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ADDRESSING REDUCTIONS IN THIRD PARTY REVENUE RESULTING FROM THE ECONOMIC DOWNTURN

- Third party revenue for fully cost-recovered services provided by departments may as a result of the economic downturn be less than previously expected.

- Where this is the case, departments need to work through the steps set out in the annexed list of questions and decision tree diagram before considering increasing charges to third parties or seeking a capital injection from the Crown.

1. Treasury Instruction 6.3.6 requires that when a department provides services to third parties on a full cost recovery basis the department is required to operate a memorandum account to record the accumulated balance of surpluses and deficits incurred in the provision of such services. This is because revenue and expenses will not necessarily equate in each financial year.

2. Where there is a close relationship between such services and the overall level of economic activity, third party revenue may fall below the level expected, resulting in an unplanned shortfall between revenue and costs and a corresponding financial operating deficit.

3. Cabinet has agreed that when departments are facing a reduction in third party revenue resulting from the economic downturn, their first reaction should not be to increase charges to third parties or to seek a capital injection from the Crown. Departments should first ensure that they are providing the services in the most cost-effective way (for example, through benchmarking, market testing, etc) and that their underlying business model is robust, and seek to lower the cost of doing business, rather than seeking to shift further cost on to businesses.

4. Cabinet agreed that a department facing a reduction in third party revenue resulting from the economic downturn and that administers a memorandum account whose balance is therefore deteriorating more rapidly than expected should take the steps set out in the list of questions and the decision tree diagram set out in the Annex to this circular.

5. These steps, to be worked through by a department addressing a downturn in third party revenue, recognise that the current economic climate impacts on fee strategies and on an intended managed run down of a memorandum account surplus. They do not alter the intention of memorandum accounts, in particular that the balance of each memorandum account is expected to trend to zero over a reasonable period of time, with deficits being met in the meantime either from cash on the department's balance sheet or by seeking approval for a capital injection from the Crown[1].

Mark Jacobs
for Secretary to the Treasury

1 Where the accumulated positive balance of a memorandum account is greater than the year's deficit, the Minister of Finance, the Vote Minister and the Responsible Minister may jointly approve such capital contributions, subject to the economic effects of reductions in the accumulated balances being minimal. Current requirements on departments operating memorandum accounts are that requests for capital contributions in these situations should be accompanied by the following information:

- the amount sought;
- the current balance of the memorandum account;
- an explanation of the cause of the deficit; and
- an assessment of the need to adjust fee levels.

ANNEX

STEPS THAT NEED TO BE TAKEN BY A DEPARTMENT WHOSE MEMORANDUM ACCOUNT BALANCE IS AS A RESULT OF THE ECONOMIC DOWNTURN DETERIORATING MORE RAPIDLY THAN EXPECTED

Q1: Are the services being provided in the most cost effective way possible? Is the underlying business model robust, with an appropriate ratio between fixed and variable costs, and able to adapt to varying volumes? Is the cost structure for the services efficient and effective?

If answer to Q1 is NO: make changes to way in which services are provided so they are cost effective; make changes to business model; make changes to cost structure.

If answer to Q1 is YES:
Q2: Is the downturn in third party revenue expected to be temporary or permanent, and if temporary for how long is it expected to last?

If answer to Q2 is permanent or long-term temporary, review cost structure to reflect likely future third party level of demand for services over reasonable period of time.

If answer to Q2 is temporary and not too long:
Q3: Before the economic downturn impacted, did the fees then charged for the service reflect the cost of the service?

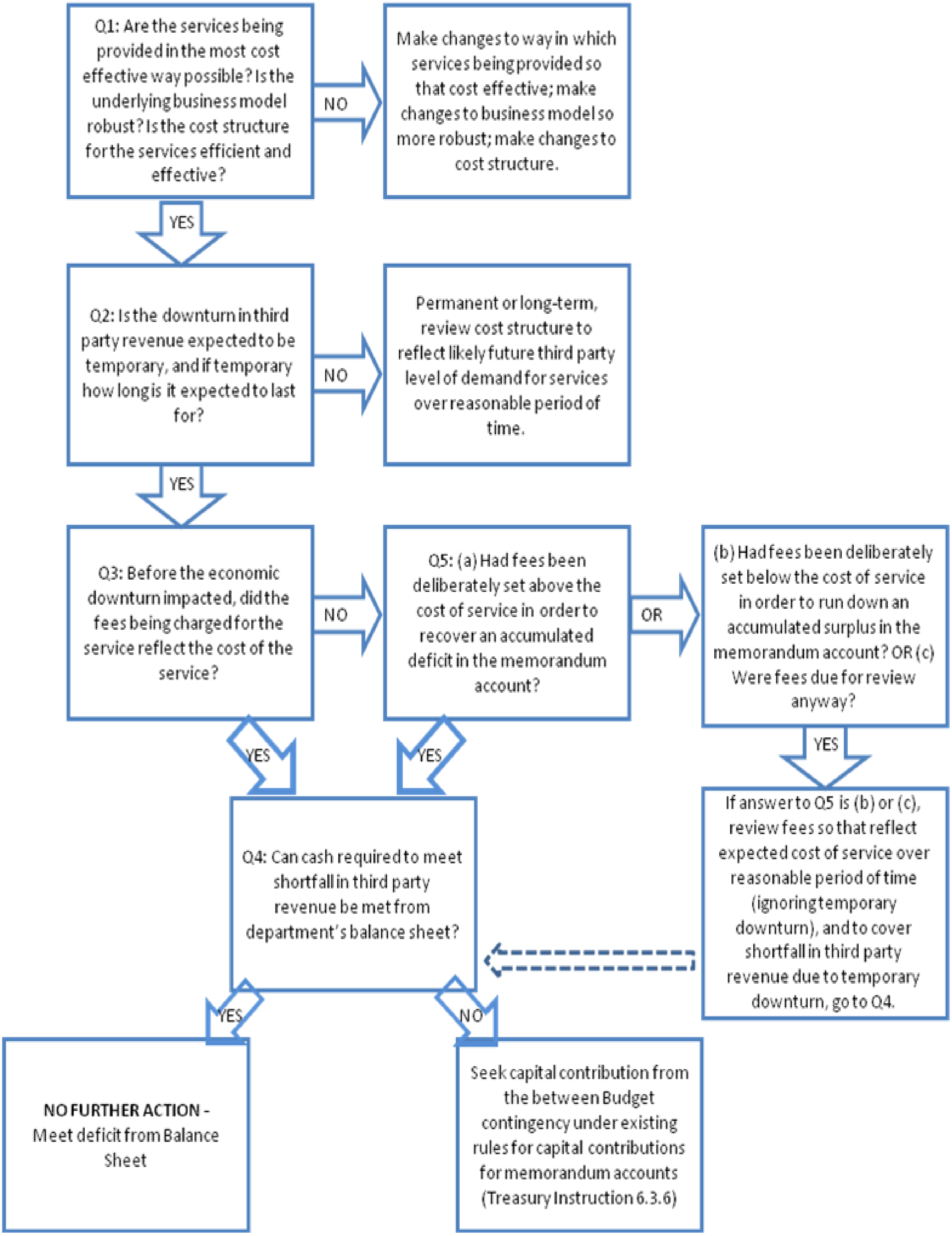
If answer to Q3 is YES:
Q4: Can cash required to meet shortfall in third party revenue be met from department's balance sheet?

If answer to Q4 is YES, do that.
If answer to Q4 is NO, seek capital contribution from the between Budget contingency under existing rules for capital contributions for memorandum accounts (Treasury Instruction 6.3.6)

If answer to Q3 is NO:
Q5: (a) Had fees been deliberately set above the cost of service in order to recover an accumulated deficit in the memorandum account? OR (b) Had fees been deliberately set below the cost of service in order to run down an accumulated surplus in the memorandum account? OR (c) Were fees due for review anyway?

If answer to Q5 is (a), go to Q4.

If answer to Q5 is (b) or (c), review fees so that reflect expected cost of service over reasonable period of time (ignoring temporary downturn), and to cover shortfall in third party revenue due to temporary downturn, go to Q4.


Q1: Are the services being provided in the most cost effective way possible? Is the underlying business model robust? Is the cost structure for the services efficient and effective?
NO
Make changes to way in which services being provided so that cost effective; make changes to business model so more robust; make changes to cost structure.
YES
Q2: Is the downturn in third party revenue expected to be temporary, and if temporary how long is it expected to last for?
NO
Permanent or long-term, review cost structure to reflect likely future third party level of demand for services over reasonable period of time.
YES
Q3: Before the economic downturn impacted, did the fees being charged for the service reflect the cost of the service?
NO
Q5: (a) Had fees been deliberately set above the cost of service in order to recover an accumulated deficit in the memorandum account?
OR
(b) Had fees been deliberately set below the cost of service in order to run down an accumulated surplus in the memorandum account? OR (c) Were fees due for review anyway?
YES
YES
YES
If answer to Q5 is (b) or (c), review fees so that reflect expected cost of service over reasonable period of time (ignoring temporary downturn), and to cover shortfall in third party revenue due to temporary downturn, go to Q4.
Q4: Can cash required to meet shortfall in third party revenue be met from department's balance sheet?
YES
NO
NO FURTHER ACTION - Meet deficit from Balance Sheet
Seek capital contribution from the between Budget contingency under existing rules for capital contributions for memorandum accounts (Treasury Instruction 6.3.6)