Report
by the Comptroller
and Auditor General

HM Treasury

Evaluating the government balance sheet: provisions, contingent liabilities and guarantees

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Key facts

£251bn
provisions and contingent liabilities as at 31 March 2015

£118bn
maximum value of main government guarantee schemes

£9,000
provisions and contingent liabilities as at 31 March 2015 per UK household

Two-thirds	increase in provisions between 2009-10 and 2014-15
£300 billion	potential size of provisions by 2020 if the rate of growth continues
£95 billion – £218 billion	range in the undiscounted nuclear decommissioning costs
One-sixth	provisions and contingent liabilities as a proportion of total assets as at 31 March 2015
£368 billion	decline in remote contingent liabilities and guarantees since 2009-10 following the reduction in direct government support to the banking sector after the financial crisis
2015-16	is the financial year in which a negative long-term discount rate will be applied to value provisions, which will double the discounted value of nuclear decommissioning provisions
9.7% GDP	average impact of contingent liabilities relating to the financial sector crystallising according to the International Monetary Fund

Summary

1 Like all organisations, the government has to manage its balance sheet well in order to support the delivery of its objectives and to withstand the impact of fiscal shocks such as poor economic performance or financial crises, on the public finances. As well as managing the regular liabilities which arise, the government also has to address its exposure to the risks associated with significant liabilities where the size, probability or timing is uncertain. Such liabilities can arise across the public sector and are, therefore, managed by a range of departments and other public sector bodies. Some are the responsibility of bodies that have been established specifically to control individual liabilities, such as the Nuclear Decommissioning Authority (NDA) or the NHS Litigation Authority (NHS LA).

2 These liabilities are accounted for differently depending on the probability of future payment. Provisions are those liabilities which will probably need to be paid at some point in the future, but where there is uncertainty around the timing or amount of that payment. Provisions are reported on the balance sheet. By comparison, contingent liabilities are possible obligations and are not recorded on the balance sheet because they may not result in any future expenditure being incurred. These are disclosed in notes to the financial statements for information only. However, as the recent financial crisis demonstrated, contingent liabilities can quickly increase and result in significant costs for the government.

3 In addition, to stimulate parts of the economy and address market failures, the government has made increasing use of guarantee schemes in recent years, which could generate additional liabilities in the future. Under the terms of these schemes, the government guarantees to reimburse a lender for any losses from non-payment of debt it has issued. For example, on the Help to Buy mortgage guarantee scheme, the government agrees to cover a proportion of losses that mortgage lenders may incur on high loan-to-value mortgages. These guarantees will initially be recorded at the value of any fees the government receives to compensate for the risk it has taken on, with the valuation of the guarantee subsequently adjusted if this income is judged to be insufficient to cover the liability. The government may also incur additional liabilities associated with its role in overseeing, in combination with the private sector, the continuing operation of the country's key infrastructure.

4 Provisions and contingent liabilities in the Whole of Government Accounts (WGA) represent a significant and increasing potential cash outflow for the government, which it has to manage alongside other spending commitments. Since the WGA was first published in 2009-10, provisions have increased by more than two-thirds to £175 billion in 2014-15. Similarly, contingent liabilities in 2014-15 were £76 billion and 85% higher than in 2009-10. Taken together (£251 billion), these are equivalent to around 17% of the government's assets and a fifth of government borrowing, as reflected in the WGA. These liabilities are also equivalent to around 14% of gross domestic product (GDP) and £9,000 per UK household.

Scope of our report

5 This report is one of a number that explore the major risks to public finances highlighted in the WGA balance sheet. These reports examine how these risks to the balance sheet have changed in recent years and considers how the government currently manages them. This report sets out the range of the government's provisions and contingent liabilities and discusses how it is addressing the risks these represent to the public finances. The Committee of Public Accounts has previously recommended that HM Treasury (the Treasury) makes better use of the WGA to inform decisions, particularly in areas that involve long term liabilities.[1,2]

6 Part One introduces the government's provisions and liabilities. Part Two outlines some of the measurement and reporting challenges. Part Three examines some of the long-term financial risks of these liabilities and how the government is managing them.

7 For this report, we have drawn mainly on published material, particularly the WGA and other public sector accounts as well as reports by the Office for Budget Responsibility (OBR) and our previous work. We have supplemented these data with information from interviews with government officials on strategic risk management as well as insight gained through our financial audit of public sector accounts.

1 HC Committee of Public Accounts, *Whole of Government Accounts 2011-12*, Thirty-second Report of Session 2013-14, HC 667, December 2013.

2 HC Committee of Public Accounts, *Whole of Government Accounts 2012-13*, Twenty-sixth Report of Session 2014-15, HC 678, January 2015.

Key findings

Nature of the challenge

8 **The government's long-term risk profile is increasing**. Provisions and contingent liabilities have been on an upwards trend in recent years. If this trend were to continue, provisions alone could reach around £300 billion by 2020. Around two-thirds of provisions – predominantly the nuclear decommissioning provision – are expected to settle after five years or more. While public sector bodies may be able to afford to pay provisions and known liabilities that crystallise in the short term, they could face greater pressures on their cash flow in the future (paragraphs 1.9, 1.14 and 3.3).

9 **The government's significant liabilities can be grouped into four broad categories with similar risk profiles and management challenges.** This shows both the concentration of the government's exposure to particular sectors and the diversity of its overall responsibilities:

a **Liabilities arising from the government's long-term energy policies:** the main liabilities relate to:

- the legacy costs of decommissioning nuclear energy sites; and
- carried back tax losses for the costs of decommissioning oil and gas installations under the Petroleum Revenue Tax regime.

These represent over half of total provisions for the government. The government plans to build new nuclear power stations to bring additional capacity to the national grid and help ensure continuity of electricity supply. Following the Energy Act 2008, the operators of new nuclear power stations are required to meet the costs of decommissioning through funded decommissioning plans. The government will need to manage the associated costs of decommissioning these sites in the future as well as its exposure under government guarantees issued to build and operate the sites. The main challenges for the government in resolving its nuclear legacy are understanding the cost drivers and reducing uncertainties around the nature, scale and timing of the liabilities – which extend far into the future – as far as possible. Organisations such as the Nuclear Decommissioning Authority (NDA) have been set up to manage specific liabilities (paragraphs 1.9a, 3.9 to 3.13).

b **Legal challenges to government:** a large and increasing element of the government's provisions and contingent liabilities relate to legal claims on the effectiveness of the delivery of government services or the administration of the tax system. The most significant are:

- clinical negligence claims (£28 billion provision and £14 billion contingent liability in 2014-15), which are managed by the NHS Litigation Authority (NHS LA) and arise from clinical incidents in the NHS; and
- tax disputes (£7.2 billion provision and £35.6 billion contingent liability in 2014-15), which are managed by HM Revenue & Customs (HMRC). These disputes reflect challenges by taxpayers of HMRC's interpretation of tax law, which are an inherent feature of tax administration (paragraphs 1.9b and 1.14).

c **Liabilities arising from the government's market interventions:** the government's increasing use of its credit rating to issue guarantees may generate cash in the short term through fees received and have a positive impact on fiscal measures such as public sector net debt. These guarantee schemes are designed to support infrastructure development, stimulate growth in particular sectors and address market failures. However, guarantees also expose the government to significant potential liabilities in the future if the expected losses on them increase above the level of income the government receives. In addition, there is a risk that the guarantees could crystallise at once in the event of a major economic shock such as another financial crisis, as they tie the public sector finances to the risk of borrowers defaulting on repayments on loans. The government has committed some £18 billion to its most significant schemes and has a maximum exposure of over £100 billion (paragraphs 1.20 and 3.16 to 3.18).

d **Government's role as an insurer of last resort:** analysis by the International Monetary Fund (IMF) has found that the most likely and costly sources of fiscal shocks relate to the financial sector and can trigger multiple liabilities to materialise at the same time. On average the impact of such liabilities crystallising is equivalent to around 9.7% of GDP. The size of the UK's banking sector relative to GDP and the scale of guarantees offered to financial institutions increases the government's exposure to a future financial crisis and any subsequent economic downturn. At the same time, an external shock or other event such as a natural disaster or act of terrorism could give rise to further liabilities given the government's commitment, which it shares with the private sector, to protect its people and key infrastructure from malicious attack and from natural hazards (paragraphs 3.19 to 3.22).

10 **Measuring some of these liabilities is inherently difficult and increases the uncertainty over the government's overall exposure to financial risk.** The uncertainty around the size, probability and timing of these liabilities makes measuring them particularly challenging. Some estimates are based on significant assumptions, complex modelling techniques and management judgement. The nuclear decommissioning provision is particularly difficult to estimate because of the long timescales involved, the technical difficulty of managing the nuclear legacy and the likelihood that future technological advances could have a major impact on costs and timescales. For example, the provision increased by just less than half between 2009-10 and 2014-15 as more information emerged about the likely future costs associated with the Sellafield site. The NDA recognises that the undiscounted costs could range between £95 billion and £218 billion (paragraphs 2.1 to 2.7).

11 **Changes to the discount rates used to value provisions in today's prices can have a significant impact on the values reported in the accounts and, therefore, the visibility and understanding of potential cash outflows in the future.** The introduction of a negative long-term discount rate from 2015-16 will increase the value of existing provisions that are reported in the accounts further. For example, the NDA's nuclear decommissioning liability is expected to double during 2015-16 due to the impact of negative long-term discount rates (paragraphs 1.11 to 1.13).

Management of the liabilities

12 **The government coordinates the management of these significant liabilities and associated risks through the Treasury's Fiscal Risk Group.** The government's approach focuses on the cash flows associated with the liabilities. In the longer term, the government needs to be able to fund future increases in provisions or crystallising contingent liabilities within the scope of the Chancellor's aim to operate a surplus by 2019-20. Provisions, contingent liabilities and guarantees are not visible in the government's preferred measures of fiscal performance until there is an impact on cash flows. The government manages short-term risks to affordability through its budgetary processes and settlements with individual departments, although these do not consider the longer-term costs beyond the current Parliament. As a result, the Treasury's Fiscal Risk Group plays a key role in coordinating its evaluation of the combined risks to the public finances presented by the government's portfolio of uncertain and long-term liabilities; and emerging financial risks (paragraphs 3.2 to 3.5 and 3.7).

13 **The government's initiative to develop its understanding of its contingent liabilities is a positive step towards managing its risks as a portfolio.** The Treasury has been developing its data on contingent liabilities, including the maximum exposure and the factors which could cause them to crystallise. These data will also help to quantify those liabilities that are currently considered unquantifiable for accounting purposes. It has begun modelling the probability and impact of potential liabilities under different economic scenarios. However, this work is at an early stage and further work is needed to develop and refine the data and the model. The expansion of the OBR's role will help to advance this process and will require the government to respond to its biennial report on fiscal risks, which will include an assessment of uncertain liabilities (paragraphs 3.23 and 3.24).

14 **The WGA has the potential to help the government to manage its uncertain liabilities but has some limitations.** The WGA is the only place where all provisions and liabilities across government are brought together. It can, therefore, be a useful tool to help the government manage the liabilities as a portfolio and assess the aggregate risks. Although the WGA meets the requirements of accounting standards, some of the disclosures are of limited use in assessing portfolio risk. For example:

- The WGA does not include important data such as the likelihood of provisions, contingent liabilities or guarantees crystallising or the expected value of the full suite of potential liabilities. The potential impact of guarantees is only visible if they give rise to specific provisions or contingent liabilities (paragraphs 1.4, 2.10 and 3.6).
- The notes to the accounts provide limited detail to explain how much of the year-on-year movement is due to changes such as the discount rate used to value provisions in today's prices; other assumptions on the timing of the liabilities or changes to the accounting boundary. Accounts of individual bodies such as the NDA and NHS LA do provide this information for specific provisions (paragraphs 2.8 and 2.9).

- Information on the timing of liabilities in the WGA and underpinning accounts is not detailed enough to provide visibility of the long-term profile of significant liabilities (paragraph 3.3).
- The lack of guidance on remote contingent liabilities limits transparency and increases the potential for inconsistency in reporting. Although the disclosure exceeds the accounting standard requirements, there is no guidance over when a liability should be classified as remote, which increases the potential for future reclassifications as contingent liabilities or provisions. Further, there are no guidelines over the value that should be disclosed. As a result, some public sector bodies report the value they would expect to pay based on the likelihood of it occurring while others report the maximum value (paragraph 2.12 and Figure 14).

Concluding remarks

15 Provisions, contingent liabilities and guarantees result from the long-term impacts of the government's energy policies; legal challenges to the government's operations and interpretation of tax law; and those risks it has actively taken on by intervening in markets. They represent a significant and rising potential future cash outflow and substantial risks to the government's overall financial position. The government needs to manage these exposures alongside its other spending commitments at a time when budgets are under pressure and it is committed to operating a budget surplus by 2019-20. The increasing use of government guarantees to support infrastructure development; stimulate growth in key sectors of the economy and address market failures; together with the government's commitment to oversee the continuing operation of the country's key infrastructure, increases the exposure of the public finances to future economic shocks.

16 The Treasury's Fiscal Risk Group monitors the combined risks to the public finances that are reflected in the government's portfolio of uncertain liabilities. The group is improving its underlying data and beginning to model the probability and impact of various scenarios on its financial risks. The government has also increased the role of the Office for Budget Responsibility in assessing the long-term impact of its financial risks, which will maintain focus in this area. This work will need to be balanced with appropriate management of the specific schemes and risks, supported by coordinated approaches to similar liabilities to drive down costs. The WGA balance sheet provides an insight into the financial implications of these risks and the impact of the government's decisions on the large, and often long-term, strategic issues it has to manage. Enhancing the WGA disclosures around the likelihood, longer-term profile, year-on-year movements and ranges in estimates would increase its usefulness as a management tool over these key financial risks and provide greater transparency. This will help the government to ensure it has flexibility in the public finances to absorb shocks when they arise.

Issues this report raises

17 This landscape report highlights a number of issues that merit further consideration and discussion:

The government's approach to managing liabilities

a **How the government can reduce the uncertainty in the costs of the liabilities it reports.** The government needs to understand the drivers of cost and reduce the uncertainties around the nature, scale and timing of the liabilities as far as possible. Using organisations such as the NDA to focus on and manage specific liabilities can concentrate knowledge and expertise. The government should consider how it shares this expertise across the wider public sector and particularly with departments, which are not necessarily expert in addressing the liabilities they are responsible for managing. A degree of uncertainty is inevitable when estimating far into the future. In this case disclosing the range of the liability as the NDA does is reasonable. The government should ensure that other organisations do the same, where there is significant potential variation in the value of the liabilities they are exposed to. In assessing aggregate financial risks the Treasury should focus on the upper end of the range of its liabilities to ensure it has sufficient capacity in the public finances to absorb shocks when they occur.

b **How the government can minimise the cost of legal challenges.** Where claims are legitimate, the government must have an established way of paying compensation promptly. As above, specialist organisations that manage claims may have an advantage in terms of capacity and economies of scale. There may be scope for departments to learn lessons from how they manage claims; and how information in claims can lead to pre-emptive action and reduce costs in the longer term.

c **How the government can manage its portfolio of guarantees.** The government must consider the full range of guarantees it has in issue and weigh up the associated aggregate risks and benefits before issuing further tranches. It must balance the risk of potential losses against the gains achieved through stimulating growth and addressing market failures, and scrutinise fee levels to make sure they reflect the risks adequately.

d **How the government can limit the impact of future economic shocks.** The government needs to advance the work begun by the Treasury to assess and model the probability and impact of liabilities crystallising to improve its visibility and understanding of combined financial risks. The IMF's recent analysis highlights the importance of a robust financial system and sustainable levels of debt that can withstand economic shocks in the future. As such, the government places significant reliance on regulators such as the Prudential Regulatory Authority; and the government's own ability to detect early warning signs of potential shocks and take early action to minimise the impact.

e **How the government can enhance disclosures in the WGA to improve its ability to inform decisions around its long-term liabilities, in particular:**

- providing a full assessment of the likelihood of liabilities crystallising, and a complete list of the maximum exposure on guarantees issued and amounts committed, would aid discussions of aggregate fiscal risk;
- describing the possible range of costs of provisions or contingent liabilities, which are subject to significant uncertainty, would increase transparency over the estimates;
- highlighting the long-term profiles of significant liabilities, in addition to nuclear decommissioning and clinical negligence, would increase understanding;
- identifying how much of the movement in liabilities is due to accounting factors, such as the discount rate used, and how much is due to new information on existing or newly identified liabilities, would provide clarity over the accuracy of the estimates disclosed; and
- setting out the range of wider performance information that supports the management of organisations that have a specific remit to manage uncertain liabilities as part of their core functions.

f **How the guidance on remote contingent liabilities can be developed.** The government could consider enhancing the Treasury's Financial Reporting Manual to make the definition of a remote contingent liability clearer. Providing expected and maximum values would increase transparency to both the government and to readers of the accounts.