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Dear Accounting Officer

DAO(GEN) 13/03

15 September 2003

REVISED COST OF CAPITAL RATE IN FEES AND CHARGES RECOVERY POLICY

Purpose of this DAO letter

The purpose of this letter is to advise departments of the need to implement a change in the cost of capital, or the rate of return on capital employed, for fees and charges; and to review the required rates of return of Trading Funds.

Action and enquiries

2. The content of this letter should be drawn to the attention of relevant staff in the Department and other bodies covered by this guidance.
3. Please address enquiries to Sue Warrington in the Treasury Officer of Accounts team (TOA) (phone 020 7270 5314 or email sue.warrington@hm-treasury.x.gsi.gov.uk).

Scope of the DAO letter

4. The guidance applies to departments including agencies and Trading Funds, non-departmental public bodies (NDPBs), NHS Trusts and other NHS bodies and certain other public bodies. It does not apply to 'self-financing public corporations' (as defined by the Treasury's General Expenditure Statistics team (GES))* or where local authorities set the fees.

* Please address enquiries on the definition of 'self-financing public corporations' to Russell Coleman in GES (phone 020 7270 5337 or email russell.coleman@hm-treasury.x.gsi.gov.uk).



Background

5. The cost of capital charge in departments' resource accounts and budgeting was reduced from 6 per cent of net assets to 3.5 per cent with effect from 1 April 2003. However, this did not cover the future of the cost of capital charge and rates of return on capital employed (ROCE) in fees and charges, or the overall required rate of return (RRR) from Trading Funds. These have now been revised in a Written Ministerial Statement by the Chief Secretary published in Hansard on 8 September 2003 (the reference is 3WS of Written Ministerial Statements[†]).

Summary of the main changes

6. The following changes will need to be implemented:

- the cost of capital, which should be included in the costing of fees and charges services, should be reduced from 6 per cent to 3.5 per cent in real terms, in statutory services, and inter- and intra-departmental services;
- for commercial services where there is no competition and no realistic prospect of competition from the private sector, an average real return on capital of 3.5 per cent in real terms (reduced from 6 per cent);
- for commercial services where there is or may be competition from the private sector, the required rate of return of at least 8 per cent is replaced by an illustrative range starting with 5.5 per cent. Departments will need to make their own assessment of the appropriate rate of return for commercial services, but the rate is expected to fall in a range of 5.5 per cent to 15 per cent in real terms (pre-tax), depending on factors such as the level of risk.

7. Further detail and guidance on this is given in the attached Annexes.

- o Annex 1 sets out the fees and charges recovery policy; and
- o Annex 2 gives further guidance on the rates of return for commercial services where there is or may be competition.

8. The revised policy will be included in updates of the Treasury guidance such as *The Fees and Charges Guide*, *Selling into Wider Markets: A Policy Note for Public Bodies*; and *Charges for Information: When and How*.

9. The revised cost of capital and rates of return from Trading Funds will need to be reviewed in the light of the change in recovery policy for fees and charges. Trading Funds undertake a wide range of charging activities – statutory, commercial, and inter-departmental or a mix of those. The required rates of return will therefore be determined individually for each fund. More guidance was given in PES paper (2003) 16 Annex 4 of 5 September 2003[‡].

[†]

http://www.publications.parliament.uk/pa/cm200203/cmhansrd/cm030908/wmstext/30908m01.htm#30908m01.html_sbhd

[‡]

http://www.hm-treasury.gsi.gov.uk/psd/pes_papers/pespaper/pespaper_2003/pes0316.htm

Timing

10. The revised cost of capital and rates of return should be used in determining fees and charges in the next Fees Order (or equivalent point for commercial or other charges). Where a consequent change in fees and charges is required, it should be effective no later than 1 April 2004.

11. Likewise, the required rates of return from Trading Funds should be reviewed, and if necessary adjusted, during the financial year 2003-04. Departments will need to decide this by end-November 2003 so that the effect on the cost of capital borne by departments on the net assets of their Trading Funds can be assessed in time to meet the timetable for adjusting the Departmental Expenditure Limit (DEL). Departments can find further information about the timetable for adjusting DEL in PES paper (2003) 16[‡].

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ANNEX 1 TO DAO(GEN) 13/03

FEES AND CHARGES RECOVERY POLICY

(a) services to the wider public and private sectors:

- For “**statutory**” fees and charges* the normal presumption is that fees should be set to recover full costs, including cost of capital of 3.5 per cent.

(Applies unless, exceptionally, there is a clear justification for less than full cost recovery. For example, NHS prescription charges are set at the acceptable level and include exemptions for, for example, the elderly. For fees and charges determined in accordance with the normal policy, fees may be rounded to a reasonable and convenient amount which may result in slightly more or less than full cost recovery overall. Apart from that modest flexibility, charges for statutory charging services should never be set deliberately to recover more than full costs unless the specific legislation authorises it.)

- For “**commercial**” services ** the normal arrangements are:
 - where a body provides a low risk commercial service, perhaps in support of an activity required by Statute, and there is no competition and no realistic likelihood of competition from the private sector, it is appropriate for the body to recover cost of capital of 3.5 per cent (that is to achieve an average real return on capital of 3.5 per cent)
 - where there is or may be competition from the private sector, an average real return on capital employed should be set, to reflect market pricing. The exact rate should take into account market prices; the level of risk associated with the activity (e.g. low, low to medium, or medium, etc) and the cost of capital experienced by private sector competitors in the relevant market; past performance and any known specific issues which may be expected to affect future performance. As an illustration, the real rate (pre-tax, of course) would normally be expected to lie between 5.5 per cent for a low risk commercial activity, and 15 per cent for a high-risk activity. In practice, the upper end of the range will rarely be used, as it is unusual for public sector bodies to engage in such high-risk activities.

(The aim in pricing commercial services where there is or may be competition is to charge the market price, including a profit element where appropriate, in the interests of fair competition. This is easy to achieve in markets where there are many sellers to determine the market price. Particular care should be taken where the public sector is in a position to affect market prices (dominant market position). In such cases charges

should be clearly related to the cost base, but should leave sufficient incentive for potential competitors to enter the market. In comparisons with market costs of capital or rates of return real rates should be compared with real or nominal with nominal, i.e. like with like.)

(b) inter and intra-departmental services*:** charges should normally be set so as to recover the full cost within the year, including cost of capital of 3.5 per cent.

* “Statutory” fees and charges services are services where there is a specific provision in statute to recover a fee or charge for a service and a Minister, department, agency, non-departmental public body or NHS trust or body is responsible for setting or approving a fee. They are normally regulatory services such as registration of companies or land ownership, passport issue, etc.

** “Commercial” services is the term used for those discretionary, non-regulatory, services where there is no specific charging power in legislation or, exceptionally, the specific charging power allows charges to be set on a commercial basis.

*** Inter and intra -departmental services are discretionary services only provided within or between departments, agencies, and perhaps NHS Trusts and bodies or non-departmental public bodies.

ANNEX 2 TO DAO(GEN) 13/03

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

Departments' responsibilities

1. 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 1 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

2. 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.

3. 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.

4. 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 1 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.

5. As noted in Annex 1, 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

6. 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.

7. An "average" market price may be measured, e.g. 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.

8. 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, e.g. 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.

9. 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, e.g. innovative projects or new enterprises and this may need to be taken into account in any comparison.

10. 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 8 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.

11. 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, e.g. 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 (i.e. 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” (i.e. 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 may 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, e.g. 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.