National Audit Office

Report
by the Comptroller
and Auditor General

HM Treasury

Exiting the EU: The financial settlement

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Summary

1 The UK invoked Article 50 of the Lisbon Treaty on 29 March 2017; as a result, it is scheduled to leave the European Union (EU) on 29 March 2019. The government is negotiating the terms of withdrawal with the EU, including the transition to a new relationship. The first phase of the negotiations included discussion on what the UK will pay towards the net commitments and liabilities that the EU entered into when the UK was a member state: the financial settlement. HM Treasury has led the government's negotiations of the settlement.

2 In September 2017, the Prime Minister set out the UK government's position that the UK would honour commitments it made while it was a member of the EU. She said that she did not want other member states to fear that they will need to pay more or receive less over the remainder of the current budget plan, which runs until December 2020, as a result of the UK's decision to leave the EU.

3 In December 2017, the government and the European Commission (the Commission) published a joint report on progress during the first phase of the negotiations. This set out the principles underpinning the financial settlement. Under these principles, the UK will continue to contribute to the EU's annual budgets until December 2020 as if it had remained a member state. The UK will also bear a share of the EU's outstanding net commitments and liabilities at that date. It will not be required to pay these off until they fall due. In some cases, such as pension liabilities, these payments could extend for decades into the future.

4 The joint report is clear that "nothing is agreed until everything is agreed". The commitments detailed in the report will not be enforceable until the UK and EU agree the final withdrawal agreement at the end of all negotiations over the UK's withdrawal. In March 2018, the UK government and the Commission published a draft of the withdrawal agreement. This translated the commitments in the joint report into a draft legal agreement, as well as providing further details on how the UK's settlement payments will be calculated and the timing of payments.

5 In January 2018, the Chancellor of the Exchequer wrote to the Treasury Select Committee setting out a 'reasonable central estimate' of the settlement's value of between £35 billion and £39 billion (**Figure 1**). HM Treasury made its estimate to provide some understanding in monetary terms of what the government had agreed with the Commission, given that the joint report itself does not contain monetary values. Its estimate was derived as far as possible from publicly available data.

Figure 1

Components of the estimated EU exit financial settlement

HM Treasury's 'reasonable central estimate' is that the financial settlement will cost between £35 billion and £39 billion

Settlement component	The UK's contributions to the EU's annual budget, 2019 and 2020	The UK's share of the EU's outstanding budgetary commitments at the end of 2020	The UK's share of EU assets and liabilities incurred before the end of 2020	Total
Value in HM Treasury's estimate (€bn)	17–18	21–23	2–4	40–45
Exchange rate applied	An exchange rate on the date the joint report was published of €1.13: £1			
Estimate (£bn)	15–16	19–20	2–4	35–39
Would the UK have paid/received this if it remained a member state?	Yes. Existing payment mechanism will be used for 2019 and 2020 contributions.	Yes. Payment would have been made through the UK's budgetary contributions to the next EU budget after 2020. The draft withdrawal agreement (March 2018) sets out arrangements for calculating and making these payments in absence of the normal budget contribution mechanisms that cover member states.		
Estimated timing of payments upon UK exit from the EU	2019–2020	2021–2026	2021–2064	

Notes

1 The sterling estimates of the settlement do not sum to £35 billion to £39 billion due to rounding.

2 Timing of payments shows HM Treasury's estimate of when the majority of payments will have been made. For outstanding commitments and liabilities there may be a small amount of payments after 2026 and 2064 respectively.

Source: National Audit Office analysis of HM Treasury data

Our report

6 This report forms part of our programme of work to examine how the government is overseeing and implementing the UK's exit from the EU. It is our first report on the financial settlement. It aims to support Parliamentary scrutiny of HM Treasury's estimate of the financial settlement. In particular, it responds to the Chair of the Treasury Select Committee's request in December 2017 that the Comptroller and Auditor General "examine the reasonableness of this payment, including the assumptions and methodologies used". We have not assessed the value for money of the settlement itself, nor how effectively HM Treasury negotiated the principles of the settlement. In this report we:

- explain the settlement within the context of the wider negotiations on the UK's withdrawal from the EU, and how much the government expects the settlement to cost (Part One);
- assess HM Treasury's estimate of the settlement, clarifying how it has been calculated and describing the uncertainties that could cause its value to be different from that estimate (Part Two); and
- set out those aspects of the financial settlement that are still to be finalised and those areas where the value of the settlement could be affected by future EU decisions (Part Three).

Key findings

The financial settlement

7 HM Treasury took legal advice on the UK's rights and obligations on leaving the EU. It has been strongly represented to us by HM Treasury that it would be damaging to the national interest to publish the legal advice in any detail and we accept that this is so at present. The advice is primarily concerned with the UK's rights and obligations in the absence of a withdrawal agreement. The advice indicates that a withdrawal agreement will fall to be interpreted on its own terms. This is important because the proposed financial settlement is part of the wider draft withdrawal agreement which covers a number of other issues, including the transition period, in contrast to the "no agreement" scenario on which the legal advice was based (paragraphs 1.4 to 1.7).

8 **The UK will continue to contribute to the EU's annual budgets in 2019 and 2020 as if it had remained a member state, but the other components of the settlement will require new, untested methods of calculation.** If it had remained a member state, the UK's share of outstanding net commitments and liabilities would have been incorporated into its annual contributions in future budget periods. When it is no longer a member state, the UK will be outside the established budget-setting process. This means new mechanisms will need to be developed to calculate its share of payments. In March 2018, the UK government and the Commission published a draft of the withdrawal agreement, which gives some detail on how these mechanisms will operate (paragraphs 1.9 and 3.2 to 3.3).

9 **HM Treasury estimates that the UK will make around 60% of settlement payments by the end of 2021 but may be making some payments for several decades.** Under the draft withdrawal agreement, the UK will not pay liabilities before they fall due unless it requests to pay them off earlier. HM Treasury expects to pay off the UK's share of outstanding budgetary commitments as at the end of 2020 over the following six years. Some liabilities are scheduled to extend much further into the future: the UK's liability to contribute to the EU pension liability may last until at least 2064 (paragraph 1.20; Figure 10).

HM Treasury's estimate of the settlement's value

10 **At the time of the joint report, the results of HM Treasury's internal modelling were consistent with its £35 billion to £39 billion public estimate of the settlement's value.** While negotiating the principles of the financial settlement, HM Treasury modelled the cost of each component using a combination of audited EU accounts, Commission forecasts and its own projections of the future based on historical trends. These models indicated that the settlement would cost the UK a net figure (payments minus receipts) of £37.5 billion (paragraphs 1.12 to 1.19; Figures 5, 6, 7, 8 and 9).

11 **The actual value of the settlement is uncertain because it depends on future events.** The joint report and the draft withdrawal agreement did not state the cost of the financial settlement. The precise value of most components of the settlement is subject to future events and therefore uncertain. For some payments, such as the UK's budget contributions, this uncertainty is partly reduced by the EU budget system, which limits how much the EU can spend and request from member states. But it has been necessary for HM Treasury to base its estimate on a number of assumptions. For example:

- The UK's economic performance relative to the EU's member states will determine the UK's budget contributions in 2019 and 2020, which in turn form part of the calculation of its share of liabilities after 2020. For its published estimate, HM Treasury used the Commission's forecast of the UK's share of budget contributions in 2018 to estimate its share in 2019 and 2020. But actual UK budget contributions in 2019 and 2020 may be different from this. HM Treasury's own forecast of the UK's share of contributions is slightly lower than the Commission's.
- The settlement estimate deducts revenues that HM Treasury expects UK public and private sector organisations to receive from the EU. HM Treasury has assumed that these receipts will continue at the same rate as in recent years. However, it is quite possible that the UK's revenues from the EU may change in the context of the UK withdrawal. For example, fewer UK businesses may apply for EU funding due to real or perceived uncertainties regarding eligibility, reducing the flow of EU funding into the UK, although HM Treasury considers this risk to be mitigated because allocations have already been agreed for the largest programmes.
- HM Treasury based the UK's share of future pension payments in its published estimate on the pension liability in the EU's balance sheet as at 31 December 2016. As with any valuation of a pension liability, this is based on a number of assumptions about future events, such as mortality rates and salary increases, as well as valuation estimates such as the discount rate used, which is historically low. Payments will be different from HM Treasury's estimate if events differ from these assumptions.
- The settlement value is exposed to changes in the exchange rate because settlement payments will be drawn up and paid in euros. For its estimate, HM Treasury used an exchange rate from the day the joint report was published to convert its estimate from euros to pounds. This may not match the exchange rate when payments are made (paragraphs 2.2 to 2.20; Figures 11 and 12).

12 **Relatively small changes to some of these assumptions would cause HM Treasury's central estimate to be outside its £35 billion to £39 billion range.** HM Treasury estimated the settlement's value in order to provide some understanding of the likely monetary impact of what was in the joint report. This meant it did not incorporate some of the main uncertainties of which it was aware, such as whether the financing share will be higher or lower than the estimate based on the Commission's forecasts, so as not to introduce new assumptions about future events. Consequently, HM Treasury's public estimate states a narrow range of possible outcomes given the degree of uncertainty over the settlement's value (paragraphs 2.21 to 2.23; Figure 13).

13 **The UK could pay up to £3 billion more in budget contributions after its withdrawal than HM Treasury estimates to offset earlier payments being lower.** The EU can request up to five months' of annual contributions in the first three months of any calendar year to pay for programmes that spend more in the earlier months of the year. HM Treasury assumes that the UK will have paid five months' worth of its annual contribution to the EU's 2019 budget before the UK's expected withdrawal date of 29 March 2019, although this is uncertain. If the EU requests three months' worth of contributions prior to withdrawal this would increase payments after withdrawal by around £3 billion. However, the EU has only requested fewer than four months' worth of contributions in the first quarter on two occasions in the past eight years (paragraphs 2.13 and 2.14).

14 **HM Treasury's public estimate of the settlement will not be the same as the payments and receipts recorded in government accounts.** HM Treasury's estimate is of the net cost of the settlement to the UK as a whole. The net cost of the settlement recorded in government accounts is likely to be higher than HM Treasury's public estimate. This is because HM Treasury's estimate includes receipts that will go directly to the private sector, which we estimate to be worth €8.1 billion (£7.2 billion). These will not come into the government's accounts (paragraph 1.16).

15 **HM Treasury's settlement estimate does not include the UK's commitments to the European Development Fund (EDF), which it expects will cost £2.9 billion after the UK leaves the EU.** The joint report states that the UK will honour its commitments to the current EDF, the EU's main instrument for providing development aid, which runs until the end of 2020. HM Treasury did not include the EDF payments in its settlement estimate because the EDF is not established under the EU treaties and sits outside the EU budget (paragraph 2.24).

16 **There are some other potential liabilities that the UK is exposed to that are not reflected in HM Treasury's published estimate as it has assessed they are unlikely to result in payments**. These include a share of the EU's contingent liabilities on the date of the UK's withdrawal or those that relate to events that take place before 31 December 2020 for legal cases. HM Treasury forecasts that the UK's share of total outstanding contingent liabilities will be €14 billion as at the date of withdrawal. Additionally, the UK will provide a guarantee worth €35.7 billion to the European Investment Bank. This guarantee could be called upon alongside contributions from remaining member states. HM Treasury and the Commission deem these liabilities to be remote, meaning they do not expect them to cost anything more than the amounts factored into the settlement estimate as provisions. But the UK will be required to pay its share towards settling any contingent liabilities that do materialise. There may also be costs to the UK if it wishes to retain access to specific funds and agencies beyond those funded during the EU's current budget period (paragraphs 2.25 to 2.30).

Future development of the settlement

17 **HM Treasury is considering the structures and processes it requires to ensure that payments to the EU are accurate.** The draft withdrawal agreement sets out how the UK's payments will be calculated after 2020. These payments, which the Commission will calculate, will not be subject to the established mechanisms for ensuring accuracy that apply to member states. Some payments, such as calculating liabilities as they fall due, could require new data systems to keep track of the UK's liability. Similarly, calculating the UK's share of the pension liability will require separate and complex calculations. HM Treasury needs to implement new processes for ensuring accuracy that are aligned with the complexity and subjectivity of the calculations, as well as ensuring it has access to the information used for those calculations. The draft withdrawal agreement includes provision for the UK to appoint auditors during the implementation of the financial settlement (paragraphs 3.2 to 3.3 and 3.7 to 3.9).

18 **The government can opt to pay off the pension liability early, but this will require careful consideration of the expected costs and benefits.** The draft withdrawal agreement provides an option for the UK to pay off its share of the pension liability early in a lump sum payment. This would be based on an actuarial valuation of the liability made in accordance with International Public Sector Accounting Standards. When deciding whether to opt for a lump sum payment, HM Treasury will need to have sufficient information on the likely costs and benefits of a one-off payment compared with ongoing payments. Any actuarial valuation includes significant assumptions, particularly the discount rate used. Changes to assumptions could adversely impact the buy-out value making this option unattractive to the government (paragraphs 3.4 to 3.6).

19 **The terms of the financial settlement mean that the Commission could skew future decisions so that they have a negative impact on the UK.** For example, the draft withdrawal agreement establishes 31 December 2020 as a key date for determining the UK's share of assets and liabilities. As with the principle of setting any cut-off date, there is a risk that this date will drive decisions on when to recognise a liability or dispose of an asset, which could affect the value of the settlement. This is mitigated to some extent by the arrangements governing EU budgets, which includes limits on what member states must contribute, and the terms of the withdrawal agreement. In particular, this states that the UK will only pay for liabilities that actually fall due and that it will not be affected by changes to general EU spending limits after its withdrawal (paragraphs 3.10 to 3.13).

Conclusion

20 We have reviewed the reasonableness of HM Treasury's published estimate of the cost of the financial settlement. This estimate, a range of £35 billion to £39 billion, was intended to provide some monetary understanding of what had been agreed in the joint report. HM Treasury based the estimate on published data and made assumptions around which costs related to the financial settlement, such as excluding payments for the European Development Fund. Given these parameters, we found the estimate to be reasonable. However, there are some qualifications that it is important to understand.

21 Future events will determine significant elements of the settlement's cost including the value of the EU's future liabilities and commitments, and what share of those the UK will pay. It is understandable therefore that the range of uncertainties were not fully reflected in HM Treasury's estimate. This means relatively small changes in events could push the cost of the settlement outside HM Treasury's published range.

22 This report seeks to increase understanding of HM Treasury's estimate and the uncertainties within it. We will do more work as the ongoing negotiations continue and details of the settlement are finalised. We have identified below a number of issues HM Treasury will need to consider to ensure that the interests of the UK taxpayer are protected as it implements the settlement.

Issues to consider

23 Our review has highlighted a number of issues that HM Treasury needs to consider when managing the risks attached to the settlement, including:

a How it will update Parliament with revised estimates of the settlement value as new information becomes available.

b The options it has available to mitigate the risks of exchange rate movements. For example, agreement could be reached to offset payments to the EU with receipts that fall in a similar period.

c The information it needs to collect and maintain to make informed decisions on future payment arrangements. For example, it needs to be able to appraise the value of different payment schedules for long-term liabilities, particularly pensions.

d The structures and processes it requires for confirming the accuracy of future payments. This will need to be determined by the extent to which calculations are complex and potentially subjective. The greater the complexity and subjectivity, the more robust structures and processes need to be to mitigate the risk that the UK pays out more than is due.

e How the arrangements for the UK to appoint auditors for the implementation of the financial settlement will be applied in practice.

f The access it will require to specific information that the EU uses to calculate different elements of the settlement.

g How disputes will be resolved should the government challenge the value of payments that the EU calculates.