National Audit Office

Report
by the Comptroller
and Auditor General

HM Treasury

Exiting the EU: The financial settlement – follow-up report

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HM Treasury

Exiting the EU: The financial settlement – follow-up report

Report by the Comptroller and Auditor General

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Comptroller and Auditor General
National Audit Office

28 November 2018

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The government has agreed with the European Union (EU) the terms of the UK's withdrawal from the EU, which includes a financial settlement. This report aims to provide greater clarity on the financial settlement in the wider context of the government's agreement with the EU.

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Contents

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Purpose of this report

1 The United Kingdom (UK) is scheduled to leave the European Union (EU) on 29 March 2019. The government has agreed with the EU the terms of the UK's withdrawal, including how it will establish a new relationship with the EU during an implementation period. As part of this agreement, the UK will continue to participate in the EU's annual budgets in 2019 and 2020 as if it had remained a member state. It will also pay a share of the outstanding commitments and net liabilities that the EU entered into by the end of 2020. This is known as the 'financial settlement'.

2 In April 2018, we reported on HM Treasury's central estimate of the cost of the financial settlement.[1] We concluded that HM Treasury's estimate that the financial settlement would cost between £35 billion and £39 billion was reasonable given the parameters it had set for the estimate. We noted that future events would determine significant elements of the financial settlement's cost and that relatively small changes in events could push the cost of the financial settlement outside HM Treasury's published range. Since April, additional information has become available that means forecasts of the value of some of the financial settlement's components can be updated.

3 The government's agreement with the EU has two major components: a Withdrawal Agreement, setting out the arrangements for the UK's withdrawal from the EU; and a political declaration on the terms of the future relationship between the UK and the EU. The Withdrawal Agreement includes the terms of the financial settlement. The House of Commons is due to have a 'meaningful vote' on the government's agreement with the EU.

1 Comptroller and Auditor General, *Exiting the EU: The financial settlement*, Session 2017-19, HC 948, National Audit Office, April 2018.

4 This report aims to provide greater clarity on the financial settlement's place in the wider context of the government's agreement with the EU in advance of the 'meaningful vote':

- Part One sets out the different components of the agreement. It highlights that, if the UK and EU ratify the Withdrawal Agreement, the UK will be committed to making financial settlement payments before the future relationship has been finalised. This part also explains that any costs that might be associated with the UK's future relationship with the EU are outside the scope of the financial settlement, as are the costs that the government is incurring in preparing for withdrawal.
- Part Two sets out the latest estimates of the financial settlement's value based on new information that has become available since our first report. Although latest government estimates of the financial settlement's value remain within the range of HM Treasury's initial central estimate of £35 billion to £39 billion, uncertainties remain about what its actual value will be.

5 This report sets out the series of events the government expects to take place in taking forward its agreement with the EU. It does not cover the implications of the UK leaving the EU without an agreement, or of there being modifications to the existing agreement, such as extending the implementation period.

Part One

The financial settlement in the wider EU Exit agreement

1.1 The UK is scheduled to leave the European Union (EU) on 29 March 2019. The government has agreed with the EU the arrangements for the UK's withdrawal, including the terms of the financial settlement. This part of the report sets out the components of the agreement and the role of the financial settlement.

Components of the EU Exit agreement

1.2 The government's agreement with the EU has two main components: a Withdrawal Agreement and a political declaration setting out the framework for the future relationship (the political declaration) between the UK and EU (**Figure 1**). The House of Commons is due to have a 'meaningful vote' on the government's agreement with the EU.

The Withdrawal Agreement

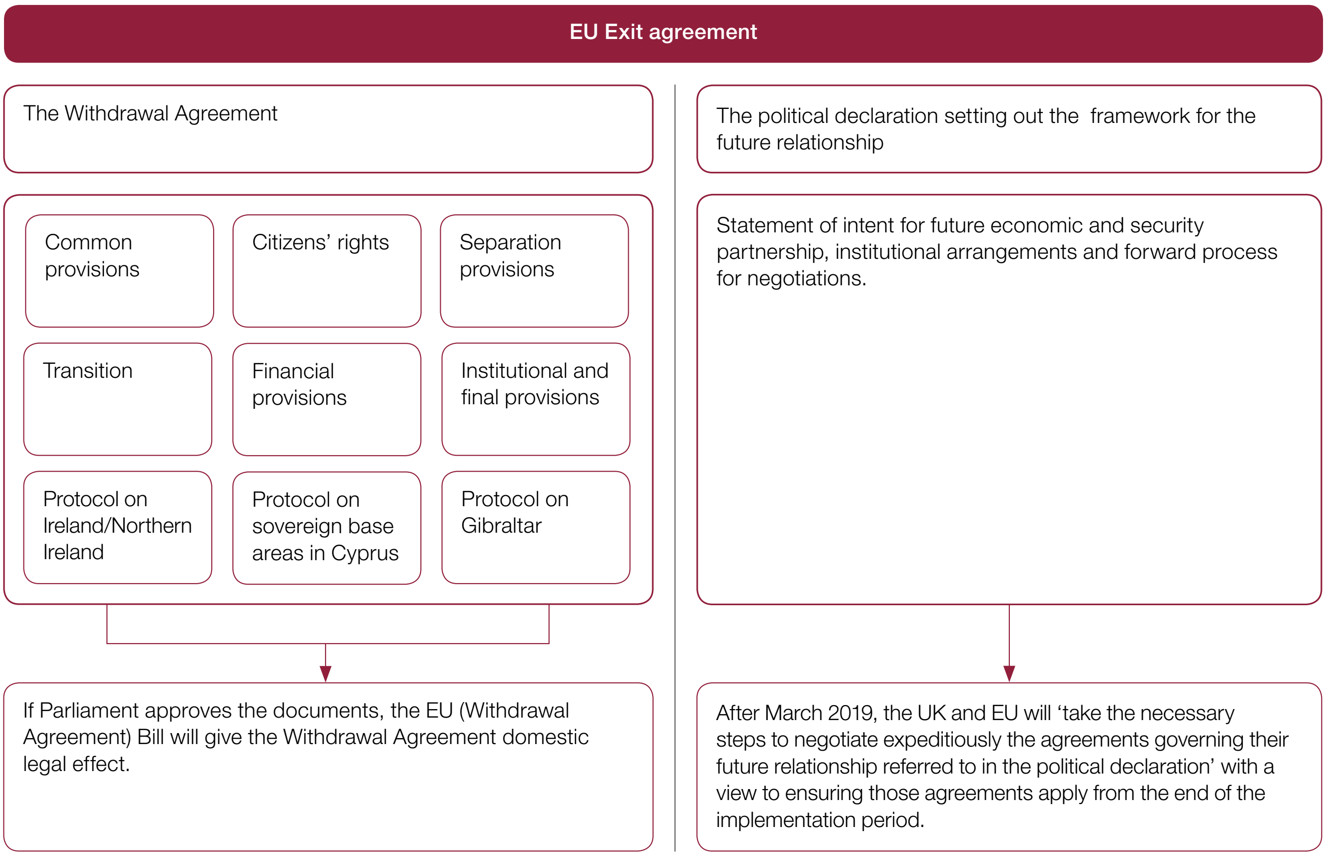
1.3 The Withdrawal Agreement sets out the arrangements for the UK's withdrawal from the EU and the European Atomic Energy Community (Euratom).[2] The Withdrawal Agreement includes:

- the financial settlement, which covers the UK's financial commitments to the EU and the EU's financial commitments to the UK;
- an implementation period between the UK's withdrawal and the end of December 2020, during which EU laws will still apply in the UK;
- protections for the rights of UK citizens in the EU and EU citizens in the UK; and
- the protocol for avoiding a hard border between Northern Ireland and Ireland, which shall apply unless and until the government and the EU come to a subsequent agreement.

2 Euratom is an organisation established by the EU to create a single market for nuclear power. Euratom covers the peaceful use of nuclear energy in the EU and the nuclear safeguards regime.

Figure 1
The European Union (EU) Exit agreement

The government's agreement with the EU consists of the Withdrawal Agreement and a political declaration setting out the UK's future relationship with the EU



Source: National Audit Office

1.4 The terms of the Withdrawal Agreement, including the financial settlement, will become binding international commitments once it has been ratified by both the UK and EU:

- The House of Commons needs to approve both the Withdrawal Agreement and the political declaration through the 'meaningful vote', and the necessary domestic legislation must then be passed through the EU (Withdrawal Agreement) Bill, for the Withdrawal Agreement to be ratified. The Bill will give the government authority to make financial settlement payments and will include a transitional provision to ensure that EU law continues to apply during the implementation period.

- If the UK and EU do not ratify the Withdrawal Agreement, its terms, including the financial settlement, will not be binding. HM Treasury has stated that, in such a scenario, the UK's obligations would have to be settled either through a negotiated settlement or through the courts.

The political declaration setting out the framework for the future relationship

1.5 The political declaration is a statement of intent about the future partnership and institutional arrangements between the UK and the EU. It establishes the parameters of a partnership across trade and economic cooperation, law enforcement and criminal justice, foreign policy, security and defence and wider areas of cooperation.

1.6 The future relationship between the UK and the EU, as set out in the political declaration, cannot be translated into a binding legal agreement until after the UK's exit from the EU in March 2019. This is because the EU is not legally able to conclude new treaties with the UK relating to the future relationship while the UK is still a member state. Therefore, if the UK and EU ratify the Withdrawal Agreement, the UK will be committed to the financial settlement before the future relationship has been finalised. The Withdrawal Agreement states that the government and the EU will take the necessary steps to negotiate 'expeditiously' the agreements in the political declaration. This is with a view to ensuring that those agreements apply, to the extent possible, from the end of the implementation period.

The role of the financial settlement

1.7 Since the referendum in June 2016, the UK government has stated its intention to negotiate a financial settlement with the EU. It has stated that the financial settlement should be fair and in accordance with the law and spirit of continuing partnership with the EU, and that the UK would honour the commitments that it made while it was a member state. The government has also stated that other member states should not need to pay more or receive less during the current EU budget period because of the UK's withdrawal.

1.8 Through the financial settlement, the UK will continue to contribute over the EU's current budget period. Member states agree budgets over seven-year terms, known as 'multiannual financial frameworks', with the current term running until the end of 2020. Therefore:

- The UK will participate in the EU's 2019 and 2020 budgets.
- The UK will make some payments after 2020 to honour its share of outstanding commitments that the EU made during the current budget period. The UK will also receive its share of outstanding commitments after 2020. The EU budget operates in a way that means there is normally a balance of outstanding commitments (known as the 'reste à liquider') at the end of any budget period, which are then paid off during the following budget period.
- The UK will pay its share of some liabilities and receive a share of certain assets that the EU has accrued at the end of 2020. The biggest EU liability that the UK will contribute to is its pension liability.

1.9 The UK will not be required to pay off liabilities until they fall due, unless it makes use of the early payment provisions set out in the Withdrawal Agreement.[3] HM Treasury predicts that the UK will pay off the vast majority of its share of outstanding commitments between 2021 and 2026 and that it will contribute to the EU's pension liability until at least 2064, though there could be a small amount to pay after this date.

1.10 The end of the EU's current budget period coincides with the end of the implementation period proposed in the Withdrawal Agreement. During the implementation period, although the UK will no longer be a member of the EU, common rules will remain in place and EU law will continue to apply in the UK, subject to the terms set out in the Withdrawal Agreement. The UK will also continue to participate in EU programmes, meaning that it will continue to receive funds such as for agriculture, rural development, fisheries, research and innovation, support for small businesses and information technology. HM Treasury has stated that the financial settlement covers the cost of the implementation period.

1.11 The Withdrawal Agreement states that the implementation period can be extended once, before 1 July 2020, for up to one or two years. The UK will make a contribution to the EU's budget for any period of extension. The Withdrawal Agreement states that the EU law determining the EU's revenue from member states would not apply to the UK during the period of extension. It also states that the UK's contribution during an extended implementation period would be decided on according to the status of the UK during that period.

1.12 Any costs that might be associated with the UK's future relationship with the EU after the implementation period are outside the scope of the financial settlement, as are the costs that the government is incurring in preparing for withdrawal (**Figure 2** overleaf). For example:

- The political declaration states that arrangements will be needed for UK-EU cooperation across a range of sectors, including financial services, digital, intellectual property, transport and fishing. These new arrangements are likely to result in some costs to the UK and EU and there is a potential for new economic and regulatory arrangements to be required.
- The plans included in the political declaration could result in the UK agreeing to contribute to the costs of EU agencies and institutions that it will continue to access after 2020, for example UK collaboration in projects of the European Defence Agency.
- The plans also include the possibility of UK participation in EU programmes in areas including science and innovation, overseas development, and space, in return for a financial contribution.

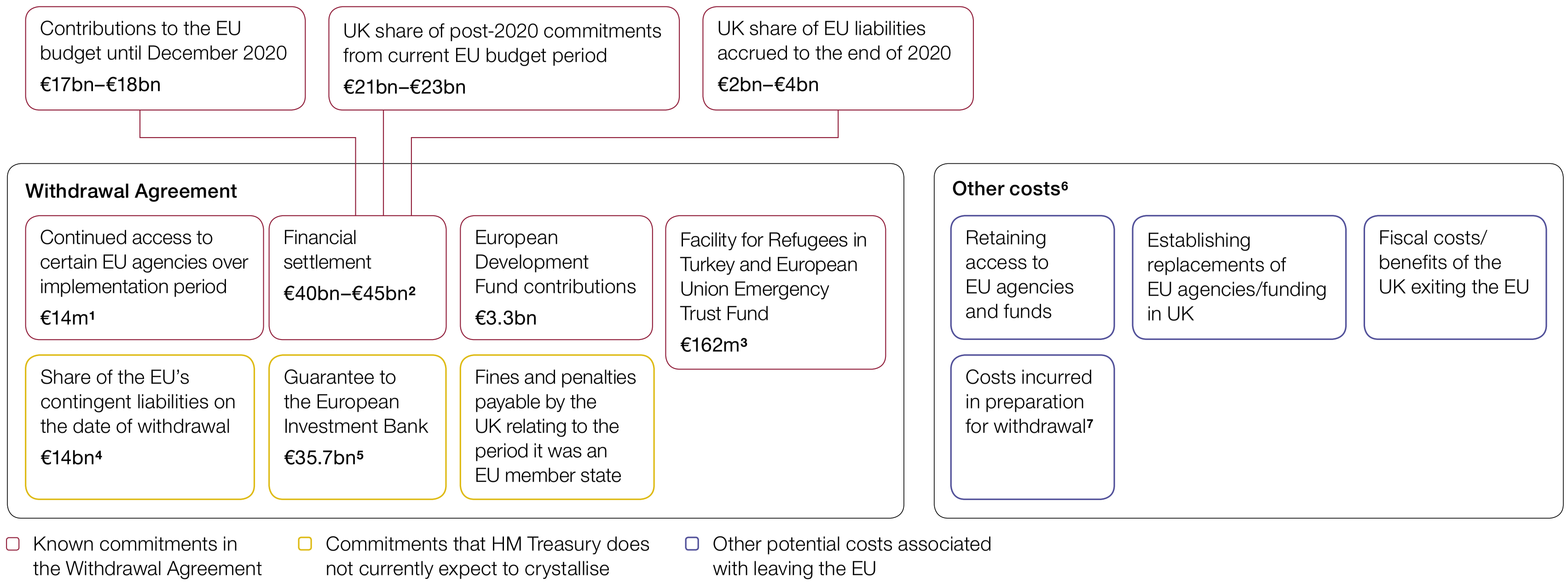
These decisions are subject to negotiations on the UK's future relationship with the EU, and future decisions of Parliament.

3 The Withdrawal Agreement states that the government can ask to pay off the outstanding commitments in a lump sum after December 2028. The UK can also request at any time to pay off the outstanding pension liability, based on an actuarial valuation of the liability made in accordance with International Public Sector Accounting Standards.

Figure 2

Known cost commitments and unknown potential costs of European Union (EU) Exit

There are a range of costs and potential costs of EU Exit and not all are included in the financial settlement



Notes

1 The Withdrawal Agreement states that the UK will contribute to the financing of the European Defence Agency, the European Union Institute for Security Studies and the European Satellite Centre until 31 December 2020.

2 The financial settlement figures are based on HM Treasury's initial estimate, January 2018 (see Figure 3; paragraph 2.3).

3 The UK will also honour its pre-withdrawal bilateral obligations for the Facility for Refugees in Turkey and the European Union Emergency Trust Fund. In our April report, we stated that these bilateral commitments were estimated to be worth €15 million. Since April, member states have agreed a second tranche of funding. HM Treasury estimates the UK will provide a further €147 million as part of this second tranche.

4 The Withdrawal Agreement provides for some liabilities that are uncertain or unknown at this time. HM Treasury has assumed that the UK will not have to make payments in respect of these contingent liabilities in addition to amounts already factored into the financial settlement estimate as provisions.

5 The guarantee to the European Investment Bank (EIB) will decline as the EIB stock associated with this guarantee decreases. HM Treasury has assumed the most likely outcome to be that the UK guarantees will never be called upon.

6 Other costs are costs that the UK will not be committed to as part of the Withdrawal Agreement. The UK may incur costs relating to the future relationship. The UK may also receive benefits as part of the future relationship after EU Exit.

7 The UK government will incur costs in preparation for leaving the EU. For example, at Autumn Budget 2017, HM Treasury committed £3 billion across departments and the devolved administrations for 2017-18 and 2018-19 to cover costs associated with preparing for EU Exit.

8 The joint report of the negotiators of the EU and the UK government published on 8 December 2017 committed the UK to discussions with EU agencies located in the UK to help them to relocate, but there is no commitment for the UK to pay any withdrawal costs of EU agencies in the UK.

Source: National Audit Office analysis of government information

Part Two

The value of the financial settlement

2.1 This part of the report sets out the estimated value of the financial settlement. It also explains the developments relevant to the financial settlement since our report in April 2018.[4]

Estimated value of the financial settlement

HM Treasury's initial estimate, January 2018

2.2 In January 2018, the Chancellor of the Exchequer wrote to the Treasury Select Committee setting out a 'reasonable central estimate' of the financial settlement's value of between £35 billion and £39 billion (**Figure 3**).[5] HM Treasury made this estimate to provide some understanding in monetary terms of what the government had agreed with the European Commission (the Commission). Its estimate was derived as far as possible from publicly available data. Its internal modelling gave a central estimate of £37.5 billion.

Figure 3

HM Treasury's initial published estimate

In January 2018, HM Treasury stated a 'reasonable central estimate' of the financial settlement's value of between £35 billion and £39 billion

Period payments relate to	Settlement component	HM Treasury's estimate (€bn)	HM Treasury's estimate (£bn)
Before the end of 2020	Contributions to the EU's budget	17-18	
After the end of 2020	Contribution to outstanding budgetary commitments	21–23	
	Share of the EU's liabilities[1]	2–4	
Total		**40–45**	**35–39**[2]

Notes

1 Includes €3.5 billion repaid capital to the UK from the European Investment Bank.

2 HM Treasury converted euro amounts using an exchange rate on the day the government and the European Union (EU) published the joint report that first set out the terms of the financial settlement (8 December 2017). This was €1.13 to £1.

3 Figures may not sum due to rounding.

Source: National Audit Office analysis of HM Treasury modelling

4 Comptroller and Auditor General, *Exiting the EU: The financial settlement*, Session 2017–19, HC 948, National Audit Office, April 2018.

5 HM Treasury, *Correspondence from the Chancellor of the Exchequer relating to the UK's EU withdrawal financial settlement*, January 2018, available at: www.parliament.uk/documents/commons-committees/treasury/Correspondence/2017-19/Correspondence-from-the-Chancellor-of-the-Exchequer-relating-to-the-UK-EU-Withdrawal-financial-settlement-dated-24-January.pdf

2.3 In our April report, we concluded that HM Treasury's estimate was reasonable, but within certain parameters that it had applied. For example:

- HM Treasury's estimate does not include the commitment deriving from the Withdrawal Agreement that the UK will continue to participate in the current European Development Fund (EDF), which covers the period from 1 January 2014 to 31 December 2020. The EDF is the European Union's (EU's) main instrument for providing development aid. HM Treasury expects the UK to make payments worth €3.3 billion (£2.9 billion) after the UK's withdrawal, with payments forecast to continue until 2026.[6] The EDF also has some assets, including its investment facility, a share of which will be returned to the UK at the end of the current EDF period. HM Treasury estimates that these are worth around €0.5 billion (£450 million).[7] The government considers this commitment to be outside the financial settlement because the EDF is not established under the EU treaties and sits outside the EU budget. It also expects to meet these commitments through existing legislation rather than the EU (Withdrawal Agreement) Bill, which gives the government authority to make financial settlement payments.

- HM Treasury has not distinguished between public and private receipts in its estimate. The estimate is net of funds HM Treasury expects that UK public and private organisations will receive from the EU. Receipts from the EU that are administered by the public sector are recorded in the accounts of the government department that they relate to and are then consolidated into the Whole of Government Accounts. Receipts to the private sector will not be received and consolidated into the UK government's accounts. We estimated that HM Treasury's financial settlement value includes receipts worth £7.2 billion that go directly to the private sector. This means that, if private sector receipts were excluded, the financial settlement's estimated value would be £7.2 billion higher.

2.4 Our April report also concluded that future events will determine significant elements of the financial settlement's costs, including the value of the EU's future liabilities and commitments, and what share of those the UK will pay. Relatively small changes in events could push the cost of the financial settlement outside HM Treasury's published range of £35 billion to £39 billion.

6 Figure given is in nominal terms.
7 Figures converted to sterling using the exchange rate that HM Treasury used in its initial estimate (£1:€1.13).

Updated estimates of the financial settlement's value

2.5 Since HM Treasury's initial estimate, documents have been published that provide new information about the financial settlement's potential value. These include the following:

- **The EU's 2017 accounts**, which provide information on the size of the EU's assets and liabilities, including its pension liability, as at 31 December 2017. The UK will pay a share of the liabilities the EU has accrued by 31 December 2020 and will receive a share of the assets it has on that date.
- **The EU's 2017 financial report**, which includes information about the amount of money the UK received from the EU during 2017 and its contribution to the budget compared with other member states.
- **Amended draft 2018 EU budget and draft 2019 EU budget**, which indicate how much the EU plans to spend, and forecasts the contributions of each member state during 2018 and 2019 respectively.
- **Updated exchange rate forecasts**: the government will make financial settlement payments after 2020 in euros, which means exchange rates on the dates of payment will determine the cost in sterling.

2.6 HM Treasury and the Office for Budget Responsibility (OBR), which publishes independent analysis of the public finances, have revised their estimates of the financial settlement's value using this information. The revised estimates remain within HM Treasury's initial estimated range of between £35 billion and £39 billion.

HM Treasury

2.7 In June 2018, the Committee of Public Accounts recommended that HM Treasury should provide an updated estimate of the financial settlement before the Parliamentary summer recess. In July 2018, HM Treasury wrote to the Chair of the Committee of Public Accounts stating that, at that time, limited new information relevant to its estimate had become available and therefore it did not have an updated estimate.[8]

2.8 In October 2018, HM Treasury provided a formal response to the Committee's recommendation, stating that it had updated its estimate based on new information received from the Commission. HM Treasury stated that its estimate remained within the range of £35 billion to £39 billion.[9] We have reviewed HM Treasury's internal modelling. HM Treasury's latest modelling provides a central estimate that the financial settlement will be worth €39.9 billion, which it has converted into a sterling figure of £35.7 billion.

8 Committee of Public Accounts, *Correspondence from Treasury on Exiting the EU: the Financial Settlement*, July 2018, available at https://www.parliament.uk/documents/commons-committees/public-accounts/Correspondence/2017-19/HMT_to_Committee_EU_Financial_Settlement_Redacted.pdf

9 HM Government, *Treasury Minutes: Government response to the Committee of Public Accounts on the Forty Third to the Fifty Eighth reports from Session 2017–2019,* Cm 9702, October 2018.

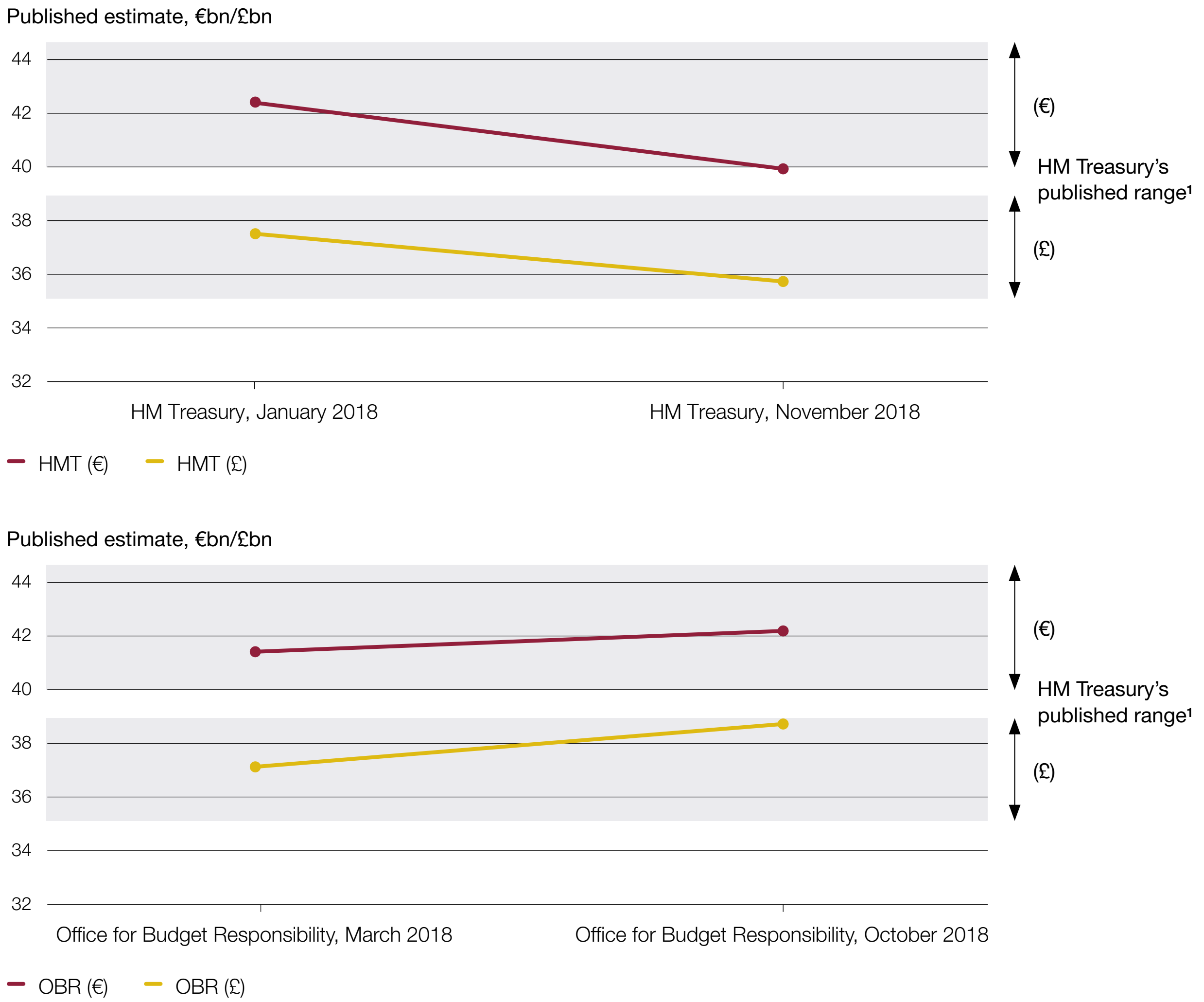
The Office for Budget Responsibility

2.9 The OBR estimated the financial settlement's value in its October 2018 Economic and Fiscal Outlook. The OBR estimated that the financial settlement will be worth €42.2 billion (£38.7 billion). This is an increase from the OBR's previous estimate, in March 2018, which gave the value of the financial settlement to be €41.4 billion (£37.1 billion) (**Figure 4**).[10]

Figure 4

Estimates of the financial settlement's value

HM Treasury (HMT) and the Office for Budget Responsibility (OBR) have revised their estimates of the financial settlement's value since we reported in April 2018



10 Office for Budget Responsibility, *Economic and Fiscal Outlook*, October 2018, Box 4.1, available at: https://cdn.obr.uk/EFO_October-2018.pdf

Figure 4 *continued*

Estimates of the financial settlement's value

Estimate	€billion	£billion
HM Treasury, January 2018	42.4	37.5
Office for Budget Responsibility, March 2018	41.4	37.1
Office for Budget Responsibility, October 2018	42.2	38.7
HM Treasury, November 2018	39.9	35.7

Note

1 In January 2018, the Chancellor of the Exchequer wrote to the Treasury Select Committee setting out a 'reasonable central estimate' of the financial settlement's value of between £35 billion and £39 billion, based on an estimate of between €40 billion and €45 billion.

Source: National Audit Office analysis of estimates published by HM Treasury and the Office for Budget Responsibility

Differences between HM Treasury's and the OBR's estimates

2.10 While both HM Treasury's and the OBR's latest estimates of the financial settlement's value fall within HM Treasury's published range (£35 billion to £39 billion), the OBR's estimate is around £3 billion higher than HM Treasury's central estimate. The main reasons for this difference are that:

- the OBR incorporates its own modelling into its estimate whereas HM Treasury primarily relies on Commission data; and
- HM Treasury and the OBR have used a different exchange rate to convert the estimate from euros to sterling.

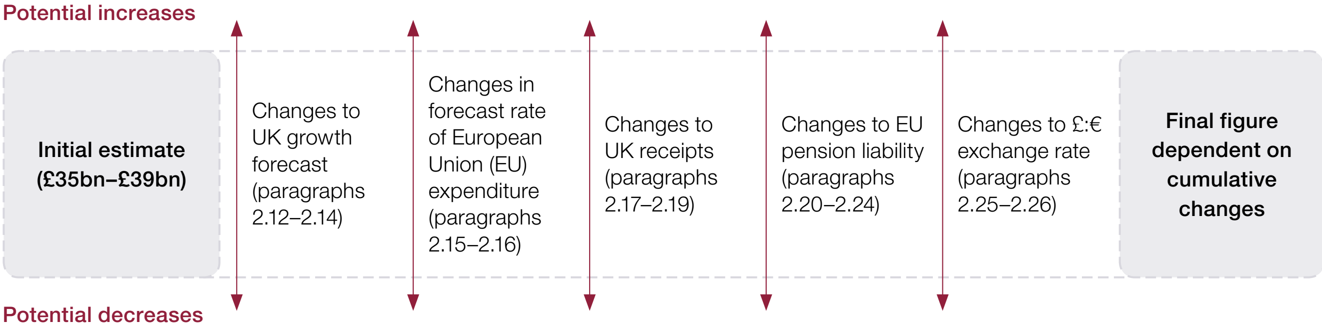
We explain below how these differences have an impact on the latest estimates of the financial settlement.

Uncertainties about the financial settlement's value

2.11 Our April report highlighted that significant elements of the financial settlement's cost will be determined by future events, which are by their nature uncertain. We revisit the main uncertainties below and explain how they are reflected in the most recent estimates of the financial settlement's value (**Figure 5** overleaf). Uncertainties remain, which mean there may be further movements in the financial settlement's estimated value before the government makes payments to the EU.

Figure 5
Impact of potential changes on the financial settlement's estimated value

Various factors could result in changes to the financial settlement estimate in both directions



Note

1 In January 2018, the Chancellor of the Exchequer wrote to the Treasury Select Committee setting out a 'reasonable central estimate' of the financial settlement's value of between £35 billion and £39 billion.

Source: National Audit Office analysis

UK contributions to the EU's budget, 2019 and 2020

2.12 The UK's contributions to the EU's budget in 2019 and 2020 are yet to be determined. Member states' contributions to the EU's annual budgets, including the UK's contributions in 2019 and 2020, are not yet known and are partly determined by their relative economic performance. The UK's budget contributions impact on the value of both the financial settlement components before 2020 and after 2020. This is because the share that the UK will pay of the EU's outstanding commitments and net liabilities at the end of 2020 will be based on the ratio of the UK's budget contributions to all member states' contributions over the period 2014 to 2020 (the 'UK's share').

2.13 Since its initial estimate, HM Treasury has reduced its forecast of the UK's future budget contributions and, consequently, the UK's share:

- For its initial estimate, HM Treasury used the Commission's latest forecast that the UK's share of contributions to the EU budget in 2018 would be 12.7% and assumed that it would remain at this level in 2019 and 2020. It estimated that the resulting UK share, 2014 to 2020, would also be 12.7%.

- HM Treasury now expects the UK's contribution in 2018 to be 11.9% of the EU's budget based on the latest amended 2018 draft budget. It has also revised its forecasts of contributions in 2019 and 2020, which it expects to be 12% of the EU's total budget, based on the EU's draft 2019 budget (**Figure 6**). The resulting forecast of the UK's share is 12.4%.

This reduction in forecast contributions before 2020, and the UK's share of outstanding commitments and liabilities after 2020, reduces HM Treasury's overall estimate by €2.8 billion (£2.5 billion).

Figure 6

HM Treasury's estimates of UK contributions to the European Union (EU)'s budget

HM Treasury has reduced its forecast of the UK's budget contributions and the UK's share, 2014–2020, based on new Commission forecasts

	HM Treasury estimate of UK contribution as percentage of total EU budget	
EU budget year	January 2018 (%)	November 2018 (%)
2018	12.7	11.9
2019	12.7	12.0
2020	12.7	12.0
The UK's share (based on an average of contributions from 2014–2020, including the estimates above)	12.7	12.4

Note

1 All figures are rounded to one decimal place

Source: National Audit Office analysis of HM Treasury forecasts

2.14 The OBR has also reduced its forecast of the UK's budget contributions. In its March estimate, it forecast the UK's share of budget contributions between 2014 and 2020 would be 12.4%. Its October estimate reduced this to 12.25%, resulting in a £300 million reduction to its estimate of the financial settlement's value. The OBR's forecast of the UK's share, 2014-2020, is lower than HM Treasury's forecast because the OBR incorporates its own modelling of EU expenditure before the end of the current budget period. The Commission will calculate the actual share of the UK's contributions between 2014 and 2020 relative to other member states in February 2022.

The EU's rate of expenditure

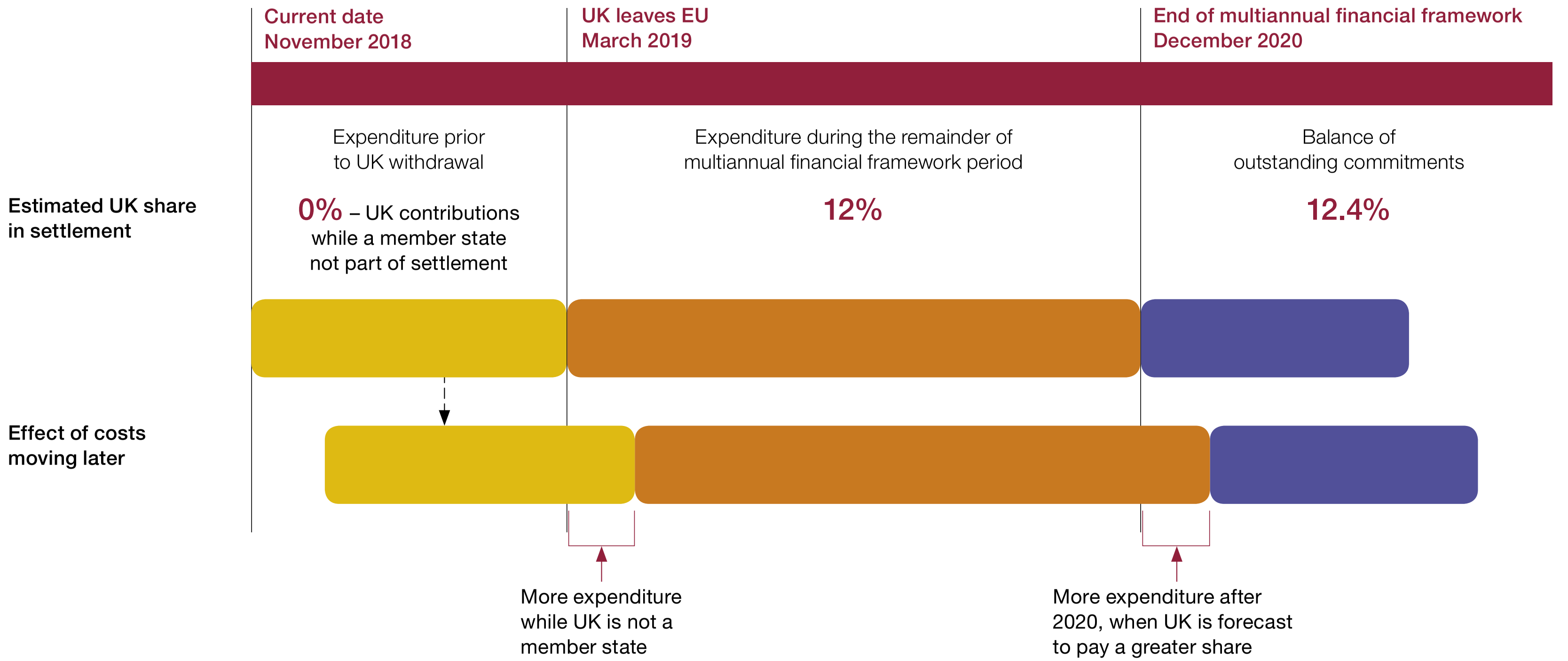
2.15 The value of the financial settlement partly depends on the rate at which the EU spends its budget over the remainder of its current budget period, which runs to the end of 2020. If the rate of expenditure is slower than forecast, the following are likely:

- More EU expenditure will occur after March 2019, meaning that the UK's budget contributions will be greater in the period where payments are part of the financial settlement rather than part of its contributions as a member state.
- More EU expenditure will be deferred to the balance of outstanding commitments at the end of 2020 rather than being incurred during the current budget period. The UK is likely to contribute a larger proportion towards outstanding commitments after 2020 than expenditure incurred before the end of 2020. This is because the UK's share after 2020, based on its contributions between 2014 and 2020, is forecast to be higher than the UK's share of the EU budget in 2019 and 2020 (**Figure 7** overleaf).

Figure 7

Impact of the European Union (EU) expenditure rate on the financial settlement

Changes in the timing of EU expenditure would change the amount paid in the financial settlement



Notes

1 Through the financial settlement, the UK will continue to contribute over the EU's current budget period. Member states agree budgets over seven-year terms, known as 'multiannual financial frameworks', with the current term running until the end of 2020.

2 The UK will make some payments after 2020 to honour its share of commitments that the EU made during the current budget period. This is because the EU budget operates in a way that means there is normally a balance of outstanding commitments (known as the 'reste à liquider') at the end of any budget period, which are then paid off during the following budget period.

3 Estimated UK shares are taken from HM Treasury's November 2018 estimate of the financial settlement.

Source: National Audit Office analysis of HM Treasury and Office for Budget Responsibility models

2.16 The EU's draft budget for 2019 indicated that there will be an increase in spending compared with 2018. For its estimate, the OBR has assumed a lower increase in year-on-year spending than the EU forecasts. It has based this on how much the EU has increased spending previously. This has caused the OBR's estimate to increase by €1.4 billion compared with its March estimate. HM Treasury's model continues to incorporate spending forecasts from the EU's 2018 budget because it is waiting for the 2019 budget to be agreed by member states before updating its model.

UK receipts

2.17 During the implementation period, the UK will continue to participate in EU programmes, such as Horizon 2020 and the European Agricultural Guarantee Fund. The UK will also receive a share of payments relating to programmes it currently participates in after 2020 from the EU's balance of outstanding commitments. HM Treasury and the OBR's estimates of the financial settlement deduct funds that the UK public and private sectors will receive after withdrawal from payments the UK government will make to the EU. For its initial estimate, HM Treasury assumed that UK receipts as a share of EU expenditure up to and after 2020 would continue at the same rate on each EU programme as in 2015 and 2016.

2.18 In our April report, we highlighted the risk that the UK's withdrawal from the EU could cause changes to the rate of the UK's receipts. For example, the UK's receipts may be lower if UK-based beneficiaries decide not to apply for EU funding or if their funding applications are not approved by the EU at the same rate as when the UK was a member state. HM Treasury considers this risk to be mitigated because allocations have already been agreed for the largest programmes and the government has communicated to stakeholders that access to funding in the current EU budget period is unaffected by the UK's withdrawal.

2.19 HM Treasury's latest modelling projects future receipts based on the average rate of receipts between 2015 and 2017. The EU's 2017 Financial Report shows that there was a slight decrease in the rate of receipts coming into the UK in 2017 compared with 2015 and 2016. When incorporated into HM Treasury's model, this results in a €400 million decrease in UK receipts compared with its initial estimate, with a corresponding increase in its overall estimate.

The EU's pension liability

2.20 The cost of the UK's future contributions to the EU's pension scheme is a particularly uncertain part of the financial settlement. This is because it is based on several assumptions about future events that are difficult to predict, especially over such a long period of time, with payments forecast to extend until at least 2064. Such uncertainty is common to all valuations of pension liabilities. For its initial estimate of the financial settlement's value, HM Treasury projected a value of the EU's pension liability at the end of 2020 based on its value in the 2016 EU accounts. It projected this forward, assuming that it would continue to grow at the same rate as it had done since 2014, excluding the impact of changes to discount rates, which are used to adjust future pension payments to current values.

2.21 The EU's 2017 accounts showed that its pension liability had increased over the year by €5.9 billion to €73.1 billion. This was primarily because of an increase in the expected rate of annual salary growth for EU employees, which is used to estimate pensions based on final salaries, from 1.2% to 1.8%. This has been partly offset by an increase in the discount rate from 0.3% to 0.4%.

2.22 HM Treasury's latest modelling of the pension liability has incorporated the increased pension liability figure. It has projected forward from the 2017 pension liability to an estimated liability at the end of 2020 using the average growth rate between 2014 and 2016. It has not incorporated the increase between 2016 and 2017 into the growth rate it has applied because it considers the salary increase assumption was not indicative of the liability's expected annual growth. This has resulted in HM Treasury's projection of the EU's pension liability at 2020 increasing from €76.1 billion in its initial estimate to €77.2 billion. However, the lower estimated budget contributions in 2019 and 2020 and consequent reduction to the UK's share, 2014-2020, means that HM Treasury's forecast of the UK's share of the pension liability has decreased by €110 million since its initial estimate.

2.23 HM Treasury is refining its modelling of the EU's pension liability using pensions data produced by Eurostat, which is the EU's statistical office. It considers this modelling to reflect more accurately the contributions the UK will make to the EU's post-employment sickness benefits scheme. It has not incorporated this model into its November 2018 estimate. This model indicates that the UK's pension liability is around €130 million higher than the estimate based on the EU's accounts.

2.24 The government and the EU have agreed that the UK can request at any time to pay off the outstanding pension liability based on an actuarial valuation of the liability made in accordance with International Public Sector Accounting Standards. We highlighted in our previous report that the accounting valuation of the pension liability is subject to interpretation of the accounting standards as well as significant assumptions such as the choice of discount rate. The movements in the pension liability in the latest set of EU accounts illustrate how assumptions about future pension payments can change from year to year. The high level of uncertainty involved in forecasting future pension cash flows will make it difficult to calculate a reliable estimate of the cost of ongoing payments to compare with a lump-sum settlement.

Exchange rates

2.25 The financial settlement value in sterling is exposed to changes in the exchange rate because settlement payments after 2020 will be drawn up and paid in euros.[11] For its initial estimate, HM Treasury used an exchange rate of €1.13:£1. This was a spot rate from December 2017 when the government and the EU published the joint report that first set out the principles of the financial settlement. This may not match the exchange rate when payments are made. HM Treasury's November 2018 estimate uses a spot rate from 20 November 2018, which was €1.12:£1.

2.26 The OBR found that an increase in its financial settlement estimate between March and October of 1.9% in euros (€0.8 billion) converted to an increase of 4.2% in sterling (£1.6 billion) because of changes to its own forecast of exchange rates. The OBR forecasts exchange rates five years into the future, with the rate held constant beyond that date. Its October estimate uses a lower rate from 2023 onwards (€1.06:£1) than it used in March (€1.10:£1), with the effect of increasing the sterling value of financial settlement payments.

HM Treasury's assurance arrangements

2.27 Payments under the financial settlement after 2020, 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.

2.28 HM Treasury needs to implement new processes for ensuring accuracy that take account of the complexity and subjectivity of the calculations to ensure that the UK does not pay more than is due. It also needs to ensure it has access to the information used for those calculations and that it has agreed with the EU a mechanism for resolving disputes. The Withdrawal Agreement includes provision for the UK to appoint auditors to audit the implementation of the financial provisions, including the financial settlement.

2.29 In October 2018, HM Treasury stated that the government is still developing its detailed assurance arrangements, and that further discussions with the EU are required to give effect to the audit rights that have been secured through the Withdrawal Agreement.[12]

11 The UK's contributions to the EU's budget in 2019 and 2020 will be paid in sterling, in line with the EU rules governing member states' contributions.

12 HM Government, Treasury Minutes: Government response to the Committee of Public Accounts on the Forty Third to the Fifty Eighth reports from Session 2017-19, Cm 9702, October 2018.

2.30 The Withdrawal Agreement provides information about the dispute resolution mechanism which will apply if any disputes regarding the interpretation and application of the provisions of the Withdrawal Agreement occur. First, the UK and EU will try to resolve disputes via a joint committee made up of UK and EU representatives. If agreement still cannot be reached, an arbitration panel will be formed to rule on the matter. In this case, the UK and EU will each nominate two members to the arbitration panel from their lists of potential members and agree a chair. The Court of Justice of the European Union (CJEU) will be consulted by the arbitration panel for matters relating to EU law. In addition, each party may request that the panel refers a question to the CJEU.

Appendix One

Our approach

Scope

1 In April 2018, we reported on HM Treasury's estimate of the cost of the financial settlement – part of the terms of the UK's withdrawal from the European Union (EU) on 29 March 2019. Our report noted that future events would determine significant elements of the financial settlement's costs and what share of those elements the UK will pay.

2 In November 2018, the government agreed a Withdrawal Agreement with the EU which includes terms for the financial settlement. Part One of this report sets out the components of the Withdrawal Agreement and of the financial settlement, explaining which of the costs associated with EU exit are included in, and which are excluded from, the financial settlement.

3 Part Two of this report sets out how HM Treasury and the Office for Budget Responsibility (OBR) have updated their estimates of the financial settlement since we last reported. It sets out remaining uncertainties about the financial settlement and explores the impact that relevant changes in circumstances (such as exchange rate fluctuations and the value of UK receipts from the EU) could have on the final cost to the UK.

Methods

4 To update our understanding of the financial settlement, we have completed:

- **interviews** – with staff at HM Treasury and the Office for Budget Responsibility;
- **document review** – of the Withdrawal Agreement, government white papers, and material published by HM Treasury and the OBR; and
- **a review of HM Treasury's financial models** – to update our understanding of the approach and the data used.

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