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Operation of the Nuclear Liabilities Fund

Dear Dame Meg,

Many thanks for your letter raising further questions on the operation of the Nuclear Liabilities Fund (NLF), following the oral evidence session on the Future of the Advanced Gas Cooled Reactors held on Monday 7 February.

We have responded under each of your questions below.

(i) Please explain the reasoning underpinning the government's support for the current investment strategy – namely the 80/20 split between National Loans Fund and other assets.
a. With the estimated Fund liabilities still increasing and the return on assets virtually flat, isn't this approach opening the taxpayer up to further requests for support?
b. What impact would current increases in inflation have on the likelihood of further top-ups?

The NLF's asset allocation between cash held as deposits in the National Loans Fund (National Loans Fund) and assets more actively invested has evolved over time. The current split is approximately 20% in the Mixed Assets Portfolio (MAP) versus 80% on deposit with the National Loans Fund but this will change – most immediately (subject to Parliamentary approval) when £5.61bn is paid into the NLF and deposited with the National Loans Fund later this month. Future changes to the size of the NLF are also likely to change the split. In particular the trustees intend to use the National Loans Fund deposit to meet decommissioning costs in the first instance, so gradually over time as the National Loans Fund is used to fund these liabilities, the deposits will be exhausted and the fund will be wholly invested in the MAP.

The NLF was originally set up in 1996 to meet the costs of decommissioning the Advanced Gas Cooled Reactor and Pressurised Water Reactor stations owned by British Energy and ensure adequate provision for decommissioning during their operation. It received initial contributions from HMG and arrangements were made for it to operate like a funded defined benefit pension arrangement – liabilities estimated, assets invested by its trustees, and contributions made by the operator which were subject to periodic adjustment. It was largely invested in listed equity in its early years.

The NLF's liabilities were then expanded to cover certain spent fuel and radioactive waste costs as part of the restructuring of British Energy which concluded in early 2005. British Energy's contribution schedule was fixed taking account of the then anticipated closure schedule (other than for Sizewell B in respect of which contributions are also made to the fund based on fuel loading).

As part of the arrangement made at restructuring the NLF had rights to 64% of British Energy's free cash flow (convertible into shares). The rights were converted and sold, resulting in a £4.4bn payment into the fund in 2009 after the sale of British Energy to EDF.

At that point NLF's assets and projected returns were considered more than sufficient to meet the then estimated liability costs, and the proceeds of the sale of shares were deposited into the National Loans Fund at HMT's request; whilst the NLF continued to actively invest the rest of the fund in what is now termed its MAP.

Over the last few years pressures on the Fund have arisen driven by 1) increases in liability cost estimates; 2) lower than anticipated returns on the National Loans Fund deposits (in turn due to a long period of historically low interest rates), and 3) last year's increase in the corporation tax rate from 19% to 25%.

To help ensure Fund sufficiency an agreement was made between NLF, HMT and BEIS in 2020 under which the NLF undertake an annual review of the sufficiency of the Fund. If a 'material shortfall' (>£300m) is identified, then BEIS and HMT are offered the choice of injecting cash into the NLF to be held in the National Loans Fund or allowing the trustees to invest some of their National Loans Fund deposit in the MAP. The MAP has higher returns than the National Loans Fund but is also higher risk and involves higher transaction costs.

In line with that agreement, BEIS made a £5bn top-up payment into the NLF in July 2020 to be held on deposit in the National Loans Fund. This was in preference to the withdrawal of a significant proportion of the NLF's then National Loans Fund deposit for investment in the MAP. The pressure in this instance was caused primarily by increased liability estimates (although lower than anticipated returns on the National Loans Fund deposit also contributed).

Late last year, HMG agreed to a further £5.61bn cash injection (subject to the forthcoming supplementary estimates process) to address a pressure caused primarily (>80%) by the increase in corporation tax rates announced by the Chancellor in March 2021.This additional top-up amount will also be held by the NLF in the National Loans Fund.

The trustees will use the National Loans Fund deposits to meet decommissioning costs in the first instance. This gives the MAP the opportunity to grow in the intervening period in order to meet longer term liabilities.

Given the very long-term profile of the liabilities (over 100 years), the estimated costs of discharge will change, either up or down; the asset allocation of the fund, the risk-free rate of return and asset performance will also vary. The extent to which further support will be required will depend on several factors, including asset returns, changes in liability discharge strategies and plans, technological advancement and inflation (a rise in inflation can be expected, over time, to increase the nominal value of both the assets and the liabilities of the NLF, though it is unlikely to have the same effect simultaneously on both sides of the balance sheet. It is not possible to predict the overall net effect). Under the 2020 agreement, whenever a 'material shortfall' arises HMG has the choice of addressing that shortfall through investment into the MAP or providing a cash injection. This is considered on a case-by-case basis.

Market expectations of long-term inflation are factored into the trustees' annual sufficiency assessments. If over time the rate of growth of actual costs differs from previously assumed inflation rates or there is a change in the spread between the projected long term growth in the value of assets and liabilities (each driven in part by inflation assumptions), this will affect sufficiency determinations. The impact of current inflation will be softened due to the use of a long term inflation assumption – nonetheless, if there is a sustained change in expected long-term inflation which has a differential impact on the value of assets and liabilities then it would affect sufficiency determinations.

ii) Why did the BEIS Department and HM Treasury opt to top up the Fund in 2020 rather than allow the trustees to take money out and invest in other assets? What options were considered by government at the time and what were the results of the cost/benefit analysis undertaken?

NLF trustees have responsibility for ensuring the Fund is able to meet the costs of its decommissioning liabilities in the future. In the interests of discharging this responsibility, NLF trustees considered taking funds out of the National Loans Fund and transferring them into the private sector because returns in the private sector have, over time, been higher than in the National Loans Fund.

In response, HMG suggested an alternative proposal to provide the NLF with additional funding in the National Loans Fund to ensure the NLF remains on track to meet in full its liabilities as they fall due. HMG's proposal was made with consideration to HMG fiscal and cash management priorities, and judgement on value for money for the Exchequer as a whole Investing in private sector assets reduces the liquidity of the balance sheet. This is not financially efficient for managing future liabilities when a government is in a net liability position. Investing in private sector assets reduces the liquidity of the balance sheet and requires a commensurate increase in debt issuance. Increased balance sheet liquidity can be used to invest in infrastructure or current spending, which generate longer term financial returns but also social and economic benefits, which are all highly valued by Government. It may also be used to pay down Government debt. By contrast, a reduction in balance sheet liquidity would entail higher debt levels, which could increase the cost of financing new debt to pay for unforeseen fiscal pressures. Finally, while investment in the MAP might provide higher returns, it would also come with higher risk and higher transaction costs than investment in the National Loans Fund. These are both costs that need to be considered in judging value for money for the Exchequer as a whole. HMG's proposal of topping up the NLF's deposits in the National Loans Fund avoided negative effects on HMG's fiscal, cash management and balance sheet position, and, along with considerations on transaction costs and risks, as a result offered better value for money.

The Government considered two options: a cash injection, or a transfer of funding into the MAP. The top-up to the NLF's National Loans Fund holdings was purely a financial transaction within the public sector boundary, with no net economic impact. However, the judgement of value for money of the different courses of action for the Exchequer as a whole was made on the basis of the principles set out in the Green Book.

(iii) In the oral evidence session the BEIS Department informed us that government is likely to support the request for a £5.6 billion top-up. Your letter to the Committee of 21 February provided further detail on the impact of the corporation tax changes on the Fund. Could you also provide information on the other factors that have prompted the £5.6 billion request together with details of the amounts involved?
a. With reference to the corporation tax change, if corporation tax rates drop in the future can the taxpayer expect an immediate rebate?
b. Does the £5.6 billion request include the impact of the recent increase in decommissioning costs arising from the early closure of Dungeness B? If not, should we expect a further top-up next year, and of how much?

The breakdown of the £5.6 bn request is as follows:

- Corporation tax - £4.6bn;
- Liability increases - £0.5bn;
- Inflation[1] - £0.3bn;
- Other[2] - £0.2bn.

The NLF expects to pay a substantial amount of UK tax over the course of the lifetime of the fund, all of which will be returned to the Exchequer. With regard to a rebate, provision is made for the repayment of surpluses from NLF to Government under the funding agreement that determines how EDF access the NLF for the repayment of qualifying costs and some of the mechanics of the NLF's operation. Broadly if the NLF is 125% funded the surplus above 125% is returned to HMG. Any surplus that remains in the fund after it has met all of its liabilities is also returned. These provisions could be utilised in the event there was a material future decrease in the rate of corporation tax payable by the fund.

The £5.6bn top-up to be made this year was requested on the basis of the sufficiency review undertaken by the NLF trustees last year. Due to the timing of when it was undertaken it did not take into account the early closure of Dungeness B. The next sufficiency review will take place later this year and will take the closure of Dungeness B into account along with all other relevant changes to the fund's liability estimates and its assets. The NLF trustees will engage HMG should they again identify a material shortfall.

[1]. In assessing Fund sufficiency the NLF uses market expectations of long-term inflation.
[2] Includes management, governance, regulatory, compliance and operations costs.

iv) Please explain the entire rationale for funding the decommissioning of the advanced gas-cooled reactors in this way. In particular, why it is necessary to inject large sums of public money into the Fund, years in advance of need, most of it earning a negligible return, and with the value of the money put in likely to be eroded by inflation. We would be very grateful for a full explanation and whether any alternative methods of funding the decommissioning of these reactors have been considered by your two departments.

The scope of the NLF and the Government's involvement with the Fund has evolved over time. While responsibility for the NLF previously sat with British Energy, responsibility for ensuring NLF sufficiency was assumed by the Government when British Energy Group (BEG) fell into financial difficulty in the early 2000s and was part re-nationalised. Under agreements signed with BEG and the NLF as part of the restructuring of British Energy, the Government committed to underwrite the NLF in the event it was not sufficient to meet its liabilities. In 2007 and 2009 the Fund was augmented by the sale of shares in the restructured British Energy with monies paid in to the National Loans Fund. The majority of NLF assets are subsequently classified to the public sector with the exception of assets held in the private sector through the Mixed Asset Portfolio.

As a result of Government underwriting of the liabilities of the NLF, and the classification of NLF assets to the public sector in the national accounts, the injection of funds into the NLF to be reinvested in the National Loans Fund has no net economic or financial impact for the taxpayer.

The reason is as follows. Since the restructuring of British Energy the liabilities of the NLF are fully underwritten by HMG, and can be considered to be liabilities of HMG. In line with the approach taken by the government to funding long-term liabilities, in cash terms the payments that will become due in the future will be funded through a mixture of future tax receipts and Exchequer borrowing. (There is an exception to this: the liabilities that will be funded from the proceeds of the MAP, a legacy of the restructuring of BEG.) There is no cash fund which the government is accumulating to pre-fund these liabilities. When addressing an identified shortfall in the NLF, as with the £5.61bn payment to be made later this month (subject to Parliamentary approval), the government credits the NLF with an additional deposit at the National Loans Fund, which will increase its liabilities accordingly, but with no net effect on the overall government balance sheet position. No actual monies need raising, depositing or ringfencing since this deposit will be funded by transfer from within the Exchequer.

This would not be the case if investment were instead made in the MAP, where investment outside the central Exchequer funds requires cash to be raised, increasing government debt at the point of investment, and resulting in different risk and return profiles on the assets acquired and the debt liabilities raised to finance them, exposing the taxpayer to increased risk. By contrast, increasing the NLF's deposit with the National Loans Fund has zero net impact on the public sector balance sheet: the increased assets held in the NLF net out exactly against the increased liabilities raised to finance them. And because those assets are invested back into the National Loans Fund, all the interest payments and economic and financial risks attached to those assets are exactly matched by equal and opposite payments and risks on the liability side of the public sector balance sheet.

For these reasons, an additional deposit within the Exchequer, leading to precisely offsetting assets and liabilities, coupled with essentially zero transaction costs of undertaking this arrangement, makes the credit of further funds to the National Loans Fund the most cost-efficient way of meeting the sufficiency requirements of the NLF for the taxpayer.

We trust that the above is helpful but stand ready to assist should you have further questions.

Kind regards,

Sarah Munby

BEIS Permanent Secretary

Tom Scholar

HMT Permanent Secretary