National Audit Office

The Shareholder Executive and Public Sector Businesses

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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).