

# Annex 6.1

## How to calculate charges

This annex discusses how to calculate the cost of public services for which a fee is charged.

### Introducing a new or updated charge bearing service

**A6.1.1.** Public sector organisations planning to set up or update a service for which a fee may be charged shall ensure early engagement with Treasury. Advice should be sought at the earliest opportunity if there are any variations on the standard model. Proposed variations may be agreed in certain instances, considering each on its merits. Each will need to be justified in the public interest and on value for money grounds.

**A6.1.2.** Practical issues which organisations will need to consider when setting up or refreshing a charge bearing service include: the definition of the service and its rationale; the proposed financial objective (for instance, full cost recovery; 70% of full cost plus a 30% public subsidy); how the service is to be delivered and which organisation is to deliver it; whether the provider should retain any income from charges; the proposed charging structure (for instance, a single service or several sub-services). Organisations will also need to refer to the checklist in box 4.9 of factors to consider when planning policies and projects.

### Measuring the full cost of a service

**A6.1.3.** With agreed exceptions, fees for services should generally be charged at cost, sometimes with an explicit additional element to match the returns of commercial competitors. So to set fees for public services it is essential to calculate the cost of providing them accurately.

**A6.1.4.** The main features to be taken into account in measuring the annual cost of a service are set out in box A6.1A. Not everything in the list will apply to every service and the list may not be exhaustive. It is important that the calculation is comprehensive, including all relevant overheads and non-cash items.

**A6.1.5.** So far as possible the calculation should use actual costs, where they are known. For services just starting, there may be no alternative to using best estimates, geared to estimated consumption patterns.

**A6.1.6.** Start-up costs which are capitalised in the accounts and the cost of fixed capital items are scored in the accounts in full. These costs should be attributed to the cost of the service as the depreciated value each year.

**A6.1.7.** Start-up costs which cannot be capitalised in the accounts are scored as they are incurred. Such costs may be recovered through fees and charges by spreading them over the first few years of service provision. It is also good

practice to set fees to recover costs which cannot be capitalised in the accounts and which have been incurred to improve efficiency and effectiveness so that charges are lower or offer better value. This needs explicit Treasury agreement and may require statutory backing.

**A6.1.8.** For services which are charged at different rates, the same procedure should be used to set the different rates. That is, the cost of any premium service should be objectively justifiable by its additional cost (e.g. where faster shipping is offered); or conversely any discount should be justifiable by saving to the supplier (e.g. using the internet rather than over the counter). Note, however, that sometimes the legislation permits differential pricing unrelated to the relative underlying costs – though even then there should be good policy reason for the difference.

#### Box A6.1A: elements to cost in measuring fees

- Accommodation, including capital charges for freehold properties
- Fixtures and fittings
- Maintenance, including cleaning
- Utilities
- Office equipment, including IT systems
- Postage, printing, telecommunications
- Total employment costs of those providing the service, including training
- Overheads, e.g. (shares of) payroll, audit, top management costs, legal services, etc
- Raw materials and stocks
- Research and development
- Depreciation of start upstart-up and one-off capital items
- Taxes: vat, council tax, stamp duty, etc
- Capital charges
- Notional or actual insurance premiums
- Fees to sub-contractors
- Distribution costs, including transport
- Advertising
- Bad debts
- Compliance and monitoring costs
- Provisions

But not:

- Externalities imposed on society (e.g. costs from pollution and crime)
- Costs of policy work (other than policy on the executive delivery of the service)
- Enforcement costs<sup>92</sup>
- Replacement costs of items notionally insured
- Start-up costs (those which are capitalised in the accounts) and one-off capital items

## Financial objectives

**A6.1.9.** The standard approach to setting charges for public services (including services supplied by one public sector organisation to another) is full cost recovery. It normally means recovering the standard cost of capital, currently 3.5% in real terms. Some exceptions are noted in section 6.4.

**A6.1.10.** One other exception is commercial services, i.e. those services which compete or may compete with private sector suppliers of similar services. These should aim to recover full costs including a real rate of return in line with the rates achieved by comparable businesses facing a similar level of risk. The normal range of rates is 5-10% but rates as high as 15% may be appropriate for the very highest risk businesses.

**A6.1.11.** Great care should be taken in pricing commercial services where public sector suppliers have a natural dominant position. The market prices of competitors will often be a good guide to the appropriate rate of return if there is genuine competition in the market. Where there are limited numbers of buyers and sellers in a market, it may be better to take other factors into account as well. These might include past performance, the degree of risk in the underlying activity and issues bearing on future performance.

## Accidental surpluses and deficits

**A6.1.12.** Despite every effort to measure and forecast costs, surpluses and deficits are bound to arise from time to time. Causes may include variations in demand, in year cost changes, and so on. It is good practice to consider mid-year adjustment to fee levels if this is feasible.

**A6.1.13.** It is also good practice to set fees to recover accumulated past deficits. This may require statutory backing through a s102 order (see paragraph 6.3.3).

**A6.1.14.** Where significant surpluses have arisen, these should usually be refunded to the payees at the earliest opportunity.

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<sup>92</sup> See HMT guidance on receipts

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