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How Does Government Use Corporate Finance Techniques To Support Taxpayers?

Matthew Rees, Director of Commercial Hub & Insights Team, National Audit Office

Thursday, 24 November 2022

A Word From Today's Chairman

Professor Michael Mainelli

Chairman

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Today’s Agenda

- 15:00 – 15:05 Chairman’s Introduction
- 15:05 – 15:25 Keynote Presentation – Matthew Rees
- 15:25 – 15:45 Question & Answer

Today’s Speaker

Matthew Rees

Director of Commercial Hub & Insights Team

National Audit Office

National Audit Office

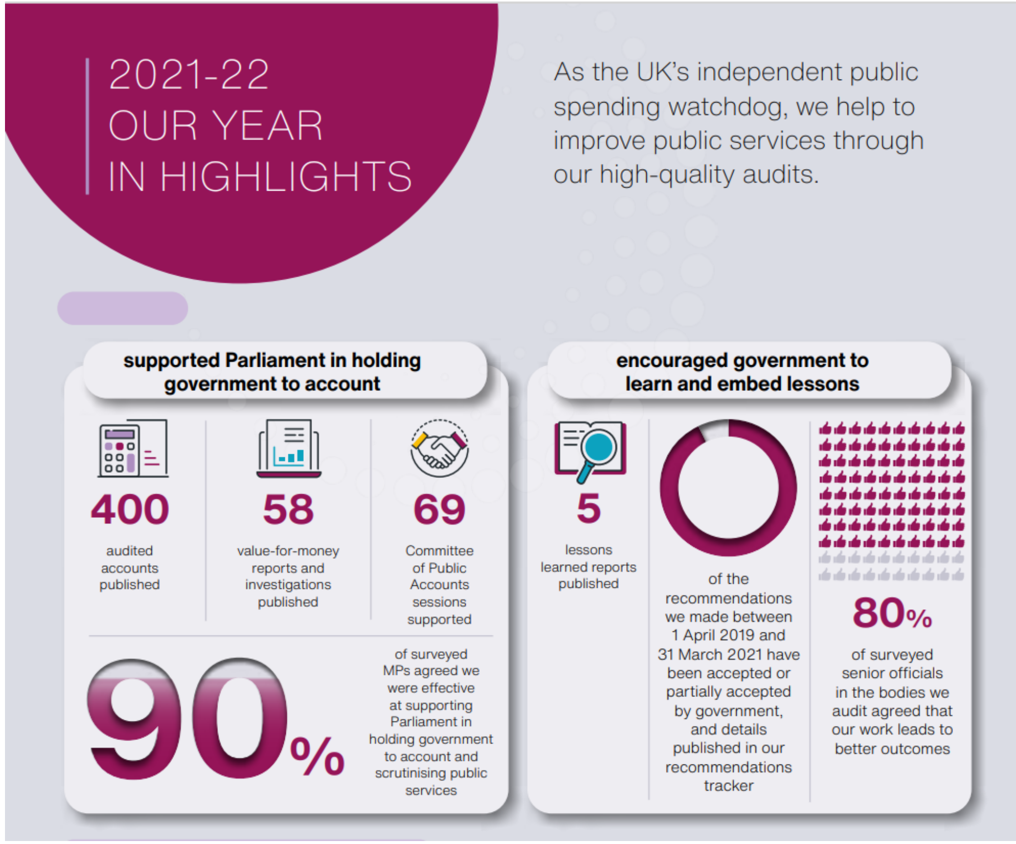
How does government use corporate finance to support taxpayers?

24 November 2022

Introduction to the NAO

The NAO supports Parliament to hold Government to account for taxpayer value

National Audit Office



HM Treasury

Department for Business, Energy & Industrial Strategy

Reviewing corporate finance activity for 35 years

Examples of corporate finance techniques used to deliver policy objectives

Privitisation / PFI (1980s/90s) → Financial Crash (2008) → Further sales / interventions (2010-14) → COVID-19 (2020-21) → Cost of living / energy costs (2022)

Private sector efficiency and incentives

Privatisations – water, energy

Private finance initiative - infrastructure

Address systemic risk

Bank rescues / subsequent sales

RBS

northern rock

LLOYDS BANK

Raise proceeds

Royal Mail

EUROSTAR

Railway arches

NetworkRail

Support businesses

#BounceBackLoans

Generate income

Local authority commercial investments

Pay suppliers faster

Supply chain finance

Greensill

Support business finance / open new markets

State owned banks

BRITISH BUSINESS BANK

Green Investment Bank

UK INFRASTRUCTURE BANK

Address corporate failures:

Adult social care

Southern Cross Healthcare

Hospitals / PFI

carillion

Passenger rail franchises

Energy supplier market – failure of retail sector

NAO guide to corporate finance in the public sector

We published the guide to support senior leaders to deliver successful outcomes

How to use this guide

This guide comprises 14 themes grouped into three areas to consider when using corporate finance techniques in the public sector:

1. Principles and concepts
2. Organisations and functions
3. Transactions

The first area is relevant for all those considering using corporate finance. It helps with the scrutiny of the **principles and concepts** for determining whether to use corporate finance and which approaches to take. Our work shows that for corporate finance activities to be successful, organisations need to have considered the underlying principles and concepts, and have the right organisational arrangements in place to support the delivery of the objective.

The next two areas explore the risks and opportunities around the various **organisations and functions**, and **transactions**, that can be used to achieve the objectives.

In **Part One** of this guide, we set out the key high-level questions senior leaders should consider when scrutinising corporate finance techniques.

In **Part Two**, we share our insights on each of the 14 themes. We set out some questions you may wish to use or consider as you develop your approach. We also include case examples and other useful resources.

Part Three provides some further resources, including information to help with understanding balance sheet accounting and implications; and additional information to support the principles and concepts.

[Good practice guidance: Guide to corporate finance in the public sector (nao.org.uk)]

Our guide contains 14 sections

Principles and concepts
- Analysis and evaluation
- Valuation and investment appraisal
- Government balance sheet and accounting
- Capability and advisers
- Governance and stewardship

Organisations and functions
- Companies
- Joint ventures
- Government financial institutions
- Commercial functions and regulators

Transactions
- Asset sales and privatisations
- Acquisitions and investments
- Lending
- Financial guarantees
- Private finance

Each section contains
- Description – what we mean
- Questions to ask based on NAO reports
- Relevant government guidance / other materials
- Case studies

The guide is informed by our past reviews

Developed by consulting experts in government, private sector, advisor community

Aimed at improving oversight by senior leaders and audit & risk committees

Not a 'how to' guide, but includes important explanation about government accounting conventions

Poll 1

Government applies a standard discount rate, known as the “social time preference rate” for investment appraisal. What is the current rate?

- 3.0%
- 3.5%
- 4.0%

Case studies

	Section	Case study 1	Case study 2
Principles and concepts	Analysis and evaluation	First sale of shares in Royal Bank of Scotland	Thames tideway tunnel early review of potential risks to value for money
	Valuation and investment appraisal	The sale of Eurostar	The Privatisation of Royal Mail
	Government balance sheet and accounting	Evaluating the government balance sheet: borrowing	The sale of student loans
	Capability and advisers	Specialist skills in the civil service	Commercial skills for complex government projects
	Governance and stewardship	Investigation into supply chain finance in the NHS	The Ministry of Defence's arrangement with Annington Property Limited
Organisations and functions	Companies	Companies in government	The Motability Scheme
	Joint ventures	Spinning out MyCSP as a mutual joint venture	Shared Service Centres
	Government financial institutions	British Business Bank	The Green Investment Bank
	Commercial functions and regulators	The adult social care market in England	The economic regulation of the water sector
Transactions	Asset sales and privatisations	The £13 billion sale of Northern Rock assets	The first sale of shares in Lloyds Banking Group The return of Lloyds Banking Group to private ownership
	Acquisitions and investments	Local Authority Investment in Commercial Property	Venture capital support to small businesses
	Lending	Investigation into the Department of Energy & Climate Change's loans to the Green Deal Finance Company	Help to Buy: Equity loan scheme – progress review
	Financial guarantees	Investigation into the Bounce Back Loan Scheme The Bounce Back Loan Scheme: an update	UK Guarantees scheme for infrastructure
	Private finance	Hinkley Point C	The choice of finance for capital investment

Asset sales and privatisations

Government uses asset sales and privatisatons to transfer a business or service to the private sector to raise proceeds or recover taxpayer support. The types of assets sold vary significantly and could range from a stake in a private or public company, to financial loans due to government. They can be categorised as private (between government and a single investor after a competitive sales process) and public (which follows Stock Exchange rules).

In general, it is government policy to sell assets where there is no policy or strategic rationale to retain them. Such sales raise cash to support public finances and aim to introduce private sector leadership and incentives into commercial enterprises. Phases of privatisations and asset sales occurred in the 1990s and after the financial crisis in 2008-09, during which government's intervention led it to buy stakes in financial institutions, many of which it later sold.

Assets sales and privatisations require government to assess the options available to enable it to achieve the policy objective, and to plan its approach, including assessing market conditions and the timing of the sale.

Relevant government guidance

Green Book – Chapter 6: Valuation of Costs and Benefits and Green Book supplementary guidance: asset valuation

HMT asset sale disclosure guidance

Value for money of public sector assets – Annex A: Valuation of corporate and financial assets and the treatment of risk

HM Treasury guide to developing the project business case – 6. Planning the scheme and preparing the Outline Business Case

Asset sale disclosures: guidance for government – sets out the process for disclosing the impacts of the sale

Questions to ask based on lessons from NAO reports

Rationale

- What is the asset, and are the rationale and objectives for the transaction clear?
- Have wider government objectives been considered when setting the objective for the sale, and has the organisation assessed alternative options?
- How does the timing of the transaction potentially affect the impact on the taxpayer/public finances? Is this the right time to do the transaction?
- Does the department or organisation responsible for the transaction have the appropriate governance processes in place to monitor the transaction, and manage any potential subsequent commitments and risks?

Implementation

- What method has been chosen to conduct the transaction, how has it been tested, and what alternative options have been considered?
- Is there a competitive market for the asset and does the chosen transaction method ensure competitive tension?

Risk

- Is the information and data available on the asset for sale sufficient for investors to assess its value and the impact of a sale?
- Do the people conducting the transaction (and managing any subsequent events) have the appropriate skills and capability?
- Are appropriate safeguards in place with respect to market/price sensitive information?

Price and monitoring

- What assumptions is the government's valuation of the asset or business based on, what are the key drivers and have any adjustments been made to the valuation?
- Is the valuation based on multiple valuation approaches, assessed against Key Performance Indicators linked to the transaction's objective and based on quality data? (See page 45 for additional information on valuation and investment appraisal).

Review and exit

- Are the financial, fiscal and accounting impacts of the transaction clear and can the benefits to the taxpayer be assessed?

Acquisitions and investments

Local Authority Investment in Commercial Property (February 2020)

Describes how local authorities have invested in commercial property as a means of generating income, and highlights some of the potential risks.

In response to substantial falls in funding since 2010-11, local authorities reduced spending on services. Some authorities have also sought to offset funding reductions by generating new income through a range of strategies, including a rapid expansion in the acquisition of commercial property, often funded by borrowing.

Local authorities acquire commercial property for a variety of reasons, but yield is currently an important factor. Local authorities are subject to a prudential framework, including powers and duties created by legislation and a set of statutory codes and guidance to which they must have regard.

Buying commercial property can deliver benefits including income generation and local regeneration. As with all investments, there are risks. Risks associated with the acquisition of commercial property include 'specific risk' associated with each individual property such as the length of the lease or the financial strength of the tenant.

Local authorities also face 'systematic risk', which reflects movements in market values and rent levels. Systematic risk is apparent in the performance of the retail sector with the shift to online sales, among other factors, leading to growth in vacancy and void rates. The implications of these risks, should they materialise, will depend on the level of exposure of authorities' finances to their property portfolios, and the capacity of their governance to mitigate these risks.

Venture capital support to small businesses (December 2009)

Considers government's oversight of its investments, alongside private sector organisations, to support small to medium-sized enterprise (SMEs) and companies with high-growth potential.

Between 2000 and 2009, the Department for Business, Innovation & Skills (the Department) placed around £338 million in a series of venture capital funds aimed at supporting SMEs. Other equity investors contributed a further £438 million, making a total of £776 million. The Department aimed to stimulate economic growth and productivity and developed aims for each fund but there were not clear, measurable objectives or priorities.

Start-up companies are risky due to initial negative cash flows and high failure rates. Equity is the usual financing choice because limited collateral and trading income mean that loans are not usually available. The funds were administered by private sector fund managers who made the investment decisions, provided expertise to help companies grow and managed the portfolio of investments over the cycle of the funds' lives. Fund managers' fees were comparable to the wider venture capital industry but over the lifecycle of the funds, depending on the eventual returns achieved, this was potentially an expensive form of business support.

This report reviewed the interim financial performance of funds more than five years old, as the venture capital industry considered it was reasonable to begin to evaluate the financial performance of funds from this point. As the Department's funds held a significant number of investments, the final performance of the funds at the end of their lives was uncertain. The Department had published minimal fund performance information. In the absence of a measurement framework and given the poor performance of the early funds at that date, the programme could not demonstrate value for money.

Other relevant NAO reports

Evaluating the government balance sheet: financial assets and investments

PFI and PF2

Equity investment in privately financed projects

Companies in Government

Help to Buy: Equity Loan scheme progress review

Poll 2

Between 2016 and 2019, what proportion of all commercial property acquisitions in the South East of England were made by local authorities?

- 4.6%
- 7.3%
- 17.5%

Understanding balance sheet accounting implications

Further information on National Accounts and the Whole of Government Accounts

Comparison of National Accounts and WGA measures

	National Accounts measures			WGA
	Public Sector Net Debt	Public Sector Net Financial Liabilities	Public Sector Net Worth[1]	WGA Net Liabilities
Assets			Non-financial assets	Non-financial assets
		Illiquid financial assets	Illiquid financial assets	Illiquid financial assets
	Liquid financial assets	Liquid financial assets	Liquid financial assets	Liquid financial assets
Liabilities	Government borrowing	Government borrowing	Government borrowing	Government borrowing
		Other financial liabilities	Other financial liabilities	Other financial liabilities
		Funded public sector pensions	Funded public sector pensions	Funded public sector pensions
			Unfunded public sector pensions[1]	Unfunded public sector pensions
			PFI contracts[1]	PFI contracts
				Provisions

Note

1 Unfunded public sector pensions and PFI contracts will be included in the Government Financial Statistics Manual measure of PSNW, but not in the European Statistics Agency 2010 based measure.

Source: Whole of Government Accounts 2019-20

Managing risk and uncertainty to protect taxpayers

Our value for money and financial audit work has supported better reporting and risk management

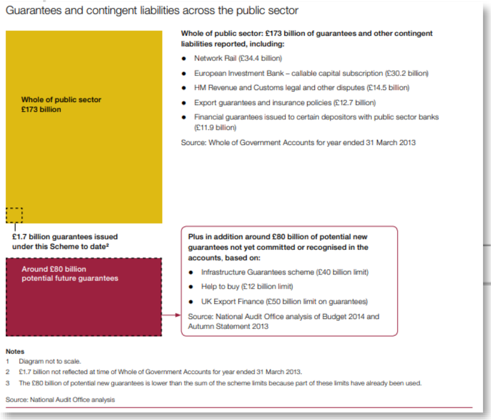
NAO report on infrastructure finance guarantees

National Audit Office

Report by the Comptroller and Auditor General

HM Treasury

UK Guarantees scheme for infrastructure



HM Treasury review of contingent liabilities

HM Treasury

Government as insurer of last resort:
managing contingent liabilities in the public sector

March 2020

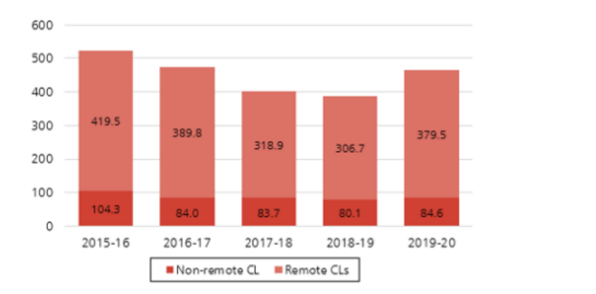
Whole of Government Accounts

HM Treasury

IFRS: IAS 37

Whole of Government Accounts:
year ended 31 March 2020

The chart below shows government's remote and non-remote contingent liabilities.



Central expertise in government to manage risk and uncertainty

UK Government Investments

Central capability Government Corporate Finance Profession

[UK Guarantees scheme for infrastructure (nao.org.uk)](#)
[Government as insurer of last resort: managing contingent liabilities in the public sector (publishing.service.gov.uk)](#)
[Whole_of_Government_Accounts_2019-20.pdf (publishing.service.gov.uk)](#)
[Contingent Liabilities - UK Government Investments (UKGI)](#)

Poll

In 2020 the Treasury published a report about the role of government as the "insurer of last resort". Which of the following types of risks did it identify as potential contingent liabilities? (note: select one or more answers)

- Financial guarantees
- Explicit government insurance
- Legal cases
- Purchaser protections

Transaction example: sale of student loans

The evolution of student loans

1.2 The government introduced student loans in 1990 to encourage people to participate in further and higher education. The first loans were mortgage-style loans with fixed repayment terms. In September 1998, income-contingent repayment loans were introduced instead of the mortgage-style loans. The first repayments were made in April 2000.

1.3 Income-contingent loans link repayments to a borrowers' income. At first, the government only provided loans to help cover living costs (maintenance loans), but in 2006 it extended the scheme to include tuition fees.

3 In 2013 the government decided to sell a portion of the student loans issued before 2012. At March 2017, the face value of all outstanding loans issued before 2012 was £43 billion. It plans to complete a programme of sales between 2017 and 2022, and to raise around £12 billion. In December 2017 the government completed its first sale of loans to private investors, consisting of most loans that entered repayment between 2002 and 2006.

4 Government had three objectives for the sale:

- to reduce public sector net debt;
- to ensure there was no detrimental impact on borrowers; and
- to achieve value for money.

[The sale of student loans (nao.org.uk)]

1.10 Plans for the sale of student loans took several years to develop

This long development period was affected by the parliamentary timetable, elections, changes in government, the financial crisis and the decision to leave the European Union. Because of the novel nature of the asset, significant work was also required to develop and refine the best way to achieve the sale's objectives.

Conclusion on value for money

20 The sale of student loans was conducted under government's policy to sell assets where there is no policy reason for continued public ownership. In this context UKGI prepared well for the sale, creating a structure which encouraged investor interest and maintained competitive tension during the process. The value of the loans is subject to a high level of uncertainty, but UKGI's estimates of what investors would pay were reasonable, and the sale achieved prices at the upper end of these estimates. In terms of the preparation, process and proceeds of the transaction itself UKGI has achieved value for money.

21 But the sale of student loans also shows limitations in the way that government assesses value for money and measures for the costs of student loans over time. The Department uses one set of assumptions for the cost of student loans when they are added to government's balance sheet, and HM Treasury uses another set of assumptions in support of its decision to sell them. This offers two different ways of calculating the subsidy to, and value of, its rapidly growing student loan portfolio. The two approaches give different answers which risks government: not knowing with enough certainty the cost to the taxpayer of student loans when they are issued; and of selling assets too cheaply relative to their long-term value despite achieving its objective of reducing public sector net debt.

Transaction example: sale of student loans

Valuation & accounting issues

2.10 The government retention value calculated by UKGI can be compared with several other valuations of student loans including:

- **a sale valuation**, an estimate of how a potential buyer is likely to value student loans. We have previously recommended that UKGI calculates sale valuations to ensure that the retention value is informed by prices that may be achieved in competitive market conditions;[12]
- **the actual sale proceeds**, from which we can infer some of the investor assumptions in valuing student loans; and
- **the carrying value** of loans on the Department's accounts. The value of £2.6 billion is in accordance with international accounting standards.

2.11 Each approach to valuing student loans results in different estimates. To a large extent these differences reflect the way that future cash flows are discounted. The higher the discount rate used, the lower the value of future payments in today's terms, and the lower the valuation. **Figure 9** compares the discount rates used in each approach.

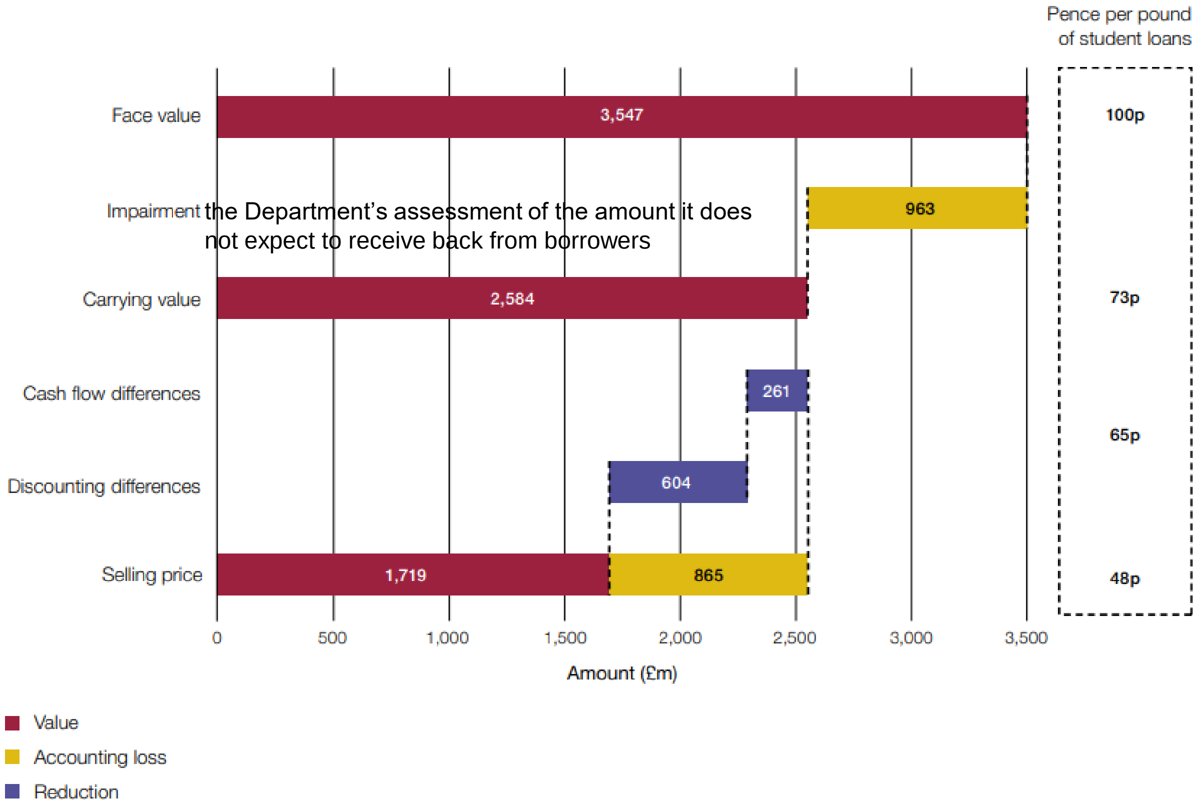
2.12 UKGI's sale valuation used a similar approach to the retention value of discounting future cash flows. However, prospective buyers do not use a predefined discount rate such as the social time preference rate as their hurdle rate, and instead tend to use actual yield on government bonds, which is referred to as the risk-free rate. UKGI estimated this as the yield on 12-year government bonds,[13] which offered a 1.6% nominal return at the time of valuation.

2.13 UKGI then added the asset risk premium calculated by GAD, plus an additional novelty premium. This novelty premium can be considered as a discount observed when a company first lists its shares on the stock market. In the NAO's report on 'The Privatisation of Royal Mail' the government's advisers estimated this discount to be in the range of 5% to 15%. UKGI estimates most of this novelty premium to disappear within five years as the market becomes more familiar with the asset class. The *Green Book* does not require government to be compensated for the novelty premium.

Type	Valuation methodology
Retention value	Discounted cash flows
Sale valuation	Discounted cash flows (plus novelty premium)
Accounting valuation	HM Treasury's Government Financial Reporting Manual 2017-18
Actual sale	Average actual yield based on price paid

Accounting for the first sale of student loans

Differences in discount rate account for £604 million



[The sale of student loans (nao.org.uk)](#)

Wrap up

1. Government is involved in a wide range of corporate finance activity
2. Various policy drivers, including interventions to safeguard or support, and initiatives to generate value
3. Transactions often involve complex, first of a kind structures
4. Accounting issues are important. For example, the various the definitions of government debt influence transaction structures; and some financial instruments are hard to value
5. NAO audits departmental accounts and reviews transactions for Parliament
6. NAO also works constructively with officials to support professional development
7. Our guide is intended to support senior leaders responsible for overseeing corporate finance in the public sector by helping them to apply the right principle and concepts, and ask the right questions

National Audit Office

Thank you

For more information about the work of the NAO

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Arboretum
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Expect Excellence GPS global processing services
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Transparency Task Force
Cygnetise
Catalina Consulting
AMSOM
Gibraltar Stock Exchange
OCORIAN

Thank You For Participating

Forthcoming Events

- Fri, 25 Nov (11:00-11:45) Financial Centres Of The World 2022: Focus On Tallinn
- Mon, 28 Nov (11:00-11:45) What Is The Purpose Of The Finance Industry?
- Tue, 29 Nov (11:00-11:45) Price Wars: How The Commodities Markets Made Our Chaotic World
- Wed, 30 Nov (11:00-11:45) Has The Banking Sector Run Out Of Options For Further IT System Energy Savings?

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