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The sale of the Government's interest in British Energy

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 Paper³, 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.