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Report by the
Comptroller and Auditor General

Department of
Trade and Industry

Sale of AEA Technology

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John Bourn
Comptroller and Auditor General

National Audit Office
9 March 1998

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Executive summary

1 On 25 September 1996 the Department of Trade and Industry (the Department) sold all their 80 million shares in AEA Technology by flotation for £227.75 million. The costs of the Department's advisers were £8 million and the cost of giving free shares to employees was £3 million (paragraphs 1.16, 2.16 and 2.18).

2 AEA Technology comprised the former commercial activities of the United Kingdom Atomic Energy Authority (the Authority), the public sector body that conducted nuclear research and development. In 1995-96 AEA Technology had a turnover of £253 million and operating profits of £19.8 million. They were split from the Authority in March 1996 to become a separate company owned by the Secretary of State for Trade and Industry (paragraphs 1.2 to 1.7).

3 Restructuring AEA Technology and separating them from the Authority before the sale cost £121million. The Department consider that these should not be treated as sale costs. This is because, in their view, substantial restructuring was necessary to ensure AEA Technology's commercial viability, and restructuring and separation of AEA Technology would also have been necessary to promote competition for decommissioning work and drive down decommissioning costs even if AEA Technology had remained in the public sector. It must remain a matter of speculation, however, when the restructuring would have taken place, what form it would have taken and how much this would have cost if the business had remained in public ownership. Without rationalisation the business was unsaleable and in December 1995 the Department justified additional funding for the rationalisation by reference to the impact they expected the rationalisation to have on the sale. Against this background we conclude that it might be reasonable to regard at least part of these costs as expenditure related to the sale (paragraphs 2.2 to 2.10).

4 In carrying out the sale of AEA Technology the Department sought to ensure that:

- the sale was completed in 1996 and the best available proceeds were obtained;

- value for money was secured from expenditure related to the sale;

- the needs and requirements of AEA Technology's customers, particularly their government customers, were taken fully into account; and
- the interests of the Authority as a major customer, landlord and nuclear licensee of the sites occupied by AEA Technology were properly safeguarded.

Completing the sale in 1996 and aiming for the best available proceeds

5 Over the two years from April 1994, the Authority, with the support of the Department, closed or disposed of operations which were not viable or not consistent with AEA Technology's business strategy and created a single, free-standing business with 21 operating groups and a much more overtly commercial culture. This was a considerable challenge; Barclays de Zoete Wedd advised the Department in December 1993 that the commercial activities of AEA Technology were unsaleable in the form they were in at that time (paragraph 1.5).

6 In spite of these difficulties the Department achieved their objective of selling AEA Technology in 1996. The sale took place broadly in line with their timetable although three months later than originally planned because of the need to correct very serious shortcomings in AEA Technology's financial information, which were primarily a consequence of difficulties in recruiting a Finance Director and senior finance staff with appropriate commercial experience. The shortcomings meant that the requirements for listing shares on the London Stock Exchange could not be met by the target flotation date of June 1996 (paragraphs 2.11 to 2.13).

7 Proceeds at £227.75 million were higher than the Department expected (paragraph 1.20).

8 On the first day of trading the market valued AEA Technology's shares at 323.5p compared to the price set by the Department of 280p (paragraphs 1.20 and 3.29).

9 Before setting the share price the Department took soundings from the market as to how many shares institutions would buy at different prices within a range (bookbuilding). But this process did not test whether there was demand above 280p, the eventual price. The Department's brokers, Cazenove, believe that, although they did not formally take soundings at prices greater than 280p, there was no evidence from responses from institutions during bookbuilding of potential

demand at higher prices. They also consider that the significant premium in the after market was the result of demand by a few institutions for more shares rather than a general recognition by the market that the 280p share price was low. Pricing at 290p might have generated an extra £8 million of proceeds (paragraphs 3.29 and 3.30).

10 Setting the price range within which soundings should be taken is a difficult judgement but we consider that there were arguments for a wider range with a higher maximum than was chosen. Cazenove do not, however, agree and consider that a higher maximum would have resulted in a material reduction in demand (paragraph 3.30).

11 The Department sold 100 per cent of their shares in AEA Technology rather than selling them in phases because they believed that a phased sale would not be successful and that the factors against phasing were conclusive. When, therefore, the decision was taken in late July to proceed with a flotation they did not investigate the case for phasing and in particular whether phasing might generate additional proceeds. Although Schroders (the Department's financial advisers) and Cazenove had both been appointed on the basis that no sale options were ruled out, they were not asked to offer views on phasing, nor did the Department document their reasons for not pursuing that option (paragraph 3.5).

12 In the event, the share price of AEA Technology has risen substantially since the sale. At 27 February 1998 it stood at 617.5p, and at that date the company was valued by the market at around £534 million. This reflects a number of factors: there was increased understanding in the market of the company, which had the strong support of institutional shareholders; there had been an increase in the Financial Times Support Services Index of some 64 per cent, and the company had expanded, acquiring five other businesses for some £58 million. Assuming that a decision to retain 40 per cent of the shares in Government hands would have had no material impact on the development of the company or the attitude of their institutional investors (assumptions that the Department do not accept), the retained shares would at 27 February 1998 have been worth some £200 million compared with £90 million at the 1996 sale price (paragraphs 1.20 and 3.6).

13 The Department remain of the view that phasing was not appropriate in this case and their advisers have told us that they would have initiated a debate on phasing if they felt it had clear advantages. Schroders have also told us that in their view it would have been difficult, given uncertainty about the timing and outcome of the General Election, to set out in the Prospectus a credible statement of Government policy in relation to a retained shareholding. The Department, Schroders and Cazenove, all considered that full value was obtained for the

company as it stood at the time of the sale. The decision on whether to phase a sale is of course a matter of judgement: there are risks attached to both 100 per cent sales and phased sales. In particular, the success of phased sales depends on an increasing share price and share prices can go down as well as up. Experience shows, however, that phased privatisations have produced substantially greater proceeds. We conclude that the presumption should be, especially where companies are difficult to value, that better proceeds would be obtained from phasing and that departments should consider the matter very carefully (paragraphs 3.7 to 3.8).

14 The Department took a full part in the allocation of 10 million shares to intermediaries but, contrary to the usual practice in privatisations, the Department did not monitor the allocation of some 68 million shares by their broker, Cazenove, to institutions. Departments usually participate in allocation decisions to ensure a fair allocation, and one to those institutions who will support the company. Whilst AEA Technology have received strong support from their institutional shareholders since flotation and we have seen no evidence that Cazenove unduly favoured any institutions including three Cazenove companies which received shares, we consider that the Department should have taken part in the allocation process, so that, amongst other things, they were aware of these allocations and capable of assuring themselves that these and other allocations were fair. The Department accept that they should have overseen the allocation process but told us that they subsequently reviewed it and satisfied themselves that it was carried out fairly (paragraphs 3.32 to 3.36).

Seeking value for money from expenditure relating to the sale

15 The Department's advisers' costs totalled £8.1 million compared to a budget of £8.0 million. The cost of giving free shares to employees was £3 million (paragraphs 2.16 to 2.18).

16 Part of the cost of Schroders, in their capacity as the Department's financial adviser, was a success fee of £1.8 million linked to the extent to which proceeds exceeded Schroders' estimate of likely proceeds. While there were some safeguards to value for money, including that Schroders were appointed through competition and the fee was capped at a maximum of £2million, we are concerned that the valuation was based on Schroders' own estimate and that the reasonableness of the methodology and the assumptions made was not reviewed independently (paragraphs 2.23 to 2.28).

Taking account of the requirements of AEA Technology's customers, particularly their government customers in the sale

Seeking to safeguard the interests of the United Kingdom Atomic Energy Authority as a major customer, landlord and nuclear licensee of the sites occupied by AEA Technology

17 The Department consulted the main customers of AEA Technology including the United Kingdom Atomic Energy Authority during the sale. The Authority and the other main customers of AEA Technology, the former Department of the Environment, the Ministry of Defence, the Health and Safety Executive and the Department of Trade and Industry have confirmed to us that they are content that their requirements were taken into account in the sale and that they are generally satisfied with the outcome(paragraphs 4.2 to 4.6).

18 Detailed agreements were put in place to safeguard the interests of the Authority as landlord and nuclear site licensee including leases negotiated to reflect market levels and conditions and which required a detailed safety control regime. The safety regime set out in the leases and in tenant safety requirements and other documentation was discussed and agreed with the Nuclear Safety Directorate of the Health and Safety Executive. The Nuclear Safety Directorate have confirmed that these arrangements have been generally effective. In line with their normal approach of encouraging licensees to do all that is reasonably practicable to control and reduce risks they have, however, been seeking continuous improvement in the Authority's management of safety arrangements (paragraph 4.7).

Recommendations

We recommend that in future sales, departments should:

1 where there is any material uncertainty about the method of sale, ensure that the right finance staff, and adequate financial systems, are in place well in advance of any announcement about privatisation (paragraph 2.11to 2.15).

2 consider carefully the case for phasing (paragraph 3.8).

3 ensure that, where in pricing shares they place reliance on prior soundings in the market place, this process is conducted rigorously so as to give as good an indication as possible of the range of likely demand at different prices (paragraphs 3.15 to 3.31).

4 play an active part in allocating shares in line with agreed criteria so as to ensure that shares are allocated to bodies that will support the company in the longer term and to assure themselves that shares have been allocated fairly (paragraphs 3.32 to 3.36).

5 where success fees are to be paid to their adviser, obtain validation independent of the adviser as to the reasonableness of the methodology and assumptions for estimating the level of proceeds to be used as the basis of the success fee (paragraphs 2.23 to 2.28).

Part 1: The business and the sale

1.1 This part of the report describes:

- the business for sale;
- preparations for sale; and
- the broad outcome of the sale.

AEA Technology's business

1.2 AEA Technology are a broadly based science and engineering services business serving public and private sector customers. At the time of the sale in September 1996, they had 21 operating groups organised for reporting purposes into four operating divisions – Consultancy Services, Engineering Services, Technical Products and Technical Services and six principal subsidiaries. In the financial year ended 31 March 1996, sales totalled £253 million and operating profits were £19.8 million. AEA Technology have four main customer groups: United Kingdom Government Departments and Agencies; the United Kingdom public sector; the United Kingdom private sector and overseas customers. Net assets were valued at £64 million at 31 March 1996. The company's sites are shown on Figure 1.

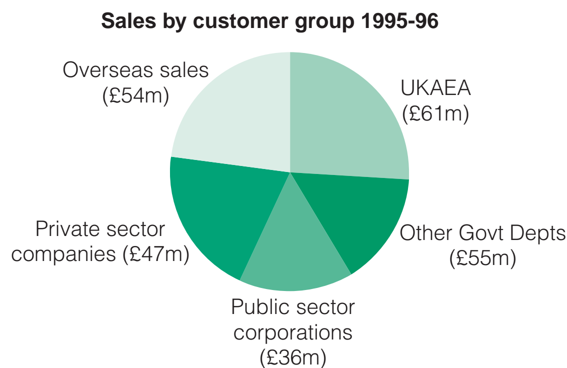
1.3 AEA Technology were formed in April 1994, bringing together commercial activities of the United Kingdom Atomic Energy Authority (the Authority) which had previously been organised as separate businesses, themselves a product of previous restructuring in 1993 and earlier. AEA Technology were a division of the Authority until March 1996 (Figure 2). The Authority were set up under the Atomic Energy Authority Act 1954 to lead the development of nuclear technology in the United Kingdom. They are a Non-Departmental Public Body, sponsored by the Department of Trade and Industry (the Department). The framework for the roles and responsibility of the Authority and the Department is set out in a number of Acts of Parliament principally the Atomic Energy Authority Act 1954 and the Atomic Energy Authority Act 1995. The Members of the Authority are appointed by the Secretary of State for Trade and Industry. The Authority work within agreed objectives, set by the Secretary of State, which are reviewed from time to time.

Figure 1

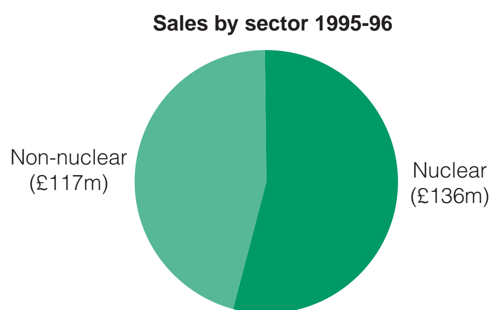
AEA Technology - summary of business activities

UK sites and offices

Sales by customer group 1995-96



Sales by sector 1995-96

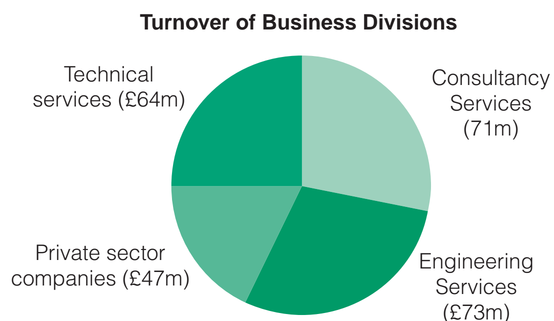


Financial and staffing data 1993-94 to 1995-96

	1993-94	1994-95	1995-96
	£m	£m	£m
Turnover	258	257	253
Operating Profits (before restructuring costs)	4.3	7.4	19.8
Restructuring[1]	1	17	46
Employees*	4,627	4,216	3,501

Note: 1. Money actually spent. An Extra £42m was committed in those years. Final restructuring costs = £106m with a further £15m spent on separation

Turnover of Business Divisions

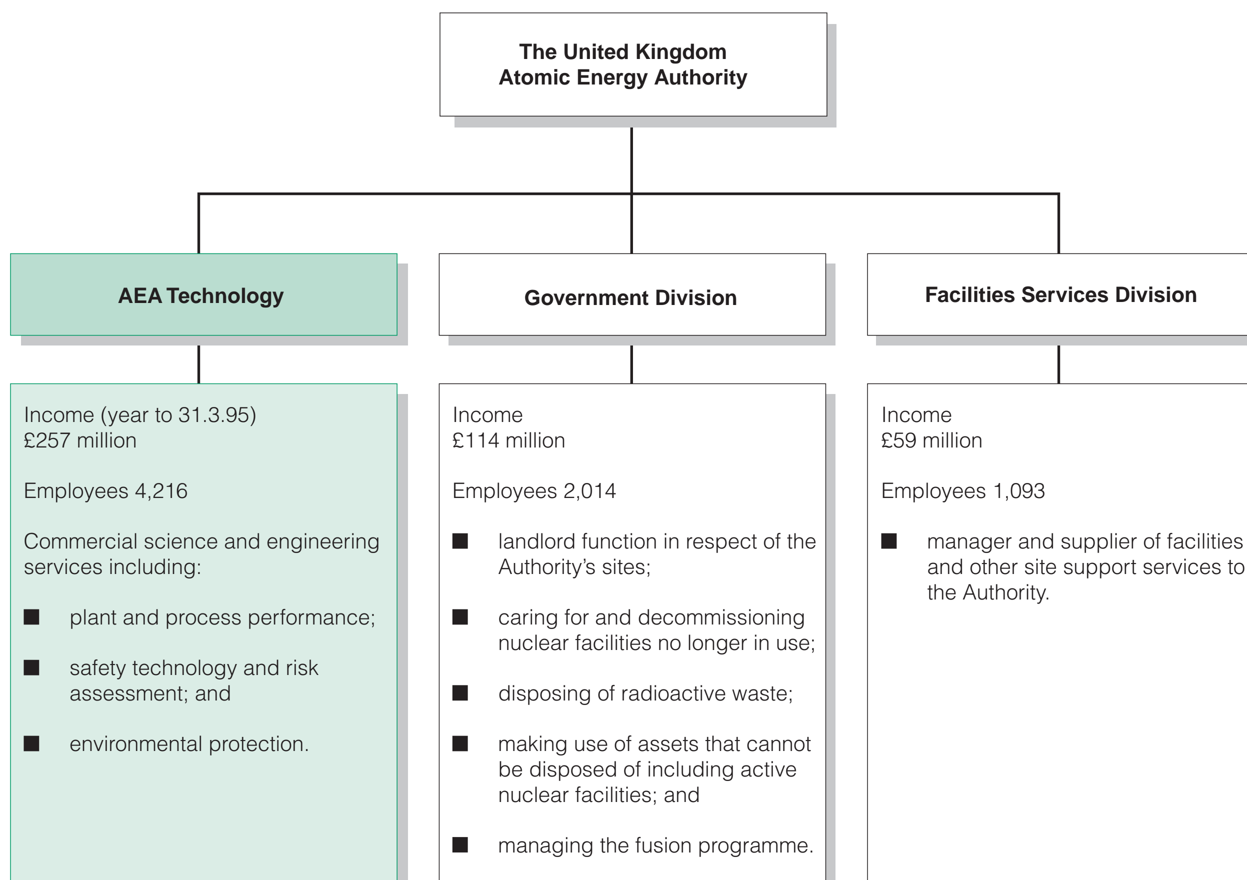


Consultancy Services	**Engineering Services**	**Technical Services**	**Technical Products**
Consultancy on safety, environmental and plant performance, management of energy and environmental programmes	Nuclear decommissioning and waste management	Service teams in the field who improve plant and processes, including using experimental facilities	Software products, hightech instrumentation, telerobotic system, licensing of battery technology

Source: Deloitte & Touche - Long Form Report and AEA Technology prospectus

Figure 2

Structure of the Authority (March 1995)



Note: Facilities Services Division was established to achieve a commercial approach to facilities management to the other divisions of the Authority. Facilities Services Division were sold in March 1995 *(United Kingdom Atomic Energy Authority: Sale of Facilities Services Division, Report by the Comptroller and Auditor General, HC 118 of Session 1996-97).*

Source: The Authority

1.4 Legislation since 1965 allowed the Authority to expand into non-nuclear areas of work and to develop a significant business in contract research and development based on their science and engineering skills and resources. The Authority became a Trading Fund in 1986 to reflect the increasingly commercial nature of their activities. A report by the Monopolies and Mergers Commission in May 1992 drew attention to the scale of the commercial activity and questioned its appropriateness for a public sector organisation. In May 1993, the Department commissioned Barclays de Zoete Wedd to carry out a strategic review of the Authority. And the appointment of Sir Anthony Cleaver as Chairman in July 1993 prompted an immediate internal review of the Authority's corporate structure. The Authority recommended in August 1993 that they should be restructured to focus on liabilities management and the development of their commercial

activities, with support services being brought together in a Facilities Service Division and sold. Barclays de Zoete Wedd independently endorsed this approach recommending that the commercial activities should be restructured and sold but emphasising that top priority should be given to driving down the cost of liabilities management through more effective internal management and the development of a competitive market for decommissioning services. Ministers accepted the recommendations and in February 1994 announced their intention to privatise the Authority's commercial activities.

1.5 The report by Barclays de Zoete Wedd recognised that before the commercial activities of the Authority could be sold they would have to be substantially restructured. They would have to be reorganised into coherent businesses rather than just a series of largely unrelated activities; business systems would need to put in place and duplication and inefficiency eliminated. Without this rationalisation, BZW considered that a number of activities were unlikely to have a long term future, and that the Authority's commercial activities as a whole could be unsaleable, particularly as a single entity. It was recognised that rationalisation would be a challenge and require considerable expenditure.

1.6 Restructuring into three divisions, each operating on an arms-length basis, formally took effect in April 1994 (Figure 2). The Facilities Services Division was sold in March 1995. Statutory provision for the separation and sale of AEA Technology was made in the United Kingdom Atomic Energy Authority Act 1995.

Formal separation of AEA Technology from the Authority

1.7 On 31 March 1996 the operational and attributable assets and liabilities of the former AEA Technology division of the Authority were formally split from the Authority and vested in a public limited company, AEA Technology plc, owned by the Secretary of State for Trade and Industry.

Preparation for the sale

Managing preparations

1.8 The Department were responsible for preparing AEA Technology for sale and for conducting the sale itself. These activities were managed by a small team of officials, aided by a number of advisers. The main advisers were Schroders (financial adviser), Cazenove (broker), Lovell White Durrant (legal adviser), and

Touche Ross (from 1 February 1996, Deloitte & Touche) (reporting accountant). Part 2 of this report examines the appointment of these advisers and the control of their costs.

1.9 The Department set up two steering groups to co-ordinate the efforts of the parties involved. The first group included representation from the division in the Department responsible for the Authority, from the finance division and from the solicitor's department. Also represented were the Department's main advisers and a representative of HM Treasury. This group met monthly to discuss major issues and monitor progress against a project plan drafted by Schroders. The second steering group consisted of representatives of the Department, AEA Technology, both parties' main advisers and HM Treasury. This group discussed major issues with AEA Technology and monitored their progress towards meeting their targets under the project plan.

1.10 Departmental staff handling the sale were experienced in matters relating to the business of the Authority and in trade sales. This was important because much of the preparation of the business for the sale required a good understanding of the Authority and because a trade sale was seen initially as the most likely method of sale. The team as a whole, however, had no previous experience of handling a flotation but had access to advice from senior management and others in the Department, the Treasury privatisation team and their own advisers.

1.11 In our view, sales of shares that have been managed or overseen by staff with previous experience of flotations (for example, the first sale of National Power and PowerGen and the sales of residual shares handled by the Treasury), had benefited as a result. For example, staff with such experience are in a better position to question advisers and perhaps take decisions with which advisers do not necessarily agree. We consider that Departments should consider these factors when putting teams together for future sales.

Making Preparations

1.12 Preparation for the sale included:

- deciding on the form, method and timing of sale;
- considering whether AEA Technology should be sold with new debt injected into them;

- making arrangements for employees including pensions and employee share participation;
- dividing assets and liabilities between the Authority and AEA Technology via a transfer scheme; and
- considering property clawback arrangements.

Method and timing of sale

1.13 In February 1994, when the Government announced their intention to privatise AEA Technology, no decision had been taken on the form or method of sale, or on timing - although the Department had in mind a sale in the summer of 1996. At that time it seemed likely to the Department that privatisation would be by means of one or more trade sales to another business, or to the management and employees, although the flotation option was kept open. Following further analysis, Ministers announced in October 1995 that AEA Technology would be sold as a single whole. A decision in principle to proceed through a flotation in September 1996 was taken only in July 1996 and confirmed at the end of August. The Department's strategy of keeping their options open as long as possible was designed to:

a) achieve a sale, whether by flotation, a trade sale or a management and employee buy-out, within the planned timescale;

b) maximise sale proceeds by playing the various sale options off against each other. Schroders contacted several potential trade buyers and financial institutions that might finance a management buy-out to compare the value they placed on the company with the estimate of proceeds from a flotation made by Cazenove. Schroders concluded in July 1996 that flotation could raise £160 million to £216 million, marginally more than a trade sale (£160 million to £210 million);

c) maximise the incentive for management to improve the performance of the business and thereby enhance the prospects of securing full value for money from the sale whatever the method of disposal; and

d) strengthen the Department's position when issues such as the level of debt to be injected or the level of employee incentives were negotiated with management.

1.14 In the event, the Department concluded in July 1996 that flotation was the preferred option because they considered it would raise higher proceeds, and as it was more likely to preserve the independence of AEA Technology, it would be more acceptable to AEA Technology's major government customers.

Whether AEA Technology should be sold with debt

1.15 Proceeds from flotations tend to be maximised by the injection of a sustainable level of debt into the company. Servicing debt capital out of any given level of profits is normally cheaper to a company than servicing equity capital. There are two reasons for this. First, interest on debt is tax deductable, while dividend payments are not. Second, dividends usually increase with time, which is not normally so in the case of interest, which if not fixed, will move only in accordance with general interest rates. At higher levels of injected debt, however, the proceeds of sale are likely to decline. This is because the costs of servicing debt beyond certain levels are likely to be perceived by investors as unacceptably high in relation to earnings and a risk to the ability to pay dividends. For this reason, debt was injected, for example, into National Power and PowerGen and the twelve Regional Electricity Companies before they were sold. Reports by the Comptroller and Auditor General: The Sale of National Power and PowerGen HC 46 June 1992; The Sale of the twelve Regional Electricity Companies HC 10 May 1992.

1.16 Schroders advised the Department that AEA Technology would need to finance their working capital from loans and would have little security in terms of assets and positive cash flow which lenders could rely on to fund debt above these working capital needs. They considered that as a consequence a major injection of debt could adversely affect proceeds, although in negotiation with AEA Technology it was agreed £3.75 million should be paid to the Department in the form of a dividend soon after the sale. The dividend was paid to the Department on 1 October 1996.

Employee rights

1.17 The Atomic Energy Authority Act 1995 gave AEA Technology employees certain rights including the right to be offered pension arrangements that were no less favourable (taken as a whole) than the Authority's scheme. In practice, the scheme offered by AEA Technology after privatisation was identical in its main respects to the Authority's scheme and included, for example, full indexation of pensions.

Allocation of liabilities

1.18 The Authority retained nuclear liabilities resulting from all their activities before April 1996 together with the provision made in their accounts relating to those activities. AEA Technology will bear financial responsibility for any nuclear liabilities that arise as a consequence of their activities from April 1996. The Authority similarly retained liability for all significant environmental and industrial disease liabilities resulting from their activities before April 1996.

Clawback

1.19 One of the recommendations of the Public Accounts Committee is that where land is considered to have development potential, serious consideration should be given to all the options for protecting the taxpayer's interest, including a separate sale or the use of clawback provisions, (13th Report, Session 1989-90 (Appendix 2)). In this sale, clawback arrangements apply to any profit made from disposals of property between September 1996 and August 2008. The rate of clawback depends on when the gain arises and the type of property to which it relates. For example, the main arrangement relates to part of the site at Risley. This was development land transferred to AEA Technology in March 1996 at a valuation reflecting its worth to the company as a location for expansion. The Authority recognised, however, that the land could be worth more to a commercial developer. If gains are made from the sale of this site the rate of clawback will be 75 per cent if the sale is within the first four years, 50 per cent during the next four years and 25 per cent for the remainder of the clawback period. For all other property subject to clawback the rate is 50 per cent for the first eight years of the clawback period, and 25 per cent for the remainder of the clawback period.

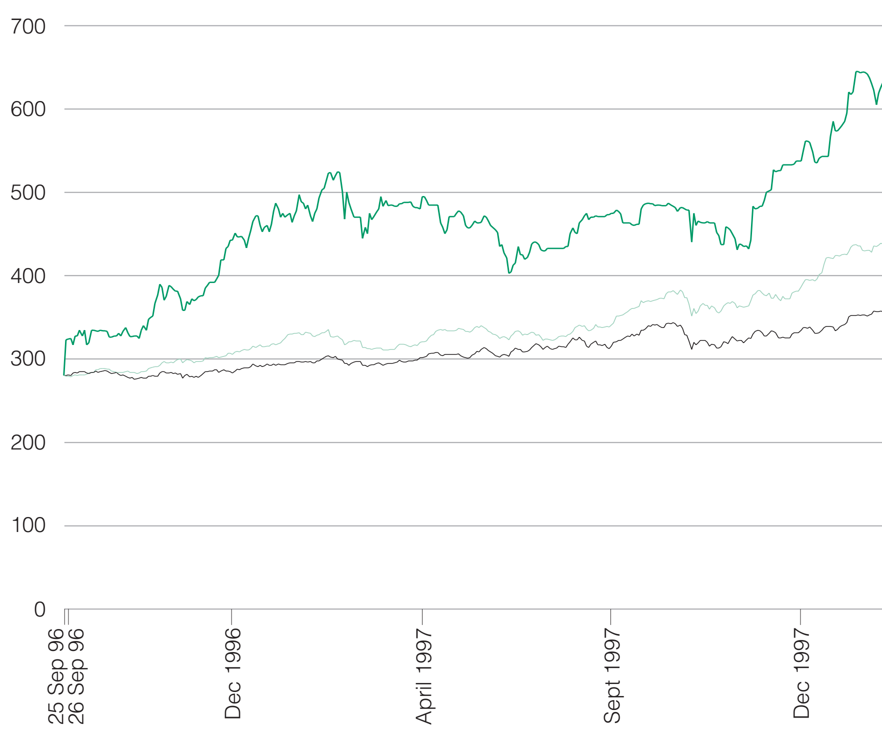
Outcome of the sale

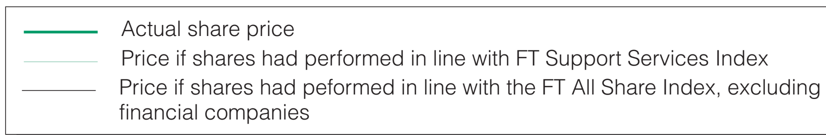
1.20 On 25 September 1996 the Department sold AEA Technology for £224 million. In addition, they received a dividend of £3.75 million giving total gross proceeds of £227.75 million which was more than the Department had expected. Shares in AEA Technology were sold for 280p each. At that price demand was 3.1 times the number of shares available compared to a minimum target of 1.5 times. On 26 September trading in the shares opened on the London Stock Exchange at 323.5p, a premium of 43.5p (16 per cent) compared to the anticipated premium of 20p (7 per cent). The share price in 1998 has ranged from 538p to 645p, out-performing the Financial Times Support Services Index (Figure 3), with the market valuing the company between £465 million and £557 million. This reflects a number of factors: there was increased understanding in the market of the

company, which had the strong support of institutional shareholders (at July 1997 Schroders Investment Management held 13.35 per cent of the shares, Hill Samuel 5.54 per cent, Mercury Asset Management 5.45 per cent, and Cazenove Fund Management 4.74 per cent); there had been a 64 per cent increase in the Financial Times Support Services Index and the company had expanded, acquiring five other businesses (Hyprotech, BR Research Limited, Advanced Scientific Computing, ERG Environmental Research and Safeguard) for some £58 million. The business in February 1998 was not, therefore, identical to that sold in 1996.

Figure 3

AEA Technology's share price compared to FT All Share Index, excluding financial companies, and the FT Support Services Index





Note: The price of AEA Technology shares is compared with the FT Support Services Index as the business is included within that sector of the market, and to the FT All Share Index, excluding financial companies, as it was one of the indices used by Cazenove to value the company.

Source: Published stock market prices

This shows that the AEA Technology share price rose sharply on the first day of trading and has since out-performed the FT Support Services Index and FT All Share Index, excluding financial companies.

Scope and methodology of National Audit Office examination

1.21 We examined the steps the Department took to prepare for the sale and meet the sale objectives. The methodology we used is summarised in Appendix 1. We were assisted in this by our adviser, Price Waterhouse. As part of the examination we compared the Department's actions against previous recommendations made by the Committee of Public Accounts on the handling of earlier sales (Appendix 2).

Part 2 : Restructuring and sale costs

2.1 This part sets out:

- the costs of restructuring AEA Technology prior to the sale;
- the cost of employee incentives; and
- the costs of advisers.

The restructuring and separation of AEA Technology

Objectives and costs of restructuring

2.2 In line with the recommendations made by Barclays de Zoete Wedd and endorsed by Ministers, the Authority, with the approval of the Department, embarked from April 1994 on a significant restructuring programme. The objectives of the programme are shown in Figure 4. The aims were to reduce costs and increase efficiency by shutting down or disposing of operations which were not commercially viable or not consistent with AEA Technology's business strategy; closing overlapping and duplicated facilities; reducing staff and accommodation requirements; and, more fundamentally, developing a more overtly commercial culture at all levels within the division. At the same time, as part of the Department's strategy for the rationalisation of the Authority, three decommissioning teams were transferred from AEA Technology to the Government Division to provide a basis, through subsequent contractorisation, for stimulating competition in the decommissioning market and decommissioning contracts were opened to external competition putting further pressure on AEA Technology to reduce costs.

2.3 In the restructuring, AEA Technology were reorganised from 28 operations into 21 operating groups. Some 'non-core' small businesses such as a metal extrusion business were either sold or closed. Staff numbers reduced from 4,627 in March 1994 to 3,501 in March 1996, the majority being voluntary redundancies and early retirements. Other staff were retrained or relocated. The costs of any non-productive time that was not chargeable (for example, where staff who were leaving worked their notice period) were also counted as restructuring costs. Additionally, there was a physical reorganisation of accommodation and communications infrastructure at the Authority's main sites. AEA Technology shared buildings, facilities and systems with the rest of the Authority. To ensure

Figure 4

Objectives of restructuring

The objectives of restructuring were to:

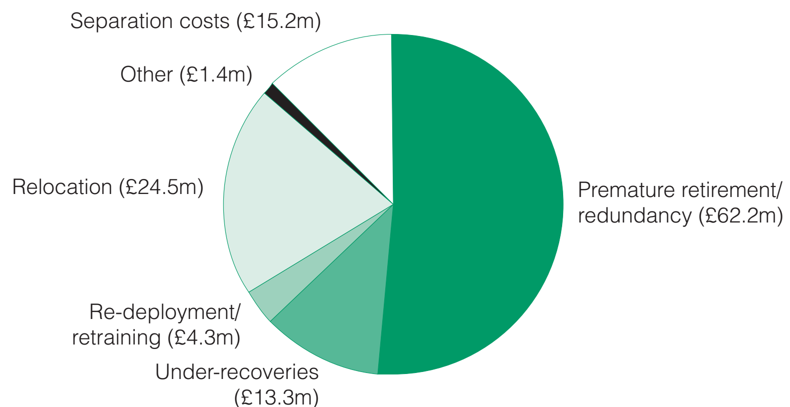
- focus on the activities most likely to be commercially successful;
- reduce costs substantially to enhance competitiveness and improve profits;
- engender a culture more focused on customer service and profit generation;
- remove a layer of management;
- improve accounting and other systems to ensure that managers have access to appropriate, accurate and timely information; and
- facilitate the legal separation of AEA Technology from the Authority.

Source: AEA Technology's prospectus

that AEA Technology's and Government Division's costs were clearly identifiable and that AEA Technology operated on a full arms length basis from Government Division, these arrangements were rationalised. Many under-utilised buildings were vacated or demolished while other accommodation was developed and refurbished and new information systems installed. Over the three years 1993-94 to 1995-96, £106 million was incurred on restructuring AEA Technology and £15 million was incurred on separating AEA Technology from the Authority. Figure 5 shows a breakdown of these costs.

Figure 5

Costs of restructuring and separating AEA Technology (April 1993 - March 1996)



Notes: 1. The costs of non-productive time, for example, where staff who were leaving worked their notice period, were charged to restructuring as under-recoveries.

2. Separation costs comprise the costs of separating accommodation, the information systems and telephone network.

This shows that just over half of the restructuring costs were for premature retirements and redundancies.

Source: Deloitte & Touche - Long Form Report

2.4 The Department funded part of AEA Technology's restructuring costs and separation from the Authority directly by grant and the Authority financed the remainder through borrowings from the National Loans Fund.

Outcome of restructuring

2.5 Following restructuring, the Department commissioned Deloitte & Touche to prepare a "Long Form Report", the key due diligence report on AEA Technology's finances and financial reporting systems for the sale's sponsors, Schroders. A draft of this report, prepared in December 1995, gave an indication, amongst other things, of how far the business had progressed and their current status. The report concluded that the management of AEA Technology had made significant progress in bringing the organisation towards a structure that was capable of flotation:

- profitability had improved. As a result of actions taken to reduce costs, management were projecting operating profits in 1995-96 of nearly £20 million compared to £7.5 million in 1994-95;
- new management had been introduced (for example, at the time of the report three of the four executive directors had been with AEA Technology less than 18 months), and a layer of management removed;
- a new accounting system had been introduced; and
- there was a clearer strategic focus.

2.6 As noted at paragraph 2.11, however, there remained serious shortcomings in AEA Technology's financial systems.

Classification of restructuring costs

2.7 The Department consider that the costs of these activities should not be treated as sale costs. This is because, in their view, substantial restructuring was necessary to ensure AEA Technology's commercial viability and restructuring and separation of AEA Technology was necessary to promote competition for decommissioning work and drive down decommissioning costs even if AEA Technology had remained in the public sector. The Treasury confirm that the status quo before restructuring was not a viable option. The Department's view that

restructuring costs should not be regarded as sale costs is consistent with the approach they adopted in previous sales, such as the Sale of British Coal's mining interests.

2.8 It must remain a matter of speculation, however, when the restructuring would have taken place, what form it would have taken and how much it would have cost if the business had remained in the public sector. The costs were incurred after Ministers had announced their intention to sell AEA Technology and AEA Technology would not have been saleable in the form in which it was sold if the costs had not been incurred. The prospect of a sale was also one of the main reasons why the Department provided additional funds of £51 million in December 1995 to pay for restructuring. The Department considered at the time that without restructuring AEA Technology would not meet their profit targets for 1995-96 or their prospects for later years and that restructuring expenditure, leading through into profit, would be more than recouped in proceeds.

2.9 Some costs were incurred earlier because of the prospect of a sale. The Department authorised the payment of special early release terms (a payment in lieu of notice) to 168 staff to encourage them to leave before 29 March 1996. In effect costs of £2.5 million were incurred six months early so that AEA Technology did not carry any redundancy liabilities in their accounts after they became a separate company. The Department's view was that such liabilities would have had an adverse impact on sale proceeds in excess of the cost of making the payments early and would have diverted management time because of the implementation of compulsory redundancy procedures. Some of the staff concerned were re-engaged by AEA Technology for a limited period on temporary contracts, for example, to complete the process of validating financial data relevant to the sale. They are, however, no longer employed by AEA Technology.

2.10 Against this background we conclude that it might be reasonable to regard at least part of restructuring costs as expenditure related to the sale.

Financial information

2.11 One of the objectives of rationalisation had been to improve accounting systems so that managers at the centre had better financial management information about the performance of the business and managers in business units could identify their own costs and identify the contribution their activities were making to the profits of AEA Technology. In December 1995, however, a draft Long Form Report and a subsequent analysis by Schroders indicated very serious shortcomings in the financial management information available as at

December 1995, with a consequent degree of uncertainty as to the quality of the results and forecasts. The concerns about weaknesses in financial management, listed in the draft Long Form Report, are shown in Figure 6.

Figure 6

Weaknesses in financial management as at December 1995

Weakness	Consequence
■ Financial information for 1993-94 was very limited. ■ Revenues and costs for 1993-94 could not be assigned to operating groups existing in 1995 because of major reorganisations in April 1994 and April 1995. ■ Business results for 1994-95 were not presented on a basis consistent with projected results for 1995-96 and thereafter.	■ Not possible to explain the reasons for substantial improvements in profitability to March 1996 or to demonstrate that they represent tangible progress, rather than being explained, in part, by reductions in notional charges, internal trading and other adjustments.
■ There was no reliable data for historical and projected working capital requirements.	■ Greater headroom required in terms of cash and/or borrowing facilities. Failure to correct this might have required a substantial injection of funds by the Department which would have reduced net proceeds from the sale.
■ Timeliness and accuracy of financial information were poor (partly a legacy of the old accounting system and the structure of the finance department). ■ Limited focus by finance staff on wider issues as well as record keeping (apparent in poor quality of explanations and analysis of trends). ■ Motivational difficulties of some accounts staff. For example at one location staff were aware that they were to be made redundant. Some left early, some were off sick suffering from stress and it was not easy to get full co-operation of remaining staff. ■ A new unproven accounting system.	■ Reduced confidence that key financial data to support year end accounts and sale documentation would be delivered on time.

Source: Draft Long Form Report and report by Schroders

2.12 Schroders concluded, and Deloitte &Touche agreed, that the problems were so serious that the company could not be floated by the then target date of June 1996 because AEA Technology's financial information was not sufficiently reliable to meet the standards required by the London Stock Exchange. Schroders were required by the Listing Rules of the London Stock Exchange to confirm to the Exchange that

> "the directors have established procedures which provide a reasonable basis for them to make proper judgement(s) as to the financial position and prospects of (the company)."
> ***(paragraph 2.11 of the Listing Rules)***

Based on the draft Long Form Report, Schroders concluded that they could not make this statement as at January 1996. Furthermore, Schroders observed that some of the problems might lead to reduced proceeds even in the event of a trade sale. For example, the inability to explain why operating profits for 1994-95 were higher than in 1993-94 cast doubts on the quality of future profits forecasts whilst weaknesses in systems for controlling work in progress and cash meant that a greater margin of error would need to be incorporated via a substantial injection of funds by the Department. A further consequence of the inadequacy of information was that Deloitte & Touche found it difficult to obtain the information they required to write the Long Form Report and they had to repeat the process. This resulted in a very substantial increase in their costs from the budgeted £850,000 to £1,750,000.

2.13 In February 1996, Schroders produced a plan to meet these problems including the secondment of two senior staff from Coopers and Lybrand to drive forward the finance functions and a dedicated team to address the issues identified by Deloitte & Touche and themselves. The plan was implemented and the issues were resolved to a point where Deloite & Touche and Schroders were willing to recommend that a flotation could proceed.

2.14 One lesson to be drawn from AEA Technology's experience is that it can be difficult and time consuming to recruit finance staff with appropriate experience at a time when the future ownership of an organisation is uncertain. In AEA Technology's case, this resulted in difficulties in producing robust financial information on a timely basis at a key stage in the sale process.

2.15 The Department and the Authority sought to have a new Finance Director in place earlier but it proved impossible to identify a suitable candidate until August 1995. This was largely due to the fact that potential candidates were deterred by the prospect that AEA Technology might be sold to a trade buyer or

buyers rather than by flotation. It would have been uncertain as to whether trade buyers would want to retain existing senior management and thus the post of Financial Director might be short term. The same problems applied to the recruitment of other key financial staff up until July 1996.

Costs of incentives to employees

2.16 The Department and their advisers considered that AEA Technology's employees represented the company's principal commercial value and thought it essential to demonstrate to potential investors that steps were taken to foster motivation and retention. The Department therefore, offered employees participation in ownership. In line with previous privatisations, the Department gave employees:

a) free shares up to the value of £160;

b) for the first £250 of shares purchased by an employee, the Department would give the employee an additional £500 worth of shares;

c) for the next £300 shares purchased, the Department would give employees an additional £300 worth of shares; and in addition

d) priority in purchasing up to £5,000 of shares each (at the offer price and at no cost to the Department).

2.17 Therefore, for an outlay of £550 each employee would receive shares to the value of £1,510. If all employees took up the offer, the Department estimated that the cost would be £3.2 million. In the event, employees purchased 526,810 shares at a cost of £1.5 million and received 200,526 free and 790,510 matching shares at a cost to the Department of £2.8 million in proceeds foregone.

Costs of advisers

2.18 One of the Department's objectives was to ensure that value for money was secured from expenditure related to the sale. By expenditure related to the sale, the Department meant the costs of their advisers. These costs totalled £8.1 million (excluding VAT), 3.5 per cent of proceeds.

Appointment of advisers

2.19 The Department employed nine advisers (Figure 7), all but one of which was appointed following competitive tendering. The exception was the Government Actuary's Department, which the Department needed to consult on pensions aspects of the legislation leading to the privatisation of AEA Technology. The Government Actuary's Department also negotiated with AEA Technology's own pensions advisers on behalf of the Authority on the amounts to be transferred from the existing pension scheme to the new company's pension scheme.

Figure 7

The Department of Trade and Industry's advisers' costs

Adviser		Function	Agreed Budget [1] (£ m)	Costs [1] (£m)	Budget: outturn variance (£ m)
Schroders:	Basic fee	Financial adviser	1.150	0.560	-0.590
	Success fee		2.000	1.990	-0.010
Deloitte & Touche		Reporting Accountant	0.850	1.750	+0.900
Lovell White Durrant		Legal adviser	1.500	1.100	-0.400
Cazenove		Broker	2.160	2.320	+0.160
Other advisers		Various other services [2]	0.412	0.414	+0.002
Total advisers' costs			**8.072**	**8.134**	+**0.062**

Notes: 1. All figures exclude VAT.

2. Five advisers provided services connected with public relations, design, printing, banking and pension advice.

Source: Department of Trade and Industry

The Department's costs of selling AEA Technology amounted to £8.75 million (incl VAT).

2.20 In assessing competitive bids, the Department took account of pre-determined selection criteria, including qualitative factors, such as the strength of the advisers' proposed approach and the personnel involved, as well as price.

Costs compared to budgets

2.21 Costs overall were more than the aggregate agreed budgets of £8.07 million by £0.06 million (0.7 per cent). Within this there were several variations. The main ones were:

a) Schroders: £0.59 million less than budgeted because of savings made against budget during those stages of the project subject to day rates. This reflected the cost control exercised by the Department and effective time management by Schroders;

b) Deloitte & Touche: £0.9 million more than budgeted because of the difficulties in obtaining suitable financial information from AEA Technology; and.

c) Lovell White Durrant: £0.4 million less than budgeted because although the company undertook more work than originally envisaged costs were held down as a result of the close interaction between them and the Department.

Monitoring of advisers

2.22 In accordance with Treasury advice, the Department consulted the Treasury before agreeing fees for each of the main advisers (Schroders, Lovell White Durrant, Cazenove and Deloitte & Touche). In all cases the Department agreed caps on expenditure. The Department held monthly meetings with Schroders, Lovell White Durrant and Deloitte & Touche to monitor progress and set budgets for the following month. The Department's Internal Audit reviewed the procedures for tendering, contracting and monitoring of advisers and found them to be managed effectively and soundly. We also consider that these arrangements were broadly sound although we have concerns over the arrangement for calculating a success fee paid to Schroders.

Schroders' success fee

2.23 Schroders were paid on the basis of daily rates for work during the period 1 April 1995 to the end of March 1996 and a success fee to cover work from April 1996 to the end of the assignment in September 1996. The success fee was to be supplemented by a payment of up to £200,000 at the discretion of the Department depending on their view of the quality of the work. The Department agreed with Schroders that the success fee should be a minimum of £1.05 million if proceeds were obtained equal to the mid-point of Schroders' valuation range for AEA Technology, increasing to a maximum of £2 million if higher proceeds were

obtained. The success fee formula was designed to give Schroders a percentage of proceeds, the percentage increasing as proceeds increased beyond certain trigger points.

2.24 In terms of cost control, the fee arrangement had two main advantages:

a) the ceiling of £2 million on the success fee placed a clear limit on the costs the Department could incur in the period April 1996 to September 1996; and

b) the principles of the fee arrangement were compared with the fee proposals of other potential advisers during the competitive appointment process. Schroders' submission proposed a package of discounted daily rates plus a substantial success fee. Given the uncertainties attached to the saleability of AEA Technology at that time, the Department and the Treasury were attracted to the relative balance between these two elements because it gave Schroders an incentive to maximise sale proceeds whatever the final form and method of sale. Other bidders for the adviser contract also offered a mix of day rates and payments tied to final proceeds but were more heavily weighted towards the day rate element.

2.25 The key element in the formula was an estimate of likely proceeds put forward by Schroders as part of their response to the Department's invitation to tender, calculated on the basis of a profits forecast supplied by AEA Technology which was made available to them and other bidders. The valuation took the profits forecast as read and multiplied them by a price earnings ratio derived from those of four quoted companies trading in the support services sector which Schroders regarded, on the basis of their then limited knowledge of AEA Technology, as the most relevant comparators. Both the Department and Schroders recognised that the valuation was uncertain.

2.26 We have two concerns about the formula which determined where within the range of £1.05 million to £2 million the fee was set. The first is that it was based on Schroders' own estimate and the reasonableness of the methodology and assumptions was not reviewed independently. Even if the success fee is capped, there is a potential conflict of interest if the fee is based on an unchecked valuation made by those who are to receive the fee.

2.27 In May 1995, the valuation was updated to take account of the fact that AEA Technology had revised their profit forecast for 1996-97 downwards from £35 million to £26 million. Our second concern is that the formula did not make provision for updating the price earnings ratio. Not updating this element in the formula meant that Schroders were bearing the risk that market conditions might

deteriorate and the Department were bearing the risk that conditions might improve. The Department considered updating the formula but concluded that many of the issues involved in valuing AEA Technology were so specific to the company that it would be arbitrary to assume that their value would change in line with changes in price earnings ratios for the relevant market sector or for the market as a whole.

2.28 Given actual proceeds of £224 million, Schroders' success fee amounted to £1.8 million and the Department paid them £185,000 as a quality payment.

Part 3: Setting the price and selling the shares

3.1 This part of the report examines the steps taken by the Department to meet the objective of obtaining the best available proceeds from the sale. In particular, it sets out:

- the decision to sell 100 per cent of the shares;
- how the company were marketed;
- how the share price was set; and
- how shares were allocated to applicants.

Selling 100 per cent of the shares

3.2 The Public Accounts Committee have urged on a number of occasions that, where the market value of the shares is uncertain, it may be advantageous to sell the shares in stages. For example, in its 13th Report, Session 1996-97 on the Second Sale of Shares in National Power and PowerGen, the Public Accounts Committee noted that additional proceeds of some £2,300 million were raised by selling shares in phases.

3.3 There are a number of general arguments in favour of phasing sales. These are:

a) where the business to be sold is little known by the market and their business is not easy to describe, there is a risk initially that the market might undervalue the business;

b) management's ability to reorganise the business further and cut costs might not initially be recognised by the market;

c) where less than 100 per cent of stock is offered for sale, the relative shortage of stock might add to pricing tensions countering any downward pressure on initial prices caused by an overhang of stock; and

d) the market can be given to understand that a minority of shares is being held back specifically to maximise proceeds, and assurances can be given about the sale timing of later tranches of shares (as was done in the sale of National Power and PowerGen) and about non-interference in the day to day running of the business.

3.4 Against this background, particularly as AEA Technology were little known by the market and their business was not easy to describe, we asked the Department whether they considered phasing the sale of AEA Technology. The Department told us they decided against phasing the sale for the following reasons:

a) consistent with securing value for money, Ministers wanted to see the sale completed before the 1997 General Election. Given the uncertainty in the summer of 1996 about the timing of the Election, the Department interpreted this as meaning that they should sell all the shares before the Election took place;

b) the Department also viewed phasing as being incompatible with their fundamental value for money objective of driving down the Authority's decommissioning costs and opening up the decommissioning market to competition. They considered that the separation of the Authority and AEA Technology was not sufficient in itself to establish confidence amongst AEA Technology's competitors that they would not be discriminated against when contract decisions were taken. They concluded that confidence could only be established by the sale of 100 per cent of the shares of AEA Technology as soon as possible;

c) the Department were similarly concerned about the attitude of institutional investors towards the potential conflicts of interest and interference which may arise when the major shareholder in a company is also its major customer;

d) particularly in view of the imminence of the General Election, the Department believed that a phased sale would reduce management's commitment to the sale. Given the decision to proceed with a flotation rather than a trade sale, they saw this as a crucial consideration since management's performance in selling the company to the institutions would have a substantial impact on demand for the stock and the price obtained;

e) AEA Technology faced increasing challenges in continuing to replace public sector work with private sector and overseas business while growing sales overall. If the company was not able to meet those challenges, a later tranche of shares might prove difficult to sell. Given AEA Technology's failure to meet previous sale and profit forecasts, Schroders' advice was that the Department

would do better to sell on the expectation that the company could achieve their projected improvements in sales and profits rather than assume that improvements would be achieved; and

f) given the small size of the issue and the fact that there was no obligation on investors to buy shares in AEA Technology, they feared that the retained Government holding would overhang the market, depressing the price gained for the initial tranche and would not have created any genuine price tension as a result of there being a shortage.

3.5 The Department considered that these factors were conclusive. When, therefore, the decision was taken in late July to proceed with a flotation, they did not investigate the case for phasing and, in particular, whether phasing might generate additional proceeds. Although Schroders and Cazenove had both been appointed on the basis that no sale options were ruled out, they were not asked to offer views on phasing, nor did the Department document their reasons for not pursuing that option.

3.6 In the event, the share price of AEA Technology has risen substantially since the sale. This reflects:

- increased understanding of the company by the market and the strong support of institutional shareholders;

- the general increase in the market; and

- the company's acquisition of five other businesses.

Assuming that a decision to retain 40 per cent of the shares in Government hands would have had no material impact on the development of the company or the attitude of their institutional investors, (assumptions that the Department do not accept), the retained shares would at 27 February 1998 have been worth some £200 million compared with £90 million at the 1996 sale price.

3.7 The Department remain of the view that phasing was not appropriate in this case and Schroders and Cazenove told us that they would have initiated a debate on phasing if they had felt it offered clear advantages in terms of securing higher proceeds. Schroders have also told us that in their view it would have been difficult, given uncertainty about the timing and outcome of the General Election, to set out in the Prospectus a credible statement of Government policy in relation to a retained shareholding. They consider that this, together with AEA Technology's

substantial reliance on public sector customers, would have made the marketing of the company difficult with a consequential negative impact on the pricing of the initial tranche of shares. The Department, Schroders and Cazenove, all consider that full value was obtained for the company as it stood at the time of the sale.

3.8 There are risks attached to both 100 per cent sales and phased sales. In particular, phased sales depend on an increasing share price and share prices can go down as well as up. The decision on whether to phase a sale must therefore be a matter of judgement and take account of the differing circumstances of different sales. In our view, the presumption should be, especially where companies are difficult to value, that better proceeds would be obtained from phasing and that in managing future flotations departments should consider the matter very carefully.

Marketing of AEA Technology

3.9 Cazenove were responsible for marketing AEA Technology. They advised that AEA Technology needed to be marketed intensively because:

- AEA Technology had no direct stockmarket comparators. Investors often value a company by comparison with others whose value is already known. Not having a direct comparator makes valuation difficult and uncertain;
- AEA Technology had a short track record and relatively new management;
- they were facing a changing competitive environment; and
- they were little known by the market and their business was not easy to describe.

Target Market

3.10 AEA Technology were a relatively small company compared to, for example, Railtrack and British Energy, the two Government flotations immediately prior to the sale of AEA Technology. Given the size of the issue, the Department decided it would not be cost effective to sell the shares to retail investors or to launch a major marketing campaign abroad. After taking advice from Cazenove, the Department decided to market the shares to:

a) United Kingdom institutional investors who specialise in smaller companies and high technology funds together with institutions with general funds, on the basis that AEA Technology would outgrow the smaller companies sector;

b) overseas investors in jurisdictions where the shares could be offered on the basis of the United Kingdom sale prospectus. The Department took the view that the costs of producing United Kingdom prospectus to the standards required in other jurisdictions, for example, the United States, were not worthwhile. Firms in the United States could apply through their United Kingdom offices; and

c) financial intermediaries, such as brokers, with up to 10 per cent of the offer reserved for this category, although it could be increased depending on demand. This introduced competitive tension.

Marketing programme

3.11 The marketing programme was extensive:

a) Cazenove circulated a research note to institutions in July 1996;

b) a pathfinder prospectus (without some details such as the expected indicative price range for the shares) was issued on 2 September, and the full prospectus on 10 September; and

c) AEA Technology's senior management gave presentations to more than 200 institutions and financial intermediaries from 3 September to 23 September.

3.12 Presentations by AEA Technology's senior management were the critical element in the marketing campaign since they were the basis on which potential investors formed a view of the quality of AEA Technology's management, their plans for developing and growing the business, and improving shareholder value. The commitment shown by management was crucial in both investors' willingness to bid for stock and the level of their bids.

3.13 There was substantial overlap between the period of the presentations and the period during which institutions could bid for shares (3 September to 24 September). The last presentation was made on the day before bidding closed. Cazenove were keen to balance the importance of presenting the company to as many institutions as possible for the reasons set out at paragraph 3.9 with the desirability of maintaining a timetable which was sufficiently tight to ensure that AEA Technology remained at the forefront of the priorities of those institutions that they wanted to encourage to participate.

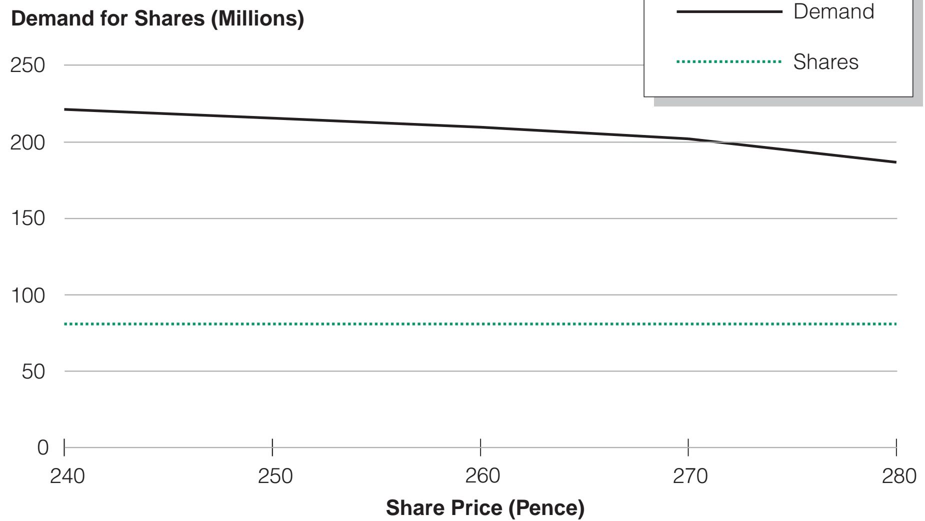
3.14 In the event, demand surged very considerably at the end of the sale process, with 68 (46 per cent) of the 148 eventual institutional bidders making their bids in the last two days of the bidding process. It became apparent to Cazenove that demand was considerably higher than expected on the day before the deadline for bids.

Setting the price of shares

3.15 The Department set the price for shares following a process of obtaining bids from the market (known as bookbuilding). Bookbuilding is designed to maximise the price which institutional buyers are prepared to pay for shares while at the same time retaining a cross section of high quality institutional investors. It also aims to ensure that institutions believe the shares will trade at a (ideally modest) premium to the offer price so as to justify their commitment to the offering itself as against taking their chances in the aftermarket. A successful bookbuilding operation also seeks to generate upward price momentum during the bookbuilding period by creating price tensions between different investors. The purpose is to establish how many shares institutions would purchase at a range of prices. From the resulting demand curve, the price at which demand falls off is shown and the vendor can then judge the price which strikes a balance between obtaining the best possible proceeds and giving investors a reasonable premium in the aftermarket. Figure 8 overleaf, the demand curve for AEA Technology, shows that the point at which demand fell off substantially was not shown by the bookbuilding exercise.

AEA Technology final institutional demand for shares

Figure 8



This shows that the price at which demand would have fallen substantially was not shown by the bookbuilding exercise.

Source: NAO Reports

3.16 The vendor generally gives the market an indication of the price it expects to achieve and this is done by setting an indicative price range for bookbuilding. That indicative range is based on the vendor's valuation of the company and its assessment of what potential investors may be willing to pay.

Valuation

3.17 Cazenove valued AEA Technology using the standard approach of multiplying their profits by a price earnings ratio derived from those of comparable companies already quoted on the Stock Exchange. In this case, there were no directly comparable companies. For their valuation Cazenove therefore used an average of price earnings ratios from the FT All Share Index, excluding financial companies, and an average price earnings ratio from their own small company index. This produced a valuation of £190 million to £227 million, equivalent to a share price of 237p to 284p (Figure 9).

Cazenove's valuation of AEA Technology

Figure 9

	Price earnings ratio for year to March 1996	Profit post tax for year to March 1996 £m	Value £m
FT All Share Index(excluding financial companies)	15.0	12.7	190
Cazenove Small Company Index	17.9	12.7	227

Note: As AEA Technology were not a financial company, Cazenove excluded financial companies from the FT All Share Index when they valued them.

Source : Cazenove

3.18 In July 1996, Cazenove considered that proceeds were likely to be at the lower end of their valuation range because of market deterioration and volatility. There had been a number of major share issues, on some of which institutions had lost money, and a number of new issues were in difficulty or had been withdrawn. Given that a substantial proportion of AEA Technology's sales were to the nuclear industry and that it was likely to be seen initially as a nuclear stock, Cazenove and Schroders were particularly concerned that market sentiment on issues arising from the sale and the initially poor aftermarket performance of British Energy would have a negative impact on the sale of AEA Technology.

The indicative price range

3.19 The Department had to decide on the indicative price range to be published in the prospectus and used in the bookbuilding process by the morning of 9 September at the latest. This enabled Cazenove to use the feedback from the first week of marketing and bookbuilding to inform their recommendation on the most appropriate indicative price range. Prior to their marketing of the company, Cazenove were considering a range of 230p to 260p, but by 6 September they were more optimistic about the price that AEA Technology could fetch and recommended that an indicative price range of 240p to 270p, a range of 12.5 per cent, be used in the bookbuilding process, equating to a market value of £192 million to £216 million.

3.20 Cazenove recommended the higher range because:

- the marketing campaign suggested that there was strong institutional interest in the company as one with potential for substantial earnings growth;
- the initial one to one meetings with institutions had gone well;
- press comment had been almost wholly positive with key issues well covered;
- there were initial signs that demand from financial intermediaries would be significant;
- there was potential demand for the stock in Europe and the Far East as well as from United States institutions with a presence in the United Kingdom; and
- evidence from institutions, which had entered bids by 6 September, indicated that they were prepared to pay more for the stock.

3.21 There is no standard price range for flotations. Ranges are determined by a number of factors including the particular circumstances of the business for sale. The indicative price range of 30p (12.5per cent) for AEA Technology was, however, narrower than the arithematical average of price ranges used in flotations from December 1995 to September 1996 (18.3 per cent). Although they considered that AEA Technology were a difficult company to value, Cazenove and Schroders advised the Department should avoid setting a wider range as this would lead investors to conclude that the Department had no clear view of the value of the company and would undermine the sale. The advisers also cited the sale of British Energy where institutions had, in their view, been wary because of the wide price range used (180p to 280p, 55 per cent). They considered that a 30p range was not only appropriate but necessary to guide potential investors as to valuation and that giving a lead to the market would boost confidence in the sale and thus generate demand.

3.22 Cazenove and Schroders based their advice to the Department on the view that the objective of the marketing campaign should be to achieve a final offer price at the top of the range to indicate to the market that there was strong demand for

the shares at that level. They thought that pushing the price range higher than 270p would run the risk of falling short of that objective and send a negative signal to the market.

3.23 However, we and our advisers, Price Waterhouse, consider that there were arguments for a wider indicative range with a higher maximum point. These arguments include:

a) the fact that a business is difficult to value may justify a wider rather than a narrower range. Where a company is difficult to value, there is a greater risk that the Department's valuation will not match that of the market. A wider range would reduce the risk that the market price for the business lies outside the range chosen by the Department;

b) Cazenove's valuation (paragraph 3.17) points to the top of the range being at least 285p (£227 million by ÷ 180 million shares);

c) whilst the British Energy case may be cited as a reason why the range should be less than 55 per cent it does not necessarily suggest a range of 12.5 per cent; and

d) the initial bids received before the setting of the indicative price range (Figure 10), suggested that even before the price range had been set there was significant demand at 270p. In our view, this indicated that demand at prices above 270p would need to be tested.

Demand for shares at 6 September 1996

Figure 10

Price (p)	Amount (£m)	No. of shares	% of 72m shares
240	-	-	-
250	65.79	26,316,000	36.5
260	49.79	19,150,000	26.6
270	39.79	14,737,037	20.5

Notes:
1. 15 bids were received, nine of which were at "strike" i.e. the bidders were willing to buy a given value of shares at whatever price the Department eventually set. There were three specific bids at 250p, two at 260p and one at 270p.
2. One bid at 250p was for £20 million of shares, and one bid at 270p was for £30 million of shares.
3. The Department expected to allocate at least 72 million shares to institutions.

This figure shows that ten institutions were willing to pay for 21% of the expected share allocation at 270p before the indicative price range for the bookbuilding process was set.

Source: Cazenove

Bookbuilding

3.24 The day before the close of the offer, 94 institutions had bid for 131.4 million shares at 270p a share, 1.64 times the number of shares to be issued, compared to the Department's minimum target of 1.5 times. Cazenove advised that, if the shares were sold at that price, there was likely to be a substantial premium. After receiving the Department's permission, Cazenove explored the scope for raising the price range to 280p a share with institutions. They reported that there was strong demand at that level and recommended that the indicative price range should be increased to 250p to 280p a share.

3.25 Raising the indicative price range during a sale is not common and is not without risk. In one case just before the sale of AEA Technology, raising the price range during the sale met with hostility in the market which resulted in a collapse of demand as institutions withdrew. Cazenove have told us that they would not normally have advised such a course, but in the circumstances of a privatisation were mindful of their responsibility to the taxpayer to obtain the highest proceeds possible.

Investigating demand at prices beyond the indicative price range

3.26 Figure 11 shows that, in the event, there was substantial over-subscription for the shares at the price of 280p with significant scaling back, especially for financial intermediaries despite the increase in their allocation from 8 million to 10 million shares. Figure 3 shows that the immediate aftermarket premium was 43.5p, more than twice the Department's anticipated premium.

Figure 11

Demand for shares at 280p a share

Bidder	Demand for shares million	Allocation of shares million	Degree of over-subscription	Shares allocated as a percentage of demand
Institutions	187.0	68.22	2.74	36.5
Financial Intermediaries	60.9	10.00	6.09	16.4
Employees*	1.78	1.78	1.00	100.0
Total	**249.68**	**80.00**	**3.12**	**32.0**

Note: * includes free shares given to employees.

Source: Department of Trade and Industry

3.27 Cazenove told the Department that they were very reluctant to raise the indicative price range any higher than 250p to 280p because:

- institutions are hostile to changes in indicative price ranges, especially so close to the end of bookbuilding;
- to push for a higher price would have been an abuse of institutions' willingness to reveal their demand; and
- institutions would assume that the top of the extended range would be the sale price.

3.28 Five institutions declined to bid at 280p withdrawing previous bids totalling £16.7 million. This and indications from some institutions that they would withdraw their demand at any higher price than 280p led Cazenove to believe that there was a precipice just beyond 280p where demand would fall very sharply. While anticipating a premium of up to 20p, when asked by the Department about the scope for setting a higher price, Cazenove's firm advice was to price at 280p. Also they considered that institutional demand for the shares at whatever price might have collapsed, especially as AEA Technology was not a "must have" share. After considering this advice, the Department set the share price at 280p a share.

3.29 On the first day of trading the shares of AEA Technology were valued at 323.5p, substantially higher than 280p. The Department, Schroders and Cazenove believed, and their feedback from the market indicated, that the market considered that a price of 280p represented a very good result for the taxpayer.

3.30 Pricing the shares at 290p might have produced an extra £8 million of proceeds. A key factor was that bookbuilding did not identify the full range of demand i.e. demand beyond 280p a share. It is difficult to say whether this could have been foreseen and avoided for example, by setting a wider price range and a higher range maximum in the bookbuilding process. Cazenove do not, however, agree and consider that a higher maximum would have resulted in a material reduction in demand. Cazenove believe that, although they did not formally take soundings at prices greater than 280p, there was no evidence from responses from institutions during bookbuilding of potential demand at higher prices. They also consider that the significant premium in the after market was the result of demand by a few institutions for more shares rather than a general recognition by the market that the 280p share price was low.

3.31 In our view, and that of our advisers, Price Waterhouse, the factors set out at paragraph 3.23 pointed to a higher indicative price range maximum than was set. We acknowledge, however, that these are difficult judgements and that once the range had been set and additional demand identified, the Department took the unusual step of increasing the indicative price range during the sale.

Allocation of shares

3.32 To secure the best possible price for the shares, vendors generally attempt to generate competitive tension between the various groups of potential investors. The Department did this by indicating to institutional investors that the allocation to financial intermediaries would be increased if their demand merited it. Competitive tension can also be increased by announcing a policy of allocating shares to likely long-term investors, because that can reduce the perceived risk that shares will be sold for a quick profit immediately after the sale.

3.33 The Public Accounts Committee noted, in their report on the Second Sale of shares in National Power and PowerGen, "that the Treasury had taken decisions on how shares should be allocated among investors on the basis of objective criteria which had been published in advance of the sale. As such allocations may result in considerable profit for those who received the shares, the Committee looks to all departments to take similar action in future sales", (13th Report, Session 1996-97 (Appendix 2)). The Treasury noted, in their reply to the Committee's report that procedures similar to those on National Power and PowerGen were followed by the Department of Transport and the Department of Trade and Industry on the sale of Railtrack and British Energy respectively.

3.34 In this case, the Department were consulted about the allocation of shares to financial intermediaries and approved the criteria on which this was based. The total allocation to this group was increased from 10 per cent to 12.5 per cent of the issue (10 million shares) and applications were capped and scaled back so as to leave applicants with just over 22 per cent of what they applied for.

3.35 The allocation of 68 million shares between institutions was handled by Cazenove using standard criteria for flotations with which fund managers are familiar (Figure 12). Allocations were determined by ranking institutions by reference to the criteria set out in Figure 12 (rank 1 receiving the largest allocation and rank 8 the smallest allocation). The Department and Schroders did not monitor this process or review the eventual allocation but relied on Cazenove's experience.

Cazenove's criteria for the allocation of shares to institutions

Figure 12

- **Investor quality and portfolio objectives.** Criteria considered: propensity to be long term holders; size of funds under management; type of fund; funds dedicated to relevant sector/country; and credit worthiness.
- **Price leadership.** Criteria considered: high bids and clear indication of price thresholds.
- **Timing of order.** Early entry of orders.
- **Aftermarket intentions.** Criteria considered: no history of short term profit-taking; and expressions of intention to buy in the aftermarket.
- **Size of order.** In absolute terms and in relation to the institution's perceived normal unit size.
- **Attendance at presentation.** Notwithstanding criteria on timing of order, institutions meeting the AEA Technology management towards the end of the presentations were not penalised in terms of allocation provided their orders were received promptly following the individual or group meeting in question.

This shows the criteria applied by Cazenove in determining the allocation of shares to individual institutions.

Source : Cazenove

3.36 Price Waterhouse have advised us that the criteria used by Cazenove result in an investor base that should support AEA Technology. Since the sale, institutions have given strong support to the company. There are, however, differences in the allocation arrangements compared with those used in other recent privatisations:

a) Cazenove have told us that in accordance with their standard working practices the allocation criteria (Figure 12) were not set out in writing and published in advance but were communicated verbally during the marketing process;

b) in accordance with their standard working practices the weighting given to each of the criteria were not set out;

c) because the criteria are not weighted, the allocation itself was made as a matter of judgement. This makes it difficult to review the allocation for fairness. In other recent Government sales, vendors have used a computer model which makes the allocation on a consistent basis according to agreed weighted criteria. This enables the allocation to be checked and gives greater assurance of accuracy and fairness; and

d) the Department did not play any part in the allocation to institutions. The Department were not at the time in a position to assure themselves that the allocation was consistent and fair. We have seen no evidence that Cazenove unduly favoured any institutions, including three Cazenove companies which received shares, but we consider that the Department should have taken part in the allocation process so that they were capable of assuring themselves that these and other allocations were fair. The Department accept that they should have overseen the allocation process but told us that they subsequently reviewed it and satisfied themselves that it was carried out fairly.

Part 4: Other objectives

4.1 In carrying out the sale the Department also sought to ensure that:

- the needs and requirements of AEA Technology's customers, particularly their Government customers, were taken fully into account; and
- the interests of the Authority as a major customer, as landlord and nuclear licensee of the sites occupied by AEA Technology were properly safeguarded.

This part of the report sets out the steps the Department took to meet these objectives.

Requirements of customers

4.2 Excluding sales to the rest of the Authority, AEA Technology's main customers were the Department of Trade and Industry, the former Department of the Environment, the Ministry of Defence, the Health and Safety Executive and United Kingdom NIREX Ltd.

4.3 The customers' principal requirements were that AEA Technology should remain independent. For example, the Department of the Environment employed AEA Technology in various schemes to monitor environmental pollution and were concerned that the independence of AEA Technology would have been compromised if it was sold to a company that was a known or potential polluter. Similarly, the Ministry of Defence, which employed AEA Technology to monitor and assess the work of defence contractors, wanted it to continue to offer credible, competent and impartial advice by being demonstrably independent of the principal prime contractors to the naval nuclear propulsion system.

4.4 Both the Department of Environment and Ministry of Defence told the Department that they would take business away from AEA Technology if it lost its independence through being sold to an unsuitable purchaser. The Department eliminated this possibility and the Departments' concerns, for the short term, by selling AEA Technology through flotation rather than trade sale, and by the Secretary of State retaining a "special share" until October 1999 so no individual or firm can hold more than 15 per cent of voting shares without the approval of the Secretary of State.

4.5 The Department's advisers concluded that such a special share would not cause significant concern to potential investors, although it might reduce proceeds by up to five per cent. However, they considered that a loss of business from the Department of Environment and the Ministry of Defence because of a sale to an unsuitable buyer would have a significantly greater impact on proceeds.

4.6 AEA Technology's main Government customers have confirmed to us that their views were taken into account in the sale process and that the sale has not adversely affected AEA Technology's ability to meet their needs and requirements.

Safeguarding the interests of the Authority

4.7 **(a) as a major customer:** in 1995-96 the Authority were the major customer of AEA Technology, accounting for £61 million (24 per cent) of sales. Prior to the sale of AEA Technology, existing work was put on a contractual basis where it had not been won in competition, and new work was placed following competition. The Authority are content that these arrangements will safeguard their position as a customer.

(b) as landlord: AEA Technology lease some 100 buildings from the Authority on sites shared with them. The Department decided that it would be impractical to divide those sites, apart from the Risley site, and that the Authority should retain the freeholds of the properties AEA Technology leases. The Authority and AEA Technology, with advice from Jones Lang Wootton and Linklaters and Paines, negotiated the terms and conditions of the leases to reflect market levels and conditions. One of the functions of the Authority as landlord is to manage, treat or dispose of any radioactive waste produced by AEA Technology and to decommission radioactive facilities situated on land they lease to AEA Technology. Where AEA Technology's activities after 1 April 1996 increase the costs of waste management, disposal or decommissioning, they will bear the cost of that work. On this basis the Authority is content that the arrangements in place safeguard their interests as landlord.

(c) as nuclear licensee: a company requires a nuclear licence to use a site for the installation or operation of a nuclear installation. The nuclear licences for the licensed sites at Harwell, Dounreay, Windscale and Winfrith are held by the Authority. The Nuclear Safety Directorate of the Health and Safety Executive is responsible for administering the licences and regulating the safety of licensed sites. A proportion of AEA Technology's business depends upon access to nuclear-licensed facilities and these they lease from the Authority. To discharge their duties in relation to these sites the Authority established a detailed safety control regime contained in the terms of their leases, tenant safety requirements

and other documentation which was discussed and agreed with the Nuclear Safety Directorate. Under this regime, the Authority exercises a detailed degree of control over the activities of AEA Technology on site. The Nuclear Safety Directorate have confirmed to us that these arrangements have continued to be generally effective. In line with their normal approach of encouraging licensees to do all that is reasonably practicable to control and reduce risks they have, however, been seeking continuous improvement in the Authority's management of safety arrangements. In relation to nuclear liabilities, the Authority have indemnified AEA Technology against any loss that they may suffer by the Authority failing to meet their obligation to ensure safety or to maintain and comply with licenses held by them. In turn, AEA Technology have indemnified the Authority against any loss they might suffer by AEA Technology breaching any terms or requirements of the safety control regime or their failure to comply with or follow any instruction given for the purposes of that regime.

Glossary

Bookbuilding	Indications from investors in terms of the number of shares at different prices they would be willing to purchase.
Decommissioning	In relation to the activities of AEA Technology, activities undertaken to remove nuclear fuel and radioactive plant and equipment from nuclear reactors or radioactive facilities to long term storage or disposal. The Authority are responsible for decommissioning and long term maintenance of their nuclear facilities.
Financial intermediaries	Stockbrokers dealing in shares on behalf of investors or on their own behalf.
FTSE All Share Index	An index of share prices of companies quoted on the London Stock Exchange.
Institutional investors	Institutions such as pension funds and life assurance companies who invest in shares on behalf of their policy holders.
Long Form Report	A detailed investigation of the business for sale culminating in a report to the sale's sponsors ensuring that the business satisfies the London Stock Exchange's requirements for listing.
Pathfinder prospectus	A document that is identical to the prospectus but does not contain any pricing information. It is issued a week or two before the start of the bidding process to allow potential investors to familiarise themselves with the business to be sold.
Phased sale	A sale of a company, usually through flotation on the London Stock Exchange, in two or more tranches.
Price earnings ratio	The current price of a share multiplied by the total number of shares divided by the company's after tax earnings. It is used to compare the performance of companies, and to value companies.
Property clawback	The inclusion of provisions relating to a specific property or properties, giving the vendor the right to receive a proportion of any subsequent profit from the resale of the specified properties. Such provisions are normally time-limited.
Prospectus	A document giving detail that a business is required to make public to support an issue of shares.

Special share

One special rights redeemable preference share of £1 held by the Secretary of State in AEA Technology.

Chronology of events

September 1993	Barclays de Zoete Wedd report on the options for the future of the Authority and the practicability of privatisation.
February 1994	Announcement of government intention to privatise the commercial activities of the Authority.
April 1994	Creation of AEA Technology as a separate unit within the Authority.
November 1995	Atomic Energy Authority Bill passed empowering the sale of AEA Technology.
March 1996	AEA Technology plc created and wholly owned by the Secretary of State.
July 1996	Announcement of intention, in principle, to sell AEA Technology through flotation on the London Stock Exchange.
2 September 1996	Publication of pathfinder prospectus.
3 to 23 September 1996	Institutional and financial intermediary presentations.
10 September 1996	Publication of sale prospectus.
24 September 1996	Close of offer.
25 September 1996	Announcement of offer price and allocations.
26 September 1996	Commencement of dealing in the shares.

Appendix 1: Methodology used by the National Audit Office

1 In examining the conduct of the sale, the National Audit Office focused on how the major decisions made by the Department impacted on the achievement of their sale objectives:

- to ensure that the sale was completed in 1996 and the best available proceeds were obtained;
- to ensure that the needs and requirements of AEA Technology's customers, particularly their government customers, were taken fully into account;
- to ensure that the interests of the Authority as a major customer, as landlord and nuclear licensee of the sites occupied by AEA Technology are properly safeguarded; and
- to ensure that value for money is secured from expenditure related to the sale.

2 The main aspects of the methodology used were:

- collection of data and information held by the Department on the strategy for, and the handling of, the sale;
- collection of data and information from the Department's advisers, in particular data relating to the bookbuilding process and allocation of shares; and
- evaluation of data and information collected, including the use of a financial adviser to advise on specific issues.

Collection of data and information held by the Department

3 Data and information were collected from the Department's files relating to the sale. This included: advice received from Schroders, the Department's financial adviser, and Cazenove, the Department's broker for the sale; and

submissions made to Ministers by Departmental officials. Discussions were held with Departmental officials and their advisers to examine the key aspects of how they handled the sale.

Collection of data and information held by the Department's advisers

4 Data and information concerning institutional investors' bidding behaviour and allocations to institutions were collected from Cazenove, the Department's broker for the sale.

Evaluation of the data and information collected

5 Methods for evaluating the data and information collected included:

- an assessment of the approach adopted on major aspects of this sale compared with best commercial practice;
- a comparison with the conduct of previous privatisations by flotation on the London Stock Exchange;
- an assessment whether the decisions taken by the Department maximised the likely achievement of the sale objectives;
- an assessment whether decisions were taken against a background of appropriate information and after taking appropriate advice; and
- consideration of whether the Department had followed:
  - the recommendations of the Public Accounts Committee and the National Audit Office arising from previous sales (Appendix 2); and
  - appropriate guidance issued by the Treasury.

The use of a technical expert to advise on specific issues

6 Following competitive tendering processes, the National Audit Office engaged the following organisation to provide specialist advice on certain aspects of the sale:

- Price Waterhouse who were engaged to report on:

  - specific issues relating to the sale including valuation of the company, the indicative price range used in the bookbuilding, the conduct of the bookbuilding and allocation policy used; and

  - whether the sale could have been phased such that proceeds could have been obtained higher than those gained through the sale of AEA Technology in its entirety.

Appendix 2: Public Accounts Committee recommendations

Phasing of sales

PAC Recommendation

We recommend that departments should continue to consider the phased sale by tranche which was used successfully in the sales of British Aerospace and Associated British Ports. 34th Report, Session 1987-88 para 3 (iii).

Treasury Minute

The Government will continue to consider, in the circumstances of each sale, the respective merits of full and tranche sales. 34th Report HMT, Session 1987-88 para 70.

PAC Recommendation

As our predecessors stated in 1987-88, there can be considerable benefits in a phased sale. Although the Department took account of our predecessors' views in reaching their decision, we regret that a phased sale was not undertaken. 7th Report, Session 1992-93 para 3 (viii).

Treasury Minute

The Government considered that the possible benefits of a phased sale were outweighed by the disadvantages, including the cost of a further offer (for sale) of shares at a later date and the possibility that shares retained by the Government would overhang the market. 7th Report HMT, Session 1992-93 para 98.

PAC Recommendation

We note that the Department actively considered the option of a phased sale. We also note their concern that such arrangements might have been seen as a failure of nerve. We reiterate our predecessors' recommendation that phasing the sale should always be considered as an option. 16th Report, Session 1992-93 para 3 (iii).

Treasury Minute

The Department agrees that consideration be given to the possible benefits arising from a phased sale …the Department considered a partial sale but concluded that the objectives of the sale would best be met by selling all the shares. 16th Report HMT, Session 1992-93 para 66.

PAC Recommendation

We welcome the fact that additional proceeds of some £2,300 million were raised by not selling the shares in 1991. This is consistent with the view that we and our predecessors have expressed on many occasions that, where the market value of the shares is uncertain, it may be advantageous to the public purse to conduct such sales in stages. 13th Report, Session 1996-97 para 2(viii).

We note that the decision on whether to sell in one or more stages is one that departments will continue to consider carefully in the circumstances of individual sales. We will look to them to do so. 13th Report, Session 1996-97 para 2(ix).

Treasury Minute

The Treasury welcomes the Committee's comments. This was a positive result of the decision taken in 1991 not to sell all the Government's holding at that time. 13th Report HMT, Session 1996-97 paras 5 and 6.

Property Clawback

PAC Recommendation

Where land is considered to have development potential, serious consideration should be given to all the options for protecting the taxpayers' interest, including a separate sale or the use of clawback provisions. 13th Report, Session 1989-90 para 3 (v).

Treasury Minute

The Treasury has reminded departments of the importance of fully considering property issues, and of the need to consult the Treasury in the particular circumstances of each sale. 13th Report HMT, Session 1989-90 para 26.

Co-ordinating role of the Treasury

PAC Recommendation

While we accept that departments are responsible for arranging privatisations, the Treasury should in future do more to ensure that experience gained and lessons learned from past privatisations are passed on to departments. 13th Report, Session 1989-90 para 3 (vi).

Treasury Minute

The Treasury will continue to be involved in all privatisations and to offer advice on those decisions, drawing on its experience from past sales. 13th Report HMT, Session 1989-90 para 27.

PAC Recommendation

We look to the Treasury to ensure that...benefits (from the lessons learned) are passed on to other departments who may be considering undertaking flotations. 42nd Report, Session 1992-93 para 3 (v).

Treasury Minute

As on previous sales the Treasury seeks to ensure that lessons learned are constantly updated and made available to departments. 42nd Report HMT, Session 1992-93 para 58.

Success fees

PAC Recommendation

We recommend that, if vendors intend to use a valuation as a reference point for success fee payments for the body carrying out the valuation, the valuation should be checked by an independent party who is aware of this intention. 32nd Report, Session 1995-96 para 2 (viii).

Treasury Minute

The Department notes the Committee's recommendation. The Department acknowledges the importance of having a valuation checked by an independent body where the body carrying out the original valuation has an interest in the outcome. It also accepts that special care is needed in considering the terms of success fee arrangements. 32nd Report HMT, Session 1995-96 para 20.

Allocation of shares

PAC Recommendation

We note the Treasury's assurances that they had taken decisions on how shares should be allocated among investors on the basis of objective criteria which had been published in advance of the sale. As such allocations may result in considerable profit for those who received the shares, we look to all departments to take similar action in future sales. 13th Report, Session 1996-97 para 2(ix).

Treasury Minute

The Treasury notes the Committee's comments. Procedures similar to those on the National Power and PowerGen share sale were followed by the Department of Transport and DTI respectively on the sales of Railtrack and British Energy. 13th Report HMT, Session 1996-97 para 8.