

# Guidelines for Setting Charges in the Public Sector

April 2017



**THE TREASURY**  
Kaitohutohu Kaupapa Rawa

New Zealand Government

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# Contents

- Overview..... 1
  - Purpose of this guidance..... 1
  - When this guidance should be used ..... 1
  - What’s new and the context ..... 2
  - Cost Recovery Impact Statement templates ..... 3
  - Questions and Feedback ..... 4
  - Further information..... 5
- Stepping through a cost recovery analysis ..... 6
- Definitions of terms used throughout ..... 7
- 1 The policy and legislative frameworks..... 9
  - 1.1 What is cost recovery? ..... 9
  - 1.2 Should the government cost recover? ..... 9
  - 1.3 Key considerations in cost recovery ..... 9
  - 1.4 Review procedures ..... 10
- 2 Scoping and planning a cost recovery analysis..... 12
  - 2.1 What is the scope and purpose of the work? ..... 12
  - 2.2 What is the role of different entities?..... 12
  - 2.3 What project and governance structures will be needed? ..... 12
  - 2.4 What is the legal authority to charge?..... 13
  - 2.5 Consultation approach..... 13
  - 2.6 Meeting the Regulatory Impact Analysis requirements..... 15
  - 2.7 Prior reviews and other contextual information ..... 15
  - 2.8 Policy process and CRIS requirements ..... 15
- 3 The policy rationale for cost recovery..... 17
  - 3.1 Understanding what is intended to be achieved and the related outputs.. 17
  - 3.2 What are the economic characteristics of the good or service?..... 18
  - 3.3 Externalities ..... 20
  - 3.4 Impacts and incentives in cost recovery regimes..... 20
- 4 Understanding the costs of outputs..... 22
  - 4.1 Outputs and costs..... 22
  - 4.2 Demonstrating efficiency ..... 24

5	Bringing it all together – Design of cost recovery regime .....	25
5.1	Who should pay? .....	25
5.2	A fee, a levy, or a combination?.....	26
5.3	Partial or full cost recovery? .....	27
5.4	Charging based on flat or variable charges .....	28
5.5	Identifying the rate for levies .....	29
5.6	Other design considerations .....	30
5.7	Final check – does the charging regime meet the policy objectives? .....	32
6	Implementation, monitoring and managing cost recovery regimes .....	33
6.1	Implementation issues .....	33
6.2	Monitoring cost recovery regimes .....	33
6.3	Financial and non-financial performance information .....	34
6.4	Demonstrating cost control in monopoly services.....	34
6.5	Memorandum accounts .....	34
6.6	Ongoing stakeholder involvement.....	35
6.7	Reviews of cost recovery regimes .....	35

# Overview

The government provides a variety of services to the public in pursuit of its policy objectives. There is a range of possible funding sources for these government activities, including cost recovery, general taxation, revenue from government investments, and revenue received through commercial charges which are usually based on market rates.

In some cases, legislation allows the cost of these services to be recovered from users. The types of activities that are cost-recovered are decided on a case by case basis depending on the nature of the activity, the intended policy outcomes, who can or should be charged, and the effectiveness and efficiency of cost recovery.

Users and the public should be assured that government agencies are managing their costs efficiently and effectively, and taking appropriate consideration of principles such as transparency and accountability.

## Purpose of this guidance

The purpose of this guidance is to assist government agencies in designing and advising on cost recovery regimes and to effectively manage and monitor cost recovery. It provides guidance on the issues to consider and on engaging stakeholders in the development of cost recovery proposals.

## When this guidance should be used

The guidance should be used when there is statutory authority to charge third parties to cover the costs of an activity undertaken by the government (or local government) and the government is a monopoly supplier of the activity.

This might include the supply of goods or services (such as passports), approval activities (such as inspection of facilities or equipment, assessment to undertake activities, evaluation of products for safety) or compliance activities (such as monitoring compliance with safety standards or investigations of breaches of standards).

You should use this document as your starting point for preparing analysis on cost recovery regimes, both when they are being established, and when existing charging regimes are being reviewed.

Internal regulatory review panels, Treasury teams, and stakeholders of charging regimes may also use this guidance to assist in their roles in providing feedback and advice on developing cost recovery regimes.

This guidance **does not apply** to:

- ▶ commercial or market-based products or services where users could choose alternative providers (such as the provision of legal advice). In these instances, it is presumed that competitive pressure ensures that prices are set at efficient levels
- ▶ contractual payments
- ▶ charges for Crown-controlled resources (such as minerals) and access charging regimes, as such charges may be determined on a basis other than cost recovery
- ▶ taxes, duties or levies (where they are more akin to a tax – more on this in sections 1.1 and 5.2)

- ▶ penalty fees that are not related to cost recovered activities (for example, motor vehicle speeding fines), and
- ▶ intra-government charges (ie, charging arrangements between government agencies for services performed on another's behalf).

However, the principles and information outlined in this guidance might be of use when determining prices in these kinds of situations.

Where there is more specific charging guidelines in place (eg, the Ministry of Justice's guidelines for charging for official information requests) this guidance should be read alongside the specific charging guidance.

## What's new and the context

The Treasury first issued guidance for cost recovery in the public sector in 1999. This latest review of the guidance has been prompted by Ministerial interest in ensuring an 'open book' approach is applied to cost recovery charges imposed by the public sector; that is, that charges are efficient and effective and that stakeholders have visibility over the costs that underpin the charges they pay.

'Open book' refers to engagement and transparency throughout the fee setting process, from the initial proposal to charge, to setting levels, to monitoring the efficiency and effectiveness of fee structures, and in reviews.

At its simplest, this expectation is that agencies need to demonstrate to fee payers throughout this process that fees are fair and reasonable, and this requires demonstrating transparency about the composition of fees (that is, inputs and costs), how the agency will assess efficiency (eg, benchmarking) and that there are appropriate constraints on charging practices (in particular where charges are on an hourly or variable basis).

This update also responds to a recommendation by the Productivity Commission, in its inquiry on Regulatory Institutions and Practices,<sup>1</sup> to review and consolidate guidance on cost recovery. The Productivity Commission included a chapter on 'Approaches to Funding Regulators', with a range of recommendations to improve New Zealand's approach to cost recovery through strengthening the governance and accountability framework.

The guidance has also been expanded, with more detail on the legal aspects of cost recovery, as well as implementation and monitoring of cost recovery regimes, and a clearer expectation for regular reviews.

Finally, this revised guidance also launches a new set of Regulatory Impact Statement templates that are specific to cost recovery proposals, called Cost Recovery Impact Statement templates.

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<sup>1</sup> Available at: <http://www.productivity.govt.nz/inquiry-content/1788?stage=4>

# Cost Recovery Impact Statement templates

Each cost recovery regime should be based on sound analysis, underpinned by transparent information and a good understanding of the impact of the cost recovery regime. In summary, a public entity that generates revenue via cost recovery should be able to demonstrate:

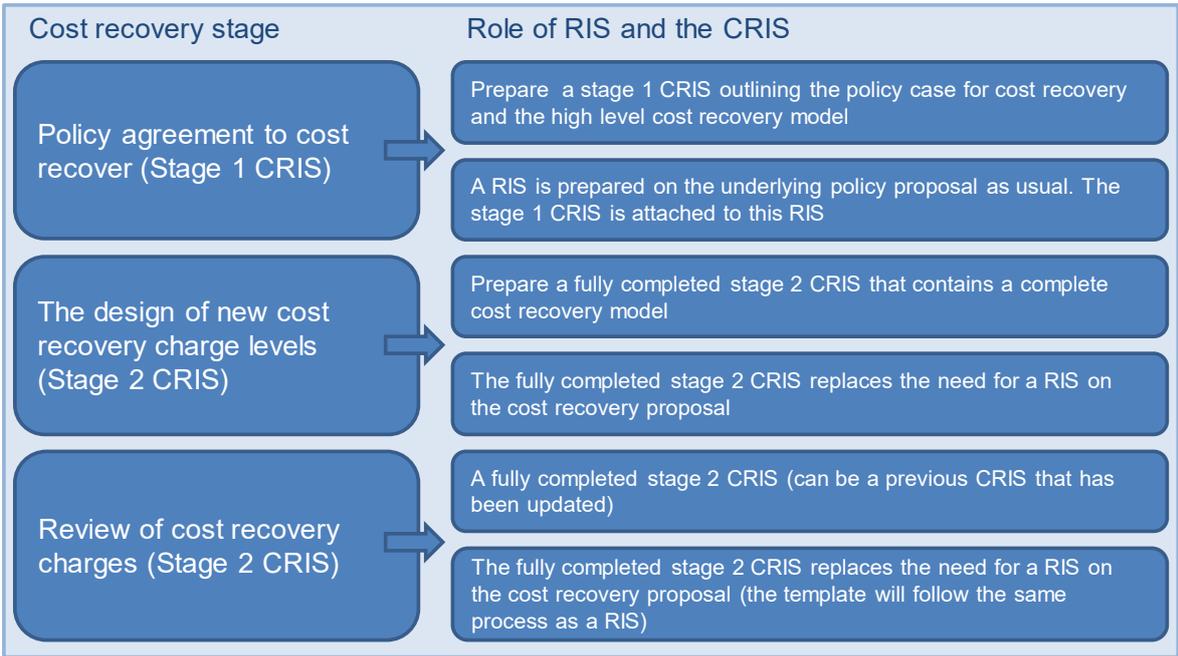
- ▶ a documented approach to its charging system that makes clear the legal authority for charging, the scope of and rationale for charges, and any other sources of revenue
- ▶ a clear understanding of the objectives sought and the trade-offs that have been made
- ▶ a sound cost-allocation process, with clear assumptions
- ▶ for each charge-setting process, a clear audit trail showing the assessment of costs incurred (where applicable), expected to be incurred and forecast demand, and the way in which the charges have been determined
- ▶ that the entity has a performance framework against which their cost recovery activities are measured
- ▶ lines of accountability for the activity being cost recovered and the related charges, and
- ▶ a plan for implementation, monitoring and review.

Two Cost Recovery Impact Statement (CRIS) templates, based on the Regulatory Impact Analysis (RIA) requirements have been designed to assist with cost recovery proposals.

The templates are designed specifically to help elicit the information required to meet the RIA requirements and to ensure that decision makers are fully informed when setting up a cost recovery regime and setting cost recovery levels. Any questions about the RIA requirements for a cost recovery proposal should be directed to the relevant Treasury vote team.

The templates should be used alongside this guidance. The templates reference the relevant sections of this guidance.

Figure 1: Cost recovery stages and templates



## Stage 1 – Policy approval to cost recover

The objective of this stage is to gain policy approval to cost recover a specific government activity. This stage normally involves seeking approval to draft primary legislation to give authority to cost recover. If agreement is being sought on specific cost recovery levels then the stage 2 CRIS should be used.

A stage 1 CRIS containing the policy rationale for cost recovery and a high level cost recovery model should be prepared and attached to the RIS on the underlying policy proposal.

## Stage 2A – Approval of the design of new cost recovery charge levels

The objective of this stage is to gain approval on the design and level of the proposed user charge. This stage normally involves seeking approval to draft regulations that contain the detail behind the user charges.

A stage 2 CRIS can be prepared and substitute the normal RIS. The stage 2 CRIS should contain at minimum:

- ▶ the policy rationale to cost recover (section 3 of these guidelines)
- ▶ a detailed cost recovery model (section 4)
- ▶ impact analysis of the proposed user charges (section 3.3, 3.4 and 5)
- ▶ results from consultation with stakeholders on the proposed cost recovery charges (section 2.5)
- ▶ implementation plan (section 6), and
- ▶ how the user charges will be monitored, evaluated and reviewed (section 6).

## Stage 2B – Review of existing cost recovery arrangements

The objective of this stage is to gain approval to any changes that need to be made to current cost recovery arrangements based on the results of a cost recovery review. See section 6.6 for guidance on reviews of existing cost recovery arrangements.

A stage 2 CRIS can be prepared and substitute the normal RIS. A stage 2 CRIS for a review could be an updated version of a previous stage 2 CRIS. The stage 2 CRIS is intended to be a living document.

The fully completed stage 2 CRIS can substitute the normal RIS. A conversation about whether it is appropriate to replace the RIS should be had with the relevant Treasury vote team.

## Questions and Feedback

Any agency-specific questions should be addressed to your Treasury Vote team.

This document has been prepared with input from a range of agencies in the public sector. Any comments as to how we could improve this guidance are very welcome.

## Further information

This document is part of a suite of guidance relating to setting user charges. Other documents that should be considered when considering cost-recovery arrangements are:

- ▶ Regulatory Impact Analysis Handbook (link in table below).
- ▶ The new CRIS templates (stage 1 CRIS and stage 2 CRIS – link in table below).
- ▶ Office of the Auditor General's (OAG' *Charging fees for public sector goods and services* (link in table below).
- ▶ Treasury circular on memorandum accounts (link in table below).

Other useful information can be found:

Name	Website	Ref. (where applicable)
Regulatory Impact Analysis Handbook	<a href="http://www.treasury.govt.nz/regulation/regulatory-proposal/ria/handbook">http://www.treasury.govt.nz/regulation/regulatory-proposal/ria/handbook</a>	
OAG guidance	<a href="http://www.oag.govt.nz/2008/charging-fees">http://www.oag.govt.nz/2008/charging-fees</a>	
OAG report from 2013 on memorandum accounts in central government	<a href="http://www.oag.govt.nz/2013/central-govt/part11.htm">http://www.oag.govt.nz/2013/central-govt/part11.htm</a>	
Australian Cost Recovery Guidance	<a href="https://www.finance.gov.au/resource-management/charging-framework/">https://www.finance.gov.au/resource-management/charging-framework/</a>	
Productivity Commission report on Regulatory Institutions and Practices	<a href="http://www.productivity.govt.nz/inquiry-content/1788?stage=4">http://www.productivity.govt.nz/inquiry-content/1788?stage=4</a>	Chapter 12
LAC guidelines	<a href="http://www.lac.org.nz/guidelines">http://www.lac.org.nz/guidelines</a>	Chapter 15
Memorandum account information	<a href="http://www.treasury.govt.nz/publications/guidance/circulars/pdfs/tc-2011-10.pdf/view">http://www.treasury.govt.nz/publications/guidance/circulars/pdfs/tc-2011-10.pdf/view</a>	
Treasury Instructions	<a href="http://www.treasury.govt.nz/publications/guidance/instructions">http://www.treasury.govt.nz/publications/guidance/instructions</a>	Section 6.3.7
CAB guide	<a href="http://www.cabguide.cabinetoffice.govt.nz/">http://www.cabguide.cabinetoffice.govt.nz/</a>	
Standing Orders	<a href="https://www.parliament.nz/en/pb/parliamentary-rules/standing-orders-2014/">https://www.parliament.nz/en/pb/parliamentary-rules/standing-orders-2014/</a>	
Ombudsman's guidance on charging for OIAs	<a href="http://www.ombudsman.parliament.nz/resources-and-publications/documents/new-charging">http://www.ombudsman.parliament.nz/resources-and-publications/documents/new-charging</a>	

# Stepping through a cost recovery analysis

Stepping through a cost recovery analysis will always depend on the facts of the situation. Here is a list of questions, which, combined with this guidance, can help shape the policy process for agencies when establishing or reviewing cost recovery regimes.

- 1 What is the policy and legislative framework?
  - ▶ Should government provide the good or service?
  - ▶ What is the legal authority to charge?
  - ▶ Key considerations for cost recovery analysis: efficiency, effectiveness, authority, transparency, consultation, equity, simplicity, performance, accountability.
- 2 Research and planning
  - ▶ What is the scope and purpose of this work?
  - ▶ What information needs to be gathered, or activities planned in order to give effect to the 'open book' approach?
  - ▶ What kind of consultation should be run?
- 3 The policy rationale for cost recovery
  - ▶ What are the outputs and how do they link to outcomes?
  - ▶ Who are the beneficiaries?
  - ▶ Are there any risks? What are they? Are there risk exacerbators?
- 4 Understanding the costs of outputs
  - ▶ What are the outputs and business processes?
  - ▶ How much do they cost?
- 5 Bringing it all together – designing fees and charges
  - ▶ Who should pay?
  - ▶ What period of time are costs expected to be recovered?
  - ▶ What and how much should they pay?
  - ▶ Design the cost recovery. Check in: does this meet the policy objectives?
- 6 Monitoring and managing cost recovery regimes
  - ▶ Collecting and publishing financial and performance information.
  - ▶ Periodically reviewing cost recovery regimes.

## Definitions of terms used throughout

Allocative efficiency	The efficient allocation of resources ensures that goods are produced at the level at which the last unit produced provides a benefit to the consumer that is equal to the cost of producing that unit.
Capital costs	The costs of the capital assets, such as buildings and IT, that are required for the production of goods or services.
Compliance costs	The costs of complying with a regulation or other requirement, such as collecting information, maintaining records or filling in forms.
Contestable markets, contestability of supply	A market for the supply of a good or service where there is a freedom of entry and where exit is inexpensive. Even if there is only a single current supplier, its prices and profits will be constrained by the threat of new entrants.
Cost of supply	The cost of producing and delivering a good or service.
Cross-subsidies	Subsidising losses on the supply of one output from profits on another.
Cost recovery	The charging of a party for the costs of producing a good, service or activity. Used interchangeably with 'fee setting'.
Cost efficiency	Producing the largest amount of outputs for the smallest amount of resource.
Equity	Fairness or justice.
Evasion	The deliberate non-payment of charges or taxes, or the avoidance of other obligations.
Externalities	When an activity generates benefits that extend beyond those who are immediately involved to others who also benefit – and who cannot be prevented from doing so – it is said to involve a positive externality. Conversely, where it generates harmful effects it is said to involve a negative externality.
Goods, club	A club good has the property that people can be excluded from its benefits at low cost, but its use by one person does not detract from its use by another.
Goods, merit	A merit good has the property that the community as a whole desires the higher use of the output than would be likely if it were charged for at full cost.
Goods, private	A private good has the property that people can be excluded from its benefits at low cost, and its use by one person detracts from its use by another.
Goods, public	A public good has the property that excluding people from its benefits is either difficult or costly, and its use by one person does not detract from its use by another.
Incremental costs	The costs of producing one of a set of outputs, over and above those of only producing the other outputs.
Marginal costs	The costs of producing an additional unit of an output. Short run marginal costs disregard those costs (such as capital costs) which are fixed in the short term. Long run marginal costs include all those that vary with different production levels.

Monopoly supplier	The sole supplier of a good or service. A monopoly supplier situation may be the natural result of the underlying economics of producing the good or service, or may be the result of statutory limitations on the entry of competitors.
Risk exacerbators	Those whose actions create negative externalities or who put a positive externality at risk.
User	Those who use, operate, or receive a benefit of a good or service. In the context of cost recovery, users will be charged fees. In general, the user will typically be the beneficiary of the cost recovered output, but in some circumstances, they may instead be the risk exacerbator.
Cost	The full cost of producing outputs, including all overhead and non-cash costs (such as the capital charge). It is measured in accrual accounting terms.
Outputs	The goods and services produced by a government agency.

# 1 The policy and legislative frameworks

This section covers the key policy and legislative considerations of a cost recovery analysis. It sets out some of the initial questions that the analysis should cover.

## 1.1 What is cost recovery?

Cost recovery occurs when an agency seeks to recover some or all of the costs of service provision from the users of that service, over a reasonable period of time. Cost recovery specifically applies to services that the government has a statutory authority to deliver. Broadly, there are two main categories of cost recovery – fees and levies.

- ▶ **Cost recovery fees:** charges imposed on a *specific* individual or organisation for a good, service or regulation *directly* provided to (or *directly* benefiting) that individual or organisation.
- ▶ **Cost recovery levies:** charges imposed on a group of individuals or organisations (eg, an industry) as a proxy for the individuals or individual organisations who directly receive or benefit from the good, service or regulation.

In reality the distinction between fees and levies is not always a bright line. Whether a fee or levy approach is used will depend on the facts of a given situation, such as the characteristics of the service and the overall policy objectives. This is discussed in more detail on pages 26-27.

**Important note:** Charges that are in excess of the costs of providing the service could be interpreted as a tax, in which case such charges must be authorised by or under an Act of Parliament as required by section 22(a) of the Constitution Act 1986. Taxes are outside of the scope of this guidance.

## 1.2 Should the government cost recover?

In a cost recovery analysis, it is worthwhile considering whether the government should in fact recover costs at all. Even if cost recovery has been in practice for some time, it should still be able to be justified. In some instances, it might be more appropriate to cover the costs of an activity through general taxation. Other alternatives to cost recovery are also covered on page 18.

## 1.3 Key considerations in cost recovery

Cost recovery regimes are 'living' regimes. The decision to cost recover is only part of the process. The cost recovery charges also need to be designed, implemented, monitored and regularly reviewed.

Throughout the different parts of the process, an open book approach should be borne in mind. As part of this, the following considerations should be key.

- ▶ **Authority:** does the public entity have legal authority to charge a fee for the goods and services provided?

- ▶ **Effectiveness:** Are resources allocated in a way that contributes to the outcomes being sought by the activity? Is the level of funding fit for purpose? Does it enable the cost recovered activity to be delivered to a level of quality that is appropriate for the circumstances (eg, it should not be ‘gold-plated’ or conversely at a poor level of performance that impedes the ability of organisations to do business)?
- ▶ **Efficiency:** are decisions on volume and standards of services, and costs to recover and when to recover, consistent with the efficient allocation of resources? What efforts have been made to ensure that there are reasonable constraints on charging, in order to demonstrate efficiency, particularly in the context of variable or hourly fees? Have options for pricing been considered in terms of what would be most efficient?
- ▶ **Transparency:** is information about the activity and its costs available in an accessible way to all stakeholders? Has the cost recovery analysis been approached in an ‘open book’ manner? Is detailed information about the cost drivers and the components that make up the charges available to stakeholders?
- ▶ **Consultation:** Has the entity engaged in meaningful consultation with stakeholders, and is there opportunity for stakeholders to contribute to the policy and design of the cost recovery activity?
- ▶ **Equity:** have the impacts of the proposed or existing cost recovery regime been identified? Will stakeholders be treated equitably? Have impacts over time been identified?
- ▶ **Simplicity:** is the cost recovery regime straightforward and understandable to relevant stakeholders? Have the costs of participation been kept low and evasion opportunities mitigated to acceptable levels?
- ▶ **Accountability:** public entities are accountable to Parliament and to the public. In practical terms, this can be demonstrated by consultation with stakeholders about change, through recording any surpluses and deficits generated by cost recovery regimes, through reporting on performance, and through reviews of the use of powers to set fees under regulation.

It is important to recognise that cost recovery analysis will be part of an overall mix of different policy settings. Sometimes these principles outlined above might be in conflict. For example, what is most efficient or equitable might not necessarily be the simplest approach.

## 1.4 Review procedures

When setting cost recovery charges, it is useful to be aware of the potential review procedures that it could be subject to.

### Regulations Review Committee

The Regulations Review Committee (the Committee) acts on Parliament’s behalf to ensure that delegated law making powers are used appropriately. It can examine regulations and investigate complaints about regulations. It reports to Parliament and can move that the House of Representatives vote to ‘disallow’ a regulation. A fuller discussion of the Committee and its role is available in the OAG’s guidance.

The Committee uses the grounds set out in Parliament's Standing Order 319(2) to determine whether a regulation setting a fee should be brought to the attention of Parliament. The most relevant grounds are likely to be:

- ▶ The regulation is not in keeping with the general objects and intentions of the statute under which it is being made (Standing Order 319(2)(a)).
- ▶ The regulation trespasses unduly on personal rights and liberties (Standing Order 319(2)(b)).
- ▶ The regulation makes some unusual or unexpected use of the powers conferred by the statute under which it is made (Standing Order 319(2)(c)).
- ▶ The regulation is more appropriate for parliamentary enactment (Standing Order 319(2)(f)).

### **Example: Migrant settlement fees**

In 1998 the Committee considered a regulation that set out a migrant settlement fee payable by applicants for residence visas or permits. A large portion of the fee was intended to go towards the cost of providing English language tuition for non-English speakers. The fee was the same regardless of whether the applicant needed this tuition or not. The Committee recommended that the regulation be revoked under Standing Order 319(2)(a) because the fee could be considered a tax, which would not be in keeping with the general objectives and intentions of the enabling legislation.

### **Judicial review**

There are grounds relating to the process followed when setting fees or levies on which a regulation could be challenged in the courts through judicial review. The High Court has the power to invalidate a fee if, for example, upon reviewing the process by which it was set, the Court finds that the process was unfair or, unreasonable or that irrelevant considerations were taken into account.

### **Review by the Auditor-General**

The Auditor-General can examine the process used to set charges. This may inform advice to the Regulations Review Committee about whether cost recovery setting processes are in line with the relevant guidelines. The Auditor-General may also look at the cost recovery setting process as part of its annual auditing duties, or as part of its other roles, such as conducting inquiries.

## 2 Scoping and planning a cost recovery analysis

This section sets out some of the considerations to be aware of when commencing work on a cost recovery review or proposal.

### 2.1 What is the scope and purpose of the work?

Cost recovery analysis should always be informed by the overarching policy objectives, and the business processes that deliver those objectives.

It will not always be necessary to revisit the policy objectives, or business processes as part of setting/reviewing cost recovery charges. However, a review of a cost recovery regime should be able to demonstrate that the policy objectives are still appropriate and that business processes are operating efficiently. Effective monitoring processes should enable these to be demonstrated (refer section 6.2 for more detail).

It is worthwhile checking the scope of the analysis or review against the relevant legislation, to make sure the scope tallies with the legal parameters.

### 2.2 What is the role of different entities?

This is relevant when the fee charging entity and the monitoring entity are different.

- ▶ Who is doing the review?
- ▶ What other entities will assist with the review?
- ▶ Who will assess the review?

At an early stage, determine whether a cost recovery proposal will require involvement of the Regulatory Impact Assessment Team (RIAT) at Treasury. Those proposals that have significant impact or risk will require RIAT involvement. You can talk to your usual Treasury contacts about this (your Finance team will usually know who to speak to).

### 2.3 What project and governance structures will be needed?

This will depend on the size, scope, and complexity of the cost recovery work as well as your organisation's usual expectations about governance and project management.

As part of this it will be important to consider the skills and expertise that may be required. Typically work on cost recovery regimes requires a mixture of policy, economics, and finance and accounting expertise. In some cases, entities will look for external support, either from the wider regulator community or the private sector.

## 2.4 What is the legal authority to charge?

A public entity must have legal authority to charge for goods or services.

The authority will be in an Act of Parliament. The legislation will usually include an empowering provision that authorises the entity or the Governor-General to set the amount through regulation. Acting without legal authority may lead to one of the review procedures outlined in section 1.4.

Before deciding the type or level of charges, clearly identify and understand the scope and any constraints or limitations of the empowering legislative provision. Empowering provisions can vary greatly including factors such as:

- ▶ whether charging is required or discretionary
- ▶ prescriptions about the process that must be followed
- ▶ the type of charges that can be used (eg, a fee or a levy)
- ▶ specific definitions of key terms, such as 'efficiency'
- ▶ what types of costs can be recovered (for example, some may allow recovery of costs related to policy advice while others don't), and
- ▶ any other options for cost recovery (for example, the extent to which methods such as differential pricing are permissible).

You should consult your legal team early in the process to ensure that there is legal authority for the proposed charge and that the correct process is followed.

## 2.5 Consultation approach

Stakeholder engagement is an important part of establishing cost recovery charges as it provides an opportunity for the public to question and comment on charges. This serves two main purposes – to enable a good understanding by prospective payers of charges, and to improve the design and implementation of the charging regime and related services. In some cases, consultation may be required by the empowering Act.

### Who to consult

Stakeholder engagement is most effective when it is well planned. Identifying stakeholders is the first step. Entities can then decide when and how to consult. Ideally the entity will consult throughout the process, and in some cases have ongoing relationships with key stakeholder groups. The consultation process should be designed in a way that gives those paying the best opportunity to provide feedback on costs, charges, and service standards and levels. However, it should be clear that consultation assists with the decision-making process, but is not a negotiation or undertaking to reach an agreement.

The main emphasis should be on current and prospective payers of charges. In some cases it may be appropriate to identify some key stakeholders and concentrate efforts on seeking their input. However, those conducting consultations should not be overly influenced by particular stakeholders to the detriment of groups that don't have a strong voice.

## When to consult

The timing of consultation will need to take into account key decision-making points, the level of authority required for different types of consultation, and how the information gained through consultation feeds into decision-making. For example, discussion documents may/will need to be approved by the Portfolio Minister/Cabinet before release. Consultation on draft regulations must comply with the Attorney-General's protocol for release of draft Government legislation outside the Crown (CO (14) 4).

It may be necessary to undertake more than one round of consultation.

## What to consult on and how to consult

As with all parts of the charging process, the amount of effort put into consultation should be appropriate to the significance and complexity of the changes to charges. Entities should consider the legal standards for adequate consultation. For more information on what constitutes the legal standards for adequate consultation refer to *Wellington International Airport v Air New Zealand [1993] 1 NZLR 671* and discuss with your legal team. In essence consultation needs to be more than 'mere notification'. As a minimum:

- ▶ there should be sufficient time for genuine and considered feedback to be developed by the stakeholders
- ▶ the information provided in a consultation process should be appropriate to the audience
- ▶ the material used in consultation processes should include enough underlying cost data and accompanying analysis to enable stakeholders to understand the rationale for the proposed levels for charges, and
- ▶ entities should genuinely consider how the feedback provided through the consultation process could change its advice.

Consultation processes can involve a significant amount of resources. Entities should consider how to get the most out of these consultation opportunities, including whether it is useful to gather information about how they can better meet their customers' needs. This can feed into ongoing thinking about the development of the service. A summary of the key feedback and details of the outcome of consultation should be incorporated into the CRIS.

## Difficulties when consulting on cost recovery proposals

The default is for entities to consult on cost recovery proposals. In some circumstances consulting may be difficult, for example where signalling a potential fee increase would lead to a surge in demand that could not be managed. When entities don't consult there should be good and well documented reasons for not doing so.

Entities should also consider other mechanisms for getting feedback that better manage potential risks. This may include drawing on feedback from previous changes to the charging regime, or consulting with a stakeholder group, including a group formed specifically for the purpose.

**Further information** on effective consultation and drafting discussion documents can be found in the Treasury's Regulatory Impact Analysis Handbook.

[\(http://www.treasury.govt.nz/regulation/regulatoryproposal/ria/handbook/\)](http://www.treasury.govt.nz/regulation/regulatoryproposal/ria/handbook/)

## 2.6 Meeting the Regulatory Impact Analysis requirements

Any changes to cost recovery regimes that are made via regulation are subject to the Regulatory Impact Analysis (RIA) requirements. A Cost Recovery Regulatory Impact Statement template is available on the Treasury website. For projects that require initial setting up of empowering legislation and then the subsequent setting of fees, this will be a two-stage process. Thoroughly completing this template should ensure that the RIA requirements are met. A separate RIS template is not required.

**Further information** on the RIA requirements can be found in the Treasury's Regulatory Impact Analysis Handbook.

(<http://www.treasury.govt.nz/regulation/regulatoryproposal/ria/handbook/>)

## 2.7 Prior reviews and other contextual information

Before starting a review of cost recovery regimes, it can be instructive to revisit previous reviews to understand what changes have been made and why. For regimes that have been in place for some time, customers/users may have previously provided feedback and insights that can be revisited.

Cost recovery regimes do not operate in isolation. Customers/users will have many other interactions with government services. It is useful to understand what recent or potential changes in government charging arrangements may have an impact on the customer/user base so that your approach and analysis can be adapted accordingly. For example, changes to the border levy and the civil aviation passenger levy will impact on some of the same users (ie, international air passengers), so changes in one regime can be usefully referenced in advice on the other. This will help in assessing the overall impact to the user from changes across related cost recovery regimes.

## 2.8 Policy process and CRIS requirements

### Policy process

An important part of the research and planning is establishing the process that the analysis and reporting will need to go through to give effect to any recommendations.

Depending on the specifics of the situation, a cost recovery analysis might need to go through several steps and iterations, such as reporting and briefing decision makers (such as Ministers and Cabinet on the outcome of the analysis, organising consultation with stakeholders, organising legislation or regulation (if it is required), making plans for implementation as well as ongoing monitoring and review. The exact process will depend on the specifics of the situation. Please contact your Vote team if you have any questions.

### CRIS requirements

Two Cost Recovery Impact Statement (CRIS) templates have been designed to ensure that cost recovery regimes are based on sound analysis and assumptions and gaps are documented. More detail on the two CRIS templates and when they should be is in the overview section.

As part of fulfilling the CRIS requirements, entities will need to design a high-level cost recovery model at the point where the ability to cost recover is being considered by Ministers. Consultation with the entity's Finance and Operational teams will be required. The high-level model will then be outlined in the stage 1 CRIS.

The basic information required to develop a high-level cost recovery model are:

- ▶ the policy outcome being sought
- ▶ estimates of expenses and revenue for the activity
- ▶ any underlying assumptions, and the way in which any changes to them might affect the financial estimates
- ▶ providing incentives for efficiency in the delivery of the outputs
- ▶ an indication of the outputs needed to fulfil the activity (such as the steps outlined in the example in section 4.1)
- ▶ identification of some of the options for cost recovery charges, and
- ▶ an estimate of the cost recovery charges.

Consideration should also be given to issues such as the degree of flexibility required in the policy design to enable the right degree of agility in the operational design (so as to not need to get agreement to policy change for minor changes to the operational design), and the way in which the entity will demonstrate transparency in pricing (for example, by benchmarking).

Once the initial policy has been agreed to, the high-level model will then form the basis of the detailed design of the cost recovery, which will then form the basis of the stage 2 CRIS.

The stage 2 CRIS is intended to work as a living document. When a cost recovery regime or fee level is reviewed, the stage 2 CRIS should be updated to reflect any changes that have happened since the initial analysis.

### 3 The policy rationale for cost recovery

This section focuses on the key policy questions that should be considered when setting up a cost recovery regime and when reviewing charges. Having legal authority to charge for an activity, is not the same as justifying a particular charging policy. This is a matter of good policy practice and goes to the objectives of transparency and efficiency.

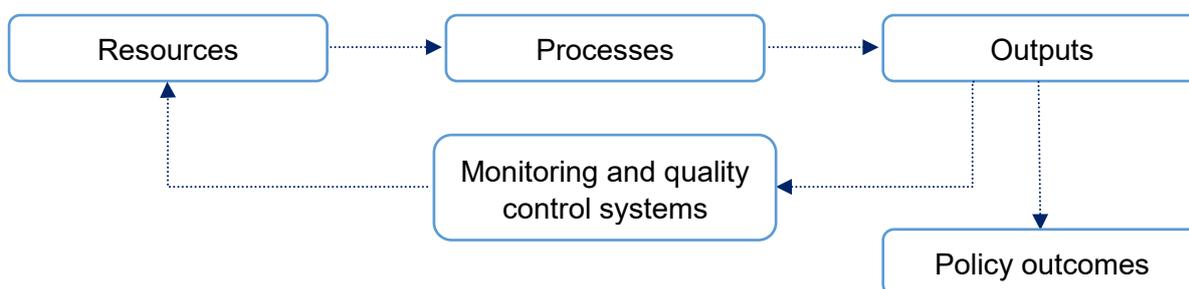
For some reviews, a restatement of the existing policy rationale from previous reviews may suffice. However, if there has been stakeholder feedback on the policy rationale, changes in related policy areas, or changes in the environment then the policy rationale may need more substantial re-working.

#### 3.1 Understanding what is intended to be achieved and the related outputs

Describing what is intended to be achieved (the policy objectives or outcomes) and the outputs to be delivered will help identify whether cost recovery is appropriate. This should be available from the policy work underpinning the regulatory regime.

In addition to a description of what is intended to be achieved, agencies also identify who will be affected by the activity (both positively and negatively), and what the situation would be if the activity wasn't performed by government. See also the section on externalities.

Figure 2: How outputs link to policy outcomes<sup>2</sup>



#### Example: Food safety inspection fees

The Ministry for Primary Industries operates a cost-recovery process when carrying out the outputs (in this case, inspections of premises) which ensures that food is safe and suitable, and eligible for export (the intended outcome).

#### Do the outputs still deliver the desired outcome?

Agencies should assess whether the outputs still deliver the intended policy outcomes. This might involve asking:

- ▶ Has anything in the environment or other policy settings changed?

<sup>2</sup> Figure taken from the *Australian Government Cost Recovery Guidelines, Resource Management Guide No. 304*, July 2014 – Third edition, produced by the Australian Government Department of Finance (<https://www.finance.gov.au/resource-management/charging-framework/>), and reproduced under Creative Commons Attribution 3.0 Australia licence (<http://creativecommons.org/licenses/by/3.0/au>).

- ▶ Are these still the right outputs to deliver the policy objectives?

These questions will help determine whether a policy review or business process review is needed before undertaking a cost recovery review.

### Are there other ways to achieve the outcomes?

As part of articulating the policy rationale for cost recovery, there should be an exploration of whether there are other ways to deliver the outcomes more efficiently or effectively.

Alternative delivery options could include:

- ▶ **Alternative public-sector provision** – are there other providers in the public sector that could deliver (or partner with to deliver) the outcomes more efficiently or effectively? Are there other agencies providing similar or related goods or services?
- ▶ **Introducing contestability** – are there ways in which contestability could be introduced into the delivery of the outcome, or components of it as a way of driving innovation and efficiency?
- ▶ **Outsourcing** – could production be outsourced (for example, where the private sector undertakes similar activities, could it be more efficient due to the scale or use of existing infrastructure)?
- ▶ **Devolution** – could production be devolved to an industry or other private sector provider to deliver at its own cost (potentially subject to Government imposed standards)?

## 3.2 What are the economic characteristics of the good or service?

Understanding the economic characteristics of a good or service can help to guide whether cost recovery is appropriate in a particular situation, and whether full or partial cost recovery is most suitable.

Goods<sup>3</sup> can be grouped based on two key economic characteristics:

- ▶ Is it **excludable** – can people be prevented from using it?
- ▶ Is it **rivalrous** – if one person uses the good, does it reduce other's enjoyment of it?

Categorising goods under public, private, merit or club goods is often used to characterise the economic characteristics of goods and services provided by government. Here is a summary of the different types of goods and the way in which they can usefully guide decision making for cost recovery. They are not intended to be determinative.

### Public goods

A good is considered to be a public good when excluding people from its benefits is either difficult or costly, and its use by one person does not detract from its use by another. Sometimes excluding other users is not only impractical, but undesirable.

There is a good case for recovering the costs of a public good from the community as a whole via general taxation or, if the benefits are localised, from local government revenue.

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<sup>3</sup> Note that 'good' in this context can refer to goods or services.

### **Example: Public goods**

Common examples of public goods are things like fireworks displays, national security and street lighting.

In practice, pure public goods are very rare. However, many Government-provided outputs share the characteristics of public goods to some extent. Although such goods or services might have some elements of a public good, there still might be justifications for recovering costs.

### **Club goods**

A club good is one where people can be excluded from its benefits at a low cost but its use by one person does not detract from its use by another, at least until the point where congestion occurs.

### **Example: Club goods**

Examples of club goods provided by the public sector include toll roads and nature parks.

The ability to exclude means that it is feasible to charge for the use of a club good. Charging club members can be an efficient way of recovering costs. A common way to charge for the use of a club good is a levy applied to a group of users, such as members of an industry group.

### **Private goods**

A private good is one where people can be excluded from its benefits at a low cost, and use by one person conflicts with use by another.

### **Example: Private goods**

Private goods that the government produces are things like passports and birth certificates. These are specific to the person they are generated for, and can only be used for their own personal use. In this way, they are rivalrous. They are also easily excludable in that the owner of the passport or birth certificate cannot let another person use the documents.

There is a strong case for recovering the costs of a private good from those who benefit from it. Recovery of these costs would most likely take the form of a fee.

Purely private goods are not commonly provided by the public sector. In general, when government provides a good or a service, there is likely to be an element of public benefit for having provided the good or service. In the example above about birth certificates and passports, although there are elements to these goods that are akin to private goods, the wider public also benefits from official identification.

### **Merit goods**

A merit good is one that is likely to be produced at a lower level than the community desires in a free market situation. This may be because the public benefit of the good is greater than the private benefit, and consumers only take into account the private benefit when making decisions. It may also be because the benefits are long-term and consumers don't take these benefits into consideration when making decisions.

### Example: Merit goods

An example of a merit good is vaccinations – individuals may be willing to risk not being vaccinated but the health of the population requires a large number of people to be vaccinated.

There *may* be a case for charging at less than full cost or not charging at all for merit goods, but the difference between the actual cost and the charge to the user is likely to need to come from general taxation.

## 3.3 Externalities

The analysis should cover whether externalities, positive or negative are generated by the supply of the good or service, and identify any risk exacerbators (that is, those whose actions create negative externalities, or who put a positive externality at risk).

Risk exacerbators act in ways that might make it necessary for government to become involved, depending on the nature of the risk. Most of the examples outlined in this guidance demonstrate positive externalities; that is, where the supply generates benefits that extend beyond the parties to the arrangement.

However, negative externalities occur when harmful effects are generated. In this way, government may have a role to play in designing goods or services (and the associated charges) in a way that encourage actions with positive externalities and discourage actions with negative ones.

### Example: Externalities

In the previous example, vaccinations are shown to generate positive externalities by helping to build herd immunity. In this way, the public at large benefits from the actions of a smaller group of people directly engaged with vaccinating.

A common example of a negative externality is pollution arising from risk exacerbators who engage in wasteful or carbon intensive activity. There is a range of ways in which government might respond to this behaviour. Responses relevant to this guidance include things like selling permits to pollute.

Similarly, cost recovery in the management of fisheries includes the principle that the 'cost of conservation services or fisheries services provided to avoid, remedy, or mitigate a risk to, or an adverse effect on, the aquatic environment or the biological diversity of the aquatic environment must, so far as practicable, be attributed to the persons who caused the risk or adverse effect' (section 262 of the Fisheries Act 1996).

## 3.4 Impacts and incentives in cost recovery regimes

Understanding the impact of a cost recovery regime on current and potential users is an important step in assessing whether the cost recovery regime is appropriate. The questions that should be considered include:

- ▶ What is the cumulative impact of government cost recovery charges on those who pay the charges? (ie, there should be consideration of the impact of the range of charges that affect those who pay charges, not just a narrow focus on the impact of a particular cost recovery regime)
- ▶ Is the cost recovery charge likely to be a barrier to entry for new entrants to the market?
- ▶ What incentives and behaviours is the regime likely to create for those who pay charges?

- ▶ What incentives and behaviours is the regime likely to create for the charging entities?

When reviewing fees, it might be possible to use data and evidence based on previous changes to the cost recovery regime to understand potential impacts. In addition the impact of cost recovery regimes can be illustrated by user experience analysis, through developing 'personas' of some typical charge payers. This can help to demonstrate the impact of new charges or changes in charges in the context of the range of government charges that a fee/levy payer may face.

### **Incentives for users/payers**

Consideration should be given to how to set incentives for the right behaviour from users and payers. This will require going back to the outcomes sought by the implementation of a cost recovery regime. The kind of behaviour sought might be things like ensuring the services are accessible, using the services at efficient levels (that is, not over-using them, but also not having inappropriate barriers to use), that businesses operate in accordance with regulations, and ensuring adequate levels of safety responses.

Charging regimes can influence these behaviours so consideration should also be given to ability to pay and other aspects of differential pricing. For more discussion on this, see section 5.6.

### **Incentives for agencies**

Cost recovery regimes should be designed so that agencies can demonstrate that the outputs they deliver are cost efficient, in order to avoid the perception of things like cost-padding, or inefficiency. Being clear about the analysis of the cost regime in the CRIS, benchmarking, and reviewing the charges periodically are practical ways to achieve this.

## 4 Understanding the costs of outputs

This section provides guidance for understanding in detail the outputs and business processes associated with an activity and their costs. All entities are expected to know the detailed costs of delivering their outputs. Understanding these is important to support key decisions such as what outputs to provide, who is best placed to provide them and to what quality. This information is also necessary so that appropriate costs are recovered, over- or under-recovery of costs is minimised, and the entity can manage costs and monitor performance over time, and demonstrate that it is operating efficiently.

As with all aspects of developing cost recovery regimes, the effort put into this should be proportionate to the size and complexity of the costs to be recovered.

### 4.1 Outputs and costs

#### What are the outputs and business processes required to achieve the outcomes?

Identifying outputs and processes is an important way of ensuring transparency in the setting of user charges. It should be clear how the outputs contribute to achieving the policy outcomes.

There are a number of different approaches to assigning costs to activities or outputs. Whatever approach is used, the key considerations are ensuring that the full costs are captured and that this is done in a manner that supports decisions such as resource allocation. Assumptions are necessary and critical, and should be made clear, and reviewed regularly against actual performance.

It will typically involve: (i) identifying the underlying business processes; (ii) identifying the direct and indirect costs; and (iii) a methodology for assigning these to each of the processes.

#### Example: Assessing a permit application to import an animal

Where the output is assessing a permit application to import an animal, the following business processes may be involved:

- ▶ checking the accuracy of information in the application
- ▶ reviewing the application
- ▶ deciding on the application
- ▶ notifying the applicant of the decision, and
- ▶ issuing the permit.

In this scenario, the output (assessing the permit) might contribute to a policy outcome of keeping the resident animal population free from diseases such as rabies.

#### Costs of production

Once the outputs and processes have been determined, entities should prepare detailed information on the cost of production. Establishing this might include:

- ▶ identifying the different goods and services being produced

- ▶ identifying the resources used in production
- ▶ estimating the volume of each good or service to be produced in a given period
- ▶ estimating the volume and cost of resources required to produce each good and service in that period
- ▶ understanding the direct and indirect cost drivers (more detail on indirect costs can be found on pages 24 and 25 of the OAG guidance), and
- ▶ identifying which costs are sensitive to changes in volume.

Assumptions should be made clear. The approach taken and the level of detail should be proportionate to the complexity and sensitivity of the process.

The fees for a publically produced good or service should, generally, be in line with the cost to produce it.

### **Example: Direct and indirect costs**

#### Direct Costs

- ▶ The most common direct costs are staff salaries (including on-costs, such as training, superannuation and leave) and supplier costs (eg, office supplies).

#### Indirect Costs

- ▶ Common indirect costs include overhead costs such as salaries of staff in corporate (eg, finance, human resources) and technical support (eg, legal or IT) areas, or accommodation costs (eg, rent, maintenance, utilities).

## **Capital costs**

The analysis should consider whether capital costs should be recovered, and if so, how they should be recovered (noting that all outputs should be fully costed, but that is separate from the decision as to whether all costs should be recovered).

As a starting point, we typically would expect all costs (including capital charge and depreciation of related assets) to be recovered so that users are paying the true and full cost. Where Government investment is initially required, such as to build a database or other asset to support a cost recovered activity, this investment will often be recovered through the depreciation expense incurred (and charged as a cost) over the life of the asset.

The analysis should cover the cost of production over the life of the capital assets involved, both in the short and the long term, and any other variations such as location or time of service.

## **Allocating overhead costs**

It is reasonable to recover overhead costs to the extent that these costs are necessary for the production of the good or service. As overheads are most likely to be an indirect cost, they should be apportioned using the appropriate costing methodology.

The enabling legislation may also place restrictions on the extent to which overhead costs can be recovered.

## 4.2 Demonstrating efficiency

Agencies need to demonstrate that their service offering is efficient, in that it meets the needs of stakeholders, and represents value for money.

A key way of demonstrating efficiency is by reporting against a set of performance metrics. The stage 2 CRIS should include details of how the agency intends to measure its performance. This should be updated regularly.

Efficiency isn't necessarily about making the service as low cost as possible. Consultation with stakeholders to understand their needs and to design services that meet these needs is crucial. Agencies should test with stakeholders the way in which they should be charged.

For fee structures with a degree of uncertainty in the level of charging (for example, variable fee structures and those based on hourly rates), there should also be safeguards in place to ensure that fees are reasonable and justifiable. Suggestions for safeguards are discussed in more detail in section 5.4.

## 5 Bringing it all together – Design of cost recovery regime

This section covers some of the key design considerations, and the way in which the analysis should be documented. Once the main policy parameters have been determined, consideration should be given to how the cost recovery might operate in reality, and ensuring that the implementation aligns with the policy intent.

An open book approach to designing cost recovery regimes is crucial. Consultation can provide useful insights into the needs of the users, which in turn can improve the design. Also, the design stage is an opportunity to set up the structures that will facilitate an open book approach in an ongoing way (for example, by defining performance metrics that can be reported against).

### Example: Setting WorkSafe’s major hazards fees and levies in an ‘open book’ way

WorkSafe New Zealand is a work health and safety regulator. In 2016 new regulations came into force, setting up a new major hazards facilities safety regime. In agreeing to the original policy decisions, Cabinet agreed that the costs of administering this regime should come from major hazard facility operators, rather than the safety levy that all businesses pay.

As the new regulations necessitated a new approach to work health and safety monitoring, the exact costs of the new regime were not known. The consultation demonstrated an open book approach by including:

- ▶ Research on the costs of similar regimes in comparable jurisdictions.
- ▶ A detailed set of fee proposals, including detailed breakdowns of the cost drivers of the proposed fees.

The consultation discussion document and materials can be found at: <http://www.mbie.govt.nz/info-services/employment-skills/workplace-health-and-safety-reform/development-of-regulations-to-support-the-new-health-and-safety-at-work-act/fee-and-levy-options-for-worksafe-new-zealands-oversight-of-regulations-for-major-hazard-facilities>

See pages 19-23 and appendix 2 of the discussion document.

### 5.1 Who should pay?

There are some options about who should pay cost recovery charges. These might include:

- ▶ people who benefit from the output (such as the holders of permits, owners of passports and so on), and
- ▶ risk exacerbators (that is, the individuals or organisations whose actions make it necessary for the government to become involved). Examples of risk exacerbators include firms that produce waste or pollution, or certain road users.

The analysis should identify the parties that could be charged, and then assess the possibility of charging each of them on the basis of:

- ▶ legislative authority
- ▶ administrative feasibility

- ▶ behaviour and incentives on the parties, and
- ▶ equity.

In reality, the decision about who to charge may be based on what is administratively feasible, and in some instances the charges will subsequently be passed through to the final consumers. This includes managing the transaction costs involved (eg, costs of collection, compliance and enforcement), and ensuring that levels of evasion of charges would not be unacceptably high.

Where a charging entity cost recovers from a party who is not a direct beneficiary of the service, they should be able to justify this. In some instances, such as in the example below of airline tickets and aviation levies, the enabling legislation might require this. Beneficiaries should bear the economic burden so that they consume an efficient level of the good or service.

Behavioural changes can be prompted by cost recovery charges and the analysis should consider the implications of this for take up rates and the wider policy objectives. For example, charging risk exacerbators could lead to users avoiding activities like safety inspections and therefore undermine the overall policy objective.

Equity has a role to play in this consideration. In general it is more equitable to charge those who benefit directly or singularly from the output rather than spread the cost across the general public through taxation. The economic characteristic analysis will help here (for example, excludable and rivalrous goods will likely have a strong case for charging the user). For more on analysing the economic characteristics, see section 3.2.

The final decision will likely involve a weighing of these three factors.

#### **Example: Airline tickets and aviation levies**

International and Domestic Passenger Safety Levies are paid by airlines to the Civil Aviation Authority. These levies are passed through to airline passengers in the ticket price. Passengers are not able to be levied directly as the Civil Aviation Act 1990 only allows levies to be imposed on aviation document holders.

Although airlines bear the legal burden of paying these costs, passengers are the beneficiaries of the safety services driving these costs, and therefore bear the economic burden in the sense that the costs are being passed on to them.

## **5.2 A fee, a levy, or a combination?**

In general, a fee is a defined payment from a specified party to another in return for the provision of a good or service. A levy will also be charged to a particular party or group, for a specified purpose, but not necessarily for a specific good or service. In this way, a levy might be more akin to a tax.

In practice, fees and levies might not fit into discrete categories and might instead be better conceptualised as being on a spectrum. This discussion of the difference is intended as a guide rather than a definitive statement on the difference between a fee and a levy. The exact nature of a charge will turn on the context and the facts of the situation.

The decision about whether to cost recover using a fee or levy will depend on the nature of the output that is being cost recovered, who should pay for it, and the legislative parameters around cost recovery. Refer to section 2.4 for more detail.

When an entity intends to charge a levy, it is crucial that the enabling legislation gives the ability to structure the cost recovery in this way. As with fees, levies should not charge more than what it costs to delivery those activities for which the entity is legally empowered to cost recover.

It may be that within the one charging regime, a combination of a fee for some outputs is appropriate, and a levy for others.

#### **Example: Financial Markets Authority**

The Financial Markets Authority (the FMA) is an independent Crown entity that has mandate to promote and facilitate the development of fair, efficient and transparent financial markets.

The FMA administers a range of fees and levies. Fees are charged for a range of services (for example, the provision of a licence for a new financial market service, or to apply to be an Authorised Financial Adviser). Levies are also a feature of the charging regime, as the FMA receives funding from the Crown with a proportion of these costs being recouped via levies.

### **5.3 Partial or full cost recovery?**

There are some circumstances where charging at less than full cost may be appropriate. A decision to charge at less than full cost recovery would need the shortfall to be made up from general taxation. The advice on cost recovery charges should provide a good case for why general taxation should contribute to the costs of an activity, as taxation has economic costs and also affects budget constraints.

In some circumstances full cost recovery would lead to a situation where the cost recovery regime undermines the policy objectives. In these cases a policy decision may be made to partially recover costs. For example full cost recovery of civil court proceedings may create a cost barrier that inappropriately limits access to justice.

Partial cost recovery may also be appropriate in circumstances where charges are being phased in. This can enable those paying charges to adjust to new charges.

When partial cost recovery is recommended, the advice should include options for different levels of partial cost recovery and an assessment of the impact of each option, as well as reasons for and against. The assumptions and evidence that underpin the advice should be well documented.

As always, care must be taken when estimating the full costs of recovery as often the statutory authority for charging will not extend to allowing for over-recovery. This can cause difficulties if an entity is trying to recover a deficit after a previous period of under-recovery. However, the entity can manage these issues provided that there is enough scope in the statutory authority, and if it is clear that the surpluses and deficits are being managed within a reasonable budgeting framework for managing costs and setting fees over a period of time. Memorandum accounts are one way of managing surpluses and deficits over time in a transparent way (discussed further in sections 5.6 and 6.5).

## Charging at short run marginal cost

In some instances it may be efficient to charge at short run marginal cost, that is, what it would cost to produce one more unit,<sup>4</sup> rather than full cost recovery. Situations where this might occur could be the production of goods that are incidental to the provider's core business.

### Example: Incremental costs

Government frequently receives requests for official information from the public. In some cases, a fee is charged to recover the cost of this activity. As the production of this output is incidental to the core business of government, it might be appropriate to charge on an incremental rather than full cost recovery basis.

Charging at the marginal cost (that is, the cost of producing one more product or service) can promote efficient levels of consumption, as well as the level of production over the short term. Whether it does so will depend on the extent to which demand and/or supply are sensitive to the price.

## Revenue shortfall

If a shortfall from charging at short-run marginal cost cannot be made up from fixed charges, it has to be met from general taxation. Taxation has economic costs and also affects budget constraints.

## Net benefits of charging at short-run marginal cost

The analysis should consider the trade-off between:

- ▶ the costs resulting from poor decisions if charges differ from short-run marginal costs, and
- ▶ the costs resulting from poor decisions and/or higher taxation if charges differ from long-run marginal costs.

## 5.4 Charging based on flat or variable charges

### Flat fee

Flat fees are fixed charges for a particular good or service. The benefits of this approach to charging are that it is simple and provides certainty for charging entities and stakeholders. Consumers tend to dislike unstable prices as they might make it hard to plan. However, flat fees can have a disproportionate impact on occasional users, so might discourage continued involvement in an activity.

### Variable charges

For some cost recovered activities the costs of producing an output could vary considerably depending on individual circumstances. For example the cost of approving an application for a permit could vary significantly depending on the specific application. In these

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<sup>4</sup> For example, if the agency had produced 60 units in a given period, the short run marginal cost would be what it costs the agency to produce the 61<sup>st</sup> unit.

circumstances an input-based fee may be most appropriate (eg, the number of hours it takes to approve an application). This also creates an incentive for stakeholders to be efficient in their consumption of services, for example by ensuring that their applications are completed in full so as to minimise the amount of time required to process them.

Input based charges (eg, charges based on a particular number of hours to process an application) also have the disadvantage of providing less certainty to fee payers and create a risk that charging entities will not operate as efficiently as they could. Variable fee structures such as these are more complex than flat fee structures. This complexity will increase transaction costs. A balancing exercise is needed to weigh the cost of a more complex fee structure against simplicity.

Charging entities should actively ensure they are operationally and financially efficient. For example, by requiring justification for charging over a certain level (known in some jurisdictions as 'speed humps'), or publishing information about past/average charges, in line with the requirement in section 4.2 to publish information about their performance. Another approach is to use a two tier charging structure, such as a combination of a flat fee with additional input based charges for complex or time consuming cases.

#### **Example: Variable charges for financial market service licences**

The Financial Markets Authority (FMA) charges application fees for licences to provide financial market services. The fees vary according to the type of licence and are based upon a set number of hours to process the application (eg, derivatives issuer licence is estimated to take 70 hours to process, whereas the estimate for a crowd funding service licence is 40 hours). Additional fees, based on an hourly rate, may be charged where the application process exceeds the stated number of hours.

In some circumstances there may also be a case for using a variable levy structure, such as complex activities where there are multiple cost drivers.

When deciding to use variable charges, it is imperative that agencies set up structures to actively demonstrate that they are operating efficiently. Variable fee structures need to have in place safeguards to ensure that the eventual charges are reasonable, and that there are constraints to help prevent overcharging. This could take the form of benchmarking, having a high level internal sign-off for charges beyond a certain value, and having a process of review or appeal of charges. Consultation with stakeholders is particularly important in the case of variable charges, to ensure that the output is fit for purpose.

## **5.5 Identifying the rate for levies**

An appropriate way to distribute levy payments among levy payers needs to be identified, based on the relevant cost drivers. A flat rate would split the levy evenly between all users. Alternatively a differentiated rate would split the levy payments based on the resources used or level of activity generated by groups of levy payers. This could be based on payer size, level of activity, level of risk or other criteria. A differentiated rate might result in a more complex cost structure, but reduce the potential for cross subsidisation and improve fairness between levy payers to the extent that the payers who drive the costs bear the costs also.

See also section 5.4 for discussion on variable charges and variable levy structures.

## 5.6 Other design considerations

### Differential pricing

Differential pricing refers to a situation where different users might be charged different prices for the same output (eg, children are charged less than adults for passports, despite the fact that they are effectively the same product). When considering whether to use differential pricing, it is important to be mindful of the incentives on fee payers that might arise due to this kind of fee structure (eg the extent it encourages or discourages access to the service). Differential pricing is different to cross-subsidisation between different outputs, which should generally be avoided.

### Cross subsidisation

Cross subsidisation occurs when the charges for providing one type of good or service are put towards the cost of providing another type of good or service. Cross subsidisation should generally be avoided, as the costs are not borne by the users. In this way it is not consistent with the efficient allocation of resources.

However, there may be situations where cross subsidisation makes sense for policy reasons.

The extent to which cross-subsidisation is lawful will always depend on the wording of the relevant empowering provisions and the entity is recommended to seek legal advice in these situations. Any cross-subsidisation must be clearly authorised and transparent, and the reasons for doing so clearly documented. External review organisations such as the Regulations Review Committee may consider the appropriateness of such a structure. The consequences of this are explained in section 1.4.

### Assumptions and judgements

When designing cost recovery charges it is important to be mindful of:

- ▶ the legislative parameters relevant to the specific cost recovery regime
- ▶ the policy objectives
- ▶ how transaction costs are managed
- ▶ how to encourage efficiency in charging, and
- ▶ equity implications.

In considering these issues, it is possible that assumptions and judgements will need to be made. Those that have been made in determining the design of a cost recovery charge should be clearly documented in the CRISs.

### Refunds, exemptions and waivers

Payment of a fee or levy cannot be waived or refunded without authorisation from an Act. The Act (or regulations lawfully made under an Act) will identify the circumstances in which the fee or levy may be waived or refunded. A refund or exemption cannot be made unless the legislation authorises it.

Exemptions and waivers may also feature in the cost recovery regime. Fee waivers might be justified for charitable or volunteer organisations. When considering whether to include these, the overarching policy objectives will be helpful.

## **Estimating the volume to be produced in a given period, and the volume and cost of resources required**

As part of the analysis, the entity should also consider the future demand. Volume is important for pricing and design. If forecasts are volatile then it might make sense to consider a floating vs fixed charge, or to set more frequent review periods.

Assumptions will be required (particularly in the case of new activities, where alternative sources of information will need to be sourced, and be reasonable and logical) and the analysis should be clear about these so that they can be tested by stakeholders.

The analysis should also consider changes and fluctuations in volumes over time, such as escalating volume as awareness and demand picks up, or an initial surge during peak seasons. This will help in determining the right level of charges, so that revenue will equal costs over a reasonable period of time.

Once the volume has been forecast, the entity can then estimate the required resources and their costs. Further assumptions will be required, such as the price that the entity expects to pay for the resources that it needs to produce the goods and services. Consideration should be given to both fixed and variable costs and the impact of inflation.

The analysis should identify a logical period over which the volume and costs should be based. If charges are reviewed every three years, then this would be a reasonable period to base the assumptions.

## **Testing and understanding efficiency and effectiveness**

Efficiency and effectiveness in government involve making the proper use of available resources (people, money and other supplies) to achieve government policy outcomes. The question of how to create incentives for efficient and effective services should be a key consideration in the design of cost recovery regimes. However, incentives to be cost efficient are weak when there is little or no competitive tension, such as in the case of monopoly providers (as government providers of statutory services are).

It is important, therefore that in order to maintain the confidence of stakeholders, the entity is able to demonstrate it is efficient, even though this is challenging.

Charging entities should also ensure that they have mechanisms in place to ensure that they are not:

- ▶ gold plating services or investments by building in unnecessary costs or delivering services at a higher standard than is necessary, or
- ▶ using cost recovery charges to 'hide' inefficiencies in operations, by passing costs onto users who are unable to exert effective pressure to reduce costs.

Transparency will play a big role in creating incentives on entities to look for efficiencies. Cost recovering agencies should be able to explain the cost drivers and the way in which their outputs help deliver on the intended policy outcomes. The expectation is that this is collated in the CRIS templates and made public so that stakeholders can engage with the analysis.

Other ways of encouraging efficiencies include:

- ▶ Using benchmarks for activity costs and processes against similar government activities and/or organisations in New Zealand or overseas. Benchmarking can be against either the whole activity, or where there is no directly comparable activity against part of the activity (eg, business processes). Benchmarking against the private sector may be possible but it should be noted that government entities have a range of accountabilities and that some cost recovered activities have unique cost drivers.
- ▶ Preparing multiple options for different service levels and/or models and working through the costs of each.
- ▶ Monitoring charges and output standards and levels (more on this in section 6.2).

To the extent possible, payers should be given the opportunity to provide feedback on the quality and quantity of a good or service via consultation and other stakeholder engagement processes.

### **Under-recovery and over-recovery of costs**

The analysis should cover the question of whether it would be suitable to 'smooth' the costs of the service over an appropriate period of time.

User charges should match actual costs. However, charges will typically be set in advance of when they will be applied, and so a set of assumptions will need to be made. Where those assumptions don't correspond with the actual results, the revenue received by the agency will not match the actual cost of producing the good or service.

The appropriate period of time to consider whether revenue has matched costs will depend up on the specific situation, and factors such as the useful life of capital investments, likely changes in input costs, cyclical changes in volumes, and how constant (for example, airlines) or changing (for example, passport applicants) the set of payers is.

Although the general requirement is to match charges to costs as closely as possible, this is expected to occur over time. This recognises that it is not practicable to precisely match revenues to costs at a point in time and that there are downsides to frequent price changes, such as the extra costs of business process changes and communication to users. Where entities choose to use a period that is longer than a year for aligning expenses and revenue, that position must be justified. There must not be systematic over- or under-recovery of costs.

Memorandum accounts are one tool to help manage price smoothing and to be transparent with current status of under or over recovery. These are discussed in section 6.5.

## **5.7 Final check – does the charging regime meet the policy objectives?**

Once they have been developed cost recovery regimes should be tested against the policy objectives. Introducing new charges, or changing the way that charges operate will likely have an impact on the behaviour of those who pay the charges. It may also have an impact on the way that the charging entity's staff implement the policy. This should be tested back against the policy objectives to test for possible unintended consequences.

For example, if charges are introduced for safety audits this may cause a decrease in the amount of time spent on safety audits. If the overall policy objective is to improve safety then a cost recovery regime designed this way may undermine the policy intent. This does not necessarily mean that cost recovery is not appropriate, but that the design might need reconsidering.

## 6 Implementation, monitoring and managing cost recovery regimes

This section covers the management and monitoring practices that should take place once a cost recovery regime has been implemented. Adequate management and monitoring is an important part of giving effect to the principles, in particular, the principle of transparency.

### 6.1 Implementation issues

Charging entities are responsible for implementing their cost recovered activities. The specifics of what this will involve will depend on the entity and the nature of the activity. Here is a list of issues that should be considered when developing an implementation plan:

- ▶ **Timing and planning.** When should the charging commence? How does the time of the charge work in relation to other charges by government? Should payments be made up-front or in arrears, instalments or one-off? When should a review be scheduled? Do staff have the right mix of skills to implement the cost recovery? Do any specialist skills or equipment need to be procured? Do changes need to be made to legislation?
- ▶ **Checking in with the policy intent.** Does the detailed design of the implementation meet the outcomes that are intended to be generated by the outputs?
- ▶ **Governance and management.** How will the implementation project be governed? How will the cost recovery be governed once it has been implemented? What is the management structure that will be in place?
- ▶ **Performance and reporting.** What are the performance and reporting measures that will be put in place? Implementation is expected to put in place performance and reporting measures, so that:
  - ▶ outputs can be measured against forecasts
  - ▶ costs can be appropriately reviewed at reasonable intervals, and
  - ▶ the CRIS can be regularly updated.

Engaging in consultation and project management disciplines will go a long way in identifying potential implementation issues. Efforts should be made to ensure that consultation with stakeholders is ongoing.

#### Example: Timing of charges

Car registration fees contain a few components, such as vehicle licencing fees, and risk-related ACC levies. Although these fees are for different and distinct purposes, they are collected at the same time.

### 6.2 Monitoring cost recovery regimes

Charging entities should monitor the performance of cost recovery regimes. Monitoring should be a part of the implementation of the cost recovery regime. This information should be made public (eg, published on the agency's website) to provide transparency to stakeholders about the performance of the activity that they are funding.

Entities should also consider how regularly they publish information depending on the costs of gathering the information and the level of stakeholder interest. At a minimum this information should be provided annually.

### **6.3 Financial and non-financial performance information**

Government entities should measure and publish their performance to see whether they have achieved government policy objectives. This will help give customers confidence that the payments they make do achieve their intended purpose. It is also an important plank of transparency.

We suggest that entities report along the following lines:

- ▶ Well-defined measures that demonstrate when outputs have been achieved. These measures should be reviewed when there are policy changes that impact on the delivery of the outputs.
- ▶ Actual revenue and expenses compared with past forecasts, and the current state of any memorandum account.
- ▶ The report should be endorsed by those that are accountable for the delivery of the outcomes that the cost recovery regime is designed to achieve, for example, senior leaders or Ministers.

### **6.4 Demonstrating cost control in monopoly services**

A powerful mechanism to demonstrate cost control is to be transparent about the input costs, the level of service that this purchases, and how this changes over time. This means that charging entities should consider:

- ▶ 'opening the books' as part of their consultation with stakeholders about changes to cost recovery regimes
- ▶ developing an ongoing reporting regime to demonstrate costs associated with cost recovered activities and the performance of these activities, and
- ▶ considering whether there are appropriate benchmarks that could be used (for example, comparisons with other jurisdictions or similar types of goods/services in the public or private sector).

The charging entity's approach to reporting on cost control and performance should be set out as part of the consultation with stakeholders and in advice to decision-makers about changes to cost recovery regimes.

### **6.5 Memorandum accounts**

Memorandum accounts record the accumulated balance of surpluses and deficits incurred in the provision of certain outputs on a full cost recovery basis. The purpose of memorandum accounts is to:

- ▶ increase transparency to charging practices
- ▶ provide a credible commitment that charging entities will not inadvertently benefit from over-recovery
- ▶ focus the attention of entities on possible over- or under-recovery, and

- ▶ establish an even-handed regime in terms of their treatment of short-term surpluses and deficits, by applying a long-term perspective.

Departments **must** use memorandum accounts to record the accumulated balance of surpluses and deficits incurred in the provision of third party, fully cost-recovered outputs.

Memorandum accounts **should** be used wherever:

- ▶ third parties are to be charged for services provided on a full cost-recovery basis
- ▶ refunding surpluses or levying short-falls through a contractual arrangement is costly or impractical, and
- ▶ the benefits of preparing a memorandum account clearly outweigh the compliance costs involved.

The expectation is that the balance of each memorandum account will trend towards zero over a reasonable period of time, with interim deficits being met either by cash from the agency's balance sheet or by seeking approval for a capital injection from the Crown.

What constitutes 'reasonable' will differ from case to case and is dependent on the specifics of the circumstances. Factors relevant are things like the useful life of capital investments, likely changes in input costs, cyclical changes in volumes, and how constant (for example, airlines) or changing (for example, passport applicants) the set of payers is.

More information on memorandum accounts can be found in Treasury Circular 2011/10, the Treasury Instructions 2016, the OAG guidance (section 3.57).

## 6.6 Ongoing stakeholder involvement

Effective consultation with stakeholders can result in more fully formed policy and implementation. We recommend that entities develop an engagement strategy with stakeholders that makes allowance for ongoing consultation. Feedback from stakeholders should be sought when policy changes are made, and the outcome of consultation should be incorporated into the CRISs.

## 6.7 Reviews of cost recovery regimes

Cost recovery regimes should be 'living' regimes that are reviewed regularly to ensure that they are operating efficiently and that over-recovery or under-recovery is minimised.

We recommend that they be reviewed at least every three to five years.

However, there are other reasons why a cost regime might be reviewed outside a regular review cycle, including:

- ▶ a legislative requirement
- ▶ if the accumulated surplus or deficit in the memorandum account is trending away from zero
- ▶ change in government priorities or a policy change
- ▶ a material change in service delivery costs
- ▶ changes in service relevance, and
- ▶ a change in market conditions.

## Triggering a review

When a cost recovery regime is established or changed, the process should identify what the trigger points for the next review are. This might include financial triggers such as large memorandum account balances, or material changes in forecast costs or levels of demand. For some cost recovery regimes a review period is set out in legislation. Good practice is for regimes to be reviewed at a minimum of every three years.

The information gathered through regular monitoring of cost recovery regimes should provide a good indication of when a cost recovery regime requires reviewing. Other factors when considering the timing of fee reviews are the stability of the service users and the stability of demand for the service.

### Example: Border clearance levy

A new border clearance levy came into effect in New Zealand on 1 January 2016. It is designed to recover the costs of protecting New Zealand from imported pests, diseases, illegal drugs and contraband. Previously these costs were met by taxpayers. However, in recent years, passenger volumes have increased substantially, and are forecast to continue to increase. The Government considered that it was fairer for border risk management services to be funded by travellers. The levy rate was initially set at \$18.76 + GST for air travellers and \$22.80 + GST for cruise passengers for 30 months. At the end of this period it will be reviewed to assess its effectiveness and whether it needs to be adjusted.

## Planning a review

Reviews should be adequately planned and scoped. Things to consider:

- ▶ **Process.** How will the review run? When will the entity report to decision makers and in what form? How will this fit with other functions of government such as the annual Budget cycle, particularly if it seems likely that taxpayer funds might be required? How will consultation with stakeholders be run and managed?
- ▶ **Scope.** What entities will be involved in the review? What charges, or types of charges will be reviewed? What activities will be considered?
- ▶ **Research.** What other reviews have taken place? What other contextual information is relevant? What has changed since the last review? How has the implementation of the cost recovery regime performed against the performance measures that were identified at its establishment or at the last setting of the rate? What (if any) are the policy, legal or operational issues and risks that have been identified in the implementation?

Earlier sections of this guidance should be helpful when planning and scoping a review.

## Reporting on the outcome of a review

Our expectation is that the CRIS templates will be updated with the outcome of the review.