Controller and Auditor-General
Tumuaki o te Mana Arotake

Setting and administering fees and levies for cost recovery: Good practice guide

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Auditor-General's overview

E ngā mana, e ngā reo, e ngā karangarangatanga maha o te motu, tēnā koutou

A public organisation needs to follow a robust process when it sets and administers a fee or levy for producing a good or providing a service. This is vital for ensuring the integrity of the charging regime.

Parliament, the public, and fee and levy payers need to have confidence that public organisations have the proper authority to charge the fee or levy, and that they are charging an amount that reflects the costs of producing the good or providing the service.

This guide provides guidance on settings fees and levies to recover costs. It is an update on the guide we published in 2008, and has been expanded to cover some levies as well as fees.

It also updates the principles that public organisations should consider when making any decisions on setting and administering fees and levies: equity, efficiency, justifiability, and transparency.

These principles apply equally to fees and levies. We have updated them to recognise changes in public expectations, particularly the need for transparency and engagement. Whether you are setting a new charge or reviewing an existing one, these principles should guide your decision-making.

This guide also sets out the matters that we expect public organisations to consider when calculating the costs of producing goods or providing services and setting charges to recover those costs.

Our guidance complements the guides produced by the Treasury and Taituarā – Local Government Professionals Aotearoa. Those guides provide further support and information, particularly on the policy processes that precede any decision on whether to charge for producing a good or providing a service and the amount of that charge.

I hope that this guide will help public organisations with the statutory authority to charge fees or levies to do so in a way that improves the trust and confidence of fee and levy payers, Parliament, and the broader public.

Nāku noa, nā

John Ryan
Controller and Auditor-General
19 August 2021

1 Introduction

1.1 If you work in a public organisation[1] that has legal authority to charge a fee or levy[2] for the goods or services that it provides, then this guide is for you.

1.2 This guide is intended to help you implement and administer equitable and transparent charging practices so you can justify the fees and levies you use to recover the costs of producing goods or providing services. This enables your organisation to be accountable to Parliament, the public, and fee and levy payers.

1.3 It provides guidance on setting fees and levies to recover costs. It has been updated from the guide we published in 2008.

1.4 We are interested in ensuring that:

- the costs public organisations recover through fees and levies are justified;
- public organisations use the revenue they gather from fees and levies appropriately; and
- the practices of public organisations are transparent to fee and levy payers.

1.5 This guide discusses the legal basis for charging. It also describes the principles that we consider should underpin any charging arrangements and how you should apply them and sets out other factors you should consider when creating, implementing, and managing charging arrangements.

Why do public organisations charge for goods and services?

1.6 Public organisations generally charge fees or levies when the goods or services they are required to provide:

- provide an individual or group of individuals (and not the population as a whole) with a direct benefit; or
- are necessary to mitigate risks presented by the activities of an individual or group of individuals.

1.7 In these circumstances, charging fees or levies for the goods or services might be considered more equitable than using Crown funding or rates revenue to pay for them.

Why is the Auditor-General interested in fees and levies?

1.8 We seek to provide Parliament and the public with an independent view about how well public organisations operate and account for their performance.

1 In this guide, we use the term "public organisations" to describe those entities within the Auditor-General's mandate. Section 5 of the Public Audit Act 2001 defines these entities.

2 For the purpose of this guide, we use the term "fees" to describe fixed charges to individuals and "levies" to describe charges to groups of individuals.

1.9 We want to ensure that the charging practices of public organisations that charge fees or levies for goods or services are not only lawful but also equitable, efficient, justified, and transparent enough to provide accountability.

What this guide covers

1.10 This guide covers fees and levies that public organisations charge for goods and services that they are required to produce or provide.

1.11 The focus of this guide is on recovering costs. This guide is not intended to provide detailed information on all possible charging arrangements. Rather, this guide sets out the principles and administrative matters that you need to consider when setting and administering charges, noting that you always need to work within the confines of the specific empowering provisions in the relevant legislation.

1.12 This guide has been expanded to include levies, as well as fees, designed to recover the costs of providing services.

What this guide does not cover

Levies designed to create a fund

1.13 This guide does not cover levies that are designed to create a fund to be drawn on for future unspecified costs. This includes road user charges, Accident Compensation Corporation levies, or premiums paid to the Earthquake Commission to fund the recovery of residential property after a natural disaster.

Contractual payments for goods and services

1.14 Contractual payments for goods or services that a public organisation provides to third parties on a discretionary basis are normal commercial transactions. They are voluntary for both parties and are outside the scope of this guide.

1.15 For example, when the Department of Internal Affairs provides translation services to businesses, central and local government, and private individuals, this is a normal commercial transaction. The Department is not obliged to provide these services. The amount the translation service charges is a contractual payment that the recipient agrees to. This means that it is not a fee within the scope of this guide.

1.16 The following two examples illustrate the differences between charges for services a public organisation is required to provide and charges for services that are discretionary.

1.17 The Dog Control Act 1996 contains detailed provisions setting out the basis that councils can charge fees for registering dogs on. Dog owners are required to pay the fee. However, a council does not need equivalent empowering provisions when it hires out a hall or community facility to a private party. This is a simple matter of contract, and there is no obligation for the council to hire the hall out.

1.18 This guide covers the fees charged to register dogs but not those for hiring out the hall (even if the council hires out the hall for dog control purposes).

Why have we updated the guide?

1.19 This guide updates and replaces our 2008 good practice guide *Charging fees for public sector goods and services*. We have expanded it to cover some levies. It also provides detail on using levies.

1.20 This guide also discusses aspects of cost allocation you need to keep in mind. It encourages more focus on the monitoring of fees and levies, and on reporting systems to promote greater transparency.

1.21 The Regulations Review Committee is the Parliamentary select committee responsible for scrutinising regulations, including those that set fees and levies. In updating this guide, we have considered the Committee's reports *Activities of the Regulations Review Committee in 2019* and *Activities of the Regulations Review Committee in 2020*.

Guidance from other organisations on charging

1.22 The Treasury and Taituarā – Local Government Professionals Aotearoa (Taituarā) also produce guidance on charging fees and levies.[3]

1.23 One of the purposes of the Treasury's guide, which it updated in 2017, is to help you to take proper account of relevant policy considerations when you prepare charging regimes. It also helps you to operate your cost-recovery regimes transparently.

1.24 The Treasury's guidance discusses issues that we have no mandate to comment on. This includes who should be charged a fee or levy and why, and whether you should recover less than the full costs of producing the goods or providing the services.

1.25 Taituarā's guidance provides support for local government staff when setting prices for goods and services. It includes information on understanding the legal framework, setting prices, and consulting on, implementing, and reviewing charging practices.

1.26 The Treasury and Taituarā's guidance and this guide complement each other and should be read alongside each other. The first point of reference for resolving any conflict between the guides should always be the legislation and regulations that provide the legal authority to charge the fees or levies. We provide more information on this in Part 2.

3 The Treasury (2017), *Guidelines for setting charges in the public sector*; Taituarā – Local Government Professionals Aotearoa (2017), *The price is right – the Kiwi version*.

Principles guiding the setting and administration of fees and levies

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2.1 In this Part, we discuss:

- the requirement for your public organisation to have legal authority to charge for the goods or services it is required to provide; and
- our expectations for how you administer and manage fees and levies, based on four principles.

Legal authority

2.2 A public organisation must be sure that it has the appropriate legal authority before implementing and managing charges to recover costs.

2.3 Legislation authorising charging is often permissive, and it sometimes presents a range of options to consider. However, this is not always so. Therefore, your starting point always needs to be making sure that you have the appropriate legal authority to charge and administer fees or levies in the way you intend.

2.4 That legal authority will usually be in an Act of Parliament. The Act will usually include an “empowering provision” that authorises the setting of the amount of a fee or levy through regulations. It will not usually specify the amount to be charged.

2.5 The empowering provision may also specify other matters, such as:

- the activities a public organisation is authorised to charge fees or levies for;
- the recovery period;
- how often it must review its fees and levies (for example, every five years); and
- the circumstances in which it can waive or refund the fee or levy, or exempt someone from paying it.

2.6 It is important that you thoroughly check the provisions in the relevant Act and any related regulations.

Guiding principles

2.7 Once you have established the legal authority for charging fees or levies, four principles should guide how you administer them. They are:

- equity;
- efficiency;
- justifiability; and
- transparency.

2.8 Following these principles helps you to administer fees or levies appropriately. It also helps you to provide adequate transparency to enable fee and levy payers, Parliament, and the public to hold your public organisation to account.

2.9 There might be tension between the principles, and you will need to consider any trade-offs that you need to make when deciding how to administer charges.

First principle: Equity

2.10 Equity is about ensuring that you administer and manage fees and levies in a way that is administratively fair.

2.11 When implementing and reviewing fees or levies, it is important that you consider equity matters so that the recovery of costs from fee and levy payers is fair. This means that you do not seek to recover costs from one group that could benefit a previous or future group.

2.12 If you do not review your fees or levies regularly, equity issues between groups of fee payers could develop over time.

2.13 Equity might also be an important consideration when determining when and who to charge, but these are policy choices that are outside the scope of this guide. For more information on this, see the Treasury's guidance.[4]

Second principle: Efficiency

2.14 Efficiency means that public organisations produce as many goods, or provide as many services, to the desired level of quality as possible from a given quantity of resources. This achieves value for money.

2.15 You need to structure fees and levies in a way that closely reflects the costs needed to produce the goods or provide the services to an individual or organisation. Setting or updating fees is an opportunity to review the costs of delivering goods and services.

2.16 This is an opportunity to check that your public organisation is delivering those goods and services as efficiently as possible and that it is not incurring any unnecessary costs that you then need to recover from fee or levy payers.

2.17 You also need to consider how much effort you will put into determining the costs of services. Sometimes, accurately costing individual consumption might take more effort and generate more costs than the cost of the goods and services that you will recover. You will need to decide which approach is most efficient.

2.18 There are also other considerations – for example, the incentives that particular cost structures create. For this, see the Treasury's guidance.

Third principle: Justifiability

2.19 Justifiability means that the costs you recover through fees or levies reasonably relate to the goods or services you are charging the fees or levies for. Where possible, it means eliminating cross-subsidisation (see Part 3).

4 The Treasury (2017), *Guidelines for setting charges in the public sector*, paragraph 3.4.

2.20 To justify fees or levies, you need to have an accurate understanding of both the direct[5] and indirect costs[6] of the goods or services. When charging for a service, you also need be clear about what the service is and the standard your public organisation delivers it to, so that the costs reflect the service quality the recipient requires.

2.21 Reliably establishing the costs of delivery is essential to managing costs and identifying potential inefficiencies. This is important regardless of how you recover the costs. It is important that you recover only those costs that can reasonably be attributed to producing the goods or providing the services that the charges apply to.

2.22 This includes a reasonable portion of costs that can be attributed to multiple services (for example, overhead costs). Services will draw on other indirect costs, such as an organisation's management layer.

2.23 It is justifiable to recover a portion of the direct and indirect overheads associated with the goods or services through an overhead component in the charge.

Fourth principle: Transparency

2.24 A public organisation is accountable to Parliament and the public. To be accountable for your charging practices, you need transparent processes for setting and managing fees or levies.

2.25 Fee and levy payers need to have enough information to understand and assess whether the:

- basis or method for setting the fee or levy is appropriate;
- fees or levies are fairly costed; and
- revenue generated is correctly accounted for and used appropriately.

2.26 Transparent fees, levies, and charging practices are the main way that public organisations are held to account for their charging decisions. Part 4 discusses the several ways that public organisations can achieve transparency and accountability. These include:

- building relationships by engaging with fee and levy payers;
- recording surpluses and deficits associated with the fees and levies; and
- regularly reporting the status of memorandum accounts, changes in forecast revenues and costs, changes in service mix, performance, and cost allocations to fee and levy payers.

5 These are costs that are directly determined by providing a unit of service, such as labour, materials, and motor vehicle mileage.

6 These are costs that are not directly determined from the consumption of a particular unit of service, such as information management, corporate services, management, and other overheads.

3 Setting fees and levies

3.1 In this Part, we discuss what public organisations need to consider when they set fees and levies.

3.2 This guide does not set out a single standard that you must follow when setting fees or levies. Instead, we provide guidance on the information that you should consider.

3.3 This is because a public organisation can charge fees or levies for various reasons. A public organisation could also charge fees or levies for two different types of goods or services that each have their own legal authorities, policy justifications, and cost structures.

3.4 As well as expecting you to follow the principles discussed in Part 2, we expect you to consider the following questions:

- What legal authority do you have to charge?
- What is the justification for charging?
- What type of fee or levy makes the most sense?

What legal authority does your public organisation have to charge?

3.5 When considering the legal authority to charge a fee or levy, you need to be clear about:

- the legal authority's purpose and scope; and
- whether the fees or levies are consistent with the legal authority's purpose and scope.

Purpose and scope of the legal authority

3.6 Some public organisations have the legal authority to charge fees or levies under different sections of one Act and/or under different Acts.

3.7 The legal authority can differ subtly or substantially between different Acts. This is also the case for empowering provisions. Some cost elements could be recoverable under one empowering provision but not under another. You will need to check the precise terms of each empowering provision.

3.8 For example, section 150 of the Local Government Act 2002 is an empowering provision that allows councils to charge fees for various services, including certificates, permits, and consents. This empowering provision states that fees must not recover more than the reasonable costs incurred by a council.

3.9 Section 36 of the Resource Management Act 1991 states that councils must follow what is set out in section 150 in the Local Government Act when charging fees for resource consents and other services and must also use the special consultative process in the Local Government Act.

3.10 You need to clearly identify and understand the scope of the empowering provision, as well as any constraints or limitations on it, before deciding how you will charge and how much.

3.11 Some Acts may require a public organisation to charge a fee or levy, while other Acts may state that charging is up to the public organisation. You should also be aware of any details in subordinate legislation, such as regulations, that set out how charges may be designed or administered.

3.12 Good practice would be to document your understanding of the legal authority in a policy manual or similar document. Ideally, this document should be in plain English and publicly accessible.

General principle of cost recovery

3.13 Setting a fee or levy that recovers more than the cost of producing the goods or providing the services could be viewed as a tax. Unless authorised by an Act, this would breach the constitutional principle that Parliament's explicit approval is needed to impose a tax.[7] **Therefore, any legal authority to charge a fee or levy is implicitly capped at the cost of producing the goods or providing the services**.

3.14 However, in many instances, public organisations may be authorised to recover deficits from a previous period of under-recovery. Sometimes, there are limits on recovering deficits. It is important for you to be aware of any legal restriction on the period you can recover historical deficits for.

3.15 You can manage these issues if there is enough scope in the legal authority and it is clear, at an administrative level, that you are managing surpluses and deficits within a reasonable budgeting framework for managing costs and setting fees or levies over a period of time. Memorandum accounts can be helpful in managing surpluses and deficits (see Part 4).

3.16 You will need to carefully consider the implications of any attempt to recover historical deficits through current fees or levies. In some instances, it might not be equitable to recover deficits.

3.17 For example, if recovering historical deficits is likely to result in you charging current fee and levy payers more than the costs of the goods or service they receive, the current recipients of those goods or services could be subsidising the costs of previous recipients (see paragraphs 3.25-3.29).

7 See section 22(a) of the Constitution Act 1986.

3.18 This might be a particular concern when a deficit is a result of an unexpected significant shock. For example, when a pandemic closes borders, agencies that charge fees for border services will see a significant decline in revenue, even though their costs remain relatively fixed. This might result in significant under-recovery of costs.

3.19 How a public organisation addresses the deficits resulting from such a situation is a policy matter that is outside the scope of this guide. However, regular fee reviews are one way of managing equity considerations between current and future users of goods or services. We discuss this in Part 4.

Policy and other considerations affecting the amount of the fee or levy

3.20 A range of policy considerations might influence the amount you set fees or levies at. For example, although you could fully recover your costs by charging fees or levies, you might choose not to.

3.21 The fees set for civil court proceedings are an example of a public organisation charging less than full cost recovery because of policy considerations. Historically, these fees have not recovered all costs because to do so would limit people's access to justice.[8]

3.22 A public organisation's ability to charge less than the full cost of the goods produced or services provided depends on other sources of funding, such as Crown funding or rates revenue. Not all public organisations will have this option.

3.23 The circumstances that this is appropriate in are outside the scope of this guide. However, we expect you to document the policy decisions you make about charging less than the amount you need to recover costs in the methodology you use to set the fees or levies.

3.24 We encourage you to refer to the Treasury's guidance when considering the appropriateness of charging fees or levies at a particular amount. It contains useful information on the objectives for charging fees and appropriate charging methodology.

Need to consider cross-subsidisation

3.25 Cross-subsidisation occurs when the fees or levies collected for one type of good or service cover some of the costs of providing another type of good or service. As a result, the cost of some goods or services might be over-charged and others under-charged, and some goods or services might be over-recovered and others under-recovered.

8 When the Regulations Review Committee considered these fees in 2004, it concluded that some of the increases to fees proposed at that time would create barriers to accessing the court system. Report of the Regulations Review Committee, *Investigation and Complaints Relating to Civil Court Fees Regulations 2004*, [2005] AJHR I16H.

3.26 The extent to which it is possible to have any cross-subsidisation between different fees or levies depends on the wording of the empowering provisions.

3.27 For example, the Department of Internal Affairs charges for many of its activities, including passports and licences for gaming machines.[9] A cross-subsidy could exist if the Department over-charged for passports and used that income to cover some of the costs of providing gaming machine licences. Another example would be if the Department over-charged for an adult's passport and used that income to cover the cost of a child's passport.

3.28 It might not be possible to completely prevent cross-subsidisation. Estimates of costs and division of services are unlikely to be completely accurate in all circumstances. You might not have systems that break down costs enough to avoid the risk of cross-subsidisation, and it might not always be cost-effective to do so.

3.29 However, we expect you to be aware of equity issues that cross-subsidisation can create and take reasonable steps to minimise those risks as much as practicable.

3.30 Some levies might be an example of authorised cross-subsidisation. Levies often impose a uniform cost on all levy payers, even when the costs of producing a good or providing a service to one individual might be greater than providing it to another. This might be because it is not practical or efficient to identify and charge the precise cost to produce the good or provide the service to everyone.[10]

3.31 Given the potential equity issues with cross-subsidisation, you might need to obtain legal advice if you are unclear about the purpose and scope of your ability to charge fees, including any questions about cross-subsidisation.

Waivers, refunds, and exemptions from fee and levy payments

3.32 A fee or levy may be waived or refunded for various reasons. There are also various reasons why a party or parties may be exempt from paying the fee or levy. A waiver, refund, or exemption might mean that, in certain contexts, other fee or levy payers will pick up the costs associated with delivering the goods or services.

3.33 For this reason, the ability to waive, refund, or exempt should be fully justified (ideally, by being explicitly provided for in the Act that gives the legal authority to charge fees or levies). In many instances, reasons for a waiver, refund, or exemption will be provided for in the relevant legislation. You need to consider any relevant provisions.

9 These fees are set under the Passports Act 1992 and Gambling Act 2003 respectively.

10 Levies can be charged more precisely in some industries. This might apply to a situation where a proxy for the benefit received by a levy payer can be identified (for example, export volume), so costs incurred in establishing a specific regime can be recovered on that basis.

3.34 So that your decisions to grant a waiver, refund, or exemption are transparent, you also need to have clear, well-documented policies or procedures.

What is the justification for charging?

3.35 Justifying a charge means that you have a sound basis for any charge. This is found in:

- the policy basis for the charge (which is outside the scope of this guide) and its legal authority;
- the choices you make about the design of any charge; and
- the efficient and fair allocation of the costs incurred in producing the good or providing the service.

3.36 The choices you make about the design of a charge can include policy considerations that might benefit from considering the principles provided in this guide (even though policy considerations are outside the scope of this guide). In making decisions on charges, we expect you to make practical and efficient choices, so that the administrative costs are not too high.

3.37 You should clearly document the justification for any charges you set and administer, so how you have reached the amounts of the charges is transparent.

Establishing the costs of producing a good or providing a service

3.38 Fees or levies should reflect the costs that you estimate that producing the goods or providing the service will incur.

3.39 Establishing the cost involves:

- identifying the different goods that will be produced or services that will be provided and the level or quality of service needed;
- estimating how much of each type of good will be produced or the services that will be provided in each period; and
- identifying the resources used in producing each type of good or providing each service.

3.40 When you consider the way you structure your costs, you should also consider:

- whether you could improve the efficiency of services to reduce costs, including the costs of administering and collecting the charges (the transaction costs in managing a charging regime should not be out of proportion to the sums involved);
- how to deal with capital expenditure, fixed assets, and depreciation (see paragraphs 3.75-3.77); and
- the allocation of indirect costs between activities.

3.41 Once you have gathered all this information, you can set fees or levies to charge for each type of goods or service.

Identifying and grouping goods and services

3.42 You should identify, then logically group, the goods and services that you are charging for. For services, you need to be clear about the service to be delivered and the expected service level.

3.43 It might be more practical to divide complex services into smaller components. Sometimes, it might be easier to group several related products together for costing purposes (as long as the legal authority provides for this and you take reasonable steps to minimise the risk of cross-subsidisation).

3.44 Over time, you should use forecast information to describe and calculate the anticipated changes to costs.

3.45 Once you have identified and grouped the goods and services, you need to determine and cost the resources used to produce or provide them. These resources usually include labour, materials, overheads, depreciation on fixed assets and related costs, and other relevant costs.

3.46 Your cost analysis should identify any associated activities that might not be directly related to producing the goods or providing the services, such as specific research activities or providing legal advice to the team that produces the goods or provides the services.

3.47 This will help you to consider the relationship of these costs to the goods or services. In turn, this will enable you to make a clear choice about the allocation of these costs and their recovery through the fees or levies that you charge.

3.48 You should understand the drivers of cost and consider any opportunities to improve efficiency. For example, when you assess applications, do applicants provide enough information for you to carry out the assessment efficiently? If not, costs for service users could be higher than necessary, and you could improve your communication to applicants about the information they need to provide. Greater efficiency could reduce costs to users.

Determining the cost of goods and services

3.49 There are different ways of allocating costs. These include the time needed to produce goods and provide services, the materials used, the number of goods requested, or service usage levels. We expect public organisations to have a system for allocating and collating cost information.

3.50 A system to allocate and collate cost information should take account of the context your public organisation operates in and be in proportion to the level of revenue and costs that you need to track.

3.51 Effective cost accounting methodologies that identify a public organisation's total costs of producing a good or providing a service (by assessing the variable costs of each step, as well as fixed costs and overheads) are essential aspects of good charging practice.

3.52 To identify the resources and costs involved in providing the forecast volume of goods or services for a specified period, you need to use the best information available and make reasonable assumptions about prospective information.

3.53 You can use several methods to forecast costs. Generally, a good understanding of past costs that are adjusted for any inflationary and demand factors will provide a reasonable basis for future estimates. We expect cost inflation and demand assumptions to be documented and transparent.

3.54 It might also be necessary to consider any anticipated future costs that might affect both the forecasting of costs and recovery of them through fees and levies. Reviewing costs provides a good opportunity to look at any areas where you might be able to generate efficiency savings.

3.55 It could be appropriate to estimate a "standard rate" that averages out the resources that you expect to use to produce or contribute to a particular good or to provide or contribute to a particular service.

3.56 For example, even though workforce costs may vary, it might be useful to use an average rate based on the time it will take to produce or contribute to a particular good or to provide or contribute to a particular service. You can then use this as a basis to estimate costs over a forecast period.

Direct and indirect costs

3.57 The costs discussed above can have a direct or indirect relationship with the goods or services.

3.58 Direct costs are directly associated with producing a good or providing a service (such as labour costs to provide a service or the materials that go into making something). These should be relatively easy to identify, and include, in the cost of a good or service.

3.59 Direct costs might also include depreciation and the capital charge levied by the Treasury for those assets that you exclusively use to produce the goods and provide the services you are charging for.

3.60 If there is a clear and immediate relationship between a cost and an activity, you should, as far as practicable, include these in the cost calculation as direct costs.

3.61 Indirect costs contribute to the production of a good or provision of a service but are not incurred exclusively for that purpose (for example, rent or electricity costs for premises used for multiple outputs). They include a proportion of the capital costs associated with those assets that partially contribute to those products – for example, those associated with the building that the whole organisation is located in.

3.62 Indirect costs should be allocated based on the extent to which the indirect cost contributes to, or was caused by, the goods or services. Examples are the floor space the team providing the service uses in the building or the percentage of time that managers spend supporting that service relative to other services.

3.63 If a direct or indirect relationship is not readily identifiable (such as the percentage of a chief executive's time that is used in overseeing one service relative to others), the costs should be allocated systematically between the various goods or services.

3.64 This could be done by including these costs as an overhead. There is considerable accounting knowledge on overhead allocations, and you should apply good practice in this area with reference to your public organisation's circumstances.

3.65 Sometimes, overhead costs are better treated as direct costs. For example, legal costs might be better treated as direct costs if a substantial proportion of the legal team's time is spent on issues specific to the service you are charging for. Separately estimating those costs and including them as direct costs is likely to be more accurate and transparent.

3.66 If you do this, you need to treat these costs appropriately in the overhead calculation for the charge and make sure you do not count them twice.

3.67 Allocating indirect costs might not always be straightforward, but you need to make a reasonable assessment of indirect costs and their allocation against goods or services. Whatever approach you take, you should clearly document the method for allocating overheads and other business support costs, and any assumptions should be explicit and transparent.

Typical costs incurred

3.68 Typical costs that are incurred in producing goods or providing services include:

- labour;
- materials;
- overheads; and
- depreciation and other costs related to capital.

3.69 **Labour** includes remuneration costs and other employment-related costs, such as fringe benefit tax and Accident Compensation Corporation levies.

3.70 Time is often an appropriate basis for allocating labour costs to different activities. If employees work on more than one type of good or service, you need to determine how to allocate their time.

3.71 If full-time recording is practical, you could gather this information by recording the time spent (by a sample of employees on different types of goods or services). If this is not practical, you could develop an informed estimate. In developing your estimates, you should clearly document any assumptions that the estimate is based on.

3.72 You can determine the average quantity of **materials** needed to produce goods or provide services using previous information. If that is not available, you can make estimates or do a trial run. The quantity of materials includes any usual scrap or wastage.

3.73 If you already know the volumes and costs of materials used in each period, you could determine the standard material cost for an item by dividing the estimated total material cost by the estimated number of individual items produced in the period.

3.74 **Overheads** include the costs of all business support services received or purchased from other parts of the organisation or from third parties (such as rent and information technology).

3.75 It is generally not appropriate to include **capital expenditure** (purchasing fixed assets, such as land, buildings, other physical construction, and equipment) in the calculation of costs for setting fees or levies.

3.76 Recovering the costs in the year they were incurred can treat current and future fee and levy payers inequitably, because one group will be paying for something (such as an improved information technology system) that they might not get the benefit of. This is usually not appropriate.

3.77 The cost of goods or services should include **depreciation** charges on the relevant **fixed assets**. Depreciation should be calculated based on your normal accounting policy. Where charged, the **capital** charge represents a cost to the organisation and should be included in the cost calculation.

3.78 The fees or levies will need to include goods and services tax in accordance with the Goods and Services Tax Act 1985.

3.79 In determining costs for charging fees or levies, you need to be careful to avoid including expenses funded through other means.

Estimating demand for goods and services

3.80 You also need to estimate the demand for each type of good or service in the period that you are carrying out the analysis for. Sometimes, this can be forecast using information from previous periods. At other times, it will be less clear, and you will need to make assumptions about the different factors that might affect demand.

3.81 Once you have information about the expected demand, you can estimate the resources you will need and their costs.

3.82 When quantifying the costs of the resources needed to meet the expected demand, you need to consider both fixed and variable costs.

3.83 Fixed costs are stable within a certain volume range and change only when significant changes in volume occur. Variable costs change continuously with changes in volume. Any technology or capital investments might also change service levels or costs.

3.84 You will need to make transparent your assumptions about the prices that you expect to pay for the resources needed to produce the goods or provide the services. You will need to use judgement to make reasonable, transparent, and logical assumptions that are based on the best available information on anticipated changes (such as inflation).

3.85 Although memorandum accounts should target a zero balance over the medium term, you will nevertheless need to review fees and levies as the relevant Act requires or when there is a significant change in costs or anticipated revenue.

3.86 This will help return surpluses or recover deficits in a timely way. It will also help to avoid triggering a limit in the relevant statute that prevents deficits from being recovered[11] or a loss of equity between current and future fee and levy payers.

Determining the basis for setting and charging fees and levies

3.87 Once you have identified the cost structures and individual cost components, and estimated the volume of demand and costs that will be incurred, you can decide how to set fees or levies. You will need to factor in any policy choices that have been made about the proportion of costs to be recovered through the fee or levy and your understanding of service use.

3.88 The appropriate basis for determining the amount of a fee or levy will depend on what is produced or provided. If the goods or services are standardised, it might

11 For example, section 128(4) of the Electricity Industry Act 2010 includes a limit of five years to recover a "levy shortfall".

be as simple as dividing the total costs by the estimated number of goods to be produced or services to be provided.

3.89 However, if the costs incurred in producing individual goods or providing individual services vary significantly, an average cost might not be the best method. You might need more specific charges.

3.90 Wherever possible, you should set the fees or levies before you produce the goods or provide the services. Users should know the fees or levies in advance so they can decide whether they want to pay their share of the costs associated with the goods or services.

What type of fee or levy makes the most sense?

3.91 Types of charges include:

- fixed charges to individuals (fees);
- charges to groups of individuals (levies); and
- variable/differentiated charges to individuals (such as hourly rates or the level of service that an individual service user generates). It is important to check the legal authority to know what type of charge you can use.[12]

3.92 Hourly rates generally recover the costs of staff salaries and a portion of overheads attributable to the service (for example, information management, costs related to premises, and costs related to health and safety). Hourly rates are particularly useful when there is a high degree of variability in the time it takes to deliver a unit of service.

3.93 Fixed charges generally recover the costs of staff salaries and overheads. This type of charge is used when there is a high degree of certainty about the time and cost associated with delivering a service.

3.94 A combination of a fixed charge and hourly rates might also be appropriate because it provides some of the benefits of both fixed and variable charges.

3.95 In these circumstances, you can set the fixed charge to cover the cost associated with most services that you deliver. The hourly rate is then reserved for when it takes longer to deliver the service.

3.96 Marginal cost charges charge an initial fee that covers direct costs and overheads. If a service takes longer to deliver than expected, additional charges seek to recover only the additional variable cost.

12 For more on the design of a cost-recovery regime, see The Treasury (2017), *Guidelines for setting charges in the public sector*, Part 5.

3.97 Marginal cost charges recognise that much of the overhead cost associated with delivering the service is fixed. Therefore, delivering additional service does not necessarily cause the service provider to incur additional overhead costs.

3.98 A levy is usually a charge that does not necessarily have a "direct line of sight" to an individual's consumption of a good or unit of service.

3.99 Levies are often charged to recover the cost of a service, or group of services, when it is not efficient to identify the amount of the services that any one individual uses, so it is not feasible to charge for this directly. Biosecurity levies at the border are an example of this.

4 Administering fees and levies

4.1 In this Part, we discuss:

- the need to clearly document your decisions about fees or levies, the charging system you use, and the expected level of revenue and costs;
- using memorandum accounts;
- monitoring and reviewing fees and levies; and
- engaging with fee and levy payers at regular intervals.

Clear documentation of decisions, charging system, and revenue and costs

4.2 A public organisation that charges fees or levies should have:

- documentation of its charging system;
- an appropriate cost-allocation methodology and process;
- for each charge-setting or review exercise, a clear audit trail showing its assessment of costs incurred and forecast demand, the drivers of cost and how it has considered them, and how it has determined the level of fees or levies; and
- a record of how it considered the principles and questions in this guide. The extent and level of detail will depend on the scale and significance of the good or service and their cost.

4.3 The documentation of your charging system should describe the legal authority and rationale for charging fees or levies, and the scope of those fees and levies. It should also describe other sources of revenue (such as from the Crown) and your approach to calculating fees or levies.

4.4 Having the information referred to in paragraph 4.2 documented means you can show external reviewers, stakeholders, and fee and levy payers that you have a robust and reasonable process for identifying the costs of your activities and for setting fees and levies.

Monitoring revenue from fees and levies

4.5 Once fees or levies are set, you should monitor and record the revenue generated and the associated costs of producing the good or providing the service. This should help ensure that your financial management practices support statutory compliance. Memorandum accounts are one way of doing this.

4.6 We recognise that there are other methods of monitoring and recording revenue generated and costs incurred. The most important point is that whatever method you use has enough transparency to identify any surpluses or shortfalls relating to individual charges so that you can address these.

Using memorandum accounts

4.7 To properly account for your charging practices, you need to know how much revenue your fees and levies generate relative to costs. Memorandum accounts are one method of recording this information.

4.8 Memorandum accounts allow organisations to monitor the annual surpluses and deficits that result from a specific charging regime, with the expectation that the account will trend towards zero over time.[13] They support practices for charging and reporting on fees and levies, and show when you should review fees and levies.

4.9 The Treasury's guidance notes:[14]

> *Departments* ***must*** *use memorandum accounts to record the accumulated balance of surpluses and deficits incurred in the provision of third party, fully cost-recovered outputs.*
>
> *Memorandum accounts* ***should*** *be used wherever:*
>
> - *third parties are to be charged for services provided on a full cost-recovery basis;*
> - *refunding surpluses or levying short-falls through a contractual arrangement is costly or impractical; and*
> - *the benefits of preparing a memorandum account clearly outweigh the compliance costs involved.*

4.10 We agree with this position. In our view, it is good practice for public organisations to use memorandum accounts whenever possible.

4.11 You should set fees and levies to recover costs in the short to medium term. However, in most instances, the costs incurred and revenue received will vary from what was forecast for the period. Forecasts are unlikely to be completely accurate.

4.12 Memorandum accounts can track the recovery of costs over time. The requirement to use memorandum accounts recognises that some smoothing between periods will be needed.

4.13 If you use memorandum accounts, it is good practice to:

- consider whether to establish separate memorandum accounts for fees or levies with different authorising statutes and, if you have many different charges, make sure you have adequate records and monitoring for each individual fee or levy;

13 For more on expectations for memorandum accounts, see The Treasury (2017), *Guidelines for setting charges in the public sector*, paragraph 6.5.

14 For more on the design of a cost-recovery regime, see The Treasury (2017), *Guidelines for setting charges in the public sector*, Part 6.

- show, for each account or line item, an opening balance, the movements (income, costs, and other adjustments) during the period, and a closing balance (which will indicate whether over- or under-recovery is occurring);
- explain the characteristics of each account, such as the review period and any limits on recovery, and provide the basis for charging; and
- if over- or under-recovery is occurring, explain what you are doing to smooth year-by-year variations in the fees or levies charged.

When to operate multiple memorandum accounts

4.14 Some public organisations are responsible for administering multiple fees and levies.

4.15 Memorandum accounts generally show only the headline balance and whether there is a surplus or deficit. They do not necessarily explain what is causing the surplus or deficit.

4.16 Managing multiple fees and levies through a single memorandum account can increase the risks of cross-subsidisation (see Part 3). This is because you might inadvertently recover a deficit from, or return a surplus to, a group of fee and levy payers who did not contribute to that deficit or surplus.

4.17 In our view, you should, where practical, use separate memorandum accounts to manage fees and levies that are authorised under different statutes and that have different requirements and review periods.

4.18 This will minimise the risk that charging practices are unlawful because the different statutory requirements of different fees or levies have been confused. It will also provide fee and levy payers with more confidence that you are following those requirements – including regularly reviewing fees or levies, or complying with limits on the recovery of deficits.

Understanding memorandum account balances

4.19 If you are managing multiple fees and levies under a single memorandum account, you will need to understand, at a more detailed level, how those fees or levies contribute to the overall account balance.

4.20 For example, revenue or expenditure from one type of fee or levy might dominate. As long as the revenue for that fee or levy does not generate a significant deficit or surplus, the memorandum account will appear to balance within acceptable limits. However, this might mask a significant imbalance with other fees or levies managed in the same account.

4.21 Therefore, it is important that you have a good and well documented understanding of movements in the revenue for each fee and levy managed under the memorandum account. This means that you can review and adjust fees or levies in a timely way when surpluses or deficits related to specific charges occur – regardless of the overall balance of the account.

Forecasting for deficits and surpluses

4.22 Fee and levy revenue and expenditure are highly unlikely to be completely in balance. Consequently, memorandum accounts are almost always likely to be in either surplus or deficit.

4.23 Regular forecasting will help you see when memorandum accounts are heading too far into either surplus or deficit. You will then need to understand what is driving the change in forecast and whether you need to make any changes to the current fees or levies.

4.24 Your forecasting of costs and revenue needs to be detailed enough that, as well as it providing the overall account balance, you can anticipate movements from specific fees or levies.

Understanding service performance

4.25 In our view, you should also collect non-financial service performance information about the goods or services that you are charging for. This information can indicate long-term changes in service use/revenue and/or service costs that might lead to future surpluses or deficits.

4.26 Non-financial service performance information is a useful indicator of whether the goods or services that you are charging for are meeting the needs of fee and levy payers. If they are not, fee and levy payers might question current service levels (and costs) and whether they meet expectations.

4.27 Fee and levy payers and their representatives are also increasingly asking for non-financial service performance information (for example, number of service requests, timeliness of response, accuracy of response, or satisfaction of service recipients) to help them understand the value for money of what they receive.

4.28 We consider that this is best practice and a good way to provide transparency and accountability for your performance.

Monitoring and reviewing fees

4.29 Regularly monitoring and reviewing fees or levies is critical so that you:

- do not have to write off large deficits;

- minimise equity risks associated with recovering historical costs from future service users or returning historical surpluses to future service users; and
- provide service users with certainty and relative stability in the price they pay for goods or services, as opposed to irregular and large increases in fees or levies.

4.30 It is important that you regularly monitor the performance of fees or levies and act when necessary. This is important regardless of whether there is a legislated review period for the fee or levy.

4.31 You will need to regularly monitor the status of memorandum accounts, underlying costs, service mix, other influences, and associated fees and levies. This will help you avoid situations where you fail to meet a statutory limit on recovering historical deficits, which could lead to you having to write off large deficits. It will also help you avoid having to make substantial changes to fee and levy levels after reviewing them.

Reporting to, and engaging with, fee and levy payers

4.32 Public organisations are expected to regularly engage with fee and levy payers and provide regular reporting.[15] Historically, public organisations engaged with fee or levy payers periodically (during consultation on a review of charges). However, in recent years, expectations of public organisations' levels and frequency of engagement and reporting have increased.[16]

4.33 Fee and levy payers expect more regular (such as annual or bi-annual) reporting on:

- actual and forecast changes in the underlying costs and what is behind any changes to those costs;
- the status of memorandum accounts (and how specific fees or levies are performing against cost-recovery objectives);
- performance of the goods or services funded by fees and levies; and
- future projections of costs and revenue, and service-improvement initiatives.

4.34 Public organisations are expected to have ongoing relationships with representatives of fee and levy payers. You are also expected to provide regular reporting on matters such as changes in:

- services – for example, the need to manage new or emerging risks, facilitate increased demand, or take advantage of technology;
- costs – for example, increased labour costs from concluded pay negotiations or increased capital costs from implementing technology;

15 See "Developing a cost recovery proposal" at treasury.govt.nz.

16 See The Treasury (2017), *Guidelines for setting charges in the public sector*, section 2.5.

- cost allocation – for example, changes in the attribution of overhead components to reflect new or increased/decreased delivery of various goods or services, or changes in which activities are attributed to levies;
- service performance – for example, increases or decreases in the number of units delivered because of changes in demand behaviour and performance against any agreed service standard; and
- government policy – for example, to address an emerging or increasing risk.

4.35 Reporting periods should be meaningful and determined in consultation with fee and levy payer representatives. They should recognise that there is both a benefit and a cost involved in reporting.

4.36 Engagement and greater transparency enable fee and levy payers to manage their demand for goods or services. For example, if fee and levy payers can understand why there is an increase in the costs associated with services delivered to manage risks, they might be able to take steps to address those risks to avoid a fee or levy increase.

4.37 More engagement might also support a smoother fee or levy review. It might also allow reviews to be timed more appropriately, instead of simply occurring at regular intervals. Transparency will mean that businesses or fee and levy payers can anticipate reviews and plan for them in advance.

4.38 In our view, developing ongoing relationships with fee and levy payers and adopting a regular monitoring and reporting cycle should help mitigate any challenges with formal public consultation and contribute to transparency, accountability, and ongoing improvements.

5 External review of charging powers

5.1 In this Part, we discuss the external parties with a role in ensuring that public organisations are setting fees and levies lawfully. They are:

- the Regulations Review Committee;
- the courts; and
- the Auditor-General.

The Regulations Review Committee

5.2 The Regulations Review Committee (the Committee) considers, on behalf of Parliament, whether a regulation falls outside certain criteria. It uses Standing Orders of the House of Representatives to assess that.[17]

5.3 The Committee will consider whether a regulation setting a fee or levy ought to be drawn to Parliament's attention, based on one or more of the rules set out in Standing Order 327(2). You need to consider these rules. You can find more detail in the *Regulations Review Committee Digest*.[18]

Not in accordance with the general objects and intentions of the statute

5.4 Standing Order 327(2)(a) states that a regulation that "is not in accordance with the general objects and intentions of the enactment under which it is made" should be brought to Parliament's attention.

5.5 The Committee considers whether a regulation setting fees or levies is consistent with the intentions of the enactment as a whole and whether the legal authority in the Act authorises the making of such a regulation.

5.6 Fees and levies must be imposed under clear legal authority. A fee or levy could be objectionable if it is so high that it defeats the purpose of the enabling Act. A fee or levy would also not be in keeping with the enabling Act if it is not based on the costs you incur and would result in over-recovery.

Trespasses unduly on personal rights and liberties

5.7 Standing Order 327(2)(b) states that a regulation that "trespasses unduly on personal rights and liberties" should be brought to Parliament's attention. The Committee considers whether a regulation setting fees and levies:

- is unjustified in the circumstances;
- clearly reflects unacceptably inefficient operation by the relevant organisation; or

17 Our references in this Part are to the 2020 edition of the Standing Orders.

18 For details on matters considered by the Committee under Standing Order 327(2), see Clark, E and Knight, D R (2020), *Regulations Review Committee Digest*, seventh edition, New Zealand Centre for Public Law, Wellington, at wgtn.ac.nz.

- includes a component irrelevant to the person paying unless there is enough justification for doing so.

Unusual or unexpected use of powers

5.8 Standing Order 327(2)(c) states that a regulation that "appears to make some unusual or unexpected use of the powers conferred by the enactment under which it is made" should be brought to Parliament's attention.

5.9 If consumers are paying for something that they do not receive, then the regulation setting the fees or levies could constitute an unusual or unexpected use of the power. This is how the Committee considers the need for equity between current and future fee and levy payers.

5.10 For example, the Committee reviewed the license fees that flight crews and aircraft maintenance engineers must pay.[19] A portion of the fees goes towards research into training methods for pilots.

5.11 The Committee concluded that this was an unreasonable and unexpected use of the regulation-setting authority because current pilots would not benefit from the research and should not have to pay for it. An individual should not have to pay if they are not going to get the benefit of the resource they are paying for.

5.12 The Committee's review of licensing fees for gaming machines was another example.[20] The fees, based on full cost recovery, substantially increased. The Committee thought that requiring all licence holders to pay the same fee regardless of their size was an unusual or unexpected use of authority.

More appropriate for parliamentary enactment

5.13 Standing Order 327(2)(f) states that a regulation that "contains a matter more appropriate for parliamentary enactment" should be brought to Parliament's attention. This is based on the principle that Acts should set out the policy and substance of the law and that regulations should be limited to detail and implementing the policy.

5.14 The Committee can bring increases to fees or levies that are so significant that they represent a substantive shift in policy to the attention of Parliament. This could also happen if the money recovered is more than the cost (because the presumption is that Parliament could not have intended to levy a charge that amounts to a tax through regulations). For the same reason, a charge imposing a penalty (such as a late payment penalty) would need specific authority.

19 Report of the Regulations Review Committee (1989), *Inquiry into the Civil Aviation Regulations 1953, Amendment No. 30*, AJHR I16.

20 Report of the Regulations Review Committee (1998), *Investigation into the Gaming and Lotteries (Licence Fees) Regulations 1997*, AJHR I16H.

5.15 The Committee considered regulations from 1990 that significantly increased civil aviation fees.[21] One of the fees was an international operator's fee charged to the aviation industry, which partly covered the cost of New Zealand's membership of an international governmental organisation. The Committee concluded that taxpayers should pay for the cost of this membership because it benefits the wider community.

Judicial review

5.16 You should also be aware of the grounds on which a regulation could be challenged through judicial review proceedings. The High Court can review the decision-making process and invalidate a fee set by regulation if it is unfair, unreasonable, or unlawful.

Review by the Auditor-General

5.17 The Auditor-General can examine the process you used to set fees or levies and manage memorandum accounts. This is part of the Auditor-General's role in providing assurance to Parliament and the public that public organisations are operating consistently with Parliament's intentions.

5.18 Looking at the process to set fees or levies and manage memorandum accounts could be part of the annual audit. We may also do it through one of our other functions, such as carrying out a performance audit or inquiry.

21 Report of the Regulations Review Committee (1990), *Inquiry into the Civil Aviation Charges Regulations 1990*, AJHR I16B.

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