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5 October 2004

**DAO(GEN)13/04**

Dear Accounting Officer

## **DEPARTMENTAL LENDING TO SPONSORED BODIES OPERATING IN COMPETITIVE MARKETS**

**This letter sets out revised arrangements for long and short term Government lending to those public sector bodies which operate in a competitive market (criteria outlined in annex A). The letter amplifies Chapter 29 of Government Accounting<sup>1</sup> and replaces PES(2001)5, which is now withdrawn.**

### ***Action***

2. Accounting Officers are asked to:

- assess which of their sponsored bodies should now borrow under the terms of this revised policy (Annex A defines this group);
- draw this letter to the attention of those responsible for administering lending in their departments; and
- regularly review which sponsored bodies should borrow on the terms set out in this letter.

### ***Contacts***

3. If you have queries about this policy, please telephone the Treasury's Corporate and Private Finance team (CPF) on 020 7270 4497 or email

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<sup>1</sup> [www.government-accounting.gov.uk](http://www.government-accounting.gov.uk)



[commercialendingpolicy@hm-treasury.x.gsi.gov.uk](mailto:commercialendingpolicy@hm-treasury.x.gsi.gov.uk). CPF welcomes users' feedback on this policy to help inform any future policy adjustments.

### ***Rationale***

4. As chapter 29 of Government Accounting explains, central government lending to most public sector bodies, whether through the National Loans Fund (NLF) or through Voted expenditure, is at interest rates which reflect the cost of the government's own borrowing plus administration costs. The cost of such loans is normally lower than the cost of borrowing in the private sector. Departments making loans in this way will of course need to check that they have adequate legislative authority.

5. However, there are some public sector bodies which should not borrow on such fine terms. It is illegal for EU member states to grant state aids, including loans on favourable terms<sup>2</sup>, to public sector bodies which operate in a competitive market for a significant proportion of their business. Government departments which make loans to sponsored public sector bodies in this position must therefore set commercial terms for these loans.

6. This letter sets out the method through which departments may arrive at a commercial rate, with no explicit or implicit government guarantee, for loans to these bodies. The policy applies to all lending to eligible bodies for periods of seven days or longer. For loans of 0-6 days, bodies in this position should use private sector overdrafts (see Annex B for further detail).

7. This policy is designed to ensure that:

- public sector bodies operating in competitive markets compete fairly in their commercial operations;
- they are subject to appropriate financial disciplines, including those for investment appraisal in the Green Book;
- they have access to short terms loans to help manage cashflow;
- the risk of legal challenge is greatly reduced.

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<sup>2</sup> Preferential lending rates provided as part of a notified and approved scheme e.g. a rescue and restructuring scheme, will be viewed as an exception and do not constitute illegal state aid.

### ***The changes***

8. The new arrangements explained in Annex B contain only minor adjustments to those in PES(2001)5:

- departments should use an independent credit rating for lending to these sponsored bodies in most circumstances;
- explicit guidance is given to departments on short-term lending; and
- the rules now spell out, for the avoidance of doubt, that certain public sector bodies should use commercial overdrafts from private sector lenders for loans of up to six days.

### ***Application***

9. Public corporations, trading funds and non-departmental public bodies may be eligible for this policy. Please see Annex A for further detail.

**PAULA DIGGLE**  
**Second Treasury Officer of Accounts**

## ANNEX A to DAO(GEN) 13/04

***The guidance below details the criteria to be used by Sponsor Departments in assessing whether a body is eligible for the commercial lending policy. While this guidance replaces PES paper (2001)5<sup>3</sup>, it supplements that provided by Chapter 29 of Government Accounting<sup>4</sup>, and should be read in conjunction with it.***

2. Accounting Officers are asked to note that the arrangements set out in this letter apply to new loans taken out after the date of this letter, and to investments that have already been made on the express understanding that their funding will be through borrowing subject to this policy. Otherwise, existing loans will continue on the terms and conditions that applied when they were taken out. Bodies should not redeem existing loans in order to benefit from a more preferential rate of lending or any other aspect of this policy. Where bodies are exceptionally permitted to redeem such loans, a premium may be payable (this applies not only to NLF loans but also to loans provided from the Estimate).

### **How to apply the commercial lending policy**

3. Sponsor Departments are responsible for identifying any public bodies whose borrowing might fall within the commercial lending policy guidelines. The following guidelines will be used to determine whether an enterprise is operating in a competitive market and therefore falls within the policy set out in this note:

- (i) bodies, or their major subsidiaries, that compete with the private sector for a significant majority (over 75 per cent) of their business (measured by turnover) would automatically fall within the new lending policy;
- (ii) bodies that compete with the private sector for between 20 and 75 per cent of their business would be subject to consideration on a case-by-case basis;
- (iii) bodies that compete with the private sector for less than 20 per cent of their business are likely to fall outside the scope of the new policy, although the purpose of the loan would have to be assessed against the discrete activity condition (iv) below to

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<sup>3</sup> [http://www.hm-treasury.gsi.gov.uk/psd/pes\\_papers/pespaper/pespaper\\_2001/pes0105.htm](http://www.hm-treasury.gsi.gov.uk/psd/pes_papers/pespaper/pespaper_2001/pes0105.htm)

<sup>4</sup> [www.government-accounting.gov.uk](http://www.government-accounting.gov.uk)

ensure that this part of their business did not represent a significant competing service in that particular market;

- (iv) bodies that seek finance for a particular, discrete activity that would compete with the private sector would be subject to consideration on a case-by-case basis but would usually be expected to fall within the scope of the policy.

## **Application to sponsored bodies**

### ***Public Corporations***

4. We would expect public companies which provide monopoly services (for definition guidance contact the CPF team – details above), and which do not operate in competitive markets to fall outside the scope of the new lending policy. However, companies (and their subsidiaries) such as Royal Mail, which increasingly operate in competitive markets, are likely to fall within the new regime.

5. In cases where a public company is the subject of a move to an alternative ownership structure, which involves a substantial transfer of risk and responsibility to the private sector, then the general presumption will be that borrowing prior to the sale will fall within the new regime, but, provided the necessary powers exist, subsequent borrowing will be directly from the private capital markets.

### ***Trading Funds***

6. Most Trading Funds (TFs) are financed by means of Voted loans through their Sponsor Department and not directly by the NLF. Many TFs supply statutory monopoly services and so any lending to them would be unaffected by this new policy. However, the new lending policy would, in principle, apply to any TF that competes with the private sector to a significant degree.

### ***Non-Departmental Public Bodies (NDPBs)***

7. Whilst, in practice, the amount of borrowing by NDPBs may not be significant (most are financed by grant-in-aid), this policy will apply to them, but subject also to them satisfying the borrowing conditions set out in Chapter 5 of *Cabinet Office guidance on Non-Departmental Public Bodies: A Guide for Departments*, March 2000<sup>5</sup>. These conditions include: NDPBs having significant receipts, i.e. over half their expenditure is met from revenue; and having provisions for loan finance in the statute under which the NDPB operates.

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<sup>5</sup> [www.cabinetoffice.gov.uk/agencies-publicbodies/guiddepts/docs/ndpb%20guide%202000.pdf](http://www.cabinetoffice.gov.uk/agencies-publicbodies/guiddepts/docs/ndpb%20guide%202000.pdf)

## ANNEX B to DAO(GEN) 13/04

***The guidance below details the methodology to be used in applying the commercial lending policy. While this guidance replaces PES paper (2001)5<sup>6</sup>, it supplements that provided by Chapter 29 of Government Accounting<sup>7</sup>, and should be read in conjunction with it.***

### **Background**

2. The general principle set out in chapter 29 of Government Accounting remains. That is that central government lending to public sector bodies should be at a rate reflecting the cost of government borrowing, including administration costs. Such lending is at better rates than public sector bodies could obtain directly from the private capital market since central government is able to command more favourable borrowing terms. However, for bodies meeting the criteria outlined in this paper, market rates for lending will be set.

3. PES paper PES(2001)5 enabled departments to set market rates for central government lending (either from the National Loans Fund or via departmental Estimates<sup>8</sup>) to public enterprises operating in competitive markets. In such a context, the interest rate charged on such borrowing should reflect the enterprise's own creditworthiness, specifically excluding any implicit or explicit government guarantee. That is, where a significant proportion of the body's business is in competition with private sector companies in the market, the rate of interest should be comparable to the commercial rate charged on a comparably-sized company operating in a similar commercial environment in the private sector, on the basis of a credit rating which excludes any explicit or implicit government guarantee.

### **Rationale**

4. The revised policy in the guidance annexed to this letter will:
- ensure that public sector bodies facing direct private sector competition in the UK and / or internationally are exposed to similar financial disciplines (e.g. commercial borrowing rates) as their private sector counterparts as far as this is possible, i.e. create a level playing field amongst all competitors; and

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<sup>6</sup> [http://www.hm-treasury.gsi.gov.uk/psd/pes\\_papers/pespaper/pespaper\\_2001/pes0105.htm](http://www.hm-treasury.gsi.gov.uk/psd/pes_papers/pespaper/pespaper_2001/pes0105.htm)

<sup>7</sup> [www.government-accounting.gov.uk](http://www.government-accounting.gov.uk)

<sup>8</sup> Public sector bodies should look at their enabling legislation for guidance as to whether they are permitted to borrow from Departmental Estimates or the NLF.

- deliver best value for money for the public sector, and in turn the taxpayer through transparency: Government pricing of lending rates will exclude an implicit guarantee which may feature in private market assessments, but which can prove complex to uncover.

5. A commercial rate for borrowing should:

- remove the possible risk of challenge on the basis that lending at preferential interest rates is an illegal state aid<sup>9</sup>;
- help to reinforce commercial disciplines on the management of public sector bodies operating in commercial markets;
- reinforce the Required Rate of Return (RRR) for public sector bodies set out in *Investment Appraisal in the Public Sector* (the Green Book). This regime ensures that public sector bodies set prices in order to achieve an agreed rate of return on capital employed by the activity as a whole before tax and financing costs. The new commercial lending policy reinforces the rate of return requirement by ensuring that the body faces a commercial cost of capital;
- signal to competitors that there is no implicit government subsidy since public enterprises operating in a competitive market will not receive preferential terms for their borrowing; and
- continue to offer value for money to the public sector as a whole since central government will be able to maximise the efficiency of a pooled borrowing approach and minimise the subsequent cost of funds.

6. Allowing public sector bodies to obtain overdrafts from commercial banks will ensure that public sector bodies are able to satisfy their short-term cash flow needs:

- (i) where a compelling commercial case can be made for such an arrangement; and
- (ii) as central government is in most cases unable to provide overdrafts of less than 7 days.

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<sup>9</sup> Preferential lending rates provided as part of a notified and approved scheme e.g. a rescue and restructuring scheme, will be viewed as an exception and do not constitute illegal state aid.

## Procedure

### How to apply the longer-term commercial policy

7. Sponsor Departments are responsible for identifying any public bodies whose borrowing might fall within the commercial lending policy guidelines (See Annex A for eligibility). It is important that Departments notify the Treasury of any borrowing that may fall within the scope of this policy at the earliest opportunity. Once a Sponsor Department has identified this need, it, along with the body in question, should consult with the Treasury CPF team<sup>10</sup> who will be their primary contact for guidance through the ensuing lending policy process. Other Treasury teams involved in the process are also encouraged to consult with CPF when necessary. The following procedure should then ensue<sup>11</sup>:

- ! The Treasury will discuss with the Department before deciding whether or not the body does need to borrow at a commercial rate (bodies may borrow at a commercial rate whether the lending is secured or unsecured). This process will include consultation between the Department and the DTI's State Aid Unit;
- ! If commercial lending is proposed and there are no immediate state aid issues, and unless the financial health of the body is beyond question the Department will then need to obtain independent financial advice on the appropriate credit rating. The rating should be based on the assumption that the body in question has no guarantee from government, whether explicit or implicit (e.g. through public ownership). If the financial health of the body is beyond question, Departments will decide whether to obtain the rating itself, or in house – with the body in question. Following an in-house rating process, the body may be requested to provide to the Treasury, within a reasonable time, information outlining the basis upon which the rating has been reached.
- ! The NLF is prepared to lend on both a secured and an unsecured basis: bodies, in consultation with their Sponsor Department and financial advisers, should consider which is most appropriate for them in terms of the impact of loan security on their credit rating.
- ! The Sponsor Department will, in consultation with the DTI State Aid Unit, also ensure that the procedure determining the rate of lending does not significantly diverge from the guidelines set out

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<sup>10</sup> Phone: 020 7270 4497, email [commerciallendingpolicy@hm-treasury.x.gsi.gov.uk](mailto:commerciallendingpolicy@hm-treasury.x.gsi.gov.uk)

<sup>11</sup> See Annexes C and D for flowchart of procedure.

by the European Commission. Together they will discuss the setting of higher lending rates for unsecured loans, and ensure that the financial health of the organisation does not constitute conflict with European Commission state aid rules.

- ! The Department will need to supply the information upon which the credit rating decision was based to the Treasury spending team as soon as possible. If the credit rating of the public body is determined to be of investment grade then the information must be supplied at least five working days before the loan is required. This information will also need to specify the day on which the loan needs to be made. However, if the credit rating of the body is deemed to be sub-investment grade, Treasury will require the information to be supplied at least one month in advance of the required date of the loan.<sup>12</sup> Once the Department has supplied the information, the presumption will be that the loan will be made at the appropriate rate and on the specified day. The rate will be fixed on the day the funds are issued from the NLF.
  
- ! On the basis of this detailed advice and any other relevant information<sup>13</sup>, the Treasury (the Debt and Reserves Management Team, involving the Debt Management Office) would then determine the appropriate interest rate and check that it complies with the National Loans Act 1968. For NLF lending, the Treasury spending team also needs to send to the Treasury's Exchequer Funds and Accounts team (EFA)<sup>14</sup>: (i) a signed instruction to issue the loan on the terms and date specified; (ii) the Department's written request for the approval of the loan; (iii) the body's request for the loan; and (iv) the body's Borrowing Certificate<sup>15</sup>. As the rate for commercial rate loans is fixed on the day of issue it is preferable that the Treasury spending team issue an instruction *in advance* to the EFA Team to issue the loan, at the rate to be determined by the Debt and Reserves Management Team and the Debt Management Office.
  
- ! Once this has been done for the first time, the credit rating should be reviewed annually by the Sponsor Department using independent financial advice, for example as part of the body's corporate planning process. The credit rating may also need to be

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<sup>12</sup> The additional notice is required in order to agree the relevant arrangements for determining the appropriate credit spread with the sponsoring Department as arrangements for sub-investment grade bodies will be determined on a case by case basis.

<sup>13</sup> As specified by the Treasury including the terms of the loan e.g. maturity, amortisation profile, security etc.

<sup>14</sup> The EFA team may be contacted on 020 7270 4760/4761.

<sup>15</sup> The EFA team can advise on the appropriate format of a borrowing certificate.

reviewed during the year – for example, if there were material changes to the company mid-year (e.g. in debt levels). The need for review of the credit rating in the light of material changes should be agreed with the relevant HMT spending team<sup>16</sup>.

8. The Shareholder Executive<sup>17</sup> can provide advice to Departments on the appointment of advisers and likely fees. Any such appointment would be expected to follow normal guidelines on procurement. In the first instance, Departments should make direct contact with the Shareholder Executive as required.

9. It is for Departments to decide who will bear the cost of the financial advice, in discussion with the body concerned.

#### ***Borrowing at variable rates***

10. Bodies required to borrow at commercial rates will usually borrow on fixed rate terms. Consideration of variable rate lending will be on a case-by-case basis. If bodies wanted to borrow on variable rate terms, they would need to demonstrate the business need to the Treasury. If approved, repayments on variable rate loans can be made monthly, quarterly, or half-yearly when the loan is rolled over. At each rollover date a new interest rate will be set to take account of changes in short-term rates.

#### ***Borrowing in foreign currency***

11. In some circumstances public bodies may wish to borrow to finance a project or an acquisition in a currency other than sterling. In these circumstances the public body would be expected to borrow in sterling and then undertake a foreign currency swap. This would be subject to the body (or its subsidiaries) having the requisite statutory powers, expertise and risk controls to undertake foreign currency swaps. The body in question should discuss this well in advance with the Treasury's DRM team who will be able to advise further<sup>18</sup>.

#### ***Accounting for borrowing at commercial rates***

12. This policy has no implications for the scoring of expenditure in accounts and budgets.

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<sup>16</sup> Sponsor Departments should contact the Treasury's CPF team where no spending team exists.

<sup>17</sup> Shareholder Executive may be contacted on 020 7215 0200.

<sup>18</sup> The DRM team may be contacted on 020 7270 4337.

## **How to apply the short-term commercial lending policy**

13. The policy that central government lending (from the National Loans Fund (NLF) and from Voted loans) to public sector bodies competing commercially should be at a commercial rate also applies to short-term commercial lending. This annex makes the provision explicit and provides guidance on the process and methodology for short-term loans, and should be read in conjunction with the general guidance on the application of the longer term commercial lending policy provided earlier in this paper, and Chapter 29 of *Government Accounting*.

14. Short-term commercial lending applies to loans between one week and 364 days.

15. The same guidelines as outlined in the general guidance on longer term lending above should be used to determine whether an enterprise is operating in a commercial market. That is to say that, as for long-term loans, Departments will be responsible for identifying any public bodies whose borrowing might fall within the guidelines.

16. Departments should consult with the relevant Treasury spending team for any borrowing, including short-term loans, which may fall within the scope of this new policy at the earliest opportunity.<sup>19</sup>

17. The process for putting the loan in place will be similar to that for long-term loans outlined in paragraph 7 above, except that:

- If the body already has a credit rating for long-term borrowing (which, as stated, is subject to annual review), and if there have been no material changes, this will be used to set short-term borrowing rates<sup>20</sup>.
- With the prior agreement of the Treasury spending team, EFA and the Sponsor Department, (the above mentioned procedures must be concluded prior to the undertaking of any short-term lending), a body may draw down short-term loans as and when required (so long as loans fall within temporary borrowing limits and there have been no material changes that require a review of the appropriate credit rating – it is the Sponsor Department's responsibility to keep this under continuous review, and to notify EFA if there has been any significant deterioration). A body wishing to undertake short-term loans having completed the above mentioned procedures will make direct contact with the EFA team, who will in turn obtain the appropriate lending rate from the Debt Management Office, as outlined in paragraph 7 of this annex. The EFA team will send a faxed confirmation of the terms of the loan agreed to the

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<sup>19</sup> Sponsor Departments should contact HMT's CPF team where no spending team exists.

<sup>20</sup> The margin, which will contribute to the overall borrowing rate, can be set at this stage.

Sponsor Department and the borrower. It is the Sponsor Department's responsibility to ensure that the funds are transferred forthwith to the borrower.

### ***Methodology for setting short-term commercial lending rates***

18. The methodology for the setting of short-term commercial lending rates from the NLF will be based on the British Bankers Association's official sterling inter-bank offer (LIBOR) fixings. The BBA fixings for commercial lending rates are published on Reuters for rates overnight, one week and two-week and from one month to one year. These rates are published to five decimal places.

19. A basis point credit spread will be applied to the prevailing LIBOR fix according to the body's credit rating. A small facility premium will be added to reflect the fact that this NLF commercial loans service offered by HMT is more flexible and cheaper to run for public sector bodies than for a commercial organisation (notifiable on request). Once the credit spread and premium<sup>21</sup> are added, the commercial lending rate will be rounded to the nearest three decimal places. A straight-line interpolation will be applied to calculate rates in between the published terms.

20. There is a legal requirement that the rates at which the NLF lends shall cover its costs of borrowing (including a margin to cover its administrative costs) on the same terms and for the same maturity period. Therefore, the DMO will check that the commercial rate determined as described above meets the legal requirement. If it does not, it will set the rate at the minimum level required to satisfy the legal requirement.

### **How to apply the private capital market borrowing policy**

21. Public sector bodies may also be permitted to borrow directly from the private capital markets through the use of overdrafts. The following procedure will apply:

#### ***Overdraft***

22. Departments will be responsible for monitoring any private sector overdrafts taken by public sector companies, where the body possesses the necessary power to do so. Such overdrafts may be taken to meet the body's short-term cash flow needs where the commercial lending policy cannot, and must be value for money. Such overdrafts will have a maximum duration of 6

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<sup>21</sup> Please note that the premium applies both to borrowing from the NLF and to funds provided from the Estimate.

days, and an explicit government guarantee is permitted if necessary: Departments should consult with the DTI's State Aid policy unit. **A public sector body may not enter into such an arrangement without specific authority from its Sponsor Department and the Treasury.**

23. In every case it will be necessary for the Sponsor Department to satisfy itself that the public sector body has the necessary powers to borrow (and has powers to borrow from the private capital market). A non-departmental public body's powers will be derived from its constituting legislation and a trading fund's powers will be derived from section 2B and 2C of the Government Trading Funds Act 1973 and the order providing for its establishment. In the case of a publicly owned limited company (such as Royal Mail Holdings Plc.) the relevant memorandum of association of the company will generally permit private sector borrowing but there may be provision (e.g. in privatisation legislation) constraining a body's powers to borrow while publicly owned or requiring departments to report such borrowing to Parliament.

### **Credit rating and state aid issues**

24. In relation to credit ratings, it is important to ensure that an independent credit rating is obtained in all circumstances, other than those outlined below, as this will avoid potential state aid challenges and encourage the company to behave more commercially.

### **Legal Basis**

25. Subsection (6) of section 5 of the National Loans Act of 1968, as amended by the Finance Acts of 1982 and 1983, provides that the Treasury in determining a rate of interest on loans from the NLF may take into account any consideration justifying a rate higher than the rate sufficient to avoid lending at a loss from the NLF. Higher rates would in particular be justified where they were required in order to avoid unlawful State Aid.

26. The rate of interest charged on central government lending from Estimates is referenced to NLF rates and as such the same policy will apply.

### **Other issues**

27. Other aspects relating to policy and guidance on central government borrowing remain in place. Such details are provided in *Government Accounting*, including for example, the application of the rules on premature repayment of NLF and voted loans, prior notification and Treasury consent.