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The sale of the Government's interest in British Energy

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The sale of the Government's interest in British Energy

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Amyas Morse
Comptroller and
Auditor General

National Audit Office

18 January 2010

This report examines: the extent to which the Government met its strategic objectives for the sale, the management of the sale and the proceeds raised.

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This report can be found on the National Audit Office website at www.nao.org.uk/britishenergy2010

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Summary

1 Until it was bought by EDF SA (EDF) in January 2009 at a cost of £12.5 billion British Energy was the largest independent electricity generator in the UK, and owner of sites viewed by industry as being the most suitable for new nuclear power stations. It was a publicly listed company in which the taxpayer held an interest through the Nuclear Liabilities Fund. This Fund sold its 36 per cent interest in British Energy to EDF, which is the world's largest nuclear electricity producer and 85 per cent owned by the French state, for £4.4 billion. The Fund received the proceeds to put towards the cost of decommissioning British Energy's existing nuclear power stations.

2 This report examines:

a the extent to which the Government met its strategic objectives for the sale; and

b the management of the sale of the Government's interest and the proceeds raised.

The Government's interest in British Energy

3 British Energy was publicly owned until its privatisation through a stock market flotation in 1996.[1] The Government obtained a financial interest in the business once again in 2005 after helping British Energy achieve a solvent restructuring, following a sustained deterioration in its financial position. The Government agreed to provide assistance because the Company was of national strategic importance. British Energy agreed to make annual payments to the Nuclear Liabilities Fund of 65 per cent of the Company's available free cash flow as a condition of the restructuring.[2] The Nuclear Liabilities Fund, which is responsible for the future cost of decommissioning British Energy's existing fleet of nuclear power stations, was directed by the Government to exercise its right to convert part of this entitlement into shares in June 2007 when it reduced its interest from 65 per cent to 36 per cent in a sale to institutional investors, raising £2.3 billion.

4 The Shareholder Executive, which was created in 2003 to improve the Government's performance as a shareholder, had responsibility for monitoring British Energy's financial and operational performance and for advising on decisions to sell the Government's interest. It was, until June 2009, part of the Department for Business, Enterprise and Regulatory Reform (BERR), which developed the objectives for the sale, but is now part of the Department of Business, Innovation and Skills. From October 2008, when responsibility for the sale objectives transferred from BERR to the newly created Department of Energy and Climate Change, the Shareholder Executive reported to the Secretary of State for Energy and Climate Change on the sale.

1 C&AG's report, *The Sale of British Energy*, HC 694 1997-98.
2 See: C&AG's report, *Risk Management: The Nuclear Liabilities of British Energy plc*, HC 264 2003-2004 and C&AG's report, *The Restructuring of British Energy*, HC 943 2005-06.

Main findings

On the realisation of the Government's strategic policy objectives

5 Following the launch of the process by British Energy in late 2007 that led to the sale, and the Government's subsequent public announcement in January 2008 that it was supportive of new nuclear power stations, the Government set a clear hierarchy of objectives for the sale of its 36 per cent interest, as follows:

- A primary objective to ensure nuclear operators are able to build and operate new nuclear power stations from the earliest possible date and with no public subsidy.
- An additional objective to maintain the viability and continued safe operation of British Energy's existing nuclear power stations.

Secondary objectives to:

- minimise the Government's exposure to the risk of being unduly dependent on a single company for timely nuclear new build; and
- maximise the value of the Government's interest in British Energy.

6 The reasons the Government provided for emphasising new nuclear build over competition and price, which reflected overarching policy goals to help minimise the cost of meeting climate change targets and ensure security of supply through diversity in electricity generation, were as follows:

a **Climate change:** It considers that new nuclear power stations could play a key role in tackling climate change, as carbon dioxide emissions from nuclear generation are low.

b **Security of energy supply:** The Government considers that new nuclear power stations would help maintain a diverse mix of electricity generating technologies, and make an important contribution to future energy security when existing power stations close and reliance on imports of oil and gas increases at a time of rising global demand and increasing politicisation of international energy supplies.

c **Scarcity of sites suitable for new nuclear power generation:** The Government set out in its 2008 White Paper that industry had indicated sites in the vicinity of existing nuclear facilities were the most viable for new nuclear power stations. British Energy therefore owned sites that industry was likely to nominate in the Department of Energy and Climate Change's Strategic Siting Assessment, but it did not have the skills and resources needed to build new nuclear power stations itself. Five of the eleven sites subsequently nominated by industry in 2009 were owned by British Energy.

7 EDF's purchase of British Energy will not necessarily lead to new nuclear power stations being built in the UK with no public subsidy. This will depend on a number of factors, many outside EDF's control, including:

a wider economic and market considerations such as the price of carbon;

b the achievement of all necessary consents, including the design of new power stations; and

c EDF's overall strategic priorities and financial position.

8 Against this background, the Department did not seek, and EDF did not offer, any binding commitment to build new nuclear power stations as a condition of the sale. It is unlikely that the Department would have been able to extract any such commitment because EDF's future decision over whether to build depends on these other factors.

9 EDF's acquisition of British Energy has improved the prospect of investment in new nuclear power stations as British Energy was not financially strong enough to make such investments itself. EDF has made a significant investment in British Energy and is one of a small number of companies worldwide with the capability to finance, build and operate new nuclear power stations. It has publicly announced plans to build four new nuclear reactors on land owned by British Energy at Sizewell and Hinkley Point. The sale has also secured the viability and continued safe operation of British Energy's existing nuclear power stations.

On competition

10 The Department had a secondary policy objective to minimise the risk of being unduly dependent on a single company for the achievement of new nuclear in a timely fashion, as this could, for example, limit the extent of the nuclear programme or adversely affect its negotiation position on matters such as setting the cost of disposing of nuclear waste. The Department secured agreement from EDF to dispose of land suitable for new nuclear power stations at Wylfa and, subject to EDF receiving certain consents for new nuclear power stations, land at Bradwell and either Dungeness or Heysham. The Department coordinated its approach to land disposals with the subsequent sale in May 2009 of sites owned by the Nuclear Decommissioning Authority to other major European utilities who intend to develop new nuclear plants on the sites. This has reduced the Government's dependence on EDF, although EDF now owns some of the most attractive sites for building new nuclear power stations.

11 The Shareholder Executive also recognised the sale might adversely impact competition and prices in electricity markets for industrial and commercial customers, but did not seek possible remedies from EDF on the basis that it was a matter for the European competition authorities. The acquisition increased EDF's share of the UK's electricity generation capacity from 6 per cent to 17 per cent, continuing a trend of consolidation and vertical integration in the UK market.

12 The European Commission initially had substantial concerns about the impact of the sale on competition for new nuclear sites and on electricity markets. It subsequently approved the deal, in December 2008, after receiving the following undertakings:

- Competition for sites: the Commission required the unconditional disposal of Heysham or Dungeness, which the UK Government had asked EDF to dispose of only if it received consents for new nuclear power stations.
- Competition in electricity markets: the Commission required the sale of British Energy's coal-fired station at Eggborough and EDF's Sutton Bridge gas-fired station, as well as an undertaking to sell a substantial quantity of power through trades or structured agreements between 2012 and 2015.

On the price the Government achieved for its shareholding

13 The best way to maximise price is through vigorous competition from a number of parties. The Nuclear Sites Steering Group, set up by the Shareholder Executive, BERR and HM Treasury to coordinate the sale of the Government's interest in British Energy and disposal of land owned by the Nuclear Decommissioning Authority, concluded that it should rely on the board of British Energy to generate competition and secure the best price. British Energy's board discussed offers with a number of potential bidders, but only EDF submitted a formal offer after other competitors withdrew for reasons including changes in strategic priorities and price expectations.

14 To help negotiate the best possible price, sellers generally attempt to determine the strategic value of the business to the buyer and then negotiate accordingly. The strategic value to EDF was a scarce opportunity to acquire additional generation capacity in the UK, and a potentially dominant position in new nuclear in the UK that could give it a significant influence over the realisation of the Government's strategic policy objective for new nuclear power stations. The Nuclear Sites Steering Group commissioned UBS to provide advice and an assessment of the 'fair value' of British Energy, but not the strategic value of the business to EDF on the basis that British Energy's board would factor this into its judgement on the best price achievable for shareholders. The Shareholder Executive did not therefore seek to influence the price directly, but instead advised stakeholders that the Government supported the board's position.

15 The final cash offer negotiated by the board of British Energy, in discussion with its shareholders, was 774 pence. This was 10 per cent higher than the Shareholder Executive's valuation of 703 pence per share, which was based on cautious but not unreasonable assumptions. Movements in energy prices after the completion of the sale show that EDF put forward its offer when energy prices were at a peak, and this was reflected in the price it paid for the Government's interest.

16 The largest institutional shareholder opted in favour of an alternative offer of 700 pence plus a nuclear power note, instead of the 774 pence cash option. The nuclear power note is a derivative financial instrument that entitles owners to receive payment of up to 575 pence for each note. The future value of these notes is highly uncertain, as payments depend on volatile prices and output, and could be zero, and this particular instrument was not suitable for the Nuclear Liabilities Fund to hold.

On the management of the sale

17 British Energy's board announced that it was in discussions to sell the company in March 2008. The team in the Shareholder Executive that was responsible for advising on the possible sale of the Government's interest was led by an investment banker with extensive power sector and mergers and acquisitions experience. This team reported to the Nuclear Sites Steering Group.

18 The size of the Nuclear Liabilities Fund's interest, together with regulatory and other powers, gave the Government sufficient influence to block a sale. The Nuclear Sites Steering Group decided that rather than seeking to directly influence the sale it should rely on British Energy's board to manage the process and communicate with other shareholders. The Shareholder Executive had expected the board of British Energy to recommend an offer of 765 pence per share put forward by EDF in July 2008. The Shareholder Executive had not expected that some of the major shareholders would not agree to it. Against this background, the board decided it could not recommend this offer. This put the deal in jeopardy as EDF announced that it was prepared to walk away. EDF subsequently chose to put forward a revised offer of 774 pence per share, which was accepted.

19 The Nuclear Sites Steering Group selected UBS investment bank in March 2008, after receiving bids from three firms, to advise on how to achieve a deal that met the Government's objectives and provide valuations of British Energy based on assumptions provided by the Department. The Shareholder Executive, which negotiated the terms, agreed to pay UBS a success fee of £3.5 million on completion of the sale, from which a monthly retainer of £100,000 would be deducted. The Shareholder Executive also agreed to pay UBS a further £500,000 if the sale was more complex than had been envisaged, which UBS received on the basis of a three-month delay in completing the deal and involvement in additional negotiations. The Nuclear Liabilities Fund paid UBS's fee of £4.0 million and a further £1.3 million to its own financial advisors, Lazard, that was capped at one third of the fees paid to UBS.

On the management of risks and liabilities

20 Although the Government no longer has a direct financial interest in British Energy, it remains responsible for funding any shortfall if the Nuclear Liabilities Fund is unable to meet the future cost of decommissioning British Energy's existing nuclear power stations. The Shareholder Executive did not carry out a formal assessment during the sale process of the possible impact of the sale on the risk of taxpayers having to bear nuclear liabilities if, for example, the new owner operated British Energy's power stations in a way that required earlier payment of decommissioning costs. The Shareholder Executive told us it believed a risk assessment was unnecessary as a legal undertaking British Energy had made when it was restructured to be reasonable and prudent in the operation of its power stations would continue under EDF's ownership. The proceeds from the sale did, however, increase the total value of assets held by the Nuclear Liabilities Fund to £8.3 billion. This exceeds, at current prices, the discounted cost estimate of cleaning up British Energy's existing nuclear power stations by approximately £3.6 billion. These liabilities fall over many decades, however, and are highly sensitive to assumptions about the likely expenditure profile and costs.

21 Since October 2008, risk management responsibilities have been shared between the Department of Energy and Climate Change, which has overall policy responsibility for nuclear liabilities, the Shareholder Executive and the Nuclear Decommissioning Authority. The Shareholder Executive is in the process of implementing new risk monitoring arrangements, established in October 2009, including how it will use rights to information that remained in place after the sale.

Value for Money Conclusion

22 The Government has so far received good value from the sale of its interest in British Energy, with EDF's final offer of 774 pence per share reflecting the influence of the main private sector shareholders on British Energy's board to get EDF to raise its offer above 705 pence, and also prevailing market conditions. Longer-term value for money will depend on whether the sale delivers the Government's strategic policy objective to ensure nuclear operators are able to build and operate new nuclear power stations with no public subsidy. The business has been sold to a credible nuclear operator with the capability to build new nuclear power stations, but the outcome will depend on other influences such as planning decisions and EDF's future strategic priorities. Arrangements for risk monitoring are in the process of being implemented, and the likelihood of future liabilities falling to the Government is reduced as sale proceeds have increased the assets of the Nuclear Liabilities Fund well above the current liabilities estimate.

Recommendations

On the achievement of energy policy objectives

a **The Department considers that EDF has a strong financial incentive to build new nuclear power stations on British Energy's sites, which would help meet future demand for electricity after existing power stations close. Factors such as economic conditions, planning restrictions or changes in EDF's strategic priorities could, however, make building new nuclear power stations in the UK unattractive.** The Department is seeking to remove barriers to new nuclear power stations by taking forward the facilitative actions described in the 2008 White Paper[3], but should progress work on developing contingency plans setting out the action it would take if its monitoring indicates EDF is not willing to build new nuclear power stations at no public subsidy to its planned timetable, or at all.

3 *Meeting the Energy Challenge* a White Paper on Nuclear Power, January 2008, CM 7296.

On risk management

b **Although the sale proceeds increased the current value of the Nuclear Liabilities Fund and therefore reduced the likelihood of it being unable to meet the cost of decommissioning British Energy's existing nuclear power stations, there is still a residual risk of these liabilities falling to Government. The Shareholder Executive did not, however, prepare a formal assessment of the impact of the sale to EDF on liabilities risks.** In future sales, Departments should take a structured approach to assessing the impact of sales on risks to taxpayers.

c **Responsibilities for monitoring British Energy are now shared by the Shareholder Executive, the Department of Energy & Climate Change and the Nuclear Decommissioning Authority. Revised arrangements were not established until October 2009.** The various parts of Government involved in monitoring and managing the risks associated with British Energy should approach risk monitoring and management, and how these responsibilities will be exercised, in line with good practice.

On maximising value

d **The Shareholder Executive concluded it did not need to assess the strategic value to EDF of its interest in British Energy as the Company's board would assess this in its consideration of offers.** In future sales where, unlike the sale of British Energy, the Government is leading the process, it should seek to assess the specific value of its shareholding to acquiring companies and reflect this in its negotiating strategy and assessment of offers.

e **As British Energy led the sale of the business, it was appropriate in this case for the Shareholder Executive to rely on the Company's board to liaise with shareholders.** In future sales, where Government is leading the sale of companies in which other shareholders also hold sizeable stakes it should seek regular and timely information directly from shareholders so that it understands their intentions.

On sale management

f **The Shareholder Executive negotiated a success fee for UBS of £4.0 million on completion of the sale. The Nuclear Liabilities Fund paid its financial advisors a fee of £1.3 million, capped at one third of the fee paid to UBS.** In future sales, public bodies should ask prospective financial advisors to include alternative fee structures in their bids.

Part One

The impact of the sale on energy supply

1.1 On 5 January 2009, the Government sold 36 per cent of British Energy to a wholly owned subsidiary[4] of EDF SA, as part of EDF's £12.5 billion purchase of the Company. The Government received £4.4 billion for its interest, which was set towards the cost of decommissioning British Energy's existing nuclear stations.

1.2 This part of the report examines the extent to which the Government met its energy policy objectives when it sold its interest to EDF.

The Government's objectives for the sale of its interest

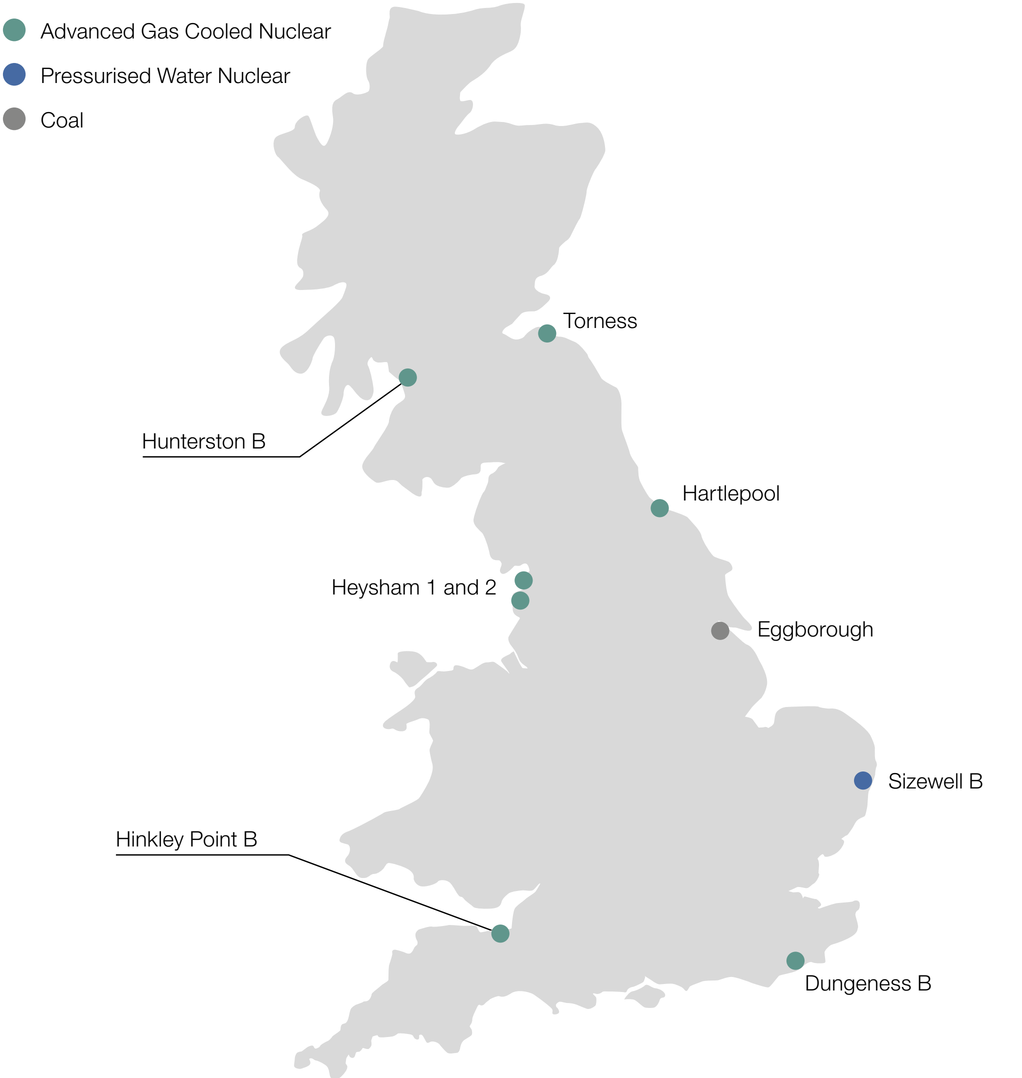
1.3 British Energy was the largest independent UK electricity generator, with an annual turnover of £2.8 billion in 2007-08, before it became part of EDF Energy in January 2009. Its eight nuclear power stations generate approximately 13 per cent of electricity used in the United Kingdom (UK) (**Figure 1** overleaf).

1.4 The Government's ownership of a 36 per cent interest in British Energy was of strategic importance to achieving its policy goals for encouraging investment in new nuclear power stations. This reflected the industry view set out in the Government's 2008 White Paper that sites in the vicinity of existing nuclear facilities were the most viable for new nuclear power stations. The sites owned by British Energy include those such as Hinkley Point and Sizewell that are considered by industry to have the best infrastructure, grid connections, access to cooling water and proximity to local workforces with nuclear skills. The Government wanted to ensure that British Energy was sold to a buyer that planned to build new nuclear stations on British Energy's sites, and had the skills and resources to do so. The energy industry subsequently nominated 11 sites in the UK as being potentially suitable for new nuclear build, including five sites owned by British Energy. Final approval of sites is subject to a number of future policy and regulatory decisions, including the Strategic Sites Assessment.

4 The purchaser was 'Lake Acquisitions' wholly owned by EDF's UK subsidiary.

Figure 1
British Energy's power stations

British Energy operated eight nuclear power stations, and Eggborough a coal fired station



Source: British Energy

1.5 The impetus for the sale came from British Energy, which wanted to play a part in new nuclear build but was unable to raise investment funds because of its financial record, the poor performance of some of its reactors, and its lack of experience of building new reactors. The board saw operating British Energy solely as a run-down agency for its eight existing nuclear power stations as commercially unsustainable. However, the Government would have barred British Energy from building new nuclear power stations as long as it retained an interest in the Company as the Government did not want to expose taxpayers to nuclear investment risk.

1.6 The main public bodies involved in the sale process were:

a **The Shareholder Executive** managed the sale of the Government's interest in British Energy on behalf of the Department of Energy and Climate Change (the Department). It was created in 2003 to improve the Government's performance as a shareholder, and had responsibility for monitoring British Energy's financial and operational performance and for advising the relevant department on decisions about the conversion of the cash sweep. Until June 2009 it was part of the Department for Business Enterprise and Regulatory Reform, but is now part of the Department for Business, Innovation and Skills.

b **The Department for Business Enterprise and Regulatory Reform** set the objectives for the sale and was responsible for the Government's wider energy policy until responsibility transferred to the Department of Energy and Climate Change in October 2008.

c **The Department of Energy and Climate Change** assumed responsibility for the Government's objectives for the sale in October 2008, when it took over responsibility for energy policy from the Department for Business Enterprise and Regulatory Reform. The Shareholder Executive now works to this department in relation to the nuclear assets the Department holds.

d **The Nuclear Liabilities Fund** is responsible for the future cost of decommissioning British Energy's existing nuclear stations and held the interest in British Energy that the Government acquired following the 2005 restructuring. The Government agreed as part of the restructuring to meet any shortfall if the Fund is unable to meet decommissioning liabilities.

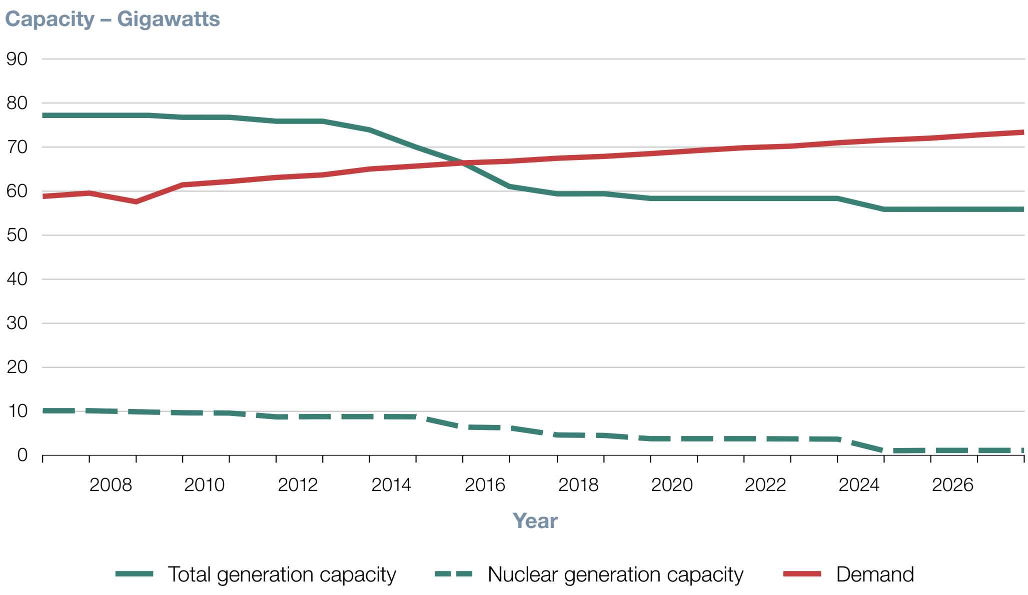
1.7 The Government decided to monitor developments closely and take decisions on the basis of its obligations to taxpayers, and its energy policy objectives set by the Nuclear Sites Steering Group and approved by ministers in January 2008. The Government set a clear hierarchy of objectives for the sale of its 36 per cent interest as follows:

- Primary objectives:
  - ensuring that nuclear operators are able to build and operate new nuclear power stations from the earliest possible date, to the widest possible extent, with no public subsidy, and with all unnecessary obstacles removed; and
  - maintaining the viability and continued safe operation of the existing British Energy fleet.
- Secondary objectives to:
  - minimise the Government's exposure to risk of being unduly dependent on a single company for nuclear going ahead in a timely fashion; and
  - maximise the value of the Government's interest in British Energy and Nuclear Decommissioning Authority sites.

1.8 The overarching policy goals were to help minimise the costs of meeting climate change targets and ensure security of supply through diversity in electricity generation, as set out in the Government's January 2008 White Paper. The Government identified new nuclear power stations as having a role to play in tackling climate change as carbon dioxide emissions from nuclear power stations are relatively low. It also concluded that new nuclear power stations would help maintain a diverse mix of electricity generating technologies. New generating capacity, which could be met in part by new nuclear power stations, is required because existing capacity is declining through the closure of older power stations (**Figure 2**).

Figure 2
Forecast generating capacity of existing power stations

New generating capacity will be required to meet demand as existing power stations close



Source: The Department of Energy & Climate Change

The sale of the Government's interest

1.9 British Energy had been publicly owned until 1996 when it was privatised in a stock market flotation, leaving the Government with only a Special Share[5] that allowed it to prevent any takeover of the business it considered to be contrary to national security. The Government acquired an interest once again after British Energy asked for financial assistance in September 2002 when it could not meet all its liabilities. The Government helped British Energy achieve a solvent restructuring that was completed in January 2005.[6] As a condition of the restructuring, British Energy agreed to make an annual payment to the Nuclear Liabilities Fund of 65 per cent of the Company's available free cash flow after tax and payment of financing costs, but before dividend payments, as a contribution towards decommissioning liabilities. The Nuclear Liabilities Fund had an option to convert this entitlement – the 'cash sweep' payment – into equity equivalent to 65 per cent of the ordinary shares in British Energy.

1.10 The Government reduced its original 65 per cent interest to 36 per cent in May 2007 after directing the Nuclear Liabilities Fund to convert part of its cash sweep entitlement into 450 million shares, which it then sold through a private placement for 520 pence each. The Government followed NAO recommendations for staged disposals in this sale: if it had sold all of its interest for 520 pence per share in June 2007, it would have received £1.4 billion less than it finally received on the disposal of its remaining interest to EDF for 774 pence per share. The 2007 sale raised £2.1 billion towards decommissioning costs, and was intended to diversify the assets held by the Nuclear Liabilities Fund. Although the sale reduced the Government's economic interest in British Energy, it did not reduce the voting rights it could acquire on conversion of the cash sweep to shares, which were capped at 29.9 per cent.

1.11 The Department directed the Nuclear Liabilities Fund to sell the remainder of its interest (**Figure 3** overleaf), after advising ministers, in September 2008, that this would meet the following objectives:

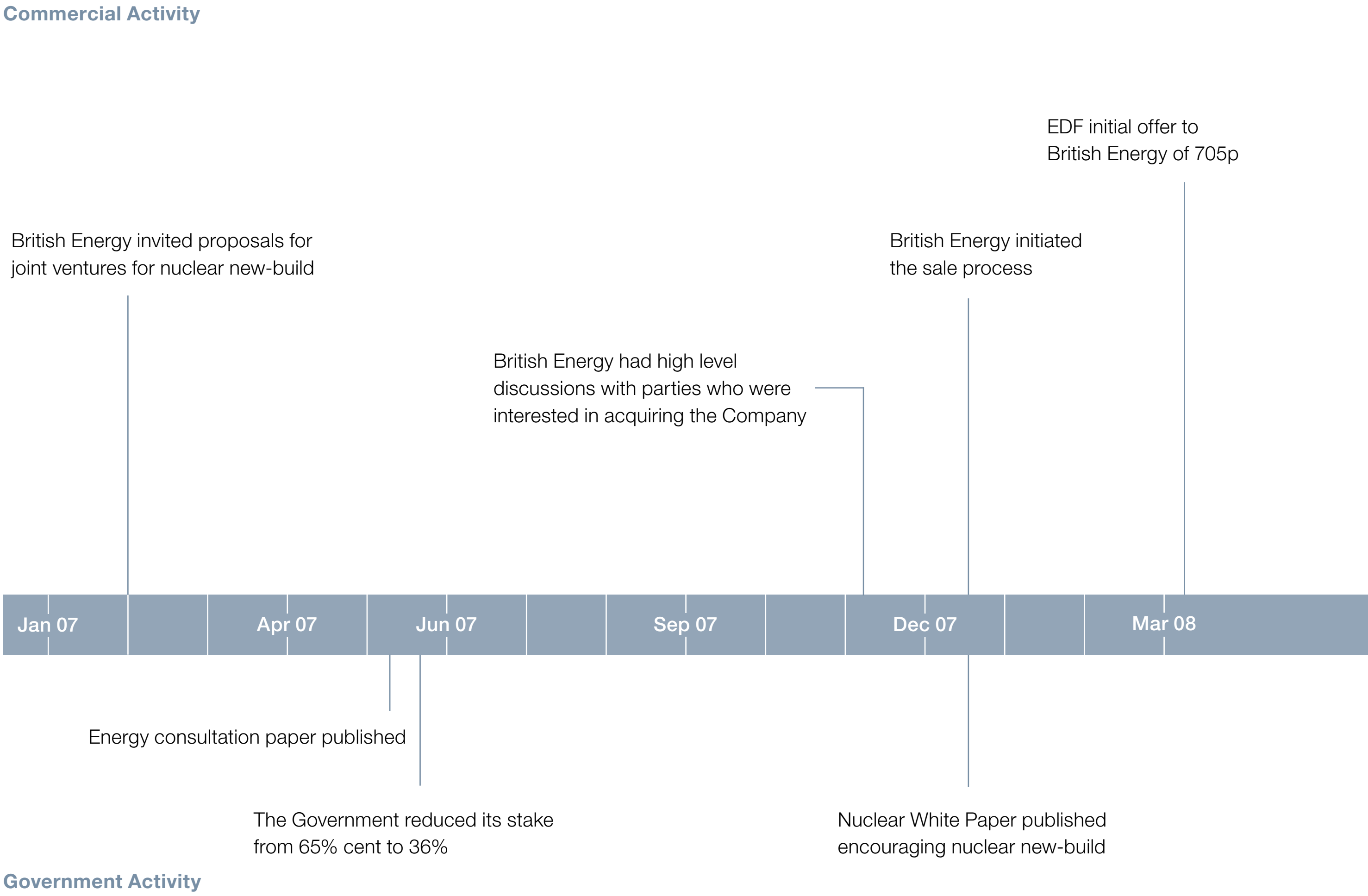
- **a** getting nuclear new build to happen as soon as possible;
- **b** the safe running of British Energy's plant for as long as possible; and
- **c** enabling there to be more than one new nuclear operator; while
- **d** getting value for the taxpayer from the Government's interest.

5 The current sale to EDF excluded the special share, which the Government retains.
6 C&AG's report, *The Restructuring of British Energy*, HC 943 2005-06.

The impact of the sale on the Government's objectives for new nuclear

1.12 EDF has said it intends to build four nuclear reactors on the land acquired through its purchase of British Energy – two at Hinkley Point in Somerset and two at Sizewell in Suffolk. The Department has estimated that each reactor could take around ten years to complete, including four years planning. EDF has publicly announced that it is aiming to build the four new reactors by 2025, with the first operational by 2017. The Department concluded on the basis of discussions with EDF that EDF has a credible programme to deliver the new reactors, but the Department recognises that the construction of these new stations depends on a range of factors, many of which are outside EDF's control, including:

Figure 3
Timeline of key stages of the sale

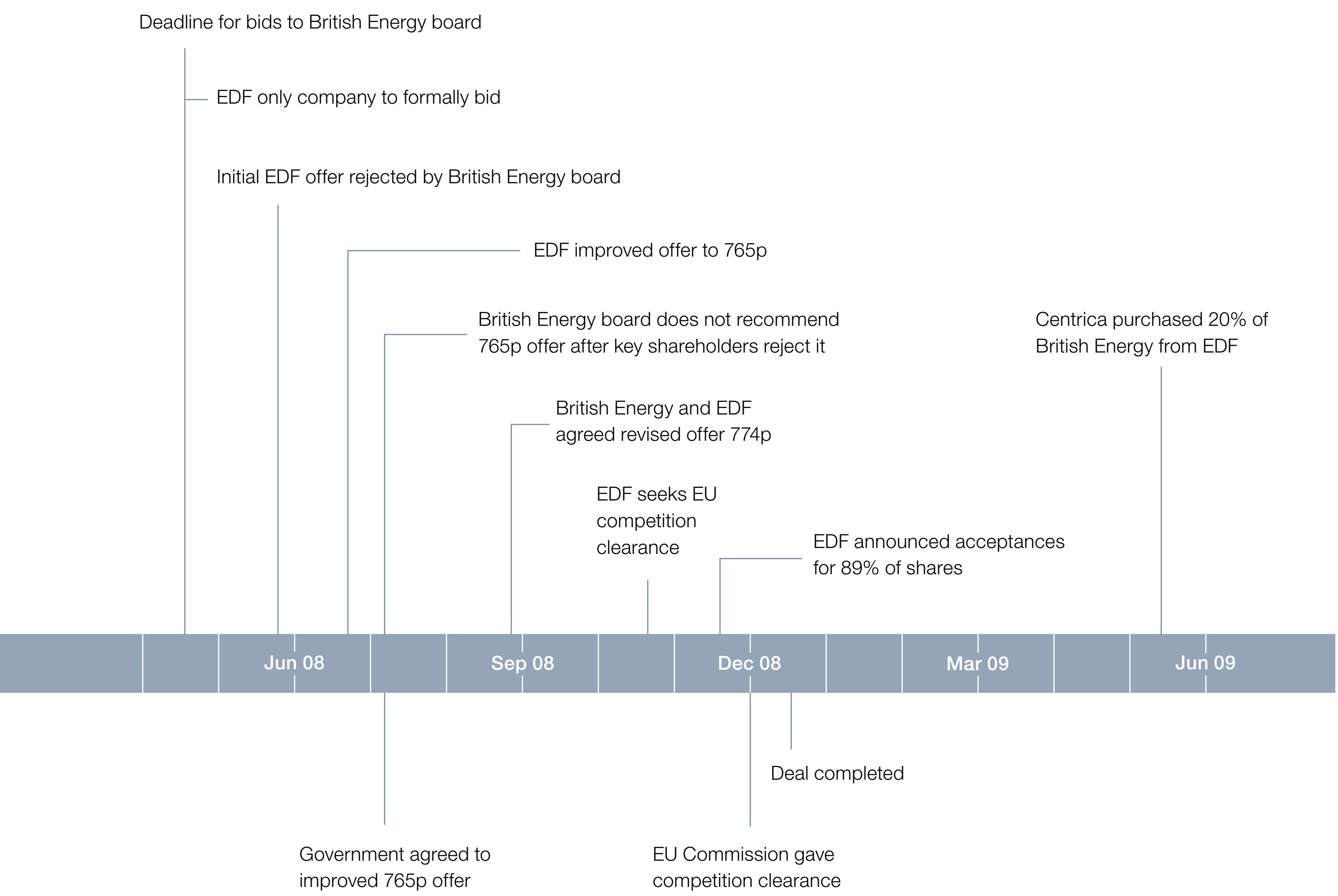


Source: National Audit Office

a wider economic and market considerations including the price of carbon. High carbon prices benefit Nuclear Generators, as increases in the price of carbon credits raises the costs of fossil fuel generation and power prices;

b gaining planning consent and all necessary licences and permissions to build new nuclear power stations; and

c EDF's overall strategic priorities and financial position.



1.13 Against this background, it was unlikely that the Department would have been able to secure any binding commitment from EDF for new nuclear build. EDF has, however, made a significant investment in British Energy's existing business and land that could be used for new nuclear power stations. It also has proven experience as the largest nuclear operator in the world and is one of a small number of companies worldwide with the capability to finance, build and operate new nuclear power stations on its own. The Department is seeking to remove barriers to new nuclear power stations by taking forward the facilitative actions described in the 2008 White Paper, and identifying ways of achieving its wider objectives for electricity supplies.

1.14 It will be several years before the Government can determine whether the sale of British Energy will lead to the construction of new nuclear power stations at no public subsidy. The first key milestone will be for EDF to secure planning consents for its new reactors at Hinkley Point and Sizewell. To meet its timetable EDF will need to obtain planning consents in 2011.

1.15 To minimise exposure to the risk of being unduly dependent on a single company for the timely progression of new nuclear build, and avoid being in a weak negotiating position on issues such as the carbon price and the cost of disposing of nuclear waste, the Government secured some legally binding commitments from EDF as a condition of selling its interest. This was coordinated with plans for the disposal of land owned by the Nuclear Decommissioning Authority. EDF agreed to sell British Energy land at Bradwell (next to a site owned by the Nuclear Decommissioning Authority) and either Dungeness or Heysham subject to decisions relating to the Strategic Siting Assessment and development consents for new reactors at other sites. EDF also agreed to sell land it owned at Wylfa, subject to the outcome of the Strategic Siting Assessment in relation to certain other sites.

1.16 These undertakings provided EDF with sufficient British Energy land to support its new build plans while offering opportunities to other nuclear operators. EDF sold its land at Wylfa in May 2009 in a joint auction of land owned by the Nuclear Decommissioning Authority at Wylfa, Bradwell and Oldbury. EON UK Plc and RWE Npower Plc jointly acquired the Wylfa and Oldbury sites, and have publicly announced their intention to have their first nuclear reactor up and running around 2020. The auction has therefore ensured that more than one operator owns sites that are potentially suitable for new nuclear build. EDF acquired the land owned by the Nuclear Decommissioning Authority at Bradwell, but will have to sell this if it receives planning permission to build new reactors at Sizewell and Hinkley Point, in line with the undertaking.

1.17 The proposed purchase by EDF was referred to the European Commission, which concluded the undertakings secured by the UK Government did not offer a sufficient remedy against the concentration of ownership of land suitable for nuclear new build. The Commission secured from EDF a commitment to sell significantly earlier, unconditionally, either Dungeness or Heysham, at the purchaser's choice. On 8 May 2009, EDF invited credible nuclear operators to come forward with expressions of interest in Heysham or Dungeness. It is not clear when that transaction will complete, but it should further reduce the Government's reliance on a single operator for new nuclear build.

1.18 EDF still owns five of the eleven sites nominated for the Strategic Siting Assessment by industry as potentially suitable for new nuclear build, including two of the three sites (Hinkley Point and Sizewell) generally considered, by industry, to be the most attractive and most likely to be developed first. EDF therefore has a central position in new nuclear in the UK and a potentially significant influence over the realisation of the Government's aims for the construction of new nuclear power stations. RWE and EON's successful bid in May 2009 for sites previously owned by the Nuclear Decommissioning Authority at Oldbury and Wylfa has, however, created a credible competitor.

The safe operation of British Energy's existing power stations

1.19 The Government decided that it would only sell its interest if the viability of British Energy's existing power stations was maintained. The Shareholder Executive met with potential bidders to evaluate their experience of operating nuclear plants and review the views of the national nuclear safety regulators. The Nuclear Installations Inspectorate confirmed that it did not object to the sale to EDF. British Energy relies on a small team of engineers to maintain its existing stations, and continuity of knowledge is critical to the successful and safe management of British Energy's reactors, as each one is unique. Grouping British Energy's existing stations with EDF, as a new build operator, made those engineers less susceptible to poaching and was an appropriate approach to securing the viability of the existing stations.

The impact of the sale on competition in electricity markets

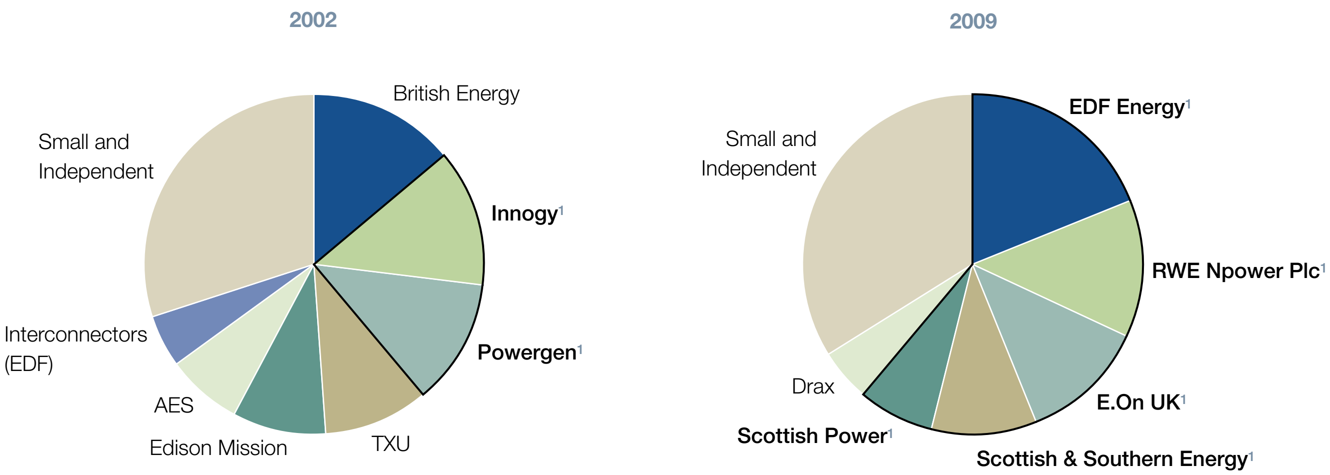
1.20 The Department recognised the sale would reduce choice and potentially increase prices for industrial and commercial customers, but did not seek possible remedies from EDF on the basis that this was a matter for the competition authorities. Due to its size the case was referred, in November 2008, to the European Commission, which initially expressed serious concerns. These were mainly about the potential for EDF to raise prices by withdrawing capacity and changing its commercial strategy for industrial and commercial customers, leading to a reduction in liquidity. It was also concerned that holding three National Grid connection agreements at Hinkley Point could act as a barrier to entry for other competitors in the region.

1.21 The Commission therefore asked EDF to sell the power station it owned at Sutton Bridge, and British Energy's station at Eggborough, and to sell certain minimum volumes of electricity in the British wholesale market. It also required a commitment to terminate one of the three grid connection agreements with the National Grid at Hinkley Point. The Commission concluded that the transaction, as modified by these commitments in addition to those imposed by the Government, would not significantly impede effective competition in electricity markets in the European Economic Area or any substantial part of it.

1.22 The purchase of British Energy has nevertheless given EDF a stronger strategic position, and continued the trend of consolidation in the UK electricity market[7]. As at September 2009, EDF had by far the biggest share of the UK's generation market, at 17 per cent, the next largest being RWE Npower plc with a 12 per cent share (See **Figure 4**). This may well have a long term effect on retail competition in the future as a result of the consolidation of generation into vertically integrated businesses and the resulting reduction in market liquidity.

Figure 4
Consolidation of the Wholesale Generation Market

The sale continues the consolidation of the generation market around the vertically integrated businesses



Source: Digest of UK Energy Statistics

NOTE
1 Bold text/black outline = Vertically integrated.

7 Digest UK Energy Statistics, Association Electricity Producers data.

Part Two

The management of the sale of the Government's interest and proceeds obtained

2.1 This part of the report examines the Shareholder Executive's conduct of the sale of the Government's interest, the value for money of the proceeds obtained, and the financial risks to which taxpayers remain exposed following the sale.

The Shareholder Executive's role in the sale

2.2 The sale of the Company as a whole was managed by British Energy's board. The Shareholder Executive managed the sale of the Government's interest in British Energy on behalf of the Department of Energy and Climate Change, which took over responsibility from BERR for the sale objectives in October 2008. The Nuclear Liabilities Fund, which held the Government's interest in British Energy and received the proceeds from the sale, set its own objective for the sale, which was to maximise the financial return.

2.3 The team within the Shareholder Executive that was responsible for advising on the Government's interest in the sale was led by an investment banker with experience of mergers and acquisitions in the energy sector. This team included policy officials and was overseen by a Nuclear Sites Steering group set up by BERR, the Shareholder Executive and the Treasury. This Group met regularly during the sale to discuss progress and the achievement of objectives.

2.4 The Government was not a controlling shareholder in British Energy, and did not therefore have access to the levers that it would have in the sale of a Government-owned company. It nevertheless had sufficient influence to block the sale, mainly through its 36 per cent interest in British Energy. The Government was, however, supportive of a sale, subject to it being consistent with the hierarchy of objectives (para 1.7). The Shareholder Executive was satisfied that it did not need to be directly involved in stimulating market interest in the Company as British Energy's board was already engaged in negotiations with potential bidders.

2.5 The sale was governed by the Takeover Code, which regulates when and what information must or cannot be released publicly in relation to bids, timetables for certain aspects of the bid, and minimum bid levels. The Code allowed the Shareholder Executive to discuss the terms and conditions of the transaction with potential bidders. Its discussions covered a range of issues including relaxing certain restrictions which the Government placed on British Energy as part of the restructuring, such as holding a minimum of £490 million in free cash, and requirements for potential bidders to sell some of British Energy's sites to other buyers.

The value of the Government's interest

2.6 The Government set a secondary objective to maximise the value of its interest in British Energy. The best way to get a good price is through competition. British Energy's board held discussions in early 2008 with a suitable range of potential purchasers (**Figure 5**). By May 2008, however, all but one – EDF – had withdrawn from these discussions due to management decisions on a range of factors, individual to each bidder, such as: the commercial logic of acquiring British Energy, the future output and reliability of British Energy's stations, and the level of overseas political support for state owned companies investing in UK nuclear. British Energy's board had little influence over the companies' decisions on these factors. At the key stages in negotiations from May 2008, EDF did not therefore face pressure from competing bidders to maximise its offer.

Figure 5
Market Discussions

Discussions were held with most credible potential purchasers

Company	Description
Centrica plc	UK power company and the largest gas supplier in the UK and one of the largest electricity suppliers. Not currently a nuclear operator.
EDF SA	French integrated electricity company, 85 per cent owned by the French Government. The largest nuclear operator in the world. Operates 63 gigawatts of nuclear generation.
E.On AG	German renewable energy, electricity generation and distribution, natural gas exploration, production, transportation and distribution company. Operates 7.7 gigawatts of nuclear generation.
GDF Suez SA	French energy company active in electricity generation, natural gas and renewable energy. Operates 5.9 gigawatts of nuclear generation.
Iberdrola SA	Spanish electricity company, which is the largest renewable energy operator in the world. Operates 3.3 gigawatts of nuclear generation.
RWE AG	German electricity supplier and natural gas company. Operates 6.3 gigawatts of nuclear generation.
Vattenfall	Swedish power company, wholly owned by the Swedish government. Operates 2.7 gigawatts of nuclear generation.

Source: Shareholder Executive

2.7 Against this background, EDF put forward an initial offer of 705 pence per share in May 2008, which British Energy's board rejected on the grounds that it did not represent a good price for the value of British Energy. The Nuclear Sites Steering Group appointed UBS in March 2008 to provide advice on achieving the Government's strategic policy objectives and give a 'fair value' assessment of British Energy. UBS submitted its first formal valuation of British Energy in July 2008, which gave a 'fair value' price for British Energy's shares of 734 pence. This was based on the Department's assumptions about UK power prices, British Energy's output, lifetime extensions to the existing stations and new nuclear build (**Figure 6**). Our assessment showed that these assumptions were cautious, producing a relatively low valuation, but not unreasonable given the inherent uncertainty in assessments of future output and, particularly, power prices.

2.8 In response to EDF's final offer, UBS updated its valuation in September, using revised assumptions about power prices and the value of British Energy's pension deficit. This reduced its valuation of British Energy's shares from 734 pence to 703 pence (Figure 6). The Shareholder Executive told us that it would accept offers at or above that price, subject to a sale meeting energy policy objectives.

Figure 6
The Shareholder Executive's valuations of British Energy

UBS provided buyer neutral valuations of British Energy

Valuation (pence per share)	July 2008	September 2008	Change
Core nuclear business	563	559	-4
New build	100	100	0
Eggborough	33	24	-9
Net cash & receivables	38	21	-18[1]
Total pence per share	**734**	**703**[1]	**-31**[1]
Assumptions			
Oil price ($/Barrel)	102-109	64-68	
Peak output of British Energy's existing stations (TWh)	55.5	55.5	
Carbon Price (€/tonne)	30	30	
Value of Eggborough (£m)	537	388	
Net pension deficit (£m)	175	509	
Liabilities to Nuclear Liabilities Fund (£m)	–	202	
Net financial cash position (£m)	611	76	
Receivable related to forward power sales (£m)	–	260	

Source: Shareholder Executive

NOTE

1 Values do not sum due to rounding.

2.9 Key inputs and assumptions underpinning the valuations were the price of oil, which indicates energy price trends, the price of carbon which influences fossil fuel energy prices, and the output of British Energy's existing stations. Uncertainties about the future output of British Energy's stations and power prices make any valuation inherently uncertain. Sensitivity analysis showed a wider range in values from a low case of 548 pence per share to a high case of 859 pence per share (**Figure 7**). This wide range is primarily a result of the inherent difficulty in estimating power prices, which are difficult to predict due to historic volatility.

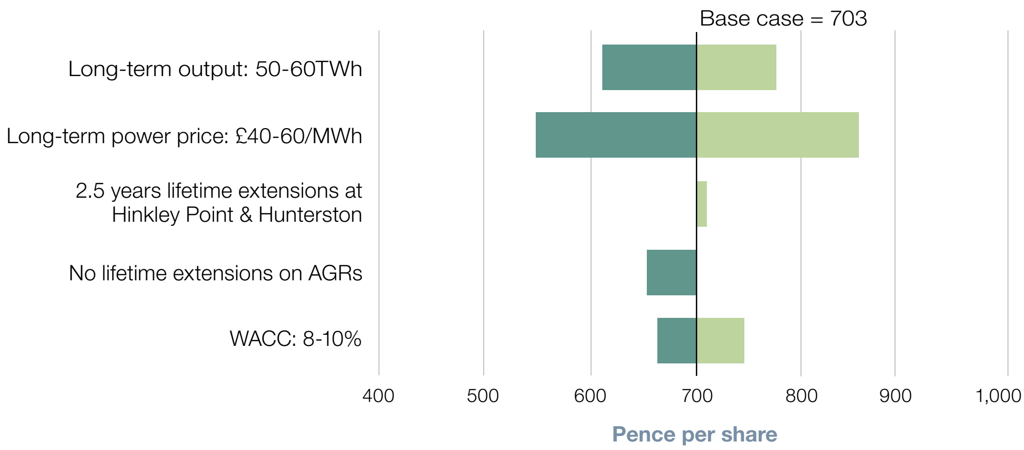
2.10 The changes in British Energy's share price, quoted on the London Stock Exchange during the sale process, further illustrate the volatility of the market's view of the Company's value. In 2007, before the start of the sale process, British Energy's share price averaged 550 pence, reflecting uncertainty about the future of nuclear power and British Energy's stations poor performance. Following the public announcement of a potential sale in March 2008, the share price increased peaking at 785 pence in April 2008. The week before EDF put forward its first formal offer in June 2008 it was 726.5 pence (**Figure 8**).

2.11 The difference between the Shareholder Executive's final valuation of 703 pence per share and EDF's final offer of 774 pence reflected different assumptions about power prices and output, as well as the exclusion from the Shareholder Executive's valuation of the strategic value of British Energy to EDF. The Shareholder Executive recognised that EDF had a strategic interest in British Energy that went beyond the direct financial value of the Company. For example, acquiring British Energy would move EDF from a relatively weak position in the UK's generation market to owning around a fifth of generation capacity. The acquisition would also provide EDF with a central position in the market for new nuclear build in the UK, giving it a potentially significant influence over the realisation of the Government's strategic policy objectives for new nuclear build are achieved.

Figure 7
Sensitivity Analysis

The Shareholder Executive considered several sensitivities from a low case of 548p per share to a high case of 859p per share

Sensitivities



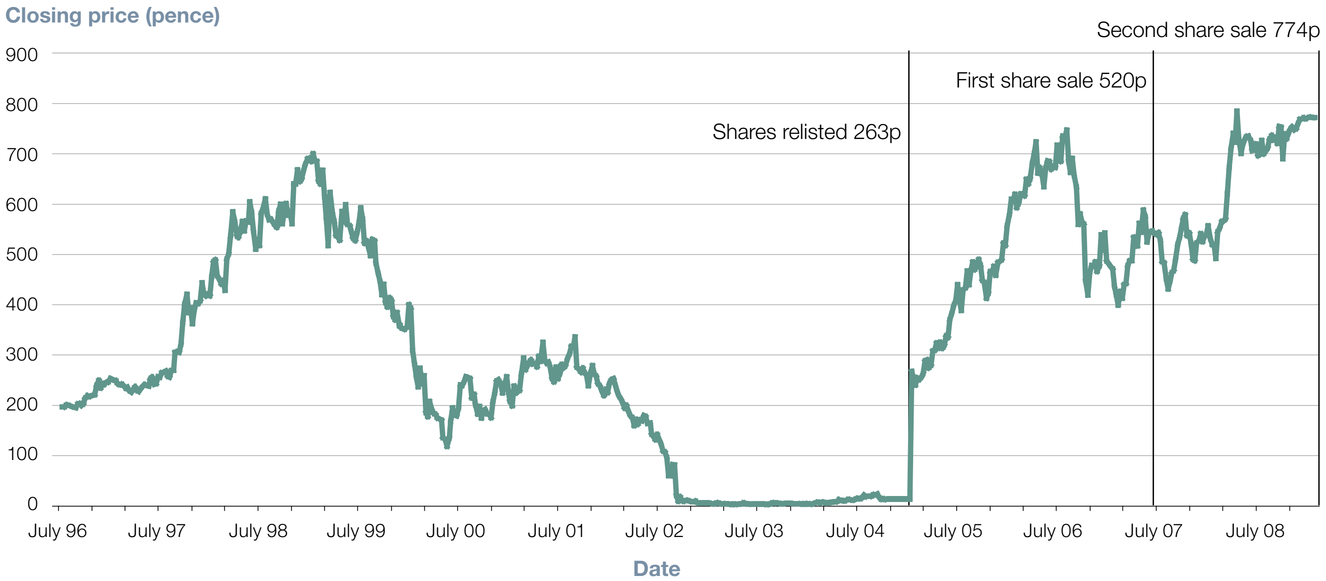
Source: Shareholder Executive

2.12 British Energy's advisors, Rothschild, assessed the strategic value of British Energy, but the Shareholder Executive did not see this valuation. The Shareholder Executive considered that it did not need to carry out its own assessment or develop a strategy to capture the strategic value of British Energy to EDF on the grounds that the Company's board would factor this into its judgement of the best price it could achieve for shareholders. The Shareholder Executive also considered that it did not need to achieve the same price as other shareholders to achieve value for money, taking into account the benefit of achieving the Government's wider policy objectives. It did ultimately benefit from the assessment of strategic value developed by British Energy's board and its advisors, and the larger institutional shareholders that had significant holdings in British Energy following the sale of part of the Government's interest in the Company in May 2007.

Other significant shareholders

2.13 The Takeover Code allowed the Shareholder Executive to hold discussions with other shareholders, but it preferred to rely on British Energy's board, which was leading the sale process. In late July 2008 the Shareholder Executive had expected EDF's offer of 765 pence per share or 700 pence and a nuclear power note (para 2.15) would be recommended by British Energy's board and accepted by the Government. It did not know, however, that two of the largest private sector shareholders – Invesco Perpetual and M&G – who together owned 22 per cent of the Company and whose acceptance was needed for the sale to proceed, were not happy with the offer. Against this background, British Energy's board did not recommend the offer. EDF issued a public statement following the rejection of its offer indicating it was prepared to walk away from the deal, which would have put the Government's objectives for the sale at risk.

Figure 8
British Energy's Share Price



Source: British Energy

The terms of the final offer

2.14 The deal was subsequently revived following discussions between Invesco Perpetual, M&G and the boards of British Energy and EDF, prompted in part by the Shareholder Executive. These resulted in the revised and final offer of 774 pence for each British Energy share, or an alternative offer of 700 pence in cash and a revised Nuclear Power Note per share, offering greater potential returns if power prices or output are high.

2.15 EDF secured acceptance of its offer by offering the main institutional investors this revised nuclear power note, which is a financial instrument offering a series of annual payments, allowing holders who forecast sustained high electricity prices to benefit from the high prices. It offers them potentially significant rewards for taking significant risks. If British Energy performs well and power prices peak, the note could earn holders up to 575 pence per share (**Figure 9**). However, low output and power prices means the notes generate no return. EDF increased the theoretical maximum value of the note from 394 pence per share to 575 pence per share in its final offer. There is limited scope to sell them.

Figure 9
The Nuclear Power Note

Present value of payments per nuclear power note (pence) assuming illustrative levels of long term output and power prices in 2008 real terms

2008 Real power prices (£/MWh)	Output (TWh base)				
	45	50	55	60	65
40	0	0	10	51	85
45	0	0	36	87	130
50	0	13	77	127	175
55	0	50	118	168	225
60	24	86	154	212	275
65	56	123	192	258	325
70	88	160	232	303	375
75	121	197	273	349	425
80	153	234	314	394	475
85	185	270	355	440	525
90	218	307	396	486	575
95	226	307	396	486	575

Source: British Energy

2.16 The Government agreed not to take the nuclear power note. As its value is dependent on power prices and output, both of which are highly volatile, it would be a risky instrument for the Government to hold. It also creates a potential conflict through a Government interest in achieving high power prices. Moreover, the Nuclear Power Note was an unsuitable instrument for the Nuclear Liabilities Fund to possess as falls in British Energy's output could lead to the early closure of British Energy's power stations, which would reduce the value of the note (and hence value of the Fund's assets), and would increase decommissioning costs (and hence the Fund's liabilities).

2.17 EDF's final offer was £404 million higher than the valuation used by the Shareholder Executive, reflecting the influence of the main institutional shareholders on British Energy's board. The Shareholder Executive also benefited from prevailing market conditions at the time when EDF put forward its offer, with energy prices at all time highs. The deal was agreed just before energy prices collapsed (**Figure 10**).

The cost of the sale

2.18 The Shareholder Executive incurred some internal staff costs, but the main cost was financial and legal advice. The Nuclear Sites Steering Group appointed UBS as financial advisors and Slaughter & May as legal advisers to work with the Shareholder Executive. It also took financial public relations advice from Tulchan. UBS were appointed as offering the best proposal and price after a competition involving two other firms – Lazard and Morgan Stanley. UBS initially bid a £6 million success fee, which the Department negotiated down to £3.5 million, together with a monthly retainer of £100,000 deductible from the fee.

Figure 10
Brent crude spot price

The price of oil peaked in 2008. European natural gas prices are tied to oil prices, thus oil prices act as a proxy for energy prices, including electricity because gas is the major fuel used for electricity generation

Source: National Audit Office

2.19 The main outputs which UBS provided were advice on strategy, support in negotiations, and the two valuations prepared in July 2008 and September 2008. As the sale progressed the Nuclear Liabilities Fund appointed its own financial and legal advisors, and conducted its own valuation, because its objective to maximise financial returns was potentially in conflict with the Department's primary objective to enable new nuclear build. The Fund paid its advisors £2.5 million, including £1.3 million for financial advice from Lazard who were appointed in April 2008.

2.20 The Shareholder Executive agreed terms on the basis often used in mergers and acquisitions to set fees based on the transaction size. Using this approach, the Shareholder Executive agreed that UBS would be paid a success fee of £3.5 million on the completion of the sale. It also agreed to pay an additional discretionary fee of £500,000 if the sale was more complex than originally envisaged, although it did not define the precise criteria it would apply. The Shareholder Executive accepted after the completion of the sale that it had been more complex than envisaged.

2.21 The Nuclear Liabilities Fund paid UBS the final success fee of £4.0 million, including the additional £500,000, after receiving assurances from the Shareholder Executive that it represented value for money (**Figure 11**). The Fund paid its own financial advisors, Lazard, a fee of £1.3 million that was capped at one third of the fees paid to UBS. Lazard, who were appointed in April 2008, based their valuation on UBS's model. Linking success fees to financial advice that includes valuations creates a possible risk of encouraging financial advisors to provide low valuations to facilitate sales.

Figure 11
Public Sector Advisors

The Shareholder Executive and the Nuclear Liabilities Fund had separate advisors, paid for by the Fund at the direction of the Secretary of State

Advisor		Cost (£m)
Shareholder Executive		
UBS	4.1[1]	
Slaughter & May	0.9	
Tulchan	0.3	
Total		5.3
Nuclear Liabilities Fund		
Lazard	1.3	
Shepherd and Wedderburn	1.0	
Total		2.3
Total		**7.6**

Source: Shareholder Executive and the Nuclear Liabilities Fund

NOTES

1 Includes disbursements.

2 All figures are exclusive of Value Added Tax.

The management of ongoing risks

2.22 The Government no longer holds a direct financial interest in British Energy. In terms of its interest in the Company, it is now in substantially the same position as it was when British Energy was privatised in 1996. However, the Government now underwrites the costs of decommissioning British Energy's nuclear power stations and is responsible for spent nuclear fuel liabilities, while British Energy remains a strategically important business. It is therefore important that effective risk monitoring, and management arrangements are maintained to minimise the likelihood of another rescue package being required in the future.

2.23 We have highlighted in previous reports on British Energy that spreading responsibilities across different Departments increases the likelihood of information on risks not being shared. Responsibility for monitoring and managing the risks is now spread across the following bodies:

- The Shareholder Executive, which is now part of the Department for Business Innovation and Skills, has assumed overall responsibility for risk management in relation to British Energy and reports to DECC Ministers.
- The Office for Nuclear Development (until October 2008 part of the Department for Business Enterprise and Regulatory Reform but now part of Department of Energy & Climate Change) is responsible for new nuclear development, and has responsibility for risks associated with liabilities associated with British Energy's existing power stations.
- The Nuclear Decommissioning Authority is responsible for providing oversight of British Energy's planning for the decommissioning of its nuclear power stations through obligations under the Energy Act 2004.

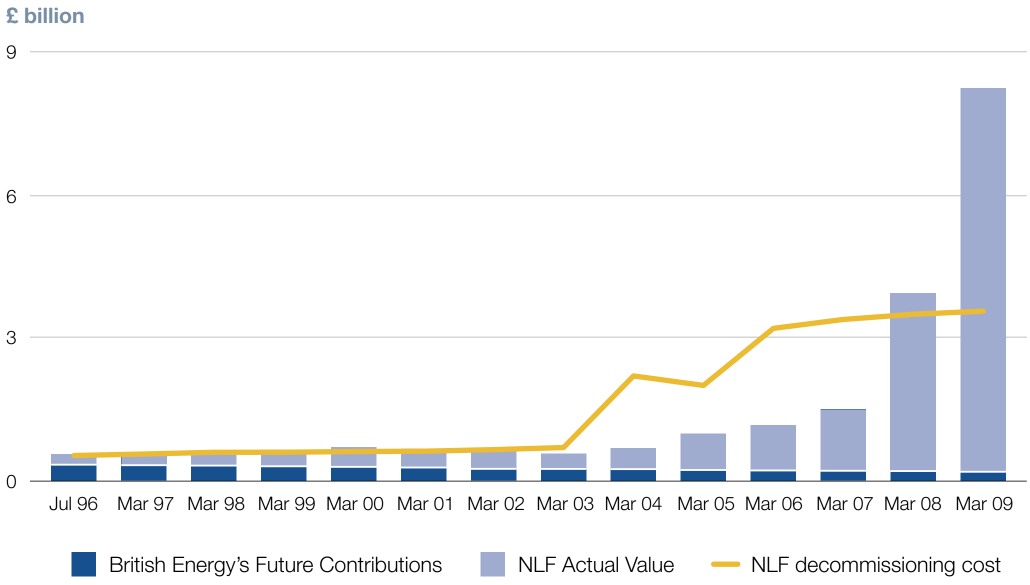
2.24 The Government acquired an entitlement to access financial and performance information from British Energy as part of the restructuring of British Energy completed in 2005, and this remains in place. We found from our examination of risk management that while EDF's purchase of British Energy has significantly reduced the immediate risks, the Shareholder Executive had not carried out a formal assessment of the possible impact of the sale on the risk of taxpayers having to bear the cost of nuclear liabilities, if, for example, the new owner operated British Energy's power stations in a way that required earlier payment of decommissioning costs. The Shareholder Executive told us it believed a risk assessment was unnecessary as a legal undertaking British Energy had made when it was restructured to be reasonable and prudent in the operation of its power stations would continue under EDF's ownership. The Shareholder Executive is in the process of implementing new risk monitoring arrangements, established in October 2009, including how it will use rights to information that remained in place after the sale.

2.25 In July 2009, the Office for Nuclear Development prepared a high level description of the remaining risks in response to our request for information. This was the first documented assessment of risks since the completion of the sale. The first main risk to which the Government is exposed is that it may need to provide funds or take on additional liabilities if British Energy's financial position deteriorates, as happened in 2002. The Company is on a stronger commercial footing as a result of the sale as it is now part of a larger vertically integrated business. The likelihood of it experiencing financial difficulties has therefore reduced, but there is still a residual risk that could also put the achievement of the Government's objectives for new nuclear power generation capacity at risk.

2.26 The second main risk is that the Government has to fund the future costs of decommissioning British Energy's existing power stations if the Nuclear Liabilities Fund is unable to meet them. The current estimated value of the Fund's assets is £8.3 billion, which significantly exceeds the current estimated costs of discharging British Energy's liabilities obligations of £3.6 billion (**Figure 12**). The Fund's value each year is the total of the year end value of the fund including investment returns and the present value of British Energy's future contributions under the Decommissioning Fund Agreement which set up the Nuclear Liabilities Fund. The estimated decommissioning cost is the net present cost of meeting the Fund's anticipated decommissioning obligations. The increase in estimated decommissioning costs over the period 2004-2006 reflects the additional obligations transferred from British Energy during the restructuring. All future payments and costs are discounted at three per cent. Undiscounted, these liabilities were £12 billion as at 31 March 2009.

Figure 12
Nuclear Liabilities Fund

The sale crystallised the value of the Nuclear Liabilities Fund's assets



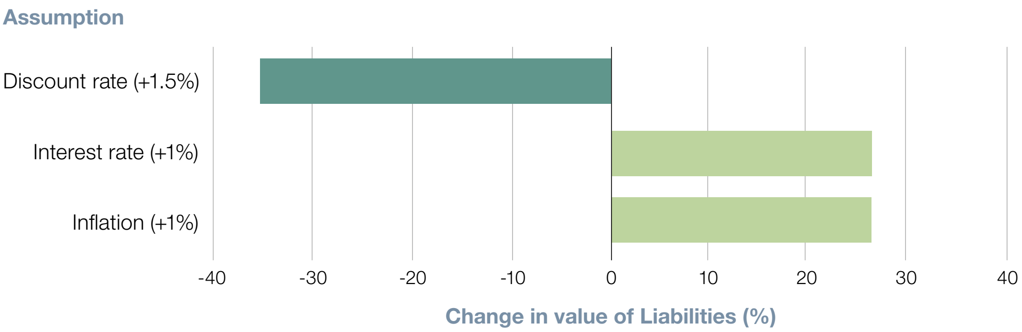
Source: Nuclear Liabilities Fund

2.27 These liabilities fall over many decades and cost estimates are highly sensitive to assumptions about the likely expenditure profile. Aggressive operation of British Energy's existing plant could lead to early closure which would increase the liabilities. In addition, sensitivity analysis carried out by Lazard on behalf of the Nuclear Liabilities Fund demonstrates that small changes in interest rates, inflation, discount rates can have a large impact on the liabilities the Fund has to meet to pay for decommissioning (**Figure 13**).

2.28 The third main risk is that liabilities associated with new nuclear build fall to Government. The Government's intention is that decommissioning liabilities created by new nuclear stations will be met by the operators of these stations. The general principles are set out in the part 3 of the Energy Act 2008, and detailed arrangements will be established when EDF puts forward firm proposals for new nuclear build.

Figure 13
Lazard Sensitivity Analysis

The Nuclear Liabilities Fund commissioned Lazard to analyse the volatility of the Fund's liabilities to changes in assumptions



Source: Nuclear Liabilities Fund

Appendix One

Methodology

The main elements of our fieldwork completed between April and July 2009 were:

Method	Purpose
1 Review of key documents	
We reviewed the papers held by the Shareholder Executive on the sale and submissions to the Secretary of State on the sale. We reviewed legal documentation prepared by Slaughter & May.	To assess: • the management of the sale of the Government's interest; • how evidence was used and the basis for decisions reached; • the adequacy of records retention and management; and • the ongoing legal and monitoring arrangements.
2 Financial Analysis	
• We assessed UBS's valuation of British Energy comparing it with share price trends, the views of the Expert Panel and analyst/broker reports.	To assess: • whether the Shareholder Executive made sensible use of data from credible sources; • whether the economic assumptions underpinning their analysis were reasonable; and • the level of uncertainty in the valuation and the implications for value for money.
3 Literature Review of:	
• previous NAO & PAC reports on risk management and asset sales; • the Energy White Papers; • the EU Commission's competition decision; and • the Takeover Code.	To understand: • good practice in risk management; • the Government's wider energy policies; • the impact of competition in the market; and • the mechanics of a sale.

Method	Purpose
4 Semi-structured interviews	
We interviewed staff and senior officials from: • the Shareholder Executive; • the Department of Energy and Climate Change; • the Department for Business Innovation & Skills; • British Energy; • British Energy Shareholders; • EDF; • The Shareholder Executive's financial and legal advisors; • Potential Bidders; • Nuclear Liabilities Fund; • The Fund's financial advisors; • The Nuclear Installations Inspectorate; • Ofgem; and • National Grid.	To identify: • the priority of sale objectives; • how the sale was managed; • the dynamics of negotiations between sale parties; • the management of information flows and relationships between stakeholders; and • how the Department would manage the risks from future liabilities of British Energy.
5 Expert Panel	
We used an Expert Panel to review our findings, conclusions and recommendations. The Expert Panel consisted of: Richard Morse Adrian Olsen Johnny Reed Clare Spottiswoode Richard Wade	To understand: • the industry view of the quality of the sale team in the Shareholder Executive and its understanding of the market for the Government's interest in British Energy; • best practice in acquisitions covering major shareholder behaviour and the remuneration of advisors; • the analysis of the methods, data and assumptions used in the Shareholder Executive's valuation and assessment of the value for money of EDF's offer; and • the effectiveness of the Shareholder Executive's management of the sale.

A more detailed description of our methodology is at: www.nao.org.uk

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