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CAPITAL CHARGE RATE AND CHANGES TO THE INCENTIVE REGIME

Executive Summary

1. In October, Treasury consulted with all departments on proposals to improve incentives on departments for good financial management [Treasury Circular TC2000/14 refers]. We would like to thank the departments that took the time to provide comments and feedback on the incentive proposals. This Circular outlines changes to the incentive regime recently approved by Cabinet [CAB (00) M 42/11 refers].

2. Further work on other elements of the incentive framework is likely to follow. The work on incentives is part of wider central agency work programme on public sector management issues, such as capability, strategic planning and accountability documentation. The changes to the incentive regime support and complement this other work.

3. In summary, the approved changes to the current regime are:

Capital Charge

- Changes to the formula used to calculate the capital charge rate for each year, including using a three-year moving average rounded to the nearest 0.5%;
- Set the capital charge rate at **9%** for 2001/02, to reflect the new formula. Departmental baselines will be reduced in the BBU so that the change is

neutral in cash terms. Departments should include this change in their BBU submissions;

- From 2002/03 onwards, the capital charge compensation regime will have the following features:

  For most departments, the presumption will be that baselines will **not** change as a result of changes in capital charge but, if warranted, the department or Treasury can seek a baseline change through the normal budget process; and

  For a small number of capital-intensive departments meeting specified criteria, Treasury will support an automatic baseline change to reflect future changes in capital charge payable.

Working Capital Management

- Further develop a differential capital charge scheme to improve incentives for better working capital management by subjecting departmental cash balances and term deposits to lower capital charge rates corresponding to the standard rate less relevant interest rates offered by the Debt Management Office.

- Provided that this design work confirms that implementation is feasible, run pilots with a small number of departments during 2001/02 and evaluate the results to determine whether the scheme should be extended to other departments from 2002/03 or withdrawn.

Multi-year Appropriations

- Pilot multi-year appropriations with up to six departments commencing in the 2001/02 year.

Memorandum Accounts

- Remove the requirement for departments to assess savings opportunities when seeking a capital contribution to fund a memorandum account deficit, provided the amount sought is less than the net accumulated surpluses previously paid to the Crown; and

- Delegate authority to the Minister of Finance and the Responsible Minister jointly to approve such capital contributions, provided Ministers consider the economic implications of reducing the accumulated balances would be insignificant.

4. The approved changes relating to capital charge and working capital management are detailed in separate annexes to this Circular. Further details on multi-year appropriations and memorandum accounts will be communicated in separate Treasury Circulars [TC2000/17 and TC2000/18 refer].

Further Information

5. For further information on these changes to the departmental incentive regime, departments should contact their Treasury vote team.

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ANNEX ONE:

CHANGES TO THE CAPITAL CHARGE REGIME

Introduction

6. Capital charge is a cost levied on the Crown's investment in each department. It reflects the cost to the Crown of investing in a department versus other uses of that money.

7. Treasury has identified changes to the regime that are likely to enhance the value for money of public expenditure by:

- Strengthening incentives for departments to maintain efficient asset levels;

- Encouraging departments to manage and minimise capital charge costs. Departmental savings could be used to offset fiscal pressures and risks elsewhere in that vote; and

- Reducing compliance costs for Ministers and departments, and achieving more consistency across departments and over time.

8. The reasons for reviewing capital charge, and the rationale behind the changes to the formula and compensation regime, are discussed in more detail in Treasury's October consultation document [TC 2000/14 refers].

Changes to Capital Charge Formula

9. The previous formula for the capital charge rate was agreed in 1991, and no longer reflects current best practice. This results in potential distortions to the rate. The approved formula changes are largely technical in nature, and do not change the substance of the regime. In particular, the capital asset pricing model (CAPM) is retained as the basis for the capital charge rate. The changes to the formula are:

- Assumption of 100% equity financing for departments, rather than the previous 50/50 debt/equity split, to recognise that departments are prohibited from borrowing under the Public Finance Act. This means that the weighted average cost of capital, in effect, becomes the cost of equity;

- Use of an unlevered asset beta co-efficient of 0.3 to reflect the relatively low financial risk associated with most departmental operations, and a market risk premium of 9%, when calculating the cost of equity using CAPM;

- Changing the tax treatment within the CAPM formula to better reflect current tax legislation and use of a tax rate of 33%;

- Use of five year inflation and interest rate forecasts; and

- Use of point estimates for the various parameters rather than the mid-point of high and low scenarios.

10. These changes mean the formula for calculating the nominal capital charge rate is now:

$$\frac{\text{Risk free interest rate * (1-tax rate) + market risk premium * asset beta}}{\text{(1-tax rate)}}$$

11. This nominal rate is then converted into a real rate using the following formula:

$$\text{Real rate} = \frac{1+\text{nominal rate}}{1+\text{inflation}} - 1$$

12. The rate of capital charge applying for a given year is now set using a three-year moving average of the rates calculated for the current year and two previous years, rounded to the nearest 0.5%. Under a moving average approach, rates will be less affected by short-term fluctuations in interest rates or inflation, but underlying trends in the cost of capital will still be captured. Less frequent rate changes will reduce compliance costs.

13. The changes to the capital charge formula and rate setting take effect commencing with the rate set for the 2001/02 financial year.

Setting the Capital Charge Rate for 2001/02

14. Each December, Ministers will continue to set the capital charge rate for the following financial year, using interest and inflation forecasts in the December Economic and Fiscal Update.

15. Using this year's forecasts, and the revised calculation method set out above, the capital charge rate for 2001/02 will drop from 10% to **9%**.

16. In accordance with the current capital charge compensation regime, departmental baselines for 2001/02 and outyears will be adjusted downwards to reflect this decreased cost of capital. Departments are requested to make the appropriate adjustments in the Budget Baseline Update. Under the new compensation regime to apply from 2002/03, most departmental baselines will no longer be adjusted across-the-board for any future capital charge rate changes.

Changes to Capital Charge Compensation Regime

17. To date, departmental baselines have been fully adjusted whenever the capital charge rate changes, while there is mixed practice regarding baseline adjustments when taxpayers' funds change due to capital injections or asset

revaluations. In most cases, departments have been compensated for increased capital charge arising from increases in taxpayers' funds. Full adjustment undermines value for money because departments are protected against having to adjust for any changes in the cost of their capital.

18. For all other input costs, there are no automatic adjustments to baselines whenever there is a change in the input price or the amount used. If changes in other inputs prices lead to financial pressures then the department has to justify to Cabinet any proposal to change baselines. The treatment to date of capital charge has been inconsistent with the general approach for input prices because it envisages automatic adjustment to baselines.

19. The changes to the capital charge compensation regime set out below treat capital charge in the same way as other input costs, similar to labour, IT and vehicle running costs. That is, each chief executive can choose the input mix to produce a given set of outputs, and capital charge is an input cost associated with the choice of capital employed in this production process.

20. The new implementation regime means that from 1 July 2002:

- For most departments, the presumption will be that baselines will not change as a result of changes in capital charge but, if warranted, the department or Treasury can seek a baseline change through the normal budget process; and

- For a small number of capital-intensive departments, price changes in response to changes in capital charge will be automatically supported by Treasury over the thresholds set out in the table below, providing departments can meet certain information requirements (see paragraph 24) demonstrating that they are operating efficiently. The departments currently within this capital intensive category are Ministry of Education, NZ Defence Force, Department of Corrections, Department for Courts, Police, National Library and Ministry of Foreign Affairs and Trade.

21. The implications of this for different types of movement in capital charge payable are outlined in the table below.

22. The following rules apply equally to increases and decreases in capital charge payable. That is, if a department would be expected to absorb an increase in capital charge, then that department would retain savings from a decrease in capital charge payable. In either case (increase or decrease), either the department or Treasury can make a case to Ministers for changing baselines.

Reason for Change in Capital Charge Payable	Impact on Departmental Baselines
Capital charge rate change	Baselines adjusted on a variable scale: • Taxpayers' funds > $200m *and* total capital charge payable > 50% of total output expenses: full adjustment of baseline; • Taxpayers' funds > $200m *and* total capital charge payable < 50% of total output expenses: department absorbs/retains changes equivalent to up to 0.1% of taxpayers' funds, baseline adjusted for remainder of change in capital charge payable, providing department meets certain information requirements (see paragraph 24); • Taxpayers' funds < $200m *and* total capital charge payable > 15% of total output expenses: department absorbs/retains changes equivalent to up to 0.2% of taxpayers' funds, baseline adjusted for remainder of change in capital charge payable, providing department meets certain information requirements (see paragraph 24); • All other departments: No change in baseline, unless department or Treasury can make a case to Ministers for a change.
Net asset valuation changes	Baselines adjusted on a variable scale: • Taxpayers' funds > $200m *and* total capital charge payable > 50% of total output expenses: full adjustment of baseline; • Taxpayers' funds > $200m *and* total capital charge payable < 50% of total output expenses: department absorbs/retains changes equivalent to up to 0.1% of taxpayers' funds, baseline adjusted for remainder of change in capital charge payable, providing department meets certain information requirements (see paragraph 24); • Taxpayers' funds < $200m *and* total capital charge payable > 15% of total output expenses: department absorbs/retains changes equivalent to up to 0.2% of taxpayers' funds, baseline adjusted for remainder of change in capital charge payable, providing department meets certain information requirements (see paragraph 24); • All other departments: No change in baseline, unless department or Treasury can make a case to Ministers for a change.
New capital contribution	Funding for additional capital charge as part of baseline as a result of a new capital contribution would be based on the business case. There is no automatic assumption that capital charge should be funded as part of the business case – each proposal would be considered on its merits.
Voluntary capital withdrawal	No change in baseline. Departments will retain all savings in capital charge payable.

Accounting policy changes, eg those arising from any implementation of ED-82	Baseline adjusted on a variable scale: • Taxpayers' funds > $200m *and* total capital charge payable > 50% of total output expenses: full adjustment of baseline; • Taxpayers' funds > $200m *and* total capital charge payable < 50% of total output expenses: department absorbs/retains changes equivalent to up to 0.1% of taxpayers' funds, baseline adjusted for remainder of change in capital charge payable, providing department meets certain information requirements (see paragraph 24); • Taxpayers' funds < $200m *and* total capital charge payable > 15% of total output expenses: department absorbs/retains changes equivalent to up to 0.2% of taxpayers' funds, baseline adjusted for remainder of change in capital charge payable, providing department meets certain information requirements (see paragraph 24); • All other departments: No change in baseline, unless department or Treasury can make a case to Ministers for a change.

23. The thresholds of $200m in taxpayers' funds and capital charge of more than 15% of total output expenses are proxies for asset specificity and capital intensiveness. Asset specificity and capital intensiveness impact on a department's ability to make significant savings in output expenses by adjusting the means of production.

Process for Baseline Adjustments in Response to Changes in Capital Charge

Capital Intensive Departments

24. "Capital intensive" departments (ie those falling within the above categories) will need to demonstrate to Treasury's satisfaction the efficient use of inputs in the production of outputs, before Treasury can support a baseline increase arising from a change in capital charge. This will require evidence of an active and well-managed programme of identifying and selling surplus assets and ongoing self assessment of the level of fixed assets required. This is to ensure that the partial baseline adjustments regime is broadly consistent with the information requirements for seeking a baseline increase for other reasons.

25. For capital intensive departments, baseline adjustments for changes in capital charge will continue to occur in the Budget Baseline Update.

All Other Departments

26. If a department that does not meet the criteria for Treasury to automatically support partial baseline adjustment considers it needs an increase in baselines to meet an increase in capital charge payable, it can make a case to Ministers to demonstrate that need. A department seeking a baseline increase in this case will need to demonstrate the efficient use of inputs in the production of

outputs. Conversely, Treasury can make a case to Ministers to reduce baselines where there has been a decrease in capital charge payable for a department.

27. If a department seeks a baseline increase, Treasury will need to verify whether the information provided by a department is robust. Issues Treasury will consider when assessing a request for a baseline increase include:

- How the existing baselines were set;
- Are there any other offsetting savings? If there are then these may be more appropriately applied to the cost pressure rather than to new policy initiatives;
- Are the assets integral to the business? If not, then the assets should first be rationalised;
- Does the department have a robust asset management/review plan? If not, then this should first be implemented. An interim adjustment may be made until this plan is completed;
- Are there any cheaper alternatives or options pursuable within the medium or long term, eg a leasing option? Interim adjustments may be made until this solution can be implemented;
- Overall is the baseline reasonable and sustainable against a price benchmark? For example, how do they relate to equivalent outputs in Australia or the private sector?

28. Baseline changes for non-capital intensive departments in response to changes in capital charge will require explicit Cabinet decisions. These decisions will most appropriately be considered during the Initiatives phase of the Budget round, where they can be assessed against other competing priorities within the department and the Government as whole.

Timing of Changes to the Compensation Regime

29. The changes to the compensation regime outlined above will be implemented from the 2002/03 financial year. This is to provide time for departments to adjust out-year planning and budgeting to take account of the new regime.

ANNEX TWO

WORKING CAPITAL MANAGEMENT: DIFFERENTIAL CAPITAL CHARGE

Introduction

30. An initiative aimed at encouraging better working capital management – the differential capital charge scheme – was outlined in a consultation document attached to Treasury circular 2000/14 of 20 October 2000. Its objective is to reward departments and also benefit the Crown as a whole through lower borrowing costs.

Outline of the Scheme

31. The proposed scheme involves applying a lower capital charge rate on cash in departmental bank accounts and term deposits held at the Debt Management Office, with the rate reduction corresponding to prevailing interest rates. Thus, the higher the proportion of taxpayers' funds held as cash or term deposits reflecting good management of debtors, creditors and inventories – the lower a department's capital charge. The scheme would require new rules relating to cash drawdowns, and the possible introduction of an overdraft facility.

32. The net effect would be to allow departments to retain any additional interest earned on cash and term deposits. To ensure that the Crown is not thereby fiscally disadvantaged and that improvements in working capital management are rewarded, a 'normalised' or base level of interest earnings would be determined and deducted from each department's baseline.

Departmental Feedback

33. Twenty departments responded to the proposal. Their comments were valuable in identifying issues and uncertainties, and we wish to express appreciation for the time taken to give us full and considered views.

34. The main conclusions we reached from the consultation were that departments:

- welcomed the idea of rewarding better management of working capital;
- cautiously supported the principle of a differential capital charge, assuming that possible appropriation and reporting problems could be resolved;
- felt, however, that any gains they could make would be relatively small and at the margin; and
- would need to know more about implementation details and how their baselines would be adjusted before introduction of the scheme could be supported.

Ministers' Decisions

35. The feedback suggested that further design work is justified in order to allow the differential capital charge to be piloted. This approach has been accepted by Ministers.

36. On 18 December 2000, Cabinet:

- agreed to the development of a differential capital charge scheme along the lines outlined in paragraph 2 above, with formalised drawdown rules and limited early drawdown;

- delegated authority to:

  - the Minister of Finance to approve operational details for implementing the scheme; and

  - the Minister of Finance, jointly with relevant Responsible Ministers, to pilot the scheme with a small number of departments in 2001/02; and

- invited the Minister of Finance to evaluate these pilots and report back to the Cabinet Committee on Government Expenditure and Administration in due course on whether the scheme should be extended to other departments from 2002/03, or withdrawn (CAB (00) M 42/11 refers).

Next Steps

37. Significant work is required to pilot the differential capital charge proposal. Implementation issues that need to be confirmed or addressed include:

- consistency with appropriation rules and generally accepted accounting practice;

- rules surrounding the negotiation and specification of cash disbursement schedules, and early and delayed drawdowns;

- the basis for determining interest rates on cash and term deposits, an 'overdraft' rate on early drawdowns, and the treatment of debtor-Crown balances;

- recognition of revenue Crown and the scope for fiscal risks to the Crown; and

- technical design parameters, and operational details related to the calculation and payment of interest.

38. We propose to invite a few departments to pilot the initiative and look forward to working closely with them on implementation issues. This stage will be progressed in January and February with a view to obtaining the required

Ministerial approvals and accommodating any baseline changes as technical adjustments in the 2001 Budget process. The deadline for submission of technical adjustments is 26 March 2001.

39. Treasury is approaching the differential capital charge proposal with an open mind. We wish to see the scheme thoroughly tested and evaluated next financial year. If it is successful, wider application is likely to be recommended. If it does not prove beneficial to the pilot departments and the Crown, then it is unlikely to proceed further and the pilots would be unwound.