National Audit Office

Report
by the Comptroller
and Auditor General

HM Treasury

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

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HM Treasury

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

Report by the Comptroller and Auditor General

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Comptroller and Auditor General
National Audit Office

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This report examines provisions, contingent liabilities and guarantees in the Whole of Government Accounts (WGA), the associated risks and benefits to the UK's public finances and how the government is managing them.

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Contents

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Foreword

Provisions and contingent liabilities represent a significant and increasing potential cash outflow for the government which it has to manage alongside other spending commitments. In 2014-15, the government estimated its provisions were £175 billion and contingent liabilities were £76 billion: equivalent to around £9,000 per UK household; around a sixth of total assets and a fifth of government borrowing, as reflected in the Whole of Government Accounts (WGA).

The government's long-term risk profile is increasing. Since the WGA was first published in 2009-10, provisions have increased by around two-thirds and contingent liabilities by 85%. If this growth were to continue, provisions could reach around £300 billion by 2020. At the same time, the government's increasing use of guarantees to support the development of infrastructure, stimulate growth in the economy and address market failures exposes it to potential significant liabilities in the future. These guarantees tie the repayment of loans, in the housing and infrastructure sectors, directly to the public finances and could crystallise at once in the event of a major shock to the economy, such as another financial crisis. Further, the government has a shared responsibility with the private sector to oversee the continuing operation of the country's key infrastructure.

This report is one of a number that explore some of the major risks to public finances highlighted in the WGA balance sheet and how the government currently manages them. Specifically, this report sets out the range of the government's provisions and contingent liabilities; and discusses how the government is addressing the long-term risks to the public finances.

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.

Part One

The government's provisions, contingent liabilities and guarantees

Definitions

1.1 As with all organisations, good management of the balance sheet can help support the government in delivering its objectives. It is also critical to maintaining the health of the public finances and their ability to withstand fiscal shocks such as poor economic performance or a downturn in global financial markets. However, managing the balance sheet and, therefore, exposure to such risks can be complicated where the size, probability and, or, timing of significant liabilities on and off the government balance sheet are uncertain.

1.2 Whereas with regular liabilities there is usually a clear obligation to pay an agreed amount in the future, provisions and contingent liabilities arise where the obligation to pay or the timing or amount of that payment are less certain. Guarantees or indemnities may also give rise to a provision or contingent liability, depending on the likelihood of them being called upon in the future. **Figure 1** provides more detailed definitions and examples.

1.3 There is considerable variability in the nature, size and duration of the government's obligations that can result in a provision or a contingent liability. Some may be a consequence of recurring activities such as providing healthcare whereas others arise from a specific policy decision to provide guarantees to help growth in particular sectors. Some obligations will be relatively short term while others present on ongoing long-term commitment. Provisions, contingent liabilities and guarantees can arise across the public sector and are therefore managed by a range of departments and other public sector bodies.

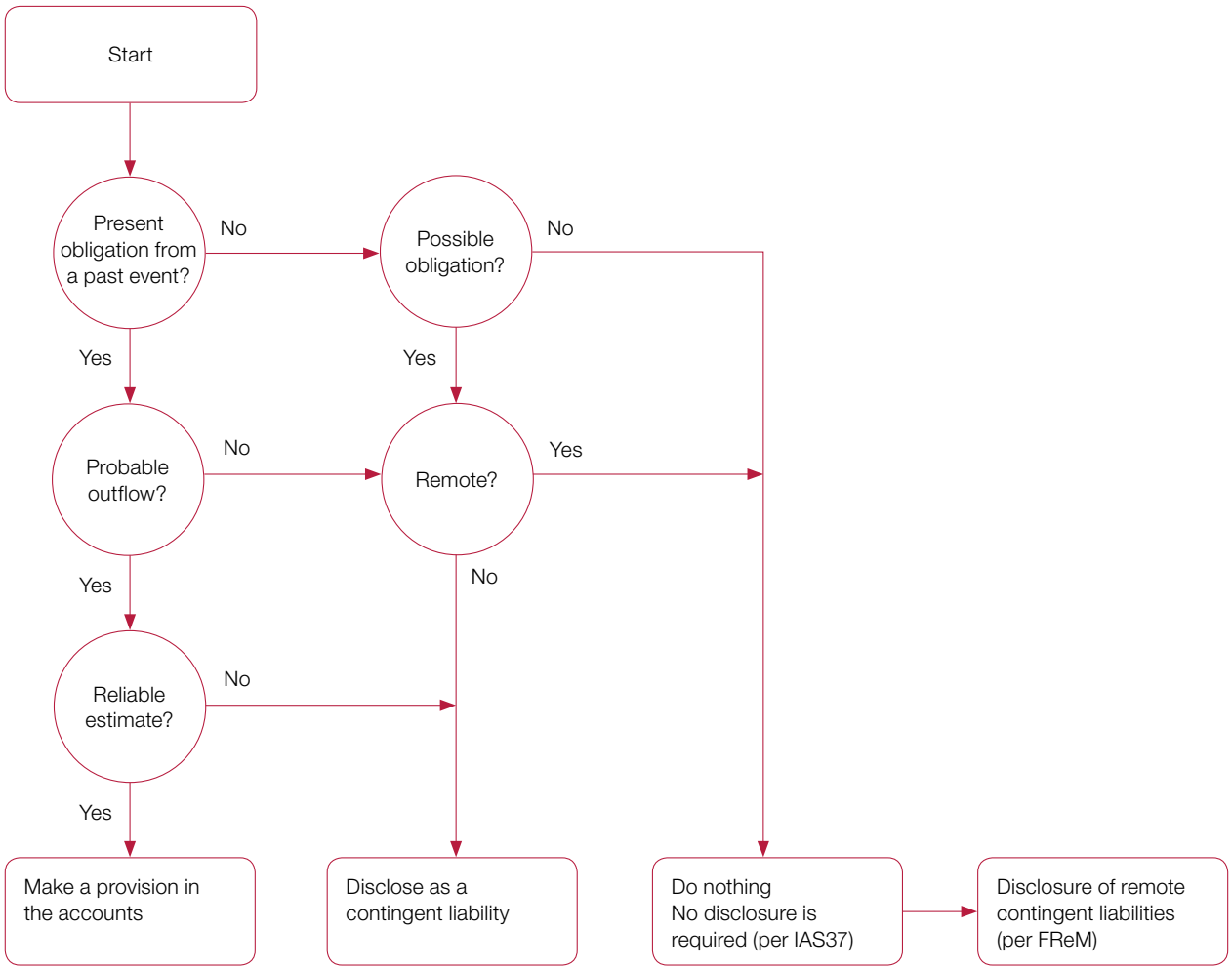
Figure 1
Definitions of provisions and contingent liabilities

Type	Definition			Examples
Liability	A present obligation arising from past events which is expected to result in an outflow of economic resources.			Trade payables. Government borrowing. Public sector pensions.
Provision	A liability of uncertain timing or amount where: ● there is a present obligation as a result of a past event; ● it is probable that an outflow of resources will be required; and ● a reliable estimate can be made of the amount.			Costs associated with decommissioning nuclear power stations. Clinical negligence claims.
Contingent liability	A **possible obligation** where the existence of the liability will be confirmed by a future event the entity cannot control.	**or**	A **present obligation** which is not recognised because: it is not probable that an outflow of resources will be required; or the amount cannot be measured with sufficient reliability.	A legal case that an organisation expects to win.
Remote contingent liability	A possible or present obligation where the likelihood of an outflow of resources is remote.			Capital on investments in financial institutions which might be called upon.
Guarantees	A contract that requires the issuer to make specified repayments to reimburse the holder for a loss it incurs because a specified debtor fails to make payments when due.			Under its Affordable Housing Guarantee Scheme, the Department for Communities and Local Government (DCLG) provides financial guarantees over housing providers' debt in order to stimulate the supply of affordable housing.

Source: IAS37, FRS102 and Whole of Government Accounts

1.4 Provisions, contingent liabilities and guarantees are all accounted for differently. **Figure 2** shows how the definition of the liability impacts on their visibility in the financial accounts. Because provisions are likely to need to be paid at some point in the future they are recognised as liabilities on the balance sheet and charged to expenditure. As the likelihood or amount of a future payment is more uncertain, contingent liabilities are not recognised on the balance sheet but disclosed in notes to the accounts for information. Unless they give rise to a provision or a regular liability, guarantees will only impact on the balance sheet through any fees received to compensate the government as guarantor for the risk it has taken on. A guarantee may be disclosed as a contingent liability.

Figure 2
Provisions and contingent liabilities decision tree



Source: IAS37 and FReM

1.5 HM Treasury's (the Treasury) Financial Reporting Manual (FReM), which is the guide to preparing public sector financial statements, extends the scope of the accounting standards to require public sector bodies to also disclose remote contingent liabilities to enhance accountability.

1.6 In this part we set out the government's significant provisions and liabilities and how they have changed since the Whole of Government Accounts (WGA) was first published in 2009-10. We draw on the WGA, as it provides the most comprehensive information on liabilities across the public sector. Part Two considers some of the challenges around measuring these liabilities. Part Three examines some of the long-term financial risks these liabilities present and how the government is managing them.

Overview of provisions and contingent liabilities in the WGA

1.7 The WGA was first published for the 2009-10 financial year and now consolidates the accounts of over 6,000 organisations across the public sector to produce an accounts-based picture of the UK public finances. It is the largest consolidation of public sector accounts in the world. The WGA represents a major step forward in accountability and transparency as it brings together liabilities across government. It can also provide useful trend analysis which shows movements in liabilities over time. Nonetheless, the Committee of Public Accounts has recommended previously that the Treasury makes better use of the WGA to inform decisions, particularly in areas that involve long-term liabilities.[3,4]

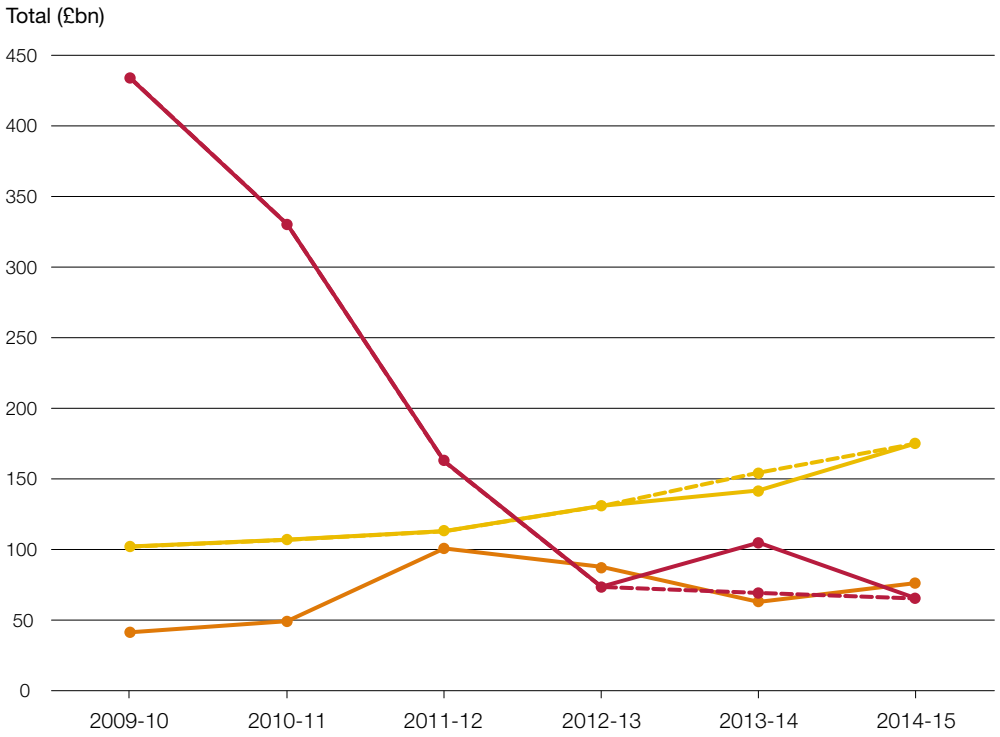
1.8 The most significant liabilities on the government balance sheet in 2014-15 were the public sector pension liability (£1,493 billion), which we consider in our companion report on pensions, and government borrowing (£1,175 billion), which we will report on later in 2016-17.[5] In addition to these commitments, government provisions and contingent liabilities are significant and represent a sizeable potential cash outflow to government. In 2014-15, provisions totalled £175 billion while contingent liabilities were £76 billion. Taken together these liabilities (£251 billion) are equivalent to around one-sixth of total assets and one-fifth of government borrowing, as reflected in the WGA, on the balance sheet. They also represent around 14% of GDP and are equivalent to around £9,000 per UK household. Both have increased in size since the WGA was first published in 2009-10 (**Figure 3** overleaf).

3 HC Committee of Public Accounts, *Whole of Government Accounts 2011-12*, Thirty-second Report of Session 2013-14, HC 667, December 2013.
4 HC Committee of Public Accounts, *Whole of Government Accounts 2012-13*, Twenty-sixth Report of Session 2014-15, HC 678, January 2015.
5 Comptroller and Auditor General, *HM Treasury, Evaluating the the government balance sheet: pensions*, HC 238, National Audit Office, June 2016.

Figure 3

Movement in provisions and contingent liabilities since 2009-10

Provisions, contingent liabilities and remote contingent liabilities between 2009-10 and 2014-15



	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Restated 2013-14						
Remote contingent liabilities	434.0	330.5	162.4	73.6	69.4	65.5
Provisions	102.2	107.0	113.0	131.0	154.6	175.2
Contingent liabilities	41.4	49.5	100.8	87.9	63.0	76.4
Original 2013-14						
Remote contingent liabilities	434.0	330.5	162.4	73.6	104.9	65.5
Provisions	102.2	107.0	113.0	131.0	141.8	175.2
Contingent liabilities	41.4	49.5	100.8	87.9	63.0	76.4

Note

1 Dotted lines show the restated values for 2013-14 as per the 2014-15 WGA report. These figures were restated to reflect changes to accounting boundaries in 2014-15.

Source: Whole of Government Accounts 2009-10 to 2014-15

Provisions

1.9 In 2014-15, the government's provisions were £74 billion, or two-thirds, higher than in 2009-10. The most significant provisions relate to (**Figure 4** overleaf):

a) The government's long-term energy policies

- **Nuclear decommissioning** (£83 billion) includes the cost of dealing with radioactive waste, nuclear fuels and redundant facilities, most of which is managed by the Nuclear Decommissioning Authority (NDA). The provision is subject to significant uncertainty due to the inherent complexity and the long timescales involved, which extend over 100 years into the future. The NDA estimates the undiscounted cost could range between £95 billion and £218 billion.[6] The largest element of the provision (£53.2 billion) is due to the costs of decommissioning Sellafield which is the UK's largest and most hazardous site. The provision has increased by just less than half since 2009-10 mainly due to changes in cost estimates as more information became available about the likely future costs of decommissioning and cleaning up Sellafield.

- **Decommissioning oil and gas fields in the North Sea** (£7.5 billion). Petroleum Revenue tax is payable on certain oil fields. The losses arising from decommissioning these fields may be carried back indefinitely. This provision reflects potential future reductions in tax revenue as oil companies decommission installations in these fields. HMRC calculates the estimate through to 2041 and it is subject to considerable uncertainty. It is calculated using oil and gas industry data and the timing and cost of decommissioning activity is uncertain.[7]

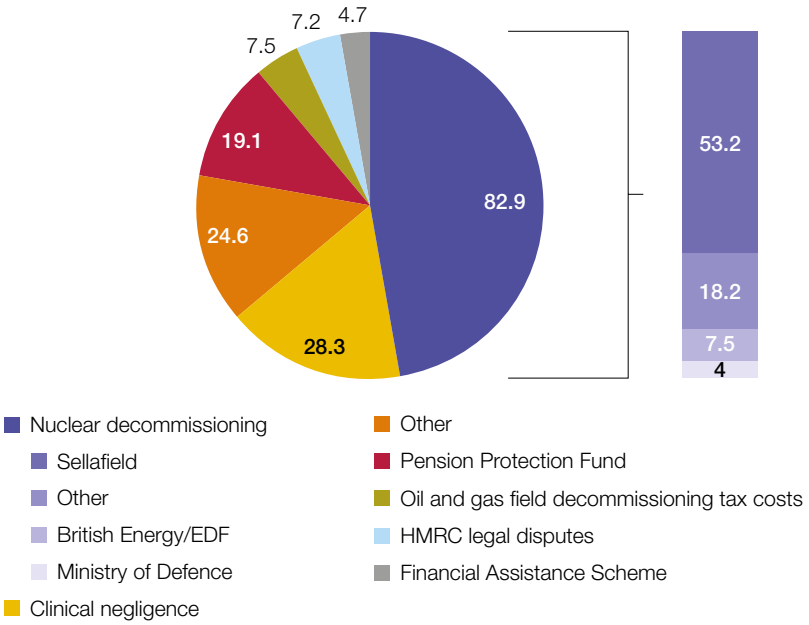
b) Legal challenges to government

- **Clinical negligence** claims against the NHS in England (£28 billion provision and £14 billion contingent liability 2014-15), which are managed by the NHS Litigation Authority (NHS LA).[8] The provision reflects the estimated future costs of clinical incidents, where it is more likely than not that a claim will be successful. It also includes provision for any lump sum and subsequent regular payments, which may need to be made over the life of a claimant following a court order. The NHS LA is responsible for managing the claims against the NHS on behalf of its members, which comprise NHS trusts and NHS foundation trusts. The growth in provision follows an upwards trend in the number of claims made from 6,652 in 2009-10 to 11,497 in 2014-15. NHS LA identify an increasing number of patients treated, incidents reported, and number of lower-value claims as just some of the factors which have contributed to the increases.[9]

6 Nuclear Decommissioning Authority, *Annual Report and Accounts 2014-15,* HC 197, June 2015.
7 HM Revenue and Customs, *Annual Report and Accounts 2014-15,* HC 18, July 2015.
8 The WGA includes a figure for clinical negligence provisions of £29 billion. The difference is due to other similar NHS provisions being brought together within the WGA, whereas the NHS LA accounts disclose the specific provisions.
9 NHS Litigation Authority, *Report and Accounts 2014-15,* HC 293, July 2015.

- **Legal claims against HMRC** (£7.2 billion provision and £35.6 billion contingent liability). HMRC is involved in a number of legal and other disputes relating to legal claims where taxpayers are disputing HMRC's interpretation of legislation through the courts and are seeking a reassessment of the tax payable. Clarifying the meaning of tax legislation through the courts is an inherent feature of tax administration. On the basis of legal and other specialist advice, the department may make a provision for the expected loss or disclose a contingent liability. In 2014-15, the provisions had increased by just less than half compared to 2009-10.

Figure 4
Provisions in 2014-15 (£bn)



Note

1 The WGA includes a figure for clinical negligence provisions of £29 billion. The difference is due to other similar NHS provisions being brought together within the WGA, whereas the NHS Litigation Authority accounts disclose the specific provisions.

Source: National Audit Office analysis of 2014-15 Whole of Government Accounts

1.10 Other significant provisions include:

- £19.1 billion for the Pension Protection Fund provision: the majority of which relates to liabilities to pay compensation to members; and
- £4.7 billion for the financial assistance scheme set up by the government to provide assistance for individuals for pension promises lost when their private sector employer went insolvent. Our companion report on pensions discusses the movement in the financial assistance scheme provision in more detail.[10]

Discount rates

1.11 The value of provisions reported in the accounts is affected significantly by the discount rate used. Provisions are discounted to reflect the cash flows that might occur in the future in today's prices so that the predicted costs, which might occur over different time periods, can be budgeted and managed alongside other spending commitments. On a legal claim provision, for example, the value may be discounted over just a few years whereas the nuclear decommissioning provision will be discounted over more than 100 years. Ordinarily each year the value of the provision increases as it becomes one year closer to being paid out, offset by the value of the expenditure incurred against the provision.

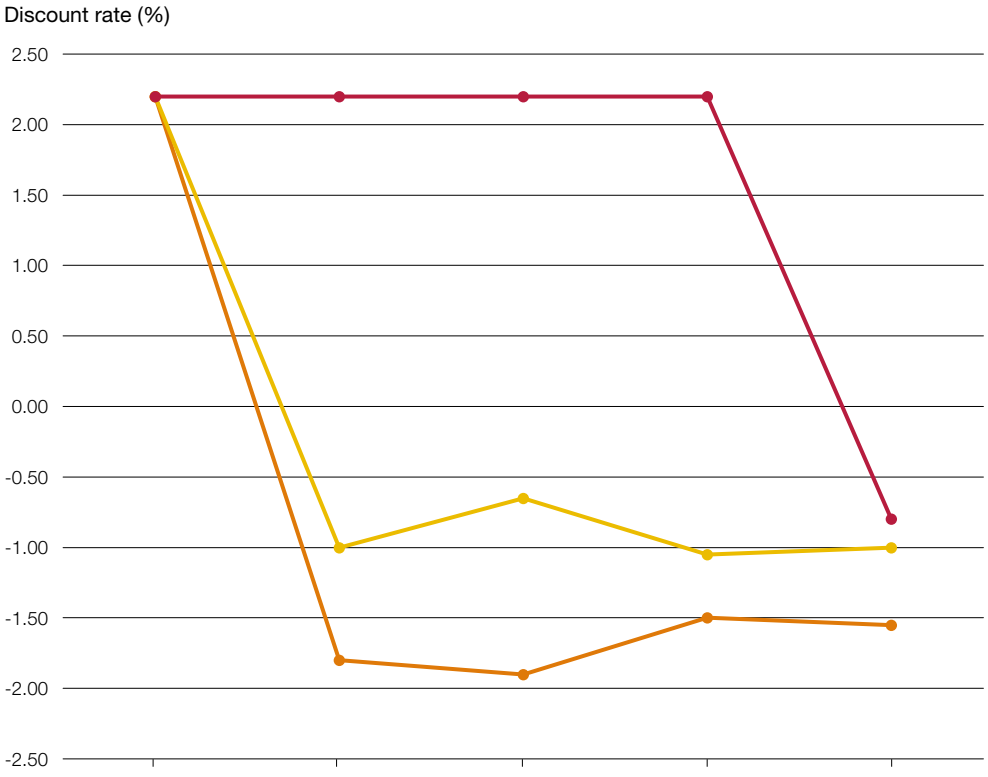
1.12 Since 2012-13, different discount rates have been used to value short-term (0-5 years), medium-term (5-10 years) and long-term cash flows (over 10 years).[11] The Treasury sets the short- and medium-term discount rates each year in line with the accounting standard for provisions and based on the yields on UK index-linked gilts. The long-term rate is also based on gilts but is reviewed before each spending review period. To reflect that the cost of government borrowing was lower than inflation, from 2012-13 the Treasury introduced negative discount rates for short- and medium-term cash flows. The introduction of a revised long-term rate was delayed until Spending Review 2015 and applies to long-term provisions from 2015-16. The impact of a negative rate is that the reported value of a provision in today's prices will be higher than estimates of future cash flows. This also has the effect that the estimates for later years, for which there is greater uncertainty over the underlying future costs, constitute a larger proportion of the discounted liability estimate, thereby increasing the overall level of uncertainty. **Figure 5** overleaf shows the changes in discount rates applied to provisions in recent years.

10 Comptroller and Auditor General, *HM Treasury, Evaluating the the government balance sheet: pensions*, HC 238, National Audit Office, June 2016.

11 For simplicity, this section covers discounting in real terms. In nominal, i.e. pre-inflation terms, discount rates are higher and are not currently negative.

Figure 5
Movement in discount rates

Discount rates for short-, medium- and long-term cash flows by financial year (%)



	Until 2011-12	2012-13	2013-14	2014-15	From 2015-16
Long term (>10 years)	2.20	2.20	2.20	2.20	-0.80
Medium term (5–10 years)	2.20	-1	-0.65	-1.05	-1
Short term (0–5 years)	2.20	-1.80	-1.90	-1.50	-1.55

Source: National Audit Office analysis of HM Treasury Public Expenditure System (PES) papers

1.13 The NDA estimates that the introduction of new discount rates since 2012 has increased the value of the nuclear decommissioning provision reported in the accounts by £3.7 billion. The extension of a negative discount rate to long-term provisions will more than double the provision in 2015-16. Part Two considers further the sensitivity of provision estimates to changes in underlying assumptions, including discount rates.

Contingent liabilities

1.14 The government's contingent liabilities have also been on an upwards trend. In 2014-15 they had increased by 85% to £76 billion from £41 billion in 2009-10 (**Figure 6** overleaf). During this period, the most significant increases related to:

- **tax dispute claims** (£35.6 billion) which in 2014-15 represented almost half of total contingent liabilities. This liability has increased by over 500% since 2009-10 due to a revision of the estimates for cases currently in litigation and because an adverse judgement in a particular case prompted a number of similar cases to be classified as contingent liabilities; and
- **clinical negligence liabilities** (£14 billion) not already provided for (paragraph 1.9b) and which relate to those cases where there is greater uncertainty over whether the Department of Health is liable and the amount of liability. There has been an 87% increase on 2009-10 figures.

1.15 As Figure 6 also shows, contingent liabilities peaked at around £100 billion in 2011-12. However, this peak was driven by two significant liabilities which were subsequently reclassified:

- A £20 billion liability for reductions in tax revenue due to oil and gas field decommissioning which was changed to a £3.8 billion provision in 2012-13 by HMRC.
- Within financial stability interventions, a £29.7 billion liability for the UK's callable capital to the European Investment Bank. This liability was reclassified as remote in 2013-14 as the likelihood of the Bank being unable to meet its obligations and asking member states to pay their share of the capital had decreased.

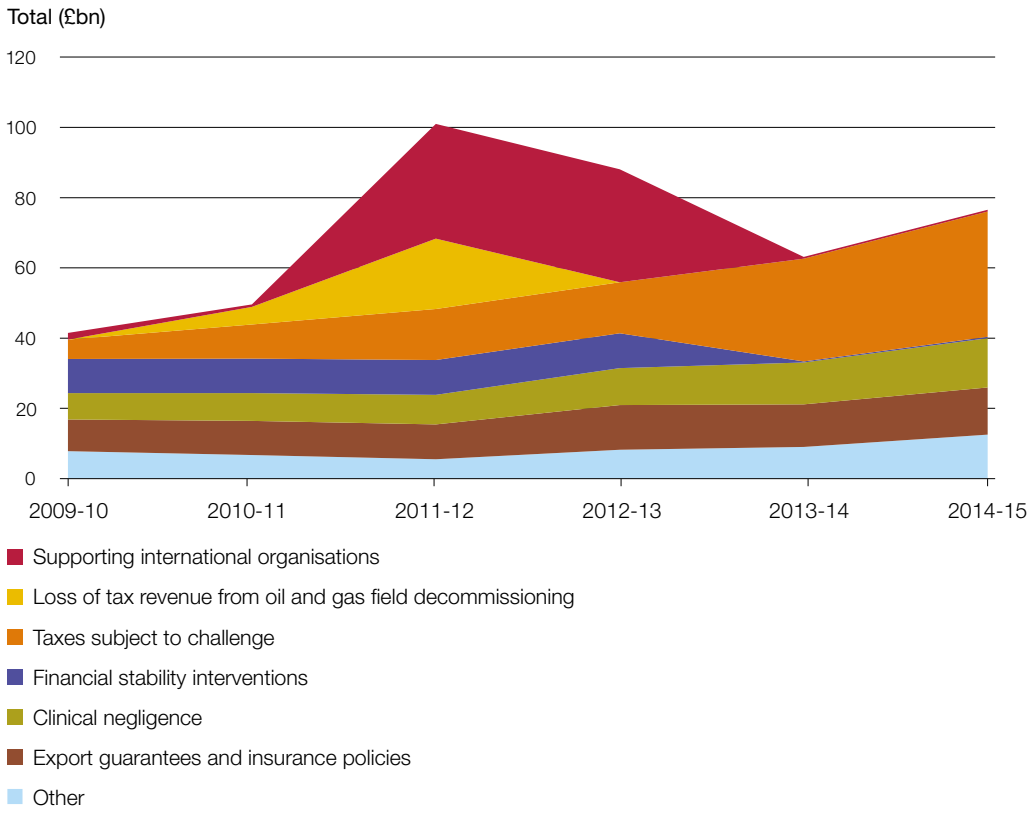
Remote contingent liabilities

1.16 In line with the requirements of the FReM (paragraph 1.5), the WGA also reports those contingent liabilities where the government considers the likelihood of the liability materialising to be remote.[12] Between 2009-10 and 2014-15 remote contingent liabilities decreased from £434 billion to £66 billion (**Figure 7** on page 25). Most of this movement was due to the closure of two financial support schemes which the government had set up in 2009 to maintain lending to the economy. The Credit Guarantee Scheme provided taxpayer guarantees for debt issued by UK banks while the Asset Protection Scheme protected assets in participating banks against the risk of default. The government did not have to pay out on either scheme before they closed in 2012.

12 As set out in Part Two, there is inconsistency in the disclosure of remote contingent liabilities, with some disclosed on the basis of the expected value of the liability and others on the maximum value. The figures in this section show the disclosed numbers, noting this variation in measurement.

Figure 6
Contingent liabilities

Contingent liabilities between 2009-10 and 2014-15 by category



Note

1 Financial stability interventions included the European Investment Bank callable capital liability between 2011-12 and 2013-14.

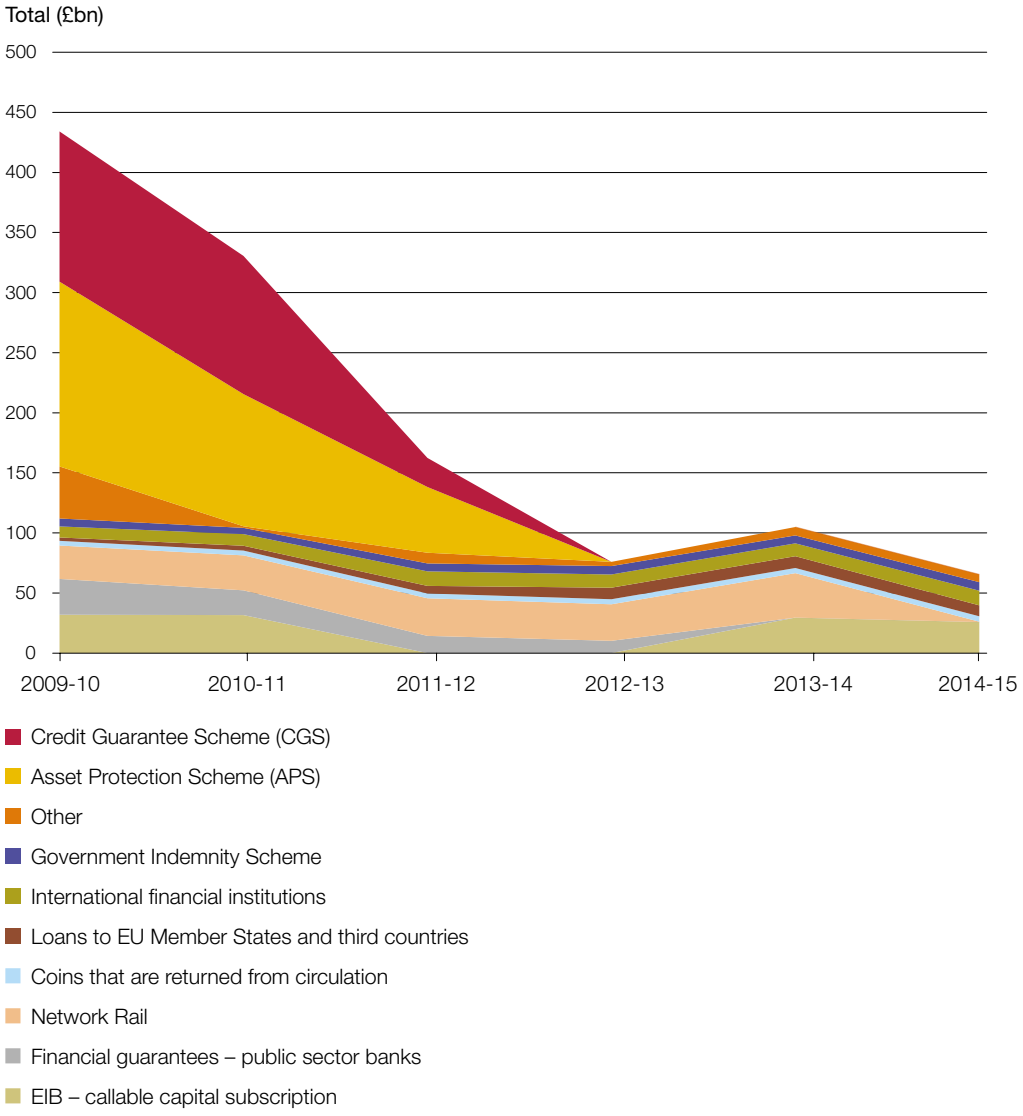
Source: Whole of Government Accounts 2009-10 to 2014-15

1.17 Excluding these financial support schemes, remote contingent liabilities have remained broadly static since 2009-10. They fell by £37 billion between 2013-14 and 2014-15 as a result of the reclassification of Network Rail as a public sector body and removal of related liabilities upon consolidation into the WGA. In 2014-15, the key components were:

- the UK's callable capital to the European Investment Bank (£25.8 billion) which since 2013-14 has been reclassified as a remote liability (paragraph 1.15);
- callable capital on investments in international financial institutions (£12.2 billion); and
- the maximum liability from current outstanding loans to European Union member states and third countries (£9.1 billion).

Figure 7
Remote contingent liabilities

Remote contingent liabilities between 2009-10 and 2014-15



Notes

1 Credit Guarantee Scheme and the Asset Protection Scheme closed in 2012.

2 Network Rail was consolidated into the WGA in 2014-15.

Source: Whole of Government Accounts 2009-10 to 2014-15

Unquantifiable contingent liabilities

1.18 The 2014-15 WGA also discloses 11 contingent liabilities in a note to the accounts which the government considers unquantifiable, either because they cannot be estimated with reasonable certainty or to quantify them could jeopardise the outcome of any legal proceeding. **Figure 8** provides further detail on the unquantifiable contingent liabilities in 2014-15.

Figure 8
Unquantifiable contingent liabilities in 2014-15

Contingent liability	Description
Legal claims	Legal claims, compensation claims and tribunal cases made against a range of WGA entities, for which no reliable estimate of liability could be made.
Commitments in relation to pension scheme deficits	Commitments made to provide funding for pension liabilities of some individual pension schemes if deficits need to be funded.
Contingent liabilities for reinsurance arising from acts of terrorism	Liability should the losses incurred by the reinsurer of industrial and commercial property damage and consequent business interruption exceed their available reserves.
Civil nuclear liabilities	Department for Business, Innovation & Skills has civil nuclear liabilities arising from both the United Kingdom Atomic Energy Authority and British Nuclear Fuels Limited and obligations under international nuclear agreements and treaties.
Financial Assistance Scheme	A commitment by the government to provide assistance and pay benefits to certain individuals who lost out on their pensions when their private sector employer went insolvent. It will not be possible for the Department for Work & Pensions to estimate the impact of pension scheme assets transferring to the government on the FAS pension liability until all the assets from those schemes are transferred.
Contingent liability in relation to the Channel Tunnel	The Department for Transport has a statutory liability that if, after the end of the Channel Tunnel concession, the tunnel will not be used, it will take steps to leave the land in a suitable condition.
Service Life Insurance	Ministry of Defence provides access to life insurance for service personnel through Service Life Insurance.

Remote contingent liabilities	Description
Regional development banks and funds	The Department for International Development is responsible for the maintenance of the value of subscriptions paid to the capital stock of regional development banks and funds.
National Health Service	Represents 22 indemnities the Department of Health has with various health bodies and private companies.
Nuclear matter	Indemnities have been given to UK Atomic Energy Authority by the Department for Business, Innovation & Skills to cover indemnities given to carriers against certain claims for damage caused by nuclear matter in the course of carriage.
Guarantee to protect British Telecom's pension liabilities	When BT was privatised in 1984, the government gave a guarantee (contained in the Telecommunications Act 1984) in respect of certain liabilities of the privatised company. This guarantee only applies if BT were ever to be wound up. This guarantee is currently reported as an unquantifiable contingent liability by the Department for Culture, Media & Sport but is thought to approximate in size to the BT pension liability which was reported on 30 June 2014 as £7 billion.

Source: Whole of Government Accounts 2014-15

1.19 Nonetheless, as shown by the example of Pool Re – a liability which is currently unquantified in the WGA – quantifying liabilities based on expected loss as well as maximum exposure can increase visibility of the associated future risks or benefits and could lead to more effective management (**Figure 9**).

Figure 9
Quantification of government's guarantee to Pool Re

About Pool Re

A mutual reinsurance company set up in 1993 to provide cover for large terrorism losses to insurance companies so they can provide the security that policyholders need.

Government guarantee

In return for a share of the insurance premium, the Government provides the insurance industry with a guarantee of financial support in the event of an extreme terrorist attack in which Pool Re's own funds are insufficient.

Why was the extent of the guarantee quantified?

The government asked the Government Actuary's Department (GAD) to review its arrangement with Pool Re because of changes to the risk since it was first set up and to ensure that the premium it receives reflects the risks government is taking on. To determine how much premium government should charge, GAD had to determine the value of the government guarantee.

What was the outcome?

The government renegotiated the risk premium with Pool Re which meant the premiums increased from 10% to 50% of the annual gross premium. The Treasury estimates that this revised arrangement will generate an additional £175 million for the Exchequer each year.

Source: Analysis by the Government Actuary's Department

Government guarantees

1.20 Recent policy announcements could generate additional provisions or contingent liabilities in the future. The last five years have seen a rapid expansion in the number of guarantee schemes set up by the government through its market interventions. The most significant schemes have a maximum value of £118 billion. These guarantees are designed to stimulate growth and address market failures. To date the total amount committed is £18 billion owing to the relative infancy of these schemes. The significant amount of head room in these schemes means that these discretionary financial commitments are likely to increase as take up of the schemes continues to rise (**Figure 10**). The most significant schemes are:

- **UK Guarantees scheme:** The scheme was introduced in October 2012 to help infrastructure projects, including energy, transport, and housing, raise finance from banks and the capital markets. The scheme has a maximum value of £40 billion. It is designed to avoid delays to investment in infrastructure projects due to adverse credit conditions.

- **UK Export Finance:** UK Export Finance (UKEF) is the UK's export credit agency. It helps UK exporters by providing insurance to exporters and guarantees to banks to share the risks of providing export finance. In addition, it can make loans to overseas buyers of goods and services from the UK. UKEF has a notional commitment limit of £50 billion.

- **Help to Buy mortgage guarantee:** As part of the Budget 2013 the Treasury committed to provide a guarantee up to £12 billion to mortgage lenders to cover a maximum of 14.25% of any losses incurred as a result of a default on a high loan-to-value ratio mortgage (deposits are between 5% and 20%).

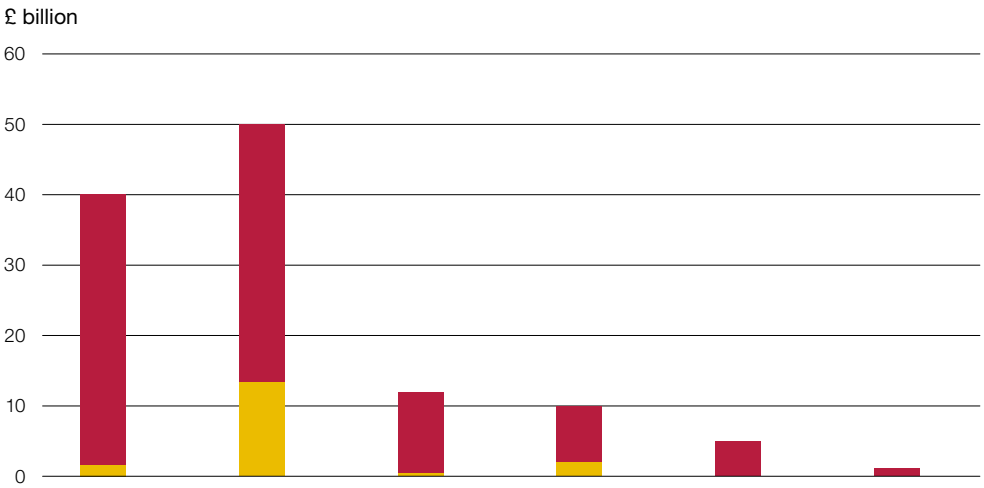
- **Housing guarantee scheme:** In 2012, the government announced two housing guarantee schemes to provide up to £10 billion of lending guarantees, so that investors can expand the private rented sector and build new affordable homes. The Affordable Housing Guarantee Scheme expired in March 2016, whereas the Private Rented Sector Guarantee Scheme runs until December 2016.

- **UKEF's Export Refinancing Facility:** In April 2014, the Refinancing Facility was announced enabling UK-based exporters to offer competitive long-term financing to overseas buyers who require loans in excess of £50 million to purchase UK capital goods and services. The repayment of bonds issued by the buyer to refinance an initial loan will be guaranteed. The scheme covers £5 billion and will run permanently.

- **Business Bank Wholesale Guarantees:** As part of the Autumn Statement 2013, the Business Bank Wholesale Guarantee Programme was announced to encourage additional lending to smaller businesses. The guarantees incentivise lending to small and medium-sized enterprises by reducing the capital lenders must hold. The scheme potentially covers up to £1.25 billion.

Figure 10
Government guarantees

Value of government guarantees issued and remaining by significant scheme



	UK Guarantee Scheme	UK Export Finance	Help To Buy: mortgage guarantee	Housing Guarantee Scheme	Export Refinancing Facility	Business Bank Wholesale Guarantees
Value of remaining available guarantees	38.3	36.6	11.4	7.8	5.0	1.1
Value of guarantees issued	1.7	13.4	0.6	2.2	0.0	0.1

Source: National Audit Office analysis of Annual Report and Accounts; Office for Budget Responsibility, *Fiscal Sustainability Report*

1.21 More recent government announcements suggest that the use of guarantee schemes will increase. The government is planning to invest £120 billion in infrastructure by 2020-21 and has extended the UK Guarantees scheme to 2021 to help infrastructure projects raise finance from banks and the capital markets. The Budget 2016 stated that the government was willing to consider using the UK Guarantees scheme on infrastructure to help maximise the economic recovery of oil and gas. It is also exploring options to use guarantees to encourage the private sector to invest in low-cost homeownership.[13]

The government's overarching responsibilities

1.22 The government's commitment to maintain the country's key infrastructure also creates additional potential liabilities. There are 13 sectors which have been identified as providing essential services upon which the UK relies. These sectors are: communications, emergency services, energy, financial services, food, government, health, transport, water, defence, civil nuclear, space and chemicals.[14]

1.23 The government shares responsibilities for managing these risks with the private sector and works closely with the relevant authorities to ensure that these sectors are managed appropriately and are secure. Obligations arising from disruption to these sectors would be assessed on a case by case basis and the costs would not necessarily fall to government.[15]

13 HM Treasury, Budget 2016, HC 901, March 2016.
14 Centre for the Protection of National Infrastructure, available at: www.cpni.gov.uk/about/cni/
15 Centre for the Protection of National Infrastructure, available at: www.cpni.gov.uk/about/Who-we-work-with/

Part Two

Measurement and reporting challenges

Estimating provisions and contingent liabilities

2.1 Provisions and contingent liabilities are inherently difficult to measure because the size, probability or timing of any future payment is uncertain. Compared to other liabilities where costs and payment dates are predetermined through contracts, valuing provisions and contingent liabilities relies on estimation, management judgement and, in some cases, complicated modelling techniques to generate a reliable measure as required by accounting standards. These values are also subject to change as new information emerges which can change the likelihood, amount or timing of future payments and could affect their classification as either a provision or contingent liability. These challenges mean that the government's understanding of its exposure to risk is always changing and its liabilities can expand rapidly in the event of significant economic disruption.

2.2 Accounting standards set clear requirements for disclosing provisions and contingent liabilities in financial statements and rules that a 'best estimate', taking into account risk and uncertainty, must be reported. To arrive at this estimate, however, the government may need to use statistical methods and, in doing so, needs to make sure that:

- the design and operation of its models are fit for purpose and transparently disclosed;
- the data input to the models is of sufficient quality; and
- the assumptions it has adopted are appropriate given the data available and the methodology used.

Analytical models

2.3 Nonetheless, until a HM Treasury (Treasury) review of government models in 2013 and subsequent publication of its Aqua Book in March 2015, there was no guidance for departments on how they should produce such analytical models or how to quality assure them.[16] The review found significant variation in the type and nature of quality assurance applied. The Treasury's Aqua Book sets out the key principles for quality assurance over models and provides advice to help support commissioning and delivery of analysis which is fit for purpose.

16 HM Treasury, *Review of quality assurance of government models: final report,* March 2013; HM Treasury, *The Aqua Book: guidance on producing quality analysis for government,* March 2015.

2.4 Some variation in the levels of sophistication in the models used to estimate provisions and contingent liabilities across government is to be expected, given the differing nature of liabilities, financial risks posed and differences in an organisation's remit. For example, modelling carried out by organisations such as the NHS Litigation Authority (NHS LA) and the Nuclear Decommissioning Authority (NDA), which manage specific liabilities, may be more in-depth than that of a department with numerous objectives where provisions or contingent liabilities are not significant in terms of its overall liabilities. For example, whereas the NHS LA model will include cases which have occurred but not yet been reported, some government departments may only model known legal cases.

Data quality and assumptions

2.5 In addition to the model used, the degree of uncertainty around an estimate will depend on the quality and completeness of the underlying data and the assumptions adopted. If the data are poor, incomplete or not fit for purpose, then the estimate could be subject to significant revisions. Having to estimate far into the future presents a particular challenge for departments and other bodies as the dataset is often incomplete and more assumptions are needed. For example, the nuclear decommissioning provision increased by £5.6 billion between 2013-14 and 2014-15 due to changes in the cost estimate as more information became available about future costs.

2.6 Estimating and managing long-term liabilities requires significant assumptions about future changes in factors such as inflation rates or technology, for example, which could have a major impact on the value reported. The nuclear decommissioning provision in particular covers a period up to 2137. The NDA reflects this uncertainty by reporting a range for the undiscounted nuclear decommissioning provision, of between £95 billion and £218 billion in 2014-15. Similarly some clinical negligence provisions can involve estimating not only the volume of claims but also the amount of payment required and the longevity of the claim. As a result, these estimated values can be highly sensitive to changes in assumptions. To illustrate, the nuclear decommissioning provision increases by £6.1 billion if the discount rate used to value the liability in today's prices decreases by 0.5%. This sensitivity will be significantly affected by the application of long-term negative discount rates in 2015-16. **Figure 11** provides further examples of the sensitivity of some provisions to changes in assumptions which are highlighted in the annual reports and accounts of the individual bodies.

Figure 11
Sensitivity of provisions to key assumptions

What happens if?	Effect on total value (£bn)		Modelling assumption
Nuclear Decommissioning			
The discount rate increases by 0.5%?	▼	7.9	The government's long-term cost of capital is estimated at 2.2% + RPI
The discount rate decreases by 0.5%?	▲	6.1	The government's long-term cost of capital is estimated at 2.2% + RPI
Clinical Negligence			
The discount rate increases by 0.1%?	▼	0.24	The government's short- and medium-term cost of capital is estimated at -1.5 % and 1.05% + RPI respectively
The discount rate decreases by 0.1%?	▲	0.25	The government's short- and medium-term cost of capital is estimated at -1.5 % and 1.05% + RPI respectively
The claims value inflation decreases by 2%?	▼	2.41	The model assumes 9%
The claims value inflation increases by 2%?	▲	2.96	The model assumes 9%
Claim numbers decrease by 10% after 2010-11?	▼	1.15	The model uses historic data and patterns in order to estimate expected claims
Claim numbers increase by 10% after 2010-11?	▲	1.15	The model uses historic data and patterns in order to estimate expected claims
Affordable Housing Guarantee Scheme			
The probability of default is downgraded by 5 notches?	▲	4.52	The model uses Standard & Poor's credit rating system
Loss given default is decreased to 5%?	▼	3.2	The model assumes a loss given default is set at 10%
Loss given default is increased to 20%?	▲	6.5	The model assumes a loss given default is set at 10%

Source: National Audit Office analysis of annual reports and accounts

2.7 In the last few years, we have not qualified the accounts of any department as a result of these estimates. However, our audit reports on the NDA and the NHS LA have highlighted the particular measurement challenges of estimating far into the future and the potential significant impact on the reported values if events differ to assumptions (**Figure 12**).

Limitations of disclosures in the WGA

2.8 The information provided in the WGA meets the requirements of both the accounting standards and the FReM. The WGA is the only place where all provisions and liabilities across government are brought together and it provides some useful narrative about the most significant items. Nonetheless, the WGA does not provide enough additional information to explain the reasons for year-on-year movements in the reported values, particularly the impact of discounting (paragraph 1.12). For example, the WGA attributes the increase in the contingent liability for tax litigation to a growth in the number of large cases but does not provide additional information which would explain why the number of cases has increased. Where supplementary data are disclosed in the accounts of individual bodies such as the NDA, it shows that year-on-year changes in the liabilities can be due to a combination of factors (**Figure 13**).

2.9 Furthermore, trend data can be difficult to interpret due to changes in the way liabilities are reported over time. As seen with contingent liabilities (paragraph 1.15), movements due to reclassifications as liabilities become more or less probable can be significant. Changes to accounting boundaries can also have a large impact as entities are included or excluded from the WGA. For example, contingent liabilities relating to the UK Asset Resolution Ltd (which manages the legacy assets of Northern Rock and Bradford & Bingley) were eliminated upon consolidation into the Treasury Group and therefore WGA for the first time in 2013-14: reducing contingent liabilities and remote contingent liabilities by £1.9 billion and £11.9 billion respectively.

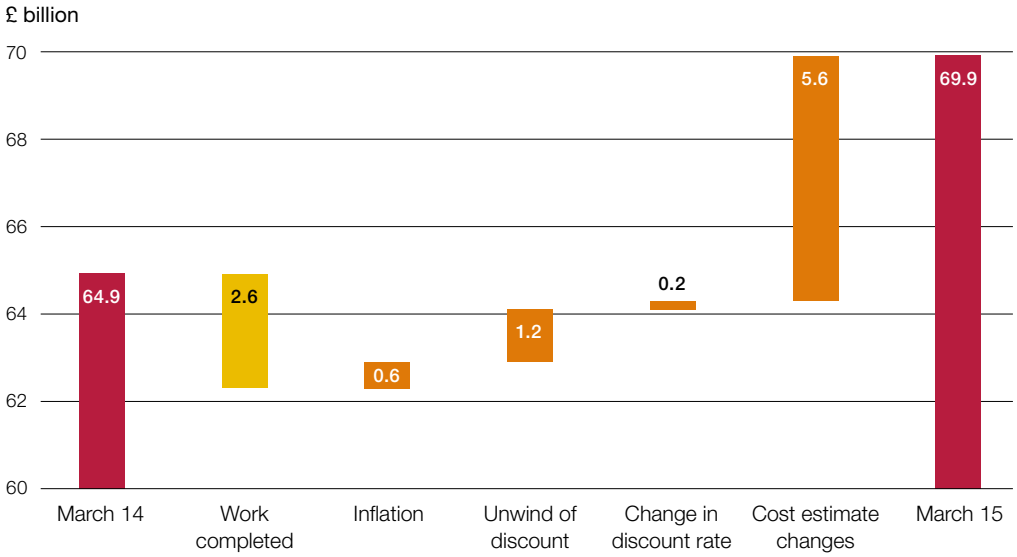
Figure 12
Emphasis of Matter paragraphs

	NDA	NHSLA
Issues highlighted	1 Uncertainty of timescale 2 Complexity of plants and materials being handled 3 Uncertainty about subsequent information and events	1 Long-term nature of liabilities 2 Number and nature of assumptions required 3 Uncertainty about subsequent information and events
Number of years National Audit Office have reported an Emphasis of Matter	The last 10 years	The last 3 years

Source: Nuclear Decommissioing Authority Annual Report and Accounts 2004-05 to 2014-15, NHS Litigation Authority Annual Accounts 2010-11 to 2014-15

Figure 13
Movement in NDA provision

Reasons for movement in NDA provision between end March 2014 and end March 2015



Note
1 The yellow column on the chart represents a reduction in the provision while orange represents an increase.

Source: Nuclear Decommissioning Authority Annual Report and Accounts 2014-15

Completeness

2.10 The WGA can be considered a true and fair reflection of the government's probable and possible future liabilities in accounting terms. The 2014-15 WGA shows that the government's total risk exposure from provisions and contingent liabilities, including remote liabilities, is around £317 billion. However, the WGA does not include all provisions and liabilities across government and therefore the aggregate exposure for the government could be higher. Excluded liabilities fall into 3 categories:

- **Unquantifiable contingent liabilities** (paragraph 1.18) are liabilities that cannot be measured with sufficient reliability, or where quantifying them in the accounts could prejudice an ongoing legal case.
- **Unknown events** are liabilities that are unanticipated by the government. The government will always be exposed to events that are unforeseen and history shows that such events can have significant financial consequences. The most recent example was the 2008 financial crisis which, at its peak, resulted in the government paying out £133 billion in the form of loans to insolvent banks and nationalising Lloyds Banking Group (Lloyds) and the Royal Bank of Scotland (RBS).
- **Unavoidable obligations** are potential additional liabilities for the government such as maintaining the proper functioning of key infrastructure in the event of a significant crisis or other major event; or the government's unavoidable expenditure commitments offset by secure revenue streams backed by legislation.

Consistency in reporting

2.11 Definitions provided in accounting standards help to inform management decisions about when to recognise a liability as either a provision or a contingent liability. However, both the assessment of probability and the ability to make a reliable estimate of the obligation are open to interpretation. Such management judgements are reviewed as part of our financial audits.

2.12 Nonetheless, because accounting standards do not require remote contingent liabilities to be disclosed there is limited guidance on them and the potential for inconsistency in reporting between public sector bodies is greater. The lack of definition of remote contingent liabilities in the FReM allows for more flexibility around when they are recognised and the value reported. For example, the standard requires provisions or contingent liabilities reported to reflect the expected value but neither it nor the FReM specify what value should be reported for remote contingent liabilities. As a result, while some bodies report the expected value of remote contingent liabilities, others instead report maximum values (**Figure 14**).

Figure 14
Comparison of expected and maximum values

Definition of measure	Public sector example
Maximum value	
The largest possible amount that could become payable or lost regardless of the likelihood or the risks attached.	If a loan of £10 million is granted, the maximum loss will be £10 million, regardless of the borrower's credit rating or repayment history. The remote quantifiable liability in WGA 2014-15 in relation to loans to EU member states and third countries discloses the maximum liability of £9.1 billion.
Expected value	
The amount that most likely will have to be paid or could be lost considering not only the maximum possible exposure, but also the likelihood of its occurrence. This method considers the risk that is attached to a commitment.	If a guarantee issued has a maximum exposure of £10 million and a borrower's credit rating and repayment history shows there is a 30% chance that it will be called on, then the expected value disclosed would be £3 million. In line with IAS37, the provision for Affordable Housing in the Department for Communities and Local Government's 2014-15 accounts is calculated using expected value. The expected value is £3.98 million. The maximum value would be £668 million, the amount of guarantees drawn at 31 March 2015.

Source: National Audit Office analysis of IAS37, Financial Reporting Manual, Whole of Government Accounts and the Department for Communities and Local Government's 2014-15 accounts

Part Three

Managing the long-term financial risks

Affordability

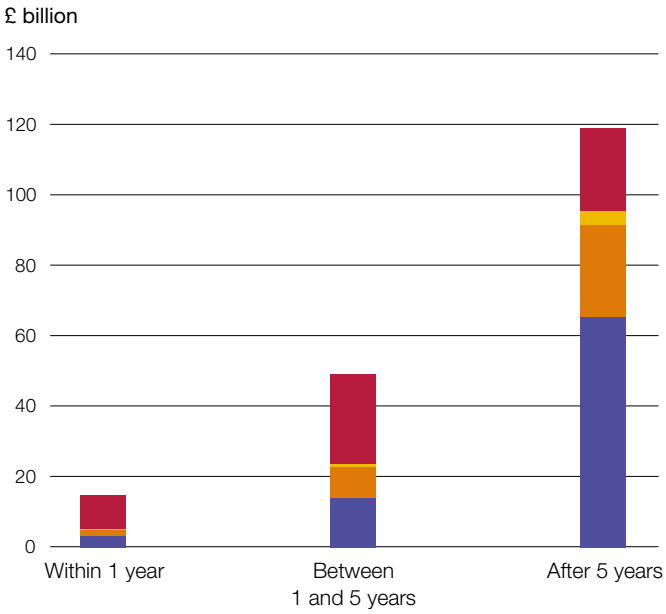
3.1 The Whole of Government Accounts (WGA) shows that the government's total risk exposure from provisions and contingent liabilities, including remote liabilities, at the end of March 2015 is around £317 billion. The most significant long-term financial risk is that significant liabilities, with a large combined value, crystallise at the same time. If the value of provisions that must be paid is greater than initially estimated, expenditure will increase. As government expenditure currently exceeds its income, if contingent liabilities crystallise this would increase the deficit further, assuming government income remains at similar levels. This shows the importance of HM Treasury's (the Treasury) overall role in balancing the public finances as set out in the fiscal framework.

3.2 To fund an increase in the deficit the government would therefore need to increase government borrowing (£1,175 billion in 2014-15, per the WGA), increase revenue from taxes or make significant cuts in other areas of expenditure already under budgetary pressure. Currently, the government's ability to increase its borrowing means short-term affordability is not an immediate concern but the future costs need to be managed within the Chancellor's aim of operating a budget surplus by 2019-20. Neither provisions nor contingent liabilities are included in the government's preferred measure of fiscal performance, public sector net debt (PSND), until the liability crystallises and there is an impact on cash flow, meaning that the Treasury's role in monitoring uncertain liabilities is crucial.

3.3 Continued growth in provisions and contingent liabilities could put cash flows under pressure in the long term if the liabilities were to crystallise. If this growth continues, provisions could reach around £300 billion in five years' time. Even without these increases, the public sector may feel greater pressure on their cash budgets in the longer term because of the uncertainty in the value of provisions (**Figure 15** overleaf). The information on the timing of liabilities in the WGA and, in the main, the underpinning accounts, is not sufficiently complete nor detailed enough to provide visibility on the long-term profile of these liabilities.

Figure 15
Expected timing of provision cash flows

Timescales over which provisions as at 31 March 2015 are expected to fall due



	Within 1 year	Between 1 and 5 years	After 5 years
Other	9.56	25.52	23.3
Financial assistance scheme	0.14	0.68	3.9
Clinical negligence	1.9	8.8	26.2
Nuclear decommissioning	3.3	14.2	65.4

Source: 2014-15 Whole of Government Accounts, Department for Work & Pensions Annual Report and Accounts 2014-15

3.4 The government manages short-term risks to affordability of provisions through its routine budgetary processes. Provisions are reviewed during spending reviews and subsequent settlements of departmental budgets. However, this budgeting framework does not consider the longer-term costs beyond the current Parliament. Contingent liabilities are not part of this process because they do not have an immediate budgetary impact.

3.5 Provisions and contingent liabilities are managed by the departments in which they arise and are overseen through monitoring by the Treasury's departmental spending teams. Departments must also notify Parliament of those liabilities which are outside the course of normal business and exceed £300,000. However, what is considered 'normal business' is open to interpretation. This means the government could enter into significant commitments that increase the risks to affordability without prior Parliamentary approval.

Managing aggregate risks to public finances

3.6 Although more forward-looking information on timescales and probabilities of liabilities crystallising would aid visibility of the key risks to affordability, the WGA provides a whole-system view of government activity and an insight into the impact of government policies on the future cost of past activities, which are not available from other data.[17] As highlighted by the Committee of Public Accounts, the WGA has the potential to inform the government's long-term decision-making and management of cumulative strategic risks to public finances.

3.7 Currently, the Treasury monitors its portfolio of uncertain liabilities through its Fiscal Risk Group. This group is responsible for assessing the existing portfolio of provisions and contingent liabilities and its impact on the government's overall risk profile along with the government's top spending and tax risks.[18] It also scrutinises new and emerging risks in more detail.

3.8 The government needs to ensure it balances this monitoring with an appropriately detailed approach to the risks it is exposed to with similar characteristics across the range of its liabilities. Although significant uncertain liabilities are managed by a number of organisations across the public sector and the approach to addressing them will depend on the nature of the liability, they can be grouped into four broad categories with similar profiles and challenges:

- liabilities arising from the government's long-term energy policies;
- legal challenges to the government;
- liabilities arising from market interventions; and
- government's role as an insurer of last resort.

The government's long-term energy policies

3.9 As highlighted in paragraph 1.9a, the government has significant provisions related to the impact of its energy policies. Of these the most significant relate to the costs of nuclear decommissioning and carried back losses for the costs of decommissioning oil and gas installations under the Petroleum Revenue Tax regime. Together these represent over half of total provisions.

3.10 As well as the considerable cost of decommissioning sites such as Sellafield, the nuclear decommissioning provision also includes £7.5 billion for the government's commitment to meet EDF Energy's (formerly British Energy) liabilities for managing nuclear waste and decommissioning its power stations. This will crystallise in the event that they exceed the assets in the Nuclear Liabilities Fund Limited that was set up to meet these costs.

17 The Office for Budget Responsibility's *Fiscal sustainability report* provides an assessment of the long-term financial effects of the government's proposed policies.
18 The Fiscal Risk Group (FRG) is a sub group of the Treasury's Executive Management Board.

3.11 The government intends to build new nuclear power stations as part of its wider plan to bring additional capacity to the national grid to help ensure continuity of electricity supply. These new sites will help to secure the UK's long-term energy supply, but will also generate decommissioning costs that will need to be managed. Following the Energy Act 2008, the operators of new nuclear power stations are required to meet the costs of decommissioning through funded decommissioning plans. In addition, the government is also issuing guarantees that are attached to its contracts to build and operate the new sites.

3.12 In addition to the nuclear decommissioning liabilities and the £7.5 billion provision for reductions in tax revenue arising from decommissioning certain oil and gas fields in the North Sea, the government also has potential future liabilities, related to:

- the £918 million obligation of the Coal Authority associated with its ownership of abandoned coal mines, including remediating mine water pollution; and
- unquantifiable civil nuclear liabilities arising from both the United Kingdom Atomic Energy Authority and British Nuclear Fuels Limited as well as obligations under the various international nuclear agreements and treaties.

3.13 The long-term impact of these issues means that the government may be unable to directly influence some of the associated costs or when they might fall due. Unlike some other liabilities, the risk that these liabilities could all crystallise at once is limited. Instead, the government's main challenge is to understand the drivers of their valuation; and reduce the uncertainties around the nature, scale and timing of the liabilities as far as possible. Where costs are controllable these need to be managed as efficiently as possible, including making best use of available technology. Using organisations such as the NDA to focus on and manage specific liabilities can enhance the government's management of the associated financial risks.

Legal challenges

3.14 A large and increasing element of the government's provisions and liabilities relates to legal claims as a result of the government's activities. The most significant being clinical negligence claims (paragraphs 1.9b and 1.14) and the impact of challenges to the interpretation of tax legislation (paragraph 1.14). However, legal claims may occur across a wide range of the government's operations and the WGA also includes lower-value claims under 'other provisions'. For example, the Department for Energy & Climate Change includes a provision for compensation claims relating to personal injuries suffered by former British Coal mineworkers.

3.15 Some legal claims may be an inevitable part of the government's operations. Where claims are legitimate, the government can minimise legal and administrative costs by having an established way of paying compensation promptly. In doing so, there can be benefits to having a specialist organisation such as the NHS Litigation Authority (NHS LA) to manage claims. The Government Legal Department can also provide legal advice to departments. Where there are problems in the government's processes which have given rise to the claim, these factors need to be identified and corrected to reduce the likelihood and scale of incidents occurring in the future.

Market interventions

3.16 Since the financial crisis, the government has increasingly used its credit rating to issue guarantees to schemes which are designed to support key sectors of the UK economy and address market failures. These schemes increase the risks to the government because a significant shock to the economy could affect borrowers' ability to meet their payments, and generating a number of liabilities for the government simultaneously. At the height of the crisis, government guarantees peaked at £1.029 trillion. More recently the government has extended the £40 billion UK Guarantees Scheme to March 2021 to continue to help infrastructure projects raise finance from banks and the capital markets. The most significant guarantee schemes represent over £100 billion in potential government liabilities should the guarantees all be taken up (paragraph 1.20, Figure 10).

3.17 In the longer term, these commitments could impact substantially on affordability if called upon. However, in the short term they may have benefits over other ways of delivering the government's objectives in key sectors such as housing, infrastructure, exports and business lending. In particular, the upside is that these guarantees do not require any initial outlay but generate income for the government in the form of fees paid to compensate it for the risk taken on. These commitments do not impact on the government's measure of debt unless the guarantee is called upon.

3.18 However, guarantees can be issued by a range of public sector bodies and currently the government does not manage these schemes as a portfolio or bring together the associated risks. The government has control over whether to enter into, extend or continue its guarantee schemes and should, in line with best practice from the International Monetary Fund (IMF), undertake cost–benefit analysis when deciding whether or not to use guarantees as a way of delivering its policy objectives.[19] In doing so, it must consider the whole range of guarantees in issue and balance the risks of potential losses for the taxpayer against the gains which might be achieved. The fee level which the government sets should reflect the associated risks and in aggregate be sufficient to cover any amounts that the government might have to pay out. Changes in the risk associated with guarantees may increase the expected losses above the level of income that the government receives.

19 International Monetary Fund, *Analyzing and Managing Fiscal Risks – Best Practices*, May 2016, available at: www.imf.org/external/pp/longres.aspx?id=5042

Insurer of last resort

3.19 In addition to the potential liabilities the government knows about, it is exposed to other unanticipated events which could increase its liabilities and result in payment of existing ones. The likelihood of multiple liabilities becoming due at the same time is increased when a number could be triggered by a single event. For example, because many of the government's guarantees are designed to stimulate growth or address market failures, a significant shock to the economy such as a further UK, European or International recession could result in a number of these liabilities crystallising at once.

3.20 The government has committed to working with infrastructure owners and operators to mitigate risks to the country's key infrastructure (paragraph 1.22), particularly if an event occurs which could impact on the delivery of essential services. The government has identified acts of terrorism, cyber attacks, major accidents and natural hazards as the most serious risks in this area.[20]

3.21 Analysis by the IMF of fiscal risk and over 200 instances where contingent liabilities had crystallised shows that many occur at the same time following a major crisis.[21] It also found that the most frequently occurring sources of fiscal shocks are those associated with the financial sector, state-owned enterprises or natural disasters. The costliest shocks are those relating to the financial sector, due to their impact on wider economic performance. The average impact of contingent liabilities relating to the financial sector crystallising was equivalent to 9.7% of GDP across the 80 countries they analysed.

3.22 The IMF's analysis shows that those countries with stronger institutions and low growth volatility tend to suffer less from contingent liabilities crystallising, indicating that much can be done at an institutional level to prevent costly shocks to the public finances. The size of the UK's financial sector relative to GDP and the scale of guarantees offered to financial institutions increases the government's exposure to a future financial crisis and subsequent economic downturn. Regulators of financial services, the Bank of England, Prudential Regulatory Authority and the Financial Conduct Authority are primarily responsible for maintaining the stability of the financial system. Nonetheless, the government must ensure public finances and levels of debt are sustainable and resilient enough to absorb such potential shocks in the future.

20 Cabinet Office, *Keeping the Country Running: Natural Hazards and Infrastructure*, October 2011, available at: www.gov.uk/government/uploads/system/uploads/attachment_data/file/61342/natural-hazards-infrastructure.pdf

21 International Monetary Fund working paper on *The Fiscal Costs of Contingent Liabilities: A New Dataset*, 2016. Available at: www.imf.org/external/pubs/ft/wp/2016/wp1614.pdf

3.23 As part of wider work to improve knowledge and modelling of fiscal risks, the Treasury has been developing its understanding of the government's existing stock of contingent liabilities. The first stage of its work has involved developing a database of all contingent liabilities including information on maximum exposure, length of exposure and factors which could cause them to crystallise. Using this database, the Treasury is building a model to simulate the probability and impact of liabilities crystallising under various domestic economic scenarios. However, as the Treasury recognises, it does not hold comprehensive data on all contingent liabilities and it needs to do further work to refine the data and the model. It also plans to extend the scenario analysis to consider international factors and focus on combined risk.

3.24 In future, following a review of its role in 2015, the Office for Budget Responsibility (OBR) will report specifically on fiscal risks including contingent liabilities at least every two years and the government will have to respond formally to its report.[22,23] The review recommended that the OBR produces a regular report on fiscal risks, in line with the recommendations of the IMF's Fiscal Transparency Code which sets the international standard for disclosing information about public finances. Among other things, the Code highlights best practice as identifying, quantifying and disclosing all government guarantees and their probability of being called; total obligations under public–private partnership contracts; explicit government support to the financial sector; and all support between the government and public corporations. The specific details about what the OBR's report will cover are in development and a consultation period is expected. In June 2016, the IMF published a further paper on best practices in analysing and managing fiscal risks that contains further recommendations.[24]

22 The Charter for Budget Responsibility sets out the government's approach to managing fiscal policy and, in accordance with the Budget Responsibility and National Audit Act 2011, provides guidance to the OBR on its role and duties within the fiscal policy framework.

23 HM Treasury, *Charter for Budget Responsibility: autumn 2015 update*, October 2015.

24 International Monetary Fund, *Analyzing and Managing Fiscal Risks – Best Practices*, May 2016, available at: www.imf.org/external/pp/longres.aspx?id=5042

Appendix One

Our approach and evidence base

1 This study examined provisions, contingent liabilities and guarantees in the Whole of Government Accounts (WGA), the associated risks and benefits to the UK's public finances and how the government is managing them. We reviewed:

- how significant provisions and contingent liabilities are valued and reported;
- the current size, profile and nature of these assets and how these are changing;
- the long-term financial risks associated with these liabilities;
- the government's approach to managing these liabilities; and
- how the WGA could help the government's understanding of and management of these liabilities.

2 We reviewed the information relating to liabilities in all WGAs published since its inception in 2009-10 and some individual financial accounts that are consolidated into the WGA. Much of our assurance comes from the significant body of financial audits that we carry out across central government. We reviewed fiscal sustainability reports published by the Office for Budget Responsibility to gain insight into the long-term implications of the government's commitments. We reviewed other relevant information in the public domain including publications by the Office for National Statistics, HM Treasury and the International Monetary Fund.

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