At my appearance before the Committee on 6 December 2017 I was asked a number of questions on the financial settlement in relation to our withdrawal from the European Union. As set out by the Prime Minister in her statement before the House of Commons on 11 December, the Government and the European Commission on 8th December published a joint report on progress during the first phase of the negotiations. In the spirit of transparency, I felt it appropriate to write to the Committee to explain the details of the agreement on the financial settlement set out in that report. The report covers the components of the settlement and the principles for their valuation.

Components of the settlement

There are three broad components of the settlement. First, the UK will pay a net contribution in years 2019 and 2020 and benefit from the implementation of the budget as if it had remained a Member State. This means that the UK will fully participate in EU programmes and receive receipts from the EU until the programmes close. This component is consistent with the Prime Minister’s speech in Florence where she confirmed that our partners should not fear that they will need to pay more or receive less over the remainder of the current budget plan as a result of our decision to leave. It was also agreed that the framework around the budget will be frozen for the UK, so any changes to the Multiannual Financial Framework (MFF) and Own Resources Decision after our exit will not affect the UK in those years.

Second, consistent with the Prime Minister’s assurances that the UK will honour commitments we have made during the period of our membership, from the end of 2020 the UK will contribute to its share of the outstanding budgetary commitments – the so-called ‘RAL’. The UK will continue to get its share of these receipts as well.

Third, consistent with the UK participating in the budget until 2020, the UK will pay its share of the Union’s liabilities as at the end of 2020. The majority of liabilities have corresponding assets, and therefore are excluded. So, in practice the main liability is pensions.
The UK will also take a share of the EU’s contingent liabilities, but only those entered into up to the date of withdrawal, except for legal cases related to the budget and linked policies and programmes, where the cut-off point is the end of 2020. Most of these contingent liabilities relate to guarantees on EU and European Investment Bank financial operations, and are reported to Parliament in the Consolidated Fund accounts as having a remote probability of crystallising. The UK will get a share of the associated pre-paid guarantee funds and reflows from the financial operations. Similarly, in the event of a contingent liability being triggered, the UK will receive its share of any subsequent amounts recovered by the EU.

Principles for valuation

The UK has secured three principles for valuing the settlement. The first is that “the UK will not finance any commitments that do not require funding from Member States, and will receive a share of any financial benefits that would have fallen to it had it remained a Member State”. In other words, the UK will pay and receive funding on the same basis as other Member States. This means in relation to the EU budget, the UK’s share will be based on actual budget implementation and exclude those parts in which the UK already has an opt-out, and in relation to liabilities, contingent liabilities and assets, this means the UK will not have to pay for any liabilities that do not materialise. The UK will also receive a share of funds that accrue to the EU budget.

The second principle concerns the calculation of the UK’s share, in respect of the components of the settlement. The UK’s share of EU contributions in 2019 and 2020 will be based on what it would have been had it remained a Member State. For any payments relating to periods after that, it will be based on the average of this MFF – in other words, the average of the UK’s share of EU contributions across 2014 to 2020. This is a development on the EU’s ‘Essential Principles on the Financial Settlement’ position paper, which proposed the UK pay a fixed financing share based on our share of EU contributions over the period 2014-18.

The third principle is that the UK will only be required to make payments as they fall due. The UK will not be required to incur expenditure earlier than would be the case had it remained a Member State unless agreed by both sides. This principle is particularly relevant to pensions, given their long-term nature and the uncertainty about their ultimate value.

Other components

There are a number of other elements that sit within or alongside the settlement. First, the European Investment Bank (EIB). Our underlying aim has been to provide mutually beneficial certainty and not to disrupt the functioning of the EIB in relation to a very significant stock of operations outstanding at the point of withdrawal, including loans disbursed in the UK. The arrangements for the UK’s financial support to the EIB have two key elements:
i) The UK’s paid-in capital of almost €3.5 billion will be returned in eleven equal instalments of €300 million a year from 2019, with a final payment to cover the remainder in 2030.

ii) The UK will provide two guarantees in respect of the stock of operations. First, a callable guarantee equivalent to its current callable capital. Second, as the paid-in capital is returned to the UK, an equivalent amount will be provided as a guarantee. Both these guarantees will decrease over time as the operations outstanding at the point of UK withdrawal decrease.

The most likely outcome is that the UK guarantees will never be called. The EIB has never made a capital call, requiring payment from Member States. The UK will be treated on equal terms with Member States if any calls are made for risks arising from operations before withdrawal.

In respect of the European Central Bank (ECB), the report confirms that the UK’s stake in the ECB will be returned to the Bank of England following withdrawal and in line with rules governing the ECB. The UK will also honour commitments it made for the EU Trust Funds and the Facility for Refugees in Turkey.

Finally, separate from the wider settlement the report also makes provision in relation to the European Development Fund (EDF). This Fund is established under a separate international agreement and is not established under the Treaties. The UK will continue to participate in the current EDF. Almost all of the 11th EDF has been committed, and going to low income countries. Our continued participation forms an important part of the UK’s overall commitment on Overseas Development Assistance. The Union and the UK have agreed that in the next phase of the negotiations we will discuss the governance processes for dealing with this, to ensure the UK, as a departing Member State, maintains its oversight of the Fund.

Valuation of the settlement

Given that the value of the components of the settlement are by their nature dependent on future events and the UK will only pay for components that fall due, it is not possible to put a definitive number on the settlement. But using publicly available European Commission data it is possible to estimate a range and as stated by the Prime Minister in the House, a reasonable central estimate is currently £35-39bn (£40-45bn).

On the financing share the 2018 EU budget estimates assume a UK share of the budget of 12.7%, and if it remained at this level in 2019 and 2020, then the share over the whole MFF period would also be 12.7%. Applying the appropriate shares to each of the components in turn, gives the following breakdown:

i) The UK’s net contribution to the EU budget for the remainder of 2019, following our withdrawal, and for 2020 is around €17-18 billion. This is
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consistent with the forecast published by the Office for Budget Responsibility and takes account of receipts received by the UK private sector.

ii) For the RAL after 2020, the UK’s net share is currently estimated at €21-23 billion. This is based on the forecasts released in the 2016 mid-term review of the MFF, updated to reflect recent approved budgets and adjusting for commitments not implemented as payments. Estimates of the UK’s share of receipts can be derived from recent EU Financial Reports.

iii) For liabilities, the estimate is €9-10 billion. After taking into account both reflows associated with these liabilities and also corresponding assets, including the return of €3.5 billion from the EIB, this generates an overall range of €2-4 billion. The bottom end of that range is based on the figures in the 2016 annual accounts. The assets and liabilities are currently expected to generate flows for a number years (in the case of pensions, for many decades). This creates significant uncertainty over the actual value that will be paid and abnormally low Eurozone interest rates create a high valuation for the pension liability in the EU’s accounts.

In total this provides the reasonable central estimate of £35-39bn (€40-45 billion).

Finally, I would like to draw the Committee’s attention to paragraph 96 in the report, which states ‘[the report] is agreed by the UK on the condition of an overall agreement under Article 50 on the UK’s withdrawal, taking into account the framework for the future relationship, including an agreement as early as possible in 2018 on transitional arrangements.’

I am copying this letter to the Chairs of the Committee of Public Accounts, Exiting the European Union, European Scrutiny, European Union and the EU Financial Affairs Sub-Committee. I have deposited a copy of this letter in the House of Commons Library.

PHILIP HAMMOND