

**Note on the treatment of contingent liabilities.
on HMG balance sheet and in the National Accounts**

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1. INTRODUCTION

Successive governments have been reluctant to provide guarantees for large infrastructure projects. This is understandable given the tendency for such projects to run over time and over budget in an unacceptably high proportion of cases. Current examples in the public eye include HS2 and the large nuclear plants currently under construction.

In the case of the much-discussed Small Modular Nuclear Reactors (SMR) currently being planned there are a number of good reasons for revisiting this reluctance.

This note explains the current treatment of such guarantees in the National Accounts based on the latest available information from the Office for National Statistics and the accounting standards used in the UK for the description of such guarantees. These guarantees may be regarded as a specific case of a contingent liability.

In the context of this note, a guarantee is a contingent liability, that is, a guarantee which is only called if a specific event fails to occur and is time limited. Whilst at first glance the liability is open ended, in practice it can be managed through a combination of project related measures. The *probability* of it materialising and *the impact* if it occurs are the major variables that needs to be assessed in computing its acceptability. The government method of assessing the likelihood of a call on such a guarantee is not currently leading edge; it could benefit from revision in the light of the need for such guarantees both by government in order to avoid calls on the public purse, and by the private sector in order to give them confidence to lead the way in first-of-a-kind development funding.

2. THE TREATMENT OF CONTINGENT LIABILITIES

As with all National Statistics in the domain of the National Accounts, the inclusion of contingent liabilities is done in way that is consistent with the European System of Accounts 2010 (ESA10), aligned with the UN System of National Accounts. This constrains the preparation of National Accounts and ensures that they are comparable with other countries in the OECD.

Accordingly, only actual, unconditional obligations are recorded as financial liabilities (e.g. issued debt, loans outstanding). Other potential or contingent liabilities, such as government guarantees on bank lending, corporate borrowing, or deposit protection

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schemes, are not considered actual liabilities unless and until the guarantee is called upon. They are seen as *conditional obligations* — the government only pays if the counterparty defaults.

Although they are not included in headline measures of government debt or liabilities (e.g. Public Sector Net Debt), ESA10 requires supplementary disclosure of contingent liabilities, especially for significant guarantees issued by government. These are published as *memorandum items* or in annex tables, but outside the core balance sheet.

For example, HM Treasury and the ONS report on government guarantees (like the UK Guarantees Scheme or COVID support schemes) in the Whole of Government Accounts (WGA) and supplementary ONS statistics.

It should be noted that in more recent improved reporting controls the Whole of Government Accounts (WGA) provides consolidated reporting of liabilities and assets in line with IFRS. Contingent liabilities are included in the WGA as part of improved reporting controls—though only actual realized liabilities affect the core statement of financial position. The WGA also includes notes on other contingent exposures.

The WGA is made up of over 10,000 bodies, across the whole public sector including central government departments, local authorities, devolved administrations, the NHS, academy schools, and public corporations. It therefore represents the widest available view of the overall Public Sector financial position. The 2023-2024 WGA can be found [here](#). There are frequent references to Contingent Liabilities in the WGA but whilst they are included, there is little commentary on them. The principal reference is in section 1.21, and in reference to PPF compensation, and further in detail in Note 30 where they are disclosed in accordance with IAS37, where the major figures relate to clinical negligence and nuclear decommissioning, with an overall reduction of 22.8% over the prior year. The Note records other individual contingencies but makes it clear that in general there is no expectation that they will materialise.

The overall tenor of the WGA report is to note the existence of these contingent liabilities whilst making clear that they are not included in the statement of liabilities in the accounts. Currently, Medical Negligence and Nuclear Decommissioning account for 83.7% of the £52b total of Contingent Liabilities noted in the WGA.

3. IMPLICATIONS FOR PRIVATE SECTOR INVESTMENT IN SMR DEVELOPMENT AND OPERATION

One model of investment in SMR design and build in the UK is for a private sector entity to invest let's say £5bn in the programme via an SPV in which it takes a 50% equity

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stake. This money is invested on the basis of a preferential guaranteed annual return of say 5% indexed to inflation for the period needed for the investment to be repaid.

The repayment is in the form of an annual or quarterly “coupon.” The payment of this coupon on time is guaranteed by an investment grade entity of which HMG would be one example.

The amount of the initial investment will be structured such that it is large enough for the payment of the coupon up to such time as the programme is revenue generating.

The guarantee needed is therefore contingent, and is only called:

- a) For the coupon payments if the Project SPV cannot make them
- b) Limited not only to the amount of the periodic payment, but also time limited for the period during which the shortfall persists.

As an example, consider a forty-year investment for the SMR programme. The first ten years cover the design and build up to the point of revenue generation. The initial investment is sufficient to make the repayments up to the point where the project generates revenue. The subsequent thirty years of operation are sufficient to generate adequate revenue for the repayment of the initial years advance, and profit for distribution. One model shows this approach provides significant upside return at £78 pMWH.

If the programme runs to time, then no guarantee is called because the initial investment is enough for payment of the coupon for the first ten years, and revenue flows thereafter. In this case, the guarantee remains in place until the full repayment of the investment but is never called upon.

If the project does not run to time (which has been common in Nuclear, although widely believed to be much less probable in SMR due to fundamental design and build differences) then the guarantee is needed for the periods of time between the initial funding expiring and the point at which revenue is generated. The amounts paid by the guarantor are repaid to them in the early years of the operational phase. The period during which the guarantor may be called upon to make the periodic repayments could be for one year or more in an extreme case, but it is clear that the liability would be extremely unlikely to approach any material proportion of the full investment.

It is only if the project calls the guarantee that any liability actually materialises in the governments borrowing figures. The guarantee is therefore a way for government to support investment rather than have to invest themselves. By acting as guarantor however, government can still hold an equity position in the new development. At a time when government borrowing is heavily constrained this approach could represent a

cost effective and lower risk approach to kick starting SMR implementation than the conventional route.

Moreover, it maintains the political advantages of cash injection, whilst, as demonstrated in the first part of this note, not requiring recognition of the investment as a liability in the National Accounts.

Even if the full value of the investment were to be represented as a Contingent liability, an investment of £10bn (sufficient for the construction of four SMR units) using this model would increase the Governments contingent liabilities by less than 20%, without any immediate cash cost, and with no impact on the PSBR or Government accounts.

In practice, the time and probability adjusted level of the guarantee is more likely to be £1b-£2b given the shorter timescale needed to build and commission an SMR on the current projections.

The reasons for adjusting the policy on, and approach to, implementing, guarantees to ensure investment in SMR build can be summarised as:

1. Such guarantees do not count against the PSBR or HMG balance sheet.- Hence politically they are a “win” with no money cost.
2. A call on the guarantee is not a call on the invested amount (say, £10b) but could be a call on a limited number of periodic payments.
3. The risk of a call drops to near zero when the plant(s) enter revenue generation at a unit price of electricity even if that price is significantly lower than projected levels.
4. In any case, the scale of guarantees needed is less than 20% of current levels with lower risk even at the outset (arguably) than the two categories which account for 83% of the £52b of existing contingent liabilities, namely medical negligence, and nuclear decommissioning.

It is recommended that the relevant parties meet to discuss how this model could be used to facilitate and accelerate SMR development.

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Disclaimer

The figures here are examples only. The real financials of any specific case would need to be separately agreed, and this note is purely for illustrative purposes. It should only be shared with the prior agreement of the author.

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