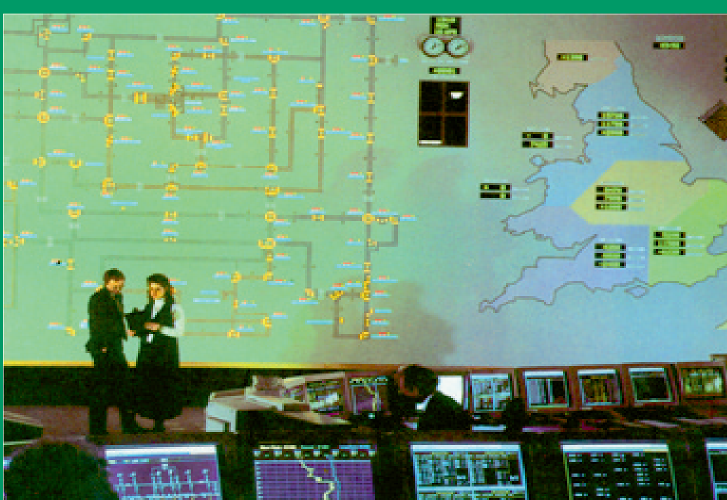
NATIONAL AUDIT OFFICE

Report by the
Comptroller and Auditor General

Department of Trade
and Industry

Obtaining a Benefit for Electricity Customers from the Flotation of the National Grid



HC 651 Session 1997-98
27 March 1998

Contents

Executive summary

1 Ownership of the National Grid (the network of high voltage transmission lines in England and Wales) was transferred from the Central Electricity Generating Board to the regional electricity companies prior to their privatisation in 1990. Since privatisation, the market values of the regional electricity companies had increased significantly. In 1994, the regional electricity companies announced their intention to float their National Grid shares on the London Stock Exchange and transfer them to their own shareholders. In addition, the National Grid's Pumped Storage Business (a source of hydro-electric power at times of peak demand) would be demerged and sold. To float the shares and demerge the Pumped Storage Business, the regional electricity companies needed the consent of the Government, which held special shares in the National Grid.

Special shares

2 Special shares owned by the Government (sometimes known as golden shares) were created in most companies on privatisation. The companies in which special shares have been retained are listed at Appendix 1. The reasons for having special shares varied. In many privatisations there was a need to protect a business from unwelcome take-over on the grounds of national security or, as a temporary measure, to provide an opportunity for company management to adjust to the private sector.

3 The special shares require that certain provisions in the Articles of Association of privatised companies may not be changed without the specific consent of the special shareholder. The details of the provisions in the Articles of Association vary according to the circumstances of each company but they typically include a prohibition on any one person (or group of persons acting in concert) controlling 15 per cent or more of the ordinary shares of the company. Unlike ordinary shares, however, the Government's special shares do not carry any rights to future dividends paid by the companies.

4 When a company in which the Government retains special shares proposes to alter its structure or ownership, the question arises as to what the Government should do to protect the public interest. This report deals with the Government's response to proposals put forward by the regional electricity companies to transfer the National Grid to their shareholders. As the Department of Trade and Industry (the Department) held the special shares in the National Grid on behalf of the Government, they had to decide what steps should be taken.

The Department's objectives

5 The flotation was completed in December 1995, following negotiations over 18 months between the regional electricity companies and the Department (a chronology is at Appendix 2). In these negotiations, the Department aimed to achieve two key objectives:

a) to maintain competition by ensuring that the National Grid would remain independent of the rest of the electricity industry;

b) to obtain a visible benefit for electricity customers. In pursuit of this objective, the Department aimed for a 50:50 split between regional electricity companies' domestic customers and their shareholders of the estimated increase in the value of the National Grid, after tax payable by the companies on the capital gain had been deducted.

6 This report analyses how the Department went about achieving these key objectives and what lessons may be learned for future cases where the existence of special shares can play an important role in securing the public interest following a change in the status of the company concerned.

Findings and conclusions

7 The flotation was a private sector transaction, the structure of which was primarily a matter for the regional electricity companies, who owned the National Grid. Although the regional electricity companies needed the Department's consent as the holder of special shares, the Department could not insist on a customer discount. At an early stage in negotiations the Department sought professional advice on the legal and financial implications of a flotation. The Department's ability to influence the regional electricity companies was constrained by two factors. First, if the companies were not content with elements of the Department's negotiating stance, they had the option of abandoning the flotation and seeking to enhance shareholder value by other means. Secondly, if the Department had withheld consent to changes in the Articles of Association purely on the grounds that the proposed customer discount was not large enough, the regional electricity companies could have had a basis for a legal challenge under company law or through judicial review. Against this background, **we conclude that the Department successfully achieved their key objectives in negotiations with the companies.** This general conclusion is considered in more detail below.

Objective 1: To maintain competition in the electricity industry

8 On privatisation, the Government created a two-tier structure which separated ownership of the National Grid from its day to day operation. An arms-length relationship was established between The National Grid Company, which operated the transmission system, and National Grid Holdings which owned the share capital of the National Grid Company. With the exception of a small number of shares owned by employees, National Grid Holdings became a jointly-owned subsidiary of the regional electricity companies. To maintain their independence, the Government held special shares in both companies (paragraphs 2.2 - 2.4).

9 On flotation, the Department redeemed the special share in The National Grid Company. They retained, however, a special share in National Grid Holdings (renamed the National Grid Group). The Articles of Association of the new National Grid Group replicated existing restrictions on directors of electricity or generating companies becoming directors of the National Grid Group and added two further provisions:

a) companies operating in the electricity industry were not allowed to own more than one per cent of the National Grid Group's issued share capital; and

b) the National Grid Company and the National Grid Group were precluded from entering the market for electricity generation.

The Department thus achieved their objective to maintain competition by ensuring that the National Grid remained independent of the rest of the electricity industry (paragraphs 2.5 and 2.6).

Objective 2: To obtain a visible benefit for electricity customers

10 The Department considered that it would be equitable for some of the increase in value of the National Grid since privatisation to flow to customers. Following negotiations between the Department and the regional electricity companies, agreement was reached in September 1995 that domestic customers would each receive a net discount of £52 from their electricity bills in early 1996. This was worth, in total, £1,118 million and was equivalent to a 17 per cent reduction on the average electricity bill of £300 a year. **The Department therefore achieved their objective to obtain a visible benefit for electricity customers (paragraphs 3.2 - 3.4 and 3.16 - 3.18).**

Did the Department achieve a 50:50 split between customers and shareholders of the increase in value of the National Grid?

11 On flotation in December 1995, the National Grid had increased in value by £2,974 million since privatisation. The Department aimed to achieve a target of a 50:50 split of the increase in value, after deducting the gross tax liability of the regional electricity companies on their capital gains in the National Grid and from the sale of the Pumped Storage Business. We estimate that the regional electricity companies' gross tax liability on the capital gains was £630 million, giving a tax-adjusted increase in value of £2344 million. On this basis, the customer discount of £1,118 million represented 48 per cent of the net increase in value of the National Grid. **The Department therefore narrowly missed their negotiating target to agree a customer discount which represented half of the tax-adjusted increase in value (paragraphs 4.3 and 4.4)**.

12 Apart from the regional electricity companies' gross tax liability on their capital gains, there were a number of other tax consequences of the flotation which the Department decided should be disregarded in negotiations on the size of the customer discount. If the Department's negotiating target had included these other tax consequences then the customer discount of £1,118 million would have represented about 36 per cent of the increase (paragraphs 3.13 and 4.5).

Who financed the customer discount?

13 Of the £52 discount for each domestic customer, the regional electricity companies financed £31 from special dividends paid to them by the National Grid and from the sale of the Pumped Storage Business. The balance of £21 was provided by the taxpayer and non-domestic electricity customers. There were two reasons for this. First, consistently with normal tax rules, the discount had the effect of reducing the taxable profits of the regional electricity companies, resulting in a lower charge to tax equivalent to £15 per customer. Second, there was a consequential reduction of £6 in the amount of VAT and Fossil Fuel Levy on each customer's discounted electricity bill (paragraph 4.6).

Could the Department have negotiated a higher customer discount?

14 The Department were aware that if a 50:50 split was to be achieved after taking all the tax consequences of the flotation into account, they would have had to seek a higher discount than was actually obtained. The Department considered, however, that the companies could not be persuaded to agree to a higher figure. The directors of the regional electricity companies were constrained by the fact that, like other companies, they had a legal responsibility to use shareholders'

funds in a way which could be justified on commercial grounds. They felt that this limited the size of the customer discount they were able to pay. The Department were concerned that making a higher discount a condition of their approval to the flotation could have risked legal challenge or the abandonment of the flotation by the regional electricity companies. This risk was heightened during the closing stages of negotiations by increasing take-over and merger activity within the electricity industry. If the flotation had been abandoned, the National Grid would have remained under the ownership of the regional electricity companies who could still have extracted dividends from the National Grid for use in their businesses or to pass on to their shareholders. Electricity customers would not have benefited (paragraphs 3.14 and 3.15; 4.7; 4.14 and Appendix 4).

15 Nevertheless, there was one aspect of the negotiations which could have been handled differently. In negotiations, the Department accepted the regional electricity companies' estimate that the Pumped Storage Business would be worth £300 million when it was sold as part of the flotation. However, the sale was completed two weeks after the flotation for proceeds of £680 million. Although the Department consider that this outcome was unexpected, they did not seek an independent valuation of the Pumped Storage Business to inform negotiations with the regional electricity companies. An independent valuation we commissioned indicated that a higher value could have been placed on the Pumped Storage Business. Although, in the outcome, the Department's original estimate of the increase in value of the National Grid as a whole was close to its value at flotation plus proceeds from the sale of the Pumped Storage Business, an independent valuation of the Pumped Storage Business would have strengthened the Department's hand in negotiations (paragraphs 4.9 to 4.11).

Recommendations

16 In achieving their objectives, the Department had to address a number of complex issues in negotiations with the regional electricity companies and their experience underlines a number of important points which might usefully be borne in mind:

a) **in instances such as this, where privatised companies require the Government's consent as special shareholder to changes in their Articles of Association, departments should be aware of any scope to negotiate benefits for customers**. The Department realised at an early stage that the regional electricity companies' proposal for a flotation was an opportunity to negotiate a visible benefit for customers. This was achieved alongside their key concern to ensure that the National Grid remained independent of the rest of the electricity industry;

b) **departments should seek professional advice before entering into complex negotiations with privatised companies.** The Department sought professional advice on the legal and financial implications of a flotation at an early stage in negotiations. As a result, they had a clear understanding of the key elements which needed to be addressed during negotiations and were prepared to push hard for improvements in the level of customer discount offered by the regional electricity companies in early discussions;

c) **departments should ensure that estimates of the value of assets are robust before they are relied on during negotiations.** The Department could have sought an independent valuation of the Pumped Storage Business. It is likely that this would have indicated a higher value for the business than they had assumed, strengthening the Department's hand in negotiations with the regional electricity companies.

Part 1: Background to the flotation

What is the National Grid?

1.1 As part of the privatisation of the electricity industry during the early 1990s, the Government transferred ownership of the National Grid to the twelve regional electricity companies in England and Wales (listed at Appendix 4). Two new companies were formed. The National Grid Company owned and operated the network of high voltage transmission lines in England and Wales (usually referred to as the National Grid), which enable the bulk transfer of electricity from power stations to the distribution systems of the regional electricity companies (Figure 1). National Grid Holdings held the share capital of The National Grid Company and became, on privatisation, a jointly-owned subsidiary of the regional electricity companies (with the exception of a small number of shares owned by employees).

1.2 The National Grid Company also owned and operated two pumped storage power stations in North Wales (the Pumped Storage Business). These stations use water from a high reservoir, previously pumped from a lower reservoir, to generate hydro-electric power. Water can be pumped from the lower reservoir at times of relatively cheap electricity (typically at night) and then used to generate electricity when prices are higher (typically when generation is most needed).

1.3 The high-voltage transmission system facilitates competition between generating companies and between individual power stations through a wholesale market, the Electricity Pool. Most electricity is traded through the pool. Each day generating stations bid their output of electricity into the pool by submitting prices and quantities at which they will trade on the following day. The National Grid Company co-ordinates the timing and level of generation output on to the transmission system so that demand and operational standards are continually and economically met. Charges made to the electricity and generating companies by the National Grid for transmission of electricity are subject to price control by the Director General of Electricity Supply, who is the regulator for the electricity industry.

Figure 1

The National Grid

Source: National Grid Group plc

This figure shows the network of high voltage transmission lines in England and Wales which enable the bulk transfer of electricity from power stations to the distribution systems of the regional electricity companies.

Why was ownership of the National Grid transferred to the regional electricity companies?

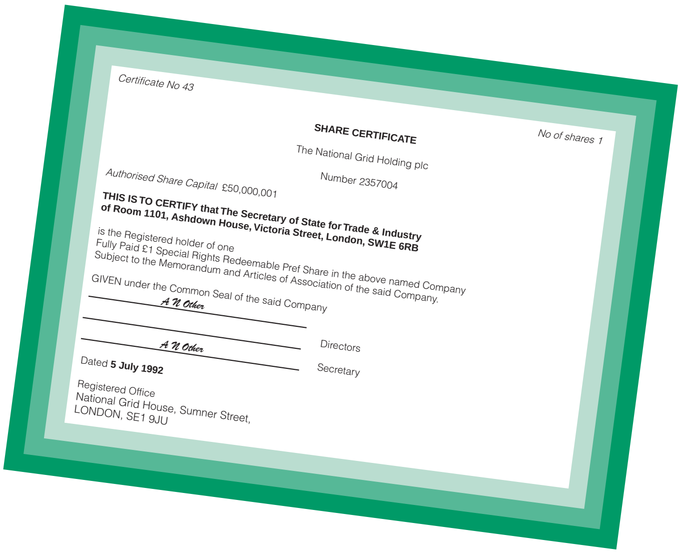
1.4 There were a number of options on privatisation of the electricity industry:

a) **to sell shares in the National Grid to institutional and individual investors:** the Government considered that investors would not have been responsive to the sale of what was a largely unknown component of the electricity industry. Unlike the Area Boards (the regional electricity companies' predecessors) the National Grid had been an integral part of the Central Electricity Generating Board without any direct trading record with electricity consumers or distributors and its future income depended, in part, on the smooth operation of a newly created pool for trading in electricity;

b) **to transfer ownership to the generating companies:** as the National Grid would be responsible for co-ordinating the output of generating plant on the basis of bids by the generating companies and capacity constraints within the transmission system, such a transfer of ownership was not considered conducive to the maintenance of competition;

c) **to transfer the business to the regional electricity companies:** although the regional electricity companies would be entitled to dividends paid by The National Grid Company to National Grid Holdings, the day to day operation of the transmission system by The National Grid Company would not be under their direct control. This two-tier structure was chosen as it was seen as the least problematic option.

1.5 To ensure that an arm's length relationship was maintained between The National Grid Company and the regional electricity companies, the Government retained special shares in both The National Grid Company and National Grid Holdings. The special shares restricted the regional electricity companies' ability to alter the Articles of Association of The National Grid Company and National Grid Holdings without the Government's prior consent. The existence of the special shares, which were not time-limited, played an important role in negotiations ahead of the flotation.


Certificate No 43

SHARE CERTIFICATE

No of shares 1

The National Grid Holding plc

Number 2357004

Authorised Share Capital £50,000,001

THIS IS TO CERTIFY that The Secretary of State for Trade & Industry of Room 1101, Ashdown House, Victoria Street, London, SW1E 6RB

is the Registered holder of one
Fully Paid £1 Special Rights Redeemable Pref Share in the above named Company
Subject to the Memorandum and Articles of Association of the said Company.

GIVEN under the Common Seal of the said Company

A N Other

Directors

A N Other

Secretary

Dated **5 July 1992**

Registered Office
National Grid House, Sumner Street,
LONDON, SE1 9JU

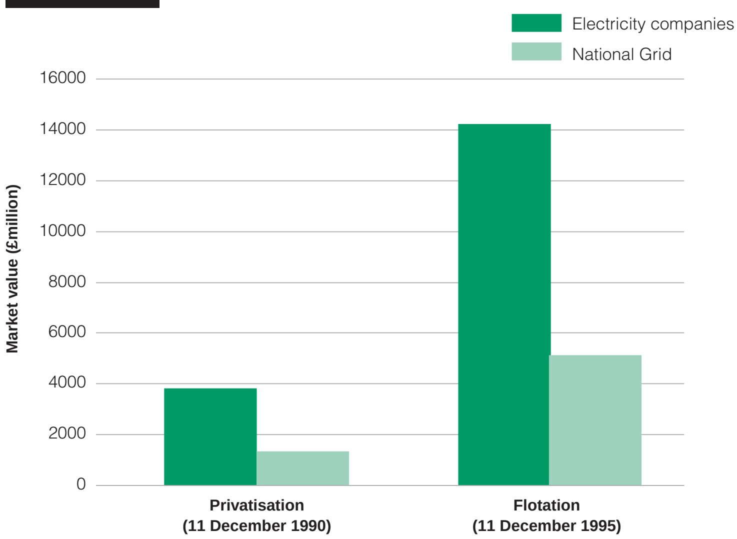
The special share certificate for National Grid Holdings

By how much had the National Grid increased in value since privatisation?

1.6 Estimates made by the Department in early 1995 of the National Grid's value at privatisation ranged from £1,200 million to £1,700 million, significantly higher than the network's assets, which were valued at £780 million in the privatisation prospectus for the regional electricity companies issued in 1990. In June 1995 the regional electricity companies and the Inland Revenue agreed, for capital gains tax purposes, a figure of £1,350 million for the value of the National Grid on privatisation. The Department accepted this figure in subsequent negotiations on the size of the customer discount. On flotation in December 1995, the National Grid was worth £5,160 million (Figure 2), an increase of £2,974 million or 2.3 times the value at privatisation (after adjusting for an increase of about 66 per cent in the market prices of shares in other leading companies over the same period). The increase in the value of the National Grid was in line with the increase in the value of the regional electricity companies themselves.

Figure 2

Increase in market value of the regional electricity companies and the National Grid since privatisation



Source: National Audit Office

This figure shows the increase in market value of the regional electricity companies and the National Grid between privatisation in 1990 and the flotation in 1995.

1.7 Like the regional electricity companies, the National Grid had been privatised at a time of very high interest rates and market uncertainty connected with the threat of war in the Gulf. Dividend forecasts in the privatisation prospectus were very cautious and, since privatisation, the National Grid had achieved substantial reductions in operating costs (a fall of 39 per cent in real terms from 1991 to 1995).

Why did the regional electricity companies wish to transfer ownership of the National Grid to their shareholders?

1.8 The regional electricity companies were entitled to dividend payments from the National Grid and, in theory, the value of their investment was reflected in the market prices of the regional electricity companies' own shares. However, shareholders in the regional electricity companies saw potential for added value if the National Grid could be transferred from the regional electricity companies' ownership and separately quoted on the Stock Exchange. Such a move would give shareholders a direct interest in future dividend payments which, until a flotation, were only received indirectly as a component in the level of dividends paid by each of the twelve regional electricity companies.

1.9 A flotation of the National Grid was seen by the regional electricity companies as a means of ensuring that the transmission system linking them to the generating companies was, and would be seen to be, wholly independent of the rest of the electricity industry. The Director General of Electricity Supply and the Department supported the principle of the flotation as they were concerned that continued ownership of the National Grid by the regional electricity companies, which had become involved in the generation as well as the distribution of electricity since privatisation, was not compatible with the development of competition in the electricity industry. The Director General of Electricity Supply was also concerned that, as part of any flotation, operation of the Pumped Storage Business should be transferred from the National Grid to a new owner which was not an existing electricity or generating company.

How did the regional electricity companies plan to transfer ownership to their shareholders?

1.10 The regional electricity companies planned to float the National Grid's shares on the London Stock Exchange through a series of transactions:

a) the regional electricity companies would sell the Pumped Storage Business to a trade buyer following a competitive auction;

b) the National Grid Company would borrow money to finance special dividends to be paid to the regional electricity companies through National Grid Holdings. These dividends, along with the proceeds from the sale of the Pumped Storage Business, would be used by the regional electricity companies to finance a customer discount and their liability to capital gains tax on the flotation;

c) following a series of bonus issues to increase the number of National Grid Holdings shares in existence, the regional electricity companies would then either pass the shares on to their own shareholders in the form of a dividend (a dividend in specie rather than in cash) or sell the shares in the market for cash (which could be re-invested in their businesses or used to increase future dividends).

1.11 On completion of these transactions, the regional electricity companies and the Department envisaged that:

a) direct ownership of the National Grid would be in the hands of investors who would be free to trade their shareholdings on the stock market;

b) following a trade sale, the Pumped Storage Business would be an independent electricity generator competing with other generating companies for a share of the market;

c) electricity customers would receive a benefit in the form of a discount on their electricity bills; and

d) the Government would also benefit from additional tax on the capital gain in the National Grid between privatisation and the flotation.

Why were the Department involved?

1.12 The regional electricity companies had to obtain the consent of the Department to changes needed in the Articles of Association of National Grid Holdings and The National Grid Company before a flotation could take place. The regional electricity companies also wanted to ensure that, before they finalised the structure of any flotation and announced their intentions, the Government would be content that there were no adverse implications for competition in the electricity market. The regional electricity companies accepted from an early stage that some form of customer benefit should flow from the flotation and wanted the Government's agreement as to its size and scope.

What were the Department's objectives?

1.13 In negotiating with the regional electricity companies, the Department aimed to achieve two key objectives:

a) to maintain competition by ensuring that the National Grid would remain independent of the rest of the electricity industry; and

b) to obtain a visible benefit for electricity customers. In pursuit of this objective, the Department aimed for a 50:50 split between regional electricity companies' domestic customers and their shareholders of the estimated increase in the value of the National Grid, after tax payable by the companies on the capital gain had been deducted.

What was the scope of the National Audit Office examination?

1.14 We examined whether the Department achieved their objectives in negotiating the flotation with the regional electricity companies. The rest of this report is split into three parts:

Part 2: how the Department aimed to maintain competition by ensuring that the National Grid remained independent of the rest of the electricity industry;

Part 3: ahead of the flotation, how the Department sought to negotiate a visible benefit for electricity customers; and

Part 4: how, following the flotation, the increase in value of the National Grid was split between customers and shareholders, taking account of the tax flows surrounding the flotation.

1.15 This report is based on an examination of the Department's papers, discussions with the Department's staff and discussions with other interested parties involved in the flotation. Our methodology is set out at Appendix 3.

Part 2: Maintaining competition in the electricity industry

2.1 In negotiating with the regional electricity companies, the Department's first objective was to ensure that the National Grid would remain independent of the rest of the electricity industry. This part of the report shows that the existing arrangements were strengthened as a result of the flotation, that the Director General of Electricity Supply was satisfied with the outcome and that the Department therefore achieved their first objective.

What were the specific provisions which ensured the National Grid's independence on privatisation?

2.2 The Articles of Association of The National Grid Company created an arms-length relationship with National Grid Holdings and its shareholders, the regional electricity companies. The day to day operation of the National Grid was not under the control of the regional electricity companies and directors of The National Grid Company could not be members of the board of directors of National Grid Holdings or of any of the regional electricity companies.

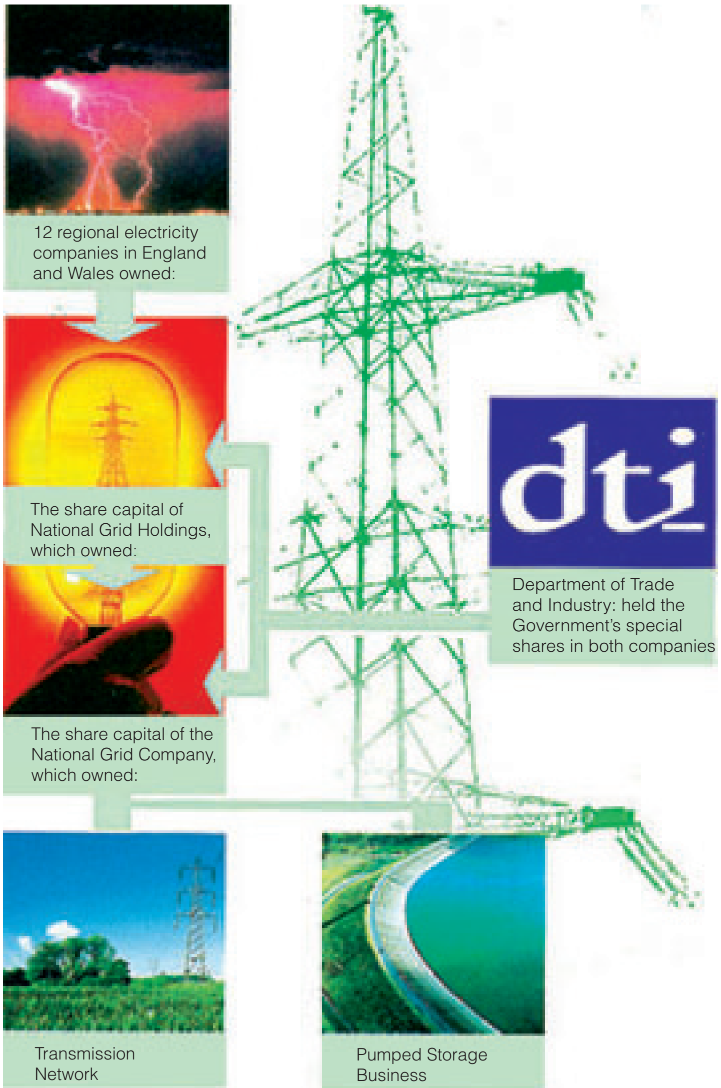
2.3 The President of the Board of Trade held special shares in both companies (Figure 3). As special shareholder, the Department had the following rights:

a) their consent was required for any amendment to the Articles of Association of The National Grid Company and for any transaction, other than on an arms length basis, between The National Grid Company and any shareholder of The National Grid Company or National Grid Holdings;

b) their consent was also required for any amendment to the Articles of Association of National Grid Holdings, including those articles which prevented any person from voting 15 per cent or more of the shares at an ordinary general meeting of the company. Consent would also be required before a shareholder in National Grid Holdings could enter into an agreement or arrangement to transfer ownership of the shares (such as a flotation).

Shareholders in the National Grid before the flotation

Figure 3



This figure shows the ownership structure of the companies forming the National Gid before flotation.

Source: National Audit Office

2.4 In the prospectus for the regional electricity companies' privatisation in 1990, the Government stated that the use of any of its rights as special shareholder would be aimed at maintaining the existing measure of independence afforded to The National Grid Company.

Were any changes introduced to maintain the National Grid's independence following the flotation?

2.5 After taking legal advice, the Department agreed that the special share in The National Grid Company could be redeemed and its articles redrafted on a normal, commercial basis. This was expected to enhance the value of the shares on the stock market (for instance, by allowing the National Grid a greater degree of freedom to diversify its activities). A special share was, however, retained in National Grid Holdings which was renamed the National Grid Group (Figure 4). The Articles of Association of the National Grid Group replicated the provisions of the old National Grid Holdings articles and added two further restrictions:

a) holders of a licence under the Electricity Act 1989 (including the regional electricity companies, the generating and Scottish electricity companies) or their affiliates were not allowed to own more than one per cent (previously 15 per cent) of the National Grid Group's share capital; and

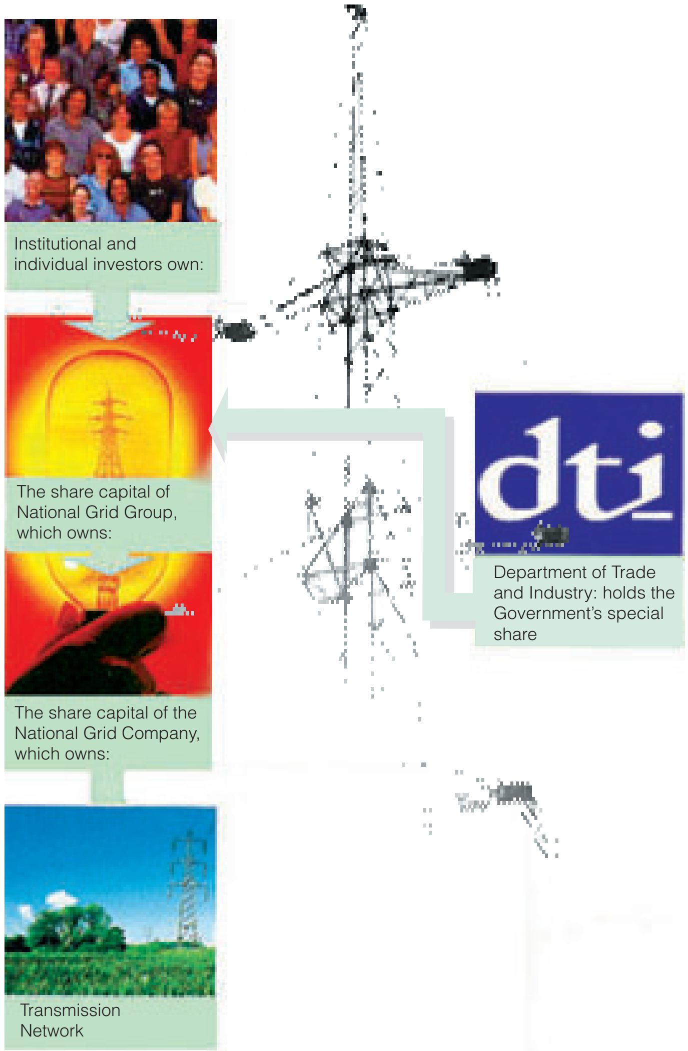
b) following the sale of the Pumped Storage Business, both the National Grid Group and The National Grid Company were precluded from re-entering the market for the generation of electricity.

Was the Director General of Electricity Supply content with the changes made?

2.6 The Director General of Electricity Supply had aimed to have electricity licence holders prohibited from holding any shares in the National Grid Group following the flotation. The regional electricity companies, however, wanted to retain small holdings of up to one per cent of the National Grid Group's shares in order to compensate their own directors and employees who held options over electricity company shares. These options would be less valuable as, following the flotation, the share prices of the regional electricity companies would fall to reflect the loss of the dividend stream from the National Grid.

Figure 4

Shareholders in the National Grid after the flotation



Source: National Audit Office

This figure shows the ownership structure of the companies forming the National Gid after the flotation.

Part 3: Seeking a visible benefit for customers

3.1 As the holder of special shares, the Department aimed to obtain a visible benefit from the flotation for the 21.4 million domestic customers of the regional electricity companies. Agreement was reached in September 1995 that customers would receive a net discount of £52 from their electricity bills worth, in total, £1,118 million. The Department therefore achieved their objective.

Why did the Department wish to obtain a visible benefit for customers?

3.2 The Department saw benefits for the competitive structure of the electricity industry from a flotation but also believed that it would be equitable for some of the increased value contained in electricity company shares, and released by such a transaction, to be directed to customers as well as shareholders.

How much of a customer benefit did the Department aim for?

3.3 In August 1994, the Department's initial negotiating position was that the regional electricity companies should provide a visible benefit for electricity customers but without an indication of what the Department regarded as visible.

3.4 In November 1994, the regional electricity companies' opening suggestion was a £210 million discount which would yield roughly £10 for some 21 million domestic customers. The Department considered this to be unacceptable and obtained professional advice on what might realistically be achieved in negotiations. They appointed Morgan Stanley as their financial advisers, who advised the Department that the regional electricity companies had been cautious in early negotiations and suggested that a much higher discount was achievable.

3.5 In February 1995, Ministers asked the Department to take forward the negotiations with the regional electricity companies on the basis that the increase in value of the National Grid should be shared 50:50 between regional electricity companies' domestic customers and their shareholders, after deduction of tax payable on the capital gain by the companies. The Department considered that any discount should be limited to domestic customers. A discount for business customers would have to be linked to their levels of electricity consumption to have an impact and would have led to a significant reduction in the size of the discount for domestic customers.

How did the Department set about this?

3.6 To negotiate with the regional electricity companies for a 50:50 share of the post-tax increase in value of the National Grid, the Department needed:

a) an estimate of the market value of the National Grid on flotation - the actual increase in value since privatisation would not be evident until the price of the newly listed National Grid shares had been established in trading on the Stock Exchange; and

b) an estimate of tax revenue from the transaction - the actual tax take would depend on the size of the capital gain and the tax allowances and reliefs available to the regional electricity companies and their shareholders.

3.7 The Department took advice from Morgan Stanley on the increase in value of the National Grid, the likely size of the capital gain and resultant tax revenues. However, there were risks in negotiations based on such estimates. For instance, if the Department under-estimated the increase in value or over-estimated the likely tax take, the negotiated customer discount would be lower than might have been justified.

Estimating the increase in value since privatisation

3.8 To estimate the increase in value it was necessary to determine the value of the National Grid at privatisation in 1990 and compare it with the expected value of the company on flotation. Following an examination of the regional electricity companies' proposals in March 1995, Morgan Stanley advised the Department that:

a) the value of the National Grid at privatisation was between £1,200 million and £1,700 million. Morgan Stanley considered, however, that the true value was closer to the top of this range than the bottom and suggested that a figure of £1,600 million was reasonable. The Inland Revenue subsequently agreed a valuation of £1,350 million with the regional electricity companies for capital gains tax purposes and the Department adopted this figure during final negotiations;

b) the value at privatisation should be adjusted upward to reflect the gain that an investor would have made by investing in a security of similar risk over the same timescale. Based on movements in the FTSE100 Index, such an adjustment would reflect the real gain which had accrued for shareholders. Between December 1990 and September 1995, the FTSE100 Index had increased in value by 65 per cent (equivalent to an addition of around £877 million on a base value of £1,350 million);

c) after adding back the expected level of special dividends to be paid to the regional electricity companies (£850 million) and the estimated value of the Pumped Storage Business (£300 million), Morgan Stanley calculated that the value of the National Grid on flotation would be between £5,000 million and £5,600 million with a reasonable estimate at the mid-point of the two figures, giving a value of £5,300 million.

3.9 Subject to adjustment for any material stock market movements prior to the flotation, the increase in value was estimated at just over £3,070 million (Figure 5) within a range of £2,770 million to £3,370 million.

The Department's estimate of the increase in value of the National Grid

Figure 5

	Low *£ million*	***Mid-point*** ***£ million***	*High* *£ million*
Value at privatisation in 1990	1,350	**1,350**	1,350
Add: adjustment for increase in FTSE100 Index	877	**877**	877
Adjusted value	2,227	**2,227**	2,227
Estimated value on flotation	5,000	**5,300**	5,600
Estimated increase in value	**2,773**	**3,073**	**3,373**

This figure shows that the Department estimated the increase in value of the National Grid at just over £3,070 million, within a range of £2,770 million to £3,370 million.

Source: The Department

Estimating the likely tax revenues

3.10 In negotiating the customer discount, neither the Department nor their advisers had access to Inland Revenue records of the corporation tax positions of the regional electricity companies and the National Grid. Such information is confidential to the Inland Revenue and could not be disclosed to third parties, such as the Department, without the consent of each company involved. The Department considered that the regional electricity companies would be unlikely to give such consent. The Department could not be sure, therefore, whether their estimates of corporation tax payable by the regional electricity companies were accurate, leading to inevitable uncertainty when negotiating the size of the customer discount.

3.11 To estimate the likely tax revenues, the Department relied on Morgan Stanley and advice, in general terms only, from the Inland Revenue. Morgan Stanley advised the Department that actual tax revenues would depend on how the tax flows were calculated:

a) **The tax payable by the regional electricity companies:** each electricity company would be liable for corporation tax on the capital gain resulting from the increase in value of the National Grid after deductions for the special dividends paid to the regional electricity companies, the value of the demerged Pumped Storage Business and an adjustment for inflation between 1990 and the flotation. The likely capital gain was estimated to be £2,410 million and the liability to tax at £800 million. Morgan Stanley noted that the actual tax paid could fall below this figure if the regional electricity companies had existing capital losses in other parts of their businesses, which could be offset against the capital gain on the National Grid. They were also aware that the regional electricity companies might create offsetting capital losses through the use of specially designed financial products (for instance, some of the companies had established leasing portfolios as a means of saving tax);

b) **The tax position of shareholders in the regional electricity companies:** around 50 per cent of the share capital of the regional electricity companies was held by tax-exempt investors, such as pension funds, who were entitled to payments of tax credits corresponding to Advance Corporation Tax paid by the regional electricity companies on the transfer of National Grid shares. If all the regional electricity companies transferred the shares to their shareholders, the likely scale of these payments of tax credits was estimated by Morgan Stanley at £475 million, partially offset by additional income tax from individual shareholders, who were higher-rate taxpayers, of about £80 million;

c) **The impact on Government revenue:** during negotiations, the Inland Revenue accepted arguments put forward by the regional electricity companies that any customer discount given by them should be treated as reducing their profits liable to corporation tax. In view of this tax treatment, the regional electricity companies agreed with the Department to pass the benefit of lower tax payments (estimated at £330 million) on to customers by paying a higher discount than they might otherwise have paid.

3.12 Thus the net impact for Government revenue was estimated to be a future payment by the regional electricity companies of £800 million in corporation tax on the capital gain, offset by net tax reductions to shareholders of some £395 million and tax relief on regional electricity companies' trading profits amounting to £330 million. There would also be an estimated reduction of £86 million in VAT paid by domestic customers on their discounted electricity bills. The inclusion of all the estimated tax flows surrounding the flotation would result in an estimated reduction of £11 million in overall tax revenues (Figure 6).

Estimated effect of the flotation on overall tax revenues

Figure 6

		£ million	£ million
Estimated tax on the capital gain		800	
Higher rate tax from individual shareholders		80	880
Less:	Tax relief on customer discount	-330	
	Payments of tax credits to exempt shareholders	-475	
	Reduction in VAT	-86	-891
Net reduction in tax revenues			-11

Note: excludes tax relief on interest paid by the National Grid as the Department did not make any estimate for this item at the time of the negotiations.

This figure shows that the inclusion of all estimated tax flows surrounding the flotation would have resulted in an estimated net reduction of £11 million in overall tax receipts.

Source: National Audit Office

How did the Department treat the various tax flows when negotiating a benefit for customers?

3.13 The measurement of the split of the increase in value of the National Grid between shareholders and customers depended on how tax flows surrounding the flotation were brought into the calculations. The Department decided to negotiate the level of the customer discount on the basis of the increase in value of the National Grid after deduction of the regional electricity companies' gross tax liabilities on their capital gain. In the Department's view, the other likely tax effects of the transaction should be disregarded:

a) **allowances against capital gains ä** if the regional electricity companies used existing capital losses to reduce their tax liabilities on the capital gain, such losses would not be available, if needed, in later years and the companies' use of financial products to create offsetting capital losses was unquantifiable;

b) **payments of tax credits to tax exempt shareholders and payments of higher rate tax by individual shareholders ä** these were part of the normal operation of the tax system governing the payments of dividends.[1] For instance, if the regional electricity companies had decided to increase dividend payments to shareholders, rather than float the National Grid, tax exempt shareholders would still be in a position to claim tax credits on these payments;

c) **tax relief on the customer discount ä** discounts offered to customers in the normal course of business usually reduce taxable profits. The tax relief allowed to the regional electricity companies was consistent with the normal effects of the tax code;

d) **VAT and Fossil Fuel Levy ä** the reduction in VAT and a temporary reduction in Fossil Fuel Levy on discounted electricity bills was also a consequence of the normal operation of the tax system and the basis on which the Levy was made;

e) **tax relief on interest paid by the National Grid on borrowings to finance the payments of special dividends to the regional electricity companies ahead of the flotation ä** this was a further consequence of the normal operation of the tax system.

Were there any constraints on the Department's ability to influence the regional electricity companies?

3.14 Although the regional electricity companies wanted the Government's agreement before going ahead with their proposals, the Department's ability to influence the companies was constrained by two factors:

a) if the regional electricity companies were not content with elements of the Department's negotiating stance, they had the option of abandoning the flotation and seeking to enhance shareholder value by other means. The most likely route would have been to increase future dividends from the National Grid and pass the extra cash on to their own shareholders. Such a move would not have required the special shareholder's consent as it would not have involved changes to the Articles of Association of either National Grid Holdings or The National Grid Company;

1 Payments of tax credits to pension funds and insurance companies were abolished from 2 July 1997 and other tax-exempt shareholders (such as charities and holders of personal equity plans) will lose their entitlement to these payments from April 1999.

b) the Department's legal branch advised that if the Department had withheld consent to changes in the Articles of Association purely on the grounds that the proposed benefit to customers was not large enough, the regional electricity companies or their shareholders could have had a basis for a legal challenge under company law or through judicial review. The most likely course would have been for the regional electricity companies to apply to a court under the Companies Act 1985 claiming that the Department were acting in a way which was unfairly prejudicial to other shareholders. If the regional electricity companies had succeeded in such an action, the courts could have over-ruled the Department's veto and allowed the proposed changes to go ahead.

3.15 The directors of the regional electricity companies were constrained by the fact that, like other companies, they had a legal responsibility to use shareholders' funds in a way which could be justified on commercial grounds. They felt that this limited the size of the customer discount they were able to pay. The regional electricity companies emphasised to the Department in negotiations that, in their view, the maximum available to fund the customer discount and tax liabilities was around £1,150 million (comprising an estimated £850 million in special dividends from the National Grid plus expected proceeds of around £300 million from the sale of the Pumped Storage Business).

An electricy bill showing the customer discount

What was finally agreed?

3.16 Following final negotiations in September 1995, the Department and the regional electricity companies agreed that just under 21.4 million domestic customers would receive a net discount of £52[1] on their bills during the first quarter of 1996. The discount did not apply to electricity customers in Scotland or Northern Ireland, which are not served directly by the National Grid, or to electricity consumers in England and Wales who were not direct customers of the regional electricity companies (for example, people who buy electricity from resellers such as landlords and caravan site owners).

1 The gross discount was £54.60. This included reductions in VAT (£4.04) and Fossil Fuel Levy (£4.60) which domestic customers would normally have had to pay. At the time, Fossil Fuel Levy was charged at a rate of 10 per cent on all electricity customers' bills and VAT at a rate of 8 per cent. The reduction in the Fossil Fuel Levy was, however, recovered in subsequent electricity bills for both domestic and business customers, resulting in a repayment of £2.30 by each domestic customer and a net discount of £52.30.

Share of the increase in value after tax, based on the Department's estimates prior to the flotation

Figure 7

	£ million
Estimated increase in value	3,070
Less: estimated tax payable by the regional electricity companies	-800
Net increase in value	2,270
Customer discount	1,118
Customer discount as percentage of net gain	**49%**

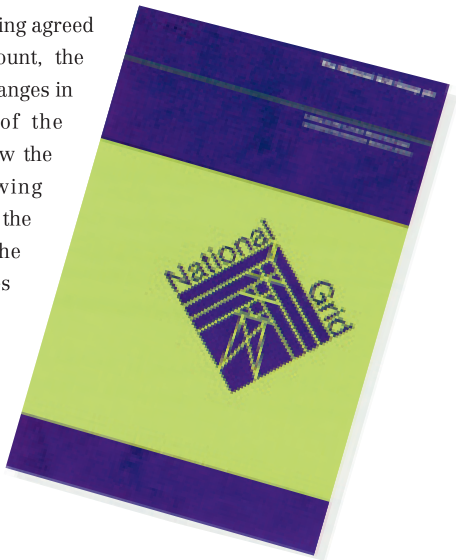
Source: National Audit Office

This figure shows that, on the basis of Department's estimates prior to the flotation, the customer discount represented 49 per cent of the estimated net increase in value.

Did the Department achieve a visible benefit for customers?

3.17 The net discount of £52 was equivalent to a reduction of over 17 per cent on the average domestic electricity bill of £300 a year. At £1,118 million for over 21 million customers, this was a visible benefit and significantly more than the £210 million suggested by the regional electricity companies at the start of negotiations. On the basis of the Department's estimates prior to the flotation, the net discount represented around 49 per cent of the increase in value of the National Grid after tax (Figure 7).

3.18 On 25 October 1995, having agreed the size of the customer discount, the Department gave consent for changes in the Articles of Association of the National Grid which would allow the flotation to proceed. Following approval by the shareholders of the regional electricity companies, the flotation went ahead and shares in the National Grid were listed on the London Stock Exchange from 11 December 1995.



The listing document for the flotation of National Grid shares on the London Stock Exchange

Part 4: Achieving a 50:50 split between customers and shareholders

4.1 In negotiating a discount for each domestic electricity customer, the Department aimed for a 50:50 split between regional electricity companies' domestic customers and their shareholders of the estimated increase in the value of the National Grid since privatisation, after deduction of tax payable on the capital gain by the companies. This target was narrowly missed.

4.2 To determine whether such a split had been achieved, we compared the size of the customer discount with the actual increase in value of the National Grid, after deduction of the regional electricity companies' gross liabilities to tax on the capital gain. We also compared the customer discount with the actual increase in value after further adjustments for the effect of tax allowances and refunds, created by the way the flotation was structured.

What was the increase in value of the National Grid between privatisation and flotation?

4.3 At the close of the first day of trading (11 December 1995), the price of National Grid shares stood at 208 pence a share. After adding back special dividends paid to the regional electricity companies (a total of £938.5 million) and the proceeds from the sale of the Pumped Storage Business (£680 million), the value of the National Grid on flotation was £5,136 million, compared with a value at privatisation of £2,162 million (£1,350 million uprated by £812 million, representing the increase in the FTSE100 Index between privatisation and the flotation). The National Grid had therefore increased in value by £2,974 million more than would be expected from the general increase in share values. This was close to the estimate of £3,070 million used by the Department during negotiations with the regional electricity companies.

What proportion of the increase in value did the customer discount represent?

a) If only the gross tax payable on the capital gain is included

4.4 As noted in paragraph 3.13, the Department conducted negotiations with the regional electricity companies on the basis that the only tax consequence of the flotation that would be taken into account in the calculations of the customer discount would be the gross tax payable by the regional electricity companies on the capital gain. Using the Department's methodology, we estimate that the capital gain was £1,910 million and that the gross liability to tax was £630 million. This was less than the Department's original estimate of £800 million as the actual value of National Grid shares on flotation had fallen by some 20 per cent compared with the original estimate, in response to adverse market sentiment towards the electricity sector. On this basis the customer discount represented 48 per cent of the tax adjusted increase in value (Figure 8).

Figure 8

Share of the actual increase in value after allowing for the gross tax payable by the regional electricity companies on the capital gain

Estimated: £000m		*Actual: £000m*
3,070	Increase in value	2,974
-800	Less: gross tax liability on the capital gain (£1,910 million)	-630
2,270	Net increase in value	2,344
1,118	Customer discount	1,118
49%	**Customer discount as percentage of net increase in value**	48%

This figure shows that the customer discount as a proportion of the increase in value (after allowing for the gross tax payable by the regional electricity companies on the capital gain) was 48 per cent

Source: National Audit Office

b) If all tax allowances and refunds are included

4.5 Paragraph 3.13 refers to a number of tax consequences of the flotation which the Department decided should be disregarded when negotiating the level of the customer discount:

a) **allowances against tax on the capital gain ä** the amounts paid by the regional electricity companies may have been less than £630 million if they used existing capital losses or other means to offset their tax liability on the capital gain. We therefore asked the regional companies how much additional tax they had paid. They told us that there was no straightforward answer. First, the relevant tax computations had not all been agreed with the Inland Revenue. Secondly, there were a number of factors which complicated the position. Regional electricity companies were members of groups of companies and, therefore, the amount of tax paid depended on the underlying taxable profits of each group rather than any individual company within a group. Such group profits were, in turn, affected by the availability of capital losses in group companies and other group reliefs, which could have been offset against the capital gains on the flotation of the National Grid. Thirdly, the Advance Corporation Tax position of each group would also affect the tax paid.

b) **payments of tax credits to tax exempt shareholders of £296**[1] **million and additional tax (£22**[1] million) paid by individual shareholders who were higher rate taxpayers;

c) **tax relief for the regional electricity companies (£324 million) on the discount given to domestic customers;**

d) **the reduction in VAT (£86 million**) on discounted electricity bills (the reduction in the amount of Fossil Fuel Levy was a temporary change as it was recovered in subsequent electricity bills);

e) **tax relief (estimated at a present value of £70 million) on interest paid by the National Grid on borrowings to finance special dividends for the regional electricity companies.**

If the Department's negotiating target had included these other tax consequences then the customer discount of £1,118 million would have represented about 36 per cent of the increase in value (Figure 9).

1 These figures are lower than earlier estimates (paragraph 3.11(b)) as the value of the National Grid had fallen ahead of the flotation and four of the regional electricity companies, which had been taken over before the flotation, sold their National Grid shares in the market as opposed to transferring them to their shareholders.

Figure 9

Share of the actual increase in value after allowing for all tax allowances and refunds

The Department's estimates prior to the flotation £000m	*After the flotation:*	*After allowing for all tax allowances and refunds £000m*
3,070	Actual increase in value	2,974
-800	Less: tax on the capital gain	-630
2,270	Net increase in value	2,344
–	**Add back: net tax reduction to shareholders (*)**	**274**
–	**Add back: tax allowed on customer discount**	**324**
–	**Add back: VAT**	**86**
–	**Add back: Tax relief on interest paid by National Grid**	**70**
2,270	**Adjusted increase in value**	**3,098**
1,118	Customer discount	1,118
49%	**Customer discount as percentage of net increase**	**36%**

Note: * The net figure of £274 million is based on the Department's assumption that around half of electricity company shares are held by tax-exempt shareholders. This is reasonable and at the low end of what would be expected in other major UK companies as many individuals who invested in the regional electricity companies on privatisation in 1990 had retained their shares.

This figure shows that the inclusion of all tax allowances and refunds reduces the share for customers to 36 per cent of the adjusted increase in value.

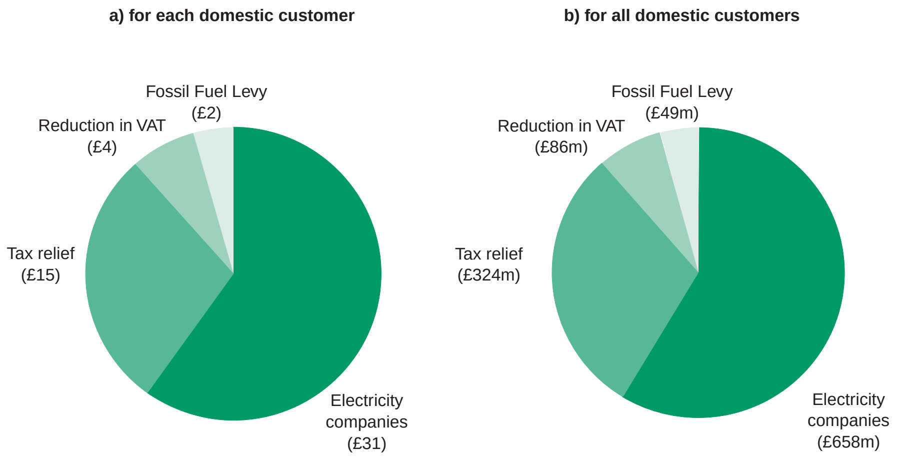
Source: National Audit Office

How was the customer discount financed?

4.6 Of the £52 net discount to each domestic customer, the regional electricity companies financed £31 from special dividends paid to them by the National Grid and from the sale of the Pumped Storage Business. The balance was provided by the taxpayer or non-domestic electricity customers (Figure 10). There were two reasons for this. First, consistently with normal tax rules, the discount had the effect of reducing the taxable profits of the regional electricity companies, resulting in a lower charge to tax equivalent to £15 a customer. Second, the balance of the discount was a consequential reduction in the amount of VAT (£4) and a proportion (£2) of the Fossil Fuel Levy repayment borne by non-domestic electricity customers (see footnote to paragraph 3.16). The impact on non-domestic electricity customers was offset by the Government's decision, at about the same time, that the Fossil Fuel levy would be reduced from 10 per cent to 3.7 per cent, following the privatisation of British Energy (which took place in July 1996).

Figure 10

Financing of the customer discount



This figure shows that of the £52 discount to domestic customers, £31 was financed by the regional electricity companies and the balance by the taxpayer (tax relief and reduced VAT) or non-domestic electricity customers (repayments of Fossil Fuel Levy). In total £658 million was financed by the regional electricity companies.

Source: National Audit Office

How did Government revenue fare in the flotation?

4.7 We estimate that the Government is likely to have suffered a net reduction in overall tax revenue of some £124 million (Figure 11) as a result of the flotation. However, the impact on tax revenue has to be set in the context of what might have happened if the flotation of the National Grid and the demerger and subsequent sale of the Pumped Storage Business had not gone ahead. In such circumstances, the regional electricity companies might not have given a discount to their customers and passed the special dividends of £938 million received from the National Grid to their own shareholders. We estimate that this would have had a greater impact on tax revenues, which would have fallen by some £178 million (Figure 11).

Figure 11

Effects on overall tax revenue

		Flotation £ million	No flotation £ million
Tax liability of the regional electricity companies		+630	0
Higher rate tax from individual shareholders		+22	+9
Less:	Tax relief on customer discount	-324	0
	Payments of tax credits to exempt shareholders	-296	-117
	Reduction in VAT	-86	0
	Tax relief on interest paid by the National Grid	-70	-70
Net reduction in tax revenues		**-124**	**-178**

This figure shows that the inclusion of all tax flows surrounding the flotation results in a net reduction of £124 million in overall tax receipts. If the flotation had not gone ahead, however, the impact on tax revenue might have been a larger reduction of £178 million.

Source: National Audit Office

How did the regional electricity companies and their shareholders fare in the flotation?

The regional electricity companies

4.8 The regional electricity companies received £938 million in dividends from the National Grid and £680 million from the sale of the Pumped Storage Business. The companies' contribution to the customer discount amounted to £658 million and their estimated gross tax liability was £630 million. The flotation may therefore have generated additional cash for the regional electricity companies of £330 million (£1,618 million received less £1,288 million paid).

4.9 The key reason for this was that proceeds from the sale of the Pumped Storage Business were £380 million higher than the £300 million estimate used by the regional electricity companies in negotiations with the Department. As this was a relatively minor issue in the context of the main flotation negotiations, the Department did not challenge this estimate or seek an independent valuation of the business, before completion of negotiations on the customer discount. The Pumped Storage Business was demerged from the National Grid to the regional electricity companies on 20 November 1995 at a revised value of £450 million. The business was then sold, following a competitive tender, to Mission Energy (a company based in the United States) in December 1995 for £680 million. The winning bid was much higher than the other bids, of which the next highest was around £500 million. The Department consider that, given uncertainty over the value of the business and the timing and market dynamics of what might be seen by potential purchasers as a forced sale, there was no realistic prospect ahead of the actual sale that a bidder would have paid such a high price.

4.10 We commissioned Corporate Valuations (London), specialist advisers in valuing businesses, to examine the information available on the Pumped Storage Business and to determine whether a value of £300 million was a reasonable estimate at the time the Department were negotiating the customer discount. Corporate Valuations advised that the stock market was relatively stable from April to December 1995, with the electricity sector at a consistently lower level than the broader privatised utilities sector and the market generally. It would appear, therefore, that the price achieved by the regional electricity companies for the Pumped Storage Business was not due to an upward movement in the market. A value of £300 million for the business implied a price-earnings ratio of six, significantly below the price-earnings ratio of the electricity sector (a ratio of 10) and the market as a whole (16). The Pumped Storage Business had a strong asset base (valued by the National Grid at £444 million), substantial historic growth in revenues and profits and operated in a very profitable sector of the electricity market. All these factors pointed to the likelihood of a sale price for the Pumped Storage Business in excess of £300 million.

4.11 However, the role of the Pumped Storage Business makes valuation very difficult using conventional methodology. The business responds to peak demands on the transmission system which can occur for a variety of unpredictable reasons (such as changes in the availability of conventional generating plant or extreme weather conditions). Revenues are therefore volatile and can vary considerably from year to year, making estimates of future profitability unreliable. In the light of such uncertainty, however, we consider that the estimated value of £300 million, accepted by the Department during negotiations, was not a reliable guide to the potential value of the business. Although, in the outcome, the department's original estimate of the increase in value of the National Grid as a whole was close to its value at flotation plus proceeds from the sale of the Pumped Storage Business, an independent valuation of the Pumped Storage Business would have strengthened the Department's hand in negotiations with the regional electricity companies.

Electricity company shareholders

4.12 Shareholders received National Grid shares worth £3,500 million at their market price on the close of the first day of trading (11 December 1995). However, their existing shareholdings in the regional electricity companies fell in value as future dividends from the National Grid would be paid directly to shareholders rather than the companies. It is difficult to compare the market value of an investors' shareholdings prior to the flotation with their value afterwards. Share prices had been volatile ahead of the flotation due to speculative trading on prospective takeovers and mergers. In addition, the market may have priced the effects of the flotation into the shares beforehand.

4.13 Analysis of share prices in seven regional electricity companies one week before the flotation and of the combined share prices of the companies and the National Grid one week after the flotation indicates a loss in value of just under six per cent against a small decline of one per cent in the FTSE100 Index (Figure 12).

Figure 12

Share prices in the regional electricity companies before the flotation and in the companies and the National Grid after the flotation

This figure shows that the prices of shares in the regional electricity companies and in the National Grid fell immediately after the flotation.

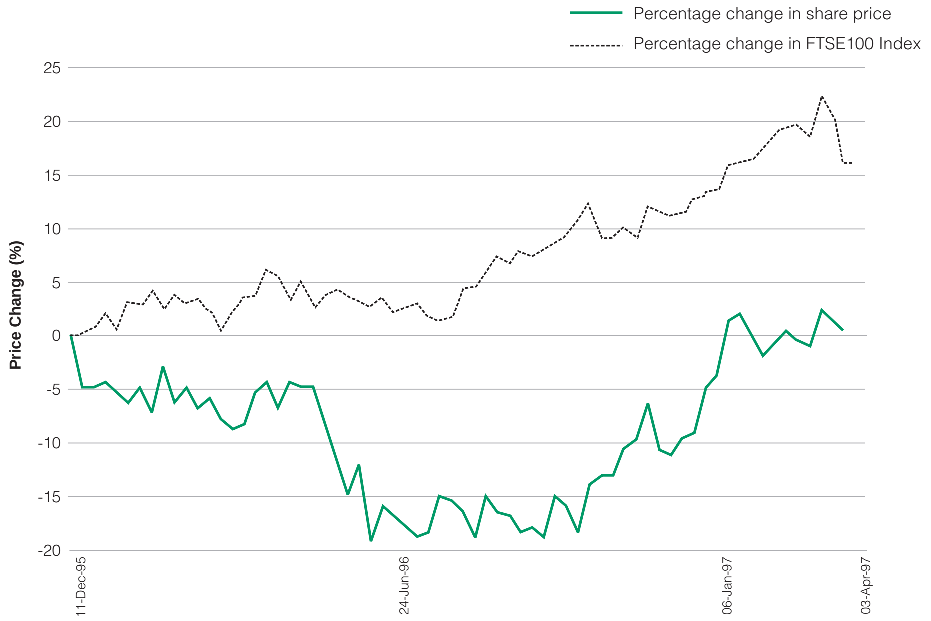
Source: Published stock market prices for the National Grid and the following regional electricity companies: East Midlands, London, Midlands, Northern, South Wales, SEEBOARD, and Yorkshire (four of the other companies had been taken over before the flotation and one other paid the dividend in specie in January 1996, rather than December 1995).

4.14 As part of the flotation the regional electricity companies were required to pass the shares to their own shareholders shortly after the listing or to sell them within one year. Some 10 per cent of the new National Grid shares were sold into the market on the first day of trading by three of the four regional electricity companies which had been taken over. This depressed the share price. Appendix 4 lists the regional electricity companies which had been taken over prior to the flotation and further changes in ownership since the flotation.

4.15 In the twelve months after the flotation the shares continued to underperform against the market (Figure 13) but by the beginning of April 1997 had recovered sufficiently to stand virtually unchanged from the level (208 pence a share) at which they traded on flotation. The key reasons for the under-performance were the expected review of the National Grid's price controls during 1996 by the Director General of Electricity Supply and that further sales of National Grid shares by the regional electricity companies' new owners were expected during 1996.

Figure 13

Price performance of National Grid shares following the flotation



This figure shows that shares in the National Grid under-performed against the FTSE100 Index from the date of the flotation.

Source: Published stock market prices

4.16 Ahead of the flotation, the Department examined the scope for a clawback arrangement if the price of shares in the National Grid outperformed the market following the flotation. Such an arrangement would have involved the issue of additional shares by the National Grid to be held in trust on behalf of electricity customers. If, after a fixed period of two to three years, National Grid shares had outperformed the FTSE100 Index, the additional shares would be sold and proceeds used to fund a further discount on domestic electricity bills. In view of the difficulties involved in valuing the Pumped Storage Business prior to its sale by the regional electricity companies, the Department also sought to have it included in any clawback arrangement.

4.17 Although the regional electricity companies entered into negotiations on the detailed application of clawback they considered that the inclusion of such a provision as part of the flotation would have had an adverse effect on the price of National Grid shares on flotation and for the period over which clawback would operate. This would reduce both shareholder value and potential tax receipts on the capital gain. In reaching agreement on the size of the customer discount, both sides agreed that a clawback should not be adopted. Nevertheless, the Department consider that the prospect of a clawback arrangement was helpful during final negotiations with the regional electricity companies.

How did directors and employees of the regional electricity companies and the National Grid fare in the flotation?

4.18 The flotation affected directors and employees in two ways. First, directors and around two-thirds of the employees of the regional electricity companies and the National Grid held options to purchase shares under Inland Revenue approved schemes. Following the flotation the value of these options would fall:

a) directors and employees of regional electricity companies would have options over shares which were worth less in the market as the dividend stream from the National Grid would be removed from the regional electricity companies;

b) options held by National Grid directors and employees would also be worth less as the payment of special dividends and the transfer of the Pumped Storage Business to the regional electricity companies served to reduce the overall value of the National Grid when it was listed on the Stock Exchange.

4.19 As part of the flotation negotiations, the Department accepted that option holders should be compensated for this loss in value by the allocation of additional National Grid shares. The total value of the additional shares involved was around £180 million, of which £154 million was allocated to some 40,000 employee members of Save As You Earn schemes and £26 million to just under 900 senior managers and directors.

4.20 Second, directors and employees who were also shareholders in the National Grid would receive their share (£6.7 million) of the special dividends paid before the flotation and part of the proceeds from the sale of the Pumped Storage Business. Although National Grid directors were legally entitled to receive these payments, the Department expressed reservations, in the context of general concern about pay in the privatised utilities, that individual directors would receive substantial cash sums, ranging from £38,000 to £358,000, and pressed those concerned voluntarily to forego the amounts due to them. The Department were unsuccessful.

Glossary of terms

Advance Corporation Tax	When a company pays a dividend or other qualifying distribution to its shareholders, it has to pay Advance Corporation Tax to the Inland Revenue. Advance Corporation Tax paid on distributions made in an accounting period can, within certain limits, be set off against a company's corporation tax liability on profits for that period.
Area Boards	The predecessors of the regional electricity companies. The 12 Area Boards were responsible for the distribution and supply of electricity to domestic and commercial customers in their respective areas in England and Wales.
Articles of Association	A statement of the objectives and powers of a company, approved by its shareholders.
Capital gain	The increase in value of an asset over the cost of the asset. There were two bases on which this was calculated. In negotiating the customer discount, the Department estimated the **increase in value** of the National Grid before the deduction of special dividends and the expected value of the Pumped Storage Business. This estimate was then adjusted for the movement in the FTSE100 Index between privatisation and the flotation. For tax purposes, however, the special dividends and value of the Pumped Storage Business reduced the size of the **capital gain**, which was adjusted by the increase in the RPI between privatisation and the flotation.
Capital Gains Tax	A tax charged on the capital gain realised on the disposal of an asset. Companies pay corporation tax on capital gains, calculated along similar lines to capital gains tax.
Central Electricity Generating Board	The Central Electricity Generating Board owned and operated the National Grid, most of the generating plant in England and Wales and was responsible for co-ordination and control of the electricity industry. On privatisation, the National Grid and the Pumped Storage Business were transferred to the National Grid Company and the remaining power stations were split between two companies, National Power and PowerGen.
Clawback	A provision, agreed between vendor and purchaser at the time of a sale, in which the purchaser agrees to pay back to the vendor an agreed proportion of any future capital gains or profits in excess of an agreed amount.
Demerger	The transfer by a company to its shareholders of shares in a subsidiary undertaking.

Director General of Electricity Supply	The Director General has specific responsibilities under the Electricity Act 1989 for economic regulation and the general supervision and enforcement of the licensing regime governing companies in the electricity industry.
Dividend	Part of a company's profits distributed to shareholders.
Dividend in specie	A dividend paid by a company to shareholders in shares or other assets rather than in cash.
FTSE 100 Index	An index of share prices of 100 of the largest companies quoted on the London Stock Exchange.
Flotation	The occasion on which a company's shares are listed and their price quoted on the stock market for the first time.
Fossil Fuel Levy	Following privatisation the regional electricity companies were required to make premium payments to the nuclear generators for each unit of nuclear output produced up to a particular annual limit. Electricity customers' bills were increased by a Fossil Fuel Levy which, in turn, was used to compensate the regional electricity companies for the premium payments made to nuclear generators.
Increase in value	See capital gain.
Licence holders	Under the Electricity Act 1989, companies engaged in the generation and/or supply of electricity must hold a licence to do so from the Director General of Electricity Supply.
(Share) options	The right (but not the obligation) to buy or sell shares at a fixed price within a specified period.
Price-earnings ratio	The market share price divided by the last published earnings per share, where earnings per share is the net profit of a company divided by the number of ordinary shares. It is an indicator of the level of confidence that investors have in a company or group of companies in a particular sector of the stock market. Generally, the higher the price-earnings ratio, the higher the confidence.
Privatisation	Conversion of a public sector organisation into a private sector company, often accompanied by a sale of shares to investors.
Regional electricity companies	The 12 companies which took over the responsibilities of the Area Boards on privatisation.

Save As You Earn Schemes Schemes through which employees in the electricity industry could save to purchase shares in their employers.

Special dividends Dividends paid by the National Grid to the regional electricity companies prior to the flotation, financed by the National Grid from additional borrowings.

Tax-exempt investors Institutional shareholders, such as pension funds and charities, which were not liable to tax on dividends from their shareholdings. As a result they were entitled to claim tax credits on dividends and other qualifying distributions paid to them.

Trade sale The sale of an organisation or part of an organisation to another company.

Appendix 1: The Government's special shares in privatised companies

Cable and Wireless
Sealink Stenna Line
British Aerospace
VSEL Consortium
British Gas
Nirex
Rolls Royce
BAA
National Grid Group
National Power
PowerGen
Scottish Power
Scottish Hydro-Electric
Northern Ireland Electricity
Belfast International Airport
British Energy
(plus separate special shares in two subsidiaries: Nuclear Electric and Scottish Nuclear)
AEA Technology
Rosyth Dockyard
Devonport Dockyard

In many sales there was a need to protect newly privatised businesses from unwelcome take-over (for example, on the grounds of national security or as a temporary measure, to provide an opportunity for company management to adjust to the private sector). The Government therefore retained special shares (sometimes known as "golden shares") in such companies. The special shares require that certain provisions in the Articles of Association of a company may not be changed without the specific consent of the special shareholder. The details of the provisions in the Articles of Association vary according to the circumstances of each company, but they typically include a prohibition on any one person (or group of persons acting in concert) controlling 15 per cent or more of the equity of the company. Special shares do not carry any rights to future dividends paid by the company.

Appendix 2: Chronology of the flotation

1 April 1989	National Grid Company incorporated as the wholly-owned subsidiary of National Grid Holdings.
23 May 1990	Ownership of National Grid Holdings transferred to the regional electricity companies.
11 December 1990	Regional electricity companies privatised.
20 April 1994	Regional electricity companies announce their intention to seek a listing for the National Grid on the Stock Exchange.
6 July 1994	Initial meeting between the regional electricity companies and Department officials.
16 November 1994	Following discussions with the Inland Revenue and the Office of Electricity Regulation, the regional electricity companies seek approval for their plans from the Department and offer a discount of £10 per electricity customer.
12 December 1994	Morgan Stanley appointed as financial adviser to the Department. Detailed negotiations get underway.
6 February 1995	Ministers request the Department to negotiate a 50:50 split of the increase in value of the National Grid after tax has been taken into account.
7 March 1995	Director General of Electricity Supply announces unexpected review of regional electricity companies' distribution price controls (to be completed by end of June 1995). Negotiations on the flotation of the National Grid put on hold by the regional electricity companies.
7 June 1995	Regional electricity companies offer customer discount of £30. Morgan Stanley advise the Department that £45 might be negotiable.
15 September 1995	Regional electricity companies offer customer discount of £35 to £45.
25 September 1995	Following further negotiations, regional electricity companies announce £50 discount to domestic electricity customers.
October 1995	Eastern Electricity taken over by Hanson and South Western Electricity taken over by Southern Company (Atlanta).
25 October 1995	As special shareholder the Department agree to changes in the Articles of Association of the National Grid which will allow the flotation to proceed.

November 1995	Manweb taken over by Scottish Power and Norweb by North West Water.
17 November 1995	Flotation approved by shareholders in the regional electricity companies.
22 November 1995	Listing document published.
11 December 1995	National Grid shares start trading on London Stock Exchange. Three regional electricity companies sell holdings on stock market, eight of the other nine pass the shares on to their own shareholders. National Grid shares close at 208 pence.
22 December 1995	Regional electricity companies sell Pumped Storage Business to Mission Energy (US) for £680 million.
Jan - May 1996	Customer discounts included in quarterly electricity bills.
3 October 1996	Director General of Electricity Supply announces results of price control review for National Grid. Transmission charges to be reduced by 20 per cent on 1 April 1997 and by a further four per cent in real terms for each of the following three years. National Grid shares close at 177 pence.

Appendix 3: Scope of the study and methodology

Scope of the study

1 We focused on how the major decisions taken by the Department impacted on the achievement of their key objectives, in particular the negotiations which led to the agreement of a discount for domestic electricity customers. As the flotation was a matter for the privatised regional electricity companies, we could not (and did not seek to) examine the companies' decisions on the structure and conduct of the flotation itself.

Main aspects of the National Audit Office's methodology

2 The main aspects of the methodologies used were:

a) the collection of information relating to the flotation and the Department's handling of negotiations with the regional electricity companies;

b) the evaluation of the information collected; and

c) the use of technical experts to advise on specific issues.

Collection of information

3 Information was collected from the following sources:

- a review of the Department's files and other records relating to the flotation;
- examining with Departmental officials the key aspects of how they handled the negotiations with the regional electricity companies;
- discussions with: the Chairman of the steering group formed by the regional electricity companies to oversee arrangements for the flotation; Dresdner Kleinwort Benson, the companies' financial adviser for the flotation; and the National Grid Group plc.
- discussions with the Inland Revenue on the general framework of tax law in which the flotation took place and figures from the regional electricity companies on their gross tax liabilities as a result of the flotation;

- share prices quoted on the London Stock Exchange for the regional electricity companies and the National Grid Group plc;

- discussions with the Office of Electricity Regulation on the regulatory and competition aspects of the flotation.

Evaluation of the information collected

4 Methods for evaluating the information collected included:

- an assessment of whether the decisions taken by the Department maximised the likely achievement of key objectives in negotiations with the regional electricity companies;

- consideration of whether the decisions were taken against a background of appropriate information and after taking appropriate advice;

- analyses of movements in share prices of the regional electricity companies before the flotation and of the companies and the National Grid Group after the flotation.

Use of technical experts to advise on specific issues

5 We engaged the following organisations to advise on certain aspects of the flotation:

- **Norton Rose** were engaged to examine: the limits of the powers conferred on the Department by the special shares in the National Grid, particularly the scope they had to negotiate a customer benefit before granting consent to a flotation; the structure of the flotation proposed by the regional electricity companies in comparison with other private sector flotations; whether there were other means available to the companies to increase shareholder value from the National Grid;

- **Winckworth & Pemberton** were engaged to review the presentation in this report of tax aspects of the flotation;

- **Corporate Valuations (London),** specialist advisers in valuing businesses, were engaged to review the estimated value of £300 million placed on the Pumped Storage Business by the regional electricity companies during negotiations with the Department and the reasons for the significant difference between the estimated value and the actual proceeds realised by the companies shortly after the flotation.

Appendix 4: Changes in ownership of the regional electricity companies

Regional electricity companies which had been taken over before the flotation

Electricity company:	*New owner:*	*Taken over in:*
Eastern Electricity *	Hanson	September 1995
South Western Electricity (SWEB)	The Southern Company (US)	September 1995
Manweb	Scottish Power	October 1995
Norweb	North West Water (United Utilities)	November 1995

* In February 1997, Hanson demerged The Energy Group (which included Eastern Electricity).

Changes in the ownership of the other regional electricity companies since the flotation

SEEBOARD	CSW (US)	January 1996
South Wales Electricity	Welsh Water (Hyder)	January 1996
Midlands Electricity (MEB)	Avon Energy (US)	August 1996
East Midlands Electricity	Dominion Resources (US)	January 1997
London Electricity	Entenergy (US)	February 1997
Northern Electric	CalEnergy (US)	February 1997
Yorkshire Electricity	AEP/Colorado (US)	April 1997
Southern Electric	no change	–

The regional electricity companies on privatisation in 1990