Office for
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Responsibility

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Mr Andrew Tyrie MP
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Treasury Select Committee
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Dear Andrew

Thank you very much for your letter regarding the treatment of proposed asset sales and privatisation proceeds in the OBR forecast. We are very happy to explore whether and how we could provide more information on the potential fiscal impact of such transactions and, now that the Budget is published and we are able to discuss the specifics of current treatment, I am writing to set out some of the issues that arise in deciding how to proceed.

In whatever we do, we will of course need to be guided by the *Charter for Budget Responsibility*. This states that:

> *The OBR's published forecasts shall be based on all Government decisions and all other circumstances that may have a material impact on the fiscal outlook. In particular:*
>
> - *where the fiscal impact of these decisions and circumstances can be quantified with reasonable accuracy the impact should be included in the published projections, and;*
>
> - *where the fiscal impact of these decisions and circumstances cannot be quantified with reasonable accuracy, these impacts should be noted as specific fiscal risks.*

In considering how we should apply the Charter, it is helpful to distinguish between sales of fixed assets on the one hand, and sales of financial assets and privatisation proceeds on the other.

Sales of fixed assets are netted off gross capital expenditure in the national accounts, and therefore reduce public sector net borrowing. Our current forecasts include sales of fixed assets where these can be quantified and forecast with reasonable accuracy. This is possible when the assets are relatively small and sold in quantities that follow predictable trends. So, for instance, our forecasts reflect trends in the volume of housing sales and sales of commercial properties.

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It should be borne in mind that central government sales of fixed assets are included within departments' capital DELs. The DEL limits apply on a net basis, so that if departments sell more assets this enables them to increase their other capital expenditure, which would leave spending and the public finances unaffected. Our forecasts reflect net DEL plans that were set in last October's Spending Review. Departments have not yet published detailed gross and net spending plans, but this does not affect the accuracy of the forecast as it is based on net capital DEL limits. We make a specific forecast for local authority asset sales based on historical trends, including their sales of housing from their Housing Revenue Accounts, where the latter are classified as sales of assets by public corporations in the National Accounts.

Sales of financial assets and 'privatisation proceeds', covering sales of company securities, are not generally scored within the national accounts aggregate of public sector net borrowing. Instead they are usually classified as financial transactions. They will have an effect on public sector net debt and will have an indirect effect on net borrowing through their effect on debt interest payments and if the Government loses a related income stream.

Consistent with the *Charter*, we only incorporate estimates of privatisation proceeds and financial asset sales in our central forecast when the government has made a firm decision to proceed and when the details and timing of the prospective transactions are sufficiently clear to quantify the impact on the public finances with reasonable accuracy year by year. This is because such transactions are by their nature very lumpy and are very difficult to quantify ahead of an announcement of a final sale agreement.

That is why, of the Spending Review announcements that you listed in your letter, we currently include in the forecast only the £2bn proceeds in 2010-11 from the sale of High Speed One, which was completed in autumn 2010. In the case of the other announcements, no final sale agreements have been reached. However, in Chapter 4 of the EFO we note the Treasury's current public position on these other prospective sales and privatisations and point out that these could affect the outlook for the public finances when firm decisions are made and full details are available.

Notwithstanding the possibility that the Government will receive more privatisation and financial asset sale proceeds than are included in the central forecast, the hurdle of requiring a firm and detailed decision from the Government before including them is a sensible one. It is striking, for example, how successive governments have for many years been committed to selling the Tote without ever actually doing so. To remove the 'firm and detailed decision' hurdle would also be an open invitation to ministerial manipulation, potentially allowing an unscrupulous Chancellor to flatter the outlook for public sector net debt by making a broad commitment to asset sales or privatisations that he had no firm intention of proceeding with.

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That said, maintaining the current approach to the central forecast need not preclude us from providing more information on the potential impact of possible future transactions where that information is available. This would help illustrate the potential risks to the central forecast.

In this spirit we already present in the EFO an estimate of the profit or loss implied by current market prices for the Government's shareholdings in Royal Bank of Scotland and Lloyds Banking Group. The current estimate, as of Budget 2011, is a potential loss to the taxpayer of £1.6bn. This would have an impact on public sector net debt. Given that this estimate is very sensitive to movements in market prices, and that there has been no announcement of when and how these stakes would be sold, it would be misleading to score this or the associated financial transactions in our central projection. But the implications of these potential disposals are a significant risk to the forecast and so it is appropriate that we provide an assessment of it. We can certainly examine how we might apply this principle more widely.

Unfortunately, in the case of most prospective financial asset sales and privatisations, there is no market price to provide an objective estimate of the potential proceeds. The sale price and terms will typically depend on the outcome of commercially confidential negotiations and on market conditions prevailing in the relevant sector at the time the deal is completed. Moreover, many such assets are inherently very difficult to value, for example rights to use part of the spectrum. Prices in the UK 3G auctions held in 2000 were more than 100 times higher on a comparable basis than the subsequent spectrum auctions at 3.4GHz even though the two bands were relatively similar in their physical properties. Judging by recent German auctions for 4G spectrum, which raised some €4.4bn, the proceeds for the UK auctions due in early 2012 may be substantial, but we do not yet have enough information to make an estimate of the outcome.

Even when sale terms and prices have been agreed, the effect of asset sales on the public finances is often far from straightforward. It will often depend on an Office for National Statistics classification decision that, given the complexities involved, may not be agreed until some time after the sale has been completed. For example, only in January 2011 did the ONS take the classification decisions related to the British Energy sale made two years earlier in 2009. The ONS have not reflected this change in the public finance statistics, and we have not been able to reflect it in our forecasts, because there is still uncertainty about the effect on the fiscal aggregates.

The national accounts treatment of awards of licences to use the spectrum is another example of this difficulty. The OBR follows the ONS practice of treating these receipts as rental payments for the use of an asset, However, Eurostat maintains that the government is actually selling an asset and scores the receipts as negative capital expenditure. Unlike financial asset sales, both treatments of spectrum receipts have a favourable impact on net borrowing. But the timing of the impact will be very different, because the rental treatment means accruing the receipts evenly over the whole licence period.

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You suggest in your letter that the omission of potential asset sales means that our central forecast is necessarily a pessimistic one rather than a central one. This might be the case in respect of the impact on financial transactions and public sector net debt, although the current estimate of potential profits from the public sector banks represents a downside risk to PSND. In addition, the impact on the Government's chances of meeting its supplementary target of having PSND falling in 2015-16 might not be favourable, as it would be determined by the precise profile of these transactions.

But it also is important to bear in mind that asset sales will often have offsetting effects in different parts of the public finances, affecting public sector net borrowing and the current budget. The sale of a financial asset may provide the Government with a lump sum that leads to a one-off reduction in debt in the year the sale is made, but the Government may also lose future flows of income from that asset (for example, the gross operating surplus of public corporations, such as British Energy). The net impact of the asset sale on future government borrowing will depend on the relative size of the income foregone and the debt interest payments saved.

In your letter you suggest that we could avoid providing specific forecasts of the impact of particular sales by presenting an aggregate total that is not broken down into individual items.

This would be difficult to do properly, given the various classification issues. But one approach would be to construct a bottom-up estimate of the aggregate impact on financial transactions based on estimates for specific sales that we do not reveal in public. This would still leave us with the problem of coming up with sensible estimates on a year by year basis. More fundamentally, presenting an aggregate figure that we were unwilling to explain or justify with reference to its components would run counter to our commitment to transparency and might well encourage suspicions that the Treasury had put pressure on us to paint a flattering picture.

An alternative would be to base an aggregate estimate on some average of historical sales. However, financial asset sales are by their nature very lumpy, with large sales in some years and very little in others. In effect, we would end up basing such an estimate on the previous Government's record of asset sales and privatisations, which does not seem particularly appropriate.

There are clearly many practical challenges involved in providing more information on potential asset transactions, but the goal is a worthwhile one to pursue. We will examine how best to proceed and would be very happy to discuss any potential improvements with you when we have done so.

Best regards,

Robert.