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DRAFT OF FURTHER GUIDANCE ON RATES OF RETURN FOR COMMERCIAL SERVICES WHERE THERE IS OR MAY BE COMPETITION

This Annex forms a first draft of relevant material to go in, or be annexed to, the commercial services chapter of the update of the *Fees and Charges Guide.* Departments will be invited to comment on this draft update in the autumn but may find it helpful to have this extract in advance.

Departments responsibilities

2. Departments and other public bodies are responsible for assessing the appropriate rates of return for commercial services where there is or may be competition from the private sector. They are expected to satisfy themselves that they are setting their rates of return at the appropriate level having regard to the factors indicated in Annex 2 and in the further guidance below. The issues considered in the assessment should be recorded so that explanation can be provided if required.

Key points on rates of return (supplementing Annex 2)

3. The rate of return on the government capital employed in a service is measured on the value of the net assets employed, and is taken into account (together with other costs) in setting charges for the service. The appropriate rate, or rates, of return will vary according to the business activity or activities in which the department or body is engaged.

4. A rate of return should normally be determined for a minimum period of a year. It should not normally be less than 5.5 per cent (the illustrative rate for low risk activities) but may be higher where appropriate in the light of all the factors.

5. If needing to set a rate for medium risk, the department or body should not equate the mid-point between 5.5 and 15 per cent of the illustrative range in Annex 2 with medium risk. Precise rates always contain a measure of judgement, but anything over 10 per cent should probably be regarded as on the high side.

6. As noted in Annex 2, the upper end of the range, 15 per cent, will rarely be used, as it is unusual for public bodies to engage in such high-risk activities.

Making the assessment of rate of return

7. The nature of the assessment should be commensurate with the size and nature of the service or services provided, and may differ between different services of the same body. For example, the emphasis should be on market prices where there are many buyers and sellers in the market, in other cases comparative risk and the cost of capital experienced by competitors will need more consideration. Particular care should be taken by those in a dominant position in the relevant market, especially where their turnover of services where there is or may be competition from the private sector, totals some £5 to £10 million or more.

8. An “average” market price may be measured, eg as the mid-point of the range encompassing a substantial proportion of prices in the market. An average market price may be compared with the department or other public body’s costs (excluding cost of capital/rate of return) to derive an appropriate rate of return for the service. The department or public body would set its own prices to achieve the rate of return but may vary them from the market average in the light of quality and other factors.

9. Where there appears to be only a small number of private sector competitors, it may be possible

to increase the number of comparators by looking at services in a more generic way, eg IT software creation, consultancy and advice, procurement activity, financial services, etc and looking at similar services in other industries where the risks and cost of capital may be similar.

10. The level of risk and cost of capital of private sector competitors may vary according to the nature of the service, the reliability of customer demand, the continuity of supply of resource inputs (staff, raw materials, etc), the past performance of the specific organisation, etc. Some activities have a tendency to be more risky than the generality, eg innovative projects or new enterprises and this may need to be taken into account in any comparison.

11. The assessment of the rate of return may also be assisted by an overview of the weighted average cost of capital (WACC) of competitors in the relevant market. Existing overviews of WACC in the relevant market (or a comparable market – see paragraph 9 above) may be available from relevant organisations such as a competition regulator, or other reputable organisations (but would need to be of reasonably recent date). Alternatively, the public sector body could consider whether there would be value in seeking a new assessment of this type of information.

12. Where assessment of the rate of return has been based on the past performance of the market, adjustment may be needed if there are any known specific issues which may be expected to affect future performance, eg the entry of new competitors into the market, major technological development, or other factors affecting the quality of the service, customer demand, etc.

FURTHER QUESTIONS ON RATES OF RETURN

Q1. Why set returns in average real terms?

A1. An average real return is set for government departments and other bodies fees and charges services covered by this guidance as they are required by the Resource Accounting Manual (or equivalent guidance for trading funds or NDPBs) to regularly revalue or uprate their fixed assets to current asset values. Private sector companies and others may use nominal terms for cost of capital and rates of return, for example where total assets are not valued at one point in time but at the historic value at the time of acquiring individual assets. In any comparisons with market costs of capital or rates of return, real rates should be compared with real, or nominal with nominal (ie like with like).

Q2. How did the Treasury decide its illustrative range for where there is or may be competition from the private sector?

A2. The lowest point of the illustrative range, 5.5 per cent, takes account of the risk free borrowing rate (taken as around 2 to 2.5 per cent based on recent years yields on UK government bonds), a small allowance for risk, and an allowance for income or corporation tax of 1 to 1.5 per cent. In assessing the rates to quote for the bottom and top of the range, Treasury also looked at a few assessments of the weighted average cost of capital for regulated industries, or industries where the Competition Commission has reported, where available at a reasonably recent date.

Q3. Why is the illustrative range "pre-tax"?

A3. The illustrative rates are "pre-tax" (ie assume that income or corporation tax may be payable from any operating surplus from the activity) because, although the department or body itself may not be required to meet such taxes, its private sector competitors may well.

Q4. How is the "market" drawn for assessing market prices?

A4. The “market” used to assess market prices would normally contain two dimensions: a service (or product) and a geographic area. For example there maybe be similar services supplied by competitors which could fulfil the same function or substitute for it; and, depending on the nature of the service, customers may be willing to consider substitutes worldwide, or over a far more limited geographic area. Some services may also have other dimensions to the market, such as markets segmented by time, eg for some modes of travel different prices apply according to the time before the journey at which the purchase is made.

Q5. What is dominance, why does it matter?

A5. There is no absolutely hard and fast rule on what constitutes dominance. Market share, and how market share has changed over time, is an important factor but, for example, the potential for new competitors to enter the market or for existing customers to buy elsewhere may also be relevant to determining whether there is dominance. Abuse of a dominant position in a market is contrary to the Competition Act 1998, and to Articles 81 and 82 of the EC Treaty.

Q6. What is “weighted average cost of capital” (WACC)?

A6. A weighted average cost of capital (WACC) of a company takes account of both equity and debt. It may be calculated using a method such as the capital assets pricing model (CAPM). A short summary note is available from Treasury fees and charges branch.