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Chief Executives
Chief Financial Officers

Contact for Enquiries: Vote Analysts

UPDATED PUBLIC SECTOR DISCOUNT RATES FOR COST BENEFIT ANALYSIS

1. This circular updates the public sector discount methodologies and rates that agencies should use when undertaking cost benefit analysis (CBA). The Treasury publishes the public sector discount rates (PSDR) and the underlying methodologies, see Discount Rates | The Treasury New Zealand. The discounting updates will also be reflected in CBAx, the Treasury's CBA tool.

2. The updated discount rates do *not* alter the Government's fiscal constraint. Individual spending proposals will continue to be prioritised within a budget constraint (fiscal allowances). The updated PSDR may, however, alter the relative attractiveness of different proposals, depending on their differing profiles of costs and benefits over time.

Discounting review to strengthen CBA foundations

3. The updates strengthen the technical foundations of CBA and value for money advice. This is to better inform ministers' decision-making, particularly for policy and investment decisions with long-term impacts. Well thought-out intervention logic and estimates of costs and benefits remain key components of CBAs.

4. Since the 1970s the Treasury has used the "Social Opportunity Cost of Capital" (SOC) methodology to calculate the PSDR used for all CBAs. We have reviewed this methodology and resulting PSDRs, in light of the policy environment, changing international practice and advances in the economic and policy literature.

Updated public sector discount rates (PSDR)

5. The Treasury review of public sector discount methodologies and rates has led us to derive PSDRs using two internationally-recognised approaches to setting PSDRs, the 'social opportunity cost of capital' (SOC) and the 'social rate of time preference' (SRTP). Agencies should apply the PSDRs derived from these methodologies for CBA as follows:

   a. *continue* using the "social opportunity cost of capital" (SOC) rate as the default PSDR to assess proposals with *mainly commercial* costs and benefits. We have updated the SOC rate, based on higher risk-free interest rates (a key parameter used to calculate the SOC rate) than in 2020, when the SOC rate was last reviewed; and

b. using the “social rate of time preference” (SRTP) rate as the default PSDR to assess proposals with *mainly non-commercial* costs and benefits. This new PSDR declines over time for proposals with long-term costs and benefits.

6. The resulting discount rates, applicable for CBAs submitted from 1 October 2024 (including for initiatives for Budget 2025, where applicable), are set out below. The Treasury will review the two rates every three years.

Discount Rates (Real)	**Year 1-30**	**Year 31-100**	**Year 101+**	**Sensitivity test (mandatory)**
Non-commercial proposals (SRTP)	2%	1.5%	1%	8%
Commercial proposals (SOC)	8%	8%	8%	2%

7. In addition to the default rate, agencies are required to use the alternative rate for mandatory sensitivity analysis. Agencies can use the CBAx model, which has the SRTP rate default rate with declining rates over time and the SOC rate for sensitivity analysis. In the CBAx model, agencies can use the SOC rate as default for mainly commercial proposals.

Two methodologies for setting PSDRs

8. The Treasury is publishing the new PSDRs and background material, including expert advice provided to the Treasury and the methodologies for estimating the SOC and SRTP discount rates, see Discount Rates | The Treasury New Zealand. The two approaches are relevant for different types of costs and benefits (commercial and non-commercial), as summarised below.

9. The SOC rate discounts future commercial costs and benefits in accordance with the opportunity cost of the funds invested. *i.e.*, the estimated cost to the private sector of providing capital. It is a suitable discount rate for proposals with mainly commercial costs and benefits because it approximately reflects the rate of return for an alternative use of capital by the private sector with similar risk characteristics, i.e., the proposal’s financial opportunity cost. As has been the case, proposals with mainly commercial costs and benefits can also use project-specific rates where there are objective grounds for doing so, *e.g.*, to reflect risk or different mixes of debt and equity.

10. By contrast, SRTP represents people’s rate of time preference – how much current consumption (understood broadly as consumption of both material and non-material goods) they are willing to forgo in exchange for more future consumption. That is, it captures societal trade-offs of welfare impacts across time. In practice, discount rates derived from SRTP are lower than those derived from SOC. SRTP rates can decline over time, reflecting the sense that people value impacts in the long term and very long term similarly.

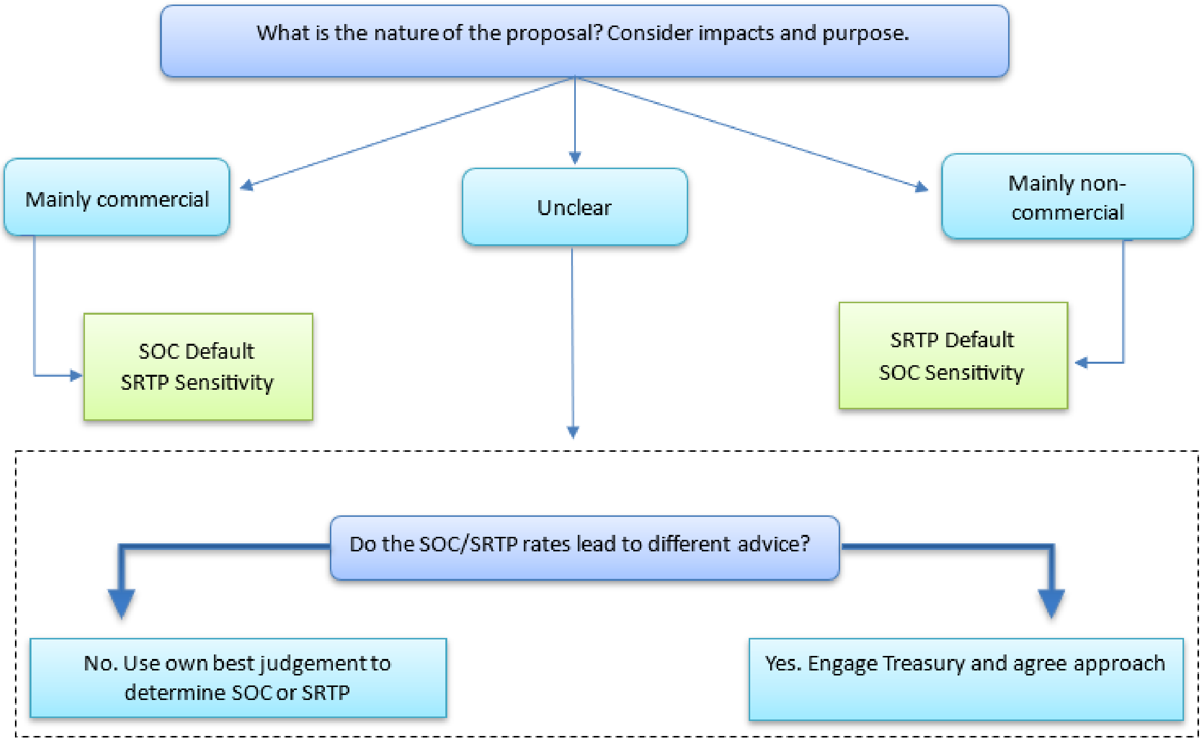
11. Updating the discounting regime to use SRTP as the default for proposals with mainly non-commercial costs and benefits makes the CBA settings more technically robust, especially in a policy environment where there is increasing focus on long-term impacts of policy.

12. Some agencies currently use different rates for their internal purposes. The Treasury recommends that agencies review these in light of the updated PSDRs. Consistent PSDRs across agencies support comparability and efficiency in agency CBA practices and in ministerial decisions.

Default rate - mainly commercial or non-commercial impacts?

13. Agencies should use both PSDRs as default and mandatory sensitivity-test rates. That is, all proposals should use both the SRTP and SOC rates, but the default varies, depending on whether their costs and benefits (impacts) are mainly commercial or non-commercial.

To determine default/sensitivity rates



14. Most public policy proposals are likely to use the SRTP rate as the default and use the SOC rate for sensitivity testing. This reflects that most public policy proposals are likely to have mainly non-commercial costs and benefits.

15. Some proposals will have both non-commercial and commercial impacts. Agencies should identify the predominant costs and benefits and accordingly apply the SRTP or SOC default. If there are both non-commercial and commercial significant impacts, agencies can in addition apply mixed rates or use different rates for different impact streams. The Treasury may publish further guidance as we gain experience with the new PSDRs. We encourage agencies to engage their Treasury Vote Analyst early where it is unclear which PSDR to use as the default and where the use of a different rate would lead to different advice.

16. To help agencies assess the appropriate PSDRs according to their commercial and non-commercial impacts, the table below sets out pointers, pending emergence of precedents through implementation. These pointers are a general guide only: agencies should still assess the nature of the impacts for individual proposals.

	Commercial	**Non-commercial**
Nature of the impacts	Private interest benefits and costs	Public interest benefits and costs
Pointers	• Commercial financial return • Competes with private sector commercial firms • Commercialises risk • Industry and trade impacts • Business and economic development impacts • Investments partially privately financed, on a commercial basis	• Public or merit good • Distributional or equity goals • Public safety impacts • Defence and security impacts • Health impacts • Environmental and climate change impacts • Cultural impacts • Social housing impacts • Public education impacts

17. An agency's organisational form and functions[1], although not determinative of the impacts of particular proposals, also point to whether its impacts are likely to be commercial or non-commercial.

    a. A Crown entity company, a Public Finance Act (PFA) schedule 4 company, a State-Owned Enterprise or a Mixed Ownership Model company is likely to have mainly commercial goals, functions and impacts, and therefore to use a default SOC rate.

    b. Public service agencies and Crown entities are likely to have mainly non-commercial goals, functions and impacts, and therefore to use a default SRTP rate.

1 See Framework for organising mixed commercial and public policy functions and Organisational Form Summary: Design Choices

Implications outside agency CBA

18. The Treasury will be providing advice to the Minister of Finance on the implications of the new PSDRs for the capital charge. In the meantime, the current capital charge rate (5 percent) remains unchanged. The Treasury will communicate any change to the capital charge to agencies.

19. The public sector discount rates for CBA purposes do *not* affect the discount rates used to determine the net present value of assets and liabilities for accounting valuation purposes.

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