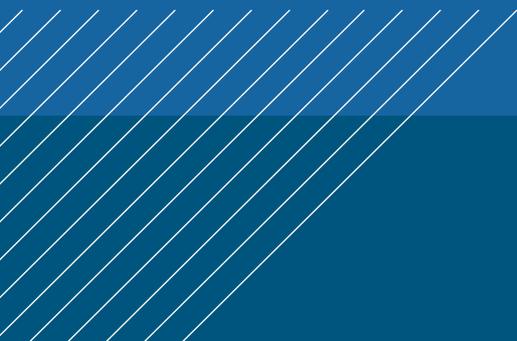


# **Cost Recovery Guidelines**

January 2013

Incorporating the information formerly published in the  
*Guidelines for Setting Fees and User-Charges Imposed by  
Departments and Central Government Agencies*



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# Conventions

## **Charges, fees, and levies**

In practice, there are a number of different terms associated with cost recovery. For example:

- **'Regulatory fees'** are characterised by granting access rights to engage in a desired activity. For example, access might be in the form of a permit or licence enabling the Government to regulate an activity as an instrument of government policy.
- A **'user charge'** or **'fee-for-service'** is the direct charge for the provision of a good or service by the Government in an open market. Examples include the charge of processing a Freedom of Information request, and the fee for a copy of a marriage, birth or death certificate.
- **'Levies'** are a form of tax that is imposed on a specific industry or class of persons (rather than a tax of general application). An example is the building permit levy that is imposed on participants within the housing construction sector.

In Chapters 1 to 4 of these Guidelines, **'charge'** tends to be used as a generic term covering all cost recovery arrangements.

In Chapter 5, to be consistent with the legislation that is discussed, the term **'fee'** is used to cover all regulatory fees, user charges and fees-for-service that are subject to indexation policy and other government processes.

# 1. Introduction

## 1.1 Purpose and structure of these Guidelines

The purpose of these Guidelines is to clarify the Government's policy principles underpinning cost recovery arrangements, and provide a rigorous framework for use by government departments, agencies and regulators when considering, developing and/or reviewing cost recovery arrangements.

The Guidelines establish a whole-of-government framework for ensuring that cost recovery arrangements in Victoria are transparent, efficient, effective and consistent with legislative requirements and government policy.

Government-provided goods and services vary widely in their economic and institutional characteristics. Similarly, the nature of government regulation is diverse. Thus, no single cost recovery charging mechanism will be appropriate for every case. Consequently, it is not possible to issue guidance material that is definitive.

Rather, these Guidelines are designed to establish a central framework, which provides a checklist and discussion of the key issues on which to base sound analysis and evaluation. In many cases, the analysis may not suggest a single charging approach, but will instead help to identify a range of options for the recovery of costs. The preferred option will then depend on the relative weights given to different criteria, such as efficiency and equity, and on implementation factors.

Thus, it is important that government departments, agencies and regulators develop their own cost recovery arrangements that customise the central framework to meet their own particular circumstances, while ensuring that their arrangements are consistent with the Government's expectations.

The Guidelines are structured as follows:

- The **objectives and principles of cost recovery** are discussed in Chapter 2. This explains what cost recovery is, and considers the rationale of using cost recovery as a means of achieving efficiency and equity objectives. This chapter also articulates the key policy principles that should underpin cost recovery arrangements in Victoria.
- Chapter 3 looks at **output analysis and charging considerations**, by examining the different types and characteristics of government-provided goods/services and regulatory activity, and discussing the implications for cost recovery arrangements.
- A discussion of the different steps involved in the **design and implementation of cost recovery arrangements** is provided in Chapter 4.
- **Process issues** are covered in Chapter 5, which includes information about indexation and appropriate government approval processes, along with other administrative matters, such as concessions and the impact of the Goods and Services Tax.

## 1.2 Scope of these Guidelines

These Guidelines incorporate and expand on the explanatory material that was formerly published by the Department of Treasury and Finance in the Guidelines for Setting Fees and User-Charges Imposed by Departments and General Government Agencies.

The Guidelines apply to cost recovery arrangements of government departments and general government agencies, including the recovery of:

- the costs associated with the provision of certain government good and services – for example, those that are subject to user charges or fees-for-service;
- the costs incurred by government in administering regulation (e.g. registration, licensing, issuing of permits, monitoring compliance, investigations, enforcement activity etc); and
- the costs of activities undertaken in natural resource-based sectors (such as forestry, fishing and aquaculture, minerals and petroleum, and land-based industries like agriculture) and ecological services (including wildlife habitat and food sources, soil conservation, water catchment protection, cleaner air, and recreational services).

However, these Guidelines do not apply to:

- general taxation;
- local government charges;
- charges by government business enterprises and private sector-government partnerships (e.g. water authorities and energy suppliers);
- fines or pecuniary penalties;<sup>1</sup>
- rents charged for access to Crown-owned resources;<sup>2</sup>
- the setting of taxes, fines or other penalties to limit negative externalities (i.e. harmful effects that extend beyond the people directly involved) associated with a particular activity.

It should be noted that these Guidelines describe situations where full cost recovery may not be appropriate, which includes government services where objectives of income redistribution or social insurance are important (e.g. the provision of health, education, public transport and social housing).

### 1.3 Application of these Guidelines

These Guidelines are primarily intended for policy officers within government departments and agencies, including those involved in the preparation of Regulatory Impact Statements that deal with fees and charges. The Guidelines cover issues to be considered in developing or reviewing cost recovery arrangements. Where some form of cost recovery is deemed necessary, and therefore knowledge of the appropriate cost base is needed, it is expected that finance officers will also play a role in the application of these Guidelines.

Nevertheless, for any large cost recovery project, the comprehensive application of these Guidelines will require a broader mix of skills and expertise, including policy, financial, economic, project management and sectoral specific knowledge.

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<sup>1</sup> While these Guidelines do not apply to the *setting* of fines or penalties, Chapter 5 does contain information relating to the *indexation* of fines and penalties.

<sup>2</sup> Cost recovery and resource rents are different concepts. Resource rent represents the profit a natural resource firm makes over and above the normal profit, business costs and government charges that arise because access to the resource is restricted. The profit is over and above the profit that would be required to prompt investment in the resource in a competitive market.

When applying these Guidelines, users should be aware of other policy and regulatory requirements and undertake the necessary complementary analysis. Examples include: Victorian Guide to Regulation (available from [www.vcec.vic.gov.au](http://www.vcec.vic.gov.au)).

Where formal assessments are required (e.g. through a fees RIS), a sound application of the principles in these Guidelines will assist with these assessments.

- Competitive neutrality guidelines will apply where government-provided services compete with services provided by private sector interests. (These are also available from [www.vcec.vic.gov.au](http://www.vcec.vic.gov.au)).
- Business Impact Assessment and Regulatory Impact Statement (RIS) processes are required where consequential changes are required to be made to primary or secondary legislation, or where new legislation is proposed. These are detailed in the Victorian Guide to Regulation (see [www.vcec.vic.gov.au](http://www.vcec.vic.gov.au)).
- Where essential services are affected, regulatory oversight of the Essential Services Commission may apply (see [www.esc.vic.gov.au](http://www.esc.vic.gov.au)).

In addition, the Standing Directions of the Minister for Finance under the *Financial Management Act 1994* (available from government intranet: [http://hoddle.dpc.vic.gov.au/BudgetGuide/DMA/DMA\\_July-06-Update.doc](http://hoddle.dpc.vic.gov.au/BudgetGuide/DMA/DMA_July-06-Update.doc)) specify a number of relevant matters that must be complied with in respect to implementing and maintaining appropriate financial management practices, including in relation to charges for goods and services. These matters are outlined in Chapter 5 of these Guidelines.

## 2. Objectives and Principles of Cost Recovery

**This chapter examines the role of cost recovery, and considers the rationale for cost recovery as a means of achieving efficiency and equity objectives. There is also discussion about the principles that should underpin cost recovery arrangements in Victoria.**

### 2.1 What is cost recovery?

In the past, it was common for many government activities to be largely funded from general taxation revenue. More recently, however, with a desire to improve efficiency and equity outcomes, governments have increasingly been recovering some or all of the costs of various activities by more direct means.

In the case of general taxation, revenue is raised to fund a wide range of government activities, and there is rarely a direct link between the source of the tax and the expenditure of the revenue raised from that tax. In contrast, cost recovery is the recovery by government of some or all of the costs of a particular activity.

Cost recovery may be defined as the recuperation of the costs of government-provided or funded products, services or activities that, at least in part, provide private benefits to individuals, entities or groups, or reflect the costs their actions impose.

In practice, cost recovery involves setting and collecting charges to cover the costs incurred in undertaking activities such as:

- the provision by government of certain goods and services purchased by customers (e.g. Freedom of Information requests, title searches);
- the administration of regulation (e.g. registration, licensing, issuing of permits, monitoring compliance, investigations, enforcement activity etc); and
- government measures in natural resource-based sectors (such as forestry, fishing and aquaculture, minerals and petroleum, and land-based industries like agriculture) and ecological services (including wildlife habitat and food sources, soil conservation, water catchment protection, cleaner air, and recreational services).

The costs of these activities will need to be recovered in some way – either from users or others who benefit from the good, service or activity; those whose actions give rise to it; or from taxpayers more generally.

### 2.2 Objectives of cost recovery

When designed and implemented appropriately, the adoption of cost recovery has the potential to advance efficiency and equity objectives.<sup>3</sup> Achieving these goals is important,

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<sup>3</sup> Cost recovery can also advance fiscal sustainability goals. Cost recovery can provide a transparent way for government agencies and for government agencies and regulators to identify and fund the cost of undertaking their activities without the need to rely solely on revenue secured through the budget process. This potential for reduced reliance on general taxation revenue can relieve fiscal pressures, and ensures that general taxation revenue is diverted to more appropriate sources.

not only from a government perspective, but also because of the benefits provided to businesses and the community as a whole.

Efficiency and equity considerations may need to be balanced against each other in determining the appropriate form of cost recovery.

### **Efficiency objectives**

Appropriate cost recovery can improve the way that resources are allocated within the economy, thereby contributing to allocative efficiency (a situation where resources are allocated in a way that maximises the net benefit to society). Allocative efficiency is achieved when the value consumers place on a good or service equals the cost of resources used up in production. By requiring payment for goods/services provided by government, cost recovery charges can give important signals to users about the costs of the resources involved in their provision. Full cost recovery ensures that all the relevant costs of bringing the good/service to market are incorporated in the relevant price signals.

The recovery of costs incurred by government in undertaking regulatory activity will have similar allocative efficiency effects. Incorporating the costs of administering government regulation into the prices of regulated products and services ensures that the costs to the community of the resources used to allow the regulated activity to take place will become apparent to producers and consumers. This means that activities that require high levels of regulation are not favoured over activities that require low levels of regulation.

By decreasing the level of general taxation needed to finance government products, services or regulated activities, cost recovery also reduces the costs of tax administration and compliance, and the 'deadweight loss' of tax-related distortions.<sup>4</sup>

### **Equity objectives**

When used in a public finance context, equity can have both horizontal and vertical dimensions.

*Horizontal equity* refers to treating people in similar situations in similar ways. In the case of cost recovery, horizontal equity refers to those who benefit from government activities, or those that contribute to the need for government regulation, having to pay the associated costs. This improves equity because it avoids the situation where all taxpayers have to pay the associated costs regardless of whether or not they benefit from – or give rise to the need for – the government activity/regulation.

Moreover, the establishment of a standard cost recovery framework improves equity by facilitating consistent treatment across regulated industries. Meanwhile, cost recovery arrangements that incorporate competitive neutrality principles also ensure that there is consistent treatment between private and public sector entities by making appropriate adjustments to offset any cost advantages or disadvantages arising from government ownership.

*Vertical equity*, on the other hand, refers to those with greater means contributing proportionately more than those with lesser means. In the context of cost recovery, vertical equity may be affected if different charging arrangements apply to different groups of users

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<sup>4</sup> In economics, a deadweight loss is a loss in economic efficiency that can arise from the imposition of taxes (amongst other things) because the tax prevents some people from engaging in what they perceive as mutually-beneficial transactions.

or industries. For example, concessions may be provided on certain charges to particular user groups (e.g. those on low incomes), where the goal is to maximise these groups' access to certain goods and services.

## 2.3 Principles of cost recovery

### Full cost recovery

As stated in the *Victorian Guide to Regulation*,<sup>5</sup> general government policy is that regulatory fees and user charges should be set on a **full cost recovery basis** because it ensures that both efficiency and equity objectives are met. Full cost represents the value of all the resources used or consumed in the provision of an output or activity. (The calculation of recoverable costs is discussed in **Step 6** in Chapter 4).

Full cost recovery is consistent with achieving the efficiency and equity objectives outlined in Section 2.2 above:

- Full cost recovery promotes the efficient allocation of resources by sending the appropriate price signals about the value of all the resources being used in the provision of government goods, services and/or regulatory activity.
- From a horizontal equity point of view, full cost recovery ensures that those that have benefited from government-provided goods and services, or those that give rise to the need for government regulation, pay the associated cost. Those parties that do not benefit or take part in a regulated activity do not have to bear the costs.

While general policy is for costs to be recovered on a full cost basis, there are nevertheless situations where it may be desirable to recover at less than full cost, or not to recover costs at all. Examples of such situations are discussed in more detail in Chapter 4, and include circumstances where:

- practical implementation issues make cost recovery infeasible;
- there are benefits to unrelated third parties (sometimes referred to as 'positive externalities');
- social policy or vertical equity considerations are considered to outweigh the efficiency objectives associated with full cost recovery; and/or
- full cost-recovery might adversely affect the achievement of other government policy objectives.

Where the government is providing goods and services on a commercial basis, in competition with the private sector, it is appropriate for charge to be set at the commercial market price – even if this implies a level that exceeds full cost recovery.

Even in cases where there may be justifiable reasons to depart from the full cost recovery principle, these Guidelines still provide the central framework of the various issues that need to be addressed when designing cost recovery arrangements.

For more information, refer to:

Is charging feasible, practical and legal – **Step 4** in Chapter 4.

Is full cost recovery appropriate? – **Step 5** in Chapter 4.

Which costs should be recovered? – **Step 6** in Chapter 4.

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<sup>5</sup> See Section 3.2.13 of the *Victorian Guide to Regulation*.

## Other principles of well-designed cost recovery arrangements

There are other principles that need to be taken into account when designing and implementing cost recovery arrangements. These may be grouped into principles relating to the appropriateness of cost recovery; those that affect the nature of cost recovery charges; and other desirable implementation features of cost recovery arrangements.

These principles are outlined below, and are incorporated into the discussion of the different steps involved in practical design and implementation of cost recovery arrangements in Victoria, which is the focus of Chapter 4.

### Appropriateness of cost recovery

Cost recovery arrangements should be:

- **consistent with, and supportive of, the policy objectives of cost recovery:** cost recovery arrangements should advance the cost recovery objectives of efficiency, equity and fiscal sustainability.
- **imposed directly, where possible:** recovering costs directly from those that benefit from, or whose actions give rise to the need for, the government good/service/activity is most likely to advance the objectives of cost recovery. Nevertheless, there may be situations where practical implementation considerations dictate where the charge is imposed (e.g. it may be more cost effective to charge representative agencies);
- **cost effective and practical:** the cost of administering cost recovery arrangements should be less than the value of the costs recovered. Potential levels of evasion should not be unacceptably high;
- **feasible and legal:** there are no insurmountable policy, legal or other impediments to the implementation of cost recovery arrangements; and
- **consistent with other policy objectives:** cost recovery arrangements should at least be compatible with, if not complementary to, the overarching outcomes the Government seeks to advance through providing or funding products and services. Furthermore, cost recovery arrangements should not jeopardise other government objectives – for example, by restricting or stifling competition and industry innovation.

For more information, refer to:

- Chapter 3 – Output Analysis and Charging Considerations.
- Section 4.2 of Chapter 4 – **Steps 1 to 5**.

### Nature of cost recovery charges

Cost recovery charges should:

- **be set according to an ‘efficient’ cost base:** best practice cost recovery arrangements require that charges are set at a level that recover the ‘efficient’ (i.e. minimum) costs of providing the good/service at the required quality, or of undertaking the necessary regulatory activity;
- **not be used to finance/achieve unrelated activities/objectives:** cross subsidies should be avoided because they are inequitable and often create incentive effects that are contrary to the desired efficiency objectives;
- **avoid volatility:** a framework of cost recovery charges that smooth year-on-year fluctuations will facilitate the forward planning processes of government, enterprises and industries; and
- **be simple to understand:** complex arrangements that are theoretically pure may introduce unjustified costs and unnecessary confusion.

For more information, refer to:

- Sections 4.3 of Chapter 4 – **Steps 6 to 8.**

#### **Implementation features**

When implementing cost recovery arrangements, it is important that they be:

- **decided in consultation with relevant parties:** cost recovery arrangements will benefit from the information and insights of relevant parties, and are more likely to succeed if those parties have some degree of ownership of the arrangements;
- **transparent, with clear accountability:** this will help to build trust in the integrity of the process, and will impose a discipline to keep costs down to 'efficient' levels; and
- **monitored and reviewed regularly:** this will ensure that they continue to be appropriate and based on relevant costs.

For more information, refer to:

- Section 4.4 of Chapter 4 – **Steps 9 and 10.**

## 3. Output Analysis and Charging Considerations

**This chapter examines the different types and characteristics of government-provided goods/services and regulatory activity, and discusses the implications for cost recovery arrangements.**

### 3.1 Purpose of output analysis

Deciding the appropriate nature of charging regimes requires a detailed analysis of the outputs and outcomes that arise from government activities. As such, it is important that these outputs and outcomes are described and analysed in sufficient detail in order to be able to determine:

- the economic characteristics of the outputs/outcomes arising from the activity – for example, where they sit on the public private good ‘continuum’;
- the beneficiaries of the government activity (including any unintended third-party beneficiaries);
- the parties and circumstances that create the need for the government activity; and
- whether the activity contributes to achieving other policy objectives or desired outcomes beyond those that it is intended to achieve.

This analysis will help to decide whether full cost recovery is appropriate, or whether partial cost recovery or funding from general taxation should be considered. It will also identify feasible options of which entities should be charged.

This chapter categorises government activities under two broad headings:

- the provision of goods and services (Section 3.2); and
- regulation to address other market failures (Section 3.3).

### 3.2 Government provision of goods and services

This section discusses the different economic characteristics of the goods and services typically provided by government, which need to be taken into account when considering appropriate charging mechanisms.

Typically, the ‘beneficiary pays’ approach can be used to identify who should pay for the provision of government goods and services. Under this approach, private parties should, in general, meet their share of the costs of providing goods/services that confer private benefits, but cost recovery charges should not be applied to costs incurred by the Government from meeting public interests or providing public goods/services.

#### **Public, selected public, club, and private goods**

The economic characteristics of products and services delivered by government can be categorised along a public-private good continuum, a classification that is based on the principles of:

- **excludability** – i.e. the extent to which it is possible to exclude a party from the consumption/benefits of the good; and

- **rivalry** – i.e. the extent to which the consumption of the good by one party affects the consumption/benefit by another party.

At one end of the public-private good continuum are pure public goods, which are non-excludable and non-rivalrous, so that consumption of the good and the benefits arising from that consumption are available to the community as a whole. Such goods are often associated with the free rider problem, which exists when people enjoy the benefits of government-provided goods/services regardless of whether or not they pay for them.<sup>6</sup> Where the degree of free-riding is significant and beyond redress through user pricing, the private sector would struggle to make a profit from the provision of such goods, and so there is a strong case for the government provision of pure public goods, to be funded by the community as a whole through general taxation.

In practice, there are very few pure public goods as many of the goods and services provided by government display a mixture of public good and private good characteristics (i.e. they display varying degrees of excludability and rivalry, so they sit somewhere along the public-private good continuum). In such cases, the appropriate cost recovery arrangements may be more complex and require careful consideration.

For instance, **selective public goods** are public goods that only benefit specific groups, such as basic strategic research that benefits a particular industry group. A number of policy initiatives have been introduced to enable selective public goods to be funded by the beneficiaries – for example, legislation that allows compulsory levies to be introduced on identifiable groups that benefit from research and development. Where there are some external benefits to society from selective public goods, consideration might be given to using funds from the budgets of the government departments responsible for the relevant activity/benefit group.

**Club goods** are those where people can be excluded from their benefits at low cost (thereby distinguishing them from pure public goods), but where use by one person (within the ‘club’) does not detract from its use by another. The key difference between club goods and selective public goods is that the ability to exclude implies the feasibility for charging for the use of a club good. Club goods may be provided (and funded) by member-owned collectives (such as an industry association). In some cases, the public sector may also provide club goods, in which case charging the members of the ‘club’ can be an efficient way of recovering costs.

At the opposite end of the public-private good continuum are **private goods**, where consumption by one party conflicts with its use by another, and where benefits of consumption only accrue to the consuming party. Under these circumstances, there is a strong case for the party consuming and benefiting from the private good to pay for its provision. An example of a private good would be a copy of a birth certificate.

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<sup>6</sup> An example of the free rider problem is national defence spending. No individual person can be excluded from being defended by a country’s military forces, and thus free riders could refuse or avoid paying for being defended, even though they are still as well guarded as those who do contribute to the nation’s defence effort. To overcome this free rider problem, it is usual therefore for defence spending to be funded through general taxation.

## Merit goods and positive externalities

Governments also often provide **merit goods** – these have the property that the community as a whole desires a higher use of the output than would be likely if it were charged at full cost. If left to the market, a merit good is under-consumed because the value that individual consumers place on the good is not as high as the value placed on it by society as a whole (i.e. without intervention, consumers would consume ‘too little of a good thing’). This may provide an argument for charging at less than full cost. Examples of merit goods include education, exercise and the arts.

Similarly, the consumption of certain goods and services by individuals may generate external benefits to unrelated third parties – a concept that is sometimes referred to as **positive externalities**. An example is preventative healthcare, such as vaccinations against infectious diseases. Immunisation prevents an individual from getting a disease, but has the positive effect of the individual not being able to spread the disease to others in the community. As with merit goods, there is a case for charging at less than full cost recovery for those goods and services displaying positive externality characteristics because they generate both private and public benefits.

### 3.3 Government regulation to address other market failures

The rationale for governments being involved in the provision of public, selective public, club and merits goods is that, left to the market, the best outcomes may not be delivered for society. In such cases, the market is said to be ‘failing’. There are a number of other forms of market failure that provide a rationale for governments to intervene and regulate in order to decrease the risk of harm or damage that may arise to consumers, the whole community or the environment. Such market failures include:

- **Negative externalities** (or negative ‘spillovers’) – these occur when an activity imposes costs (which are not compensated) on parties not directly involved in the activity. Without regulation, the existence of negative externalities results in too much of an activity taking place from the point of view of society as a whole. A good example of a negative externality is pollution.
- **Inadequate information** – consumers may not have adequate access to the information they require to make decisions that are in their best interests. For example, the cost to the consumer of acquiring the relevant information may be too high and/or the consumer may be unable to assimilate the information in order to make a rational choice (e.g. the information may be technically complex). Sometimes, sellers may have access to better information than buyers (often referred to as ‘information asymmetries’). Under such circumstances, governments may regulate to require information disclosure, to provide the information directly, or place restrictions on the supply of goods or services regarded as dangerous.
- **Market power** – the existence of overwhelming market power – which may arise from uncompetitive market structures (e.g. a monopoly or a small number of market participants) or from anti-competitive conduct (e.g. collusion) may result in prices being higher or output lower than they should be, and too few resources are allocated to the production of particular goods and services. In other words, the market does not produce enough of what best meets society’s needs. Regulation may be required to ensure this market power is not exploited to the detriment of consumers – for example, involving pro-competitive structural reform and/or application of competition law.

There will be costs incurred in administering the government regulation to address these market failures.

From the point of view of economic efficiency, it is important that the cost structures of an industry reflect all of the costs to society that must be expended for that industry to continue. If industry participants do not face the full costs associated with the efficient regulation<sup>7</sup> of that industry, prices will tend to be too low and output too high than the best outcome for society as a whole. To address this, the costs incurred by government in administering regulation should be internalised as part of the cost of production of the good or service in question.

This is consistent with the full cost pricing principle, which requires incorporation of the total value of all the resources used in the production of a good or service, or in carrying out an activity. In this way, the prices of regulated goods and services would incorporate all of the costs of bringing these products to market, and would provide appropriate price signals to both consumers and producers about the costs of the resources involved in allowing the regulated activity to take place. This will ensure that industries that require high levels of regulation are not favoured over lightly-regulated industries.

Ensuring that these costs are internalised to the industry also has the effect of holding regulators accountable for the costs of the regulatory solutions. This, in turn, can be expected to act as a discipline against over-regulation in many circumstances.

When recovering costs from the participants of the industry that is creating the need for this regulation, the outcome will often be the same whichever group (firms or consumers) is targeted – i.e. the price of the regulated product incorporates the cost. Thus, it may be left to practical considerations to determine where the charge is levied. In practice, this usually means that charging the regulated businesses will be the most efficient and cost effective approach. However, if there is a commercial relationship between the businesses and their customers, the costs will be passed down the production line, so that the costs will be ultimately shared between both parties.

### 3.4 Summary

Table 3.1 provides a summary of the different types of government activity and associated charging considerations, which have been discussed and in this chapter. It is important to emphasise that, because government-provided goods and services and different forms of government regulation vary widely in their economic and institutional characteristics, no single charging formula applies to every case. Rather, the discussion in this chapter should be used as a guide for identifying feasible charging options based on a robust analytical framework.

The charging approach that is ultimately adopted will depend on a host of factors, including:

- the relative weights given to the different efficiency and equity objectives of cost recovery charges. There may be trade-offs involved between these objectives. For example, while full cost recovery may be the best way to achieve efficiency gains, the pursuit of vertical equity goals might warrant a departure from the full cost principle;

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<sup>7</sup> Efficient regulation may be defined as a concept that involves creating appropriate incentives that will achieve an efficient market outcome.

- practical implementation and legal issues, including the transaction costs associated with the costs of collection, compliance and enforcement of cost recovery charges, the likely levels of evasion, what is permitted under the relevant legal authority; and
- consistency with other government policy goals (e.g. social insurance, income redistribution, encouraging innovation).

**Table 3.1: Types of goods, government regulation and charging considerations**

Description	Examples	Charging considerations
<p><b>‘Pure’ public goods</b> display the following characteristics:</p> <ul style="list-style-type: none"> <li>• they are non-excludable, which means that anyone can have access to them once they are provided; and</li> <li>• they are non-rivalrous, which means that any person can benefit from them, without diminishing any one else’s enjoyment.</li> </ul>	<ul style="list-style-type: none"> <li>• National defence</li> <li>• Street-lighting</li> </ul>	<p>Given the wide-ranging and non-exclusive nature of the benefits, there is a strong case for funding pure public goods from the community as a whole through general taxation.</p>
<p><b>‘Selective’ public goods</b> are public goods that benefit specific groups. For example, the groups may be differentiated by:</p> <ul style="list-style-type: none"> <li>• area of interest (e.g. all Victorian beef producers); or</li> <li>• geographical region (e.g. wine grape growers in the Yarra Valley).</li> </ul>	<ul style="list-style-type: none"> <li>• Basic strategic research</li> <li>• Development of new crop varieties</li> </ul>	<p>A number of policy initiatives have been introduced to enable these type of public goods to be funded by the beneficiaries – e.g. legislation that allows compulsory levies to be introduced on identifiable groups that benefit from research and development.</p> <p>Funds may come from the budgets of the government departments responsible for the relevant activity/benefit group, where there are external benefits to society.</p>
<p><b>Club goods</b> are those where people can be excluded from its benefits at low cost (unlike a public good) but its use by one person (within the ‘club’) does not detract from its use by another (at least until congestion becomes an issue).</p> <p>The key difference between club good and (selective) public goods is that the ability to exclude implies the feasibility of charging for use.</p>	<ul style="list-style-type: none"> <li>• Cable television</li> <li>• Private schools</li> <li>• National parks (where entrance fees can be charged)</li> </ul>	<p>Club goods may be provided (and funded) by member-owned collectives (such as an industry organisation).</p> <p>In some cases, the public sector may also provide club goods, in which case charging the members of the ‘club’ can be an efficient way of recovering costs.</p>

Description	Examples	Charging considerations
<p><b>Private goods</b> display the following characteristics:</p> <ul style="list-style-type: none"> <li>• they are excludable – it is physically, technically and/or legally possible to prevent use by another party; and</li> <li>• they are rivalrous, which means consumption/benefit by one party rules out consumption/benefit by another.</li> </ul>	<ul style="list-style-type: none"> <li>• Birth certificate</li> <li>• Research and development tailored to a specific party</li> </ul>	<p>There is a strong case for recovering the costs of a private good from those who benefit from it.</p>
<p><b>Merit goods</b> have the property that the community as a whole desires a higher use of the output than would be likely than if they were charged at full cost. Similarly, some goods display <b>POSITIVE EXTERNALITIES</b> because they also benefit unrelated third parties.</p>	<ul style="list-style-type: none"> <li>• Education</li> <li>• Healthcare</li> <li>• Exercise</li> <li>• The arts</li> </ul>	<p>There may be a case for charging at less than full cost – i.e. providing a government subsidy – because there may be both private and public benefits.</p>
<p>There is often a need for Government regulation in order to reduce the risk of harm or damage that may arise to consumers, the whole community or the environment.</p>	<p>Regulation to address:</p> <ul style="list-style-type: none"> <li>• Negative externalities</li> <li>• Inadequate information</li> <li>• Market power</li> </ul>	<p>On economic efficiency grounds, there is a case for the administrative costs of regulation to be internalised into the cost structure of the regulated industry. Practical considerations normally mean charges are imposed on businesses (but may ultimately be shared with consumers with costs shifting along the production line).</p>

## 4. Designing and Implementing Cost Recovery Arrangements

**This chapter provides guidance about the various issues that need to be addressed when designing, implementing and reviewing cost recovery arrangements in Victoria.**

### 4.1 Checklist of steps

Chapters 2 and 3 outlined some key theoretical and policy principles underpinning cost recovery. This chapter focuses on practical design and implementation issues by discussing the various steps involved in the process of establishing cost recovery arrangements.

The discussion is arranged under a series of ten 'steps' (listed in Table 4.1 below), which encompass the various guidelines that should be followed. These steps need not be applied sequentially – rather, they are organised under the broad headings of the principles of cost recovery (discussed in Chapter 2), and provide an indication of the different considerations and issues that will need to be addressed in designing and implementing cost recovery arrangements.

**Table 4.1: Key issues to address when considering cost recovery arrangements**

Step	Issues to be addressed
<b>Appropriateness of cost recovery</b>	
1	Is provision of the output or level of regulation appropriate?
2	What is the nature of the output or regulation?
3	Who could be charged?
4	Is charging feasible, practical and legal?
5	Is full cost recovery appropriate?
<b>Cost structures and nature of charges</b>	
6	Which costs should be recovered?
7	How should charges be structured?
8	Are cost recovery charges based on efficient costs?
<b>Implementation features</b>	
9	What is the importance of consultation?
10	How should cost recovery arrangements be monitored and reviewed?

### 4.2 Appropriateness of cost recovery

**Steps 1 to 5** are designed to ensure that cost recovery arrangements are only introduced where they are consistent with the over-riding objectives of efficiency and equity.

The steps utilise the analysis of outputs and outcomes presented in Chapter 3 to provide a short-list of entities that might be charged, taking into account practical, legal and other policy considerations.

**The guidelines incorporated in these steps are as follows:**

Guidelines checklist	Further information
Ensure the level and standard of provision of government goods and services, and the nature of any government regulation, are the minimum necessary to meet the needs of the community and achieve the Government's objectives.	<b>Step 1</b>
Define the relevant product or form of regulation whose costs are potentially to be recovered, and articulate the objectives of the Government's activity.	<b>Step 2</b>
Undertake an analysis of the outputs to assess economic characteristics, beneficiaries, the parties giving rise to the need for government activity, and interactions with other policy objectives.	<b>Step 2</b> Chapter 3
Based on the output analysis, develop a short-list of possible entities to be charged.	<b>Step 3</b>
Ensure the cost recovery arrangements have the appropriate legal authority.	<b>Step 4</b>
When deciding who ultimately pays and the form of charging, take into account a range of factors, including: <ul style="list-style-type: none"> <li>• the relative weights given to the different efficiency and equity objectives of cost recovery charges;</li> <li>• practical implementation and legal issues; and</li> <li>• consistency with other government policy goals.</li> </ul>	<b>Steps 4 and 5</b> Chapter 3
Justify and explain any departure from full cost recovery.	<b>Steps 2,4, and 5</b> Chapter 3

## Step 1 – Is provision of the output or level of regulation appropriate?

Before considering cost recovery arrangements, it is important to ensure that the level and standard of provision of government goods and services, and the nature of any regulation imposed by government, are the minimum necessary to meet the needs of the community and achieve the Government's objectives. Without this discipline, the ability to cost recover may create incentives that can result in unnecessarily high cost recovery charges. This may be due to factors known as:

- **'gold plating'**: where unnecessary high standards or facilities are adopted in the provision of goods and services – with government agencies imposing their own preferred levels of service, rather than the lower levels that would be sufficient to meet client needs or achieve government objectives;
- **'cost padding'**: where costs are inflated above efficient levels, motivated by the knowledge that all costs can be recovered; and
- **'regulatory creep' or over-regulation**: where additional or unnecessary regulation is imposed without adequate scrutiny. Regulatory creep or over-regulation can impose significant additional costs that are recovered from affected parties.

Valuable information about the appropriate standards and level of provision of goods and services can be obtained through consultation with the community, and through benchmarking (i.e. comparing) with similar goods and services provided in other jurisdictions. Consultation and benchmarking are also among the strategies that can be adopted to address cost padding by assisting efforts to keep costs at 'efficient' levels. (These, along with other approaches, are discussed further in **Step 8.**)

As far as regulation is concerned, the Victorian Government has introduced processes to scrutinise regulatory proposals that are designed to ensure that regulation does not unduly impact on business productivity and growth. For instance:

- business impact assessments (BIAs) must be prepared for any new or amended primary legislation that has potentially significant effects for business and/or competition; and
- regulatory impact statements (RISs) are required for evaluating subordinate legislation (e.g. 'regulations' made under Acts).

The BIA and RIS processes help to set the appropriate level of regulation – for example, by requiring analysis of the appropriateness of government intervention and the most effective form that government intervention might take to achieve a desired objective. BIAs and RISs also attempt to demonstrate whether the proposed government action is likely to yield benefits that outweigh the costs it imposes.

For more information, refer to:

- Are cost recovery charges based on efficient costs? – **Step 8.**
- Chapters 4 and 5 of the *Victorian Guide to Regulation* (available from [www.vcec.vic.gov.au](http://www.vcec.vic.gov.au)) discuss the Government's processes for the scrutiny of regulatory proposals.

## Step 2 – What is the nature of the output or regulation?

As discussed in Chapter 3, the analysis of the outputs and outcomes that arise from the provision by government of goods and services, or from government regulation, is pivotal to assessing the appropriateness and nature of cost recovery arrangements, including the identification of which entities should be charged.

It is important to define the relevant product or form of regulation whose costs are to be recovered, and to articulate the objectives of the Government's activity. This will ensure that the associated costs can be adequately estimated and assigned.

The following types of questions can assist in developing a clear definition and description of the output/regulation to be costed, and in the appropriate analysis to determine the appropriateness of full cost recovery:

- What is the purpose of providing the output or for imposing regulation?
- What are the processes associated with the output/activity? Where do they begin and end? If there is uncertainty, what is specifically excluded from the output?
- What is the context within which the output takes place (e.g. relevant policy issues, government directives, standards or principles of operation)?
- Does the activity contribute to achieving other policy objectives or desired outcomes beyond those that it is intended to achieve?
- What are the economic characteristics of the outputs/outcomes arising from the activity? Where they sit on the public private good 'continuum'?
- Who are the beneficiaries of the government activity (including any unintended third-party beneficiaries)?
- Who are the parties and what are the circumstances that create the need for the government activity?

For more information, refer to:

Output Analysis and Charging Considerations – Chapter 3.

### Step 3 – Who could be charged?

Based on the output analysis described in Chapter 3, a short-list of possible entities to charge can be developed. This list might include:

- **private parties**, such as individuals or business enterprises, who benefit directly from the government activity;
- **collectives**, including industry or community organisations – the benefits of the government activity may extend to distinct groups of enterprises or individuals, and there may be practical benefits in charging collectives rather than seeking to recover costs from a large number of businesses or individuals;
- **those whose actions place the outcomes desired by government at risk** and thereby give rise to the need for government activity (e.g. in the form of regulation) – as discussed in Chapter 3, there are strong economic efficiency arguments for ‘internalising’ the costs of government regulation;
- **related parties**, either upstream or downstream of the directly-targeted entity – for example, where a commercial link exists between the directly-targeted industry and its suppliers or customers, the incidence of the charge may be passed up or down the production line, so that the costs may ultimately be shared between the parties. In such cases, practical considerations may determine where the charge is imposed in the first instance – which in most cases will be the regulated industry; and/or
- **general taxation**, where activities provide benefits to the general community (e.g. public goods), or where alternative charging options are not practical or cost effective.

As discussed in Chapter 3, differences in the characteristics of government-provided goods and services, and in the nature of government regulations, mean that there is no single ‘best’ approach that applies to every case. Instead, decisions about who ultimately pays the charge will depend on a range of factors, including:

- the relative weights given to the different efficiency and equity objectives of cost recovery charges;
- practical implementation and legal issues (which are discussed further in **Step 4**); and
- consistency with other government policy goals (see **Step 5**).

For more information, refer to:

- Output Analysis and Charging Considerations – Chapter 3.
- Is charging feasible, practical and legal? – **Step 4**.
- Is full cost recovery consistent with other policy objectives? – **Step 5**.

### Step 4 – Is charging feasible, practical and legal?

The feasibility of introducing cost recovery arrangements – and decisions about who ultimately pays cost recovery charges – will be influenced by practical implementation considerations, and by what is administratively feasible. This, in turn, will be determined by:

- transaction costs – the costs of collection, compliance and enforcement should not be prohibitive; and
- levels of evasion – these should not be excessively high.

If it is possible but very costly to develop an appropriate charging system, there is a risk that the costs of administering cost recovery will outweigh its benefits, so it is not in the public interest to charge. A good example of this is attempting to charge an entry fee into a national park where there are multiple entrances. The costs of manning and collecting entrance fees under such circumstances may be prohibitive.

Whatever charging mechanism is chosen, it should have the appropriate legal authority, which provides the support in law for the charges levied on the community. It is therefore important that legal advice is sought on cost recovery arrangements at an early stage, as the legal environment may affect the nature and form of cost recovery and charges. In some cases, the legal authority may set out the purposes to which the related revenue may be put. For example, the relevant legislation could specify the details of the cost recovery charge (level, rates, level of consultation etc), or describe characteristics of the charges that should be imposed. In some cases, the legal authority may also set out the purposes to which the related revenue may be put.

Cost recovery arrangements are often established under the authority of acts of parliament or in supporting subordinate legislation (e.g. 'regulations'). For charges set under regulations, any new cost recovery charge (or an increase to an existing charge) that imposes a significant economic or social burden on any sector of the public needs to be justified through the regulatory impact statement process (see Section 5.4 in Chapter 5).

While the ability to cost recover may be enshrined in legislation, the actual value of charges may be determined by an authorising process, involving either an Order-in-Council; their publication in the Government Gazette; or their publication in the Government Gazette after the approval by the responsible Minister. It is important that departments and agencies maintain appropriate documentation that provides evidence of the authorisation of all charges that they manage.

The *Monetary Units Act 2004* provides for charges to be expressed as monetary units, which are then indexed annually using a rate determined by the Treasurer (see Sections 5.2 and 5.3 in Chapter 5).

For more information, refer to:

- Process Issues – Chapter 5.

## Step 5 – Is full cost recovery appropriate?

Having established that charging is deemed to be feasible, practical and legal (see **Step 4**), general government policy is for charges to be set on a full cost recovery basis. Nevertheless, there may be circumstances in which a departure from the full cost principle may be justified (which may require making a trade-off between efficiency, equity and other policy considerations).

Reasons for such a departure include the following:

- **Where merit goods are being provided or where activities generate benefits to unrelated third parties** (sometimes referred to as 'positive externalities'). In the case of merit goods, there may be under-consumption from society's point of view if charging was at full cost (e.g. education). Similarly, it would be inappropriate to charge at full cost for activities (such as preventative healthcare) if it can be demonstrated that they generate broader benefits to society that are unrelated to the individual provision of such goods and services. In other words, some goods, services and activities may generate both private and public benefits.

- **Where objectives of income redistribution or social insurance are important.** For services such as health, education, public transport and social housing, it can be argued that the pursuit of social policy and vertical equity goals outweigh the efficiency arguments associated with full cost pricing.
- **Where concessions are deemed appropriate.** Partial cost recovery through the use of concessions on charges may be justified in order to maximise the access of certain groups (e.g. those on low incomes) to particular goods and services. Once again, social policy and vertical equity considerations may be relevant here.
- **Where full cost recovery may undermine innovation and product development.** Innovation may be stifled in instances where new products require regulatory approval before coming onto the market. The first new example of a product may have to go through a more onerous and costly process than that for subsequent models. (Those that subsequently develop newer models could be argued to be ‘free-riding’ on the approval of the first applicant.) Charging on a full cost basis for the initial approvals would penalise the first firm that introduces the new product, and could act as a disincentive to innovation and product development.
- **Where the government is providing goods and services on a commercial basis in competition with the private sector.** Under these circumstances, then it is appropriate for charges to be set at the commercial market price, even if this implies a level which exceeds full cost recovery.<sup>8</sup> (The principles of competitive neutrality may be relevant here – there may be some net cost advantages arising from public ownership that need to be taken into account<sup>9</sup>.)
- **Where full cost charging could undermine other objectives.** There may be instances where charging could potentially undermine the very purpose of the government activity. For example, charging consumers to make a complaint or obtain advice from the regulator would discourage them from using this service. This would undermine the regulator’s ability to inform consumers about their rights and to obtain valuable information about where problems in the industry are arising. Such a charge would undermine the effectiveness of complaint/information services and, thus, their ability to achieve the Government’s objectives of making the market and the regulator more informed.

If it is determined that full cost recovery is not consistent with other policy objectives of the Government, then it may not be appropriate to introduce a full cost recovery regime. Consideration could be given to a regime of partial cost recovery (if it can be demonstrated that a lower than full cost recovery does not jeopardise other objectives), and/or to rely on other funding sources (e.g. general taxation) to finance the government activity.

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<sup>8</sup> It is also feasible that the commercial market price may be *below* the full cost of the government-provided good/service. If this is the case, however, the question arises as to why the Government would be competing with private providers in such a market.

<sup>9</sup> An example would be a government agency controlling and operating a fitness centre to improve the fitness of government employees as part of occupational health and safety objectives, but which also provides the services to the general public on a user pays basis. Further information about competitive neutrality included in **Step 6**.

## 4.3 Cost structures and nature of charges

**Steps 6 to 8** examine different costing approaches, the types of costs that should be recovered, and discuss the ways that charges should be structure to promote efficient and equitable outcomes. Possible measures to ensure that cost recovery charges are based on efficient costs are also outlined.

**The guidelines identified in these steps are summarised below:**

Guidelines checklist	Further information
Determine and justify the appropriate costing approach, taking into account the particular nature of the provision of the good, service and/or regulatory activity.	<b>Step 6</b>
Identify all the costs that are integral to the product or activity that is subject to cost recovery, including an appropriate allowance for indirect costs, but exclude costs of any functions that are not a fundamental part of the good, service or activity.	<b>Step 6</b>
Assess whether it is appropriate to adopt a flexible approach to cost recovery charging which might involve: <ul style="list-style-type: none"> <li>• measures to ‘smooth’ charges from year to year to prevent excessive fluctuations from affecting investment;</li> <li>• variable charges to encourage competition; and/or</li> <li>• spreading recovered costs over a long time period to mitigate the impact of high start-up costs on emerging industries.</li> </ul>	<b>Step 7</b>
Avoid cross-subsidisation when structuring charges.	<b>Step 7</b>
Ensure cost recovery charges are simple to understand and implement.	<b>Step 7</b>
Identify ways of keeping costs down to ensure that charges are based on the minimum cost recovery necessary to deliver the product/activity and still maintain quality, or achieve government objectives, over time.	<b>Step 8</b>

### Step 6 – Which costs should be recovered?

The step involves deciding the appropriate costing approach and the identification of all costs to be recovered. It therefore represents a pivotal part of the design of cost recovery arrangements. A clear definition of the outputs and functions that will be subject to cost recovery – undertaken as part of **Step 2** – will assist greatly in the identification of the associated costs.

#### Different costing approaches

As stated previously, general government policy is for cost recovery charges to recover the full costs incurred by government. This requires a choice of an appropriate costing approach that reflects the particular nature of the provision of the goods, services and regulatory activities by government.

Table 4.2 outlines two broad methodologies for determining the appropriate cost base (along with some variants of these models), and describes the circumstances where it may be appropriate to use each approach.

The first broad approach is the ‘fully distributed cost’ method. This represents the most comprehensive costing approach, and allocates all costs (including direct, indirect and capital cost components) to the output, and is typically used where cost-recovered activities account for a large proportion of an agency’s activities.

The second broad approach is the ‘incremental cost’ method. This method recognises that, at times, it may be inappropriate to attempt to recover overhead and capital costs if these would be incurred anyway even if the particular activity were not undertaken (e.g. the activity represents an ‘add on’ to an existing core activity). Within this broad approach, there are two methods to determine these incremental costs: the ‘marginal cost’ approach and the ‘avoidable cost’ approach. These methods are conceptually similar – the main distinction is that marginal costing focuses on the change in costs arising from an additional unit of output, whereas the avoidable cost approach considers the costs that would be avoided if an entire function or operation were not undertaken.

Further details of these methods, and the circumstances in which it may be appropriate to use them, are provided in Table 4.2.

Whichever costing approach is adopted, it is important to be transparent and to justify the choice of approach.

**Table 4.2: Different costing approaches**

Type of approach	Description	When appropriate to use
<b>Fully distributed costs</b>	Allocates the total costs of an agency across all outputs. It includes direct, indirect and capital costs. Direct costs are allocated to their respective output, while indirect costs are allocated across all outputs (using either a pro-rata approach, or the activity-based costing approach – see <b>Appendix C</b> ).	Where cost-recovered activities account for a large proportion of an agency’s activities.
<b>Incremental costs</b> Within this broad approach, there are two main methods:	Allocates the increase in costs that are attributable to undertaking the cost-recovered activity.	Where overhead and capital costs would be incurred anyway even if the cost-recovered activity were not undertaken (e.g. the cost-recovered activities account for a small proportion of an agency’s outputs).
• <b>Marginal costs</b>	The increase in cost involved with producing an additional unit of output. It excludes costs that are unaffected by the level of activity/production in the short run (such as capital costs).	May be used in situations where a product or service is provided predominantly for a core user/s, and where additional capacity is available at little or no extra fixed cost. This approach will often be appropriate for setting charges for services provided in off-peak periods where demand exhibits peaks and troughs. Where different users face different charges, the distributional consequences should be carefully examined, and charges determined in accordance with the Government’s expectations of equity, as well as efficiency. Issues of competitive neutrality may arise.

Type of approach	Description	When appropriate to use
• <b>Avoidable costs</b>	Refers to the costs that would be avoided if that particular activity was no longer undertaken.	Suitable for recovering the additional costs of undertaking 'add-on' work outside core activities, in which case the costs to be recovered should be those that would have been avoided if the 'add-on' activity had not been undertaken. This approach might be used, for example, if a new function is added to the responsibilities of a long-standing regulator.

### Different types of costs

Depending on the costing approach that is adopted, there are a number of different types of costs that may need to be included in the calculation of the recoverable cost base. Typically, these will include:

- direct costs; and
- indirect costs (including capital costs).

These are summarised, with examples, in Table 4.3 below. **Appendix B** provides a template of major items that can be used as a checklist to assist in identifying relevant costs to be included in the recoverable cost base.

**Table 4.3: Types of Costs**

Type of cost	Examples
<b>Direct costs</b> are costs that can be readily and unequivocally attributed to a product or activity because they are incurred exclusively for that particular product/activity	<ul style="list-style-type: none"> <li>• Labour costs (and on-costs), such as base wage/salary, payroll tax, superannuation, training costs, workers' compensation premiums, overtime and other <b>allowances</b></li> <li>• Office accommodation, equipment, supplies</li> <li>• Materials/consumable supplies</li> <li>• Power</li> <li>• Maintenance</li> </ul>
<b>Indirect costs</b> are not incurred exclusively for the particular product/activity – often referred to as 'overheads'	<ul style="list-style-type: none"> <li>• Corporate services costs, such as salary of the chief executive, financial services, human resources, information technology</li> </ul>
Indirect costs also include <b>capital costs</b> , which comprise depreciation of owned assets (which reflects the extent to which capital is 'consumed' over a period), and the opportunity cost of capital (which recognises that the funds tied up in the capital used to deliver the product/activity could have been invested elsewhere)	<ul style="list-style-type: none"> <li>• Depreciation</li> <li>• Opportunity cost of capital</li> </ul>

(See below for a discussion of valuing capital.)

## Valuing capital

Capital invested by Government has an opportunity cost that needs to be considered to ensure that scarce capital resources are directed to the optimal mix of assets in the State's asset base. A Capital Assets Charge (CAC) was introduced in the Victorian public sector in 1998-99 and provides the proxy for the 'cost of capital' to the government. In technical terminology, it is a charge levied on a department's written down value of controlled, non current physical assets.<sup>10</sup> CAC helps to undertake full costing of outputs, as the charge attributes the opportunity cost of capital used by the controlling entity in its service delivery.

The values of different classifications of capital assets are recorded and depreciate according to Australian Accounting Standards.

## Exclusion of costs that are not integral

It is important that the costs of all outputs that are integral to the good, service or activity subject to cost recovery are included in the full cost calculation. However, it is also important that the costs of any functions that are not a fundamental part of, or directly related to, the output are excluded from the cost base. In particular, costs associated with the broad development of policy/regulation and general parliamentary servicing roles of government should be excluded from the cost base. Such activities represent the broader roles of government, with public benefits, and may therefore be more appropriately funded from general taxation. Examples include the costs associated with:

- the review of the appropriateness or effectiveness of a regulatory function, and assessment of regulatory alternatives (e.g. costs of undertaking the regulatory impact statement process and/or a major consultation process as part of regulatory development);
- advising Parliament on issues on which the agency has expertise;
- answering parliamentary questions;
- briefing Ministers and responding to their correspondence;
- financial reporting; and
- complying with international treaties.

## Competitive neutrality adjustments

In cases where the Government is providing goods and services under market conditions (e.g. in competition with private sector suppliers), costs will need to be adjusted to take into account any advantages and/or disadvantages that arise from government ownership. This is required under the Government's competitive neutrality policy.

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<sup>10</sup> At the time of writing, the rate of levy is currently set at a real rate of 8 per cent per annum. Updated information is included in the Department of Treasury and Finance's Budget and Financial Management Guides (BFMG) on the *Capital Assets Charge* (BFMG-12) and *Asset Investment Budgeting* (BFMG-17), available from the government intranet: [http://bfm.dtf.vic.gov.au/CA25713E0002EF44/WebObj/BFMGs/\\$File/BFMGs.pdf](http://bfm.dtf.vic.gov.au/CA25713E0002EF44/WebObj/BFMGs/$File/BFMGs.pdf)

## Competitive neutrality

The Victorian Government is party to the inter-governmental Competition Principles Agreement (CPA), which is one of the three agreements that collectively underpin National Competition Policy. Under the CPA, Victoria is obliged to apply competitive neutrality policy and principles to all significant business activities undertaken by government agencies and local governments, where the benefits of applying competitive neutrality exceed the costs.

Competitive neutrality is about ensuring that the significant business activities of publicly-owned entities compete fairly in the market where it is in the public interest for them to do so. It is about transparent cost identification and pricing in a way that removes the net cost advantages arising from public ownership. (However, competitive neutrality does not apply to non-business, non-profit activities of government.)

As far as is practicable, all user charges should be adjusted to ensure competitive neutrality, consistent with an assessment of public policy consequences and, if appropriate, a public interest test (i.e. in cases where there may be a potential conflict between competitive neutrality and other public policy objectives).

Full cost-reflective pricing is one of the most common ways of implementing competitive neutrality, and should take into account all the costs that can be attributed to the provision of the good and service, plus the competitive advantages and disadvantages of public ownership. Competitive neutrality policy can mean that goods and services supplied on a commercial basis in an open market may be set above full cost recovery level, reflecting the higher costs faced by private sector competitors.

## Allocating costs

The appropriate allocation of costs requires accounting/costing systems that allow sufficient detail to be obtained to identify the costs involved in providing the activity defined in **Step 2**.

Allocating direct costs to outputs is relatively straightforward because, by definition, they are directly and unequivocally attributable. However, the allocation task becomes more difficult where indirect costs are involved.

There are two broad methods that may be used to allocate indirect costs between outputs:

- activity-based costing method; and
- the 'pro rata' approach.

An overview of these methods is provided in a more detailed discussion, including examples, can be found in **Appendix C**.

## Allocating indirect costs: overview of methods

**Activity based costing** (ABC) links an organisation's output to activities used to produce these outputs, which are in turn linked to the organisation's costs.

The activities that comprise the production process culminate in the delivery of outputs. ABC examines the activities undertaken within an organisation, determines why they are used in the production process, and then assigns costs to outputs according to the consumption of each activity in the production of the outputs. Each activity is costed on the basis of the resources consumed.

Where products use common resources differently, some sort of weighting is needed in the cost allocation process. The measure of the use of a shared activity by each of the products is known as the cost driver, which is the factor or variable that has the greatest effect on the level of activity. For example, possible cost drivers for human resources services might

include the number of employees and the number of new recruits. In the case of information technology, appropriate cost drivers might be the number of employees or the number of personal computers in the organisation.

Because it represents the most accurate way of allocating indirect costs, the ABC method should be adopted wherever possible. However, it may not always be practicable to use that methodology to allocate indirect costs because it may not be possible – or it may be too costly – to identify actual resource usage of different activities from an indirect cost pool. In such cases, a *pro rata approach* may be adopted that allocates indirect costs on a proportionate basis by using measures which are easily available, such as:

- staff involved in the activity as a percentage of total staff;
- direct costs for the activity as a percentage of total costs; or
- budget for the activity as a percentage of total budget.

In its simplest form, the pro rata approach can be used by grouping all indirect costs into a single pool, and then applying a proportional allocation measure (such as one of those listed above).

For more information, refer to:

- Allocation of Indirect Costs – **Appendix C**.
- *Competitive Neutrality Policy and Competitive Neutrality Policy: Guide to Implementation* – available from [www.vcec.vic.gov.au](http://www.vcec.vic.gov.au).

## Step 7 – How should charges be structured?

In addition to establishing the costing approach and recoverable cost base (Step 6), there are a number of other considerations that need to be taken into account when structuring the cost recovery charges. These are discussed below.

### **Importance of smoothing fluctuations: under- and over-recovery of costs**

Stability is important to facilitate the forward planning processes of government, enterprises and industries. Fluctuating and unpredictable cost recovery charges from year to year can create uncertainty, which is not a conducive environment for planning or investment. Volatile charges may also have equity effects. These problems are exacerbated when cost recovery charges account for a sizeable proportion of overall expenses. Under these circumstances, it may be appropriate to introduce measures to ‘smooth’ fluctuations in charges and facilitate a degree of stability<sup>11</sup> from year to year. As a consequence, this may result in under- or over- recovery of costs in any one year.

Another reason for under- or over-recovery of costs is the often prospective nature of the setting of charges, which are based on projected estimates of costs and volumes. To minimise the extent of this under- or over-recovery, there may be value in refining:

- business planning systems – for the purposes of being able to better predict future costs and demands; and
- data collection and reporting processes – for example, monthly reporting may provide data that enable periodic fluctuations in costs and demand to be better anticipated.

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<sup>11</sup> This concept of stability does not extend to increases in fees that are required under the Government’s automatic indexation policy – see **Chapter 5**.

## **Would the charge stifle investment, competition or innovation?**

In some cases, cost recovery charges could prohibit certain types of business from entering the market or discourage new products from being introduced. For example, a fixed charge for registering to provide a certain service in a market may discourage a diversified business from providing that service in conjunction with its other services because the additional work may not offset the registration charge. This may have the effect of stifling competition in the relevant market.

Similarly, care is needed when imposing cost recovery charges relating to regulation of new industries in emerging sectors. If the regulatory costs are heavy at the start-up phase, high cost recovery charges may act as a deterrent to entry, thereby jeopardising the development of innovation industries.

To overcome the potential problems outlined above, a flexible approach to cost recovery charging may be required. For example, measures could be taken to 'smooth' charges from year to year to provide some stability; variable charges could be introduced to encourage competition; and recovered costs could be spread over a long time period to mitigate the impact of high start-up costs on emerging industries.

Of course, when a flexible approach is adopted, the principle of transparency about the cost recovery arrangements remains paramount.

## **Avoiding cross-subsidisation**

Cross-subsidies occur when one group of users pay for more than the costs of the services (or products) they receive, and the 'surplus' is used to offset the cost of services provided to other users.

Cross-subsidisation should be avoided when structuring charges, unless there is an explicit decision of the Government to cross subsidise – for example, in order to pursue equity or social policy objectives.

From an economic efficiency point of view, cross-subsidies are undesirable because those paying the subsidy will under-consume resources, and those receiving the subsidy will be encouraged to consume more resources than would be the case if the relevant product/activity were to be appropriately priced. Conversely, those who receive a subsidy may be encouraged to use too much of the product/activity. There may also be 'flow-on' effects where the cross subsidised activities are inputs to other processes.

Often, the costs of cross-subsidies remain hidden. Favoured groups can receive benefits without those incurring the costs knowing they are doing so. This is contrary to the important principle of transparency. Direct subsidies are a more transparent form of assistance and thus are preferable to hidden cross-subsidies.

Poorly-designed cost recovery levies can create the possibility of cross-subsidies between parties when the administrative costs of regulation are being recovered. This possibility arises because a levy applies to all members of a leviable group equally. If, within that group, some members require a greater degree of regulatory supervision than others, then they can end up subsidising those members that require more intensive regulation.

One solution to this risk of inefficient cross-subsidisation is to define narrow leviable bands, based on identified regulatory cost drivers, so that those that make similar calls on the regulator's resources pay the same levy.

## **Simplicity**

When structuring charges (and, indeed, when designing cost recovery arrangements in general), it is important to ensure that they are simple to understand (and to implement).

Complex arrangements, while theoretically pure, may result in unjustified costs, unnecessary confusion, and high levels of evasion.

## Step 8 – Are the cost recovery charges based on efficient costs?

Whilst cost recovery can promote efficiency by instilling cost consciousness in the departments and agencies seeking to recover their costs, poorly designed arrangements can create incentives for and inefficiency and ‘cost padding’. For example, costs may be inflated by poor administration or other practices when departments and agencies know that costs will ultimately be recovered from other parties. Therefore, best practice cost recovery arrangements need to ensure that charges based on the minimum cost recovery necessary to deliver the product/activity and still maintain quality or achieve government objectives over time.

Efficient costs are particularly important in the context of capital costs. An oft-cited problem is when assets are installed that are unnecessarily large or sophisticated relative to the needs of users (a phenomenon known as ‘gold plating’).

Establishing the level of efficient costs is not always simple. Nevertheless, there are a number of techniques that can assist in keeping costs at ‘efficient’ levels. These techniques include:

- **Benchmarking of performance or costs** can be an important tool for measuring the relative efficiency of government operations. It involves the comparison of performance and/or costs over time or between departments/agencies (both domestically and internationally) undertaking similar activities. It is also possible to undertake ‘like with unlike’ benchmarking at the activity level, comparing the costs of similar processes, such as the provision of corporate services, in two otherwise dissimilar organisations.
- **Consultation with affected stakeholders:** Those who pay for an activity have an interest in the design, delivery and cost of that activity. When the parties who are paying for an activity are both informed and sufficiently organised, they can exert pressure to help keep cost down. Consultation with affected parties can therefore provide an important discipline to maintain costs at efficient levels.
- **Introduction of competitive pressures:** The negative incentives created by cost recovery are often related to the lack of market forces that normally drive efficiency. However, even in circumstances where government agencies hold a monopoly position in the activity/product they provide, some market forces can be used to encourage agency efficiency. For example, market testing and third-party competition allow suppliers other than a specified agency to deliver services. Market testing involves putting the provision of an agency activity out to public tender (e.g. running a tender to choose a private consultancy to undertake research). Third-party competition allows the users of a service to choose from multiple providers (e.g. alternative providers of mandatory assessment services could be licensed or certified).
- **Audits undertaken by the Auditor-General:** In Victoria, the Audit Act 1994 establishes the legislative framework governing the ongoing role and functions of the Auditor-General. This Act identifies the statutory powers and responsibilities of the Auditor-General, which include undertaking performance audits within the public sector which encompass assessments of the economy, efficiency and effectiveness of the management of public resources by the government or individual agencies of government. Such performance audit reports can be used to assess cost effectiveness of those agencies that recover costs.

## 4.4 Implementation features

**Step 9** discusses the need and value of consultation with relevant stakeholders in the design and implementation of cost recovery arrangements. **Step 10** looks at appropriate governance arrangements, focusing on monitoring and review mechanisms to ensure that cost recovery arrangements remain appropriate over time, and are based on relevant costs.

**These steps cover the following guidelines:**

Guidelines checklist	Further information
Undertake an appropriate consultation process before cost recovery arrangements are implemented.	<b>Step 9</b>
Ensure governance arrangements are in place so that departments and agencies are accountable for the costs they are seeking to recover.	<b>Step 10</b>
Introduce an appropriate monitoring process.	<b>Step 10</b>
Review annually the level of charges, as stipulated in the Standing Directions of the Minister for Finance under the <i>Financial Management Act 1994</i> .	<b>Step 10</b> Section 5.9 in Chapter 5

### Step 9 – What is the importance of consultation?

The value of consultation in improving the design and acceptance of cost recovery arrangements is internationally recognised. Consultation with affected parties is an important aspect of the transparency and accountability underpinning cost recovery arrangements.

Consultation can also improve the efficiency of government activities and cost recovery arrangements since those who pay for an activity will have an interest in the design, delivery and cost of that activity. A major benefit of consultation is that it provides a discipline on departments and agencies to be accountable for their costs. Faced with direct exposure to stakeholders, there is pressure to maintain their cost bases at efficient levels.

In some cases, the appropriate level of consultation is stipulated in legislation underpinning the cost recovery arrangements. Nevertheless, in all cases, the consultation process should seek feedback on costs and charges, as well service standards and levels. Stakeholders should have easy access to all relevant information, such as cost data and details of the policy and charging options that are being considered for adoption.

Effective consultation should provide officials and ministers with an understanding of the likely stakeholder reaction to proposals under consideration. Cost recovery arrangements are more likely to be 'accepted' if the affected parties feel they have some degree of 'ownership' over them. It is therefore important that the approach to consultation is sufficiently broad as to engage all levels of stakeholders.

### Step 10 – How should cost recovery arrangements be monitored and reviewed?

To maintain an emphasis on the efficiency of cost recovery arrangements, appropriate governance arrangements need to be in place so that departments and agencies are accountable for the costs that they are seeking to recover. Ideally, departments and agencies which have cost recovery arrangements should be accountable to either a government minister, or to a board that is accountable to a minister.

When establishing new cost recovery arrangements, a process for effective ongoing monitoring should be introduced to assist in determining whether:

- the current arrangements remain relevant given changes in circumstances (such as government policy changes);
- the objectives of cost recovery are still being met and/or there are better ways of achieving the objectives; and
- cost recovery charges are based on efficient and transparent costs.

This is particularly important for cost recovery arrangements made under subordinate legislation, which may remain unchanged until the relevant legislation sunsets (usually after ten years). During this time, circumstances may have changed.

The appropriate extent of ongoing monitoring will depend upon the significance of the cost recovery arrangements and the impact on stakeholders. By allowing minor issues to be addressed as they arise, ongoing monitoring can reduce the frequency of major reviews of cost recovery arrangements. Key components of the monitoring process include:

- consultation with stakeholders and affected parties to obtain feedback on cost recovery arrangements;
- mechanisms to monitor efficiency (see **Step 8**);
- availability of detailed cost information; and
- transparent reporting processes.

Requirements about the review of existing cost recovery arrangements are stipulated in the Standing Directions of the Minister for Finance under the *Financial Management Act 1994*. As discussed in Section 5.9 of Chapter 5, these Directions require the Chief Financial and Accounting Officer of each government department to document, approve and (through a delegate) annually review the level of charges levied by the department for the goods and services it provides. The related guidance recommends that departments establish appropriate policies and procedures that, among other things, address how charges for goods and services are determined and approved, and how the associated revenue is processed and recorded within their information systems.

In undertaking regular reviews, it is important to keep adequate documentation about how charges are set (including relevant cost information and evidence that appropriate authorisation processes have been followed).

For more information, refer to:

- Standing Ministerial Directions – Section 5.9 in Chapter 5.

## 5. Process issues

**This chapter provides information about the indexation of fees and penalties, and about approval processes relating to fees, that must be followed by Victorian Government departments and agencies, along with other matters such as concessions and the impact of the Goods and Services Tax.**

### 5.1 Introduction

This chapter covers issues relating to the indexation of fees<sup>12</sup> and penalties, and about approval processes that must be followed when implementing new fees, or increases in existing fees. It replaces the explanatory material formerly published by the Department of Treasury and Finance in the *Guidelines for Setting Fees and User-Charges Imposed by Departments and General Government Agencies*.

### 5.2 The annual rate

An amount known as the 'annual rate' is set by the Treasurer as part of the state budget process, as laid out in section 8(1)(d) of the *Subordinate Legislation Act 1994*. It is relevant to the annual automatic indexation of fees and fines, and also relevant to the approval process for manual, one-off increases in fees and fines not subject to annual indexation.

Under section 5(4) of the *Monetary Units Act 2004*, the Treasurer must set the annual rate before 1 March for the following financial year. Once set, the annual rate is advised in writing to the Chair of the Scrutiny of Acts and Regulations Committee.

The Treasurer's annual rate is available on the Department of Treasury and Finance website: <http://www.dtf.vic.gov.au>.

### 5.3 The *Monetary Units Act 2004* and automatic indexation policy

The *Monetary Units Act 2004* allows for fees and penalties to be fixed by reference to a fee or penalty 'unit' that can be indexed each year by the annual rate. In this way, fees and penalties expressed in units in their governing legislation are automatically indexed each year by the annual rate.

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<sup>12</sup> In previous chapters of these Guidelines, the term 'charge' has been used in a generic sense to cover all cost recovery arrangements. However, in this chapter, the term 'fee' is used. This is merely to be consistent with the terminology used in the *Monetary Units Act 2004* and *Subordinate Legislation Act 1994* – legislation that is referred to in this chapter – and should therefore not be interpreted as a narrow definition. Indeed, section 3 of the *Monetary Unit Act 2004* defines 'fee' as including charges or other amounts, so the discussion of 'fees' in this chapter would be relevant to a range of regulatory fees and user charges.

A policy of automatic indexation was announced in the 2003-04 Victorian Budget.<sup>13</sup> The policy requires Victorian Government fees and fines over the value of one unit, and payable to the Public Account, to be automatically indexed unless they are exempt. Fees and fines not subject to the **automatic indexation policy** include:

- those not payable to the Public Account;
- those subject to external price determination regimes (e.g. cemetery trusts);
- those set by privatised entities or corporatised entities (e.g. public transport);
- those subject to national agreements (e.g. fees for petroleum exploration titles);
- those set by self-funding statutory authorities (e.g. Primesafe charges the licensee of a meat processing facility a fee for its inspection service); and
- those less than one fee unit or penalty unit (e.g. photocopying charges, certain document search fees).

#### ***Exemption from automatic indexation***

The Treasurer's approval is needed for an exemption in other cases where, for policy or administrative reasons, it is not appropriate to apply automatic indexation. This is ordinarily handled via ministerial correspondence.

#### ***Application of the annual rate***

The annual rate determines the adjustment of the value of a fee unit or penalty unit for the following financial year. After setting the annual rate, the Treasurer then publishes the new fee and penalty units in the Victorian Government Gazette and in major daily newspapers. Indexation of all automatically indexed fees and fines takes effect each year from 1 July.

The following rounding conventions are adopted:

- When indexing the value of one fee unit or penalty unit by the annual rate, the value is rounded to the nearest cent (that is, two decimal places).
- When describing a fee or penalty in units, there is no restriction on the decimal place. That is, the fee may be expressed as 2 units, 2.4 units, 2.43 units, as required.
- When converting to dollar amounts, fees are rounded to the nearest 10 cents, and penalties to the nearest whole dollar.

#### ***Public disclosure requirements***

Departments are required to publish the correct dollar value of all the fees and fines which they are responsible for.

Departments are required to maintain a consolidated and comprehensive list of automatically indexed fees and fines (that is, those expressed in fee units or penalty units in the governing legislation) within their portfolio responsibility on their respective websites. Information for each fee or fine should include:

- a short description of the item (so that the nature of the fee or fine is clear to a person unfamiliar with the regulation);
- the associated fee or penalty units; and
- the actual dollar value.

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<sup>13</sup> See 2003-04 Budget Paper No.2, *Budget Statement*, Appendix A, p.262.

The information is to be updated continuously so that the list is always current. In general, for ease of administration and updating, departmental lists should group fees and fines according to the governing legislation.

## 5.4 Preparation of Regulatory Impact Statements for fees

Unless an exemption certificate is issued, sections 7 and 12E of the *Subordinate Legislation Act 1994* require the preparation of a Regulatory Impact Statement (RIS) in respect of a proposed statutory rule or legislative instrument or an amendment to a statutory rule or legislative instrument, including where these set or change fees. The *Subordinate Legislation Act 1994* Guidelines (SLA Guidelines) and the Victorian Guide to Regulation detail the requirements and process surrounding the preparation of RISs.<sup>14</sup>

One of the most common grounds for an exemption from a requirement to prepare a RIS is if the proposed statutory rule or legislative instrument is unlikely to impose a significant economic or social burden on a sector of the public. However, the **introduction of new fees** may impose a significant burden within the meaning of the Act, and thus require the preparation of a RIS. There are exceptions in cases where a very minor fee is imposed (e.g. a photocopying charge), or where only a small group of society is affected. Thus, in making the judgement about whether a significant burden is imposed, consideration needs to be given to the level of the fee, the impact it may have on an individual, and the overall size of the particular revenue base involved in relation to the level of that fee. The SLA Guidelines nominate \$500 000 per year as an indicative threshold for significant burden and this may assist in assessing whether a RIS is required.

Proposed statutory rules or legislative instruments that **reduce existing fees** do not usually impose a significant burden, and so may be exempt from the RIS process, provided they do nothing else that would warrant the need for a RIS. However, there are exceptions where the reduction in fees is the result of shifting costs to other parties.

A statutory rule or legislative instrument being made that re-imposes an existing fee at the same level generally imposes a significant burden and thus requires a RIS to ensure review of the continuing appropriateness of the fee, and the level of the fee. (This situation may occur the remaking of sunseting regulations.)

In cases where amendments are proposed to existing regulations or legislative instruments that will **increase fees**, the need to prepare a RIS will depend on the size of the proposed increase. Under sections 8(1)(d) and 12F(1)(c) of the *Subordinate Legislation Act 1994*, a RIS is not required where the proposed statutory rule or legislative instrument increases either at or below the annual rate as set by the Treasurer as part of the State Budget process. (In such cases, it is legitimate to allow for rounding provided it is to the nearest reasonable amount and the difference is not material.)

Increases in fees that are above the Treasurer's annual rate, however, will generally require preparation of a RIS – unless it is the opinion of the responsible Minister that the increased fees would not impose a significant burden on a sector of the public (which is unlikely to happen in practice unless the fee is very minor).

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<sup>14</sup> Copies of the *Victorian Guide to Regulation* may be downloaded from the website of the Victorian Competition and Efficiency Commission – [www.vcec.vic.gov.au](http://www.vcec.vic.gov.au).

It is acceptable to make a statutory rule or legislative instrument setting a **package of fees** (often referred to as the ‘basket’ approach). However, the section 8(1)(d) and 12F(1)(c) exemptions to the RIS requirement do not apply if any individual fee component in the package exceeds the Treasurer’s annual rate. Where this is the case, the RIS process will generally have to be undertaken even if the average fee increase across the package is at or below the annual rate because the individual fee increase may have a significant adverse impact on some sections of the community and/or industry.

The SLA Guidelines and *Victorian Guide to Regulation* provide further information about the processes to be followed for seeking exemptions to the RIS requirement.

**For more information, refer to:**

- *Subordinate Legislation Act 1994* Guidelines (available from [www.vcec.vic.gov.au](http://www.vcec.vic.gov.au)) – especially Part 4.
- *Victorian Guide to Regulation* (available from [www.vcec.vic.gov.au](http://www.vcec.vic.gov.au)) – Section 4.3, Section D.3 of Appendix D and Part 4 of Appendix E.

**Table 5.2: Summary of requirement to prepare an RIS for fees**

Type of fee	RIS required?	Comment
Introduction of new fee	✓	If fee is so minor that it is considered not to impose a significant burden, then exemption from RIS process may be sought.
Reduction of existing fee	✗	However, RIS will be required if other elements of statutory rule or legislative instrument impose a significant burden or if the reduction in fee involves cost shifting to other parties.
Increase in existing fee or package of fees		
• <u>not exceeding</u> Treasurer’s annual rate	✗	However, RIS may be required if an individual fee component within a package exceeds the annual rate, even if the average increase of the package does not exceed the annual rate.
• <u>above</u> Treasurer’s annual rate	✓	If fee is so minor that it is considered not to impose a significant burden, then exemption from RIS process may be sought.

## 5.5 Treasurer’s approval

In addition to the RIS requirements described in the previous section, any increase in fees above the Treasurer’s annual rate that is expected to generate revenue of more than \$100 000 a year requires the approval of the Treasurer.

Submissions to the Treasurer should follow the RIS public consultation process and:

- briefly state the case for increase;
- include a comparison with fees for equivalent services elsewhere;
- describe the impact on business;
- detail the extent of consultation undertaken; and
- evaluate the alternatives to the proposed increase.

## 5.6 Concessions on fees

Unless provided by specific legislation or by Cabinet decision, eligible beneficiaries (as defined under the *State Concessions Act 2004*) may be offered up to 50 per cent concession on any fee payable for a product or services provided to an individual for which access is generally regarded as a basic right (e.g. provision of an adoption history or admission to public places).

## 5.7 Inter-departmental fees

Fees should apply to inter-departmental products and services for which there are private sector alternatives. Inter-departmental charging is also appropriate in situations where it improves resource allocation decisions.

Where a new inter-departmental fee is proposed, appropriate pricing principles should be employed with adequate notice and consultation occurring with client agencies and the relevant Department Relationship Management and Analysis Team of the Department of Treasury and Finance. This consultation must occur well in advance of any budget submission to be lodged with the Cabinet Secretariat.

## 5.8 Impact of the Goods and Services Tax

Under the provisions of the *A New Tax System (Goods and Services Tax) Act 1999* (GST Act), fees paid to a government agency are deemed to be subject to the Goods and Services Tax (GST). However, Division 81 of the GST Act has provided for certain government fees to be exempt from the GST if listed in the Federal Treasurer's determination.

Under recent changes to the GST Act:

- taxes are exempt from GST, unless specifically prescribed in Regulations under the GST Act;
- fees and charges are exempt from the GST where they apply to a permission, exemption, authority or licence [see sec 81.10(4)] or where they relate to the provision or use of information [see sec 81.10(5)]. All other fees and charges are subject to the ordinary principles of GST law.

Under these changes, from 1 July 2011:

- agencies are responsible for assessing whether taxes, fees and charges payable to them are subject to GST under Division 81; and
- as a transitional measure, all fees and charges of a kind listed in the Division 81 Determination 2011 (No.1) retain their GST exempt status at least until 30 June 2012.

## 5.9 Ministerial Standing Directions

Other important elements of the Government's policy and administrative framework relating to charges for goods and services are set out in Ministerial Standing Directions ('the Directions'), which are given pursuant to section 8 of the *Financial Management Act 1994*, and regulation 16 of the *Financial Management Regulations 2004*. As such, the Directions have legislative force and must be complied with.

Standing Direction 3.4.1 procedure (c) requires each department's Chief Financial and Accounting Officer to document, approve and (through a delegate) annually review the levels of charges levied by the department for goods and services it provides. The related guidelines recommend that departments should establish appropriate policies and procedures that, among other things, address how charges for goods and services are determined and approved, and how the associated revenue is processed and recorded within their information systems.

In other words, the costing and pricing methodologies that underpin fees and charges, along with the annual reviews of fees and charges that are required by the Directions, should be documented and made transparent. To facilitate this, it is important that departmental costing systems allow sufficient detail to be obtained to identify costs involved in service provision.

For more information, refer to:

- Standing Directions of the Minister for Finance under the *Financial Management Act 1994* – available from the Department of Treasury and Finance website:

<http://www.dtf.vic.gov.au/CA25713E0002EF43/pages/budget-and-financial-management-financial-management-compliance-framework-standing-directions-and-associated-rules>

## 5.10 Reporting requirements

Section 10 of the *Monetary Units Acts 2004* requires the monetary amount of fees and penalties to be publicly disclosed. The automatic indexation policy requires that this disclosure is made on departmental websites.

While there is no specific requirement for departments to report on user charges in the same way, it is best practice to do so to enhance the transparency of charging arrangements.

## 5.11 Appropriate legal authority

As discussed in Step 4 of Chapter 4, cost recovery arrangements must have the appropriate legal authority. While the power to cost recover is often established under the authority of acts of parliament or in supporting subordinate legislation, the actual value of charges may be determined by an authorising process, involving either an Order-in-Council; their publication in the Government Gazette; or their publication in the Government Gazette after the approval by the responsible Minister. It is important that departments and agencies maintain appropriate documentation that provides evidence of the authorisation of all charges that they manage.

It is advised that departments and agencies seek legal advice at an early stage during the development or authorisation of cost recovery arrangements.

# Appendices

Appendix	Description
<b>A. Glossary</b>	Explanation of terms used in these Guidelines
<b>B. Template of Major Cost Items</b>	A checklist of major cost items to be considered as part of the recoverable cost base
<b>C. Allocation of Indirect Costs</b>	Further details – including examples – of the two approaches that can be adopted to allocate indirect costs
<b>D. References</b>	Details of publications and documents referred to in these Guidelines

## A. Glossary

<b>Activity-based costing method</b>	A methodology for allocating costs to products and services, which seeks to identify cause and effect relationships to objectively assign costs.
<b>Avoidable costs</b>	The costs that would be avoided if a particular activity was no longer undertaken.
<b>Business Impact Assessment (BIA)</b>	A formal assessment and cost-benefit analysis of the impacts of a proposed primary legislative measure, along with alternative means of achieving the stated objective, and is designed to inform decision making in Victoria. A BIA must be prepared if it is determined that the proposed measure has potentially 'significant effects' for business and/or competition in Victoria.
<b>Club goods</b>	Products or services where it is possible, at low costs, to exclude non-payers outside of a distinctive group of beneficiaries, such as an industry. Its use by one party within the group, however, does not detract from its use by another.
<b>Competitive neutrality</b>	A policy principle that involves achieving a fair market environment by removing or offsetting any competitive advantages or disadvantages due to public ownership of government businesses.
<b>'Cost padding'</b>	Where costs are artificially inflated above efficient levels – often motivated by the knowledge that costs can be recovered.
<b>Cost recovery</b>	The recuperation of the costs of government-provided or funded products or services that, at least in part, provide private benefits to individuals, entities or groups, or reflect the costs their actions impose.
<b>Cross-subsidisation</b>	Where one group of users pay more than the costs of the goods/services that they receive, and the 'surplus' is used to offset the cost of goods/services provided to other users.
<b>Direct costs</b>	Costs that can be readily and unequivocally attributed to a product or activity because they are incurred exclusively for that particular product/activity (e.g. labour and materials).
<b>Efficiency (allocative)</b>	In the context of cost recovery, efficiency tends to mean the allocation of resources to the most valuable uses for society as a whole.
<b>Equity</b>	In general, the term 'equity' reflects concepts of fairness or justice. In a public finance context, 'horizontal equity' refers to treating people in similar situations in similar ways. 'Vertical equity' refers to those with greater means contributing proportionately more than those with lesser means.
<b>Excludability</b>	The extent to which it is possible to exclude a party from the consumption/benefits of a good/service.
<b>Externality (spillover)</b>	The uncompensated effects on a third party to a transaction (or action) that is not fully accounted for in the price or cost of the transaction. Externalities can be either positive, when an external benefit is generated, or negative, when an external cost is imposed upon others.
<b>Free rider</b>	A party who derives a benefit at no cost from a good/service that is being provided to a cost to another party.
<b>Full cost recovery</b>	The recuperation of all those costs associated with those activities or products. Full cost represents the value of all the resources used or consumed in the provision of an output or activity. In addition to the costs directly associated with the output/activity, full cost includes an appropriate allocation of indirect (including capital) costs.

<b>Activity-based costing method</b>	A methodology for allocating costs to products and services, which seeks to identify cause and effect relationships to objectively assign costs.
<b>Fully distributed costing</b>	An accounting framework that allocates the total costs of <i>all</i> resources used/consumed in the provision of the output, not just those that are directly attributable to the output (e.g. including indirect and capital costs).
<b>General taxation</b>	Represents compulsory payments to the Government for public purposes. General taxation can raise revenue to fund a wide range of government activities or products. The benefits to particular individuals as a result of these activities or products are not typically distributed in proportion to the taxation payments made by those individuals.
<b>'Gold plating'</b>	Where unnecessarily high standards or facilities are adopted.
<b>Incremental costs</b>	The increase in costs attributable to the production of a particular type of activity
<b>Indirect costs</b>	Costs that are not directly attributable to an activity – often referred to as overheads (e.g. corporate services).
<b>Market failure</b>	A condition where the allocation of goods and services in a market is not efficient.
<b>Merit goods</b>	Goods and services that society considers to be under-consumed if left to voluntary decisions by individuals – i.e. the community as a whole desires a higher use of the output that would be likely if charged for at full cost.
<b>Private goods</b>	Products or services where consumption by one party conflicts with its use by another, and where the benefits of consumption only accrue to the consuming party.
<b>Pro rata approach</b>	A method for allocating indirect costs on a proportionate basis by using measures that are easily available.
<b>Public goods</b>	A good (or service) that is non-rivalrous and non-excludable, which means: consumption of the good by one individual does not reduce the amount of the good available for consumption by others; and no one can be effectively excluded from using that good.
<b>'Regulatory creep'</b>	Where additional or unnecessary regulation is imposed without adequate scrutiny.
<b>Regulatory Impact Statement (RIS)</b>	A formal assessment and cost-benefit analysis of the impact of proposed subordinate legislation (e.g. regulations or legislative instruments), along with consideration of alternative means to achieve the stated objective. RISs are prepared where it is determined that the proposed legislation will impose a 'significant economic or social burden' on a sector of the public. RISs are released to the public, thus allowing for an informed process of consultation.

## B. Template of Major Cost Items

The following template of major cost items is intended to be used as a checklist. It will assist in ensuring that all relevant cost items are included in the cost base. However, it is underlined that not all costs will be applicable to each specific case. Equally, there may be costs relevant to specific cases that are not included in the following checklist, and which therefore should be added to the relevant cost base.

<b>Salaries</b> <ul style="list-style-type: none"> <li>• Operational staff</li> <li>• Technical support</li> <li>• Supervisory staff</li> <li>• Management</li> </ul>	<b>Non-wage labour costs<sup>a</sup></b> <ul style="list-style-type: none"> <li>• Long service leave</li> <li>• Superannuation</li> <li>• WorkCover premiums</li> <li>• Sick leave</li> <li>• Annual leave</li> </ul>	<b>Capital costs<sup>b</sup></b> <ul style="list-style-type: none"> <li>• Software costs</li> <li>• Maintenance of software applications</li> </ul>
<b>Office expenses</b> <ul style="list-style-type: none"> <li>• Rent<sup>c</sup></li> <li>• Office equipment</li> <li>• Utilities</li> <li>• Motor vehicles</li> <li>• Other (cleaning, etc)</li> </ul>	<b>Operational expenses</b> <ul style="list-style-type: none"> <li>• Publications costs</li> <li>• Communications</li> </ul>	<b>Overheads<sup>d</sup></b> <ul style="list-style-type: none"> <li>• Divisional overheads</li> <li>• Corporate overheads</li> </ul>

Notes:

- a. Care should be taken to avoid double counting in applying these costs. Where an annual salary figure is used in direct costs, it will effectively include sick leave and annual leave. However, where costs per transaction are being calculated, care should be taken to ensure that the quantum of inputs (i.e. days) obtained in respect of one full-time equivalent (FTE) takes these items into account.
- b. Care should be taken to ensure that capital costs are amortised over an appropriate time period. This will vary widely according to the type of asset considered. The amortisation period should be determined with reference to the likely productive life of the asset.
- c. Actual figures should be used where possible. Where it is possible to identify clearly the rent attributable to a particular activity, a pro rata approach, based on the proportion of FTE engaged in the activity should be used.
- d. See **Appendix C** for methods to allocate such costs.

## C. Allocation of Indirect Costs

**Step 6** in Chapter 4 outlined the two categories of approaches that might be adopted to allocate indirect costs to outputs – the activity based costing method, and the pro rata approach.

This appendix provides further details of these two categories, and contains examples and case studies as further guidance.

### Activity based costing (ABC) method

The activities that comprise the production process culminate in the delivery of outputs. ABC examines the activities undertaken within an organisation, determines why they are used in the production process, and then assigns costs to outputs according to the consumption of each activity in the production of the outputs. Each activity is costed on the basis of the resources consumed.

Where products use common resources differently, a weighting is needed in the cost allocation process. The measure of the use of a shared activity by each of the products is known as the cost driver, which is the factor or variable that has the greatest effect on the level of activity. Examples of cost drivers are contained in Table A.1.

Meanwhile, Box A.1 provides an example that illustrates the application of activity based costing in the case of allocating the indirect costs associated with human resources services.

**Table A.1: Examples of indirect cost drivers**

Cost	Possible cost driver	Comments
Building costs, utilities, cleaning	No. of employees	Data collection and cost allocation is simple. It is suited to processes where all staff occupy similar floor space.
	Floor space (sq. metres)	Applicable if floor space occupied by staff working on different output varies considerably. Data collection is more difficult than employee numbers.
Depreciation, government financing charge, maintenance, leases, insurance	No. of outputs produced	May present difficulties if individual major assets are used to produce a number of different outputs.
	Floor space (sq. metres)	A simple and useful driver to use for building and associated costs.
Information technology	No. of employees	Low cost to develop and maintain. Applicable where the number of terminals and level of IT support is similar for most employees. Not recommended if different activities require different systems and levels of support.
	No. of personal computers	Can be more accurate than using the 'no. of employees', but again not recommended if different activities require different systems and levels of support.
	CPU seconds used	Accurate and sensitive to change, but may be costly to develop and maintain.

Cost	Possible cost driver	Comments
Communications (e.g. phone, fax, mail, courier)	No. of employees	Low cost and simple. Assumes use of communications by employees is similar.
	No. of outlets (e.g. no. of phones, fax machines)	Low cost, relatively simple, but additional benefits may not outweigh costs of data collection compared to using no. of employees.
	Actual usage	Accurate and sensitive to change. Data generally available, as systems are capable of producing reports.
Customer inquiries	No. of phone calls	Accurate, but would require a system to track calls and the output to which they related, which may encounter resistance. An estimate could be made or based on a sample of calls.
Management salary	No. of outputs, assets employed, or linked to staff	The decision here should be guided by management's role in an organisation (i.e. is more time spent managing outputs, assets or people?)
Payroll services	No. of employees	Data simple to collect but may not accurately reflect costs if some groups of employees require greater level of payroll services.
	Payroll amounts	Simple, as data would be readily available, but the dollar amount for payroll amount may not accurately reflect time and cost associated with processing.
	No. of payments processed	Data collection simple, and probably more reliable than no. of employees.
Human resources services	No. of employees	Data simple to collect.
	Payroll amounts	Data available, but unlikely there will be a strong cause and effect relationship between payroll and HR costs.
	No. of new recruits	Relevant as new recruits would take more time than dealing with existing staff. However, would not represent the resources devoted to existing employees.
Accounts payable services	No. of fund transfers made	Would require a system to sum the number of payments for each charge code.
	No. of line items in invoices processed	Would require a system to sum the number of line items processed for each charge code.
Vehicles	Link to driver's salary and allocate in same way	Simple and low-cost method. However, it is inaccurate if use of the vehicle varies between different outputs. Recording is difficult if more than one driver.
	Time, recorded in log books	Accurate and data can be used for fringe benefit tax purposes. Can be costly to implement and maintain, and there may be staff resistance.

Source: Appendix B from DTF's Output Costing Guide.

**Example of activity based costing**

A government agency comprises two divisions which undertake two distinct outputs: (1) licensing of individuals to undertake a regulated activity, and (2) enforcement of the associated regulations.

The human resources (HR) department of the agency has total annual costs of \$300 000. The main functions of the HR department, and the staff estimates of the time spent on each of these functions, are presented in the table below. The table also identifies the cost driver that has the greatest influence on the level of each activity.

Activity	Estimated % of effort	Total cost of activity (\$)	Cost driver
Recruitment	30	90 000	No. of positions advertised
Selection	20	60 000	No. of interviews
Payroll processing	50	150 000	No. of employees
<b>Total</b>	<b>100</b>	<b>300 000</b>	

In the past year, the allocation of the HR department's functions between the two divisions was as follows:

Activity Cost driver	Licensing Division	Enforcement Division	Agency Total
Recruitment No. of positions advertised	5	15	<b>20</b>
Selection No. of interviews	20	30	<b>50</b>
Payroll processing No. of employees on payroll	40	60	<b>100</b>

Equipped with this information, it is possible to allocate the indirect cost of the HR department's services to each of the outputs of the agency as follows:

Activity	Licensing Division Cost (\$)	Enforcement Division Cost (\$)	Agency Total Cost (\$)
Recruitment	22,500 (5/20 x \$90 000)	67,500 (15/20 x \$90 000)	<b>90 000</b>
Selection	24,000 (20/50 x \$60 000)	36,000 (30/50 x \$60 000)	<b>60 000</b>
Payroll processing	60,000 (40/100 x \$150 000)	90,000 (60/100 x \$150 000)	<b>150 000</b>
<b>Total</b>	<b>106 500</b>	<b>193 500</b>	<b>300 000</b>

Thus, using the activity based costing method, the allocation of the agency's total HR (indirect) costs between its two outputs are \$106 500 for the licensing output and \$193 500 for the enforcement output.

## The 'pro rata' approach

Because of its accuracy, the activity based costing approach should be adopted, wherever possible. However, it may not always be practicable to use that methodology to allocate indirect costs because it may not be possible – or it may be too costly – to identify actual resource usage of different activities from an indirect cost pool. In such cases, a pro rata approach may be adopted that allocates indirect costs on a proportionate basis by using measures which are easily available, such as:

- staff involved in the activity as a percentage of total staff;
- direct costs for the activity as a percentage of total costs; or
- budget for the activity as a percentage of total budget.

In its simplest form, the pro rata approach can be used by grouping all indirect costs into a single pool, and then applying a proportional allocation measure (such as one of those listed above).

A more complex approach would be to increase the number of indirect pools used, and to apply a proportionate allocation measure that is appropriate for each of the pools. The more disaggregated the approach (i.e. the greater the number of indirect cost pools used), the more likely that the pro rata methods will yield results similar to those achieved under the more complex (and more accurate) activity based costing approach.

Using the same information used for the activity based costing method example shown in Example of activity based costing of the simple pro rata approach is provided below.

### *Example of simple pro rata method*

Using the human resources (HR) example presented in Box R, the simple pro rata method could allocate the total \$300 000 cost of the HR department between the agency's two outputs using the number of staff employed in each division as the basis for the proportional allocation of HR costs.

Using this method, the allocation of costs would be as follows:

- **Licensing Division: \$120 000** (40 staff/100 x \$300 000); and
- **Enforcement Division: \$180 000** (60 staff/100 x \$300 000).

This compares with \$106 500 and \$193 500, respectively, using the activity based costing method (see page 43).

## D. References

***Competitive Neutrality Guide to Implementation***, Victorian Department of Treasury and Finance, 2000 – available from [www.vcec.vic.gov.au](http://www.vcec.vic.gov.au)

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