National Audit Office

Report
by the Comptroller
and Auditor General

HM Treasury

The sale of Eurostar

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Key facts

£585.1m	£172m	22
sale price for 40% stake in Eurostar	price paid by Eurostar to redeem preference share	expressions of interest for Eurostar shares

3	bids in the final round of bidding
6 months	duration of the formal sale process, October 2014 to March 2015
almost double	the sale price (£585.1 million) was 192% of the government's valuation of £305 million
1.1%	transaction fees as a proportion of total proceeds (the 40% stake and preference share)
£3 billion	estimate for total taxpayer investment in the Eurostar train service, one part of the High Speed 1 project, which cost taxpayers more than £8 billion

Summary

1 Following a successful sale process the government agreed to sell its 40% stake in Eurostar International Limited (Eurostar) for £585.1 million in March 2015. The winning bidder was Patina Rail LLP, a consortium made up of Caisse de dépôt et placement du Québec (CDPQ), a Canadian investment fund, and Hermes Infrastructure (Hermes), a UK-based fund. Eurostar also agreed, in a separate transaction, to redeem the government's preference share, providing a further £172 million for the taxpayer.

2 Eurostar is the sole operator of passenger rail services between London and continental Europe via the Channel Tunnel. The train service opened in 1994 as a joint venture between the UK, French and Belgian governments. In 1996 the UK arm of Eurostar was transferred to London & Continental Railways (LCR), a private sector consortium, which planned to finance the building and operation of a new high-speed rail link between St Pancras and the Channel Tunnel. However, as the number of passengers using Eurostar was significantly lower than expected, LCR could not raise the private finance needed to build the link (now called High Speed 1 (HS1)). To keep the project alive taxpayer support was provided to LCR and the company was eventually nationalised in 2008. In public ownership, LCR was restructured and split into 3 parts that could be sold: Eurostar UK (the passenger train service), HS1 Ltd (the track/infrastructure) and a property portfolio.

3 In 2010 the entire Eurostar business was incorporated as a UK company jointly owned by the UK government (40% stake) and the national rail operators of France, SNCF (55% stake) and Belgium, SNCB (5% stake). A preference share was also issued by the company to the UK government at this time. Eurostar carried forward significant UK tax losses which could be offset against future taxable profits and thus reduce future UK corporation tax (as standard tax rules allow). The preference share would pay a dividend to the UK government as the tax losses were utilised over time (see Part Five).

Scope of this report

4 This report considers whether the government achieved its policy objective of maximising the proceeds from the sale of its stake in Eurostar and the redemption of the preference share. The report is structured as follows:

- Part One covers the background and context for the sale;
- Parts Two and Three describe the sale preparation and process;
- Part Four considers the valuation of the Eurostar shares; and
- Part Five provides further detail on the redemption of the preference share.

5 We have published three previous reports on the HS1 project, of which the UK stake in the Eurostar train service is one part.[1] The aggregate proceeds from the sale of Eurostar, the previous sale of the HS1 track infrastructure and forthcoming sale of property assets will be significantly less than the taxpayer's investment in the entire HS1 project. We have previously concluded that the benefits to transport users did not outweigh the costs of the HS1 project. The sale of Eurostar does not alter that assessment. Appendix Three gives more information on the historical context.

Key findings

Context and sale decision

6 **Eurostar has performed well since its incorporation in 2010 under its current management team**. Prior to restructuring, the UK arm of Eurostar made losses amounting to around £1.8 billion. Since its incorporation, Eurostar has been profitable – passenger numbers, revenue and profit have all increased. A major contributor to this improved financial performance was a reduction in the track access charges as a result of a new charging regime which started at the end of 2009 (paragraphs 1.6 and 1.7, Appendix Three).

7 **The total taxpayer investment in Eurostar, prior to its incorporation, is significantly greater than the proceeds generated from this sale**. Taxpayer spending on the HS1 project, of which the Eurostar cross-Channel train service is one part, was more than £8 billion. We estimate that UK taxpayers' financial investment in Eurostar and its predecessors (including the write-off of losses incurred) amounts to approximately £3 billion. The Department for Transport (DfT) told the Committee of Public Accounts it would complete and publish an evaluation of the costs and benefits of the whole HS1 project by summer 2013. This document was published in October 2015 but was not available during our fieldwork so we have not commented on it in this report (Appendix Three, Figure 23).

1 Comptroller and Auditor General, *The Channel Tunnel Rail Link*, Session 2000-01, HC 302, National Audit Office, March 2001; Comptroller and Auditor General, *Progress on the Channel Tunnel Rail Link*, Session 2005-06, HC 77, National Audit Office, July 2005; Comptroller and Auditor General, *The completion and sale of High Speed 1*, Session 2010–2012, HC 1834, National Audit Office, March 2012.

8 **The government had held its minority shareholding in Eurostar as a financial investment**. The trading performance of the company is not expected to be altered by the change of ownership. Some asset sales are justified by government on the basis that the sale will result in improved efficiency for the business but this was not the case with Eurostar. Eurostar has its own management team and benefits from the rail expertise of its majority shareholder (SNCF). The sale business case concluded that the hold and sell values would be theoretically similar. The government justified the sale on the basis that the proceeds could be used to reduce national debt. The sale was consistent with government policy to sell assets which it has no policy reason to hold (paragraphs 1.8–1.12).

Sale preparation and process

9 **Eurostar's profits are forecast to increase from 2016 once it has introduced new trains**. The business is currently undergoing a major investment cycle. New higher-capacity trains, the first of which should be rolled out at the end of 2015, are expected to increase profits. This is due to a combination of increased revenues and improved cost efficiency. The government considered waiting to sell after the new trains were introduced as it thought higher profits could feed through into a higher price. However, it concluded that any delay would come with uncertainty and risks, so decided to sell in early 2015 rather than wait (paragraphs 2.4–2.7, Figures 5–7).

10 **The government reached an agreement with the other shareholders to run a competitive sale process following extensive negotiations**. The transaction protocol ensured that the other shareholders (SNCF and SNCB) did not have a veto on any potential buyers. This maximised the pool of investors able to bid for the asset (paragraphs 2.10–2.12).

11 **Preparatory work, by the government and its advisers, made the business more marketable to potential investors**. Changes to the shareholder agreement were effective in encouraging investors' interest and appetite for the shares. In particular, the new agreement provided an improved dividend policy, sell-on rights and protections for the new shareholder (paragraphs 2.10–2.12, Figure 8).

12 **Once the sale was launched in October 2014 the timetable was tight with little room for contingency because of the intention to agree a deal before the General Election**. The preparation for the sale was complicated by the need to transfer the shares away from DfT to avoid a potential conflict of interest as Eurostar was part of a consortium bidding for a rail franchise which DfT would be awarding. Negotiations with the other shareholders also took longer than anticipated. The formal sale process began in October 2014 and an agreement needed to be reached by March 2015 before the election period began. Bidders told us that the timetable was tight yet sufficient (paragraphs 2.8, 2.9, 2.12, 3.13–3.15, Figure 10).

13 The government and its advisers ran the sale process well and there was competitive tension between the bidders. The vendor due diligence reports combined with the meetings with management and SNCF had the desired effect, enabling bidders to gain confidence in the prospects of the business and encouraging higher bids. The 3 final round bids were around one-third higher than these bidders' first round bids. One of the final round bidders, a UK local authority pension fund, became aware of the sale much later than the other bidders but the process was flexible enough to allow it to participate (paragraphs 3.8–3.15, Figures 12 and 13).

14 Transaction costs were approximately 1% of the sale proceeds. Total adviser fees and other costs related to the transaction amounted to £8.2 million, 1.1% of the proceeds of the 40% stake in Eurostar and the preference share. The financial adviser had good knowledge of the business from its past involvement in the HS1 project. The legal adviser was paid on a billed time basis rather than a fixed fee. The legal cost for an internal transfer of shares, from DfT to HM Treasury, was £0.5 million. HM Treasury was concerned about the cost of the legal work and considered re-procuring the legal adviser during the sale process but it decided that a change of legal team midway through the process would have been inefficient and problematic due to the time-critical nature of the work. The government also agreed an incentive package with Eurostar management and key employees of up to £0.3 million in total upon successful completion of the sale (paragraphs 2.13–2.17, Figure 9).

Valuation and proceeds

15 The 3 valuations, which formed part of the advice to ministers on whether to go ahead with the sale, were prepared using conventional techniques. As with other government asset sales, the valuations were used to form a judgement about whether the offers received were fair and exceeded the value of retaining the shares. Additional assurance from an independent expert was used alongside the valuations prepared by the government and its financial adviser. The ministerial submissions provided valuation ranges and underlying assumptions. A detailed valuation annex to the final business case provided sensitivity analysis to explore the likely effects of alternative assumptions on potential bid levels. The project team noted that they would be unlikely to recommend that a sale below the independent adviser's valuation of £315 million (range of £265 million to £370 million) would represent value for money, but that an offer just above this level would not have been recommended automatically (paragraphs 4.2–4.4, Figure 14 and 15).

16 **The valuation of Eurostar is particularly sensitive to the likelihood of a competing rail service emerging. The valuations assumed that a competitor would commence rail services in the next 10 years**. The valuations prepared by the government and its advisers assumed that a competitor would commence rail services before 2025, significantly reducing Eurostar's profits. Sensitivities were run by the government and its advisers which showed that their valuations were around one-third lower than scenarios in which a competitor did not emerge. It would take several years for a new entrant to begin operations and there are currently no public statements by any potential competitor of a firm date to run a competing train service. Other important factors affecting the valuation include Eurostar's future business performance, the discount rate applied to its future cash flows to compensate for risk, and any discount that a holder of the shares would require as a minority shareholder in an unlisted company (paragraphs 4.6–4.8, 4.20).

17 **The sale price of £585.1 million for the 40% stake in Eurostar was more than 90% above the mid-point valuations of £305 million prepared by the government and its financial adviser. Given that the proceeds were much higher than the valuations, a hindsight review provides an opportunity to examine this gap**. To a large extent, the gap demonstrates the successful sale, which attracted competitive bids and took place during benign market conditions. However, without questioning the integrity of the 3 valuations, we consider that credible valuations above £500 million could have been supported without changing the assumptions about the business plan or emergence of competition. Instead, we applied lower discount rate and minority shareholder discount assumptions (paragraphs 4.3–4.20, Figure 14 and 17).

Preference share

18 **Eurostar redeemed the preference share for £172 million, giving the government a clean break from the company**. Standard tax rules allow Eurostar to carry forward its historical trading losses to offset against future taxable profits, thereby reducing UK corporation tax payments. A preference share was created when Eurostar was incorporated in 2010, which would pay a dividend to the UK government as these tax losses were utilised over time. The company was due to start paying preference share dividends to the government in 2015 and, subject to its trading performance and absorption of the historical losses, it would have continued to pay these dividends had the preference share not been redeemed. The redemption of the preference share means that the government receives cash upfront rather than receiving dividends in the future. At redemption date, the forecast dividends discounted on a simple risk-free basis could have repaid £216 million of government debt (including interest accrued), however, this assumes that there is no risk to the receipt of these dividends. In reality, there is a greater risk associated with them than with government borrowing. The £172 million price was agreed in negotiations and was more than the government's hold valuation of £158 million, which was based on a discount rate of 12.2% (paragraphs 1.4 and 1.5, 5.4–5.7, Figures 18 and 19).

Conclusion on value for money

19 The government made a policy decision as part of the 2013 Spending Round to sell the 40% stake in Eurostar before 2020. We believe that the timing of the sale, agreed in 2014, was primarily driven by the desire to sell prior to the 2015 General Election. This transaction took place during a period of benign market conditions and low interest rates. There were a number of risks to value for money associated with this deal that the deal team managed successfully, including: the tight timetable, the need to attract high-quality bids at a time that Eurostar was embarking on investment in new and unproven trains, and the corresponding uncertainty about the increase in future profits.

20 Once the decision was made to sell, the government and its advisers prepared well. Changes to the shareholder agreement made the investment attractive to a wide range of investors, such as pension funds. The process was well run, and sufficiently flexible to convert competitive tension into a price significantly above the initial valuation. Given that the redemption of the preference share by Eurostar affects the cash flows to the new owners of the 40% stake (via dividends) it is appropriate to conclude on the combined outcome of the 2 transactions. We consider that the sale process of the UK government's entire financial interest in Eurostar, which yielded £757.1 million, resulted in the government achieving its objective of maximising proceeds and represented value for money for the taxpayer.

Recommendations

The government is undertaking a significant asset sales programme forecast to exceed £62 billion over the current Parliament. The recommendations below are general principles prompted by our review of the Eurostar sale, not a commentary on this sale. We recommend that HM Treasury should take the lead in ensuring that all departments selling assets should:

Sale preparation

a consider how they can encourage the widest possible number of credible bidders for all assets they are selling;

b give due prominence, in business cases for asset sales, to the relationship between the timing of the sale and the marketability to investors (including a consideration of the track record and future prospects);

Sale process

c use sale processes that exhibit the right balance of rigour and discipline, but sufficient flexibility;

d ensure deal teams contain the right balance of internal staff and external advisers. Where external advisers are appointed, continue to place downward pressure on all costs, while acknowledging that the lowest price will not always provide best value;

Valuation

e apply a range of valuation methods, and use market-based assumptions, as a rigorous cross-check alongside the Green Book methodology to ensure that 'hold' valuations are informed by the prices that may be achieved in competitive and negotiated deals in the prevailing market conditions; and

f consider whether the additional assurance on valuation that may be provided by an independent valuation expert would be strengthened if this expert had no prior knowledge of existing valuations.