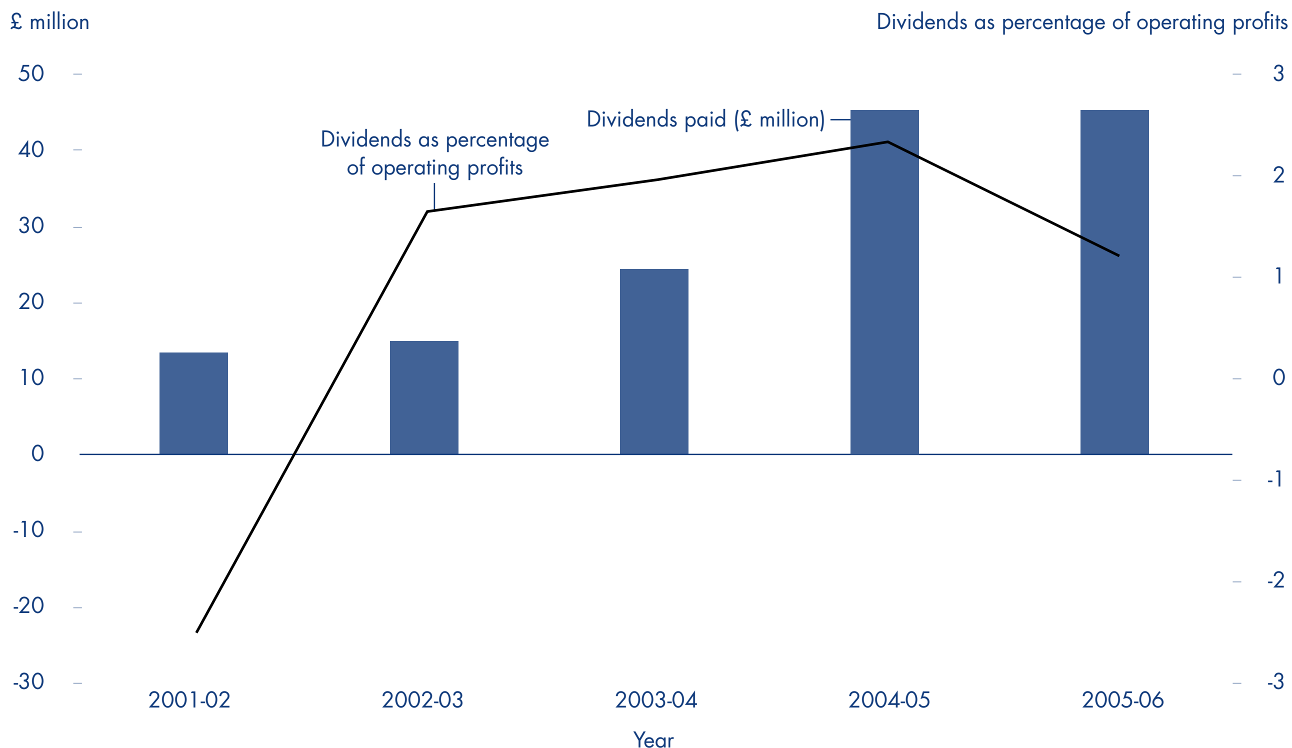
36 Each business that joins the portfolio has a pre-existing capital structure, and it could be argued that that the Executive should simply hold management accountable for delivering value under that structure. But this legacy structure may not always be appropriate, having for example too little or too much debt, and it may not allow for essential investment to maintain or enhance the competitiveness of the business. In fact, many formerly publicly owned businesses underwent a capital restructuring before privatisation.

37 For example, as part of the Royal Mail's Renewal Plan, the Government agreed not to take dividends for three years; British Energy returns cash to the Government as part of the cash sweep arrangement; a debt covenant prevents NATS' regulated subsidiary (NERL) paying dividends until 2008; BNFL agreed to return value to the taxpayer through the disposal of assets; and Channel 4 and British Waterways, both statutory corporations are required to break even and reinvest any surplus towards their public service objectives.

38 This process does not apply in the same way to some businesses, designated as self-financing public corporations. The department may make a contribution to the Treasury; however, this is generally substantially less than a cost of capital charge.

10 Dividends have increased over time but represent a smaller percentage of operating profit

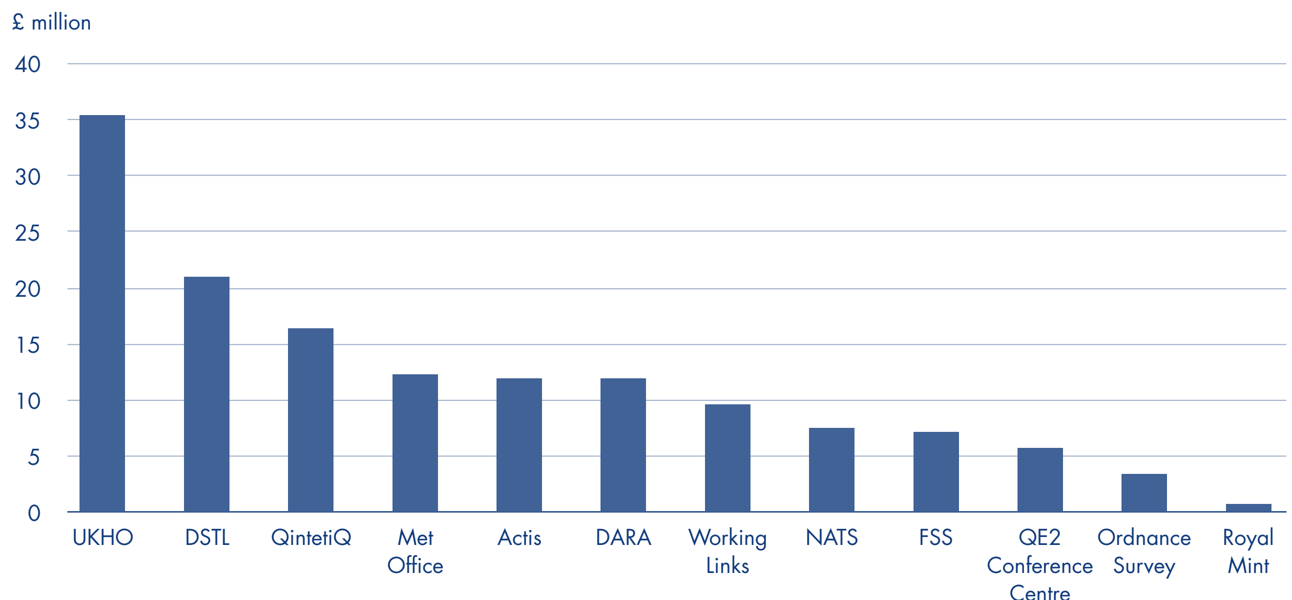
In 2001-02, the businesses made a cumulative operating loss and therefore the percentage value figure is negative in this year.



Source: National Audit Office

11 Businesses within the portfolio which paid dividends between 2001 and 2006 (£ million)

Dividends paid over the period totalled £143.1 million.



Source: National Audit Office

Changes are required to keep up momentum and to build on early achievements

3.1 Part 2 identified a number of issues and practical barriers that could limit the Executive's effectiveness as it evolves further after its good start. These relate to the Executive's location, remit and the nature of its responsibilities. Addressing these concerns will be important because the Executive faces a number of strategic challenges in the near future, as outlined in the next section.

In the near future the Executive and some businesses face strategic challenges

3.2 Royal Mail has to restructure and modernise to meet the challenges of a more open and competitive market for postal services. This will require major investment which current government policy requires should be sourced from Royal Mail's resources and public funds on a commercial basis. The Executive has limited freedom of action to mobilise investment funding in such cases. It has, however, engaged actively in helping to build the investment case for modernisation. The proposal was first submitted with a view to a decision in April 2006 and agreement was reached on investment of £2 billion in February 2007.[39] The documents we reviewed support the Executive's positive influence in two areas: first, in articulating the financial implications of different options and second, in setting robust financial targets to hold management to account. The injection of capital into the company, if it takes place, will initially decrease performance against the Economic Profit target because it will be some time before the modernisation programme provides a return on the investment. Figure 12 on page 26 shows the contribution made by the Royal Mail to the Executive's performance against its £1 billion target. Investment by Royal Mail will, therefore, have a large impact on the Executive's ability to meet its current £1 billion target (or any future version of it).

3.3 Other strategic challenges relate to the potential conflict between nuclear energy policy and the Government's interests in the nuclear power sector. The Secretary of State for Trade and Industry (along with Ofgem) has a statutory responsibility to protect the interests of consumers through, wherever appropriate, effective competition.[40] He also owns BNFL and, through the Nuclear Liabilities Fund, is the owner of an option on part of British Energy's equity. One potential challenge is the plan for BNFL to break up the British Nuclear Group (BNG) and sell the business at the same time as the Nuclear Decommissioning Authority (NDA) is letting a long-term contract for operating, decommissioning and cleaning up the nuclear sites at Sellafield. These sites are currently operated by a part of BNG. The decision to sell BNG in parts might reduce the value obtainable but was taken in the light of the overall nuclear decommissioning strategy. A second challenge, following the recent energy review,[41] relates to the potential development of sites for nuclear power generation next to those owned by British Energy or the NDA. The Executive will need to ensure that the debate is informed by full knowledge of shareholder value issues and, as in the case of the first challenge, should put forward the shareholder case clearly.

39 This will be financed through a loan of £900 million for the letters business to be repaid by 2013; a £300 million shareholder loan; and a transfer of £850 million from the company reserves (access to which requires prior approval from the Government).
40 These responsibilities are set out under the Gas Acts 1986 and 1995, the Electricity Act 1989, the Utilities Act 2000 and the Energy Act 2004.
41 "The Government believes that nuclear has a role to play in the future UK generating mix alongside other low carbon generating options" (paragraph 5.93, *The Energy Challenge: Energy Review Report 2006*, Department of Trade and Industry, July 2006).

Resolving conflicting roles in its postal industry responsibilities needs to be a key priority

3.4 The Executive's responsibility for policy on the postal market and Post Office network issues and its sponsorship of PostComm and PostWatch are part of the legacy of the Executive's transfer to the DTI, when it absorbed the responsibilities of the former Royal Mail team (paragraph 1.8). As a non-ministerial Government department, the annual budget of Postcomm is agreed by the Treasury, without the involvement of the Executive, reflecting the regulatory independence of Postcomm. The Executive, however, appoints the PostComm commissioners. The Executive is also in the lead on policy for consumer representation in the postal services market, it has a sponsorship role for PostWatch and and advises Ministers on PostWatch's budgetary proposals before they are put forward for parliamentary approval. These conflicting roles make it hard for the Executive to give clear and transparent advice on Royal Mail shareholder issues while at the same time ensuring that there is fair and open competition within the marketplace and that the interests of consumers of postal services are protected. While we have found no evidence of problems so far, this will become a larger issue as the postal market becomes increasingly competitive. The separation of shareholder role from the policy, customer and regulatory roles in other departments has been one of the benefits brought about by the Executive and is very much in line with OECD guidance (paragraph 2.23).

More meaningful measures could be adopted to provide a better assessment of the Executive's work

3.5 There are risks associated with the Executive's £1 billion portfolio target. It is very common for private sector investment companies to manage investments on a portfolio basis.[42] This is a standard risk management technique which recognises that businesses may suffer sporadic poor returns as a result of cyclical or market conditions.The overall financial risk to the portfolio is, however, reduced through careful selection of a large number of investments that behave in different ways. The effect of this is that no one individual business will affect the overall portfolio return greatly. Equally, a private sector investor can dispose of a consistently poorly performing business.

3.6 The Executive is unable to select a balanced portfolio in this way. First, it does not have the ability to dispose of poor performers in its portfolio. Second, the financial performance of a few significant businesses in the Executive's portfolio can change its overall performance markedly within a short space of time, either positively or negatively. In a balanced portfolio the exposure to this risk would be much smaller; but in the Executive's portfolio several of the companies are of such a size that cyclical movements and other factors affecting a single business could jeopardise the Executive's performance against its target.

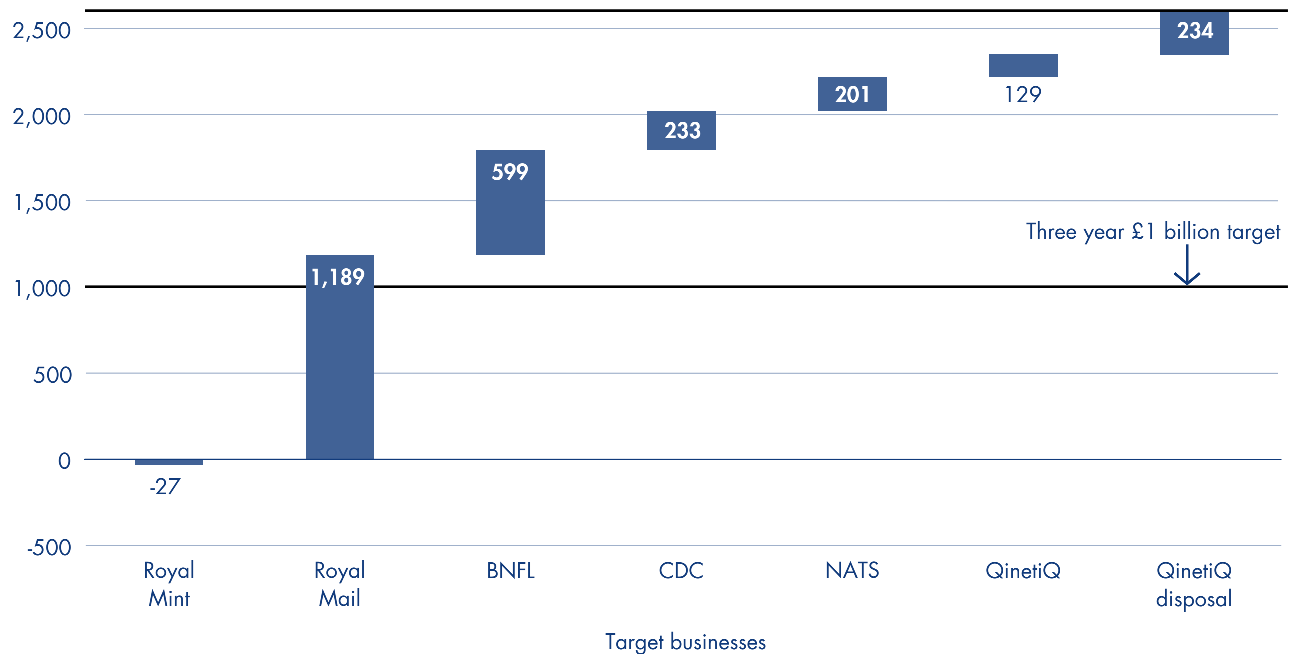
3.7 This appears to have been the case in the first two years (2004-05 to 2005-06) of the three year target reporting period. In these two years, the value of the six target businesses increased by a total of £2.56 billion (£1.64 billion in 2004-05 and £0.92 billion in 2005-06). 47 per cent of this increase was due to Royal Mail and 23 per cent to BNFL over these two years **(see Figure 12 overleaf)**. Over the next year, the investment in Royal Mail, if approved, could erode a large portion of the value increase achieved in these two years because it will take a few years before the business can provide a return on the additional capital invested in it. This would not necessarily be an indication of poor performance on the part of the Executive. As progress towards the financial target might be affected in this way, alternative targets would better reflect the Executive's performance with respect to each of the businesses. For example, the Executive could be required to meet an overall portfolio-level target which could be broken into a series of individual business-level targets. To avoid the risk outlined above, the Executive would, over a given reporting period, have to meet a certain proportion of these business-level targets – suitably weighted towards the larger businesses to avoid a loss of focus on overall value.

42 This is generally true of pension fund managers rather than private equity firms, which may select a risky portfolio in an attempt to achieve a higher return on its investments.

12 The Executive's target businesses have increased in value by £2.56 billion in the first two years of the 2004-07 reporting period

But changes in the value of one large business (in this case Royal Mail) can have a massive influence over the performance of the portfolio as a whole (all figures are in £ million).

Cumulative Economic Profit change
Total = £2,557 million



Source: Shareholder Executive

3.8 In paragraphs 2.25 to 2.27 we explained that businesses could have an incentive to hold back dividends and build up reserves of surplus cash against future financing needs. In some cases, the Executive and the business have an agreed rationale for holding back dividends. For the rest of the portfolio, the Executive could examine each case on its merits and construct a dividend target for each business so that reserves of surplus cash do not build up on the balance sheet. Currently the Executive has the initial aim of "providing a progressive return to dividend paying". In the absence of any changes in the Executive's ability to arrange financing for businesses (as proposed below – see paragraphs 3.12–3.13) this target would need to take account of future investment needs so that cash was not unnecessarily extracted from the business by the centre.

The Shareholder Executive itself needs to be seen to be managed for value

Location and reporting arrangements

3.9 The Executive's current governance arrangements do not fit well with its government-wide mission, as discussed earlier (paragraphs 2.19 –2.20). The Chief Executive retains a supportive link to the Cabinet Secretary which is valuable as a line of communication but an institutional link would give it greater central authority. The Executive also reports to the Stakeholder Group which monitors the Executive's performance against its objectives. Membership of this Group could be extended to include, as it once did, a Cabinet Office representative and representatives from other shareholding departments. The Group carries out a valuable role as "champion" of the Executive across

government but may not be in the best position to carry out the challenge function. As representatives of the shareholding departments they also have policy interests in the businesses which could make it difficult for them to take an independent view on the shareholder value objectives. Changes to reporting arrangements - such as the creation of a Board of Directors to reinforce management accountability – could improve the Executive's ability to carry out its government-wide mission and increase its effectiveness. The New Zealand approach to public shareholdings is one in which the equivalent body provides advice to ministers under a statutory framework setting out the roles and responsibilities of shareholding ministers and separating commercial from policy aspects.

3.10 Trying to transplant one country's system wholesale to another can cause difficulties. Moreover, establishing similar arrangements in the UK would be time-consuming and costly. An alternative approach which would give the Executive greater central authority would be that the Cabinet Office and Treasury require departments to either delegate full executive responsibility for the ownership of their businesses to the Executive, or explain to the satisfaction of the Cabinet Office and the Treasury why that should not be the case, or why, as with the Ministry of Defence, a joint team would be a better way for the Executive to secure both a direct relationship with the business and a role in advising ministers.

Funding

3.11 The current ring-fenced portion (£4.6 million) of the Executive's annual £5.1 million administrative budget (paragraph 1.6), which followed the move from the Cabinet Office, is currently in place until 2008.[43] Subsequent arrangements have not been finalised and any changes to the Executive's portfolio as a result of this report will have implications for the Executive's current level of funding. There are a number of possibilities including a continuation of the current arrangement under which the Executive does not charge other government departments for its involvement and the Treasury makes provision for government shareholdings within the DTI budget.[44] An alternative option that could be considered would be for the Executive to begin charging departments for its services. There is a possible risk that this would reduce its involvement with departments to an ad hoc advisory role (unless the Executive was required to take on a direct role in managing shareholdings on behalf of departments), and that the charging mechanism would be costly to implement. A third option would be for the Executive's budget to be set independently of the DTI's as in the case of Postcomm (paragraph 3.4) – although this would necessitate a change in status.

Ability to arrange financing

3.12 In the countries we looked at for overseas comparisons, most public businesses are able to borrow from private sources of capital provided they can convince both the shareholder body and private lenders that the business plan is viable, and that they will be able to service the debt and make the required return on capital. Such countries consider that this market discipline and increased shareholder oversight generally favours well thought through investment plans. As a matter of policy, UK Government Accounting excludes this approach on value for money grounds given the lower cost of Government borrowing.[45]

3.13 If the Executive had the ability to provide businesses with access to finance, it would have an additional lever to help it manage for value. This might be achieved in various ways, including the following:

- Government departments could delegate to the Executive a budget, consisting of funds within Departmental Expenditure Limits that were planned for investment in businesses. This would enable the Executive to support, within reason, well thought through investment cases and strengthen its ability to ensure the excess cash was paid back to government.[46] Such arrangements are possible within the current budgetary framework. The Accounting Officer could retain formal responsibility for Government Accounting purposes but would delegate authority to the Executive for investment purposes. It follows that the Accounting Officer could revoke this delegated authority should changing priorities so require.
- Another option would be to give the Executive responsibility for monitoring and reporting on departmental investment planning for public businesses. This would include assessing the impact on shareholder value of the operation of the current framework. This option would make the results of financing decisions transparent and should, therefore, lead over time to better decision-making.

43 The ring-fencing was originally due to expire in 2007 but has been extended by one year.
44 The only exception to this is that the MoD paid 80 per cent of the salary of a staff member of the Shareholder Executive for his role within the joint team which manages the Department's shareholdings in its trading funds.
45 Only the NHS Foundation Trusts are able to borrow against future projected cash flows, and provide a rare example of bodies classified to the public sector that are able to access private capital. Government-owned businesses classified to the private sector are able to raise third party debt.
46 In the case of departments where alternative arrangements exist, the Executive could chair an investment committee which advised the Accounting Officer.

The Executive must plan to maintain the quality of its staff and consolidate its knowledge base

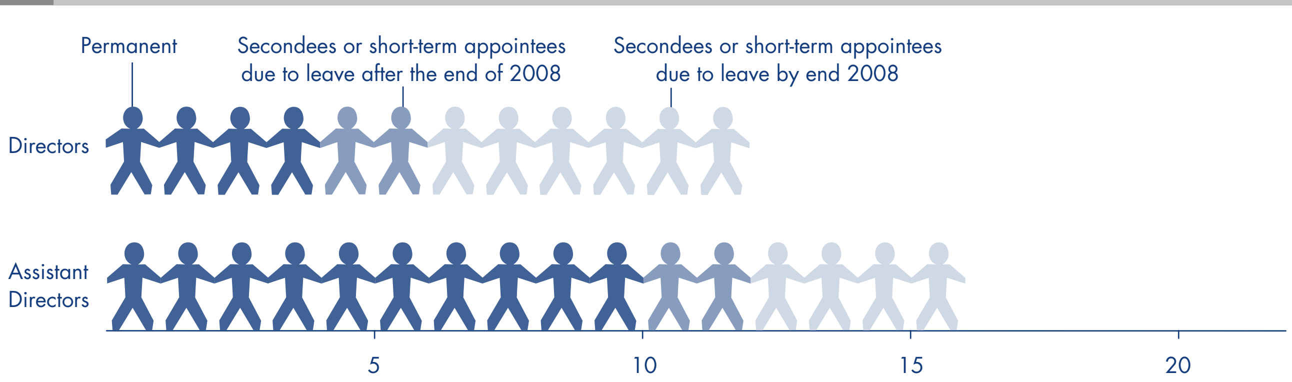
3.14 High calibre staff are essential to the Executive's work. Given the range of commercial issues dealt with by the Executive a significant proportion of its staff are recruited from industry and the financial services sector, currently on fixed-term contracts or on secondment. This benefits the Executive because the steady flow of individuals in and out of the organisation ensures that staff have the most up-to-date knowledge and experience. There are risks associated with this: for example crucial corporate knowledge and experience could be lost and relationships with key stakeholders would need to be re-built following the departure of a particular member of staff.

3.15 The Executive will need to manage these risks through knowledge management and robust succession planning, as part of a broader human resources programme tailored to attracting and retaining the mix of public and private sector skills on which its success depends. It has limited scope to match the remuneration available to staff with similar skills in the private sector because it is bound by the DTI's pay and grading system. The Executive need not try to compensate individuals at the same level as the private sector because it offers unique opportunities – for example, working to ministers on high-profile issues. It may, however, need to have greater flexibility than is afforded under the current pay and grading structure to ensure that the flow in and out of the organisation is maintained under any market conditions. For the Executive to have greater flexibility a change in status would be required. Partnerships UK,[47] for example, also relies on recruiting experienced staff from the private sector and, as a Companies Act company, has greater flexibility over pay and terms and conditions.

3.16 So far, this has not caused difficulties. The first fixed-term appointments and secondments were made at a time when the external labour market conditions were favourable to the Executive because the financial services sector experienced a temporary lull in recruitment and because the Executive was able to offer the attraction of working on interesting public sector deals to potential new recruits. As a number of the original appointments and secondments at a senior level come to an end in 2007 and 2008 these conditions no longer apply if the upturn in recruitment within the City of London continues.[48] This could also make a notable difference to the Executive's corporate knowledge and external relationships, as six of the current 12 directors and four of the 16 assistant directors are due to leave within this two year period. **Figure 13** shows the staff numbers in each category (fixed-term, permanent and secondment) for these two levels.

3.17 Another factor that could affect recruitment is the Executive's perceived proximity to the centre of Government. Decisions taken on the future location and status of the Executive should, therefore, consider the influence these will have on its ability to attract staff with the right skills and experience.

13 Staff numbers by employment status: the ten leavers in 2007 and 2008 could have a significant effect on the Executive



Source: Shareholder Executive

47 Partnerships UK (PUK) is a joint venture between HM Treasury (which owns 44.56 per cent of the company), the Scottish Ministers (which owns 4.44 per cent) and the private sector (which owns 51 per cent). HM Treasury has a substantial minority shareholding. PUK works exclusively for the public sector to improve the delivery of Public Private Partnerships.

48 According to the Centre for Economics & Business Research, a consultancy which compiles figures on trends in City activities and jobs, the number of jobs in London's finance and business services has risen strongly in the last two years. This confirms trends noted by recruitment consultants Joslin Rowe (who reported a downturn in 2003), and Morgan McKinley, whose London Employment Monitor estimated only 2,104 new City jobs in September 2003, compared with 5,733 two years later, and 9,639 in August 2006.

APPENDIX ONE

Study methodology

This section outlines the research methods used in the course of our examination.

Interviews

We conducted in-depth interviews with staff from the following organisations (the number of interviews conducted with each is in parentheses). The interviews generally lasted an hour and were largely semi-structured.

Whitehall bodies

- Shareholder Executive (18)
- DTI (1)
- Cabinet Office (1)
- Treasury (2)
- Ministry of Defence (1)
- Department for International Development (1)
- Department for Transport (2)

Government-owned businesses

- Actis (1)
- British Energy (1)
- BNFL (1)
- CDC (1)
- NATS (1)
- Royal Mint (1)
- Royal Mail (1)

Private Equity Firms

- 3i (1)
- Apax (1)

International bodies (interviews conducted by phone)

- Division for State-Owned Enterprises, Ministry of Industry, Employment and Communications, Sweden

In addition, we corresponded by email with staff from the bodies listed below under 'examination of overseas experience'.

We also attended a "live" meeting of the Stakeholder Group (5 July 2006) and the Shareholder Executive's internal performance monitoring meeting (12 July 2006).

These interviews provided information for all aspects of our work. The more discrete streams of work are highlighted below.

Documentary review and analysis

We have reviewed a range of documentary evidence relating to the Shareholder Executive and its work, and government owned businesses, in particular:

- Correspondence and formal agreements, including Chairman's Letters, between government departments, the businesses, and/or Shareholder Executive
- Agreements and correspondence between Shareholder Executive, DTI, and the Cabinet Office
- The businesses' and the Shareholder Executive's own annual reports, management information and board minutes
- Information on the Executive's and the DTI's remuneration framework
- The Executive's 'Traffic Lights' and Investment Reviews and other documents relating to performance monitoring and review

Organisational review

To deepen our understanding of how the Shareholder Executive operates and how it manages its internal and external relationships, we carried out an organisational effectiveness review. The review used the NAO's Efficiency Toolkit as the basis for structuring questions to understand these aspects of the Executive's working practices.

The NAO's Efficiency Toolkit offers a framework for assessing the various factors which influence an organisation's efficiency, and making recommendations for improvements. Some of these factors are also highly relevant to the organisation's effectiveness, and we drew on these aspects of the Toolkit, including its modules on people management and internal communication. More information on the toolkit and how it can be applied can be found on our website, at http://www.nao.org.uk/efficiency/toolkit/index.htm

Our organisational review work involved interviews with eight of the Executive's directors and group interviews with eleven members of staff below director level. In total we spoke to over a third of the Executive's employees. The interviews were semi-structured with independent facilitators leading the group discussions. These covered topics such as:

- leadership
- external stakeholders
- communication
- people management.

We also integrated some of these inquiries into interviews with external stakeholders such as departments and business representatives (see the schedule above).

We were also advised by an Expert Panel member with specialism in organisational health and effectiveness on the general methods [and design of the questions] for this part of our study.

Case studies

We selected the following businesses for closer examination as case studies on how the Executive manages its shareholdings or equity interests:

- British Energy
- Royal Mail
- NATS
- CDC and Actis (taken together)
- Royal Mint
- BNFL

We also reviewed the Executive's corporate finance advisory work via the Industrial Development Unit.

These particular examples were selected to give us coverage of the different types of working arrangement the Executive has with businesses (i.e. executive, advisory, joint leadership) as we predicted that this would determine the extent of its influence. We also wished to cover businesses of significant value on the grounds that scrutiny of these cases would have greater impact on improving value for money from the portfolio as a whole. These businesses cover approximately 71 per cent of the portfolio by turnover (2005) and 75 per cent by value (as of June 2006).

The case studies were designed to examine whether or not the Executive could demonstrate early signs of effectiveness.

Examination of overseas experience

We considered the general international context to the Shareholder Executive's work, referring to the OECD's 2005 *Corporate Governance of State-Owned Enterprises: A survey of OECD countries*. In particular, we compared the Shareholder Executive's role with that of equivalent bodies in New Zealand, France, Sweden, and Australia. These particular comparators were chosen for a number of reasons. They represent a variety in the size, nature and relative importance of the state-owned sector. Each of the countries has undertaken some reform and centralisation of the state ownership function in recent years, but they have done it in different ways. And the OECD survey highlighted areas of interest and good practice in each one, which provides interesting comparisons for UK experience.

This involved internet research, review of documents such as Annual Reports, and contact with our fellow Supreme Audit Institutions in those countries. We also conducted detailed email and/ or telephone discussions with representatives of the Agence Des Participations de l'Etat in France, the Crown Company Monitoring Advisory Unit in New Zealand, the State-Owned Enterprises Division in Sweden, and the Government Businesses Advice Branch in Australia.

Valuation

We assessed the Executive's application of an Economic Profit methodology to track changes in value over time. In particular, we examined why this particular method was chosen and whether or not it was fit for its intended purpose. This included building the Executive's model from first principles and testing its sensitivity to its assumptions. A brief description of the model and our analysis is provided in Appendix 3.

As the Economic Profit methodology does not provide an absolute valuation of the businesses in the Executive's portfolio, we conducted an exercise to obtain an approximate valuation for the businesses. We generally used a "market multiples" approach which is also described in Appendix 3. The valuation range obtained can be found in paragraph 2.5.

Comparison with private equity firms' approach to shareholding

Private Equity investment managers do not usually apply an explicit set of methodologies in a formalised way, but they do make full use of the shareholder levers (described in Figure 3).

The Private Equity firms we interviewed employ differing skill sets, for example fund managers with business sector expertise but who are also financially astute and well trained; or investment managers with proven financial expertise, but who also have hands-on business experience. Their starting objective is to buy a business at an attractive price relative to how they view its prospects. This could mean, for example, buying in at a low multiple of earnings, intending to exit later when the stock market revalues the sector at a higher multiple of earnings.

Apart from timing the purchase to avoid paying too high an entry price, there are two main value drivers. The first is financial engineering, mainly finding ways to increase the level of debt that can be serviced. The second is taking steps to grow the profits that the entity can generate. This might be achieved by cutting costs, by re-allocating resources or – very selectively – by new investment or an acquisition strategy.

To deliver value, the controlling shareholder has to build a common agenda with the executive management. This is done through agreeing value targets, typically equity related, and rewards that are likewise typically linked to equity. Along with rewards, the methodology also involves applying sanctions, for example dismissing underperforming management, ruthlessly.

Analysis of businesses' financial performance

Using data published in the annual reports of the businesses in the portfolio we conducted an analysis of financial performance, looking at trends in turnover, operating profits before tax and interest and return on capital employed.

As part of the case studies, we touched on financial strategy issues – in particular the significant financial challenges faced by some of these business over the next few years (see paragraphs 3.2 and 3.3).

Expert panel

We put together an Expert Panel to review and challenge our work and thereby provide quality assurance. The panel consisted of a range of experts external to the National Audit Office. They were invited to comment on the emerging findings as we completed our fieldwork, and on the structure and draft of the report. Panel members were:

- Dr Harry Bush, CB — Board Member and Group Director, Econcomic Regulation, Civil Aviation Authority
- Dr Mee-Yan Cheung-Judge — Consultant and organisational effectiveness specialist
- Jonathan Kestenbaum — Chief Executive, NESTA
- Professor David Parker — Research Professor in Privatisation and Regulation, Cranfield School of Management

APPENDIX TWO

The Shareholder Executive's Start-Up Review

A review of Government's performance as a shareholder was commissioned by Sir Andrew Turnbull, then Cabinet Secretary, as part of the Shareholder Executive's initial business plan. The aim was to assess the performance of the Government as shareholder, and to make evidence-based recommendations about how this performance could be improved. The report was discussed in detail with the main shareholding departments and incorporates their comments. The methodology and key findings and recommendations are summarised below.

Methodology

The Shareholder Executive was informed by a broad range of evidence and information, including a detailed review of a sample of seven key portfolio businesses: Royal Mail, NATS, BNFL, QinetiQ, Met Office, Royal Mint and CDC. The Executive conducted an extensive interview programme to gather information. They spoke to a wide range of stakeholders, including departmental officials; board members of government-owned businesses; external advisory firms; and representatives from other relevant parties including regulatory bodies, private equity firms, and overseas government shareholding teams. In total some 97 individuals were interviewed. The report also draws on a detailed review of relevant departmental files and correspondence; company reports and business plans; and published corporate governance guidance.

All this information was used to analyse financial performance, and to assess governmental practice in using shareholder levers.

Findings and recommendations

The Review concluded that, despite some recent progress, the overall performance of government-owned businesses had been poor. 20 of the businesses now within the Executive's portfolio had sustained losses of £2.7 billion over the three years to 2003-04, excluding losses relating to nuclear liabilities. The causes of poor performance reflected a number of weaknesses at both the shareholder and business levels. The report's key findings and recommendations to improve the performance of Government as a shareholder are summarised below.

The report's concluding chapter offers a new model for the management of government shareholdings. It proposes overarching principles, including clarity and transparency of objectives, a shared vision between the Board and the shareholder for the company, robust shareholding involvement in exercising key shareholder levers and a clear incentive framework for Boards to reward long-term value performance.

Finding	Recommendation
Absence of appropriate corporate governance arrangements	Systematic application of corporate governance best practice, including a formal Governance Letter setting out arrangements
Multiple, unclear and inconsistent objectives for government-owned businesses	Clear objectives to be set out in Chairman's Letter, with maximisation of value within the policy and regulatory framework an explicit aim and the financial impact of non-commercial objectives made transparent
Failure to ensure Boards have appropriate skills; little systematic assessment of boards and delays in tackling underperformance	More systematic involvement in board appointments; regular internal and external Board assessments; clear determination to terminate appointments in case of poor performance
Board remuneration and incentives were at inappropriate levels and were not clearly aligned to key high-level targets	Set remuneration at a level to attract high calibre staff, and link individuals' incentives to a few clear targets
Ineffective performance monitoring by the shareholder, coupled with sometimes excessive and ineffective interventions	Clear methodology for monitoring business performance against plan, with intervention more targeted and effective
Poor financial management including a lack of equity and debt discipline	Regular reassessment of capital structure, clear dividend policies, borrowing from government on commercial terms
Inconsistent approach across shareholding departments, with teams lacking appropriate skills and high staff turnover	Introduce a professional and consistent approach to the shareholder function, with suitably skilled and senior staff and good career incentives
Inefficient use of external advisors	Reduce the use of external advisors, build up in-house expertise, improve management of advisors.

APPENDIX THREE

Approaches to valuation

Introduction

Fundamentally businesses purchase assets at a cost with the aim of creating value greater than the cost. Assets can be either tangible such as plant and machinery or intangible such as staff contracts or intellectual property. The historic cost of an asset is usually straightforward to measure and is often a matter of fact. Measuring value is more difficult. An identical asset will be worth more if it is better managed. Valuation methodologies seek to quantify the worth of better management. Any valuation method is a process tool, which makes it subject to the vulnerability of "garbage in, garbage out". This Appendix gives a brief outline of the methodologies used in the course of our study.

Valuation methodologies

During the course of our study we have referred to three methodologies:

Economic profit: The methodology selected by the Shareholder Executive using historic data. On this basis Economic Profit is the after-tax operating profit less a cost of capital charge for the operating assets. It is based on past performance and so cannot be manipulated by future forecasts or by altering the timing of year end cash-flows. Economic Profit has the benefit of incorporating profitability, size of capital base, return on capital and the cost of capital into a single measure;

Discounted cash flow: Discounted cash flow analysis generally uses future free cash flow projections, that is the cash available after all business costs are paid. The cash flows are discounted, most often using the weighted average cost of capital as the discount factor. The resulting present value is a statement of the business's value in today's money;

Multiples: A valuation theory based on the proposition that, in an efficient market, similar assets sell at similar prices. Therefore a ratio comparing value to some business specific variable (operating margins, earnings, etc.) will be the same across similar firms.

The National Audit Office commissioned Accenture to develop a valuation range for the Executive's businesses using a multiples method. The results are set out on page 36.

Economic profit

The Economic Profit Model's prime purpose is to analyse the impact of change to the in year Economic Profit. An analysis of the accuracy of the Economic Profit Model, based on its assumptions has been conducted to understand the impact of varying these assumptions on the model's output. This shows that the Economic Profit Model, in common with other methodologies, is sensitive to the underlying inputs into the model. Where possible, the Executive has reduced the measure's reliance on volatile assumptions to a minimum in comparison with other approaches it could have chosen, by holding stated assumptions constant over the three year period.

Components of the methodology

Weighted Average Cost of Capital (WACC): This is the return owners and lenders expect for investing in an asset. It is the sum of the cost of debt and the cost of equity, each weighted by their share of the overall value of the asset. Increasing the cost of capital usually leads to a decline in change in value of enterprise. However, the sensitivity of value change for each business is different.

Capital structure: The percentage of debt impacts the value change in a business as capital structure is an important component in ascertaining the WACC. Generally, because lenders accept less risk, debt tends to be cheaper than equity and hence highly indebted businesses tend to have lower WACC.[49]

Taxes: Increasing tax has a negative impact on valuation as lower profits are received by equity holders and hence valuation tends to decline.

Growth rate: Growth rates, being predictions of the future, can have dramatic effects on a valuation. The Shareholder Executive model uses a zero growth rate and hence it has no impact on the value change. This intentionally means that the Executive's valuations are not presented as complete valuations of the businesses it supervises.

Generally speaking, adjusting the individual assumptions seems to have a mild impact on the change in value, which reflects the stability of the model. For example, in the case of three businesses (Royal Mail, Royal Mint and NATS) a one per cent increase in WACC (eg 7.80 per cent to 7.87 per cent) leads to decline in change in enterprise value by one per cent. For the other three target businesses this one per cent increase in WACC would reduce enterprise value by two per cent. There is a larger degree of sensitivity to changes in net operating profit, with a one per cent increase typically increasing value by between two per cent and six per cent.

The Weighted Average Cost of Capital is one of the key assumptions that is held constant in the model. This allows the Executive to assess business performance on a constant basis and excludes the possibility of manipulation. The market assessment of risk, however, changes from year to year and would be relevant to a valuation of the business undertaken for other purposes. Below is a comparison of the WACC assumptions of the Economic Profit model vs. WACC rates that emerge by inputting a different beta value into the model[50] – beta is one of the key metrics used to derive the WACC rates. From the table below one can see that dynamic modelling of individual sub assumptions such as beta leads to change in some of the key inputs, which in turn impacts the accuracy of calculation of the change in value.

Discounted Cash Flow

If conducted on the same basis Discounted Cash Flow should produce an equivalent result to Economic Profit methodology.[51]

The advantages of using Discounted Cash Flow are:

- it calculates value of business as the expected cash flow discounted at a rate that reflects the risks inherent to the cash flow. Modelling individual components of the cashflow for different risk characteristics may be advantageous;

14 Change in WACC as a result of change in betas

Dynamic modelling of individual sub assumptions such as beta leads to change in some of the key assumptions, which in turn impacts the accuracy of calculation of the change in Value.

	BNFL	CDC	NATS	Qinetiq	Royal Mail	Royal Mint
Original Equity Beta [Fixed over time]	0.958	0.980	1.167	1.195	1.214	1.050
Accenture Equity Beta 2005	0.403	1.114	0.682	0.598	0.857	1.096
Accenture Equity Beta 2006	0.612	1.308	1.308	1.333	0.856	1.159
Original Post-tax nominal WACC (per cent) [Fixed over time]	7.059	9.512	7.762	8.572	8.634	7.997
Accenture Post-tax nominal WACC (per cent) from beta change 2005	5.261	10.237	6.193	6.315	7.283	8.171
Accenture Post-tax nominal WACC (per cent) from change in beta 2006	5.939	11.285	7.515	9.094	9.084	8.409

Source: National Audit Office

49 The Executive measures Economic Profit at the entity value, in a way which excludes financing effects. The only impact of capital structure comes through the WACC figure. In addition, there is no straight line correlation between WACC and capital structure: if gearing goes beyond a certain point the WACC increases because of a risk that the business cannot service the debt

50 The *beta* is a measure of market risk, based on whether the past observed correlation of a given stock with the stock market is greater than or less than parity. A stock that is considered defensive will have a correlation of less than one – falling (or rising) in value by less than the market movement. Any price movement that differs from the beta is the result of stock specific risk.

51 For a mathematical proof of equivalence see Appendix B of "Valuation: Measuring and Managing the Value of Companies", McKinsey & Company, 2005 (4th edition).

- it is the theoretically strongest approach to estimating the intrinsic value of a company, which enables a detailed bottom up analysis by each cost driver and business segment to be created;
- it is ideal for valuing specific changes to a business or building a range of scenarios, which shows the impact on value of different views of the company's future; and
- it explicitly measures change in cash flows from capital investments.

The two key disadvantages of Discounted Cash Flow are that:

- it is time consuming to get right, which includes selecting an appropriate discount rate; and
- it includes a wide range of forward looking forecast assumptions, the accuracy of which significantly affect the ultimate valuation of a company.

Multiples

Generally speaking, multiples are considered an inferior method of valuation unless there are very good comparators. The principal reasons are:

- they are too affected by one-time events;
- it is difficult to account for future events; and
- it is difficult to account for risk differences between businesses.

The use of multiples has advantages. It incorporates a variety of information in a simple way. It implicitly includes market consensus about comparable businesses discount rate and growth. It is in effect a free ride on the available market information. Business multiples are most often used to value privately held companies where market pricing and valuations do not exist. This is an analogous situation to that of government owned businesses. A second common use is to validate the results produced by other methods. A careful review of a company's multiples against those of its competitors can help verify those alternative valuations.

The principle underlying the method is to search the equity markets for businesses most comparable to the target business. Important characteristics include: operating margin, company size, products, customer segmentation, growth rate, cash flow, location of operations, etc. Once this is done an average multiple is calculated. There are a number of ways of calculating the multiple. The most common method is to use Enterprise Value divided by Earnings Before Interest Tax Depreciation and Amortisation. This multiple is then applied to the Earnings Before Interest Tax Depreciation and Amortisation of the target business to arrive at an Enterprise Value.

In carrying out the valuation exercise, Accenture identified a number of close comparators for seven of the businesses covered by the Shareholder Executive. Accenture found moderate comparators for a further nine businesses. Two businesses have stock exchange listings, providing market valuations. Finally nine companies did not have appropriate listed comparators and were therefore not considered. The results cover 18 businesses in the portfolio for which a market value or close and moderate comparators could be found.

The valuation exercise generated two separate ranges. The higher valuation range was between £17.1 billion and £20.8 billion as of 30 June 2006.

This can be broken down by segment as shown in **Figure 15**.

15 The valuation range for businesses in the Shareholder Executive's portfolio, by type

Segment		Valuation range[1] (£ million)	
		Lower end	Upper end
Listed businesses	British Energy QinetiQ	5,643	5,643
Investment businesses	CDC Actis ECGD	4,722	5,209
Utilities	BNFL Royal Mail UKAEA NI Water Service Scottish Water	5,755	8,723
Service businesses and others	NATS Channel 4 Ordnance Survey Working Links DSTL Royal Mint Covent Garden Market Authority Tote	991	1,209
	Total	**17,111**	**20,784**

Source: National Audit Office

NOTE

1 This valuation range excludes liabilities that Accenture considered equivalent to debt obligations, such as pension liabilities and significant operating leases. The impact of the latter on value is not always fully captured by a company's reported financial information. Taking such liabilities into account reduces the valuation range by more than half to between £4.97 billion and £8.84 billion.

APPENDIX FOUR

International approaches to Government Shareholding

As part of our investigation, we considered the Shareholder Executive's role within the broader international context, and with particular reference to experiences in Sweden, New Zealand, France and Australia. The methodology is explained in Appendix 1. The findings of this work are summarised here.

The International Context: the government shareholding function in OECD countries[52]

In spite of a wave of privatisations during the 1980's and 1990's, the role of state ownership in OECD economies remains significant, described by the OECD as 'remarkable for its size [and] economic impact' (p. 21). The UK's government-owned businesses had a turnover well in excess of £25 billion in 2005, or well over two per cent of GDP; by comparison, state-owned enterprise turnover is over five per cent of GDP in New Zealand and over 10 per cent of GDP in Italy, Sweden and France.

Although individual circumstances within each country may vary, there are common issues faced by state-owned businesses internationally. Foremost among these is a lack of exposure to market disciplines: the threat of takeover or bankruptcy is largely absent. Most of the OECD government businesses are fully or majority owned by the state; only a minority are listed. Secondly, there is also often no clear owner of the business, but instead a range of competing stakeholders with differing objectives: civil servants, different Ministers, parliament and the general public. This can cause difficulties in the articulation of clear business objectives, and in the relative prioritisation of commercial, policy and regulatory interests.

The OECD survey examines how the ownership function is organised in different countries, categorising models into three basic types, termed Sector, Dual and Centralised. **Figure 16** defines each model, and gives advantages and disadvantages of each one.

16 Basic ways of organising the state ownership function

Type of ownership	Advantages and disadvantages
Sector (Decentralised): state-owned enterprises are under the responsibility of relevant sector ministries	Industry expertise concentrated in one area, but harder to separate policy or regulation from shareholding issues, as all lodged together.
Centralised: ownership is concentrated in one Ministry, usually Finance or Industry	Clear separation of shareholder function from policy and regulation and consistency in ownership approach. Centralisation of expertise; possibly resultant greater flexibility in remunerating necessary private sector skills. Risk of too strong a commercial focus.
Dual: ownership shared between sectoral Ministry, and a central one, usually Finance	Scope for clear separation of roles, but also for businesses to become too powerful if neither Ministry exercises control effectively. This model has generally evolved as a result of Finance Ministry power, rather than through design.

Source: OECD and National Audit Office

52 The OECD published Corporate Governance of State-Owned Enterprises: A survey of OECD countries in 2005, following a trend of reforms in the way member countries organise their shareholding functions. This section is based on their work.

Trends in ownership of the government shareholding function

There has been a trend in recent years towards centralisation of ownership itself **(see Figure 17)**, or at least towards creation of a co-ordinating body to provide consistency in ownership policy. As with the state businesses, common issues internationally are also faced by the state ownership bodies. They may require a degree of autonomy in order to bring sufficient focus on ownership and value interests. They also generally need to be able to recruit people with specialist private sector skills. Greater autonomy may make a body better able to attract such skills, and allow greater flexibility in setting remuneration outside the usual constraints on public sector organisations.

Case Example: New Zealand

New Zealand's Crown Company Monitoring Advisory Unit (CCMAU), set up in 1993, is one of the longest-established international equivalents of the Shareholder Executive.

The New Zealand model of state ownership offers a clear separation of shareholder value from policy and regulatory interests, with certain ministers given a specific remit to focus on commercial priorities. Primarily this remit rests with the Minister of State-Owned Enterprises, who is responsible for shareholder value in the 18 state-owned enterprises. The Minister for Crown Research Institutes has similar responsibilities for the nine Crown Research Institutes. Other Ministers have responsibility for the shareholding in individual companies, as can be seen in **Figure 18**. In each case the Minister of Finance has 50 per cent ownership, with the other relevant Minister owning the remaining 50 per cent. CCMAU has an advisory and monitoring role for all such businesses.[53]

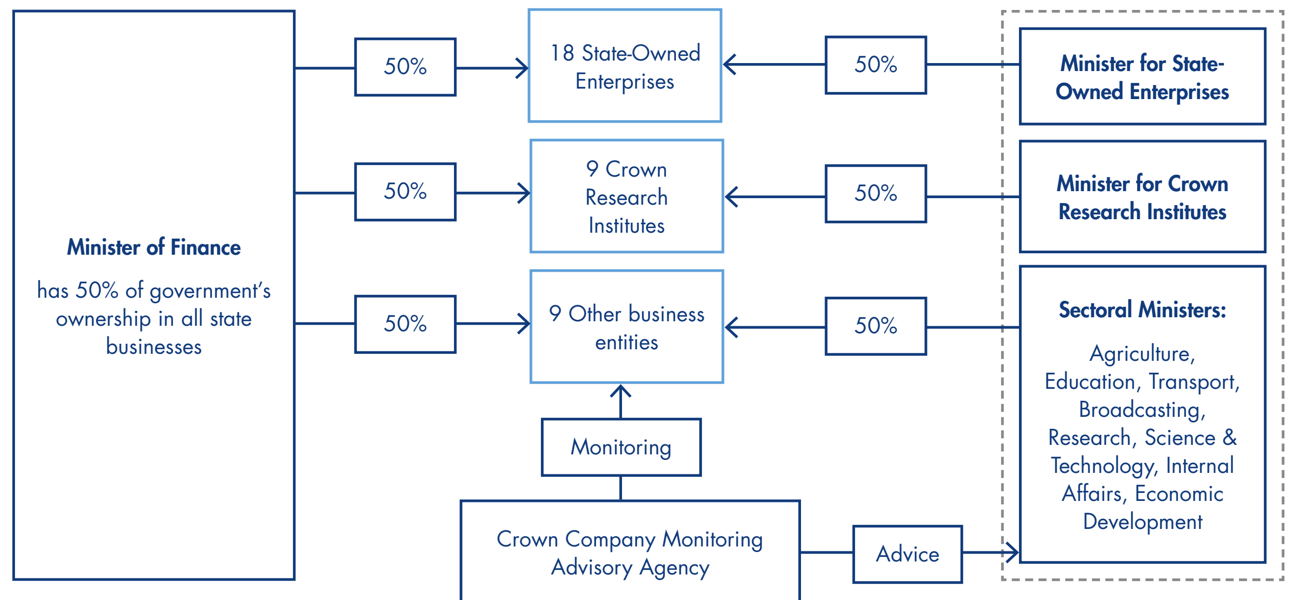
17 The OECD survey shows a trend towards centralisation of ownership function in western governments

Date	OECD country	Nature of centralising reform
1993	New Zealand	Crown Companies Monitoring Advisory Unit established to advise the Ministers responsible for shareholder value in government businesses.
1997	Australia	Commonwealth Shareholder Advisory Unit (now Government Businesses Advice Branch) established to provide commercially focused advice to the Minister of Finance and Administration. The Commonwealth's ownership interest is generally represented by the Minister for Finance and Administration and the relevant portfolio Minister.
1998	Sweden	Ownership of the majority of government businesses centralised to Ministry of Industry, Employment & Communications, to be overseen by a dedicated Division for State-Owned Enterprises (SOEs).
1999	Finland	Revision of ownership procedures, but ownership still sectoral, with a Unit in the Ministry of Trade and Industry playing a co-ordinating role.
	Netherlands	Ownership function centralised to the Ministry of Finance, late 1990's.
2001	Denmark	Ownership responsibility for 11 SOEs transferred to a special unit within Ministry of Finance.
2002	Norway	Supervision of a number of SOEs transferred and consolidated in a special unit of Ministry of Trade and Industry.
	Sweden	Division for State-Owned Enterprises given greater responsibility (for board nominations and ownership policy).
2003	UK	Shareholder Executive established.
2004	France	Ownership centralised and the Agence des Participations de l'Etat (APE) created to oversee the function.

Source: OECD

53 There is one exception, Air New Zealand, where the Crown's majority ownership interest is overseen directly by the Treasury.

18 Dual but centralised ownership of New Zealand government businesses



Source: Crown Companies Monitoring Advisory Unit, New Zealand

For the State owned enterprises, policy is kept separate from commercial priorities not only through this ownership structure, but also through a requirement of the State-Owned Enterprises Act, that activities required for policy rather than commercial reasons are carried out through arms' length contracts which make their cost explicit.

CCMAU exists to advise the Minister for State-Owned Enterprises on business performance, and strategic ownership issues. It is a centre of expertise on governance and appointments, and also provides other ministerial support. It plays an active monitoring role, receiving and analysing quarterly reports from the businesses. Whilst it does not set value targets for the businesses, it does encourage the use of Economic Value Added reporting, similar to the Shareholder Executive's Economic Profit measure.

Although housed within Treasury for administrative reasons, CCMAU is independent. It has about 21 employees, organised into four teams, three of which are sectoral and one specialising in governance and appointments. As a small public sector organisation requiring specialist skills, it faces similar staffing and corporate knowledge risks to the Shareholder Executive (see paragraphs 3.14 – 3.17), managing these by ensuring more than one advisor works on each business at any given time, and by careful rotation of advisors between businesses.

Case example: Sweden

Sweden centralised the ownership of most of its government shareholdings to a new dedicated division within the Ministry of Industry, Employment and Communications in 1998. The State-Owned Enterprises Division is currently responsible for some 36 out of the Swedish government's 57 wholly or partly-owned companies. The businesses which remain with the relevant sectoral ministries are there because they are considered to have special societal objectives which may outweigh commercial concerns.

There are parallels with the Shareholder Executive, in that the Division sits within a department which has policy responsibilities relevant to some of the businesses; and also in not having full responsibility for all government businesses.

Sweden addresses the first of these issues with a thorough 'Chinese walls' division between the shareholding division and any relevant policy teams within the department. As regards the businesses owned by other departments, the State-Owned Enterprises Division still has a significant role in their oversight, being responsible for the overall state ownership policy, for the board nominations process, and for quarterly and annual reporting of consolidated summary accounts showing turnover, profits, gross cashflow, and balance sheet figures.

19 The role and functions of equivalent shareholding bodies overseas

Country and Ownership unit	Role in Board appointments	Business objectives	Dividends and finance	Valuations of businesses
New Zealand				
CCMAU, independent team of 22 located in Treasury	No seat on Board, but CCMAU manages the process for identifying and appointing new directors; with the final decision resting on Ministers.	CCMAU reviews and advises the Minister for SOEs on the financial targets set by Boards in their Statements of Corporate Intent. State-Owned Enterprise legislation requires commercial profitability.	Dividend policy required as part of Statement of Corporate Intent, approved by Minister for SOEs. SOEs are able to borrow privately; the government explicitly does not guarantee the loans.	CCMAU does not value the businesses.
Sweden				
Division of 20 staff, within Ministry of Industry	Senior Division staff have seats on Boards. The Unit is also responsible for the nomination process for external candidates, ultimate decision being the Minister's.	The Division sets businesses targets on profitability, dividend payment, and financial structure. Key role in strategy due to seat on board.	Sets dividend requirement for each company, as a percentage of profits. State owned companies normally borrow in private markets and are not allowed to borrow from the state except in exceptional cases.	Annual valuations obtained from external experts, but results not all made public.
France				
APE, Agency of Finance Ministry, c. 60 staff	APE will have a seat on the Board, but minor role in other board appointments.	Businesses have profitability and debt sustainability targets.	Companies are financed through private borrowing, with no state guarantee.	No explicit value targets.
Australia				
Australia Government Businesses Advice Branch (GBAB)	Advice to Minister for Finance and Administration on board composition and potential candidates where relevant.	Principal objective for all Government Business Enterprises (GBEs) is to add to shareholder value.	Estimated dividend levels agreed annually between Directors and shareholding Ministers, who prefer dividends over capital growth. Government Businesses usually borrow from private markets.	No explicit value targets. GBAB does not value the business unless examining the future ownership options of the entity.

Source: National Audit Office

APPENDIX FIVE

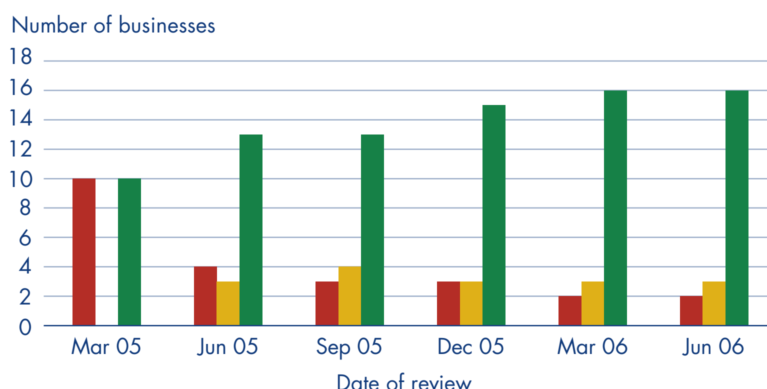
The Executive's internal reporting

As illustrated by **Figures 20 to 22**, the "traffic lights" evaluation takes the form of a quarterly assessment against six key categories: implementation of the shareholder model; the shareholder relationship; balance sheet and risk; future strategy; the management team and financial performance. Each test is broken down into several different criteria, some of which are objective (in the form "yes/no" factual answers) while others are more subjective (such as an assessment of quality of management). A positive score against most of the criteria will lead to a business being given a green mark within a test, an amber colour where there is a mixture of positive and negatives, and a red colour where several, or particularly critical, scores are negative.

Figures 20 to 22 provide a summary of the number of red, amber and green traffic lights achieved against each of the six key categories since the Executive first started conducting these reviews in March 2005.

20 Between March 2005 and June 2006 most businesses became fully compliant with the Shareholder Model and the extent of engagement between the Executive and businesses improved

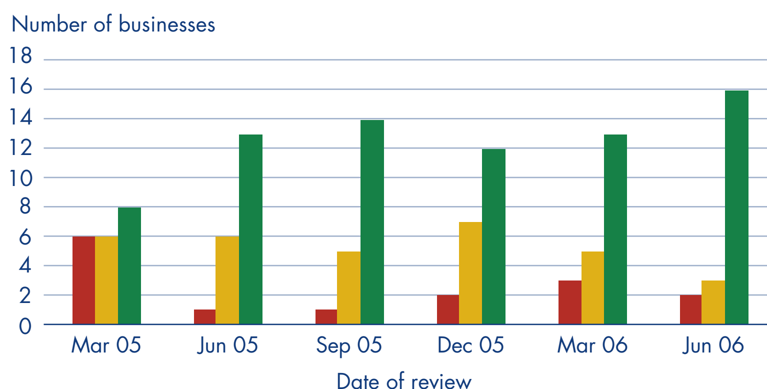
a) Implementation of Shareholder model



Main criteria:

- There is a Governance letter, Chairman's letter, Statement of Government Objectives for the business.
- There is a clear separation of business management from policy.
- There are appropriate shareholder monitoring and remuneration frameworks and timely financial information is available on a regular basis.

b) Shareholder Relationship



Main criteria:

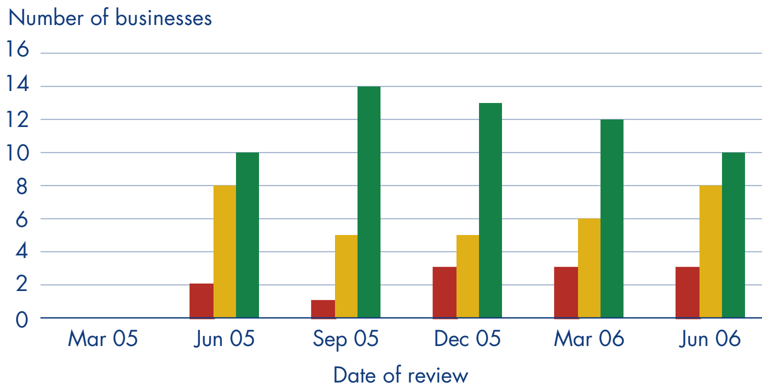
- Staff in the company have regular and informative contact with Executive.
- There is a "no surprises" policy between the company and the shareholder.

Source: Shareholder Executive

The principal benefits brought by the Executive's new approach mean that the monitoring of strategy and performance is now more active, systematic and consistent for those businesses within the Shareholder Executive's remit. Another aim of quarterly 'traffic light' reviews is to provide early warning of potential problems. Compared to the rapid progress shown in Figure 20, Figure 21 shows that, as one might expect, it takes longer to tackle the issues around strategy, balance sheet and risk.

21 There was a mixed picture between March 2005 and June 2006 after some early improvement with respect to Balance Sheet Risk and Strategy

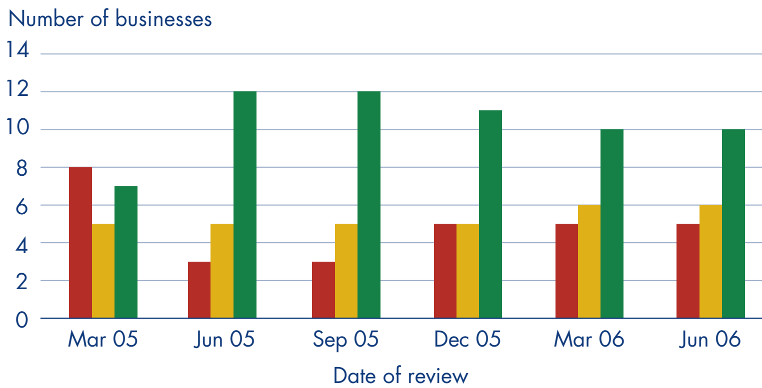
a) Balance Sheet and Risk



Main criteria:

- There is an agreed balance sheet strategy; a capital structure in place (which provides adequate funding for the business in the medium term), and dividend policy (if dividends are able to be paid).
- There is no major pension deficit or any major issues with liabilities and the balance sheet is solvent.

b) Strategy



Main criteria:

- The Board and the Shareholder have a shared understanding of the strategic agenda.
- The strategic plan has been suitably scrutinised, is credible, is likely to create/enhance value; and do the right things for the business.

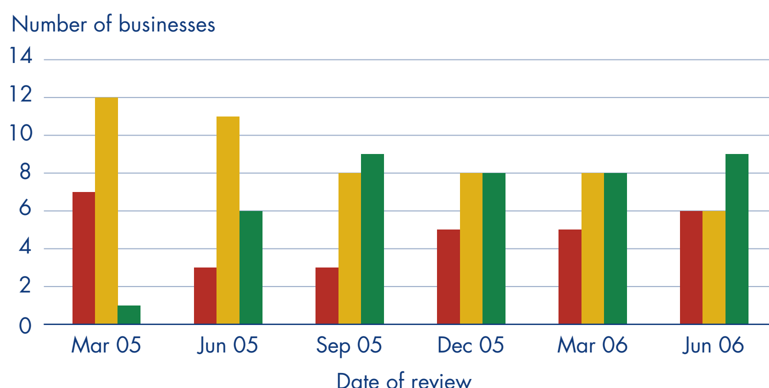
Source: Shareholder Executive

The Executive has also taken steps to ensure that management teams and Boards are sufficiently strong (Figure 22a), showing some progress although 18 months is a relatively short period to implement planned improvements. Taking all the right steps would be expected to stabilise and then improve financial performance – the final chart (Figure 22b) shows that it is still early days in this regard:

This traffic lights model is used only an internal monitoring tool and the Shareholder Executive does not make public the appraisal status of an individual business.

22 There was limited progress between March 2005 and June 2006 as the steps taken need more time to show results with respect to proven Board quality and Financial Performance

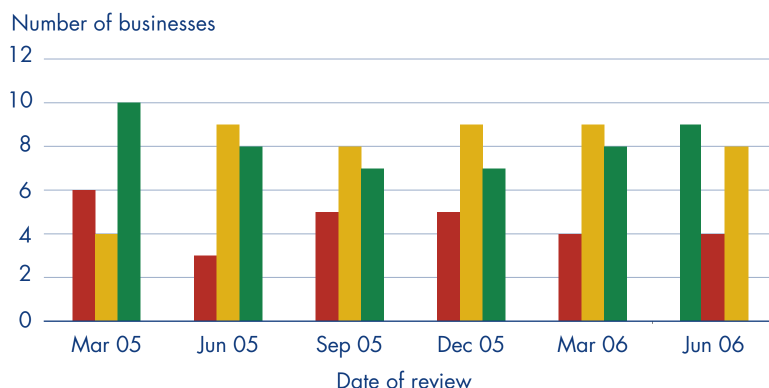
a) Management Team and Board



Main criteria:

- The right board dynamics are present with a strong non-executive director team; and a succession plan for senior management.
- The Board is compliant with the Combined Code and has reviewed its own performance recently.

b) Financial performance



Main criteria:

- The company produces positive economic profit; and the business is performing in line with or ahead of budget.
- The company is maintaining or improving financial performance over the foreseeable future and the business is free form any substantial accounting anomalies.

Source: Shareholder Executive

APPENDIX SIX

Previous PAC and NAO references to shareholding issues

Report	Conclusions and recommendations on improving value for government as shareholder
NAO report: Financial Support for Post Offices, HC 287 (2004-05) Publication Date: 24/02/2005	The Department, as shareholder of Royal Mail Holdings, has put in place sound arrangements for monitoring the company's performance. The Department, through its Shareholder Executive, should ensure that it has in place similar arrangements for other companies in which the Government has a majority shareholding.
NAO report: Risk Management: The Nuclear Liabilities of British Energy plc HC 264 (2003-04) Publication Date: 06/02/2004	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.
PAC report: Risk Management: The Nuclear Liabilities of British Energy plc PAC 37th Report (2003-04) Publication Date: 09/09/2004	The Department failed to establish a credible overview of British Energy's deteriorating financial position, and did little more than gather information. Its inaction was compounded by split responsibilities for monitoring British Energy and the design of the New Electricity Trading Arrangements. In designing and coordinating energy policy it failed to consider the taxpayer's potential exposure. The Department should establish effective oversight of British Energy's financial position. British Energy's management did not respond effectively to the changes in the electricity market and the Department did not challenge the company's strategic direction.
PAC report: The Acquisition of German Parcel PAC 10th report, HC 422, 2001-02 Publication Date: 11/01/2002	The Department should ideally have had agreed overall financial targets for the Post Office's business, taking into account the proposed acquisition strategy, before they agreed to the acquisition of German Parcel. They should for the future set clear financial targets and milestones for both an acquisition and the overall business in advance of an acquisition and monitor them rigorously.
NAO report: The Acquisition of German Parcel, HC 858 (1999-00) Publication Date: 24/08/2000	One of the 'points of good practice' departments could follow to protect the interest of the taxpayer when handling major acquisitions: ■ formation of a departmental team with corporate finance experience and sectoral knowledge, supplemented by external advisers, to oversee the acquisition being kept fully informed on all aspects including negotiations and due diligence.
PAC report: The Flotation of Railtrack HC 256 (1998-99) Publication Date: 14/07/1999	[On policy-driven timing of the sale and implications for value] The Department claimed that the timing of the sale was influenced by the need to maintain the momentum of the rail privatisation programme…Given their view that the timing of the sale was likely to have an adverse impact on proceeds we are concerned that the Department did not do more to identify the potential of the business and more to maximise its value. [On not phasing the sale to maximise value] We note that the Department decided to opt for a 100 per cent sale on the basis of their judgement that it would not have been possible to phase the sale of shares over a period of years. This decision had important implications for the potential value to be secured from the sale.…we are not convinced that they gave this option the thorough investigation that it merited……

Report ***(continued)***	**Conclusions and recommendations on improving value for government as shareholder** ***(continued)***
PAC Report on The Sale of Railfreight Distribution, HC 601 (1999) Publication Date: 10/11/1999	This marked difference [between projected and actual freight volumes] leads us to question whether the minimum usage charges [guaranteed until November 2006] were set to get the best possible result for British Rail or, rather, set at a level to support Eurotunnel, leaving Railfreight Distribution to bear the financial consequences. The volume of freight carried was…of key importance to the success of the business and its value in the long term. Yet the Department did not think creatively about how to encourage growth in rail freight…. We urge departments to think creatively about how to extract the maximum value from their assets. The Department managed to attract only two bidders. We are not convinced that the challenging timetable they set for the sale did not discourage other bids….[To encourage strong competition in bidding] we recommend that in future sales departments set timetables which give bidders adequate time to consider their bidding strategy, including the options for forming consortia with other interested parties.
NAO report: The Flotation of Railtrack HC 25 (1998-99) Publication Date: 16/12/1998	In future flotations, we recommend that departments should: ■ Begin the privatisation process with the presumption that better value for money will be obtained by selling shares in stages, with a view to disposing of the remaining shares through a subsequent sale, or series of sales, once the company has established a track record in the private sector. ■ Ensure that the company is floated with the most favourable capital structure to maximise the sale proceeds using the optimum mixture of debt of equity.
PAC report: The Sale of the Stationery Office HC 599 (1998) Publication Date: 15/06/1998	The Office of Public Service took a hands-off approach to the business…and chose to limit their role to providing advice to Ministers only if requested. In the light of HMSO's increasing commercial problems, we consider that the Office of Public Service should have taken an active interest in the business and should have taken the initiative, in defence of the taxpayer's interest, to advise Ministers about the need for action to help performance. Not doing so contributed to a loss of value in the sale. We do not accept the Office of Public Service's view that the provision of advice to Ministers about the decision to sell was the responsibility of the Chief Executive of HMSO because he was the Accounting Officer. It is contrary to good practice to leave it to the management of a business which is to be sold to take the lead in advising on a decision to sell. HMSO had provision for up to three non-executive directors, but positions were allowed to remain vacant after July 1995. Individuals with commercial experience to draw upon could have seen how badly HMSO was being run and could have alerted the management and the Office of Public Service to the risks. We are not convinced that the Office of Public Service obtained full value for money from their financial advisers, Coopers & Lybrand.
PAC report on British Rail Maintenance Ltd: Sale of Maintenance Depots HC 168 (1996-97) Publication Date: 03/04/1997	…The Committee note that the Department agreed objectives for the sale with British Rail. We are concerned that they did not then monitor British Rail's handling of the sales more closely to assure themselves that agreed procedures were being properly applied in all key respects. We regret that the Department did not ensure that comprehensive valuations of the maintenance depots were carried out…Experience suggests that the process of considering how a business should be valued enhances the vendor's understanding of the enterprise, and its underlying assets. It should also give the vendor an insight into the appeal that they may have to various potential purchasers. We are surprised and regret that the Department did not inform themselves about the expected financial performance of the businesses to be sold.
PAC report: The Sale of the Water Authorities in England and Wales HC 140 (1992) Publication Date: 13/07/1992	We therefore recommend that consideration should be given in future cases for responsibilities for regulatory decisions and for selling to be located separately. This would enable the Departments concerned to demonstrate clearly to Parliament that both had received full attention.

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