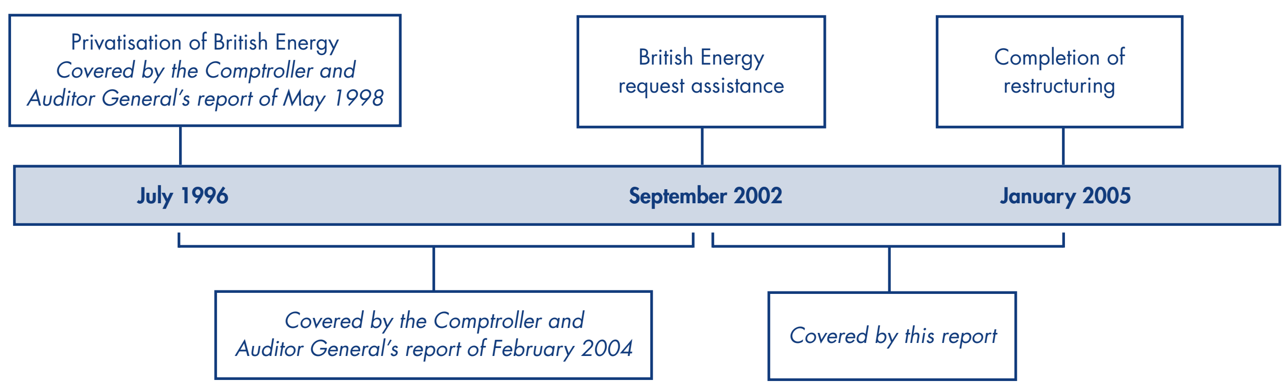
EXECUTIVE SUMMARY

1 British Energy was privatised in 1996. In 2002, the price of electricity fell and on 5 September 2002, the Company applied to the Department of Trade and Industry (the Department) for financial assistance. In November 2002, the Department agreed to provide financial assistance with the proviso that the Company's financial arrangements would be restructured.

2 In September 2004, the Committee of Public Accounts[1] analysed how effectively the Department had managed the risks that privatisation had left with it up until the Company ran into financial difficulties. This report deals with the financial aid that the Department gave to British Energy and the terms of the restructuring of British Energy[2].

1 Timeline of events since privatisation



Source: National Audit Office

1 Details of the Committee of Public Accounts report and the Government's response are at Appendix 7.

2 The intention to produce this report was set out in paragraph 4 of the National Audit Office's report *Risk Management: The Nuclear Liabilities of British Energy plc*, HC 264 Session 2003-04, 6 February 2004.

Overall conclusion

3 Normally, when private companies get into difficulty the Department's policy is not to intervene on the argument that United Kingdom productivity goes up if relatively inefficient firms are allowed to close and this process should not be inhibited by government action. In this instance, the Department decided to intervene because, in its assessment, unplanned closures of British Energy's nuclear power stations would have had safety implications and put electricity supplies at risk.

4 After British Energy approached the Department for financial assistance in September 2002, the Department had to respond quickly. The Department decided to support the restructuring of the company, in preference to allowing it to fall into administration but kept the latter as an option should the restructuring fail. The Department's decision was underpinned by an extensive review of both options.

5 As part of its review the Department recognised that to ensure a viable company, it would need to take responsibility for a large proportion of the Company's liabilities, thereby taking back the responsibility it had transferred at the time of privatisation. This also reflected the fact that the liabilities would have fallen to it anyway in the event of the Company's liquidation. The Department, however, did not have an up-to-date estimate of what those liabilities to be funded through a Nuclear Liabilities Fund might be. Estimates of key elements of British Energy's liabilities had not been updated (other than through indexation) since privatisation. The focus for the Department was to agree a restructuring deal whereby British Energy's contributions to meet those liabilities were maximised without jeopardising the Company's long-term viability. As the Department had already decided to take on a large proportion of the liabilities, and the fact that seeking new estimates would have been time consuming to produce, it decided that it would not require the Company to provide updated estimates of the liabilities during the restructuring as this would not have changed its overall analysis. As part of the restructuring agreement the Department has now put in place arrangements for the estimates of the liabilities to be updated at least every five years. New estimates, yet to be validated by the Nuclear Decommissioning Authority, were published by British Energy in February 2006 and resulted in a £1,165 million increase in the liabilities to £5,287 million.

6 The Department's efforts during restructuring focused on securing the maximum ongoing contribution from the Company towards meeting the liabilities whilst reducing the risk that these contributions could put the Company in jeopardy in future. The mechanism put in place was a cash sweep[3] plus a fixed annual contribution. The cash sweep requires the Company to make a bigger contribution to the Nuclear Liabilities Fund when it is doing well. In the 12 months following completion of restructuring in January 2005, the wholesale electricity price rose sharply and the Company's share price more than doubled. The Company's creditors who under restructuring acquired most of the shares in British Energy will have benefited significantly from the high share price. The Nuclear Liabilities Fund should also benefit from contributions from the cash sweep at a level higher than the most optimistic scenarios considered by the Department and its advisers during the restructuring process. The electricity market has, however, proved to be particularly volatile over recent years. The Nuclear Liabilities Fund is therefore left particularly exposed to British Energy's financial and operational performance.

7 British Energy remains a company wholly-owned by private shareholders but its actions will continue to have significant implications for the public purse. This therefore places an onus on the Department to monitor closely the Company's financial and operational performance and to be prepared to act quickly and effectively to manage its interest. Day-to-day responsibility for monitoring various aspects of the Company's performance currently lies with a number of teams within the Department[4], reflecting the need to bring to bear financial and nuclear expertise. There is, however, in our view, a real risk that information learned by the different teams is not shared quickly and evaluated and that insufficient staff resources are committed to safeguarding the taxpayer's significant interest. To assist its management of the taxpayer's interest, the Department will need to prepare sufficiently comprehensive contingency plans to enable it to act quickly under the range of scenarios that might arise.

3 The cash sweep is equivalent to 65 per cent of the Company's available cash flow each year. The Department can convert the cash sweep into British Energy shares.

4 Responsibility within the Department for the monitoring of British Energy's financial and operational performance and for making decisions about possible conversion of the cash sweep rests with Shareholder Executive, created in 2003 to improve the Government's performance as a shareholder in the businesses in which it has a stake.

Detailed conclusions and findings

On the Department's role in the restructuring of British Energy

8 When British Energy approached the Government for help on 5 September 2002, the Department decided to act to protect electricity supplies and maintain nuclear safety:

- **Maintaining electricity supplies**. National Grid Transco, the electricity transmission network operator, advised the Department in September 2002 that losing output from all of the Company's stations in England and Wales would lead to power cuts and forecast demand exceeding supply by 20 per cent, by January 2003.
- **Maintaining nuclear safety**. Because of capacity constraints for the receipt, storage and reprocessing of spent fuel, British Energy's nuclear stations would have needed to have remained fuelled for many years to allow control of safety critical functions (such as reactor power levels, cooling and containment) to be maintained. In addition, before September 2002, the Nuclear Installations Inspectorate had raised a number of concerns with the Department about the Inspectorate's ability to regulate British Energy effectively should the Company fall into administration. In administration, until the Company was formally dissolved it would continue to be the site licensee and would remain responsible for ensuring compliance with the licence.

9 The Department commissioned analyses to inform its strategy for supporting British Energy. Often when companies are failing, potential purchasers have to decide whether to make an offer prior to administration or wait until the company fails in the hope of paying less for it or its constituent assets. In this case, the Department's objective was to ensure that the Company continued to function as a private company to maintain the generation of electricity. Analyses undertaken by the Department's advisers **(Figure 2)** indicated that the cost to the Department of the Company going into administration was likely to be broadly comparable to the cost of supporting the restructuring of the Company.

10 But the Department and its advisers considered that administration also carried greater risks which they did not think possible to quantify. In particular the Department's advisers thought it likely that the Company's investment of £410 million in Bruce Power, a business that leased Canadian nuclear stations, would be lost in administration because of conditions attached to the lease, thereby reducing the funds available for restructuring the Company. In addition, the Nuclear Installations Inspectorate had raised a number of concerns including the risk of low morale and loss of staff at nuclear stations as a result of the uncertainty arising in the event of insolvency. The Department therefore opted to support a restructuring, but continued to maintain administration as an option until restructuring was completed.

2 Comparison of the costs to the taxpayer of the restructuring of British Energy with letting the Company go into administration, November 2002

	Restructuring £m	Administration £m	Difference £m
November 2002			
Most optimistic assumption of costs	1,423	1,172	(251)
Most pessimistic assumption of costs	2,463	2,533	70

Sources: Department of Trade and Industry, Credit Suisse First Boston, Deloitte, National Audit Office

11 The Department tested the robustness of the new financial structure proposed by the Company against a range of assumptions. The Department concluded that to ensure the Company's viability it would need to assume responsibility for the Company's contracted spent fuel liabilities[5]. This decision removed a significant element of the Company's fixed costs thereby reducing its exposure to movements in the wholesale price of electricity. The Department also decided that the Nuclear Liabilities Fund would assume responsibility for the Company's uncontracted liabilities, as well as its decommissioning liabilities. With assistance from Grant Thornton, the National Audit Office reviewed the financial projections produced by the Department's advisers which supported these decisions. These projections, based on assumptions about a variety of future electricity prices and output, and conducted between September and November 2002, indicated that the Company would not have been viable without the removal of these nuclear liabilities.

12 The cost of restructuring was shared between shareholders, creditors and the taxpayer. Shareholders lost 87 per cent of the value of their shareholding between the Company's financial collapse and relisting although they would have received nothing if the Company had gone into administration. The Company's main creditors agreed to extinguish their debt claims against British Energy in return for new bonds and 97.5 per cent of the share capital in the restructured Company. When these creditors signed up to the restructuring plan in October 2003, those who took equity in the new company effectively lost some £289 million[6] compared to their position before the Company's approach to the Department in September 2002. But by the date of the relisting of the Company on 17 January 2005 their holding had risen in value to £1,871 million compared to the £834 million of loans to British Energy they had made before the Company's collapse. As shown in **Figure 3**, as at 28 February 2006, all the three main parties to the restructuring have seen a further increase in the value of their holdings in British Energy following the rapid rise in the Company's share price after January 2005. For the taxpayer, the rise in the share price illustrates the potential value of the cash sweep, but also the significant sensitivity of any potential surplus or deficit to the Company's performance and the market conditions within which it operates.

13 The Department made effective use of the advice provided by a range of advisers but there were weaknesses in the procedures used by the Department to procure this expertise. Between September 2002 and January 2005, the Department paid £29.1 million in fees to its advisers, in addition to its own administrative costs of £2.5 million. The Department subsequently negotiated an agreement with British Energy for a contribution to its advisory costs of £16.5 million, resulting in a net cost to the Department of £15.1 million. The use of advisers with sufficient and relevant expertise was important, given the complex nature of restructuring and the level of expertise available to British Energy and to the Company's banks and bondholders. Of the four main firms of advisers only one was appointed through a competitive process for the work on British Energy. In the other three cases the Department extended existing contracts on the basis that the need for urgent advice and commercial sensitivity precluded them from putting this work out to competition. In each of the three cases the fee rates were reviewed once during the two and a half years the work was being undertaken. In the case of the Department's contract with Credit Suisse First Boston, the actual fees paid significantly exceeded the capped amount put in place on the original contract.

14 The Department, and the Shareholder Executive in particular, are regular users of financial and legal advisers. Where possible, the Department should employ the approach which it has now adopted for the appointment of legal advisers and which is widely used by some other departments, of entering into standing agreements with a number of firms appointed on a competitive basis and with fee policies agreed in advance which could be called upon to provide advice. It is also important particularly on long contracts that fee rates are regularly reviewed.

5 Under the restructuring agreements the Department took responsibility for liabilities under existing or "historic" contracts for spent fuel management. Liabilities and other monetary amounts shown in this report, which may arise over many years, are discounted to present values using a real discount rate of 3.5 per cent unless stated.

6 The difference between the market value of creditors' holdings at 3 September 2002 and 1 October 2003, the day that creditors formally agreed to restructuring.

3 Value of the holdings in British Energy of creditors, shareholders and the taxpayer

	Before approach (3 September 2002) £m	At relisting (17 January 2005) £m	Current valuation (28 February 2006) £m
Shareholders[1]	307	66	107
Creditors[2]	834	1,871	3,867
Taxpayer:			
Estimated contributions from British Energy[3, 4]	–	3,821	7,753
Estimated nuclear liabilities assumed/underwritten[5]	–	(4,054)	(5,287)
Estimated net value/(liability) to the taxpayer arising from nuclear liabilities[6]	–	**(233)**	2,466

Sources: National Audit Office, Grant Thornton analysis of Departmental Accounts and data

NOTES

1 The current valuation is based on some 569 million shares in issue. The valuation at relisting includes shares valued at £37 million and warrants valued at £29 million.

2 The value to creditors at 28 February 2006 consists of 97.5 per cent of the company's equity (currently valued at £3,428 million) and British Energy bonds (currently valued at £439 million).

3 Estimated contributions from British Energy at 28 February 2006 consist of: the value of the cash sweep (currently estimated at £6,495 million), British Energy bonds (valued at £283 million), the value of investments held in the Nuclear Liabilities Fund (valued at £672 million) and future fixed payments relating to the cost of decommissioning and for each tonne of fuel loaded into the Sizewell B reactor (estimated at £303 million). The estimated value of the cash sweep element at 28 February 2006 derives from applying the Company's share price of £6.17 on that day to 65 per cent of the number of shares that would be in issue if all of the cash sweep was converted to shares. This estimate assumes any conversion and sale does not result in a dilution of shareholder value, whereby a reduction in the Company's cash sweep liability would lead to a commensurate increase in equity value. Over time the value of the cash sweep increases and decreases with movements in the share price.

4 If the Department decides to convert and sell all or part of the cash sweep, British Energy will issue a number of shares to the Nuclear Liabilities Fund, calculated with reference to a formula in the Liabilities Agreements and credited as fully paid. Voting rights attached to these shares are limited so long as they are held by the Nuclear Liabilities Fund (paragraph 3.5).

5 Estimated nuclear liabilities consist of the contracted spent fuel liabilities assumed by the Department (currently estimated at £2,573 million) and the uncontracted (an estimated £350 million) and decommissioning (an estimated £2,364 million) liabilities assumed by the Nuclear Liabilities Fund. Estimates for uncontracted and decommissioning liabilities had not been updated (other than through indexation) since privatisation. The estimates above are based on the estimates published by British Energy in February 2006, which have yet to be vaildated by the Nuclear Decommissioning Authority, and are adjusted for example for the use of a consistent discount rate.

6 Before British Energy's approach to the Department in September 2002 the Company was responsible for meeting all of its nuclear liabilities, however the taxpayer retained residual liability should the Company fail.

7 The table does not include the benefit to the taxpayer of the renegotiation of British Energy's contracts with British Nuclear Fuels plc, estimated by British Energy at £714 million, the cost of the standstill agreement to British Nuclear Fuels plc, amounting to £452 million, and the net administrative cost to the Department, amounting to £15.1 million.

8 The current valuation includes market valuations at 28 February 2006, or at 31 January where these are not available; other amounts are stated at December 2005 prices. Valuation at relisting includes market valuations at January 2005 where these are available; other amounts are stated at January 2005 prices. Valuation at September 2002 includes market valuations at September 2002.

On the Department's role since restructuring

15 Under the restructuring agreement reached with the Company, the Department will play no direct role in approving the Company's commercial strategy. However, the Department has placed limits on British Energy's actions through conditions attached to the Liabilities Agreements[7] reached with the Company and in covenants attached to the British Energy bonds (some of which are held by the Nuclear Liabilities Fund). The Department has also strengthened its ability to monitor and evaluate British Energy's performance with a right of access to financial and operational information – prior to September 2002 the Department had no right of access. In the months following restructuring the Company supplied financial information to the Department on a regular basis, including a rolling 18-month cash flow forecast, and officials had met representatives from the Company regularly to review performance.

7 On the completion of restructuring British Energy, the Department and other parties entered into a number of legally binding agreements collectively referred to as the Liabilities Agreements, governing amongst other things the nuclear liabilities assumed by the Department and the Nuclear Liabilities Fund and the Company's contributions to the Fund. More details are provided in Appendix 5.

16 Although the Government sometimes appoints a director, as in the case of Network Rail, the Department considered and rejected the idea of appointing a director to British Energy's Board on the grounds that once appointed a director's duty is to the company and not to the appointing body. The Department also thought that the presence of a Government-nominated director could lead to questions about the integrity of the Department's policy-making and regulatory functions. The Department's intention is that the restrictions imposed by the various agreements and covenants, together with the Company's agreement to follow a "prudent" trading strategy, will protect the taxpayer's exposure to the Company's performance whilst not interfering with the Board's ability to run the business.

17 The Department's investment policy leaves the Nuclear Liabilities Fund highly exposed to British Energy's financial performance. Normally, it is good practice that funds built up to meet long term liabilities, for example pension funds, rely on a diversified portfolio of investments. In the case of the Nuclear Liabilities Fund, the Fund's main source of income will come via the cash sweep. Of its existing capital, worth £787 million at 31 March 2005, £275 million was accounted for by British Energy Bonds issued at restructuring, other than this the Fund is only permitted to invest in government gilts (because of HM Treasury rules governing investments by public sector bodies), which prevents further diversification of the Fund through other investments. The existing equity investments of the Nuclear Liabilities Fund will be converted to gilts over the next three years. The Department does have power to convert part or all of the cash sweep into ordinary shares in the Company which could then be sold. This would reduce the Fund's dependence on the Company's performance but the Department would need to take account of the effect this would have on its ability to influence the Company if it needed to. Given the risks involved, the Department needs to develop appropriate contingency plans to help it oversee the Fund's interests and act quickly should it need to.

18 The liabilities to be taken on by the taxpayer remain subject to uncertainty. The size of the liabilities to be met from the assets of the Nuclear Liabilities Fund will be affected by such factors as the day-to-day operation of the power stations, the expected operating life of each station and the developing knowledge of how to undertake the task of decommissioning and the timescale involved. At the time of restructuring the estimate of liabilities at privatisation in 1996 had not been updated, other than through indexation. As the Department had already decided to take on a large proportion of the liabilities and had judged that seeking new estimates would be time consuming it decided that it would not require the Company to provide updated estimates of the liabilities during restructuring. The Liabilities Agreements with the Company now provide for the liabilities to be re-valued at least once every five years. The Company has recently released new estimates, although these are still subject to review by the Nuclear Decommissioning Authority.

19 The Nuclear Decommissioning Authority has responsibility for ensuring certain of the terms of the Liabilities Agreements[8] are adhered to. Removal of British Energy's nuclear liabilities gives the Company weak incentives to reduce or to minimise the effect of its activities on them. The Liabilities Agreements therefore specify arrangements which are intended to minimise the extent to which the Company's operational decisions increase the liabilities to be met by the taxpayer. The Agreements also allow for the Authority to review and approve British Energy's decommissioning plans and for the Department to acquire the stations to decommission. The Authority currently has one full-time official responsible for its work on British Energy, supported by other Authority officials during peak working times. When British Energy's power stations move towards being decommissioned the Authority will need to make provision within its business plan to ensure sufficient staff are recruited to monitor the Agreements in the medium term. The Department has made provision within the Liabilities Agreements for the Company to receive incentive payments to reduce the liabilities of the Nuclear Liabilities Fund. However, by January 2006, this facility had yet to be used. The Department will need to ensure that it has sufficient procedures in place to spot potential opportunities for reducing liabilities and make use of incentives where this is appropriate. The Department reported that the incentives and the associated payment to British Energy will be negotiated on a case-by-case basis.

8 The Historic Liabilities Funding Agreement and the Nuclear Liabilities Funding Agreement.

20 Overall responsibility for managing the taxpayer's interest in British Energy lies with a senior official within the Department. However, day-to-day responsibility for evaluating the Company's performance, and assessing market and other factors that might have an impact on the taxpayer's interest, lies with a number of different teams:

- responsibility for managing the risks to the taxpayer arising from British Energy's financial performance lies with a senior official within the Shareholder Executive;
- responsibility for monitoring the liabilities arising from British Energy's activities lies with the Departmental team within the Department's Energy Group with responsibility for liaising and monitoring the work of the Nuclear Decommissioning Authority;
- responsibility for wider energy policy sits in various units in the Department's Energy Directorate - changes in the Department's energy policy can have a direct impact on the net liabilities likely to be borne by the taxpayer.

Each of these teams currently has appropriate expertise to monitor the issues to which they have been assigned but there is a risk that information learned by the different teams is not shared quickly and evaluated as a whole. Similar risks arise where the Department seeks to achieve its objectives at arms length through other organisations such as the Nuclear Decommissioning Authority. The Department's Internal Audit team reported that it is starting work to provide assurance that risk management arrangements between the Department and related bodies, including the Nuclear Decommissioning Authority, are sufficiently complementary. In addition, there is a risk that a high turnover of staff in key areas in either the Department or the Nuclear Decommissioning Authority could lead to a loss of expertise which might have a detrimental effect on monitoring issues, for example, liabilities.

RECOMMENDATIONS

a The Shareholder Executive is responsible for managing the Government's exposure to British Energy's performance. The Shareholder Executive needs to maintain and keep under frequent review its plans for managing this exposure.

b The Department should ensure that the Company fulfils its new requirement to update its estimates at least every five years of the liabilities likely to fall to the Nuclear Liabilities Fund and publishes the results of any formal reviews of the Fund's assets and liabilities.

c The Department, working with the Nuclear Decommissioning Authority, should consider whether alternative arrangements, such as a pre-determined framework, would provide British Energy with a stronger incentive to reduce the liabilities of the Nuclear Liabilities Fund than the current provisions within the Liabilities Agreements.

d The Department should continue to identify the range of risks associated with its interest in British Energy and keep this register up to date. Crucially, against the key risks on its register, it should prepare and maintain adequate contingency plans to enable it to act quickly and effectively when required, including arrangements to draw upon appropriate expert advice outside the Department.

e In line with good practice the Department should appoint professional advisers following competition. Where advisers are frequently needed at short notice, the Department should where possible employ the approach which it has now adopted for the appointment of legal advisers and which is used by other departments, of entering into standing arrangements with a number of firms appointed on a competitive basis and with fee policies agreed in advance. On long contracts, fee rates should be reviewed regularly.

The restructuring of British Energy

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f The Health and Safety Executive is concerned that if a company like British Energy went into administration its ability to regulate the company could be compromised. The Department needs to consider what means are required, including legislation, to establish provisions which could assist the Inspectorate to ensure the safety of nuclear assets is maintained.

g The Department should ensure that there is effective co-ordination of the risk management arrangements it has in place, to ensure that the Shareholder Executive has all the information it needs to fulfil its role effectively and that the Department is fully aware of the potential effects on British Energy when making policy decisions.

h The Department, and the Nuclear Decommissioning Authority, should manage continuity amongst staff, including keeping adequate records of their various monitoring activities, to ensure that the accumulated knowledge and understanding of British Energy's activities is maintained.

i To carry out its responsibilities in relation to British Energy effectively, the Nuclear Decommissioning Authority should re-examine whether it has, and is likely to be able to maintain, sufficient staff with the right skills in place to enable it to monitor compliance with the Liabilities Agreements and spot opportunities for reducing liabilities as its workload increases.