House of Commons

Business and Enterprise Committee

Funding the Nuclear Decommissioning Authority: Government Response to the Committee's Fourth Report of Session 2007–08

Fifth Special Report of Session 2007–08

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The Business & Enterprise Committee

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Fifth Special Report

The Business and Enterprise Committee published its Fourth Report of Session 2007–08 on 7 April 2008. The Government's response was received on 5 June 2008, together with a Report on the NDA budgeting shortfall. The Committee requested further clarification and the Secretary of State responded on 26 June 2008. The Government response, the correspondence with the Secretary of State and the Report on Budgeting Shortfalls and the Secretary of State's letter are appended to this Report.

Appendix 1: Government response

RESPONSE TO THE BUSINESS AND ENTERPRISE COMMITTEE REPORT FUNDING THE NUCLEAR DECOMMISSIONING AUTHORITY.

1. The purpose of this memorandum is to provide a response to the Business and Enterprise Committee's report, "Funding the Nuclear Decommissioning Authority", which was published on 7 April.

2. We welcome publication of the Committee's report and have noted the detailed conclusions and recommendations. The report makes a number of pertinent and constructive comments and asks the Department to produce additional work to address several issues. In a number of cases, these are issues which the Department had already identified as needing further work, and we have already begun discussing with the NDA and Treasury.

3. Attached to this response is a report, "NDA Budgeting Shortfall 2007-08 – Lessons Learned Report", commissioned by the Permanent Secretary and referred to in his evidence to the Committee.

<u>Waste Substitution Income</u>

We emphasise that none of the issues raised in this short report should have any consequences for the construction of new nuclear power stations. Separate special funding arrangements are being developed for their decommissioning. (Paragraph 7)

4. We welcome the Committee's recognition that none of the issues raised in the report should have any consequences for the construction of new nuclear power stations.

<u>Shortfall in the NDA's Budget</u>

The National Audit Office (NAO), in its January 2008 report into the NDA, identified uncertainty as to whether the waste substitution income budgeted for would actually be forthcoming in the 2007/08 period. It seems that this uncertainty has been resolved and the money has been raised; we are therefore surprised that the NDA was suddenly told by the Treasury that—owing to a technical accounting issue—it might not be able to spend it. (Paragraph 12)

We believe this issue could and should have been addressed earlier. The nature of waste substitution income has been known since the 2004 consultation, if not earlier, and we

find it unlikely that the relationship of these contracts to the original reprocessing contracts became clear only immediately before contracts were finalised in December 2007. (Paragraph 13)

5. In Autumn 2006 the Department recognised that there was uncertainty about waste substitution income, a significant element of the NDA's commercial income for 2007/08. As noted in the National Audit Office's report, *The Nuclear Decommissioning Authority: Taking Forward Decommissioning* (para 3.18) the possibility that there would be a £400 million shortfall in commercial income in 2007/08 led to a review from November 2006 of how that shortfall could be managed, including through finding offsetting savings and the deferral of work on sites owned by the NDA.

6. In February 2007 when notifying the NDA of their budget allocation for 2007/8 the Department and the NDA recognised that there was still a significant degree of uncertainty remaining in relying on income from the waste substitution contracts.

7. The waste substitution contracts and underlying waste reprocessing contracts are exceptional and are highly complex, reflecting both the nature of the activities performed and individual variations between customers. The contracts themselves have been in the process of negotiation for a number of years and the detailed terms of the contracts were not finalised until December 2007.

8. As the terms of the contract were being finalised, the Department, the NDA and its advisers and the NAO looked at the detail of the budgeting and accounting treatment of waste substitution income. As these discussions developed between NDA, BERR, Shareholder Executive and HMT, it became clear that there were doubts about whether the proceeds could be applied in total and immediately to expenditure

9. At the time of the Spring Supplementary, the Department took a prudent position on the NDA's budget, based on the information available at the time having taken into account advice from NDA's advisers. This indicated that on the basis of analysis conducted up to that point, there would be a requirement to recognise the revenue over the life of the original reprocessing contracts rather than being able to apply the proceeds immediately and in full in 2007/8. Therefore, at this stage the prudent course of action for the Department was to submit a bid to cover the shortfall in NDA's budget that would then result.

10. On 21 April 2008 the NAO submitted their final paper setting out their opinion on the proposed accounting treatment of WSI. Their conclusion is that the NAO considers the NDA's proposed accounting treatment to recognise all of the WSI in 2007/8 is reasonable. With the accounting treatment confirmed, the budgeting treatment usually follows suit. This will allow the Reserve Claim and additional funding provided by BERR at the Spring Supplementary to be repaid.

NDA Derogation

The previous existence of a derogation allowing the NDA to recognise the income from some long-term contracts upon receipt suggests that the NDA, the Treasury and the Department should already have been alert to the fact that the accounting treatment of long-term contracts might need to be considered. We are therefore surprised and

disappointed that when this issue reappeared, albeit in a different context, everyone appears to have been caught unawares. (Paragraph 16)

11. The response to this is addressed in detail in the accompanying report, "NDA Budgeting Shortfall 2007–08—Lessons Learned Report."

The 2005/06 derogation could have been the basis for a solution that would not have involved spending £256 million of the Department's accumulated EYF and claiming on the reserve. We would like to know if this was considered as an option once the issue came to light and, if it was rejected, for what reason. Given the references to the derogation in the Estimate Memorandum we would like to know whether any party wrongly assumed that the derogation still applied and if not—as seems likely from the evidence we received—why the Estimate Memorandum made reference both to the derogation and the date of its expiry in April 2006. (Paragraph 17)

12. Reinstating the derogation was rejected as an option for funding the shortfall in the NDA's budget as it would have the same cost for Government as providing additional funding through End Year Flexibility and from the Reserve and would also be less transparent.

Spring Supplementary Estimate Memorandum

The Spring Supplementary Estimate Memorandum did not give an entirely accurate picture of the situation. Accuracy in such documents is always essential, but for such a large request for additional funding at such a late stage in the financial year, this is particularly regrettable. These differences between the Memorandum's version of events and what we were told in evidence suggest poor communication between the Department and the NDA, which might have played some part in the situation occurring in the first place. We expect that future Estimates Memoranda will be drawn up after close consultation between the parties involved. (Paragraph 21)

13. The Memorandum on the Spring Supplementary Estimate was prepared by the Department on the prevailing understanding of the issue at the time—i.e. that the need to recognise WSI under the principles of long-term contract accounting had resulted in a potential shortfall in NDA budgets in 2007/8 which needed to be addressed through the use of End Year Flexibility and a Call on the Reserve. This was essentially a snapshot during a time of intense co-operative work between BERR, NDA, HMT, the NAO and external advisors to determine the correct accounting treatment for the complex waste reprocessing contracts and the substitution contracts. BERR, NDA and HMT also worked closely together to prepare evidence for the Committee hearing. The Department accepts that it is crucial that all parties involved communicate fully on issues around the Estimates Memoranda.

Impact on the Department

We recognise that, due to the provision in the Spring Supplementary Estimate, there has been relatively little impact on the NDA, despite the sums of money involved. We are concerned, however, that accounting uncertainty had the potential to impact drastically upon the NDA's funding of decommissioning of existing nuclear liabilities.

We urge the Government to resolve this issue as soon as possible in a way which will not delay future spending on decommissioning. (Paragraph 25)

14. The waste substitution income contracts are highly unusual in that they combine significant complexity with very high value (hundreds of millions of pounds). As a result, the question of whether the income could be recognised in 2007/8 had a very substantial impact both on the Department's and the NDA's budget.

15. The Spring Supplementary Estimate process ensured that the NDA's decommissioning expenditure commitments were safeguarded. However, for commercial income contracts of such complexity it is inevitable that there will be some degree of uncertainty over income levels until the NAO sign-off the accounts.

16. The Department will continue to work with the NDA and its advisors and the NAO to ensure that any areas requiring accounting judgements are highlighted and well understood in order to minimise levels of uncertainty at year end.

Sir Brian told us that the precise sequence of events that led up to the requirement for an additional £303 million is the subject of a review within the Department, HM Treasury, the NDA and the Shareholder Executive. We look forward to receiving the Permanent Secretary's promised note outlining its findings and any action to be taken. In particular, we would like to know exactly when and how this issue came to light, what advice the Department gave to the NDA, what advice the Treasury gave to the Department, what grounds there were for the Treasury's apparent insistence on spreading this income over several years and what action will be taken to ensure that such issues are identified sooner in future. (Paragraph 26)

17. The points in paragraph 8 of the conclusions and recommendations in the report are addressed in the accompanying report, "NDA Budgeting Shortfall 2007–08—Lessons Learned Report."

Funding the NDA

Public funding for the NDA will almost certainly have to increase significantly in the coming years over and above current plans. If nuclear decommissioning is going to be carried out as planned this has major implications for the Department for Business, Enterprise and Regulatory Reform, which already spends over 40% of its Departmental Expenditure Limit on the NDA. (Paragraph 31)

18. Government spending on the NDA will increase by over £0.8bn in the Comprehensive Spending Review 2007 (CSR07) compared with Spending Review 2004 settlement; this is equivalent to annual average real growth of 4.9%, reflecting the Government's commitment to ensure the UK's civil nuclear liabilities continue to be managed safely, securely and cost effectively. The level of public funding for the NDA will be reviewed in future Spending Reviews, recognising the need to strike a balance between what is desirable and what is affordable, while ensuring site safety.

19. We have issued formal budget allocations for 2008/9 and indicative budget allocations for the remainder of the CSR period that reflect the Department's settlement

and are unaffected by the action taken on the NDA in the Spring Supplementary Estimates.

We welcome the assurance given by the Permanent Secretary that the Department's budget will be insulated from the NDA for 2008/09 and subsequent years and look for further specific assurances from Government that NDA funding requirements will not impact on other areas of the Department's work. Government departments that have experienced funding problems in one area of their activities have often had to make reductions in other unrelated areas. The scale of the NDA as a proportion of BERR's overall budget makes such a prospect completely unacceptable in this case. (Paragraph 32)

20. The NDA's budget is ring-fenced within BERR's budget. Current arrangements are that all BERR budgets (including the NDA) are managed within the overall Departmental Expenditure Limit. As such, should additional funding be needed for the NDA in future years BERR will first look to non-ringfenced budgets to make good the shortfall: this is a standard budgeting arrangement and ensures resources are allocated as efficiently as possible within the department and across Government and better enables the Government to manage its total finances.

We believe the NDA's funding model is unsustainable. We note the Department's assurances that a solution has been found for the current Comprehensive Spending Review period. However, in view of the volatile—and declining—nature of the NDA's commercial income we are sceptical about how watertight such an assurance can be. Nuclear decommissioning is too important to be left to the mercy of changing priorities in the Treasury and uncertain commercial income; as the Permanent Secretary acknowledged, a new system of funding is needed, and work on this needs to begin urgently. (Paragraph 37)

21. The NDA was set up to deliver the Government's commitment to dealing with the nuclear legacy, which was not being sufficiently addressed by either BNFL or UKAEA, neither of which had decommissioning as a priority.

22. The NDA is funded by a combination of Government funding and commercial income. This duality of funding provides an incentive for NDA to optimise the returns from its commercial assets but does present a challenge as a number of these assets are ageing and therefore operationally unpredictable. Since the NDA was created the amount being spent on decommissioning and liabilities management has very significantly increased year on year. The NDA's total spend was £2.4 billion in 2005/06; £2.6 billion in 2006/07; and is forecast to be around £2.7bn in 2007/08. Government funding has increased proportionately more at £1.2 billion in 2005/06, £1.5 billion in 2006/07 and £1.8 billion in 2007/8. Commercial income is volatile and over time is declining as sites progressively close and move into the decommissioning phase.

23. The funding model was originally selected because it incentivises NDA to make the best use of its existing assets for revenue generation, minimising decommissioning costs for the taxpayer, whilst providing ring-fenced funding from BERR's budget.

24. Government has agreed that it will consider whether there are changes that could be made to the NDA funding model to better enable its funding to be managed effectively

while maintaining the right incentives and controls. It has been agreed that these options will be considered by HMT in advance of the next spending review.

Appendix 2: Correspondence with the Secretary of State

Letter from the Chairman of the Committee to the Secretary of State

My Committee is grateful to BERR for its response to our recent Report on *Funding the Nuclear Decommissioning Authority*, but would appreciate clarification on one extremely important point.

When he appeared before the Committee, Sir Brian Bender told us "what the Treasury have accepted is that we insulate the department's budget for 2008-09 and subsequent years from the NDA." (Q 63). The Government response says:

"The NDA's budget is ring-fenced within BERR's budget. Current arrangements are that all BERR budgets (including the NDA) are managed within the overall Departmental Expenditure Limit. As such, should additional funding be needed for the NDA in future years BERR will first look to non-ringfenced budgets to make good the shortfall: this is a standard budgeting arrangement and ensures resources are allocated as efficiently as possible within the department and across Government and better enables the Government to manage its total finances."

Given the inherent difficulty in predicting NDA's budgetary requirements, we are extremely concerned that movements in the NDA's financial position could have very serious effects on the budget of the Department as a whole. We would be grateful for an explanation of the apparent discrepancy between what Sir Brian told us, and the subsequent Response.

Peter Luff, Chairman, Business and Enterprise Committee

17 June 2008

Letter from the Secretary of State to the Chairman of the Committee

Thank you for your letter of 17 June 2008.

You sought clarification between comments which Sir Brian Bender made when appearing before the Committee on 4 March 2008 and the Government response regarding the funding for any shortfalls in the NDA and the impact on non-ringfenced areas of the Departmental budget.

Sir Brian's comments were accurate, non-NDA budgets were insulated in 2008–09 and were not cut, nor was there a delay in issuing them as a result of the issues surrounding the NDA.

During the Committee hearing Sir Brian also explained the process that would be involved in making good any future shortfall within the NDA: "step one, have the NDA got the money; step two is the money somewhere in the Department's books, including the end-year flexibility cushion…..; step three, if neither of us have got it can the Treasury find it from the reserve" (Q 53).

Were the NDA unable to manage any shortfalls arising in-year the Department would look to any internal underspends in non-ringfenced budgets. These underspends represent money that would not have been spent—irrespective of any shortfalls in the NDA—and future budgets for those areas would be unaffected.

Finally, were the Department unable to meet shortfalls from underspends we would approach Treasury for access to End Year Flexibility or make a request for resources from the Reserve. This is the standard mechanism for addressing such shortfalls and is consistent with the response from the Government.

I hope this letter addresses your concerns and I thank you for the opportunity to do so prior to publication of the final response.

The Rt Hon John Hutton MP, Secretary of State for Business

26 June 2008

Appendix 3: NDA Budgeting Shortfall 2007–08: Lessons Learned Report Summary

NDA BUDGETING SHORTFALL 2007–08 LESSONS LEARNED REPORT SUMMARY

Introduction

1. The 2008 Spring Supplementary Estimate for BERR asked for an additional £400 million to be made available to the Nuclear Decommissioning Authority (NDA) for the financial year 2007-08. Of this total, £256 million of near cash was raised from the Department's End Year Flexibility (EYF), £97 million was claimed from the Reserve and £47 million of capital was allocated from unspent funds elsewhere in the Department.

2. When the Reserve claim was made, BERR's Permanent Secretary asked his Head of Internal Audit, in co-operation with the NDA and Treasury (HMT), to examine the circumstances that led to the need for a reserve claim with a view to learning lessons for the future. This is the report of that work.

Background

3. In November 2007 at a meeting between BERR and NDA officials it came to light that the budgeting treatment for certain commercial income streams which, at that stage, was assumed to include Waste Substitution Income (WSI), was likely to be different from the budgeting treatment assumed for 2007-08 and in the CSR07 settlement.

4. Both the 2007-08 forecast for commercial income and CSR settlement, were based on WSI being recognised when the cash was expected to be received allowing for end-year accruals. In November 2007, during the latter stages of WSI contract negotiation, it was agreed that WSI would be contracted as a variation to original reprocessing service agreements rather than being subject to a separate agreement. In January 2008, the UK GAAP accounting treatment of WSI that would follow as a consequence of this agreement was still under discussion. At that time, on the basis of work completed, advice from the NDA's accounting advisors, Deloitte, was that the revenue from WSI should be taken as part of the long term work in progress accounting and spread over the life of the relevant contracts. Under HMT's budgeting rules, HMT determines the budgeting treatment of income which usually follows the UK GAAP accounting treatment. Consequently, in the absence at that time of more specific information for the relevant contracts, it was presumed likely that only a proportion of the WSI would be recognised as income in 2007-08. Therefore, the Department took the prudent course of requesting a Supplementary Estimate to address what was considered to be the likely budgetary shortfall.

5. By the middle of March, NDA had further developed their review of the WSI income and the relevant contracts to the point that an alternative accounting treatment was proposed. Their view was that it was correct application of UKGAAP and Government accounting rules (under the Government's Financial Reporting Manual - FReM) to take the invoiced amount in full to income in the month in which the invoices were raised.

This would lead the NDA to record income of £438m for the contracts in the 2007-08 financial year meaning that the additional funding granted in the Spring Supplementary Estimate would not be required and therefore that the Reserve claim could be repaid. On 21st April 2008 the NAO confirmed that this proposed accounting treatment was reasonable.

Findings and lessons learned

6. In May 2005, a revenue derogation was granted by HMT which allowed revenue from certain long-term contracts for which the accounting treatment was uncertain to be scored in full to the Departmental Expenditure Limit (DEL) at the point of invoice. The derogation was for one year only to allow time for the correct accounting treatment to be determined.

7. At a meeting in February 2006 between the NDA and HMT, the NDA understood verbal agreement to have been given to the extension of the revenue derogation beyond 2005-06. This was a misunderstanding, the most likely cause of which is set out in paragraph 18 of the main report.

8. When accounting policies were agreed for the 2005-06 audit, subsequent years' budgets were not revisited and re-profiled to match the accounting treatment. In 2006-07 the immaterial difference between the cash receipts and accruals treatment meant that this discrepancy went unnoticed.

9. Although the derogation was wrongly assumed by NDA to be in operation after 2005-06, it was not applied to WSI. The uncertainty over the budgeting treatment of WSI arose from the fact that in November 2007, during the latter stages of the WSI contract negotiation, it was agreed that WSI would be contracted as a variation to original reprocessing service agreements rather than being subject to a separate agreement. This raised uncertainty over the accounting, and hence budgeting treatment of WSI, which Deloitte were then engaged to advise on.

10. At the time of the Spring Supplementary Estimate, on the basis of work completed, the advice from the NDA's accounting advisors, Deloitte, was that the revenue from WSI should be taken as part of the long term work in progress accounting and spread over the life of the relevant contracts. In the absence at that time of more specific information for the relevant contracts, it was presumed likely that only a proportion of the WSI would be recognised as income in 2007-08. Therefore, the Department took the prudent course of requesting a Supplementary Estimate to address what was considered to be the likely budgetary shortfall.

11. BERR, NDA and HMT have considered what lessons can be learned from the chain of events that led up to the need for a Spring Supplementary Estimate. The Lessons Learned section of the main report includes agreed actions under the following headings: Corporate Memory; Strengthening of the NDA finance team; Clarity of financial reporting; Maintenance of formal records; and the NDA funding mechanism, as well as acknowledgement of action taken in November 2007 to strengthen BERR's governance of the NDA.

DETAILED REPORT

12. When the NDA was created in 2005-06, specific treatments for the reporting of income and expenditure against the Departmental Expenditure Limit (DEL) were agreed in a letter from HMT to DTI dated 26th May 2005.

13. This letter sought to align the NDA's DEL budget with its cash requirements by excluding potentially significant and unpredictable non-cash items from BERR DEL and allowing them to be classified in BERR Annually Managed Expenditure (AME). These included:

- New provisions and changes to existing provisions (i.e. the nuclear liability);
- and charges for the cost of capital and depreciation.

14. This derogation from standard budgeting treatment was set out in DTI's SR2004 settlement of July 2004 and was subsequently rolled over into the CSR07 period and the continuation of these derogations is explicitly stated in the CSR07 settlement letter from HMT to BERR of 8th October 2007.

15. However, the May 2005 letter addressed to DTI also agreed exceptional treatment in 2005-06 for certain revenue flows where the accounting treatment was uncertain and the accruals profile was likely to differ significantly from the cash profile assumed in SR2004. Flows covered by these revenue derogations were in relation to Thorp and Magnox reprocessing income, Mox income and related long term work in progress costs.

16. For these items, revenue could be scored in full to DEL when the cash was received, allowing for end-year accruals. Any difference between this figure and the accounting treatment under FReM (and therefore UK GAAP) was to score as AME. This derogation was not reflected in DTI's SR2004 settlement letter of July 2004 and was, according to the May 2005 letter, applicable only to the 2005-06 financial year.

17. The revenue derogation was granted in May 2005 in recognition that the accounting policies for certain long term contracts had not been agreed and therefore NDA were unable to prepare 2005-06 budgets using the same basis as the accounting. A delay in agreeing the treatment of £3.3bn of deferred income on BNFL's balance sheet, led to all three years of SR2004 being profiled on the basis of the derogation.

18. At a meeting in February 2006 between the NDA and HMT, the NDA understood verbal agreement to have been given to the extension of the revenue derogation beyond 2005-06. No minutes of this meeting can be found. In the absence of a written record of the meeting this misunderstanding is most likely explained by a reference to the roll forward of the SR2004 derogations mistakenly being taken to also include the time limited revenue derogation set out in the HMT's letter to DTI on 26th May 2005.

19. When accounting policies were agreed for the 2005-06 audit, the accounting treatment of income from long-term contracts was to recognise income according to the stage reached in the contract by reference to the value of work done. Under HMT's budgeting guidance, the budgeting treatment of income usually follows the accounting

treatment. However, budgets for 2006-07 and subsequent years were not re-profiled to reflect the agreed accounting policy but instead remained on the basis of the derogation.

20. This oversight was not picked up in 2006-07 because in that year there was an immaterial difference in accounting terms between the income figure recognised on the basis of FReM and the cash received (allowing for end-year accruals). It was less than £10m and 1% of total income for the year of £1,250m. At no time did NDA apply the derogation to WSI.

21. The timing of income from waste substitution was first flagged by the NDA in April 2006 as part of discussions on the 2007-08 budget and CSR07 submission. At that time it was anticipated that WSI would be subject to a separate agreement rather than a variation to existing reprocessing, waste management and decommissioning contracts. On the basis of this assumption, NDA informed BERR that if WSI were to be included, it would be included on the basis that it was recognised when invoiced and receivable. BERR therefore confirmed to HMT that WSI would be recognisable in both budgets and accounts.

22. In their initial bid for 2007-08 funding and CSR07 bid NDA did not include WSI revenues and instead requested additional Grant-in Aid funding to fill the shortfall that would materialise if WSI were not received. As BERR/HMT assumed the accounting/budgetary treatment was set/agreed the issue that dominated discussions was that of the timing of the WSI (i.e. when the income could be recognised) and the subsequent impact on the 2007-08 budget. Following discussions with BERR and HMT over the likely timing and accounting recognition trigger (not treatment) of WSI, the Permanent Secretary of BERR wrote to the NDA chairman in February 2007 confirming that for budgeting purposes, NDA should assume that the WSI will be earned in 2007-08. This letter was sent to acknowledge that the evidence available at that time was that WSI would accrue in 2007-08, and to record that in the event that it did not, DTI would provide NDA with additional Grant in Aid. However, the letter was also seen by the NDA as a correct and reasonable instruction that confirmed their understanding of the budgeting treatment.

23. In November 2007, during the latter stages of WSI contract negotiation, it was agreed that WSI would be contracted as a variation to original reprocessing service agreements rather than being subject to a separate agreement. NDA engaged Deloitte to consider the accounting consequences of this decision. The NDA were aware of the possibility that the accounting treatment could be different to the budgeting treatment assumed in CSR07 and the 2007-08 budget, but did not regard this as problematic because of their understanding that the revenue derogation had been extended, and therefore of the possibility that it could be applied to WSI.

24. BERR became aware of the continued reliance on the derogation by NDA during discussions with them in early November 2007. This was then raised by BERR in a meeting with HMT on 14th November. At a further meeting between HMT and BERR on 29th November it was established that there was no agreement to roll forward the derogation beyond the end of 2005-06 and therefore no possibility of it applying to WSI.

25. On 15th January 2008 a meeting was held between NDA, BERR, HMT and Deloitte, at which an accounting treatment paper drafted by Deloitte was discussed. Deloitte's advice at this meeting was that WSI was a contract variation and should be taken as part of the long term work in progress accounting and spread over the life of the relevant original contracts. Although other accounting treatments were discussed, at this time, on the basis of preliminary work done, these were not seen as viable options. Under HMT's budgeting rules, HMT determines the budgeting treatment of income which usually follows the accounting treatment. Consequently, in the absence at that time of specific contract information for the relevant contracts, it was presumed likely that only a proportion of the WSI would be recognised as income for 2007-08. With the likelihood that the majority of the WSI revenue was to be excluded from income, there was a need for additional funding for the expenditure that was to have been funded by this income. Although BERR were aware that NDA had further work to do before reaching a definitive judgement on accounting treatment, the Department took the prudent course of requesting a Supplementary Estimate to address the likely budgetary shortfall.

26. At the time of the preparation of briefing for the Select Committee hearing on 4th March 2008, NDA's work reviewing the extremely large and complex long term contracts, which included the WSI contracts, had progressed to a point where alternative accounting treatments were thought possible. It was therefore reported to the hearing that this work was still in progress and had yet to conclude.

27. By the middle of March, the review of the contracts had progressed to the point that an alternative accounting treatment was proposed by the NDA. At the NDA audit committee on 19th March 2008 the committee endorsed a paper setting out the NDA's alternative accounting, and therefore budgeting, treatment for WSI. The proposed treatment was to take the invoiced amount in full to income when the service was delivered. This would lead the NDA to record income of £438m for the contracts in the 2007-08 financial year. The paper noted that the above treatment had been fully disclosed to the NAO for consideration via NDA's interim accounts. However, it is the Office for National Statistics (ONS) acting as an independent agency that determines the treatment of income in the National Accounts and confirmation is still awaited that WSI may be treated as income.

28. On 21st April 2008 the NAO submitted their final paper setting out their opinion on the proposed accounting treatment of WSI. This set out that the NAO considers that NDA's proposed treatment to recognise all of the WSI in 2007-08 was reasonable. This is still subject to final sign-off of the accounts by the CA&G. Therefore with the accounting treatment agreed the budgeting treatment usually, subject to confirmation by ONS, follows suit.

29. In correspondence throughout 2006 and 2007, there was incorrect and inconsistent use of the term 'near cash' budgeting treatment when used in relation to the NDA. There was a misconception that the term meant that income associated with long-term contracts would be recognised on a cash receipts or receivable basis. This led to confusion between NDA, BERR and HMT as when NDA stated they were budgeting on a 'near cash' basis, for example in their CSR07 submission, BERR and HMT would have understood this to mean income was being treated in accordance with the accounting treatment required by the FReM and UK GAAP (as per Treasury's budgeting guidance)

whereas NDA were actually saying income was being treated on a cash received or receivable basis (i.e. allowing for year end accruals).

LESSONS LEARNED

30. BERR, NDA and HMT have considered what lessons can be learned from the chain of events that led up to the need for a Spring Supplementary Estimate. The actions that have been agreed are described in the next section of this report.

Corporate Memory

31. The time limit on the revenue derogation granted in May 2005 was overlooked by BERR and HMT. Had there been some form of prompt in place near the time of its expiry, either within BERR or HMT, then the erroneous application of the derogation by NDA into 2006-07 would most likely have been picked-up.

32. The Finance Directorate in BERR (FRM) has committed to establish and maintain a log of key budgeting and accounting issues and judgements. This will include all material departures from standard government accounting and budgeting treatment which have been agreed, such as budget derogations agreed with HMT and accounting treatment agreed with the NAO for highly material, complex or subjective areas where significant debate and/or consultation has been undertaken to agree the appropriate treatment.

33. This log will be subject to regular review jointly with the HMT, NAO and other relevant third parties, such as the NDA, to ensure these departures from standard treatment are still appropriate. Timing of the review will coincide with the Spending Review, budget/Estimates preparation and the review of accounting policies by FRM during the resource accounts preparation period.

Strengthening of NDA finance team

34. The NDA recruited a finance team with a high degree of commercial expertise and experience. However, government accounting and budgeting rules are complex and differ in some material ways from those that apply in the commercial world. The NDA has acted to acquire training for its finance staff from the National School of Government. When this is completed the NDA will assess whether any further action is required to equip the team with the requisite level of government accounting and budgeting knowledge. This assessment is to be discussed with BERR.

Clarity of financial reporting

35. NDA's budgets are complex with many individual elements that are prone to fluctuation and over which the NDA has varying degrees of direct control. In order that all parties can maintain a complete understanding of the numbers, NDA and BERR have undertaken to consider jointly how the reporting of financial information to BERR can be done with greater transparency, for example, by showing the movement of individual budget elements even when the net movement may be immaterial, and being clear as to which elements are expected to move over time and why.

36. The underlying accounting records and processes in the Nuclear Estate are wholly and exclusively based on commercial accounting, and do not have embedded within

them government accounting or budgetary controls which have to be overlaid by the NDA. The NDA will undertake an assessment of how the government accounting framework is applied to budgetary control, the results of which will be considered along side the assessment of the skills of their finance team.

Maintenance of formal records

37. The meeting in February 2006 at which NDA understood HMT to have given verbal agreement to the extension of the revenue derogation was significant. There is no formal record of that meeting, nor was there subsequently any correspondence that confirmed what those present believed to have been agreed. To minimise the risk of misunderstandings in the future, all parties have acknowledged the importance of agreeing a written record of all material decisions and future actions.

NDA funding mechanism

38. The NDA is funded by Government funding and from commercial income. The commercial income is volatile and over time will decline as sites progressively close and move into the decommissioning phase. The grant-in-aid portion of the NDA's income already represents a very sizeable proportion of BERR's annual budget - 42% of the original total DEL for the 2007-08 financial year.

39. Although the accounting treatment of WSI has now been agreed on a basis other than was assumed at the time of the Supplementary Estimate, the fact that the funding gap anticipated was met in part by using all of BERR's end year flexibility, illustrates the extent to which the Department is vulnerable to movements in the NDA's budget caused in large degree by the reliance on volatile commercial income.

40. Government has agreed that it will consider whether there are changes that could be made to the NDA funding model to better enable its funding to be managed effectively while maintaining the right incentives and controls. It has been agreed that these options will be considered by HMT in advance of the next spending review

Governance of the NDA

41. In November 2007 it was agreed that the level of resource devoted within BERR to sponsorship of the NDA should be increased and that responsibility should transfer from the Department's Energy Group to the Shareholder Executive. This change was made in order to provide a level of finance and governance expertise commensurate with the inherent risks posed by the NDA's business. The NDA team within Shareholder Executive has a balance of commercial and government accounting and budgeting experience which will be kept under review to ensure that the correct skills set is maintained. There will continue to be regular communications between NDA, Shareholder Executive, HMT and BERR.

BERR Internal Audit
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