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Comptroller and Auditor General

Department of the Environment,
Transport and the Regions

Privatisation of the Rolling Stock Leasing Companies

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This report has been prepared under Section 6 of the National Audit Act 1983 for presentation to the House of Commons in accordance with Section 9 of the Act.

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National Audit Office
17 February 1998

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Executive summary

Introduction

1 This report is about the sale by the Department of Transport (now the Department of the Environment, Transport and the Regions) of the three rolling stock leasing companies - Angel Train Contracts Limited (Angel), Eversholt Leasing Limited (Eversholt) and Porterbrook Leasing Company Limited (Porterbrook). The Department signed binding contracts for the sale of the companies to three separate purchasers in November 1995 and completed the sales in January and February 1996 for consideration of some £1.8 billion in total (Figure 1). In addition, the Department and British Rail extracted some £800 million cash from the companies prior to the sales. The Department incurred costs of £7 million on the sales, mainly for banking, legal and other professional advice. British Rail incurred costs of £3 million.

Proceeds of sale

Figure 1

	£ million
Angel - Sold to GRS Holding Company Limited	696.3
Eversholt - Sold to Eversholt Holdings Limited[1]	518.3
Porterbrook - Sold to Porterbrook Leasing MEBO Limited	528.3
Gross proceeds[2]	**1,742.9**

Notes: 1. Further proceeds of up to £80 million may be received depending on the delivery of Networker Express trains.

2. Include extra proceeds of £36.9 million arising from adjustments in interest rates, plus £6.5 million interest.

Source: Department of Transport

Gross proceeds (including deferred proceeds) were some £1.8 billion.

2 The rolling stock leasing companies own some 11,260 vehicles, almost all the passenger rolling stock which had belonged to British Rail. Their main business is to lease this rolling stock to train operating companies, which provide passenger rail services. At April 1995, the three companies together employed 150 staff and in 1994-95 generated annual turnover of £797 million on which they made pre-tax profits of £332 million.

3 The purchasers of Eversholt and Porterbrook were management and employee buy-out teams backed by financial institutions which usually aim to realise a significant profit on successful investments within three to five years. By February 1997 these purchasers had sold the businesses at a substantial profit. Porterbrook were sold to Stagecoach Holdings in August 1996 for £826 million, 56 per cent more than the £528 million received by the Department. In February 1997 the Forward Trust Group, part of HSBC Holdings plc, bought Eversholt for £726 million, 40 per cent more than the £518 million received by the Department **(paragraphs 2.62-2.68).**

4 GRS Holding Company, a consortium including Babcock and Brown and Nomura International, bought Angel and in December 1997 sold it to the Royal Bank of Scotland Group in a transaction valuing the business at some £1.1 billion, 58 per cent more than the £696 million received by the Department **(paragraphs 2.62, 2.63, 2.69).**

Timetable, proceeds and valuation

5 The over-riding objective of the then Government was to secure the sale of the companies as soon as practicable in 1995. The Government saw major advantages in the early sale of these very large businesses, ahead of the privatisation of Railtrack and the train operating companies, including early receipt of substantial proceeds and added impetus to rail privatisation. The chosen timing of the sale probably had an adverse impact on proceeds because:

- many bidders were concerned that they would not know the identity and creditworthiness of the companies' customers (the train operating companies, which were expected to be privatised afterwards);

- the companies were sold with little or no relevant track record in the new industry; and

- bidders could not be certain that the overall rail privatisation programme would be completed because there was stated political opposition to rail privatisation. There was, therefore, a risk that they might have a single, public sector, rail operator as their customer, that the privatised industry might not develop as originally proposed, and that there might be reduced scope for profitable business after initial leases expired. The Department told us that this concern continued during the sale process in 1995 but diminished in 1996 with the privatisation of Railtrack and other rail businesses.

These concerns had an impact on the number of bidders for the rolling stock leasing companies and on the prices they bid **(paragraphs 2.3-2.7, 2.39, 2.40).**

6 The Department were responsible for ensuring that in the consideration of policy proposals all relevant financial considerations, including the impact of the timetable on proceeds, were taken into account and brought to the attention of Ministers where necessary. The Department recognised that early sale risked foregoing some of the sale proceeds that might be obtainable by waiting until the companies were well established businesses. They carried out illustrative calculations in March 1994 showing that a potential loss of £100 million to £300 million might arise if a sale took place in mid-1995, ahead of the privatisation of the train operating companies which was then assumed would take place in mid-1996. They did not take the analysis any further. The Department told us they considered that uncertainties over the assumptions that bidders might make meant that such an analysis could not have assisted decisions in any meaningful way. They considered that a wide range of possible results could be generated from a range of reasonable assumptions about the effect of the timing of the sale on other sales and on the possible success of rail privatisation generally **(paragraph 2.8).**

7 Although the Department commissioned a number of valuations of the companies in 1994 when they were planning the sales (before major decisions were taken on the final terms of the leases), they did not update these to take into account later financial information and agreement on the treatment of risks. These early valuations and on-going discussions with bidders provided them with an insight into bidders' likely negotiating strategies and concerns. The Department believed, however, that the calculation of a meaningful comprehensive benchmark valuation would not have been possible in the circumstances of this sale where no close private sector comparators existed. We consider that it would have been possible to undertake such an analysis on the basis of cash flows despite the absence of external comparators. A thorough, up to date, valuation before bids were received would have assisted them to judge the reasonableness of the bids and given them further insight into special factors that might have influenced individual bidders **(paragraphs 2.12 - 2.17).**

8 After the Department had selected preferred bidders, they used an analysis of cash flows carried out by their advisers, Hambros, to help them assess the assumptions bidders were making about the businesses and to calculate the rate of return implied by the final bids. In Hambros' view bidders were making very cautious assumptions and were heavily discounting the value of income after the end of the initial lease period, because of the political uncertainties they perceived arising out of stated political opposition to the sale. Hambros also considered that

bidders were unwilling to assume that they could achieve any reductions in cost (even though the companies' contracts for heavy maintenance, their largest cost, provided for cost reductions). The analysis did not examine the potential financial improvements which a purchaser would seek. The Department considered that the analysis established that the short-listed bids were consistent with each other and were based on returns which were within a range which seemed reasonable at the time, given the uncertainty about how far the rail industry would be privatised in the face of political opposition. Taken with other aspects of the analysis of final bids, and particularly the outcome of discussions with bidders, it helped satisfy the Department that the final bids represented the best opportunity in the circumstances for achieving the key sale objectives **(paragraphs 2.30 - 2.32).**

9 Our analysis of the companies' cash flows shows that under continuing public ownership the value of the three companies was £2.9 billion, based on their net income receivable from initial, existing, leases (£2.0 billion) and from possible future leases (£0.9 billion) (Figure 8). In return for selling the companies the Government achieved sale proceeds of around £1.8 billion and might receive future tax income of up to £0.2 billion. In addition, they transferred to purchasers up to £0.2 billion of risks relating to modifications to rolling stock that might be required by the Health and Safety Executive. We estimate, therefore, that Government may receive benefits totalling up to £2.2 billion. Our separate analysis of how prospective purchasers might have valued the companies (Figure 10) produced a range for the three companies of between £2.0 billion (largely on the basis of the very cautious assumptions which the Department's financial advisers attributed to bidders in the light of their discussions with them and the bids received) and £2.5 billion (on more moderate but not the most favourable assumptions) **(paragraphs 2.18-2.29).**

10 We recognise that these cash flow analyses are only a starting point in the assessment of value for money and they do not take into account the offsetting but unquantified wider economic benefits which the Department expected to come from the privatisation. The Department attached particular importance to these wider benefits which they expected would ultimately come from the impetus that this first major rail privatisation would give to the rail privatisation programme as a whole: increased competition in the rail industry, the freeing of future rail investment from public sector borrowing constraints and the transfer of risk to the private sector. We believe, nevertheless, that the Department should have carried out cash flow analyses of this sort before bids were accepted. Such analyses would have allowed them to consider the expected wider benefits against the approximate value of future revenues which were foregone by the public sector when the companies were sold. The Department consider such analyses would not be relevant in this sale because it would have been difficult to quantify the wider

benefits in a meaningful way and because the then Government's over-riding objective was to privatise the rolling stock leasing companies as soon as practicable in 1995 **(paragraphs 2.18-2.29).**

11 Although there had been nine bidders at the indicative offer stage, there were only four final bidders (three management and employee buy-out bidders and GRS Holding Company). The Department succeeded in maintaining competitive tension between these bidders. Because of their objective to encourage competition in the industry to put pressure on future costs, from the outset the Department's policy was to sell the companies to three separate bidders. As only two bids were received for each company the Department therefore sold Porterbrook to the management and employee buy-out consortium for proceeds which were £55 million below the higher bid from GRS Holding Company (who were the winning bidders for Angel) **(paragraphs 2.44 - 2.52)**.

Provisions for sharing in gains if companies were sold on

12 The Department told us that at various stages in the sale process they had considered, but decided against, including provisions in the sale terms for them to share in any gains made if the companies were sold on by the initial purchasers within a certain period. They were concerned that such provisions would depress the price and particularly deter venture capitalists who they expected would be important to the sale. They believed that devising effective arrangements would be problematic. We found little written evidence of the Department considering this issue before final bids had been received. The Department considered that, although it would have been possible to introduce these provisions after final bids had Ministers wished, such a move could have prompted some bidders to withdraw and may have undermined competition in the sale **(paragraphs 2.53 - 2.61).**

Gains made by the initial investors when the companies were sold on

13 The Department recognised that any management and employee buy-out purchasers would hope to sell their investment at a significant profit three to five years after privatisation, thus giving their financial backers the target returns usual on successful investments by their industry. In the event Porterbrook and Eversholt were sold by their initial investors soon after privatisation, for a substantial profit. The speed with which such significant gains were realised was unusual. Although the initial purchasers of Angel were not a management and employee buy-out team they also made a substantial profit when they sold the business (**paragraphs 2.62-2.69).**

Safeguarding pensions and other employee interests

14 The existing pension rights of employees of the companies are protected by their transfer to designated sections of the Railways Pension Scheme **(paragraphs 3.4-3.6).**

Encouraging economy, efficiency and safety in the use and renewal of rolling stock

15 The Department considered that competition was vital for encouraging economy and efficiency. In addition they sought to encourage economy and efficiency in the use and renewal of rolling stock through the lease pricing method they adopted. Their intention was to produce initial lease prices similar to those that would be charged in a competitive market and which were high enough to avoid step increases in prices and public sector subsidy to train operating companies when leases were renewed in future. The Department considered carefully three different options, each with different cost implications. The option which best met their objective was not the most expensive option but it has resulted in higher costs - and thus a higher public sector subsidy to the train operating companies - than if an alternative pricing method had been used. The higher prices will, however, have increased the sale proceeds received. The Department expected that the system would encourage new investment while not leading to the premature retirement of existing satisfactory rolling stock, but they recognised that future new investment could not be guaranteed **(paragraphs 3.10 - 3.16).**

16 Although the Health and Safety Executive and other parties are concerned about the crash resistance of some types of slam-door rolling stock, the Department, with the consent of the Health and Safety Executive, agreed that the companies should lease such stock to train operating companies. This was because the Health and Safety Executive judged that it was not reasonably practicable to withdraw or replace the stock in the short term. In July 1997 the Health and Safety Executive announced that their objective was to secure the phasing out of this rolling stock, or to ensure that significant safety modifications are made, well before the year 2007 **(paragraphs 3.26-3.30).**

Securing competition amongst those who lease rolling stock

17 The sale of three companies to separate purchasers and the allocation of rolling stock between the companies has set a basis for future competition in the leasing of rolling stock. It is too early to confirm the long-term effectiveness of the

arrangements intended to promote competition. There is evidence of some shortages at present of surplus serviceable vehicles, and the Franchising Director and some train operating companies are concerned that future bidders for franchises for train operating companies will have little alternative but to lease the majority of the rolling stock already used. Since privatisation train operating companies that have placed orders for new stock have found significant competition to finance the acquisition. In January 1998 the Department announced that they had asked the Rail Regulator to report by April 1998 into the operation and possible regulation of the rolling stock leasing companies **(paragraphs 3.31-3.47).**

Recommendations

18 For future sales of Government-owned assets or businesses we recommend that vendors should:

a) carry out a valuation well ahead of bidding, to assist in negotiations with bidders and in deciding on the acceptability of bids **(paragraphs 2.12- 2.17);**

b) give detailed and evidenced consideration as to the value for money achieved and the reasons for proceeding, wherever the values of bids are low compared to analyses of value **(paragraphs 2.22 - 2.25, 2.29);** and

c) at an early stage in the sale process, give detailed and evidenced consideration to the possibility of including provisions in the sale terms which will allow them to share in gains made if businesses are resold within a specified period. This consideration should include whether to ask for bids both with and without such provisions **(paragraphs 2.53 - 2.61).**

Part 1: Background and preparation for sale

Restructuring and privatisation of the railway industry

1.1 The Department of Transport (the Department) published proposals for the restructuring and privatisation of the railway industry in July 1992 aimed at encouraging better use of the railways, providing greater responsiveness and a higher quality of service to the customer, and achieving better value for money for the public. The Railways Act 1993 provided the legislative backing for the new structure, separating the provision of passenger train services from management of railway track and signalling, stations and rolling stock. British Rail's operations were re-organised into nearly one hundred businesses. Figure 2 shows the new structure. In June 1997 the Department became part of the Department of the Environment, Transport and the Regions.

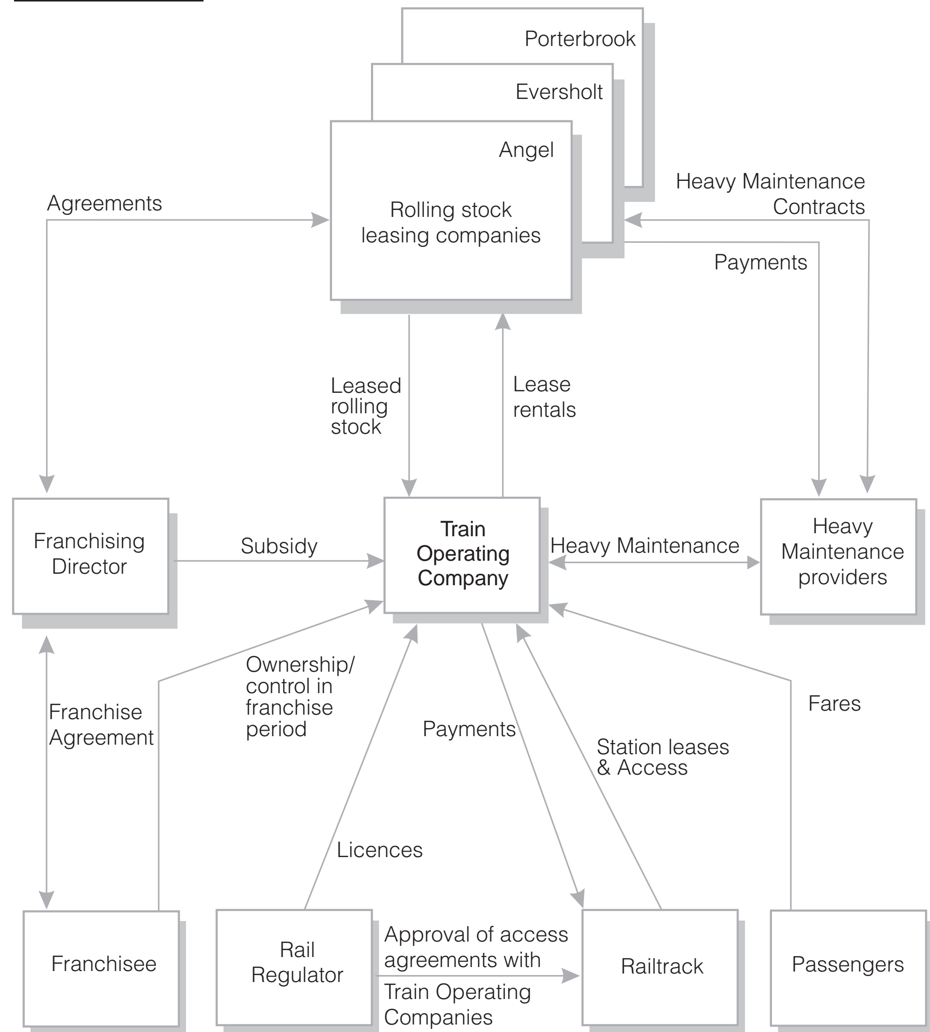
1.2 The key participants in the re-organised industry are:

- **the rolling stock leasing companies** - Angel Train Contracts Limited (Angel), Eversholt Leasing Limited (Eversholt) and Porterbrook Leasing Company Limited (Porterbrook). In March 1994 they took ownership of almost all the passenger rolling stock previously owned by British Rail, which they lease to train operating companies. The Department completed the sale of the rolling stock leasing companies in January and February 1996;

- **25 train operating companies** (formed from British Rail's three passenger businesses - Network South East, InterCity, and Regional Railways). These are almost the only customers of the rolling stock leasing companies and are responsible for providing passenger train services. Originally set up as subsidiaries of British Rail in April 1994, they were privatised in stages between February 1996 and March 1997 through a franchising process. As part of this process, bidders competed to be awarded the franchise to operate a train operating company for a period of years.

The new structure of the passenger railway industry as at November 1997

Figure 2



This figure shows the new structure of the passenger railway industry and the principal relationships between the main parties

Some 13 parties won franchises to operate the 25 train operating companies. Five companies are operated under franchises of 15 years, two for ten years, seventeen for about seven years, and one for five years. All of the franchises (except for Gatwick Express) were awarded in return for Government subsidy which either reduces or is replaced by payments to Government over the franchise period. We reported on the award of the first three franchises in October 1996 (1995-96, HC701);

- **Railtrack**, the owner and operator of the national rail network in Great Britain, are responsible for the maintenance and renewal of the fixed infrastructure (mainly track, signalling, stations, and depots), the control of the day to day operations of the signalling system, administering the timetable, monitoring and ensuring the safety of vehicles used, including the safety acceptance of new trains onto the network. The Department sold Railtrack in a public flotation in May 1996. We are currently studying this privatisation;

- **six heavy maintenance depots** which British Rail sold in April and June 1995 to three separate purchasers. These currently provide rolling stock leasing companies with heavy maintenance services (maintenance work performed at intervals greater than one year) which are the rolling stock leasing companies' main operating cost. We reported on the sale of these depots in July 1996 (1995-96, HC583);

- **seven infrastructure maintenance companies and six track-renewal companies** which are the main suppliers of maintenance and track renewal services to Railtrack. These were sold to nine purchasers between February and July 1996.

1.3 The 1993 Act established two new bodies to regulate and administer the new structure:

- the **Rail Regulator,** who regulates access to track, stations and depots and the charges paid by train operating companies for access to these facilities, and who grants licences for the operation of trains. The Rail Regulator is responsible for preventing anti-competitive practices, and for promoting consumer interests and maintaining the benefits of an integrated network; and

- the **Franchising Director,** head of the Office of Passenger Rail Franchising, who negotiates, awards and monitors franchises granted to private sector bidders for the train operating companies and agrees the maximum level of regulated fares that they can charge. We examined the responsibilities of the Franchising Director in our October 1996 report on the award of the first three franchises (1995-96, HC701).

In November 1997, the Franchising Director was issued with new objectives, instructions and guidance by the Secretary of State for the Environment, Transport and the Regions. As part of a wider review of the regulatory framework, the

present Government are currently examining the roles of both the Rail Regulator and the Franchising Director and have stated that they will create a new strategic rail authority. The Department expect the results of the review to be available in 1998. As part of the review they are examining the current performance and future operation of the rolling stock leasing market.

1.4 The role of the Health and Safety Commission and Executive in the regulation of railway safety was extended with the new industry structure. In addition to their existing role of enforcing safety legislation they also became responsible for supervising Railtrack's arrangements for monitoring and ensuring the safety of vehicles used.

The role of the rolling stock leasing companies

1.5 Because the economic life of rolling stock exceeds 30 years, much longer than the length of the franchises awarded, the Department decided that, in general, train operating companies should lease rather than own their rolling stock. Leasing would enable prospective franchise operators to start operations without having to incur initial major capital expenditure on new or refurbished vehicles. The Department did not, however, preclude train operating companies from buying rolling stock in addition to the stock allocated to them initially on leases, or from subleasing rolling stock. Train operating companies did not surrender any rolling stock initially leased to them. They were not precluded from doing so although, as usual in commercial leases, penalty clauses in the leases might discourage them from doing this.

1.6 The Department decided that dividing the ownership of the passenger rolling stock between three rolling stock leasing companies would provide competition in the supply of stock, while still allowing each company to benefit from economies of scale. Because the companies would operate in a competitive market the Department decided that they need not be regulated by the Rail Regulator, although they would be subject to normal competition law. The three companies were established on 21 March 1994 and from 1 April 1994 they took ownership of 11,258 vehicles (almost all of the rolling stock previously owned by British Rail), which they immediately leased back to British Rail. (Freight trains were excluded from these transactions, as were Eurostar trains built for international services run by European Passenger Services.) The average age of the rolling stock transferred was about 16 years. A third of the vehicles were under 8 years old and a quarter were over 24 years old.

Vehicles transferred to rolling stock leasing companies as at 1 April 1994

Figure 3

	Angel	Eversholt	Porterbrook	Total number
Electric multiple units	2,099	2,684	1,615	6,398
Locomotives & loco-hauled stock	-	1,366	789	2,155
Diesel multiple units	1,094	-	681	1,775
High speed trains	539	-	370	909
Other	21	-	-	21
Total number of vehicles	**3,753**	**4,050***	**3,455**	**11,258**
Average age	16 years	17.6 years	16 years	

* excluding trains still under manufacture

Source: National Audit Office

The rolling stock leasing companies have broadly comparable portfolios of passenger rolling stock

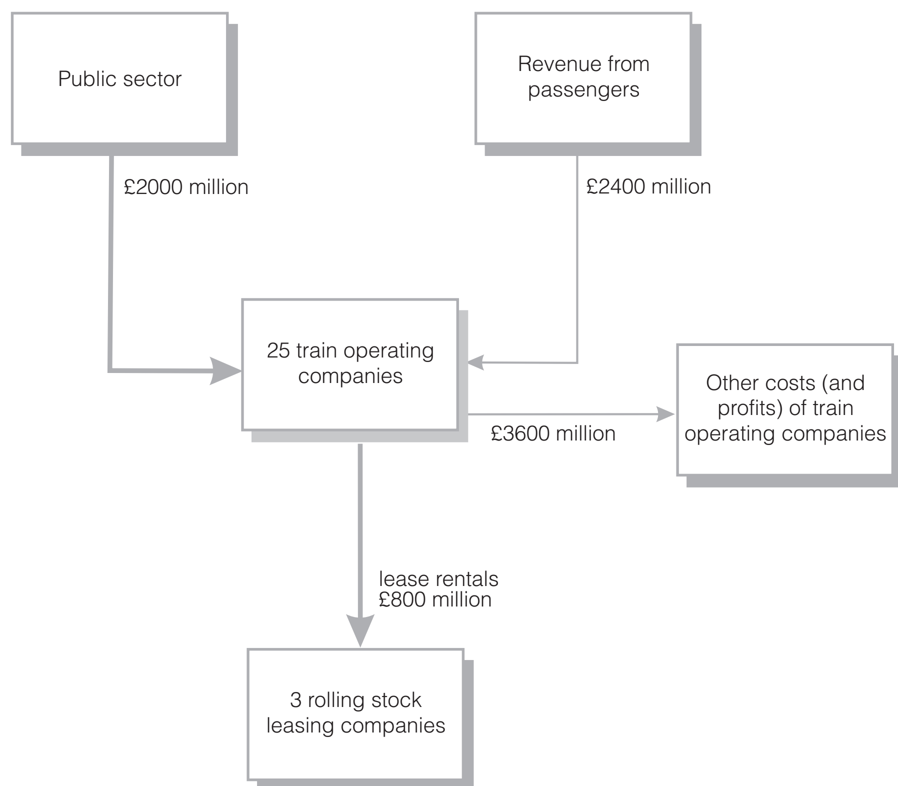
1.7 In addition to the above, Eversholt were allocated 41 new Networker Express trains which had not been delivered at the time of the sale. Because of the considerable uncertainty over the likely dates of delivery from the manufacturers and the timescales to achieve safety clearances from Railtrack, Eversholt were unable to provide a reliable estimate of when the new trains would be likely to be introduced to service. Indicative financial projections were, however, produced, based on introduction to service for operation in September 1997 and March 1998, depending on the form of electrical current used. The trains had been acquired by British Rail through finance leases with two banks. British Rail's obligations under the finance leases were guaranteed by the Government. Eversholt inherited the original finance leases and Government guarantee and entered into sub-leases with train operating companies. This resulted in Eversholt making losses on sub-leasing the trains because payments under the original finance leases, together with maintenance expenditure, would be greater than rentals receivable under the sub-leases. However, before the sale, the Department decided not to increase the rentals, thus keeping rental pricing for Networker Express trains consistent with other rolling stock, despite a likely loss of proceeds.

1.8 The nature of the businesses meant that the rolling stock leasing companies employed very few staff and few assets other than rolling stock. In April 1995, Angel employed 51 staff, Eversholt 60 staff and Porterbrook 39 staff. The companies rented offices from British Rail, and owned no land or buildings. The turnover of the companies in 1995-96 was some £800 million, on which pre-tax profits of £331 million were generated. Virtually all of their income comes from the train operating companies, who in 1995-96 derived almost half of their income

from public subsidy. Public subsidy to train operating companies is expected to reduce from £2,000 million in 1995-96 to £400 million in 2003-04. The extent to which the rolling stock leasing companies' income for 1995-96 could be considered to derive from public funds is illustrated in Figure 4. Figure 5 shows that initial leases for existing rolling stock will generate gross income for the rolling stock leasing companies up to 2003-04, and that any subsequent leases for this stock may generate income for a further 25 years or more depending on demand and on the stock's remaining life. Rolling stock acquired after 1994 will generate additional income and costs.

Passenger railways annual cash flows

Figure 4



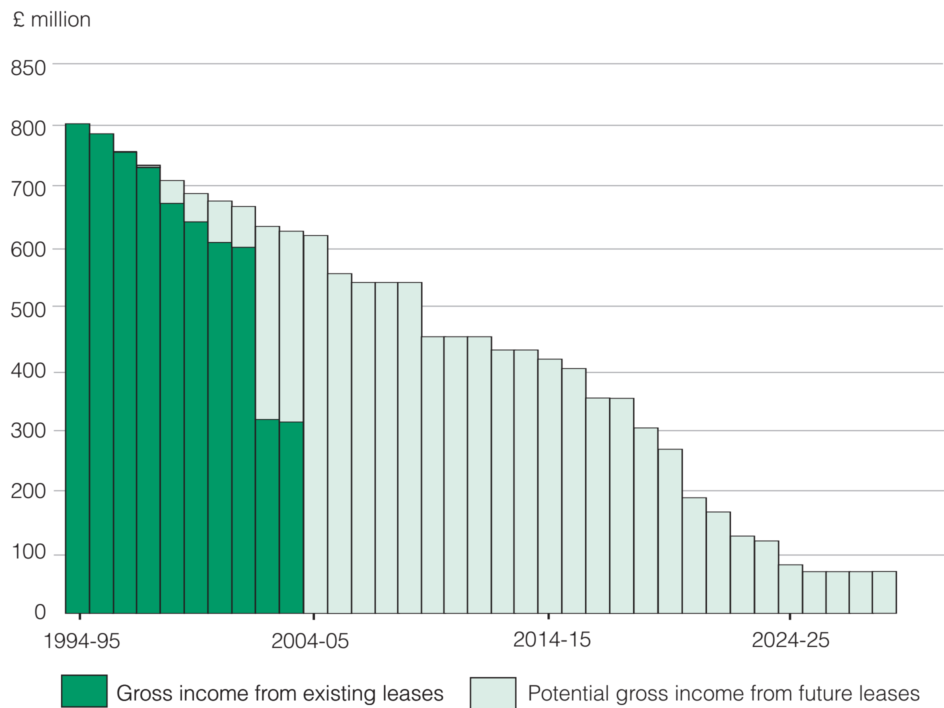
Note: The amounts shown are British Rail's estimates of train operating companies' cash flows for 1995-96.

Rolling stock leasing companies' income is partly funded by public sector grants to the train operating companies, which is planned to reduce to £400 million by the year 2003-04.

Source: British Railways Board evidence to the Transport Select Committee, January 1995 (HC 206)

Gross lease income of the rolling stock leasing companies

Figure 5



Note: This figure includes the three rolling stock leasing companies' forecast gross income from the rolling stock they owned in April 1994; it excludes potential income from rolling stock acquired after that date. Income is not discounted and is shown at 1994-95 prices adjusted for forecast reductions in non-capital rental prices.

Existing leases will generate gross rental income for the rolling stock leasing companies up to 2003-04. Afterwards, depending on their age and the availability of new replacements, some existing vehicles could be leased again, to generate rental income for periods of up to 25 years or more.

Source: Department of Transport Information Memorandum

Development of the passenger rolling stock leases

1.9 Passenger rolling stock leases were substantially agreed by December 1994. A single master lease incorporated terms and conditions applicable to all rolling stock, and lease supplements gave details specific to individual types of vehicles - such as routes on which they may be used, maintenance programmes and performance criteria. The principal obligations under the leases are shown in Figure 6.

1.10 A feature of these leases is that the rolling stock leasing companies as lessors are responsible for procuring heavy maintenance. Given the relatively short length of the franchise awards, the Department considered that the companies, with their long term interest in the rolling stock, would be best placed to maximise economy and efficiency in the procurement of heavy maintenance.

Principal obligations of parties under the rolling stock leases

Figure 6

Rolling Stock Leasing Companies' (lessors) obligations

- delivery of the rolling stock to the lessee in an agreed condition;
- allowing the lessee quiet enjoyment of the rolling stock;
- procurement from contractors of heavy maintenance and heavy repair and ensuring that rolling stock meets prescribed performance criteria immediately following such maintenance or repair;
- rectification of major faults and design or endemic faults, and paying those costs not met by the lessee;
- procuring and paying for any mandatory modifications required to rolling stock by the safety regulatory authorities;
- procurement of property damage insurance of rolling stock.

Train Operating Companies' (lessees) obligations

- payment of rent to the lessor;
- performance of running maintenance and repairs;
- use of the rolling stock in accordance with the criteria specified in the lease supplement;
- paying for major faults and design or endemic faults (in full up to specified thresholds and on a shared basis thereafter);
- insurance of the rolling stock against third party liabilities and repayment to the lessor of premiums for property damage insurance;
- indemnification of the lessor against losses relating to the leasing, use and operation of rolling stock in certain circumstances;
- return of the rolling stock to the lessor at the end of the lease period in the condition specified in the lease supplement.

This table shows the principal obligations of the parties under the leases. Unusually, the lessors are responsible for procuring heavy maintenance.

Source: Department of Transport

1.11 The lengths of most leases either broadly match franchise periods or, at the train operating company's option, were extended to match their franchise period. Some 30 per cent of leases are for periods of less than 8 years from April 1994, enabling early replacement of stock nearing the end of its economic life and allowing the train operating companies some flexibility in the amount of stock leased. The Franchising Director let some franchises for longer than the standard seven year period, subject to conditions requiring franchisees to obtain new rolling stock. The length of the franchise will revert to seven years if these conditions are not met.

1.12 Each lease rental includes a capital rent (to pay the rolling stock leasing company for the use of its vehicles) and a non-capital rent (which is intended to recover expenditure on maintenance and other running costs evenly over the vehicles' economic life). The Department set rental prices for the initial leases on the basis of prices which they intended would make operators indifferent to leasing old or new stock. They considered that this would be the best

approximation to prices chargeable in a competitive market. The background to the Department's decision and the implications for encouraging economy and efficiency in the use and renewal of rolling stock are discussed further in paragraphs 3.11 to 3.16, and Appendix 4.

Responsibilities of the Department and British Rail

1.13 The Department conducted the sales and were responsible for advising the then Secretary of State, for example on: the structure of the new rolling stock leasing market, including the number and structure of the companies and the terms of the leases; the allocation of vehicles between the rolling stock leasing companies; and the terms of the sales, and selection of the successful bidders.

1.14 The Department's key objective for the privatisation was to secure the sale of the rolling stock leasing companies as early as practicable in 1995 having regard to the need:

a) to secure the sales on the most favourable financial terms;

b) to encourage management/employee teams to bid;

c) to ensure that employee pension benefits and other employee interests were safeguarded;

d) to encourage economy, efficiency and safety in the use and renewal of rolling stock by franchisees of train operating companies; and

e) to secure competition amongst rolling stock lessors.

1.15 British Rail were responsible for establishing the companies and managing them before their transfer to the Department. Pending the franchising of the train operating companies, they were the companies' customer and the source of their income. They also provided advice to the Department on many aspects of the sale process.

Key dates in the sale process

1.16 The key dates in the sale of the three rolling stock leasing companies are shown in Figure 7.

Figure 7

Key dates

1994	
March	British Rail established the three companies as wholly-owned subsidiaries.
July	Government announced their aim to sell the three companies in 1995.
October	Marketing documents were despatched to 340 interested parties.
December	Passenger rolling stock leases were substantially agreed.
1995	
May	Information Memorandum sent to 78 interested parties.
July	Following indicative bids (7th July), eight consortia began due diligence (13th July). A ninth, IAF, (a late bidder) began in August.
August	Ownership of companies transferred from British Rail to the Secretary of State for Transport (12th August).
September	£745 million cash extracted by British Rail.
	Final bids received (29th September).
October	Exclusive negotiations with preferred bidders.
November	Sale agreements signed (8th November) for Angel, Eversholt and Porterbrook.
	The Department extracted £54.5 million cash from the rolling stock companies prior to sale.
1996	
January	Completion of sales of Porterbrook and Angel.
February	Completion of sale of Eversholt.
August	Stagecoach Holdings plc bought Porterbrook for £826 million.
1997	
February	Forward Trust Group bought Eversholt for £726.5 million.
December	Royal Bank of Scotland Group bought Angel in a transaction valuing the business at £1.1 billion.

Source: National Audit Office

Part 2: The financial terms achieved

2.1 The Department's key objective, in line with Government policy, was to achieve the sale of the rolling stock leasing companies as early as practicable in 1995. Their other objectives, including securing the sales on the most favourable financial terms, were subsidiary to this. The sales were agreed and contracts were exchanged in November 1995. The sales were completed in early 1996, later than expected, partly because of the time taken by the European Commission to grant clearance and, in the case of Eversholt, because of the time needed to renegotiate complex legal documents and because the purchasers of Eversholt made the sale of the other two companies a condition of completing their own sale.

2.2 This part of the report examines the financial terms achieved by the Department. To help assess the extent to which the Department achieved the most favourable terms, having regard to the circumstances of the sales, we examined:

a) the impact of the timing of the sales on proceeds;

b) the extent to which the Department took account of recommendations of the Committee of Public Accounts on valuation, and comparisons of the value of the companies and the purchase price;

c) the extent to which the Department managed to achieve effective competition between potential purchasers;

d) the Department's decision not to provide for them to share in any gains made if the companies were sold on within a specified period of time;

e) the implications of the onward sales of the companies after privatisation, and gains made by the initial purchasers;

f) the sale of the businesses with some cash balances; and

g) the arrangements for completing the sales, including payment of the proceeds in two instalments.

Warranties and indemnities issued by the Department and the costs of the sale are dealt with in Part 4.

Impact of the timing of the sale on proceeds

2.3 The objective of securing the sales of the rolling stock leasing companies as soon as practicable in 1995 probably had an adverse impact on the proceeds of those sales.

2.4 In July 1994, the Government concluded that the success of the overall rail privatisation programme depended upon the achievement of an early, major, successful sale and that this first sale should be that of the rolling stock leasing companies. The then Government expected there would be substantial proceeds and they attached high priority to the early receipt of these. As a consequence their overriding objective was to secure the sale of the companies as early as practicable in 1995. Taking account of advice from their financial advisers, the Department concluded that sale in 1995 might lead to a loss of proceeds, compared to a later sale, because of the impact of bidders' perceptions of the riskiness of the businesses which would lead to lower bid prices than they might otherwise offer.

2.5 One of the major concerns of bidders was that they did not know the identity and creditworthiness of the franchisees of the train operating companies, who are the customers of the rolling stock leasing companies, nor did they know the length of the franchises. Unusually the new owners of the companies had no choice over their customers and no ability to charge higher rentals to those customers who they considered might be more likely to default on their payments. Although the Department sought to overcome this concern by agreeing provisions which reduced significantly the impact of customers defaulting on payments or becoming insolvent during the initial lease periods (see Part 4), these concerns could not be fully alleviated.

2.6 A further concern was that the companies had little or no track-record in the private sector rail industry. This led to uncertainty over how well the companies would perform in the new structure.

2.7 A third concern of bidders, in the Department's view, was that if rail privatisation was not completed then the rolling stock leasing companies could be trading with a single, public sector, rail operator. The Department told us that this concern continued throughout the sale process in 1995 but diminished in 1996 with the sale of Railtrack and British Rail's infrastructure and track renewal businesses. They also told us that in 1995 there was stated political opposition to the privatisation of British Rail which meant that potential bidders could not be certain that the entire rail privatisation programme would be completed. Although the terms on which trading took place over the medium term would be largely

determined by contracts in place at privatisation, the Department considered there would be uncertainty about the general business environment in which the companies would be working and about costs and revenues in the longer term. As part of the sale process the Department had to draw material matters to the attention of bidders, and so in the Information Memorandum in 1995 they reminded bidders that a general election would have to be called no later than May 1997. They said that the Labour Party had stated its opposition to the privatisation of British Rail and had established a working party to examine the feasibility of bringing British Rail back into public ownership and control and that its aim was to find ways of ensuring a publicly owned, publicly accountable railway. The Memorandum said that the Labour Party had not expressed any specific pledges regarding the privatisation of the rolling stock leasing companies but that it had, in the past, expressed support for the introduction of private finance into public sector projects, especially through leasing. The Memorandum said that the Liberal Democrat Party also opposed the privatisation of British Rail.

2.8 The Department carried out in March 1994 an illustrative calculation of the possible size of the loss of proceeds that might arise from privatisation of the companies in mid-1995, compared to a later sale, and ahead of the expected privatisation of the train operating companies in mid-1996. They believed that any estimate of this loss would be highly debatable but, as a purely illustrative calculation based on speculative assumptions, they estimated it as between £100 million and £300 million. They did not update this analysis or take it any further. The Department told us they considered that the uncertainties over the assumptions that bidders might make on costs and revenues meant that such an analysis could not have assisted decisions in any meaningful way, given the wide range of possible results that could be generated from a range of reasonable assumptions about the effect of the timing of the sale on other sales and on the possible success of rail privatisation generally.

2.9 In 1994 when they were considering the proposed method of sale the Department noted that the companies would only be able to meet Stock Exchange requirements for continuity of management and financial track record by mid-1996 at the earliest. The objective of securing the sales by the end of 1995 therefore meant that a trade sale was the only option. Also the Department believed that a trade sale to a corporate purchaser, or to a consortium of corporate investors, was likely to secure better value than a flotation because they considered the natural purchasers would be rolling stock manufacturers, existing leasing companies and investing organisations who might pay more because of the cash flow and tax opportunities arising from the sales.

Valuation

2.10 Although the Department prepared a number of valuations in 1994 when they were planning the sales, they did not carry out an up to date or comprehensive benchmark valuation of the companies before they received bids. Their analysis, carried out after bids were received, concluded that bidders had adopted a cautious approach, and that the bids were broadly consistent with each other and were based on rates of return that were within a reasonable range.

2.11 Our analysis shows that the likely value of the companies' forecast cash flows to purchasers was between £2.0 billion, on very cautious assumptions, and £2.5 billion on more moderate (but not the most favourable) assumptions. This was less than the £2.9 billion value of the cash flows to Government because, for example, of the private sector's higher funding costs. Our analysis also shows that the value received by the Government for these forecast cash flows was up to £2.2 billion (including sale proceeds, likely tax receipts, and risk transferred). It does not take account of any wider effects from rail privatisation, including any effects from increased competition and the freeing of future rail investment from public sector borrowing constraints.

Benefits of Valuations

2.12 The Committee of Public Accounts have recommended that valuations of companies should be carried out at an early stage in the sales process. The Committee have stressed that the benefits of valuations go beyond deciding on a value or range of values for a business. In their view, the process of considering how a business should be valued enhances the vendor's understanding of the enterprise and its assets and gives an insight into special factors that may influence interested parties (Appendix 1).

2.13 The Department's consideration of the use of valuations in the sale was guided by the view stated in the Treasury Minute (Cm 1819, February 1992) responding to the report by the Committee of Public Accounts on the Sale of the Rover Group (First Report 1991-92). The Treasury Minute said that the Government did not agree that a benchmark valuation set by a mechanistic process ahead of the sale should determine the acceptability to the vendor of the price finally negotiated with the bidder. It said the Government believed that the process of determining what was, or was not, a realistic price for the assets being sold was best achieved by a competitive market. The Department consider a valuation such as ours (paragraph 2.11 above) would not be relevant in this sale. This is because the then Government's over-riding objective was to privatise the

rolling stock leasing companies as soon as practicable in 1995 and because, in the Department's view, the analysis of cash flows could have been carried out using a wide range of reasonable assumptions. Moreover the analysis could not take account of the value of benefits which Ministers expected would ultimately come from the sale's impact on the rail privatisation programme as a whole: increased competition, risk transfer, efficiency and safety in the use and renewal of rolling stock and the freeing of future rail investment from public sector borrowing constraints. The Department told us that Ministers considered that these wider benefits amply justified their decision to proceed with the sale.

Initial valuations undertaken by the Department

2.14 In planning the sale in August 1994 the Department's financial advisers, Hambros, produced illustrative projections of the discounted value of the companies' cash flows. At that stage some important policy issues, with an impact on the risks facing the companies, still had to be resolved. Hambros' analyses were intended to be illustrative of the scale of possible proceeds. The Department told us that these analyses were not capable of being developed in detail because there were no market comparators for the companies and that, in their view at that time, such comparators were a vital ingredient for preparing meaningful and sensible valuations. In their recent reports on other sales, published in 1997 after the privatisation of the rolling stock leasing companies, the Committee of Public Accounts said they were unconvinced by similar arguments to this (Appendix 1, section 5 refers).

2.15 In November 1994 Hambros carried out sensitivity analyses of the impact on value of the Government guaranteeing different proportions of the companies' revenues, giving a range of valuations between £2.3 billion and £3.6 billion. The figures also included some £800 million of cash which was eventually extracted prior to the sales. These calculations will have helped the Department understand the value of the companies but the final terms of the leases (including provisions for risk sharing) were not agreed at that stage. The Department did not seek to update these calculations nearer to the sale - for example, to assist them in negotiations with bidders or for assessing bids.

2.16 Before the receipt of final bids the Department concluded, on the basis of advice from Hambros, that it still would not be possible to produce a meaningful valuation. The main reasons were:

a) the unique nature of the companies, there being no comparable companies and so no guide as to how the market would judge the risks;

b) the lack of certainty of the private sector's desire to invest in the industry because the sales represented the first major stage of the Government's railways privatisation programme;

c) the difficulty in assessing the impact on value of selling three very large similar companies simultaneously; and

d) that ultimately the level of proceeds would depend on competition in the sales process and the purchasers' perceptions at the time of the principal risks of ownership of the companies.

2.17 Hambros told us they were made aware of bidders' particular areas of concern during their extensive discussions with them during the marketing of the businesses. We consider that it should have been possible, therefore, to derive a range of plausible assumptions and to evaluate their impact on expected sale proceeds before bids were received. Once the bidding process has occurred, many of the advantages of carrying out a valuation are lost, such as the ability to inform the decision-making process and to detect and address any misapprehensions by bidders. However the Department consider that the range of assumptions would have been so wide as to render the results of limited value for the purpose of informing decisions, and Hambros did not believe that such an exercise would have added anything of value to the knowledge they had already gathered from discussions with bidders.

The National Audit Office's valuation of the companies

2.18 We assessed the value to Government of retaining the companies within the public sector. To shed light on the value for money achieved in the sale, we used a range of alternative assumptions to analyse how prospective purchasers might have valued the companies. Details of our methodology are given in Appendix 2, and we explain below the major assumptions we made.

2.19 The value of the rolling stock to purchasers results from its capacity to generate future revenue and profit. There were two likely sources of revenue:

- income from the initial lease contracts with train operating companies, 80 per cent of which was guaranteed by Government (contracted income); and

- income arising from any future leases negotiated to start after the expiry of the initial lease contracts (non-contracted income).

2.20 Through selling the rolling stock leasing companies, the Department also transferred to the private sector certain risks attaching to the ownership of the companies and, in return for selling the three companies, the Government received consideration from the new owners in two forms:

- the sale proceeds paid to the Department; and
- the possibility of on-going tax revenues paid on future profits.

2.21 The value of tax revenues to Government depends, for example, on the amount of debt used to finance the companies (as interest on loans is a tax-deductible expense) and, ultimately, tax is only paid if the companies are profitable. With the agreement of the Treasury and the Inland Revenue, the companies were established with a proportion of British Rail's capital allowances which could be applied against taxable profits, to reduce the companies' tax charges in the early years. The amount of tax revenues will depend not only on the tax position of the companies themselves but also on the tax position of their shareholders. It is possible, for example, that shareholders would receive tax credits for the Advance Corporation Tax incurred on dividends paid by the companies, thus reducing the net tax flow to Government. Our estimation of tax revenues is therefore likely to reflect their maximum potential value to Government, whereas in practice they could be lower.

Our assessment of the value of the companies to Government

2.22 As a starting point, we assessed the value of the cash flows of the companies within the public sector on the following basis:

- we have assumed that revenue from the non-capital element of lease rentals equals operating costs, as the Department intended. This allows us to derive a value for the companies by analysing the value of the capital element of the lease rentals alone;
- we have used a discounted cashflow method at a discount rate appropriate for the public sector for income derived from the initial leases;
- we have assumed that, as the initial leases expire, companies are able to re-let stock at rents which are subject to some pricing risk. We have accounted for this risk by using a higher discount rate;

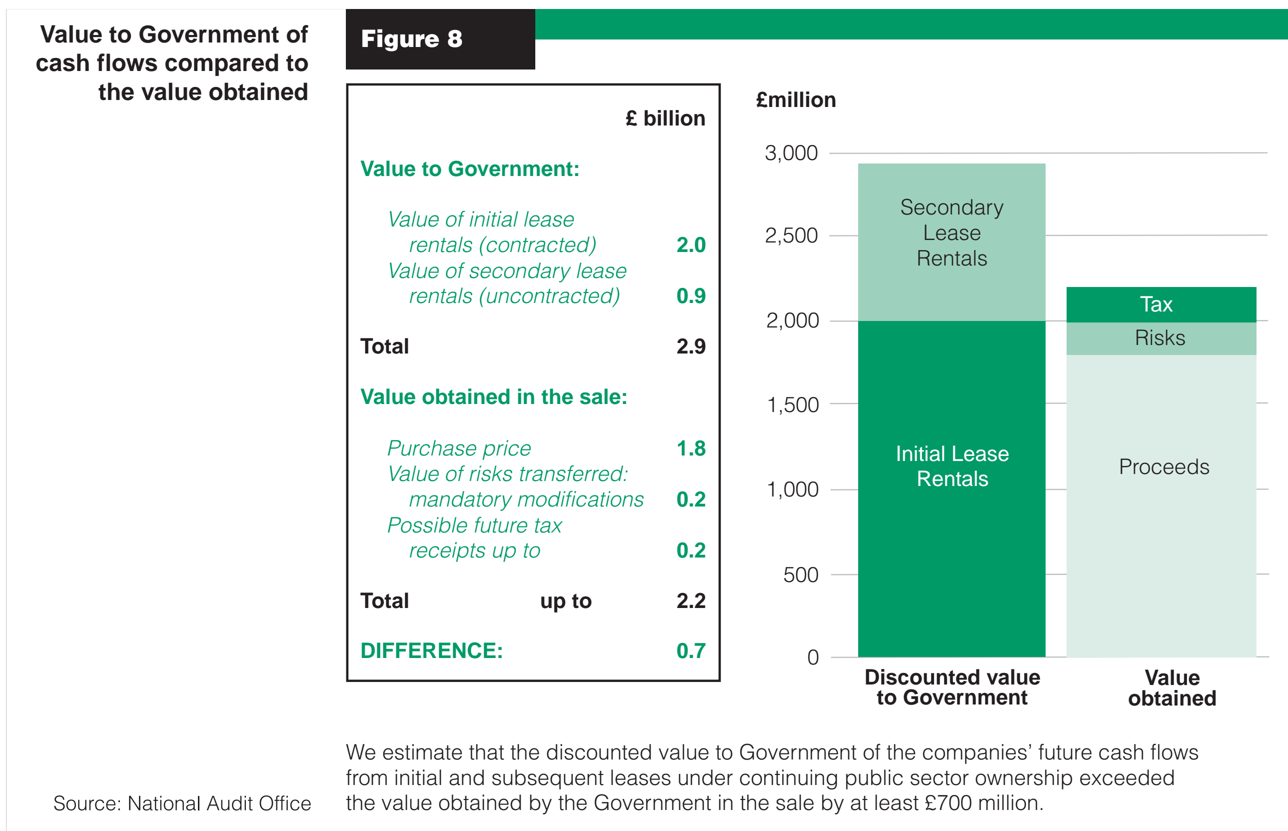
- we have assumed that the companies could achieve sufficient efficiency savings in maintenance and other operating costs to offset the 3 per cent annual reductions in non-capital rentals provided for in the initial leases (see paragraph 3.19). Historically, British Rail had achieved real reductions in operating costs and there was evidence of inefficiency and over-capacity in the heavy maintenance industry. Also, an element of cost reduction was already provided for in the companies' contracts with heavy maintenance suppliers; and

- we made separate provision for risk relating to the cost of modifications to rolling stock which the Health and Safety Executive might require, after taking account of provisions for cost sharing (paragraph 4.3).

2.23 Our analysis shows that the total value to the Government of contracted and non-contracted income was approximately £2.9 billion; the total consideration paid by the purchasers was £1.8 billion and they also absorbed likely potential liabilities of £210 million. We estimated the maximum value of future tax revenues to Government to be £201 million. These results are shown in Figure 8.

Value to Government of cash flows compared to the value obtained

Figure 8



		£ billion
Value to Government:		
Value of initial lease rentals (contracted)		**2.0**
Value of secondary lease rentals (uncontracted)		**0.9**
Total		**2.9**
Value obtained in the sale:		
Purchase price		**1.8**
Value of risks transferred: mandatory modifications		**0.2**
Possible future tax receipts up to		**0.2**
Total	**up to**	**2.2**
DIFFERENCE:		**0.7**

We estimate that the discounted value to Government of the companies' future cash flows from initial and subsequent leases under continuing public sector ownership exceeded the value obtained by the Government in the sale by at least £700 million.

Source: National Audit Office

2.24 The Department believed that bidders had perceived high degrees of risk relating to their ability to re-let the rolling stock at the end of the initial leases and to the rental prices which could be achieved. Therefore we carried out further analysis (Figure 9) focusing only on the value of the initial lease income, 80 per cent of which was subject to a guarantee from Government.

Figure 9

Value to Government of cash flows (from the initial leases only) compared to the value obtained

		£ billion
Value to Government of initial lease rentals (contracted):		
guaranteed		1.6
non-guaranteed		0.4
Total		**2.0**
Value obtained in the sale:		
Purchase price		1.8
Value of risks transferred: mandatory modifications		0.1
Possible future tax receipts up to		0.1
Total	**up to**	**2.0**
DIFFERENCE:		**0**

Source: National Audit Office

We estimate that under continuing public sector ownership the value obtained by the Government in the sale only reflected the discounted value of the companies' future cash flows from initial lease contracts, and did not reflect any value for any subsequent leases.

2.25 Our analysis shows that the proceeds obtained by the Department only reflected the value to Government of the revenues derived from the initial leases. Thus the Department may not have obtained any value for the rolling stock beyond the initial leases, even though the average useful economic life of that rolling stock significantly exceeded the lifetime of the initial leases.

2.26 In commenting on our analysis the Department emphasised that Ministers had decided in February 1995 against offering bidders any guarantees of rental income beyond the initial leases. Although the potential benefits to sale proceeds could have been substantial, Ministers had considered that such guarantees would have been inconsistent with creating a competitive market, would have acted as a serious constraint on the Government, and would have led to inefficient use of resources. After the indicative bids had been received, the Department drew to the attention of Ministers that bidders were attributing little value to potential rental

income after the initial lease contracts had expired and that the Department had calculated these rentals to be worth up to £500 million. Ministers decided to confirm their earlier decision against guarantees for these rentals. After final bids had been received, the Department told Ministers that although bidders continued to have concerns about the eventual success of the rail privatisation programme, the bid prices had remained reasonably firm (except for Eversholt where the bid prices had suffered due to concern about the liabilities for Networker Express trains).

Our assessment of the value of the companies to purchasers

2.27 Clearly, bidders would have valued the companies using their own operating and financing projections taking into account their own perceptions of risks. These valuations would differ from the value of the companies to Government in a number of areas. Firstly, the cost of capital for purchasers would be higher than for the Government; the actual cost would have depended on the types of finance used by each bidder. Also purchasers would have provided for their future liability to pay tax on profits (which is calculated after interest payments to lenders, but before dividend payments to investors).

2.28 Purchasers' likely perceptions of the businesses' operational risks are set out below:

a) any costs of modifications to rolling stock to meet the requirements of the Health and Safety Executive; the Government agreed to share costs in the initial lease period above a certain threshold in any one year (in total companies would pay 90 per cent of the first £20 million of costs and, thereafter, their liability would be limited to 30 per cent of the costs);

b) the costs of rectifying any design or endemic faults in rolling stock over and above the allowance included in lease rentals;

c) the ability to achieve reductions in operating costs to compensate for the 3 per cent annual reductions in non-capital rental income which were written into the initial leases;

d) the rental price achieved for any rolling stock which is leased again after the initial leases expired, and the risk that some stock might not be leased in future;

e) the possibility of the future insolvency of a train operating company and the risk of financial loss of those revenues not guaranteed by the Government; and

f) the possibility that rail privatisation would not succeed, leaving Government as a single monopoly customer of the rolling stock leasing company.

Also, in balancing the potential risks of operating the companies, purchasers would have considered their ability to achieve efficiency savings in costs.

2.29 To help understand how well the final bids fitted with a reasonable range of possible values for the companies we carried out a theoretical analysis of how prospective purchasers might have valued the companies. For this we used a range of different scenarios, each reflecting different risks and opportunities. We consider that if the Department and Hambros had carried out such an analysis, before final bids were accepted, it would have given Ministers a better view of whether the final bids represented good value for money for the taxpayer. Our analysis produced a range of values for the three companies in total of between £2.0 billion on very cautious assumptions, and £2.5 billion on more moderate assumptions (although not the most favourable ones) and particularly on the assumption that considerable opportunity existed to cut costs. The results are summarised in Figure 10. The Department and Hambros consider that this theoretical valuation would not have been useful: the value prospective purchasers actually placed on the companies, in the light of the risks perceived at the time, is ample evidence of this.

Likely value of companies to purchasers under alternative assumptions

Figure 10

Scenario	Description	£million
a	National Audit Office most cautious case	2,002
b	Lower risk on non guaranteed contracted leases	2,012
c	Lower risk on re-letting rolling stock	2,098
d	Cost savings achieved to offset efficiency factors in contracted leases	2,300
e	Reductions achieved in overhead costs	2,021
f	Reduction in forecast level of mandatory modifications	2,085
g	Combination of all of (b) to (f)	2,539

A description of the assumptions used in scenarios (a) to (f) is given in Appendix 3.

We estimate that the possible value of the companies to purchasers was between £2.0 billion on the most cautious assumptions used and £2.5 billion on more optimistic (but not the most favourable) assumptions.

Source: National Audit Office

The Department's assessment of the bids received

2.30 After the Department had selected preferred bidders, they used a variety of methods to assess the acceptability of the final bids in relation to the key objectives of the sale. These included:

a) an analysis of cashflows to determine the rates of return to purchasers implied by their bid prices;

b) a comparison of final bids with the indicative bids;

c) interviews with the preferred bidders to endeavour to negotiate as many improvements in the bids as possible; and

d) a qualitative assessment of bidders as future participants in a competitive leasing industry.

2.31 Of particular importance was the Department's analysis of the companies' cashflows. This analysis reflected Hambros' interpretation of bids in the light of the feedback they had received during their extensive discussions with bidders. The Department and Hambros believed bidders had adopted a cautious approach to their bids to the degree that bidders were unwilling to attribute any value to their ability to achieve cost reductions or improve on forecast revenues. In particular:

a) bidders could not be sure of obtaining any savings in maintenance costs, even though some reductions had already been incorporated into the contracts with suppliers;

b) bidders would incur annual costs relating to modifications to rolling stock required by the Health and Safety Executive, initially of £10 million each and thereafter reducing as trains reached the end of their useful economic life. Bidders were concerned that significant modifications might be required. For this reason, the companies were sold with provisions in place for Government to bear some of the costs. However, at the time of sale it was uncertain whether there would be imminent expenditure on such modifications;

c) bidders believed that the 20 per cent of rentals under the initial leases entered into, which were not guaranteed by Government, carried significant risk of non-payment due to the potential insolvency of train operating companies and discounted these revenues by 13.5 per cent, compared to the 9.5 per cent discount applied to the guaranteed revenues. We consider that this generally over-stated the risk. Each rolling stock leasing company has approximately 16 customers, and it was unlikely that more than one or two of these would become insolvent. Even in this event the Franchising Director would take over

the operational responsibilities of an insolvent train operating company until he was able to re-let the franchise, and would have a continuing need for the most part of the leased fleet. This could be expected to result in the rolling stock leasing companies receiving significantly more than the 80 per cent of revenues guaranteed by the Government;

d) bidders' ability to re-let rolling stock after the initial leases would be subject to a high degree of risk due to factors including: the possibility of deterioration in the financial health of train operating companies; outmoding of existing stock by technological and safety developments; the likelihood of competition from other parties offering new and more efficient alternatives; and the possibility that rail privatisation would not be successfully completed. These concerns were reflected in the analysis by discounting the forecast secondary lease rentals at a much higher rate. However, there was no commensurate reduction in associated costs, though in practice it is likely that purchasers would minimise maintenance on rolling stock if there was little prospect of letting the stock; and

e) bidders would incur costs on overheads and in rectifying design and endemic faults equalling the allowances included in contracted rents. However, at the time of sale the Department's advisers reported evidence to suggest that the short-term forecasts of costs had been overstated and therefore the allowances might afford a net profit to the rolling stock leasing companies.

Hambros told us that although the above arguments may be disputed, in their view there was no doubt that bidders' attitudes during the sale process were very cautious.

2.32 The results of Hambros' analysis are summarised in Figure 11. The analysis was not intended to be the Department's sole guide to the value for money of the bids. They did not extend the analysis to assess the levels of return available to investors under more favourable circumstances (such as the scenarios we analysed in paragraph 2.28) and whether these remained at acceptable levels. The Department considered that the analysis established that the short-listed bids were consistent with each other and were based on returns which were within a range which seemed reasonable at the time, given bidders' uncertainty about how far the rail industry would be privatised. Taken with other aspects of the analysis of final bids, and particularly the outcome of discussions with bidders, it helped satisfy the Department that the final bids represented the best opportunity in the circumstances for achieving the key sale objectives.

The Department of Transport's post bid analysis of value based on cashflows compared to final bids

Figure 11

	Angel	Eversholt	Porterbrook	Total
Winning bid (£ million)	672.5	(1)580.0	527.0	1,779.5
Post-bid analysis of value based on cash-flow projections (£ million)	696.3	578.8	536.7	1,811.8
Difference between winning bid and analysis of value (per cent)	-3.4	+0.2	-1.8	-1.8

Note: (1). Includes £80 million deferred proceeds

Source: Department of Transport

The difference between the Department's post-bid analysis of value and winning bids was small.

2.33 It is not possible to come to firm conclusions why bids were low compared to the value of the cashflows. The Department told us that they believe it was mainly because bidders' concerns (paragraphs 2.4 - 2.7) meant that bidders attached little value to cashflows beyond those provided by the initial leases. A key element in achieving the best price possible is the extent of competition achieved in the sale process and so we examine below the steps the Department took to attract and maintain sufficient interest in the sales and to generate effective competition.

The achievement of competition between bidders

The generation of interest in the sales

2.34 The Department attracted significant early interest in the sales, resulting in 78 organisations pre-qualifying as acceptable bidders.

2.35 In October 1994 the Department, through their financial advisers, Hambros, wrote to some 340 organisations from 22 countries with information on the three companies and setting out the Department's intention to sell them to the private sector as soon as possible. Hambros spoke at many seminars in the United Kingdom and the United States, and they had meetings with and made presentations to over 100 potentially interested parties. The proposed sales were advertised in the national press and the Official Journal of the European Community, and publicity was generated through official visits to the United States and Japan. As a result the Department received some 125 expressions of interest

from a variety of organisations. In March 1995, they invited some 100 parties who remained interested to pre-qualify to bid for the companies; these included British, other European, North American and Japanese companies.

Interest at indicative bidding stage

2.36 Nine bids were received at indicative bidding stage involving some 30 organisations. Six of these were consortia of external bidders who put in bids for all three companies. Three were from management/employee buy-out teams backed by financial institutions. The indicative bids valued the companies for less than the Department had expected in the light of early valuations.

2.37 The detailed Information Memoranda and an accountants' report giving detailed information on the business and financial performance of each company were sent in May 1995 to all the organisations that had pre-qualified, including

Figure 12

Indicative bidders

Group name	Consortium members
Angel Management Buy-out[1]	Angel management/employees*****, HSBC Private Equity (formerly Montagu Private Equity)*****, Barings*****, SBC Warburg*****, Mercury Development Capital, Warburg Pincus, 3i Group plc, Deutsche Bank, Lehman Brothers, Midland Bank
CVC Capital Partners	CVC Capital Partners, Prudential Venture Managers Ltd, Citibank, Chemical Bank and NatWest
Eversholt Management Buy-out	Eversholt management/employees, Candover Partners Ltd, Electra Investment Trust Ltd, Morgan Grenfell, Deutsche Bank, Societe General, Fuji Bank, Intermediate Capital Group
First Rail [2]	Nomura International plc, Babcock & Brown Europe Ltd, Prideaux & Associates, USL Capital Corporation (member of Ford Motor Company, USA), Royal Bank of Scotland
GE Capital	GE Capital
IAF Group	IAF
Nationsbank	Nationsbank
Natwest Markets	Natwest Markets (division of National Westminster Bank plc),GATX Capital Corporation (USA)
Porterbrook Management Buy-out	Porterbrook management/employees, Charterhouse Capital Partners V, Bankers Trust Company

Note: 1. Angel Management Buy-out consortium at final bidding stage included those marked *****, together with Stagecoach Holdings.
2. First Rail (without USL Capital Corporation and Royal Bank of Scotland) submitted final bids as Great Rolling Stock Company and later became GRS Holding Company Limited

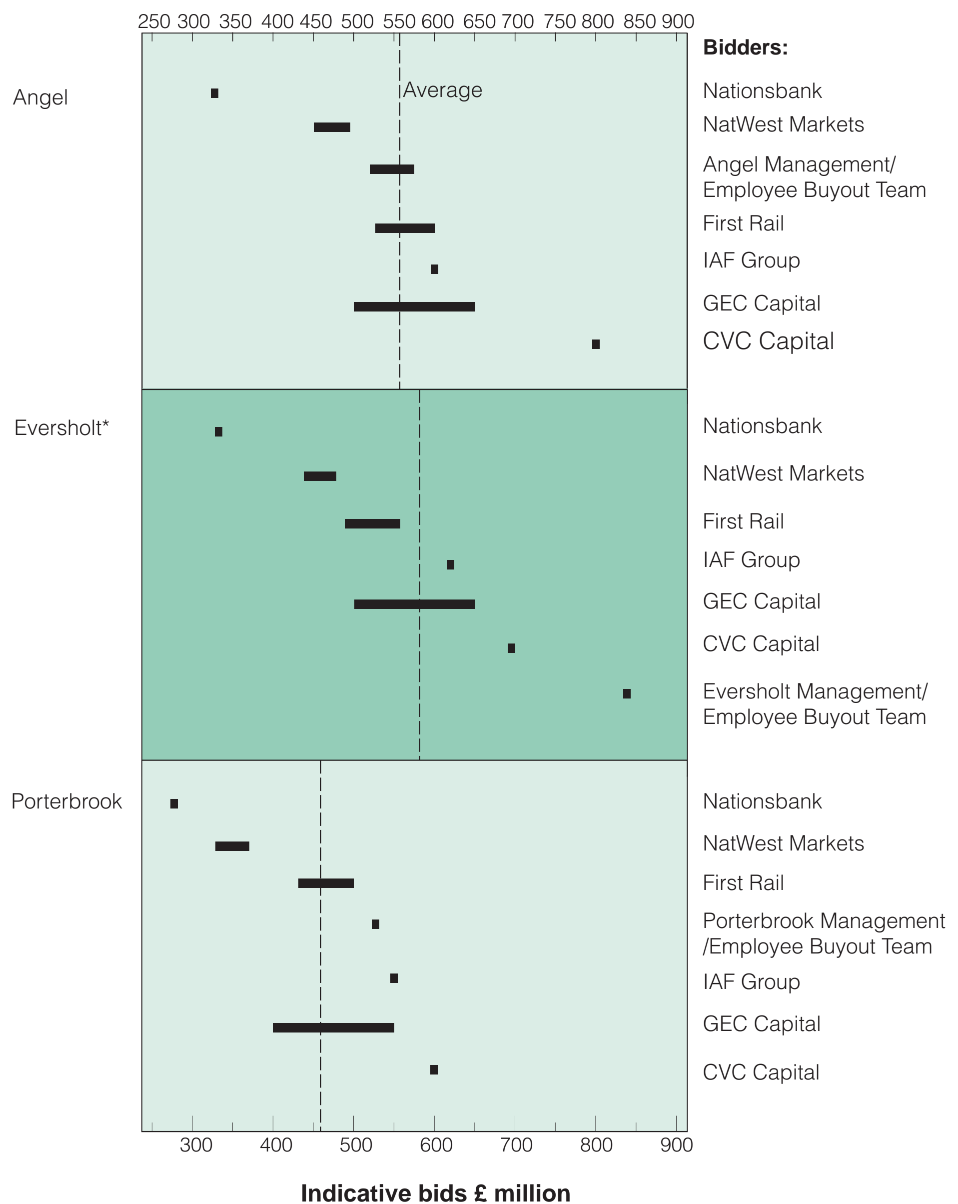
Source: Department of Transport

Some 30 private sector firms were involved in consortia at indicative bid stage.

banks, leasing companies, venture capitalists, rolling stock manufacturers and the three management/employee buy-out teams. The Department gave potential bidders nine weeks to 7 July 1995 to prepare non-binding indicative bids, in line with the timetable given at the pre-qualification stage. Management/employee buyout teams were allowed to bid for their employing company only. All other

Indicative bids

Figure 13



Note: * Indicative bids for Eversholt excluded provision for Networker Express trains.

The range of indicative bids received for each company was wide.

Source: Department of Transport

parties were invited to bid for one or more of the three companies. The Department made clear, however, that, to maximise competition in the industry and drive down future costs, no bidder would be allowed to purchase or invest in more than one company.

2.38 The Department received nine indicative bids as set out in Figure 12. All consortia, other than the management buy-out teams, submitted indicative bids for all three companies. The bids averaged £555 million, £582 million and £463 million for Angel, Eversholt and Porterbrook respectively (Figure 13). At the Department's request the indicative bids for Eversholt excluded provision for Networker Express assets and liabilities because the financial information was not available at that stage.

Compilation of final bids

2.39 The Department shortlisted seven of the eight bids received initially (rejecting the bid from Nationsbank on price grounds) and subsequently accepted a late bid from a consortium headed by the IAF Group, in August 1995. They were disappointed at the level of proceeds suggested by the indicative bids. They believed that bidders had taken a pessimistic view of the likely value of lease income from current rolling stock after the initial lease period, although they could not be certain because only three of the nine indicative bidders had stated the value they ascribed to income after the first lease period (ranging between £1 million and £160 million for each relevant company). This pessimistic view was consistent with the Department's analysis of interested parties' concerns over the identity of the companies' customers, the shortness of the companies' track record and the risk of the rail privatisation programme not being completed (paragraphs 2.5-2.7).

2.40 Two successful purchasers and two of the bidders who withdrew from the sale told us that they had considered the risks associated with partial privatisation of the core rail industry to be significant as there was considerable political opposition to rail privatisation at the time. One of the successful bidders, therefore, decided to bring in other participants into their bidding consortium to share the risks. In contrast, the third successful purchaser told us that their main concern had been over the identity of their customers and that they had considered the risks associated with the completion of the rail privatisation programme to be small, because the prime concern of any Government would always be to ensure an efficient, attractively-priced rail service.

2.41 The Department originally allowed final bidders two months from 17 July 1995 to 15 September 1995 to review more detailed information on the businesses, compile their final bids and secure the necessary funds. The Department extended the deadline by two weeks at a late stage because they had been unable to finalise contractual arrangements associated with the Networker Express trains which Eversholt were taking on (see paragraph 1.7 above) and they considered it essential to have the same timetable for the sale of all three companies. During this due diligence phase bidders were able to meet the companies' management, the Department and their advisers and key participants in the new rail industry such as train operating companies, Railtrack, the Rail Regulator and the Franchising Director. They were also able to obtain written answers from the Health and Safety Executive.

2.42 Bidders were generally satisfied with the level of detail provided although the NatWest/GATX consortium commented that British Rail's inability to provide full data relating to maintenance records contributed to their decision not to submit a bid. Shortly before the deadline for final bids, the Department gave bidders some new and updated information. External bidders considered that, although the Department had given them this data as soon as practicable, the volume of it introduced at a late stage in the process made the bidding process difficult. Members of the consortia backing the management/employee buy-out teams told us, however, that they had not had any difficulty in assimilating the information.

2.43 The Department recognised that the timetable was tight but told us that any longer period for the review of detailed information on the businesses would have jeopardised achievement of the objective of completing the sales in 1995. They saw it as essential to avoid slippage in the timetable which might have been misinterpreted as lack of commitment to the sale and other imminent rail privatisations. The relatively short time for submitting bids may, however, have increased the inherent advantage that management/employee buy-out teams always have because of their familiarity with the businesses. No bidder suggested this to the Department or their advisers, however, and several were complimentary about the comprehensiveness of the material supplied in the Information Memorandum. Also, the management and employee buy-out bids for Angel and Porterbrook were below those from the external bidder.

Competition in the final stages of bidding

2.44 At the final bid stage there were only two bids for each company: one from a private sector consortium which had bid for all three companies and one from each of the three management/employee buy-out teams. The Department had decided at an early stage that, to encourage competition in the industry and drive down future costs, no bidder should buy more than one company. Therefore they sold Porterbrook to the management buy-out consortium for proceeds which were £55 million below the higher bid they had received.

2.45 Four external bidders withdrew before putting in final bids. The IAF Group, who started due diligence late, withdrew at an early stage but three (CVC Capital Partners, GE Capital and NatWest/GATX) withdrew much later. GE Capital and NatWest/GATX notified their intentions only 48 hours before final bids were due. All parties gave the main reason for their withdrawal as the uncertainty about the outcome of the rail privatisation programme, particularly that of the train operating companies, who were the companies' only customers. GE Capital also cited the companies' exposure to damages for environmental hazards, even though to alleviate these concerns the Department had agreed to indemnify purchasers against part of the potential costs.

2.46 The Department received four bids on 29 September 1995:

- one bid from each of the three management buy-out consortia; and
- one bid for each of the three companies from GRS Holding Company.

There were thus two final bidders for each company (Figure 14).

2.47 Although there were only one private sector consortium and the management buy-out team in the final competition for each rolling stock leasing company, all final bidders told us that they considered that the Department had maintained competitive tension well. In accordance with normal confidentiality provisions, none knew the exact number or identity of other bidders remaining in the competition. GRS Holding Company told us that their bids were relatively high because they believed they faced significant competition.

2.48 In addition to their main bids, which mostly complied with the Department's requirements, GRS Holding Company submitted alternative bids offering an additional £25 million for each company in exchange for additional warranties and indemnities. The Department rejected these alternative bids,

Final Bids

Figure 14

Bidders:	Angel £ million		Eversholt £ million		Porterbrook £ million	
	Final	*Final - revised*	*Final*	*Final - revised*	*Final*	*Final - revised*
GRS Holding Company	675.0	**672.5***	505.0	502.5	585.0	582.5
Angel Management Buy-out	547.8	560.0				
Eversholt Management Buy-out (Eversholt Holdings)			600.0 (Note 1)	**580.0*** (Note 2)		
Porterbrook Management Buy-out (Porterbrook Leasing Company MEBO)					530.0	**527.0***

Notes: 1 Includes deferral of up to £30 million until satisfactory delivery and performance of Networker trains

2 Includes deferral of up to £80 million until satisfactory delivery and performance of Networker trains

* **Winning bid**

There were two final bidders for each company. The highest bid for Porterbrook, from GRS Holding Company, was rejected because no bidder was allowed to buy more than one company.

Source: Department of Transport

mainly because they believed that the proposed warranties exposed them to unquantifiable risks arising from future actions by the new owner whilst greatly limiting the latter's share of any costs that arose.

2.49 Neither of the bids for Eversholt complied with the Department's requirements, because of bidders' proposed treatment of Networker Express trains (paragraph 1.7 above). Both bidders had proposed setting up subsidiary companies to own the Networker Express trains, thus protecting the remainder of the business from the financial risks associated with their performance and delays in delivery and safety clearance. GRS Holding Company made an alternative non-compliant bid of £620 million for Eversholt without the Networker Express trains, compared to their later compliant bid of £502.5 million with the Networker Express trains. The Department rejected these non-compliant bids because a subsidiary company would have a higher risk of failure, with the result that the Government's guarantee (paragraph 1.7 above) would have been more likely to be called. They asked bidders to submit compliant bids and subsequently accepted a revised bid from the Eversholt management buy-out consortium for £500 million, plus further proceeds of up to £80 million which would be deferred pending satisfactory delivery into service of the Networker Express trains:

- up to £50 million maximum, payable by 30 June 1999 at the latest, based on £1.2 million for each Networker Express unit upon satisfactory completion of six months' operation; and

- up to £30 million maximum, payable on or soon after 30 June 1999, based on a formula for sharing any difference between £50 million and Eversholt's actual net cash outflow on the Networker Express trains up to April 1999.

2.50 This bid from Eversholt management buy-out consortium was the highest bid for Eversholt which conformed as closely as possible to the draft sale agreement. (Eversholt told us that they have safety approvals for some of the Networker Express trains, so that their introduction into service is likely to be earlier than previously assumed. They expected in October 1997 that the Department would receive deferred proceeds of some £60 million; of this, £24 million was expected to be paid by 31 March 1998, including £22 million which was paid to the Department up to 30 September 1997).

2.51 The Department granted exclusive negotiating rights to GRS Holding Company for Angel and the management buy-out consortia for Eversholt and Porterbrook on 19 October 1995. Two weeks later, the institutions (Montagu Private Equity, Stagecoach Holdings and Barings) which had failed in their management-backed bid for Angel increased their bid from £560 million to £600 million. They also offered £520 million and £600 million respectively for Eversholt and Porterbrook, subject to a further period of due diligence, if the Department's negotiations with the winning bidders did not come to fruition. The Department rejected these late bids because:

- they did not wish to signal to the market that the bidding process was being reopened;

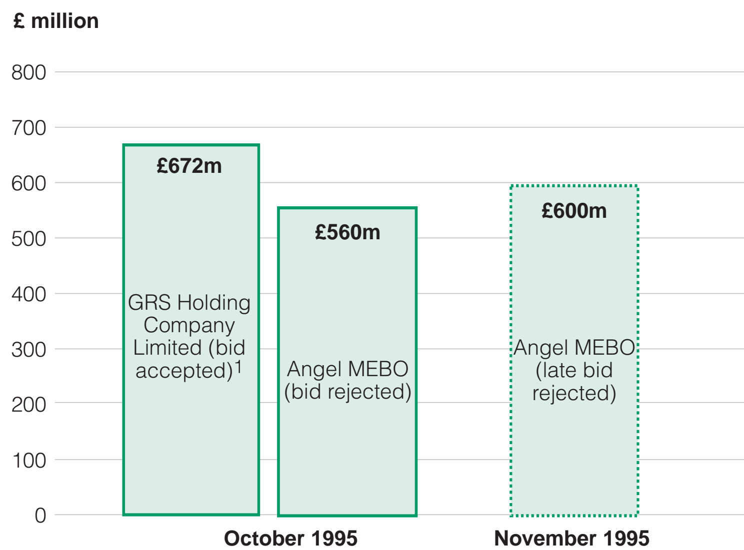
- the bid for Angel was still below the winning bid; and

- there was no guarantee that the bids offered would survive the due diligence process.

2.52 Because of their objective to encourage competition in the industry and drive down future costs, the Department's policy was to sell the companies to three separate bidders. As only two bids were received for each company the Department decided to sell Porterbrook to the management/employee buy-out consortium for proceeds which were £55 million below the higher bid from GRS Holding Company (who were the winning bidders for Angel). The Department told

Bids received for Angel

Figure 15



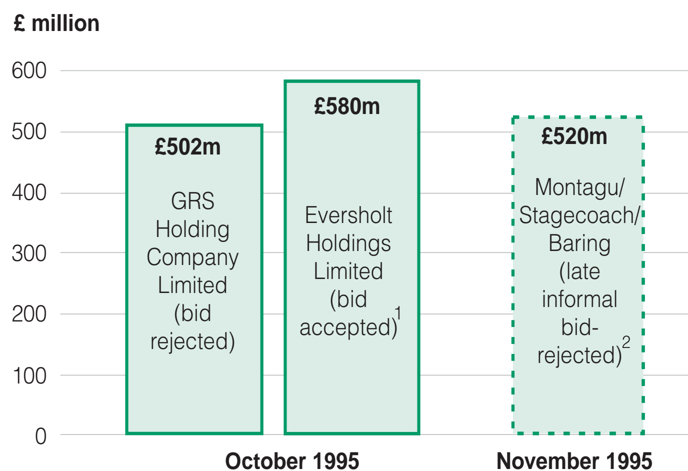
Note: 1. Bid price shown excludes £23.8 million interest adjustments payable on completion

Source: Department of Transport & bidders

The Department accepted the highest bid for Angel in October 1995.

Bids received for Eversholt

Figure 16



Notes: 1. Bid price shown excludes £18.3 million interest adjustments payable on completion

2. This late informal bid was without due diligence.

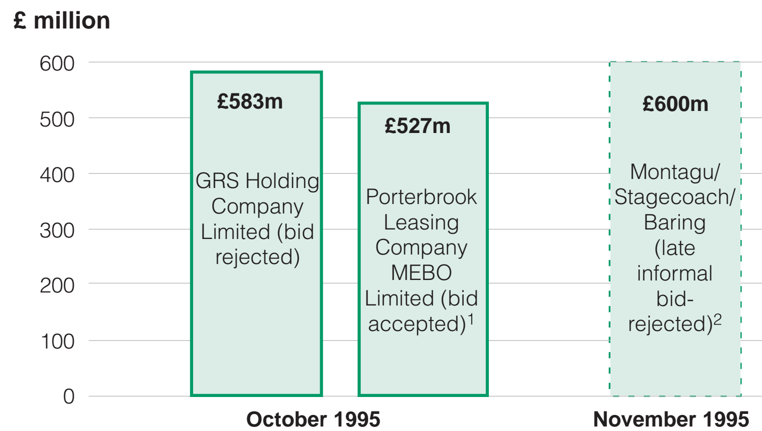
3. All bids include amounts offered for Networker Express trains

Source: Department of Transport & bidders

Including provision for Networker Express proceeds, the bid accepted by the Department was 16 per cent higher than the other bid received by October 1995.

Bids received for Porterbrook

Figure 17



Notes: 1. Bid price shown excludes £1.3 million interest adjustments payable on completion

2. This late informal bid was without due diligence.

Source: Department of Transport & bidders

The bid accepted by the Department was 10 per cent less than the highest bid in October 1995.

us that they were sure that this was the correct decision in the interest of controlling future costs. Their overriding objective was to sell all three companies as soon as practicable and they considered it was not feasible for only two to be sold. Also, under the terms of their sale and purchase agreement, the purchasers of Eversholt were not committed to complete their purchase until the other two companies had been sold. The Department believed that failure to sell the companies on time would have impacted badly on other rail privatisations.

Provisions for sharing gains if the companies were sold on

2.53 Before bids were received, the Department should have given more detailed and evidenced consideration to including provisions in the terms of the sale enabling them to share in any gains made if the initial purchasers sold the companies within, for example, five years.

2.54 We found little written evidence of the Department considering, before bids were received, the inclusion of provisions in the terms of the sale which would allow them to share in any gains made if the companies were sold on by the initial purchasers within a certain period of time. The Department told us that at various stages in the sale process they had considered carefully with Hambros whether to include such provisions but had decided not to do so because they felt that they would deter prospective purchasers, particularly venture capitalists such as those who eventually backed the two successful management and employee buyout consortia. In their view this could have affected proceeds very adversely or it could have led to the failure of the sale. Hambros told us that they agreed strongly with that assessment and had told the Department so before the bids were received, although not in writing.

2.55 The Committee of Public Accounts recommended the inclusion of provisions to allow the Government to share in profits made on onward sales in their report on the Department of Transport's Sale of Trust Ports (31st report, session 1993-94 published in July 1994 - see Appendix 1). Treasury guidance on trade sales, issued in July 1996, after the sales of the rolling stock leasing companies, advised Departments to assess the case for using clawback in the circumstances of each sale. It also recommended them to view proposals for profit clawback with particular caution, because of the risk that sale proceeds might be reduced by an amount greater than any benefit gained from clawback.

2.56 Stagecoach Holdings, who did not succeed in purchasing any of the companies in the initial sales but went on to buy Porterbrook from the initial purchasers, told us that they were surprised that no such provisions were included. Three bidders (Candover, Charterhouse and Nomura) and three other interested parties (GE Capital, Forward Trust and NatWest Markets) indicated that such provisions would not necessarily have deterred them from bidding although the inclusion of such provisions would have impacted adversely on the sale price.

2.57 Several parties (Charterhouse, CVC Capital Partners, Montagu Private Equity and Candover) told us that a preferable arrangement, which was fairly common in the private sector, would have been the retention of a minority

shareholding in the companies by the Government, allowing them to benefit from the onward sale of the companies at a higher value, whilst also sharing some of the risk of a fall in value. This, however, would have been contrary to Ministers' wish to secure a clean break between the industry and the Government and transfer as much risk as possible to the private sector. The Department noted that there was widespread concern amongst potential purchasers about the possible scope for Government interference following the sale. They told us that any proposal for Government to retain an interest would have exacerbated that concern and depressed market interest.

2.58 We recognise that provisions for sharing in gains from the onward sale of the companies would have had to be considered carefully to avoid a reduction in the initial price without any likelihood of additional proceeds. We believe that there were particularly compelling reasons to consider carefully at an early stage the inclusion of such provisions in the terms of the sales:

- as the policy was to allow a bidder to buy only one company, it was always possible that the Department might have to sell one or two companies for less than the highest price bid, and that these original purchasers might therefore be in a position to make significant gains from any onward sale to new purchasers soon afterwards;

- the Department expected bidders to take a cautious view of the companies' prospects, given that they were the first major sales of the railway privatisation programme;

- the likelihood that bidders would discount heavily for the uncertainty over the completion of the privatisation programme and the rolling stock leasing companies' lack of a track record; and

- it was likely that, if the privatisation was seen to have been successful, more investors would be attracted to the railway sector, causing the rolling stock leasing companies' values to rise, regardless of any improved performance achieved by the companies' initial purchasers.

2.59 In October 1995, shortly before granting exclusive negotiating rights to the preferred bidders, the Department considered whether to introduce such provisions to share in gains made if the businesses were sold on. This was because the three bids from management and employees were backed by financial institutions who usually seek an exit within three to five years at a significant profit on successful purchases.

2.60 At this stage the Department considered it would still have been possible to introduce such provisions had Ministers decided in favour of them. However, in accordance with their officials' advice Ministers decided against introducing such provisions for the following reasons:

- the possibility of the bidders withdrawing from the sale;
- the delay to the sale while bidders consulted their financial backers could have jeopardised the timetable for securing the sales within 1995; and
- difficulty in defining what element of profit would be attributable to the goodwill generated by the new owners.

2.61 The Department told us that their decision had to be judged in the particular context at that time. In particular, in the closing stages of the bidding process, interest in the sales was very limited, and the sales' success depended on maintaining the interest of the financial institutions who were backing each of the bids. Moreover, if it proved impossible to sell one or two of the companies, the Department believed none would have been sold (because of possible fears by the private sector about their ability to compete on equal terms with a Government-owned company). They also believed that failure to sell the companies on time would have impacted badly on other rail privatisations.

The on-sale of the companies after privatisation

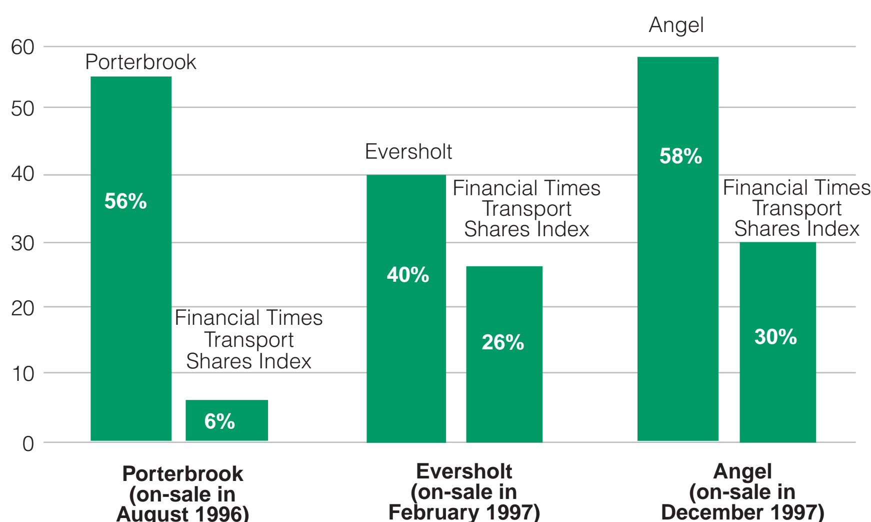
2.62 By December 1997 all three companies had been sold by the new owners at a substantial profit - Porterbrook in August 1996, Eversholt in February 1997 and Angel in December 1997.

2.63 Porterbrook were sold to Stagecoach Holdings for £826 million in August 1996, 56 per cent more than the £528 million received by the Department. Stagecoach had submitted unsuccessful bids for each of the companies in late 1995. Eversholt were sold to Forward Trust Group, a wholly owned subsidiary of The Hong Kong and Shanghai Banking Corporation for £726 million in February 1997, 40 per cent more than the £518 million received by the Department. Following a series of complex financial transactions Angel were sold to the Royal Bank of Scotland Group plc in December 1997. The initial purchasers of Angel sold the right to the capital rental income of the business for total proceeds of some £690 million shortly after privatisation. The Royal Bank of Scotland Group

paid £395 million for the remainder of the business in December 1997. These transactions together valued the business at some £1.1 billion, 58 per cent more than the £696 million received by the Department.

Figure 18

Increase in the value of the three rolling stock leasing companies at the time of their onward sales



Source: Department of Transport

The value of the three companies increased faster than the share price index for transport businesses. Their shares are not quoted on the Stock Exchange.

2.64 In putting forward their bids for Porterbrook and Eversholt, the financial institutions backing the management and employee buy-out teams made it clear to the Department's advisers, and later to us, that they would, as normal, expect to realise a significant profit on their investment within three to five years, either through a flotation on the Stock Exchange or a sale to a third party. We understand from analysis carried out by the British Venture Capital Association and from discussions with venture capitalists that, in providing funds for management buy-outs, financial institutions look for a return of between 25 per cent and 40 per cent a year on their investment. The percentage gains made by the equity investors in the Porterbrook and Eversholt management/employee buy-out teams exceed these figures; also their gains are very large in money terms, compared to those of most management buy-outs (Figures 19 and 20 on pages 45 and 46). Charterhouse, the backers to the Porterbrook management/employee buy-out team, attributed the size of their gain almost entirely to the willingness of Stagecoach Holdings to pay a premium to obtain control of the company and to

Stagecoach Holdings' ability to finance the transaction by selling the right to some of Porterbrook's future income flows in return for a cash sum (securitisation of the cash flow), following the example of the initial purchasers of Angel.

Change in value of equity and debt in Porterbrook Leasing Company (MEBO) Limited

Figure 19

	Initial purchase from Department £ million		Purchase by Stagecoach £ million		Change £ million	
Purchase price		**528.3**		**826.0**		**297.7**
Financed by						
Equity						
Financial institutions						
■ Charterhouse*	52.7		276.5		223.8	
■ Metropolitan Life Insurance	6.5		34.1		27.6	
■ BTI Investments	4.6		24.1		19.5	
■ CU Life Assurance	3.0		15.7		12.7	
■ Royal Bank Investments	2.3		12.1		9.8	
■ The Hillman Foundation	2.0		10.5		8.5	
■ Foreign and Colonial Enterprise	1.8		9.5		7.7	
■ Glenbrook Partners	1.3		6.8		5.5	
■ PRICOA	0.5		2.6		2.1	
Total financial institutions	74.7		391.9		317.2	
Management and employees	0.3		83.7		83.4	
Total equity		**75.0**		**475.6**		**400.6**
Of which:preference shares	72.5		77.2		4.7	
	2.5		398.4		395.9	
ordinary shares						
Debt		**453.3**		**350.4**		**-102.9**
Total		**528.3**		**826.0**		**297.7**

Note:* The amounts shown for Charterhouse include additional investments by the other financial institutions listed here.

The value of the initial equity in Porterbrook increased by £400.6 million from £75 million in January 1996 to £475.6 million when sold to Stagecoach Holdings in August 1996; debt reduced by £102.9 million

Source: National Audit Office

2.65 Stagecoach Holdings had secured the franchise for South West Trains in December 1995, before they bought Porterbrook. They told us that, as a trade purchaser, their interest in Porterbrook is long-term and they intend to continue to increase their investment in new rolling stock. They said that they had initially

Figure 20

Change in value of equity and debt in Eversholt Holdings Limited

	Initial purchase from Department £ million	Purchase by Forward Trust £ million	Change £ million
Purchase price	**518.3**	**726.5**	**208.2**
Financed by:			
Equity			
Financial institutions			
■ The Candover Group:			
■ Candover Investments plc	5.6	29.1	23.5
■ Funds managed by Candover	17.1	100.4	83.3
	22.7	129.5	106.8
■ Electra Fleming	22.7	129.5	106.8
■ Alpinvest	8.2	46.7	38.5
■ Advent	6.5	36.8	30.3
■ Barclays de Zoete Wedd	6.0	34.0	28.0
■ Gartmore	2.5	14.1	11.6
■ Royal Bank of Scotland	1.0	5.7	4.7
Total financial institutions	69.6	396.3	326.7
Management and employees	0.4	57.2	56.8
Total equity	**70.0**	**453.5**	**383.5**
Of which: preference shares	67.4	67.4	0.0
ordinary shares	2.6	386.1	383.5
Debt	**448.3**	**273.0**	**-175.3**
Total	**518.3**	**726.5**	**208.2**

The value of the initial equity in Eversholt increased by £383.5 million from £70 million in February 1996 to £453.5 million when sold to Forward Trust Group in February 1997; debt reduced by £175.3 million. The purchase price is the initial price before taking into account up to £80 million of deferred proceeds for Networker Express trains.

Source: National Audit Office

been attracted to investing in the rolling stock leasing companies because they considered them to be subject to less risk than other participants in the restructured rail industry and potentially to have the largest margins for profit to support needed investment. They had been discouraged initially from bidding for the companies because they had expected them to be sold for more than was eventually the case, although they did participate at a late stage in one of the bidding consortia. Their share price doubled between November 1995 and August 1996 and they told us that this helped them gain financial support for their

acquisition of Porterbrook, which they bought using shares and cash. They said that improved prospects for profitability and the implementation of a large part of the rail privatisation programme had also assisted them in obtaining additional finance for their bid for Porterbrook.

2.66 Candover, the backers to the Eversholt management/employee buyout team, attributed most of the increase in the value of Eversholt to the achievement of the major part of the rail privatisation programme following the successful franchising of most of the train operating companies and the flotation of Railtrack. This view was shared by Forward Trust, the subsequent purchasers of Eversholt.

2.67 As is typical in management/employee buy-outs backed by financial consortia, the purchases of Porterbrook and Eversholt were financed mainly by debt, with only a small amount of the payment accounted for by equity. The investors structured the transactions so that management and employees were given a much larger equity stake in the business than was represented by the amount of money that they put in. The structure is normal for such transactions and mainly reflects financial institutions' concern to give management an incentive to work for the success of the business after the sale. This incentive was provided through the share structure of the management/employee buy-out companies, in which the institutions who provided equity finance bought ordinary shares but had the largest part of their investment in preference shares, whereas the management and employees only bought ordinary shares.

2.68 The onward sales of Porterbrook and Eversholt each resulted in very substantial gains for the institutional and individual equity investors, because the increase in value of the company accrued to the ordinary shareholders alone, who put in only a small proportion of the initial sale price, and because debt had decreased.

2.69 Nomura told us that they sold Angel because they had achieved their aim of transforming it into an efficient business, well placed to take advantage of the new business opportunities becoming available. They considered that Royal Bank of Scotland Group plc, as a long term trade investor, was now better placed to take the business further. They told us that the profit of some £390 million realised on the transaction was shared in proportion to the consortium's initial shareholding - 84.5 per cent Nomura, 10 per cent Babcock and Brown and 5.5 per cent Prideaux and Associates.

Extraction of cash from the companies before sale

2.70 In inviting bids the Department said they would remove cash from each company equal to the estimated bank balance at 31 October 1995, the date they expected sale contracts to be exchanged. However they left £35 million in the businesses; the purchasers have provided us with analyses which suggest that this arose from slippage in payments and projects, and so did not result in a net loss to the Government.

2.71 Cash was extracted from the companies in two tranches. Firstly British Rail extracted £745 million on 7 September 1995, which included an allowance for uncleared cheques. Secondly, in September 1995 the Department informed bidders that they would extract £54 million from the companies prior to sale, representing their forecast of cash balances as at 31 October 1995, which was the day on which sales were expected to be completed. They also told bidders that all cash accruing after that date would remain in the company. In practice, cash balances as at 31 October (including allowance for uncleared cheques) were higher than forecast. The Department extracted the agreed £54 million on 21 November but left in the businesses an unanticipated £35 million including an allowance for uncleared cheques (Figure 21). The Department and the rolling stock leasing companies have subsequently produced evidence showing that the unanticipated £35 million cash left in the businesses arose mainly from slippage in payments and projects and, therefore, could not be considered a loss to the Government.

Figure 21

Cash extracted from the rolling stock leasing companies

£ million	Angel	Eversholt	Porterbrook	Total
Cash extracted before the sale:				
■ by British Rail, September 1995	316	166	263	745
■ by the Department of Transport, as at 31 October 1995	17	21	16	54
	333	187	279	799
Cash left in the business:				
■ as at 31 October 1995	12	10	13	35
■ which by completion in January/February 1996 was	76	56	67	199

The Department extracted £54 million from the companies as at 31 October 1995. Cash remaining in the business accrued to the purchasers, under the terms of the sale.

Source: Department of Transport

2.72 At completion in January and February 1996 (originally expected to be at the end of October 1995) cash balances in the companies totalled £199 million. The cash left in the businesses at completion, other than the unanticipated £35 million left in, should have been taken into account by bidders in the bids they offered. At the time of the sales it was not certain whether the arrangements the Department adopted resulted in any loss of proceeds. It would have been possible for the Department to extract cash on completion, rather than at an earlier date, although this would have required them to ensure that temporary changes in working capital did not disadvantage the purchasers. Extraction of cash at completion would have ensured that the Government received the full value of any cash held in the businesses. In the Department's view bidders would have required any arrangements for extraction of all cash at completion to be matched pound for pound by adjustments to the purchase price. They believed such completion adjustments would have required significant extra work and expense to administer and risked lengthy and costly disputes between the parties.

Completion arrangements

2.73 The Department and the purchasers signed the sale and purchase agreements for the three companies on 8 November 1995, but completion was delayed because the European Commission took longer than expected to resolve some issues. The Commission's clearance that the sales did not breach European legislation was received at the end of November 1995. It was only after this clearance that the bidders for Porterbrook and Angel could seek the Commission's clearance on merger issues. With the Christmas period intervening, this delayed completion until 8 and 17 January 1996 for Porterbrook and Angel respectively. Completion for Eversholt was delayed to 2 February 1996, until it could be confirmed that the other two companies had been sold and mainly because of the time taken to finalise legal documentation for Networker Express trains.

2.74 The proceeds of the sales were accounted for in the Department's public expenditure provision for 1995-96 and 1996-97. The Department therefore required successful bidders to pay the purchase price in two instalments: the first (totalling £0.74 billion) on completion of the sales in January and February 1996, and the second (totalling £1 billion) on 1 April 1996. The second instalments were secured by letters of credit from the purchasers' bankers; they were paid on time on 1 April 1996 and the Department charged no interest on them because they expected the benefit had already been taken into account in the bid prices received.

2.75 The Department required purchasers to pay interest to them on the first instalments for the period between 1 December 1995 and completion, resulting in additional revenue of £6.5 million. Purchasers benefited from a 30-day interest-free period because interest was charged from 1 December 1995 rather than 1 November 1995 (the day after the expected date for exchange of contracts at the time final bids were invited); for this period they received the benefits of the lease cash flows, but without having paid over any proceeds. Interest on the first instalments of proceeds for that 30-day period would have resulted in additional proceeds of some £4 million. We asked the Department whether they had considered the merits of charging interest from 1 November 1995. They told us that they had considered this question at the time and had decided not to charge such interest for delays entirely outside the bidders' control. This was because bidders were then extremely nervous about the continuing delay in obtaining European Commission clearance and so any indication that the Department had doubts whether this would be achieved imminently would have put the sales at serious risk.

2.76 Bids were largely financed by loans from banks. Bidders had been concerned that their liabilities to the banks might be excessive if interest rates on the loans increased considerably between exchange of contracts and completion of the sales, and they sought a warranty against any increase. Instead the Department agreed to include provision in the sale agreements for adjustments to the sales prices for interest rate changes, thus sharing the risk. However, interest rates went down during the period and so, under the agreements, the Department received additional proceeds of £37 million.

Summary of the proceeds of sale

Figure 22

	Angel	Eversholt	Porterbrook	Total
Purchaser	*GRS Holding Company Limited*	*Eversholt Holdings Limited*	*Porterbrook Leasing Company (MEBO) Limited*	
	£ million	£ million	£ million	£ million
Sale price	672.5	500.0 *(Note 1)*	527.0	1,699.5
Adjustments to sale price				
■ arising from changes in interest rates	20.7	16.2	-	36.9
■ interest for period 1 December 1995 to contract completion	3.1	2.1	1.3	6.5
Gross proceeds (after adjustments)	**696.3**	**518.3**	**528.3**	**1,742.9**
External costs of sale (excluding VAT)				
- British Rail				(3.2)
- Department of Transport				(7.1)
Net Proceeds *(Note 2)*				**1,732.6**

Notes: 1. There may be up to £80 million additional proceeds for Eversholt, deferred until 30 June 1999 at the latest, pending delivery into service of 41 new Networker Express trains which were on order at the time of the sale. Of this, some £22 million deferred proceeds had already been received by September 1997, and the Department expect some £30 million will have been received by April 1998.

2. In addition to the above proceeds cash totalling £799.6 million was extracted from the companies by British Rail and the Department of Transport before the sales.

Source: Department of Transport

Proceeds (including deferred proceeds) were some £1.8 billion.

Part 3: Achieving the Department's other objectives for the sales

3.1 This part of the report examines the extent to which the Department achieved their objectives of:

- encouraging management/employee teams to bid;
- ensuring that employee pension benefits and other employee interests were safeguarded;
- encouraging economy, efficiency and safety in the use and renewal of rolling stock by train operating companies; and
- securing competition amongst those who lease rolling stock.

Encouraging management/employee teams to bid

3.2 The Department were right not to offer preferential terms to management employee buy-out teams to encourage them to bid. Three management/employee teams submitted bids for their respective companies; two of these were winning bids.

3.3 Encouraging employee participation in the sales was one of the Department's objectives. The Department considered that the small number of staff employed by the companies, and the high value of the companies, meant that staff were unlikely to be able to provide much equity finance to purchase their employing company. They expected the management/employee teams would have little difficulty in obtaining backing from financial institutions. Therefore they decided that there was no need to offer preferential terms to management/employee buy-out teams either through reimbursement of expenses or through price preferences. Three management/employee buy-out teams, one from each company, bid for their respective company; two of these bids were winning bids (Eversholt and Porterbrook).

Safeguarding pensions and other employee interests

Pensions

3.4 The existing pension rights of employees of the rolling stock leasing companies are protected by their transfer to designated sections of the Railways Pension Scheme.

3.5 Under the Railways Act 1993 staff who were employed as at 5 November 1993, and who were members of a British Rail pension scheme, are guaranteed pension rights at least as favourable as those under their former pension scheme. Their employer has a legal obligation to provide an adequately funded occupational pension scheme which meets those requirements. Relevant staff are also entitled, under the 1993 Act, to continued membership of the railways joint industry pension scheme for as long as the employer is engaged in the rail industry. The joint industry scheme is the Railways Pension Scheme, run by independent trustees. This was established in October 1994 as an industry-wide scheme open to all employees within the railways industry. The Railways Pension Scheme has a pensioners' section (to meet the pensions of existing and deferred pensioners as at 30 September 1994) and designated sections for employer/employee groups. Employers and employees are responsible for funding their sections in the ratio 60:40 respectively.

3.6 Designated sections of the Railways Pension Scheme were established for each of the rolling stock leasing companies in 1995. Some £4 million, £5.9 million and £4.8 million were transferred to the sections for Angel, Eversholt and Porterbrook respectively. These give statutory protection of pension rights to employees of the rolling stock leasing companies at the time of the sale. Employees retain their entitlements to no less favourable pension rights and to membership of the Railways Pension Scheme if the businesses are further sold on. A valuation at 1 April 1996 showed that, overall, the rolling stock leasing companies sections were in surplus (see Figure 23). Independent trustees, with the consent of the employer, determine whether those surpluses will be distributed and the method of distribution. Pensioners, employees and employers may benefit from surpluses through:

- enhanced benefits (pensioners and employees); or
- reduced contributions (employees and employers); or
- a combination of both.

Actual valuation of pension funds at 1 April 1996

Figure 23

Section of the Railways Pension Scheme	Angel	Eversholt	Porterbrook	Total
Surplus of assets over liabilities in section (£'000)	628	245	847	1,720
Funding level (per cent)	115	104	120	

The rolling stock leasing companies' sections of the Railways Pension Scheme were all in surplus, but surpluses were small.

Source: Department of Transport

Employees' terms and conditions

3.7 The Department did not negotiate any changes to employees' terms and conditions before sale. Within the constraint of employment law employers and their staff are free to renegotiate terms and conditions after sale.

3.8 The rights of the employees of transferred undertakings stem from the Acquired Rights Directive issued by the European Union which has been implemented in the United Kingdom through the Transfer of Undertakings (Protection of Employment) Regulations 1981 and subsequent measures, collectively known as TUPE.

3.9 TUPE did not apply to the transfer of the rolling stock leasing companies from British Rail to Government ownership in August 1995 nor to their subsequent sale to the private sector. This was because both transactions involved the transfer of shares rather than the transfer of the business. The rolling stock leasing companies continued throughout as the employers. On sale, there was no interruption to contracts of employment and no change to employees' terms and conditions. Subject to general employment law, the purchasers are free to negotiate revised terms and conditions with their staff, as would be the case had TUPE applied.

Encouraging the improvement of economy, efficiency and safety

3.10 The Department do not have a direct role either for monitoring or enforcing economy, efficiency and safety in the use and renewal of rolling stock. On economy and efficiency, the Department expect the main improvements to stem from private sector owners introducing commercial practice into the rolling stock leasing companies. Other improvements may derive from the lease agreements

(which, for example, specify the performance criteria for the rolling stock) and from various agreements the Franchising Director has made with rolling stock suppliers. The main input the Department had to economy and efficiency was through setting the lease prices for the first lease period. They expect that safety will be enhanced by the extended role of the Health and Safety Executive (paragraph 1.4). Against this background we examined how the Department's decisions took account of:

a) economy and efficiency in the use of rolling stock through the Department's setting of initial lease prices; and

b) the safety of rolling stock and, in particular, the safety of older, Mark 1 stock.

Economy and efficiency through lease pricing

3.11 The Department sought to encourage economy and efficiency in the use and renewal of rolling stock by selecting a method of lease pricing for the initial leases that was meant to mimic rental prices that would be charged in a competitive market. Their intention was to encourage new investment whilst discouraging the premature retirement of existing satisfactory stock. Although the Department considered that their leasing arrangements would encourage future investment, they recognised that the system could not deliver a guarantee of future investment.

3.12 Although the pricing method the Department adopted for initial lease prices was not the most expensive of the three main options they considered, it has resulted in higher costs - and higher public sector subsidy to train operating companies - than if an alternative pricing method had been used. However, it also resulted in higher proceeds for the Government.

3.13 As a leasing market for passenger rolling stock did not exist previously, the Department had to set lease rental prices, and determine the capital values of the rolling stock on which such rentals should be based. Three main pricing methods were considered, each with different implications for the income of the rolling stock leasing companies and for the amount of public sector subsidy payable to train operating companies. The Department selected a method for setting lease rental prices (called equivalent cost pricing) which was intended to make the lessees, the train operating companies, indifferent on cost grounds between similar stock of different ages. Under this method the rentals were calculated so that total capital and running costs would be the same for both new and old stock.

Additionally the Department expected this method to produce rental prices which mimicked those that could be charged in a competitive market and to allow for a smooth transition to market prices when leases were renewed.

3.14 The Department set the lease rental prices high enough so as to avoid step increases both in the prices paid by train operating companies and in the level of public sector subsidy to those companies when leases are renewed in future. Although this form of pricing was less expensive than one of the three main pricing methods they considered, it produced higher costs, and gave the rolling stock leasing companies higher income, than their third main option. The Department believed that the two rejected options could have led to the premature replacement of existing, fully serviceable, vehicles, or to the prolonged use of older vehicles which might be inefficient or uneconomic to run. Further details on the implications of different methods of lease pricing are in Appendix 4. In calculating the lease rental prices the Department decided to accept British Rail's advice and reduce the estimate of the capital values for new rolling stock produced by a working group, chaired by British Rail and set up early in the process of establishing the companies.

3.15 Even after taking account of the Department's decision to reduce the working group's estimates of capital values for new rolling stock, equivalent cost pricing leads to higher capital rentals than a method based on historic costs, resulting in higher costs for the train operating companies and, hence, a larger requirement for public sector subsidy through grants from the Franchising Director. The Department considered it was important to avoid setting lease rentals too low on the alternative basis of historic cost, because this would have resulted in a disincentive to investment in new stock and would have led to a step increase in subsidy requirements when leases were renewed. We note that this higher income for the rolling stock leasing companies will have generated higher proceeds for the Department when they sold the companies because it led to higher cash flows, and bidders used these cashflows in their valuations of the companies.

3.16 Through the capital rental, equivalent cost pricing is intended to provide the rolling stock leasing companies with a 10 per cent annual return on the assumed capital cost of rolling stock (8.5 per cent, representing an estimate of 25 year interest rates on investment, plus 1.5 per cent gross profit margin). The current owners of the rolling stock leasing companies have told us that they aim to fund significant new investment in rolling stock. Since privatisation, the rolling stock leasing companies have been active in bidding to supply train operating companies with new stock and, by June 1997, one of them (Porterbrook) had won several orders to invest in new stock (Figure 27 and paragraph 3.44 below).

Downward pressure on non-capital costs

3.17 Under the leases they put in place the Department ensured that the element of lease rentals covering non-capital costs, such as heavy maintenance and overheads, will be reduced annually in real terms.

3.18 The rolling stock leasing companies are contractually required to comply with the heavy maintenance programmes set out in their leases with the train operating companies. They currently procure heavy maintenance services from contractors (mainly former British Rail Maintenance Limited depots, but also manufacturers and some train operating companies).

3.19 On the basis that over-capacity in the heavy maintenance market should lead to scope for efficiency savings, the Department built into the rolling stock leases an annual price adjustment which provides for the non-capital rentals charged by the rolling stock leasing companies to increase or decrease annually by the change in the producers price index less 3 per cent. The Department estimated that by 2004 this 3 per cent adjustment would have produced accumulated savings of over £430 million in non-capital rental charges.

3.20 The operators of the Chiltern and InterCity East Coast services told us that in their view, even after this price adjustment to non-capital rental charges, the rolling stock leasing companies would be able to make profits on heavy maintenance. They suggested this was due, for example, to a possibly over-pessimistic view by British Rail's engineers of the repair risks when the forecasts were made, the difficulty of forecasting repair costs for the lifetime of the rolling stock, and there being much greater scope than estimated for savings on heavy maintenance of relatively new stock. The Department's accountants reported that most of those involved in compiling the forecasts viewed them as being prudent. Stagecoach Holdings told us that one of the reasons that they were able to offer more for Porterbrook in August 1996 than the management team had paid in January 1996 was that maintenance costs were now looking more favourable. Angel told us that they had made significant progress in bringing maintenance costs down but that the decreases provided for in the initial leases had been very challenging. Forward Trust, the owners of Eversholt, told us that although there may be some profit or loss on the rolling stock leasing companies' heavy maintenance activity at any point in time, the uncertainties of forecasting their expenditure over long timescales meant that the rolling stock leasing companies are exposed to significant risks for years ahead.

3.21 The non-capital element of rental charges was designed not only to fund heavy maintenance expenditure but also certain other costs. The Department included the following total annual allowances in the non-capital rental charges in respect of these, split equally across the three rolling stock leasing companies:

	£ million
overheads	40
rectification of design or endemic faults in rolling stock	10
movements of rolling stock to and from heavy repair depots	6
	56

3.22 The companies retain any profit or loss arising from differences between the non-capital rentals they receive and the heavy maintenance and other non-capital costs they incur. As with heavy maintenance costs, the scope for future profits on other non-capital costs will be limited by the annual 3 per cent reduction built into the lease formula for non-capital rentals. We have no details of what profits or losses the rolling stock leasing companies have incurred, or expect to incur, on their non-capital rentals since privatisation. However, before privatisation, when the companies' cash surpluses were retained by British Rail, many of the costs covered by the non-capital rentals were significantly less than the relevant collection to cover them. For example, in 1995 overheads for the three companies were £24 million compared with the £40 million of revenue collected through the non-capital rentals. The companies have told us that staff numbers and overheads have since increased.

Economy and efficiency in acquisition of new rolling stock

3.23 The rolling stock leasing companies' need to re-let rolling stock at the end of lease periods is likely to result in standardisation of stock which could lead to greater economy. Further economies may result from train operating companies' proposals to transfer responsibility to rolling stock leasing companies and manufacturers for the performance of vehicles.

3.24 Rolling stock leasing companies, train operating companies and manufacturers told us that they expect to achieve economies of scale through standardisation of new rolling stock, using common designs and technology which would already have safety clearance for operation on as much of the network as possible. Greater standardisation should also reduce the risk of rolling stock leasing companies being unable to re-let stock at the end of leases, and this in turn could encourage them to set lower rentals.

3.25 Two franchisees of train operating companies, Chiltern and Midland Mainline, told us that in their pursuit of competitively priced, reliable rolling stock, they have aimed to transfer to the rolling stock leasing company and the manufacturer the responsibility for maintenance and availability of stock, including specifying detailed performance criteria. Under such arrangements the rolling stock leasing companies will not receive any lease rentals until the new stock is in revenue-earning service nor for any period for which the stock is not available.

Safety of rolling stock

3.26 Although the Health and Safety Executive and other parties are concerned about the crash resistance of some types of slam-door rolling stock, the Department, with the Health and Safety Executive's consent, agreed that the rolling stock leasing companies should lease such stock to train operating companies. This was because the Health and Safety Executive judged that it was not reasonably practicable to withdraw and replace the stock in the short term. In July 1997 the Executive announced that their objective was to secure the phasing out of this rolling stock, or to ensure that significant safety modifications are made, well before the year 2007.

3.27 The primary responsibility for ensuring safety in the day to day operation of rolling stock rests with train operating companies. The rolling stock leasing companies are responsible for ensuring that heavy maintenance schedules are adhered to, and that any modifications are carried out as required by the Health and Safety Executive to enhance safety standards. Figure 24 below sets out possible future mandatory modifications, identified at the time of the sale. Arrangements providing for potential costs of these to be shared by the Department are set out in paragraph 4.3.

3.28 Some 23 per cent of the rolling stock transferred to the rolling stock leasing companies was Mark 1 slam-door rolling stock. This type of rolling stock was first built during the 1950s although later variants were built as recently as 1974. The Health and Safety Executive consider that such stock is not inherently unsafe, but in the event of a collision it has lower crash resistance than more recent stock. Following an accident at Clapham Junction in 1988, British Rail indicated that they planned to replace all such rolling stock by 1999 although they later said that some would still be in use after this date. The Department, with the agreement of the Health and Safety Executive, agreed that pending replacement of such vehicles the rolling stock leasing companies should lease this stock to train operating companies, in some cases until 2004.

Possible future mandatory modifications

Figure 24

Possible future mandatory modifications included:

- automatic train protection, to prevent trains passing signals at danger;
- secondary doorlocks, controlled by staff on trains with slam doors;
- data recorders on train, similar to aircraft "black box" records;
- controlled emission toilets on trains;
- restrictions on diesel emissions;
- adhesion enhancement, using a sander to improve adhesion of stock to the track;
- extension of the use of cab secure radios, for communication between train and signalling staff;
- crash resistance of all rolling stock;
- improved access for the disabled.

Before the sale the Department identified to bidders possible modifications which the Health and Safety Executive might require to the rolling stock.

Source: Department of Transport

3.29 The Franchising Director was aware of the concerns about the crash resistance of Mark 1 stock, and this influenced his approach in awarding franchises for the train operating companies. He told the Transport Select Committee in October 1996 that any requirement for significantly earlier replacement was unlikely to represent value for money, but that any mandatory changes required by the Health and Safety Executive would be progressed within the contractual structure put in place for the train operating and rolling stock leasing companies. The Franchising Director expects that under the terms of the franchises he has let there will be a progressive reduction in remaining Mark 1 fleets with replacement achieved by 2007 by either the first or second bidders of the franchises. In November 1996 he announced that replacement of Mark 1 stock would be mandatory in bids for all remaining unlet franchises, reflecting the limited expected life of the Mark 1 vehicles used on these franchises.

3.30 The Health and Safety Executive consider that early replacement of Mark 1 slam-door stock is desirable but it is not reasonably practicable to require all stock to be withdrawn and replaced. They have said that they may be willing to sanction reasonably practicable alternatives. Research is continuing into ways to improve the crash resistance of Mark 1 stock. In the meantime, they are working towards setting a firm timetable for the withdrawal or modification of this stock, with due regard for the practicalities involved. They will also be liaising with the industry and other interested parties to ensure that the timetable set is achievable. In July 1997 they announced that their objective was to secure the phasing out of this stock, or to ensure that significant modifications are made, well before the year 2007.

Competition in the leasing of rolling stock

3.31 The Department aimed to create a competitive market for the leasing of passenger rolling stock which would stimulate capital investment and commercial practice. Train operating companies can now invite bids for the supply of new or refurbished rolling stock, and the rolling stock leasing companies compete both against each other and against other suppliers, such as manufacturers, to supply this stock. One rolling stock leasing company told us that they, nevertheless, had a high level of expectation that franchisees would want to continue to lease the majority of their existing rolling stock and that if this was not the case then financiers of new rolling stock, who provided funds on the basis of a long term assessment of the riskiness of the market, would charge more (with an impact on lease prices) and might be less willing to lend at all. They also told us that this expectation of a relatively stable leasing market had a positive impact on the amount they were prepared to pay for the companies through their perception of the future prospects of the businesses.

3.32 It is too early to come to firm conclusions as to the extent to which the Department achieved their competition objective. We examined, however, how the Department sought to promote competition, and developments in the market since privatisation. In particular, we looked at:

a) the structure of the industry and the allocation of rolling stock between the companies; and

b) the likely extent of competition when new leases are sought for existing or new rolling stock.

The structure of the industry and allocation of rolling stock

3.33 The sale of three companies to separate purchasers and the allocation of rolling stock between the companies has set a basis for future competition in the leasing of rolling stock. It is too early to confirm the long-term effectiveness of the arrangements intended to promote competition. There is evidence of some shortages at present of surplus serviceable vehicles, and the Franchising Director and some other parties are concerned that future bidders for franchises for train operating companies will have little alternative but to lease the majority of the rolling stock already used. Since privatisation train operating companies that have placed orders for new stock have found significant competition to supply the acquisition.

3.34 The Department saw a key element in the promotion of competition in the leasing of rolling stock as being the sale to separate purchasers of three evenly sized companies which could compete effectively with each other. In addition, other parties, particularly manufacturers of rolling stock, would be free to compete with the rolling stock leasing companies.

3.35 British Rail's 11,258 vehicles varied in age from only a few years to over 30 years and were of many different designs. Moreover, not all of the rolling stock could run on all parts of the rail network, because of differences in track layout and power systems. The Department decided to allocate the vehicles between the companies in a way that would maximise the opportunity for competition between them when new leases for rolling stock are sought. The criteria they used for allocating the stock were that:

- each lessor should have a comparable number of vehicles;
- as many train operating companies as possible should lease stock from more than one rolling stock leasing company;
- comparable or competitive vehicles should be allocated to more than one rolling stock leasing company; and
- small numbers of identical vehicles or specialist vehicles that can only run on very limited parts of the network would be allocated to a single rolling stock leasing company to allow for management efficiencies.

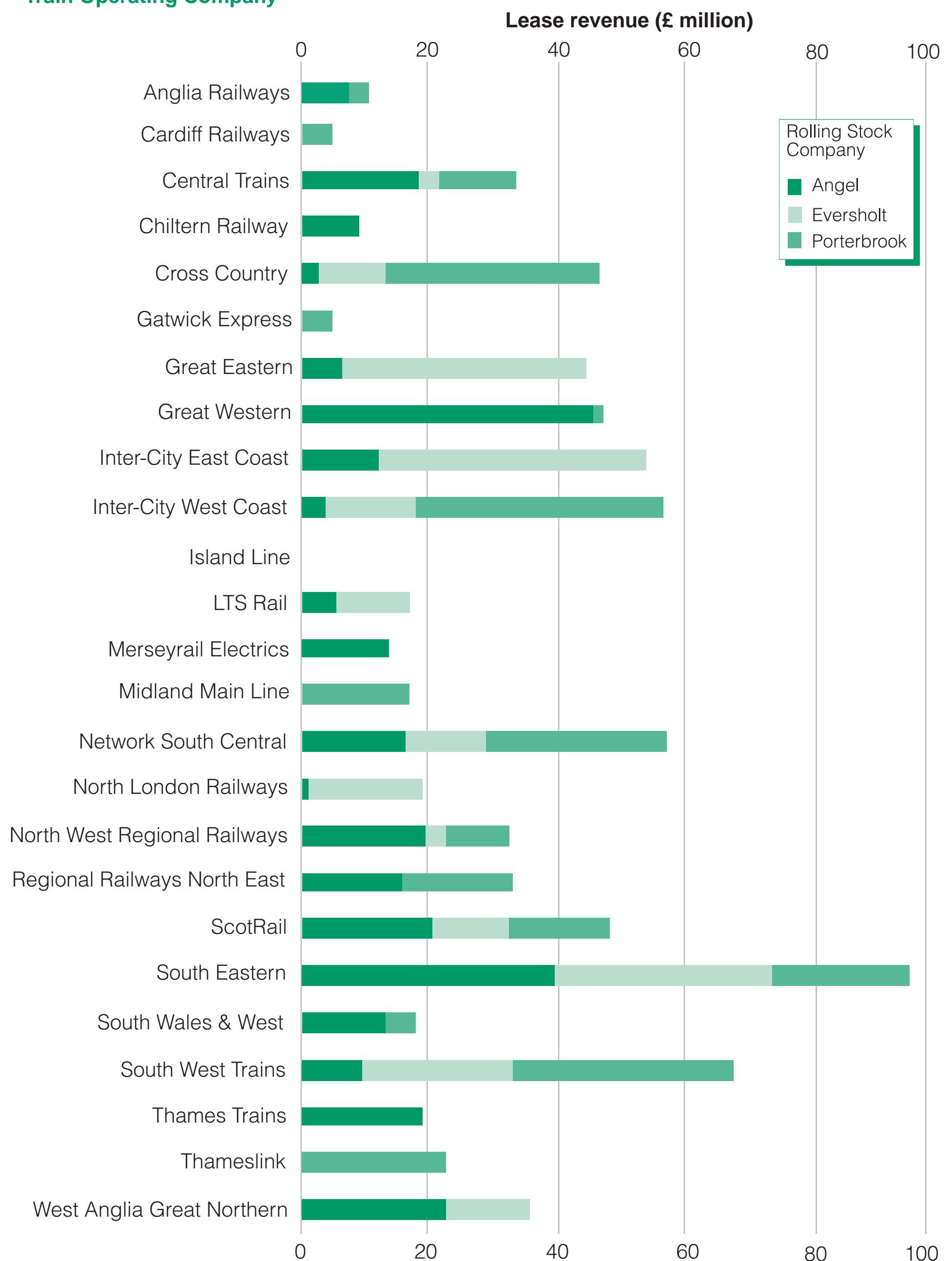
3.36 The average age of stock allocated to each company was broadly similar (about 16 years). This is, however, only a crude indicator of the condition of the vehicles as the older stock included vehicles that had benefited from major refurbishments and the condition of the stock depended upon the maintenance carried out on it. Each rolling stock leasing company leased stock to at least 16 train operating companies. Eight train operating companies, however, lease rolling stock from only one rolling stock leasing company (Figures 25 and 26).

The likely extent of competition

3.37 Some 30 per cent of leases initially entered into end part way through a franchise. The remainder are co-terminous with the lengths of franchises. New leases are or will be sought when:

Lease rentals paid by train operating companies to rolling stock leasing companies in 1994-95

Figure 25

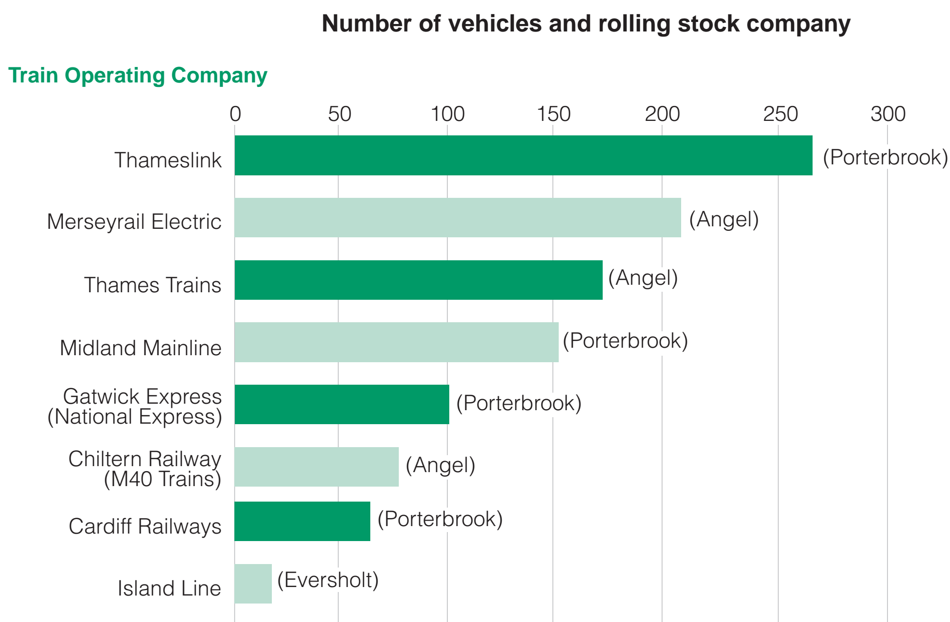


Source:
Department of Transport

This figure shows the wide variation in the volume of business that train operating companies have with rolling stock leasing companies.

Operators with fleets leased from only one rolling stock leasing company

Figure 26



Source:Department of Transport

At April 1994 eight of the 25 train operating companies leased stock from only one rolling stock leasing company, accounting for about 9 per cent of all rolling stock. Most of these train operating companies have either small fleets of less than 100 vehicles or have specialist stock.

a) there is extra demand for rolling stock, for example, for additional services;

b) existing leases are coming to an end; or,

c) a new franchise is being sought (by an existing franchisee or a new bidder).

The principal options in these circumstance are to lease surplus rolling stock, or lease again the rolling stock that had been used, or lease new rolling stock.

3.38 Train operating companies' ability to lease surplus rolling stock is currently constrained by the number and type of surplus vehicles available. Over 90 per cent of vehicles allocated to the rolling stock leasing companies in 1994 are at present leased to train operating companies. Of the remainder, some have been scrapped (providing useful spares for other vehicles) and some are stored. A small number is used as replacement stock during major refurbishments. There are few powered vehicles available to be leased and one train operating company, Great North Eastern Railway, told us that they were unable to find any surplus high speed (125 mile per hour plus) powered vehicles despite an intensive search. Powered vehicles are necessary if a train operating company wants to lease whole trains rather than additional coaches only. Of the vehicles available, few are modern or in

good condition. The stored vehicles vary from serviceable or near serviceable to very poor condition and would normally require significant expenditure on them before being leased. One rolling stock leasing company told us they are keen to lease their vehicles on long or short-term lease but have found very limited demand for them and they are retaining the vehicles to meet possible future demand. A second company said that they had experienced difficulty in leasing rolling stock that had been surplus for some years, including modern powered vehicles capable of speeds of 125 miles per hour, and some older refurbished stock which may be suitable for short-term leasing. The third company indicated that they had few surplus vehicles.

3.39 Competition between rolling stock leasing companies for the supply of existing vehicles is likely to be limited on some parts of the network over approximately the next ten years, because differences in the specifications of vehicles, track and signalling systems mean that the demand and supply of some stock is restricted, impeding an effective market in that stock. Of the 6,400 electric multiple units, which represent over half of all vehicles on lease at 1 April 1994, only eight per cent are compatible with both the overhead-powered and the third-rail systems used in different parts of the country.

3.40 There will be limited ability to transfer vehicles from one franchisee to another, because of different dates for the renewal of franchises. The Franchising Director and train operating companies have serious concerns that bidders for new franchises will have little alternative but to lease the majority of the existing stock in use, largely because of the amounts needed. This problem is mitigated to some extent by certain powers of the Franchising Director and by undertakings made by rolling stock leasing companies, together with the provisions of competition law (set out below). Three train operating companies told us that, in their view, the rolling stock leasing companies should be more closely regulated, mainly because it will take some time for a fully competitive market to develop. The rolling stock leasing companies, however, have a small customer base and one rolling stock leasing company (Angel) told us that they would regard any attempt on their part to charge an unreasonable amount in the short term to be disadvantageous to their commercial interest in the longer term. Angel believed that the affected franchisee would take the earliest opportunity to replace their rolling stock with stock from another company. Moreover, in their view this would impede the development of joint business overseas, which they considered to be attractive.

3.41 In the case of Porterbrook, whose new owners (Stagecoach Holdings) were also the franchisees of two train operating companies, both Porterbrook and Stagecoach gave a number of legally binding undertakings to the Department of

Trade and Industry, which were instead of a reference to the Monopolies and Mergers Commission under the Fair Trading Act 1973. These undertakings aim to ensure that Porterbrook will be even-handed in conducting their business with all train operating companies, including those not controlled by Stagecoach, based on principles of non-discrimination, confidentiality and cooperation with the train operating companies. The Franchising Director and the Rail Regulator will be primarily responsible for monitoring these undertakings.

3.42 In addition the Franchising Director has secured a number of other undertakings from Stagecoach, including an undertaking that Stagecoach will offer the incoming franchisee leases on terms which are no less favourable than in the existing leases. These undertakings have the effect of protecting the Franchising Director's financial position for subsequent franchises, for broadly a third of the existing fleet. Also the Franchising Director has negotiated agreements with the rolling stock leasing companies and manufacturers which give him the option to extend the leases for all new stock acquired by franchisees for up to three years beyond the first franchise, for use by an incoming franchisee on the same terms as its predecessor. These agreements allow the incoming operators time either to negotiate terms for a new lease or to seek new stock elsewhere. He intends to enter into similar agreements with lessors and manufacturers for all significant new leases, whether for existing or new stock; under the terms of franchise agreements train operating companies are required to ensure that the rolling stock leasing companies and other parties have direct agreements with the Franchising Director before entering into key contracts.

3.43 The Department and the Franchising Director were concerned that the rolling stock leasing companies might reduce supply by selling or scrapping vehicles and so be able to demand rental increases on renewal of leases, leading to demands from franchisees for increased Government subsidy. The Department and the Franchising Director, therefore, negotiated agreements so that before the rolling stock leasing companies withdraw surplus rolling stock or transfer it outside Great Britain, the Franchising Director has the opportunity to acquire it in open competition. This rolling stock would be available for him to lease to franchisees. He would expect the net cost of any such arrangements, to be met from Parliamentary grants, to be less in the long term than the increased subsidy requirements mentioned above.

3.44 Following privatisation there is evidence of active competition between suppliers to provide new rolling stock. Up to November 1997 one of the rolling stock leasing companies (Porterbrook) have largely financed firm orders for new stock (see Figure 27), but the other companies expect to finance a significant share of the rolling stock committed to by train operating companies but not yet ordered.

Angel told us that they are to finance £50 million of new stock for a train operating company which has not yet chosen a manufacturer for the stock and had the option to finance another £400 million of business with another company. Train operating companies who have already ordered new rolling stock, and those who have invited tenders for stock to meet their commitments under their franchises, told us that they received offers to supply leased rolling stock from up to ten parties, including manufacturers and the three rolling stock leasing companies. One rolling stock leasing company told us they believed that this competition was responsible for a significant improvement in the time taken to deliver new stock (between 12 and 15 months as opposed to 3 years). Another told us that competition had also resulted in savings of up to 30 per cent on the cost of new stock, compared to the cost of the last stock ordered through British Rail. They were concerned that funding for such a large investment programme (which could

Figure 27

Orders for new rolling stock

Company	Date	Stock	Supplier	Cost* £ million
M40 Trains/ Chiltern	August 1996	5x4-vehicle trains	Adtranz/ Porterbrook	18
National Express Group/Gatwick Express	April 1997	8 x 8-vehicle trains	GEC Alstholm/ Porterbrook	100
National Express Group/Midland Mainline	May 1997	17x2- vehicle trains	Adtranz/ Porterbrook	41
Stagecoach/South West Trains	May 1997	30 x 4-vehicle trains	GEC Alstholm/ Porterbrook	90
Prism Rail/LTS Rail	June 1997	44 x 4-vehicle trains	Adtranz/ Porterbrook	170
Connex	June 1997	30 x 4 vehicle trains	Adtranz	90
Great Western Holdings/North Western Trains	July 1997	11 x 2 and 16 x 3 - vehicle trains	GEC Alstholm	64
Total				**573**

Note: * Costs may not be comparable because of differences between contracts with regard to responsibilities for maintenance.

Source: Office of Passenger Rail Franchising

By November 1997, there were orders for over 600 new vehicles.

cost up to £2 billion) would need to come from a wide range of sources and that the relevant parties might not participate in future or might charge more if they perceived any increase in the riskiness of the business.

3.45 Great North Eastern Railway told us that in 1996 they had been unable to order new rolling stock because the high speed trains needed could not easily be used elsewhere on the network and they could not enter into the necessary contracts with rolling stock leasing companies because their franchise was only for seven years. Angel and Eversholt told us that they are willing to enter into short leases for this new stock and had made committed offers to other train operating companies. Porterbrook announced in November 1997 that it was their intention to place a contract for diesel trains costing some £25 million on a speculative basis. These trains could be used throughout the network and would be capable of speeds of up to 100 miles per hour.

3.46 Under United Kingdom competition law the Director-General of Fair Trading is responsible for monitoring the market in goods and services and for tackling anti-competitive practices. Under the Fair Trading Act 1973 he has to advise the Secretary of State for Trade and Industry whether mergers and acquisitions should be referred to the Monopolies and Mergers Commission for further investigation and whether undertakings in lieu of a reference may be appropriate. Whereas Stagecoach's acquisition of Porterbrook resulted in such undertakings, Forward Trust's acquisition of Eversholt was cleared by the Secretary of State without condition. As at February 1998 a decision had yet to be made on the Royal Bank of Scotland's acquisition of Angel. A new Competition Bill currently before Parliament is intended to prohibit anti-competitive agreements and abuse of a dominant position. The Bill proposes to extend the Director-General's powers to investigate and act against such activities. It also proposes that, for matters connected with the provision of railway services, he should exercise such powers concurrently with the Rail Regulator. This new legislation is expected to come into full effect in Summer 1999.

3.47 In January 1998 the Secretary of State announced that he had asked the Rail Regulator to report by April 1998 on the operation and possible regulation of the rolling stock leasing companies, in view of concerns expressed about the companies' market power.

Part 4: Potential liabilities and the costs of the sales

4.1 This part of the report examines the warranties and indemnities issued by the Department to purchasers and the costs of the sales, including the Department's appointment of professional advisers and contractors.

Warranties and indemnities

4.2 The Department realised that potential bidders would have had difficulty in financing their bids if the identity and creditworthiness of their principal customers were unknown. They agreed, therefore, to guarantee 80 per cent of the companies' lease rental income under the leases initially allocated to them. The Department considered the risk of franchisees defaulting on their obligations to be small but that without a guarantee bidders would have discounted their bids leading to a potential loss of proceeds of up to £80 million.

4.3 The Department also agreed to indemnify purchasers for part of the cost of carrying out modifications to rolling stock which the Health and Safety Executive might require in future to enhance safety standards. The Department agreed to compensate the companies for 60 per cent of any such costs over £20 million a year in total for the initial lease period. (The rolling stock leasing companies are required to bear, in total each year, 90 per cent of any costs incurred up to £20 million and 30 per cent of costs over £20 million; the relevant train operating companies are responsible for the remaining 10 per cent.) The Department estimated the potential cost to the Government to be up to £108 million. Parliament was notified about both these potential liabilities on 24 May 1995. Separately, as mentioned in paragraph 2.73, the European Commission gave their clearance at the end of November 1995.

4.4 In addition, in September 1995 the Department agreed to give indemnities to purchasers relating to potential liabilities which may have arisen before the sale, in respect of:

- industrial disease and industrial injury. The Department and the company agreed to share the first £10 million of claims from current and past employees of the company equally, and that the Government would bear all costs above £10 million; and

- damage to property arising from environmental hazards. It was agreed that the Department and the company would share equally the first £20 million of claims, and the Department would bear all costs above £20 million.

4.5 The Department also agreed that purchasers of Eversholt would continue to have the benefit of the guarantee which the Government had given to banks in supporting British Rail's proposed acquisition of Networker Express trains (see paragraph 1.7). In consultation with the Treasury, they decided to leave the guarantee in place because to do so was unlikely to cost anything whereas withdrawing it could lead to an obligation for immediate payment by the Government of up to £180 million. All parties agreed in June 1997 that the guarantee could be dropped, because existing legal agreements already provided the same level of protection to the parties concerned.

Costs of the sales

The Department's costs

4.6 The Department's main costs of sales comprised fees for professional advice and services. All main advisers were appointed following competitive tendering. The appointments of marketing and engineering advisers were made by single tender because no suitable alternative expertise was available within the Department's timescale.

4.7 Hambros were the Department's principal advisers for the sale and were appointed for a fixed fee of £5 million without any provision for success fees. This was a reduction of £5 million from Hambros' original proposal. The Department later paid additional fees of £0.3 million to Hambros when the contract was extended for two months and for extra work carried out.

4.8 The Department's legal advisers, Freshfields, were originally appointed for a fixed fee of £0.6 million until December 1995, plus hourly fees totalling £0.2 million thereafter. In addition they were paid hourly fees totalling £0.6 million for extra work up to December 1995, unforeseen when the contract was let, but they did not secure the Department's prior approval for cost estimates before starting this extra work. The Department considered carefully Freshfields' request for additional authorisation and agreed to pay at contractual hourly rates for work which they identified as being outside the scope of the fixed price contract.

The Department of Transport's costs

Figure 28

Contractor	Function	Method of appointment	Costs (£ million)
Hambros	Corporate finance and sales advisers	Competitive tender	5.3
Freshfields	Legal advisers	Competitive tender	1.4
Price Waterhouse	Reporting accountants and tax advice	Competitive tender	0.2
Gresham	Marketing advisers	Single tender at the price offered by the parent company following a winning competitive bid for other rail work	0.1
Four others	Printing; specialist accountancy advice	Competitive tender or single tender	0.1
Total costs			**7.1**

Note: VAT was not payable on most of these costs and is excluded.

The Department paid £7.1 million for external advice and professional services, representing 0.4 per cent of gross proceeds.

Source: Department of Transport

British Rail's costs

4.9 British Rail incurred consultancy costs of £3.2 million, including £1.4 million for work carried out by their main legal advisers (Clifford Chance), £1.2 million for work carried out by Hambros (before their appointment as the Department's advisers), and £0.6 million for legal services from other consultants.

Glossary

Contracted rents	Rental income receivable by the rolling stock leasing companies under the initial lease contracts (mostly for eight to ten years from 1994). 80 per cent of this income is guaranteed by the Government.
Diesel multiple units or DMUs	Diesel-powered passenger units, some of which operate as single vehicles but most of which are coupled together as two or three car units.
Due diligence	A process by which the bidders had access to detailed factual material about the companies, including having interviews with management, prior to submitting a final bid.
Electrical multiple units or EMUs	Electric-powered passenger units, operated as two, three, four or five car units which are only taken apart in exceptional circumstances. EMUs draw power from alternating current overhead cables or from a direct current third rail. Some “dual voltage” units can draw power from either source.
Equivalent cost pricing	The Department’s method for calculating rental prices for initial leases. Under this method, the total costs to train operating companies of running older rolling stock (including lease rentals) are equivalent to the total costs of running newer rolling stock.
Franchise	The provision of passenger rail services through a train operating company for a period of years under a franchise agreement between the franchisee and the Franchising Director.
Franchisee	The owner of a train operating company, subject to a franchise agreement.
Franchising Director	The Director of the Office of Passenger Rail Franchising in charge of awarding franchises and negotiating the level of subsidy to franchisees.
High Speed Train or HST	High Speed Trains, comprising two power cars (diesel locomotives with an electric alternator) and a number of non-powered coaches which operate in sets on some long distance routes and are marketed as InterCity 125 trains.
Indicative bid	The first bid by bidders for a rolling stock leasing company.
Information Memorandum	The formal documentation supplied to prospective purchasers which includes financial and other information about the businesses for sale.

Initial leases	The leases put in place between rolling stock leasing companies and train operating companies, mostly for eight or ten years, from 1 April 1994. Eighty per cent of the rolling stock leasing companies' income under the initial leases is guaranteed by the Government.
Invitation to tender	Document relating to each rolling stock leasing company sent to each potential bidder who had met the Department's pre-qualification requirements.
Lease	An agreement between a rolling stock leasing company as owner of rolling stock (lessor) and a train operating company (lessee) which allows the latter to use the rolling stock for a specified number of years at a specified rent.
Management/ Employee Buy-Out	The purchase of a company by a team led by the existing management and employees, usually in partnership with external providers of finance.
Mandatory modifications	Modifications or additions to rolling stock required by law or by a Government Authority (for example the Health and Safety Executive) or by Railtrack.
Master lease	The standard lease document signed by rolling stock leasing companies and train operating companies incorporating the principal terms of each leasing relationship.
Networker Express trains	41 new trains ordered by British Rail and allocated to Eversholt, but not delivered at the time of the privatisation.
On-sale/onward sale	The sale of a privatised business by its private sector owners.
Preferred bidder	The final bidders whose offers were initially accepted by the vendor. Following the selection of preferred bidders, negotiations then took place to complete the sales.
Rolling stock	Passenger railway vehicles, including powered (traction) stock.
Rolling stock leasing company	The owners of passenger rolling stock which they lease to train operating companies.
Secondary leases	Future lease contracts which rolling stock leasing companies might agree with train operating companies for any rolling stock which will become available following the expiry of the initial leases. The rolling stock leasing companies' income under such future leases is not guaranteed by the Government.
Train operating company	One of 25 companies which provide passengers with rail services. Prior to franchising each was a wholly-owned subsidiary of British Rail. Following franchising the franchisee owns the relevant train operating company for the period of the franchise and subject to the terms of a franchise agreement.

Uncontracted rents Rent receivable under future secondary leases for existing rolling stock.

Vehicle A railway car or locomotive, including an individual car within a multiple unit.

Methodology used for the study

Main aspects of the National Audit Office's methodology

1 Our examination focused on the major decisions made by the Department in the conduct of the sales and how these impacted on achievement of the objectives set out in paragraph 1.14. It included:

- the collection of relevant information relating to the sales process, the Department's handling of the sales, and the onward sales by the purchasers (paragraph 2 below);
- the evaluation of the information collected (paragraph 3);
- the use of consultants to advise on specific issues (paragraph 4); and
- consultation with other organisations (paragraph 5).

The collection of relevant information

2 We collected information from the following sources:

- review of the Department's files and other records relating to the sale;
- interviews with Departmental officials on the key aspects of how they handled the sale and controlled costs;
- the computer model used by the Department's advisers in their assessment of the value and acceptability of the bids received;
- interviews with organisations who had a substantial interest in the sale or who have a continuing interest in the companies, including those who bought two of the companies from the original purchasers; and
- information and advice from consultants.

The evaluation of the information collected

3 We assessed how the major decisions made by the Department of Transport were reached and how they contributed to one or all of the Department's objectives for the sale. Our evaluation included consideration of whether:

- the decisions made maximised the likely achievement of sale objectives;
- the decisions were taken against a background of appropriate information and after taking appropriate advice;
- reasonable assumptions had been used consistently by the Department and their advisers in assessing the value and acceptability of the bids received;
- the Department had taken appropriate account of all their objectives, especially where there was potential conflict between them; and
- the Department had taken account of best practice, for example as reflected in recommendations of the Committee of Public Accounts and the National Audit Office arising from previous sales.

Details of our methodology for valuing the companies' cashflows are given in Appendix 2.

The use of consultants to advise on specific issues

4 Following competitive tendering, we engaged the corporate finance department of Binder Hamlyn to advise us on:

- the Department's handling of the sales, in particular the method of sales, their sequence and timing; impacts on proceeds of the sequence, timing and method of sales;
- the feasibility of clawback or other profit-sharing arrangements;
- the adequacy and timing of the valuation commissioned by the Department; and
- the structure and financing of the bids received by the Department and, subsequently, the onward sales by two of the purchasers.

Consultation with other organisations

5 In the course of the study the National Audit Office met, or obtained information from:

- the Department's main advisers, Hambros;
- the final bidders for each of the rolling stock leasing companies, including their financial backers;
- Stagecoach Holdings and Forward Trust, the subsequent purchasers of Porterbrook and Eversholt respectively;
- British Rail;
- the operators of six train operating companies, who between them now run 15 of the 25 train operating companies ;
- the Health and Safety Executive;
- the Office of Fair Trading;
- the Office of Passenger Rail Franchising;
- the Rail Regulator;
- four of the five bidders who withdrew from the sale (one declined to comment); and
- three manufacturers of rolling stock.

Appendix 1
The Committee of Public Accounts: main recommendations relevant to the sale of the rolling stock leasing companies

In reviewing the sale of the rolling stock leasing companies the National Audit Office compared the Department of Transport's actions against recommendations made by the Committee of Public Accounts on the handling of other sales. A selection of the most relevant is given below, including recommendations made by the Committee in reports on the Sale of London Transport's Bus Operating Companies, the Sale of the British Rail Maintenance Depots, the Award of the First Three Passenger Rail Franchises, and the Disposal of SWIFT (all four of which were published after the sales of the rolling stock leasing companies).

PAC Recommendation	Treasury Minute Response	Current C&AG's Report References
1. Timing We recommend that Departments do not subject themselves to time deadlines which render them vulnerable to last minute pressures to sell at a lower price than that to which the negotiations were tending. [Sale of Rover Group, 1st Report, 1991-92, HC 51, paragraph 7 (xi)]	The Government agrees on the importance of not allowing deadlines set to ensure the efficient conduct of business to constrain the Government's ability to pursue value for money for the taxpayer. [Treasury Minute, 1st Report, 1991-92, Cm1819, paragraph 16]	paragraphs 2.3-2.9
2. Marketing ....we regard the reliance on "discreet approaches" to selected firms as unsatisfactory; and we believe that publicising the privatisation programme more widely might have secured better value for money … [Privatisation of work in New Town Bodies, 19th Report 1990-91, paragraph 2(vi), HC 440]	The Government accepts the principle of open competition when privatising functions and services and that appropriate and effective publicity is a key element in attracting maximum competition and so ensuring best value for money. The Department accepts that, where contracts for the privatisation of functions are to be let on a competitive basis, there should be appropriate publicity. [Treasury Minute, 19th Report, 1990-91, Cm 1617, paragraph 47]	paragraphs 2.34-2.35
3. Competition We recommend that anything other than full and open competition should be the exception. [Sale of Rover Group, 1st Report, 1991-92, HC51, paragraph 7(i)]	The Government agrees that, wherever practical and consistent with the objectives for sale, full and open competition maximises value for money from the sale of government assets. [Treasury Minute, 1st Report, 1991-92, Cm 1819, paragraph 2]	paragraphs 2.36-2.52

continued …

PAC Recommendation	Treasury Minute Response	Current C&AG's Report References
4. Method of Sale		
Management buy-out teams should be treated on the same basis as other bidders. [Sale of the Skills Training Agency, 19th Report 1991-92, HC 117, paragraph 2 (v)]	The Department welcomes the Committee's recognition of the steps it took to secure equal treatment of all bidders and potential bidders.[Treasury Minute19th Report 1991-92, Cm 1998, paragraph 18].	paragraphs 2.41-2.43, 3.2-3.3
We consider it an important principle that all serious bidders should, as far as possible, be given as much information as is needed to ensure that there is fully informed competition among bidders. [The Sale of British Technology Group, 32nd Report 1993-94, HC273, paragraph 2(iii)]	The Department agrees with the Committee's conclusion. The Department believes that all serious bidders should be given as much information as necessary to encourage informed bids. Where management participation in a bid occurs, the Department strives to release as much information as possible to ensure fairness. [Treasury Minute 32nd Report 1993-94, Cm 2677, paragraph 54]	
5. Valuation of the Companies		
Before entering negotiations, we expect the selling departments to make their own comprehensive valuation of the undertaking to be sold.. such as by reference to a realistic estimate of the business's future earnings or to the worth of its capital assets. [Sale of Rover Group, 1st Report 1991-92 , HC51, paragraph 7(ii)]	… the Government believes that the process of determining what is, or is not, a realistic price for the assets being sold is best achieved by a competitive market.... The Government agrees that it may be appropriate, in some cases, to employ a benchmark or range of benchmarks in assessing tender bids, for example where competition has failed to produce a wide enough range of acceptable purchasers to safeguard value for money. But these should be constructed as appropriate, in the circumstances of the time, not in advance. The Government believes that any such benchmark will be an aid to judgement only, to be weighed against the objectives of the sale and other factors affecting the sale decision. [Treasury Minute1st Report 1991-92, Cm 1819, paragraph 6]	paragraphs 2.10 - 2.17, 2.30 - 2.33
We believe departments will, in general, be better able to judge bids and strengthen their negotiating position through having valuations based on likely proceeds. [Department of Transport Sale of London Transport's Bus Operating Companies, 32nd Report, 1995-96, HC 251, paragraph 2 (iii)].	The Department is not convinced of the practicability of estimating likely proceeds accurately, and doubts therefore that such estimates would contribute to the negotiating position. Having taken advice from its independent advisers, the Department took the view that it was not feasible to second guess how the market would behave … [Treasury Minute 32nd Report, 1995-96, Cm 3384, paragraphs 14 -15]	
The Committee are unconvinced by the argument [that because there were no comparable companies, a benchmark valuation would not have been helpful to the sales process]. We consider that the benefits of carrying out valuations go beyond obtaining a value or range of values for a business to be sold. Experience suggests that the process of considering how a business should be valued enhances the vendor's understanding of the enterprise, and its underlying	The Department will be guided by the Committee's view in any future consideration of the appropriateness of valuations... [They accept] that the process of valuing an enterprise can enhance the vendor's understanding of the business being sold and assist in deciding the sale strategy, though where there are no satisfactory comparators ... such valuations need to be interpreted with caution. [Treasury Minute 22nd Report, 1996-97, Cm 3714, paragraphs 5 and 6].	

continued …

PAC Recommendation	Treasury Minute Response	Current C&AG's Report References
assets and give the vendor an insight into the appeal that they may have to various potential purchasers. The valuation process itself can therefore be of considerable assistance in deciding on sale strategy and in subsequent negotiations with bidders. We regard having a clear understanding of a business's potential worth to be a key part of the sale process; and we continue strongly to recommend therefore that vendors should carry out valuations in advance of sales negotiations, subject of course to the amount of effort put into valuations being appropriate to the size of the business to be sold. [British Rail Maintenance Limited Sale of Maintenance Depots, 22nd Report 1996-97, HC168, paragraphs 2 (v) - (viii)]		
If there is no established market in comparable businesses … in our view it is precisely in these circumstances that vendors are at most risk of failing to obtain full value in disposals, and that the need is greatest for vendors to have the understanding of potential value that a valuation can bring. [Disposal of SWIFT, 3rd Report 1997-98, HC 368, paragraph 2(viii)]	[Not available]	
6. Sharing of gains (clawback provisions) We consider that the Department would have been in a better position to evaluate the bids received if they had … invited bids for the Company both with and without a clawback provision... and if they had obtained an estimate of potential values, even though this would have been conjectural, before deciding whether clawback was necessary to protect the taxpayers' interest.... We recommend that departments should have up-to-date valuations [of land and other assets] before a privatisation sale... Serious consideration should be given to all the options for protecting the taxpayers' interest, including the use of clawback. [Further examination of the sale of Royal Ordnance plc 13th Report 1989-90, HC352, paragraphs 3 (iii) and (iv)]	The Treasury believes that … all the appropriate options for protecting the taxpayers' interest [in relation to property assets] are fully considered. As regards clawback, a range of considerations will need to be taken into account. Its use will generally make the business less attractive to potential purchasers, and thus reduce initial proceeds, whilst future benefits to the Exchequer are necessarily uncertain. [Treasury Minute13th Report, 1989-90, Cm1150, paragraph 25].	paragraphs 2.53 - 2.61
We note that the Department have not previously considered introducing clawback on increases in the value of shares, since such increases may result from extra efficiency rather than uncovenanted gains. We recognise that it would not be appropriate to claw back increases in the value of the new company which have arisen as a result of the new owners' efforts. However, we agree with the Department that this is a grey area and we urge the Department to consider, for future	The Government will continue to consider the case for using clawback mechanisms in the particular circumstances of a privatisation. [Treasury Minute 31st Report, 1993-94, Cm2677, paragraph 52]	

continued …

PAC Recommendation	Treasury Minute Response	Current C&AG's Report References
sales, the case for a clawback... It will clearly be necessary to specify in advance the circumstances in which the clawback will be enforced. [Department of Transport: The First Sales of Trust Ports, 31st Report 1993-94, HC225, paragraph 3 (xiii)]		
We are reassured to note that London Transport sought to safeguard their interest in the future value of certain assets by agreeing extensive property clawback arrangements in the sale and a clawback on the onward sale of shares in one company. [Department of Transport: Sale of London Transport's Bus Operating Companies, 32nd Report, 1995-96, HC251, paragraph 2 (xiii)]	The Department notes the Committee's comments. London Transport took full account of experience from previous privatisations and earlier recommendations of the Committee, and in this particular instance concluded that clawback arrangements were appropriate. [Treasury Minute 32nd Report, 1995-96, Cm 3384, paragraph 23]	
7. Cash extraction We note that it is generally regarded as good practice for cash to be extracted before sale because the vendor can then be assured of getting full value for the cash…. We recommend that, where departments have responsibilities in relation to sales, they ensure that key financial information about the business is obtained by the vendor including the financial prospects and cashflow profiles, and that the vendor ensures that full value is achieved for cash. [British Rail Maintenance Limited Sale of Maintenance Depots, 22nd Report 1996-97, HC168, paragraphs 2(xi) and (xiv)]	The Department agrees that cash should be removed on sale or, if cash is left in the business, full benefit is obtained. [Treasury Minute 22nd Report, 1996-97, Cm 3714, paragraph 10]	paragraphs 2.70 - 2.72
8. Safety It seems to us ….that the ability to travel safely is an important part of quality of service. We urge the Franchising Director, in conjunction with the Health and Safety Executive, to continue to explore ways of securing the replacement of Mark 1 stock as soon as practicable. [The Office of Passenger Rail Franchising: The Award of the First Three Passenger Rail Franchises, 15th Report 1996-97, HC 39, paragraph 2 (xi)]	The Office of Passenger Rail Franchising note the Committee's concerns.... However, it would not have been appropriate to take decisions on safety which would have had the effect of diminishing the clarity and accountability of the Health & Safety Executive. [Treasury Minute15th Report, 1996-97, Cm 3714, paragraph 10]	paragraphs 3.26-3.30
9. Control of costs We note that ......advisers were appointed previously by the Department of Transport following competitive tenders… We nevertheless urge departments to give careful consideration in such cases to the risk of their becoming dependent on particular advisers, which could eventually reduce competition and so put value for money to the taxpayer at risk. [The Office of Passenger Rail Franchising: The Award of the First Three Passenger Rail Franchises, 15th Report 1996-97, HC 39, paragraph 2 (xiv)]	The Office notes the Committee's concerns. [Treasury Minute15th Report, 1996-97, Cm 3714, paragraph 13].	paragraphs 4.6-4.9

Appendix 2
Methodology used for National Audit Office analyses of value of the rolling stock leasing companies

Source of Data

1 The figures used for our analyses of value were extracted from the valuation model used by the Department. These figures had originally been included in the Information Memorandum and the Supplementary Information Memorandum which the Department had sent to potential bidders. They comprised:

- projected rental income from November 1995 onwards (after the effective date of the Department's cash extraction), broken down into their capital and non-capital parts and expressed as cashflows over a 20 year period. They are derived from initial leases (contracted income) and the Department's forecast of income from future leases for existing rolling stock (uncontracted income);

- the percentage of income which was guaranteed by Government, adjusted in the early years to reflect the progress of rail franchising and so reflecting that some train operating companies remained in public ownership during this time; and

- projected operating costs (including overheads, the cost of design and endemic faults, and heavy maintenance) expressed as cashflows over a 20 year period. These costs are assumed in the base case to be fully covered by income receivable from the non-capital rentals.

2 The non-capital rentals were used after deducting the annual compounded 3 per cent adjustment provided for in the leases. This adjustment (or 'efficiency factor') represents the savings which purchasers were expected to achieve on operating costs and would need to achieve in order to be fully compensated by the non-capital rental income.

Costs relating to Contracted & Uncontracted Rental Income

3 Where we have assessed separately the level of costs and risks associated with both contracted and uncontracted income, we have divided the total costs (as given in the Department's valuation model) pro-rata to the level of contracted and uncontracted rental income in each year.

Eversholt purchase price and the Networker Express trains

4 For the purposes of our analysis, we have used Hambros' financial projections for the Networker leases. These projections are based on the assumptions that all Networker Express trains would be in service by June 1999 and that they result in a cumulative cash outflow of £75 million at 31 March 1999. The purchase price payable for Eversholt by the winning bidder was £500 million, plus up to £80 million deferred depending on the introduction to service of the Networker Express trains. Hambros' assumptions in October 1995 were that £50 million of deferred proceeds would be payable to the Department. When this sum is discounted to take account of the delayed payment date of June 1999, compared to the expected sale completion date of October 1995, the value of the deferred proceeds becomes £40 million.

Discounting Method

5 In recognition that rents are payable monthly in advance and that purchasers would not have the benefit of any income accrued up to 31 October 1995, we analysed the companies' cashflows in the following manner:

a) the capital and non-capital elements of rents were first discounted to the beginning of each financial year for 1996-97 onwards using the monthly equivalent of the relevant annual discount rate;

b) forecast operating expenditure was treated in the same way to give the equivalent costs as at the beginning of each financial year;

c) costs were then deducted from the total revenues in order to give annual cashflows for each company; and

d) these annual cashflows were then discounted back to 1 November 1995 along with five months of the net income accruing in the year to 31 March 1996.

Discount Rates Used

6 The cashflow projections we used as the basis for our analyses were expressed in nominal terms (i.e. ignoring inflation). Therefore we used nominal rates to discount these cashflows, calculated as follows:

Nominal interest rate = ((1 + real interest rate) x (1 + inflation rate)) - 1

7 We used a nominal discount rate of 9.0 per cent (monthly equivalent 0.72 per cent) to calculate the value of contracted rentals to Government. This was based on a 6.0 per cent real discount rate prescribed by the Treasury, adjusted for inflation as described above.

8 To assess the value of uncontracted rentals, we used a higher discount rate of 13.5 per cent (monthly equivalent 1.06 per cent) in recognition of the pricing risk associated with these rents.

9 Where we have calculated the financial cost arising on the crystallisation of risks, we have used discount rates appropriate to the rental period. For example, under public ownership, we used a discount rate of 9.0 per cent where these costs relate to contracted rents and we have used a discount rate of 13.5 per cent where costs relate to uncontracted rents.

Treatment of Taxation

10 The tax liability of purchasers of the rolling stock leasing companies and, therefore, the likely value of tax receipts to Government, has been calculated as follows:

a) firstly a deduction was made from the net annual cashflows of each company at the corporation tax rate of 33 per cent (the rate prevailing at the time of the sale);

b) the net present value of the fully taxed cashflow was then adjusted by adding back the net present values of interest tax-relief and capital allowances;

c) for simplicity, interest was calculated on the basis of an interest rate of 8.5 per cent and a debt level equivalent to the value of each company;

d) capital allowances were based on the fixed levels granted to each company taken at 25 per cent a year on a reducing balance, then discounted at the after-tax borrowing rate; and

e) our calculations did not take into account the potential for shareholders in each company to obtain tax credits against the Advance Corporation Tax on dividends received from the companies. Though this would not effect the tax paid by the rolling stock leasing companies themselves, it would impact on the overall tax revenues accruing to Government.

Appendix 3
Results of the National Audit Office's valuation analyses

This Annex is in four sections and it records the following results:

- section 1 - our analysis of the value of the companies under continuing public ownership;
- section 2 - our analysis of the value of the companies to potential purchasers under seven alternative scenarios (a) to (g);
- section 3 - a comparison of Hambros' cashflow analysis with our base case scenario (a) from section 2; and
- section 4 - a comparison of our analyses of value under continuing public sector ownership (from section 1) with our upside scenario (g) (from section 2).

In these analyses the value of Eversholt includes provision for Networker Express trains.

We recognise these cashflow analyses are only a starting point in the assessment of value for money and they cannot take into account the wider economic effects which the Department expected to come from the privatisation. The Department consider that such analyses would not be relevant in their sale of the rolling stock leasing companies because the then Government's overriding objective was to privatise the companies as soon as practicable in 1995. Moreover, in the Department's view, the analyses could have been carried out using a wide rage of reasonable assumptions. The assumptions we used are cautious, however, and are based largely on the assumptions the Department's financial advisers believed bidders were using.

1. Value of companies under continuing public ownership

Results of our analysis of the theoretical value of each of the rolling stock leasing companies under continuing public ownership are given in Figures 29 and 30 below:

Value to Government of cashflows compared to the value obtained

Figure 29

£ million	Angel	Eversholt	Porterbrook	Total
Discounted value to Government under continuing public ownership:				
Value of contracted income:	785	605	631	2,021
Value of uncontracted income:	323	296	274	893
Total	**1,108**	**901**	**905**	**2,914**
Value obtained in the sale:				
Purchase Prices[1]	673	540[2]	527	1,740
Value of risks transferred: mandatory modifications	70	70	70	210
Possible future tax receipts	up to 83	up to 51	up to 67	up to 201
Total	**up to 826**	**up to 661**	**up to 664**	**up to 2,151**
Difference:	282	240	241	763

Notes: 1. The purchase prices exclude £43 million receipts from interest and from adjustments in interest rates.

2. Eversholt purchase price includes £500 million plus estimated proceeds of £40 million (discounted) for Networker Express trains as calculated at paragraph 4 of Appendix 2.

A summary of this Figure appears at Figure 8. We estimate that the discounted value to Government of the companies' future cash flows from initial and subsequent leases under continuing public sector ownership exceeded the value obtained by the Government in the sale by at least £760 million.

Source: National Audit Office

2. Value of companies to potential purchasers under alternative scenarios

Most Cautious Assumption (Scenario (a))

a) Contracted guaranteed net rents discounted at 9.5 per cent

b) Contracted non-guaranteed net rents discounted at 13.5 per cent

c) Uncontracted lease rentals discounted at 17.5 per cent

Value to Government of cashflows (from initial leases only) compared to the value obtained

Figure 30

£ million	Angel	Eversholt	Porterbrook	Total
Discounted value to Government under continuing public ownership:				
Value of guaranteed contracted income	628	484	505	1,617
Value of non-guaranteed contracted income	157	121	126	404
Total	**785**	**605**	**631**	**2,021**
Value obtained in the sale:				
Purchase Price[1]	673	540[2]	527	1,740
Value of risks transferred: mandatory modifications	52	51	51	154
Possible future tax receipts	up to 56	up to 26	up to 45	up to 127
Total	**up to 781**	**up to 617**	**up to 623**	**up to 2,021**
Difference:	4	(12)	8	0

Notes: 1. The purchase prices exclude £43 million receipts from interest and from adjustments in interest rates.

2. Eversholt purchase price includes £500 million plus estimated proceeds of £40 million (discounted) for Networker Express trains as calculated at paragraph 4 of Appendix 2.

A summary of this Figure appears at Figure 9. We estimate that under continuing public sector ownership the value obtained by the Government in the sale only reflected the discounted value of the companies' future cash flows from initial lease contracts, and did not reflect any value for any subsequent leases.

Source: National Audit Office

d) Discount rates reflect cost of capital (all interest deductible)

e) Total mandatory modifications (after risk sharing) of £30 million a year reducing as rolling stock reaches the end of its useful economic life

f) No efficiency gains made in maintenance costs

g) No reductions made in overhead costs

Figure 31

Possible value to purchasers under alternative assumptions

Scenario	Description	Angel	Eversholt	Porterbrook	Total
			£million		
a	National Audit Office most cautious case	761	639	602	2,002
b	Lower risk on non-guaranteed contracted leases	764	643	605	2,012
c	Lower risk on re-letting rolling stock	795	673	630	2,098
d	Cost savings achieved to offset efficiency factors in contracted leases	881	712	707	2,300
e	Reductions achieved in overhead costs	775	639	607	2,021
f	Reduction in forecast level of mandatory modifications	788	667	630	2,085
g	Combination of all of (b) to (f)	973	785	781	2,539

A summary of this Figure appears at Figure 10, and a description of the assumptions used is given in Appendix 3.

Source: National Audit Office

We estimate that the possible value of the companies to purchasers was between £2.0 billion on the most cautious assumptions that we used and £2.5 billion on more optimistic (but not the most favourable) assumptions.

h) Fixed capital allowances

i) Corporation tax rate of 33 per cent

Scenario (b) – Discount rate on all contracted rents (both guaranteed and non-guaranteed) is reduced to 9.5 per cent

Scenario (c) – Discount rate on secondary lease net rentals is reduced to 15 per cent

Scenario (d) – Savings are achieved in costs to offset fully the efficiency factors included in the contracted lease rentals

Scenario (e) – Overhead costs reduced from the 1996-97 level pro-rata to the annual overhead charge provided for in lease rentals

Scenario (f) – Mandatory modifications are reduced to 50 per cent of their forecast level in each year

Scenario (g) – All scenarios (b) to (f) are applied to the base case.

3. Comparison of Hambros' cashflow analysis with our most cautious scenario (a)

Hambros' cashflow analysis interpreted the bids (in the light of their discussions with bidders during the marketing of the sales), and produced a figure of £1,812 million which can be compared with £2,002 million in our most cautious scenario (a) above. The reasons for the difference of £190 million between these figures are as follows:

- Hambros discounted all mandatory modifications at 9.5 per cent, whereas the National Audit Office model attributes mandatory modifications pro-rata across each type of revenue stream and uses the corresponding discount rate (i.e., 9.5 per cent for guaranteed contracted rents; 13.5 per cent for non-guaranteed contracted rents; and 17.5 per cent for secondary rents). This has a potential effect of £35 million (post-tax);
- Hambros' model discounted all efficiency factors at 9.5 per cent. Scenario (a) uses the appropriate rate for the income to which the efficiency factors relate. This has a potential effect of £102 million (post-tax);
- the remaining difference arises due to the methodology used by Hambros and the National Audit Office to discount the cashflows.

Figure 32

Comparison of Hambros' analysis with our most cautious scenario (a)

	£ million
Value of companies in our scenario (a)	**2,002**
Discounting of maintenance cost reductions (efficiency factors) at 17.5 per cent for secondary rental period and 13.5 per cent for non-guaranteed contracted rents (post-tax)	(102)
Discounting of costs of mandatory modifications at 17.5 per cent for secondary rental period and 13.5 per cent for non-guaranteed contracted rents (post-tax)	(35)
Differences in discounting methodology and roundings	(53)
Hambros' analysis of value	**1,812**

Our valuation based on our most cautious scenario (a) exceeded Hambros' analysis of value by £190 million.

Source: National Audit Office

4. Comparison of our analyses of value under continuing public ownership and scenario (g)

The difference of £375 million between our £2,539 million scenario (g) and our analysis of value under public ownership of £2,914 million arises as follows:

- the public sector valuation uses discount rates of 9 per cent and 13.5 per cent for contracted and secondary lease income respectively. Scenario (g) uses factors of 9.5 per cent and 15 per cent. This has an effect of £141 million (pre-tax);
- overhead savings worth £25 million (pre-tax) are achieved under private ownership, but not under public ownership;
- in scenario (g) the Government are assumed to have transferred mandatory modification risks to the private sector (at 50 per cent of forecast level) potentially costing up to £100 million (pre-tax); and
- the private sector has to allow for a net tax charge (after capital allowances and interest relief) of £159 million.

Our valuation of the companies under public ownership and under our upside scenario (g)

Figure 33

	£ million
Value of companies under public ownership	**2,914**
Higher cost of capital for private owners (pre-tax effect)	(141)
Overhead savings achieved by private sector (pre-tax effect)	25
Transfer of mandatory modification risks to private sector (pre-tax effect)	(100)
Tax liability of private sector	(159)
Value of companies to purchasers under upside scenario (g)	**2,539**

We estimate that on upside assumptions the companies were worth £375 million less to purchasers than the value of the companies under continuing public sector ownership.

Source: National Audit Office

Appendix 4
Lease pricing options considered by the Department

1 The Department had to set prices for the initial lease period. In the absence of a market to set lease prices, the Department determined the prices based on "equivalent cost pricing", which was intended to make operators indifferent to leasing old or new stock, and which they considered would be the best approximation to prices chargeable in a competitive market.

2 The Department rejected historic cost pricing because:

- it did not mimic the market properly;
- it would not reflect the ability of older stock to earn revenue;
- it would result in stepped changes in train operators' subsidy requirements as rolling stock was renewed;
- it would discourage investment in new rolling stock as old rolling stock would be comparatively cheap to lease; and
- it would lead to a diminution of the value of the rolling stock leasing companies.

3 Although replacement costing would avoid step changes in future lease rental prices, the Department rejected this option because it would have made new stock no more expensive than old stock to lease and it would thus encourage the premature replacement of rolling stock.

Calculation of lease prices using equivalent cost pricing

4 Lease rental prices comprise elements for capital and non-capital costs. The Department calculated the capital element for existing stock by:

- estimating the purchase and heavy maintenance costs for a new fleet of vehicles able to carry out the tasks of the present fleet. Purchase costs were reduced by 10-20 per cent to take account of future savings in production costs. Purchase and heavy maintenance costs were allocated over the estimated life of the new fleet;

- adding the interest rate costs forecast and a profit element in the lease rentals;

- subtracting from the total of the above a revenue adjustment in respect of the potential for new rolling stock to earn higher revenue as a result of environmental quality, journey time improvements and reduced overcrowding. The adjustment varied from 0 per cent for stock less than three years old to 8 per cent for stock over 30 years old; and

- subtracting the difference in estimated running costs between existing and replacement rolling stock.

They provided for non-capital costs (such as heavy maintenance and overheads) as described in paragraphs 3.18-3.22 of the Report.

5 For new leases taken out since the rolling stock leasing companies were privatised, the lease prices are subject to negotiation between the companies and the train operating companies.