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HM Treasury

# Public Expenditure System

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Secretariat: 020 7270 5525

## **DETERMINING REQUIRED RATES OF RETURN FROM TRADING FUNDS - PRACTICAL ISSUES.**

### **Purpose**

1. This paper supplements [PES \(2003\)16](#) issued on 5 September 2003 and should be read in conjunction therewith. It provides further guidance to departments and trading funds on some of the practicalities involved in determining the revised financial objectives (the required rates of return) to be set for trading funds following the amendment in the discount rate from 6 to 3.5 per cent – see also paragraph 4 of [Annex 4 to PES \(2003\)16](#).
2. The primary audience for this supplementary paper is departments which sponsor trading funds, and the trading funds themselves. Other recipients of the paper may find the issues raised of interest but may not be required to take any action.
3. Other guidance is given in a letter to Accounting Officers ([DAO \(GEN\)13/03 Revised Cost of Capital Rate in Fees and Charges Recovery Policy](#), issued on 15 September 2003.)

### **Timing**

4. In order to meet the deadline for inputting the changes to the PES database, it will be necessary to determine the new financial targets by end-November 2003 – see PES (2003) 16.

### **Summary**

5. This paper considers the following issues:
  - Identifying the type of business (paragraphs 9 to 13);
  - The period over which the target should be set (paragraph 14);
  - The date from which the new targets should become effective (paragraph 15);
  - Defining “return on capital employed” (paragraphs 16 to 18);
  - Issuing Treasury Minutes (paragraphs 19 to 20)

### **Background**

6. Full details of the background to the implications for fees and charges and financial targets of the changes in the discount rate are given in PES (2003) 16.
7. Trading funds have a statutory obligation (a) to break-even taking one year with another and (b) “to achieve such further financial objectives as the Treasury may from time to time, by minute laid before the House of Commons, indicate as having been determined by the responsible Minister (with Treasury concurrence) to be desirable of achievement” (Government Trading Funds Act 1973, section 4(1)(b)).
8. For most trading funds, the “further financial objective” is to achieve a given return on its capital employed (ROCE) – the return currently varies between 6 per cent and 11 per cent depending on

the type of activity.

### **Identification of the type of business**

9. As outlined in paragraph 3 of Annex 4 to the PES paper, the intention is that the target set for each trading fund should be a weighted average of the required rates of return on the different types of service which the fund provides. It will thus be necessary to confirm the extent to which a trading fund engages in:

(a) Statutory,<sup>[1]</sup> regulatory, inter and intra-departmental <sup>[2]</sup> and low-risk commercial services <sup>[3]</sup> where there is no competition – either actual or potential – from the private sector; and

(b) commercial services where there is, or may be, competition from the private sector.

10. Services under 9 (a) are expected to earn a return on capital employed of 3.5 per cent.

11. Services under 9 (b) are expected to earn higher returns on capital employed and it will be necessary to establish from trading funds in this position what rate of return they expect to achieve from these services. Depending on the degree of risk and market prices, PES(2003)16 notes that the expected return should be between 5.5 per cent and 15 per cent.

12. Many trading funds engage to a greater or lesser extent in both categories of activity and, for the business as a whole, the target set should reflect the mix of services and the likely returns which will be earned. One approach would be to weight the target in direct proportion to the mix by value. Thus, for example, a trading fund demonstrates that 80 per cent of its business is in category 9 (a) (3.5 per cent ROCE) with the remaining 20 per cent being in category 9 (b) on which a return of (say) 7 per cent on its capital employed is anticipated. The overall return required from the trading fund will be 4.2 per cent of its average capital employed.  $[80 \times 3.5 = 280; 20 \times 7 = 140. 280 + 140 = 420. 420 / 100 = 4.2]$

13. There seems little point in being too accurate, especially where the overwhelming proportion of the services provided fall into category 9 (a). Figures to the nearest 0.5 of a per cent will be acceptable, although to impose a more demanding financial discipline it may be appropriate to round up rather than round down. In the above example, the target should be 4.5%.

### **Period over which the target is to be measured**

14. Although some trading funds currently have annual targets, most are required to achieve an average target measured over a period – usually 3 or 5 years – which best reflects the planning cycle of the trading fund. There is no suggestion that, in future, the period over which performance is measured should be the same for all trading funds and the period chosen will need to be agreed in the light of the particular circumstances of each fund.

### **Date from which the new targets will become effective**

15. The new targets should be effective from no later than 1 April 2004. This may cause problems for trading funds which are currently part-way through the period over which their average performance is measured, and which are relying on better performance in the later years of that period to make good poorer performance in the early years. However, the “clean break” approach is necessary because continuing the old targets will result in overcharging.

### **Definition of “Return on Capital Employed”**

16. Although the more recent Treasury Minutes define “return” and “capital employed” a number of the older ones do not. In addition, for resource accounting purposes, a different definition of “capital employed” is used from that used for measuring trading funds’ performance. As a result that there is a risk that the performance of trading funds is not being measured on a consistent

basis. Wherever possible, the “return” and the “capital employed” should be defined as described below, but it is fully appreciated that there may be cases where a more meaningful measure of a trading fund’s performance will be give if alternative definitions are adopted. Decisions will thus need to be taken on a case-by-case basis.

17. Subject to the point made in paragraph 16 above, the aim should be to define the “return” as the operating surplus, ie the surplus before certain exceptional items, interest (payable and receivable) and dividends. However, where the arrangements are for customers to pay for the service in advance (eg driving tests), it is equitable that interest earned by the trading fund on these receipts should be included within the return. So there may need to be variations on the standard approach; such variations should be agreed with the Treasury.

18. Again subject to the point made in paragraph 16 above, the aim should be to define “capital employed” as the long-term loan capital, PDC and reserves. Although some trading funds may already be determining their capital employed in this way, the current practice is for capital employed to consist of long-term loan capital, PDC, reserves and provisions. In other words, the proposal is that, in future, provisions will no longer be treated as being part of capital employed. This approach is consistent with that used for resource accounting purposes.

### ***Issuing Treasury Minutes***

19. The agreed financial target for each trading fund is announced to Parliament by means of a Treasury Minute (see paragraph 7 above), the laying of which is the responsibility of the Treasury.

Before the Minute can be laid, the Chief Secretary has to approve the wording which, in turn, requires the preparation of an accompanying submission.

20. In order to simplify this procedure, it is not proposed to prepare individual submissions for each trading fund, but rather to batch together as many as possible. The timing will thus depend on progress towards agreeing the new targets although in practice, with the exception of Medicines and Healthcare Products Regulatory Agency (MHRA) and Vehicle and Operator Services Agency (VOSA), timing is not too critical so long as the Minutes are laid before the start of the new financial year. But as the new financial targets will have had to be agreed by end-November 2003, there should be no difficulty in laying the Treasury Minutes by the start of the new financial year. (For MHRA and VOSA it is important that the Treasury Minute is laid as soon as possible in order for the new targets to become effective from 1 April 2003 – the date of their incorporation as trading funds.)

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[1] **Statutory services** are those 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.

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

[3] **“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.