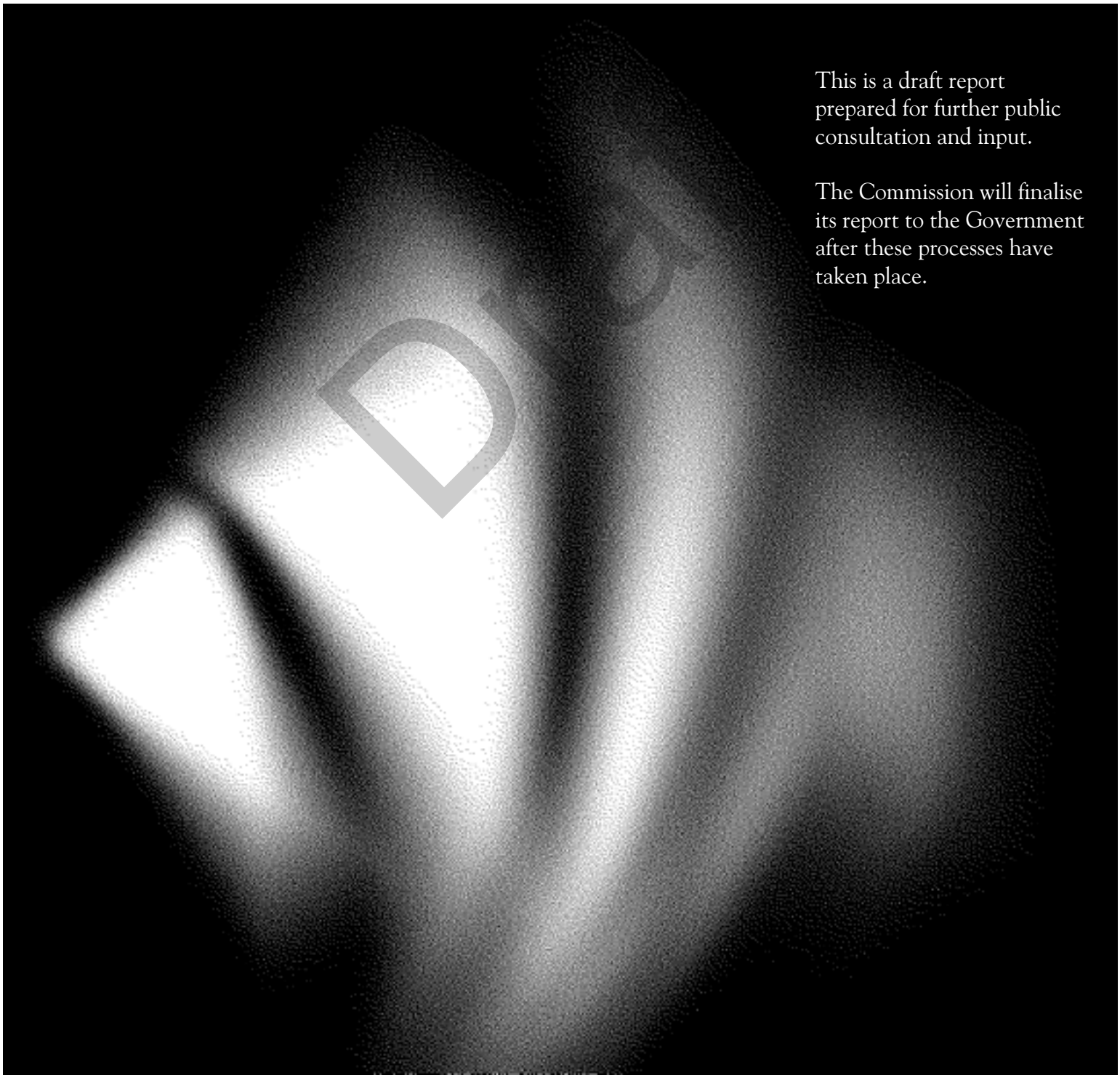
PRODUCTIVITY COMMISSION

Cost Recovery

Draft Report



This is a draft report prepared for further public consultation and input.

The Commission will finalise its report to the Government after these processes have taken place.

Publications Inquiries:
Media and Publications
Productivity Commission
Locked Bag 2 Collins Street East
Melbourne VIC 8003

Tel: (03) 9653 2244
Fax: (03) 9653 2303
Email: maps@pc.gov.au

General Inquiries:
Tel: (03) 9653 2100 or (02) 6240 3200

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The Productivity Commission

The Productivity Commission, an independent Commonwealth agency, is the Government's principal review and advisory body on microeconomic policy and regulation. It conducts public inquiries and research into a broad range of economic and social issues affecting the welfare of Australians.

The Commission's independence is underpinned by an Act of Parliament. Its processes and outputs are open to public scrutiny and are driven by concern for the wellbeing of the community as a whole.

Information on the Productivity Commission, its publications and its current work program can be found on the World Wide Web at www.pc.gov.au or by contacting Media and Publications on (03) 9653 2244.

Opportunity for further comment

You are invited to examine this draft report and comment on it in writing and/or by attending a public hearing.

The proposed public hearings schedule is shown below. Confirmation of dates and venues will be advertised through our circulars and in national newspapers. Anyone interested in attending a hearing should complete a registration form or contact the Productivity Commission.

The Commission will also be holding workshops in May to test the guidelines contained in Chapter 9 of the report.

The final report will be prepared after submissions have been received and will be forwarded to the Commonwealth Government on 16 August 2001.

Public hearing dates and venues

Location	Date	Venue
Melbourne	Commencing Monday, 4 June	Productivity Commission
Sydney	Commencing Thursday, 7 June	Australian Business Centre
Canberra	Commencing Wednesday, 13 June	The Brassey of Canberra

Commissioners

For the purposes of this inquiry and draft report, in accordance with section 40 of the *Productivity Commission Act 1998* the powers of the Productivity Commission have been exercised by:

Mrs Helen Owens	Presiding Commissioner
Professor Judith Sloan	Commissioner
Dr Robin Stewardson	Associate Commissioner

Terms of reference

I, ROD KEMP, Assistant Treasurer, pursuant to Parts 2 and 3 of the *Productivity Commission Act 1998*, hereby refer the cost recovery arrangements of Commonwealth Government regulatory, administrative and information agencies — including fees charged under the *Trade Practices Act 1974* (TPA) — to the Commission for inquiry and report within twelve months of receipt of this reference. The Commission is to hold hearings for the purpose of the inquiry.

Background

2. This inquiry is principally a general review of cost recovery arrangements across Commonwealth regulatory, administrative and information agencies. In addition, the inquiry will incorporate the review of fees charged under the TPA which is required under the *Commonwealth Legislation Review Schedule.* The inquiry will take into account the analytical requirements for regulation assessment by the Commonwealth, including those set out in the *Competition Principles Agreement*, where relevant.

Scope of Inquiry

3. The Commission is to report on:
   - (a) the nature and extent of cost recovery arrangements across Commonwealth Government regulatory, administrative and information agencies, including identification of the activities of those agencies for which cost recovery is undertaken;
   - (b) factors underlying cost recovery arrangements across Commonwealth Government regulatory, administrative and information agencies;
   - (c) who benefits from the regulations, administrative activity and information to which cost recovery arrangements are applied;
   - (d) the impact on business, particularly small business, consumers and the community of existing cost recovery arrangements, including any anti-competitive effects and incentive effects;
   - (e) the impact of cost recovery arrangements on regulatory, administrative and information agencies, including incentive effects;
   - (f) the consistency of cost recovery arrangements with regulatory best practice;
   - (g) appropriate guidelines for:
     - (i) where cost recovery arrangements should be applied;
     - (ii) whether cost recovery should be full, partial or nil;
     - (iii) ensuring that cost-recovered activities are necessary and are provided in the most cost-effective manner;
     - (iv) the design and operation of cost recovery arrangements, including the treatment of small business;
     - (v) the review of cost recovery arrangements; and
     - (vi) where necessary, implementation strategies to improve current arrangements.
4. In reporting on matters in 3 above, the Commission should, where relevant, have regard to:
   - (a) implications of recent and emerging technologies; and
   - (b) legal constraints on the design and operation of cost recovery arrangements.

5. With respect to fees charged under the TPA, the Commission should have particular regard to:
   (a) those fees charged that restrict competition, or which impose costs or confer benefits on business; and
   (b) whether cost recovery arrangements that restrict competition should be retained in whole or part, taking into account whether the benefits to the community as a whole outweigh the costs, and whether the objectives of those arrangements can be achieved only by restricting competition.
6. In making its assessment of fees charged under the TPA:
   (a) the Commission is to have regard to environmental, welfare and equity considerations; economic and regional development; occupational health and safety; consistency between regulatory regimes and efficient regulatory administration; the interests of consumers generally; the competitiveness of business including small business; compliance costs and the paperwork burden on small business; and the efficient allocation of resources; and
   (b) the Commission should:
      (i) identify the rationale for fees charged under the TPA;
      (ii) clarify and assess the objectives of the fee arrangements;
      (iii) identify whether, and to what extent, the fee arrangements impose costs or confer benefits on business or restrict competition;
      (iv) identify any relevant alternatives to these fee arrangements;
      (v) analyse and, as far as reasonably practical, quantify the benefits, costs and overall effects of the arrangements and alternatives identified in (iv);
      (vi) identify the different groups likely to be affected by these arrangements and alternatives;
      (vii) list the individuals and groups consulted during the review and outline their views;
      (viii) determine a preferred option for the fee arrangements, if any; and
      (ix) examine mechanisms for increasing the overall efficiency, including minimising the compliance costs and paper burden on small business, of the arrangements and, where it differs, the preferred option.
7. The Commission should take account of any recent substantive studies relevant to the above issues.
8. In undertaking the review, the Commission is to advertise nationally, consult with key interest groups and affected parties, and produce a report.
9. The Government will consider the Commission's recommendations, and the Government's response will be announced as soon as possible after the receipt of the Commission's report.

ROD KEMP

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BOXES

FIGURES

TABLES

Abbreviations

ABA	Australian Broadcasting Authority
ABARE	Australian Bureau of Agricultural and Resource Economics
ABC	Activity based costing
ABS	Australian Bureau of Statistics
ACA	Australian Communications Authority
ACCC	Australian Competition and Consumer Commission
ACCI	Australian Chamber of Commerce and Industry
ACS	Australian Customs Service
ACSMA	Australian Chemical Specialties Manufacturers Association
AEC	Australian Electoral Commission
AFFA	Department of Agriculture, Fisheries and Forestry — Australia
AFGC	Australian Food and Grocery Council
AFMA	Australian Fisheries Management Authority
AGAL	Australian Government Analytical Laboratories
AGS	Australian Government Solicitor
AGSO	Australian Geological Survey Organisation
AMSA	Australian Maritime Safety Authority
ANAO	Australian National Audit Office
ANZFA	Australia New Zealand Food Authority
APMA	Australian Pharmaceutical Manufacturers Association
APMF	Australian Paint Manufacturers Federation
APRA	Australian Prudential Regulation Authority
AQIS	Australian Quarantine and Inspection Service
ARPANSA	Australian Radiation Protection and Nuclear Safety Agency
ARTG	Australian Register of Therapeutic Goods
ASA	Airservices Australia

ASFA	Association of Superannuation Funds of Australia
ASIC	Australian Securities and Investments Commission
ASIO	Australian Security Intelligence Organisation
ASMI	Australian Self Medication Industry
ATO	Australian Taxation Office
ATSB	Australian Transport Safety Bureau
AUSLIG	Australian Surveying and Land Information Group
AUSTRAC	Australian Transaction Reports and Analysis Centre
Austrade	Australian Trade Commission
BASI	Bureau of Air Safety Investigation
BoM	Bureau of Meteorology
BTR	Bureau of Tourism Research
CAC Act	*Commonwealth Authorities and Companies Act 1997*
CAPM	Capital asset pricing model
CASA	Civil Aviation Safety Authority
CCNCO	Commonwealth Competitive Neutrality Complaints Office
CER	Closer Economic Relations
CHC	Complementary Healthcare Council of Australia
CLERP	Corporate Law Economic Reform Program
COSBOA	Council of Small Business Organisations of Australia
CPA	Competition Principles Agreement
CRF	Consolidated Revenue Fund
CRIS	Cost Recovery Impact Statement
CSDC	Commonwealth Spatial Data Committee
CSIRO	Commonwealth Scientific and Industrial Research Organisation
CSO	Community Service Obligation
CTBTO	Comprehensive Test Ban Treaty Organisation
DCITA	Department of Communications, Information Technology and the Arts
DEH	Department of Environment and Heritage (Environment Australia)

DETYA	Department of Education, Training and Youth Affairs
DEWRSB	Department of Employment, Workplace Relations and Small Business
DFAT	Department of Foreign Affairs and Trade
DHAC	Department of Health and Aged Care
DIMA	Department of Immigration and Multicultural Affairs
DISR	Department of Industry, Science and Resources
DoF	Department of Finance (now DOFA)
DOFA	Department of Finance and Administration
DORC	Depreciated optimised replacement cost
DTRS	Department of Transport and Regional Services
EAC	Efficiency Audit Committee
ECCB	Exclusive Capturable Commercial Benefit
ERC	Expenditure Review Committee
ERIC	Environmental Research and Information Consortium Pty Ltd
FaCS	Department of Family and Community Services
FDA	Food and Drug Administration (USA)
FDC	Fully distributed cost
FMA Act	*Financial Management and Accountability Act 1997*
FTE	Full-time equivalent
GBE	Government Business Enterprise
GSV	Geological Survey of Victoria
IFSA	Investment and Financial Services Association
IGCC	Industry Government Consultative Committee
IPA	IP Australia
JCPAA	Joint Committee of Public Accounts and Audit
LRIC	Long run incremental cost
LRMC	Long run marginal cost
MIAA	Medical Industry Association of Australia
MOU	Memorandum of Understanding

NCC	National Competition Council
NICNAS	National Industrial Chemicals Notification and Assessment Scheme
NLA	National Library of Australia
NOHSC	National Occupational Health and Safety Commission
NRA	National Registration Authority for Agricultural and Veterinary Chemicals
NSC	National Standards Commission
NTGS	Northern Territory Geological Survey
OFLC	Office of Film and Literature Classification
OGTR	Office of the Gene Technology Regulator
OMB	Office of Management and Budget
ORR	Office of Regulation Review
PACIA	Plastics and Chemicals Industries Association
PBRO	Plant Breeders Rights Office
PBS	Portfolio Budget Statements
PC	Productivity Commission
PM&C	Department of Prime Minister and Cabinet
PSA	*Prices Surveillance Act 1983*
RAM	Royal Australian Mint
RBA	Reserve Bank of Australia
RIS	Regulatory Impact Statement
SLASO	Space Licensing and Safety Office
SMA	Spectrum Management Authority
SPS	Sanitary and Phyto-Sanitary
SRMC	Short run marginal cost
SSA	ScreenSound Australia
sub.	submission
TBT	Technical Barriers to Trade
TGA	Therapeutic Goods Administration

TICC	Therapeutic Goods Administration — Industry Consultative Committee
TPA	*Trade Practices Act 1974*
trans.	transcript
WACC	Weighted average cost of capital
WIPO	World Intellectual Property Organisation
WMO	World Meteorological Organisation
WTO	World Trade Organisation

Glossary

Accrual accounting	An accounting framework which recognises revenues and expenses in the accounting period in which they occur, irrespective of when cash is paid or received.
Agency capture	A situation which occurs when a private interest group has an inappropriate level of influence or control over a public agency.
Appropriation	An authorisation from Parliament to withdraw funds from the Consolidated Revenue Fund.
Avoidable costs	The costs that would be avoided if an output was no longer produced by an agency.
Beneficiary pays	The idea that those who benefit from the provision of a particular good or service should pay for it.
Benefit principle	A principle which suggests that economic efficiency would be improved by requiring people to contribute (through taxation) according to the value they place on the publicly provided goods and services they consume.
Benefit tax	A tax based on the benefit principle.
CAC Act	*Commonwealth Authorities and Companies Act 1997*, regulating the financial, ethical and reporting requirements of corporate public authorities with a separate legal existence outside the Commonwealth Public Service.
Cash accounting	An accounting framework which recognises revenues and expenses when payments are made or received.
Charge	The price or cost imposed. In this report it is used as a generic term to cover all cost recovery imposts, including both fees for service and taxes.

Community Service Obligation	A situation where the government requires a government business enterprise to engage in a non-commercial activity in order to meet a social objective.
Competitive neutrality	A policy principle which requires the prices charged by government businesses in actual or potential competition with the private sector to be adjusted to reflect the advantages and disadvantages of public ownership.
Compliance costs	The costs associated with abiding by a regulation or with paying a tax.
Core	That part of an agency's output which is essential to meeting its charter or policy directives.
Cost padding	The artificial inflation of costs, motivated by the knowledge that all costs can be recovered.
Cost recovery	A system of fees and specific purpose taxes used by government agencies to recoup some or all of the costs of particular government activities.
Cross subsidy	A situation where revenue from one activity is used to decrease the price of another activity.
Deadweight cost	The cost to society of distortions of production and consumption decisions.
Demand management	The implementation of a pricing policy designed to instil cost consciousness in consumers and to allow producers to gauge the demand for their products.
Deprival value	The value of an asset, measured in terms of the services or benefits provided by the asset which an agency would forgo it if were deprived of the asset.
Direct costs	Costs that can directly and unequivocally be attributed to an activity (for example, labour and materials).
Earmarking	The assignment of revenue received from a specific tax or taxes to the financing of a particular governmental activity.

Externality	A situation when a decision to produce or consume has positive or negative welfare consequences for those not party to the decision.
Fee for service	A direct charge for the provision of a good or service. As a general principle, a fee should bear a direct relationship with the cost of providing the good or service, or could be open to legal challenge as amounting to a tax.
Financial contagion	A process whereby the failure of one financial institution leads to the failure of others, through a loss of confidence by customers.
First mover disadvantage	The disadvantage associated with being the first to apply for an authorisation, licence or permit, when competitors can 'free ride' on the initial approval.
FMA Act	*Financial Management and Accountability Act 1997*, which provides a framework for the management of public money and property for Commonwealth bodies that financially are agents of the Commonwealth.
Free-rider	An individual or firm who derives benefits at no cost from a good or service being provided at a cost to someone else.
Fully distributed costing	An accounting framework whereby the value of all resources used or consumed in the provision of an output — including direct, indirect and capital costs — is used in the costing of that output.
Gold plating	The adoption of unnecessarily high standards or facilities.
Governance	Refers to the processes that direct, control and hold to account agencies.
Hypothecating	See 'Earmarking'.
Incidence	The ultimate distribution of a tax between producers and consumers.

Incremental costs	Increase in costs attributable to the production of a particular type of good or service (sometimes used as a proxy for the marginal cost of producing an additional unit of that good or service).
Indirect costs	Costs that are not directly attributable to an activity and are often referred to as overheads (for example, corporate services).
Information gap	A situation where there is insufficient or inadequate information about such matters as price, quality and availability for businesses, investors and consumers to make informed decisions.
Levy	A form of tax. It is often used to refer to a tax that is imposed on a specific industry or class of persons, rather than a tax of general application.
Marginal cost	Increase in costs attributable to the production of an additional unit of a good or service.
Market failure	A situation where the characteristics of a market are such that its unfettered operation will not lead to the most efficient outcome possible.
Moral hazard	A situation where the application of a regulation creates incentives to act in a way contrary to the objectives of the regulation.
Natural monopoly	A situation where it is more efficient for one firm to supply all of a market's needs than it would be for two or more firms to do so.
Net appropriation	Appropriations under section 31 of the FMA Act, allowing FMA agencies to, in effect, retain cost recovery revenue.
Non-core	See 'Core'.
Non-excludable	Describes a good or service which, once it is provided to one person, others cannot be prevented from consuming it also.
Non-rival	Describes a good or service for which consumption by one person will not diminish the amount available to others.

Private good	A good for which it is physically and economically feasible to identify and charge users (or beneficiaries) and to exclude non-purchasers. Therefore, if it is profitable to provide the good or service, the market will normally do so.
Public good	A good or service where provision for one person means the good or service is available to all people at no additional cost. Public goods are said to be non-rival and non-excludable. These goods are unlikely to be provided to a sufficient extent by the private market.
Regulated pays	The idea that those who, through their actions, create a risk that requires regulation, should pay for the cost of that regulation.
Regulatory creep	A situation where additional regulation is imposed without adequate scrutiny.
Section 20	See 'Special (standing) appropriation'.
Section 31	See 'Net appropriation'.
Special (standing) appropriation	An appropriation under section 20 of the FMA Act, under which components of the Consolidated Revenue Fund are set aside for specific purposes.
Spillover	See 'Externality'.
Tax	'A compulsory exaction of money by public authority for public purposes, enforceable by law, and is not a payment for services rendered'. There are specific Constitutional requirements for imposing taxes.
User charge	A charge for the provision of a specific good or service to an individual user, related to the quantity consumed.

Key messages

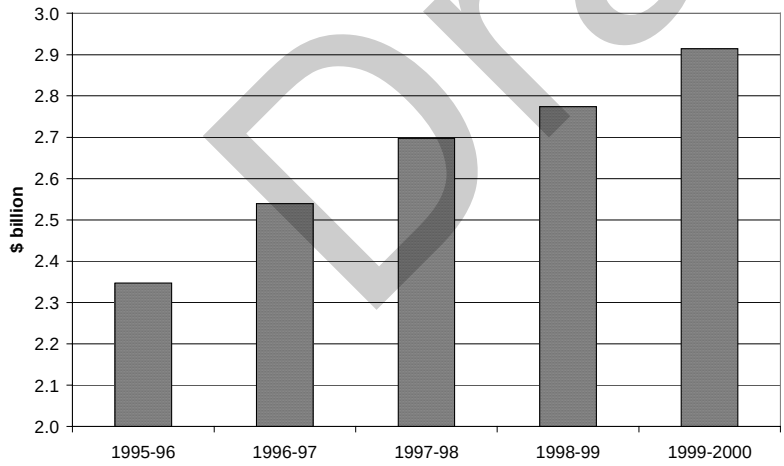
- The scale and scope of cost recovery by Commonwealth regulatory and information agencies have grown considerably in recent times:
  - almost all agencies recover some of their costs;
  - the proportion of costs recovered is increasing;
  - more than $3 billion was raised in 1999-2000; and
  - cost recovery revenue grew by 24 per cent in real terms over the past 5 years.
- Many users are dissatisfied with current cost recovery arrangements and point to the risk of regulatory creep, gold plating and cost padding.
- Despite their frequency, cost recovery arrangements generally lack the attributes of good policy:
  - most arrangements are *ad hoc*, lack transparency, have poor accountability and review mechanisms, and some have questionable legal grounding.
- Many aspects of current cost recovery arrangements are inconsistent with sound economic principles:
  - this has the potential to distort the allocation of resources in the economy and ultimately to reduce living standards.
- Current arrangements often create perverse financial incentives, particularly for the agencies, can reduce innovation and competition, and are on occasions incompatible with overarching government objectives.
- Well designed cost recovery arrangements, by contrast, can promote economic efficiency and equity, through:
  - instilling cost consciousness among agencies and users; and
  - ensuring that those who might impose costs on others or who benefit from government activities are made to pay.
- The Commission has proposed a detailed and integrated set of cost recovery guidelines with which to review existing arrangements and test new proposals:
  - if implemented, the new guidelines would enable all Commonwealth agencies to decide: (i) on the appropriateness of cost recovery for their activities; and (ii) on the best approach to implementation; and
  - those paying would have greater confidence in the reasonableness of specific cost recovery arrangements.

Overview

The scale and scope of cost recovery is increasing.

Regulatory and information agencies in the Commonwealth public sector are increasingly turning to cost recovery to fund their activities. New agencies are being created with a presumption in favour of cost recovery, and existing cost recovery arrangements have ratcheted upwards. Since the mid 1990s, cost recovery revenue has grown by 24 per cent in real terms (figure 1). The scale and scope has expanded to the point where the Commission estimates cost recovery revenues were over $3 billion in 1999-2000.

Figure 1 **Cost recovery revenue of Commonwealth regulatory and information agencies[a]**
(in 1999-2000 dollars)



[a] Cost recovery revenue for 1999-2000 is less than the $3.2 billion reported elsewhere due to the exclusion of agencies that did not report cost recovery revenues for each of the five years.

Cost recovery has important efficiency and equity implications but …

While such cost recovery is substantial in its own right, it has an importance beyond the dollars involved. Cost recovery can have a significant impact on both actual and potential users of regulatory and information agencies. It can have both positive and negative influences on the way government

agencies operate. There is also the issue of equity between those who pay and those who do not.

… it lacks a good policy framework.

Notwithstanding its increased significance, cost recovery currently lacks the attributes of good policy — clear rationale, accountability, transparency, performance assessment and review. Participants indicated that this is an important and timely review.

What is cost recovery?

Cost recovery involves a link between the charge and the service provided.

Cost recovery differs from general taxation. General taxation raises revenue to fund a wide range of government activities, with no direct link between the source of the tax and the expenditure of the revenue raised. Cost recovery, on the other hand, is the recovery by government of some or all of the costs of a particular activity. Examples of cost recovered activities include the provision of some statistical information by the Australian Bureau of Statistics (ABS), the mandatory assessment of new drugs by the Therapeutic Goods Administration (TGA) and the provision of aviation safety services by the Civil Aviation Safety Authority (CASA).

Cost recovery involves fees for service and taxes earmarked to a particular activity or agency.

The most direct forms of cost recovery are where particular users are charged a fee based on the cost of providing the government good or service they consume. Less direct forms of cost recovery include special levies or earmarked taxes to fund a specific government activity. The link between the revenue raised and the funding of a specific activity distinguishes cost recovery from general taxation (box 1). The fact that cost recovery is not (usually) performed on a commercial basis — that is, with a view to generating a profit — distinguishes cost recovery from the pricing objectives of government business enterprises.

Box 1 **Charges, taxes, levies and fees**

These terms are often used interchangeably in the discussion of cost recovery. However, they can have quite distinct legal meanings. They are used in this report in accordance with the following definitions.

Charges is a generic term covering all cost recovery arrangements.

Taxes are defined as 'a compulsory exaction of money by public authority for public purposes, enforceable by law, and is not a payment for services rendered'. There are specific Constitutional requirements for imposing taxes. Many cost recovery charges are legally taxes.

Levies are a form of tax. The term is often used to refer to a tax that is imposed on a specific industry or class of persons, rather than a tax of general application. Many cost recovery arrangements imposed as taxes are labelled as 'levies'.

Fees for service are direct charges for the provision of a service. The general principles are that fees must reflect the actual costs of a service provided; the service must be rendered to, or at the request of, the party paying the account; and the charge must be 'proportionate' to the cost of the service rendered. If these principles are not met, a purported fee for service may actually amount to a tax, and legislation imposing the fee could be open to Constitutional challenge.

Background to inquiry

The rationale for existing cost recovery arrangements is not always clear.

Many Commonwealth regulatory and information agencies use charges to recover some of their costs, and some have been doing so for a long time. For example, the Civil Aviation Safety Authority has been recovering the costs of aviation safety regulation since 1956. Despite this, there has been a lack of clear policy guidelines governing the implementation of cost recovery. In practice, the rationale for charging arrangements is not always apparent. Nor is it always clear why some agencies recover costs while comparable agencies do not. Some charges appear to be arbitrary or accidents of history. Faced with a policy (and legislative) vacuum, agencies have often been left to fend for themselves, relying on outdated and inadequate Department of Finance and Administration (DOFA) publications, *ad hoc* reviews and consultants' advice, for guidance.

Agencies have been operating in a policy vacuum.

Cost recovery has its critics.

Not surprisingly, cost recovery has its critics. While the views of industry vary considerably, there is a general

perception that cost recovery charges are not always warranted or are too high (box 2).

Box 2 Selected industry views on cost recovery

While [recognising] the difficulty of defining and identifying, in a practical cost sense, the extent of public good of regulation, it should be acknowledged that virtually every area of regulatory activity provides some public benefit. Therefore, it is inappropriate for the costs involved to be totally recovered from the private sector. (Australian Chamber of Commerce and Industry, sub. 70, p. 28)

TGA's fees and charges, being the highest in the world as a result of the Government's 100 per cent cost recovery policy, are unacceptable because we believe:

- they are a barrier to trade;
- they potentially stifle competition;
- they create undue burden on start-up companies; and
- they prevent the public from access to medical devices and higher quality health care. (Cochlear Ltd, sub. 49, p. 10)

As a small business, we believe ABS charges for computer data are irrational and excessive. These excessive charges result in very low levels of use ... Innovation and competition are strongly discouraged … High prices will deter many potential users with genuine needs for data, so that sales reflect only a small part of the demand. Users often cannot judge the relevance of ABS data to their real needs without making explorations. Specific data may be of considerable commercial value to a few users, but also be relevant to many members of the community. (Cumpston Sargeant, sub. 77, pp. 1–2)

Government bodies employing the 'cost recovery principle' are, in effect, pursuing a monopoly pricing policy. Their operations are not subject to competition and the fees and charges they raise are therefore determined almost solely by the bureaucrats who run the organisations. The policy is invariably to maximise revenue. Initially the income stream may be directed towards meeting the basic costs of the operation but very soon is seen by the bureaucrats as a way of extending the organisation's operations. Each such extension may be justified as advancing the objectives of the legislation. But, as the department operates as a monopoly, these decisions do not have to stand the test of competitive scrutiny. (Australian Paint Manufacturers Federation, sub. 74, p. 4)

The policy of full cost recovery fails to recognise public good benefits provided by regulation. The full benefit flows through to the wider community … The benefit is not confined to the company, so therefore we believe that the company should not pay the full bill of compliance. (Plastics and Chemicals Action Agenda, trans., p. 156)

The Commission was asked to review the issues and develop guidelines.

Against this background, the Government asked the Commission to undertake a review of the nature and extent of cost recovery arrangements by Commonwealth agencies. The Terms of Reference have three main parts:

- a review of existing cost recovery arrangements by regulatory, administrative and information agencies;
- the development of cost recovery guidelines on how and where cost recovery should apply; and
- a review of cost recovery arrangements under the *Trade Practices Act (1974*), as part of the Legislative Review required by the Competition Principles Agreement.

There is a distinction between regulatory and information agencies.

While the inquiry covers regulatory, administrative and information agencies, in practice all agencies in the Commonwealth public sector are administrative in one sense or another, and hence the more useful distinction is between regulatory and information agencies. Thus 'regulatory agency' is a term that can encompass all agencies that administer regulations. 'Information agency' is a term that the Commission uses to describe agencies whose prime purpose is the collection, compilation and dissemination of information.

The Commission surveyed many agencies.

Unfortunately, little information is published directly by regulatory and information agencies, or through budget documents, on this important area of government activity. Cost recovered revenues often are not distinguishable from other revenues. To meet its requirement to report on the nature and extent of cost recovery by regulatory and information agencies in the Commonwealth public sector the Commission surveyed 127 agencies.

Better information on cost recovery needs to be made available.

While this inquiry is a one-off exercise, the proper scrutiny of cost recovery requires that better information be available to users and government on an ongoing basis. The Commission has made various draft recommendations to address these needs.

Cost recovery in practice

There is a wide range of cost recovery arrangements.

The information the Commission received has revealed a wide range of cost recovery practices. Some regulatory agencies recover little or none of their costs, others recover the costs of some activities and not others, and some are recovering all of their costs (table 1).

Table 1 **Cost recovery in selected regulatory agencies, 1999-2000**

Agency	*Cost recovery revenue*	*Cost recovery/ total expenses*
	$m	%
Aust. Communications Authority	54.2	110.6
Aust. Maritime Safety Authority	52.4	69.8
Aust. and NZ Food Authority	0.8	6.1
Aust. Prudential Reg. Authority	88.3	150.2
Aust. Quarantine Inspection Service	136.7	76.7
Aust. Securities and Investments Com.	361.0	249.3
Civil Aviation Safety Authority	59.8	71.4
National Industrial Chemicals Notification and Assessment Scheme	3.7	99.3
National Registration Authority for Agricultural and Veterinary Chemicals	17.6	108.6
Therapeutic Goods Administration	41.4	84.5

Some regulatory agencies recover substantially more than their own costs.

Given that actual cost recovered revenues may fluctuate from year to year, some agencies may under or over collect in any given year. For example, the TGA has a cost recovery target of 100 per cent of agency expenses, but in 1999-2000 it recovered only 84.5 per cent of expenses. In other cases, agencies are recovering significantly more than their own costs (for example, the Australian Prudential Regulatory Authority (APRA) and the Australian Securities and Investments Commission (ASIC)). The additional revenue may be used to fund affiliated services (APRA transfers some funds to the Australian Tax Office for administering small superannuation funds) or in the case of ASIC, to make compensation payments to the States.

Information agencies tend to supply most or all of their core services free of charge.

Information agencies generally recover small proportions of their total costs (table 2). Typically, information agencies distinguish between core services, which are mostly funded through general appropriations, and non-core services which may be cost recovered.

Table 2 **Cost recovery in selected information agencies 1999-2000**

Agency	*Cost recovery revenue*	*Cost recovery/ total expenses*
	$m	%
Aust. Bureau of Agricultural and Resource Economics	11.2	50.9
Aust. Bureau of Statistics	21.5	8.4
Aust. Geological Survey Organisation	12.1	16.5
Aust. Surveying and Land Information Group	4.7	14.2
Bureau of Meteorology	35.2	17.3
National Library of Australia	8.6	16.9
ScreenSound Australia	1.7	3.6

Cost recovery targets are currently imposed on some agencies.

Some agencies have discretion as to the level of charges imposed, while others do not. Information agencies, on the whole, have considerable latitude over their fees, though constrained by international agreements in some cases. Nonetheless, some information agencies have had cost recovery targets imposed on them, as do many important regulatory agencies. Generally speaking, information agencies have lower targets (for example, the Australian Geological Survey Organisation has a 30 per cent target) than regulatory agencies (for example, TGA and APRA have 100 per cent targets).

Regulatory charges may be fees or taxes. Information agencies use fees.

Regulatory agencies employ a wide variety of fees for service and earmarked taxes (including levies) to recover their costs. On the other hand, information agencies that cost recover do so exclusively by way of fees (for goods and services, or for access).

There is some uncertainty about the legal basis for some cost recovery charges.

The legal foundation for cost recovery varies, and there is some uncertainty about the legal standing of some cost recovery charges. Under the Constitution, taxes (often described as levies) require explicit and stand alone legislative backing; fees for service generally do not. Under certain circumstances — for example, where charges are not directly related to the costs of providing a service to a particular user — fees may be subject to challenge as inappropriately amounting to taxation.

Why agencies recover costs

Agencies recover costs for a variety of reasons, but ...

The lack of a coherent policy governing cost recovery, and the different circumstances in which agencies operate, are reflected in the diverse range of rationales mentioned by agencies in response to the Commission's questionnaire. These included:

- increasing efficiency;
- managing demand;
- expediting approval processes;
- raising agency revenue;
- expanding the volume and/or range of services;
- addressing equity or distributional issues;
- conforming with international agreements; and
- abiding by competitive neutrality requirements.

… these are not always explicit.

Some agencies also provided explicit rationales for not recovering the cost of certain activities. Conversely, many agencies did not provide any rationale for their arrangements beyond attributing the introduction or existence of them to government policy or administrative decisions.

In general, rationales were more clearly articulated by information agencies than regulatory agencies.

Why have cost recovery?

Cost recovery can affect the way resources are used in the economy.

Cost recovery can provide an important means of improving the efficiency with which government services are produced and consumed. Charging for goods and services consumed can give users or their customers important messages about the costs of the resources involved. Cost recovery charges are also of value on the supply side. By recovering some or all of the costs of services, government agencies can more easily adjust their outputs to meet genuine demand.

Its effects may be more pronounced where consumption is discretionary.

The degree to which users of government services respond to price signals will vary according to how much discretion they have about paying cost recovery charges. The customers of information agencies can generally choose whether to use a service or not, and how much to consume. Regulated firms may also have some discretion in the amount of cost recovery charges they incur; for example, where charges are related to output. But in the case of pre market regulation, firms basically only have a binary choice: to participate in the market and be regulated, or to decline to participate. They cannot choose how much regulation to consume at this stage. Charging for regulatory services can have impacts on resource flows in the economy by altering industry costs and hence influencing industry size.

There are two main approaches to cost recovery by regulatory agencies: beneficiary pays and regulated pays.

There are two ways of approaching cost recovery for regulatory services which stem from the primary objective of the regulation. If the regulation is intended for the purpose of providing benefits to users of the regulated products (for example, by providing information or product assurance), a 'beneficiary pays' approach may be appropriate. If the prime objective of the regulation is to minimise the detrimental effects of external spillovers — for example, by preventing environmental damage — a 'regulated pays' (a broader concept than 'polluter pays') approach may be more appropriate.

Beneficiary pays is based on the notion of the customers of regulated firms being the main beneficiaries, while …

The 'beneficiary pays' principle has both efficiency and equity dimensions. It encourages those who benefit to recognise that there are resource costs involved. The beneficiary pays principle covers most regulatory activities addressing product safety or assurance issues, and the discretionary consumption of information services. Regulated firms are not normally thought of as the major beneficiaries of regulation, although they may benefit from regulatory endorsement of their products.

The beneficiary pays approach would normally target the users of regulated products, not the suppliers. However, this approach would often be impractical. Charging regulated firms may be a more cost effective option, if they are able to pass on some or all of the costs. In this case, beneficiaries

would still ultimately pay. Alternatively, where it is impractical to charge the regulated firms, there may be a case for taxpayer funding of the regulatory activity.

… regulated pays is based on negative spillover effects.

The existence of spillover effects can have an influence on the way cost recovery is implemented and who is charged. Where regulations are directed at reducing negative spillovers there is a case for charging the regulated firms for the costs of administering such regulations, again provided that charging is cost effective.

Cost recovery for information agencies should be limited to non-core services.

The arguments for cost recovery by information agencies rest on the extent to which there are private benefits. Core activities comprise those information services with a high degree of 'public good' characteristics and those which the Government defines as having broad community benefits. In these cases, cost recovery is inappropriate. Cost recovery is only relevant to non-core activities. These are often by-products of core activities. Non-core activities need to be consistent with the agency's charter, without crowding out private market development.

Cost recovery may be more efficient than raising the general level of taxation.

To the extent that cost recovery reduces the call on general taxation revenue, efficiency losses from higher general taxation are avoided. However, if cost recovery is not linked to the supply of a particular activity and is undertaken merely to raise revenue, it may have even more adverse efficiency effects than budget funding.

Operational principles for cost recovery

Cost recovery should:

From the considerations outlined above, several operational principles for cost recovery emerge.

… apply to activities not agencies;

Cost recovery arrangements should apply to specific activities, not to the agency that provides them. This is because benefits are more easily linked to an activity than an agency. This implies that the practice of requiring agencies to recover a specific proportion of their total costs ('targets') should be discontinued. Targets can create perverse incentives, such as information agencies losing sight of their

core activities, and regulatory agencies focusing on new ways to extend their revenue raising activities.

… not be used to finance other government activities;

'Over-recovery', where an agency is required to recover more than its costs for a particular activity, in order to fund other Government commitments, is a particularly inappropriate type of revenue target.

… or activities undertaken for Government.

Cost recovered activities should not include activities undertaken for the Government such as policy development, ministerial or parliamentary services, and complying with international obligations. These public interest duties would be undertaken even in the absence of the regulation.

It should avoid building in cross subsidies between user groups.

Cross subsidisation in the provision of cost recovery activities should be avoided because it undermines efficiency. An exception may be made where an industry levy is used to fund activities that benefit the industry as a whole (or its customers), and it is impractical or inconsistent with policy objectives to charge individual firms.

There are further reasons not to implement cost recovery.

The operational principles above notwithstanding, there may be further reasons why agencies should not charge for some activities. For instance, cost recovery might not be warranted where:

- it is not cost effective to do so;
- it would be inconsistent with (or compromise) regulatory or policy objectives (for example, charging firms directly for product recalls or for safety information); or
- it would stifle industry innovation and development (for example, where a lack of intellectual property rights or lack of an established industry creates substantial free rider or 'first mover' problems for users).

Cost recovery principles are lacking for regulatory agencies …

Existing cost recovery arrangements of Commonwealth regulatory and information agencies do not always embody these principles. For example, regulatory agencies have not, as a group, been consistent in identifying which activities should be cost recovered and who should pay.

The Commission has found that information agencies have, on the whole, developed structured objectives for their cost

recovery arrangements, with most agencies tying their cost recovery arrangements to the mission or objectives of the agency itself and through the distinction between core and non-core activities and products.

… and imperfectly applied by information agencies.

However, there is an inherent tension between cost recovery, and the basic objective of information agencies in providing information. This tension requires thorough consideration of objectives and priorities. In particular, information agencies should carefully define the boundaries of their core data collection, analysis and dissemination activities. This should be a dynamic process, with requests for new information services tested for consistency with the agencies' public policy objectives, and existing activities regularly reviewed.

Core information services should be free of charge, and non-core services should be priced at incremental cost.

Once information agencies define their core activities, these sould be provided free of charge. Non-core activities should be charged at incremental cost or, where relevant, at prices in keeping with competitive neutrality principles. Charges for non-core services should not attempt to claw back the costs of undertaking the core services for which these agencies were originally established.

Impact on agencies

Agencies face mixed incentives.

Cost recovery can create both positive and negative incentives for the agencies involved, and this has important implications both for the feasibility of introducing cost recovery, and for the appropriate design of cost recovery arrangements.

Efficiency may be encouraged, but budget scrutiny weakened.

Cost recovery can increase agency efficiency through instilling cost consciousness and promoting demand responsiveness. But it can also weaken government scrutiny through normal budget processes. To the extent that agencies become in effect self-funding, there is less incentive for their respective portfolios and expenditure review processes to subject them to close scrutiny.

Regulatory creep, gold plating and cost padding are risks.

According to a number of participants, cost recovery has impaired agency efficiency by leading to regulatory creep, gold plating and/or cost padding. These can occur where cost

recovery revenues are earmarked to the agency and when the agency is a monopolist (as is the case for most regulatory agencies). Further, cost recovery can lead agencies to exceed the optimal level of regulation or shun non-cost recoverable activities.

The budget framework is important.

The way cost recovered revenues are treated in the budget framework can have important effects on agency incentives. Under the Constitution, all money raised through cost recovery must be credited to the Commonwealth's Consolidated Revenue Fund, and all agencies and departments funded through appropriations. In practice, however, mechanisms have been developed that can 'earmark' cost recovery revenues to the particular agencies. The most common are Net Appropriation Agreements (that is, section 31 agreements under the *Financial Management and Accountability Act 1997*).

Accountability for performance is imperative.

The Commission considers that, generally, it is not appropriate for regulatory agencies to have what is, in effect, automatic access to cost recovery revenues, independent of adequate budgetary and parliamentary scrutiny. Where cost recovery is justified on economic grounds, it is also imperative that external systems are implemented to shore up accountability and to encourage agency efficiency. Several instruments are available for this purpose, such as DOFA output pricing reviews, and internal or external (Australian National Audit Office) performance audits. These might be supported by the imposition of 'efficiency dividends', price monitoring, benchmarking, mutual recognition, and market testing.

Better governance …

Cost recovery should be subject to the same public administration principles as apply to all government activity. Governance arrangements are important in encouraging agencies to adopt these principles and fulfil their obligation to deliver efficiently produced services.

… should include industry consultation.

Some industries have made strong claims for a greater say in the operation of these agencies, invoking a 'user pays, user says' argument. While this creates a risk of undue influence or 'agency capture', a degree of industry consultation is necessary to help drive agency efficiency. Those expected

(or required) to pay have a clear interest in the costs, efficiency and quality standards of activities, and this interest should be harnessed.

The Commission has made some suggestions for improving existing consultative arrangements and requested comment on the desirability of alternative vehicles such as Efficiency Audit Committees (EACs). These agency-specific committees would investigate efficiency related matters with a focus on cost recovery, and would include industry and consumer representatives. They would undertake regular reviews of agency efficiency, including cost recovery arrangements, and report directly to the relevant Minister.

Impacts on users

Even where agencies are operating efficiently and, in the case of regulatory agencies, the regulation is appropriate, cost recovery may have other impacts on users.

Cost recovery can help information agencies to respond to users.

For information agencies, cost recovery may make agencies more responsive to market demands; it has often made possible some services that would not otherwise have been undertaken. In this way it can extend the non-core activities of the agency in accordance with private benefits. Adapting ABS surveys or tailoring meteorological services for the needs of particular users are examples. If not sensibly applied, however, cost recovery could significantly restrict access to information.

Distinguishing impacts of cost recovery from impacts of regulations is difficult …

In the case of regulatory agencies it is often difficult to distinguish the impact of cost recovery on users from that of the regulations themselves, or from market conditions. Nonetheless, participants have expressed concerns about the effects of cost recovery on industries, firms and consumers.

… but in some cases it may be creating barriers to entry …

In some cases, cost recovery charges may act as barriers to the entry of new firms or new products. This may be because of 'free rider' problems created by the lack of property rights over regulated products. This is mainly relevant in the case of pre market regulation. For example, charging could discourage firms from applying for variations in food

standards that would also benefit all other subsequent suppliers. Alternative approaches might need to be considered: either a levy on all firms which stand to benefit; or where this is not cost effective, general budget funding.

… and innovation.

Even where the absence of property rights is not an inhibiting factor, the level of cost recovery may prevent or discourage entry of firms into markets. Cost recovery arrangements also have the potential to impede entry of new, more technologically advanced products into the market. The difficulty in assessing these impacts is in not knowing what might have happened in the absence of cost recovery. The possible impacts of cost recovery must also be weighed against other factors such as high compliance costs and small market size.

Small businesses receive some concessions.

The design of cost recovery arrangements can have particular effects on small business. For example, a flat fee may have a greater impact on a small firm than a levy based on turnover or sales. Some agencies have introduced sliding fee scales and, in some cases, exemptions for very small firms or products with low levels of demand. However, when fees are uncoupled from the underlying cost structures, efficiency will be compromised.

Most impacts on consumers are indirect.

On the whole, few consumers pay cost recovery charges directly. Most of the impact on consumers occurs indirectly, through firms passing on cost recovery fees and charges to their customers. In practice, this means that cost recovery charges are usually borne jointly by the firm and its customers, depending on the competitive circumstances.

Cost recovery under the *Trade Practices Act 1974*

The inquiry includes a review of cost recovery under the TPA.

The inquiry incorporates a review of fees charged under the *Trade Practices Act 1974* (TPA). This review stems from the Government's commitment under the Competition Principles Agreement (CPA) to review legislation that restricts competition. This aspect of the inquiry attracted very little attention from participants.

Charges under the TPA …

Under the TPA, fees are charged by the Australian Competition and Consumer Commission (ACCC) for arbitration functions, discretionary services such as publications, various applications including applications for authorisations and notifications and those relating to conference agreements made by international shippers, and copying of documents.

… are relatively small.

The ACCC collected around $1.2 million in charges under the TPA in 1999-2000. This was around two per cent of the ACCC's total operating revenue of $58.4 million. Around half of this revenue was earned from charging for discretionary services such as conducting workshops, seminars, training and providing information. Revenue from discretionary activities is earmarked for the ACCC's use, while non-discretionary revenue collected under the TPA is transferred into the Consolidated Revenue Fund.

Some charges are set at the lowest expected costs.

The ACCC only recovers the lowest expected cost of providing arbitrations, applications, notices and copies of documents. This policy is designed to minimise the possibility of these charges being legally interpreted as taxes. Because of this explicit 'lowest cost' policy, and because it does not retain its non-discretionary revenue, the ACCC does not face incentives to expand this segment of its cost recovered activities.

The ACCC's charges nevertheless appear to perform a useful role.

The Commission has concluded that the cost recovery fees charged by the ACCC under the TPA may play a useful role in discouraging unwarranted applications. The fees do not otherwise appear to have a significant impact on business or competition. In support of this, the Commission notes that the fees associated with the ACCC's regulatory functions (arbitrations, authorisations, etc) appear to be very small compared with the overall costs of compliance.

Guidelines

The Terms of Reference of this inquiry ask the Commission to report on appropriate guidelines for cost recovery. The

evidence and analysis available to the Commission support the need for such guidelines to fill the current policy vacuum.

The Commission has produced guidelines …

Accordingly, the Commission has produced decision trees to assist departments and agencies in identifying those activities where cost recovery is appropriate, and in determining the best arrangements for its implementation.

… for Commonwealth regulatory and information agencies.

The guidelines are intended to guide cost recovery in Commonwealth regulatory and information agencies. While the principles may have broader application, they were not written with the intention of being applied to government business enterprises or infrastructure services provided by government.

The Commission's guidelines provide a detailed framework for the design, implementation and review of cost recovery arrangements.

The guidelines ask a number of questions:

The guidelines allow for differences in the issues that need to be addressed by regulatory and information agencies. Nonetheless, they put forward a common set of questions that should be asked by any agency considering cost recovery. They are:

- whether or not the benefits of the government activity or regulation are captured directly by the organisation charged, or by its customers; *Who benefits?*
- whether or not it is technically feasible to charge the main beneficiaries of the government activity or service. This requires either that the beneficiaries can be billed directly (for example, purchasers of information products) or that regulated firms can pass on some or all of the costs to the main beneficiaries (usually the consumers of the product or service); *Can the beneficiaries be charged?*
- whether a regulatory activity is part of minimising an actual or potential negative effect on third parties (spillovers); and *Are there any spillovers?*
- whether cost recovery is compatible with the primary objectives of the government activity or regulation, and with overarching principles such as equity. *Is cost recovery compatible with wider objectives?*

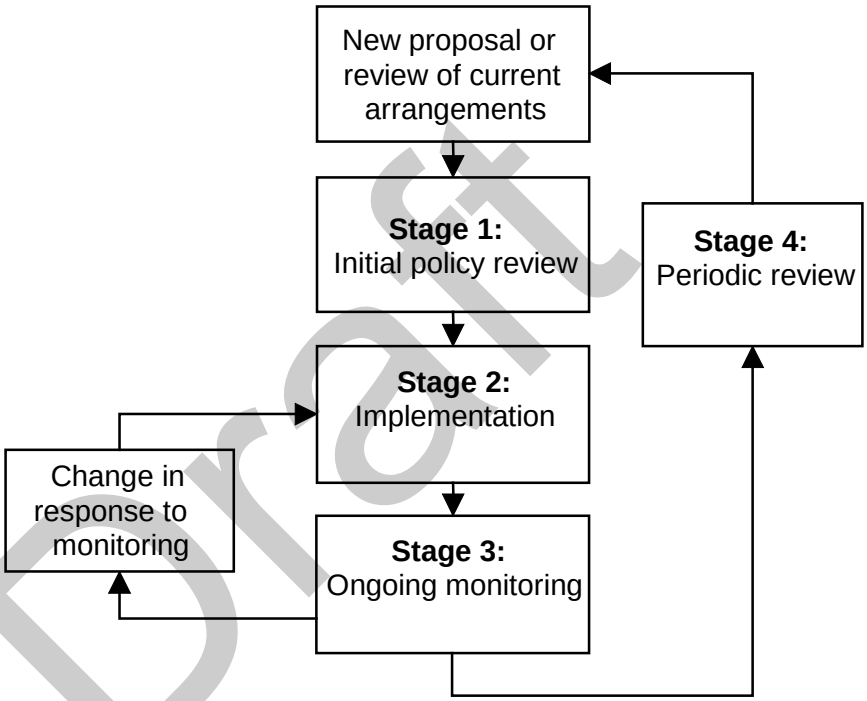
Governance arrangements are important.

In addition, sound governance arrangements should be in place to limit the potential for cost recovery to compromise the independence, efficiency and efficacy of the government agency.

There are four stages in the process.

These issues form an integral part of the four stages of the proposed cost recovery 'life cycle'(figure 2).

Figure 2 **Processes for assessing cost recovery**



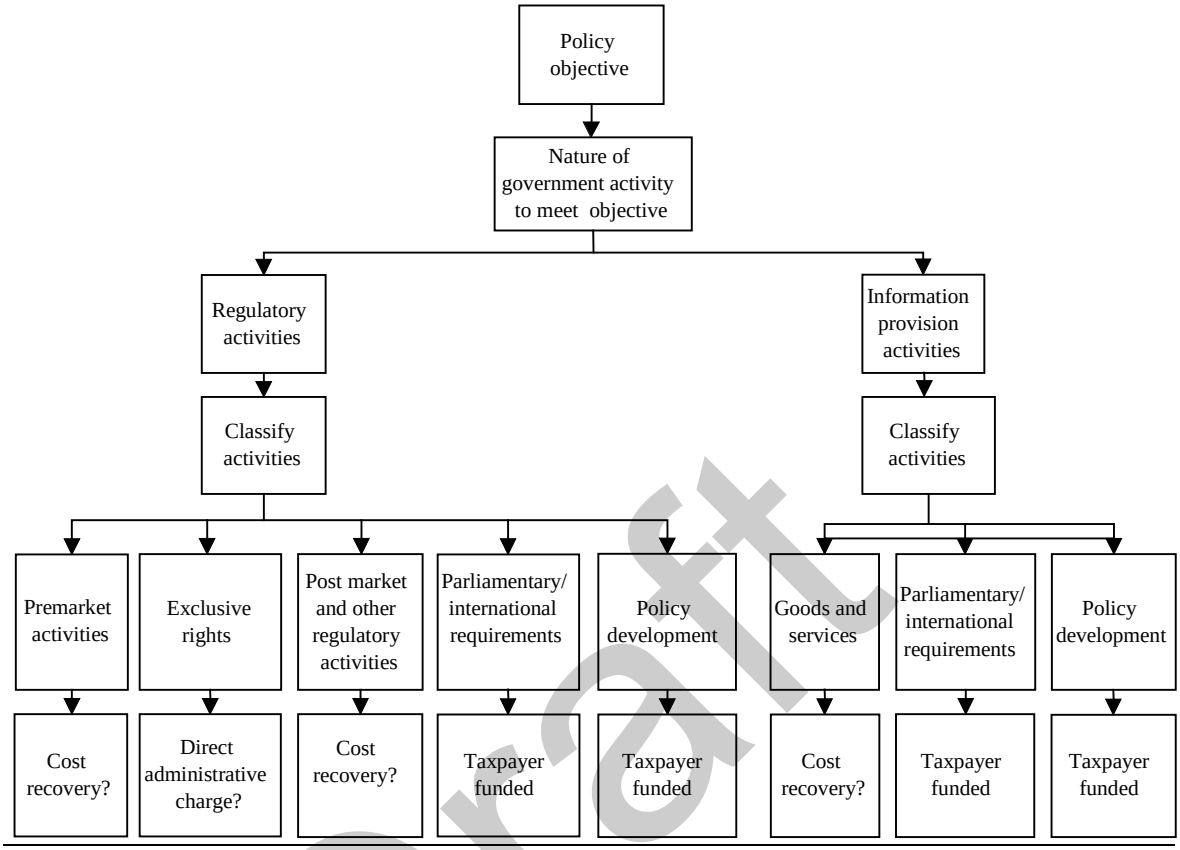
Agencies need to identify the nature of their activities accurately…

An important part of the cost recovery process lies in agencies accurately classifying the types of activity which they seek to cost recover. While obvious differences exist between the outputs of regulatory and information agencies, agencies need to distinguish their activities further, on the basis of several criteria. The preliminary classification of activities is summarised in figure 3.

… if cost recovery is to be warranted in principle and in practice.

If, based on these preliminary tests, it is decided that cost recovery may be appropriate, further steps are necessary, including estimating the relevant costs and identifying which parties to charge. More details of the process are provided in the report.

Figure 3 **Classification of activities**



Some implementation issues

The Commission has produced guidelines for cost recovery which, when this inquiry is finalised, will be submitted to the Government for its consideration. As an important first step, the Government should then release a set of endorsed guidelines outlining the principles for cost recovery. A second step would be the further enhancement of the guidelines and their integration with existing financial and regulatory processes.

The Government should move quickly to release an endorsed set of guidelines …

The prompt release of endorsed guidelines would enable the Government to move quickly into the review of existing cost recovery arrangements. It would also give it a framework for assessing new cost recovery proposals. The review of existing arrangements would be a substantial task but should be completed within five years. This would require that the Government develop a schedule of reviews.

… and review existing cost recovery arrangements in the next five years.

These should involve stakeholder consultation, independent scrutiny and transparent processes.

The reviews would result in the production of either an enhanced Regulatory Impact Statement (RIS) or a Cost Recovery Impact Statement (CRIS). These would involve stakeholder consultation, be subject to independent scrutiny, and be conducted as transparently as possible. Such statements would not be costless, however. To achieve net benefits from the process it would be necessary to limit their application to the more substantial arrangements.

Better methods for monitoring cost recovery are needed.

Ongoing monitoring of cost recovery also needs to be improved. This requires that cost recovery revenue should be identified separately and reported in portfolio budget statements and agency annual reports.

How would our proposals affect the community?

Benefits of:

In the Commission's view, the effective implementation of its proposed guidelines for cost recovery would produce tangible benefits for Australian industry and the community.

… efficiency;

It would improve economic efficiency through the direct linkage of costs and activities, and through the removal of undesirable incentives on agencies.

… rigour;

It would provide a clear and consistent framework within which to review and implement cost recovery, thus reducing the risk of inappropriate practices.

… transparency;

It would promote greater transparency and accountability of cost recovery objectives and processes.

… and confidence should follow.

Those paying cost recovery charges would have greater confidence in the basis on which costs are recovered, the charges they are paying, and the reasonableness of the cost base from which charges are derived.

Draft recommendations, findings and information requests

Draft recommendations and findings

Chapter 3 Legal and fiscal framework

DRAFT RECOMMENDATION 3.1

All cost recovery arrangements should have appropriate and clear legal authority. Agencies, with advice from their legal counsels, should identify the most appropriate authority for their charges, and ensure that fees for service are not vulnerable to challenge as amounting to taxation.

FINDING

There is a lack of transparency and accountability in current cost recovery arrangements. It is difficult to identify from existing sources the level of cost recovery by Commonwealth regulatory and information agencies. Publicly available data are incomplete and inconsistent, and the Department of Finance and Administration is unable to identify cost recovery receipts separately from other revenue.

Moreover, at the individual agency level, it is difficult to establish the objectives, costing and revenue raising of many cost recovery arrangements.

DRAFT RECOMMENDATION 3.2

Revenue from the Commonwealth's cost recovery arrangements should be identified separately in budget documentation and in the Consolidated Financial Statements. It should also be identified separately in each agency's Annual Report and in Portfolio Budget Statements.

FINDING

The absence of current cost recovery guidelines has led agencies to rely on outdated publications such as the 'Guidelines for Costing of Government Activities'(DOF 1991), ad hoc reviews and consultants' advice.

FINDING

The Regulatory Impact Statement (RIS) is a valuable tool for assessing proposed regulation, but has not dealt directly with many cost recovery proposals.

DRAFT RECOMMENDATION 3.3

The Regulatory Impact Statement (RIS) process should be clarified to make it explicit that, where a regulation under review includes a cost recovery element, the RIS should address cost recovery by applying the guidelines proposed by this inquiry.

DRAFT RECOMMENDATION 3.4

A Cost Recovery Impact Statement (CRIS) process should be developed for application to all significant cost recovery proposals or amendments to existing cost recovery arrangements not covered by an enhanced Regulatory Impact Statement (RIS).

FINDING

International obligations can constrain the ability of some Commonwealth agencies to set cost recovery charges because:

- *specific international agreements set fees for certain services (or require some services to be free); and*
- *harmonisation and mutual recognition of assessments can lead to price competition in regulation.*

Chapter 4 Current cost recovery arrangements

FINDING

There is no clear, current Government policy on cost recovery. This has contributed to inconsistency in many aspects of cost recovery within and across agencies and portfolios.

FINDING

The rationales for cost recovery for most information agencies are better developed and articulated than those for regulatory agencies.

DRAFT RECOMMENDATION 4.1

The Commonwealth Government should adopt a formal cost recovery policy for regulatory and information agencies. This policy should implement the cost recovery guidelines recommended by this inquiry.

FINDING

Cost recovery arrangements exist, to some extent, in most Commonwealth regulatory and information agencies. However, there is little consistency in the application of these arrangements. Generally:

- *there is no uniform approach as to which activities are subject to cost recovery; and*
- *there are wide variations in the proportion of costs recovered for comparable activities undertaken by different agencies.*

Chapter 5 Effects of cost recovery on agencies

FINDING

It is generally not appropriate for regulatory agencies to have, in effect, automatic access to cost recovery revenues for regulatory activities without proper budgetary and parliamentary scrutiny.

DRAFT RECOMMENDATION 5.1

As a general rule, the funding of cost recovered regulatory activities should be subject to the same budgetary and parliamentary oversight as budget funded government activities.

FINDING

Improving agency efficiency can reduce the cost burden on those subject to cost recovery and taxpayers alike. Mechanisms such as efficiency dividends, benchmarking, market testing and third party competition can help drive agency efficiency. Harmonisation of standards and mutual recognition can also encourage regulatory agency efficiency by improving contestability of assessment and approval processes.

DRAFT RECOMMENDATION 5.2

The Government should address the effectiveness of the existing performance review processes and the need for a more performance based efficiency audit approach based on stakeholder consultation.

Chapter 6 Economic effects

DRAFT RECOMMENDATION 6.1

Cost recovery arrangements which are not justified on grounds of economic efficiency should not be undertaken merely to raise revenue for government activities.

FINDING

Some agencies have been required to meet cost recovery targets on a whole of agency basis. This has led to agencies inappropriately recovering costs for activities such as policy development, ministerial or parliamentary services and international obligations.

DRAFT RECOMMENDATION 6.2

As a general principle, cost recovery arrangements should apply to specific activities, not to the agency which provides them.

DRAFT RECOMMENDATION 6.3

The practice of setting targets that require agencies to recover a specific proportion of their total costs should be discontinued.

DRAFT RECOMMENDATION 6.4

Cost recovery arrangements should not include the cost of activities undertaken for Government, such as policy development, ministerial or parliamentary services and international obligations.

FINDING

Information agencies generally have attempted to tie their cost recovery arrangements to the objectives of the agency itself, through the notion of core and non-core activities. However, in some cases, it is difficult to define clearly the boundary between core and non-core activities.

DRAFT RECOMMENDATION 6.5

Information agencies should carefully define the boundaries of their core and non-core activities. This should be a dynamic process, with core activities determined with reference to:

- ***the agencies' broad public policy objectives;***
- ***the public good characteristics of the activity; and/or***
- ***any positive spillovers associated with the activity.***

DRAFT RECOMMENDATION 6.6

The core activities of information agencies (which may include some defined level of dissemination) should be wholly budget funded and not subject to cost recovery.

DRAFT RECOMMENDATION 6.7

Non-core activities of information agencies should be charged at marginal (incremental) cost or, where relevant, at prices in keeping with competitive neutrality principles.

DRAFT RECOMMENDATION 6.8

Where the main objective of regulation is to provide benefits to the users of regulated products, a 'beneficiary pays' approach should be adopted. Under this approach regulated firms would be charged for the costs of regulation only where:

- ***it is not feasible to charge beneficiaries directly;***
- ***costs can be passed on to beneficiaries;***
- ***it is cost effective; and***
- ***it is not inconsistent with policy objectives.***

DRAFT RECOMMENDATION 6.9

Where the main objective of regulation is to minimise the detrimental effects of external spillovers, a 'regulated pays' approach should be adopted. Under this approach, regulated firms should be charged for the costs of regulation only where:

- ***those businesses are the source of the negative spillovers;***
- ***it is cost effective; and***
- ***it is not inconsistent with policy objectives.***

FINDING

Cost recovery can be a useful tool for conveying price signals and reducing excessive demand for some regulatory activities, but it requires careful consideration due to potential conflict with other agency functions and objectives.

FINDING

Barriers to entry for firms and products arising from cost recovery charges are difficult to separate from barriers arising from the regulations themselves (including compliance costs) or from general market factors.

FINDING

Direct regulatory charges for generic products may give rise to 'first mover disadvantages', inhibiting the introduction of new products.

FINDING

Some information and data services appear to be priced at levels which are higher than their incremental costs, and some information agencies are not taking full advantage of new technologies to lower their dissemination costs. These factors may be impeding the progress of Australian research and industry development.

FINDING

Australian consumers may be affected by cost recovery indirectly, in that they may pay higher prices or have a smaller range of choice for some regulated products.

Chapter 7 Cost recovery under the *Trade Practices Act 1974*

FINDING

The ACCC could improve public information on the costs that TPA fees are intended to recover.

FINDING

Where the TPA prescribes the level of fees, they have been set at a level that recovers the lowest expected cost of performing associated activities. This helps ensure that the fees are not susceptible to challenge as amounting to taxation. Where the TPA gives the ACCC discretion in setting the level of fees, they are usually set at the cost of performing the service.

FINDING

Fees charged under the TPA appear to have little effect in restricting access to the activities for which they are charged. Hence, their effect on competition appears to be minimal.

FINDING

The fees charged under the TPA do not appear to impose a significant burden on business as they are typically set at low levels, particularly when compared to the transactions costs associated with undertaking, for example, an authorisation application.

FINDING

Fees charged under the TPA may play a useful role by discouraging unwarranted applications.

FINDING

Overall, fees charged under the TPA appear to be broadly appropriate.

Chapter 8 Improving administrative arrangements

DRAFT RECOMMENDATION 8.1

Government equity or social objectives should be funded through direct cash transfers to users or direct funding of agencies, rather than through cost recovery arrangements.

Information requests

Chapter 3 Legal and fiscal framework

INFORMATION REQUEST

The Commission seeks further views on appropriate independent mechanisms for preparing or reviewing Cost Recovery Impact Statements.

Chapter 5 Effects of cost recovery on agencies

INFORMATION REQUEST

The Commission seeks further views on how to improve parliamentary scrutiny of cost recovery receipts.

INFORMATION REQUEST

The Commission seeks further views on the establishment of Efficiency Audit Committees to address the efficiency of cost recovery agencies.

Chapter 6 Economic effects

INFORMATION REQUEST

The Commission seeks further views on the effect of cost recovery (as distinct from the effect of Government regulation or normal market factors) on firms (including small business) and consumers, particularly in relation to:

- *the introduction of new and innovative products; and*
- *adoption of new technology.*

Chapter 9 Guidelines for cost recovery

INFORMATION REQUEST

The Commission seeks further views on the usefulness of the guidelines contained in this draft report as a framework for deciding whether or not cost recovery should be introduced and for identifying the best approach to recovering costs. Also, it would be helpful if agencies could advise the Commission on how well the guidelines apply to their own circumstances and the impact their application would have on revenue raising.

INFORMATION REQUEST

The Commission considers that these guidelines will need to address a number of the specific issues that are common in designing cost recovery arrangements across regulatory agencies. Therefore, it seeks further views on these common problems and how they should be addressed. Possible areas to consider include:

- *how to deal with cost recovery in agencies with a high proportion of capital and overhead costs;*
- *the use of minimum and maximum levies and the application of formulae to decide on individual charges within that band;*
- *establishing cost recovery arrangements for new organisations where the start-up costs are high and the regulated industry is small; and*
- *the timing of cost recovery payments, particularly in the case of new product approvals, where the product is still to be marketed.*

INFORMATION REQUEST

The Commission considers that these guidelines will need to address a number of the specific issues that are common in designing cost recovery arrangements across information agencies. Therefore, it seeks further views on these common problems and how they should be addressed. Possible areas to consider include:

- *charging for information services when the level of future demand for that service is unclear; and*
- *whether agencies should charge different users different prices to access the same information.*

Chapter 10 Implementation

INFORMATION REQUEST

The Commission seeks further views on the key issues that are likely to emerge during implementation of the guidelines.

Appendix E Case Study — Australian Communications Authority

INFORMATION REQUEST

The Commission seeks further views on the effect of Australian Communications Authority cost recovery charges on firms (including small business) and consumers.

1 This inquiry

The Commonwealth Government has asked the Productivity Commission to review cost recovery arrangements across its regulatory, administrative and information agencies, and to develop guidelines for the future application of cost recovery.

1.1 What is cost recovery?

Until relatively recently, most government activities, other than those of government business enterprises (GBEs), were largely funded from general taxation revenue. Increasingly, however, governments have been recovering some or all of the costs of particular government services by more direct means. Commonwealth agencies' cost recovery charges can include fees, levies and specific purpose, earmarked taxes. They can be imposed not only on firms and private individuals, but also on other governments (foreign, State, Territory or local) or other Commonwealth agencies.

Charges have been levied for a number of reasons including:

- to regulate demand for government services;
- to provide resources for government activities additional to those available from government appropriations;
- to provide incentives to improve the efficiency of government services provision; or
- to improve the equity of the distribution of the costs of government services.

There are different mechanisms used to recover costs which, in this report, are referred to as charges. These charges fall into two broad categories; fees and taxes. Fees include fees for services (which include goods) and royalties, whereas taxes include levies, excises and customs duties.

Cost recovery is different from general taxation even though some taxes are included under cost recovery. General taxation raises revenue to fund a wide range of government activities, with no direct link between the source of the tax and the expenditure of the revenue raised. Cost recovery, on the other hand, is the recovery by government of some or all of the costs of a particular activity. The most direct

form of cost recovery involves charging the users of a government service a fee based on the cost of providing that service. Less direct forms of cost recovery include special levies or taxes that raise revenue to fund specific government services. The direct link between the revenue and the funding of a specific activity distinguishes such 'cost recovery' taxes from general taxation.

In Australia there have been various attempts to apply an analytical framework to cost recovery in Commonwealth Government agencies. These have been done largely on a case by case basis, with little overarching framework. The Department of Finance and Administration has released a number of guides, including the *Guidelines for Costing of Government Activities* (DoF 1991) and a *Guide to Commercialisation* (DoF 1996). The Australian National Audit Office has also completed a number of reports that have been influential in shaping the cost recovery arrangements of government agencies. There have also been a number of reports on particular agencies and industries such as the *Report of the Independent Inquiry into Aviation Cost Recovery* (Bosch 1984), *Cost recovery for Managing Fisheries* (IC 1992) and two reviews of the cost recovery activities of the Bureau of Meteorology (Slatyer 1996 and Slatyer 1997).

The lack of a consistent framework has left its mark. The rationale for charging arrangements is not always clear. Some charges appear arbitrary or to be accidents of history. Legislation does not always explain the rationale for charges that agencies are required to implement. Nor is it always clear why some agencies impose cost recovery while comparable agencies do not.

1.2 Purpose of inquiry

A major purpose of this inquiry is to develop principles and guidelines for the future application of cost recovery by the Commonwealth Government. To ensure these guidelines are relevant and useful they should comprehend the full variety of issues and circumstances likely to confront Commonwealth agencies.

The inquiry has three main parts:

- a review of existing cost recovery arrangements by 'regulatory, administrative and information agencies';
- the development of guidelines; and
- a review of the cost recovery arrangements under the *Trade Practices Act (1974*) (TPA) as part of the Legislative Review required by the Competition Principles Agreement (CPA) between the Commonwealth and the States and Territories.

Review of existing cost recovery arrangements

The Terms of Reference require the Commission to undertake a review of the nature and extent of cost recovery arrangements by Commonwealth regulatory, administrative and information agencies, identifying the activities subject to cost recovery, the beneficiaries of those activities, and the factors underlying the arrangements.

The Commission is also required to evaluate the impact of these cost recovery arrangements on business, particularly small business, consumers and the community, as well as on the agencies themselves and to examine the extent to which cost recovery arrangements meet best practice regulatory principles.

Developing guidelines for the future

The Terms of Reference direct the Commission to develop principles and guidelines as to where and to what extent cost recovery should be applied. The guidelines also cover the detailed design of cost recovery arrangements including providing incentives for cost-effective service delivery, avoidance of 'cost-padding' and systematic review procedures.

The Commission has also been asked to consider the impact of new technology and of legal constraints on the design and operation of cost recovery schemes. The digital revolution and the provision of services over the Internet are likely to affect the feasibility of charging for many government services.

The Terms of Reference relate to cost recovery arrangements by 'regulatory, administrative and information agencies'. While this provides the focus for the guidelines developed in this Draft Report, they could also be applied more generally.

Review of fees charged under the *Trade Practices Act 1974*

The inquiry also incorporates a review of fees charged under the TPA. This part of the inquiry stems from the Government's commitment — under the CPA — to review legislation that restricts competition. Thus, in addition to its own guidelines set out below, the Commission must consider the CPA's requirements that legislation should not restrict competition unless it can be demonstrated that:

- the benefits of the restriction to the community as a whole outweigh the costs; and
- the objectives of the legislation can only be achieved by restricting competition.

This section of the Terms of Reference (paragraphs 5 and 6) contains many detailed criteria for the review of the TPA, but there is substantial common ground between these criteria, the rest of the Terms of Reference, the Commonwealth's standard requirements for regulation assessment and the Commission's own guidelines.

1.3 Scope of inquiry

A wide variety of cost recovery arrangements by Commonwealth Government agencies are encompassed by this inquiry. The inquiry includes regulatory, administrative and information agencies that recover none of their costs as well as those which recover some or all costs.

Agencies and activities

The Terms of Reference require the Commission to examine the cost recovery arrangements of regulatory, administrative and information agencies. This requires some distinction to be made between different types of agencies. In practice all agencies in the Commonwealth public sector are administrative in one sense or another. The more useful distinction is between regulatory and information agencies. Thus 'regulatory agency' is a term that can encompass all agencies that administer regulations.

'Information agency' is also a broad term. Virtually all agencies supply some information, but in many cases this may be limited to information about the programs they administer. 'Information agency' is a term that the Commission uses to describe agencies whose prime purpose is the collection, compilation and dissemination of information. These include bodies such as the Australian Bureau of Statistics, the Bureau of Meteorology and 'cultural institutions' such as the National Library and ScreenSound Australia. Other bodies that may be described in other ways (such as intelligence agencies or research institutes) may nevertheless have significant roles in providing information. They have also been considered in the review and guidelines.

The Commission found it useful to focus on *activities* rather than on agencies as such. This is because the rationale for cost recovery of one activity might differ substantially from the rationale that applies to another, even within the same agency.

Policies and legislation

A wide variety of government policies relate to arrangements that include cost recovery. This inquiry reviews the cost recovery arrangements, not the overarching policies to which they relate; for example, the inquiry examines the cost recovery arrangements of the Australian Quarantine Inspection Service (AQIS), but does not review the merits of quarantine policy itself. Nevertheless, it is difficult to evaluate the cost recovery arrangements of regulations without regard to the regulatory processes themselves. The design of cost recovery arrangements can provide both positive and negative incentives to those subject to regulation and the regulatory agencies themselves. Consequently, this report does not question *whether* regulatory, administrative or information activities should be undertaken, but it is concerned with *how* they are undertaken. The Commission is also required under the Terms of Reference and its policy guidelines to consider measures which reduce regulation of industry where this is consistent with the social and economic goals of the Commonwealth, and to ensure good regulatory practices are followed.

The inquiry covers cost recovery arrangements authorised by specific legislation as well as those implemented by regulation or administratively. The public inquiry process provides an opportunity for these arrangements to be reviewed in an independent, open and transparent manner.

The Terms of Reference also require the Commission to develop implementation strategies to improve current arrangements.

Activities not covered by this inquiry

Individuals, firms, organisations and other governments pay the Commonwealth Government for many reasons. Many of these transactions are not 'cost recovery' for Commonwealth regulatory, administrative or information agencies and are outside the scope of the inquiry. Examples of such exclusions are:

- commercial arrangements by GBEs in contestable markets such as telephony charges by Telstra, workers' compensation payments to Comcare, and payments under Commonwealth insurance schemes such as the Export Finance Insurance Corporation. Commercial activities of regulatory, administrative and information agencies are under reference if they are related to cost recovery activities;
- general taxation (including the Medicare levy) but not the many specific purpose levies implemented through tax legislation;
- repayments of loans to the Commonwealth under policies for various purposes (for example, industry restructuring via the Rural Adjustment Scheme);

- asset sales including sale of rights to access resources such as radio frequency spectrum, fish stocks and mineral resources;
- fines and pecuniary penalties whether imposed by courts or administratively under legislation; and
- payments by customers to non-Commonwealth organisations and firms for goods and services where the prices may be affected by Commonwealth policies (for example, the Pharmaceutical Benefits Scheme and the copayment of medical fees under Medicare).

Some Commonwealth policies would be excluded on more than one of these grounds.

1.4 Commission's approach

This is the first comprehensive inquiry into the cost recovery arrangements of Commonwealth Government regulatory, administrative and information agencies. Previous inquiries tended to focus on particular agencies and arrangements. Some agencies, such as AQIS and the Bureau of Meteorology, have been the subject of numerous reviews, while other agencies have had little scrutiny. The Commission has been concerned to draw general lessons from current practices to guide the development of future arrangements, rather than to review or assess in detail all existing approaches. Adoption of the proposed guidelines should result in greater consistency by agencies in their approach to cost recovery, while still allowing sufficient flexibility for them to take account of their particular circumstances.

The Commission is responsible for providing independent analysis and advice to the Commonwealth Government. In undertaking this inquiry, the Commission is bound by its Act and the Terms of Reference to use processes that are open and public. The public inquiry process is outlined in appendix A. The Commission is also bound by its Act to follow certain policy guidelines (box 1.1). These policy guidelines require the Commission to consider measures that will improve overall economic performance and encourage the growth of efficient and competitive industries. The Commission must also recognise the interests of all parties likely to be affected by proposed measures. Broadly, this means the Commission must look at what is best for the community as a whole, not just for particular industries or groups. Accordingly the proposed guidelines do not focus on achieving narrow outcomes, such as simply improving the Commonwealth Government's budgetary position or just reducing business costs.

Box 1.1 **Productivity Commission policy guidelines**

The Commission must have regard for the need:

(a) to improve the overall economic performance of the economy through higher productivity in the public and private sectors in order to achieve higher living standards for all members of the Australian community; and

(b) to reduce regulation of industry (including regulation by the States, Territories and local government) where this is consistent with the social and economic goals of the Commonwealth Government; and

(c) to encourage the development and growth of Australian industries that are efficient in their use of resources, enterprising, innovative and internationally competitive; and

(d) to facilitate adjustment to structural changes in the economy and the avoidance of social and economic hardships arising from those changes; and

(e) to recognise the interests of industries, employees, consumers and the community, likely to be affected by measures proposed by the Commission; and

(f) to increase employment, including in regional areas; and

(g) to promote regional development; and

(h) to recognise the progress made by Australia's trading partners in reducing both tariff and non-tariff barriers; and

(i) to ensure that industry develops in a way that is ecologically sustainable; and

(j) for Australia to meet its international obligations and commitments.

Source: Productivity Commission Act 1998, s. 8.

The Terms of Reference also direct the Commission to have regard for the CPA principles. These principles have much in common with the Commonwealth's analytical requirements for regulation assessment, which the Terms of Reference also require the Commission to follow. Regulations should be effective and be the most efficient means of achieving the relevant policy objectives. This means that regulations should not only be able to achieve a particular policy goal, they must also be the 'best' means of achieving that goal (ORR 1998, p. A1). Assessment of regulations requires clarification of the objectives of the legislation, identifying whether and to what extent the fee arrangements impose costs or confer benefits on business or restrict competition, and, in light of this, identifying relevant alternatives. The Commission is required to analyse and, as far as reasonably practical, quantify the benefits, costs and overall effects of the arrangements and any alternatives proposed on the broader economy as well as the industries and different groups likely to be directly affected, including consumers and small business.

1.5 Conduct of the inquiry

Many individuals and organisations have taken the opportunity to participate in this inquiry, with the Commission receiving 109 submissions at the time of writing (see appendix A). The success of an inquiry of this nature is, in part, due to the willingness of participants to inform the Commission of their views on the issues under review. The Commission is grateful for the contributions received.

Many users of the output of Commonwealth agencies made submissions that allowed the Commission to understand the impact of current cost recovery arrangements on industry and the community. Many Commonwealth Government agencies made submissions that allowed the Commission to understand the rationales and operation of the current cost recovery arrangements.

The Terms of Reference require the Commission to report on the nature and extent of current cost recovery arrangements. The Commission has been hampered in this task by a lack of consistent and readily available information on cost recovery arrangements. In an attempt to address this lack of information, the Commission undertook a survey of the cost recovery practices of Commonwealth Government regulatory, administrative and information agencies. This survey covered quantitative and qualitative aspects of current cost recovery arrangements including the amount of revenue raised; the size of this revenue relative to other sources of revenue; and rationale, legal and institutional framework and operation of these measures. Some of the results from this survey are reported in chapter 4 and appendix B. A more detailed report of the survey will be included in the final report. Appendix J lists those agencies the Commission approached to participate in the survey.

To provide a more detailed consideration of current arrangements, a number of case studies of particular agencies were undertaken. These case studies relate to:

- information agencies like the Australian Bureau of Statistics and the Bureau of Meteorology. Information agencies are, in some respects, different from regulatory and administrative agencies and may require a different approach to cost recovery (appendix C);
- public health and safety regulatory agencies like the Therapeutic Goods Administration, the Civil Aviation Safety Authority and the National Registration Authority for Agricultural and Veterinary Chemicals. Public health and safety agencies are an example of regulatory agencies (appendix D);
- the Australian Communications Authority (appendix E); and
- financial regulatory agencies (appendix F).

1.6 Structure of report

In this report, the underlying economical rationale for cost recovery (chapter 2) and its legal and fiscal framework (chapter 3) are discussed. Current cost recovery arrangements are outlined (chapter 4). The impact of cost recovery on agencies is examined (chapter 5) and the wider effects of cost recovery on the broader community are considered (chapter 6). The fees charged under the TPA are reviewed (chapter 7). Proposals for improving the administrative arrangements of cost recovery (chapter 8), the Commission's proposed guidelines for cost recovery (chapter 9) and some implementation issues for the Government (chapter 10) are presented.

2 Economics of cost recovery

Chapter one introduced the concept of cost recovery and how it differs from general taxation. But why recover costs at all? Why not fund all government activities from general revenue sources such as the taxation system? The general answer to these questions is that funding government activities through cost recovery mechanisms can have quite different economic effects from financing the same activities through general taxation revenue. Because cost recovery can be used to make business and consumers pay more directly for the services they receive from government, it can be used as a tool for improving economic efficiency. Cost recovery may also make possible offsetting cuts in taxation or the provision of additional government services.

The economics of cost recovery is nevertheless not always well defined in the literature. The Commission's current thinking on the matter is set out in this chapter. As on all matters in the draft report, the Commission welcomes comments from participants and other interested parties.

2.1 Provision of government goods and services

In Australia most goods and services are provided by the private sector. Where markets are working well this results in efficient levels of production and pricing. However, for a variety of social, cultural, and economic reasons, governments (including the Commonwealth Government) also supply a large array of goods and services, or are involved in regulating the way the private sector supplies particular goods or services. For many government activities it is not possible or appropriate to charge groups directly for those activities. Therefore, at the Federal level, most activities are funded from general taxation through the budget. Expenditure on the social security system, defence, and transfers to the State Governments for the provision of social services such as hospitals and schools are major areas of activity financed through general revenue. Applying full cost recovery to these types of services would not make sense economically or socially.

At the other end of the spectrum, governments supply goods and services which are not very different from those that private markets might (or do) supply. With many former government business enterprises (GBEs) now privately owned, government

provision of private goods has shrunk considerably in recent years. There are nevertheless still cases where government agencies are supplying goods or services that have private good characteristics. GBEs aside, agencies may often do this as a by-product of their core public policy purposes. The provision of such private goods may be on an opportunistic basis which improves the utilisation of their assets — for example, ScreenSound Australia providing a meeting venue for professional, academic and social functions (sub. 30, p. 4) — or it may result from agencies supplying additional services that build on their core public policy activities — for example, through the sale of publications, or customised services to meet the demands of a particular group.

While the reasons for government intervention and activity are many and varied, they usually include the intention to address market failures. These arise from information problems, 'public good' characteristics, 'externality' or 'spillover' effects and/or monopoly characteristics (box 2.1). Thus the Commonwealth Government is involved in providing services such as defence (for 'public good' reasons), pre-market screening and labelling of some goods and services (to address information failures), environmental protection (for spillover reasons), and regulation (or ownership) of natural monopolies (to avoid monopoly pricing).

Alternatively, where it is possible to do so, the government may be able to devise a system of property rights to help private markets address market failures (for example, fishing licences). Or, for serious negative spillover effects, the government may simply ban certain goods and services altogether, for example an industrial process or use of a particular chemical. The nature of the market failure — and of the chosen response to it by the government — can have particular implications for the way in which cost recovery should be applied.

2.2 Reasons for cost recovery

Cost recovery can be a means of improving the efficiency with which the government uses resources. It may also be a means of raising revenue although, in some circumstances, using cost recovery for this purpose may compromise the effects on economic efficiency.

Box 2.1 Market failure and government

Government regulation and information activities may address market failures arising from 'information gaps', 'public goods', 'externalities', or 'natural monopoly' characteristics.

Public goods exist where provision for one person means the good or service is available to all people at no additional cost. Public goods are said to have two main economic characteristics: they are said to be non-rivalrous (that is, consumption by one person will not diminish consumption by others); and non-excludable (that is, it is difficult to exclude anyone from benefiting from the good). Common examples include flood-control dams, national defence and street lights. Since exclusion would be physically impossible or economically infeasible, these goods are unlikely to be provided to a sufficient extent by the private market.

This definition of 'public good' is important in economics. It should not be confused with phrases such as 'good for the public', 'public interest' or 'publicly produced goods', which are not related.

A **private good** is the opposite — it is physically and economically feasible to identify and charge users (or beneficiaries) and to exclude non-purchasers. Therefore, if it is profitable to provide the good or service, the market will normally do so.

Externalities or **spillovers** occur when an activity or transaction has positive (benefits) or negative (costs) welfare effects on others who are not direct parties to the transaction. An example of a positive externality is disease immunisation, which protects the individual, but also lowers the general risk of disease for everyone. The cost of providing such goods and services is often shared between public and private beneficiaries. Negative externalities might include pollution, or a large building blocking sunlight to its neighbours. Such activities can be regulated through legal restrictions and/or pricing mechanisms. Public goods and externalities are similar analytically. Externalities have public good characteristics in that they are non-rivalrous and non-excludable (Brown and Jackson 1990, p. 38).

Information failures occur where there is insufficient or inadequate information about such matters as price, quality and availability for businesses, investors and consumers to make informed decisions. In some instances markets can address these problems through intermediary services, for example consumers purchasing advisory services. But in some cases where the issues are highly technical, governments may perceive a role to complement or verify market supplied information, for example, government licensing, registration and labelling regulations for chemicals and pharmaceuticals.

Natural monopoly occurs where it is more efficient for one firm to supply all of a market's needs than it would be for two or more firms to do so. It arises where there are strong economies of scale resulting from fixed costs which are large relative to the variable costs of supply. Since monopolies may charge excessive prices, regulation or government ownership are often adopted.

Cost recovery may also have equity effects. It can improve equity by making those who benefit from government services pay for those services, thus reducing the dependence on general taxation (paid by many who do not benefit from the services). However, cost recovery may also price some 'deserving' users out of the market for government services. In these cases, it may be more appropriate to target equity effects through subsidies to specific groups, rather than by sacrificing the economic efficiencies of cost recovery.

Improving the allocation of resources

Generally speaking, cost recovery can be regarded as an attempt to get firms and consumers to pay more directly for the government-provided services they consume. By requiring a payment for services rendered, it is argued that users will better recognise the costs of the resources involved and gain an incentive to adjust their consumption in line with their willingness to pay. Similarly, by charging for the services supplied, government agencies receive signals about the demand for their services and can adjust their supply accordingly. Since the cost of resources used in producing a good or service includes the foregone opportunity of using them elsewhere, pricing based on costs helps to ensure that resources are allocated more efficiently within the economy.

The pricing of government goods and services can have an impact on the role and structure of government itself. If governments provide goods and services free of charge, users are likely to demand more than is efficient. In such an environment, people will demand more of the seemingly costless goods and services of most interest to them, yet at the same time have an interest in constraining the overall size of the public sector (and hence their individual tax burden). As Bird found:

> An important advantage of pricing is thus to curb the demand for expanded public sector activities by making their real costs apparent to the prospective beneficiaries in a meaningful fashion. Correct pricing can alleviate … the pressures to expand government … If [beneficiaries] are not willing to pay what the expansion of a service will cost, then it should not be expanded; if they are, it should be … (Bird 1976, p. 35)

In practice, cost recovery can be an important means for agencies to gauge the demand for the goods and services they produce. Even the imposition of a modest fee, where none was charged before, may give agencies important signals about the demand for particular products or services, and it may discourage excessive, frivolous or vexatious demands. For example, it may be in everyone's interest to discourage students and researchers from collecting personal sets of government publications which they may only rarely use (instead of sharing them, reading them online, or borrowing them from a library).

Pricing of private goods

The resource allocation arguments are at their simplest where government agencies supply private goods (box 2.1). In such circumstances, pricing differently from marginal cost would create distortions on both the production and consumption sides. Where an agency competes with the private sector, its ability to price above competitive levels would be limited, but underpricing, with its impacts on competition and hence resource allocation, is an issue (competitive neutrality considerations are discussed below).

In many instances, government agencies are statutory monopolies, meaning that they have the potential to set fees or charges above competitive levels. This could lead to over-recovery of costs and the poor use of resources. It could also create poor incentives for agencies to control their cost base. Investing in facilities of an unnecessarily high standard (sometimes called 'gold plating'), or cost padding may result. Methods for improving the technical efficiency of statutory monopolies include using market testing for services which can be contracted out, and benchmarking with similar organisations.

Paying for non-discretionary activities

The potential for cost recovery charges to influence resource allocation depends to some extent on the degree of discretion users have about consuming the service in question. On the one hand, there are those who voluntarily choose whether to purchase a good or service (for example, ABS publications or customised surveys), and how much to purchase. On the other hand, those who are regulated have less discretion about the amount of regulation they must consume, and hence about the amount of cost recovery charges they must pay. Where regulatory charges are related to output, firms may react by producing less of the regulated good. But in the case of pre-market regulation, firms either participate in the market and be regulated (and pay the corresponding charges) or they decline to participate.

In these cases, cost recovery would have efficiency effects if regulatory charges influenced firm decisions to develop or introduce some products into the Australian market. Rather than firms reacting to the fees by marginally curtailing production or supply of some goods or services, some may decide not to supply at all. Alleged examples include ranges of complementary health care products not registered in Australia, and claims that environmentally friendly chemicals are not being sold here (see chapter 6). Resource allocation would be affected at the industry level by a contraction in supply and an increase in prices.

Making beneficiaries pay

The 'beneficiary pays' principle has been widely cited as one of the major rationales for developing and implementing cost recovery. It is based on the notion that those that benefit from the provision of a particular good or service should pay for it. It has both economic and equity dimensions. It encourages those who benefit to recognise that there are resource costs involved, and it decreases the taxation burden on those who do not benefit. Its weaknesses include the practical difficulties that may be present in identifying beneficiaries and charging them, and in distinguishing between benefits that accrue to users, and benefits that arise through alleviating negative impacts on others (externalities or spillovers are discussed below).

The beneficiary pays principle encompasses the situation of users who voluntarily purchase government supplied goods and services because they have a willingness to pay that equals or exceeds the purchase price (that is, a private good market such as for government publications). But it can also apply to the provision of public goods where direct charges are not feasible or desirable (box 2.2).

There are many instances where government services benefit particular groups in society and, if an appropriate mechanism can be found to make those groups pay more directly for those services, economic efficiency and equity may be improved simultaneously. An example of this is air safety regulation. To some extent, air travellers reward the good safety practices of airlines with their patronage and the prices they pay. But there are serious information problems involved, making it difficult for air travellers to make informed choices. The cost of making the wrong choice may be catastrophic. For these reasons governments invariably take on the task of air safety regulation. But who should pay for this regulation and what might be the effects on economic efficiency?

Arguably, air travellers are the main beneficiaries of air safety regulation and should pay for most if not all of its provision (spillover effects on the wider community are discussed below). This would give better signals about how much air safety was valued.

Alternative approaches to funding air safety regulation include a ticket tax, or as is the case in Australia, a tax on aviation fuel. Neither of these will be perfectly efficient ways of raising the revenue needed to fund air safety regulation. But by making the beneficiaries pay a little more directly than they otherwise would, these measures may be preferable on economic and equity grounds to funding air safety regulation through general taxation revenue.

Box 2.2 The benefit principle and earmarked taxes

The concept of 'beneficiary pays' has its origins in the public finance economics concept of the benefit principle. This principle suggests that economic efficiency would be improved by requiring people to contribute (through taxation) according to the value they place on the publicly provided goods and services they consume. In practice it is almost always impossible to estimate these values. Individuals have an incentive to understate their valuation and free-ride on others, the result being that less revenue would be raised than would be necessary to supply the goods and services society collectively demands.

The benefit principle has given rise to the term 'benefit taxes'. Levies imposed on a particular group for the supply of a particular good or service are examples of benefit taxes.

Another term that arises in this field is earmarked (or hypothecated) taxes. Earmarking is the assignment of revenue received from a specific tax or taxes to the financing of a particular governmental activity. An important distinction between earmarked taxes and benefit taxes is that in the former case, the activity being taxed is not necessarily related to the activity being financed, though it may be more easily justifiable when it is (Bird 1976, pp. 23, 27; Anderson 1991). Benefit taxes are earmarked taxes, but not all earmarked taxes are necessarily benefit taxes.

Earmarked taxes have advantages and disadvantages. Their main advantage is that by linking the tax to a specific activity, they may be easier to justify than a general rise in taxation. Their disadvantages are that they are inflexible — they may raise too much money or too little to fund the target activity — and they may be difficult to undo. They can thus create problems for central agencies in rebalancing expenditure priorities across portfolios. They may also introduce rigidities on the consumption side.

Dealing with spillover effects

One weakness in the beneficiary pays principle is that if beneficiaries only paid for the benefits they received, they may not recognise the possibility of spillover effects on others (box 2.1). Spillover effects may be positive or negative. An example of a positive spillover effect would be one in which information services benefit firms or individuals other than those who directly consume them.

A negative spillover occurs when the actions of one person lead to third parties incurring actual or potential costs. The most common example of actual costs is pollution, while potential costs come from products or activities which carry a risk of damage to the health and safety of the environment or the community (such as food or drugs with risks of side effects or contamination, or financial activities with risks of economic instability or 'financial contagion'). Where the actual or potential risks to society are deemed unacceptable, the product or activity may be banned

altogether. Where the risks are considered acceptable (but are not zero), the source may be regulated to minimise or at least reduce them, subject to the costs. Other ways of addressing spillovers include private negotiation between parties, common law remedies, taxation measures and creating property rights (box 2.3).

Spillover effects may have an influence on the way cost recovery is implemented and who is charged. Where a government provided good or service has positive spillovers, subsidies to decrease the costs to users may be appropriate. Where the government regulates to address negative externalities, there may be a case for those who are regulated to pay for not only their own compliance costs, but also the costs of administering the regulations.[1] This can improve equity by decreasing the taxation burden for those who neither contribute to the externality, nor benefit from the products or services with which it is associated. The impacts of spillovers on the cost recovery practices of information and regulatory agencies are discussed in further detail below.

Revenue raising

Cost recovery charges raised $3.2 billion in 1999-2000. Given that general Commonwealth Government revenues in 1999-2000 were estimated to have been $166.6 billion (excluding GBEs and inter-agency transfers), cost recovery is a relatively minor, but not insignificant source of revenue.

In the context of cost recovery, the term 'revenue raising' is sometimes interpreted to mean only the revenue raised which is surplus to expenditure. The Commission considers that anything above zero cost recovery should be regarded as a revenue raising measure, in the sense that it is an alternative to other government revenue raising measures such as taxation.

Using cost recovery to finance the provision of government goods and services can improve economic efficiency on two fronts. First as explained above, when there is a link between the charge and the service being provided, cost recovery can improve the efficiency with which goods and services are used and produced. Second, by decreasing the level of general taxation needed to finance the provision of government goods and services, it decreases the costs of tax administration and compliance, and the 'deadweight' or efficiency costs associated with distortions to economic decisions.

[1] In implementing user charges, the New Zealand Government identified the importance of accounting for spillovers and in particular of identifying firms or people whose actions make them 'risk exacerbators' (New Zealand Treasury 1998, p. 8).

Box 2.3 Alternative means for addressing spillovers

One approach to dealing with harmful spillover effects is for those affected to sue the creator of the spillover at common law. Where the parties are identifiable and the costs measurable, this approach may encourage businesses to moderate their behaviour to minimise external effects. However, these conditions may often be absent, making this process inefficient, uncertain and slow. And where incentives are weak it may not prevent the spillover occurring in the first place.

A largely theoretical approach to dealing with negative externalities would be to tax those firms who give rise to the spillover effects to align the private and social costs of their actions.[2] This would prompt the firms involved to scale back their production to what was deemed socially acceptable. However, this approach is fraught with numerous problems not the least being to identify who, what and how much to tax. Measuring the dollar value of externalities and translating that into a corrective tax system is virtually impossible in many situations.

Spillover effects can sometimes be addressed through the creation of a system of property rights. In the cases of pollution, polluters may be given rights to emit a specified amount of pollutants, the overall output being deemed acceptable to society. If these are tradeable, and enforceable, the most efficient producers will end up holding the most rights, thus ensuring that the allowable amount of pollution was associated with a maximum amount of production. Alternatively, those affected by the pollution could enter the market in effect to pay the polluter to stop polluting.

In many cases covered by this inquiry, regulatory agencies are addressing issues in which property rights are ill defined, or the potential harm is too great to wait for market or legal solutions. For example, most people have a general expectation to have access to safe drugs, but this is not something that can be translated into a property right *per se*. Thus regulation remains as the main instrument for addressing spillovers in many cases.

Government intervention to address spillovers will not always be warranted. If the costs of regulating, creating and enforcing property rights, or imposing taxes are higher than the estimated benefits derived from these actions, it may be more efficient to refrain from intervening — the misallocation of resources may need to be substantial before intervention produces net benefits to society.

As Freebairn and Zillman state, tax systems are non-neutral across many decisions:

> Taxation distorts decisions on work versus leisure, on spending now or in the future, on the choice of which goods and services to produce and consume, on the form of business organisation, and so forth, with resulting efficiency costs. (2000b, p. 11)

[2] Such taxes go beyond the scope of cost recovery *per se*. For example, the New Zealand guidelines exclude 'the setting of taxes (over and above cost recovery) to limit negative externalities (harmful effects that extend beyond the people directly involved) associated with a particular activity'. (NZ Treasury 1998, p. 3)

Available international estimates indicate that the average efficiency costs of taxation revenue are around 30 cents for every dollar raised. This includes the costs of collection (approximately one cent), compliance (approximately ten cents), and the distorting effects taxation has on production and consumption decisions (approximately 20 cents) (Stiglitz 2000; Sandford 1995 in Freebairn and Zillman 2000b, pp. 10–11).

Comparing one efficiency effect with another suggests that even cost recovery arrangements that are less than perfect may still improve efficiency overall, relative to general taxation. However, the greater the separation between the service provided and the charge (for example, some earmarked tax arrangements), the less tenable the cost recovery arrangements become on economic grounds. If there is no connection — such that an earmarked tax has no effect on the production or consumption decisions of the good or service in question — the choice between general taxation and the specific earmarked tax boils down to which is the least distorting way of raising revenue. The choices between alternative revenue sources is therefore far from simple in terms of the overall effects on economic efficiency.

However, not all cost recovery arrangements are designed from the ground up with economic efficiency in mind. The risk is that the political and financial pressures to raise revenue (and possibly to avoid external financial scrutiny) may have led to the imposition of cost recovery where it was not warranted on economic efficiency grounds.

2.3 Competition issues

Cost recovery may affect competition in different ways. The way regulatory agencies charge may affect firms differently and, where an agency is in competition with a private sector provider, competitive neutrality considerations may be important.

Cost recovery charges are one of the costs firms may have to incur to enter a regulated market. An issue for this inquiry is whether such charges may be so high as to constitute a barrier to entry, thus affecting competition. In many instances, cost recovery charges do not appear to create significant barriers to entry of themselves (see chapter 6). For example, the Association of Superannuation Funds of Australia commented that APRA levies paid by superannuation funds do not alter firms' decisions about entering the market (sub. 8, p. 7).

However, in other cases, the way cost recovery arrangements are designed may create substantial barriers to entry. For example, concerns about the impacts of recovering the costs of the newly created Office of the Gene Technology Regulator

on industry development led to arrangements to phase in cost recovery over a period of time, rather than introduce it immediately (see chapter 6).

The way regulations and cost recovery arrangements are designed may have an impact on competition between firms in an industry. In some cases, where regulation is in place or its introduction is imminent, it will be in the industry's interests to influence the nature and extent of that regulation. While firms in an industry may collectively prefer less regulation to more, there may be opportunities for sections of the industry, including individual firms, to shape the regulations and the fee structure to their benefit. By influencing regulatory design to have a greater adverse effect on competitors or new firms than themselves, firms may be able to tilt the playing field in their direction. Discouraging competition and allocating resources to lobbying regulators and Government will reduce economic efficiency.

Competitive neutrality

Just as competition may be affected by the pricing of government inputs, it may also be influenced by the terms and conditions by which government agencies compete with the private sector. If government agencies are exempted from paying taxes or fees that private competitors would have to pay, or they are given other special treatment, they may be able to operate at an advantage over their private sector competitors. (They may also suffer competitive disadvantages such as more onerous accountability requirements).

Competitive neutrality is a cornerstone of the government's competition policy and has been implemented by the Commonwealth and all States and Territories pursuant to the Competition Principles Agreement (1996). Under this policy the prices charged by government businesses are required to be adjusted to reflect the advantages and disadvantages of public ownership. Prices should at least cover costs (including a return on capital invested and all relevant taxes and charges).

Although GBEs are not covered by this inquiry, competitive neutrality considerations are relevant because there are a number of business units operating within government agencies. The Bureau of Meteorology, for instance, operates a commercial business supplying weather services in competition with the private sector. The issue in such a case is to ensure that competition is not disadvantaged by the Bureau of Meteorology supplying its core weather services (upon which the commercial services are built) to itself on conditions that are any different from those applying to private sector competitors. Applying competitive neutrality principles to the pricing of government business units requires careful consideration to attributing overhead and capital costs (see appendix H).

2.4 Cost recovery rationale for information agencies

The rationale for recovering the costs of supplying information services and products is quite different to that which might apply to regulatory agencies. First, consumption of information services is usually discretionary, not mandatory. Thus cost recovery may have an effect on the demand for and supply of information goods and services. Second, information agencies tend to distinguish between core services, which they pursue for a variety of economic and social reasons, and non-core services which are not essential to the agency's charter or policy directives and may be cost recovered.

Core services typically include the collection and compilation of data or other material (for databases or archives), and some, but by no means all, analysis and dissemination. Additional data analysis and dissemination to private firms and individuals, which is of a value added nature (and which is likely to have private benefits), would lie outside this core. However, particularly in relation to dissemination services, it can be difficult for agencies to define precisely the boundary between these core and non-core services. Cost recovery targets for some agencies are making the task of distinguishing between core and non core tasks even more difficult. They may discourage agencies from adopting low-cost methods of dissemination, such as the Internet, that might reduce the ability — but also the need — to raise revenue (see chapter 6).

Governments supply core information services for a number of reasons including:

- the special information needs of governments themselves, for the purposes of policy development, planning and service provision;
- the public good characteristics of many information services, which means they are unlikely to be provided adequately by the market; and
- the positive spillover effects of some information services, such that they are also unlikely to be provided adequately by the market.

In addition, there are strong economies of scale and scope in the collection and dissemination of core data or information. These factors will influence the rationales for charging (or not charging) users of these core information services.

Public good characteristics are present in many information services. Where information is non-rivalrous (consumption by one person does not use up the resource, so it is still available to others), and it would be difficult or undesirable to exclude others from using it, public provision may be necessary. For information services with a degree of public good characteristics, it will not be possible or desirable to attempt to recover costs. For example, basic weather services can be

consumed simultaneously by numerous groups, and it would be difficult to stop people passing the information on to others. Some ABS information services fall into a similar category although, arguably, users may be excluded to some extent, through conditional access systems or pricing for publications.

In practice, there are very few pure public goods, and private markets have devised various ways of providing information on an exclusive basis that enables them to charge users for access. The possibility of devising ways to exclude non-purchasers from using information services raises a further policy issue for government provision of information services. Once collected, the cost of supplying information to an additional user tends to be low. The increasing use of digital technologies and the Internet are lowering these costs so that in many cases, they may be close to zero. Prices which are any higher than the costs of dissemination (for example, the costs of a publication or downloading data from a website) may discourage socially desirable uses of this information.

The presence of positive spillovers may further strengthen the case for including some information services in an agency's core activities. Two situations illustrate where these may have important influences on pricing. First, basic weather forecasts allow people to take evasive action when warnings of floods and other hazardous climatic conditions are conveyed to the general population. This could have substantial impacts on, for instance, the deployment of emergency services. Second, basic statistical data about the economy helps to create an informed and prepared community, and contributes to a well functioning democracy. Charging for these basic services may be possible, but to do so may seriously undermine the benefits that might otherwise accrue.

The creation of such positive spillovers needs to be compared with the purchase of data for commercial purposes where the benefits are private and excludable. By contrast, the same data could be used in research uses where positive spillovers are subsequently generated. The important distinction to make here is that these positive spillovers arise from the application of the data, not from the data itself. Further, distinguishing between users on the basis of the likelihood of positive spillovers would be operationally difficult. The appropriate policy response in these circumstances might be to support the activities that generate the spillovers (that is, the research), not necessarily the provision of the information itself.

The high costs of collecting and compiling data mean that many information agencies have strong economies of scale, not just in the collection and compilation phases, but also in the subsequent analysis and dissemination phases. Information agencies such as the ABS, the Australian Geological Survey Organisation, the Australian Surveying and Land Information Group and the Bureau of Meteorology,

must all incur high data collection costs before producing any further analysis or other information services based on those data.

This influence alone would suggest that where charges are imposed for non-core services, they should reflect marginal or incremental cost only. If economies of scale were the only influence on cost recovery, however, it might be possible to devise a two-part tariff arrangement which recovered overhead costs through an access fee. In this way, it might be possible to recover all of the costs of the core services, in addition to non-core ones. However, for the public good reasons outlined earlier, core services, which invariably include most of the primary data collection and compilation tasks, should be primarily funded from budget appropriations.

The economics of gathering data mean information agencies will also have a substantial advantage over other (actual or potential) competitors in incrementally expanding their activities to meet the specific needs of particular users. There will be some additional services that only they can provide, perhaps for reasons of confidentiality of data, or possibly for technical reasons. At some point, however, it becomes feasible for outside firms, drawing on the same core dataset, to supply competing services. Competitive neutrality considerations would then apply (see chapter 6 and appendix C).

2.5 Cost recovery rationale for regulatory agencies

There are many regulatory agencies in the Commonwealth public sector that have cost recovery policies in place. Many are involved in regulating goods or services to decrease the risk of harm or damage. Typically they are involved in pre-market assessment of products or services and post market enforcement and compliance. In part, they exist as an alternative or an adjunct to the use of the common law as a means of addressing or reducing the damages that might arise from the production and consumption of goods or services which have a high degree of risk attached to them. Examples include the Therapeutic Goods Administration (TGA), the National Industrial Chemicals Notification and Assessment Scheme (NICNAS), the National Registration Authority for Agricultural and Veterinary Chemicals (NRA) and the Australian Prudential Regulation Authority (APRA).

Many of these agencies address market failures arising from information failures and externalities. Information failures occur where one party, the supplier, has more information about product characteristics than consumers (box 2.1). If consumers do not have sufficient information, or the information supplied is of such a highly

technical nature that it is difficult to interpret, they may have difficulty making informed choices. As Boadway and Wildasin (1984) state:

> Consumers might not know the implications of various products for their health and safety, nor will they have full information on the relative merits of various competing consumer items. … The provision of information has the attributes of a public good, especially the joint consumption property. Thus, information on product safety and health hazards is often publicly provided (for example, the Food and Drug Administration). (pp. 65–66)

One way to address this issue is through government regulation aimed at providing information in a more accessible form (for example labelling). But regulatory agencies may go much further than this by making choices on our behalf (for example on the safety and efficacy of pharmaceuticals or chemicals). The problem is to reflect accurately society's preparedness to trade off risk against access to new products which may have substantial benefits. Invariably, at any chosen level of risk, there will be some who would be disadvantaged by not being able to gain access to high risk products. For example, terminally ill patients may be prepared to accept the possibility of dangerous side effects from the use of a non-approved drug if it gave them a longer life expectancy or a better quality of life.

And as discussed previously, spillover effects may be an important issue in the design and application of some regulations. Negative spillovers could include such things as pollution from the careless use of chemicals, a run on all financial institutions from the failure of one institution that followed poor practices, and the impacts of exploiting common property fisheries resources.

These considerations suggest that there are two ways of thinking about cost recovery for regulatory agencies: one based on a 'beneficiary pays' principle; the second based on a 'regulated pays' approach which incorporates the regulatory costs of addressing negative spillovers.

Beneficiary pays

Under the beneficiary pays approach, cost recovery could be argued to be an appropriate way of recouping the costs of administering the regulations from those that benefit. This would have efficiency and equity advantages over the alternative of budget financing (see above).

If the regulations accurately reflect society's preferences, and the agency has not been captured by those being regulated (see chapter 5), the main beneficiaries are likely to be the consumers of the products of the regulated firms. For example, consumers benefit through the provision of information and the assurance they

receive about the safety or decreased risk of using regulated goods or services, and would be prepared to pay a premium for such information.

Some of the benefit could be captured by the regulated firm through prices charged, or through promoting regulatory approval as a selling feature of their product. To some extent, regulated firms may therefore be prepared to pay for the administration costs of regulation. But the extent to which they receive any additional marketing benefits over and above what they might achieve through an industry operated, self-regulatory approach, is questionable. Regulations are usually not usually introduced to benefit those regulated, but to modify their behaviour. Government-imposed regulations can therefore be expected to be more stringent and broader than those which firms might apply to themselves through self-regulation.

The beneficiaries of regulation will also include those who, by virtue of the additional information made available to them, opt out of using that particular good or service. A system of fees or taxes that charged these beneficiaries directly would be one approach to recovering costs. But designing a system to charge all beneficiaries directly (including those who chose not to use the regulated good or service) may be impractical. Even where consumers of the regulated products or services are the main beneficiaries, it may be too difficult to identify and charge them in a cost effective manner. This does not necessarily lead to the beneficiary pays principle being abandoned. As the Industry Commission has stated:

> … cost recovery from a diverse group of beneficiaries may still be possible. For example, charging the suppliers to such a group is often an efficient way to charge those who ultimately benefit. Depending on the extent to which businesses can pass on the costs, any increase in business costs will be borne by the industry in the form of lower profits and by consumers in the form of higher prices. (1995, p. 26)

Charging the regulated firms may also be more practical where the services provided differ substantially between firms (for example, assessments made on a fee for service basis can vary according to the time and effort needed to undertake each assessment), and at different points over a product's life cycle. Translating such differences into consumer charges would result in a highly differentiated approach to setting fees, and conceivably require that different fees attach to different products, and to similar products marketed by different companies. Charging regulated firms for services actually provided would reflect costs more directly.

The 'beneficiary pays' approach may also include a 'community pays' component for activities with benefits which accrue to the wider community, and not specifically to the regulated firm or its customers. There are some activities, such as policy advice provided by some regulatory agencies to Ministers or Parliament, that

might need to be conducted in the absence of regulation. This suggests that these activities should be budget funded.

Spillovers

The existence of spillovers extends the framework within which benefits and costs need to be considered. Where the regulated firms contribute to negative spillovers, and the primary purpose of the regulation is to address those spillover effects, it may be appropriate for them to pay for the costs of administering those regulations. In this way, the prices paid for the goods and services of regulated firms would reflect all of the costs of bringing them to market. In this case, the regulated firms would be the appropriate first point to apply the charges. But, as under a beneficiary pays approach, the ultimate burden of the charge will depend on the extent to which the fees can be passed on to consumers and other firms in the supply chain.

The Industry Commission has commented on the implications of spillovers for cost recovery by regulatory agencies:

> Where it is not possible to allocate property rights and some other form of government action is being used to correct for spillovers, the question of who should pay will depend on the nature and size of the spillover and who is able to affect the size of the spillover at least cost. The prime objective is to achieve an efficient allocation of resources at least cost. … With respect to cost recovery, in general where those being regulated are the source of a negative externality, it may be efficient to charge them also for the cost of administering the regulation … as this is part of the costs of their activities imposed on society. (1995, pp. 25–26)

An alternative approach, which might be suggested by the application of the beneficiary pays principle, would be for the general public to meet some of the costs of administering the regulations through the budget. This would be in recognition of the beneficial impacts the regulations have on lessening spillover impacts on the general community.

There are two problems with this budget funded approach. The benefits to the rest of the community result from costs foregone (that is, from not incurring a cost or coming to some harm) and, on equity grounds, arguably the community should not bear this expense. To fund such activities from the budget would disguise the costs to society of the regulatory activities deemed necessary to limit the risk of the spillover occurring. This could give inappropriate encouragement to expand the regulated industry to the disadvantage of other industries where spillover effects are not as important, and regulatory costs are not as high.

Which approach is appropriate?

The preceding discussion suggests that there are two approaches to thinking about recovering costs for regulatory agencies: a 'beneficiary pays' approach, and a 'regulated pays' approach based on spillovers. Other things being the same, these approaches suggest that beneficiaries would pay where the private benefits exceed the costs of providing the services, and firms would pay where they are regulated because they give rise to negative spillovers.

The approach taken may depend on the circumstances. A good starting point for making such a choice would be the objects clauses of the legislation establishing the regulatory arrangements. Thus, if it could be established that regulations were introduced primarily for the benefit of consumers, the beneficiary pays approach might be the most appropriate conceptual framework. If containing negative spillovers was the prime objective, the regulated pays approach may be more appropriate. Some legislation may address both objectives, in which case a judgement might need to be made about which is the more important.[3] Some examples of regulatory objects are shown in box 2.4.

From these departure points one could then examine the feasibility of charging the target group. There may be a number of practical considerations that make cost recovery from the direct beneficiaries impractical. Where regulated firms can pass costs on, such that the they are shared between them and their customers, the beneficiary pays approach could be implemented through a charge on regulated firms. In practice, where spillover effects are not significant, the two approaches may often reach the same outcome of charging the regulated firms.

Incentive effects

Cost recovery may have important influences on the behaviour and efficiency of government regulatory and information agencies, and it may have impacts on innovation and product development in the regulated industry. The impacts on agencies may be positive (it may heighten consumers' interest in the efficiency of the regulator) or negative (it may create incentives for regulatory creep and gold plating). These issues are discussed further in chapter 5.

[3] If these object clauses are not clear, second reading speeches or explanatory memoranda may be useful guides.

Box 2.4 **The objects of selected pieces of legislation**

Ensuring that risks to consumers are minimised and hence that a beneficiary pays approach might be warranted, could be imputed from the objects of the *Therapeutic Goods Act 1989,* which states that the Act is to:

> provide for the establishment and maintenance of a national system of controls relating to the quality, safety, efficacy and timely availability of therapeutic goods that are … used in Australia … (s. 4)

Addressing spillover effects would appear to be the prime purpose of the *Space Administration Act 1998,* under which fees can be set for rocket launches and other related purposes, suggesting that a regulated pays approach is appropriate. Section 3 states that the objects of the Act are:

> (a) to establish a system for the regulation of space activities carried on either from Australia or by Australian nationals outside Australia; and
>
> (b) to provide for the payment of adequate compensation for damage caused to persons or property as a result of space activities regulated by this Act; and
>
> (c) to implement certain of Australia's obligations under the UN Space Treaties.

In some cases the objectives of the regulation may address both issues. For example, the newly created Office of the Gene Technology Regulator would appear to have been set up in part to address spillover effects and to protect consumers. The object of the *Gene Technology Act 2000* is to:

> … protect the health and safety of people, and to protect the environment, by identifying risks posed by or as a result of gene technology, and by managing those risks through regulating certain dealings with GMOs. (s. 3)

In such cases, either approach might seem appropriate, suggesting that other issues would need to be considered before arriving at a suitable model for cost recovery.

Effects on industry

Imposing full cost recovery on regulatory agencies may create adverse incentive effects on innovation and product development in the medium to long term where property rights are weak, or charges are poorly designed.

The impact of property rights can be illustrated by comparing the example of two regulated industries: food regulated by the Australia and New Zealand Food Authority (ANZFA), and pharmaceuticals registered by the TGA. At first glance, it might be presumed that there are similar grounds for imposing cost recovery in both cases.

In the case of food, ANZFA could theoretically charge applicants 100 per cent of the costs for assessing and processing a variation to a food standard. However, in the absence of intellectual property rights, a variation in a standard initiated by one

firm would be available to every firm in the industry. While the safety of all consumers of that product (produced by any firm and not just the output of the applicant) would be protected, all other firms producing that food could free-ride on the first firm. As such an approach could discourage innovation in the development and marketing of new foods, budget funding (or an alternative levy-based arrangement which charged all consumers) may be more appropriate.[4] In the case of patented pharmaceuticals, intellectual property rights ensure that free-rider problems are minimised and are not a deterrent to introducing cost recovery.

The way fees are set may also have perverse incentive effects on regulated firms. Given that some firms and some products may impose greater risks than others, and hence require more regulation, a flat fee structure would benefit some at the expense of others. A system of cost recovery charges that recognised the regulatory efforts involved in addressing risk might be more appropriate. However, even in such cases, care may need to be taken that cost recovery is not otherwise contrary to policy objectives. For example, if APRA were to charge a fee for compulsorily auditing a financially troubled firm, the result might be counterproductive (see appendix F).

2.6 Concluding comments

For information agencies, the case for recovering costs directly from users varies across activities. Factors relevant to deciding appropriate levels and types of cost recovery for each information activity include whether or not it is:

- part of the 'core' services of the agency, such as collection, archiving, basic analysis and some dissemination, with public good characteristics and/or positive spillovers; or
- part of the 'non-core' services of the agency, such as value-added analysis, research and broader dissemination services, which have private benefits for users; or
- an additional activity, also outside the 'core', which is subject to competitive neutrality considerations.

The case for recovering the costs of administering regulation from the beneficiaries of regulation or from regulated firms is complex, and requires case by case assessment of a number of matters:

- the ease of identifying the main beneficiaries;

[4] Currently, there are no charges for varying food standards, except where an 'exclusive capturable commercial benefit' is present.

- the presence or absence of significant spillover effects;
- the cost effectiveness of implementing a cost recovery system;
- the degree to which costs may be passed forwards (or backwards) and shared between regulated firms and consumers;
- the degree to which cost recovery conveys price signals to users;
- the possibility of adverse incentive effects on product development and innovation; and
- the incentive effects on the agencies themselves.

The challenging issues involved suggest that the onus should be on the government and its agencies to demonstrate that there would be net benefits from introducing cost recovery for particular regulatory or information activities.

They highlight the importance of getting the regulatory structure or information service right in the first place. Imposing cost recovery on top of inappropriate or inefficient government regulation or services will only compound their distortionary impact. It is also necessary to have processes in place which ensure that agencies are as open and transparent as possible. Existing and proposed cost recovery arrangements could then be considered on their merits, in line with the guidelines and processes proposed in chapters 9 and 10.

3 Legal and fiscal framework

A legal and fiscal framework underpins the design and operation of cost recovery arrangements. The Commonwealth Constitution places legal constraints on the nature of charges, whilst the division of powers between the Commonwealth and States has influenced the design of these arrangements. The Commonwealth Government's budgetary framework creates the broad fiscal context within which cost recovery mechanisms operate. International obligations also require acknowledgment as they can constrain agencies' abilities to recover costs. International models of cost recovery can provide insights into the legal and fiscal arrangements in other jurisdictions.

3.1 Constitutional issues

The Commonwealth Constitution defines the structure of government and the respective powers of the Commonwealth and State Governments. Two particular considerations affect cost recovery arrangements:

- the need to distinguish between 'taxation' and 'fees for service'; and
- the division of powers between the Commonwealth and the States.

Distinguishing taxes and fees for service

It is important to distinguish taxes from fees. Under certain circumstances, a purported fee for service may actually amount to a tax. If this is the case, the legislation imposing the fee could be open to Constitutional challenge.

Taxation

Taxation is defined as:

> A compulsory exaction of money by public authority for public purposes, enforceable by law, and is not a payment for services rendered. (*Matthews v Chicory Marketing Board*)

Taxes incorporate duties of customs and excise, but exclude royalties and fees for service. The Constitution outlines the taxation powers of the Commonwealth in section 51 (ii):

> The parliament shall, subject to this Constitution, have power to make laws … with respect to: — taxation; but so as not to discriminate between States or part of States. (Commonwealth of Australia Constitution Act, s. 51(ii))

When imposing taxation, the Commonwealth must ensure that it complies with the requirements of section 55 of the Constitution:

> Laws imposing taxation shall deal only with the imposition of taxation, and any provision therein dealing with any matter shall be of no effect. Laws imposing taxation, except laws imposing duties of customs or of excise, shall deal with one subject of taxation only; but laws imposing duties of customs shall deal with duties of customs only; and laws imposing duties of excise shall deal with duties of excise only. (Commonwealth of Australia Constitution Act, s. 55)

If a single Commonwealth Act attempted both to impose a tax and to deal with other matters, the imposition of the tax would be valid, but the remainder of the Act would not. Therefore, to introduce a new tax, Parliament is required to pass at least two Acts — one authorising its imposition and one authorising 'other matters', including its collection and administration.

Fees for service

Under certain circumstances, agencies may charge fees for service. In some situations, agencies must have specific legislative authority to charge fees. In others, this authority may be implied. The distinction between these situations is sometimes unclear.

The general principle is that fees must reflect the actual costs of a service provided; the service must be rendered to, or at the request of, the party paying the account; and the charge must be 'proportionate' to the cost of the service rendered (see appendix I).[1]

The Commission sought the advice of the Australian Government Solicitor (AGS) on when legislative authority was required to impose fees for service. The AGS advised that:

1 This approach was based on a statement in *Air Caledonie International v Commonwealth* (1988) suggesting that there had to be a 'discernible relationship' between the fee and the 'value' of what is acquired (by way of service) and that, to the extent that the fee exceeds that value, the fee could be seen to be a tax [as opposed to fee for service] (see appendix I).

> The position in relation to charging for services is less clear cut … We take the view that the imposition of charges in respect of the performance of statutory duties (including the delivery of services as a matter of statutory duty) needs to be authorised expressly by legislation or by necessary implication from legislation … Thus, statutory authority would be required to impose a fee in respect of, say, an inspection which is required to be performed under statute. The position in relation to the performance of *discretionary* activities is more complicated and it is in relation to this that judicial authority appears to be divided. (see appendix I)

Even when an agency has express or implied authority to charge fees for services, the fee must not be such as to amount to taxation. Several agencies charging fees for service have sought legal advice on the distinction between fees and taxes. The Space Licensing and Safety Office (SLASO) received advice that it was not imperative for fees to exactly equal costs, as 'if the fees were calculated in good faith' they would not amount to taxation. However, should revenue exceed costs in one period, fees should be adjusted in the next period to achieve balance (DISR, sub. 62, p. 16). AQIS received legal advice that over-recovery by 10 per cent or more would result in a charge being construed as a tax (ANAO 2000a, p. 69).

The AGS advised the Auditor General that the most recent High Court case (relating to Airservices Australia) had recognised that:

> … at least in some circumstances, a charge that discriminates between users of a service, and recovers the costs of maintaining a network of services, not all of which may be used by particular users, may still be a fee for service, at least where the services are highly integrated. Other factors which may be relevant to the characterisation of a charge as a fee for services include the commercial context in which the charge is imposed, and whether it has a revenue raising purpose. (AGS *in* ANAO 2000c, p. 36)

The AGS stated that in relation to the Airservices case, 'the main significance of the decision is in indicating a more flexible approach to cost recovery than was previously thought acceptable' (see appendix I). [2]

Legal implications of the differences between fees and taxes

Where a Commonwealth agency has express legal authority to charge a fee for service, the same piece of legislation usually deals with a number of other matters. A single piece of legislation will often establish the agency, describe its functions and grant the power to charge a fee for service. If the fee were to be challenged on

[2] The decision in *Airservices Australia v Monarch Airlines* was handed down by the High Court on 2 December 1999. Decisions were handed down at the same time in *Airservices Australia v Canadian Airlines International Ltd* and *Airservices Australia v Polaris Holding Company*, which raised the same issues and were heard concurrently.

Constitutional grounds and found to be a tax, the fee would remain valid (as a tax), but all other parts of the legislation would become invalid (because an Act imposing a tax may only deal with the imposition of that tax, and all other provisions are of no effect).

Concern about the possible implications of fees versus taxes has led to several outcomes.

Legislative drafters have attempted to ensure that legislation granting agencies power to charge fees for service makes it clear that Parliament does not intend to impose a tax. Acts have been written in such a way that if a fee is found to be a tax, the fee becomes invalid, rather than the rest of the legislation. For example, the *Civil Aviation Act 1988* allowed the Civil Aviation Authority — now Airservices Australia — to make determinations fixing charges provided:

> The amount or rate of a charge shall be reasonably related to the expenses incurred or to be incurred by the Authority in relation to the matters to which the charge relates and shall not be such as to amount to taxation. (*Civil Aviation Act 1988*, s.67)

Some agencies, for example the Australian Competition and Consumer Commission (ACCC) (see chapter 7) have deliberately set charges at the level of the minimum direct cost of providing a service, to ensure that there is no risk of fees being found to be taxes. This may lead to significant undercharging if there are major overhead costs which should be charged, or if direct costs are well above the minimum.

In some instances, the government has chosen to use tax Acts to impose cost recovery charges — although charges imposed as taxes are not always identified as such in the legislation or in policy documents (for example, National Registration Authority for Agricultural and Veterinary Chemicals (NRA) and Therapeutic Goods Administration (TGA) charges are levied under tax Acts). Using tax Acts avoids possible Constitutional challenge and often offers greater administrative simplicity than tailored fees for service.

The use of tax Acts also may have disadvantages, as the link between a tax and the costs of the service funded by that tax is, by necessity, indirect. A fee for service can be calculated on the basis of actual costs incurred, but taxes are typically levied on some sort of proxy basis, such as turnover, revenue or volume. If the proxy chosen does not closely reflect the underlying cost structures, the tax may introduce cross-subsidies between users of the service. It will also fail to have the allocative efficiency effects of more direct charging arrangements (see chapter 2).

It also may be more difficult to change the level of a tax over time (by changing legislation or regulations) than to administratively alter a fee for service. This may

provide benefits of certainty, but it restricts the flexibility of the cost recovery arrangements to respond to changes in costs.

There is, in addition, a serious risk that a tax imposed for cost recovery reasons will, over time, come to be regarded purely as a source of revenue. The Australian Customs Service (ACS) argued that this was the case with the Passenger Movement Charge:

> … the passenger movement charge was introduced as a cost recovery measure, but in law it was a tax. With a 1998-99 budget decision to increase the passenger movement charge from $27 to $30 per passenger, a policy shift has taken place. The passenger movement charge is levied under Commonwealth taxing powers and is now partly applied as a general revenue-raising source. As a consequence the passenger movement charge is no longer solely linked to cost recovery of Customs, Immigration and Quarantine. (trans., p. 447)

It is essential that cost recovery arrangements are underpinned by appropriate legal authority (either explicit legislative authority to charge fees for service or a separate tax Act). This not only ensures the validity of the charge, but provides accountability and transparency. Where fees for service may potentially be characterised as taxes, agencies should be cautious about relying on the recent High Court case to validate their fees. Although the decision appears to indicate a more flexible approach, its application to individual agencies is not certain. Agencies, with advice from their legal counsels, should determine the most appropriate authority for their charges, and structure any fees for service so they cannot be challenged as amounting to taxation.

DRAFT RECOMMENDATION 3.1

All cost recovery arrangements should have appropriate and clear legal authority. Agencies, with advice from their legal counsels, should identify the most appropriate authority for their charges, and ensure that fees for service are not vulnerable to challenge as amounting to taxation.

Commonwealth/State arrangements

The division of powers in the Constitution affects the abilities of the Commonwealth and the States to act in certain areas. It has created two major concerns that affect Commonwealth cost recovery arrangements:

- the ability of States to raise revenue independently; and
- the inability of the Commonwealth to act in some areas.

Although in theory, States have significant revenue raising powers, they are in practice reluctant to act unilaterally to impose taxes such as income taxes. There is a fear that any State imposing a new tax will become less attractive States with lower tax rates.

The High Court's interpretation of sections 90 and 96 of the Constitution has defined the limits of the States' abilities to raise revenue. Under section 90, the power to impose duties of customs and excise is exclusive to the Commonwealth. The High Court ruled in 1997 that a tax applied anywhere in the production and distribution chain is a 'tax on production', and hence an excise. The States, which had been imposing sales taxes, lost a major source of revenue.

In consequence, States have been reluctant to enter into national schemes without 'compensation' from the Commonwealth for the loss of any existing sources of revenue. On occasions, this 'compensation' has been raised by imposing an additional charge on those subject to the regulation. Commonwealth agencies then act as collection agencies for the States and redistribute the revenues raised. For example, a proportion of charges raised by the Australian Securities and Investment Commission (ASIC) is paid to the States to 'compensate' them for agreeing to a national scheme of corporate regulation.[3]

This problem can be compounded by the Commonwealth's lack of power to legislate directly in some areas. Section 109 of the Constitution makes it clear that should States' legislation conflict with Commonwealth legislation, Commonwealth legislation prevails. However, in some areas the Commonwealth has no power to legislate and must cooperate with the States to implement its policies. The Commonwealth and States have tried a number of ways to work around these Constitutional limits: States can 'refer' (or transfer) their powers to the Commonwealth; States can agree to pass identical legislation implementing a national scheme; or one State can pass 'template' legislation that all other States then adopt by reference.

3 The Australian Government Solicitor advised the Commission that while a fee that raises revenue (including to finance compensation arrangements) rather than merely recovers the costs of delivering a service is likely to be a tax, there is no constitutional prohibition on the imposition of both taxes and fees under the Corporations Act (Cwlth), since it is a law for the government of the Australian Capital Territory and section 55 of the Constitution has no application in relation to such a law, even so far as it imposes a tax. The Fees Regulations are also applied by the Corporations Act of each of the States (including the Northern Territory) as laws of the State. There is also no requirement equivalent to section 55 of the Constitution in relation to the State legislation, except under the Constitution of Western Australia. Western Australia has a separate tax imposition Act to impose the fees in so far as they are taxes (see appendix I).

The Commonwealth's ability to cost recover in some areas is also affected by section 51(ii) of the Constitution which provides that taxes cannot discriminate between States or parts of States. For example, as the ACCC is not the electricity and gas transmission regulator in all States, s.51 has prevented it from charging industry levies on gas and electricity (as they would not apply consistently across all States) (see chapter 7).

3.2 Legislative and fiscal arrangements

The Commonwealth Government's legislative framework, budgetary processes and reporting requirements affect cost recovery arrangements. The current legislative framework relating to the financial management and accountability of Commonwealth agencies, authorities and companies was introduced in 1997, when the Commonwealth Authorities and Companies Act (CAC Act) and Financial Management and Accountability Act (FMA Act) replaced the *Audit Act 1901*.

Consolidated Revenue Fund

The Consolidated Revenue Fund (CRF) is the principal working fund of the Commonwealth. Section 81 of the Constitution requires that all revenues or monies raised by the Commonwealth be credited to the CRF. Section 83 of the Constitution states that monies cannot be drawn from the CRF without parliamentary approval (an appropriation). Therefore, cost recovery revenue must be paid into the CRF, and agencies can only spend money that has been appropriated to them by Parliament. In practice, various mechanisms such as Special Appropriations and Net Appropriations have been developed to allow agencies to use funds raised from cost recovery for their own purposes (box 3.1).

Box 3.1 **Special appropriations and 'net' appropriations**

Special (Standing) Appropriations (FMA Act, section 20)

Section 20 of the FMA Act sets aside components of the CRF for specific purposes through a Special Appropriation. The amount appropriated will depend on the claimants satisfying program eligibility criteria (specified in the Act of a legislatively based program), or the Minister for Finance and Administration may determine an amount in accordance with specified criteria.

These appropriations are not subject to Parliament's annual budget control as they do not lapse at the end of each financial year, differentiating them from annual appropriations.

As special appropriations are allocated to specific purposes, they are often hypothecated to specific outputs. Examples include the *Aviation Fuel Revenues (Special Appropriation) Act 1988*, under which revenue collected from industry through aviation fuel customs and excise is appropriated to the Civil Aviation Safety Authority.

Net Appropriations (FMA Act, section 31)

Net Appropriation agreements under section 31 of the FMA allow agencies to enter into agreements with the Minister for Finance and Administration to use funds raised from cost recovery for their own purposes.

There are three categories of eligible departmental receipts which may be made available to the agency that are marked as 'net appropriations'. Category B receipts correspond to net receipts from 'user charging' activities, including those from the provision of goods and services.

These agreements can be for any period of time and do not need to relate to any particular Appropriation Act. 'Net' appropriation reflects the fact that the normal budget appropriation for the agency subject to the agreement will be 'net' of the estimated cost recovery receipts.

Commonwealth Authorities and Companies Act

The CAC Act applies to bodies with a separate legal existence outside the Commonwealth Public Service — that is, they may have 'ownership' of their operating funds and assets, independent of the Commonwealth. Some CAC bodies, (for example Government Business Enterprises operating in commercial markets) may control money in their own right and are able to spend receipts and receive revenues independently of the CRF.

However, those CAC bodies that handle public monies on behalf of government, such as the collection of fees or levies, are required to credit these funds into the

CRF and are subject to the financial management arrangements that apply under the FMA Act.

CAC bodies do not need to have the words 'corporation' or 'authority' in their title — the Australian Broadcasting Corporation, the Australian Broadcasting Authority, CSIRO, the Special Broadcasting Service, the ABS, the National Library of Australia and the Australian Trade Commission are all subject to the Act.

The requirements of the CAC Act are additional to those of Corporations Law, and regulate the financial, ethical and reporting requirements of corporate public authorities. The Act also provides a mechanism for the application of Commonwealth policies to CAC bodies.

Financial Management and Accountability Act

The FMA Act applies to Commonwealth bodies that financially are agents of the Commonwealth (that is, they manage public money and property on behalf of the Commonwealth). They include Departments of State, Parliamentary Departments, Statutory Authorities and Commonwealth bodies. The FMA Act provides a framework for the management of public money and property for these agencies. Those elements particularly relevant to cost recovery include:

- the CRF and a system of special accounts and the rules that apply to parliamentary appropriations;
- special responsibilities of Chief Executives for the control and management of public money and property; and
- the preparation and audit of financial statements including annual agency reports (FMA Act 1997).

Chief Executive responsibilities

The FMA Act places a general obligation on the Chief Executive of agencies (in some cases Departmental Secretaries) to manage resources efficiently, effectively and ethically by setting out responsibilities in key areas. These include the control and management of public money and property as well as preparation of financial statements (DOFA sub. 20, JCPAA 2000, p. 2).

The Act gives Chief Executives some autonomy and responsibility in the management of agencies. However, the devolution of authority to Chief Executives is balanced against the need for a chain of accountability back to Parliament. The Minister and Department of Finance and Administration retain a degree of control

through the ability to issue orders and guidelines on matters such as accounts and records, and oversight of the general budgetary process (see below). The Parliamentary Library Brief to the FMA Act noted:

> Part of that balance is maintained by not granting to Chief Executives the degree of autonomy that might be expected to apply if, for example, the [Australian Public Service] were broken up into a multiplicity of self-governing/self-contained corporate entities. It is arguable that under the present Act, the powers of the Department of Finance remain firmly entrenched, although somewhat further removed from day to day operations. (Commonwealth of Australia 1997b, p. 7)

Upon commencement of the FMA Act, all agencies were given a model set of Chief Executive Instructions to provide a guide on matters dealing with public money and property. Agencies are now responsible for putting into place their own control mechanisms and appropriate risk management strategies including cost recovery arrangements.

Financial statements

The FMA Act requires the maintenance of accounts and records as required by the Finance Minister's Orders for FMA agencies. Similarly, the CAC Act requires Commonwealth bodies and authorities to prepare annual reports. Both Acts require financial statements to be subject to an independent audit by the Auditor-General, while the remaining content is at the discretion of the reporting Department/agency (BASI 1999, p. 89).

The Appropriation Acts each year specify that 'net appropriations' received by agencies must be identified as such. Although these are usually identified as 'section 31 appropriations' in the agency's financial statements and Portfolio Budget Statements, the terms of the agreement are not identified. Similarly, there are no requirements as to how cost recovery revenue is recorded, which may pose problems with transparency and accountability.

Under current financial reporting arrangements it is difficult to estimate the extent of cost recovery in the Commonwealth public sector (see chapter 4). Limited data are available in budget documentation such as the Budget Papers and the Portfolio Budget Statements along with the *Commonwealth Government's Consolidated Financial Statements*. However, the data contained in these publications are typically not disaggregated sufficiently to allow cost recovery revenue to be identified separately, particularly at the agency level.

DOFA provided the Commission with data on 'Other taxes' and 'Commonwealth Government revenue from the sale of goods and services'. However, the Commission found these data also were too aggregated to enable analysis at the

agency level. In addition, a number of items included both cost recovered and non-cost recovered revenue which the Commission was not able to identify separately. Similar problems arise with data provided in agencies' annual reports and Portfolio Budget Statements. It is difficult to establish the objectives, costing and revenue raising of many cost recovery arrangements.

DOFA suggested improvements to current reporting arrangements:

> Public reporting can be used to monitor the nexus between cost recovery receipts and expenditure of funds on a service. For example, the Portfolio Budget Statements could be used to project cost recovery revenue and expenditure at the output level, with ex post reporting through the annual report. (sub. 38, p. 5)

The Commission considers that, at a minimum, the scale and scope of cost recovery activities should be made visible in official financial documents.

FINDING

There is a lack of transparency and accountability in current cost recovery arrangements. It is difficult to identify from existing sources the level of cost recovery by Commonwealth regulatory and information agencies. Publicly available data are incomplete and inconsistent, and the Department of Finance and Administration is unable to identify cost recovery receipts separately from other revenue.

Moreover, at the individual agency level, it is difficult to establish the objectives, costing and revenue raising of many cost recovery arrangements.

DRAFT RECOMMENDATION 3.2

Revenue from the Commonwealth's cost recovery arrangements should be identified separately in budget documentation and in the Consolidated Financial Statements. It should also be identified separately in each agency's Annual Report and in Portfolio Budget Statements.

However, these arrangements may not provide sufficiently detailed information to assess the efficiency of agencies imposing cost recovery. Other mechanisms for providing more detailed information on the objectives, costing and revenue raising of individual activities are discussed in chapter 6 as part of the discussion of ways to improve efficiency.

Accounting issues

Traditionally, most Commonwealth reporting was done by program (area of activity) on a cash basis. White papers published in the 1980s *Reforming The*

Australian Public Service (1983) and *Budget Reform* (1984) provided impetus for reforming the Commonwealth's reporting arrangements. The introduction of the FMA and CAC Acts resulted in two major changes to financial reporting arrangements: how the output is measured (from cash to accrual); and how the activity is described (from programs to output/outcomes based).

From cash to accrual

Cash accounting involves recording revenues in the period in which the cash is received and expenses when the cash is paid. In contrast, accrual accounting recognises revenue and expenses as they accrue in a given period (usually the financial year) (Hoggett and Edwards 1987, p. 94).

Accrual reporting systems are favoured over cash systems as they promote greater transparency and accountability in financial reporting, and attempt to match economic costs incurred during a reporting period against the economic benefit accrued in that same period. The accrual framework also facilitates the comparison of the full costs of a transaction against benchmarks or standards.

Accrual accounting allows for expenses to be assessed more accurately and has enabled 'costs' for cost recovery purposes to be more accurately identified. In some cases this has led to increases in cost recovery charges as costs that could not be readily identified under the cash system (such as capital costs and depreciation) are now recognised and taken into consideration.

Output based reporting

In April 1997, the Commonwealth shifted from program based reporting to output based reporting. This requires authorities and agencies to specify and set prices for the outputs they will deliver, describe planned outcomes to which outputs contribute and to specify the performance information required to monitor, manage and account for the output delivery and the achievement of actual outcomes.

Output based reporting requires all outputs to be identified separately and costed. It appears that some agencies have not identified some outputs relating to the 'public interest' separately, such as the development of policy and providing advice to Ministers. These costs have been included in agency overheads and allocated across other outputs, many of which are subject to cost recovery. This can lead to overcharging for these cost recovered activities (see chapter 6).

3.3 Institutional arrangements

A number of agencies have roles in managing Commonwealth public finance arrangements, including cost recovery (box 3.2). Parliament, the Finance Minister and the Department of Finance and Administration (DOFA) have overall responsibility for budgetary processes. Other agencies have roles in relation to specific aspects of public finance. However, these arrangements have some serious shortcomings in relation to cost recovery, for example:

- the lack of transparency in financial reporting may impair effective scrutiny by the Australian National Audit Office (ANAO) and Parliament. In addition, cost recovery arrangements are not reviewed systematically by the ANAO;
- the regulatory impact statement (RIS) is a valuable tool for assessing proposed regulation, but has not captured many cost recovery proposals; and
- bodies such as the Commonwealth Competitive Neutrality Complaints Office (CCNCO) act to protect consumer and business interests but do not play a significant role in cost recovery arrangements.

Department of Finance and Administration

DOFA oversees agencies' compliance with the FMA and CAC Acts as well as monitoring the operation of the Acts (JCPAA 2000, p. 3).

DOFA provides input into the budget process which may determine the level of appropriations for certain agencies and their activities/programs. DOFA also monitors the robustness of agencies' pricing for outputs (under the accrual output framework) through pricing reviews.

Pricing reviews

Pricing reviews were introduced by DOFA in 1999-2000 to hold agencies accountable for their performance with respect to the quality, quantity and price of outputs. These reviews could play a role in reviewing cost recovery charges. The objectives that guide the direction of these reviews include:

- bedding down the Government's reform agenda by assisting agencies to implement robust output costing systems;
- achieving greater transparency of drivers of output prices for Ministers; and
- assessing the reasonableness of the price of agencies' outputs (DOFA 2000, p. 7).

Box 3.2 Agencies involved in managing Commonwealth public finance

Australian National Audit Office

The Australian National Audit Office (ANAO) is a specialist Commonwealth agency that provides audit services (performance audits, financial statement audits and better practice guides) to the Parliament, Commonwealth agencies and statutory bodies. *The Auditor-General Act 1997* regulates the powers and responsibilities of the Auditor-General and the ANAO. ANAO performance audits can include cost recovery arrangements. For example, AQIS's Cost-Recovery Systems were the subject of an audit in 2000. Performance audits are performed on an *ad hoc* basis and do not form a systematic review mechanism for cost recovery arrangements.

The Auditor-General is responsible for undertaking annual financial statement audits of government departments, statutory authorities and government business enterprises. These focus on compliance with financial reporting requirements rather than the appropriateness or efficiency of cost recovery.

Better practices guides are produced by the ANAO to improve public administration practices. The ANAO has not published any Better Practice Guides in relation to cost recovery activities.

Joint Committee of Public Accounts and Audit

The Joint Committee of Public Accounts and Audit (JCPAA) is a Parliamentary committee empowered to scrutinise the monies spent by Commonwealth agencies from funds appropriated to them and examines all reports of the Auditor-General which are tabled in Parliament. In addition to the JCPAA's statutory review process, the House of Representatives may refer reports to standing committees. The purpose in reviewing audit reports is to assess whether audited agencies have responded appropriately to the Auditor-General's findings.

Commonwealth Competitive Neutrality Complaints Office

The Commonwealth Competitive Neutrality Complaints Office (CCNCO) investigates complaints on the application of competitive neutrality principles at the national level and advises the Treasurer. Competitive neutrality principles apply where a government business is in competition with the private sector. They do not apply to government agencies imposing cost recovery as monopoly providers, but may apply to government agencies operating in competitive markets.

Agency boards and advisory committees

Typically a body operating under the CAC Act is governed by a Board which is responsible for management to the Minister. The CAC Act sets out standards of conduct for its Directors, such as establishing an audit committee to assist in financial reporting, risk management and internal control. Most statutory bodies and agencies (including FMA Act bodies) make provision for consultative committees, but their establishment and functions are not standardised.

The introduction of outcomes/outputs based accrual budgeting requires agencies to price the outputs they produce in order to achieve the Government's desired outcomes. Pricing reviews enable Government (through DOFA) to assess the robustness of the prices of these outputs. Outputs are priced through market testing, various forms of benchmarking and the costing of outputs and inputs.

The outcome of a pricing review is a pricing review report (a joint document drafted by the agency and DOFA). It includes the unit price of each output covered by the review. Where the proposed unit price is higher or lower than that already in the budget forward estimates, the difference must be justified. The report also indicates options to Government to reduce prices through requiring efficiencies; requiring different levels of quality; and if necessary, indicating a compromise on expected outcomes.

In 1999-2000, DOFA conducted pricing reviews into the Department of Agriculture, Fisheries and Forestry Australia, the Attorney-General's Department, the Department of Foreign Affairs and Trade, the Department of Immigration and Multicultural Affairs, the Department of Family and Community Services, the Australian Customs Service and Environment Australia.

Environment Australia undertakes limited cost recovery, but the pricing review focused on outputs related to corporate services, policy analysis and advice (box 3.3).

These reviews could potentially play a role in improving agency efficiency, thereby reducing costs imposed on those who pay cost recovery charges and the general taxpayer. However, reviews to date have not specifically addressed cost recovery activities.

> The Commonwealth has in place a rolling schedule of pricing reviews which focuses on the prices paid by Government for departmental outputs. These reviews can incidentally include cost recovery from other sources where relevant outputs are within scope, but cost recovery can and should be addressed more frequently and separately at any time as necessary. (DOFA, sub. 38, p. 5)

Box 3.3 **Environment Australia pricing review**

In 1999-2000 Environment Australia was subject to an output pricing review. The objectives addressed were:

- determining whether outputs are being delivered efficiently with regard to the price of those outputs compared with the prices of comparable outputs in other agencies or external providers; and
- providing guidance for future output structure and reporting practices.

Stage One examined the overall cost effectiveness of corporate services and identified outputs with potential for cost reduction. This resulted in a reduction of $5 million in Environment Australia's overall resource allocation for the 2000-01 budget year.

Stage Two of the review (still in progress) includes those remaining departmental output groups such as policy analysis and advice. These outputs are more difficult to price as they do not follow a predictable or replicable path or process and the criteria for success may change from case to case. Pricing policy advice requires benchmarked standards for the types of policy advice provided and a comparative basis for the price of that advice.

Source: Environment Australia (sub. 76, Att. D).

Budget processes

Budget processes subject governmental financial arrangements to parliamentary scrutiny and can play a role in ensuring the transparency and accountability of cost recovery arrangements. In principle, cost recovery agencies are subject to the same budgetary processes that apply to all Commonwealth agencies, but in practice this scrutiny is reduced through the use of section 20 and section 31 appropriations. The budget process (box 3.4) is a combination of both top-down (Government strategies) and bottom-up (agencies' strategies) elements. A complete budget cycle requires at least 22 months to complete, so that a number of periods will overlap.

DOFA is responsible for co-ordinating the preparation of the budget estimates, facilitating the consideration of expenditure proposals by the ERC and ensuring the budget estimates are accurate and consistent with budget policy requirements. DOFA is also responsible for the explanation of line items in the estimates process, including differentiating between 'aggregate non-tax' and 'other taxes, fees and fines' (line items which may include elements of cost recovery).

Whilst DOFA is ultimately accountable for budget estimates, portfolio departments and agencies have shared accountabilities to their Minister for constructing accurate and timely estimates for their contributions to budget documentation.

Box 3.4 **Budget process**

- Ministers bring forward policy initiatives;
- Ministerial initiatives are considered within the overall fiscal strategy of Government;
- Senior Ministers' Review considers the range of Ministers initiatives;
- Ministers submit initiatives in the form of Portfolio Budget submissions to the Expenditure Review Committee (ERC);
- DOFA Budget Group make recommendations to the ERC in the form of the *Green Brief* (an assessment of both financial and non-financial aspects of the Portfolio Budget submissions);
- Budget delivered in Parliament; and
- Senate Legislative Committees review Budget on a Portfolio basis.

Source: DOFA (2000).

DOFA guidelines

In the past, DOFA has been responsible for the formulation of guidelines to assist agencies to implement Government policy on financial management. Various DOFA publications have affected the implementation of cost recovery. Inquiry participants cited the *Guide to Commercialisation* (DoF 1996), and *Guidelines for Costing of Government Activities* (DoF 1991) as sources of information on the introduction of cost recovery (box 3.5). However, these guidelines have focused on costing issues and have not addressed fundamental questions about the implementation of cost recovery arrangements. While these guidelines are no longer current DOFA publications, they have been referred to by several participants as the basis for their existing cost recovery arrangements. Those agencies that did not use the DOFA guidelines relied on *ad hoc* reviews and consultancy advice. For example the Bureau of Meteorology cited reviews by Freebairn and Zillman (2000a) and Slatyer (1997).

FINDING

The absence of current cost recovery guidelines has led agencies to rely on outdated publications such as the 'Guidelines for Costing of Government Activities'(DOF 1991), ad hoc reviews and consultants' advice.

Box 3.5 **'*Guidelines for Costing of Government Activities*' (1991)**

These Guidelines outlined the scope for the costing of government activities and how the costs of activities and programs should be apportioned whilst keeping in mind the broad objectives of:

- ensuring that the level of usage of services is related to the full resource costs of providing the services;
- assessing the performance of individual units of production;
- meeting the requirements of any specific Government policies (rate of return); and
- ensuring that there is opportunity for fair and effective competition, if there is competition between the public and private sectors.

When user charging is involved, prices should reflect the financial charter and objectives of the organisation as well as competition between the public and private sectors. The options available include:

Full cost pricing

The concept of full cost recovery (including a return on capital) was identified as a primary benchmark, equating with the requirement that private sector organisations must satisfy in the long term if they are to remain viable. Full cost pricing would therefore be the policy objective of any public sector agency (or unit) with a self-sufficiency or commercial charter. Full cost recovery would mean that prices would be set to equate to average costs of production in the long term.

Marginal cost pricing

Short term marginal cost pricing was identified as a useful technique where marginal output decisions are needed and full cost pricing appears to be inappropriate. These situations may include:

- national security and/or other 'public interest' reasons;
- services characterised by seasonal troughs in demand over the year or off-peak periods of the consumption cycle; and
- government requirements to meet Consumer Service Obligations to particular regions or recipients.

Staffing, labour on-costs and overheads

Most of the labour costs relevant to the production of a particular output can be readily assessed. However, those costs unable to be assessed can be taken into account by applying an overhead rate to the direct labour costs. These costs relate to salaries; administrative/operational expenses; compensation and legal expenses; accommodation; superannuation; and corporate support.

Source: DoF 1991.

Office of Regulation Review

The Office of Regulation Review (ORR) provides advice to Government, Commonwealth departments, regulatory agencies and statutory authorities on the efficacy of new regulatory proposals and reviews of existing legislation. This is done through the Regulatory Impact Statement (RIS) process which details the costs and benefits of regulation through seven steps (box 3.6).

Box 3.6 Regulatory Impact Statement process

- Outlining the issue or problem which gives rise to the need for action;
- Outlining the desired objectives from the action;
- Outlining all options (regulatory and non-regulatory) that are viable means of achieving the objectives;
- Assessing the impact of each option (costs and benefits) on consumers, business, government and the community;
- Providing a consultation statement;
- Including a recommended option; and
- Outlining a strategy for the implementation and review of the preferred option.

Source: ORR (1998, p. A2).

A RIS is required for any regulatory proposal affecting business, not just those considered by the Cabinet. The RIS is prepared by the portfolio department making the proposal. Exemptions to the RIS process include regulations which:

- are of a minor or machinery nature and do not substantially alter existing arrangements;
- involve the procurement of specific goods;
- are required in the interest of national security; and
- are primary or delegated legislation responsible for implementing international agreements.

Although the ORR Guidelines state that development of a RIS is mandatory, the absence of a satisfactory RIS has no automatic affect on a regulatory proposal. So long as a regulation is validly made (for example, the agency has the power to make the regulation and it has been gazetted) the absence of a RIS does not make it invalid. The Government may choose to delay the implementation of a regulation or postpone policy approval until the RIS process has been completed, or it may choose to proceed without an adequate RIS. The only RIS enforcement mechanism

is 'moral suasion' through criticism of agencies that fail to develop satisfactory RISs in the ORR Annual Report.

While overall performance is improving, the ORR notes that in 1999–2000 a RIS had been prepared in only 91 per cent of cases at the time regulation was tabled in Parliament. RISs were prepared at the decision making stage of policy development in only 82 per cent of cases (PC 2000b, p. 3). Therefore, there needs to be continued government commitment to the RIS process to ensure they are prepared early in the policy development process.

Many of the cost recovery regulations and services subject to this inquiry meet the criteria that require them to be subject to a RIS. They are established using legislative and quasi-legislative processes and they affect business. By definition, any cost recovery associated with the regulation of business would have a direct effect on business, and therefore, should be subject to RIS requirements. But whilst the RIS process is thorough, there are problems in its application to cost recovery.

The existing RIS guidelines do not explicitly address cost recovery, and most RISs focus on the regulation being introduced, with little or no attention to proposed cost recovery mechanisms. Many agencies see cost recovery as implementing government policy, rather than a regulatory option, and choose not to go through the RIS process. In other cases, incremental changes to existing cost recovery arrangements have been exempted from the RIS process under the 'minor and machinery' provision — for example, the CPI based indexation of fee schedules and changes consequential on the introduction of the GST.

Over the past four years there have been only 13 occasions when cost recovery proposals have been subjected to the RIS process; this represents only about one per cent of all RISs. There were only three occasions when the RIS process was applied in a comprehensive way to cost recovery proposals:

- the development of a more equitable charging system by the Civil Aviation Safety Authority;
- a new structure for recovering costs of certain applications to the Australia New Zealand Food Authority; and
- consideration of cost recovery options for the new Office of Gene Technology.

Many RISs are pitched at a relatively high level of principle, as they address the economic costs and benefits of regulation. In some instances, this may mean that a RIS would not address many important issues in cost recovery, such as the structure of charges and agency efficiency.

Many cost recovery arrangements are introduced as taxes, for which special RIS arrangements apply. Tax RISs follow a similar process to the standard RIS, but consultative requirements differ because it may not be appropriate to consult on proposed tax changes due to the sensitivity of information and the possibility of taxpayers engaging in tax avoidance or minimisation schemes (ORR 1998, p. B10). Whilst these concerns may be valid for general tax measures, they are less significant for taxes imposed for cost recovery.

Other cost recovery arrangements would not be subject to a RIS at all. Regulatory arrangements that affected individuals, rather than businesses, or administrative arrangements (such as those underpinning many information agencies' cost recovery) do not require a RIS. In addition, although the RIS process captures new proposals or one-off reviews of existing regulation, it does not require regular reviews of the existing stock of regulation.

FINDING

The Regulatory Impact Statement (RIS) is a valuable tool for assessing proposed regulation, but has not dealt directly with many cost recovery proposals.

Improving institutional arrangements for cost recovery

A review process is required to ensure the adequate scrutiny of existing cost recovery arrangements and new cost recovery proposals, as well as ongoing monitoring of the appropriateness of these arrangements. This might be referred to as a Cost Recovery Impact Statement (CRIS) process.

The Commission does not want to duplicate existing review mechanisms. As stated above, the Commission considers the RIS process to be a valuable tool for assessing regulation. With minor enhancements, the RIS can perform much of the CRIS role for cost recovery arrangements that fall within the RIS ambit.

These enhancements would clarify that cost recovery arrangements of regulatory agencies that affect business, or cost recovery arrangements that are established in regulation and affect business, are properly subject to a RIS. It should also be made clear that the RIS should address both the rationale for establishing cost recovery, and the impact of the proposed charging mechanisms on business, the agency and the broader community. The adoption by Government of the Cost Recovery Guidelines proposed by this inquiry would provide guidance on this part of the RIS (see chapter 10).

These enhancements could be achieved through a direction from the Treasurer to the ORR, and incorporated in the next edition of the ORR publication, *A Guide to Regulation*.

DRAFT RECOMMENDATION 3.3

The Regulatory Impact Statement (RIS) process should be clarified to make it explicit that, where a regulation under review includes a cost recovery element, the RIS should address cost recovery by applying the guidelines proposed by this inquiry.

Although an enhanced RIS process could adequately provide scrutiny of many cost recovery arrangements, a separate process is required for those cost recovered activities that are not covered by this process (for example, cost recovery for regulations that affect individuals, not businesses; ongoing reviews of cost recovery arrangements without an associated review of regulation; and cost recovery introduced administratively by information agencies). A separate CRIS process should be developed to ensure these cost recovery arrangements are subject to equivalent scrutiny to the RIS process. The CRIS process is summarised in box 3.7, and is also discussed in chapter 9.

Although a RIS should apply the cost recovery guidelines to the implementation of cost recovery, a CRIS could be used to consider the implementation of cost recovery if these issues involve a greater level of detail than undertaken in a RIS.

There would be one fundamental difference between a RIS and a CRIS. The RIS process examines the need for regulation and all available options for achieving the objectives of the regulation. The CRIS process would focus specifically on the rationale for and suitability of cost recovery arrangements, and not on those of the underlying activity. Government has instituted other governance arrangements to determine appropriate activities of the agencies, such as boards and consultative committees. It would not be appropriate for the CRIS process to 'second guess' the outcomes of these processes. However, the CRIS could examine whether due processes had been followed in reaching those decisions. For example, that board approval or Ministerial endorsement had been received where required.

The CRIS process could be developed with varying degrees of independence. The CRIS could be wholly conducted by the agency or department responsible for the cost recovery arrangement, or an agency prepared CRIS could be subject to independent review (as occurs for RISs). A third option would be to have the entire CRIS undertaken by an independent body.

Box 3.7 Cost Recovery Impact Statement process

The CRIS process would cover all cost recovery arrangements not subject to the RIS process, such as cost recovery for regulations that affect individuals, not businesses; ongoing reviews of cost recovery arrangements without an associated review of regulation; and cost recovery introduced administratively by information agencies. The CRIS process requires the following steps:

- determine who will prepare the CRIS, with reference to established criteria — for example, a CRIS may be prepared:
  - by persons internal to the agency or department;
  - by persons internal to the agency or department with an independent review; or
  - by persons wholly independent of the agency or department.
- examine the objective of the activity to be cost recovered — for example:
  - did the decision to undertake the activity follow due process; and /or
  - is the objective of the activity clearly stated;
- application of the cost recovery guidelines, which will involve:
  - determining who should pay cost recovery charges if they are introduced;
  - an assessment of whether cost recovery should be imposed including analysing the impact (costs and benefits) on consumers, business, government and the community of the proposal;
  - determining the form of charges;
  - an assessment of how costs should be calculated and allocated between activities;
  - a recommended option; and
  - a strategy to implement, monitor and periodically review cost recovery;
- a description of the level of consultation undertaken;
- the Statement may be subject to independent review;
- the Statement is released, together with any independent review and a statement of the agency or department's intended approach; and
- a government statement on its intended approach should be published on the agency web site, in the agency annual report and portfolio budget statements.

The Commission considers that transparency and independence would be important elements of the CRIS, and has a strong preference for some degree of independent scrutiny of the CRIS. However, given the wide variety of cost recovery arrangements, with varying levels of contention, a single model may not be appropriate. A similar approach to that used by governments to implement the Competition Principles Agreement Legislation Review Program may be appropriate, where different review mechanisms may be chosen for different arrangements, according to criteria such as whether it is a new proposal or relatively

minor modifications to existing arrangements; the degree of stakeholder concern; and the amount of revenue raised/to be raised.

To promote greater transparency and accountability, the outcome of the CRIS process (that is, the Cost Recovery Impact Statement itself) should be made publicly available. Along with the report of any independent review mechanism, it could be placed on the agency's web site and published in agencies' annual reports.

DRAFT RECOMMENDATION 3.4

A Cost Recovery Impact Statement (CRIS) process should be developed for application to all significant cost recovery proposals or amendments to existing cost recovery arrangements not covered by an enhanced Regulatory Impact Statement (RIS).

INFORMATION REQUEST

The Commission seeks further views on appropriate independent mechanisms for preparing or reviewing Cost Recovery Impact Statements.

3.4 International obligations

International obligations may place constraints on the ability of Commonwealth agencies to set cost recovery charges. These obligations may take various forms, including, bi-lateral and multi-lateral agreements, harmonisation and mutual recognition.

International agreements

A number of specific international agreements set the price (sometimes zero) that Commonwealth agencies can charge for at least part of their services. This is particularly the case where Australia provides one element of an international service, such as intellectual property rights (which are granted on a territorial basis) or information services which have a geographic basis. International agreements may also govern the price for information supplied to international bodies such as the United Nations, the OECD and the World Trade Organisation (WTO).

Intellectual property rights

The ability of IP Australia to determine and set prices is constrained by the Patent Cooperation Treaty. Fees relating to applications filed under the Treaty are set by agreement with the World Intellectual Property Organisation (WIPO). These fees

contain two components — the first is paid by IP Australia to the International Bureau of WIPO and the second is retained by IP Australia. The fees for the first component are determined by the Bureau (IP Australia, sub. 57, p. 11).

International information services

Australia belongs to a number of international bodies that provide standardised global information on subjects such as the weather and mapping. These organisations have agreements about information sharing that affect Australia's ability to recover the costs of collecting and distributing this information (box 3.8).

The impact of these agreements may be mitigated by several factors:

- restrictions on the 're-export' of the information for commercial purposes; and
- the fact that the information is often limited to copies of information that is already freely available in Australia.

World Trade Organisation

Other international agreements potentially restrict Australia's ability to impose cost recovery on imported goods and services. Article VIII of the General Agreement on Trade and Tariffs restricts the ability of member countries to charge fees and duties in connection with importation or exportation. Fees and charges must be limited to the approximate cost of services rendered, and not represent an indirect protection to domestic products or a taxation of imports or exports for fiscal purposes (WTO 1995).

WTO agreements with particular relevance to cost recovery include the Application of Sanitary and Phyto-Sanitary Measures (SPS Agreement) and Technical Barriers to Trade (TBT Agreement). The TBT Agreement defines how technical barriers to trade may be used legitimately. The SPS Agreement places an obligation on signatories not to restrict trade more than 'necessary' to maintain quarantine security. Charging undertaken by regulatory agencies for import risk or equivalence assessments could raise WTO issues under this Agreement. The Department of Foreign Affairs and Trade has flagged the *Australia New Zealand Food Authority Act 1991*, the *Agricultural and Veterinary Chemicals Code Act 1994*, the *Industrial Chemicals (Notification and Assessment) Act 1989*, and the *Gene Technology Bill 2000* as examples of domestic legislation which could raise WTO concerns (DFAT, sub. 97, p. 2).

Box 3.8 **International information agreements**

World Meteorological Organisation (WMO): requires members to provide to other members 'those basic data and products required to describe and forecast weather and climate and to support WMO programmes … on a free and unrestricted basis'. Members may be justified in placing conditions on their re-export for commercial purposes outside of the receiving country (WMO Resolution 40-Cg XII).

Australian Bureau of Statistics (ABS): Section 6 (f) of the *Australian Bureau of Statistics Act 1975* requires the ABS to provide 'liaison between Australia, on one hand, and other countries and international organisations, on the other hand, in relation to statistical matters'. The ABS meets this obligation by supplying data and one copy of standard publications on a complimentary basis to international organisations such as the United Nations.

Australian Geological Survey Organisation (AGSO): provides seismic data free of charge (daily, weekly, monthly and annually) to World Data Centres globally and to the International Data Centre in Vienna 24 hours a day. AGSO also has an agreement with the Comprehensive Test Ban Treaty Organisation (CTBTO) to maintain telecommunications links to international seismic stations to allow for the continuous transmission of data. The CTBTO pay AGSO for the provision of this service.

AGSO has a Memorandum of Understanding (MOU) with the US Geological Survey and is about to enter into a similar arrangement with the China Geological Survey. Although these MOUs are not legally binding they provide for the sharing of data and exchange of scientific and technical knowledge.

Australian Surveying and Land Information Group (AUSLIG): has no international arrangements in place for data sharing. It has arrangements with satellite operators at commercial rates.

Source: BOM (sub. 35); AUSLIG (sub. 44).

Harmonisation

Australia is pursuing agreements to harmonise standards in some areas. For example, the Closer Economic Relations (CER) free trade agreement between Australia and New Zealand applies to goods and services and, increasingly, to harmonising standards and legislation. One example of these arrangements was the establishment of the Australian and New Zealand Food Authority (ANZFA) and the associated development of joint food standards in 1995. Harmonisation can lead Australian regulators to adopt different standards than they would have in the absence of an agreement. If these standards impose different costs, this can affect the level of cost recovery.

Mutual recognition

The mutual recognition of regulatory assessments and approvals can lead to price competition between regulators. If Australia were to recognise the assessments and approvals of overseas regulators, there would be an incentive for firms wishing to sell on the Australian market to seek approval from the cheapest regulator. This would place pressure on the Australian regulator to maintain competitive prices. Mutual recognition can also reduce firms' costs by removing the need for multiple approvals to sell in more than one market.

The National Standards Commission (NSC), for example, is moving towards mutual recognition as a member of the International Organisation of Legal Metrology. Under this arrangement, international laboratories would accept each other's reports. The NSC recognises this would place it in price competition with overseas laboratories and significantly reduce the amount of testing conducted in Australia (sub. 31, p. 4).

Australia is pursuing mutual recognition in a few other areas, such as medical devices and chemicals. In the case of medical devices, Australia is a participant in the Global Harmonisation Taskforce — compromising of Canada, Japan, the European Union and the United States. Whilst this has not yet led to a significant increase in the recognition of overseas assessments or approvals, the Government recently decided to adopt the international classification of medical devices from the European Union — but retain the TGA's role in approving products for supply in Australia (PC 2000a, p. 145). Progress is also being made with respect to the mutual recognition of laws relating to chemicals through the Trans-Tasman Mutual Recognition Arrangement Chemicals Cooperation Program (Australian Chemical Specialties Manufacturers Association, sub. 60, p. 7).

FINDING

International obligations can constrain the ability of some Commonwealth agencies to set cost recovery charges because:

- *specific international agreements set fees for certain services (or require some services to be free); and*
- *harmonisation and mutual recognition of assessments can lead to price competition in regulation.*

3.5 Other models of cost recovery

Whilst the Commonwealth is yet to implement official guidelines or legislation to assist agencies implementing cost recovery, State Governments and other countries have adopted different approaches to cost recovery.

International models

Although different issues are highlighted in different jurisdictions (as discussed in appendix G), a common theme is the distinction between taxes and user charging. The Constitutions of New Zealand, Canada and the United Kingdom are similar to Australia, in that they require that taxes be implemented on the basis of specific legislation. Therefore, user charges that have the characteristics of a tax, but are not supported by the legislation, may be invalid. The distinction between user charges and taxes in the United States is unclear and there has been considerable litigation surrounding this issue (see appendix G).

The New Zealand approach to cost recovery is outlined in *Guidelines for Setting Charges in the Public Sector* (New Zealand Treasury 1998). They contain some information on the accounting, costing and the economic issues surrounding cost recovery. It is not clear how strongly the New Zealand guidelines promote the use of cost recovery. However, they seem to encourage the use of cost recovery for revenue raising purposes. One of the stated objectives is 'reducing reliance on funding from general taxation' (New Zealand Treasury 1998, p. 2).

The guidelines examine the economic principles that may make cost recovery inappropriate but provide limited practical advice on how these principles should be applied. For example, the guidelines provide a case for partial cost recovery, but state that 'the loss in public benefits from charging at full cost would have to be significant' (New Zealand Treasury 1998, p. 2). The guidelines state that the potential beneficiaries of government activities, and individuals, groups or firms that require regulation ('risk exacerbators'), should be subject to cost recovery.

The New Zealand Treasury has also identified characteristics which determine whether user charges amount to taxation. These include: whether the transaction is voluntary; the strength of the link between the revenue source and its use; the magnitude of the user charge; and whether indirect as well as direct costs are recovered (1998, p. 17).

The Canadian approach to cost recovery is outlined in its *Cost Recovery and Charging Policy*. This was produced in 1997 by the Treasury Board of Canada Secretariat (following consultation with stakeholders) and provides guidelines to

Canadian government agencies on their fees and charges. The guidelines have adopted a beneficiary pays approach and require government agencies to ensure consultation with affected parties before and during the cost recovery process. The guidelines make provision for deviation from full cost recovery, if the activity is affected by some public policy objective, or contains a mix of public and private benefits (1997b).

The Canadian guidelines also contain some information on the economic issues surrounding cost recovery and limited information on accounting and costing matters. *User Charging in the Federal Government — A Background Document* (Treasury Board of Canada Secretariat 1997a) is another useful document which contains a detailed discussion of economic issues associated with user charges.

Cost recovery guidelines in the United Kingdom are outlined in *The Fees and Charges Guide* (UK Treasury 1992). This provides guidelines to the United Kingdom government agencies on their fees and charges. It contains detailed accounting and costing information but little information on economic issues. The guide appears in favour of full cost recovery, but it does not attempt to address when full cost recovery is inappropriate, other than stating that partial cost recovery is permissible with Ministerial agreement. Government agencies in the UK are unable to charge for services unless they have specific legislative authority to do so (UK Treasury 1992, p. 2).

In the United States, the *Circular No. A-25 Revised* (OMB 1993) provides guidelines to United States federal government agencies on their fees and charges. It contains limited information on the accounting, costing and economic issues surrounding cost recovery. It appears to encourage cost recovery strongly and states that full cost recovery is appropriate from identified recipients of government activities, irrespective of whether all or some of the benefits are passed onto others, including the public in general. The Office of Management and Budget views cost recovery as an alternative to budget funding and believes this has been an important factor behind the increase in United States user charges.

The Finnish approach to cost recovery is unique in that it appears to be the only country with a specific Act — *User Charging for Government Services Act 1992*. It promotes the use of cost recovery and provides guidelines to Finnish government agencies on their fees and charges. The legislation lists many possible exemptions including: health care and other welfare services, administration of justice, environmental protection services, education and general cultural activities, but does not provide a rationale for these exemptions.

State models

New South Wales, Victoria, Tasmania and Western Australia have all published guidelines on cost recovery (see appendix G). These contain guidance on issues related to costing, pricing and competitive neutrality issues. All of the guidelines promote full cost recovery but deviate from this general rule in situations where there may be conflicting policy objectives (related to perceived equity concerns), public goods or externalities.

The Victorian guidelines identify regulatory fees as separate from other 'user fees', and do not impose full cost recovery on these charges. New South Wales also identifies regulatory fees as distinct from other charges and does not cost recover for them.

Most of the state guidelines promote some form of internal review on an annual basis in conjunction with the publication of their pricing policies. The results of these are made available in various forms. For example, in Western Australia they are located in annual reports, in Victoria they are located in departmental business plans and in Tasmania they can be found in specific manuals related to charges.

4 Current cost recovery arrangements

4.1 Introduction

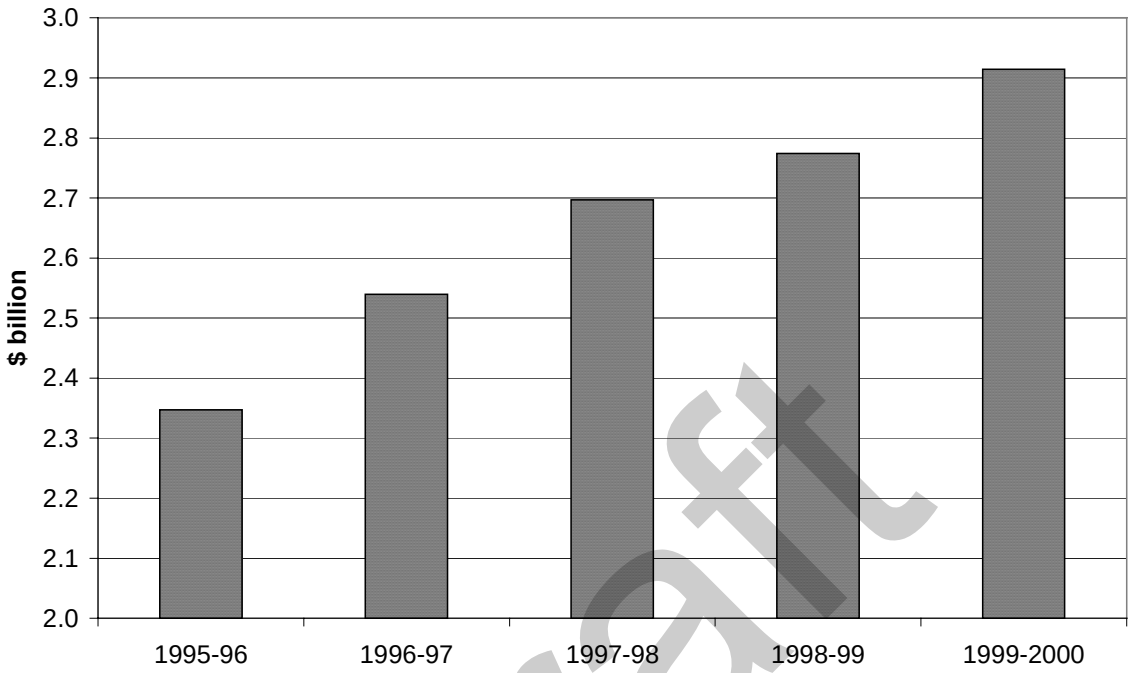
A wide range of cost recovery arrangements exist within Commonwealth regulatory and information agencies. Agencies employ a variety of mechanisms to recover the costs of their activities and have varying rationales for these arrangements. The arrangements of regulatory agencies on one hand, and information agencies on the other, are often influenced by common factors which are discussed under separate headings in sections of this chapter.

A significant amount of revenue is collected through cost recovery arrangements across Commonwealth regulatory and information agencies. As noted in chapter 3, publicly available data relating to these arrangements at both the national level and individual agency level are incomplete. Hence, the Commission undertook a survey of agencies in order to estimate the magnitude and extent of their cost recovery arrangements.

Departments and agencies that responded to the questionnaire collected a total of $3.2 billion in cost recovery revenue in the 1999-2000 financial year.[1] As indicated in figure 4.1, cost recovery revenue of regulatory and information agencies has increased annually since 1995-96. Over this period, cost recovery revenue increased by 24.2 per cent in real terms. This compares with an increase in total Commonwealth Government outlays of 10.6 per cent over the same period. The cost recovery revenue of regulatory and information agencies within each portfolio is indicated in table 4.1.

[1] This figure provides a general indication of the magnitude of cost recovery in Commonwealth regulatory and information agencies. However, it is based on agencies' own estimates of their cost recovery revenue. It includes revenue only of agencies that responded to the Commission's questionnaire. Further, it includes transactions both between agencies and between agencies and the private sector. It does not include some revenues that fall outside the scope of this inquiry, such as primary industry levies.

Figure 4.1 **Cost recovery revenue of Commonwealth regulatory and information agencies[a]**
(in 1999-2000 dollars)[b]



[a] Cost recovery revenues are based on agencies' own estimates. Revenues include only those of: a) agencies that responded to the Commission's questionnaire; and b) agencies that reported cost recovery revenues for all five years. Further, revenues include transactions both between agencies and between agencies and the private sector. They do not include some revenues that fall outside the scope of this inquiry. Cost recovery revenue for 1999-2000 is less than the $3.2 billion reported elsewhere in this report due to the exclusion of agencies that did not report cost recovery revenues for each of the five years. [b] Current dollars converted to constant 1999-2000 dollars using an implicit price deflator based on total final consumption expenditure.

Data sources: PC estimates based on questionnaire responses; ABS National Accounts on dX-Online database (accessed February 2001).

Agencies within these portfolios recover different proportions of their costs through a range of mechanisms. Some agencies do not undertake cost recovery whilst others recover over 100 per cent of their costs. The nature and extent of current cost recovery arrangements are discussed in more detail in sections 4.3 and 4.4.

Some agencies have a long history of cost recovery and many began recovering at least some of their costs when they commenced operations. Although agencies introduced initial arrangements at different times, there has been a general trend to increase the level of cost recovery. Most of the existing arrangements described by agencies in responses to the questionnaire were implemented in the last decade. Many emerged from internal reviews and independent reports such as the Wallis (1997) inquiry into Australian financial systems and Bosch (1984) inquiry into aviation cost recovery.

Table 4.1 **Cost recovery revenue by portfolio, 1999-2000**

Portfolio	*Cost recovery revenue*[a]	*Total expenses of portfolio*[b]	*Cost recovery/ total expenses*[c]
	$m	$m	%
Agriculture, Fisheries and Forestry	202	1 603	12.6
Attorney General	479	1 525	31.4
Communications, Information Technology and the Arts	72	1 483	4.9
Defence	12	13 458	0.1
Education and Youth Affairs	5	11 170	0.0
Employment, Workplace Relations and Small Business	32	1 631	2.0
Environment and Heritage	55	816	6.7
Family and Community Services	1	50 559	0.0
Finance and Administration	72	4 807	1.5
Foreign Affairs and Trade	172	2 364	7.3
Health and Aged Care	58	37 049	0.2
Immigration and Multicultural Affairs	226	774	29.2
Industry, Science and Resources	403	2 273	17.8
Prime Minister and Cabinet	24	1 164	2.0
Transport and Regional Services	730	2 905	25.1
Treasury	678	29 105	2.3
Veterans' Affairs	0	7 657	0.0
Total	**3 221**	**170 343**	**1.9**

[a] Figures include some transactions between agencies. [b] Figures are estimates of 1999-2000 'Total General Government Expenses by Agency' which include $15 354 million of inter-agency transactions but do not include $3 404 million of small agency expenses. [c] These percentages may be lower than actual percentages due to the inclusion of expenses of agencies not surveyed by the Commission (and those that did not respond) in the total expenses of portfolio figure.

Sources: PC estimates based on questionnaire responses; Budget Strategy and Outlook 2000-01, pp. 6.70–6.72.

4.2 Agency rationales for current cost recovery arrangements

In the Commission's questionnaire, departments and independent agencies within portfolios were asked to explain their rationales for their current cost recovery arrangements. The stated rationales within selected agencies are identified in table 4.2.

Table 4.2 **Rationales of selected agencies' current cost recovery arrangements**

Agency[a]	*Raise revenue*	*Expand services*	*Economic efficiency*	*Demand management*	*Agency efficiency*	*Equity/ distributional issues*	*International Agreements*	*Competitive Neutrality*	*Government policy or administrative decision*	*No cost recovery imposed*
ABARE								✓		
ABS	✓		✓	✓						
ACS	✓									
AEC								✓		
AFMA			✓							
AQIS									✓	
ASIC			✓			✓				
BoM[b]			✓				✓	✓		✓
CASA			✓						✓	
CSIRO					✓					
Environment Australia						✓				
IP Australia							✓			
National Library	✓			✓						
NRA									✓	
ScreenSound Australia	✓	✓								
TGA			✓						✓	

[a] ABARE – Australian Bureau of Agricultural and Resource Economics, ABS – Australian Bureau of Statistics, ACS – Australian Customs Service, AEC – Australian Electoral Commission, AFMA – Australian Fisheries Management Authority, AQIS – Australian Quarantine and Inspection Service, ASIC – Australian Securities and Investment Commission, BoM – Bureau of Meteorology, CASA – Civil Aviation Safety Authority, CSIRO – Commonwealth Scientific and Industrial Research Organisation, NRA – National Registration Authority for Agricultural and Veterinary Chemicals, TGA – Therapeutic Goods Administration. [b] These rationales relate to separate activities within BoM — only some of which are subject to cost recovery.

Sources: PC estimates based on questionnaire responses; submissions.

Questionnaire responses indicated a wide range of rationales for existing arrangements and that often there was more than one reason for the current arrangements of individual agencies.

Common rationales included:

- to raise agency revenue — cost recovery arrangements were introduced to reduce funding from appropriations and lower the budget deficit (for example the Australian Customs Service partly attributed the introduction of cost recovery for its import processing activities to the Government's need to reduce the budget deficit [sub. 29, p. 2]);
- to expand services — cost recovery arrangements were introduced to supplement revenue from appropriations and provide funds for additional services (for

example, ScreenSound Australia indicated that the expansion of its range of services was a guiding principle behind its cost recovery policy [sub. 30, p. 9]);

- to increase economic efficiency — a number of agency responses may be grouped under the heading of economic efficiency, including 'user pays' and 'beneficiary pays'. For example, the Australian Fisheries Management Authority stated:

  > Current Government policy on cost recovery for fisheries management originated in the mid-1980s as part of the general philosophy that the beneficiaries of Government services should meet the cost of those services in accordance with the concept of user pays. (sub. 65, p. 1);

- to manage demand — cost recovery arrangements were introduced to influence the demand for the services of the agency. Generally, such arrangements attempt to prevent unnecessary service burdens on agencies by encouraging only genuine demands for agency services (for example, the Department of Immigration and Multicultural Affairs [DIMA] explained that non-Electronic Travel Authority visitor fees act as a deterrent to frivolous applications [trans., p. 572]);
- to improve agency efficiency — for example, CSIRO listed one of the rationales for its arrangements as 'to open certain activities to market-related forces to ensure their relevance to the needs of users and to improve their efficiency' (sub. 88, p. 4);
- to address equity or distributional issues — through cost recovery arrangements agencies seek to improve equity in the distribution of costs. For example, Environment Australia noted that:

  > Where a government service provides an individual or group with a benefit over and above that which accrues to the general public, cost recovery can be used to improve equity in the distribution of the costs of providing the service. (sub. 76, p. 2);

- to conform with international agreements — for example, fees imposed by IP Australia relating to applications filed under the Patent Cooperation Treaty are set by agreement with the World Intellectual Property Organisation (sub. 57, p. 11); and
- in accordance with competitive neutrality requirements — agencies providing services in competition with private providers must charge fees for these services which are consistent with competitive neutrality principles (for example, the Australian Electoral Commission and ABARE stated that these principles were considered when deciding which services should be cost recovered [sub. 73, p. 1; sub. 56, p. 15]).

In submissions to the inquiry a number of agencies provided rationales for not imposing full cost recovery for at least some of their activities. These rationales included:

- provision of a public good — most information agencies cited this rationale for providing certain services free of charge. For example, the Bureau of Meteorology (BoM) stated:

  > … the rationale for the provision of basic public information, forecast and warning services free to the community at large through the mass media rests on the fact that, because of their public good nature, the total national economic benefit from these services is the sum of their value to every individual decision maker; and the total economic benefit is therefore the greater the more widely they are made available and consumed. (sub. 35, p. 4);

- conflict with policy objectives — for example, the Australian Transactions Reports and Analysis Centre (AUSTRAC) stated that it was:

  > … decidedly opposed to its clients having to pay a money cost for AUSTRAC services. That is because the [Financial Transaction Reports] Act is part of a program being promoted by Government and the Parliament to better focus law enforcement and revenue administrators on issues concerning financial misbehaviour and certain types of tax evasion … To charge those officers and agencies a money cost for the data and the services of AUSTRAC would be a retrograde step in the promotion of that goal. (sub. 22, pp. 13–14); and

- equity and access considerations — for example, fees for application to the Migration Review Tribunal are waived under certain conditions, including severe financial hardship. (DIMA, sub. 53, appendix D)

There is also a number of examples of rationales that have changed over time, including rationales for the Passenger Movement Charge and the Therapeutic Goods Administration's (TGA) cost recovery arrangements.

In the second reading speech for the legislation introducing the Passenger Movement Charge, the then Treasurer said the charge was to 'fully offset' the costs of Customs, Immigration and Quarantine processing of incoming and outgoing passengers, and to recover the costs of issuing short-term visitor visas (Qantas, sub. 63, p. 9). However, in a recent report the Australian National Audit Office (ANAO) found that the Passenger Movement Charge was 'applied partly as a general revenue raising source, and is no longer solely linked to cost recovery of Customs, Immigration and Quarantine service' (ANAO 2000d, p. 13).

When the TGA commenced operations, the Minister responsible for health services at the time advocated only partial cost recovery on the grounds that some activities of the TGA were performed in the public interest. However, in a submission to the inquiry, the TGA argued the subsequent increase to 100 per cent cost recovery was warranted on the grounds that industry gains a significant commercial benefit from product endorsement and 'that all regulatory effort by the TGA is undertaken solely because the industry exists' (sub. 89, p. 10).

At the agency level, there does not appear to have been a consistent approach applied among similar agencies or within portfolios. However, some rationales were more predominant for regulatory agencies, while others were more commonly applied to information agencies.

On the whole, information agencies typically had more clearly articulated rationales than regulatory agencies. The rationale of expanding services was more common among information agencies. The ABS cited the following objectives in the introduction of its current arrangements:

> (a) to enable demand for ABS products and services to be used as a more reliable indicator of how ABS resources should be used; (b) to encourage users to address their real needs for ABS products; and (c) to relieve the general taxpayer of those elements of the cost of the statistical service which had a specific and identifiable value to specific users. (questionnaire response)

On the other hand, the questionnaire responses of many regulatory agencies did not provide clear rationales for their arrangements, beyond attributing the introduction or existence of their arrangements to 'government policy' or an administrative decision (for example, the Department of Industry, Science and Resources stated that an 'administrative decision' was the rationale for cost recovery of the Ionospheric Prediction Service [questionnaire response]).

Some agencies referred to external reviews for the rationale of their cost recovery arrangements. For example, the Australian Maritime Safety Authority (AMSA) referred to the Review of AMSA Levies (Taylor 1997). Other agencies have undertaken internal reviews of their cost recovery arrangements. However, these reviews have typically focused on the implementation of cost recovery policies rather than their rationale.

It might be expected that rationales would differ according to the circumstances of agencies. However, the wide range of observed rationales, and the poor focus on economic efficiency, reflects the absence of any overarching government policy on cost recovery.

FINDING

There is no clear, current Government policy on cost recovery. This has contributed to inconsistency in many aspects of cost recovery within and across agencies and portfolios.

FINDING

The rationales for cost recovery for most information agencies are better developed and articulated than those for regulatory agencies.

DRAFT RECOMMENDATION 4.1

The Commonwealth Government should adopt a formal cost recovery policy for regulatory and information agencies. This policy should implement the cost recovery guidelines recommended by this inquiry.

4.3 Extent of current cost recovery arrangements

A wide range of cost recovery arrangements are imposed by Commonwealth regulatory and information agencies. As indicated above, significant amounts of revenue are obtained through these arrangements. This section provides an overview of the extent of cost recovery in regulatory and information agencies, both in terms of the revenue raised, and the activities that are subject to cost recovery.

Regulatory agencies

Cost recovery arrangements exist, to some extent, in almost all Commonwealth regulatory agencies. The cost recovery arrangements of the health and safety regulatory agencies, Australian Communications Authority and financial regulatory agencies are discussed in greater detail in appendices D, E and F respectively. The extent of cost recovery arrangements across selected regulatory agencies is summarised in table 4.3.

Regulatory agencies undertake a number of different types of activities, including regulatory activities, 'community service obligations', and activities undertaken for government, such as policy development and prosecution. Most agencies recover different proportions of the costs of these activities.

At the lower end of the range, the Australia New Zealand Food Authority (ANZFA) and the Australian Radiation Protection and Nuclear Safety Agency (ARPANSA) recover under 10 per cent of costs. ANZFA has not generated any cost recovery revenue from its regulatory activities, despite recent amendments enabling it to charge fees in limited circumstances. At the other end of the scale, the Australian Securities Investment Commission (ASIC) recovers 249 per cent of its costs. This variation reflects the different activities for which agencies recover costs.

Table 4.3 **Cost recovery in selected regulatory agencies 1999-2000**

Agency[a]	*Cost recovery revenue*	*Cost recovery / total expenses*	*Agency cost recovery target?*	*Cost of compliance monitoring recovered?*
	$m	%		
ACA	54.2	110.6	Yes	Yes
AMSA	52.4	69.7	No	Yes
ANZFA	0.8[b]	5.8	No	No
APRA	88.3	150.0	Yes	Yes
AQIS	136.7	76.7	No	No
ARPANSA	1.2	7.7	No	No
ASA	585.4	108.6	Yes	Yes
ASIC	361.0	249.0	Yes	Yes
CASA	59.8	71.4	No	Some[c]
NICNAS	3.7	99.3	Yes	Some[d]
NRA	17.6	108.4	Yes	Yes
TGA	41.4	84.5	Yes	Yes

[a] ACA – Australian Communications Authority, AMSA – Australian Maritime Safety Authority, ANZFA – Australia New Zealand Food Authority, APRA – Australian Prudential Regulatory Authority, AQIS – Australian Quarantine and Inspection Service, ARPANSA – Australian Radiation Protection and Nuclear Safety Agency, ASA – Airservices Australia, ASIC – Australian Securities and Investment Commission, CASA – Civil Aviation Safety Authority, NICNAS – National Industrial Chemicals Notification and Assessment Scheme, NRA – National Registration Authority for Agricultural and Veterinary Chemicals, TGA – Therapeutic Goods Administration. [b] ANZFA has not generated any cost recovery revenue from its regulatory services. This revenue is revenue from sale of publications. [c] CASA receives an appropriation for 50 per cent of its compliance monitoring and standards setting functions. [d] NICNAS receives an appropriation for 50 per cent of its compliance monitoring costs.

Source: PC estimates based on questionnaire responses.

Some agencies are required to meet cost recovery targets to recover a specified proportion of their costs, or the costs related to certain activities, whilst others have discretion regarding the activities that will be cost recovered. For example, the TGA and the Australian Prudential Regulatory Authority (APRA) have cost recovery targets of 100 per cent of total agency costs, whereas the Australian Quarantine and Inspection Service (AQIS) is required to recover 100 per cent of the costs relating to its inspection and certification services only. ANZFA requires the payment of fees only where an 'exclusive capturable commercial benefit' can be identified or where applicants request their applications be fast tracked (although these arrangements have not yet generated any revenue). These arrangements are discussed further in appendix D.

The activities for which costs are recovered also vary across agencies. Some regulatory agencies, including the TGA, the National Registration Authority for Agricultural and Veterinary Chemicals (NRA), ASIC and APRA, recover costs relating to compliance monitoring and other post market activities. Others, such as the National Industrial Chemicals Notification and Assessment Scheme (NICNAS)

and the Civil Aviation Safety Authority (CASA), receive an appropriation to fund a proportion of such activities.

The cost recovery arrangements of ASIC (see appendix F) differ from other regulatory agencies in that they are intended to recover:

> (a) the amounts appropriated for ASIC … (b) the amounts paid to the States and Northern Territory as compensation for corporations fees revenue foregone; and (c) the notional costs of the Treasury and the Attorney-General's portfolio agencies (for example, Courts, [Director of Public Prosecutions, Administrative Appeals Tribunal]) associated with the administration of the national corporate regulation scheme. (ASIC, questionnaire response)

Some agencies also recover costs associated with policy functions. These functions include preparing ministerial briefings and research papers, standards development, and complying with government accountability requirements. However, some agencies do not have responsibility for these policy functions and do not need to consider whether to apply cost recovery to them. For example, policy functions relating to industrial chemicals are undertaken by the National Occupational Health and Safety Commission rather than NICNAS.

Typically, regulatory agencies recover fees and charges from individual firms or industries. For example, firms seeking company or product registration from a regulatory agency will incur any fees associated with these services. Further, once these firms become part of a regulated industry, they may be required to pay levies imposed on the whole industry by the regulating agency.

Some cost recovery charges of regulatory agencies are paid directly by individual consumers. For example, visa application and citizenship fees imposed by DIMA are charged directly to persons seeking visas or citizenship. Consumers may also pay the cost recovery charges of regulatory agencies indirectly through the purchase price of products and services. However, this will depend on the ability of firms to include some or all of these charges in their prices (see chapters 2 and 6).

Regulatory agencies also receive payments for services from other government agencies and departments. Some of these payments are determined by contracts, memoranda of understanding or service level agreements and are not cost recovery payments. For example, Centrelink has service level agreements with other areas of government to deliver social welfare payments. Similarly, the TGA and NRA have a memorandum of understanding for the provision of assessment services and associated payments. In other instances, agencies and departments pay cost recovery fees and charges in the same manner as non-government users. For example, the Australian Electoral Commission has both government and non-government users which pay cost recovery fees.

Information agencies

All information agencies that responded to the Commission's questionnaire have some cost recovery arrangements. These arrangements are discussed further in appendix C. As with regulatory agencies, the proportion of costs recovered varies. However, the proportion of costs recovered was generally lower in information agencies than in regulatory agencies. Some agencies have an agency-wide cost recovery target. The Australian Geological Survey Organisation (AGSO), ABARE and CSIRO have cost recovery targets of 30 per cent of costs imposed on them. These targets are substantially lower than the 100 per cent targets imposed on some regulatory agencies. The extent of cost recovery arrangements across selected information agencies is summarised in table 4.4.

Table 4.4 **Cost recovery in selected information agencies, 1999-2000**

Agency[a]	*Cost recovery revenue*	*Cost recovery/total expenses*	*Agency cost recovery target?*
	$m	%	
ABARE	11.2	50.9[b]	Yes
ABS	21.5	8.4	No
AGSO	12.1	16.5	Yes
AUSLIG	4.7	14.2	No
BoM	35.2	17.3	No
CSIRO	250.4	32.3	Yes
National Library	8.6	16.9	No
ScreenSound Australia	1.7	3.6	No

[a] ABARE – Australian Bureau of Agricultural and Resource Economics, ABS – Australian Bureau of Statistics, AGSO – Australian Geological Survey Organisation, AUSLIG – Australian Surveying and Land Information Group, BoM – Bureau of Meteorology, CSIRO – Commonwealth Scientific and Industrial Research Organisation. [b] ABARE exceeds its cost recovery target of 30 per cent.

Source: PC estimates based on questionnaire responses.

Information agencies generally base the imposition of cost recovery on distinctions between activities. The activities of information agencies can generally be separated into collection, compilation, analysis and dissemination. These activities can be further divided into core and non-core services. However, this division varies between agencies and types of services. For example, some of the ABS's dissemination activities are treated as core activities, and some are regarded as non-core activities. Most information agencies identify a large public good component in most of the services which are classified as core services and funded mostly through general budget appropriations. Non-core services are typically cost recovered. For example, the pricing policy of the ABS is:

- no charge for products and services considered to be community service obligations;

- partial cost recovery for products and services, where there is an element of [Community Service Obligation] CSO contained in the product or service, although significant private benefit also exists;
- full cost recovery for products and services, where no CSO is perceived to exist; and
- a very few prices which include an allowance for 'risk' as well as cost recovery, where the product is seen as 'commercial'. (ABS, sub. 36, pp. 7–8)

Information agencies, like regulatory agencies, impose cost recovery fees for non-core activities on a range of users. The services of information agencies may be purchased by individual firms, consumers or other government agencies, each of which will be required to pay any cost recovery charges imposed.

FINDING

Cost recovery arrangements exist, to some extent, in most Commonwealth regulatory and information agencies. However, there is little consistency in the application of these arrangements. Generally:

- *there is no uniform approach as to which activities are subject to cost recovery; and*
- *there are wide variations in the proportion of costs recovered for comparable activities undertaken by different agencies.*

4.4 Cost recovery mechanisms

The cost recovery mechanisms applied by regulatory and information agencies can be grouped into two categories — fees for services, and taxes (often called levies). The distinction between fees for service and taxes, and the legal criteria for the application of these mechanisms are discussed in chapter 3. The differing nature of activities provided by regulatory agencies on one hand, and information agencies on the other, has meant that different cost recovery mechanisms have often been applied.

Regulatory agencies

Regulatory agencies generally use a mix of fees for service and levies to recover costs. As a consequence of the many different activities undertaken by regulatory agencies, a wide variety of fees for service are applied. Similarly, levies imposed by these agencies vary in nature and magnitude. The different cost recovery mechanisms used by regulatory agencies are illustrated in table 4.5.

Table 4.5 **Current cost recovery mechanisms imposed by selected regulatory agencies**

Agency[a]	*Type of fee for service imposed*	*Type of tax or levy imposed*
ACA	Apparatus licence transaction fees	Annual Carrier licence charge, apparatus licence fee
AMSA		Marine Navigation Levy, Regulatory Functions Levy, Protection of the Sea Levy
ANZFA	Assessment fees	
APRA		Financial Supervision Levy
AQIS	Fees for service, registration charges, documentation fees	Quantity charges (customs and excise duties)
ARPANSA	Licence application fees	
ASA	Commercial service charges	
ASIC	Document lodgement fees, application fees, information search fees	
CASA	Regulatory service fees	Fuel excise
NICNAS	Assessment fees, administration charges	Company registration charge
NRA	Application and renewal fees	Levy on disposals of registered products
TGA	Application, evaluation, assessment and inspection fees	Annual charge

[a] ACA – Australian Communications Authority, AMSA – Australian Maritime Safety Authority, ANZFA – Australia New Zealand Food Authority, APRA – Australian Prudential Regulatory Authority, AQIS – Australian Quarantine and Inspection Service, ARPANSA – Australian Radiation Protection and Nuclear Safety Agency, ASA – Airservices Australia, ASIC – Australian Securities and Investment Commission, CASA – Civil Aviation Safety Authority, NICNAS – National Industrial Chemicals Notification and Assessment Scheme, NRA – National Registration Authority for Agricultural and Veterinary Chemicals, TGA – Therapeutic Goods Administration.

Source: PC estimates based on questionnaire responses.

Fees for service

Fees for service can be used to recover the costs of specific services which are provided directly to the fee payer, where the fee is related to the cost of the service. A wide range of existing cost recovery mechanisms applied by regulatory agencies meet these criteria including application, registration, assessment and licence fees (table 4.5). Agencies may impose fees for service to recover partial, full, or in some circumstances, greater than full costs of providing particular services (for example, fees may recover a return on assets or 'profit' component). DIMA recovers part of the costs of providing its citizenship services through application fees (partial cost recovery). NICNAS imposes assessment and administrative fees to recover the full costs of its New Chemicals Assessment Program (full cost recovery). Airservices Australia (ASA) recovers the costs of its services, including a 'reasonable rate of profit', through fees for service (greater than full cost recovery).

Many of the fees for service imposed by regulatory agencies are modular. That is, services provided by agencies are broken down into small components, each attracting a fee. Regulated firms then pay the sum of these fees to reflect the level of service provided. For example, TGA evaluation fees:

> … are levied on a modular basis with separate fees being paid for each section of the required submission, based on the number of pages and the type of information contained in each part of the submission. (Australian Self Medication Industry, sub. 23, p. 6).

Fees for service imposed by regulatory agencies generally differ from fees imposed by information agencies. The customers of information agencies can choose whether to use a service or not, and how much to consume. Regulated firms may also have some discretion in the amount of cost recovery charges they incur, for example, where charges are related to output. But in the case of premarket regulation, firms basically only have a binary choice: to participate in the market and be regulated, or to decline to participate in the market. They cannot choose how much regulation to consume.

Most regulatory agencies derive legal authority to charge fees from an Act of Parliament. The levels and types of fees are usually then set out in regulations.

Taxes and levies

Unlike a fee for service, taxes (including levies) are often imposed where there is no direct relationship between the payment and the service provided. Taxes and levies are therefore used to recover general agency costs such as costs associated with policy and research activities or compliance monitoring functions (for example, the NRA funds its general policy functions and post market activities from a levy on sales). In some cases, even though agencies can identify the users of their services, they may not wish to charge them directly. For example, it may be administratively simpler to recover costs from a regulated industry through a single levy rather than collecting multiple fees (AMSA funds its regulatory activities relating to maritime safety from an industry levy rather than a series of direct fees due to the administrative complexity of recovering these separate fees).

To recover costs through a tax or levy, agencies require legal authority under a dedicated Act of Parliament. The amount and nature of the levy is then determined by further Acts or by regulation.

Although agencies require a specific Act to impose a charge under taxation legislation, many agencies do not refer to this charge as a tax. For example, the TGA's annual charge to maintain the registration or listing of a product is imposed

as a tax under the *Therapeutic Goods (Charges) Act 1989*, but referred to more generally as a charge. Similarly, NICNAS refers to an annual charge imposed under taxation legislation as 'company registration'.

Information agencies

Responses to the Commission's questionnaire indicated information agencies recover costs through a range of fees for service including royalties.[2] The Commission is not aware of any information agencies recovering costs through taxes or levies. The cost recovery mechanisms imposed by selected information agencies are summarised in table 4.6.

Table 4.6 **Current cost recovery mechanisms imposed by selected information agencies**

Agency[a]	*Type of fee for service imposed*
ABARE	Service charges for economic research, publications and data services
ABS	Fees for sale of goods and services, licence fees, royalties
AGSO	Sale of geoscientific information (maps, datasets, other publications), fees for services and commissioned research
AUSLIG	Publication sales, data licence fees, royalties
BoM	Service charges for meteorological and commercial services
CSIRO	Fees for contract and collaborative research and development, technical and consulting services, grants, royalties and license fees, subscriptions, sale of publications and other products
National Library	Service charges, transaction fees, fees for sale of products and services
ScreenSound Australia	Fees for service, licence fees, product sales, copying costs; fees for public program activities

[a] ABARE – Australian Bureau of Agricultural and Resource Economics, ABS – Australian Bureau of Statistics, AGSO – Australian Geological Survey Organisation, AUSLIG – Australian Surveying and Land Information Group, BoM – Bureau of Meteorology, CSIRO – Commonwealth Scientific and Industrial Research Organisation.

Source: PC estimates based on questionnaire responses.

Information agencies are responsible for a variety of types of information. The differing nature of this information alters the nature of services provided by agencies and subsequently the nature of the cost recovery arrangements. Agencies that provide information in the form of data and publications can recover costs through purchase prices. Other agencies provide less tangible services to users and charge fees to access information. For example, the ABS produces publications to which it can attach purchase prices, while ScreenSound Australia provides a range

[2] The term 'royalty' can also refer to a type of tax. However, information agencies impose royalties in relation to copyright and re-use of the information for commercial purposes.

of less tangible services such as screenings, presentations and exhibitions of audiovisual material for which it partially recovers costs through access fees.

Thus, a wide range of fee types and combinations of fee types may be applied by information agencies. The Australian Surveying and Land Information Group (AUSLIG) imposes licence and copyright fees, and royalties. However, it receives a relatively small proportion of its revenue from royalties and noted that this form of payment attracted high administrative costs for many users (trans., p. 435).

4.5 Costs recovered

In order to implement cost recovery arrangements, agencies must identify and measure the costs to be recovered and allocate these costs to particular activities or services. The processes for identifying and measuring costs are outlined in appendix H. Agencies may use a number of methods to allocate costs. These include using direct costs, fully distributed cost, marginal cost and incremental or avoidable cost. Regulatory and information agencies typically use different approaches to allocate costs to reflect different circumstances.

Regulatory agencies

As noted above, regulatory agencies aim to recover different proportions of their costs. Some regulatory agencies apply cost recovery to the agency as a whole, others to specific activities. Under either approach, agencies may recover partial, full or above full costs.

Most regulatory agencies operate on a full cost recovery basis — either in relation to the agency as a whole or to individual activities. Agencies aiming to recover the full costs of programs or activities tend to allocate costs using fully distributed costing (FDC) methods. Under these methods, direct costs are allocated to their respective services, and indirect costs are allocated across the range of cost recovered services. FDC methods include allocating indirect costs pro-rata to direct costs (for example, assuming that activities use the same share of indirect costs as their share of labour). They also include activity based costing, which attempts to allocate costs to each activity in a way that reflects usage of resources. ANZFA, ARPANSA and AQIS allocate costs as a proportional share of direct costs. NICNAS, the NRA and AMSA use activity based costing to apportion costs (see appendix D).

Information agencies

As noted above, the imposition of cost recovery in information agencies is generally based on a distinction between core and non-core activities. Core activities are usually taxpayer funded, while non-core activities are subject to some degree of cost recovery. However, there are some exceptions whereby some core activities are cost recovered. Non-core activities can usually be divided further between incremental services and commercial services.

Incremental services tend to be charged on the basis of incremental or avoidable costs (see appendix H). Incremental cost is the increase in cost attributable to the production of a particular type of good or service. Avoidable costs include all the costs that would be avoided if an output was no longer provided by the agency. For example, BoM's charges for specialised services to the aviation industry and the Australian Defence Forces are 'determined to recover the incremental costs of the provision of [these services], above the basic service' (BoM, questionnaire response).

Charges for commercial services are usually based on recovering the incremental or avoidable costs as well as other costs such as the cost of capital and, in some cases, a profit component. Compliance with competitive neutrality requirements is a factor for agencies when determining which costs should be recovered. Most agencies set fees for commercial services according to the market. For example, CSIRO's Costing and Pricing Policy states that 'the pricing of commercial activities must be based on the perceived value to the client and an estimate of their full costs' (sub. 88, p. 9). Similarly, AGSO stated that 'services competing with the private sector are charged at full cost (including all AGSO overheads), plus a proxy for rate of return' (questionnaire response).

4.6 Influences on current cost recovery arrangements

A number of factors influence which cost recovery mechanism is implemented by agencies and the level at which charges are set. Agencies and/or Government may consider the presence of any legal constraints, the nature of the industry or market in which the fees are imposed, and the existence of any access or equity considerations. Regulatory and information agencies are often subject to different influences.

Regulatory agencies

Regulatory agencies are constrained in the implementation of cost recovery arrangements by a range of legal, social and market factors. Agencies have differing legislative authority to impose cost recovery, ranging from broad authorisation to the imposition of specific charges. The cost recovery arrangements of these agencies are also influenced by several market factors, including competition in the provision of services and the possible influences of such arrangements on the behaviour of regulated firms. Further, many regulatory agencies have structured their cost recovery arrangements to address access or equity concerns.

Legal factors

Several legal factors influence cost recovery arrangements. Some regulatory agencies impose taxes (or levies) and these must be authorised by a specific Act of Parliament. Most agencies impose fees for service. As discussed in chapter 3, there are legal limits on the amount that can be cost recovered through fees for service. Many regulatory agencies appear to have specific legislative authorisation to impose fees. Some agencies face legal restrictions on what activities they can cost recover and the extent of such cost recovery. For example, Section 110 (1) of the *Industrial Chemicals (Notification and Assessment) Act 1989* enables NICNAS to charge fees in relation to certain services that are provided under the Act. Other agencies have a large degree of autonomy regarding the fee structures and levels they can impose. For example, under s. 54 of the *Australian Radiation Protection and Nuclear Safety Act 1998*, the CEO of ARPANSA may charge for services provided in the performance of its functions.

Market factors

In designing their cost recovery arrangements, agencies may be influenced by the nature of the markets in which they, and their clients, operate. Although more prevalent among information agencies, some regulatory agencies provide services in competitive markets. Competitive markets for regulatory services may emerge where agencies open specific aspects of their activities to competition (such as technical assessments) or where mutual recognition arrangements exist with other regulatory bodies. For example, the National Standards Commission is currently working on an international mutual recognition agreement that would place it in price competition with overseas laboratories (sub. 31, p. 4).

Agencies may establish cost recovery arrangements to influence the behaviour of regulated firms. For example, the ANAO noted:

> AQIS sets some fees above or below the estimated cost of the services provided, in order to influence industry behaviour. … In order to encourage industry to use the electronic certificates available through EXDOC, AQIS undercharged for these and overcharged for the manually-issued certificates. (ANAO 2000a, p. 80)

In addition to using cost recovery fees to encourage users to adopt certain technologies, agencies may also use cost recovery to ration demand for services. For example, DIMA imposes non-Electronic Travel Authority visa application fees to deter frivolous applications (trans., p. 572).

Many regulatory agencies have identified potential negative influences on regulated firms and have developed their cost recovery arrangements to minimise such impacts. The imposition of cost recovery may result in regulated firms behaving in a way that is inconsistent with policy objectives, such as the promotion of health and safety, or the development of small business and new technology. Charging regulated firms fees to notify regulatory agencies of potential threats to public health and safety could deter them from making such notifications. In addition, some cost recovery arrangements could create barriers for small firms and new products to enter markets. These issues are discussed further in chapter 6.

Access and equity considerations

Access and equity issues may also influence the implementation of cost recovery by regulatory agencies. As noted above, some agencies stated that a rationale for their arrangements was, in part, to address equity issues. Agencies may implement cost recovery in response to community perceptions that recovering costs from users of regulatory agencies is more equitable than charging the whole community through general taxation. For example, Environment Australia noted that:

> Where a government service provides an individual or group with a benefit over and above that which accrues to the general public, cost recovery can be used to improve equity in the distribution of the costs of providing the service. (sub. 76, p. 2)

On the other hand, the implementation of cost recovery by regulatory agencies may raise access concerns. Cost recovery charges may be set at levels where firms are discouraged from accessing agency services. Such discouragement may be of concern for two reasons. First, fees may act as a barrier to market entry by firms or products, resulting in less competition and fewer choices for consumers (see chapter 6). Second, in the absence of adequate enforcement of regulation, firms may choose to avoid regulations and associated fees and offer unregulated (and potentially unsafe) products or services to consumers.

The design and structure of agency cost recovery arrangements may be influenced by access and equity considerations. Agencies may seek to encourage access by

particular groups to certain services through reducing the burden of cost recovery fees and charges. Some regulatory agencies seek to improve access to their services by particular user groups such as small firms or users in regional areas. Regulatory agencies use a number of fee mechanisms to encourage access by these groups including:

- minimum levy payment thresholds. For example, only 'persons/companies importing or manufacturing industrial chemicals above $500 000 must register annually with NICNAS and pay a registration charge [levy]' (NICNAS, sub. 33, p. 2).
- reductions or waivers of some fees. For example, fees for applications to the Migration Review Tribunal are waived under certain conditions, including severe financial hardship (DIMA, sub. 53, appendix D).
- minimisation of up-front payments. For example, the NRA imposes only partial up-front cost recovery to avoid 'unduly disadvantag[ing] smaller companies or mitigat[ing] against local research and development efforts and the promotion of minor agricultural industries' (NRA, sub. 39, p. 7).

Regulatory agencies also use fee mechanisms and structures to distribute the burden of their cost recovery charges between users. These mechanisms include:

- levy caps. For example, the NRA limits the annual per product levy paid by registrants of agricultural and veterinary chemical products to $25 000 (NRA, sub. 39, p. 5).
- sliding scales for the calculation of fees. For example, two of the three levies imposed by AMSA are calculated on a sliding scale following 'strong industry representations that the system of a quarterly flat charge … irrespective of usage was inequitable' (Taylor 1997, p. 10).

Government or individual agencies may also address access and equity issues through direct subsidisation of cost recovery arrangements imposed on particular groups. For example, the cost of providing regional airport towers is subsidised directly through a government appropriation (ASA, sub. 107, p. 4).

Information agencies

Like regulatory agencies, information agencies may be influenced by a range of factors when determining their cost recovery arrangements. These influences include legal constraints, competitive neutrality principles, and access and equity objectives.

Legal factors

Information agencies typically charge fees for service. Information agencies generally have broad discretion to charge fees for service under legislation. However, the National Library of Australia (NLA) stated that the *National Library Act 1960* does not specifically preclude nor empower it to charge service fees (questionnaire response). Some information agencies are constrained in the imposition of cost recovery through international agreements that require information to be provided free of charge to international agencies, which in turn provide it free of charge to the public. For example, under the Convention of the World Meteorological Organisation, BoM is required to provide certain essential data and products to other National Meteorological Services on a free and unrestricted basis (BoM, sub. 35, p. 10).

Market factors

Information agencies may provide some services in competitive markets. As with regulatory agencies, information agencies that compete with alternative providers must consider market prices, and the principles of competitive neutrality, when determining their cost recovery arrangements. For example, BoM stated it charges:

> … commercial rates for specialised private-good meteorological services provided in competition or potential competition with the private sector [in part due to] the requirement for competitive neutrality. (sub. 35, p. 5)

Due to the discretionary nature of their services, cost recovery arrangements will affect consumption of services. For example, Cumpston Sarjeant Pty Ltd noted that 'high prices will deter many potential users with genuine needs for data, so that sales reflect only a small part of the demand' (sub. 77, p. 2).

Access and equity considerations

The implementation of cost recovery arrangements by information agencies may be influenced by access and equity considerations. Like regulatory agencies, information agencies may impose cost recovery in response to community perceptions that recovering costs from users is more equitable than recovering costs through general taxation. For example, one of the key objectives of ABS's charging policy is 'to relieve the general taxpayer of those elements of the cost of the statistical service which have a specific and identifiable value to particular users' (sub. 36, p. 4).

However, access and equity considerations may also result in the costs of certain activities not being recovered by information agencies. Access concerns are

particularly relevant in relation to their core activities. Agencies do not generally recover the costs of their core activities due to the public objective of promoting access to core information.

Information agencies may also need to consider the objective of encouraging access to information when establishing the level of fees for cost recovered services. If fees are set at a level where users are discouraged from accessing information, the cost recovery arrangements may conflict with other agency objectives.

Information agencies may encourage certain users to access particular services through the adoption of concessional pricing policies. Agencies that charge access fees may distinguish between users and charge prices according to age (child or pensioner discounts), income (discount for low income earners) or employment status (student or unemployed discounts). For example, ScreenSound Australia stated that:

> … a grandmother who's looking for … footage where she was an extra in a silent movie [and] we have an access video sitting in our headquarters building … that costs nothing. At the other end of the spectrum, if we're talking about the Nine Network wanting material for its 60 Minutes program we charge them big time. (trans., p. 345)

Some information agencies have special arrangements to encourage access to their services by particular user groups. For example, the ABS has an arrangement with the Australian Vice Chancellors Committee 'to enable most universities to have access, with some controls, to confidentialised unit record files' to increase the use of this information for academic and research purposes (ABS, trans., p. 523).

Some information agencies have special arrangements with other agencies for the provision of information. However, it is not clear whether such arrangements are to achieve access objectives. For example, BoM has a Memorandum of Understanding with CASA and Airservices Australia for the provision of meteorological services to the aviation industry and is developing similar arrangements for the provision of its defence services (sub. 35, att. G, p. 5-1).

4.7 Governance arrangements

Governance refers to the processes that direct, control and hold to account agencies. The cost recovery arrangements of regulatory and information agencies may be affected by the governance arrangements of these agencies. Key elements of governance include: the transparency of the agency and its activities; the implementation of effective risk and financial management; and accountability to government, users and the public through clear and timely disclosure.

All Commonwealth agencies have some broad governance arrangements in place. Agencies that are regulated by the *Commonwealth Authorities and Companies Act 1997* (CAC Act) are accountable to a board. Agencies that are regulated by the *Financial Management and Accountability Act 1997* (FMA Act) are accountable to a Chief Executive Officer. The board or Chief Executive Officer are in turn accountable to the responsible Minister.

In addition to these broad accountability requirements, some agencies have developed specific governance arrangements in relation to their cost recovery activities.

Agencies have a variety of arrangements that address governance issues. These arrangements include: the establishment of consultation and review processes; the development of agency specific cost recovery policies and guidelines; and the publication and dissemination of fee structures and levels.

Regulatory agencies

Regulatory agencies have varying institutional arrangements. Some agencies are independent statutory authorities, others are situated within departments. Some agencies are accountable to a board, which is in turn accountable to a Minister. A number of boards include one or more representatives from industry, who may provide a useful link between the agency and the regulated industry, in particular, providing feedback from those paying cost recovery fees and charges. For example:

> The NRA Board comprises members having experience in regulatory affairs, consumer interests, OH&S, farming, government and the chemicals industry under an independent Chairperson. This allows a balancing of interests/expertise. (NRA, sub. 39, p. 6)

However, industry representation on a board may introduce conflicts of interest (see chapter 5).

Some regulatory agencies facilitate consultation with industry through mechanisms such as industry consultative committees. The structure of these committees varies across agencies. For example, the TGA has a single committee known as the TGA Industry Consultative Committee (TICC) which comprises representatives from the TGA and peak therapeutic goods industry groups. The TGA stated that the TICC:

> … facilitates consultation between TGA and the industry regarding input into the TGA budget and accounting against the TGA Corporate Plan; also provides direct feedback from industry to TGA on broad policy, resource allocation and performance issues. (sub. 89, p. 17)

The TICC Terms of Reference include 'to examine and comment on the TGA budget, including new initiatives and other budget measures, and on the proposed industry fees and charges' (Australian Self Medication Industry, sub. 23, p. 8).

AQIS has a separate committee for each of its 14 agency programs, each comprising a wide range of industry representatives (see appendix D).

Regulatory agencies have varying processes for reviewing their cost recovery arrangements. Most agencies review their fee levels or levy rates at least annually. However, these reviews typically do not extend to the structure or imposition of the actual arrangements. Most agencies do not have provisions for regular formal reviews of their arrangements and conduct reviews, if at all, on an *ad hoc* basis. A number of agencies indicated that their cost recovery arrangements had been the subject of formal independent reviews. For example, AQIS cost recovery arrangements have been reviewed by the ANAO (2000a) and AMSA levies were the subject of the Taylor Review (1997).

Information agencies

Like regulatory agencies, information agencies have a mixture of institutional structures. Some are established as independent statutory authorities and others exist within government departments. Information agencies are typically governed by a Director or Chief Executive Officer who is responsible to a Minister. Some information agencies also have committees. For example, the Australian Statistical Advisory Council was established under the *Australian Bureau of Statistics Act 1975* as an advisory body on the Bureau's statistical services, work program and related matters. The Interim Council of ScreenSound Australia and the NLA's Library Council have similar roles.

Consultation with users can have important implications for the cost recovery arrangements of information agencies. Consultation may provide feedback on the nature and level of cost recovery fees, or it may focus on the activities of the agency which can have implications for the application of cost recovery. For example, users may be able to influence which services are cost recovered, and whether such cost recovery is applied on a full or partial basis. However, these consultative committees are advisory only and policy decisions remain the responsibility of the Director or Chief Executive Officer.

Most information agencies have some type of mechanism to consult with, or gain feedback from, the users of their services. These mechanisms range from informal consultations and market research to formal committees. ScreenSound Australia, AUSLIG, AGSO and ABARE all indicated in their questionnaire responses that

they undertook market research and client surveys to gauge client satisfaction with services and charging policies. Alternatively, the NLA has a formal committee made up of elected and appointed industry representatives to advise on strategic and policy issues affecting the delivery of the Kinetica service. As most information services are discretionary purchases, the consumption of these services may provide some indication of demand and user satisfaction with the level of fees and value for money.

Most information agencies have undertaken, or are currently undertaking, reviews of their cost recovery policies. Some reviews have been internal (such as the ABS), whilst others have been external (NLA, BoM). There does not appear to have been a consistent approach to reviewing cost recovery arrangements.

4.8 Conclusion

Almost all Commonwealth regulatory and information agencies have some type of cost recovery arrangement. These agencies collect a significant amount of revenue through a wide range of cost recovery arrangements. Agencies have stated various rationales for these arrangements and there does not appear to have been a consistent policy applied among similar agencies or within portfolios.

Most agencies recover the costs of some activities, but relatively few aim to recover all of their costs. Some agencies impose cost recovery arrangements to recover specified proportions of the agency's total costs, others have discretion regarding the level of cost recovery imposed. There is no uniform approach to which activities are subject to cost recovery, and there are wide variations in the proportion of costs recovered for comparable activities undertaken by different agencies.

Regulatory and information agencies have applied many different fee mechanisms to recover costs. Information agencies use only fees to recover costs, whereas regulatory agencies impose fees for service, taxes (or levies), or a combination of both.

In determining the level of cost recovery charges, agencies use different methods to allocate costs. Regulatory agencies typically allocate costs using fully distributed costing methods. Information agencies generally base their charges on incremental or avoidable costs.

Agencies may be influenced by a range of social, legal and market factors when determining their cost recovery arrangements. Agencies may consider the presence of any legal constraints, the nature of the industry or market in which the fees are imposed, and the existence of any access or equity considerations. Many agencies

have specific legislative authority for their arrangements, but some do not. Some agencies are further constrained by international agreements or competitive neutrality principles.

Regulatory and information agencies have a variety of governance arrangements. Accountability and transparency arrangements include: boards; consultation and review processes; cost recovery policies and guidelines; and the publication and dissemination of fee structures and levels. However, many of these arrangements are not formalised and occur on an *ad hoc* basis.

5 Effect of cost recovery on agencies

Cost recovery can create both positive and negative incentives for regulatory and information agencies, and this has important implications both for the feasibility of introducing cost recovery and for the appropriate design of cost recovery arrangements.

5.1 Incentives for agency efficiency

The introduction of cost recovery can complement an agency's goals by instilling cost consciousness in the agency and in the users of the service. But poorly designed arrangements can create incentives that run counter to agency efficiency and its broader objectives.

Cost recovery encourages users to take a greater interest in agency efficiency and to demand improved agency accountability. This has been recognised by both regulatory and information agencies. For example, the National Registration Authority for Agricultural and Veterinary Chemicals (NRA) stated:

> The expectation by industry that a fully cost-recovered regulatory agency will have a greater focus on efficiency and overall performance has resulted in the NRA paying considerable attention to performance … (sub. 39, p. 5)

Similarly, Austrade stated:

> … as a service delivery agency, our view is that if we charge, then Australian businesses expect better service ... (trans., pp. 741–742)

This has also been recognised by industry. The Australian Chamber of Commerce and Industry (ACCI) stated:

> The design, enforcement provisions, and method of funding of regulatory agencies influences the competitiveness of regulated industries. The introduction of user charges can create an incentive for industry to improve the cost effectiveness of the regulatory agency. The involvement of industry in the activities of these regulatory agencies benefits the community through improved economic efficiency. (sub. 70, p. 14)

Cost recovery can also allow agencies' budgets and resources to be more responsive to demand. Where demand is unpredictable and charges are closely linked to the costs of providing a service, cost recovery can allow an agency to meet unexpected

demand without seeking additional budget funding if it has access to cost recovery revenues through section 20 or section 31 arrangements (see chapter 3).

But there is a downside to allowing agencies too much independence from the budget process and Parliamentary scrutiny. The ability to raise revenue that is to a degree sheltered from external scrutiny can reduce incentives for the agency to become more efficient, and encourage a number of undesirable practices such as regulatory creep, gold plating and cost padding (box 5.1).

Box 5.1 **Undesirable incentive effects of cost recovery**

Cost recovery can create incentives for a number of undesirable activities such as:

Regulatory creep — additional regulation imposed without adequate scrutiny. Regulatory impact processes may be followed less stringently when cost recovery is possible, and the burden of additional regulation may be underestimated when it imposes no net cost to the government.

Gold plating — the adoption of unnecessarily high regulatory standards or facilities. The ability to cost recover may allow agencies to impose their own preferred levels of service, rather than the minimum necessary to satisfy clients or achieve government objectives. The agency may be technically 'efficient' but providing a 'Rolls Royce' level of service where a less expensive level would suffice.

Cost padding — The artificial inflation of costs, motivated by the knowledge that all costs can be recovered.

A number of participants raised concerns about potential agency inefficiencies. The Australian Paint Manufacturers Federation stated that cost recovery can lead to regulatory creep as 'it is seen by the bureaucrats as a way of extending the organisations operations' (sub. 74, p. 4). ACCI was also concerned about regulatory creep:

> … we seem in most areas of government activity to constantly be building on the existing base rather than reviewing the existing base and removing that which needs to be removed and replacing that which needs to be replaced, and the development of new regulation only where it's appropriate. (trans., pp. 798–799)

The Council of Small Business Organisations of Australia (COSBOA) was concerned that a lack of transparency led to inefficiency:

> One of our central concerns with cost recovery is, because it is so widespread and so difficult to measure and assess, it is difficult to … measure the efficiency of the delivery of the service or good for which costs are being recovered. (trans., p. 533)

A simple example of apparent overcharging was presented by Mr Robert Hadlow:

> Really it comes down to the question of why at Commonwealth facilities over the last two years have I been charged 20 cents a photocopy page when I go down the street and get it for 6 cents? (trans., p. 419)

The Complementary Healthcare Council of Australia (CHC) stated that cost recovery effectively 'quarantined' the Therapeutic Goods Administration (TGA) from pressures to be more efficient:

> As a 100 per cent cost recovery agency, the TGA has been quarantined from the government requirements for an efficiency dividend. It has resisted introducing contestability as required by competition principles, when carrying on a number of core functions such as audit and licensing of manufacturers, sampling and testing of therapeutic goods, operating a computer database (register) of therapeutic goods, and substance evaluation. There appears to be little regard for government policy of requiring regulatory and business impact statements when making legislative change. (sub. 98, p. 2)

Although the Commission has not had the opportunity to examine these (and other) claims about agency inefficiency in detail, there is sufficient anecdotal evidence about the negative incentive effects of cost recovery to raise serious concerns.

Agency access to cost recovery revenue

In principle, agencies cannot spend cost recovery revenues without Parliamentary Appropriation. However, in practice, arrangements such as 'net appropriations' can, in effect, allow agencies to 'retain' cost recovery revenues. 'Net appropriations' are also known as section 31 agreements as they are established under section 31 of the Financial Management and Accountability Act [FMA Act] (see chapter 3). Section 31 agreements have been widely adopted for cost recovery agencies. But although it may be efficient for agencies to cost recover for some of their activities (see chapter 2), it does not necessarily follow that the revenue raised should be earmarked for use by the agency.

Where an agency can, in effect, retain cost recovery revenue, this may create positive incentives to provide services that users want (or are willing to pay for). Not allowing agencies to retain cost recovery revenue may mute these demand signals. Retaining revenue may also help agencies meet the resource requirements of unpredictable demand, for example, the unanticipated introduction of a new technology leading to a surge in applications for product approvals.

But retaining revenue can also contribute to significant perverse incentives. The ability to retain cost recovery revenues shields agencies from the same level of departmental and Parliamentary scrutiny applied to budget funded activities. Budgetary and parliamentary scrutiny are important to minimise incentives for

regulatory creep, gold plating and cost padding. This is particularly important for regulatory agencies with a 'captive market'. ACCI stated that:

> There are also concerns about the scrutiny of expenditure in the budget process for an agency that raises all its operating costs from business. The level of scrutiny in the normal budgetary process means agencies have to bid for and justify the allocation of funds. Where an agency is self-funding, there is not the same rigour or review. (sub. 70, p. 15)

The CHC had similar views about the TGA:

> Without some Government [financial] involvement there is no interest on the part of central Government oversighting agencies in the management and efficiency of an agency. … As there are no Parliamentary appropriations there is little or no Parliamentary oversight of the agency or its operations. (sub. 17, p. 8)

For both regulatory and information agencies, retaining cost recovery revenues may encourage agencies to concentrate on activities for which they can cost recover, at the expense of other activities. For example, the Australian Geological Survey Organisation (AGSO) argued that:

> Undue focus on the pursuit of cost recovery … as an objective in its own right has the potential to subvert and distort longer-term strategic Government objectives in favour of short-term imperatives likely to attract funding from industry. … Any requirement to meet an arbitrary cost-recovery target … has the potential for a loss of focus from efficient delivery of agreed key outcomes to seeking alternative sources of funding. (sub. 55, p. 14)

The Commission recognises that cost recovery has the potential to influence the budgetary process even where agencies do not have direct access to the funds they raise. For example, it is argued that it is easier to have new proposals approved if they make no net call on the budget. However, it is still the case that Parliament is accountable to the public for all spending by the Commonwealth Government, and therefore should have the opportunity to review all such spending. Cost recovery agencies should be subject to the same budgetary oversight and stringency as other agencies.

Information agencies are already subject to this discipline to the extent of their budget funding for 'core activities' (a very large proportion of their total revenue in most cases). Any additional revenue raised through cost recovery of discretionary activities is subject to a degree of market discipline, which can help drive agency efficiency.

Some regulatory agencies, on the other hand, raise a large proportion (and in some cases all) of their revenue through cost recovery of compulsory regulatory activities, where there is little scope for market forces to drive efficiency. This revenue should

be subject to the same level of budgetary discipline and parliamentary oversight as non-cost recovery revenue.

Two approaches may achieve this result. The first is increased parliamentary oversight of section 31 and section 20 arrangements. This could be achieved through more transparent reporting of cost recovery arrangements as part of the budget process. The Commission recommends improved reporting arrangements in chapter 3.

The second approach would be to stop using section 31 agreements to grant agencies automatic access to cost recovery revenue from compulsory regulatory activities. All such funds could be deposited in the Consolidated Revenue Fund and all regulatory activities be budget funded.

Under this approach, it could still be appropriate to retain the use of section 31 agreements for non-compulsory activities such as the provision of additional information, which are subject to greater market discipline. The Australian Competition and Consumer Commission (ACCC) already has this sort of arrangement in place, with access to funds derived from 'discretionary activities', but not to those derived from regulatory activities (see chapter 7).

Either approach would mean that regulatory agencies would not have automatic access to cost recovery revenues to meet unexpected demand for regulatory activities. This would place regulatory agencies in the same situation as other government bodies that cannot cost recover. Output based budgeting requires all departments and agencies to estimate the cost of the activities they anticipate undertaking. The fact that some agencies are in a position to cost recover for some activities should not excuse them from the rigour of this process.

Existing budgetary mechanisms for 'topping up' appropriations in cases of unexpected calls on agency budgets may be adequate to meet unexpected demand. Recent changes in financial arrangements allow agencies to build up 'reserves' if they do not spend all of their appropriation in a given year. With the permission of the Minister for Finance, they may then draw on these reserves in subsequent years. In addition to using their own reserves to deal with fluctuations in demand, agencies may approach the Department of Finance and Administration (DOFA) for additional funding through the 'additional estimates' process and/or may also have access to an advance from the contingency reserve under the Minister for Finance's control.

FINDING

It is generally not appropriate for regulatory agencies to have, in effect, automatic access to cost recovery revenues for regulatory activities without proper budgetary and parliamentary scrutiny.

DRAFT RECOMMENDATION 5.1

As a general rule, the funding of cost recovered regulatory activities should be subject to the same budgetary and parliamentary oversight as budget funded government activities.

INFORMATION REQUEST

The Commission seeks further views on how to improve parliamentary scrutiny of cost recovery receipts.

5.2 Encouraging agency efficiency

It is important to have in place arrangements to enhance the positive effects of cost recovery on agency efficiency and to minimise its negative effects. A number of mechanisms for promoting agency efficiency already exist — this section examines their application to agencies undertaking cost recovery.

Efficiency dividend

Most Commonwealth agencies are subject to an annual reduction in their budget funding, known as an efficiency dividend. Agencies that are subject to the efficiency dividend are expected to offset these budget cuts through efficiency improvements in their running costs.

The efficiency dividend has been criticised as a 'blunt' instrument for pursuing efficiency gains as it is not targeted at particular outputs or activities. However, in the absence of market forces to drive efficiency, a moderate efficiency dividend may be a desirable means of promoting across-the-board productivity improvement. It is important that the efficiency dividend is not relied upon in isolation — it should be supported by regular, comprehensive reviews of agency efficiency (discussed below).

The efficiency dividend currently does not apply to any amounts deemed to be appropriated to agencies under a section 31 agreement (see chapter 3). This blanket exclusion not only relieves cost recovered activities from efficiency pressures, but can create incentives for agencies to increase cost recovery charges to offset

reduced budget funding in other areas, or to impose cost recovery for more activities, to avoid the efficiency dividend.

Some participants in this inquiry have argued that cost recovered activities should also be subject to the efficiency dividend. The CHC stated:

> An efficiency dividend would be a good start. Why should a cost-recovering agency be exempted from a discipline applied routinely to other Government agencies when there are no other disciplines, no benchmarks, no guidelines, no competition, no regulations as to how it conducts its business, no marketplace? (sub. 17, p. 12)

The question arises as to whether it would be necessary to impose an efficiency dividend if cost recovery were to cover the efficient costs of an activity. However, it may be difficult in practice to establish efficient costs, and it is also important to create incentives to pursue efficiency improvements over time. Under these circumstances, efficiency dividends might still be considered.

Benchmarking

Benchmarking (also known as yardstick competition) is an important tool for measuring the efficiency of government agencies. The Department of Industry, Science and Resources (DISR) stated that benchmarking was particularly relevant for monopolies and regulators:

> While the market is an excellent mechanism for ensuring efficiency in the pricing of government activities, it may also be necessary to use other mechanisms to ensure that the prices of government activities are commensurate with the costs of providing those services. These mechanisms may include transparent costing processes which provide consumers with avenues for querying costs; and international benchmarking of both costs and costing processes to ensure best practice. Two areas where such additional mechanisms would be particularly relevant are government monopolies and regulators where consumers are not provided with a competitive market situation and are forced to accept the government set charges. (sub. 62, p. 5)

Benchmarking can be used for strategic budget and policy planning, and for policy evaluation as well as price setting. It can promote debate about comparative performance by allowing agencies to compare their performance over time, or with other agencies undertaking similar activities.

The Commission considers that benchmarking can play an important role for agencies undertaking cost recovery, particularly in improving the transparency of charging and allowing for informed consultation with users. Benchmarking is an important element of output based budgeting, and is an integral part of the pricing review process (discussed below).

Harnessing competitive forces

The negative incentives created by cost recovery are often related to the lack of the market forces that normally drive efficiency. Many information agencies have natural or statutory monopolies on the products and services they sell. Regulatory requirements, including charges, are compulsory in order to gain entry to certain markets. However, some market forces can be harnessed to encourage agency efficiency even in these circumstances.

Market testing and third party competition

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. The tenderer able to supply the required quality and quantity of service at least cost is then chosen (in some cases the agency itself may enter and win the tender). Third party competition allows the users of a service to choose among multiple providers. This is possible for both discretionary and compulsory regulatory activities — for example, providers of assessment services can be licensed or certified.

Using mechanisms such as market testing and third party competition to introduce competitive pressures to agency activities can lead to significant improvements in accountability, quality and cost effectiveness. They are widely used by non-regulatory public sector agencies in Australia and overseas, and regulatory agencies overseas have begun to adopt them. For example, commercial organisations called 'Notified Bodies' undertake conformity assessment of medical devices on behalf of governments in the European Union (TGA, sub. 89, p. 23). The TGA is the equivalent of a Notified Body and can charge users to conduct assessments on behalf of European Union regulatory agencies (AWIN, sub. 20, p. 2).[1]

DOFA stated that its current priorities include the application of competitive tendering and contracting principles and market testing to drive efficient and effective operations (sub. 38, p. 2). But many Australian cost recovery agencies do not appear to be enthusiastic about market testing their services. Participants have been particularly critical of the TGA. For example, the CHC stated:

> Many TGA activities could be contested by the private sector. For example, the Australian Register of Therapeutic Goods (ARTG) is a database of information, much

[1] Under the Australian/EC Memorandum of Understanding, the TGA can act as a Conformity Assessment Body, the term used for non-European based bodies undertaking the responsibilities of a Notified Body (AWIN, sub. 20, p. 2).

> of which appears on product labels and could be managed by a range of licensed service providers. Laboratory analysis of substances could be carried out by NATA accredited laboratories. Manufacturing facilities in Australia and overseas could be audited out by local auditors. At the very least contestability would benchmark TGA performance. (sub. 17, p. 2)

Blackmores argued for contracting out of TGA audits of overseas manufacturers:

> Audit fees charged by the TGA to certify [Good Manufacturing Practice] in Australia are reasonable but charges for overseas manufacturers' audits seem excessive and industry has no avenue to scrutinise these costs. … The private sector could equally perform audits on a contract basis for the TGA at reduced cost. (sub. 25, p. 2)

Agencies may have a number of reasons for not pursuing market testing and third party competition. Both regulatory and information agencies may be reluctant to incur the costs of internal redundancies and down-sizing if work is performed outside the agency. Regulatory agencies, in particular, may be concerned about a (real or perceived) lack of expertise in the private sector. There may also be concerns about permitting the private sector to undertake aspects of regulatory activities such as assessments and approvals. This may reflect fears that private providers of these services are more vulnerable to commercial pressures to make decisions favourable to applicants.

Such concerns need not rule out the introduction of competitive pressures to regulatory agencies, but they highlight the need to select carefully those activities to be market tested and to have in place rigorous accreditation criteria for private sector suppliers. The government agency must remain responsible for managing outcomes, even if it does not undertake the actual activity. The Plastics and Chemicals Industries Association (PACIA) suggests agencies should:

> … outsource the technical review aspects and undertake a more managerial approach to the assessment process. This would likely lead to competitive costs and reduced overheads which are more justifiable to the applicant. Government would still need to be assured of the quality of the process and retain its role as final arbiter of results to ensure that the level of technical support remains independent and sound. (sub. 24, p. 3)

The Commission considers that departments and agencies should assess the scope for market testing and third party competition on a case-by-case basis, as part of the ongoing process of ensuring that agency activities are both necessary and provided as efficiently as possible.

Harmonisation and mutual recognition

Competitive pressures can also be brought to bear on the efficiency of regulatory agencies by encouraging international harmonisation of standards and mutual

recognition of regulatory decisions by overseas agencies with comparable standards and levels of rigour. This would make assessment and approval processes more contestable by increasing the number of agencies worldwide which could provide those services.

Harmonisation and mutual recognition can also reduce industries' compliance costs by saving the costs of preparing multiple submissions to meet different requirements, and by reducing unnecessary repetition of tests in Australia and overseas. The Australian Chemical Specialties Manufacturers' Association (ACSMA) noted:

> One area with the potential for regulators to decrease their costs significantly, and therefore the amount recovered from industry, is the improved recognition of chemical approvals by foreign regulatory authorities. This would also significantly reduce the costs of companies providing information to regulators. (sub. 60, p. 6)

Mutual recognition would affect all aspects of agencies' efficiency, including timeliness and the level of cost recovery charges. Mutual recognition could also lead to agencies ceasing some functions if they cannot provide them at competitive cost. For example, the National Standards Commission (NSC) stated:

> … as a member of the International Organisation of Legal Metrology (OIML), the Commission is actively working towards an agreement under which major international laboratories would accept each other's test reports. Such mutual recognition agreements would place the Commission in price competition with overseas laboratories, and would significantly reduce the amount of testing conducted in Australia. (sub. 31, p. 4)

The Commission considers that harmonisation of standards and mutual recognition with jurisdictions with comparable standards can improve contestability of assessment and approval processes and encourage regulatory agency efficiency. This in turn will reduce the cost recovery burden on those subject to regulation. If a regulator cannot compete with international regulators (for example, because of economies of scale that are not available in Australia), but the Government wishes to retain a regulatory presence (for 'national sovereignty' or other reasons) there may be justification for government subsidisation of an 'inefficient' regulator. This would avoid penalising industry (via higher cost recovery charges) for a social choice that imposes more expensive regulation than is required to achieve a given level of safety.

Australian National Audit Office performance audits

The Australian National Audit Office (ANAO) is a specialist Commonwealth agency that provides audit services (performance audits, financial statements audits and better practice guides) to Parliament, Commonwealth agencies and statutory

bodies. *The Auditor-General Act 1997* regulates the powers and responsibilities of the Auditor-General and the ANAO. ANAO performance audits can include cost recovery arrangements. For example, the Australian Quarantine and Inspection Service's (AQIS's) cost recovery systems were the subject of an audit in 2000. Performance audits are performed on an *ad hoc* basis and do not form a systematic review mechanism for cost recovery arrangements.

Pricing Reviews

The Government has initiated a program of pricing reviews across Commonwealth departments and agencies to assess the robustness of the prices of outputs used in the outcomes/outputs accrual budgeting framework. Pricing reviews also promise to be valuable tools for providing Ministers with better information on which to base resourcing decisions. However, they have potential limitations in relation to driving the efficiency of cost recovery arrangements:

- DOFA has only recently completed the first round of eight reviews and begun a second round of reviews. Many agencies with significant cost recovery activities have not yet been reviewed, and it is not known when they will be scheduled for review;
- the process for ongoing review is unclear;
- pricing reviews are conducted between DOFA and the agency, with only limited opportunity for stakeholder involvement;
- it is unclear if outputs provided to non-government purchasers (activities that are cost recovered) will be subject to the same degree of scrutiny as outputs purchased by government; and
- it is unclear if the outputs subject to review are defined narrowly enough to provide useful scrutiny of individual cost recovery charges. For example, the ACCC has only two nominated outputs — 'the proper administration and enforcement of the *Trade Practices Act 1974*, the *Prices Surveillance Act 1983* and related laws'; and 'performance of actions that promote competition and fair trading and enable well functioning markets' (Treasury 2000d, p. 65). However, the ACCC has five separate areas of charging, with multiple charges in each, just in relation to administration of the Trade Practices Act (see chapter 7).

The Commission recognises that pricing reviews are a relatively recent innovation and are still under development. It is likely that some of the problems identified above will be addressed as the pricing review process is bedded down. Many could be addressed relatively simply, through:

- the publication of a review schedule identifying all agencies to be reviewed and their anticipated review date;
- the establishment of a rolling review process into the future;
- a clear statement (and consequential amendments to guidance notes, etc.) ensuring that pricing reviews also cover the pricing of cost recovered outputs;
- ensuring cost recovery outputs are defined sufficiently narrowly to allow meaningful review of agency efficiency; and
- establishing mechanisms to allow meaningful stakeholder consultation in the review of cost recovery outputs.

Efficiency conclusions

Improving agency efficiency can reduce the cost burden on those paying cost recovery charges as well as general taxpayers. The mechanisms discussed above can help offset the potential negative incentives for agency efficiency created by cost recovery. These mechanisms should be actively pursued to the extent that they are compatible with broader government and agency objectives.

FINDING

Improving agency efficiency can reduce the cost burden on those subject to cost recovery and taxpayers alike. Mechanisms such as efficiency dividends, benchmarking, market testing and third party competition can help drive agency efficiency. Harmonisation of standards and mutual recognition can also encourage regulatory agency efficiency by improving contestability of assessment and approval processes.

5.3 Governance and consultation arrangements

Governance refers to the processes that direct, control and hold agencies accountable to government, users and the public. These processes aim to ensure the transparency of the agency and its activities, the implementation of effective risk management and financial management, and accountability through clear and timely disclosure. These arrangements can play an important role in promoting the transparency and accountability of cost recovery. There is no single model of good corporate governance, and governance arrangements vary among agencies.

Consultation

Governance arrangements can have a significant effect on consultation arrangements, as consultation needs to be supported by open and accountable processes that reduce the risk of conflicts of interest or undue influence.

Agencies contemplating cost recovery should undertake meaningful and effective consultation with those who will be subject to the charges. Those who pay for an activity have an interest in the design and delivery of that activity. Agencies should also consult with other affected parties to ensure that competing policy objectives are not compromised.

However, despite the undeniable benefits of consultation with user groups, there is also the risk of real or perceived conflicts of interest or undue influence where a private interest group has an inappropriate level of influence or control over a public agency. This is not unique to cost recovery — it can occur in any situation where a powerful interest group faces a regulator. ACCI referred to the risk of agencies being 'captured' by industry:

> … the move to full cost recovery and industry involvement may create the perception that industry has 'captured' the activities of the regulatory agency to the extent that the agency may not fulfil its primary role of protecting the community. (sub. 70, p. 14)

Cost recovery, particularly 100 per cent cost recovery, can increase the risk of 'capture', particularly where firms have been encouraged to believe they are the 'beneficiaries' of regulation — they feel that if they are paying for a benefit, they should be able to dictate the nature of the 'benefit' they receive. This has led some industries to view an ability to influence regulatory agencies as a right. ACSMA stated:

> It is highly unreasonable to expect industry to pay the entire costs of a particular agency but not permit sufficient accountability to allow industry to determine whether that agency is run in an efficient manner with a full appreciation of potential efficiency improvements. (sub. 60, p. 6)

PACIA stated similar views:

> Industry, if required to fund a scheme to 100 per cent should have a strong ability to influence the allocation and priority of the activities. (sub. 24, p. 7)

Despite the risks of 'agency capture', it is clear that stakeholder consultation is necessary to help drive agency efficiency. Those expected (or required) to pay have a clear interest in the costs, efficiency and quality standards of agency activities and should be consulted on these arrangements. However, there will be practical limits to this when there are competing policy objectives. The issue is determining the

most appropriate structure to encourage meaningful consultation, with the least risk of agency 'capture'.

Boards

Agencies that are regulated by the *Commonwealth Authorities and Companies Act 1997* (CAC Act) typically have a board structure in place. [2]

The Chief Executive Officer of the agency reports to the board, which in turn is accountable to the responsible Minister. This contrasts with agencies regulated by the *Financial Management and Accountability Act 1997* (FMA Act), which do not have a board, and the Chief Executive Officer of which is accountable to the Minister for the operation of the agency.

Inquiry participants, such as Avcare, suggested that a board structure with industry representation 'may be one way to achieve transparency, and scrutiny of cost recovery' (Avcare, trans., p. 385). However, it is important to note that many agencies have multiple stakeholders, not just industry. The ANAO identified a range of stakeholders, including Parliament, Minister(s), central agencies, the general community, customers and employees (ANAO 1999, p. 14).

ACCI argued that cost recovery agencies should be governed by independent boards made up of representatives of all stakeholders:

> The governance of these agencies should play a crucial role in improving the cost effectiveness or achieving value for money in these agencies. An independent board of directors comprising representatives of all stakeholders, including the broader community, with the power to make decisions regarding the actions and financial activities of the agency can make these agencies provide cost efficiency protection of consumers and the environment. (sub. 70, pp. 17–18)

Many cost recovery agencies currently have boards that include members drawn from among a variety of stakeholders. The NRA has many stakeholder groups represented on its board:

> The NRA board comprises members having experience in regulatory affairs, consumer interests, OH&S, farming, government and the chemicals industry under an independent Chairperson. This allows a balancing of interests/expertise. (NRA, sub. 39, p. 8)

[2] The CAC Act imposes duties on directors, rather than on the board — the term 'board' is a commonly accepted term for the forum in which directors meet jointly to carry out these duties (see chapter 3.

However, it is important to note that under the CAC Act directors have a legal responsibility for the performance of the agency in meeting its stated objectives and obligations as a public body, rather than representing a particular group of stakeholders (ANAO 1999, pp. 8–9). Directors set strategy and targets, select and monitor management and review the performance of management. They pursue these tasks subject to a number of general duties imposed on them by the Act — duties to exercise due care and diligence (s.22), to act in good faith in the best interests of the Commonwealth authority (s.23) and not to use their position or access to information improperly to gain an advantage for themselves or anyone else or to cause detriment to the Commonwealth authority or to another person (ss. 24 and 25). These wider responsibilities and duties can present unavoidable conflicts of interest for directors who are expected to 'represent' certain stakeholder interests.

The ANAO has stated that directors should be selected on the basis of their expertise relating to the agency and financial management skills, as they have an obligation to manage the agency with public interest objectives in mind (ANAO 1999). The ANAO noted the relative breadth of responsibilities held by Boards of Government agencies, compared to private sector companies:

> … the very nature of public services, with often broad objectives, variable and complex benefits and society wide impact, distinguish management of public services from management of most private services where the overriding objective is to maximise the organisation's value, including dividends to shareholders. (1999, p. 4)

It is an important principle of good governance that a majority of the Board should be independent (of both management and stakeholders). The ANAO *Better Practice Guidelines for Corporate Governance in Commonwealth Authorities and Companies* states 'The majority of the CAC Board should be independent of both the management team and any commercial dealings with the CAC Act' (ANAO 1999, p. 22). This would help avoid perceptions of conflict of interest and reduce the potential for board members having any undue influence.

This raises concerns about arrangements such as the recently proposed changes to the board structure of the Australia New Zealand Food Authority (ANZFA), as part of the creation of a new board to be known as the Board of Food Standards Australia and New Zealand. The current ANZFA arrangements allow for one 'industry' board member. Under the new arrangements, it appears that industry representatives will be able to hold up to five of the ten places on the board (*ANZFA Amendment Bill 2001*).

There are clear limits to the extent to which Boards can act as vehicles for pursuing stakeholder and consumer consultation. However, alternative mechanisms, such as consultative committees, may be able to fill this role.

Audit committees

Agencies operating under both the CAC and FMA Acts may have a number of committees reporting to the Board or Chief Executive Officer. One of the most important of these is the Audit Committee.

Audit Committees are mandated under both the CAC Act and the FMA Act. They are responsible for oversight of the audit function, including liaison with internal and external auditors.

Although Audit Committees perform an important function in the governance of public sector agencies, they have major drawbacks in relation to driving the efficiency of cost recovery agencies. Although they may include external members, they are typically internal expert committees with a specific focus on financial accountability and compliance with legal requirements, rather than broader concepts of agency efficiency.

Consultative committees

Many agencies have consultative committees in place. These committees may be statutory (established by legislation) or administrative, and perform many different roles. The TGA, for example, has established many advisory and consultative committees (box 5.2).

Agencies and industry had different views of the value of existing consultative committees. For example, the TGA stated that the:

> TGA Industry Consultative Committee (TICC) facilitates consultation between TGA and the industry regarding input to the TGA budget and accounting against the TGA Corporate Plan; [it] also provides direct feedback from industry to TGA on broad policy, resource allocation and performance issues. (sub. 89, p. 17)

This view contrasts with those of a number of other inquiry participants. There were three main criticisms of consultative committees: the scope of their functions is limited to non–economic matters, industry members are not given sufficient information on which to base their contributions, and industry advice can be ignored by the agencies. For example, the CHC suggested the TICC is not sufficiently accountable and transparent, particularly regarding issues of financial management:

> The TICC committee which has been referred to in so much of the hearings is managed by the TGA with little opportunity to question expenditure or budget. The transcripts show many conflicting attitudes to the usefulness of this forum (CHC, sub. 98, p. 5).

Box 5.2 **TGA expert and consultative committees**

In addition to a number of expert committees that advise on therapeutic products and complementary healthcare products, the TGA stated that it has established the following committees, the purpose of which is to facilitate consultation:

TGA–Industry Consultative Committee (TICC) facilitates consultation between TGA and the industry regarding input to its budget and accounting against the Corporate Plan; also provides direct feedback from industry to TGA on broad policy, resource allocation and performance issues;

Complementary Healthcare Consultative Forum promotes and fosters constructive relations between the government and the complementary healthcare sector and examines policy and other issues relating to regulation, research, education, and industry, consumer and practitioner concerns; and

The National Coordinating Committee for Therapeutic Goods is a Commonwealth-State and Territory committee which enables a national approach to the regulation of therapeutic goods (to be established).

These committees, both statutory and non-statutory, provide the TGA with expert advice. They act as a check on the regulator through the quality of advice, the need for consensus in some situations, and the linkages and networks the committee system provides to the TGA in its day-to-day operations.

Source: sub. 89, p. 17.

The Australian Pharmaceutical Manufacturers Association (APMA) criticised the lack of powers of industry members of the TICC:

> … the industry members may 'examine and comment' upon the TGA's performance and budget, but it has no directional powers, for example to require the TGA to achieve certain performance standards or to expend its revenue in ways that the industry members might consider most cost effective. (sub. 14, p. 4)

A number of representatives from other industries also regarded existing consultative arrangements as inadequate. Avcare, for example, stated that the Office of Gene Technology Consultative Group could not oversee economic aspects of the regulator:

> So what we are left is really no body which can oversight the operation of the Office of Gene Technology regulator from an economic point of view. There is a body called the Community Consultative Group, but that's simply policy in regard to approvals and so forth. There is an ethics committee and there is a Ministerial Council, none of which as we read the legislation, has any role to play in the cost of the operation. (trans., p. 399)

Some of the critics of existing consultative arrangements appear to want to blur the line between consultation and management — they wanted a more direct voice in operational decision making. This is not appropriate for agencies that have multiple

stakeholders and other governance and accountability arrangements in place. However, this does not mean that existing consultative mechanisms cannot be improved.

An initial step would be to recognise that cost recovery arrangements are an appropriate subject for consultation — those subject to cost recovery charges may have valuable insights into ways to promote appropriate regulation and efficient agency operations. Agencies should be open to advice from industry on cost recovery issues.

It is also important to provide sufficient information to all parties to allow meaningful consultation to take place. The Commission has noted elsewhere in this report the lack of satisfactory information on cost recovery objectives, costing and revenue, and made some draft recommendations to improve agency reporting (see chapter 3). This information should also be made available to consultative committees. 'Commercial in confidence' concerns are unlikely to be legitimate reasons for failing to release costing information for cost recovery agencies. Regulatory agencies operate as statutory monopolies for most activities and are not competing in a commercial market. A small proportion of the activities of information agencies could be considered commercial services, but their core function is to provide government funded services. For both regulatory and information agencies, if sufficient competition exists to create commercial in confidence concerns, the need for government provision of these activities should be questioned.

Agencies have also been criticised for ignoring the advice of consultative committees. Although agencies should not be bound to follow their advice, it is appropriate that agencies give a considered response to this advice, providing reasons for not accepting recommendations of the committee.

Consultative arrangements are not mandated in the CAC Act or FMA Act — some committees are established under agency-specific legislation while others are administrative in nature. The Finance Minister's Orders or Chief Executives instructions could be used to direct the broadening of existing consultative committees to include cost recovery arrangements.

Many elements of the current accountability and governance arrangements for Commonwealth Government agencies (for example, pricing reviews) are relatively new, and yet to be completely bedded down. The Commission has made a number of draft recommendations to improve the way these arrangements deal with cost recovery and incentives for agency efficiency. It is appropriate at this stage to monitor the performance of these arrangements and the impact of these draft recommendations.

Many participants appeared to favour more sweeping reform. One potential reform would be to develop a consultative committee with more explicit powers to examine agency efficiency — an agency-based Efficiency Audit Committee.

Efficiency Audit Committees

A more direct, focused process for scrutinising agency costs and fee structures would be to introduce the concept of an Efficiency Audit Committee (EAC). An EAC would deal with a broad range of efficiency related matters, with a particular focus on cost recovery. It would include both industry and consumer representatives appointed by the relevant Minister, and agency representatives. The Chair of the EAC could be independent, but in any case should not be from the regulatory agency. The EAC would be granted powers to require such information as is reasonably necessary for it to undertake its role.

The EAC would have no direct control over the agency, but would report directly to the Minister (with copies of reports to the head of the agency). Subject to confidentiality concerns, these reports could also be made publicly available. The Minister would have discretion as to whether or not to accept the recommendations of the EAC and direct the agency accordingly (either directly or through legislative amendment, according to established mechanisms).

Although providing a 'direct line' to the Minister may be regarded as inviting 'regulatory capture', many industries already directly lobby Ministers. The EAC mechanisms would provide a more transparent and public mechanism for conveying stakeholder views.

The creation of EACs gives rise to various implementation issues. They could be created on an agency by agency basis, or incorporated in broad legislation such as the CAC Act and FMA Act. The Commission is reluctant to impose a new layer of bureaucracy where it is not necessary or desired, or to duplicate the activities of existing processes such as pricing reviews. One approach could be to make EACs contingent on agency size (or amount of cost recovery) and sufficient industry support. It may also be appropriate to limit EACs to regulatory agencies which impose compulsory charges.

Some inquiry participants provided views on establishing EACs. ACCI questioned who would bear the cost of such arrangements, but suggested including Audit Office expertise on the EAC 'as an independent third party in that efficiency audit review process' (trans., p. 799).

The Medical Industry Association of Australia supported the EAC:

> I think that [EACs] would be a significant lift in level of accountability without in any way abrogating government's responsibility, at the end of the day, to manage the government agency, but to be listening to the people who are the prime users and the funders for it. (trans., p. 119)

DOFA stated that such committees could be useful for large regulators:

> … one size won't necessarily fit all, but that facility probably would be quite useful in certain circumstances. … for a regulator that has a large impact on the community, I would suspect the framework that you talk about would help … (trans., p. 631)

Other participants were more cautious. The Chemicals and Plastics Action Agenda stated that some existing consultative arrangements were working well but could be improved by incorporating some of the EAC principles:

> A number of our members have expressed a strong desire that the model of the National Registration Authority Board is a good one to look at. We also feel that the Industry-Government Consultative Committee, which is the forum used with NICNAS, is a good model of industry and government coming together to look at the issues. How that information is used could well be strengthened I think by maybe restructuring that a little bit towards your comments about an efficiency audit committee. (trans., p. 229)

AQIS stated that it had comprehensive consultation arrangements in place, and was wary of the EAC's potential to introduce 'political games':

> The regulator could be caught in a very difficult situation, with being required to recover their costs by government policy, but with a vehicle being established where political games could be played. I think you would need to think carefully about establishing some sort of formal process, whereby the regulated — and we're just talking about regulation here — had some mechanism or vehicle for having another party make judgments about how the regulator was running its business. (trans., p. 672)

The Department of Transport and Regional Services did not want to make the role of agency boards any more complex:

> [boards] have a great deal of difficulty balancing the many priorities that are given to them. An external group of advisers, no matter how well-intentioned, becomes another problem in that process, because … they don't have the responsibility but they have got the ability to advise. (trans., p. 318)

The Commission recognises that as part of the new financial systems currently being bedded down in the public sector, agencies are now subject to the scrutiny of the ANAO, audit committees and pricing reviews. In addition, the Commission has made a number of draft recommendations for improving the application of current processes to cost recovery. Whether these will be sufficient to drive the efficiency of cost recovery arrangements, or whether more explicit means of dealing with cost recovery are required is not clear.

DRAFT RECOMMENDATION 5.2

The Government should address the effectiveness of the existing performance review processes and the need for a more performance based efficiency audit approach based on stakeholder consultation.

INFORMATION REQUEST

The Commission seeks further views on the establishment of Efficiency Audit Committees to address the efficiency of cost recovery agencies.

5.4 Distorting agency objectives

Cost recovery arrangements can have significant interactions with agency objectives. As discussed in section 5.1, cost recovery can reinforce these objectives and contribute to agency efficiency, for example, by providing price signals about levels of client demand. It also creates an incentive for users to take an interest in agency efficiency.

But in other cases, cost recovery can set up incentives that run counter to the agency's objectives and distort decision making by both users and the agency. Cost recovery has the potential to detract from agencies' main objectives or core activities. It may encourage agencies to charge fees for activities that should not be cost recovered, or may distract agencies' focus from core activities (for which they do not charge) toward non-core activities for which they can charge.

A related issue is the potential for creating 'moral hazard'. Placing financial imperatives on regulatory agencies to raise revenue may create incentives to choose regulatory mechanisms such as licensing and approvals, which can be cost recovered, rather than less stringent mechanisms (such as self-regulation) which cannot be cost recovered, even though the higher level of regulation is not required.

The incentive to shift resources from activities that do not recover costs to those that do is accentuated where agencies are required to pursue agency cost recovery targets. The 'Nairn Report', *Australian Quarantine: A Shared Responsibility* (1996), identified this as a problem for AQIS, which at the time was required to meet an agency cost recovery target:

> Observations during the inspection phase of the Review lent weight to the view that quarantine staff were tending to concentrate effort on cost-recovered programs to the detriment of budget-funded activities … some quarantine activities appeared to be driven more by the ability to charge for services than by the need to meet the objectives of quarantine. (Red Meat Advisory Council, sub. 47, p. 23)

These particular concerns have been at least partially addressed by AQIS's move to full cost recovery on a program basis in 1997, but similar concerns remain in other agencies. (Other impacts of setting agency-wide cost recovery targets are discussed in chapter 6.)

A further concern is that cost recovery may distort user incentives in a way that detracts from achievement of the objectives of Government or individual agencies. The Australian Transaction Reports and Analysis Centre (AUSTRAC), the Australian anti-money laundering and individual agency and broader specialist financial intelligence agency, argued that the introduction of cost recovery (for example, charging other agencies a fee to access AUSTRAC information) would create incentives running directly contrary to the Government objectives behind the establishment of AUSTRAC:

> With some exceptions, there is no ready market in the law enforcement for this type of data; rather the supply of the data is part of legislative driving of law enforcement to better deal with aspects of financial crime and money laundering. (sub. 22, p. 14)

The NSC stated that the imposition of 100 per cent cost recovery was contributing to a breakdown in the regulatory system:

> There is a significant price differential between trade-approved and non approved weighing scales, due to a combination of design requirements and testing costs. Sales data suggest that traders are increasingly risking prosecution by using cheaper, non approved scales. (This is exacerbated by the fact that State and Territory Governments have inadequate resources for trade measurement inspection.) Indirectly, it appears that the cost of pattern approval may be contributing to a breakdown of the regulatory system. (sub. 31, p. 3)

In addition, cost recovery had 'severely limited the ability of the [NSC] to carry out its public interest responsibilities (such as pattern compliance audits) as the cost of such work is not recoverable from industry' (sub. 31, p. 4).

Inappropriate cost recovery can have a particular effect on information agencies. One of the objectives of virtually all information agencies is the wide use or dissemination of data. AGSO stated that excessive cost recovery charges could limit the use of information:

> Benchmarking of AGSO products against its international competitors indicates that under present cost recovery policies the price of Commonwealth spatial and other related data is becoming uncompetitive and a disincentive to uptake. Logically, prices need to be set at levels which maximise the uptake of the information rather than maximising the level of cost recovery. (sub. 55, p. 16)

In some cases, a large proportion of cost recovery transactions are between government departments, which charge each other for administrative services, information, and other activities (see chapter 4). Charging for services between

government agencies can have positive incentives such as better resource management and accountability across portfolios. But it may also have negative effects such as less effective inter-agency communication and cooperation.

5.5 Effects on agency innovation and technology

As well as affecting innovation by industry and the availability of new products (discussed in chapter 6), cost recovery interacts with the adoption or use of new technologies by agencies.

Cost recovery, especially the imposition of cost recovery targets, can create perverse incentives for agencies not to adopt newer, more efficient technologies. This appears to be a particular problem for information agencies, where technological developments such as the Internet are reducing the cost of making information available, but cost recovery can discourage their adoption. This appears to place raising revenue above the general goal of information agencies of encouraging the dissemination of information.

New technologies can also affect the desirability or capacity of agencies to cost recover. At its simplest, this may mean adopting electronic payment systems that reduce administrative costs. Lower administration costs make it more likely that cost recovery will be cost-effective. New technology may also promote both agency and industry efficiency which may be reflected in lower charges. The Department of Agriculture, Fisheries and Forestry Australia (AFFA), provided a number of examples of new and emerging technologies affecting cost recovery within the Department (box 5.3).

Financial regulators are rapidly adopting new technologies, such as the Australian Securities and Investment Commission's (ASIC's) electronic registration and data lodgment. ASIC also disseminates information electronically, with 94 per cent of company searches occurring online in 1999-2000. In February 2000, the Australian Prudential Regulation Authority (APRA) initiated a statistics project which should result in electronic lodgement and consultation of financial information being available by the middle of 2001 (APRA 2000).

Some agencies are actively encouraging users to adopt new technologies which will reduce agency and user costs. For example, in order to encourage industry to use electronic certificates for export, AQIS undercharges for using Electronic Export Documentation (EXDOC) and overcharges on manually issued certificates. The ANAO Report into AQIS noted that this practice was agreed with industry (2000a, p. 89).

Box 5.3 New technologies affecting AFFA cost recovery arrangements

Many areas of the Department accept payment by credit card and electronic payments. In some cases, for example Australian Bureau of Agriculture and Resource Economics (ABARE) publications, invoice payments have been completely phased out. Such developments have seen a reduction in administrative costs which flows through to users. Implementation of new technologies is expected to continue. For example the Plant Breeders Rights Office (PBRO) plans to move towards electronic payments.

ABARE and PBRO are both interested in introducing e-commerce to their data provision services. Currently both organisations provide data to clients on a user pays basis. The fees charged recover the cost of the time involved in providing the data. These services can be time consuming, particularly if the requests are complex or require extensive searches for information, and can involve significant costs for regular users. Developing technologies which would enable clients to access the databases through the Internet, selecting and purchasing the data they require themselves would result in significant savings for both clients and these areas of AFFA. ABARE believes it could save 10 per cent of its costs by introducing such technology.

AQIS has embraced new technology and e-commerce with a number of databases of quarantine and commodity information now being available online. In addition many of the AQIS inspection services are supported by online systems that provide efficient access for regular importers and exporters.

Source: AFFA, sub. 69, p. 11

6 Economic effects of cost recovery

The extent of cost recovery and its effects on government agencies were examined in chapters 4 and 5. This chapter extends the discussion to the economic objectives of cost recovery, and the economic impact of cost recovery on industry, consumers and the wider community. Most charges associated with government cost recovery — and particularly charges associated with government regulation — are paid by firms rather than individuals. To the extent that these charges are then passed on to other firms and to individual consumers through higher prices, they are, in most instances, ultimately paid by the main beneficiaries of the government activities or regulations with which they are associated. Cost recovery charges may also have an effect on consumers by reducing the range of products available or increasing prices, although such effects can be difficult to separate from the impact of the regulations themselves. Taken together, the effects listed above may lead to changes in resource allocation and efficiency across the economy.

6.1 Appropriate economic objectives for cost recovery

In chapter 2, the Commission argued that the main rationale for cost recovery should be to improve economic efficiency. Improving the equity of government revenue raising methods is also important, as is maintaining a link between the objectives of cost recovery and those of the government agencies or activities themselves. That is, cost recovery arrangements should not impede or divert the basic objectives of the activities they support.

These broad objectives are of relevance to all government agencies, but their application will vary, depending on each agency's functions, activities, users and beneficiaries. For information agencies, the 'private good' nature of some of their products, and the need to attach price signals to finite agency resources, may be of most relevance. For regulatory agencies, identifying the beneficiaries (usually the consumers of the regulated products or services), acknowledging any actual or potential spillovers which must be managed, and ensuring consistency with the primary objectives of the regulations, will be more relevant.

Cost recovery as a revenue raising mechanism

Raising revenue is an important (but not always stated) objective of cost recovery for regulatory and information agencies. Where agencies have specified cost recovery targets (for up to 100 per cent of their costs), revenue raising would appear to be an important objective of the arrangements.

It could be argued that if cost recovery is used purely as a revenue raising mechanism (for example, through a compulsory levy on certain products or activities), without regard for identifying the beneficiaries or efficiency implications, then it is serving the function of a tax, and should be assessed as if it were a tax. 'Over-recovery', where an agency is required to recover more than its costs in order to fund other Government activities, is an obvious example of this.

Depending on the particular situation (such as the characteristics of demand and the costs of administration) such charges may (or may not) be efficient taxes, but it is inappropriate to characterise them as cost recovery. Taxation, like all government revenue raising, is not without its distortions and opportunity costs for the economy, and these should be properly examined (see chapter 2).

Related to this is the issue of how some government charges are perceived by those who pay them. The Council of Small Business Organisations of Australia (COSBOA) indicated that many small business people perceive virtually all cost recovery charges to be essentially taxes:

> .. small business I think regards almost all imposts from the public sector as taxes in some form and it regards in many areas cost recovery mechanisms as effectively double taxation. Whether that's a fair assessment or not, it's most definitely my perception of what small business believes. (COSBOA, trans., p. 532)

The Australian Paint Manufacturers' Federation, many of whose members pay charges relating to chemicals regulation, also thought cost recovery charges and taxes are the same:

> Such fees and charges cannot be seen other than as a tax on their operation. In this context the fees and charges are not only a tax on the industry, but they are a tax on the downstream consumers of the products produced by the chemical industry. (APMF, sub. 74, p. 3)

These sentiments show that, at least for some members of the public, there is no clear delineation between cost recovery charges and taxes, in terms of their objectives and their impacts on business. Clarifying the objectives and effects of cost recovery — and differentiating them from taxation — is therefore necessary.

Cost recovery arrangements which are not justified on grounds of economic efficiency should not be undertaken merely to raise revenue for government activities.

Cost recovery targets

Revenue raising targets for cost recovery are particularly problematic where they are set at an agency level. For example, the Therapeutic Goods Administration (TGA) and the National Registration Authority for Agricultural and Veterinary Chemicals (NRA) are required to recover 100 per cent of all agency costs. This has led them to recover costs from industry (through regulatory charges) for activities such as internal administration, policy development, ministerial and parliamentary services, contributions to international organisations and obligations, and public information. As these activities are not directly related to the agencies' regulatory activities, nor to the beneficiaries of regulation, their costs should not be recovered from regulated firms. Further, such activities should be budget funded in order to maintain both the appearance and reality of independence and accountability to Government (see chapter 5). Cost recovery arrangements should therefore be developed and implemented at an activity rather than an agency level.

Even where agency wide cost recovery targets are set at less than 100 per cent and do not include the costs of policy related and similar activities, they can set up undesirable incentive effects. As discussed in chapter 5, agencies with specific revenue raising targets for the agency, or for whole activities, can be at risk of losing focus on the activities which form the core duties or services to Government.

For example, information agencies are typically budget funded for their core activities, and recover all or some of the additional costs of any non-core work undertaken for customers. Where specific cost recovery targets are set for non-core activities, it may encourage agencies to pursue the value added activities which can be cost recovered, at the expense of other, budget funded work (or to distort budget funded work toward areas where there may be value adding opportunities).

Specific cost recovery targets for agencies or for particular activities may also discourage agencies from adopting lower cost methods of service delivery (such as cheaper data dissemination methods), because of the impact on revenues. The funding of agencies currently required to meet fixed cost recovery targets should therefore be reviewed, and their cost recovery arrangements revised in line with the guidelines proposed by this inquiry (see chapter 9).

FINDING

Some agencies have been required to meet cost recovery targets on a whole of agency basis. This has led to agencies inappropriately recovering costs for activities such as policy development, ministerial or parliamentary services and international obligations.

DRAFT RECOMMENDATION 6.2

As a general principle, cost recovery arrangements should apply to specific activities, not to the agency which provides them.

DRAFT RECOMMENDATION 6.3

The practice of setting targets that require agencies to recover a specific proportion of their total costs should be discontinued.

DRAFT RECOMMENDATION 6.4

Cost recovery arrangements should not include the cost of activities undertaken for Government, such as policy development, ministerial or parliamentary services and international obligations.

Cost recovery objectives for information agencies

Cost recovery objectives appear to be more straightforward for information agencies than for regulatory agencies. They generally relate to identifying 'public good' and private benefit elements in various information services, and to managing better the demand for finite government resources such as staff time. External benefits to the wider community from information services can come from the data itself (for example, weather information) or more typically, from the research or forecasting which is undertaken using the data.

Information agencies listed a number of objectives for cost recovery, including:

- recognising the 'private good' characteristics of some government services, which should be paid for by the users who benefit from them (for example, some data from ABS or Bureau of Meteorology (BoM) are used for commercial purposes);
- managing demand for finite government services so as to encourage users to address their real needs and to improve the internal efficiency of agencies; and

- providing financial resources in addition to government appropriation to increase services and to reduce the cost to taxpayers for the provision of these services (that is, revenue raising, as discussed above).

Conversely, some of the reasons given by information agencies for *not* introducing cost recovery for some services, or for not introducing full cost recovery were:

- the 'public good' characteristics of many information services, whereby an almost unlimited number of people can use the same piece of information without diminishing each other's access or utility, and it is not socially desirable to attempt to exclude them (see chapter 2);
- the real benefits to the public of having certain types of information directly and freely available (for example, weather forecasts); and
- the potential benefits to the whole economy arising from research and exploration (for example, positive spillovers from academic research), which can be encouraged by allowing researchers timely, low cost access to original data.

Defining core versus non-core services for information agencies

In applying these rationales and objectives to their activities, most information agencies make a distinction between core and non-core activities, as defined by each agency's mission statement, program objectives or charter of obligations. Non-core activities are sometimes further classified along a spectrum, from those which are incremental to the core services, to more commercial, separate services. Such an approach appears to be an appropriate — and fairly practical — starting point for applying cost recovery in these agencies.

Some agencies have been more successful than others in identifying each product or activity they offer as core or non-core, which can be more difficult than first appearances may suggest (see appendix C). Outcomes have also been mixed in applying consistent cost recovery arrangements within the two groups of activities.

For agencies which collect data, such as the ABS, BoM, ABARE, Australian Surveying and Land Information Group (AUSLIG) and Australian Geological Survey Organisation (AGSO), core activities include most data collection, and some analysis and dissemination. These activities or products tend to have strong 'public good' (and positive spillover) characteristics, and relate directly to the stated objectives and functions of the agency. By contrast, their non-core activities mainly relate to additional dissemination to private users, or further commissioned collection or analysis activities which have clear private benefits for those commissioning or using them.

For core products which are not disseminated free of charge, prices typically include the cost of publication and dissemination, but not the cost of collecting, compiling and analysing the data. The economic rationale for attaching a price to these core publications is primarily to meet demand management objectives for both users and agencies. For example, AUSLIG charges fees for all packaged products such as maps and satellite images, while the ABS charges individual consumers for general data publications.

Where core or standard data can be widely disseminated at little or no marginal cost to the agency (for example through the media or education institutions), it is often provided free of charge. For example, BoM does not charge media outlets for basic forecasting information, and the ABS provides free sets of its standard publications to public libraries and education institutions (and some media), which in turn provide free access to students and the public. However, students and others wanting their own copies of the same standard ABS publications must pay for them.

In information agencies which also have strong research functions, such as ABARE, the division between core and non-core activities is usually more flexible, with non-core research generating a greater degree of private or commercial interest (for example, commissioned and joint research projects). These projects are cost recovered, while the core public interest research is not. However, the identification of individual projects as core or non-core is complicated for these agencies by the imposition of a 30 per cent agency wide cost recovery target. In practice, individual activities are charged at anywhere from zero to 100 per cent of costs, depending on their potential commercial demand, so as to meet the overall agency target (see appendix C). As discussed above, the Commission recommends the removal of such agency-level cost recovery targets.

Agencies with archive and library functions, such as the National Library of Australia and ScreenSound Australia, appear to have relatively well defined and documented core and non-core activities for cost recovery purposes. These agencies tend to define their core activities as their public services, which are wholly budget funded. Additional, non-core services attract fees in line with how peripheral they are to their core activities of collecting, preserving and enabling public access to their collections and archives.

For all agencies, the content of their core services — and appropriate pricing policies for disseminating them — may change over time, in line with changing Government objectives, technologies and demands. The emergence of the Internet provides a good illustration of this. Currently, some agencies are failing to take maximum advantage of the Internet's potential for widespread, cheap dissemination. For example, the ABS places samples of data and summaries of its standard publications on the Internet for free access, but not whole publications,

even though the marginal cost of doing so would probably be close to zero and would contribute considerably to the agency's objectives of informing the community. Instead, the ABS charges the same prices for downloading documents as for the equivalent hard copy publications (with lower prices for subsequent downloads of the same document by the same user). In addition, the downloadable files are often in PDF format, which means the data cannot be readily manipulated by users and full advantage of available technologies cannot be made.

Similarly, ABARE has made only some of its standard data (such as the *Digital Atlas of Australian Soils*) available for free downloading from the Internet. Several participants argued that all core or standard data from the ABS, ABARE and other agencies should be disseminated free through the Internet, because the information itself is essentially a public good (that is, it can be provided to an unlimited number of users at very low marginal cost per user) and because it can produce positive externalities (that is, its dissemination may benefit the wider community). For example, Commodore Station said that all ABARE core data should be free:

> ABARE should make all the data free on the Web — as is done by many government agencies. That would be the most economically responsible policy. Economic data is a non-rival public good with strong positive externalities; by depriving access to potential users there is waste. (Commodore Station, sub. 84, p. 3)

These examples demonstrate the importance of information agencies carefully defining their core activities and objectives, as well as disseminating all core material in the most cost effective and user-friendly manner. As discussed above, several information and research agencies would be greatly assisted in achieving this by the removal of agency wide cost recovery targets.

FINDING

Information agencies generally have attempted to tie their cost recovery arrangements to the objectives of the agency itself, through the notion of core and non-core activities. However, in some cases it is difficult to define clearly the boundary between core and non-core activities.

DRAFT RECOMMENDATION 6.5

Information agencies should carefully define the boundaries of their core and non-core activities. This should be a dynamic process, with core activities determined with reference to:

- ***the agencies' broad public policy objectives;***
- ***the public good characteristics of the activity; and/or***
- ***any positive spillovers associated with the activity.***

Funding core services for information agencies

Apart from having to determine the boundaries of their core services, a key area of concern regarding cost recovery for many information agencies is deciding how to price core versus non-core products and services. In principle, the simplest and clearest pricing policy for information agencies would be for all core services and activities to be budget funded and provided to users free of charge, with cost recovery imposed for additional dissemination, analysis or other specialist services.

Many information (and other) agencies appear to do this already. The ABS, BoM and other key information agencies have fee structures based upon the level of specialisation of the request, relative to their core or standard products (see appendix C). Similarly, although it is not strictly an information agency, Austrade provides general information and advice services to all users free of charge, with 'demand for the more expensive-to-produce services being moderated by the charging of appropriate fees', on a scale which rises according to the degree of 'tailoring' required and the private benefit derived (sub. 58, p. 6).

Some dissemination will always be part of information agencies' core activities. However, not all dissemination of core data or information can, or should be, regarded as essential to meeting agency objectives. For example, in order to provide free public access to core data, it may be sufficient to give free hard copies to public libraries, education institutions, and the media, but not necessarily to all individual users who request it. Indeed, this is exactly how most information agencies currently distribute their standard publications.

It can be argued that this additional dissemination to private users should be defined as non-core dissemination, because it is not essential to ensuring public access. Even small charges based on marginal costs[1] for this additional dissemination can help agencies to measure and respond to user demand, and will reduce demand for unnecessary additional copies of publications from students and others.

In all cases, maximum use should be made of new technologies to lower dissemination costs of core data and information. While there may be good demand management reasons for charging the marginal publication costs of hard copies to private users (as is practised by virtually all information agencies), the Commission has been presented with no good reasons explaining why the ABS and other agencies have not made all of their core data publications freely available through the Internet. Doing so would greatly improve access for students and other people

[1] Marginal cost is the increase in costs from producing an additional unit of output (see appendix H).

with limited access to public libraries (for example, due to physical disability or regional location).

DRAFT RECOMMENDATION 6.6

The core activities of information agencies (which may include some defined level of dissemination) should be wholly budget funded and not subject to cost recovery.

Pricing non-core services for information agencies

Direct pricing is more relevant to non-core information services, where there is a private benefit to the user, and sometimes, a need to ration finite agency resources due to the additional costs involved. In practice, pricing arrangements for non-core services depend largely upon the degree to which the service is provided incrementally to core services, or is of a more commercial, contestable nature. For services which are incremental extensions of core information products or services, there are unlikely to be any competitors, so competitive neutrality pricing considerations will not apply.

Providing additional data analysis and manipulation would appear to be expensive. The ABS said that:

> We certainly recognise our prices are high and, for example, our charges for clerical services are much higher than people like, but when you bring into account all the costs of providing those clerical services — I think it's $120, $130 an hour — it's more expensive than getting a plumber, so they are quite high. But when you factor in all the costs involved, that's what we charge. (ABS, trans., p. 529)

However, in this example, it is not clear what costs are being included in the quoted hourly rate for special data requests.

Some participants said that high prices for data requests not only deter potential users, but might also weaken the demand signal that prices can give to the agency about individual products. Cumpston Sarjeant stated that:

> Users often cannot judge the relevance of ABS data to their real needs without making explorations. … High prices will deter many potential users with genuine needs for data, so that sales reflect only a small part of the demand. (Cumpston Sarjeant Pty Ltd, sub. 77, p. 2)

As identified by AGSO, prices for all information services should be set to help maximise demand (and cover costs) rather than to maximise revenue:

> Logically, prices need to be set at levels which maximise the uptake of the information rather than maximising the level of cost recovery. (sub. 55, pp. 15–16)

This implies that non-core services which are incrementally built onto core services need to be provided efficiently, and that only the incremental costs of direct relevance to the additional service should be included in the price.[2] The incremental cost of providing the service would be a reasonable aim for pricing, in the interests of both demand and resource management, as well as in order to prevent such work diverting resources from core activities, which should always take precedence over additional, commercial work. Where services are further removed from core activities and are of a more commercial, contestable nature, competitive neutrality principles may apply (that is, if there are other agencies or private firms which could potentially do this type of work).

In addition to direct user charges, several information agencies such as AUSLIG and ScreenSound Australia use copyright, licence fees and royalties in their cost recovery arrangements (trans., pp. 344 and 435). Such mechanisms are 'the exception rather than the rule' (AUSLIG, trans., p 435), and raise only a relatively small proportion of revenue, but can have significant demand and efficiency effects. Once information has been generated, the marginal costs of its dissemination are often very low. The use of royalties and licence fees — which are linked to the value of subsequent use rather than to the cost of providing the service — may discourage some users who would have paid the incremental cost of dissemination, such that a potential use of the information has been prevented.

DRAFT RECOMMENDATION 6.7

Non-core activities provided by information agencies should be charged at marginal (incremental) cost or, where relevant, at prices in keeping with competitive neutrality principles.

Differential pricing practices

Differential pricing is usually associated with normal profit maximising behaviour by private firms. Typical examples include cinema tickets, advance purchase airfares and business premiums on utilities and other services, where different prices are charged for customers with different levels of marginal utility (or willingness to pay) for the same or similar products or services.

It is arguable, on economic grounds, whether differential pricing should be used by government agencies and particularly by agencies which are seeking to recover their costs and not to maximise their revenue collection.

[2] Incremental cost is the increase in costs attributable to the production of a particular type of good or service. In practice, it is often used as a proxy measure for marginal cost.

Among government information agencies, some agencies charge different prices for similar material, for public versus private sector clients, or for education and research versus commercial clients. For example, the ABS has special arrangements for data access and pricing for Australian universities, while most agencies have special arrangements for providing data to relevant government departments for policy purposes. These arrangements are not necessarily examples of differential pricing to maximise revenue, but may be related to the agencies' core service functions, or to access policies for special groups, such as students or academics.

In the case of academics and other non-commercial researchers who use information services, the resulting research often has strong potential for positive externalities (that is, public benefits which cannot be captured by the producers of the research). Such research should be — and is — supported by government through a variety of mechanisms. This government support is, in most cases, better provided though direct policy measures, such as subsidies or grants, than through relatively small pricing discounts, which may require individual information agencies to make potentially difficult social and equity judgements about the value or 'worthiness' of downstream applications of their data.

Price discounts become even more problematic if they are (or are perceived to be) funded through cross subsidies from other service users. As identified by COSBOA, any discounts should be funded through taxation and not by other users:

> … any good or service in the marketplace should be purchased at the same rate, and if society believes that some disadvantaged group needs support that should be through some sort of tax relief or some benefit. … if society determines that these people need support it is the state's responsibility to deliver the support and not the private sector. (COSBOA, trans., p. 535)

As discussed above, the Commission has made a draft recommendation that core information services, including some dissemination to education institutions and the like, should be budget funded (Draft Recommendation 6.6). For non-core dissemination and value added, commercial information services, the Commission has made a draft recommendation that prices include only the marginal or incremental cost of providing the service, except where competitive neutrality considerations apply (Draft Recommendation 6.7). In most cases, users of information services should be charged no more than marginal or incremental costs, and differential pricing should not occur.

Cost recovery objectives for regulatory agencies

The number and level of cost recovery charges have been increasing across regulatory agencies over the last decade. However, the rationale behind these

increases, and the objectives the charges are seeking to address are not always clear (see chapter 4).

In practice, regulatory agencies seem to have had greater trouble than information agencies with identifying appropriate cost recovery objectives, and with formulating coherent, consistent cost recovery policies. This is largely due to the *ad hoc* development of cost recovery in many regulatory agencies, and the difficult economic and social issues involved.

The Commonwealth regulatory agencies examined by this inquiry cover a wide range of industries, and have a wide variety of cost recovery arrangements in place, recovering from zero to over 100 per cent of agency costs. While the objectives of these arrangements were often not clearly defined, they generally included one or more of:

- charging regulated firms for the benefits that they, or more often their customers, are presumed to receive from the regulations (for example, assurance of safety);
- charging regulated firms (and often by extension their customers) the cost of minimising any negative spillovers or risks to the community (that is, the costs of regulation) associated with their products;
- demand management of regulatory services; and
- revenue raising (as discussed above).

Looking broadly across the range of Commonwealth regulatory agencies, the most common objective for cost recovery appears to be in order to charge regulated firms and their customers for the benefits they derive from regulation. Both of the financial regulatory agencies (the Australian Securities and Investment Commission [ASIC] and the Australian Prudential Regulation Authority [APRA]) said that they recover costs with this objective in mind (see appendix F). Some of these benefits were also acknowledged by the users of these agencies. For example, the Investment and Financial Services Association (IFSA) stated that financial regulation increases customer confidence in their members' products, and contributes to a 'level playing field' for products to 'compete on their merits'. In recognition of these benefits, IFSA said that the industry is willing to contribute to the costs of regulation (IFSA, sub. 9, p. 2).

The TGA, NRA and other health and safety agencies justified their cost recovery arrangements in a similar way, arguing that regulated firms and their customers benefit from having a government 'seal of approval' on the regulated products. ANZFA (Australia New Zealand Food Authority) also has a 'beneficiary pays' objective for its cost recovery policy, with fees payable for variations to product

standards which give the applicant an 'exclusive capturable commercial benefit' (this has not yet been applied in practice, see appendix D).

It could be argued that, in most cases, the consumers of the regulated products are the main beneficiaries, and hence should pay for these benefits directly, through levies or charges. However, it is usually more efficient to charge the producer, who can then pass some or all of the incidence of the charge on to consumers (see chapter 2). This method of charging has the added advantage of sending price signals directly to firms about their true production costs, rather than having them filter back more slowly through consumers in the form of lower demand.

A smaller number of regulatory agencies with health and safety functions said that their objective was to recover costs which should be regarded as a 'normal business expense' (for example, the Australian Quarantine and Inspection Service [AQIS] and the Australian Maritime Safety Authority [AMSA]). That is, the cost of minimising any negative spillovers, such as health or safety risks to the wider community which arise from a firm's products or services, should be treated as a normal cost of business, to be built into the price of the product, and ultimately paid for by the consumer of the product.

Regardless of how regulatory agencies formulate their objectives for cost recovery, the caveats of feasibility, as well as compatibility with overarching agency and activity objectives, must also be addressed by cost recovery arrangements. For example, direct user charges have been minimal in food standards regulation to date, due to feasibility problems which allow all food producers to 'free ride' on the first application for a relevant variation to a food standard. A direct charge might therefore discourage some firms from applying for a variation. (Similar free rider problems can arise for new therapeutic claims for non-patented medicines, see section 6.2 below.)

In a similar fashion, unique market issues are likely to arise for other regulatory agencies, with implications for both the imposition and design of cost recovery. For example, the Office of the Gene Technology Regulator (OGTR) and the Space Licensing and Safety Office (SLASO) have been set up very recently to oversee the development of new industries in Australia. It is important that cost recovery arrangements do not conflict with, or unreasonably discourage, that development (for example, by setting prohibitively high fees for initial assessments or entry). These and other market considerations are discussed in section 6.2 below.

DRAFT RECOMMENDATION 6.8

Where the main objective of regulation is to provide benefits to the users of regulated products, a 'beneficiary pays' approach should be adopted. Under this approach regulated firms would be charged for the costs of regulation only where:

- ***it is not feasible to charge beneficiaries directly;***
- ***costs can be passed on to beneficiaries;***
- ***it is cost effective; and***
- ***it is not inconsistent with policy objectives.***

DRAFT RECOMMENDATION 6.9

Where the main objective of regulation is to minimise the detrimental effects of external spillovers, a 'regulated pays' approach should be adopted. Under this approach, regulated firms should be charged for the costs of regulation only where:

- ***those businesses are the source of the negative spillovers;***
- ***it is cost effective; and***
- ***it is not inconsistent with policy objectives.***

Appropriate activities for cost recovery by regulatory agencies

Regulatory agencies have varied widely in how and why they have identified particular activities as appropriate and suitable for cost recovery. In a similar manner to the information agencies' categorisation of activities into core and non-core functions, some regulatory agencies have attempted to distinguish government related functions and 'community service obligations' for which they do not charge, from the activities which are directly regulatory and subject to cost recovery. For example, some regulatory agencies do not charge firms for corporate or policy functions, nor for 'public interest' functions such as public health and safety information, or search and rescue activities. In the case of the National Industrial Chemicals Notification and Assessment Scheme (NICNAS), safety and handling advice for NICNAS registered chemicals is partly provided by the National Occupational Health and Safety Commission (NOHSC), while policy development is done by the Department of Employment, Workplace Relations and Small Business, neither of which recover costs for these activities (see appendix D).

However, this notional split has not been done comprehensively or consistently across regulatory agencies, and is not always reflected in their cost recovery

arrangements. For example, the TGA and NRA must recover 100 per cent of agency costs, including (by definition) the cost of non-regulatory activities such as policy, research, community information and international liaison, despite having previously identified them as 'public interest' activities (see appendix D). Similarly, the Australian Communications Authority (ACA) raised $54.2 million in 1999-20000 (mainly through three charges) to cover a range of agency activities, including spectrum interference investigations and policy development (see appendix E).

It is the cost of these non-regulatory activities which regulated firms and users most often resent paying. For example, the Medical Industry Association of Australia stated that, in relation to TGA charges:

> These high charges are a direct result of a Government policy that obliges the TGA to recover all costs from industry, no matter that the bulk of TGA activity (and therefore expenditure) is not related to industry support. (MIAA, sub. 12, p. 4).

And IFSA expressed a similar view about APRA charges:

> While IFSA (along with many other bodies) has strongly supported [financial regulation agencies'] public policy objectives, we are of the view that the whole community should fund them. Examples include policing activity; regulation to prevent or limit tax deferral; retirement incomes policy objectives, … and retirement savings (superannuation) and incomes public education. (IFSA, sub. 9, p. 2)

As discussed above, the Commission has made a draft recommendation that the costs of activities such as policy development and public education should not be recovered from regulated firms (Draft Recommendation 6.4). Just as information agencies have tried to classify their activities as core and non-core services, regulatory agencies should also look at each of their activities separately, to determine whether cost recovery is appropriate (Draft Recommendation 6.2).

Pricing principles for regulatory activities

Intuitively, using cost recovery as a demand management mechanism may seem inappropriate to regulatory agencies, due to the compulsory nature of many regulations. However, as identified by the Department of Transport and Regional Services:

> … where the charge is levied to deter misuse or excessive use of a service … the objective for charging … [is] not so much to raise revenue but to reduce the cost of an unreasonable amount of service demand. (DTRS, sub. 48, p. 4)

In the case of regulatory agencies with a health and safety role, many agencies' charges are imposed per product, not per company, so some discretion may be possible regarding the number of products a firm chooses to register. In other cases,

charges must be paid by all firms in an industry, and there is less discretion. In either case, charges can be used to encourage or discourage certain demands and behaviours among clients and users, as well as to help manage resources and incentives within agencies (see chapter 5).

For example, the NRA charges a minimum annual fee ($200) to maintain products on its register (and thus allowable) even if sales have been nil, so as to discourage firms from continuing to register disused and superseded products. This is in part, a demand management practice, in that it discourages unnecessary registrations and keeps the register free of superfluous products (see appendix D). NICNAS's New Chemicals Assessment Program gives a 15 per cent discount to applicants who provide their assessment documentation 'in the required form' (KPMG Consulting 2000, p. 23). This encourages firms to get their application right the first time, and allows NICNAS to reduce the resources needed to process these assessments, thus lowering regulatory costs for both the agency and regulated firms.

However, as is the case for all government agencies, regulatory agencies which use charges to help manage demand, need to be careful they do not reduce demand by more than is economically or socially desirable. Such concerns have led the National Standards Commission to refrain from increasing fees since 1996:

> Past experience has shown that customers are very sensitive to increases in pattern approval charges, and current prices already restrict trade. Over the past 10 years, prices have been adjusted to meet budget imperatives, without any consultation with industry. Each price rise has been followed by a drop in demand, as suppliers decided not to launch new models in Australia. In response to this situation, the Commission has not increased prices since 1996 (except for the inclusion of GST). (sub. 31, p. 3)

In other cases, agencies have chosen not to apply direct charges to certain activities (even though they recover costs for other, related activities), due to such concerns. Direct charges might be counter productive to broad policy objectives if the fees discourage firms from coming forward to register, or if they form a barrier to entry for financially marginal — but otherwise eligible — products (see section 6.2). Also, no regulatory agencies charge directly for product recalls (although the cost of the service may be built into industry levies or other charges), so as to avoid disincentives for firms reporting defective products. To do so could seriously impede the basic objectives of providing recall services.

FINDING

Cost recovery can be a useful tool for conveying price signals and reducing excessive demand for some regulatory activities, but it requires careful consideration due to potential conflict with other agency functions and objectives.

6.2 Impact on industry

The Terms of Reference for this inquiry require the Commission to examine, among other things, the impact of cost recovery on business, including small business, new technology, competition and incentive effects (Terms of Reference 3(d) and 4 (a)).

Some participants have argued that, by creating additional costs to be met by industry, cost recovery has had an effect on the entry of new firms or products to the Australian market, industry innovation and competitiveness. It is often difficult to distinguish the impact of charges from the impact of regulations themselves, from market conditions or, in the case of information agencies, from other mitigating factors such as technology, resource limitations and data confidentiality requirements. However, it is likely that cost recovery charges have had a separate effect, albeit small, for firms or products at the margin.

Barriers to entry

Barriers to entry mean that there are impediments to new participants or new products entering a particular market. Barriers protect incumbent firms from new competition and restrict choice for consumers. The risk that cost recovery charges might act as a barrier to entry is more likely to arise for regulatory than for information services, and in particular, for regulatory charges associated with initial market entry such as up-front assessment and registration fees (as opposed to post-market charges such as industry levies or annual re-registration fees). In addition, some types of cost recovery charges may potentially set up 'free rider' or 'first mover disadvantage' problems which discourage market entry.

Cost barriers for firms

There has been little direct evidence from participants of cost recovery charges *per se* forming a barrier to entry for firms (although the associated regulations may form a barrier to entry as part of their primary function).

Some participants suggested that in certain highly regulated industries, the cost of regulation (including charges, compliance and other costs) have discouraged new local firms, but they did not give specific examples. Cochlear stated that:

> Even more concerning is the discouragement to potential start up companies which could greatly benefit from having a lower cost access to the local Australian market to build their business prior to overseas expansion. (Cochlear, sub. 10, pp. 1–2).

The Complementary Healthcare Council also claimed that regulatory fees — in conjunction with regulatory compliance costs and restrictions — may have pushed some firms overseas:

> A number of companies have relocated overseas in order to avoid costs of listing and restrictions on advertising, marketing directly back into Australia through the Internet and mail (imports for personal use are permitted outside the TGA regime). (sub 17, p. 10)

In regard to telecommunications, the ACA stated that the Annual Carrier Licence Charge may have discouraged some smaller firms from entering the telecommunications industry in the past, but that the minimum charge was lowered in 1997, and alternative fees for smaller users were introduced (sub. 108, p. 6) (see appendix E). In the financial sector, the Association of Superannuation Funds of Australia (ASFA) said that APRA industry levies for superannuation funds do not discourage market entry by firms or products:

> … the [APRA] levies being paid by individual funds are not normally of such magnitude as to drive a decision whether to start up a new fund or amalgamate or discontinue an existing fund. (sub. 8, p. 7)

Potential market entry disincentives were initially anticipated for both the OGTR and SLASO, because each individual project will need regulatory approval. In the case of the OGTR, particular problems were anticipated from charging fees for initial approvals, because the projects to be approved will be at the research and development stage, and not necessarily profit-generating or even of a commercial nature (KPMG Consulting 2000). Following a Senate Inquiry, the Government decided that the OGTR will not charge fees for at least the first two years of regulation (see appendix D). SLASO has had similar concerns with regard to the newly emerging space launch industry.

Cost barriers for products

Most examples given by participants related to barriers to individual products, not to whole companies. These were generally for consumer products being newly imported into Australia, rather than for new products developed in Australia.

Participants often described a list of factors which can discourage entry to the Australian market, indicating that cost recovery forms a barrier in conjunction with other factors rather than on its own. For example, Cochlear claimed it is the combination of relative market size, short shelf life and regulatory compliance costs, as well as the regulatory charges, which forms a barrier to new products:

> … the impact of 100 per cent cost recovery policy is to make market entry in Australia too expensive for many companies. Companies do not introduce new products to the

> Australian market where it is apparent that high up-front costs for evaluation and entry onto the Australian Register of Therapeutic Goods (ARTG) cannot be recovered in the often short market-life of the product. (sub. 10, pp. 1–2)

Cochlear further claimed that Australia's regulatory charges, as a proportion of expected sales (that is, relative to Australia's market size), are far higher than in comparable markets overseas:

> Australian [regulatory] cost per sale, if you like, is three times that of Canada and about 20 times that of Europe, in terms of the application and registration charges. … we have basically decided in terms of product offering that we have two implant models that we will not market in Australia. … the market for those is so small that we can't justify the regulatory registration cost. (trans., p. 208)

The cost of product approval charges relative to the size of the Australian market was also an issue for the National Standards Commission:

> From the manufacturers' perspective, the benefit/cost of pattern approval in Australia is relatively poor, because the price for access to the Australian market is the same as the price for access to the whole of the European Community. (sub. 31, p. 5)

Similar claims were made about registration costs for complementary health care products. Individual registration fees are relatively small for these products, but in conjunction with regulatory compliance costs, they quickly add up because complementary health firms tend to market large ranges of products:

> Medium sized New Zealand companies are only able to afford to market about 20 per cent of their product range due to TGA direct cost and related costs. It costs approximately $450 to list a product with TGA, even if there are a hundred identical products already on the market. Consultancy costs required to prepare documentation cost a minimum of $500 and can easily be $2–3,000 if there are any questions raised by TGA officials. Even allowing for these costs (say $1 000 per product) it would cost a New Zealand company with a modest product range of, say, 200 products … $200 000 every year as an entry fee to the Australian market. No such costs apply in New Zealand. (National Nutritional Foods Association of New Zealand [NNFANZ], sub. 11, p. 12)

This example may overestimate the typical annual registration costs for these products, because documentation for products is required once upon their initial listing not annually, and because the TGA has a discounted annual registration fee of $75 for low volume products (NNFANZ, sub. 11, p. 12). However, it illustrates the way in which small product registration charges can mount up for firms with a large range of products.

In such cases, registration fees appear to be a 'last straw' in the cost equation for an already marginal product, rather than a significant barrier in their own right. Nevertheless, these charges may have the effect of blocking an unknown number of

economically marginal — but otherwise allowable and potentially beneficial — products from entering the market.

In most cases, this reduced range of products would mainly affect consumers, through reduced choice (see section 6.3). But where the affected product is an intermediary one (for example, industrial or agricultural chemicals), the effect of discouraging a new small-selling regulated product can flow through into other industries which may have used it instead of, or as well as, an existing input. This potential impact on industry and innovation is discussed further below.

FINDING

Barriers to entry for firms and products arising from cost recovery charges are difficult to separate from barriers arising from the regulations themselves (including compliance costs) or from general market factors.

Free rider disincentives

Free rider disincentives (sometimes referred to as a 'first mover disadvantage') occur where an entrant to a market, product or activity bears the cost of that entry, but cannot prevent others from gaining a free ride on their investment. This concept is closely related to the notion of positive spillovers (externalities), but the external benefits are limited to a firm's competitors, rather than spreading to a whole industry or to the wider public. Such a situation can provide a strong disincentive to firms wanting to enter a new market, but which are unwilling to bear the initial cost on behalf of their potential competitors. On the other hand, where the first firm gains a private benefit which still outweighs their costs, they will go ahead with market entry.

Free rider problems have been recognised by ANZFA as an important caveat in relation to food standards regulation:

> Unlike the activities of the Therapeutic Goods Administration or the National Registration Authority, in most cases, the processing of an application by ANZFA does not transfer a commercial benefit solely to the applicant. This is because the approval of an application is not limited to the applicant, nor generally to the individual product, but provides for generic amendments to the Food Standards Code. The review concluded that this 'free-rider' effect would make it inequitable to charge an applicant the full cost of processing an application. (sub. 67, p. 3)

Although other agencies charge fees for regulating similarly generic products (including the TGA and NRA), they have registration requirements (all producers must be separately registered) which reduce the free rider disincentive.

ANZFA says a similar requirement to make all food producers register individually would not be efficient for generic foods, or compatible with the overall objectives of food standards regulation. An alternative would be to introduce an industry or consumer levy, aimed at charging the beneficiaries of food standards regulation. However, ANZFA also has to deal with a product characteristic which is arguably unique to food: that is, the main beneficiaries of food regulation — food consumers — are synonymous with the entire population. Therefore, if the aim is to charge the beneficiaries of the regulation, then funding food standards through the general taxation system seems a reasonable and relatively efficient approach.

Another example of a free rider disincentive arises for assessment charges by the TGA for new therapeutic claims for generic products, for example, that aspirin thins the blood, or that certain vitamins have newly discovered health benefits. The free rider disincentive arises from the combination of the TGA charge for assessing the new therapeutic claim, and the fact that the product is generic, so that other registered manufacturers can subsequently make the same new claims for their own product. For generic complementary health products (CHP's):

> The cost of evaluating a new CHP substance is high - upwards of $10 000. There is no capturable commercial benefit to a company from having a new substance evaluated and approved for use as an ingredient as there are no patent protections for CHPs. Once a new substance is approved, all players can use the substance. Accordingly, very few companies are able or prepared to trail blaze. (Complementary Healthcare Council of Australia, sub. 17, p. 9)

This may discourage generic producers from adding such claims to their products, and deprive consumers of potentially useful product information. A less direct, product wide charge such as a levy, or an extension of annual registration charges, may therefore be more suitable than direct assessment fees.

Other examples of free rider problems raised by participants related to market circumstances rather than to cost recovery, and were used, in part, as a rationale for related industry assistance. For example, Austrade indicated that it had identified a free rider issue in relation to firms pushing into new export markets, which can be expensive and time consuming for firms working alone:

> … many markets do not view Australia as a supplier of high technology manufactured goods. It is difficult for a single firm to overcome this, and if it invests heavily in doing so, much of the benefits of the improved reputation of Australian products may be captured by other firms. (sub. 58, p. 6)

Among other things, Austrade said this partly justified its sliding scale of cost recovery, with no fees for general information services and higher fees for more tailored services for individual firms.

These examples show that factors contributing to a free rider situation in cost recovery include a lack of property rights (that is, generic products or services), and entry regulations for types of products or claims rather than for individual producers. Free rider disincentives may affect what types of cost recovery charges will be appropriate or, as in the case of ANZFA, feasible.

FINDING

Direct regulatory charges for generic products may give rise to 'first mover disadvantages', inhibiting the introduction of new products.

Technology and innovation

The main issues raised by participants in relation to technology were similar to those raised in relation to barriers to entry — that is, whether charges for information or regulatory services are impeding the introduction or development of new technology, industry or products in Australia.

Innovation effects from cost recovery by regulatory agencies

Examples of regulatory impediments given to the Commission by participants mostly involved disincentives to importing new products or technologies into Australia, rather than impediments to local innovation and development. For example, the National Standards Commission pointed to approval fees discouraging the adoption of new measurement technology for use in local industry:

> When the cost of pattern approval represents an unacceptable barrier to entry of the Australian market, it deprives the users of trade measurement equipment of access to the latest technology, and restricts market competition. (sub. 31, p. 3)

Similarly, it is possible that chemical registration fees may have discouraged the importation of new (presumably small-selling) industrial chemicals which have potential applications in the domestic manufacture of downstream products. For example, new chemicals might be available which would be more efficient or less polluting than existing processes, or would enable new or more sophisticated manufacturing processes to be carried out in Australia. The Chemicals and Plastics Action Agenda gave an example of this in the case of paint products:

> The Australian Refinish Industry uses approximately 15 million litres of paint per year, of which more than 50 per cent is low solids acrylic lacquer that has a solvent content of 70–80 per cent. While low solvent alternatives have been made available in the USA and Europe, the technology has not been introduced in Australia. It is estimated that an at least 2 million litres more solvent is emitted per year than would be the case if low solvent alternatives were available in Australia. (sub. 14, p. 4)

Other participants also gave examples of newly developed or very specialised chemicals not being imported into Australia for use by local industry due to regulatory costs and, presumably, the small Australian market for such substances (Plastics and Chemicals Industries Association, trans., pp. 4–5) It is possible that similar issues might arise for agricultural and other chemicals which have very small local markets (for example, specialist chemicals intended for only one crop).

Not all regulatory charges can be expected to have the same impact on innovation. Fees associated with premarket assessment and initial product registration are more likely to discourage innovation than post-market annual registration fees or industry levies, which are often based on sales levels (and thus unlikely to discourage products which are not yet for sale). Charges which relate to generic products might also be expected to have a smaller effect on product innovation than those for unique products, because most genuinely new technologies and products have patent protection or intellectual property rights which enable (often high) development costs to be recouped later through sales.

Several regulatory agencies have expressly recognised this in their fee structures, and particularly with regard to initial assessment and regulatory fees. For example, the NRA has lowered initial assessment fees and increased ongoing annual fees (based on product sales) so as to minimise discouragement of new registrations, with the idea that firms will pay the approximate costs of regulation over the lifetime of a product, rather than prior to entering the market (sub. 39, p. 5). This system includes a 'minor use' permit, which is issued free of charge, to companies wishing to use chemicals for research purposes or to help develop new products or activities.[3] Similarly, NICNAS has special 'early access permits' to enable fast access to new 'low hazard' chemicals for local industry (for safety reasons, normal assessment procedures and costs apply to chemicals with a higher hazard rating).

As discussed above, participants suggested that the regulatory fees originally foreshadowed for the OGTR and SLASO might discourage gene technology research and space launch activities from expanding in Australia. Avcare said that there is a risk that these new industries could relocate overseas:

> The Australian gene technology industry — which comprises a substantial public sector research and development, as well as Australian and multi-national corporate investment is in its infancy. Any move to impose full or substantial cost recovery in the near future will adversely impact on confidence and will be seen as contrary to the Government's own commitment to development of this industry, as outlined in the National Biotechnology Strategy. In the private sector, the capital resources and research and development skills behind gene technology are particularly mobile

[3] The NRA's fee structure includes several levels and scales and was developed in consultation with relevant industries (see chapter 4 and appendix D).

> internationally and can easily be withdrawn from Australia if local costs are considered too high. (sub. 28, p. iv)

Whatever other arguments there may be for cost recovery in these emerging industry sectors, great care must be taken to ensure that regulatory charges — and particularly any initial market entry fees — are designed so as not to unduly impede their development.

Innovation effects from cost recovery by information agencies

The effect of fees for information services on access to data for research purposes was raised as an issue by some participants. Some of these comments related to the level of fees (that they are too high), others related to the structure of fees, or to the fact that some fees do not appear to reflect the incremental cost of providing the data or service (for example, the cost of special data requests from the ABS).

AGSO stated that it is concerned that its cost recovery policies may be making its data too expensive for some users:

> High prices act as a disincentive to uptake and investment, and create a conflict with program objectives. Benchmarking of AGSO products against its international competitors indicates that under present cost recovery policies the price of Commonwealth spatial and other related data is becoming uncompetitive and a disincentive to uptake. (sub. 55, pp. 15–16)

Other participants confirmed this perception of high AGSO data prices:

> Benchmarking of AGSO prices against Victoria and some other states would show that the AGSO prices are significantly higher. These high prices act as a disincentive to access and use of the information. Furthermore, they disadvantage smaller companies that are likely to try to use products not suited to [the] task to minimise the cost to their exploration program instead of purchasing the AGSO data. (Geological Survey of Victoria, sub. 99, p. 2).

And for the Environmental Research and Information Consortium Pty Ltd (ERIC):

> In the case of ERIC, the annual data purchase (transaction) costs are higher than information production costs. This stifles business growth and our capacity for research and development and innovation. (sub. 7, p. 1)

As discussed in section 6.1, some cost recovery arrangements may have discouraged information agencies from making the best use of new technologies to lower dissemination costs for themselves and their customers. In some cases, this may have impeded firms' access to data and information for research and development purposes.

FINDING

Some information and data services appear to be priced at levels which are higher than their incremental costs, and some information agencies are not taking full advantage of new technologies to lower their dissemination costs. These factors may be impeding the progress of Australian research and industry development.

Compliance costs for industry

The Commission has seen little evidence that cost recovery fees and charges increase compliance costs for firms, beyond what would arise from the regulations with which they are associated, or the process of requesting the information sought. That is, compliance costs generally stem from the regulation or service and not from paying the charge.

One exception might be industry levies which require complicated calculations based on sales, turnover or other measures. However, the Commission has received no evidence that compliance costs from paying industry levies (as distinct from the levies or the regulations themselves) are currently an issue for industry.

COSBOA suggested that the proliferation of corporate regulation charges created a compliance bookkeeping burden for small businesses in certain heavily regulated industries, and added to the unpredictability of their expenses. Multitudes of small fees were often resented more than a single large impost due to the bookwork required (COSBOA, trans. pp. 540 and 543).

Competition effects

Some participants said that cost recovery arrangements have particular effects on small firms or to a lesser extent, on regional firms. In some cases, advantages were claimed for small or regional firms, but in other cases, disadvantages were highlighted.

Small business effects

Several participants claimed that small firms are disadvantaged by regulatory and other government charges. This was said to be because they may not be able to spread the additional cost of the charges across large product ranges or sales in the same way as larger firms. It may take them longer to recoup premarket regulatory costs, or they may not be able to cover annual registration fees as readily. On the

other hand, many regulatory and other agencies offer fee discounts and even exemptions, which are more likely to benefit small firms than larger ones.

The exact amount at which a charge becomes a barrier for entry for small firms, but not necessarily for larger firms, is unclear (and may vary). The National Standards Commission thought that this might be the case for pattern approval fees:

> Typically, pattern approval of an instrument costs about $20 000 and takes 8 to 12 weeks to complete. Most customers are [small to medium size enterprises] or small import agents, for whom this represents a major expense and a barrier to entry into the Australian market. … the cost of pattern approval represents an unacceptable barrier to entry of the Australian market. (sub. 31, p. 3)

Many agencies have tried to address such concerns through sliding fee scales and in some cases, exemptions for very small firms or products with low levels of demand. Agencies may do this for perceived equity considerations and in order to minimise the economic impact on small producers (NICNAS, sub. 33, p. 3). Some of the charges of health and safety and financial regulatory agencies are determined, to some extent, by firm size or sales, often with exemptions or maximum caps. For example, AMSA has a sliding scale of fees, and both NICNAS and the NRA have minimum thresholds for annual levies, and exemptions from fees in some circumstances. For example, NICNAS does not charge an annual registration fee for products with less than $500 000 annual sales (see appendix D). Such charges are on the basis of product sales and not company size, but most small firms (with smaller sales) would pay less than large firms with comparable product ranges.

In other cases, agencies do not charge very small firms or ostensibly non-commercial organisations for some services due to feasibility or equity considerations. For example, AMSA does not charge non-commercial or fishing vessels for two of its three levies (see appendix D), and ScreenSound Australia does not generally charge non-commercial groups for use of archive film footage (see appendix C)

Some participants argued that despite sliding scales and exemptions, the annual registration charges for products regulated by the TGA, NICNAS and the NRA often seemed significantly higher than the costs associated with maintaining the annual register. They said that this discouraged small-market products from staying registered. This discrepancy may reflect the fact that these annual registration charges often cover more than simple re-registration tasks, and can include related post-market monitoring, and even some premarket assessment costs (as is made explicit in the case of the NRA).

In some instances, cost recovery arrangements with sliding scale fees may appear to favour larger firms. Some participants argued that levies which have maximum

capped amounts (such as chemicals and pharmaceuticals registration fees) discriminate against small businesses, in that large firms with sales above the maximum limit enjoy an effectively lower fee per unit of output. On the other hand, if charges genuinely relate to costs, then a maximum cap may simply reflect the maximum cost of the activity or service with which the charge is associated.

Regional effects

The Commission received little information on cost recovery arrangements which may affect firms or consumers in regional areas in different ways to those in other locations. Avcare suggested that any disincentives to gene technology research (from proposed OGTR regulatory charges) might detract from agricultural development:

> A setback for the agricultural gene technology industry will impact directly on the rural sector and the regional communities that support, and benefit from, competitive profitable rural industries … (sub. 28, p. iv)

In regards to telecommunications, it is possible that ACA charges have had a different impact on regional spectrum users than metropolitan ones. However, the Commission has received no information on this from spectrum users, and the ACA said it:

> … does not believe there are significant access and equity or regional competitiveness issues associated with the radiocommunications cost recovery regime. (sub. 108, p. 9)

Cross subsidies in cost recovery charges

The Commission received evidence of several instances of cross subsidies (or perceived cross subsidies) between firms using the same or similar government services for which charges apply. To the extent that they exist, it was not always clear what effect the cross subsidies had on different types of regulated firms.

As discussed above, several regulatory agencies use sliding fee scales, concessions and exemptions for different types of regulated firms. One problem with concessional charges for small firms or other groups is that the shortfall may be made up from another group, thus introducing distortions into the fee structure. The Australian Chamber of Commerce and Industry (ACCI) stated that there are such undesirable distortions in some AQIS fees, although it was unclear whether these were based on firm size, location or other characteristics:

> The Chamber movement hears regularly from traders, both exporters and importers, of anomalies and inconsistencies. …we have been advised of substantial differences in the charging and service levels between major capital cities for what are ostensibly similar

> inspections. One member reported a specified type of inspection for the export of fresh produce can cost $100 in Melbourne, but $350 in Adelaide. (sub. 70, p. 7)

ACCI also claimed that metropolitan firms may be subsidising rural firms in some AQIS services, because travel costs are not always fully reflected in AQIS service charges:

> One notable inconsistency is the cross subsidisation of establishments. A case in point involves the travelling time of inspectors visiting regional/rural establishments, where the travel costs are not being fully borne by the establishment where the inspection is taking place but transferred, at least in part, to urban-based establishments. (sub. 70, p. 7)

A recent Australian National Audit Office report on AQIS's cost recovery confirmed that there are cross subsidies between some AQIS services, but found that 'the extent was not readily quantifiable' (ANAO 2000a, p. 23). The department responsible for AQIS services, said that where they exist, any cross subsidies between AQIS services are not significant, and may be expensive to eliminate completely (AFFA, trans. pp. 663–666).

Financial regulatory agencies' fees might also involve a degree of cross subsidisation between firms and even industries (see appendix F). This might also be the case for ACA fees for radiofrequency spectrum users (see appendix E). The Commission has not received any direct evidence on the extent or effect of any cross subsidies for these users based on firm size, location or other factors.

The issue of possible cross subsidies in aviation industry regulatory costs appears to have a regional dimension. Qantas said that a disproportionate share of the costs of the aviation industry regulatory and safety services are met by the large domestic airlines (through the aviation fuel levy), to the benefit of small operators and private users of small regional airports (Qantas, sub. 63. p. 4).

In many areas of government activity, cross subsidies to assist regional or other special groups have been progressively wound back and replaced with direct subsidies. These subsidies are a more transparent form of assistance and thus to be preferred over hidden subsidies. For example, Airservices Australia has been receiving an explicit subsidy for operating regional air towers (although it is funded from the aviation industry fuel levy), but this is to be phased out by July 2001 (see appendix D).

In theory, cross subsidies should not arise from cost recovery arrangements where only the direct or marginal costs of the service are charged to each firm. However, the experience of several agencies has shown that clear separation of activities and costs can be difficult (see section 6.1). Where cross subsidies arise from cost

recovery arrangements, the result may be neither efficient nor equitable. They should therefore be avoided as far as possible. As discussed in section 6.2, where it is desirable to support a specific group or industry for social, cultural, equity or other reasons (including positive spillovers such as increasing research outputs or access to certain pharmaceuticals), more direct mechanisms (such as research grants or the Pharmaceutical Benefits Scheme) than discounts or cross subsidies in cost recovery arrangements should be used.

6.3 Impact on consumers

The impact on consumers of Commonwealth Government regulatory and information agencies cost recovery charges comes mainly through indirect, rather than direct routes.

Direct cost recovery from consumers

Few Commonwealth Government cost recovery charges are paid directly by consumers. Examples include passport fees, some recreational activities and visa fees (paid by non-Australian residents).

Some individuals also pay for data from information agencies. However, the main customers of the information agencies examined were firms, research and education users rather than individual consumers.

Indirect effects for consumers

In the case of financial and health and safety regulations, the main beneficiaries are the consumers of the regulated products. This may be true also of consumers of products for which Government information and data are significant inputs (for example, some commercial publications). The extent to which consumers will pay for these benefits or inputs depends upon how much, if any, of the charges imposed on business can be passed on (see chapter 2 and section 6.1).

As discussed in section 6.2, some participants argued that regulatory fees imposed per product (such as for pharmaceuticals and chemicals) discourage firms from expanding or diversifying their product ranges (see appendix D). For most types of regulated product, lack of registration or listing will mean the product cannot be sold in Australia.

For therapeutic products, the absence of TGA registration makes it far more difficult and expensive — but not totally impossible — for patients to gain access to the product:

> They are not missing out totally because a physician or a surgeon can go to the TGA and say, 'I have a specific clinical need. This device will fulfil that. I want to implant it,' and then they are taking that responsibility because it hasn't been evaluated by the TGA. So it puts a lot more onus on the surgeon to make that decision. (Cochlear, trans., pp. 208–209).

Any cost recovery arrangements will, at the margin, affect the range of products available to consumers, in that products with low profitability or demand are less likely to be put on the market.

FINDING

Australian consumers may be affected by cost recovery indirectly, in that they may pay higher prices or have a smaller range of choice for some regulated products.

6.4 Conclusions

In chapter 2, and elsewhere in this report, the Commission has argued that economic efficiency should be a central objective for all government regulatory and information activities, not just for those where customers have freedom to choose whether or not to consume the product or service. Even where firms are obliged by regulation to use particular government services, efficient resource allocation is essential. Cost recovery of particular regulatory activities may be warranted on the grounds that the main beneficiaries of regulation are usually the consumers of the regulated products or services. Sometimes there may also be an actual or possible risk to others arising from the regulated product or service (that is, negative spillovers). Indeed, minimising such spillovers or risks is often one of the stated objectives of regulation.

The degree to which users of government services respond to price signals may vary according to how much discretion they have about paying cost recovery charges. The customers of information agencies can choose whether to consume a service or not, and how much to consume. Customers of regulatory agencies generally have less discretion over the amount of regulation they consume and hence over the amount of cost recovery charges they must pay. Where charges are related to output, firms may respond by producing less of the regulated product. But in the case of pre market regulation, firms have less discretion — they either participate in the market and be regulated or they decline to participate. The Commission received some evidence that products have not been introduced to the market because of the

costs involved, but it is difficult to disentangle the effects of the cost recovery from the effects of the regulations themselves. Further, it is not possible to know what might have happened in the absence of cost recovery.

Cost recovery arrangements can also have equity implications. To the extent that some types of regulatory services are not cost recovered, general taxpayers may have to fund services that mainly benefit a particular group of consumers in society (and benefit others only in so far as the services allow them to avoid a potential harm or cost). When cost recovery arrangements are appropriately implemented and carefully designed, they can directly improve the equity of government financial arrangements and the efficiency with which government services are provided.

INFORMATION REQUEST

The Commission seeks further evidence of the effect of cost recovery (as distinct from the effect of Government regulation or normal market factors) on firms (including small business) and consumers, particularly in relation to:

- *the introduction of new and innovative products;*
- *adoption of new technology; and*
- *innovation and research.*

7 Cost recovery under the *Trade Practices Act 1974*

7.1 Introduction

The inquiry incorporates a review of fees charged under the *Trade Practices Act 1974* (TPA). This review stems from the Government's commitment under the Competition Principles Agreement (CPA) to review legislation that restricts competition (box 7.1). The review of fees charged under the TPA has been specifically requested under the terms of reference and is closely linked to the rest of the inquiry.[1]

This chapter assesses the objective of the fees charged under the TPA, and the extent to which the fee arrangements impose benefits or costs on consumers and firms, while paying particular regard to their effect on competition. Under the CPA, legislation should not restrict competition unless it can be demonstrated that the benefits of the restriction to the community as a whole outweigh the costs, and the objectives of the legislation can only be achieved by restricting competition. Relevant alternatives will be identified in light of this.

7.2 Fees charged under the TPA

There is a number of fees charged under the TPA which vary in their nature and effects. Fees are charged for arbitration functions, discretionary services such as publications, authorisation applications, notifications, various other applications such as those relating to conference agreements made by international shippers, along with copying registers. This section first gives a brief description of the TPA and the role of the Australian Competition and Consumer Commission (ACCC). It then examines the fees charged under the TPA.

[1] The ACCC recently engaged KPMG to undertake a pricing review of a number of its products, including services that are discretionary in nature, and propose a pricing model. This review was conducted in March 2000.

Box 7.1 **Legislation review requirements**

Under the Competition Principles Agreement (CPA) all Australian governments agreed to review and, where appropriate, reform existing legislation that restricts competition.

The Commonwealth Government released its review timetable in June 1996. The Legislation Review Schedule nominated 98 separate reviews, and foreshadowed, amongst others, the review of fees charged under the TPA.

In announcing the Review Schedule, the Commonwealth Government also outlined a number of requirements for reviews. In particular, the Government stipulated that each review is to be approached according to clause 5(1) of the CPA which states that:

> The guiding principle is that legislation (including Acts, enactments and Ordinances or regulations) should not restrict competition unless it can be demonstrated that:
>
> a) the benefits of the restriction to the community as a whole outweigh the costs; and
>
> b) the objectives of the legislation can only be achieved by restricting competition.

The CPA also outlines how reviews should be conducted (clause 5(9)). Specifically, a review should:

- clarify the objectives of the legislation;
- identify the nature of the restriction on competition;
- analyse the effect of the restriction on competition and on the economy generally;
- assess and balance the costs and benefits of the restriction; and
- consider alternative means for achieving the same result including non-legislative approaches.

The terms of reference for the review of fees charged under the TPA (terms of reference 2, 5 and 6) are drawn from these broad requirements.

Trade Practices Act 1974

The objective of the TPA as set out in the Act itself is to 'enhance the welfare of Australians through the promotion of competition and fair trading and provision for consumer protection' (*Trade Practices Act 1974*, Part I). In broad terms, the TPA covers anti-competitive and unfair market practices, consumer protection, mergers or acquisitions of companies, product safety/liability, and third party access to facilities of national significance (ACCC 2000a).

Generally speaking the TPA applies to most corporations and the commercial activities of the Commonwealth Government. It also applies to sole traders and partnerships whose activities cross State boundaries or take place within a Territory. The TPA also applies to sole traders and partnerships who conduct their business by telephone or post or use radio or television (Parts IVA and V only). State and

Territory application legislation extends the reach of Part VI of the TPA — which relates to anti-competitive practices — to virtually all firms including unincorporated firms and government trading activities. In addition, each State and Territory has legislation which substantially mirrors the fair trading provisions of the TPA (ACCC 2000c).

The TPA covers a wide range of areas and has grown significantly since 1974. For example, it includes provisions relating to consumer protection (such as in Part V) along with industry specific parts such as international liner cargo shipping (Part X) and telecommunications (Parts XIB and XIC). Part XIB relates to anti-competitive conduct in the telecommunications industry, while Part XIC relates to telecommunications network access. The telecommunications specific parts were added in 1997 and coexist with parts that relate to more general economy wide access to nationally significant facilities (Part IIIA) and anti-competitive practices (Part IV). A major amendment was also made in 1999 when Part VB — relating to price exploitation under the new tax system — was enacted (box 7.2).[2]

Australian Competition and Consumer Commission

The ACCC is an independent statutory authority which administers the TPA, the associated State and Territory application legislation along with the *Prices Surveillance Act 1983* (PSA) and has additional responsibilities under other legislation. For example, the ACCC has responsibility regarding competition matters under the *Telecommunications Act 1997;* regulates third party access to natural gas pipelines under the *Gas Pipelines Access (Commonwealth) Act 1998;* and facilitates access to airports, undertakes performance monitoring and receives information for prices oversight under the *Airports Act 1996.* The ACCC stated that it:

> … seeks to improve competition and efficiency in markets, foster adherence to fair trading practices in well informed markets, promote competitive pricing wherever possible and restrain price rises in markets where competition is less than effective. (ACCC 2000b)

[2] Part X was the subject of a Productivity Commission inquiry released in 1999 (1999b). The Productivity Commission has recently released a position paper on Part IIIA (PC 2001a), and a draft report on Parts XIB and Part XIC (PC 2001b).

Box 7.2 **The *Trade Practices Act 1974***

The TPA is made up of the following parts:

Part I	Preliminary
Part II	The Australian Competition and Consumer Commission
Part IIA	The National Competition Council
Part III	The Australian Competition Council
Part IIIA	Access to services.
Part IV	Restrictive trade practices
Part IVA	Unconscionable conduct
Part IVB	Industry codes
Part V	Consumer protection
Part VA	Liability of manufacturers and importers for defective goods
Part VB	Price exploitation in relation to the new tax system
Part VI	Enforcement and remedies
Part VII	Authorisations and notifications in relation to restrictive trade practices
Part VIII	Resale price maintenance
Part IX	Review by tribunal of determinations of the ACCC
Part X	International liner cargo shipping
Part XIA	The competition code
Part XIAA	The new tax system price exploitation code
Part XIB	The telecommunications-industry: Anti-competitive conduct and record keeping rules
Part XIC	Telecommunications access regime
Part XII	Miscellaneous

Source: Miller (2001).

In order to achieve this the ACCC:

- undertakes compliance education programs, investigations, litigation or enforceable undertakings;
- adjudicates on business practices, including merger proposals and access to essential facilities;

- enforces product safety standards and has functions under provisions of the TPA which impose a liability on manufacturers for damage caused by defective goods;
- undertakes prices surveillance of goods and services and administers the prohibition on price exploitation in relation to the new tax system;
- maintains close liaison with Federal, State and Territory Governments, and regulatory authorities on economic structural reform; and
- provides guidance to firms and consumers about the TPA and the PSA (ACCC 2000b).

TPA fees and charges

Various sections of the TPA allow for regulations to be made concerning various matters including fees. For example, section 172 (Part XII) allows for regulations to be made regarding:

- the procedures of the ACCC and the Australian Competition Tribunal;
- fees and expenses of witnesses in proceedings before the ACCC and the Australian Competition Tribunal;
- costs that could be awarded by the Courts in proceedings under the TPA; and
- fees payable to the ACCC for making applications and notices under the TPA or the regulations (TPA, Part XII).

Fees charged under the TPA are specified in the TPA itself and under the *Trade Practices Regulations 1974*. The TPA will often allow for a fee to be charged for a particular activity with the detail, for example, the level of the fee, specified in the regulations. As the fees are specified in the TPA and the TPA regulations, the ACCC does not have discretion in varying the amount, changing the structure, or waiving the fee. The ACCC can only set fees where it is charging for discretionary services (see below).

The only way that the fees can be changed, other than fees for discretionary services, is by amendment to the TPA and the TPA regulations. Amendments to the TPA must be passed by Parliament. Where the TPA allows for regulations to be made, the regulations must be notified in the *Commonwealth Government Gazette* and laid before each House of Parliament.

Some terms relevant to the fees charged under the TPA are defined in box 7.3.

Box 7.3 **Some terminology relevant to TPA fees**

Access arbitration. The ACCC has powers to arbitrate disputes between access seekers and access providers over access to declared services. For the ACCC to engage in arbitration, an access seeker and/or access provider must notify the ACCC of an access dispute.

Authorisations give immunity from court action by the ACCC, or any other party, for a breach of particular restrictive trade practices under the TPA. Authorisations are only granted if the ACCC considers that the public benefits of the conduct outweigh the detriment from reduced competition.

Conference agreement is an unincorporated association between two or more shipping companies coordinating services on a specific trade route.

Declared services are services that access providers are under an obligation to supply to access seekers.

Exclusive dealing is generally where one individual or organisation that trades with another restricts what they deal in or whom they deal with.

Notifications give immunity from court action by the ACCC, or any other party, for a potential breach of the exclusive dealing provisions of the TPA.

Third line forcing is a form of exclusive dealing where a supplier supplies, or offers to supply, a good or service on the condition that the purchaser acquires a second good or service from another supplier. Suppliers also engage in third line forcing if they refuse to supply a good or service because the supplier has not acquired, or not agreed to acquire, a second good or service from another supplier.

Third party access is access by an access seeker to a declared service provided by an access provider. This access allows the seeker to provide goods and services using the infrastructure.

Undertakings are voluntary offers regarding terms and conditions of access, made by an access provider to the ACCC. The ACCC can accept or reject an undertaking. Under Part IIIA, undertakings may precede declaration. Under Part XIC, undertakings must follow declaration.

Source: Miller (2001); *Trade Practices Act 1974.*

Developing competition policy and drafting legislation is the responsibility of Commonwealth Treasury and/or other policy departments. The ACCC primarily applies a number of Acts, such as the TPA, along with a number of codes. However the ACCC is often asked in an advisory capacity to comment on policies or legislation developed by Treasury and any other policy departments, given its experience in applying those instruments. If the ACCC considers that the operation and effectiveness of legislation such as the TPA can be improved, it will suggest to Treasury and any other policy departments that they consider amending the legislation (ACCC, Canberra, pers. comm., 7 March 2001). There is a clear

distinction between the policy development functions of Commonwealth Treasury that are largely budget funded, and the regulatory functions of the ACCC that are partly funded through either cost recovery from TPA fees or industry levies (see below).

TPA fees can be categorised under five broad headings:

- arbitration functions such as notification of access disputes and access arbitrations;
- provision of a discretionary service such as conducting workshops, seminars training and providing information;
- applications and notifications, including applications for authorisations;
- various applications under Part X — International Liner Cargo Shipping — comprising copies of registers and registration of conference agreements; and
- obtaining copies of registers (table 7.1).

There are no fees charged under the TPA for public inquiries into declaration of eligible telecommunications services under Part XIC.[3] There are also no charges in relation to the assessment of undertakings under Parts IIIA or XIC. There are no fees for some publications in hard copy form or publications placed on the Internet (even though fees are charged for the latter in hard copy form). For further consideration of functions for which no fees are charged, see below.

[3] Part IIIA does not have similar provisions for public inquiries to be held to declare eligible services. Despite this, the National Competition Council has conducted public inquiries when it has investigated declaration of a service.

Table 7.1 **TPA fees and charges, 2001**

Fee description	*TPA part*	*Fee ($)*
Arbitration functions	**Parts IIIA and XIC**	
Notification of third party access dispute		2 750
Pre-hearing fee (excluding variation of an existing third party access determination)		10 850
Pre-hearing fee relating to a variation of an existing third party access determination		2 170
Arbitration hearing fee for each day (or part of a day)		4 340
Discretionary services	**Part XII**	
Conducting workshops, seminars and training, providing speakers, information and publications, developing industry codes of conduct		Determined by ACCC
Applications or notices	**Part XII[a]**	
Application for an authorisation of anti-competitive conduct (excluding acquisition of shares or assets)		7 500
Additional application for an authorisation relating to an earlier application for an authorisation of anti-competitive conduct (excluding acquisition of shares or assets)		1 500
Application for an authorisation of the acquisition of shares or assets		15 000
Notifications of exclusive dealing (excluding third line forcing)		2 500
Notifications of third line forcing		100 or 1 000[b]
Additional notification of exclusive dealing related to an earlier notification (excluding third line forcing)		500
Additional notification of third line forcing related to an earlier notification[c]		200
Application for registration of a contract that provides for access to a declared service		5 425
Application for registration of agreements for access to a declared telecommunication service		5 425
Application for an exemption order from anti-competitive conduct in the telecommunications industry		7 500
International Liner Cargo Shipping	**Part X**	
Application for a copy of an entry in a register or a part of a conference agreement file		30 (in part), 60 (whole)
Application for registration of a conference agreement		360 (provisional) 210 (final)
Application for registration of ocean carrier's agent, change of agent, or change of agent's details		50
Copies of registers	**Various**	
Obtaining a copy of a register		1 per page, plus 10 flat fee for certified copies

a These functions are performed under various parts of the TPA (authorisation applications and notifications are performed under Part VII, application for registration of an access contract is under Part IIIA, application for an access agreement is under Part XIC and applications for exemption orders are made under Part XIC). However, the ability to charge for the functions is contained in Part XII. **b** Fees of $100 apply to notices given by individuals or proprietary companies. Fees of $1000 apply to other applicants. **c** Excludes additional notices given by individuals and proprietary companies.

Source: ACCC (sub. 66, attach. 1, pp. 1–5.)

There is a number of cost recovery arrangements that are used to fund specific ACCC functions that are not charged under the TPA but are an important component of ACCC funding. These arrangements are not subject to the legislative review of fees charged under the TPA, but would still need to be subject to the guidelines developed in chapter 9. For example, the ACCC receives a portion of the revenue collected from the telecommunications levy. This levy is collected from telecommunications carriers by the Australian Communications Authority (ACA). The funding covers the cost of performing the ACCC's telecommunications regulation functions such as regulation of anti-competitive conduct and access to networks. The ACCC stated that:

> The telecommunications levy recovers all operating costs including: salaries, administration costs, rents and depreciation. Capital is not recovered as this is not classified as cost, instead the ACCC recovers the depreciation. (sub. 66, p. 4)

The ACCC received around $4 million from the telecommunications levy in 1999-2000. This revenue is in addition to the revenue from fees charged under the TPA for the provision of telecommunications regulation services performed by the ACCC. It includes fees charged under Part XIC, such as notification of access disputes (ACCC, sub. 66, p. 3). The ACA's cost recovery arrangements are discussed in appendix E.

In addition, the 2000-01 Budget increased the rate of excise and customs duty on aviation turbine fuel to recover the ACCC's costs of administering airport access arrangements, assessing compliance with airport price caps, monitoring prices of aeronautical related services at airports and monitoring quality of service. It is forecast that the ACCC will receive around $1 million dollars a year from the rate increases (Treasury 2001a). The 2000-01 Budget has also introduced a levy on Australia Post to recover the ACCC's costs of regulating competition for postal services. The ACCC is forecast to also receive around $1 million dollars a year from this levy (Treasury 2001a). While this chapter is primarily concerned with the fees and charges collected by the ACCC under the TPA, the emergence of these other cost recovery arrangements has substantially changed the financing context within which the ACCC operates.

Costs recovered by TPA fees and charges

The ACCC collected around $1.2 million in fees and charges under the TPA in 1999-2000 (table 7.2). This was around two per cent of the ACCC's total operating revenue of $58.4 million in 1999-2000 (ACCC 2000b). Around half of this revenue was earned from charging for discretionary services such as conducting workshops, seminars, training and providing information. This revenue was recovered by the

ACCC by way of net appropriation agreements made under section 31 of the *Financial Management and Accountability Act 1997* (table 7.2). Chapter 3 discusses net appropriation agreements in more detail. The ACCC also recovers revenue from making certified copies of documents under section 31. All other revenue is paid into the Consolidated Revenue Fund (CRF).

Table 7.2 **Revenue from TPA fees and charges 1999-2000**

TPA fee or charge	*Revenue ($)*	*CRF[a]/ACCC*
Arbitration functions	165 750	CRF
Provision of discretionary services[b]	682 018	ACCC
Applications or notices	370 850	CRF
International Liner Cargo Shipping	0[c]	CRF
Copies of registers	8 259	CRF/ACCC[d]
Total	**1 226 877**	

[a] Consolidated Revenue Fund. [b] Revenue raised from these charges is recovered by the ACCC in accordance with an agreement under section 31 of the *Financial Management and Accountability Act 1997*. [c] There was no revenue received by the ACCC from fees charged under Part X in 1999-2000. [d] Revenue raised from making certified copies of documents is retained by the ACCC. Revenue raised from making copies of other documents is paid to the CRF.

Source: ACCC (sub. 66, attach. 1, pp. 1–5).

Uses of TPA fee revenue

The ACCC has described the basis on which TPA fee revenue is either recovered under section 31 and used by the ACCC for its own purposes, or forms part of the CRF:

> Usually what is in the legislation, in the regulations, goes to consolidated revenue, except for the amounts that we have some discretion about; for instance, the publication-type work and some of the training and seminars and so forth, and that also is the same funding that we recover under the section 31 account of the Financial Management Act. (trans., p. 814)

The cost recovery revenue collected by the ACCC and paid into the CRF is not hypothecated or appropriated to the ACCC or another agency. The revenue recovered by the ACCC under section 31 is not used to fund specific ACCC activities but is used as a source of general funding.

Legal constraints on TPA fees and charges

The ACCC sets its fees in a manner that minimises the possibility of them being interpreted as taxes. Chapter 3 provides a discussion of 'fees for service' and taxes. If fees charged under the TPA were to be challenged and interpreted by the Courts

as taxes, under the Constitution all other provisions within the TPA could have no effect. A separate tax Act would be needed to impose TPA fees in this case.

On the basis of this advice, the ACCC only recovers the lowest expected cost of providing arbitrations, applications (including those under Part X), various applications and notices and copies of documents. The ACCC stated that:

> The fees and charges set out in the TPA and regulations are based on the lowest expected cost of performing the service. To that extent they do not reflect actual costs. None of these fees have been increased since their insertion into the legislation. (sub. 66, p. 4)

Charges for the provision of discretionary services under section 171A such as conducting workshops and seminars are based on the costs of providing the goods and services (see below).

Gas and electricity industry levies

The ACCC has power to regulate gas and electricity transmission from sections contained in Part IIIA of the TPA. The ACCC's power under Part IIIA to regulate gas arises from section 44ZZM and power to regulate electricity arises from section 44ZZA along with the gas code and the national electricity code. However, the ACCC stated that:

> It is not clear whether these sections of the TPA would allow the ACCC to charge fees for performing functions conferred upon it. (sub. 66, p. 6)

The ACCC has considered using an industry levy to recover the costs of regulation of the gas and electricity industries (for example, an excise that could be based on transported volumes of gas and electricity through the network). However, the ACCC stated that the levy is constitutionally invalid as:

> … the ACCC is not the electricity and gas transmission regulator in all States, and therefore an industry levy, which would be a form of excise, would apply in some states and not others. Section 51(ii) of the Constitution gives the Commonwealth the power to make laws with respect to taxation, provided that they do not discriminate between States or parts of States. (sub. 66, p. 5)

Nature and effects of TPA fees

Fees charged under the TPA vary in their effects on beneficiaries and on the degree of competition. The fees can ensure that where there are private benefits that the beneficiary pays. They can have a role in ensuring that users of the service take account of the costs of providing the service in their decisions. They could also have varying effects on access to ACCC services and competition. This section will

examine TPA fees in more detail for each of the five fee categories. The fee charging arrangements are examined, along with their public and private benefits, and their effects on access to services and competition. The effects of technology are examined where appropriate.

Table 7.3 **Determination of TPA fees and perceived beneficiaries of the function**

Function	*How fees are determined*	*Beneficiaries of the function*
Arbitration functions	Lowest expected cost of the function	Parties subject to the arbitration activity but also the public generally
Discretionary services	Costs of providing goods and services	Parties requesting the goods and services
Applications or notices	Lowest expected cost of the function	Parties lodging the application or notice but also the public generally
Applications under Part X	Lowest expected cost of the function	Predominantly parties lodging the application but also the public generally
Copies of registers	Lowest expected cost of the function	Parties requesting the copies

Source: ACCC (sub. 66, p. 3).

7.3 Fees for arbitration functions

The TPA gives the ACCC power to arbitrate disputes over third party access to services that have been declared. A dispute could arise between owners or controllers of declared nationally significant infrastructure assets, for example, an electricity grid, and individuals or organisations who seek access to that infrastructure. Either party can notify the ACCC of an access dispute. Once the dispute has been notified the ACCC arbitrates between the two parties and makes a determination regarding access. The ACCC charges fees in relation to its arbitration functions for access disputes under both the general access provisions of Part IIIA and the telecommunications specific access provisions of Part XIC (table 7.1). Under these parts and the associated regulations there are fees for:

- notifying access disputes (Section 44S and reg 6C, Section 152CM and reg 28T);
- pre-hearings for access dispute arbitrations if the dispute is in respect to an existing determination from an access arbitration (Section 44ZN and reg 6F, Section 152DM and reg 28W);
- pre-hearings for any other access dispute (Section 44ZN and reg 6F, Section 152DM and reg 28W); and

- hearings for third party access arbitrations (Section 44ZN and reg 6F, Section 152DM and reg 28W).

Dispute notification and pre-hearing fees must be paid by the party making the notification. Hearing fees are apportioned at the ACCC's discretion between the parties at the hearing on that day.

The structure and level of arbitration fees is the same under both Part IIIA and Part XIC. This is because the arbitration processes under both parts are similar and the costs of performing arbitration functions are based broadly on the lowest expected cost of performing these functions, regardless of the industry, to ensure that they cannot be considered to be taxation (table 7.3). As a result, parties to the arbitration are not treated differently in terms of fees depending on what industry they are in.

Revenue raised from arbitration functions was $165 750 in 1999-2000 (table 7.2), and can be presumed to have recovered only part of the total cost of performing these functions. This revenue was received only from arbitrations performed under Part XIC as there were no arbitrations performed under Part IIIA in 1999-2000.

Fees for notifying access disputes and pre-hearing fees are intended to recover the lowest expected cost of preliminary work undertaken by the ACCC for the arbitration hearing. For example, they recover part of the costs of ACCC staff working on the dispute. Pre-hearing fees for access disputes in respect of an existing determination are lower than for other disputes because the costs of the preliminary background work are lower. The hearing fee is intended to recover at least part of the costs of conducting the arbitration hearing itself, for example travel and room hire costs.

Charging for arbitration functions by the ACCC is in line with practices in State, Territory and Commonwealth Courts where it is common to charge fees to file matters in the courts for judicial and dispute resolution functions for civil matters. Revenue from civil court fees amounted to around 27 per cent of total expenditure in 1999-2000 for all courts in the civil jurisdiction for all States and Territories and the Commonwealth (SCRCSSP 2001).

Arbitrating a dispute between an access seeker and an access provider has a potential private benefit to the party notifying the dispute. This is most likely to be an access seeker, who stands to benefit from gaining access to a significant infrastructure asset, for example, a gas pipeline or a telecommunications network, on better terms than the facility operator has offered. However, there could be private benefits to both parties if the dispute was resolved more quickly and easily via arbitration than taking action through the courts, which would need to occur if

the TPA provisions did not exist. Using the ACCC to arbitrate could also improve outcomes for both parties involved as the ACCC has experience in dealing with matters related to access to infrastructure under the TPA.

A dispute resolution mechanism which functions more efficiently and effectively than taking action in the courts could also have benefits to the community. Access to infrastructure would be facilitated thus promoting more competition in related markets. Increased competition would, for example, reduce prices faced by the end consumers of a particular product such as telecommunications services. However, there could be a downside from greater access if the access provider defers future infrastructure investment if it considers that it may not be able to receive terms from the access seeker that are favourable enough to recover the costs of this investment. The Commission's inquiries into the National Access Regime (PC 2001a) and telecommunications specific competition regulation discuss access issues in greater detail (PC 2001b).

The potential private benefits that can be derived from an arbitration, particularly to the notifier, imply that some form of cost recovery may be justifiable for these activities. Dispute notification and pre-hearing fees mean that the notifier, who can potentially benefit from the arbitration, will pay the costs of bringing the arbitration. Who actually benefits from the arbitration will depend on the outcome and who pays the hearing fee depends on how the ACCC decides to apportion the fee. In addition, fees will limit notifications that are frivolous or vexatious. Fees will also create an incentive for parties to reach settlement without resorting to arbitration.

If the private benefits are greater than the costs to the ACCC of providing arbitration functions, the Commission considers that it is appropriate that the private beneficiary pays for the service, regardless of the size of any additional public benefits (see chapter 2). For arbitration functions, it is likely that the private benefits to access seekers are large relative to both the cost of providing the arbitration functions, and the public benefits from them.

Effects on competition

If arbitration fees were set too high they could limit access to arbitration functions and hence have an anti-competitive effect. The ACCC stated that:

> There is a risk that small third parties may be discouraged from notifying a dispute because of the increase in their operating costs from paying flat fees for notification and arbitration of a dispute. The ACCC is not aware that these disincentive effects are significant. (sub. 66, p. 4)

For most firms, it could be expected that the fees charged for arbitrating a dispute would be small relative to both the total cost of gaining access, and the potential private benefits from gaining that access. In most cases it is not considered that the current levels of arbitration fees have a significant effect on demand for arbitration services or act as a barrier to access and hence reduce competition. In relation to TPA fees and charges generally, the ACCC stated that:

> Since the other fees and charges imposed by the ACCC are set at the minimum expected cost of performing the service they are not very large and in many instances do not cover the ACCC's costs of performing the function. It is therefore unlikely that these fees and charges would have an adverse impact on the parties paying the charge or on economic activity generally. (sub. 66, p. 4)

In addition, the costs to the ACCC of undertaking the arbitration may be considerably greater than the fee. This could arguably amount to a distortion on the supply side. Firms do not have an inherent demand for lengthy and complex ACCC considerations, but if the ACCC can only recoup a small fee and the shortfall cannot be made up elsewhere, it may be reluctant to devote appropriate resources to make a proper assessment.

7.4 Fees for discretionary services

Under Part XII (Section 171A) of the TPA and the TPA regulations (Regulation 28A), the ACCC is able to charge for discretionary services (table 7.1). Under the TPA, a discretionary service is one that:

- the ACCC has the power to perform, but is not required to perform under any law; and
- the ACCC is requested to perform by an individual or organisation (TPA, Part XII).

The TPA regulations specify that the ACCC may charge for:

- conducting workshops, seminars, training and supplying material published by the ACCC in the course of carrying out its functions and powers;
- providing a speaker or information for a workshop or seminar not arranged by the ACCC or for providing information to be used in publications not published by the ACCC; and
- developing industry codes of conduct that encourage compliance with the TPA (TPA, Regulation 28).

The fee must be agreed between the ACCC and the user of the service. In addition, the TPA must not already have provision for fees to be charged to perform the

service. These fees are separate to those charged to copy public registers that are set out in various parts of the TPA.

Revenue from discretionary fees accounted for $682 750 in 1999-2000. This accounted for just over half of all revenue from TPA fees (table 7.2). They differ from the other fees under the TPA as the ACCC is able to base them on the cost of performing the services on a case by case basis, rather than on the lowest expected cost of performing the service. The ACCC engages in price discrimination when charging for some discretionary services. For example, it will often provide documents to students free for which it would otherwise have charged.

The ACCC has typically imposed fees for discretionary services in a number of ways. For example, publication prices have often been set at $10 or $15 depending on the type and size of the publication, although some are also priced at $5 or $10. Typically prices for guides to legislation and ACCC procedures, along with pricing inquiry reports and pricing monitoring reports, are set at one of these price levels. The ACCC also charges $75 for an annual subscription to the *ACCC Journal*, $100 for compliance training packages, and $50 for conduct compliance training packages. For sales of ten or more copies there is a 25 per cent discount (ACCC, sub. 66, attach. 2, p. 2). Prices are often negotiated with other government agencies and external organisations. A number of publications are offered free of charge. Free publications are also offered on the Internet. The ACCC stated that:

> Free publications are available on the Internet. Free publications are those which the ACCC consider are of benefit to the public generally, for example, consumers or large groups of people such as small business. Some free publications are also offered where the ACCC has received specific funding from Government for information programs in a particular area such as 'country of origin'. (sub. 66, p. 9)

Business and consumer information sheets and leaflets along with product safety guides and GST reports and guidelines are often free and are available on the Internet. These pricing arrangements have been based on unwritten procedures.

In addition, speaker's expenses for appearances at conferences have been charged for, and were originally determined by benchmark comparisons. However, it is unclear how frequently, if at all, these benchmarks were reviewed. Training manuals for various activities have been sold for $390. This material was prepared for public release, and the development costs have been amortised over the expected number of sales.

The ACCC recently engaged KPMG to undertake a pricing review of a number of its products and services, and propose a pricing model. This review was conducted in March 2000. Services included in this review included discretionary services and copies of documents, including copies of registers that have been placed on

CD-ROM. KPMG considered that charging for discretionary services has typically been done with little guidance available to staff:

> We were unable to locate any documentation that would give support to the principles that underpinned the adoption of the discretionary charges. As a consequence, there is no guidance available to Commission staff with which to make assessments about the appropriate pricing for new or divergent products/services, for example, CD-ROM copies from public registers. (ACCC, sub. 66, attach. 2, p. 2)

In the report KPMG proposed a pricing model to examine the pricing arrangements of some existing discretionary services and whether they could be enhanced. For example, the model can be used in making an assessment on the extent that development costs should be recovered; determining direct costs for materials on a per unit basis; assessing the time required by staff on a per unit basis; and estimating the transaction volume. KPMG found that the ACCC is 'recovering all of the costs associated with the preparation for, and distribution of, products for sale' (ACCC, sub. 66, attach. 2, p. 1).

Effects on competition

Being discretionary, it can be presumed that publications, seminars and training have private benefits to users who purchase them. However, some publications, for example, those that explain rights and responsibilities under the TPA, are educative in nature, and may have an additional public benefit. The ACCC does not charge for publications where it considers that there are public benefits from supplying the publication. Better public knowledge of roles and responsibilities under the TPA (for example, of anti-competitive practice provisions) could facilitate competition.

Charging fees to recover the marginal or incremental cost of running workshops might be considered to be a sensible application of a 'beneficiary pays' approach. Imposing fees will ensure that consumers take account of the cost of producing the publications or running the workshops in their consumption decisions. However, a case could be made that these activities are core information provision functions of the ACCC, and charging may discourage people from fully and properly complying with the TPA. Therefore, care should be taken to ensure that fees are not set at a level that unduly restricts access to information. By reducing the public's knowledge of the TPA, this could not only reduce competition, but also harm consumers if, for example, they do not have information on product safety standards.

It would not appear that current charging practices are unduly limiting access to information. The prices for most publications are set at a low level, and are provided free where the ACCC considers that there is a public benefit involved. The

ACCC also provides a number of publications free over the Internet and engages in some price discrimination. Where higher fees are charged for a service, the ACCC would typically have undertaken work in tailoring the service to the needs of a particular client, for example, running a seminar or workshop for a particular industry group.

Effects of technology

As mentioned earlier, the ACCC places a number of its publications on the Internet which are free of charge. For example the ACCC has either placed or will examine the feasibility of placing on the Internet all free publications, media releases, significant speeches, information for firms and consumers, conference papers and GST guides (ACCC 2000d). Publications can currently be ordered over the Internet. The ACCC is examining the possibility of also allowing purchasers to pay for publications online.

Providing documents on the Internet reduces the ACCC's printing and distribution costs. The marginal cost of making this information available is close to zero once it is on the Internet, although there are fixed costs involved with placing information on the web. These costs include hardware and software costs along with maintaining the website and its security. The ACCC could begin to charge for documents on the Internet cost effectively once it has set up the appropriate systems. However, there are problems associated with setting discriminatory prices when charging over the Internet:

> To recover technology costs equivalent to the type currently being recovered for paper-based transactions could probably be achieved in a cost effective way once systems are set up. However, the current paper-based system allows for discretion in charging where the person would be disadvantaged by the charge (for example, students). An electronic system, such as the Internet, makes it difficult for such discretion to be made. (ACCC, sub. 66, p. 8)

Placing publications on the Internet will improve access to information for some, but for those without Internet access it may be desirable to ensure documents can still be acquired in hard copy form. Placing publications on the Internet could also reduce the transaction costs incurred by users.

7.5 Fees for applications or notices

Part XII (Section 172) of the TPA gives the Governor-General the power to make regulations prescribing fees payable to the ACCC for making particular applications or giving notifications. The TPA regulations currently provide for fees to be

charged for authorisation applications and notifications. They also provide for fees to be charged for applications for registration of contracts that provide for access to a declared service, application for registration of agreements for access to a declared telecommunication service and application for an exemption order from anti-competitive conduct in the telecommunications industry. The ACCC reported revenues of $370 850 from applications or notices in 1999-2000 (table 7.2).

Authorisations and notifications

The TPA is a regulatory instrument for promoting competition as a means to an end, to improve the welfare of Australians. It does however, recognise that in some instances 'public benefit' may result from practices that actually lessen competition (Miller 2001). Under Part VII of the TPA, exemptions from some of the restrictive trade practices provisions can be granted through authorisations, and notifications of exclusive dealing[4] (box 7.4).

TPA Regulation 28, along with schedules 1A and 1B, specify the fees payable for authorisation applications and notifications. Fees vary depending on whether they are for an authorisation application or notification, and on the types of authorisation or notification (table 7.1).

The ACCC will not begin to process an authorisation application or notification until the fee has been paid in full. Additional related authorisation applications regarding anti-competitive conduct, excluding mergers and acquisitions, and notifications of exclusive dealing attract a concessional fee (table 7.1). The application must be lodged within 14 days of the original application, and the conduct must occur in the same or a closely related market to that involved in the original application or notification.

Effects on competition

By their very nature, authorisations and notifications lessen competition, but they are only granted if it is likely that there will be net public benefits from doing so. Of all fees and charges under the TPA, authorisation application fees and particularly merger authorisation application fees could conceivably have the biggest effect on competition and efficiency. Section 50 of the TPA prohibits:

[4] Restrictive trade practices for which authorisations can be granted include: anti-competitive agreements, including price fixing; covenants affecting competition; primary and secondary boycotts; anti-competitive exclusive dealing; exclusive dealing involving third line forcing; resale price maintenance; and acquisition of shares or assets which are likely to lead to a substantial lessening of competition. Authorisations cannot be granted for the misuse of market power.

> … acquisitions which would have the effect, or be likely to have the effect, of substantially lessening competition in a substantial market in Australia, in a State or in a Territory. (TPA)

Box 7.4 **Authorisations and notifications**

Authorisations

An authorisation gives immunity from court action by the ACCC, or any other party, for a breach of particular restrictive trade practices under the TPA. Authorisations are only granted if the ACCC considers that the public benefits of the conduct outweigh the detriment from reduced competition. For example, an authorisation could be granted for acquisitions or mergers that would result in a substantial lessening of competition, or for firms acting as a cartel, if the ACCC considered that there was a net public benefit from doing so. For example, public benefits can arise from:

- lower prices for consumers from efficiency gains through economies of scale and scope; or
- improved service to customers; or
- improved international competitiveness and growth in export markets; or
- expansion of employment or prevention of unemployment in efficient industries.

After consideration of the application, the ACCC prepares a draft determination (except for mergers). The ACCC must give the opportunity for any interested party who is dissatisfied with the draft to request a conference before making its final determination. Authorisations can be of limited duration and made subject to conditions. Only parties to the conduct can make authorisation applications.

Notifications

A notification gives immunity from court action by the ACCC or any other party for a potential breach of the exclusive dealing provisions of the TPA. Notifications for exclusive dealing differ from authorisations as the immunity operates from the date of lodgement, or 14 days after lodgement for third line forcing, and remain unless revoked by the ACCC. Parties do not have to wait for a decision by the ACCC. Only parties to the conduct can make notifications.

Source: Miller (2001).

There are both private and public benefits from allowing authorisations and notifications. The ACCC stated that:

> Although there is an element of public benefit in the ACCC assessing authorisation applications to ensure the public detriment does not outweigh the public benefit, there is also a significant private benefit in that authorisation protects the applicant from prosecution for authorised conduct. (sub. 66, p. 3)

For example, there will be a private benefit to firms from allowing a merger authorisation, as their profits could increase from the ability to exploit economies of scale and scope. However, by definition there must be a net public benefit for an authorisation to be approved. That is, the public benefits must outweigh the costs of decreased competition in the market. These public benefits could arise from factors such as lower prices for consumers, or improved service to customers (Miller 2001). Applications for non-merger authorisations can also be made, and if successful, will give a firm immunity for other activities that would otherwise have contravened other sections of the TPA. For example, a non-merger authorisation could apply to practices such as price fixing that would otherwise breach the anti-competitive conduct provisions of the TPA.

For a merger to contravene Section 50 of the TPA it would be expected that a high level of concentration in the market and barriers to entry would result. That is, the firms involved would be large relative to the size of the market. Where markets are substantial, it could be expected that they would have significant financial resources, and the benefits they receive from merging would also be large.

In a similar manner, benefits for large firms from non-merger authorisations would also be large. For example, there could be large potential benefits for the firms involved in price fixing, which otherwise would have contravened the TPA.

There is the possibility that if TPA fees are set high enough they could discourage firms from seeking authorisations or notifications. It costs a firm $15 000 for a merger authorisation application, $7500 for a non-merger authorisation application and $2500 for a notification (excluding third line forcing), regardless of their size. However, given the financial resources of what are almost invariably relatively large firms, and the benefits that could potentially arise from an authorisation or notification, it could be expected that the fees would not be high enough to act as a deterrent to the firm's decision to seek an authorisation or notification. In addition, the ACCC stated that:

> There is no quantitative evidence that the introduction of charges since 1993 has had an impact on the demand for services and products of the ACCC. There are anecdotal observations that the quality of authorisations and notifications improved after the introduction of a fee. (sub. 66, p. 4)

While the Commission does not have direct evidence, it can be presumed that the transactions costs for the firms involved are likely to be far in excess of the fee. For example, proceeding with a merger would involve substantial legal and administration costs for the firms involved in convincing not only the ACCC of the public benefits of their proposal, but also the shareholders of the two companies involved of the private benefits of proceeding. In the case of mergers, the merger application fee could be expected to be only a small portion of the total costs of the

merger that would include costs such as legal and accounting fees and consultancy costs. At the current level, it does not appear that both merger and non-merger authorisation application fees are large enough to deter the sorts of firms that typically apply for authorisations. This means that while competition can be substantially lessened through authorisations and notifications, it is unlikely that the fees will stop net public benefits to the economy as a whole being incurred.

The risk that TPA fees and charges could adversely affect small and medium firms appears to be slight. Firms that are small relative to the size of the market typically do not have the market power to 'substantially lessen competition' under the TPA by merging, and as such would not need to go through the merger authorisation process. However, they can be subject to authorisations relating to restrictive trade practices under the TPA such as price fixing. In relation to charging flat fees for authorisation applications, regardless of the size of the firm, the ACCC stated that:

> Whether that has competitive effects in terms of, in the proportionate sense, making it easier for a larger firm, say, to approach us for authorisation than it is for a smaller firm, I think that's a potential issue. (trans., p. 821)

For a small firm it is possible that the fee for a non-merger authorisation application could be a deterrent. However, if the fee is spread across a number of small parties to the authorisation, such as through a professional body or a collective, this effect would not be significant. For example, the ACCC has recently made a draft determination on an application made by Premium Milk Supply Pty Ltd in respect of the collective negotiation of farm-gate milk prices and milk quality with Pauls Limited. There are 580 Queensland milk producers currently selling through six cooperatives that will be offered membership of Premium. If all 580 milk producers take up membership of Premium, the authorisation application fee will be $12.93 each. The ACCC has made a draft determination proposing to grant conditional authorisation for up to four years (ACCC 2001). In addition, the ACCC is currently considering an authorisation application to allow the Australian Pensioner's League to make an agreement with the Western Australian Funeral Directors' Association (WAFDA), and a number of non-WAFDA funeral directors to provide concessional rates for funeral services (ACCC 2001).

While fees for authorisation applications and notifications may not be considered to be a major deterrent to making the application, there could be a greater degree of transparency of the costs that the fees are intended to recover. The Australian Chamber of Commerce and Industry stated:

> For authorisation under the TPA, a fee of $15 000 applies whether the time taken by the ACCC is one or twelve months. To industry's knowledge there is no basis for the figure of $15 000. There should be a more transparent and justifiable basis for the setting of any fee or charge. (sub. 70, p. 15)

Information on fees charged under the TPA is readily available from the ACCC. However, information of what costs the fees are intended to recover is not so readily available.

FINDING

The ACCC could improve public information on the costs that TPA fees are intended to recover.

As is the case for arbitration functions, the costs to the ACCC considering the application may be considerably greater than the fee. Again, this could amount to a distortion on the supply side as the ACCC can only recoup a small fee and is unable to easily make up any funding shortfall therefore, it may be reluctant to devote appropriate resources to make a proper assessment.

There could also be incentives for firms to 'free ride' using the ACCC as a source of low cost legal advice. For example, a firm could put in an authorisation application to see if a proposed merger would be successful. This incentive could arise because the cost of an authorisation application would often be below that of the market price of the legal advice. In this case, there are some grounds for charging a modest fee to discourage firms 'free riding' on the ACCC and to encourage them to put in good quality applications. The ACCC stated that:

> … our basic approach is that we get something which — either through inadvertence or perhaps through someone trying to free ride on our resources — if we get something that's just not complete and not adequate, our normal approach is to basically give it back to the parties and say, 'look, you really should do some more work on this'. (trans., p. 822)

Effects of technology

Technology could have some impact on authorisation applications and notifications. Currently, the authorisation application and notification forms are available over the Internet. The ACCC would like to expand the use of the Internet by allowing applications and notifications to be made over the Internet, along with payment of the fees (sub. 66, p. 9). The ACCC outlined the benefits of using the Internet for applications and notifications:

> The benefits to the public from electronic lodgement and payment would arise from time saving and reduced costs of consumables (for example, paper and postage). The public would have extra time for preparing the application and responding to submissions of other parties by reducing the time needed for postage. (sub. 66, p. 8)

The ACCC also outlined some of the difficulties involved with electronic applications:

> The greatest concerns of the public would be in the areas of privacy and security of the document and payment. To ensure that the application in its entirety could not be changed in any way and that unauthorised parties are prevented from accessing the material would be of particular concern to the individual and to the ACCC. (sub. 66, p. 9)

Fees for other applications

The TPA allows for contracts and agreements to be made that provide for access to a declared service, including a declared telecommunications service. It can also provide for exemptions from anti-competitive conduct in the telecommunications industry (box 7.5). The fees charged under the TPA and the TPA regulations for these activities are shown in table 7.1.

- Part XII (section 172) and regulation 6G allow for a fee to be payable for applications made to register a contract that provides for access to a declared service made under Part IIIA (section 44ZW).
- Part XII (section 172) and regulation 28X allow for a fee to be payable for applications made to register an agreement for access to a declared telecommunications service made under Part XIC (section 152ED).
- Part XII (section 172) and regulation 28(2B) allow for a fee to be payable for an order exempting specified activities from the scope of telecommunications industry anti-competitive conduct provisions made under Part XIB (section 151AT).

All fees are payable at the time of the application. The fees for access contracts under Part IIIA and access agreements under Part XIC are the same ($5425). An exemption order is similar in nature to an authorisation. The fees for an exemption order application are the same as for a non-merger authorisation application ($7500).

Effects on competition

There are private benefits, for the access seekers, of registering access agreements and access contracts for access to declared services. However, there could be a benefit to both parties as they would have the opportunity to agree on the terms and conditions of access that are laid down in the contract or agreement. The contract or agreement would be enforced as a determination, provided that it was in the public interest. This could reduce recourse to legal action under contract law that would take place if the TPA provisions did not exist.

Box 7.5 **Access contracts, agreements and exemption orders**

Part IIIA access contracts

Part IIIA (section 44ZW) provides for applications to be made to register a contract that provides for access to a declared service. The parties to the agreement are an access seeker and the access provider. Each party to the contract must apply to have it registered. In deciding whether to register the contract, the ACCC must consider the public interest, including the public interest in having competition in markets, and the interests of all individuals and organisations who have rights to use the infrastructure. A registered contract can be enforced as if it was a determination made by the ACCC, in substitution for the remedies available under contract law.

Part XIC access agreements

In a similar manner, Part XIC (section 152ED) provides for application to be made to register agreements for access to a declared telecommunications service. The ACCC takes into account the same factors when deciding to register the agreement as it does when registering a contract under the general access provisions. A registered agreement can be enforced as if it was a determination made by the ACCC, as is the case for an access contract under the general access provisions.

Part XIB exemption orders

Under Part XIB (section 151AT), an individual or organisation may apply for an order exempting specified activities from the scope of telecommunications industry anti-competitive conduct provisions. The order may be made if the ACCC considers that the conduct is not anti-competitive, or the conduct is likely to result in benefits to the public that outweigh the detriment from reduced competition. Exemption orders can be of limited duration and made subject to conditions.

Source: Miller (2001).

There could also be benefits to consumers as access agreements and contracts facilitate access to infrastructure. Greater access to infrastructure could improve competition and quality of service. There could also be public benefits arising from improved public accountability and transparency of access arrangements, as agreements and contracts are placed on a register.

It is important that the competitive effects of the access contracts and agreements are not limited by the size of the fees deterring firms from making an application. As is the case with fees for arbitration functions, authorisation applications and notifications, it would not be expected that the size of the fee would be large enough to deter firms from making an application. The size of the potential private benefits, particularly for the access seeker, could be expected to be large relative to the size of the fee. However, the fee could play an important role in limiting applications

and notifications that are clearly not in the public interest and would have little chance of being successful.

Exemption orders made under Part XIB are similar to authorisations and the fee charged for an exemption order application is the same as for a non-merger authorisation application. As such, the effects on competition of fees for exemption order applications would be similar to the effects of fees for authorisation applications and notifications.

7.6 Fees for applications under Part X - International liner cargo shipping

Under Part X of the TPA, international shippers are able to make and apply for provisional and final registration of conference agreements (box 7.6). Under Part X, a shipper may also apply for the registration of an agent, change of agent, or change of agent's details.

Box 7.6 **Conference agreements**

Under Part X of the TPA international shippers are able to make conference agreements which are an unincorporated association between two or more shipping companies coordinating services on a specific trade route. Conference agreements allow shippers to achieve economies of scale and scope, reducing cost to importers and exporters, and improving frequency and reliability of service. Part X exempts conferences from anti-competitive provisions (Part IV) of the TPA on the basis that they improve services to Australian exporters and provided they do not misuse any market power.

Source: PC (1999b).

Part X specifies that a number of registers along with conference agreement files be kept by a registrar or the ACCC. Registers kept include a register of conference agreements, a register of non-conference ocean carriers with substantial market power and a register of ocean carrier agents. Conference agreement files contain a number of documents related to the agreement.

Part X specifies that regulations can prescribe fees for applications for provisional and final registration of conference agreements, along with applications for copies, in whole or part, of registers and conference agreement files (tables 7.1 and 7.4). Part X also specifies the maximum amounts that can be charged (table 7.4). Regulation 31 and schedule 2 specify the current levels of fees charged (tables 7.1

and 7.4). These fees are based on the lowest expected cost of the function (table 7.3). In no case are the fees set at the maximum allowable under the TPA.

Table 7.4 **International liner cargo shipping fees, 2001 ($)**

	Current level	*Maximum allowable under the TPA*
Application for provisional registration of a conference agreement	360	1200
Application for final registration of a conference agreement	210	700
Application for registration of ocean carrier's agent, a change of agent, or a change of agent's details	50	160
Application for a copy of a part of an entry in a register or a part of a conference agreement file	30	200
Application for a copy of the whole of an entry in a register or the whole of a conference agreement file	60	200

Source: TPA.

Effects on competition

The Productivity Commission has previously outlined some of the benefits of conference agreements:

> Conferences can provide a mechanism for efficient delivery of scheduled, direct shipping services on a particular trade route. Lower costs of provision of such services require the various economies of scale and scope, which characterise liner shipping, to be captured. (1999b, p. 34)

The private benefits arising from conference agreements may be substantial. There is a potential for reduced costs of operating regular shipping services through pooling risks and improving the utilisation of shipping capacity. Benefits from having a conference agreement could include benefits to exporters, through improved frequency and reliability of service, and lower costs being passed on to them.

The fees for applying to register conference agreements are extremely low when compared to the size of the benefits that would be derived by international shippers from entering into such agreements. They are also extremely small when compared to the size of the international shipping lines that would typically enter into a conference agreement. For these reasons, it would not be expected that fees for applying to register conference agreements would restrict international shippers in applying for registration, and hence, would not have a large effect on competition.

The effects of fees for copies of registers, including those held under Part X, are discussed in the next section.

7.7 Fees for copies of registers

Various sections of the TPA require the ACCC to create or hold public registers. Individuals or organisations may be entitled to obtain copies of those registers. For example, copies can be made of the register of Part IIIA access undertakings and codes, the register of Part IIIA access agreements, or the register of declared services under Part XIC. The fees for copying these documents are set out in TPA regulation 28 and are set at $1 per page with an additional flat $10 charge for making a certified copy. These charges do not apply to making copies of registers and conference agreements under Part X.

Registers can be viewed in hard copy at ACCC offices for free. However, the ACCC's public registers are held only in the Canberra office, with the exception of the section 23 public register held under the PSA in the Melbourne office. Duplicates of the registers may be held in other ACCC offices.

Effects on competition

There are private and public benefits of allowing copies of registers to be made, mainly through greater accountability and transparency of TPA processes including ACCC decision making. For example, there are private benefits for an access seeker, or a competitor, from being able to copy the register of Part IIIA registered access agreements. In addition, private benefits could be derived by competitors, or potential competitors, from being able to access information about conference agreements.

There could be public benefits through greater scrutiny of TPA processes. For example, consumers or firms could gain benefits from being able to copy the register of authorisations and notifications which could contain information on authorisations and notifications that could potentially affect them. The information could also be beneficial to policy makers. While it would be undesirable for the fees to limit access to the information contained in the registers, they have a role in recovering costs. They are also important in ensuring that consumers take account of some of the costs of retrieving and making copies of registers in their consumption decisions.

Effects of technology

Technology could have an effect on the way that the registers are provided, and hence the costs and fees of doing so. The ACCC has placed ten statutory and voluntary registers on the Internet. These can be accessed free of charge. These

registers contain current information and also contain information relating to the past few years or so. As is the case for placing other material on the Internet, there are a number of costs and benefits involved with using the Internet to make registers available. For example, the ACCC would no longer need to incur the costs of retrieving, copying and posting copies of the register, but there would be some hardware and software costs, along with costs associated with maintaining the website.

Registers containing information relating to years prior to the last few years can now be made available by the ACCC on CD-ROM or by e-mail. There are consumable and processing costs involved with transferring these registers on to CD-ROM. There are also costs involved with the production of the CD-ROM and postage. The ACCC has treated the fee for these CD-ROMs as a discretionary charge, and uses the KPMG model to calculate it.

7.8 Alternatives to current fees and charges

There are a number of alternatives to the current TPA fee charging arrangements. Fees could be removed, they could be imposed on functions not currently subject to fees or they could be linked more closely to the cost of performing the function. These alternatives differ in their effects on demand management, incentives faced by the ACCC and users of TPA services, and the extent to which they could be considered to amount to taxation.

Remove all fees

One option would be to abolish all TPA fees. As revenue from TPA fees amounted to around only two per cent of ACCC revenue in 1999-2000, it could be conceivably replaced by budget funding with a relatively small effect on the Commonwealth budget. The ACCC would also no longer incur the transaction costs of administering and collecting the fees.

However, the Commission considers that the fees play a role in demand management. Where the fees are based on the lowest expected cost of the function – that is for access arbitrations, various applications and copying registers – they ensure that the consumers of the services take into account some of the cost of their provision. They would also ensure that incentives to free ride on the ACCC, using it as a source of low cost legal advice, are reduced. Fees for discretionary services, such as publications and workshops that are usually based on the cost of performing the service, would also manage demand by ensuring that consumers are taking the cost of their provision into account.

Impose fees on functions not currently subject to fees

There is a number of functions performed under the TPA for which no charge is currently made. It would not be appropriate to impose fees for a number of these. Many of the functions performed under the TPA are compliance and protection activities. For example, it would be inappropriate for a firm that is alleged to have been engaging in restrictive trade practices under Part IV to pay the ACCC to take legal action against it before its guilt or innocence has been found. It would also be inappropriate to charge for a number of consumer protection activities under Part V.

There is a number of functions where, at first glance, fees could conceivably be charged. For example, there are currently no fees charged under the TPA for public inquiries into the declaration of eligible telecommunications services under Part XIC. These inquiries can be held by the ACCC either on its own initiative, or following a request. The service may be declared if the ACCC is satisfied that the declaration will promote the long term interests of end users. There could be a private benefit for the access seeker from gaining access. There could also be large public benefits flowing from increased competition.

There are also no charges in relation to the assessment of undertakings under Parts IIIA or XIC. An access undertaking is a written undertaking given by an access provider that sets out terms and conditions upon which the provider will agree to offer access to all access seekers. The ACCC can decide whether to approve an undertaking or not. These functions confer a private benefit of access to infrastructure for access seekers, along with certainty for both the access seeker and the access provider. They also have benefits through increased competition in related markets by virtue of access to the service of this essential infrastructure.

However, under Part IIIA for example, access undertakings are not the only method that can be used to gain or increase access to infrastructure. For example, the service can be recommended to be declared by the National Competition Council, subject to a number of criteria which would make the service generally available to access seekers. There are no fees for declarations. The effects of charging fees for undertakings cannot be considered in isolation from other approaches to access. The ACCC stated that:

> What particularly worries us in relation to charging for these various activities would be to have a charge for one particular way of achieving access, but not having a charge on something else, or setting the charges independently because, in some cases depending on whose perspective you're looking at from out in the private sector – in some cases these different things can be very much alternatives. (trans., p. 823)

And:

> … it's really that there are several different but interrelated activities under the Part IIIA access regime. If we were to have charges on those you'd really need to do it across the board. (trans., p. 823)

Linking fees more closely to the cost of the function

Some fees could be linked more closely to the cost of performing the function and determined on a case by case basis. Some TPA fees are based on the cost of the service, for example, fees for discretionary services, fees for copies of registers and fees for each day of an arbitration hearing. However, arbitration pre-hearing fees, along with fees for authorisation applications and notifications, could only be considered as being loosely related to costs. The fees only change (that is they are lower), if they relate to existing access arbitration determinations, existing authorisation applications or notifications as the costs in these cases would presumably be lower.

The costs of some functions will not vary from case to case while costs for others will. The ACCC stated that:

> Most of the administrative costs involved in processing applications or conducting arbitrations and conferences are the same regardless of the content of the application. Some of the processes are set down in the TPA, particularly the public register process and some decision making processes. However, the assessment of applications may result in different degrees of research, consultation and analysis. The complexity of the market, the number of market players and in the case of adjudication matters the issues associated with balancing the public benefit/anti-competitive effect will impact on the costs of the case. (sub. 66, p. 6)

The fees for services have typically been based on the lowest expected cost of the function to ensure they are not considered to be taxation. For example, the ACCC has estimated that the median cost for the majority of non-merger authorisations is around $60 000 to $75 000 and the cost of an authorisation ranges from $10 000 to in excess of $100 000. It also estimated that less than 10 per cent of non-merger authorisations would cost in the vicinity of $10 000 and there would be two or three authorisations costing between $80 000 to $100 000 a year (ACCC, Canberra, pers. comm., 7 March 2001). This compares with the non-merger authorisation fee of $7500.

The costs for merger authorisations are less as they have a shorter prescribed timeframe of 30–45 days, and no requirement for a pre-decision conference or a draft determination. The ACCC has estimated the median cost to be around $55 000 (ACCC, Canberra, pers. comm., 7 March 2001). This compares with the merger authorisation fee of $15 000.

Linking fees more closely to the cost of performing the function, and determining them on a case by case basis, would increase revenue collected under the TPA if demand for such services is inelastic. A proportional approach would ensure that each user of the function or service took the full cost of the service into account when making their consumption decisions. It would also ensure that the cost of more complex and costly applications is recovered from the applicants. If fees are based on the cost of performing the particular function, there should be no difficulties associated with the fees being interpreted as taxation.

However, there is a number of difficulties associated with such charging arrangements. The ACCC stated that:

> Up-front assessment of the amount of effort and associated costs to adjudicate an application could be difficult as often it is not until some analysis is performed that the real extent of the matter becomes apparent. (sub. 66, p. 7)

This would imply that the cost of the application be calculated at the end of the case. However, the ACCC identified some difficulties with this approach:

> … there is an issue of timing of a fee after the event: should it be before or after the ACCC decision? As well, systems would have to be introduced to collect the fee if the applicant failed to pay it after a decision was made. (sub. 66, p. 7)

The ACCC also states that: '… other jurisdictions have found the preference is for a fixed fee rather than an hourly rate (for example, the Competition Bureau, Canada)' (ACCC, sub. 66, p. 7).

In addition, allowing the ACCC to charge authorisation application and notification fees based on actual costs, for example, on an hourly rate, could be thought to create incentives for it to drag out such considerations or devote more resources to the task than is efficient. But by not allowing the ACCC access to a section 31 agreement, these incentives would be minimised. (See appendix H for a discussion of costing issues).

There are also difficulties associated with the ACCC charging on a case by case basis, and using its discretion in setting charges for services where it has typically been bound by the TPA. The ACCC stated that:

> There has been thought given from time to time to whether we should have some sort of discretionary arrangement of perhaps setting a maximum charge and then … giving the ACCC the discretion to be able to, in various cases, decide on a lesser charge. That's something the ACCC hasn't been all that keen on, … [because of] … administrative appeal procedures and so forth, and [because] … we're often dealing with people who are fairly litigiously minded … We didn't particularly want to find ourselves in the situation where we were putting a fair deal of time and resources into defending the discount with regard to this person, this company and why it wasn't

larger or why this company didn't get the same discount as this company did. (trans., p. 821)

7.9 Summary

Fees charged under the TPA are set at either the lowest expected cost of performing the function or at the discretion of the ACCC. Fees that are set at the lowest expected cost of the function are for access arbitrations, various applications and copying registers. This policy is designed to minimise the possibility of these charges being interpreted as taxes. Fees that the ACCC has discretion in setting are for activities such as conducting workshops and seminars, along with providing publications. The discretionary fees are usually set at the cost of performing the service. Where TPA fees are charged, there is usually a significant portion of private benefits involved in the activity.

FINDING

Where the TPA prescribes the level of fees, they have been set at a level that recovers the lowest expected cost of performing associated activities. This helps ensure that the fees are not susceptible to challenge as amounting to taxation. Where the TPA gives the ACCC discretion in setting the level of fees, they are usually set at the cost of performing the service.

Overall, the TPA fees would appear to have little effect on competition. Fees that are set at the lowest expected cost of the function do not appear to limit access to services performed under the TPA. The fees are low when compared to the potential benefits that a firm can receive if, for example, an authorisation application or notification is successful. Discretionary fees charged by the ACCC also appear to have little if any effect on firm costs or competition.

FINDING

Fees charged under the TPA appear to have little effect in restricting access to the activities for which they are charged. Hence, their effect on competition appears to be minimal.

FINDING

The fees charged under the TPA do not appear to impose a significant burden on business as they are typically set at low levels, particularly when compared to the transaction costs associated with undertaking, for example, an authorisation application.

However, fees have a role in recovering costs and in demand management. Where fees are prescribed by the TPA, and are set at the lowest expected cost of the function, they ensure that consumers take account of some of the costs of providing the service in their consumption decisions. Hence, they would deter frivolous or poorly prepared applications. The fees have a role to play in limiting authorisation applications and notifications that attempt to 'free ride' on ACCC legal advice. Where the TPA gives the ACCC discretion in setting fees, it usually bases the fee on the cost of providing the service.

FINDING

Fees charged under the TPA may play a useful role by discouraging unwarranted applications.

There appears to be little concern with the current TPA fee charging arrangements. It could be presumed that this is not a major issue among participants to this inquiry and that compliance with the TPA is where the more significant costs are involved. Only one participant, other than the ACCC, has raised an issue related to fees charged under the TPA. The lack of comment has made it difficult for the Commission to consider some of the factors that the terms of reference has requested it to consider when making its assessment of TPA fees. For example, the terms of reference have asked the Commission to take the compliance costs and paper burden on small firms into account, but no evidence has been received on this issue.

The Commission has considered whether, under certain circumstances, there could be incentives for the ACCC to devote more resources than is necessary to perform a particular function. This could occur for discretionary services where it is able to access cost recovery revenue under a section 31 agreement and has some discretion in setting the level of the fee. For example, the ACCC could have an incentive to promote the consumption of seminars and publications to earn revenue, and there could be an incentive to price these inefficiently, if it is able to recover indirect and joint costs. (See appendix H for a discussion of costing issues.) However, these incentive effects appear to be negligible as some discretionary services can face market disciplines.

Incentive effects would also be negligible where the ACCC has little discretion in setting the fees, and where the revenue is not accessed by the ACCC under a section 31 agreement. The ACCC would have little incentive to devote more resources than is necessary to a particular service. It would also have little incentive to expand this segment of its activities.

There is a number of difficulties involved with alternative charging arrangements. Charges should not be removed as they play a role in demand management. Linking fees more closely to the cost of performing the function could be administratively difficult. There could be problems in calculating the charge before the application is performed and difficulties for the ACCC when using discretion to charge on a case by case basis.

FINDING

Overall, fees charged under the TPA appear to be broadly appropriate.

8 Improving administrative arrangements

8.1 Introduction

Cost recovery should be subject to the same good public administration principles as all Government activity, but, as noted in chapter 4, it currently operates in something of a policy vacuum. The absence of clear government policy has led to a plethora of arrangements based on old policy documents, agency-specific Chief Executive Instructions and consultants' advice. The administration of cost recovery has suffered from a number of problems as a result.

Some principles for assessing 'best practice' cost recovery arrangements are set out in box 8.1 and discussed in the following sections.

Box 8.1 **Principles of good public policy for government charges**

- Clear objectives
- Clear legal authority
- Cost reflective charging
- Avoiding cross subsidies
- Access and equity
- Accountability and transparency
- Consultation
- Performance monitoring and review
- Stability and predictability
- Efficient and effective arrangements

8.2 Clear objectives

Government policies should be based on a clear statement of their objectives. This enables the performance of an agency to be assessed against its stated objectives. As discussed in chapter 4, the rationales for cost recovery arrangements are not always clear — some charges appear arbitrary or to be accidents of history. In other cases, there appears to be a presumption of government policy in favour of cost recovery. As a rule, information agencies appear to have a clearer idea about the rationale for cost recovery than many of the regulatory agencies, although some information agencies have still experienced problems in its application.

The lack of a coherent government policy has led to inconsistency in many aspects of cost recovery within and across agencies and portfolios — from whether particular agencies or activities are subject to cost recovery at all, to the costing methodologies adopted. Some agencies impose cost recovery while comparable agencies do not. There is also evidence of an increasing, but inconsistent, use of cost recovery targets on a 'whole of agency' basis.

8.3 Legal authority

A fundamental principle of good administrative practice is sound legal authority. However, as discussed in chapter 3, there does not always appear to be good legal authority in place for some cost recovery arrangements. Agencies raise revenue through both fees for service and taxes, with differing levels of legal authority. There is also some uncertainty about the application of the law in relation to the authority necessary to charge fees for service.

Information agencies generally use fees for service to cost recover. These fees include prices for goods and services, subscriptions, licence fees and royalties. Many regulatory agencies use a combination of fees for service and taxes (often described as 'levies').[1]

Imposing fees for service

Most regulatory agencies derive legal authority to charge fees from an Act of Parliament. The levels and types of fees are then set out in regulations, or some may be set administratively.

[1] Many cost recovery arrangements are labelled as 'levies'. A levy has the same legal characteristics as a tax, but is sometimes used to refer to a tax that is imposed on a specific industry or class of persons, rather than a tax of general application (see appendix I).

However, other agencies have less explicit legal authority to charge fees for service. The Australian Surveying and Land Information Group (AUSLIG) stated that the legal basis of its fees for service comes from the *Commonwealth Public Interest Spatial Data Transfer Policy* (a Ministerial policy statement) (sub. 44, p.2). The Australian Geological Survey Organisation (AGSO), which is subject to the same policy, stated that its fees have no specific legal authority (sub. 55, p. 7). The National Library of Australia stated that it is neither prevented nor empowered by legislation to charge fees for service.

As discussed in chapter 3, there is some ambiguity about the need for explicit legal authority to charge fees in some circumstances. The Commission considers that clear legal authority is essential for all cost recovery activities, whether agencies are pursuing 'statutory duties' or 'discretionary activities'. This not only ensures the validity of the charge, but provides accountability and transparency. The intention of Parliament that an agency should be undertaking any cost recovery activity should be made explicit. (This is not an issue for charges levied in the form of taxes, as these must be imposed through legislation).

Distinguishing fees and taxes

As discussed in chapter 3, it is important to distinguish fees for service from taxes. A fee is generally defined as a charge that recovers some or all of the cost of providing a specific service. A fee which 'over-recovers' the cost of a service can effectively constitute a tax. The Constitution lays down special rules for imposing taxes, which means that fees that over-recover costs could be subject to legal challenge. On the other hand, some cost recovery charges are deliberately imposed in the form of taxes (and the special Constitutional rules are followed). Such taxes are often used where the government wishes to recover costs which can be attributed to a general class of users, but which are difficult to attribute to individual users. For example, the Marine Navigation Levy is used to fund the provision of navigation aids such as lighthouses, as it would be impractical to monitor the use of these aids by individual craft.

It is essential that cost recovery arrangements based on fees for services are underpinned by appropriate legal authority. Agencies, with legal advice, should determine the most appropriate authority for their charges, and structure any fees for service so they cannot be challenged as amounting to taxation.

8.4 Cost reflective charging

Cost reflective charging requires an in-principle decision about which approach to cost recovery is to be adopted (for example, recovery of full cost, marginal cost, incremental cost or avoidable cost). This has implications for which costs are to be recovered and how they should be measured and allocated to different activities. The calculation of capital costs is a particularly contentious issue.

Choosing a costing approach

Different costing approaches have very different efficiency implications for different activities. Some costing definitions are summarised in box 8.2. Costing issues are discussed in more detail in appendix H.

Direct costs

The direct cost method allocates to an activity only those costs that can be directly and unequivocally attributed to an activity. However, it means that the indirect costs of producing the output, such as an appropriate share of corporate overheads, are not being taken into account. Cost recovery agencies may choose to charge direct costs where cost recovered activities make up only a small proportion of their total activities, and make only a small call on agency overheads. In such cases, the impact of excluding indirect costs may not be significant.

Fully distributed cost

Under the fully distributed cost (FDC) method, the total costs of an agency are allocated 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. FDC is a simple way to allocate all costs to an output. Regulatory agencies that recover costs for a large proportion of their activities typically use a fully distributed cost approach.

Marginal cost

Marginal cost describes the increase in cost involved with producing an additional unit of output. It excludes costs that are fixed in the short run such as capital costs. This is important because the marginal cost is often much lower than the average cost, for example, where large fixed costs have to be incurred regardless of how many units are produced. Once the first unit has been produced, the marginal costs

of producing further units may be quite low. As discussed in chapter 6, this is important for pricing by information agencies. It may be costly to gather information, but once it has been collected, the cost of disseminating it to many users is very low. Other forms of pricing may reduce welfare by discouraging users who would have paid the marginal cost of dissemination.

Marginal cost pricing is appropriate for information agencies seeking to recover the dissemination costs of information that has already been produced for other reasons (either because it has public good characteristics or positive externalities). However, because it can be difficult to measure marginal cost, incremental and avoidable cost are often used as proxies (see chapter 6).

Box 8.2 Some costing definitions

Direct costs are costs that can be directly and unequivocally attributed to an activity. They include labour (including on-costs) and materials used to produce a good or service.

Indirect costs are costs that are not directly attributable to an activity and are often referred to as overheads. They can include 'corporate services' costs such as the chief executive officer's salary, financial services, human resources, records management and information technology.

Capital costs comprise the user cost of capital and depreciation. The user cost of capital represents the opportunity cost of funds tied up in the capital used to deliver services. It can be measured as the rate of return a business must earn to justify retention of the assets in the business in the medium to long term. Depreciation reflects the portion of assets consumed each period in the production of output.

Fully distributed costing requires the total costs of an agency to be allocated across all outputs. The full cost of a unit of output is the value of all resources used or consumed in the provision of that output. It includes direct, indirect and capital costs.

Marginal cost is the increase in cost involved in producing an additional unit of output. It excludes costs that are fixed in the short run, such as capital costs and a range of indirect costs.

Incremental cost usually refers to the increase in costs attributable to the production of a particular type of good or service rather than the marginal cost of producing an additional unit of that good or service. Incremental cost can also be measured as the increment in cost of producing a service for a particular customer.

Avoidable costs include all the costs that would be avoided if an output was no longer produced by the agency.

Competitive neutrality aims to promote efficient competition between government and private firms operating in the same market. It requires that government agencies do not receive competitive advantages or disadvantages by virtue of their public ownership.

Incremental and avoidable cost

Incremental cost usually refers to the increase in costs attributable to the production of a particular type of good or service rather than the marginal cost of producing an additional unit of that good or service. Incremental cost can also be measured as the increment in cost of producing a service for a particular customer. Avoidable costs include all the costs that would be avoided if an output was no longer produced by the agency. In practice, there is generally little difference between avoidable and incremental cost. The cost saved by not producing the output is usually the same as the additional cost of making the product available, at least in the long term.

Incremental and avoidable cost approaches may be used as proxies for marginal cost, but are most suitable for agencies seeking to recover the additional costs incurred for undertaking 'add-on' work outside their core activities. Because there is no public interest reason to subsidise the activity, agencies should be seeking to recover all of the costs they would have avoided if they had not undertaken the activity.

Competitive neutrality

When government agencies provide services in areas where there is actual and potential competition, cost recovery charges should be consistent with the competitive neutrality guidelines released by the Commonwealth Competitive Neutrality Complaints Office (CCNCO) (see chapter 3). Competitive neutrality does not always mean that agencies must charge 'market prices'. In some instances it is appropriate for agencies to charge incremental or avoidable cost, to allow for efficient use of idle capacity of government agencies.

Few of the Government agencies within the scope of this inquiry currently undertake significant activity in contestable markets, although some information agencies (such as the Bureau of Meteorology, ABARE and CSIRO) provide commercial as well as non-commercial services. The existence of a competitive private market for the good or service must prompt the question of why Government provision is necessary. The rationale for public sector involvement (for example, to provide services to groups facing discrimination, to use spare capacity or to maintain staff expertise) should be explicitly stated.

Capital costs

Capital used in agencies has an opportunity cost. It can be used elsewhere or can be used to retire debt. To measure this cost the assets need to be valued and a rate of

return applied to the value of the asset. In practice, it can be difficult to value assets and determine an appropriate rate of return.

As discussed in appendix H, there is a number of methods for valuing assets. The method of valuation chosen may lead to significantly different estimates of the value of capital and hence of the cost of capital. Under the Commonwealth Government's resource management framework, agencies are directed to use the deprival model to value assets. The deprival model values assets in terms of the services or benefits provided by the asset that the agency would give up if it were deprived of the asset. An agency could calculate the deprival value in one of two ways:

- if the asset would be replaced, the asset's value is the cost of replacing its service or benefit, using current costs; or
- if the asset would not be replaced, the asset is valued at market selling price (DOFA 2001, p. 1-23).

Determining an appropriate rate of return on capital reflects the cost to the community or taxpayer of government capital raising. It can be argued that, because the cost of capital reflects the cost to the Government of raising capital, the user cost of capital should not vary across different Commonwealth agencies. However, there may be some uses of capital that are more risky than others, for example, if the Government were to enter into a commercial operation in competition with other providers. In such circumstances, it may be appropriate for the cost of capital to vary according to the level of risk.

A capital-use charge is levied on Commonwealth agencies and authorities according to their net assets at the end of the reporting period. The rate is standard across agencies, calculated as the long term bond rate plus a risk premium (equal to the long term bond rate). That is, the capital use charge is effectively double the long term bond rate. Wholly budget funded agencies, and agencies which are partly budget funded, are funded for the capital-use charge through their appropriations. Agencies which are fully funded through user charges or industry levies are excluded from these arrangements (DOFA 2001).

These arrangements appear to create a risk that partially cost recovered agencies could both receive an appropriation for the capital-use charge, and also include a cost of capital in charges to users. In some circumstances, it is appropriate that cost recovery charges include a cost of capital (for example, when cost recovered activities account for a significant proportion of the use of an asset). In such circumstances, if agencies are able to retain access to the funds raised (see chapter 3), their appropriations should be reduced by the amount of the capital-use charge.

8.5 Avoiding cross subsidies

Cross subsidisation occurs when one group of users pays for more than the costs of the services they receive, and the surplus is used to offset the cost of services provided to other users (ANAO 2000a, p. 84).

Some cross subsidies are imposed deliberately where Government explicitly requires some users to subsidise other users — for example, part of the avtur fuel levy is used to subsidise regional air traffic control towers (Ansett, sub. 68, p. 13). These cross subsidies are implemented on equity or social policy grounds. However, pursuing such goals through cross subsidies can have undesirable efficiency effects. Those who pay the subsidy may restrict their use of the service or product. This may discourage desirable consumption that would have taken place if the service were appropriately priced. Conversely, those who receive a subsidy may be encouraged to use too much of the service or product. There may also be 'flow-on' effects where the cross subsidised services are inputs to other activities.

In addition, the costs of these cross subsidies often remain hidden. Favoured groups can be provided with benefits without those incurring the costs knowing that they are doing so. Even where cross subsidies are made explicit, difficulties in measuring the extent of transfers occurring under cross subsidies can reduce transparency in the provision of services and diminish accountability of agencies.

Other cross subsidies result from the choice of charging mechanism — for example, the existence of exemptions, thresholds and caps may benefit or penalise particular users (see chapter 6). The use of levies is particularly liable to introduce cross subsidies. Levies can allow charges to be imposed where individual fees for service are impractical, but the weaker the link between the activity being charged and the activity being cost recovered, the poorer the incentives for economic efficiency (see chapter 2). For example, Civil Aviation Safety Authority's (CASA) air safety services are funded by levies on fuel consumption, rather than charging individual users (for example, through a ticket tax). Some participants questioned the link between the consumption of fuel and consumption of safety services. Ansett stated:

> We have enormous concerns about the use of fuel levies as an appropriate cost recovery mechanism. Certainly I don't believe that they're efficient. They're certainly administratively easy. They're not transparent. We're not consulted on the level of activity that is used in determining and setting the level of the fuel levy. We have no reconciliation at the end of the year as to the amount paid and the amount collected in the fuel levy. (trans., pp. 693–694)

In other cases, charging individual users could be inconsistent with the objectives of the agency. It is for this reason that product recall mechanisms are often funded through an industry levy (for example, through registration fees, see chapter 6). It

would be counter-productive to discourage users from making recalls by directly charging for the full cost of the recall mechanism. This logic may also be the justification for some agencies (for example, the Therapeutic Goods Administration, TGA) funding monitoring and compliance activities from registration charges. Individual fees could discourage firms from asking for assistance, or create incentives for agencies to pursue those compliance activities that raised the most revenue, rather than those with the greatest social benefit.

Another rationale for the adoption of cross subsidies by agencies could be in response to industry consultation. The Australian Quarantine and Inspection Service (AQIS) stated that it had adopted a cross subsidisation model within its meat inspection program at the request of industry (Agriculture, Fisheries and Forestry Australia, trans., p. 668). Consultation with industry can improve the efficiency of service delivery and cost recovery charging mechanisms, but as discussed in chapter 6, agencies should be careful to avoid introducing barriers to entry or creating uneven playing fields. In such cases, cross subsidies between stages of a single process (for example, lower up-front fees recouped over time) are preferable to cross subsidies between different processes. Where all users will eventually go through the same process, over time they will both benefit from, and then pay, the cross subsidy. Cross subsidies between different processes may permanently disadvantage one group relative to another.

In conclusion, cross subsidies in cost recovery are generally undesirable because of their adverse impact on efficiency in resource use and consumption (see chapter 6). As discussed in the guidelines (see chapter 9), cross subsidies may be justified where an industry levy is used to fund activities that benefit the industry as a whole, and where it is not practical to charge individual firms (for example, where it is too costly to monitor individual use), or where direct charges would be counter to agency objectives.

8.6 Access and equity

The introduction of cost recovery can have significant access and equity implications. It can be argued that in appropriate circumstances, cost recovery improves equity by requiring those who benefit from government services or create the need for regulatory activities to meet the associated cost, rather than being subsidised by the general taxpayer (see chapter 2). There are concerns, however, that cost recovery may create barriers to access for some consumers of government services.

As noted above, in some cases this has led to the imposition of cross subsidies to fund access by certain groups. The use of cross subsidies to pursue equity goals has many parallels with the imposition of Community Service Obligations (CSOs) on commercial agencies. (CSOs arise where agencies are required to engage in a non-commercial activity in order to meet a social objective). The Commission has previously endorsed the recommendations of the Hawker Committee (PC 1999a, p. 354). These recommendations were that:

- all Community Service Obligations be defined explicitly and their details made publicly available (Hawker 1997, p. 30); and
- governments require their businesses to include in their annual reports and corporate/business plans detailed information on the objectives, definition, costing, funding and contracting arrangements for Community Service Obligations (Hawker 1997, p. 40).

Similar arrangements should apply if cross subsidies are adopted in pursuit of social objectives. However, there is a number of alternatives to cross subsidies to achieve Government objectives. These include giving users direct cash transfers or vouchers for the value of the service, or direct funding of agencies for the value of the cross subsidy. Direct funding provides a means of reducing the adverse efficiency effects associated with cross subsidies and ensures that the costs are subject to closer annual budget scrutiny. Further, the cost of the redistribution of income inherent in the cross subsidy is spread over all taxpayers rather than being limited to the users of particular goods or services.

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Government equity or social objectives should be funded through direct cash transfers to users or direct funding of agencies, rather than through cost recovery arrangements.

8.7 Accountability and transparency

Accountability and transparency are very important for government agencies, particularly where cost recovery may be creating incentives for undesirable practices such as regulatory creep, gold plating and cost padding, or in the case of information agencies, to undertake more non-core activities at the expense of core activities. The availability of information to assess agency performance, and documented adherence to established processes can assist in the ongoing monitoring of agency performance. Such information can improve transparency and help to prevent ‘agency capture’ by users of the service (see chapter 5).

Many participants expressed concern about the level of transparency and accountability of existing cost recovery arrangements. The Association of Superannuation Funds of Australia (ASFA) argued that a lack of transparency and accountability was contributing to poor consultation:

> … not only is the consultation not there but the sort of information that we used to get that we could see where the [Australian Prudential Regulatory Authority] levy was being spent and how it was being spent seems to have disappeared. (trans., p. 136)

The lack of standard institutional arrangements for cost recovery has contributed to a lack of accountability and transparency for these activities. The Commission has made draft recommendations for a number of improvements to current accountability and reporting arrangements (see chapter 5).

8.8 Consultation

Consultation with affected parties is an important component of accountability and transparency. It can also improve the efficiency of government activities and cost recovery arrangements.

Consultation arrangements have to balance the need to give interested parties meaningful input against the need to ensure that charges are still levied where it is appropriate to do so, and that a degree of consistency is maintained between agencies and industry sectors with similar characteristics.

The Government has decided that where reviews of regulation are undertaken, the terms of reference and any reports of such reviews must use a Regulatory Impact Statement (RIS) framework (see chapter 3). This framework includes mandatory consultation. In chapter 3, the Commission has made a draft recommendation to clarify the role of the RIS process in assessing regulatory cost recovery proposals, and extending a similar process to cost recovery proposals that do not currently require a RIS. Other consultation arrangements are discussed in chapter 5.

8.9 Performance monitoring and review

Regular, structured performance monitoring and review provide further transparency and accountability safeguards. Review mechanisms are implied in the governance and consultation arrangements of many agencies, but some have additional review mechanisms relating to their cost recovery activities. For example, the APRA rate setting process includes annual industry consultation on levy rates. These rates are then subject to approval by the Treasurer (or his delegate). In addition, its levy collection framework was reviewed and confirmed by

the Government in 1999, and a further review will be conducted in 2003 (APRA, sub. 21, p. 4).

All agencies are also subject to the Parliamentary review process, and to supervision by the Australian National Audit Office (ANAO). As discussed in chapter 3, the ANAO undertakes both annual financial audits and *ad hoc* performance audits of Commonwealth agencies and departments. The ANAO undertook a performance audit of AQIS's cost recovery systems in 2000-01 (ANAO 2000a). As discussed in chapter 3, the Commission considers that, because of the direct impost cost recovery places on users, cost recovery arrangements should be subject to more specific review mechanisms.

8.10 Stability and predictability

Stability in cost recovery arrangements and predictability of charges can promote business confidence and enable industry to make informed decisions. Constant changes in fee structures and levels causes problems for firms' cash flow management and financial planning. However, there can be a trade-off between stability and charges that accurately reflect costs. Consultation with users can help agencies achieve a balance between stability and cost reflective charging

Predictability of charges is very important to industry. Avcare stated:

> Fees should be set by regulation and not fluctuate each year according to the predicted workload of agencies (that is, number of applications) as happens with the TGA. A fluctuating approach does not provide the necessary cost predictiveness and budget forecast certainty for industry. (sub. 28, p. 9)

The stability of cost recovery arrangements is often out of the control of individual agencies — for example, the Government has changed the cost recovery targets imposed on agencies such as the TGA and the National Registration Authority for Agricultural and Veterinary Chemicals over time. The removal of agency targets (see Draft Recommendation 6.3) and adoption of the guidelines will provide greater certainty across Government activities in the future (see chapter 9).

Predictability of charges can be difficult to achieve if the aim is to charge the actual costs of particular activities, and these costs are uncertain. This may be the case where an agency has high fixed costs and uncertain demand. Each user's share of costs will depend on the level of demand. Some agencies have mechanisms in place to avoid overly wide variations in charges. The cost recovery arrangements of APRA are a typical example of such an approach:

- APRA can use reserves on balance sheet to help meet unforeseen demands on resources and reduce volatility in levy rates from year to year;
- the annual levy rate applying to an industry is based on a three year average of cost estimates for that industry (past year, current year, following year); and
- adjustments are made for any significant over or under collections from the current year (APRA, sub. 21, p. 3).

Predictability of cost recovery revenue is also important to agencies that rely on these revenues for funding (for example, through section 31 Net Appropriation agreements). The Commission's draft recommendation that all cost recovery revenues from regulatory activities be retained in the Consolidated Revenue Fund, and regulatory agencies be budget funded through normal appropriations, would remove agency reliance on cost recovery revenues (see chapter 5).

8.11 Efficient and effective arrangements

Cost recovery arrangements impose administrative costs on agencies and compliance costs on users. As discussed in chapter 5, cost recovery would not be worthwhile if these costs outweighed the allocative efficiency benefits. Cost recovery should be as administratively simple as possible, bearing in mind the need for transparency and accountability, and the desire to improve allocative efficiency, rather than just raise revenue.

Fee for service charges may be more costly to administer than applying a levy or tax due to the complexity in calculating appropriate charges. But any gains in administrative efficiency must be balanced against the efficiency costs of using taxes or levies. The ANAO found that:

> … entities that manage multiple levies such as APRA and AMSA face considerable cost allocation problems devising transparent and efficient costing systems given the need to allocate significant indirect costs across levies (2000c, p. 66).

APRA stated that, while it would be possible to implement a more detailed activity-based costing system, it would involve extra costs, would produce greater uncertainty regarding levies faced by industry from year to year, and would not necessarily be more efficient than the current system (APRA, trans., p. 183).

Similar concerns prompted a recommendation in the Wallis Report that:

> … as far as practicable, the [financial] regulatory agencies should charge each financial entity for direct services provided, and levy sectors of industry to meet the general costs of their regulations. (1997, p. 532)

ASFA, however, was concerned that such a system may worsen the situation of a firm in difficulty and/or discourage it from seeking assistance (sub. 8, p. 9).

Some agencies choose to outsource the collection of cost recovery charges — for example, charges relating to transport agencies such as CASA and AMSA are outsourced to the Australian Taxation Office and Australian Customs Service (ACS). This can improve administrative efficiency, but it is important that the cost of the administrative arrangements is recognised, not just shifted to another agency. The ACS collects AMSA levies in the course of its barrier management inspection duties. The ANAO recognised this was an efficient way to collect the levy, but that:

> Consistent with the need for transparency in the management of levies, the collection costs should be visible. As well, they should be included in the total costs attributed to the levy, even if this is at the reporting level and not imposed as a fee for service. (ANAO 2000c, p. 44)

8.12 Conclusion

Good public administration is important for all areas of government activity, but it has particular significance for cost recovery agencies. Adherence to good administrative practice limits the potential for perverse incentives to detract from agency efficiency and accountability.

In earlier chapters, the Commission has made a number of draft recommendations to address problems in the current administration of cost recovery. The following chapter proposes a set of guidelines designed to improve the future design, implementation and review of cost recovery arrangements.

9 Guidelines for cost recovery

9.1 Introduction

Currently, there are no Government endorsed guidelines available to Commonwealth agencies that have, or are considering introducing, cost recovery. The terms of reference to this inquiry recognise this deficiency. The Commission is to report on:

> … appropriate guidelines for:
>
> (i) where cost recovery arrangements should be applied;
>
> (ii) whether cost recovery should be full, partial or nil;
>
> (iii) ensuring that cost-recovered activities are necessary and are provided in the most cost-effective manner;
>
> (iv) the design and operation of cost recovery arrangements, including the treatment of small business;
>
> (v) the review of cost recovery arrangements; and
>
> (vi) where necessary, implementation strategies to improve current arrangements.

The evidence and analysis in this draft report further highlight the need for guidelines. Currently, there is very little guidance for agencies faced with difficult and complex decisions on implementing cost recovery. The Commission sees this as a major deficiency, particularly given recent increases in the levels of cost recovery. The absence of guidelines has meant that approaches to cost recovery are often *ad hoc* and inconsistent between agencies, even those undertaking similar activities. Further, participants in this inquiry have questioned whether all the charges currently levied by Commonwealth agencies reflect good cost recovery principles and practice.

The key questions that need to be answered to address these terms of reference are identified in box 9.1. These guidelines seek to place cost recovery in the context of the policy process — from the initial consideration of whether regulation or service provision is consistent with the agency's policy objectives, through the assessment of the type and level of charges, to the ongoing monitoring and assessment of cost recovery arrangements.

The first stage of this process, identifying why the government is involved in an activity, is particularly important. It is not possible to determine whether cost recovery is appropriate and, if so, how it should be applied, without understanding what the government is trying to achieve by its involvement in an activity.

Box 9.1 **Key cost recovery questions**

- Are the levels and types of cost recovered activities consistent with the objectives of the agency? (see section 9.3)
- Who should pay cost recovery charges? (see section 9.3)
- Should cost recovery be imposed and, if so, should fees or levies be used? (see section 9.3)
- What form of fees or levies should be used to achieve the desired level of cost recovery? (see section 9.4)
- How should costs be assessed and charges calculated? (see section 9.4)
- What monitoring mechanisms should be used to ensure cost recovered activities are provided efficiently and charges are not excessive? (see sections 9.3 and 9.5)
- How will the approaches to cost recovery be adapted over time to meet changing needs and circumstances? (see section 9.6)

To avoid duplication, the Commission has integrated the processes outlined in these cost recovery guidelines with related processes. Where relevant, these guidelines refer to Commonwealth guidelines for regulatory impact statements and the application of competitive neutrality.

The guidelines are intended to cover cost recovery in Commonwealth regulatory, administrative and information agencies. As a rule, the cost recovered activities of these agencies appear to be either administering, implementing and enforcing regulation, or providing information services. Hence the guidelines focus on these two broad activities. While the principles in these guidelines may have broader application, they were not written with the intention of being applied to government business enterprises or infrastructure services provided by government.

INFORMATION REQUEST

The Commission seeks further views on the usefulness of the guidelines contained in this draft report as a framework for deciding whether or not cost recovery should be introduced and for identifying the best approach to recovering costs. Also, it would be helpful if agencies could advise the Commission on how well the guidelines apply to their own circumstances and the impact their application would have on revenue raising.

9.2 Government activities and cost recovery

Cost recovery is not appropriate for all activities undertaken by regulatory and information agencies. For example, in chapter 6 the Commission has made a draft recommendation that, in order to meet broad agency objectives, the core services and products of information agencies should be wholly budget funded. This includes some access to core data and information free of charge (for example through libraries, education institutions or the Internet). Similarly, charging for some regulatory activities can undermine the objectives of those regulations and reduce the effectiveness of the agency. Both information and regulatory agencies undertake a range of activities. It is rarely appropriate to apply cost recovery to all of these activities and, therefore, a mix of cost recovered and taxpayer funded services would be expected.

In chapter 2, the Commission argues that the main rationale for cost recovery should be to improve economic efficiency. Improving the equity of government revenue raising methods is also important, as is maintaining a link between the objectives of cost recovery and those of the government agencies or activities themselves. (That is, cost recovery should not impede the basic objectives of the activities it supports.) The Commission proposes that the following issues be considered in relation to each activity, before cost recovery is imposed:

- whether or not the benefits of the activity are captured directly by the individual or firm charged (or by the firm's customers);
- whether or not it is technically feasible to charge the main beneficiaries of the government activity or service. This requires either that the beneficiaries can be billed directly (for example, purchasers of information products) or that the regulated firms can pass on some or all of the costs to the main beneficiaries (usually the consumers of the product or service);
- whether the activity is part of the cost of minimising an actual or potential negative effect on third parties (spillovers). Such costs should be taken into account in pricing the regulated products or activities;
- depending on the primary objectives of the government activity or regulation, there may be reasons why charges should not be attached to the goods or services. Cost recovery might not be warranted where:
  - it would be inconsistent with regulatory or policy objectives (for example, charging firms directly for product recalls or for safety information); or
  - it would stifle industry innovation and development (for example, where a lack of intellectual property rights or a lack of an established industry creates substantial free rider or 'first mover' problems for users); and

- whether sound governance arrangements are in place that limit the potential for cost recovery to compromise the independence, efficiency and efficacy of the government agency (although these should be in place even in the absence of cost recovery arrangements).

These considerations are of greater or lesser relevance to various government agencies, depending on their overall objectives, their activities, the users of their services and their beneficiaries. For information agencies, the 'private good' nature of some of their products, and the need for price signals to ration finite agency resources may be of most relevance. For regulatory agencies, identifying the beneficiaries (usually the customers of the regulated firms), acknowledging any actual or potential spillovers which must be managed, and ensuring consistency with the primary objectives of the regulations, are usually more relevant.

The questions that need to be considered for regulatory activities are outlined in figures 9.3 and 9.4. Figure 9.5 helps agencies that provide goods or services, including information agencies, to determine whether cost recovery is appropriate.

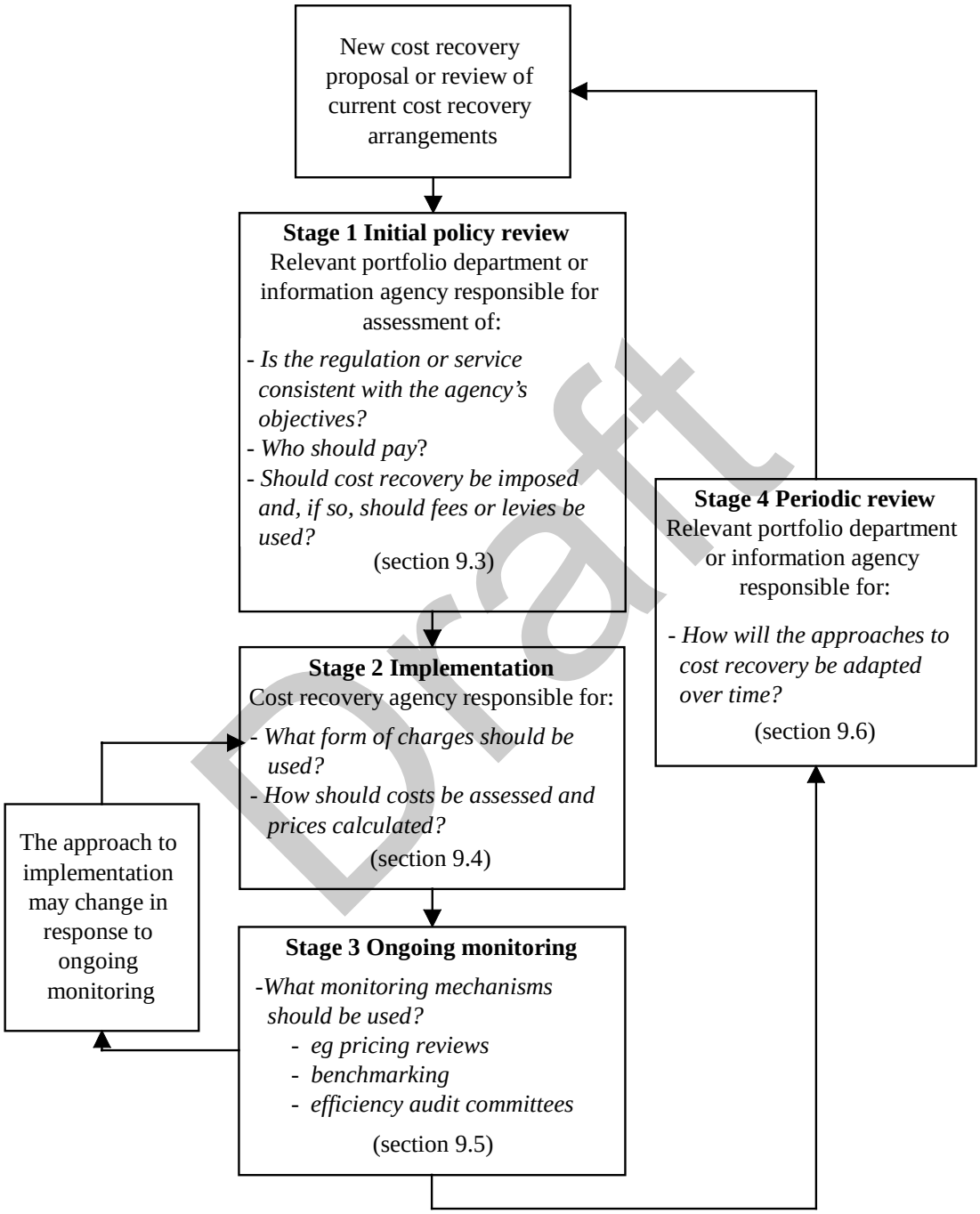
The Commission's Terms of Reference require the guidelines to consider whether cost recovery should be full, partial or nil. As a result of applying these guidelines, regulatory activities generally will be either fully cost recovered or taxpayer funded. Most agencies will have a mix of cost recovered and taxpayer funded activities. For information services, applying these guidelines will usually result in core activities being taxpayer funded, incremental services being partially cost recovered with fees covering incremental costs, and commercial services cost recovered consistent with competitive neutrality guidelines.

These guidelines provide a framework to assist policy departments and cost recovery agencies in identifying those activities where cost recovery is appropriate.

9.3 Overview of the process

The process for determining the appropriate approach to cost recovery for specific activities is outlined in figure 9.1.

Figure 9.1 **Process for assessing cost recovery**



Each element of this process is discussed in the following sections. In summary, the process involves four broad stages.

Stage 1 is an initial policy review. It should ask the following questions.

- Why is the government involved in the activity?
- Are the levels of regulation and service delivery consistent with the agency's policy objectives?
- Who should pay cost recovery charges?
- What level of cost recovery, if any, should be imposed?
- Should cost recovery revenue be collected via a fee or a levy (using tax legislation)?
- What mechanisms should be used for ongoing monitoring of the efficiency and effectiveness of cost recovery arrangements?

This stage 1 review deals with policy issues. Such policy questions are normally the responsibility of the relevant ministers and their portfolio department, particularly for regulatory agencies. However, these decisions can benefit greatly from the transparency and accountability that results from using an independent review process or having the process vetted by an independent agency. The Commonwealth has already recognised these benefits in its preparation of Regulatory Impact Statements (RISs) for new regulation and having these statements examined by an independent agency, the Office of Regulation Review (ORR). For information agencies, where cost recovery should be restricted to non-core activities, it may still be appropriate for the agency to review its activities, including assessing them against its objectives. This process also promotes transparency and accountability.

If the stage 1 policy review indicates that some level of cost recovery is appropriate, a second assessment is necessary. That assessment, **stage 2**, focuses on implementation and should consider the details of how revenue would be collected, for example, how the fees or levies should be structured and how the costs of providing cost recovered services should be calculated. As noted in section 9.5, the details of implementation will vary between information and regulatory activities.

Stage 2 requires detailed knowledge of the agency and its activities. Therefore, the cost recovery agency should take primary carriage of this assessment. Also, mechanisms need to be in place to ensure that the cost recovery agency bases its cost estimates on efficient, rather than actual costs (see section 9.5). If capital costs are to be included in charges, appropriate methods for calculating capital costs are needed and methods established to allocate capital costs and overheads. Scrutiny is

also necessary to ensure that methods adopted for collecting revenue are consistent with the broad community interest and not just the interests of the agency.

Together, the reports that result from stages 1 and 2 form a Cost Recovery Impact Statement (CRIS). The CRIS, and its relationship to the existing RIS process, are discussed in the following section.

Stage 3 requires ongoing scrutiny of cost recovery arrangements using monitoring mechanisms specified as a result of stage 1. In response to issues identified through such monitoring it may be necessary to change the approach to implementation. Over time, the cost recovery agency may need to revisit the issues considered in stage 2.

There is a range of options that could be adopted for ongoing monitoring in stage 3. These options are discussed in chapter 5. The approaches range from improving transparency to involving independent review committees to consider whether cost recovery is being applied appropriately and services are being supplied efficiently. Therefore, the agency responsible for ongoing management of stage 3 will vary depending on the approach adopted.

Finally, at least every ten years, the approach to service delivery, the level of cost recovery and monitoring arrangements need to be reviewed, to determine whether changes are necessary. This **stage 4** review should reconsider all of the issues addressed in stages 1 and 2.

The process outlined above should be applied to all new cost recovery proposals, significant amendments to existing cost recovery arrangements and existing cost recovery arrangements. For every existing cost recovery arrangement the whole process should be completed within the next five years.

9.4 Stage 1: policy review

Are the levels and types of cost recovered activities consistent with the objectives of the relevant agency?

The first step in stage 1 clarifies, for cost recovered activities, why the government is involved in the activity and whether the level of regulation or service provision is consistent with the agency's objectives. For regulatory agencies, this initial review should be the responsibility of the relevant minister and portfolio department. For information agencies it may be appropriate for the agency to undertake this review.

The stage 1 policy review recognises that cost recovery can exacerbate problems if there is over-regulation of cost recovered activities. For example, if the standards set for a particular product are too onerous, and therefore higher than necessary to provide acceptable levels of consumer safety, firms' compliance costs would also be higher than necessary. Introducing cost recovery would add to those costs and exacerbate the problems.

These concerns emerge most notably in the regulation of market entry, such as product approvals, where firms usually have a binary choice: to participate in the market and be regulated, or to decline to participate in the market. In this case, if the level of regulation does not properly reflect the riskiness of the product, then cost recovery can exacerbate problems where low risk products, that also have a low return to the supplier, would be disadvantaged by high cost regulations.

Issues for review of cost recovered activities

The stage 1 policy review considers whether both the cost recovered activities and the way they are delivered are consistent with the objectives of the agency. Defining these objectives is fundamental to later questions about whether cost recovery is appropriate.

For regulatory agencies this means considering, for cost recovered activities, how regulations will be imposed and enforced. For instance, for the assessment of chemicals, the review needs to consider the best mechanisms to reduce the risk that use of the chemical would harm individuals or the environment. The objective of this review should be to ensure that cost recovery charges are based on efficient levels of regulation. Similarly, it should avoid imposing standards that have only minor gains in reducing risk but result in high cost recovery charges.

For information agencies, the main issue for the stage 1 review is to clarify what are core and non-core activities and hence to what extent cost recovery should apply. This assessment needs to look at the whole service chain from collection and compilation to distribution.

Another step in the stage 1 policy review is to determine the ongoing mechanisms for monitoring and improving the efficiency of cost recovered activities. Although the appropriate mechanism should be decided as part of this initial policy review, the actual process for ongoing monitoring is set out in stage 3 of these guidelines. The discussion in section 9.6 outlines stage 3 and the different options for ongoing monitoring.

Method for reviewing cost recovered regulations and services

There are already government processes established to assess the effectiveness of regulation. To avoid duplication, the Commission considers in chapter 3 the extent to which these existing processes can be used to assess the application of cost recovery.

That discussion concludes that a review process is required to ensure the adequate scrutiny of existing cost recovery arrangements and new cost recovery proposals, as well as ongoing monitoring of the appropriateness of these arrangements. This might be referred to as a Cost Recovery Impact Statement (CRIS) process (see chapter 3).

The Commission considers the RIS process (box 9.2) to be a valuable tool for assessing regulation. With minor enhancements the RIS can perform much of the CRIS role for cost recovery arrangements that fall within the RIS ambit.

These enhancements would clarify that cost recovery arrangements of regulatory agencies that affect business (or cost recovery arrangements that are established in regulation and affect business) are properly subject to a RIS. It should also be made clear that the RIS should address both the rationale for establishing cost recovery, and the impact of the proposed charging mechanisms on business, the agency and the broader community as a whole.

Box 9.2 **Regulatory Impact Statement process**

The RIS process is most relevant to regulatory activities where cost recovery arrangements are implemented by legislative or quasi-legislative mechanisms and affect businesses. A RIS has seven key elements that set out:

- the problem or issues which give rise to the need for action;
- the desired objective(s);
- the options (regulatory and/or non-regulatory) that may constitute viable means for achieving the desired objective(s);
- an assessment of the impact (costs and benefits) on consumers, business, government and the community of each option;
- a consultation statement;
- a recommended option; and
- a strategy to implement and review the preferred option.

The Office of Regulation Review is responsible for monitoring and reporting on the preparation of Regulatory Impact Statements by Commonwealth Agencies.

Agencies that are unsure about whether their services fall into this category should either consult *A Guide to Regulation* (ORR 1998) or contact the ORR directly.

Although an enhanced RIS process could adequately provide scrutiny of many cost recovery arrangements, a separate process is required for those cost recovered activities that are not covered by the RIS process. For example, cost recovery for regulations that affect individuals, not businesses; ongoing reviews of cost recovery arrangements without an associated review of regulation; and cost recovery introduced administratively by information agencies. In chapter 3, the Commission has made a draft recommendation that a separate CRIS process be developed to ensure these cost recovery arrangements are subject to equivalent scrutiny to the RIS process (box 9.3). The CRIS should also be used to consider the implementation of cost recovery if these issues involve a greater level of detail than contemplated in the RIS.

Box 9.3 Cost Recovery Impact Statement process

The CRIS process requires the following steps:

- determine who will prepare the CRIS, with reference to established criteria — for example, a CRIS may be prepared:
  - by persons internal to the agency or department;
  - by persons internal to the agency or department with an independent review; or
  - by persons wholly independent of the agency or department.
- examine the objective of the activity to be cost recovered — for example:
  - did the decision to undertake the activity follow due process; and /or
  - is the objective of the activity clearly stated;
- application of the cost recovery guidelines, which will involve:
  - determining who should pay cost recovery charges if they are introduced;
  - an assessment of whether cost recovery should be imposed, including analysing the impact (costs and benefits) on consumers, business, government and the community of the proposal;
  - determining the form of charges;
  - an assessment of how costs should be calculated and allocated between activities;
  - a recommended option; and
  - a strategy to implement, monitor and periodically review cost recovery;
- a description of the level of consultation undertaken;
- the Statement may be subject to independent review;
- the Statement is released, together with any independent review and a statement of the agency or department's intended approach; and
- a government statement on its intended approach should be published on the agency web site, in the agency annual report and portfolio budget statements.

There would be one fundamental difference between a RIS and a CRIS. The RIS process examines the need for regulation and all available options for achieving the objectives of the regulation. The CRIS process would focus specifically on the rationale for and suitability of cost recovery arrangements, and not on those of the underlying activity. However, the CRIS would examine whether due processes had been followed in reaching decisions on the appropriate activities of the agency, for example, that board approval or ministerial endorsement had been received where required.

The Commission considers that transparency and independence are important elements of the CRIS, and has a strong preference for some degree of independent scrutiny of the CRIS. However, given the wide variety of cost recovery arrangements, with varying levels of contention, a single model may not be appropriate. A similar approach to that used by governments to implement the Competition Principles Agreement Legislation Review Program may be appropriate, where different review mechanisms may be chosen for different arrangements, according to criteria such as whether it is a new proposal or relatively minor modifications to existing arrangements; the degree of stakeholder concern; and the amount of revenue raised or to be raised.

To promote greater transparency and accountability, the outcome of the CRIS process (that is, the Cost Recovery Impact Statement itself) should be made publicly available. Along with the report of the independent review, it could be placed on the agency's web site and summarised in agencies' annual reports.

Who should pay cost recovery charges?

Once an assessment has been undertaken of whether the regulation or service is consistent with the agency's objectives, and it has been decided that activities should be cost recovered, the next step in the stage 1 policy review is to determine who should pay.

The policy objective determined in the first step will guide the determination of who should pay. The approaches to cost recovery discussed in chapter 2 are summarised in box 9.4. It notes that for non-core information services those who choose to use the service benefit from that service and therefore should pay. This is consistent with the beneficiary pays approach to cost recovery.

Box 9.4 **Determining who should pay**

For **information services**, the questions about what should and should not be cost recovered stem from the agency's core activities and then determining whether other, non-core, services should be priced. Carefully stating what are core services is a critical part of implementing these guidelines.

For **regulatory activities** there are two approaches to thinking about cost recovery: a 'beneficiary pays' approach, and a 'regulated pays' approach based on spillovers. Other things being the same, these approaches suggest that beneficiaries would pay where the private benefits exceed the costs of providing the services. Firms would pay where they are regulated because they give rise to negative spillovers.

The approach taken depends on the circumstances. A good starting point for making such a choice would be the objectives of the legislation establishing the regulatory arrangements. Thus if it could be established that regulations were introduced primarily for the benefit of consumers, the beneficiary pays approach might be the most appropriate conceptual framework. If containing negative spillovers was the prime objective, the regulated pays approach may be more appropriate. Some legislation may address both objectives, in which case a judgement would need to be made about which is the more important.

For regulatory activities, if the objective of the regulation is to benefit the industry or consumers of the regulated product, then a beneficiary pays approach is appropriate. One weakness in the beneficiary pays principle is that if beneficiaries only pay for the benefits they received, they may not recognise the possibility of spillover effects on others. Where the government regulates primarily to address negative spillovers, there may be a case for those regulated to pay for both their own compliance costs and the costs of administering the regulations.

Some of the main policy objectives for regulatory and information agencies are listed in table 9.1. If it has been decided that cost recovery is appropriate, this table indicates who should pay cost recovery charges.

Table 9.1 **Agency objectives guide to who should pay**

Policy objective	*Example*	*If cost recovery is appropriate who should pay?*
Deliver goods and services	Information service	Purchaser of the good or service
Provide information to consumers on product or service safety	Labelling requirements	Consumers of regulated product or service [a]
Issue an exclusive right	Issuing patents	Recipient of the exclusive right
Assess or approve product quality to the benefit of producers of that product	Quarantine inspection of exported agriculture	Firms supplying the regulated product or service
Assess or approve product quality to the benefit of consumers	Assessing pharmaceuticals	Consumers of the regulated product or service [a]
Enforce safety and quality standards to protect other firms in the regulated industry	Regulation of financial services	Firms supplying the regulated product or service
Enforce safety and quality standards to protect consumers	Air safety	Consumers of the regulated product or service [a]
Reduce the risks of harmful spillovers (including enforcing safety and quality standards) that would affect the broader community	Regulating chemicals	Firms or individuals responsible for the regulated activity

[a] If it is impractical to collect charges from consumers, agencies should consider charging upstream firms.

The incidence of a fee or levy can have an important influence on the design of cost recovery arrangements. Where the ultimate beneficiaries of a particular government activity are widespread and difficult to identify, such as the consumers of a product or service, it may be impractical to charge them directly. Budget funding may be a more realistic alternative. But if the fee or levy can be charged against a well-defined group of upstream firms, and those firms are able to pass on all or most of the charge, the end result may be similar to charging consumers directly.

Should cost recovery be imposed and, if so, should fees or levies be used?

The next step in the stage 1 policy review is to determine whether the agency should charge for all or part of its activities and, if so, should a fee or levy be used. Because most agencies have a range of activities and it is rare for these activities to have identical characteristics, each activity often warrants a separate approach to cost recovery. For example, an agency may undertake product assessment for firms, enforce standards and provide information to parliament or support to ministers. These three services are very different and the cost recovery issues arising from each are different.

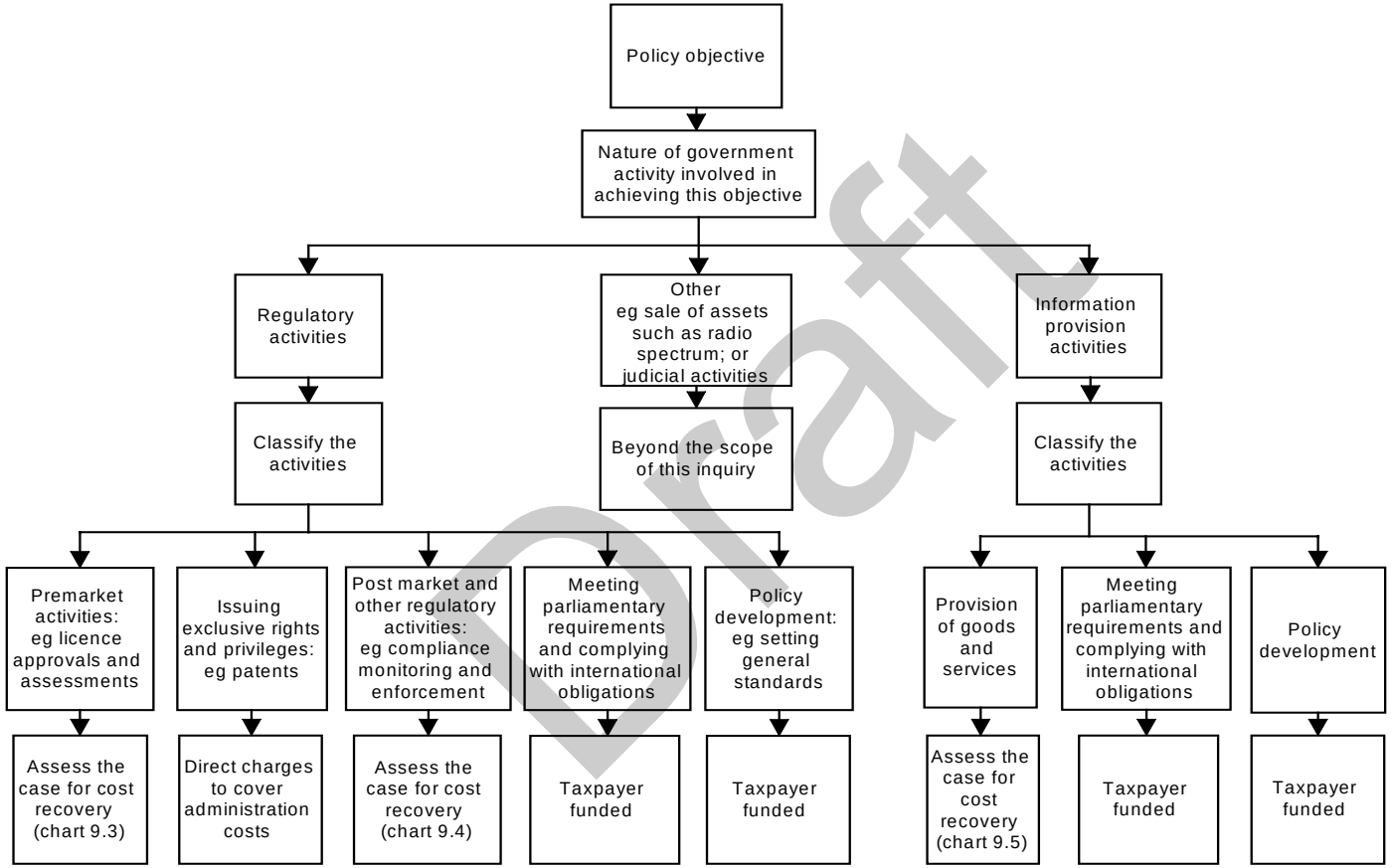
Product assessments are often designed to ensure that standards help consumers choose safe products, where there is insufficient information to judge product safety, or the information, even if available, is too technical for the average consumer to assess. Often it will be appropriate for these services to be subject to cost recovery, and a key question is whether the charges should by paid by the firms or consumers. The enforcement of standards is often designed to ensure continued protection for consumers against any potentially harmful effects of risky products. However, direct charges may hinder enforcement: for example, charging for product recalls would discourage firms from reporting faulty or dangerous products. Therefore, it may be more appropriate to use levies to recover the costs of these activities. In contrast, providing information to Parliament results more from the need to maintain a strong democratic process. Therefore, these activities should be funded by taxpayers.

Consequently, it is not possible to assess the appropriate level of cost recovery on an agency wide basis. Rather the review needs to look at each of the activities undertaken and, in each case, assess whether cost recovery should be introduced.

Figure 9.2 assists decision-makers in classifying the types of activities they undertake.

As noted above, agencies will usually undertake several activities, which may fall into different categories. The review will need to consider all of the relevant categories when assessing the appropriate approach to cost recovery. The following discussion looks more closely at each of these categories, and outlines the types of activities in each category and how to assess the appropriate level of cost recovery.

Figure 9.2 **Classification of activities**



Premarket regulatory activities

These types of activities include:

- inspecting and approving premises, such as the Australian Quarantine and Inspection Service (AQIS) inspection of abattoirs;
- registering companies before they can sell particular products or services, such as the Australian Securities and Investments Commission (ASIC) licensing investment advisers and managed investment funds before they can trade;
- approving products before they are sold in Australia, such as the Therapeutic Goods Administration (TGA) process for evaluating high risk products such as prescription medicines; and
- listing products on a register before they can be offered for sale, such as the TGA process for listing medicines that are exported and not sold domestically.

The questions that need to be considered to determine whether or not cost recovery should apply to these types of activities are illustrated in figure 9.3.

The first question is:

Will other firms be able to free ride on the approval of the first applicant?

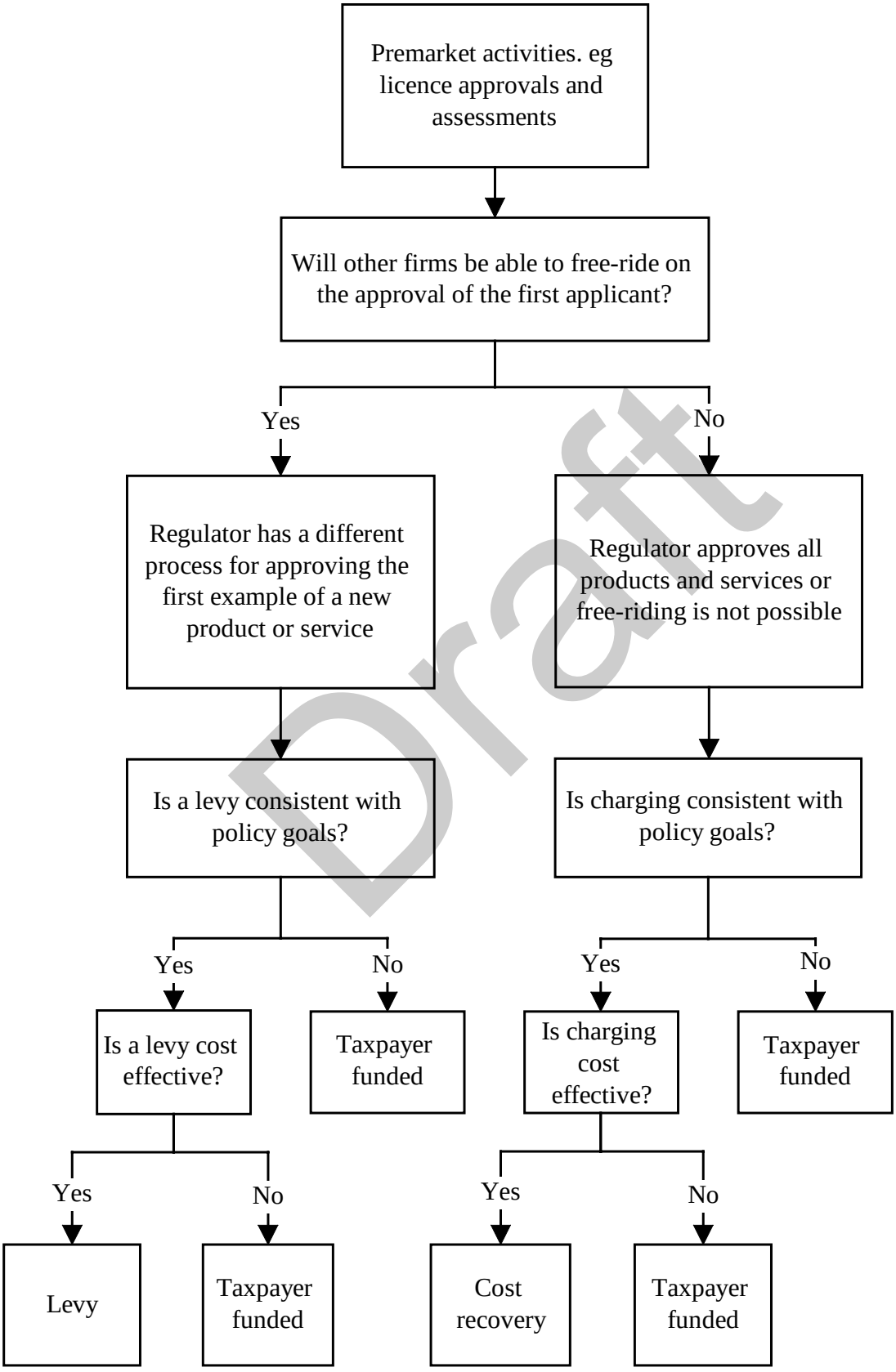
The reason for asking this question is that charging for the assessment of new products can encourage firms to avoid the costs of approvals by waiting for others to seek approval first (thus 'free-riding' on the approval of others). This is a problem when the regulator has a separate approvals process for new products or requires new products to go through a more onerous process.

The first firm may be required to pay the regulatory costs but cannot recover those costs when the product is sold because it quickly faces competition from other firms that did not have to pay the initial costs of having the product approved. Charging for such approvals would discourage firms from developing and offering new products to Australian customers.

Examples of this type of regulation include the Australia New Zealand Food Authority (ANZFA) approval of a new food standard, or the TGA approval of a new complementary health care substance, where, after approval, any firm can use the new substance in their products.

This type of regulation, however, does not include approvals where the firm is given a patent or an exclusive right to market a product. In these cases the firm that seeks the initial approval should be able to recoup the costs of that approval. These types of regulatory activities are discussed in the following section.

Figure 9.3 **Premarket activities**



Complexities arise in areas where products, services or standards are not issued with any legal exclusivity, but because of other factors, such as trade secrets, it is unlikely that similar products will enter the market quickly. In such cases, cost recovery could be applied when there is an 'exclusive capturable commercial benefit' obtained by the firm from approval of the product. This test is similar to that applied by ANZFA to its charging for the approval of food standards.

Even if it is counterproductive to charge a fee for the approval of new products, services or standards, it may still be appropriate to cost recover these regulatory activities using a levy.[1] Therefore, if the agency approves only the first example of a new product type then the next question is:

Are levies consistent with policy goals?

If imposing levies would reduce the effectiveness of the regulation or undermine the objectives of the regulator, the activity should be funded by the taxpayer.

Even if levies are consistent with achieving the agency's policy goals it is necessary to consider:

Is a levy cost effective?

This assessment should be based on the range of realistic charging options. For example, if the beneficiaries of the regulation are the consumers of a product but it is costly to levy consumers, the alternative of levying producers should also be considered.

Levies may be impractical where:

- there is a large number of firms or consumers in the industry and they are difficult to identify;
- administration costs of billing firms or consumers is excessive; or
- it is impractical to establish a basis for the levy.

For example, a levy may not be practical if only a small group of firms or consumers within an industry benefit from the activity. It is inappropriate to levy the whole industry if the benefits flow to a small group that cannot be individually charged.

If a levy is not cost effective, the cost of regulation should be funded by taxpayers. Otherwise a levy should be used to recover cost.

[1] A fee charges individual firms or consumers for particular activities. In contrast, a levy is imposed across a group of firms or consumers and is equivalent to a tax. The term 'charge' refers to both fees and levies.

If the agency approves all products and services sold in an industry, or there are 'exclusive capturable commercial benefits', the next question is:

Is charging consistent with policy goals?	Charging could be inconsistent with policy goals if it significantly increases the cost of enforcement. For example, a product register may help the regulator to identify classes of products if it needs to take action in the future. Charges to list products on the register could increase incentives for firms to avoid registration, and increase the costs of enforcement and reduce the effectiveness of the regulator. If charges are consistent with policy goals, again, it is still necessary to consider whether such charges would be cost effective.
Is charging cost effective?	As noted above, there is a range of circumstances where charges may not be cost effective. If it is inconsistent with the agency's policy goals or not cost effective to charge for the regulatory activity, the costs of regulation should be met by taxpayers.

Issuing exclusive rights and privileges

The second type of regulatory activity, depicted in figure 9.2, is the issuing of legally exclusive rights and privileges. One common example is an exclusive right over a product, that is, a patent. It can also include licences to use the radio frequency spectrum, and issuing exploration and mining licences. Cost recovery only refers to collecting the cost of administering the licence system.

Patents are designed to ensure that those who invest in researching and developing a new product are able to recoup those costs once the product is ready for sale. As a result, the process of issuing patents, as with other exclusive rights, provides firms with an 'exclusive capturable commercial benefit' and, therefore, if feasible, the cost of this regulation should be paid for by those that obtain the exclusive right.

Because of this 'exclusive capturable commercial benefit', it is unlikely that cost recovery would undermine the goals of the regulation. In most cases it will be cost effective to charge for issuing an exclusive right because the recipient will need to apply for the right. Therefore, costs would generally be recovered via fees.

Post market and other regulatory activities

Often other regulatory activities affect firms or individuals already operating in the market place. Thus, they might include:

- conducting product recalls, for example, ANZFA is responsible for the recall of food products;

- regularly collecting and assessing information to check compliance with standards, for example the Australian Prudential Regulation Authority (APRA) regularly reviews the financial statements of institutions to monitor their liquidity levels;
- auditing or other random checks to monitor compliance, for example, the Civil Aviation Safety Authority (CASA) monitors airlines' compliance with aircraft safety standards;
- managing complaints handling mechanisms, for example, ASIC oversees the Superannuation Complaints Handling Tribunal;
- investigating complaints or evidence of non-compliance, for example, the Australian Communications Authority's (ACA) investigation of recurring problems in telecommunications;
- prosecuting companies that breach standards, for example, the Office of the Gene Technology Regulator (OGTR) is responsible for enforcing licence conditions; and
- assessing and approving existing businesses to undertake particular activities that would otherwise be prohibited, for example, Australian Competition and Consumer Commission (ACCC) authorisations and approvals of mergers.

The questions that need to be considered when investigating the appropriate levels of cost recovery for these activities are illustrated in figure 9.4.

The first question is:

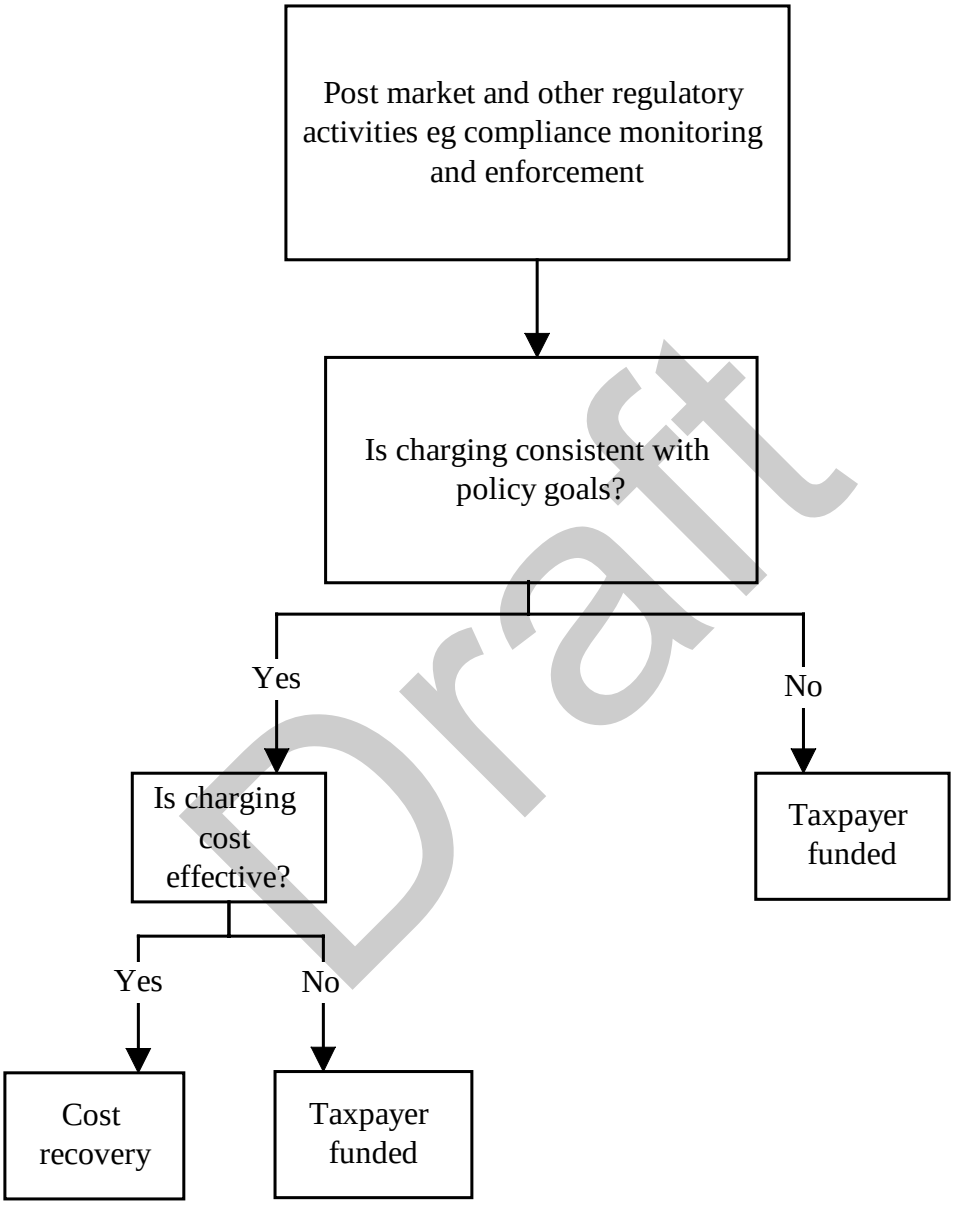
Is charging consistent with policy goals?

In many cases involving monitoring and compliance, charging fees would be counterproductive. For example, charging individual companies for product recalls may discourage them from notifying the regulator of faulty or dangerous products. Charging people for making complaints could discourage complaints that may be an essential source of information for the regulator. Similarly, charging financial institutions to investigate their financial viability could potentially exacerbate any financial difficulties they face.

Where direct charges are inconsistent with policy goals, levies should be considered. In some cases, a levy could also undermine policy objectives. For example, in legal proceedings the court normally awards costs after considering the circumstances of the case. If an agency can automatically recover its legal costs from industry, the discipline of potentially having costs awarded against it is reduced.

Therefore, charges should not be used if they would reduce the effectiveness of the regulation or the level of compliance. In such cases the regulations should be funded by taxpayers.

Figure 9.4 **Post market and other regulatory activities**



If charging is consistent with the agency's policy goals it is still necessary to consider:

Whether charging is cost effective?	There are some areas of compliance monitoring and enforcement where it is likely that charges are not cost effective. It may be difficult to link services to particular firms or identifiable groups. For example, it may be impractical to determine a basis for charging for monitoring compliance with very broad based legislation, such as the Trade Practices Act.

Provision of goods and services

For the activities covered by this inquiry, most discretionary goods and services are provided by information agencies. As discussed in chapter 2, the services provided by these agencies are very different to the activities of regulatory agencies. Therefore, the issues relevant to cost recovery considerations are also different.

The critical issue for information agencies is defining their core services. The government should fund these core services. The agency then needs to consider the best approach to recovering the costs of services beyond the core (see chapter 6).

Core services provided by information agencies usually have one or both of the following characteristics:

- they generate spillover benefits to the broader community; and/or
- they are public goods.

An information service will generate spillover benefits if one person having access to the information has flow on benefits to others. For example, weather information on storm conditions or fire risks allows the affected groups to prepare for possible problems, and substantially reduces the costs to the general community of dealing with the results of storm or fire damage.

To be a part of an agency's core services, and therefore funded by government, the flow-on benefits need to result directly from the availability of the information. There are often flow-on benefits from activities that incorporate information provided by government agencies into other activities. For example, geological information could result in the discovery of a new mine site which has substantial development benefits in a remote region. However, governments need to consider these benefits when they develop their policies on mining and exploration, not on information provision.

Information agencies' core services may also have the characteristics of public goods. In this context the term 'public good' has a specific economic meaning. A public good has characteristics that make it both undesirable and difficult to charge for the good or service. It may be undesirable to charge because one person using the service has no impact on others' ability to use it (this is known as being non-rival). The number of users can be increased at virtually zero cost. Charging for that service would then discourage people from using the information when the benefits they receive from the information outweigh the costs of supplying it. Most general information fits into this category. One person hearing the weather on the radio does not reduce anyone else's ability to use that information.

It is difficult to charge because once the service is available to one person it is difficult to stop others from using it (this is known as being non-excludable). For example, once information is on a website it can be administratively costly (passwords and security systems need to be set up) to prohibit others from accessing that information.

The questions that need to be asked when considering imposing cost recovery on goods and services are set out in figure 9.5.

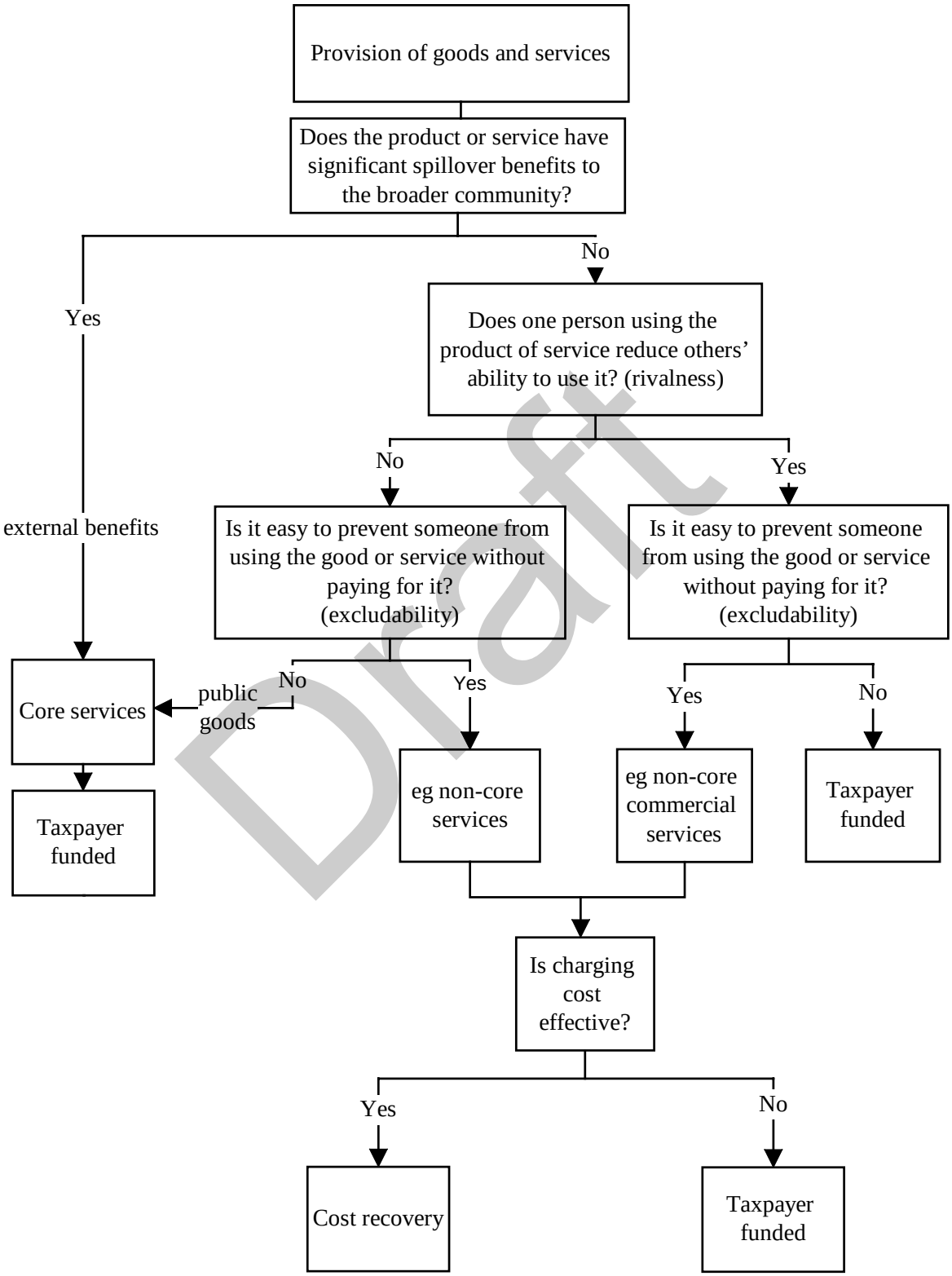
The first question is:

Does the product or service have significant spillover benefits to the broader community?	The government funds a range of information services where it considers there are spillover benefits from others accessing that information. For instance, basic ABS statistics are seen as important to having a well informed general population. Where these benefits arise directly from the information service, that service is a core service and should be taxpayer funded. If there are few benefits flowing beyond the person or organisation using the information, then it is necessary to look at other characteristics of the service to determine whether cost recovery is appropriate.

The next question to consider is:

Does one person using the product or service reduce others' ability to use it?	As noted above, a service is rival when one person using the service affects others' use of it, and charges are needed to ration the service. A service is non-rival when having a large number of people using the service has no affect on its cost or availability. and it may be appropriate to encourage its use.

Figure 9.5 **Provision of goods and services**



If the answer to the above question is 'no', the service is non-rival. Information is a good example of a set of services where some will be rival and others non-rival. The basic information set is non-rival; once information is collected and compiled many people can use it without affecting the costs of collection and compilation. Distributing such information via the Internet or the media is also non-rival. Many people can access an Internet site or listen to the radio without affecting each other's ability to use the information. A publication, however, may be rival, as several people cannot use the same publication simultaneously.

If it is decided that a particular service is non-rival, the next question to consider is whether it is practicable to charge for the service:

Is it easy to prevent someone from using the good or service without paying for it?

If the answer to this question is 'no' the activity is a public good, part of the agency's core services, and should be funded by taxpayers.

In other cases it will be relatively easy to ensure that people pay for the goods and services they use. Collection of data that have been requested by, and prepared for, a particular client is a good example.

When charging is practicable it is still necessary to consider whether it is cost effective.

Are charges cost effective?

It was concluded earlier in the discussion of this figure that the products and services being considered here are non-rival, that is, one person using the service does not reduce others' ability to use it. For these services, charges should be set in a way that does not discourage use. A restricted range of charging options are appropriate, because high fees for individual services are likely to discourage demand.

It may be costly and difficult to devise a charging approach that does not discourage demand. These complexities are illustrated by the example of information that, at the request of the client, has been extracted and manipulated to suit the needs of that client. If the information is only of interest to that client, then the issues associated with other's use of the information disappear, and the client should be charged for the extraction and manipulation of the information. If the information is likely to be of interest to a range of people, then the approach to pricing needs to balance:

- recovering the costs of extraction and manipulation;
- not discouraging others from using the information once it has been extracted; and
- not discouraging clients from coming forward with new requests for information that may be of benefit to others.

Policy makers must decide whether, in some cases, it is better to err towards having lower levels of cost recovery, rather than devising complex and costly pricing regimes that attempt to avoid creating disincentives to requesting and using information.

Returning to the alternative, where goods and services *are* rival, and one person using the service *will* reduce others' ability to use it, it is necessary to consider whether it is practicable to charge for these services.

Is it easy to prevent someone from using the good or service without paying for it?

If the answer to this question is 'no' then the good or service should be taxpayer funded. However, it may also be necessary to consider other ways of rationing the service, given that increasing the number of users will increase the costs of providing the service.

If it is practicable to charge for the service the next question is whether it is cost effective.

Is charging cost effective?

These goods and services tend to provide direct benefits to the individuals and firms that request them. Clients will seek to purchase these services in the same way they purchase privately provided goods and services. One example is commercial services provided by information agencies. Fees will usually be the best way of recovering the costs of these services. Agencies and their portfolio departments should also consider whether it is appropriate for them to be involved in the provision of such goods and services.

Meeting parliamentary and governmental requirements

Firms or their customers should not be charged for activities that involve meeting parliamentary or governmental requirements. These activities include: reporting to Parliament; answering parliamentary questions; briefing ministers; responding to letters sent to ministers; financial reporting; and complying with international obligations.

Providing services to Parliament and government results from the need to maintain a strong democratic process, more than from the activities of the regulated industry. It is the community, through Parliament, that benefits from these activities. Therefore, these services should be funded by taxpayers.

Policy development

Some regulatory agencies do not have any policy functions. Such activities have been separated from the regulator and are retained by the relevant government department. However, other regulatory agencies (and many information agencies) provide policy advice, including setting general standards.

Government sets policies across all areas of the economy. It does not require sectors not subject to cost recovery to pay directly for policy development. It is also inappropriate to impose these costs on those areas subject to cost recovery. Policy advising activities should be funded by taxpayers.

Choosing between fees and levies

Cost recovery charges can be introduced using:

- a fee which directly charges businesses or consumers for the costs of providing the activity; or
- a levy that is a general charge imposed on a group of people and legally is a form of taxation.

Levies need to be established using a tax act.

When cost recovery is imposed, activities should be charged for using fees, as long as they are cost effective and consistent with the policy objectives of the agency. As noted in chapter 8, there is a range of problems associated with levies. Because they are not closely linked to the costs of individual services, levies are often less transparent than fees. They also appear to place less direct pressure on the agency to minimise its costs, and under a levy it can be easier for the agency to expand unnecessarily its regulatory activities. Therefore, it is desirable, where possible, to charge for services directly.

Other policy issues that affect the approach to cost recovery

There are several specific factors that can affect the policy approach to cost recovery or the options on the form of pricing. Choosing the form of pricing is discussed in section 9.5.

Legal and constitutional issues

Three legal and constitutional issues that can affect the introduction of cost recovery are identified in chapter 3.

First, legal authority for cost recovery charges needs to be established. Based on advice from the Australian Government Solicitor (see appendix I), the Commission considers that clear legal authority is essential for all cost recovery activities. This not only ensures the validity of the charge, but provides accountability and transparency. The intention of Parliament that an agency should undertake any cost recovery activity should be made explicit.

Second, agencies need to determine whether cost recovery is being imposed through a tax or a fee. Taxation is defined as:

> A compulsory exaction of money by public authority for public purposes, enforceable by law, and is not a payment for services rendered (*Matthews v Chicory Marketing Board*).

When imposing taxation, the Commonwealth must ensure that it complies with section 55 of the Constitution, which requires separate legislation to establish a tax. If a single Commonwealth Act attempted both to impose a tax and to deal with other matters, the imposition of the tax would be valid, but the remainder of the Act would not. Authority to charge fees, on the other hand, can be incorporated in the cost recovery agency's general legislation.

Those considering cost recovery arrangements should seek advice from their legal counsels on structuring fees for service that cannot be challenged as amounting to taxation.

Third, the Commonwealth's ability to act in some areas is affected by section 51(ii) of the Constitution, that states that taxes cannot discriminate between States or parts of States. This requirement has prevented the ACCC from charging industry levies in gas and electricity as they would not apply consistently across all States (see chapter 7). Again, agencies need to be aware of the potential issues and seek legal advice on whether they apply to their situation.

Social policy considerations

Even where cost recovery is appropriate on economic grounds, there may be situations where the Government requires an agency to provide a subsidised activity to a particular group or sector. This may be for social reasons including access and equity concerns. Placing such a requirement on a cost recovered agency is similar to requiring a government business enterprise to provide a community service obligation.

When the Government requires the level of cost recovery to be reduced for social reasons, agencies need to be careful that these considerations do not cloud their assessment of other cost recovery issues. As noted in chapter 8, agencies have

sometimes been required to fund reductions in the costs collected from one group by collecting more from other groups. This can introduce cross subsidies and substantially reduce the benefits gained from introducing cost recovery.

Therefore, the most appropriate approach is initially to assess whether the regulation or service is consistent with the agency's policy objectives, and to determine the cost of those activities, without considering whether the costs attributable to certain groups should be subsidised. This helps to ensure that the assessment is clearly based on the merits of the proposal and not whether the activity will be taxpayer funded. Once there is full information on the appropriate level of cost recovery and the costs of those activities, the government is in a good position to define which activities, if any, should be subsidised, and to fund those services directly from the budget.

International issues

International obligations can constrain the ability of Commonwealth agencies to set cost-recovery charges through:

- specific international agreements that set fees for certain services at certain levels (or require some services to be free);
- mutual recognition of assessments;[2] and
- Australia's general commitment to the harmonisation of standards that may lead to the adoption of different standards than would otherwise be implemented.[3]

The implications of international obligations for cost recovery arrangements are discussed in chapter 3. There is a number of specific agreements that affect intellectual property, meteorological information, general statistics, geological survey information and land survey information. There are also general agreements under the World Trade Organisation that could affect cost recovery charges for goods that are imported or exported.

Agencies should consult the Department of Foreign Affairs and Trade to ascertain whether any international obligations are relevant to the activities they are considering cost recovering.

[2] Mutual recognition occurs when one country's regulator automatically recognises a product as meeting a particular standard if it has been approved by another country's regulator.

[3] Harmonisation is an agreement between countries to apply the same standards to a product or service.

9.5 Stage 2: implementation

Once it has been decided that cost recovery will be introduced, it is necessary to determine how the revenue will be collected. The stage 1 policy review will have determined whether a fee or levy is appropriate and who should be charged. The cost recovery agency then needs to determine the best way to structure that fee or levy and calculate the cost of undertaking various activities. There is a range of ways charges can be collected and various options for the structure of prices. In choosing the best approach for a particular situation agencies should:

- link the charge or charges as closely to the target group as possible;
- calculate the charge using costs that are based on the minimum necessary to undertake the activity;
- design a system that is cost effective to calculate, collect and enforce;
- design a system where the compliance costs of paying the charges are not excessive;
- provide sufficient flexibility to change the approach to calculating charges or costs if ongoing monitoring (stage 3) indicates that this is desirable;
- ensure the charging mechanism is consistent with the policy objectives of the regulation or service; and
- design charging mechanisms that are not inconsistent with other government policies.

What form of fees or levies should be used to achieve the desired level of cost recovery?

The design of charges is an important issue because collecting the same amount of revenue can have different effects on the agency, industry and customers, depending on how prices are structured.

For all agencies considering fees or levies, there are two key questions:

- what costs should be included in the fee or levy? and
- how should the fee or levy be structured?

What costs should be included in the fee or levy?

In the case of regulatory agencies, when fees or levies are imposed across a significant proportion of the agency's activities, they should include both the direct costs of the activities and overhead and capital costs.[4] If cost recovered activities are a small proportion of the agency's activities, such that they have very little effect on the agency's overheads or capital expenditure, only the direct costs of these activities should be included in cost recovery. Similarly, if taxpayer funded activities are only a small proportion of the agency's activities, the government should meet only the direct costs of these services. In cases where both cost recovery and taxpayer funding each account for a significant proportion of the agency's activities, both types of activities should be allocated a proportion of the overhead and capital costs.

Cost recovery fees or levies ideally should reflect the costs of undertaking individual activities. As far as possible, costs should be identified against particular activities to minimise the overhead costs that need to be distributed arbitrarily between activities subject to cost recovery.

However, in practice, a very precise approach to charging can be costly. With improved accounting arrangements, such as activity based costing systems, the ability to get accurate disaggregated information is improving, and therefore, agencies should be considering refining the costs they include in individual charges. However, in nearly all cases, some proxy system will be necessary to split costs among those being charged.

How should fees and levies be structured?

In order to determine the best pricing structure, agencies need a good understanding of the cost drivers behind particular activities. The factors that affect the costs of administering and implementing regulation can vary greatly. For example, the costs of a regulatory agency assessing an application for a new chemical based product will equate to the costs of processing the application and assessing the veracity of claims made and compliance with the particular standards. These costs will usually depend on: the complexity of the product and the standards; the riskiness of the product and the potential seriousness of any problems and, therefore, the amount of

[4] As noted in the following section, the methodology for valuing capital costs needs to be appropriate.

caution necessary in the testing process; and the amount of information that needs to be analysed to undertake the assessment.

Often it will be necessary to use a proxy for the costs that are attributable to a particular firm in the industry. Such proxies can include:

- classifying businesses into groups that reflect the riskiness of each group and, hence, the effort devoted to regulating each group;
- relating costs to the size of the business; and
- relating costs to the size of an application (such as number of pages) lodged by the firm (for example, when the applicant has provided all the necessary information).

In deciding which is the best proxy, the cost recovery agency needs to judge the most accurate indicator of the differences in the costs of undertaking that particular activity. If the proxy chosen does not closely reflect costs, there is a risk that significant cross subsidies will be built into the charges. For example, dividing products into different risk categories may be a better proxy than firm turnover for the costs of monitoring ongoing product safety, particularly when different firms produce different product ranges that may be more or less risky.

In practice, cost recovery agencies may have insufficient information to formulate prices that reflect those cost drivers precisely. For example, it is virtually impossible to determine accurately the risk that an individual financial institution will experience financial difficulty. Therefore, the agency needs to use the information available to set fees and levies that, as closely as possible, reflect the costs of regulation.

INFORMATION REQUEST

The Commission considers that these guidelines will need to address a number of the specific issues that are common in designing cost recovery arrangements across regulatory agencies. Therefore, it seeks further views on these common problems and how they should be addressed. Possible areas to consider include:

- *how to deal with cost recovery in agencies with a high proportion of capital and overhead costs;*
- *the use of minimum and maximum levies and the application of formulae to decide on individual charges within that band;*
- *establishing cost recovery arrangements for new organisations where the start-up costs are high and the regulated industry is small; and*
- *the timing of cost recovery payments, particularly in the case of new product approvals, where the product is still to be marketed.*

Information activities

What costs should be included in the charge?

Information agencies provide two groups of non-core cost recovered services:

- incremental services, that can only be provided by the information agency — these services rely on the agency's core services and build on or enhance those services; and
- commercial services, which could be provided by another organisation — these services usually draw on the agency's core services but also include a substantial enhancement to that basic service.

For many information agencies the costs of collection, compilation and basic distribution will all be part of the agency's core activities, with these activities accounting for most of the work of the organisation and, therefore, most of its overhead and capital costs.

In these cases, the agency should calculate the stand alone cost of providing its core services and only charge for the additional costs of providing incremental services. These costs would include few overheads or capital costs, except when they can be attributed directly to the incremental service.

When incremental services are a large part of an agency's activities it needs to look more closely at which capital costs and overheads are attributable to the incremental service. Most information agencies receive less than 20 percent of their revenue from cost recovery and, therefore, this is unlikely to be an issue. The Australian Bureau of Agricultural and Resource Economics (ABARE) is one exception where cost recovery accounts for 50 percent of its revenue. Therefore, agencies like ABARE need to consider capital costs and overheads in pricing incremental services.

For commercial services, where there is actual or potential competition, cost recovery charges should be consistent with the competitive neutrality guidelines released by the Commonwealth Competitive Neutrality Complaints Office.

How should charges be structured?

As information provision usually involves directly supplying goods or services to firms or individuals, it would rarely be appropriate to resort to a levy to recover the costs of these activities. Most charges will be fees for service, designed to collect the additional costs of providing incremental services.

Therefore, the design of charges is simpler for information agencies than regulatory agencies because there should always be a direct relationship between the cost of the individual good or service and the purchaser of that good or service. If this link cannot be established, then it is not likely to be cost effective to impose charging.

INFORMATION REQUEST

The Commission considers that these guidelines will need to address a number of the specific issues that are common in designing cost recovery arrangements across information agencies. Therefore, it seeks further views on these common problems and how they should be addressed. Possible areas to consider include:

- *charging for information services when the level of future demand for that service is unclear; and*
- *whether agencies should charge different users different prices to access the same information.*

How should costs be assessed and charges calculated?

Once the structure of prices has been decided, the next step in stage 2, implementation, is to calculate the costs of the activity. The full cost of each activity is the value of all resources used or consumed in providing that output and includes direct, indirect and capital costs (see appendix H for a discussion of various cost measures). For example:

- direct labour, such as, wages and salaries, along with other labour costs such as allowances, long service leave and superannuation;
- direct materials and services, such as stores, computer services and services obtained on a contract basis;
- an appropriate share of indirect labour, such as executive, office services, personnel, library and audit services;
- an appropriate share of indirect materials and services, such as office machinery, advertising, insurance, freight and cartage. In some cases materials classified as indirect could in fact be direct costs but attributing them to a particular output may be impractical or too costly, for example, office stationery;
- accommodation, which could be both direct and indirect, for instance rent, repairs and maintenance, cleaning and utility charges; and
- capital costs such as depreciation, interest on working capital and a capital-use charge. Some of these could be direct costs, where assets are dedicated to the production of particular outputs. Others could be indirect such as assets used by corporate services.

Only direct costs will be relevant to some cost recovered activities, such as the incremental services provided by information agencies, where charges are usually expected to exclude indirect capital and overheads.

Therefore, good approaches to estimating and allocating costs need to follow several key principles. In all cases:

- cost estimates should be based on the efficient costs of activities (see following section) not actual costs; and
- costing systems should be transparent.

If capital costs and overheads are included in charges agencies also need to:

- develop a methodology to calculate all aspects of capital costs;
- consider the appropriateness of a capital-use charge; and
- develop a methodology to distribute capital and overhead costs between activities.

Efficient costs

While cost recovery can complement efficiency by instilling cost consciousness in the agency, its customers or the regulated industry, poorly designed arrangements can create incentives for cost padding and inefficiency (see chapter 5). Therefore, cost recovery arrangements need to ensure that prices are based on the minimum cost necessary to undertake the activity.

Monitoring arrangements are discussed in section 9.5. When an agency's monitoring process identifies activities that are not provided efficiently, cost recovery charges should be reduced to reflect efficient costs. This applies equally to direct, capital and overhead costs. For example, cost recovery charges should be adjusted if the agency has over-invested in its facilities such that the investment is greater than that necessary to efficiently provide the cost recovered services.

In other situations the government may have decided to impose a higher level of regulation than has been justified on economic grounds. In such cases the cost of the additional regulation should be excluded from cost recovery charges.

Transparency

Transparency is a key driver to improve the efficiency and accountability of agencies. It requires agencies to articulate clearly their broad objectives and explain

how their activities and approaches to cost recovery contribute to those objectives. Transparency also requires consultation with stakeholders.

'Commercial in confidence' is not a legitimate reason for not releasing costing information for cost recovery agencies. Regulatory agencies, for instance, have a statutory monopoly on their activities and, therefore, do not compete in a commercial market. A small proportion of the activities of information agencies could be commercial services, but their core function is to provide government funded services and the benefits of transparency greatly outweigh any commercial considerations.

Therefore, to meet their transparency obligations, cost recovery agencies should be required to: adopt costing models sufficiently detailed to allow the Parliament, the Government and stakeholders to analyse their costs of service; make public their costing models, costs and how those costs relate to prices; and provide information on how capital costs are calculated and capital costs and overheads are allocated between various activities.

Calculating capital costs

Appendix H discusses various approaches to valuing capital costs and the strengths and weaknesses of each of these. Differences between cost recovery agencies will mean that the appropriate approach may vary between agencies. Therefore, each agency needs to calculate its capital costs and depreciation and provide a justification for the methodology used.

In general the approach chosen needs to balance:

- the costs of implementing the methodology chosen;
- optimising asset valuations to remove from the asset base facilities or parts of facilities that are not necessary to undertake cost recovered activities efficiently;
- taking into account increases or decreases in the value of the asset over time; and
- being able to incorporate changes if feedback from the ongoing monitoring process indicates that such changes are necessary.

Capital-use charge

When agencies are not required to recover the capital costs of their activities, such as most incremental services of information agencies, they also should not be subject to a capital-use charge.

For other activities, determining an appropriate cost of capital reflects the cost to the community or taxpayer of government capital raising. It can be argued that, because the cost of capital reflects the cost to the Government of raising capital, it should not vary across different Commonwealth agencies. However, there may be some uses of capital that are more risky than others, for example, if the Government were to enter into a commercial operation in competition with other providers. In such circumstances, it may be appropriate for the cost of capital to vary according to the level of risk.

A capital-use charge is levied on Commonwealth agencies and authorities, according to their net assets at the end of the reporting period. The rate is standard across agencies, calculated as the long term bond rate plus a risk premium (equal to the long term bond rate). That is, the capital-use charge is effectively double the long term bond rate (DOFA 2001). Wholly budget funded agencies, and agencies which are partly budget funded, are funded for the capital-use charge through their appropriations. Agencies which are fully funded through cost recovery charges are excluded from these arrangements (DOFA 2001).

These arrangements appear to create a risk that partially cost recovered agencies could both receive an appropriation for the capital-use charge, and also include a cost of capital in cost recovery charges. In some circumstances it is appropriate that cost recovery charges include a capital-use charge (for example, when cost recovered activities account for a significant proportion of the use of an asset). In such circumstances, if agencies are able to retain access to the funds raised (see chapter 3), their appropriation should be reduced by the amount of the capital-use charge.

Distributing capital and overhead costs

The various approaches to distributing capital and overhead costs between various activities are discussed in appendix H. Again the appropriate approach may vary depending on the characteristics of the agency. As with all components of measuring and allocating costs the agency needs to balance accuracy and precision with the costs of implementing particular methodologies. To be consistent with these guidelines the agency will need to be able to justify the methodology chosen and adjust that methodology if feedback through the ongoing monitoring process identifies that this is necessary.

9.6 Stage 3: ongoing monitoring

What monitoring mechanisms should be used to ensure cost recovered activities are provided efficiently and charges are not excessive?

One important issue is that many regulatory and information agencies are government monopolies whose activities often affect highly concentrated industry groups. Consequently, there can be incentives on both these agencies and industries to promote approaches to cost recovery that provide them with an advantage. Firms, for example, may push to minimise charges. However, those firms that have already been approved by the regulator may push for charges that discourage new firms from gaining approval. The actual incentives and the way firms respond will vary between sectors and change over time.

Monopoly agencies, on the other hand, do not face the disciplines of competition. This reduces the pressure on them to keep costs and prices low and to develop services and products to meet the needs of customers.

Effective ongoing monitoring is important to:

- give feedback to agencies so that approaches to cost recovery can be adapted in response to changing circumstances;
- provide mechanisms to improve the efficiency of cost recovery agencies and ensure their fees and levies are based on efficient costs;
- ensure firms do not have undue influence over the activities of the cost recovery agency; and
- reduce the frequency of major reviews of cost recovery arrangement by allowing minor issues to be addressed through ongoing processes.

A range of mechanisms is currently used among regulatory and information agencies to control costs and charges and to encourage input from stakeholders while maintaining the independence of the agency.

It appears, however, that in many cases the current mechanisms are inadequate to address all of the problems that have emerged during this inquiry. The extent of Parliamentary oversight of cost recovery agencies and the potential impact that raising revenue from sources outside the budget process has on this scrutiny is discussed in chapter 5.

In chapter 5 the Commission also discusses current government arrangements to improve agency efficiency such as pricing reviews, efficiency dividends, benchmarking and harnessing competitive forces. It argues that the government should actively pursue these mechanisms to improve the performance of cost recovery agencies. It also recognises the role good governance arrangements can also play in improving transparency and accountability of cost recovery. Consultation, boards of management, audit committees, consultation committees and efficiency audit committees are all discussed.

Overall, the Commission has asked for further comment on how to improve Parliamentary scrutiny of cost recovery receipts and the need for new mechanisms to improve the ongoing monitoring of cost recovery agencies.

9.7 Stage 4: periodic review

How will the approaches to cost recovery be adapted over time to meet changing needs and circumstances?

There are many factors that can change over time and affect the appropriate level of cost recovery for regulations and services. For example, new products can emerge that were not envisaged under the original regulation, resulting in a need to change the scope of the products regulated and, therefore, the scope of cost recovery arrangements. Community attitudes can change, affecting the level of risk the community is willing to accept and hence the appropriate level of regulation. This has implications for the approach to cost recovery. Also, new technology can make it easier for the private sector to provide goods originally only supplied by the government sector. This not only affects decisions about the level of cost recovery but also raises a question about whether the government should continue to provide the service at all.

Important issues can arise for agencies where, for example, developments in technology increase the range of options for distributing information. If, in the past, the agency has charged for distributing this information, there may be few external pressures for it to adopt new technologies that reduce the cost of dissemination.

This is particularly true if adopting such technology makes it impractical to charge for services or undesirable because the incremental cost of those services is very low. However, encouraging the use of this technology is in the national interest because, overall, the cost of providing these services would be lower. Agencies should be providing quality services at the lowest overall cost, regardless of whether this affects the agency's ability to charge for its services. Such issues should be considered periodically to ensure the approach to cost recovery is still consistent with the agency's overall objectives.

Therefore, agencies that have adopted cost recovery should periodically reassess those issues considered in stages 1 and 2 of these guidelines. In all areas where cost recovery has been introduced there are likely to be developments that warrant review at least every ten years. In some areas where, for example, there is rapid technological change, or international protocols are being developed, it will be necessary to review the existing arrangements within a much shorter timeframe.

The nature of the ongoing monitoring processes should also influence the period of time between reviews. Strong ongoing monitoring that facilitates continual improvements in efficiency, and adjustments in response to changing circumstances reduces the need for frequent periodic reviews.

Therefore, the initial stage 1 policy review should also consider when cost recovery should be further reviewed. These follow-up reviews should be at least every ten years.

10 Implementation

This chapter provides a brief discussion of how the Commission views the implementation of its cost recovery guidelines. In particular, it offers some suggestions for changes to the machinery of government so that the initial, ongoing and periodic cost recovery review process can be launched smoothly and without delay.

10.1 Implementing the guidelines

The Commission has produced guidelines for cost recovery which, when this inquiry is finalised, will be submitted to the Government for its consideration. In the event of their implementation, these guidelines will require the active cooperation of departments and agencies that cost recover. Accordingly, the Commission seeks advice and guidance from inquiry participants on the key issues that are likely to emerge during implementation of the guidelines. Several avenues exist to provide the Commission with feedback prior to the submission of the final report to the Government in August: in written submissions; during workshops (May); and a new round of hearings (June).

The Commission considers that certain steps will be necessary, once its final report is submitted, if the implementation of its guidelines is to follow a smooth and timely process.

As an important first step, the Government should release a set of endorsed guidelines outlining the principles of cost recovery, and announce that all existing arrangements and new cost recovery proposals will be reviewed using the guidelines. The guidelines should be disseminated widely — to departments and agencies, and to industry and consumer representative organisations.

A second step is the further development of the guidelines, and their integration with existing financial and regulatory processes. Necessary supporting material to the guidelines, for example covering technical and legal aspects should be developed as experience in applying the guidelines is gathered. Detailed costing, pricing and legislative advice to agencies that cost recover would ensure that cost recovery arrangements are robust and consistent across agencies. The Commission considers that the Department of Finance and Administration (DOFA), subject to

wide consultation with other agencies and interested parties, is best placed to undertake these tasks.

10.2 Assessment of cost recovery arrangements

An integral part of the Commission's guidelines is the requirement that all existing and new cost recovery arrangements be subject to an enhanced Regulatory Impact Statement (RIS) or a Cost Recovery Impact Statement (CRIS) process (see chapters 3 and 9). RIS and CRIS documents would assess cost recovery proposals against the Commission's guidelines. Although a CRIS could be developed with varying degrees of independence, the Commission considers that transparency and independence would be important elements, and has a strong preference for some degree of independent scrutiny of the CRIS. This could be achieved a number of ways.

One approach would be to ask DOFA, as the body responsible for making the cost recovery guidelines operational, to assess CRISs. Broad operational economies might be an advantage of this option. However, this would concentrate the responsibilities for explaining cost recovery 'best practice' to agencies and evaluating its implementation within the same department. Further, there may be perceptions of a potential conflict with DOFA's primary role in the budgetary process.

Another approach is to appoint an independent reviewer. Experience with the RIS process has demonstrated the advantages of an independent agency or persons overseeing such processes. This could be done on a case by case basis, or a specific agency could be appointed to review CRISs on a whole-of-government basis.

The Office of Regulation Review (ORR), currently in charge of assessing RISs, could be instructed by the Government to assume responsibility for the CRIS process. The ORR would monitor the rigour with which the RIS and CRIS processes were followed for cost recovery arrangements, and make a separate report to Parliament. This would present opportunities for economies of scale and scope. Further, experience gained from the RIS process would benefit CRISs.

10.3 Accountability and transparency

The issues discussed in this Draft Report highlight the need for cost recovery arrangements to be as transparent and accountable as possible. For this reason, the Commission has made a draft recommendation that, when completed, CRISs should be made publicly available. Further, it has made a draft recommendation that cost

recovery information should be made available in agencies' Annual Reports and in Portfolio Budget Statements (see chapter 3), in order to encourage Parliamentary and public overview of cost recovery. The coverage and level of detail of this information may need to be developed over time. Input from the Joint Committee of Public Accounts and Audit and/or from the Senate Estimates Committees would be valuable in determining the appropriate level of reporting. The former committee may also wish to invite the Australian National Audit Office to consider cost recovery arrangements closely as part of its ongoing Performance Audit process.

10.4 Monitoring and review

The Commission's guidelines contain suggestions for the initial review, ongoing monitoring and periodic review of cost recovery arrangements (see chapter 9).

Given the numerous cost recovery arrangements currently in existence, the Commission considers that a systematic review of all substantial arrangements against its guidelines is required, to be completed within five years. The schedule of this initial review should be the responsibility of DOFA. Possible criteria that could be used to prioritise reviews include agency size, the degree of compulsion attached to cost recovery charges, amounts cost recovered, specific requests by users and time since a major review (if any) was undertaken. The Joint Committee of Public Accounts and Audit and Senate Estimates Committees may also like to note cost recovery arrangements that they consider warrant priority consideration.

The Commission's guidelines suggest that cost recovery arrangements should be monitored on an ongoing basis. At present, an agency's arrangements in relation to output pricing and charging are subject to some Parliamentary oversight and to DOFA pricing reviews. The Commission has made proposals for improving the monitoring capacity of the latter in relation to cost recovery (see chapter 5). The Commission has also considered the possibility of other vehicles being used for the ongoing monitoring of an agency's cost recovery arrangements (see chapter 5).

The Commission considers that, in the first instance, responsibility for assessing the suitability of existing monitoring mechanisms should rest with the relevant portfolio Minister. Based on this assessment, proposals for new/enhanced forms of monitoring could be developed by that portfolio.

Though somewhat less urgent, DOFA should also establish procedures governing follow-up cost recovery reviews, provided that they occur no later than ten years apart.

INFORMATION REQUEST

The Commission seeks further views on the key issues that are likely to emerge during implementation of the guidelines.

APPENDICES

A Conduct of the inquiry

This appendix outlines the inquiry process and lists the organisations and individuals that have participated to date.

The Commission is to make its final report to the Commonwealth Government by 16 August 2001. As in all of its inquiries, the Commission aims to improve the overall performance of the Australia economy. It will have regard to the established economic, social, environmental and regional development objectives of governments. The full terms of reference are on page V.

Following receipt of the terms of reference on 16 August 2000, the Commission placed a notice in the press inviting public participation in the inquiry and released an issues paper to assist participants in preparing their submissions. The Commission received 109 submissions before releasing the draft report. Those who made submissions are listed in section A1.

The Commission also held informal discussions in Sydney, Melbourne and Canberra with organisations and Commonwealth Government departments and agencies. This visit program assisted the Commission to obtain a wide understanding of the issues of cost recovery and the views of participants. Organisations visited by the Commission are listed in section A2.

Commonwealth Government regulatory, administrative and information departments and agencies were asked to complete a questionnaire to provide the Commission with information regarding their cost recovery arrangements (see appendix B).

In November and December 2000 the Commission held public hearings in Melbourne, Sydney and Canberra. In addition, the Melbourne public hearings included video conferences with participants from Adelaide, Perth and Cairns. These were attended by 63 individuals and organisations (section A3). Submissions and transcripts of the hearings are publicly available.

A1 Submissions received

Participants	*Submission no.*
Agriculture Western Australia	80
Airservices Australia	107
Ansett Holdings Limited	68
Association of Superannuation Funds of Australia	8
Australia New Zealand Food Authority	67
Australian Bureau of Agriculture and Resource Economics	56
Australian Bureau of Statistics	36
Australian Chamber of Commerce and Industry	70
Australian Chemical Specialties Manufacturers Association	60
Australian Communications Authority	108
Australian Competition and Consumer Commission	66
Australian Customs Service	29
Australian Electoral Commission	73
Australian Federal Police	100
Australian Fisheries Management Authority	65, 95
Australian Food and Grocery Council	19
Australian Geological Survey Organisation	55
Australian Livestock Transporters Association	13
Australian National Audit Office	59
Australian Paint Manufacturers Federation	74
Australian Pharmaceutical Manufacturers Association	14
Australian Prudential Regulation Authority	21
Australian Seafood Industry Council	71
Australian Self Medication Industry	23, 85, 105
Australian Surveying and Land Information Group	44
Australian Trade Commission	58

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Participants	*Submission no.*
Australian Transaction Reports and Analysis Centre	22
Australian Visual Software Distributors Association	18
Avcare	28, 87
Awin Services Pty Ltd	20
Blackmores Ltd	25
Board of Airline Representatives of Australia	54
Bureau of Meteorology	35
Bureau of Tourism Research	92
Cairns Crocodile Farm - Australian Crocodile Traders	79
Centrelink	27
Chemicals and Plastics Action Agenda	15
Civil Aviation Safety Authority	75
Cochlear Limited	10, 49
Commodore Station Pty Ltd	84
Complementary Healthcare Council of Australia	17, 52, 98, 104
Conference of Asia Pacific Express Carriers	72
Consumers' Health Forum of Australia	64
Cosmetics, Toiletry and Fragrance Association of Australia Inc. in conjunction with Direct Selling Association of Australia	46
Council of Small Business Organisations of Australia	93
CSIRO	88
Cumpston Sarjeant Pty Ltd	77
Davis, Peter	2
Department of Agriculture, Fisheries and Forestry Australia	69
Department of Education, Training and Youth Affairs	103
Department of Employment, Workplace Relations and Small Business	86
Department of Finance and Administration	38
Department of Foreign Affairs and Trade	97

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Participants	*Submission no.*
Department of Immigration and Multicultural Affairs	53
Department of Industry, Science and Resources	62
Department of Transport and Regional Services	48
Direct Selling Association of Australia Inc in conjunction with Cosmetics, Toiletry and Fragrance Association of Australia Inc	46
Electronic International Trade Services Pty Ltd	40
English Australia	6
Environment Australia	76
Environmental Research and Information Consortium Pty Ltd	7
Geological Survey of Victoria	99
Great Barrier Reef Marine Park Authority	42
Hadlow, R.F.	34, 96
Investment and Financial Services Association	9
IP Australia	57
J.T. Larkin and Associates	45
Medical Industry Association of Australia	12, 50
Meteorological Service of New Zealand Limited	109
Mosman Municipal Council	26
Mount Morgan Shire Council	51
Mundipharma Pty Ltd	81
National Crime Authority	78
National Industrial Chemicals Notification and Assessment Scheme	33
National Library of Australia	5
National Nutritional Foods Association of New Zealand	11, 106
National Registration Authority for Agricultural and Veterinary Chemicals	39
National Standards Commission	31, 90
Nature's Sunshine Products of Australia Pty Ltd	3
Newcastle Airport Limited	101

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Participants	*Submission no.*
Nhulunbuy Corporation Ltd	4
Northern Territory Geological Survey	32
NRMA Insurance Limited	37
Office of the Federal Privacy Commissioner	91
Paterson, Mark	43
Plastics and Chemicals Industries Association	24
Qantas Airways Limited	63
Red Meat Advisory Council	47
Regional Airlines Association of Australia Ltd	61
Regulatory Solutions Pty Ltd	41, 83
Screen Sound Australia	30
SSL Australia Pty Ltd	16
Therapeutic Goods Administration	89, 94, 102
Whiteley Industries Pty Ltd	1, 82

A2 Visits

Organisation
Airservices Australia
Association of Superannuation Funds of Australia
Australia New Zealand Food Authority
Australian Bureau of Statistics
Australian Chamber of Commerce and Industry
Australian Chemical Specialties Manufacturers Association
Australian Communications Authority
Australian Competition and Consumer Commission
Australian Customs Service
Australian Electoral Commission
Australian Fisheries Management Authority
Australian Food and Grocery Council
Australian Geological Survey Organisation
Australian Maritime Safety Authority
Australian National Audit Office
Australian Prudential Regulation Authority
Australian Quarantine and Inspection Service
Australian Securities and Investment Commission
Australian Self-Medication Industry
Australian Surveying and Land Information Group
Australian Trade Commission
Avcare
Blackmores Ltd
Bureau of Meteorology
Business Council of Australia
Centrelink
Civil Aviation Safety Authority
Complementary Healthcare Council of Australia
Council of Small Business Organisations of Australia
Department of Agriculture, Fisheries and Forestry Australia
Department of Communications, Information Technology and the Arts

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Organisation
Department of Employment, Workplace Relations and Small Business
Department of Environment and Heritage
Department of Finance and Administration
Department of Foreign Affairs and Trade
Department of Health and Aged Care
Department of Immigration and Multicultural Affairs
Department of Industry, Science and Resources
Department of Transport and Regional Services
Freebairn, John
Interim Office of the Gene Technology Regulator
IP Australia
National Farmers Federation
National Industrial Chemicals Notification and Assessment Scheme
National Library of Australia
National Registration Authority for Agricultural and Veterinary Chemicals
New South Wales Department of Information Technology and Management
New South Wales Treasury
Office of Film and Literature Classification
Office of Regulation Review
Therapeutic Goods Administration

A3 Public hearing participants

Melbourne, 20 November 2000
Plastics and Chemicals Industries Association
Australian Pharmaceutical Manufacturers Association
Australian Food and Grocery Council
Whistleblowers Melbourne
Aircar Industry
Sydney, 21 November 2000
English Australia
Whiteley Industries
Sydney, 21 November 2000
Medical Industry Association of Australia
Awin Services Pty Ltd
Sydney, 22 November 2000
Association of Superannuation Funds of Australia
Australian Self-Medication Industry
Australian Visual Software Distributors Association
Nature's Sunshine Products of Australia Pty Ltd
Australian Prudential Regulation Authority
Australian Transaction Reports and Analysis Centre
Cochlear Limited
Chemicals and Plastics Action Agenda
Canberra, 27 November 2000
Direct Selling Association of Australia
Bureau of Meteorology
Complementary Healthcare Council
Paterson, Mark
Department of Transport and Regional Services

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Canberra, 28 November 2000
Regulatory Solutions Pty Ltd
Screensound Australia
J.T. Larkin and Associates
National Standards Commission
Avcare
Canberra, 29 November 2000
Australian Livestock Transporters Association
Hadlow, Robert Frank
Australian Surveying and Land Information Group
Australian Customs Service
National Library of Australia
Australian Geological Survey Organisation
Board of Airline Representatives
Canberra, 5 December 2000
Australian Bureau of Statistics
Council of Small Business Organisations of Australia
Regional Airlines Association of Australia
Australian Bureau of Agricultural and Resource Economics
Department of Immigration and Multicultural Affairs
Australia New Zealand Food Authority
Australian Chemical Specialties Manufacturers Association
Council of Asia Pacific Express Carriers
Department of Finance and Administration

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Canberra, 6 December 2000
Australian Seafood Industry Council
Department of Agriculture, Fisheries and Forestry Australia
Australian Quarantine And Inspection Service
Ansett–Air New Zealand
Australian Fisheries Management Authority
Red Meat Advisory Council
Austrade
Department of Industry, Science and Resources
Canberra, 7 December 2000
Therapeutic Goods Administration
Australian Chamber of Commerce and Industry
Consumers' Health Forum
Australian Competition and Consumer Commission
Civil Aviation Safety Authority
Qantas
Environment Australia
IP Australia
Melbourne, 11 December 2000
Cumpston Sarjeant Pty Ltd
CSIRO Land and Water (video conference from Adelaide)
Australian Crocodile Traders (video conference from Cairns)
Agriculture Western Australia (video conference from Perth)

B Selected Commonwealth cost recovery arrangements

The Terms of Reference require the Commission to report on the nature and extent of current cost recovery arrangements.

To meet this requirement, the Commission sent a questionnaire to all Commonwealth Government regulatory and information agencies. In total, 127 questionnaires were sent out, and the Commission received 99 responses (a response rate of 78 per cent). A list of the agencies to which this survey was sent, and a copy of the questionnaire is available in appendix J.

Responses from all agencies will be provided in the final report. This appendix provides a summary of responses from those agencies covered in the inquiry's case studies (see box B.1). Responses from information agencies are summarised in tables B.1 to B.5. Health and safety regulatory agencies' responses are summarised in tables B.6 to B.10, and financial regulatory agencies are covered in tables B.11 to B.15. The Australian Communications Authority's responses are summarised in tables B.16 to B.20.

Agencies were requested to provide information for each activity for which they impose cost recovery. Where cost recovery arrangements were similar across activities, agencies were requested to report on these arrangements as a group.

For presentational reasons, responses have been simplified and the responses to some questions have not been included. The full responses by each agency (except those that were provided in confidence) will be available on the Commission's web site (www.pc.gov.au).

Box B.1 **Agencies covered in case studies**

Information agencies

ABARE	Australian Bureau of Agricultural and Resource Economics
ABS	Australian Bureau of Statistics
AGSO	Australian Geological Survey Organisation
AUSLIG	Australian Surveying and Land Information Group
BoM	Bureau of Meteorology
NLA	National Library of Australia
SSA	ScreenSound Australia

Health and safety regulatory agencies

TGA	Therapeutic Goods Administration
ANZFA	Australia New Zealand Food Authority
ARPANSA	Australian Radiation Protection and Nuclear Safety Agency
AQIS	Australian Quarantine and Inspection Service
NRA	National Registration Authority for Agricultural & Veterinary Chemicals
NICNAS	National Industrial Chemicals Notification and Assessment Scheme
CASA	Civil Aviation Safety Authority
AMSA	Australian Maritime Safety Authority
ASA	Airservices Australia

Financial regulatory agencies

APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
ACA	*Australian Communications Authority*

B.1 Case study: Information agencies

Table B.1 **Overview of arrangements**

Agency	*Activity*	*Type of charge*	*Stated rationale for cost recovery*[a]	*When introduced*	*How often are charges changed/reviewed?*
ABARE		Fee	Policy/User	1989-90	Annually
ABS		Fee	Demand/Revenue	1988	Annually
AGSO		Fee	na	1988	Regularly
AUSLIG		Fee	na	Mid 1990's	Annually
BoM	*Aviation*	Fee	Policy	1988	Annually
	Defence	Fee	Policy	1988	Annually
	Special Services Unit	Fee	Policy	1988	na
	Other	Fee	Policy	1988	Six monthly
National Library	*Kinetica*	Fee	Policy	1999	Annually
	Sale of goods and services	Fee	Demand	1960	Annually
ScreenSound Australia		Fee	Revenue/Service	1983	Irregularly

[a] Demand – Demand management; Revenue – Raising revenue; Policy – Government policy; User – User pays; Beneficiary – Beneficiary pays; Services – Expand services. **na** Not available.

Source: PC summary based on questionnaire responses.

Table B.2 **Revenue 1999-2000**

Agency	*Activity*	*Revenue raised though cost recovery*	*Total revenue*	*CR revenue / total revenue*	*Total expenses*	*CR revenue / total expenses*	*Is revenue earmarked?*[a]	*What happens to revenue if it is greater than costs*[b]
		$m	$m	%	$m	%		
ABARE		11.2	22.7	49.4	22.0	50.9	Yes	na
ABS		21.5	265.0	8.1	255.5	8.4	Yes	Retained
AGSO		12.1	7.5	16.2	73.5	16.5	Yes	Retained
AUSLIG		4.7	33.2	14.2	33.2	14.2	No	Adjustment/ Services
BoM	*Aviation*	13.1	13.1	100.0	13.1	100.0	Some	Adjustment
	Defence	3.1	3.1	100.0	3.1	100.0	Some	Adjustment
	Special Services Unit	9.0	9.0	100.0	9.0	100.0	No	CRF
	Other	5.3	5.3	100.0	5.3	100.0	No	CRF
National Library	*Kinetica*	6.0	8.3	72.8	7.9	76.8	No	Adjustment/ Services/Retained
	Sale of goods and services	2.5	na	na	43.1	5.9	No	..
ScreenSound Australia		1.7	48.6	3.5	47.5	3.6	Yes	Retained

[a] Earmarking is the assignment of revenue received from a specific tax or taxes to the financing of a particular government activity. [b] Refund – CR revenue is refunded; Adjustment – Fees are adjusted; Services – Services were expanded; Retained – CR revenue retained by agency; CRF – Paid into Consolidated Revenue Fund. **CR** Cost recovery **na** Not available. **..** Not applicable.

Source: PC summary based on questionnaire responses.

Table B.3 **Costs recovered**

Agency	*Activity*	*What costs do charges aim to recover?*[a]	*How are indirect costs allocated?*[b]	*Basis for asset valuation*	*Do charges include a user cost of capital?*
ABARE		Direct/Indirect	na	na	No
ABS		Direct/Indirect	Pro rata (Direct labour costs)	Historic	No
AGSO		Direct and Total Plus[c]	na	Historic	No
AUSLIG		Direct/Indirect	Activity based costing	Deprival	No
BoM	*Aviation*	Direct/Indirect	Pro rata (Direct costs)	Replacement	Yes
	Defence	Direct/Indirect	Pro rata (Direct costs)	Replacement	Yes
	Special Services Unit	Direct/Indirect	Pro rata (Direct costs)	na	Yes
	Other	Direct/Indirect	Pro rata (Direct costs)	Deprival	Yes
National Library	*Kinetica*	Direct/Indirect	na	Deprival	No
	Sale of goods and services	Direct/Indirect	na	Deprival	No
ScreenSound Australia		Direct/Indirect	Pro rata	Replacement	Yes

a 'Direct' costs are costs that can directly and unequivocally be attributed to an activity. 'Indirect' costs are costs that are not directly attributable to an activity. 'Total plus' includes direct and indirect costs plus a proxy rate of return. **b** Indirect costs are generally allocated pro rata to some or all direct costs or by activity based costing. Activity based costing links an organisation's outputs to activities used to produce those outputs which in turn are linked to the organisation's costs (see appendix H). **c** AGSO's charges for different services cover different costs. Charges for research with national interest considerations cover direct costs. Charges for services that compete with private firms cover total costs plus a proxy rate of return. **na** Not available.

Source: PC summary based on questionnaire responses.

Table B.4 **Accountability and transparency**

Agency	*Activity*	*Legal basis*[a]	*Who was consulted when cost recovery introduced?*	*What guidelines were used?*	*Who is involved in ongoing consultation?*	*When were the arrangements last formally reviewed?*
ABARE		FMA	Govt	DOFA	Govt	1995
ABS		FMA/Other Act	Govt	DOFA	Govt/Industry	Not reviewed
AGSO		FMA	Govt	DOFA	Govt/Industry	Under review
AUSLIG		No Act	na	Other	Govt/Industry/ Consumers	Under review
BoM	*Aviation*	FMA/Other Act	Govt/Industry	Internal/Cwth	Govt/Industry	1998-99
	Defence	FMA/Other Act	Govt	Internal	Govt	1997-98
	Special Services Unit	FMA/Other Act	Govt	Internal	Govt	1997
	Other	FMA/Other Act	Govt	Internal	Govt/Industry/ Consumers	1997
National Library	*Kinetica*	No Act	Govt/Industry	na	Industry/Consumers	No
	Sale of goods and services	No Act	Govt/Consumers	DOFA	Industry	Under review
ScreenSound Australia		FMA	Govt/Industry/ Consumers	No	Govt/Industry/ Consumers	2000

a FMA – *Financial Management and Accountability Act 1997*. The main purpose of this Act is to provide a framework for the proper management of public money and public property. It is not clear whether this Act provides a legal basis for cost recovery; Tax Act – Any Tax; Act Other Act – An Act other than the FMA Act or a Tax Act; No Act – No Act supporting the arrangements. **na** Not available.

Source: PC summary based on questionnaire responses.

Table B.5 **Responsibility for various functions**

Agency	*Activity*	*Policy*	*Price setting*	*Administration*	*Revenue collection*
ABARE		AFFA/ABARE	ABARE	AFFA/ABARE	AFFA/ABARE
ABS		ABS	ABS	ABS	ABS
AGSO		AGSO	AGSO	AGSO	AGSO
AUSLIG		AUSLIG	AUSLIG	AUSLIG	AUSLIG
BoM	*Aviation*	BoM	BoM	BoM	ASA
	Defence	BoM	BoM	BoM	BoM
	Special Services Unit	BoM	BoM	BoM	BoM
	Other	BoM	BoM	BoM	BoM
National Library	*Kinetica*	National Library	National Library	National Library	National Library
	Sale of goods and services	National Library	National Library	National Library	National Library
ScreenSound Australia		ScreenSound Australia	ScreenSound Australia	ScreenSound Australia	ScreenSound Australia

AFFA – Agriculture, Fisheries and Forestry — Australia.

Source: PC summary based on questionnaire responses.

B.2 Case study: Health and safety regulatory agencies

Table B.6 **Overview of arrangements**

Agency	*Activity*	*Type of charge*	*Stated rationale for cost recovery*[a]	*When introduced*	*How often are charges changed/reviewed?*
TGA		Fee	Policy/User	..	Annually
ANZFA		Fee	Demand	Various	Annually
ARPANSA		Fee	User	1999	Annually
AQIS		Fee/Tax	Policy	1979	Bi-annually
NRA		Fee/Levies	Policy	1994	2-3 years
NICNAS	*New chemical assessment fees*	Fee	Policy	1997	Ad hoc
	Existing chemicals assessment program	Levy	User	1997	Ad hoc
	Publications and seminars	Fee	Policy	na	Ad hoc
CASA		Tax/Fees	Policy/Beneficiary	na	na
AMSA		Levies/Fee	na	na	Annually
ASA		Fee	Commercial[b]	na	Annually

[a] Demand – Demand management; Revenue – Raising revenue; Policy – Government policy; User – User pays; Beneficiary – Beneficiary pays; Services – Expand services; [b] Commercial – Airservices has a commercial charter under the *Air Services Act 1995*. **na** Not available. **..** Not applicable.

Source: PC summary based on questionnaire responses.

Table B.7 **Revenue 1999-2000**

Agency	*Activity*	*Revenue raised though cost recovery*	*Total revenue*	*CR revenue / total revenue*	*Total expenses*	*CR revenue / total expenses*	*Is revenue earmarked?*[a]	*What happens to revenue if it is greater than costs*[b]
		$m	$m	%	$m	%		
TGA		41.4	43.8	94.5	49.0	84.5	Some	Retained
ANZFA		0.8[c]	13.6	5.9	13.1	6.1	No	Refund
ARPANSA		1.2	15.2	7.9	16.1	7.5	No	Adjustment
AQIS		136.7	178.9	76.4	178.2	76.7	Yes	Adjustment/ Services/ Retained
NRA		17.6	18.5	95.1	16.2	108.6	Yes	Adjustment
NICNAS	*New chemical assessment fees*	1.6	1.6	100.0	1.6	100	Yes	Retained
	Existing chemicals assessment program	2.1	2.2	94.8	2.1	100	Yes	Retained
	Publications and seminars	0.04	0.04	100.0	0.04	100.0	No	Adjustment
CASA		59.8	98.9	60.5	83.7	71.4	Some	na
AMSA		52.4	54.5	96.1	75.1	69.8	Some	Retained
ASA		585.4[d]	596.4	98.2	539.2	108.6	No	Retained

a Earmarking is the assignment of revenue received from a specific tax or taxes to the financing of a particular government activity. **b** Refund – CR revenue is refunded; Adjustment – Fees are adjusted; Services – Services were expanded; Retained – CR revenue retained by agency; CRF – Paid into Consolidated Revenue Fund. **c** ANZFA cost recovery revenue in 1999-2000 came from royalties and sale of publications. It did not recover any revenue from regulatory activities. **d** ASA classifies this revenue as commercial service charges rather than cost recovery. **CR** Cost recovery. **na** Not available. **..** Not applicable.

Source: PC summary based on questionnaire responses.

Table B.8 **Costs recovered**

Agency	*Activity*	*What costs do charges aim to recover?*[a]	*How are indirect costs allocated?*[b]	*Basis for asset valuation*	*Do charges include a user cost of capital?*
TGA		Direct/Indirect	Activity based costing	..	No
ANZFA		Direct/Indirect	Pro rata (direct costs)	..	Yes
ARPANSA		Direct/Indirect	Pro rata (labour)	..	No
AQIS		Direct/Indirect	Pro rata (direct costs)	..	No
NRA		Direct/Indirect	Activity based costing	..	No
NICNAS	*New chemical assessment fees*	Direct/Indirect	Activity based costing	..	No
	Existing chemicals assessment program	Direct/Indirect	Activity based costing	..	No
	Publications and seminars	Direct	na	..	No
CASA		Direct/Indirect	na	..	na
AMSA		Direct/Indirect	Activity based costing	Deprival	Yes
ASA		Total plus	Pro rata (labour)	Deprival	Yes

a 'Direct' costs are costs that can directly and unequivocally be attributed to an activity. 'Indirect' costs are costs that are not directly attributable to an activity. 'Total plus' includes direct and indirect costs plus a proxy rate of return. **b** Indirect costs are generally allocated pro rata to some or all direct costs or by activity based costing. Activity based costing links an organisation's outputs to activities used to produce those outputs which in turn are linked to the organisation's costs (see appendix H). **na** Not available. **..** Not applicable.

Source: PC summary based on questionnaire responses.

Table B.9 **Accountability and transparency**

Agency	*Activity*	*Legal basis*[a]	*Who was consulted when cost recovery introduced?*	*What guidelines were used?*	*Who is involved in ongoing consultation?*	*When were the arrangements last formally reviewed?*
TGA		Other Act	DOFA, Industry, Consumers	..	Industry/Consumers	Not reviewed
ANZFA		Other Act	Govt, Industry, Consumers	DOFA/Other	Industry/Consumers	Not reviewed
ARPANSA						
AQIS		Other Acts	DOFA, Industry	DOFA/Other	Minister/Industry	Not reviewed
NRA		Other Act	na	na	na	Under review
NICNAS	*New chemical assessment fees*	Other Act	Govt/Industry/ Consumers	Independent review	Govt/Industry	Yes
	Existing chemicals assessment program	Other Act	Govt/Industry	Independent review	Govt/Industry	2000
	Publications and seminars	No Act	Govt/Industry	Cwth	Govt/Industry	Not reviewed
CASA		Tax Act/Other Act	Govt/Industry/ Consumers	Independent review	Govt/Industry	1999/2000
AMSA		Tax Act/Other Act	Industry	Independent review	Industry	1997
ASA		Other Act	na	Internal	Industry/Consumers	Yes

a FMA – *Financial Management and Accountability Act 1997.* The main purpose of this Act is to provide a framework for the proper management of public money and public property. It is not clear whether this Act provides a legal basis for cost recovery*;* Tax Act – Any Tax Act; Other Act – An Act other than the FMA Act or a Tax Act; No Act – No Act supporting the arrangements. **DOFA** –Department of Finance and Administration. **na** Not available. **..** Not applicable.

Source: PC summary based on questionnaire responses.

Table B.10 **Responsibility for various functions**

Agency	*Activity*	*Policy*	*Price setting*	*Administration*	*Revenue collection*
TGA		TGA	TGA	TGA	TGA
ANZFA		ANZFA	ANZFA	ANZFA	ANZFA
ARPANSA		ARPANSA	ARPANSA	ARPANSA	ARPANSA
AQIS		AQIS	AQIS	AQIS	AFFA
NRA		AFFA	NRA/AFFA	NRA	NRA
NICNAS	*New chemical assessment fees*	DEWRSB	DEWRSB	NICNAS	NOHSC
	Existing chemicals assessment program	DEWRSB	DEWRSB	NICNAS	NICNAS
	Publications and seminars	DEWRSB	NICNAS	NICNAS	NICNAS
CASA		DTRS	DTRS	DOFA/CASA	CASA/ATO
AMSA		AMSA	AMSA	AMSA	ACS
ASA		ASA	ASA	ASA	ASA

AFFA – Agriculture, Fisheries and Forestry — Australia; **DEWRSB** – Department of Employment, Workplace Relations and Small Business; **NOHSC** – National Occupational Health and Safety Commission; **DTRS** – Department of Transport and Regional Services; **DOFA** –Department of Finance and Administration.

Source: PC summary based on questionnaire responses.

B.3 Case study: Financial regulatory agencies

Table B.11 **Overview of arrangements**

Agency	*Type of charge*	*Stated rationale for cost recovery*[a]	*When introduced*	*How often are charges changed/reviewed?*
APRA	Fee	Beneficiary	1998[b]	Annually
ASIC	Fee	Beneficiary/Policy	1991[c]	Annually

[a] Demand – Demand management; Revenue – Raising revenue; Policy – Government policy; User – User pays; Beneficiary – Beneficiary pays; Services – Expand services. [b] Financial supervision fees were in existence before this date. [c] Company fees were in existence before this date.

Source: PC summary based on questionnaire responses.

Table B.12 **Revenue 1999-2000**

Agency	*Revenue raised though cost recovery*	*Total revenue*	*CR revenue / total revenue*	*Total expenses*	*CR revenue / total expenses*	*Is revenue earmarked?*[a]	*What happens to revenue if it is greater than costs*[b]
	$m	$m	%	$m	%		
APRA	88.3[c]	91.8	96.2	58.8	150.2	To APRA and other agencies	Adjustment
ASIC	361.0	361.0	100.0	144.8[d]	249.3	No	CRF

[a] Earmarking is the assignment of revenue received from a specific tax or taxes to the financing of a particular government activity. [b] Refund – CR revenue is refunded; Adjustment – Fees are adjusted; Services – Services were expanded; Retained – CR revenue retained by agency; CRF – Paid into Consolidated Revenue Fund. [c] Includes cost recovery earmarked to other agencies. [d] Does not includes transfers to States and Northern Territory. **CR** Cost recovery. **na** Not available.

Source: PC summary based on questionnaire responses.

Table B.13 **Costs recovered**

Agency	*What costs do charges aim to recover?*[a]	*How are indirect costs allocated?*[b]	*Basis for asset valuation*	*Do charges include a user cost of capital?*
APRA	Direct/Indirect	Pro rata	na	No
ASIC	Total plus	na	na	No

[a] 'Direct' costs are costs that can directly and unequivocally be attributed to an activity. 'Indirect' costs are costs that are not directly attributable to an activity. 'Total plus' includes direct and indirect costs plus a proxy rate of return. [b] Indirect costs allocated pro rata to some or all direct costs (see appendix H). **na** Not available.

Source: PC summary based on questionnaire responses.

Table B.14 **Accountability and transparency**

Agency	*Legal basis*[a]	*Who was consulted when cost recovery introduced?*	*What guidelines were used?*	*Who is involved in ongoing consultation?*	*When were the arrangements last formally reviewed?*
APRA	Tax Acts	Govt/Industry	Other	Govt/Industry	2000
ASIC	Other Act	Govt	Cwth/Other	None	Yes

[a] FMA – *Financial Management and Accountability Act 1997.* The main purpose of this Act is to provide a framework for the proper management of public money and public property. It is not clear whether this Act provides a legal basis for cost recovery*;* Tax Act – Any Tax Act; Other Act – An Act other than the FMA Act or a Tax Act; No Act – No Act supporting the arrangements.

Source: PC summary based on questionnaire responses.

Table B.15 **Responsibility for various functions**

Agency	*Policy*	*Price setting*	*Administration*	*Revenue collection*
APRA	APRA/Treasury	APRA/Treasury	APRA/DOFA	APRA/DOFA
ASIC	Treasury	Treasury/Minister	ASIC	ASIC

DOFA – Department of Finance and Administration.

Source: PC summary based on questionnaire responses.

B.4 Case study: Australian Communication Authority

Table B.16 **Overview of arrangements**

Activity	*Type of charge*	*Stated rationale for cost recovery*[a]	*When introduced*	*How often are charges changed/reviewed?*
Annual Licence Carrier Charge	Fee	Beneficiary	1991	Annually
Spectrum Maintenance Component	Fee	Policy/Demand/User	1995	Bi-annually
Administrative	Fee	Policy/Demand/User	1995	Bi-annually

[a] Demand – Demand management; Revenue – Raising revenue; Policy – Government policy; User – User pays; Beneficiary – Beneficiary pays; Services – Expand services.

Source: PC summary based on questionnaire responses.

Table B.17 **Revenue 1999-2000**

Activity	*Revenue raised though cost recovery*	*Total revenue*	*CR revenue / total revenue*	*Total expenses*	*CR revenue / total expenses*	*Is revenue earmarked?*[a]	*What happens to revenue if it is greater than costs*[b]
	$m	$m	%	$m	%		
Annual Licence Carrier Charge	18.5	18.5	100.0	18.4	100.3	No	Retained
Spectrum Maintenance Component	24.3	24.4	100.0	na	na	No	Retained
Administrative	5.9	5.9	100.0	na	na	No	Retained
Miscellaneous[c]	5.5	5.5	100.0	na	Na	No	Retained

[a] Earmarking is the assignment of revenue received from a specific tax or taxes to the financing of a particular government activity. [b] Refund – CR revenue is refunded; Adjustment – Fees are adjusted; Services – Services were expanded; Retained – CR revenue retained by agency; CRF – Paid into Consolidated Revenue Fund. [c] This category is comprised of numerous charges that do not raise a significant amount of revenue individually. For example, spectrum auction entry fees, speaking fees and late payments charges. **CR** Cost recovery.

Source: PC summary based on questionnaire responses.

Table B.18 **Costs recovered**

Activity	*What costs do charges aim to recover?*[a]	*How are indirect costs allocated?*[b]	*Basis for asset valuation*	*Do charges include a user cost of capital?*
Annual Licence Carrier Charge	Direct/Indirect	Activity based costing	Deprival	Yes
Spectrum Maintenance Component	Direct/Indirect	Activity based costing	Deprival	Yes
Administrative	Direct/Indirect	Activity based costing	Deprival	Yes

a 'Direct' costs are costs that can directly and unequivocally be attributed to an activity. 'Indirect' costs are costs that are not directly attributable to an activity. 'Total plus' includes direct and indirect costs plus a proxy rate of return. **b** Activity based costing links an organisation's outputs to activities used to produce those outputs which in turn are linked to the organisation's costs (see appendix H).

Source: PC summary based on questionnaire responses.

Table B.19 **Accountability and transparency**

Activity	*Legal basis*	*Who was consulted when cost recovery introduced?*	*What guidelines were used?*	*Who is involved in ongoing consultation?*	*When were the arrangements last formally reviewed?*
Annual Licence Carrier Charge	Other Act	Govt	na	Govt	No
Spectrum Maintenance Component	Other Act	Govt	Internal	Govt	1995
Administrative	Other Act	Govt	Internal	Govt	1995

a FMA – *Financial Management and Accountability Act 1997.* The main purpose of this Act is to provide a framework for the proper management of public money and public property. It is not clear whether this Act provides a legal basis for cost recovery*;* Tax Act – Any Tax Act; Other Act – An Act other than the FMA Act or a Tax Act; No Act – No Act supporting the arrangements. **na** Not available.

Source: PC summary based on questionnaire responses.

Table B.20 **Responsibility for various functions**

Activity	*Policy*	*Price setting*	*Administration*	*Revenue collection*
Annual Licence Carrier Charge	DCITA	ACA	ACA	ACA
Spectrum Maintenance Component	ACA	ACA	ACA	ACA
Administrative	ACA	ACA	ACA	ACA

DCITA – Department of Communications, Information Technology and the Arts.

Source: PC summary based on questionnaire responses.

C Case study — information agencies

Information is an important resource that is valuable for our social, cultural and economic wellbeing. Information informs us about our past, present and future and is a significant commodity in its own right. The Terms of Reference requires the Commission to review the cost recovery arrangements of Commonwealth information agencies. Information agencies are those agencies the primary function of which is the collection, compilation, analysis and dissemination of information to the public. They include agencies that provide;

- social/economic data like ABS and ABARE;
- information about the physical environment like the Bureau of Meteorology (BoM), the Australian Surveying and Land Information Group (AUSLIG) and the Australian Geological Surveying Organisation (AGSO); and
- 'cultural' information like the National Library of Australia (NLA) and Screen Sound Australia (SSA).

Other agencies, such as scientific research agencies like CSIRO also collect, compile, analyse and disseminate information to the public, but this is not their primary function. However many of the issues relating to cost recovery affect these agencies in ways similar to the other information agencies.

A central question for all of these agencies is determining which activities or outputs should be publicly funded and which should be subject to cost recovery. A second question is the extent of cost recovery that should be applied to those activities or outputs. The answer to these questions depends in part on the rationale for cost recovery adopted by an agency. Underpinning these questions is the issue of whether the activity or output should be undertaken or provided by a government agency at all. Having considered these broader issues, agencies also need to consider the appropriate mechanisms for cost recovery and whether they have the necessary legal authority to impose charges.

For some agencies consideration of these issues is complicated by a requirement to achieve an external revenue target. These targets may change the cost recovery arrangements that agencies would otherwise have put in place and this may have wider implications.

Cost recovery may have both beneficial and detrimental impacts on the operations of information agencies, which can affect the users of these services and the broader community.

Technology and innovation may also have an impact on the activities and output of many of the information agencies that in turn can affect their cost recovery arrangements. Conversely, cost recovery arrangements may influence the use of technology and innovation.

C.1 Extent and nature of cost recovery

The information supplied by information agencies is used for a variety of purposes and provides different benefits to different groups. The appropriateness and extent of cost recovery by these agencies depends on identifying beneficiaries and the feasibility of recovering costs. Where the information provides private benefits to identifiable users and it is feasible to charge these users, cost recovery can be justified on efficiency and equity grounds. However, for many of the information agencies, the collection and some compilation of data are required for public policy purposes. This can justify public funding for some part of these agencies' collection and analysis costs rather than recovering these costs from private users.

Information also has a number of characteristics that mean full cost recovery is not feasible or is inappropriate. Information often has public goods characteristics such as collective consumption (see chapter 2). Once a piece of information has been made available to one user, many can then use it repeatedly without affecting other users. Also, once collected, the cost of supplying information to an additional user tends to be low. The increasing use of digital technology and the Internet are lowering these costs further so that, in many cases, they may be close to zero. To achieve a socially desirable level of use of this information, the price should match the cost of supplying an additional user. Also, in many cases, the cost of excluding non-paying users will be high. If the cost of excluding non-payers is greater than the revenue that could be raised by charging for this information, it is impractical to charge for the use of the information, even when the beneficiaries can be easily identified.

The provision of information may also provide external benefits beyond the original user of the information. For example, the provision of warnings of severe weather conditions may reduce the need for emergency services to rescue skiers, bush walkers, sailors and fishers caught out in bad weather. Full cost recovery of these services is likely to affect these wider benefits adversely.

Activities which are subject to cost recovery

These characteristics of information and the different purposes for which information is used affects which activities and outputs of information agencies are subject to cost recovery. For most agencies, a distinction can be made between core and non-core activities. Core activities are those related to collection, compilation and some dissemination of information for public benefit. It is usually necessary for the agency to undertake these activities to fulfil its legislative function, mission statement, program objectives or charter of obligations. These activities are usually funded from appropriations. Non-core activities are classified along a spectrum, from those that are incremental to the core services, to more commercial services. Information agencies often have an advantage over private firms in incrementally expanding their activities to meet the specific needs of particular users. These advantages may arise from the need to protect the confidentiality of data or from technical aspects of the collection, compilation, analysis and dissemination of information. Agencies often undertake these activities on a cost recovery basis. A central question for most information agencies is deciding which services should form part of the core activities and which services should be provided with some degree of cost recovery.

Another important question for information agencies is the extent to which they should be involved in commercial work. Most agencies have the capacity to tailor their services to meet the needs of particular users. However, at some point, private firms, drawing on the same core data set, could also undertake this work and it may be more appropriate for government agencies not to do it. Drawing a clear distinction between which services should be provided by a government agency and which should be left to private firms is not always straightforward. Many of the services which provide a private benefit are based on the raw data collected by the government agency and it is difficult to distinguish between the public benefit of the collection of this data and the private benefits that arise from its subsequent use.

Bureau of Meteorology

BoM's approach to these questions is shown in figure C.1. The collection of raw meteorological data and some compilation of this data is undertaken by its basic infrastructure. This is designated as a public good and is funded by appropriations. BoM's dissemination activities are divided between basic and special services depending on the economic classification of the service — private, mixed or public (see chapter 2). Different economic classifications correspond to different charging regimes.

The basic services consist of:

- a basic product set which consists of reports of current weather conditions and forecasts (including warnings), which is provided free through the mass media and the Internet; and
- a basic product service which builds on the basic product set but charges users a fee for access. The cost of access includes any additional costs incurred by BoM to make the information available to suit the convenience of the individual user and the costs of accessing the services by either by phone or fax.

The special services consist of:

- specialised services for a special sector or user group which have a significant public interest component, such as aviation and defence. The charges for these services are based on incremental costs incurred in producing them and are paid by the users; and
- commercial services, such as special investigations or tailored forecasts for individual customers, undertaken in open competition with the private sector by BoM's Special Services Unit (sub. 35, p. 9).

Deciding which category a particular service falls into is also influenced by international agreements under the World Meteorological Organisation. These agreements require BoM to provide certain essential data and products to other National Meteorological Services on a free and unrestricted basis. This makes these data and products widely available and they are classified as public goods and become part of BoM's basic service. Any additional data and products are provided to these overseas agencies on a cost recoverable or commercial basis and form part of BoM's special services.

Figure C.1 **Schematic representation of the Bureau of Meteorology's services**

Service category	International exchange	Economic classification	Charging regime
Special services	Additional data and products	Private goods	Commercial
		Mixed goods	Cost – recoverable
Basic services	Essential data and products	Public goods	Access charges
			Free through media
Basic infrastructure, data and products (Basic system – public goods)			

Source: BoM, sub. 35, p. 10.

The overall economic framework for the provision of meteorological services has been outlined in a number of papers (Freebairn and Zillman 2000a, 2000b).

According to BoM, in 1999-2000, the cost of the basic product set was $51 million and the cost of the services provided at the cost of access was $0.7 million. The cost of its services to aviation was $13 million and for its services to defence were $3 million. On the other hand, its commercial operations raised $9 million (sub. 35, p.3).

Choosing which services belong to each of these categories is not straightforward. The horizontal alignments of boundaries (broken lines) in figure C.1 are approximate only and vary from case to case and time to time. A review of BoM (Slatyer 1997) recommended the introduction of the basic product set of free information as a restricted subset of the more broadly defined 'basic services' (sub. 35, att. E). BoM stated that in choosing which services should be part of the basic product set and which services should be available at the cost of access:

> …[w]e have developed a five-page set of guidelines for trying to draw the boundary … recognising that the boundary is going to change with time, with technology, with political pressure. [W]e have thousands of individual services and they change over time. (trans., p. 254)

BoM expressed some concern about this general approach:

> The need to progressively replace sensible, practical judgements and mutually acceptable quid pro quos with detailed decision rules in dealing with inherently fuzzy costing interfaces has added to the administrative complexity of planning, management and service provision in meteorology. (sub. 35, p. 15)

The difficulty of deciding the extent to which agencies should be involved in purely commercial work is highlighted by different approaches to the provision of meteorological services by overseas agencies. According to BoM, in the United States, the National Meteorological Service undertakes no commercial work. It only provides services necessary for public safety. Any specialised services to particular users are undertaken by the private sector (BoM, trans., p. 260). In New Zealand, the Meteorological Services of New Zealand Limited is a state owned provider of meteorological services. It has a commercial agreement with the Minister of Transport to provide a set of core services of meteorological data acquisition, forecasts and warning that are in effect taxpayer funded. It also provides market services to the private sector including the media and the aviation industry, both domestic and international (Meteorological Services of New Zealand Limited, sub. 109, p. 1).

Australian Bureau of Statistics

ABS's collection activities are also funded from appropriations and, according to ABS, funding its dissemination activities requires a balance between 'public good

obligations and user pays' (sub. 36, att. 1). To meet its public good obligations, ABS makes selected statistical information freely available to the community through the media, libraries and the Internet. The cost of producing these publications is funded from appropriations and is not reflected in the prices of other publications that are sold (sub. 36, att. 1).

ABS's pricing policy for its user pays component has three broad categories:

- products and services that have significant private benefits, but where there is an element of public good obligations are partially cost recovered;
- products and services that are not perceived to have any public good obligations are fully cost recovered; and
- products and services deemed 'commercial' are fully cost recovered with an allowance for 'risk' (ABS has only ever had one commercial product, CDATA) (sub 36, p. 6).

Where a user seeks to on-sell ABS products, ABS seeks licensing arrangements that ensure a contribution is obtained from each sale towards the cost of collecting and producing the data provided.

The ABS also provides other services that are cost-recovered such as statistical consultancy, outposts of ABS staff, training courses and seminars. Such services are generally for government agencies and are charged on a cost recovery basis in accordance with Department of Finance and Administration guidelines (sub. 36, att. 1).

ABS is also required to provide certain information to various international organisations such as the UN and the OECD, which are part of its public good obligations.

A summary of ABS's pricing policy for its products is provided in table C.1

Table C.1 Summary of ABS pricing policy for products

ABS Product	*Broad pricing policy*
Publications	ABS has a standard range of publications designed to meet the needs of a broad range of users. According to ABS, the cost of producing public good obligations copies of publications is funded from its budget appropriation. Copies of its publications obtained for private use are priced to collectively recover their cost of production, distribution and marketing beyond the cost of production of the copies distributed to meet public good obligations. The cost of the collection, compilation and analysis of the data is not recovered.
Other standard products	ABS has other standard products that are designed to meet similar needs as the standard publications but are generally not paper based. They include CDATA and the Integrated Regional Data Base. According to ABS, prices are based on cost recovery for a product or group of similar products. In a very few instances, an allowance for 'risk' is included in the price.
Information consultancy	ABS provides information consultancies for one-off compilations of information on request. According to ABS, these are priced for full cost recovery. There are three components to the cost recovered: • Labour – hourly charge calculated for the total time taken to undertake the consultancy. The labour charges aim to recover the costs of the labour involved including overheads. Overheads include average superannuation, workers compensation, leave and similar salary on-costs, and an allowance for accommodation, training, computing, marketing and sales and similar corporate and business overheads; • Infrastructure – this component of the ABS charging policy aims to recover the various system and database costs associated with providing non core or unpublished statistical information to clients; and • Direct costs – any costs incurred in undertaking a consultancy which are directly attributable to the consultancy such as courier charges, lamination etc.
Statistical consultancy	ABS provides statistical consultancies to advise on collecting and analysing information. These are priced for full cost recovery, with the cost to be recovered consisting of labour and direct costs (as defined above).
User funded surveys, Statistical Units, Outposted Officers and International consultancies	ABS provides a number of other services which are priced at marginal cost, with the costs to be recovered consisting of two components: • Nominal salary costs plus average superannuation, workers compensation, leave and similar salary on costs and an allowance for accommodation, training, computing and similar overheads. Overheads for corporate and business support are not included; and • Direct costs – any costs incurred in undertaking the work which are directly attributable such as travel, form printing, collection and processing costs, etc.

Source: ABS, sub. 36, p. 7.

National Library

The National Library's approach is 'for core services to be provided free of charge and for more advanced or value added services and services to other libraries to be charged at rates ranging from marginal costs through to profit in certain circumstances' (trans., p. 475). Core services are defined rather broadly as 'access to the collection' (trans., p. 476).

A number of examples of the services provided by the National Library and the cost recovery arrangements associated with them are shown in table C.2.

Table C.2 **Services provided by the National Library**

Service	*Description*
Kinetica	Kinetica is an online service provided to over 1 000 Australian libraries in order to support those libraries in areas such as cooperative cataloguing and document delivery. The Kinetica service is offered by subscription to organisations with the choice of charging for actual usage or on an agreed site licence basis. Kinetica is operated as a full cost recovery service.
Publications	The National Library produces and markets trade publications based on its collections. These publications are priced to recover their direct costs of production but not the costs of authorship or editing. The National Library's primary reason for publishing is to make its collections more accessible to the public.
Interlibrary loan/Document delivery	Charges for the loan of items or supply of documents between libraries are set within the Australian library community at a standard rate of $13. This charge does not represent the actual costs of supply of items between libraries, but is considered a reasonable cost in terms of encouraging libraries to share resources in the interests of Australian library users generally. Libraries, including the National Library, may then charge additional fees for guaranteed fast-track delivery of items.

Source: National Library, sub. 5, p. 2.

ScreenSound Australia

ScreenSound Australia, the national screen and sound archive, has taken a similar approach. Its mission is 'to increase the use, enjoyment and safety of Australia's audiovisual heritage, and through this enrich the lives of all Australians' (sub. 30, p. 1). The cost of developing, storing and preserving the collection of audiovisual material is funded by appropriations. Access to the collection, through screenings, presentations, exhibitions and video and audio products produced by ScreenSound, is partially cost recovered. Other services, such as ScreenSound's technical facilities and the use of its headquarters as a venue for professional, academic and social functions, which are not central to ScreenSound's mission are

fully cost recovered (sub. 30, p. 4). Competitive neutrality principles are applied where these services are competing with private firms. However many of its' services are very specialised and ScreenSound Australia generally does not seek to compete with private firms.

Australian Geological Surveying Organisation

AGSO, an agency within the Department of Industry, Science and Resource that provides geoscientific information on Australia's natural resources and the environment, approaches these questions by making a distinction between partly and fully funded work. A large part of AGSO's output is determined by government policy and is funded by appropriations. AGSO also undertakes cofunded or collaborative work with external bodies that will 'enhance or extend AGSO's core program and contribute to or enhance the national geoscience knowledge base'. The results from this work are made available to the public and the costs are shared in proportion to the balance of the private and public benefit (sub. 55, p.10).

AGSO also undertakes commissioned or fully funded work for both the private and public sectors. AGSO undertakes this work when it 'complements AGSO's strategic program and/or there is a benefit to AGSO through enhanced knowledge or technology transfer.' When the outputs of this commissioned work are for purely private benefits, all costs are recovered including overheads and a proxy rate of return (sub. 55, p.11).

Australian Surveying and Land Information Group

AUSLIG, a business unit within the Department of Industry, Science and Resources is Australia's national mapping agency. It does not charge for general and reference information but charges for packaged and customised products. General and reference information products include product catalogues and geodetic controls. Packaged products include maps and map data while customised products include satellite imagery (sub. 44, p. 4).

Australian Bureau of Agricultural and Resource Economics

ABARE, an agency in the Department of Agriculture, Fisheries and Forestry, provides economic information for rural, minerals and energy industries. It accepts 'research that is either of national importance or of importance to a broad spectrum of participants in one or more industries in the commodity sector. ABARE does accept funds for some research that is essentially of a private good nature, but only when it is complementary with its broader public policy role' (sub. 56, p. 4).

Rationales for existing arrangements

Generally information agencies have clear rationales and objectives for cost recovery, and a number of agencies have also provided rationales for not recovering part of their costs. The rationales for cost recovery include:

- providing financial resources in addition to government appropriation to increase services;
- reducing the cost to taxpayers for the provision of these services;
- managing demand for government services to encourage users to address their real needs;
- using a market mechanism to improve the internal efficiency of agencies by better matching resources to demand; and
- recognising 'private benefit' elements of some government services which should be paid for by users/beneficiaries.

Some agencies have also cited reasons for not introducing full cost recovery. These include:

- the public good characteristic of these services;
- the public benefit of readily available information; and
- the benefit to the public of increased exploration and development of publicly owned natural resources.

As well as clear rationales and objectives, most information agencies have policy documents, manuals or guidelines on charging, pricing and costing. Table C.3 summarises the internal documents that agencies have covering their cost recovery arrangements.

Table C.3 **Agencies policies and guidelines on cost recovery**

Agency	*Policy/guidelines*
Australian Bureau of Statistics	*Dissemination and Pricing Policy*
Australian Geological Surveying Organisation[a]	*Commercial Practices Manual*
Bureau of Meteorology	*Charging Manual*
Commonwealth Scientific and Industrial Research Organisation	*Costing and Pricing Policy*
National Library of Australia	*Guidelines on Charging*

[a] AGSO's current cost recovery methodology is based on *Guidelines for Costing Government Activities* issued by the former Department of Finance in 1991.

Source: ABS, sub. 36, p. 13; AGSO, sub. 55, p. 7; BoM, sub. 35, p. 10; CSIRO, sub. 88, p. 9; National Library, sub. 5, p. 6

When developing its initial charging policy in 1988, ABS identified three key objectives:

- to enable the demand for ABS products and services to be used as a more reliable indicator of how ABS resources should be prioritised;
- to encourage users to address their real needs for ABS products and services; and
- to relieve the general taxpayer of those elements of the cost of the statistical service which have a specific and identifiable value to particular users.

A review in 1994 strongly endorsed these initial objectives and identified a number of additional objectives, namely:

- ABS prices should be publicly defensible;
- ABS prices should be consistent;
- ABS prices should be set consistent with its mission of encouraging informed decision making and research: and
- ABS prices for commercial products and services should generate some net return to the ABS to cover the investment in their production (sub. 36, p. 4).

For CSIRO the objectives of cost recovery are to:

- build stronger links with industry and other research users;
- prevent unnecessary use of certain services; and
- use market-related mechanisms to better address the needs of users and to improve efficiency (sub. 88, p. 5).

The National Library's reasons for applying cost recovery charges are:

- to provide financial resources additional to government appropriations in order to provide a range of added value service; and
- to control demand for certain services (such as photocopying) which would be likely to be excessively used if charges were not applied (sub. 5, p. 1).

In relation to the first objective, the National Library stated that when:

> …the Library introduced the Australian Bibliographic Network the predecessor of Kinetica, approval [from] DOFA and Cabinet was granted to provide this service with the proviso that it was budget neutral (that is recovered its costs). This cost recovery principle was continued with Kinetica. (National Library, questionnaire response)

ScreenSound Australia objectives are to:

- reduce the cost to government of providing this service;

- expand the service; and
- control the demand for its products (sub. 30, p. 2).

To some extent expanding the service and controlling demand for its product are in conflict, but as ScreenSound Australia stated:

> … the solution is to come to a balance between … charging for services which increases the funds available and therefore increases the service that we can provide, and to … deter demand … to the level where the amount of demand that we are required to meet [is] brought back to our capacity to meet that demand. (trans., p. 340)

BoM has a number of rationales for charging and for not charging for certain activities. BoM does not charge for its basic services because of their public good characteristics. One of these characteristics is non-excludability (see chapter 2). In the case of basic meteorological data, non-excludability arises from the international agreements to provide free and unrestricted international exchange of this data and the ability of overseas meteorological agencies to use this data to provide meteorological services to Australian users.

BoM does not charge for basic public information, forecast and warning services provided to the community through the mass media. According to BoM, 'the total national economic benefit from these services is the sum of their value to every individual decision maker; and the total economic benefit is therefore the greater the more widely they are made available and consumed' (sub. 35, p. 4).

BoM's rationale for charging individual users the full costs of access to the freely available public services is that any additional costs incurred by BoM to make the information available to suit the convenience of individual users should be met by those users and not by the government.

BoM's rationale for charging commercial rates for specialised meteorological services provided in competition or potential competition with the private sector is a combination of the requirement for competitive neutrality and a long-standing commitment by BoM to develop a private meteorological service industry in Australia (sub. 35, p. 4).

AUSLIG's cost recovery arrangements are based on the Commonwealth Public Interest Spatial Data Transfer Policy (box C.1). According to this policy, the Commonwealth Government has a function in providing certain spatial data in the public interest where these data 'would not be provided on commercial grounds, or which would only be provided commercially at a higher price' (sub. 44, p. 11). Under this policy, charging for the transfer of 'public interest' spatial data is based on the average cost of transfer. This is defined as the 'full value of all resources

used or consumed in providing a particular product or activity, averaged over the estimated total units of output' (CSDC, p. 5).

AGSO argues that the application of cost recovery to some of its activities is inappropriate. AGSO provides geoscientific information on Australia's mineral and petroleum reserves and benefits are returned to the community through the discovery and development of these resources (sub. 55, p. 12).

Cost recovery mechanisms

Information agencies generally use fee for services to cost recover rather than taxes or levies. These fees include charges for goods and services, subscriptions, license fees and royalties. The method for setting charges varies for different services, from covering marginal costs[1] to full market pricing. For example, the National Library's *Guidelines on Charging* states that:

> The charging rate for chargeable services should be consistently applied and may vary between a minimum of the extra marginal costs involved to a full profit-making basis, depending on arguments which relate to the public good, market issues, the capacity of identified user groups to pay and, relevant Commonwealth Government policy' (sub. 5, p. 2)

AUSLIG has made use of copyright, licences and royalties in its cost recovery arrangements, although they are 'the exception rather than the rule', and it receives only a relatively small proportion of its revenue from royalties. AUSLIG noted that this form a payment is attractive to users who wish to spread the commercial risk, but for many users the high administrative costs of this form of payment makes an upfront fee more attractive (trans., p 435).

ScreenSound Australia has had a similar experience with royalties. ScreenSound Australia states that 'One of the problems … (with these) … arrangements is that there can be an awful lot of administration for trivial sums of money.' (trans. p. 344)

[1] The cost of producing an additional unit of output (see appendix H).

Box C.1 Commonwealth Public Interest Spatial Data Transfer Policy

The Commonwealth Public Interest Spatial Data Transfer Policy was developed by the Commonwealth Spatial Data Committee (CSDC), the peak forum for Commonwealth portfolios with an interest in the collection and use of spatial data. It provides guidelines for Commonwealth agencies that are custodians of spatial data that are required to supply data to the community.

The basic principle behind the policy is to maximise cost-effective use of Commonwealth spatial data, produced and funded as a 'public interest' activity, by maximising access to it. It recognises that the Commonwealth Government has a function in providing certain spatial data for the benefit of the community and is responsible for making full and effective use of those data funded by the community through taxation.

The policy applies only to nominated 'public interest' spatial data available from Commonwealth agencies. A data collection program can only be considered a 'public interest' activity if it has a legislative basis or is approved by the portfolio Minister.

Generally, at least the average cost of transfer incurred by the supplier in providing access to a dataset would be charged. The average cost of transfer is the cost of transferring the data spread over an estimated number of transactions. It includes direct costs as well as an estimated pro rata share of all overhead costs in providing the distribution service. Where applicable, royalties payable by the user to the data owner is to be included in the cost of transfer.

The costs of collecting, maintaining or upgrading, or archiving the original data are **not** components of cost of transfer.

Transfers of spatial data by Commonwealth agencies will generally be under the conditions of a licence. The licence is intended to:

- protect copyright;
- prevent the unauthorised onward transfer, or sale of the data; and
- provide for payment of royalties to the data owner if the data are used in the production of a further product for commercial gain.

Other than these restrictions, the licence does not seek to restrict the use to which the data is put.

For dealings between Commonwealth agencies, transfers may be subject to a memorandum of understanding that fulfils the same functions as the licence.

At the time of writing, a number of other agencies had nominated 'public interest' spatial data that are available under this policy. These include ABS, BoM, AGSO, CSIRO, Environment Australia, Ionospheric Prediction Service, Royal Australian Navy Hydrographic Service, Royal Australian Survey Corps and Bureau of Resource Science.

Source: Commonwealth Spatial Data Committee (1995).

Consultation and governance arrangements

Information agencies use a range of methods to consult with their users to determine whether they are using appropriate methods of cost recovery and the level of their charges. ABS has the Australian Statistical Advisory Council that is established by the *Australian Bureau of Statistics Act 1975* to advise ABS in relation to:

- the improvement, extension and coordination of statistical services provided for public purposes in Australia;
- annual and longer term priorities and programs of work that should be adopted in relation to major aspects of the provision of those statistical services; and
- any other matters relating generally to those statistical services (Part III of the *Australian Bureau of Statistics Act 1975*).

The National Library has a Kinetica Advisory Committee made up of elected and appointed industry representatives. The Terms of Reference of this committee is to provide:

> … advice on strategic and policy issues affecting the delivery of the Kinetica service, the broad direction of service development, and changes occurring in the library community which are likely to affect services' (National Library Annual Report 1999—2000).

ScreenSound Australia, AUSLIG, AGSO and ABARE all reported in their questionnaire responses that they undertook market research and client surveys to gauge their clients' satisfaction with their services and charging policies (questionnaire responses).

BoM reported that there is ongoing consultation with the aviation industry over its Aviation Weather Services. This consultation is coordinated by a variety of committees, working groups, and focus groups involving BoM, the Civil Aviation Safety Authority, Airservices Australia, the major Australian airlines, the Australian Air Transport Association, airport operators and others. BoM also reported that there is a Joint Australian Defence Force/Bureau of Meteorology Defence Weather Services Working Group which monitors and reviews the ongoing operations of the Defence Weather Services, including the development of appropriate service level agreements and performance measures (BoM 2000, p. 91).

Revenue collected through cost recovery

The information agencies that responded to the Commission's questionnaire reported they collected $95 million from cost recovery in 1999-2000 (table C.4). BoM and ABS collected around 60 per cent of this revenue. ABARE collected 50

per cent of its total expenses through cost recovery, while most of the other agencies collected between 9 and 18 per cent of total expenses through cost recovery.

ABARE and AGSO reported that they are required to obtain at least 30 per cent of their revenue from external sources. While ABARE raised 50 per cent of its total revenues from external sources in 1999-2000, around 20 per cent of its total revenues come from a single external source, which is a transfer of appropriations from the Department of Industry, Science and Resources on the basis of a service level agreement. This transfer is to fund research supporting the resources sector (sub. 56, p. 13). AGSO only raised 16 per cent of its total expenses from external sources in 1999-2000 and stated that 'it [the 30 per cent external revenue target] is no longer rigorously applied' (trans., p. 487).

Table C.4 **Cost recovery revenue 1999-2000**

Agency	*Total revenue from cost recovery*	*Total expenses*	*Cost recovery revenue/total expenses*
	$m	$m	%
Australian Bureau of Agricultural and Resource Economics[a]	11.2	22.0	50.9
Australian Bureau of Statistics	21.5	255.5	8.4
Australian Geological Survey Organisation[a]	12.1	73.5	16.5
Australian Surveying and Land Information Group	4.7	33.2	14.2
Bureau of Meteorology	35.2	202.9	17.3
Bureau of Tourism Research	0.6	4.3	13.9
National Library of Australia	8.6	51.0	16.9
Productivity Commission	0.05	21.4	0.2
ScreenSound Australia	1.7	47.5	3.6
Total	**96.6**	**711.3**	**13.6**

[a] This agency reported that it is required to achieve a 30 per cent external funding target.

Source: Questionnaire responses from agencies.

Legal basis for cost recovery

For some information agencies the legal basis for their cost recovery arrangements is clear, but for a number of agencies the legal basis is less clear. In the view of the Australian Government Solicitor, agencies that impose a charge in respect of the performance of their statutory duties, need to be 'authorised expressly by legislation or by necessary implication from the legislation' (see appendix I). For two of the information agencies that are statutory authorities — ABS and BoM — the legal authority to charge for their services is explicit in their legislation. In the case of the ABS, the *Census and Statistics Act 1905* was amended in 1988 to ensure the ABS

had the legal authority to charge for its services (sub. 36, p. 5). For BoM the relevant Act is the *Meteorology Act 1955*. Another statutory authority, the National Library, does not have explicit power in its legislation to charge for its services. However the National Library noted that it is not precluded from charging a fee for its services by the *National Library Act 1960* (National Library, questionnaire response).

The legal basis for the cost recovery arrangements of those agencies that are within a Department are not clearly defined. In response to a question in the Commission's questionnaire on the legal basis for establishing their cost recovery arrangements:

- ABARE and ScreenSound Australia cited agreements under the *Financial Management and Accountability Act 1997*. However the main purpose of this Act is to provide a framework for the proper management of public money and public property and it is not clear whether this Act provides a legal basis for cost recovery (see chapter 3);
- AUSLIG cited Ministerial endorsement of the Commonwealth Public Interest Spatial Data Transfer Policy (box C.1) as the legal basis for its cost recovery activities; and
- AGSO stated that there is no legal basis for its cost recovery activity, even though the Commonwealth Public Interest Spatial Data Transfer Policy also covers AGSO.

C.2 Impact of cost recovery on agencies

The introduction of cost recovery is likely to have both positive and negative impacts on agencies. Agencies could become less financially dependent on appropriations and become more focussed on the needs of their users. Greater use of appropriate market mechanisms could also lead to an improvement in the internal efficiency of agencies. However, cost recovery could lead to agencies placing less emphasis on their broader public policy role.

Incentive effects for agencies

Cost recovery can change the incentives faced by agencies, in ways that can be both beneficial and detrimental.

Retention of cost recovery revenue

Generally, if agencies are able to retain the revenue they raise through cost recovery, they have a greater incentive to pursue cost recovery. With the exception of BoM, all of the information agencies that responded to the Commission's questionnaire reported that they are able to access the revenue raised through cost recovery, typically through Section 31 net appropriation agreements (see chapter 3). In its response, BoM reported that only around 2 per cent of its cost recovery revenue paid into the Consolidated Revenue Fund was not earmarked for return to BoM. ABARE noted that, under its Section 31 agreement, its budget appropriations were reduced by a similar amount of its cost recovery revenue (sub. 56, p.11). ABS reported that its Section 31 agreement formalised existing arrangements where its base appropriation was reduced and all to its cost recovery revenue was returned as 'annotated' appropriations (sub. 36, p. 9). AGSO reported that when it was set a 30 per cent external revenue target, it was to retain 'all revenue up to the target and revenue in excess of the target was to be shared on an 85/15 basis between AGSO and the Consolidated Revenue Fund' (sub. 55, p. 6). However, as noted above, in 1999-2000 AGSO did not reach this external revenue target.

External revenue targets

As noted above, a number of agencies have reported that they are required to generate 30 per cent of their revenue from external sources. A risk of setting external revenue targets is that agencies will lose focus on achieving an appropriate balance between their core public policy activities and their commercial activities. Agencies may undertake too much commercial activity at the expense of their public policy activities or they may charge too much for particular services. AGSO argued that:

> Undue focus on the pursuit of cost recovery … as an objective in its own right has the potential to subvert and distort longer-term strategic Government objectives in favour of short-term imperatives likely to attract funding from industry. … Any requirement to meet an arbitrary cost-recovery target … has the potential for a loss of focus from efficient delivery of agreed key outcomes to seeking alternative sources of funding. (sub. 55, p. 14)

CSIRO expressed similar views, arguing that:

> The dilemma for individual research providers is that they have often made a considerable investment (staff and infrastructure) in a field of study and cannot afford to turn away the business and lose the external funding. (Some may also need to meet external earnings targets.) In the long term, this type of leverage on a research provider's appropriation funding could mean that less funds are available to maintain the organisation's intellectual and physical capital. It restricts the organisation's ability

> to fulfil its own research agenda, with impacts on future delivery of national benefits. (sub. 88, p. 6)

Although external revenue targets are applied to the whole agency, generally the burden of achieving the target falls on those units within the agency that are able to generate external revenue. The level of cost recovery within these units will greatly exceed the overall target set for the agency in order to cross subsidise other units which are not in a position to cost recover. As CSIRO stated:

> When you have a 30 per cent target and you translate that through to a research unit and then you look at those units that are able to actually work in a consulting environment … that 30 per cent converts into a 70 or 80 per cent target and we would expect to be fluctuating between 70 and at times even 90 per cent external revenue in terms of the way we operate. (trans., p. 907)

According to AGSO, the burden of meeting its external revenue target falls heavily on its geophysical data which it sells at a high price because it 'can be used by a mining company to assist in area selection for a mine and … the return [to these data for these companies] is very high' (trans., p. 492).

Given these concerns with external revenue targets, it is not surprising that a number of agencies have also reported that they are not strictly enforced. AGSO stated that:

> … the validity of [this] approach has … been devalued over time. It's no longer rigorously applied, but there's a wonderful ambiguity left as to exactly where you should be positioned. Our observation would be that if we were genuinely pursuing that 30 per cent external revenue target, then it would distort our program and that would be a sad experience. (trans., p. 488)

Similarly, CSIRO stated that:

> An important principle in CSIRO's triennium funding agreement with the Government is that the Government will 'view external earnings targets flexibly to allow quality and relevance of the research output and general community benefit to be considered'. (sub. 88, p. 4)

Interaction with objectives of activities being cost recovered

One of the objectives of most information agencies is to provide access to their information. For example, section 6 (b) of the *Australian Bureau of Statistics Act 1975* stated that one of the functions of the ABS is 'to collect, compile and disseminate statistics and related information'. The basic principle behind the Commonwealth Public Interest Spatial Data Transfer Policy is to maximise cost-effective use of Commonwealth spatial data, produced and funded as a public interest activity, by maximising access to it (box C.1).

Cost recovery can enhance this objective by providing agencies with additional resources that enables them to provide a greater range of services. ScreenSound Australia stated that:

> The strategic management of the Archive's programs and resources, including cost recovery issues, has resulted in an improvement in both of the two principle indicators of success … supplementation of appropriation and increase in access. … Our increase in revenue through cost recovery from $0.3 million in 1992-93 to well over $2 million last financial year has allowed us to provide a very substantial increase in access services. (sub. 30, p. 5)

Cost recovery can also conflict with this objective if charging for services restricts access. The BoM highlighted this conflict in relation to international conventions on meteorological information. The global nature of meteorological phenomena means there are large benefits from the free and unrestricted exchange of meteorological information between national meteorological agencies. The World Meteorological Organisation provides an international framework that allows the collection and exchange of meteorological information between its members on a free of charge basis. According to BoM the:

> … introduction of any realistically conceivable market framework for international trade of basic meteorological data would result in a rise in cost to Australia of maintaining its current level (quality and quantity) of meteorological service provision by a factor of two to ten or more. (sub. 35, p. 17)

Restricting access to information through cost recovery is likely to have an adverse impact on the wider benefits to the community of the use of this information. CSIRO expressed its concerns that other policy objectives of the government were being compromised because users where unable to afford the required data. CSIRO stated that:

> … the government changed from making data freely available … to one which it charged … [for] data. … [A] change that I've noticed is … from an environment where this data was … shared widely by a large number of people … to one where these datasets are now guarded very carefully, are used strategically for people to try and gain advantage and more importantly, aren't accessible … [T]his is becoming a major problem in areas like land and water management where the government has devolved responsibility down to catchment groups and to land care groups. (trans., p. 901)

Private users of government information expressed similar views. Dr Mark Paterson, a private researcher, was concerned about the impact of cost recovery arrangements introduced by the ABS in the late 1980s, for the Australian Survey of Motor Vehicle Use and the Motor Vehicle Census. These arrangements increased the cost of acquiring these data, and he claims some research with a broader public benefit was not undertaken. (sub. 43, p. 4)

Innovation and technology

The increasing use of digital technology and the Internet is having a substantial impact on the dissemination of information. This is influencing the way information is delivered, how widely it can be disseminated, the costs and charges of dissemination and the associated cost recovery arrangements.

Using the Internet to disseminate information has a number of potential benefits for agencies and users, but in many cases these benefits are often difficult to realise. For example, the Internet allows agencies to provide additional users with access to standard services at little cost. As many users do not have access to the Internet, agencies may need to continue to provide paper versions of their services, reducing the potential for offsetting cost savings from using the Internet.

ABS has outlined some of the factors that are likely to have an impact on their future cost recovery activities:

- the move from paper based to electronic means of disseminating information is associated with a downward trend in revenue from sale of publications;
- information consultancy revenue is being affected by Internet based self-help developments particularly for the more straight-forward consultancy requests;
- ongoing growth of the information market has seen greater competition in some of ABS's traditional markets;
- greater use of personal computers and the Internet in Australia has seen a rapid growth in the ability of households and firms to access information online, often with an expectation that it will be provided free; and
- the emerging practice of some other major countries of providing access to a wide range of statistical information for free on the Internet (sub. 26, p. 10).

ScreenSound Australia warned that the digital age is seen by some as a 'nirvana' which offers an almost unlimited potential to collect, manipulate and disseminate large quantities of information around the world very cheaply. However 'at the moment the digital age is a promise but the reality is just an awful lot of expense and an awful lot of work' (trans., p. 348).

Internal efficiency

Cost recovery can improve the operations of agencies by providing market signals and incentives to allocate their resources to better meet the needs of their users. ABARE reported that 'cost recovery arrangements have caused [it] to adopt formal

project management systems much earlier than it would otherwise have done' and that:

> … the changes that were necessary to service external clients have been extended to ABARE's work program as a whole. … There have been significant efficiency gains across ABARE's research program as a result of the development of these management systems. It would have been much more difficult to motivate such change in the absence of a strong external client focus. (sub. 56, p. 20)

However applying cost recovery arrangements has costs. As ABARE stated:

> … increasing levels of cost recovery have resulted in a trend toward consultancies with a shorter timeframe and for small amounts of money. … Managing a large number of time critical contracts increases the risk of bottlenecks. The process of seeking and negotiating contracts also involves considerable staff time and associated resources. (sub. 56, p. 21)

Operation of agencies

In many cases the introduction of cost recovery has had an impact on the operations of information agencies. ABS has listed some of the challenges it faced with the introduction of cost recovery. These include:

- a need to shift the culture of the ABS from one where output was provided free to one where clients were charged for all but simple enquiries;
- the development of policy and procedures to support charging, and ongoing adaptation of these policies and procedures to meet the requirements of new and different products;
- technical infrastructure had to be developed and maintained to support invoicing and management information requirements;
- the identification of the costs to be recovered and provision of systems and processes to monitor them; and
- actually achieving cost recovery. The ABS struggled to recover its costs in the early years but has moved closer to demonstrated cost recovery with costs being recovered in 1997-98 (the peak Census dissemination year) and in 1999-2000. (sub. 36, p. 5)

Calculating and allocating costs to be recovered

For most information agencies a distinction can be made between core and non-core activities. Core activities are usually funded from appropriations, while non-core activities, whether incremental or commercial, are subjected to some degree of cost recovery. The charges for incremental activities are usually based on recovering the

incremental or avoidable costs of providing the service (see appendix H). Charges for commercial services are usually based on recovering these costs as well as other costs such as the cost of capital. Compliance with competitive neutrality requirements is often a factor for agencies when determining the costs to be recovered.

The charges for BoM's incremental activity of providing services to the aviation industry and to the Australian Defence Forces 'are determined to recover the incremental costs of the provision of [these services], above the basic service' (BoM, questionnaire response). Similarly AGSO stated that 'charges vary according to the nature of the activity undertaken. Research with national interest consideration is charged at marginal cost with no overhead or proxy for rate of return' (AGSO, questionnaire response).

The charges for BoM's commercial services are:

> … determined to recover the costs of the operation … plus a discretionary component that is determined on the basis of fair competition with the private sector consistent with competitive neutrality requirements. (BoM, questionnaire response)

Similarly AGSO stated that 'services competing with the private sector are charged at full cost (including all AGSO overheads), plus a proxy for rate of return' (AGSO, questionnaire response).

For most agencies, commercial services that directly compete with private firms are only a small component of their overall operations. In these cases, agencies tend to price according to the market. For example, ScreenSound Australia stated that:

> … a grandmother who's looking for … footage where she was an extra in a silent movie [and] we have an access video sitting in our headquarters building … that costs nothing. At the other end of the spectrum, if we're talking about the Nine Network wanting material for its 60 Minutes program we charge them big time. (trans., p. 345)

Similarly, CSIRO's *Costing and Pricing Policy* stated that 'the pricing of commercial activities must be based on the perceived value to the client and an estimate of their full costs' (sub. 88, p. 9).

Some private users of the services provided by information agencies raise concerns about setting charges based on market prices. J T Larkin and Associates stated that 'any price above marginal cost is a tax, even if that price is below average cost' (sub. 45, p. 3).

The cost of a service will be influenced by the inclusion of capital costs and the method used to calculate these costs. Capital costs will, in part, depend on the value of the assets used to produce a service and there are a number of different methods

available to value assets (see appendix H). BoM and ScreenSound Australia reported that they use a replacement cost method to value their assets, while ABS and AGSO use a historical cost method. The National Library and AUSLIG use a deprival cost basis. (see appendix B).

ABS reported that it had difficulties in introducing user charges based on market prices and its pricing policy now reflects costs (box C.2).

Box C.2 **User charges and the ABS**

The ABS reported that when user charges were introduced in 1988, it proposed introducing market-based pricing for all its products and services, with the exception of those products which were provided free as part of its 'public good' obligations.

Initially, pricing was based on market prices and set without reference to actual costs because the ABS did not have mechanisms to determine the relevant costs. ABS discovered that the interpretation of what was meant by market prices was variable and difficult to assess given that in many cases it was a monopoly provider. As a result, market prices were often based on ABS's perception of the clients' willingness to pay. ABS's dissemination performance was largely measured in terms of gross revenue from the various products and there was limited review of prices. Its main response was to eliminate publications with a small subscriber base and to disseminate the results in more cost-effective ways.

In 1994, a major internal review of ABS pricing policy was undertaken to allow the ABS to articulate objectives for its pricing policy clearly and to adopt appropriate guidelines and management information. Following this review, pricing policy moved from market price to reflecting costs incurred, and procedures for regular review were established.

Source: ABS, sub. 36, p. 4.

Agencies often face practical difficulties in measuring and allocating the costs of providing a service. The introduction of accrual accounting has produced its own set of challenges (see appendix H). Box C.3 outlines some of these difficulties faced by BoM.

Box C.3 **Costing issues for the Bureau of Meteorology**

BoM reported that within its overall costing and charging policy, it has encountered significant practical issues in the costing of individual services. These have arisen primarily from the inherent subjectivity involved in locating the boundary between 'public good' or core services and 'private' non-core services. This task has been complicated by the need for consistency, or at least compatibility, with the range of approaches used by other National Meteorological Services.

In determining the cost of a service, BoM has identified the determination of overheads, especially when the service is incremental to a basic service, as requiring close attention. The recent transition from program budgeting to output budgeting has resulted in BoM significantly reducing overhead costs included in the cost recovery charges. This is particularly the case for the provision of aviation weather services.

Source: BoM, sub. 35, p.14.

Transparency and accountability

Cost recovery can improve accountability by encouraging users to be more involved with activities they are paying for. If they pay for something, users will have a greater interest in what services are produced, how they are produced and how much they are charged. Up to a point this can be useful. However, taken too far it could also lead to 'capture'. According to ABARE:

> … we cannot afford to be captured because that would compromise our ability to maintain the confidence of our … clients. … If ABARE research isn't … free of political or industry influence then …[w]e're not going to be effective in our public policy role … We'd very quickly meet our demise if our research was seriously compromised. (trans., p. 562)

Accountability may be adversely affected by cost recovery if it results in agencies being sheltered to some extent from budget scrutiny. On the other hand, accountability may be improved by the greater transparency required by cost recovery. ABARE stated that:

> Since the change to user charging … ABARE must be able to account to external clients for expenditures on and delivery of research commissioned by those clients. As well, it must be able to ensure that it spends no more than the budgeted resources on externally funded research and that it is still able to deliver core public goods research. (sub. 56, p. 21)

C.3 Economic effects of cost recovery

Cost recovery places some or all of the responsibility for funding information services on to users and away from the general taxpayer. This can promote efficiency in the production and consumption of information services. The efficiency benefits from cost recovery arise from funding core services from the budget (in recognition of their public good characteristics) and from setting prices for non-core services on the basis of incremental costs.

In this context, the detrimental effects of external revenue targets may be more widespread than simply their effects on agencies as discussed above. As the burden of meeting these targets is likely to fall on a narrow range of services which are able to generate greater amounts of revenue, agencies may find it necessary to charge higher prices for these services than the cost of providing them to an additional user. This will have an adverse impact on those users who would otherwise have purchased these services. Box C.4 outlines the impact of AGSO's pursuit of its 30 per cent external revenue target.

Effects on consumers

Some information agencies deal directly with individual consumers, for example, weather by fax, and ABS publications and data requests. Few concerns about the cost recovery arrangements of some information agencies on consumers have been raised in this inquiry.

Mr R. F. Hadlow, a private researcher, raised concerns about the cost recovery arrangements for photocopying services. Several agencies have stated that controlling the demand for their services is a rationale for cost recovery and the National Library specifically lists controlling the demand for photocopying services (sub. 5, p. 1). Hadlow claimed that:

> DIY/card operated photocopying, at tax payer funded Commonwealth facilities, is charged at 200 per cent above both actual cost and the fee charged by prominent commercial providers. (sub. 34, p. 3)

Further, in relation to photocopying by the staff of an agency, he claimed:

> The charge of 50c per copy indicates an hourly labour charge equivalent to the cost of hiring a skilled tradesman (including overheads) and is well above a reasonable cost for labour for basic photocopying. (sub. 34, p. 5)

He also stated:

> If the cost of copying material is made so expensive that it will not be used, one must question the value of maintaining it at public expense? (sub. 34, p. 3)

Box C.4 **Impact of AGSO's external revenue targets**

According to AGSO, the burden of meeting its external revenue target falls heavily on its geophysical data and charging high prices for this information will make it unlikely that it will be used for other beneficial uses (trans., p. 492).

The Environmental Research and Information Consortium Pty Ltd expresses a similar concern when it stated that:

> The cost of geophysical [data] from the AGSO is far too high for a [small to medium enterprise] to access for R&D, service innovation or service delivery purposes. While current prices for geophysical data were probably set at a level commensurate with the paying capacity of large mining companies, these data are now used … by [small to medium enterprise] for a wide range of resource assessment purposes (eg. soil mapping, hydrology assessment, etc.) and where the client's budget is very low, eg. Landcare groups. (sub. 7, p. 3)

The high price of this information has implications for other objectives of governments. It is likely to reduce the amount of exploration of Australia's mineral and petroleum resources. Reducing this activity will reduce the benefits governments receive from the discovery and development of these resources in the form of resource rent taxes and royalties. As AGSO noted:

> … the government is an equity holder in these resources with responsibility for the custodianship and management of these resources in the interests of the community. The Government, therefore, has a genuine, on-going interest in maximising investment in these resources. The benefits are returned to the community through the discovery and development of new resources. (sub. 55, p. 12)

According to the Northern Territory Geological Survey (NTGS) and the Geological Survey of Victoria (GSV), the high price of AGSO's geophysical data is having an adverse impact on cooperation between these agencies. Since 1998 both of these agencies have charged minimal fees for their geophysical data to encourage exploration. NTGS stated that:

> The differential pricing policy is a deterrent to NTGS embarking on joint projects with AGSO that involve large acquisition costs, as we have found it is difficult to agree on how the products of joint projects will be distributed. (sub. 32, p. 2)

Source: ERIC, sub. 7, p. 3; AGSO, sub. 55, p. 12; NTGS, sub. 32, p. 2; GSV, sub. 99.

Effects on industry

Cost recovery may affect industry through the price and availability of information services used by firms as inputs, and through setting prices for services that may also be provided by the private sector. If the prices of information services are set above the cost of providing them to an additional user, some firms will be discouraged from what would otherwise have been an economically worthwhile use of the data. Charging anything above the incremental cost of dissemination would be inefficient.

If the prices of the non-core services are set below the cost of providing them to an additional user, it provides the firm with an effective subsidy on its inputs, which will generally not be transparent and may not have a clear public benefit.

When the services of information agencies are competing with the outputs of private firms, pricing of non-core services below the cost of providing the services to an additional user would be contrary to competitive neutrality principles.

Drawing distinctions between core, incremental and commercial services are often difficult. Agencies need to be careful when drawing these distinctions and avoid using their ability to build on their core services to compete unfairly with private firms in their incremental and commercial activities. The Environmental Research and Information Consortium Pty Ltd stated that there is:

> Unfair competition from government agencies who are engaged in delivery of resource information and knowledge. … they can compete unfairly because they not only have ready access to public data and [intellectual property] at no cost but protect these data and [intellectual property] through minimising public access and imposing licence restrictions and high costs for public access. (sub. 7, p. 1)

Inter-agency cost recovery

Information agencies often provide services to other agencies. This can take a variety of forms and often results in special arrangements between agencies. For example, BoM has a Memorandum of Understanding with the Civil Aviation Safety Authority and Airservices Australia for the provision of meteorological services to the aviation industry and is developing similar arrangements for the provision of its services to the Australian Defence Forces (sub. 35, attach. G, p. 5-1). AGSO regularly conducts joint projects with State and Territory geoscientific agencies under the auspices of the National Geoscience Agreement (NTGS, sub. 32, p.2).

In many cases these arrangements will involve cost recovery by agencies. In the case of AGSO, these cost recovery arrangements appear to be having a detrimental effect on cooperation between agencies (box C.4). In some cases, cost recovery arrangements will involve special deals. For example, ABS has reached an agreement with the Australian Vice Chancellors Committee that provides most universities with access to confidentialised unit record files for further tabulation, analysis and modelling studies. While the universities pay, in aggregate, for these services, academics and students have direct access, at any time, to all released statistics (ABS sub. 36, p. 8). ABS also provides outposted officers to government agencies. Generally ABS fully cost recovers for the services of these officers, but where the agency can help the ABS achieve its legislative function, lower charges may be negotiated. (ABS, pers. comm., 22 March 2001)

In some cases, agencies pursuing cost recovery are mostly gaining revenue from the public sector. This means that the overall burden on the general taxpayer has not changed significantly. ABARE is in this position. It noted that its:

> … cost recovery arrangements mean that some research that once would have had direct appropriation funding is supported in other ways. Some small part of that work is now funded by the private sector. … For the most part, however, the change in support of research has been through [Commonwealth agencies]. While the focus of research has been changed by more direct links between researchers and industry and policy advisers, the ultimate sources of funds have not changed greatly. Commonwealth government matching of industry research levy funds mean that almost half the funds provided by industry research and development corporations are derived from general taxation revenue, along with all of ABARE's direct funding by government departments. (sub. 56, p. 23)

C.4 Summary

Information agencies undertake a variety of activities and provide a range of services that may be subjected to cost recovery. A central question for these agencies is to decide which services should be funded from appropriations and which should be funded through cost recovery. Generally, those services that are required for public policy purposes, have public goods characteristics, provide external benefits beyond the original users, or for which it is not feasible to charge are funded from appropriations. There is then a spectrum of services that provide private benefits to identifiable users and for which it is feasible to charge, which can be subjected to cost recovery, when it is effective to do so. These services range from those services that are incremental to agencies core services to commercial services. Another important question for agencies is the extent to which they should be involved in purely commercial work.

Most information agencies have clear rationales and objectives for recovering or not recovering various costs, and have developed guidelines or policies for implementing their cost recovery arrangements. However, in many cases, the legal basis for some of the arrangements is not clear.

Cost recovery has had an impact on the objectives and operations of information agencies. Imposing charges on the services of information agencies restricts the access to these services to some degree. This is likely to be offset by the additional resources available to agencies to provide more services and the internal efficiencies cost recovery can generate. Cost recovery has an impact on the way agencies calculate and allocate their costs so that they can set charges at levels which produce benefits for the agency and the wider community. Cost recovery can also

have positive and negative effects on the accountability and transparency of agencies.

The setting of external revenue targets for some agencies has had major implications for these agencies and the broader community. Targets create incentives for agencies to pursue cost recoverable activities at the expense of their public policy activities. Also, as there is usually only a narrow range of activities and services within an agency which are able to generate external revenue, the burden of meeting the target may shift the focus excessively on those activities and services. This is likely to result in the charges for these services being greater than what they would have been without the external revenue target. These higher charges will prevent users who would otherwise have been prepared to pay for these services from using them, and hence lessen the social welfare to be gained from the use of information services.

D Case study — health and safety regulatory agencies

A large number of Commonwealth regulatory agencies have functions aimed at protecting the health and safety of consumers, the environment and the wider community. These agencies regulate selected products, services and activities which are perceived to have particular health and safety concerns. They include chemicals, pharmaceutical products, food, imported goods, genetic research and air transport. Participation in these industries is contingent on meeting certain regulatory requirements. Therefore the regulatory services and associated charges are only discretionary at the point of entry into a market.

The health and safety role shared by these agencies, and the compulsory nature of their regulatory services, raise particular issues for cost recovery. Because most of these agencies' regulatory activities tend to affect the health and safety of wide sections of the community (as well as discrete groups of consumers), it may be difficult to identify everyone who benefits from the regulations, and/or infeasible to charge them for those benefits. To the extent that charges are compulsory for regulated industries, it may be unclear how these costs affect decision-making within regulated firms, or competition between them.

The approaches taken by various Commonwealth health and safety regulatory agencies to these, and other, cost recovery issues are discussed below. Agencies and divisions of departments included in this case study are listed in box D.1, and are collectively referred to as 'health and safety regulatory agencies' for the rest of this appendix. This case study draws upon the cost recovery arrangements of these agencies as illustrations, but does not review each of the arrangements in detail.

Box D.1 **Health and safety regulatory agencies**

Therapeutic Goods Administration: The TGA is a division within the Department of Health and Aged Care (DHAC). It administers a national system of regulatory controls for the quality, safety, efficacy and timely availability of therapeutic goods used in or exported from Australia.

Australia New Zealand Food Authority: ANZFA is a statutory authority within DHAC. It develops food standards and other food regulatory measures for Australia and New Zealand.

Australian Radiation Protection and Nuclear Safety Agency: ARPANSA is a statutory authority within DHAC. It licenses Commonwealth agencies which deal with radioactive materials or apparatus, or any aspect of a nuclear facility.

Office of the Gene Technology Regulator: The OGTR is an independent statutory office within DHAC. Its responsibilities include the health and safety of people and the environment by identifying and managing risks posed from gene technology.

National Industrial Chemicals Notification and Assessment Scheme: NICNAS is a statutory office administered by the National Occupational Health and Safety Commission (within the Department of Employment Workplace Relations and Small Business). NICNAS assesses the health and environmental risks of all industrial and selected chemicals being manufactured locally or imported.

National Registration Authority for Agricultural and Veterinary Chemicals: The NRA is a statutory authority within the Department of Agriculture, Fisheries and Forestry Australia (AFFA) responsible for administering the National Registration Scheme which provides for the assessment and registration of agricultural and veterinary chemical products prior to sale in Australia.

Australian Quarantine Inspection Service: AQIS is an agency within AFFA. It administers Australia's quarantine, agriculture and food export laws.

Space Licensing and Aeronautical Services Organisation: SLASO is a division within the Department of Industry, Science and Resources (DISR). It provides for the regulation of space activities undertaken either within Australia, or by Australian nationals outside Australia.

Australian Maritime Safety Authority: AMSA is an authority within the Department of Transport and Regional Services (DTRS). It provides regulation and oversight of Australian shipping; maritime navigation facilities; and search and rescue services.

Civil Aviation Safety Authority: CASA is an authority within DTRS responsible for the setting of aviation safety standards, registering aircraft, licensing and enforcing compliance with safety regulations.

Airservices Australia: ASA is a statutory body within DTRS. It is responsible for air traffic control and navigation facilities as well as airport firefighting services.

D.1 Extent and nature of cost recovery

Regulatory agencies with health and safety responsibilities may share similar issues and concerns with cost recovery, but the nature, extent and objectives of their cost recovery arrangements vary considerably. While some agencies recover a small proportion of their costs, or only the costs of discrete activities, others recover almost all of the costs associated with running the agency.

Revenue collected through cost recovery

In 1999-2000, the Commonwealth health and safety regulatory agencies listed in box D.1 received $899 million of revenue from cost recovery arrangements. ASA recovered the greatest amount of revenue ($585 million) and also recovered the highest proportion of agency expenses (108.6 per cent). However, the chemical and pharmaceutical regulators (NRA, NICNAS and TGA) also generated high proportions of their agencies' revenue from cost recovery arrangements (109 per cent, 99 per cent and 85 per cent respectively). Cost recovery revenue of these agencies is shown in table D.1.

Agency cost recovery revenues may be less than or greater than costs for a variety of reasons, including fluctuations in activity which may be offset between years (TGA), and cost recovery targets which include a rate of return on capital (ASA).

Table D.1 **Cost recovery revenue of health and safety regulators 1999-2000**

Agency	*Total cost recovery revenue*	*Total revenue from other sources*	*Total agency expenses*	*Cost recovery target*	*Cost recovery revenue as a % of total expenses*
	$m	$m	$m	%	%
TGA	41.4	2.3[a]	49.0	100	84.5[b]
ANZFA	0.8[c]	12.9	13.1		6.1
AQIS	136.7	42.2	178.2		76.7
NICNAS	3.7	0.1[d]	3.7	100[d]	99.3
NRA	17.6	1.0	16.2	100[e]	108.6
CASA	59.8	39.1	83.7		71.4
ARPANSA	1.2	14.0	16.1		7.5
AMSA	52.4	28.5	75.1		69.8
ASA	585.4[f]	11.0[g]	539.2	100[h]	108.6
Total	**899.0**	**151.1**	**974.3**		**92.3**

[a] Revenue from 'other sources' does not include any appropriation from government. [b] Cost recovery charges were deliberately set below costs to offset surpluses earned between 1995-96 and 1997-98. [c] ANZFA cost recovery revenue in 1999-2000 came from royalties and sale of publications. It did not recover any revenue from regulatory activities. [d] NICNAS received $113 000 appropriation from government to cover 50 per cent of its compliance costs (despite a 100 per cent cost recovery target). In previous years the appropriation was $400 000 to cover costs of government policy activities (no longer undertaken by NICNAS) and 50 per cent of compliance monitoring activities. [e] NRA has a stated 100 per cent cost recovery target, but it receives an appropriation from government of $108 000 for minor use chemicals (equal to 1 per cent of revenue in 1999-2000) (NRA, sub. 39, p. 4). [f] ASA classifies this revenue as commercial service charges rather than cost recovery. [g] ASA receives an appropriation of $11 million to subsidise the cost of towers at regional and general aviation airports. This subsidy is funded by industry from a levy on avtur fuel. [h] ASA bases its charges on the cost of providing its services, maintaining its assets and earning a reasonable profit.

Source: PC estimates based on questionnaire responses.

Agencies and activities which cost recover

The majority of agencies responsible for health and safety regulation have been established as independent statutory authorities. However, there are several agencies within the group that have different legislative structures: the TGA and AQIS are agencies within departments; and NICNAS is a statutory scheme within a statutory authority (the National Occupational Health and Safety Commission).

There are also some key differences in the way cost recovery policy is applied. The agencies recover different proportions of costs and impose contrasting fee mechanisms and costing structures. Some agencies, typically those regulating chemicals and therapeutic goods, aim to meet cost recovery targets that are applied on a whole of agency basis. For example, the NRA and TGA aim to recover 100 per cent of agency costs. Agencies such as AQIS, CASA and AMSA on the other hand, have individual cost recovery targets for particular activities rather than for the agency as a whole.

Most of the health and safety agencies recovering costs on an activity basis have distinguished activities that are provided as 'community service obligations' (CSO's) from those that have easily identifiable or direct beneficiaries.[1] For example, AMSA fully recovers the costs of regulatory services provided to industry directly, but funds its search and rescue functions, which it identifies as a CSO, through government appropriation.

ANZFA has adopted a different approach. A new model to recover the costs of ANZFA's regulatory activities was introduced in July 2000, although the arrangements have not yet generated any revenue. The new system does not impose an agency target nor does it require ANZFA to recover the costs of certain activities. Instead, it enables ANZFA to impose cost recovery where an 'exclusive capturable commercial benefit' (ECCB) can be identified from the approval of an application, or in situations where applicants request that extra resources be used to 'fast track' their application. This approach may reflect the nature of regulation undertaken by ANZFA:

> Unlike the activities of the Therapeutic Goods Administration or the National Registration Authority, in most cases, the processing of an application by ANZFA does not transfer a commercial benefit solely to the applicant. This is because the approval of an application is not limited to the applicant, nor generally to the individual product, but provides for generic amendments to the Food Standards Code. … this 'free-rider' effect would make it inequitable to charge an applicant the full cost of processing an application. (sub. 67, p. 3)

Thus ANZFA would recover the costs of an application where the applicant has a property right in a product. Section 66 (9) of the ANZFA Act states:

> … an exclusive, capturable commercial benefit applies where:
>
> (a) the applicant can be identified as a person or body that may derive a financial gain from the adoption of the draft standard or draft variation of the standard that would be prepared in relation to the application; and
>
> (b) any other unrelated persons or bodies, including unrelated commercial entities, would require the agreement of the applicant in order to benefit financially from the approval of the application.

By contrast, the TGA recovers the costs of all activities regardless of whether the applicant has a property right. Some participants have criticised this approach, arguing that the costs of assessing complementary healthcare products (which are not patentable) should be treated differently to the costs of assessing pharmaceutical products (most of which are patentable) (Complementary Healthcare Council of

[1] The term Community Service Obligation is commonly applied to non-commercial activities that Government business enterprises (GBEs) are required to undertake for social or equity policy reasons. GBEs are usually directly subsidised by government for providing CSOs.

Australia, sub. 17, p. 4). Similar issues have arisen recently with respect to new uses of products which are out of patent (such as generic pharmaceuticals).

Whilst all agencies examined (except ANZFA, OGTR and SLASO) recover the costs of their regulatory activities, there is no uniform approach to the treatment of costs relating to policy, research, compliance and monitoring functions. These functions include preparing ministerial briefings, litigation and research activities. The TGA and NRA are both required to recover the costs of compliance activities and policy development from industry. In contrast, NICNAS receives an appropriation for 50 per cent of its compliance costs, while policy functions relating to industrial chemicals are undertaken by NOHSC and funded through budget appropriation. CASA also receives an appropriation for 50 per cent of its compliance and standards setting functions.

Historical context

Cost recovery has been an established practice in some health and safety regulatory agencies for several decades. For example, CASA noted that 'cost recovery has been a feature of the provision of aviation regulatory services since 1956' (sub. 75, p. 2) and cost recovery arrangements were introduced in AQIS in 1979. Other agencies, such as the NRA and NICNAS, have only a relatively recent history of cost recovery (beginning in 1995 and 1990 respectively).

Although agencies introduced cost recovery arrangements at different times, there has been a general trend across all of the agencies to increase the proportion of costs recovered over time. For example, the TGA began operations in 1991 with a 50 per cent cost recovery target, although this target was not reached until 1996. This was later revised to require industry to fund 100 per cent of the costs of functions that were specifically related to industry. To implement this, the TGA, in consultation with industry, classified each activity as either industry related or 'in the public interest' and the costs of each activity were allocated accordingly. For example, all executive activities were attributed to public interest functions (budget funded), and almost all pharmaceutical evaluation activities were industry related (83 per cent industry funded). All corporate overheads were to be funded equally from the industry and budget. In the 1996-97 budget the Government announced an increase in the TGA's agency-wide target to 75 per cent to be phased in over three years. In the following year the Government determined that 100 per cent of the agency's costs would be recovered from industry from 1998-99.

The cost recovery arrangements of AQIS are another example of progressive fee increases. AQIS introduced cost recovery in 1979 with a requirement to recover 50 per cent of its export inspection services. Between 1979 and 1988, AQIS

expanded the range of services subject to cost recovery until all inspection services of agricultural commodities were cost recovered. The rate of cost recovery for inspection services was subsequently increased to 60 per cent of costs in 1988 and 100 per cent in 1991.

Nature of cost recovery arrangements

Health and safety agencies use a variety of mechanisms to recover the costs of their regulatory activities and functions. Most agencies impose mandatory fees for regulatory services provided to industry. These fees for service are categorised under a number of headings including assessment, administration, registration and application fees, and regulatory service fees. In addition to these regulatory fees, most health and safety agencies have fees for the sale of publications and for other non-regulatory activities such as contracted research, and the provision of seminars, conferences and training courses.

The majority of agencies also recover costs through levies or taxes including customs and excise duties. Levies may be payable on a per product basis (such as the NRA levy on disposals of products), or they may be charged on a company basis, such as the NICNAS company registration levy.

The cost recovery arrangements imposed by the NRA are outlined in box D.2 as an illustration of the types of mechanisms used by health and safety agencies.

Box D.2 **NRA cost recovery arrangements**

The NRA recovers its costs using three main mechanisms:

Application fees are imposed under the Agricultural and Veterinary Chemicals Code. These fees are set out in the regulations to the code and vary according to the type of application and the assessment required. Depending on the type of application made, fees fall into one of the following four categories — new products, variations to existing registered products, permits and modular assessments.

Annual registration renewal fees are imposed under the Agricultural and Veterinary Chemicals Code. Companies are required to pay an annual registration renewal fee for each product on the register. The fees are determined according to the product's disposals in the previous calendar year, where disposals equal the value of the product's gross sales in Australia. The fee paid per product is determined as follows:

Disposals	*Fee*
Over $25 000	$1 000
Between $10 000 and $25 000	$ 600
Less than $10 000 (registered in three or more States/Territories)	$ 300
Less than $10 000 (registered in one or two States/Territories)	$ 200
Nil disposals	$ 200

Levies on disposals of registered products are imposed under three Acts — the *Agricultural and Veterinary Chemical Products Levy Imposition (General) Act 1994*, the *Agricultural and Veterinary Chemical Products Levy Imposition (Excise) Act 1994*, and the *Agricultural and Veterinary Chemical Products Levy Imposition (Customs) Act 1994*. The levy monies are collected under the *Agricultural and Veterinary Chemical Products (Collection of Levies) Act 1994,* and the levy rates are prescribed under regulations to this Act. The above charges do not raise sufficient revenue to recover all of the NRA's costs, therefore levies are used to 'top-up' the revenue from application fees and fund compliance activities. The levies are payable on a product's gross sales, exclusive of sales tax. The current levy rates are indicated as follows:

Disposals	*Levy rate*
Less than $100 000	Nil
$100 000 or more	0.65 per cent (payable up to a maximum of $25 000)

Source: NRA (sub. 39, pp. 3-4)

Legislative arrangements

Legislation underpins the cost recovery arrangements of most agencies. The nature of these legislative arrangements varies, generally in accordance with the agency's legislative standing. Most agencies established as statutory authorities, such as AMSA and the NRA, have provision for charging fees for service in their enabling

legislation. These provisions are often qualified with a clause that such charges are not to amount to taxation (see chapter 3). Charges for services and facilities provided by AMSA are further qualified:

> The amount or rate of a charge must be reasonably related to the expenses incurred or to be incurred by the Authority in relation to the matters to which the charge relates and must not be such as to amount to taxation. (s 47(12) of the *AMSA Act 1991*)

Although the broad authority to charge fees is granted under the enabling legislation, the nature and amount of fees charged is generally provided for under regulations attached to the enabling Act.

Cost recovery regimes of non-statutory authorities also have their foundations in legislation, but the enabling provisions are generally more specific regarding the types of charges that may be imposed. For example, NICNAS sets charges under the *Industrial Chemicals (Notification and Assessment) Act 1989*. Section 110 of this Act lists the services for which fees may be prescribed under regulations.

Agencies imposing levies (which are technically taxes) must have authorisation in a separate Act (see chapter 3). For example, the TGA annual charge is authorised under the *Therapeutic Goods (Charges) Act 1989* and each of the AMSA levies is authorised under a separate Act, with associated Acts dealing with the collection of the levies. The levy rates are usually set out in regulations made under the levy Acts.

Rationale for existing arrangements

Cost recovery has become an established aspect of health and safety regulation in Australia. Although agencies introduced cost recovery arrangements at different times, it is apparent that there has been a trend to increase the level of cost recovery over time. Agencies generally have not provided detailed reasons for the introduction of their cost recovery arrangements to the Commission. In many instances, cost recovery appears to have been imposed on agencies without a formal rationale being given.

The NRA explained its move to full cost recovery in 1995-96 as being 'in line with government policy targets' (sub. 39, p. 2) and NICNAS explained its movement from 50 to 100 per cent cost recovery in 1996-97 as being 'to align … with other chemical regulatory agencies, such as the NRA' (sub. 33, p. 1).

In the Commission's questionnaire for this inquiry, agencies were asked to explain the rationale for their existing cost recovery arrangements. Generally, responses varied and provided little detail regarding rationale. Some agencies provided brief

responses such as 'user pays' and 'government decision' whilst others provided no explanation. AQIS noted that:

> … decisions to introduce cost recovery arrangements in AQIS related to various Government's policies to, where possible, recover costs of providing services to industry where services could be regarded as a normal business expense. (questionnaire response)

ANZFA provided a more detailed rationale for its recent introduction of cost recovery, stating that the arrangements were 'to allow better management of both ANZFA's scarce resources and its workload' (questionnaire response).

Although responses to the questionnaire were generally brief, the rationales for many existing arrangements have been outlined in external reviews of cost recovery arrangements. For example, a review of AMSA levies in 1997 noted that full cost recovery of AMSA's safety and regulatory activities through the Regulatory Functions Levy was introduced to conform with:

> … proper public sector pricing principles to recover avoidable costs. The principle states that, as shipping is an economic activity which requires regulation in the community interest, the cost of such regulation should be borne by those generating the need for regulation. In simple terms, if the shipping industry or shipping activity did not take place, the community would not incur the costs of regulation — as it does, those who generate the need should pay the cost and not have it borne by the general community. (Taylor 1997)

Some rationales for cost recovery arrangements have changed over time in response to policy changes. For example, the Australian Pharmaceutical Manufacturers Association (APMA) suggested that the 100 per cent cost recovery target of the TGA is inconsistent with the earlier rationale put forward by the TGA in support of partial cost recovery. In 1991, the then Minister, in support of only partial cost recovery for the TGA, noted that some activities of the TGA were performed in the public interest and should be budget funded (House of Representatives 1991, p. 464).

In a submission to the inquiry, the TGA argued that full cost recovery is warranted on the grounds that industry gains a significant commercial benefit from product endorsement and 'that all regulatory effort by the TGA is undertaken solely because the industry exists' (sub. 89, p. 10). However, this includes cost recovery of policy advice, post-monitoring compliance and administration costs.

Some agencies identified their rationale for cost recovery as resting on the arrangements of their users. For example, the Department of Environment and Heritage (DEH) conducts risk assessment reports and provides policy advice to both NICNAS and the NRA. These assessments deal with the potential effects of

chemicals on the non-human environment. The DEH fully cost recovers for this service and stated:

> Consistent with government policy on cost recovery for chemical registration functions, the NRA is fully cost recovered. Environment Australia's provision of the services of environmental risk assessment to the NRA is in turn fully cost recovered. (questionnaire response)

D.2 Impact of cost recovery on agencies

There is no uniform approach to how cost recovery has been applied by health and safety agencies. Agencies apply various charging mechanisms to recover the costs of their activities and these approaches have varying effects on agency efficiency. To be consistent with good public administrative practice, cost recovery arrangements should have appropriate governance mechanisms in place to ensure transparency, accountability and predictability in their application.

Incentive effects for agencies

Cost recovery has the potential to create positive or negative incentive effects on an agency's performance. Positive effects may arise from improved efficiency (although this may be difficult to measure), improved accountability and transparency, as well as improved demand responsiveness. Negative incentive effects may include regulatory capture, 'cost-padding', 'gold-plating', regulatory creep, and cost shifting. These negative incentive effects for agencies may be diluted if they are unable to retain the cost recovery revenue (see chapter 5).

Some health and safety agencies claim that cost recovery has promoted agency efficiency, transparency and accountability. The extent to which this is the case will be influenced by:

- whether the agency is subject to full cost recovery; and
- whether the agency engages in industry consultation; and
- the degree of disclosure of cost information.

NICNAS, for example, claimed that cost recovery has helped improve its efficiency and accountability. It supported this claim by highlighting increases in outputs, in access to products and services, and in the quality and useability of its assessments, while costs have remained at 1997 levels (sub. 33, p. 3).

The NRA stated that it has reacted to the increase in industry expectations which resulted from full cost recovery, by completing 98 per cent of submissions within

the allocated timeframe. It also claimed it has been assisted in achieving this by improved industry efficiency — applicants now lodge higher quality submissions, in the knowledge that they will bear the additional costs should their application need to be resubmitted (sub. 39, p. 1).

While cost recovery may encourage users to seek value for money in the service offered, it may also work against accountability to the public. Organisations such as the CHC stated that 100 per cent cost recovery arrangements remove statutory agencies (such as the TGA) from the Government scrutiny applied to agencies funded by appropriations, thus reducing their transparency and accountability (sub. 17, p. 11).

By pricing outputs, cost recovery can help agencies be more responsive to demand. However, the mandatory nature of the regulatory activities undertaken by these agencies gives them considerable power in setting rates and makes it difficult to use demand management techniques. ANZFA is the exception as its cost recovery policy explicitly recognises that companies may be willing to pay for the extra resources needed to fast track applications. Although this policy is in place, it is yet to be applied.

Full cost recovery, combined with strong stakeholder influence, can also lead to perceptions of industry capture, as recognised by the CHC (sub. 17, p. 22). This is particularly the case when industry believes it has a right to influence regulatory agencies' activities because it pays for them:

> Industry, if required to fund a scheme to 100 per cent should have a strong ability to influence the allocation and priority of the activities. This may be through a Board or stakeholder group that has responsibility to advise on the ongoing process. (Plastics and Chemicals Industry Association, sub. 24, p. 7)

The NRA stated that it attempts to minimise the risk of agency capture by ensuring transparency and openness within the agency:

> The NRA's management and consultative arrangements also allay fears of industry capture by being very open and transparent. All assessment reports are made available to the public and decisions are disseminated via the NRA Gazette and other communication vehicles. Strong public input is encouraged. (sub. 39, p. 6)

Some industry participants raised concerns about the prevalence of these negative incentive effects, and their impact on charges. For example, Blackmores viewed the annual charges for listing products on the Australian Register of Therapeutic Goods (ARTG) (which range between $350 and $950 per product) as excessive:

> Changes to the ARTG are made on a fee per application service. It should be reasonable to expect these application fees should also cover the maintenance of the

> database as well. A computer database of this nature could be contracted out to the private sector at a greatly reduced cost. (sub. 25, p. 1)

The Australian Self Medication Industry (ASMI), as well as the CHC, have questioned the appropriateness of industry paying the rental costs of the TGA. Industry groups stated that the TGA has had to accept a property valuation equivalent to a net annual rent of $5.3 million — an increase of $3.3 million on its present rent — to ensure maximum revenue for the sale of its premises at Symonston, ACT (sub. 104, p. 1; sub. 105, p. 1).

The Australian Paint Manufacturers Federation (APMF), stated that cost recovery for government bodies is akin to a monopoly 'whose decisions do not have to stand the test of competitive scrutiny'. As a result, cost recovery can lead to regulatory creep as 'it is seen by the bureaucrats as a way of extending the organisations operations' (sub. 74, p. 4).

When agencies cost recover for some activities and not others, there may be incentives to shift outputs from those which do not recover costs to those which do (see chapter 5). Shifting resources away from those activities with public benefits towards those with private benefits may be inconsistent with program objectives. These concerns were identified in the *Nairn Report, 1996 — Australian Quarantine: A Shared Responsibility*:

> Observations during the inspection phase of the Review lent weight to the view that quarantine staff were tending to concentrate effort on cost-recovered programs to the detriment of budget-funded activities … some quarantine activities appeared to be driven more by the ability to charge for services than by the need to meet the objectives of quarantine. (Red Meat Advisory Council, sub. 47, p. 23)

Whilst some health and safety agencies claim that cost recovery leads to greater transparency and accountability, industry participants suggest current arrangements are insufficient to address transparency and accountability concerns, and more direct approaches are required. These could include board representation, industry consultation and the formation of industry consultative committees, with access to appropriate data for measuring performance.

Agency innovation and technology

Cost recovery may also provide incentives for agencies (and/or industry) to adopt new technologies. New technologies may promote both agency and industry efficiency which may also be reflected in lower charges. Information technologies, particularly the Internet, are changing the relationship between regulators and those they regulate. Increasingly, those who must comply with the regulations are able to use Internet access to provide information needed by the regulator.

For example, in order to encourage industry to use electronic certificates for export, AQIS undercharges for electronically issuing documents and overcharges on manually issued certificates. The Australian National Audit Office (ANAO) Report into AQIS cost recovery systems noted that this practice was agreed with industry (2000a, p. 89).

In submissions to the inquiry, the TGA stated that the introduction of the Electronic Lodgement Facility has dramatically reduced processing times from 80 to 10 days in the majority of cases for low-risk products (sub. 89, p. 21). Both technologies have led to improvements in agency efficiency.

Operation of cost recovery

The implementation of cost recovery requires the calculation and apportioning of costs. Agencies differ in the way they choose to allocate costs across activities.

Calculating and apportioning costs

Regardless of whether health and safety agencies are required to fully or partially recover costs, most start by estimating their cost base and allocating both direct and indirect costs to outputs.

All health and safety agencies apportion costs by applying some form of fully distributed cost (FDC) approach (see chapter 8 and appendix H). NICNAS, the NRA, the TGA and AMSA are examples of agencies that use activity based costing to apportion costs (see appendix B). ANZFA, ARPANSA and AQIS all use FDC to allocate indirect costs as a proportional share of direct costs (box D.3).

Box D.3 **AQIS's approach to apportioning costs**

AQIS apportions costs using a FDC approach. Where possible it apportions indirect costs directly to the different user groups using its services (on a program basis) so as to minimise cross-subsidies between users.

AQIS differentiates between those indirect costs that can be specifically attributed to a sub-set of users (technical and operating costs) and those, such as overheads, which are applied across the whole agency.

- *Technical and Operational costs*: One example of these is detector dogs which are specific to the Airports, Import Clearance, Northern Australian Quarantine Strategy and the International Mail programs. These are allocated on the basis of the number of dog teams utilised.

The remaining indirect costs are apportioned through a variety of mechanisms, predominantly as a proportion of full-time equivalent (FTE) staff or as a proportion of direct expenditure:

- *Corporate expenses*: are charges to the organisation as a whole (insurance and internal audit charges). These are apportioned on the basis of FTE staff; and
- *Overheads*: including support services in finance, human resources, information technology and regional support. These are allocated on the basis of drivers such as FTE staff across relevant programs, direct expenditure, invoices processed, accounts raised and floorspace, and represent 11 per cent of AQIS's 2000-01 budget.

Source: Questionnaire response; ANAO 2000a, pp. 48, 115; AFFA, trans., pp. 664-5.

Cross subsidies

Cross subsidies occur when one group of users pays for more than the costs of the services they receive, and the surplus is used to offset the cost of services provided to other users (ANAO 2000a, p. 84). From submissions to this inquiry, rationales for the existence of cross subsidies may differ between health and safety agencies. Rationales include the difficulties associated with separating the cost of the activities/programs, identifying users of the service, perceived equity concerns about charges or as a response to industry preferences for the calculation and implementation of charges.

Most health and safety agencies are able to separate their activities within programs, and therefore do not use revenue from one program to cross subsidise another. One exception is the TGA, which uses the revenue from annual registration charges (for registration on the ARTG database) to cross subsidise post market monitoring and compliance functions.

The difficulty of identifying the users of a service was not a common rationale across health and safety agencies. The exceptions were transport agencies such as CASA and AMSA. AMSA imposes levies on vessels on a sliding scale (based on net registered tonnes), so that the total cost of services provided are recovered over a quarterly period. The Marine Navigation Levy is used to fund the provision of navigation aids such as lighthouses as it would be impractical to monitor the individual use of these aids. Although ASA now applies location-specific pricing based on the costs associated with individual towers, until 1988 it operated a network pricing framework which implicitly included elements of cross subsidy.

Perceived equity concerns were given as a rationale by various health and safety agencies for cross subsidies. CASA is able to subsidise the shortfall from regulatory service fees through fuel excise and customs taxes imposed by government. Similarly, ASA is able to subsidise the costs of operating regional towers through fuel excise (avtur and avgas) revenue from airlines.

Various participants said that equity considerations 'should be funded through a community service obligation, not via industry cross subsidies' (Ansett, trans., p. 692).

Finally, the adoption of cross subsidies by some agencies was in part, in response to industry consultation. AQIS stated that it had adopted a cross subsidisation model within its meat inspection program because of industry concerns:

> … industry felt the registration charges where too high and they wanted there to be some cross-subsidisation from the fee-for-service arrangement into the non-variable cost structure. That was agreed with industry. It adulterated the purity of our model but it was what industry preferred, and they agreed, and we agreed with them and it has been a very useful mechanism for ensuring that we have agreement with industry. (AFFA, trans., p. 668)

Managing cost recovery revenue

In situations where over-recovery of costs may occur, most health and safety agencies indicated that they would retain the revenue, although there was divergence as to how the surplus was managed. The NRA and ARPANSA stated that excess revenue leads to an adjustment of their respective charges. The TGA noted that excess revenue may be used to limit future price increases, or retained in case of future revenue shortfalls. For example, whilst the TGA over-recovered in 1995, 1996 and 1997, it only recovered 85 per cent of its costs in 1999-2000. NICNAS stated that any revenue in excess of full costs is allocated to priority projects as identified by its Industry Government Consultative Committee (questionnaire responses, appendix B).

Similarly AQIS stated that over-recovered funds are allocated into one of three liability accounts following industry consultation (box D.4). However, despite these arrangements, the ANAO found that over-recovered funds to the value of $5 million had been retained by AQIS and not yet returned to industry in the form of discounts and rebates to charges (2000a, p. 20).

Box D.4 **Treatment of over-recovered AQIS funds**

Over-recovered AQIS funds are placed into one of the three following liability accounts.

Income Equalisation Reserve (IER): used to enable AQIS and industry to overcome unforseen downturns in the recovery of expenditure over a period of years;

Revenue Rebate: used to temporarily reduce the level of charges applied for services performed by the program as agreed with industry; and

Industry Initiative Account: used in consultation with industry for projects of benefit to industry, such as research and development, marketing and promotional activities.

Source: AQIS questionnaire response; ANAO 2000a

SLASO has set its charges by calculating the expected full operating costs of the agency over the relevant period (two years) divided by the expected total number of applicants (DISR, sub. 62, p. 16). It has received advice that it was not imperative for the licence/permit fees to exactly equal the costs, because 'if the fees were calculated in good faith' they would not be such as to amount to taxation. However, the advice noted that should revenue exceed costs in one period, fees should be adjusted in the next period to achieve balance (DISR, sub. 62, p. 16).

The ability of agencies to retain revenue in excess of their full costs may create incentives for agencies to increase charges (as discussed earlier). Over-recovery of costs for a program or activity could lead to charges being construed as taxes and not fees for service. AQIS received legal advice that over-recovery by 10 per cent or more would result in a charge being construed as a tax (ANAO 2000a, p. 68). Strong governance arrangements to promote transparency and accountability would reduce these incentives.

Contestability

The operation of cost recovery within agencies can be influenced by international arrangements, such as mutual recognition, which may introduce a level of contestability within an agency. Contestability can be enhanced through the outsourcing and market testing of services.

International harmonisation of regulation is a necessary first step towards mutual recognition, but it can only be pursued with countries that have similar standards to our own. Adopting standards similar to those overseas can have implications for cost recovery. It may reduce the overall costs of compliance to industry as well as reduce agency administration and processing costs. However, health and safety agencies are not pursuing mutual recogntion as much as industry would like. For example the Australian Chemical Specialties Manufacturers Association (ACSMA) noted that:

> … the lack of international harmonisation of definitions and classifications makes provision of data and compliance more difficult and costly. (sub. 60, p. 7)

The mutual recognition of standards would increase the pressure on Australian regulators to be efficient by making them compete for services with comparable international bodies. This would affect their fee-setting arrangements. As ACSMA noted:

> One area with the potential for regulators to decrease their costs significantly, and therefore the amount recovered from industry, is the improved recognition of chemical approvals by foreign regulatory authorities. This would also significantly reduce the costs of companies providing information to regulators. (sub. 60, p. 6)

Similarly, the outsourcing of various components of the assessment process for foods, chemicals and pharmaceuticals, could lead to greater contestability and promote increased efficiency by the agency. The Plastics and Chemicals Industry Association (PACIA) suggested agencies should:

> … outsource the technical review aspects and undertake a more managerial approach to the assessment process. This would likely lead to competitive costs and reduced overheads which are more justifiable to the applicant. Government would still need to be assured of the quality of the process and retain its role as final arbiter of results to ensure that the level of technical support remains independent and sound. (sub. 24, p. 3)

This view was supported by the CHC which stated:

> Many TGA activities could be contested by the private sector. For example, the Australian Register of Therapeutic Goods … could be managed by a range of licensed service providers. Laboratory analysis of substances could be carried out by NATA accredited laboratories. Manufacturing facilities in Australia and overseas could be audited out by local auditors. At the very least contestability would benchmark TGA performance. (sub. 17, p. 2)

Administrative arrangements

The mechanism adopted for recovering costs can affect the complexity (and the efficiency and cost) of an agency's administrative arrangements. Fees for service

may be more costly to administer then a levy or tax due to the complexity in calculating appropriate charges. There are also process issues relating to the frequency and collection method of such charges, and the predictability of these cost recovery arrangements.

All cost recovery revenue (including that of health and safety agencies) must meet Constitutional requirements and be paid into the consolidated revenue fund, regardless of the type of collection mechanism chosen. Through various appropriations, funds are then allocated to agencies (see chapter 3).

In the case of AMSA and CASA, some revenue is hypothecated — that is, there is a direct relationship between program costs and levy/excise revenue returned to the agencies. For example, revenue generated from the *Fuel Aviation Revenue (Special Appropriations) Act 1998*, is earmarked for CASA. Similarly, revenue received from Regulatory Functions Levy, Marine Navigation Levy and Protection of the Sea Levy are all hypothecated to AMSA. However, it may be difficult to ensure that the amount raised through hypothecation matches the amount needed to efficiently fund the relevant activity.

The operation of cost recovery arrangements can also be influenced by the type of program which is being cost recovered. Levies may be an appropriate cost recovery mechanism when it is difficult to allocate costs and benefits to the appropriate beneficiaries, if beneficiaries cannot be charged directly, or if the costs need to be recovered over a long period of time (see chapter 8). Examples include the Marine Navigation Levy (imposed by AMSA) and the Aircraft Noise Levy (imposed by DTRS). However, fee for service arrangements are generally regarded as more transparent because there is a direct link between the charge and the service provided. As noted by Ansett:

> We have enormous concerns about the use of fuel levies as an appropriate cost recovery mechanism. Certainly I don't believe that they are efficient. They are certainly administratively easy. They're not transparent. (trans., p. 694)

While most health and safety agencies collect cost recovery charges themselves, the collection of charges relating to the DTRS and transport agencies such as CASA and AMSA are outsourced. The fuel excise is collected by the Australian Taxation Office on behalf of CASA while AMSA's levies are collected by the Australian Customs Service (ACS), which does not charge AMSA a fee for this service. ASA collects the Aircraft Noise Levy on behalf of DTRS using the same administrative system that is used in the collection of aircraft landing fees, but charges DTRS a fee for this service.

The ACS collect AMSA levies in the course of its barrier management inspection duties. This is recognised by the ANAO to be a cost efficient approach to levy collection, but:

> Consistent with the need for transparency in the management of levies, the collection costs should be visible. As well, they should be included in the total costs attributed to the levy, even if this is at the reporting level and not imposed as a fee for service. (ANAO 2000c, p. 44)

In recent times, the administrative arrangements across the majority of health and safety agencies for cost recovery have been fairly stable. Transport agencies such as CASA and AMSA have had stable administrative arrangements in dealing with excise/levies, community service obligation funding and fee for service. However, agencies such as the TGA and the NRA which at present fully cost recover, have been subject to changes in government policy relating to cost recovery targets. ANZFA has recently put into place new cost recovery arrangements, whilst the cost recovery arrangements of the OGTR and SLASO are still under review.

Governance

In broad terms, governance refers to the processes that direct, control and hold to account agency bodies. Cost recovery can have important impacts on these arrangements. Key elements of governance include: the transparency of the agency and its activities; the implementation of effective risk management and financial management; and the accountability of the agency (or its board) to stakeholders and the public through clear and timely disclosure (see chapter 8). This may involve consultation with stakeholders to enhance the predictability of cost recovery arrangements through a variety of mechanisms such as consultative committees.

Accountability

Those health and safety agencies that are regulated by the *Commonwealth Authorities and Companies Act 1997* (CAC Act) are required to have a board structure in place (examples include CASA, ASA and the NRA). It is the role of the board to promote the best interests of the agency and be accountable to the responsible Minister. This contrasts with those agencies regulated by the *Financial Management and Accountability Act 1997* (FMA Act) such as the TGA and ARPANSA, where the agency's Chief Executive Officer is accountable to the appropriate Minister.

Industry participants such as Avcare suggested that a board structure with industry representation is their preferred governance arrangement, stating that the presence

of a board may be '… one way to achieve transparency, and scrutiny of some of the costs' (Avcare, trans., p. 385).

However, as noted earlier, there may be negative consequences attached to industry representation on a board. Direct stakeholder participation may lead to perceptions of the agency being 'captured'.

The ANAO has noted that, ideally, board representatives should be selected on the basis of their expertise relating to the agency and financial management skills, as they have an obligation to manage the agency with public interest objectives in mind (ANAO 1999). With these conflicts in mind, alternative vehicles such as consultative committees may be more appropriate models for achieving stakeholder and consumer consultation and ensuring transparency and accountability.

Consultation

All health and safety agencies have some form of consultative procedure in place to deal with users, beneficiaries and other government agencies. However, there is variance as to the degree of accountability and transparency of these arrangements between agencies and within agencies. Some agencies, such as the TGA, have one committee which provides feedback and consultation on all of the agency's activities, while other agencies, such as AQIS, have separate committees for each agency program.

AQIS operates a separate Industry Consultative Committee (ICC) for each of its 14 commodity/industry groups, with the exception of Animal Quarantine Stations (as there is no easily identifiable industry for this program). For example the ICC for the AQIS meat program includes:

> A wide range of industry representatives, from game meat establishments, through to red meat establishments, through to cold store operators — everyone in the production chain. They all have sort of cross-representation. Participation in that is financed by the individual group, whoever they happen to be representing, and the secretariat services are provided by AQIS. (AFFA, trans., p. 670)

Even if consultative processes in the form of industry consultative committees are in place, the perceived value of these structures may differ between agencies and stakeholders. For example, the TGA stated that the:

> TGA Industry Consultative Committee (TICC) facilitates consultation between TGA and the industry regarding input to the TGA budget and accounting against the TGA Corporate Plan; [it] also provides direct feedback from industry to TGA on broad policy, resource allocation and performance issues. (sub. 89, p. 17)

This view contrasts with that of ASMI and the CHC, which suggested this committee was not sufficiently accountable and transparent, particularly regarding issues of financial management:

> The TICC committee which has been referred to in so much of the hearings is managed by the TGA with little opportunity to question expenditure or budget. The transcripts show many conflicting attitudes to the usefulness of this forum. (CHC, sub. 98, p. 5)

The ANAO noted that the TGA could improve its relationship with stakeholders through the publication of more detailed information in annual reports, as well as Quarterly Performance Reports (2000b, p. 54).

Predictability

Predictability in the costs and activities undertaken by an agency can improve the stability of its funding base. It can also promote business confidence and enable industry to make informed decisions. As identified by Avcare:

> Fees should be set by regulation and not fluctuate each year according to the predicted workload of agencies (that is, number of applications) as happens with the TGA. A fluctuating approach does not provide the necessary cost predictiveness and budget forecast certainty for industry. (sub. 28, p. 9)

Most health and safety agencies have processes in place to encourage predictability in costs and activities, as well as in their funding base. NICNAS operates a company registration system, which requires that all persons or companies importing or manufacturing industrial chemicals worth more than $500 000 must register annually with NICNAS and pay a registration charge. A recent evaluation by NICNAS found that:

> The company registration system provides a stable and predictable funding base, and that the administrative costs of the program compare favourably with alternative funding mechanisms such as funding from consolidated revenue. (sub. 33, p. 2)

The TGA has come under industry criticism for potentially large variances in charges. Although the TGA differentiates between high and low risk evaluations, there is still scope for divergences because assessment charges are based on the number of pages and the type of information contained in each part of a submission:

> Thus, whilst there is a specific fee, for example, for the evaluation of between 20 000 and 40 000 pages of clinical data for a prescription medicine of $88 500, the fee is only notionally related to the actual cost of the activity. (APMA, sub. 14, p. 5)

This contrasts with ANZFA's model for pricing evaluations (yet to be applied), which grades and charges applications according to their complexity (table D.2).

This is intended to 'give applicants certainty of the total charges they will face before they agree to work commencing' (ANZFA, sub. 67, p. 5).

Table D.2 **Australia New Zealand Food Authority charging structure**

Category	*Av hours*	*Cost per hour*[a]	*Actual cost*[b]	*Hours*
		$	*$*	
Very simple application	25	112	2800	0-50
Simple application	125	112	14 000	51-200
Average application	300	112	33 600	201-400
Complex application	500	112	56 000	401-600
Highly complex application	750	112	84 000	601-900

[a] Includes all salary and administration costs for a senior officer in 2000-01; [b] Charges cover all costs associated with varying a standard or having a product or process approved through to the final decision making stage by the Ministerial Council

Source: ANZFA, sub. 67, p. 5

Some industry participants expressed concern about a lack of predictability in the implementation and operation of cost recovery arrangements. For example, Ansett objected to the level of fuel excise tax on avtur (aviation turbine fuel) and avgas (aviation kerosene) as well as to the lack of consultation regarding their imposition:

> We're not consulted on the level of activity that is used in determining and setting the level of the fuel levy. We have no reconciliation at the end of the year as to the amount paid and the amount collected in the fuel levy. … we have no consultation about these levies. They're announced on budget night and take effect from midnight on budget night. They impact on our business planning. (Ansett, trans., p. 694)

D.3 Economic effects of cost recovery

The cost recovery arrangements of health and safety agencies have implications for the regulated industry, consumers and the broader economy. They may contribute to achieving the objectives of the regulation or lead to efficient resource allocation across the economy (see chapter 2 and chapter 6). Alternatively, cost recovery arrangements might have negative effects on industry, such as contributing to barriers to entry or deterring innovation. Cost recovery arrangements may also affect consumers of regulated products through higher prices (to the extent that industry passes on the costs of regulation) or through a reduced choice of products and services available.

Resource allocation effects

The activities of health and safety agencies benefit, to some extent, three main groups:

- the consumers of regulated products and services (for example, through increased product safety or service standards);
- the general public (for example, through knowing there is a range of safe products); and
- the regulated firms (for example, through government endorsement of their products).

The degree to which each group benefits may differ between agencies and activities. This can be reflected in cost recovery arrangements where agencies have adopted a beneficiary pays approach. For example, CASA identified the beneficiaries of its activities as the aviation industry, the travelling public and the general community. This is reflected in its funding arrangements — some from appropriation and some from the aviation industry, a percentage of which CASA assumes to be passed on to the travelling public (CASA, sub. 75, p. 4).

Even where agencies wish to apply a 'beneficiary pays' approach to cost recovery, there are circumstances where beneficiaries cannot be charged directly. These circumstances include where the regulatory activity also has 'public good' characteristics; where it is difficult to identify the beneficiaries; or where the beneficiaries are too numerous, and it is not practical or economically efficient to charge them directly (see chapter 2 and chapter 6).

Many health and safety agencies have identified 'public good' characteristics in some of their activities and funded these activities through appropriations. For example, AMSA funds its search and rescue operations through appropriations. Whilst an emotive issue, budget funding of search and rescue operations places no incentive on those most likely to require these services to take precautions and greater responsibility for their actions. Alternatives suggested by the DTRS include various 'insurance schemes':

> Were the cost of an individual maritime search, for example passed back to the user involved then at minimum insult would be added to injury and more probably the user would refuse to pay … however, an 'insurance' charge levied on the cost of provision of a year's search and rescue service, may well prove to be a feasible option. (sub. 48, p. 4)

In other instances, health and safety agencies do not charge beneficiaries directly due to difficulty (or cost) of identifying and charging them. For example, AMSA exempts the non-commercial shipping industry from paying two of its three levies

as it would not be cost effective to levy pleasure craft and fishing vessels (Taylor 1997, p. 20). Similarly, ANZFA does not charge for applications to change the food standards code where applicants do not have 'an exclusive capturable commercial benefit'. Changes to the food standards code may benefit other members of the industry and the consumers of food products, making the beneficiaries too numerous and the task of recovering costs impractical. This 'free rider' problem may also discourage innovation in food development (see chapter 6).

In most circumstances, consumers of regulated products and services benefit from the regulation. However, despite identifying them as beneficiaries, agencies do not usually have contact with end consumers and are unable to charge them directly. However, many agencies (for example, CASA) impose charges on the regulated industry, assuming that at least a proportion of these charges will be passed on to consumers in the purchase price.

Some health and safety agencies have assumed that industry is the main beneficiary of regulation. For example, the TGA recovers 100 per cent of its costs from industry although consumers of regulated products and the general community may also benefit from their regulatory activities. The TGA justifies this approach on the basis that industry obtain commercial benefit from regulation and the TGA and associated costs would not exist without the industry (TGA, sub. 94).

Distributional effects of cost recovery arrangements

Aside from the level of cost recovery chosen, the fee mechanisms and structures chosen by agencies may also have implications for economic efficiency. In the cost recovery arrangements of many health and safety agencies, the level of charges paid by firms are determined, to some extent, by their size. For example, the NRA imposes a cap on levy payments, and both the NRA and NICNAS impose minimum thresholds for levy payments and allow exemptions from charges in certain circumstances. There are a number of reasons why agencies may base fee calculations on firm size. For example, NICNAS indicated its arrangements are to minimise the regulatory burden on industry (sub. 33, p. 3).

Charges based on firm size may address distributional objectives, but unless the charges reflect differences in the level or cost of the regulatory services consumed (or alternatively, the risk or pollution imposed on society), the resulting allocation of resources may not be efficient.

The Council of Small Business Organisations of Australia (COSBOA) argued against agencies distinguishing between different groups in their cost recovery charges, stating that:

> … any good or service in the marketplace should be purchased at the same rate, and … if society believes that some disadvantaged group needs support that should be through some sort of tax relief or some benefit. (trans., p. 535)

There is a wide range of cost recovery mechanisms available to health and safety agencies, and inquiry participants have indicated that some may result in more disproportionate impacts on small firms than others, and in some cases may act as a barrier to entry (see below). For example, the requirement to pay substantial fees up front may be more of a burden on small firms than large firms. The NRA stated that after consultation with industry, this prompted its decision to impose only partial cost recovery of initial application costs, and to recover the remaining cost through an annual levy on sales:

> On average about 30 per cent of actual costs are recovered from application fees. However, by having a cost recovery model which have the two components, up front fees and sales levy, the cost is spread over the life of the product. In this way fees do not unduly disadvantage smaller companies or mitigate against local research and development efforts and the promotion of minor agricultural industries. (sub. 39, p. 7)

Further, the NRA commented on the likely impact on small firms of reducing its existing number of fee categories:

> To ensure fees are closely aligned with the level of service, an extensive schedule of fees and charges has been determined in consultation with the industry and reviewed on several occasions. While there has been some suggestion that the number of fees/charges should be rationalised, this may not be in the best interest of small companies who service niche, yet important agricultural sectors. (sub. 39, p. 5)

A number of participants also commented on the general disadvantage faced by small firms in not being able to spread charges across a large product range, volume or market. For example, Whiteley Industries noted:

> … the larger companies can … fund their cost recovery across a greater market share with enhanced margins, … As a consequence small suppliers simply cannot compete. (sub. 1, p. 2)

However, this 'disadvantage' may reflect the economies of scale available to larger firms.

The ability of firms to pass on cost recovery charges to consumers may differ according to the size of the firm. COSBOA noted that small firms (which are typically price takers) may not be able to adjust their prices to cover regulatory charges in the same manner as larger firms (trans., p. 544).

In some industries, firms argued that one section of the industry is paying for the costs associated with regulating another sector; that is, one section is cross subsidising another. To the extent that this occurs, price signals may be

distorted and some industry sectors may consume more or less of the regulatory service (to the extent that they have a choice) than they would otherwise. For example, Ansett and Qantas (sub. 68, p. 12; sub. 63, p. 6) suggested that the increase in aviation fuel excise to cover CASA's regulatory service costs resulted in Ansett and Qantas (which pay the majority of the fuel excise) paying the costs associated with the regulation of other industry members, as well as subsidising the cost of landing towers at regional airports (through the avtur excise). In addition, Qantas noted that only fuel purchased in Australia is subject to the excise, so that:

> Australian companies … which predominantly or exclusively conduct their business overseas, receive the benefit of the regulatory oversight provided by CASA virtually free of charge by purchasing their fuel overseas and avoiding the levy. (sub. 63, p. 6)

Other agencies have implemented cost recovery arrangements with explicit instructions that program areas or locations are not to cross subsidise other areas. For example, since 1993, AQIS has been required to recover full costs on a program by program basis, rather than across the organisation as a whole. The ANAO Report concluded that AQIS has generally been successful in this regard, but noted some exceptions due to the lack of data on actual costs incurred (2000a, p. 23).

Industry incentives

Many health and safety agencies have incorporated positive incentives to industry into their cost recovery arrangements. Through cost recovery charges, some agencies have attempted to deter frivolous or vexatious applications, promote quality in applications, and encourage industry to keep agency records up to date. However, if direct charges are set too high, firms may be deterred from submitting worthwhile applications. Agencies may seek to address these concerns by structuring charges to provide industry with particular incentives. For example, the NRA which bases annual levy payments on the gross sales of listed products, imposes a $200 levy on products with nil sales as an incentive to companies to remove old products from the list of registered products.

Cost recovery arrangements also have the potential to create undesirable incentives for industry. In response to cost recovery arrangements, industry may act against the objectives of the regulation. For example, if pharmaceutical companies were charged directly for the cost of recalling their products, they might be discouraged from notifying the TGA of any potential danger associated with the product, which might not lead to a recall. Cost recovery arrangements may also lead firms to behave in a manner that may increase the costs of the regulator. Taylor (1997) refers to a submission by the Australian Yachting Federation which suggested that:

> Charging their members direct[ly] could affect behaviour and search and rescue costs could be higher if their members were discouraged from using navigation aids through some charging arrangements. (p. 17)

Competition effects

Firms wishing to launch a product into markets regulated by health and safety agencies face potential regulatory barriers on two levels. The first is at a firm level, that is, firms are often required to register and receive approval to operate in a regulated industry. Second, firms face barriers at an individual product level through individual product assessment, approval and registration. However, it is difficult to distinguish the impact of cost recovery charges from the compliance costs associated with the regulations themselves. Cost recovery charges add to the costs associated with complying with these regulations (see chapter 6).

Firms that face cost recovery charges in addition to the cost of meeting data and regulatory requirements may be deterred from entering the Australian market. A number of submissions indicated that regulatory charges had adversely affected decisions to introduce individual products into the Australian market. As mentioned earlier, these barriers to entry are a particular problem for small firms. For example, the APMF argued that cost recovery arrangements:

> … force companies to make decisions as to what products they will or will not produce in Australia based not on market considerations but on which products are likely to incur the lowest level of fees, levies etc. … coatings manufacturers are making decisions as to which coatings to introduce into Australia not on the basis of what the market really needs but on the basis of what the market can afford having regard, in particular, to the exorbitant level of fees and charges imposed … (APMF, sub. 74, p. 4)

Similarly Cochlear Ltd stated:

> … the impact of 100 per cent cost recovery is to make market entry in Australia too expensive for many companies. Companies do not introduce new products to the Australian market where it is apparent that high up front costs for evaluation and entry onto the ARTG cannot be recovered in the often short market-life of the product. (sub. 10, p. 2)

These costs may have affected consumers by restricting product choice, as Cochlear is not intending to register two of its implant models in Australia (sub. 49, p. 9).

The TGA has responded to this criticism by stating that its regulatory charges are not prohibitive:

> I think we have got to bear in mind with Cochlear that their regulatory compliance costs were virtually minimal with the TGA from 1995, because up until that period of

> time their products erroneously, but on our current system of regulation, were considered to be low risk; but the regulations were amended at that time. (trans., p. 788)

The TGA also stated that current arrangements do not restrict consumer choice because unregistered devices are still available to Australian consumers in special circumstances:

> … in that small niche market the TGA does provide a very favourable system under our special access scheme for providing approvals to clinicians who all want to use those products … We call it the individual patient usage system. (trans., p. 789).

Awin services, also commenting on the charges imposed by the TGA for therapeutic devices, noted that it would be cheaper for manufacturers to bypass the Australian market and go directly to the US, or to the EU, where regulatory charges are significantly lower relative to the size of the market (sub. 20, p. 1).

However, not all industry participants attributed decisions about market entry to cost recovery charges. For example, Avcare noted:

> The magnitude of the regulatory costs are largely made up of data generation, ongoing sales levies and stewardship, NRA application costs by comparison are small even with full cost recovery. Business decisions to enter a market should not be made on NRA costs alone. (sub. 87, p. 4)

Technology and innovation effects

By increasing the costs of market entry, the cost recovery arrangements of health and safety regulatory agencies may impede the introduction of new technologies and deter innovation within regulated industries. A number of agencies have recognised the potential for cost recovery to influence technological development and have modified their cost recovery policies in some areas to remove disincentives to innovation.

For example, the NRA does not require permits for chemicals used in research in approved facilities and NICNAS attempts to facilitate the introduction of new technology by allowing industry fast access to new low hazard chemicals by issuing early introduction permits.

However, industry participants argued that some cost recovery arrangements may continue to act as disincentives to innovation. The costs associated with the approval of new complementary healthcare products combined with the inability of companies to take out patent protection on new substances is arguably affecting the introduction of new products and creating a ‘free rider problem’ (see chapter 6). The CHC argued that there is a first mover disadvantage:

> The cost of evaluating a new [complementary healthcare product] CHP substance is high - upwards of $10 000. There is no capturable commercial benefit to a company from having a new substance evaluated and approved for use as an ingredient as there are no patent protection for CHPs. Once a new substance is approved, all players can use the substance. Accordingly, very few companies are able or prepared to trail blaze. (sub. 17, p. 9)

DISR also observed that charges may deter innovation, by contributing to the creation of barriers to entry:

> … the long-term viability of a new and emerging industry may be inhibited by unduly heavy regulation and cost recovery, especially if these burdens are of an up-front kind. (sub. 62, p. 6)

The Chemicals and Plastics Action Agenda stated that assessment costs are a major impediment to the introduction of new technology in small Australian markets. It highlighted the case of low-solvent paints (which are available in the US and Europe) which have not been introduced into Australia. It argued that these paints would lead to a reduction in solvent emissions by at least two million litres, which in turn could 'lead to an improvement in either/or environmental quality or public health and safety' (sub. 15, p. 4).

Two recently proposed cost recovery arrangements, if implemented, could impede technological innovation. These are the proposals to recover 100 per cent of the costs of the newly established OGTR and SLASO. Each of these agencies is authorised by legislation to charge fees, although regulations determining the fee structures and levels have not yet been implemented. Evidence submitted to the Commission indicates that both agencies are unlikely to receive more than a handful of commercial applications in the initial years of operation, but are expected to operate on a 100 per cent cost recovery basis. The effect of imposing 100 per cent cost recovery on these agencies from the outset, on a strict year by year basis, would result in higher costs being borne by the industry innovators. Further, some clients of these agencies are likely to be researchers and public institutions which, some participants suggest, may have difficulty meeting these charges.

The impact of the proposed cost recovery arrangements for the OGTR was summarised by KPMG Consulting:

> ... most clients of the GTR [Gene Technology Regulator] processes (around 94 per cent of all applications for gene technology dealings) are publicly funded organisations undertaking research with little or no budgetary capacity to address cost imposts without detracting from the funds available for gene technology research. Consequently, an inappropriate cost recovery regime could lead to much proposed gene technology R&D work not being undertaken in Australia, or being moved off-shore. Under either scenario, Australia would be a major loser both economically and in its

> attempts to remain in the global mainstream of gene technology developments. (2000, p. 3)

DISR has responded to these concerns by working towards 'a concessional fee structure for non-commercial scientific and educational launches' (sub. 62, p. 19). Whilst the regulations outlining the fee structure for the GTR are yet to be finalised, the Government has agreed to delay implementing full cost recovery until after the first two years of operation.

E Case study — Australian Communications Authority

This appendix reviews the cost recovery arrangements of the Australian Communications Authority (ACA). The reason for this case study is that the Department of Finance and Administration (DOFA) is obliged to review ACA activities and report to the Expenditure Review Committee by the 2002-03 budget. DOFA have deferred the cost recovery part of this review until the Productivity Commission has completed its inquiry. The analysis in this appendix has been limited by the lack of submissions from organisations that are affected by ACA charges.

INFORMATION REQUEST

The Commission seeks further views on the effect of Australian Communications Authority cost recovery charges on firms (including small business) and consumers.

E.1 Role of the ACA

The ACA is responsible for regulating the communications industry in Australia. It has two distinct functions: the regulation of the telecommunications industry and the regulation of the radiocommunications industry. The regulation of the telecommunications industry relates to the transition of the industry from an historical monopoly to a more competitive structure. An important factor behind the regulation of the radiocommunications industry is the need to manage the radiofrequency spectrum. A large number of individuals and businesses would like to use the radiofrequency spectrum but because it is a scarce resource, it is 'rationed' by the ACA to ensure its efficient use and minimise the risks of interference. The functions of the ACA are summarised in box E.1.

The ACA has a variety of charges for the different activities it performs and has varying degrees of discretion over their levels and structures, with many being determined through legislation. ACA cost recovery ranges from charges for particular services, to amalgamated charges that cover the provision of a number of services, to charges that bear little or no relation to the costs incurred by the ACA in the provision of a particular service.

Box E.1 **Specific functions of the ACA**

The ACA performs a variety of services, which can be broadly split between its telecommunications and radiocommunications functions.

Telecommunications functions

- licensing of telecommunications carriers and telecommunication cablers;
- encouraging industry self-regulation through codes of practice developed by industry and registering those codes;
- determining and enforcing mandatory industry standards where necessary;
- seeking to ensure industry compliance with technical standards and labelling requirements;
- protecting the integrity of telecommunications networks;
- administering legislative provisions relating to the construction of communications facilities;
- reporting on telecommunications carrier performance;
- managing the Telecommunications Numbering Plan, which attempts to provide adequate number capacity for current and new services;
- overseeing fulfilment of the universal service obligation (USO), which attempts to ensure that core telecommunication services are available to all Australians; and
- overseeing fulfilment of the national relay service (NRS), which attempts to ensure that people who are deaf or have a hearing or speech impairment have access to standard telephone services.

Radiocommunications functions

- managing the radiofrequency spectrum (although responsibility for the radiofrequency spectrum used by television and radio has been delegated to the Australian Broadcasting Authority [ABA]); and
- managing electromagnetic interference.

Other functions

- representing Australia's communications interests internationally;
- developing and enforcing consumer safeguards; and
- informing consumers.

Source: ACA 2000, p. 2.

E.2 Extent and nature of cost recovery

The ACA is required to recover 100 per cent of its own costs, plus costs associated with the Australian Competition and Consumer Commission (ACCC) telecommunications regulation, Australia's contribution to the International Telecommunications Union (ITU), government research grants and industry development plans. The ACA raised $54.2 million in revenue in 1999-2000. This is more than 100 per cent of its agency costs (table E.1) but it is less than 100 per cent of the sum of all the costs it is expected to recover.

The ACA sets its charges according to the costs incurred in the previous financial year. In effect, in 1999-2000 the ACA recovered approximately 90 per cent of 1998-99 costs (when costs are defined broadly to be ACA agency costs, Australian Competition and Consumer Commission (ACCC) telecommunications regulation costs, Australia's contribution to the ITU, government research grants and industry development plans). The ACA stated that this 'under recovery' was the result of: the timing of amendments to charges, radio licensing exemptions and concessions, inaccuracies in the pricing of charges and variations in the volume of ACA activities (ACA, sub. 108, p. 2).

Table E.1 **Cost recovery by the ACA in 1999-2000**

Revenue from cost recovery (A)[a]	*Total Government appropriations (B)*	*Total agency expenses(C)*	*A/C*	*A/B*
$m	$m	$m	%	%
54.2	51.1	49.0	110.6	106.1

[a] This revenue is intended to cover ACA agency expenses, ACCC telecommunications costs, Australia's contribution to the International Telecommunications Union, government research grants and industry development plans.

Source: ACA questionnaire response.

The ACA raises revenue through three mechanisms:

1. cost recovery for regulatory activities (for example, the Annual Carrier Licence Charge for telecommunications);
2. sale of public property (for example, auctions of rights to use spectrum and levying a spectrum access tax that permits the use of the radiofrequency spectrum); and
3. levies to fund the equity and access goals of government for the telecommunications industry (for example, the universal service obligation levy).

The revenue generated by ACA charges is returned to the Consolidated Revenue Fund and the ACA receives its funding directly from Budget appropriations (ACA

2000, p. 2). In 1999-2000, the ACA received $51 million in Government appropriations and generated $1 538 million in revenues for the Commonwealth, of which $1 484 million was from the sale of assets (ACA, questionnaire response). The ACA also administered the universal service obligation levy, which was determined by the Minister to be $280 million in 1999-2000.

This appendix focuses on the charges that are used to recover ACA costs — the asset sales and levies that the ACA administers do not fall within this inquiry's definition of cost recovery (as discussed in chapter 1). There is also an emphasis upon the three charges that generate almost 90 per cent of ACA cost recovery revenue: the Annual Carrier Licence Charge (ACLC); the spectrum maintenance component (SMC); and the administrative component of the apparatus fees and charges (box E.2). The relative contribution of these charges to the revenue from cost recovery is shown in table E.2.

Box E.2 **ACA charges**

Annual Carrier Licence Charge (ACLC)

This charge recovers the costs of certain services carried out by a number of government agencies for the telecommunications industry. It is administered by the ACA. It is paid by owners of telecommunications network infrastructure according to their proportion of eligible revenue in the industry (eligible revenue is gross telecommunications sales revenue less certain revenue streams). The services for which costs are recovered are: ACA and Australian Competition and Consumer Commission costs attributable to the regulation of the telecommunications industry, the Commonwealth's contribution to the budget of the International Telecommunications Union, Industry Development Plans and grants made by Department of Communication, Information Technology and the Arts for consumer representation and telecommunications research.

Spectrum maintenance component (SMC) of the apparatus fees and charges

This charge recovers the indirect costs of ACA's radiofrequency spectrum management. It is calculated as a fixed percentage of the spectrum access tax (SAT) raised from the sale of the radiofrequency spectrum, because of potential difficulties in trying to calculate the benefits to individual operators. The SMC is currently set at 39.78 per cent of the SAT paid by operators. The components of the SMC for which costs are recovered are: international coordination, International Telecommunications Union membership, domestic planning, interference investigation and policy development.

Administrative component of the apparatus fees and charges

This charge recovers the direct cost to the ACA of a particular licence transaction for the radiofrequency spectrum. These costs are calculated using an activity based costing methodology and are reviewed at least every two years. The administrative activities for which costs are recovered include: issuing a licence, renewing a licence, processing a licence fee instalment and varying licence conditions.

Sources: ACA questionnaire response, ACA sub. 108.

Table E.2 **Revenue from ACA cost recovery charges in 1999-2000**

Charge	*Revenue*	*Contribution to revenue from cost recovery*
	$m	%
Annual Carrier Licence Charge	18.5	34.1
Spectrum Maintenance Component	24.3	44.8
Administrative component	5.9	10.9
Miscellaneous [a]	5.5	10.1
Total	**54.2**	**100.0**

[a] This category is comprised of numerous charges that do not raise a significant amount of revenue individually. For example, spectrum auction entry fees, speaking fees and late payments charges.

Source: ACA questionnaire response

The ACLC is directed at the telecommunications industry, while the SMC and the administrative component of the apparatus fees and charges are directed at the radiocommunications industry and its end users. These charges aim to recover 100 per cent of direct and indirect costs and include a user cost of capital but not a return on the assets (ACA, questionnaire response). The costs are allocated using activity-based-costing models and are audited externally. Nevertheless, there is the potential for cross subsidisation due to problems in allocating costs directly when it is not easy to identify how the benefits or costs accrue to particular users. Furthermore, particular Government agencies are charged differently to the private sector. For example, there are radiocommunications licence fee exemptions for defence, diplomatic and consular missions, organisations providing surf life saving or remote area ambulance services and certain bodies providing emergency services or services safe-guarding human life.

Cost recovery legal mechanisms and authority

The ACA was established under the *Australian Communications Authority Act 1997*, which merged the Spectrum Management Agency (SMA) and the Australian Telecommunications Authority. The ACA gets its powers, including its charging authority, from the *Radiocommunications Act 1992*, the *Telecommunications Act 1997*, the *Australian Communications Authority Act 1997* and a range of related legislation. ACA charges are supported by legislation, regardless of whether they are implemented in practice as fees for service or a tax. Section 53 of the *Australian Communications Authority Act 1997* differentiates between the two by requiring that ACA charges that are fees for service, should not amount to taxation.

The large amount of legislation that surrounds ACA charges limits ACA flexibility about the level and structure of some of its cost recovery arrangements. For

example, the various elements of the ACLC are set by the *Telecommunications Act 1997*. While it may be more transparent to disaggregate this charge, the ACA has limited capacity to do so given that the determinants of the charge are set in legislation.

Rationale for existing arrangements

Cost recovery for regulating the telecommunications industry was explicitly introduced in the earlier *Telecommunications Act 1991* (ACA questionnaire response). The second reading of the *Telecommunications Act 1991* stated that the charges provided a method of funding the increased regulation of the telecommunications industry stipulated by the Act.

The *Radiocommunications Act 1992* (section 3) has various objectives, such as the promotion of efficiency and increased responsiveness by the ACA, but does not contain explicit objectives for cost recovery. The ACA's predecessor in regulating the radiocommunications industry, the Spectrum Management Authority (SMA), held a public inquiry into the apparatus licence system in 1993 that resulted in the introduction of the current system of cost recovery for the ACA's radiocommunications activities. The objectives of this system were to reflect government policy of charging for services that are provided at a client's request, to create efficiency gains through eliminating frivolous demand and to promote the development of service providers in the private sector (SMA 1993, p. 14). The inquiry documents emphasise that there should be a distinction between the charges for ACA direct costs (the administrative component) and ACA ongoing or indirect costs (the SMC). It was hoped that the charges would create greater equity between users, in that they would pay for the costs they imposed, as well as greater transparency because the licence fees would be easily understood by any interested party (SMA 1993, p. v). However, the SMC bundles up a variety of costs, including interference investigation, domestic planning and policy development and this is likely to limit the transparency to external parties about individual activities. The use of the Spectrum Access Tax to determine an operator's SMC charge was intended to reflect an equitable distribution of ongoing SMA costs, in that SMA resources tended to be directed at higher demand spectrum and geographic locations (SMA 1995, p. 13). It is questionable whether the percentage link is sufficient to ensure that charges to an operator reflect the associated ACA costs.

E.3 Impact of cost recovery on agencies

Cost recovery can have a number of effects upon the government agency that is recovering its costs. It is likely to have an impact on the agency's incentives and it is feasible that cost recovery could encourage efficiency.

Incentive effects for agencies

If government agencies are not allowed to retain the revenues raised through cost recovery, they are less likely to seek to maximise the revenue streams, and will be disciplined by budget processes rather than the behaviour of their users. In the case of the ACA, the revenue raised goes to the Consolidated Revenue Fund and is not earmarked for return to the ACA. As noted above, the ACA receives its funding directly from Budget appropriations. This seems appropriate for the ACA, because it is the sole Australian supplier of telecommunications and radiocommunications regulation, and retention of revenue may create undesirable incentives for the agency to extend the scale and scope of it regulatory activities.

Cost recovery may nevertheless improve the performance of the ACA by indicating the level of demand for certain services that it provides. This can help to bring about an appropriate scale of delivery. To the extent that cost recovery increases the influence that ACA users have over ACA activities, cost recovery may increase the efficiency and improve the tailoring of ACA services towards user requirements. However, there is the danger of 'regulatory capture' with the possibility that the regulator's autonomy may be compromised. The Commission received no evidence on these matters with respect to the ACA.

Cost recovery has the potential to increase the transparency of a government agency's activities, particularly with respect to its costs. This information may help both governments and users to encourage greater efficiency from it. Section 53 of the *Australian Communications Authority Act 1997* requires that ACA fees for service should not amount to taxation, and this encourages a link between charges and costs and hence a degree of transparency between the two. However, the link between ACA charges and its costs is not always clear. Also, as noted above, ACA charges that cover a number of services limit transparency to external parties about the costs of individual activities.

There are some indirect effects of cost recovery on the incentives for the ACA to increase efficiency. For example, there are plans for electronic payment for the renewal of apparatus licences, the development of systems to lodge application forms electronically, and electronic time recording for internal systems. The stated

objective of such developments is to produce a more cost effective and efficient use of resources (ACA 2000, p. 103). The ACA stated that:

> The implementation of a scheme of cost recovery has acted as both a useful discipline on the ACA's radiocommunications licensing activities and a spur to reducing costs through the use of more efficient technologies and better working methods. (ACA, sub. 108, p. 5)

The ACA also stated that it does not believe that cost recovery has impeded the development of new services (ACA, sub. 108, p. 5). It gave the example of its accreditation scheme for external operators to undertake frequency assignment work. The ACA applies a reduced cost recovery charge when an accredited external assigner undertakes the frequency assignment, in order to encourage the take up of this scheme.

Operation of cost recovery

The proportion of a carrier's eligible sales revenue in the industry is used as a guide to a carrier's market share and taken as a proxy for how much the carrier is likely to benefit from or use the telecommunication services associated with the ACLC. There is also an upper and lower limit to the ACLC through a fixed component and a maximum charge amount. This appears to favour larger operators — there is a cap on the maximum amount they have to pay and the fixed component of the charge is likely to be more of a burden on smaller businesses. This may be efficient if it reflects the minimum and maximum costs of regulating a given firm. However, the Commission does not have the information to verify this.

The SMC recovers the indirect costs of ACA spectrum management and some of these costs seem to be compliance and policy–related, such as interference investigation and policy development. There is the question of whether it is desirable for industry to fund these functions of government (chapter 6).

Administrative arrangements

As noted above, the ACA has taken steps to introduce more efficient electronic-based systems to reduce costs. It is also proposing to delegate eligible revenue assessment to the Australian Tax Office (ATO).

The ACA conducts a major review of its fees and charges every two years. It appears that changes have been instigated on these occasions as well as in between times when 'there are significant changes in costs during a period' (ACA, sub. 108, p. 7). A few examples of alterations to charges include: a doubling of equipment

testing charges in 1999, an increase in the ACLC between 1995 and 2001 from 29.9 per cent to 39.8 per cent of SAT and an amendment to charges in July 2000 to reflect indirect cost savings and the introduction of the GST.

Governance

The ACA's charging process is overseen by external costing consultants, ACA's Cost Recovery Committee and a 'board' (consisting of a Chair, a Deputy Chair, between one and three members and various associate members). External costing consultants oversee the calculation of ACA costs and charges. The Cost Recovery Committee is responsible for the cost recovery process and making recommendations to the board of directors. The board is ultimately responsible for final approval and determination of all ACA fees and charges and it reviews proposed amendments (ACA, sub. 108, p. 8).

The fact that the ACA is a statutory authority encourages independence in its cost recovery activities. Currently, the board is composed of twelve directors, of whom ten are appointed from outside the ACA. However, ACA legislation and ministerial direction on certain user charges limits ACA flexibility in its cost recovery activities. The target of 100 per cent recovery of its costs from industry may further influence the autonomy of the ACA. The Commission has not received any evidence on this aspect of the ACA cost recovery arrangements but notes the general point that this can, and in other industry sectors has, led to perceptions of industry capture. Although the formulae that the ACA uses to calculate its charges are publicly available, the link between ACA charges and its costs is not always clear and this relationship is complicated by the use of amalgamated charging. ACA charges are therefore not as transparent as they might ideally be.

The ACA undertook a public consultation process before the current system of radiocommunications fees and charges was introduced ('Inquiry into the Apparatus Licence System — A New Outlook'). However, no such consultation has taken place with respect to telecommunications charges. The justification for this is that telecommunications charges are 'considered the lowest possible to achieve cost recovery' (ACA, sub. 108, p. 7).

E.4 Economic effects of cost recovery

ACA charges that recover the costs of its telecommunications functions are focused on the telecommunications industry, rather than consumers of this industry's products. This may be a concern in a 'beneficiary pays' model because, while the telecommunications industry is the direct user of ACA services, it can be argued

that the consumers of the telecommunications industries and the general public also benefit from the activities of the ACA. The ACA stated that the beneficiaries of its activities are 'consumers of the industries, the community and the industry itself' (ACA questionnaire response). However, to the extent that industry is able to pass on regulatory costs to consumers, the ultimate incidence of the charges may be similar regardless of where they are initially imposed (see chapter 2). Similar arguments apply to ACA charges for its radiocommunications functions which are levied on industry.

Economic effects on industry

As discussed in chapter 6, cost recovery may introduce barriers to entry or create uneven playing fields between firms. The choice of the cost recovery mechanism may have a differential impact upon small and large firms or upon firms located in the cities and regional areas of Australia. However, the ACA 'does not believe there are significant access and equity or regional competitiveness issues associated with the radiocommunications cost recovery regime' (ACA, sub. 108, p. 9).

To the extent that ACA charges fall disproportionably on particular businesses within the communications industries, distortions in the allocation of resources between firms in the industry and between sectors of the economy may result. An example may be ACA's preferential charging for some government agencies, such as defence, which is not charged for its use of spectrum. Another example might be the different treatment of small and large firms in the ACLC. The presence of upper and lower limits in the charge may mean that the amount paid by individual operators does not reflect the cost of regulating them.

The use of cost recovery formulae based on a company's proportion of eligible revenue in the industry, may introduce an element of uncertainty into ACA charges for the communications firms. To anticipate their ACA charges, carriers have to predict their eligible revenue and the eligible revenue of the rest of the industry. It may also encourage firms to disguise information about their operations. This problem may be reduced by the proposed plan to use the ATO to assess eligible revenue. The ATO is likely to have more expertise in scrutinising businesses' accounts and other relevant sources of information.

To the extent that the ACA charges are a significant cost to some firms entering the communications industry, they may represent a barrier to entry. The ACLC has had some influence in preventing smaller potential carriers from entering the telecommunications industry (ACA, sub. 108, p. 6). However, the *Telecommunications Act 1997* substantially lowered the minimum ACLC to $10 000 and there has been the development of other alternative charges to help

mitigate this problem, such as nominated carrier declarations. The nominated carrier declaration allows small operators to supply carriage services, such as phone or Internet access services, for a relatively low once-only application charge of $3 411.10.

Technology and innovation effects

Fees associated with the modification of apparatus licences may discourage more efficient use of the radiofrequency spectrum. However, these fees are likely to be small compared to the costs of buying and operating new radiocommunications equipment (ACA, sub. 108, p. 5). Telecommunications equipment needs ACA approval in order to be connected to telecommunications infrastructure. The high charges for this testing may be a barrier to the manufacturers of niche equipment (ACA, sub. 108, p. 9).

Compliance costs for businesses

The use of eligible revenue in the ACLC may impose compliance costs on the industry because it requires them to calculate this variable. This seems to be an insignificant factor compared to other compliance costs that the firms incur to comply with regulation and is likely to be less of an issue once the ATO begins to estimate eligible revenue.

Economic effects on consumers

The ACA was unable to comment on the extent that radiocommunications charges are passed on to end users because of the variety of licences that are available and the differences among the recipients of such licences. The ACA expected that 100 per cent of the ACLC is passed on to telecommunications consumers (ACA, sub. 108, p. 10).

An alternative approach to funding the ACA would be to use general taxation revenue. The consumers of the telecommunications industry are probably large enough to be a good proxy for the general public. However, this would most likely have different efficiency effects to the current method of ACA charging. By paying in proportion to usage, consumers arguably get some price signals about the costs of administering the regulation.

F Case study — financial regulatory agencies

The main Commonwealth financial regulators that cost recover are:[1]

- the Australian Prudential Regulation Authority (APRA); and
- the Australian Securities and Investments Commission (ASIC).

The delineation between APRA's and ASIC's responsibilities is functional rather than institutional: both agencies are concerned with the stability and transparency of financial systems. Prudential (liquidity requirements) regulation resides with APRA; disclosure and market conduct with ASIC. The two agencies can thus regulate separate aspects of the same company's activities. For instance, while APRA would scrutinise the value of a firm's assets and liabilities, ASIC would ensure that they are fully disclosed to the firm's shareholders. Although the constituencies of the two agencies overlap, APRA's is restricted to financial institutions only, while ASIC's extends to all companies in Australia.

The 1997 Financial Systems Inquiry Report (the 'Wallis Report') considered that the regulatory activities of both APRA and ASIC are designed to respond to two particular types of market failure, namely information asymmetry and third party risk.

The first market failure stems from the fact that customers of financial institutions do not usually have sufficient knowledge and expertise to be able to assess properly the risk inherent in transactions of a financial nature. For instance, bank customers have no way of easily knowing if the bank is liquid (able to meet any cash withdrawals its customers demand) and their deposits are safe. A similar reasoning applies to members of a superannuation fund or customers of an insurance company: they will be discouraged from taking out insurance and superannuation policies if they are not confident that these institutions possess sufficient capital to meet their repayment obligations.

The second market failure, relating to risk, stems from the possibility a loss of confidence in a financial institution by its customers may affect not only that

[1] The other Commonwealth financial regulator, the Reserve Bank of Australia, only recovers the costs of ancillary activities, such as publications, and is not considered in this appendix.

institution but also its competitors, thus creating an externality. For instance, a 'bank run' can begin with just one insolvent bank and spread to the whole banking sector. While banks may be aware of that risk, they may not be able to insure against it or agree on self-regulation. Furthermore, such a bank run would impose costs on the whole community which the banks are not prepared to internalise, in which case the government has to intervene.

APRA and ASIC undertake cost recovery on a large scale, recovering all or more than their operating costs.[2] According to some inquiry participants, such as the Australian Chamber of Commerce and Industry (ACCI), charges recovered from industry by these agencies amount to over-recovery. This potentially sets them apart from most other Commonwealth agencies (see chapter 4) and as such justifies a close examination of the rationales and arrangements for cost recovery in this area.

F.1 Extent and nature of cost recovery

This section provides estimates of monies cost recovered by APRA and ASIC. It also examines the current cost recovery arrangements of these two agencies, both in terms of their historical context and their objectives.

Revenue collected through cost recovery

APRA and ASIC revenues are summarised in table F.1. As is clear from that table, both agencies recover monies in excess of their operating expenses, significantly so in the case of ASIC. However, three caveats to this statement are in order. First, part of the industry levies collected by APRA are transferred to ASIC and the Australian Tax Office (ATO) to fund these organisations' consumer protection, market integrity, unclaimed monies and lost members functions. In 1998-99, these transfers amounted to $9 million, $7 million of which were received by ASIC. Figures for 1999-2000 were $14 million and $10 million respectively.

[2] Including capital replacement costs.

Table F.1 **Cost recovery by APRA and ASIC, current $ million**

	1995-96	*1996-97*	*1997-98*	*1998-99*	*1999-2000*
APRA					
Revenue from cost recovery[a] (A)				63.1	88.3
Other revenues				3.6	3.5
Total agency expenses (B)				53.4	58.8
A/B (%)				118	150
ASIC					
Revenue from cost recovery[b] (A)	275.5	297.9	326.1	331.8	361.0
Other revenues	8.3	7.0	7.5	9.2	7.6
Total agency expenses[c] (B)	140.4	127.8	133.3	153.3	144.8
A/B (%)	196	233	245	216	249

[a] Does not include a small amount of revenue from the sale of goods and services. [b] Does not include levies transferred from APRA. Includes a small amount of fines. [c] Includes a small amount of administered expenses from 1997-98 onward. Does not include payments to the States and Northern Territory.

Sources: ASIC and APRA questionnaire responses; Treasury (pers. comm.); APRA, (pers. comm.).

Second, a small proportion of the monies recovered by APRA is explicitly used to repay two Commonwealth Government loans granted in 1998-99 and 1999-2000 to fund establishment and transition costs.[3] Repayments on these loans, which will be extinguished in 2002, amounted to $5 million in 1999-2000.

Third, a large portion of the fees recovered by ASIC is transferred to the States and the Northern Territory as compensation for relinquishing their company regulation powers to a national scheme in 1991 (box F.1).

Agencies and activities which cost recover

APRA was created by the *Australian Prudential Regulation Authority Act 1998* (APRA Act), following recommendations from the 1997 Wallis Report. This agency took over the prudential supervisory responsibilities of 11 separate agencies. Its reporting and financial arrangements are governed by the *Commonwealth Authorities and Companies Act 1997*. Following recommendations from the Wallis Report, APRA's activities are almost entirely financed through cost recovery. Recovery takes the form of annual levies paid by the regulated financial institutions (banks, life and insurance companies, superannuation funds, credit unions and building societies), based on a percentage of assets held by the entity, subject to minimum and maximum levy amounts for each industry. Details of these levies for 2000-01 are given in table F.2.

[3] These costs have included the building of infrastructure, the set up of head office in Sydney, the establishment of the new APRA organisational teams and the development of new processes and systems to support the new structure (APRA, sub. 21, p. 5).

Box F.1 Commonwealth compensation of the States and Northern Territory for company regulation

In January 1991, the States and Territories ceded responsibility for the regulation of companies and securities to the Commonwealth. Under the terms of the Corporations Agreement reached at the time by the various governments, the States and the Northern Territory were to receive financial compensation from the Commonwealth for revenue foregone.

Section 703 of the agreement holds that:

(1) The Commonwealth will distribute among the States [and Northern Territory] in respect of the year commencing on 1 July 1991, and each succeeding year commencing 1 July, an amount determined in accordance with this clause; and

(2) The amount for any such year ('the current year') is the amount ascertained by adjusting the base amount of $102 000 000 upwards in line with movements in the Consumer Price Index for the financial year 1989-1990 and each succeeding financial year to and including the financial year immediately preceding the current year.

The monies transferred under this agreement since 1991-92 are as follows:

1991-92:	$116.1 million
1992-93:	$118.2 million
1993-94:	$124.3 million
1994-95:	$122.5 million
1995-96:	$126.4 million
1996-97:	$130.3 million
1997-98:	$132.6 million
1998-99:	$133.5 million
1999-2000:	$135.0 million
2000-01:	$139.1 million (budgeted)

While not specified in the agreement, these transfers have been funded in practice from ASIC fees and charges. There is no sunset clause on these transfers.

Sources: Commonwealth of Australia 1997; Treasury 2001b; Treasury (pers. comm.).

Table F.2 **APRA levies, 2000-01**

Industry	*Percentage of assets*	*Minimum*	*Maximum*
	%	$	$
Superannuation funds	0.02	300	46 000
Retirement savings account providers	0.02	5 000	18 500
Life insurers	0.02	500	280 000
General insurers	0.02	5 000	100 000
Authorised deposit-taking institutions	0.012	500	1 000 000
Foreign bank branches	0.006	500	500 000
Non-operating holding companies	Flat rate charge of $10,000		

Source: APRA (sub. 21, p. 7).

Levies are raised by APRA from institutions under the *Financial Institutions Supervisory Levies Collection Act 1998* and six supervisory levy Acts that apply to the various industries making up the financial sector. For instance, levies are collected from the superannuation industry under the *Superannuation Supervisory Levy Imposition Act 1998*. Levies received are paid into the Consolidated Revenue Fund, but are made available to APRA under a standing appropriation (special appropriation) in Section 50 of the *Australian Prudential Regulation Act 1998*.

In its submission, APRA stated that its activities fall into three categories:

- formulation and promulgation of prudential policy and practice observed by regulated institutions;
- surveillance and compliance programs and, where relevant, remediation or enforcement measures; and
- advice to Government on the development of regulation and legislation affecting regulated institutions and the financial markets in which they operate (sub. 21, p. 1).

APRA's supervisory role may take the form of an on-site visit to a financial institution to examine asset quality and risk. In the area of enforcement, APRA's activities can range from the appointment of an inspector to Federal Court action (APRA 2000, pp. 14, 16).

ASIC is an independent Commonwealth body created by the *Australian Securities and Investments Commission Act 1989*. It began operations in 1991 as the Australian Securities Commission (taking over from the National Companies and Securities Commission). Its name and charter were changed in 1998 following the Wallis Report. ASIC, in its present form, is a statutory authority under the

Commonwealth Authorities and Companies Act 1997. ASIC's main source of funding is a general budget appropriation from the Commonwealth Government, although it received $10 million in 1999-2000 from APRA to cover finance industry consumer protection. While ASIC collects large amounts in fees under Corporations Law (for example, for the lodgment of annual company returns), this is administered revenue which must go the Consolidated Revenue Fund (see chapter 3).

Fees accruing to ASIC are charged under sections 22 and 25 of the *Corporations Act 1989*. The former allows for the existence of regulations, the latter for the charging of fees (including fees that are taxes). The amount of each of the fees, established with input from Treasury, is set in the Schedule to the Corporations (Fees) Regulations. As noted earlier, fees collected are significantly in excess of ASIC's regulatory costs. This tends to suggest that the fees are really imposed for revenue raising purposes and hence in the nature of a tax (see chapter 3). While ASIC fees have not been authorised by a tax Act,[4] the fact that they are technically imposed under State law means that they are not constrained by section 55 of the Constitution, which prohibits laws imposing taxation dealing with anything but the imposition of taxation (see chapter 3).

Like APRA, ASIC's activities range from supervision to enforcement and policy advice. It also includes a strong consumer information element, through the maintenance of a publicly accessible database of company details and financial markets participants.

Historical context

The present cost recovery arrangements applying to APRA are largely the result of recommendations contained in the Wallis Report. Three recommendations are particularly relevant (box F.2).

The implementation of these recommendations has led to the application of full cost recovery by APRA. In some cases, some of APRA's predecessors cost recovered. For example, the Insurance and Superannuation Commission imposed a levy on superannuation funds under the *Superannuation Supervisory Levy Act 1991* (ASFA, sub. 8, p. 1).

[4] Except in Western Australia, where they are imposed under the *Corporations (Taxing) Act 1990* (WA).

Box F.2 **Wallis Report recommendations concerning cost recovery by financial regulators**

Recommendation 104: Regulatory agencies' charges should reflect their costs.

The regulatory agencies should collect from the financial entities which they regulate enough revenue to fund themselves, but not more. As far as practicable, the regulatory agencies should charge each financial entity for direct services provided, and levy sectors of industry to meet the general costs of their regulations (1997, p. 532).

Recommendation 106: Regulatory agencies should set their charges, subject to approval by the Treasurer.

Fees and charges imposed to recover costs of the financial regulatory agencies should be determined by the agencies, subject to approval by the Treasurer (1997, p. 534).

Recommendation 107: Regulatory agencies should be off-budget.

From the perspective of financial regulation, it is preferable that the [Australian Prudential Regulation Commission and Corporations and Financial Services Commission][5] operate off-budget. If they are funded through the Commonwealth Government budget, they should have their funding levels determined by reference to policies for financial system regulation rather than targets for the overall budgetary balance (1997, p. 535).

Source: Financial Systems Inquiry (Wallis Report) 1997.

In the case of ASIC (and its predecessors), cost recovery has existed for much longer than for the prudential regulators. Indeed, ASIC stated that:

> In Australia, cost recovery arrangements have existed since the 19th century. The existing arrangements commenced in 1991 and were modified in 1994. (questionnaire response)

It added that:

> The initial objective of the cost recovery arrangements was to cover all costs associated with the corporate regulator. In 1993, following a review involving the Attorney General's department, the Australian Securities Commission and the Department of Finance, the cost recovery arrangements were revised to cover all costs of the national corporate regulation scheme. (questionnaire response)

According to Paper no. 7 of the Corporate Law Economic Reform Program (CLERP) of the Commonwealth Government (CLERP 2000, p. 36), the amount of revenue generated by the current version of ASIC must cover:

- its own costs;
- compensation payments to the States for revenue foregone as a result of the establishment of the national regulation scheme;

[5] Now re-named APRA and ASIC respectively.

- the costs of other bodies forming part of the national scheme (for example, the Australian Accounting Standards Board); and
- national scheme-related costs of bodies that perform functions arising out of the scheme (for example, the Administrative Appeals Tribunal).

Rationale for existing arrangements

The rationale for full cost recovery by APRA is based on the Wallis Report's recommendation that, for reasons of equity and efficiency, the costs of prudential regulation should be borne by those who benefit from it (1997, p. 532).

In its questionnaire response, ASIC justified cost recovery thus:

> Successive governments have taken the view that costs associated with the administration of companies and the regulation of the futures and securities industries should be borne either directly or indirectly by all companies and market participants rather than through public funding by taxpayers.

and:

> People involved with companies and participants (and potential participants) in [the futures and securities] industries benefit through their participation in a well regulated capital market.

The rationales for cost recovery put forward by both agencies therefore reflect their belief that both suppliers and consumers of the products and services being regulated benefit from that regulation. It appears that the motivation for cost recovery in this case is the adoption of a 'beneficiary pays' philosophy (see chapter 2 for a discussion of this approach). On the other hand, as mentioned earlier, financial regulation in general, and prudential regulation in particular, is designed to force producers to take into account the potential costs that their activities impose on others, that is, to internalise externalities (the risk of financial contagion). This is a 'regulated pays' interpretation of regulation (see chapter 2 for a discussion of this approach).

Discussion of objectives

For APRA, the implications of a beneficiary pays and a regulated pays approach for cost recovery differ to some extent. If the latter model is applied, then the regulated institutions alone — as the sole creators of the potential negative externalities — would bear the cost of regulation designed to avoid them. While benefits will be created in the process, they are in the form of costs foregone and, on equity grounds, should not be borne by the community (see chapter 2). Moreover, not

charging the creators of the externality would dissuade them from changing their behaviour and would encourage them relative to less risky industries.

The beneficiary pays principle leads to different conclusions as regards APRA's activities. First, a financial institution's customers benefit directly from prudential regulation designed to overcome an information gap. Second, banks and their customers will benefit indirectly from prudential regulation designed to avoid financial contagion. Third, prudential regulation will benefit the bank industry, in that the implicit guarantee provided by the regulation will enhance its ability to compete with other repositories of wealth. Given the distribution of benefits, therefore, the beneficiary pays approach requires that both financial institutions and their customers face the cost of monitoring and enforcing prudential standards.

In practice, there is a general presumption that financial institutions pass on the cost of prudential regulation to their customers. This implies that this cost is borne jointly by producers and consumers, and is therefore closer to a beneficiary pays approach. To the extent that consumers face higher prices as a result of cost recovery, these should be regarded as the value of the benefits derived from redressing information gaps and third party risk failures.

ASFA suggested that the benefits of prudential regulation spread beyond the customers of financial institutions, stating:

> It is arguable that [APRA activities] provide benefits to superannuation funds and/or fund members and as such are appropriately funded from levy proceeds rather than from consolidated revenue. However, a number of the activities help support public confidence in the operation of the compulsory superannuation system and in the overall stability of an important part of the Australian financial system. While it is arguable that this provides grounds for a level of financial support by taxpayers generally, ASFA is not pursuing this suggestion. However, it should be noted that the population of superannuation fund members and the population of personal taxpayers is very similar given that compulsory superannuation covers the vast bulk of employees, and tax concessions for superannuation encourage involvement in the system by the self employed. (sub. 8, pp. 5–6)

This reasoning may also apply in the case of banks and insurance companies. As most taxpayers are also customers of these financial institutions, the public good element of prudential regulation (for example, confidence in the financial system), which should in theory be funded through general taxation, may be just as efficiently funded through industry levies. Indeed, the efficiency of the latter may be greater, since they also provide price signals to producers and consumers of financial services.

Turning to ASIC, the balance of direct and indirect beneficiaries differs from APRA's. This is mainly due to the fact that the risk of contagion from one firm

failing is negligible in the economy as a whole, compared to the financial sector. Thus, ASIC's regulatory activities primarily benefit company shareholders and consumers of specialised financial services such as investment advice, auditing, etc. These beneficiaries should therefore pay for the cost of the regulation, through reduced dividends and/or higher prices.

However, ASIC's questionnaire response refers to the existence of *potential* beneficiaries from its activities. This may be due to the fact that it maintains a large register of Australian companies, searchable at no cost — in some cases — by the general public. It could be argued that this aspect of ASIC's activities benefits a segment of the population which does not have to bear the cost of prudential regulation. For example, a person who, upon researching the credentials of a particular company, decides not to subscribe to its share offer, would reap the benefits but not bear the cost of ASIC's regulatory activities. This is a clear case of a positive externality, which means that ASIC's output is partly in the nature of a public good.

The public good element of at least some of ASIC's activities is illustrated further by the fact that it supplies information and documents free of charge to some media organisations and the ABS.

Another type of positive externality generated by ASIC's operations lies in the fact that transparency and trust are crucial elements of well-functioning capital markets. If they are absent, investors' decisions are likely to be sub-optimal so that scarce resources will not be allocated to their most productive ends. This would result in economy wide output and employment being below capacity, and would have far wider repercussions than just for shareholders or investors.

From the above, it appears that financial regulation produces a mixture of private and public benefits. This is the view adopted by most inquiry participants. For example, ASFA stated that:

> While the rationale from prudential regulation is clear, it is more difficult to precisely identify who are the beneficiaries of the regulatory regime. There are both public benefits as well as benefits to the entities regulated and their customers/members. (sub. 8, p. 4)

The identification of a public good element within the output of financial regulators led a number of participants to call for general taxation funding of all or part of their activities. ACCI stated that:

> Much, if not all, financial services and corporations regulation is a pure public good, and does not create direct benefits for [the] financial services industry or for individual corporations. Industry supports the public policy objectives of this regulation, but as a public good, it should be funded by the whole community. (sub. 70, p. 15)

Similar arguments were put forward by the NRMA Insurance Group (NRMA):

> … all Australian consumers and businesses benefit from a stable financial system in which all financial services providers are required to meet minimum prudential and consumer protection standards. These standards enhance consumer and business confidence in the financial system and thus improve the efficiency of the overall system and attract additional savings for investment. Due to the existence of these wider economic benefits from regulation in the financial sector there is a strong argument for funding at least part of the cost of prudential supervision and consumer protection from general budgetary revenue rather than from industry levies or charges. (sub. 37, p. 3)

The Investment and Financial Services Association concurred, stressing that over-recovery is even less desirable than full recovery:

> … given the significant public policy purposes that underlie financial sector regulation, a reasonable proportion of the cost should be borne by the whole community, through public funding. Fee and levy revenue should not be expected to meet the whole cost of regulation — and certainly should not exceed the running costs of the relevant regulators. (sub. 9, p. 2)

From these quotes, it would appear that current cost recovery arrangements by APRA and ASIC are at odds with the views of industry, since these agencies recover, at a minimum, the totality of their operating expenses. The desirability or otherwise of whole-of-agency full cost recovery targets is discussed in chapter 6.

F.2 Impact of cost recovery on agencies

Cost recovery by an agency, in addition to influencing the behaviour of those who pay the charges, can influence the operations of the agency itself. This section examines the effects of cost recovery on several aspects of APRA's and ASIC's operations, from the incentives faced, to the cost recovery mechanisms used, to the transparency and accountability with which their cost recovery is carried out. These issues are discussed in relation to Commonwealth agencies generally in chapter 5.

Incentive effects for agencies

Cost recovery may, depending on the exact nature of the arrangements, alter the incentives faced by an agency. Cost consciousness and efficiency may be encouraged. On the other hand, quasi-automatic cost recovery of all operating costs can lessen incentives for an agency to be cost-effective. Recovery of costs associated with only some of an agency's activities may persuade the agency to concentrate on these areas at the expense of others.

The operating expenses of APRA and ASIC are given in table F.3. APRA's costs are estimated based on the activities of its predecessor agencies when appropriate.

Table F.3 **Operating expenses of APRA and ASIC**

	APRA	*ASIC*
	$ million	$ million
1995-96		140.4
1996-97		127.8
1997-98	56.4[a]	127.1
1998-99	59.9[b]	145.5
1999-2000	52.6[c]	138.7
2000-01	51.1[d]	139.0[d]

[a] Estimate of the aggregate of prudential supervision costs incurred by APRA's predecessor agencies: the Insurance and Superannuation Commission, the Reserve Bank's Supervision Department and the various agencies of the state-based Financial Institutions Scheme (FIS). [b] Estimate of the aggregate of APRA's costs ($53.4 million) and state authority costs under the FIS (assigned to APRA from 1 July 1999). [c] Actual. [d] Budgeted.

Sources: ASIC (questionnaire response); APRA 2000; Treasury 2001c.

As shown in this table, APRA's operating costs have been decreasing since 1998-99. According to APRA's evidence to the Parliamentary Review into its activities, this cost reduction has been achieved at a time when financial institutions grew in complexity and size (House of Representatives Standing Committee on Economics, Finance and Public Administration 2000, p. 6).

However, that is not to say that the levies faced by individual financial institutions have decreased. Between 1999-2000 and 2000-01, the maximum levies payable by non-excluded superannuation funds and general insurers increased, while their levy rates declined from 0.04 per cent to 0.02 per cent of assets. Thus, depending on the total assets of an institution, its levy could have gone up or down. NRMA stated in its submission that the maximum levy it pays in the general insurance category increased from $75 000 in 1999-2000 to $100 000 in 2000-01 (sub. 37, p. 4).

Similarly, AFSA provided an example of the long term increase in the regulatory charges facing a superannuation fund. From a flat return lodgment fee of $30 in the late 1980s, the maximum amount payable rose to $14 000 in 1991-92 (sub. 8, p. 1). As shown in table F.2, the maximum levy payable by a superannuation fund in 2000-01 is $46 000.

ASIC's operating costs have fluctuated somewhat between 1995-96 and 1999-2000. The 14 per cent increase recorded between 1997-98 and 1998-99 may be attributable to the transfer of consumer protection functions from the Australian Consumer and Competition Commission to ASIC. Budgeted costs are predicted to remain stable in 2000-01.

In the case of ASIC, there is no formal relationship between the amount of fees it recovers and the appropriation it receives from the budget. The monies appropriated to ASIC to fund its operations remained unchanged between 1999-2000 and 2000-01 (table F.1), whereas the fees it raises are projected to increase by 7.8 per cent (Treasury 2001c). In part, the increase in fees is due to their indexation on the Consumer Price Index, in part to the increase in the number of companies seeking registration.

The lack of direct relationship between ASIC's appropriations and the fees it collects is likely to minimise incentives to engage in 'regulation creep'. However, ASFA stated that:

> Policy proposals by ASIC … indicate the likelihood that it will require APRA regulated superannuation funds to also obtain a license from ASIC in order to undertake certain core functions of such funds. (sub. 8, p. 7)

NRMA also noted that changes to ASIC fees and regulations, foreshadowed by the Commonwealth Government in CLERP 7, 'are projected to lead to a significant increase in fee revenue for ASIC and potentially an even greater over-recovery of regulatory costs' (sub. 37, p. 7).

Information dissemination

By their very nature, both APRA and ASIC collect a wealth of information on the firms they supervise. This information is contained in databases that are increasingly made available for online searches.

ASIC

After introducing electronic registration and data lodgment in 1998, ASIC now provides about half of this service online (ASIC 2000). The dissemination of information by ASIC has also benefited considerably from Internet technology. ASIC reports that, in 1999-2000, 94 per cent of company searches occurred online, and that its website ranks among the most visited Commonwealth sites, with 200 000 visits per month by June 2000.

However, it is debatable whether Internet technology is contributing to the full extent possible to a reduction in ASIC's operating costs. This is because, while ASIC makes company information available electronically at a slightly reduced charge than in hard copy, the price differential (two dollars) does not appear reflective of the difference in marginal cost.

It may even be argued that, as an integral part of its consumer and shareholder protection activities, the dissemination of financial information is a 'core' function of ASIC. In that case, as discussed in chapter 5, it should not attract a charge. If, however, it is thought that this information confers a commercial, capturable benefit to the user, it should be priced according to the incremental cost only. An exception may be when the existence of private sector competitors requires market pricing in order to comply with competitive neutrality principles. Recently, industry complaints have been reported stating that, in markets where ASIC (through its information brokers) is in direct competition with private firms, it has not abided by these principles (Allen 2001). However, the Commission has not received any evidence of this.

APRA

While it supervises a smaller constituency, APRA's data collection and dissemination functions also stand to benefit from Internet access technology. In February 2000, APRA initiated a statistics project which should result in electronic lodgment and consultation of financial information being available by the middle of 2001 (APRA 2000).

Operation of cost recovery

In this section, the cost recovery arrangements of APRA and ASIC, respectively, are presented and discussed.

APRA

As previously illustrated in table F.2, levies accruing to APRA are set annually as a proportion of an institution's assets, with a minimum and a maximum amount to be levied. These levy cutoffs vary by industry, as does the percentage of assets levied. The rationale behind this costing model is that there is a minimum cost involved in regulating any institution. Over and above that minimum, supervisory costs are assumed to grow with the size of the institution until a point is reached where size no longer affects these costs.

The costing model in use by APRA implies that an institution's contribution to the funding of the agency will not necessarily match its consumption of the agency's resources. In other words, 'good apples' are made to pay for 'bad apples' within an industry. This is inherent in the fact that the costs to be recovered from each industry are based on APRA's estimate of the costs of supervising that whole industry, not its member institutions.

The adequacy of the model attracted a number of comments from industry during the review of the financial sector levy by Treasury and APRA, prior to the determination of the levies for 2000-01. APRA summarised these comments as follows:

> Industry groups generally argued that the minimum amount payable should equal the cost of supervising these entities [institutions], however there was no consensus in industry views. Entities paying above the minimum tended to assume that minimum amounts (of around $300–$500) were too low and were less than the true minimum cost of supervision, whereas other industry groups argued the minimums were too high.
>
> Some industry groups also suggested that the maximum amount payable should either be raised significantly or even abolished — stating that there is no cap on the size of the risk associated with any entity, therefore, the amount payable should not be capped. Others did not accept this view as it would lead to the situation where the revenue raised from large institutions would be likely to far exceed the costs of supervision involved. (APRA, sub. 21, app. 5, p. 3)

An alternative to the industry levy approach would be to introduce a fee for service system, whereby individual institutions are made to pay for, say, an audit by APRA. This was one of the recommendations of the Wallis Report, which stated that 'as far as practicable, the regulatory agencies should charge each financial entity for direct services provided, and levy sectors of industry to meet the general costs of their regulations' (1997, p. 532). Under Section 51 of the *APRA Act 1998*, APRA is able to charge directly for its services. However, such a system may worsen the situation of a firm in difficulty and/or discourage it from seeking assistance (ASFA sub. 8, p. 9). It may also create incentives for the regulator to step up its fee for service activities for revenue raising purposes. While APRA is currently raising some revenue from direct charges for services provided (for example, publications), this represents only about 2 per cent of its overall revenue (APRA, sub. 21, p. 2 and APRA 2000).

Nevertheless, two issues arise regarding the calculation of costs and their allocation by APRA. First, its internal structure is not industry-based. Rather, as shown in box F.3, the main delineation occurs between diversified institutions and specialised institutions. The former covers conglomerate, multi-product groups, often with international linkages, while the second contains more narrowly defined, single product institutions. While this dichotomy is dictated by functional considerations, it does not overlap well with the levies, which are industry based. For levying purposes, divisional costs are allocated between industries on a time basis, but this process is necessarily approximate.

Box F.3 **APRA's divisional structure**

APRA is organised into four main divisions:

- Diversified Institutions Division;
- Specialised Institutions Division;
- Policy, Research and Consulting Division; and
- the Corporate groups: human resources, information technology, legal, public affairs, risk assessment, finance and secretariat.

Source: APRA, sub. 21, p. 1.

This is an issue which APRA itself recognised, stating that:

> … increasingly as we go forward it will be more difficult to allocate costs to the traditional industry groups. (House of Representatives Standing Committee on Economics, Finance and Public Administration 2000, p. 13)

For this reason, APRA expressed a wish to move to a point where the base levy rate is similar across industry sectors (banks, insurance, superannuation) but varies according to risk (trans., p. 184). If this were implemented, APRA would be able to levy conglomerates based on their overall level of risk (and therefore on their consumption of supervisory resources) rather than on their institutional make up. A move to whole-group and risk-based levies was considered by the 2000 joint APRA/Treasury review of levies. In the face of industry opposition, such a move was rejected for the time being. It will be examined again as part of the 2003 government assessment of the changes recommended by the Wallis Report.

ASFA reiterated industry reservations at the prospect of a uniform risk-based levy:

> … applying uniform percentage rates and an overall cap of $1 million for a financial services group would lead to a massive redistribution of the levy burden. Such a redistribution would be very hard to justify in terms of the regulatory costs involved for various organisations. (AFSA, sub. 8, p. 10)

However, one financial conglomerate — NRMA Insurance Group — indicated that it favoured such a levying arrangement:

> … NRMA Insurance Group believes that the levy imposed on each institution should be set more on a risk-based approach under which the levies depend on the degree of supervision or monitoring required. A significant advantage of this approach would be that it would provide an incentive for sound prudential management by financial institutions because those that are well-managed and require less supervision would pay lower levies.
>
> In view of the trend towards institutions becoming conglomerates it would appear to be more appropriate to move towards a single levy structure for the overall entity. We note

> that APRA is intending to move towards a more common levy framework, as stated in its 1999 Industry Consultation paper, and we support this intention as it will help to improve the efficiency of prudential supervision as well as eliminate inequities that exist in current arrangements. (sub. 37, pp. 4–5)

A second cost issue lies with the apportioning by APRA of overhead and non-supervisory costs across industries. As shown in box F.4, 42 per cent of APRA's costs in 1999-2000 were due to activities not immediately directed at industry (development of prudential policies and standards, administrative support and corporate governance).

Box F.4 APRA's cost structure

The percentage of total costs by activity for 1999-2000 was:

- Supervision, rehabilitation and enforcement: 49 per cent;
- Development of prudential policies and standards: 14 per cent;
- Liaison with industry: 9 per cent; and
- Administrative support and corporate governance: 28 per cent.

Source: APRA, sub. 21, p. 8.

At present, such overarching costs are pro-rated to each industry according to the time spent in the supervision of institutions belonging to that industry. The Australian National Audit Office (ANAO) found that:

> … entities that manage multiple levies such as APRA and AMSA face considerable cost allocation problems devising transparent and efficient costing systems given the need to allocate significant indirect costs across levies. (2000c, p. 66)

APRA stated that, while a more detailed activity-based costing system is possible, it would involve extra costs, would produce greater uncertainty regarding levies faced by industry from year to year, and would not necessarily be more efficient than the current system (APRA, trans., p. 183).

Further, APRA claimed that it is very difficult to develop an accurate measure of exactly how much regulatory effort goes into individual financial institutions or individual groups of financial institutions. It stated that:

> The bottom line here is that it is virtually impossible to come up with a formula for calculating levy rates for cost recovery of an organisation like APRA that will satisfy everybody every year. (House of Representatives Standing Committee on Economics, Finance and Public Administration 2000, p. 11)

Difficulties encountered in measuring and allocating costs can lead to cross subsidisation between different industries or different firms. An audit of APRA levies by ANAO found that, prior to 1998-99, smaller, self-managed superannuation funds ('excluded superannuation funds') were cross-subsidising larger financial institutions. Recovery amounted to 63 per cent of costs for larger, non-excluded superannuation funds and to 965 per cent for the excluded superannuation funds (table F.4).

Table F.4 **Under- and over-collection of levies in APRA in 1998-99**

Levy	*Program costs*[a]	*Revenue*	*Proportion of costs recovered*
	$m	$m	%
Superannuation Levy (Excluded funds)	3.5	33.8	965
Superannuation Levy (Non-excluded funds	32.7	20.7	63
Retirement Savings Account Providers Levy	0.09	0.06	71
Life Insurance levy	6.1	4.5	74
General Insurance levy	4.8	4.1	84

[a] Includes allocated administrative costs.

Source: ANAO 2000c, p. 70.

The ANAO concluded that 'prior to 1998-99 … cost recovery outcomes achieved by APRA and its predecessor the Insurance and Superannuation Commission, bear little relationship to the actual cost of prudential regulation of these funds' (2000c, p. 68).

This apparent anomaly was partly rectified in 1998-99, when the supervision of most self managed funds was transferred to the ATO, and the levy they faced reduced from $200 to $45. However, some small APRA funds continue to bear a levy burden that would appear to be in excess of their regulatory costs. According to ASFA, one superannuation Approved Trustee (responsible for the day-to-day management of over 6 000 funds) was charged $1.8 million in levies. This amount was in excess of levies paid individually by major banks, superannuation and insurance providers, due to the existence of the levy cap (ASFA, sub. 8, p. 3). It is difficult, however, to assess the significance of this example without specific knowledge of the value of and risk associated with the assets managed by that or similar trustees. The 2000 joint APRA/Treasury review of industry levies recommended that:

> … small APRA superannuation funds [be charged] the same rate as other prudentially regulated superannuation funds recognising the importance of these financial

> institutions receiving an appropriate level of prudential regulation. (Treasury 2000c, p. 4)

By charging all superannuation funds the same minimum levy of $300, the levy rate for these institutions was able to be reduced from 0.04 per cent in 1999-2000 to 0.02 per cent in 2000-01.

Beyond the question of cost allocation across industries, some participants questioned whether some of APRA's costs should be funded by industry at all. For instance, ASFA stated, in relation to APRA's policy functions:

> … paying for the policy development is a little bit odd, and paying for international aid activities by a government agency is a little bit odd as well. (trans., p. 137)

It also claimed that the benefits of these functions were not always accessible to them:

> … quite a few of these policy functions have moved into the Treasury portfolio proper within the central Treasury, and even though we may be paying for some of that policy function, when you knock on the door of APRA and want to discuss any of those policy issues you're told to go away and talk to Treasury. (trans., p. 137)

In the recent past, ASFA has also conveyed the dissatisfaction of superannuation funds at being asked to repay APRA's establishment costs, 'when these costs are not an intrinsic part of the regulation of superannuation' (cited in Blue 1999). The portion of establishment costs apportioned to non-excluded superannuation funds amounted to $2.7 million in 1998-99, $1.6 million in 1999-2000, and $2.0 million in 2000-01 (APRA, sub. 8, pp. 3–4).

Finally, ASFA expressed misgivings about the levies transferred by APRA to the ATO. It suggested that the cost of maintaining the lost superannuation members register by the ATO was almost certainly far below the amount of funds transferred from APRA for that purpose ($2.3 million per annum). It suggested that, due to the increasing use of online access technology, ATO was over-recovering the cost of answering queries and matching members and funds. Finally, it indicated that, as the Commonwealth Government benefited financially from unclaimed superannuation monies, the maintenance of the lost members register should be funded from consolidated revenue (sub. 8, pp. 7–8).

ASIC

Fees charged by ASIC range from $8 to $1 800. In contrast to APRA, these fees generally do not vary with respect to the identity and size of the applicant. However, individuals are charged a lower fee than corporations. In addition, some activities are undertaken by ASIC free of charge (for example, the supply of

corporate information to selected media organisations and the ABS). Cross subsidisation also takes place, from company returns fees to other ASIC activities (for example, licensing, fundraising and takeovers).

As noted previously, fees charged by ASIC must cover a number of costs beyond the agency's operating costs. The main non-agency item is the compensation to States and the Northern Territory for revenue foregone under the national company regulation scheme. In 1994, fees were set at a level capable of achieving equality between ASIC's total costs (including compensation) and total revenues over time. However, between 1991-92 and 1995-96, the operation of the national scheme incurred an accumulated deficit of $217.6 million (CLERP 2000, p. 34).

Given this deficit, and given the need for compensation and cross subsidisation, the annual company return fee (usually $900) has been set at a level significantly higher than the direct cost of receiving and processing annual returns (CLERP 2000, p. 36). This is meant to allow ASIC to eliminate the deficit by 2000-01 and to equate revenues with costs thereafter.

The level of fees following the elimination of the deficit is currently under examination by the government, as part of its CLERP 7 reform proposals. These proposals are aimed at simplifying lodgment and compliance by firms, as well as at revising fees in line with 'user pays' principles (ASIC, questionnaire response). ACCI stressed the need for ASIC fees to fall upon elimination of the deficit:

> … there does not appear to be any convincing revenue argument to continue ASIC fees at the current levels, even on a basis of 100 per cent cost recovery. A surplus is difficult to justify on the basis of cost recovery or public policy principles. (sub. 70, p. 15)

Another participant expressed concern about the effects high fees may have. NRMA likened ASIC fees and charges to a tax on industry, resulting in higher costs to consumers and a reduction in the competitiveness of Australia's financial services sector (sub. 37, p. 1).

Governance

The levy rate setting process by APRA incorporates a number of transparency and accountability safeguards. The industry is consulted annually on the levy rates to be implemented in the next financial year. These rates are subject to approval by the Treasurer (or his delegate). APRA is subject to the Parliamentary review process, and to supervision by ANAO. In addition, its levy collection framework was reviewed and confirmed by the Government in 1999. A further review will be conducted in 2003 (APRA, sub. 21, p. 4).

ASIC's activities are supervised by the Treasurer (or his delegate) and Parliament. Treasury sets the fees charged by ASIC under Corporations Law. In 1993, fees were reviewed by a committee comprising representatives of the Attorney-General's department (which then had portfolio responsibility for the Corporations Law), the Australian Securities Commission (ASIC's predecessor) and the Department of Finance (ASIC, questionnaire response). In 1995, the Commonwealth Government decided that there should be a series of supplementary fee increases in order to accelerate cost recovery (CLERP 2000, p. 34).

Despite the existence of consultation in the setting of APRA levies, views expressed by financial institutions or their representatives reflect their belief that the level of transparency was insufficient. For instance, NRMA stated that:

> APRA should … seek to develop transparent measures of supervisory costs for the industries that it regulates, and report regularly on its performance and cost levels. The reporting should be done on a six-monthly basis, which is the same as APRA requires of the companies that it supervises. (sub. 37, p. 1)

ASFA concurred:

> Not only is the consultation not there but the sort of information that we used to get that we could see where the levy was being spent and how it was being spent seems to have disappeared. Partly this is because of the nature of the organisations who use the levy and the way they are structured in terms of functions rather than our particular industry or industry groups. It's therefore difficult to see what part of a levy is being used for superannuation purposes. (trans., p. 136)

Concern was also expressed regarding the transparency of ASIC's operations, especially in regard to the monies it receives from APRA. ASFA noted that:

> One difficulty in evaluating whether activities of ASIC should be funded by way of the [APRA] levy arrangements is that very little information is provided by ASIC on the nature of its superannuation related activities outside the operation of the Superannuation Complaints Tribunal. The ASIC 1999-2000 Annual Report provides very little evidence of significant activity in regard to superannuation apart from a compliance review of superannuation member statements. (sub. 8, p. 6)

This concern echoes those of industry groups noted by the 2000 joint APRA/Treasury review of APRA fees, which led to the recommendation that 'steps will be taken to ensure that the [funds collected by APRA and] appropriated to ASIC is fully explained in ASIC's annual financial statements' (Treasury 2000c, p. 10).

Apart from the transparency of expenditures — and hence of fee/levy setting arrangements — another governance issue of concern to regulated institutions is

predictability. This applies mainly to APRA, since ASIC charges are known from year to year, save for CPI-related increases.[6]

APRA has a number of mechanisms in place which are designed to avoid overly wide variations in the levies imposed on the institutions it regulates:

- it can use reserves on balance sheet to help meet unforeseen demands on resources and reduce volatility in levy rates from year to year;
- the annual levy rate applying to an industry is based on a three year average of cost estimates for that industry (past year, current year, following year); and
- adjustments are made for any significant over or under collections from the current year.[7]

These mechanisms notwithstanding, ASFA was critical of some unexpected increases in levies:

> There's no evidence of [greater accountability] in the annual reports and, if anything, the process of setting the levies for the current financial year was very much truncated. I think it was a phone call at the last minute on the basis of some summary papers circulated for another purpose and then, even later in the process, an announcement that a change was being made to the maximum levy. (trans., p. 142)

APRA indicated that this unforeseen increase had been due to the funding of the Superannuation Complaints Tribunal (oversighted by ASIC) (trans., p. 186).

F.3 Economic effects of cost recovery

As an impost on firms, industries and consumers, cost recovery by financial regulators may be expected to produce a number of economic effects. In this section, effects on industry, consumers and international competitiveness are examined.

Economic effects on industry

Cost recovery by financial regulators affects individual firms as well as whole industries. This can be expected to lead to intra-industry effects (at the firm level) as

[6] However, the Commonwealth Government has foreshadowed, in its CLERP 7 document, changes to ASIC fees and regulations which, according to the NRMA, 'are projected to lead to a significant increase in fee revenue for ASIC and potentially an even greater over- recovery of regulatory costs' (NRMA, sub. 37, p. 7).

[7] All industries, except the superannuation industry, pay their levies in advance on July 1 for the financial year ahead.

well as inter-industry effects (at the industry or sector level). These resource allocation effects are examined below. Following this, possible compliance costs linked to cost recovery are discussed.

Resource allocation effects

As discussed in chapter 2, cost recovery can improve economic efficiency when it recovers the cost of regulation designed to suppress negative externalities. This is because it then forces firms (and industries) to recognise the true cost to society of producing a particular output. In the case of financial institutions, cost recovery is partly designed to finance the cost of suppressing a 'third party risk' externality, namely financial contagion. Thus, by charging institutions a cost commensurate with addressing the potential risk they create, cost recovery promotes the efficient allocation of resources.

However, cost recovery can also hinder efficient resource allocation if it imposes identical levies on firms (or industries) with different levels of risk. In its submission to the 1999 Review of Financial Sector Levies, ASFA stated that the regulatory costs of supervising a general insurer with assets of between $1 million and $5 million and a corporate superannuation scheme were far different, yet they both faced a minimum $5 000 annual levy. It suggested that, in the case of the superannuation scheme, actual regulatory costs were likely to be far below that amount [due to the low risk involved] (ASFA, sub. 8, p. 16).

At the other end of the levy scale, resource allocation will also be distorted if cost recovery is capped below the actual regulatory costs. Given that the maximum levy payable by any institution is $1 million, industry contributions to the operation of APRA do not reflect the size of the respective industries, as measured by their assets. For instance, the assets of the superannuation industry amounted to only 38 per cent of those of ADIs in 1999-2000 (APRA 2000, p. 14), yet that industry is estimated by ASFA to pay 40 per cent of the running costs of APRA, against 16 per cent for ADIs (House of Representatives Standing Committee on Economics, Finance and Public Administration 2000, p. 10).

These issues have led some industry participants to call for the removal of levy caps (Van Leeuwen 1999), or at least for levies to reflect more closely the benefits of regulation. For instance, in its submission to the 1999 Review of Financial Sector Levies, ASFA stated that:

> Prudential issues regarding large banks can involve matters of systemic stability that are not relevant to, say, a superannuation fund or life insurer. The major banks can and should pay levies which reflect the benefits of this provision of systemic stability. (Treasury 2000c, p. 17)

This reflects the view that levies should take into account the benefits — as well as the costs — of prudential regulation. Given the considerable benefits of avoiding a 'bank run', this could provide some justification for banks (especially large ones) to assume most of the costs of APRA. The current alternative — which might be termed a 'costs only' based model — means that superannuation funds are the main contributors. This is because, according to APRA, more of its staff are involved in supervising superannuation than any other sector (due to the very large number of firms in that sector) (House of Representatives Standing Committee on Economics, Finance and Public Administration 2000, p. 11).

The industry specific levy model used by APRA may also produce other forms of distortion in resource allocation. First, different levies for banking, insurance and superannuation activities may discourage firms from diversifying and exploiting economies of scope. NRMA, for instance, mentions that, as a diversified financial institution, it pays four different APRA levies (sub. 37, p. 3). Such a levy model may create perverse incentives for firms to minimise cost recovery payments by disguising their true vocation or by restructuring their activities. In the latter case, resources may be wasted through duplication of some functions and operation on a non-economic scale.

Second, the existence of a levy could discourage a firm from entering (or diversifying into) an industry. If the levy is an accurate measure of the cost of regulating a firm's operations and it makes it uneconomical for that firm to enter an industry, resource allocation would be efficient. The same argument applies to a firm being forced out of a market by an appropriately set levy. However, allocative inefficiency would result from an inappropriately set levy which drove an otherwise efficient firm out of business. According to ASFA, however, levies for the superannuation industry are not normally of such magnitude as to have this effect (sub. 8, p. 6).

Cost recovery can also create resource allocation distortions at the intra-industry level. This may be the case in the banking industry. While the assets of the big four ADIs (banks) represented 60 per cent of the ADI capital under regulation in 1998-99, they paid only 16 per cent of ADI regulatory costs (House of Representatives Standing Committee on Economics, Finance and Public Administration 2000, p. 10). This implies that the burden of the levies will bear more heavily on a small credit union than on a large bank, for reasons unrelated to potential risk.

However, a small size can also be an advantage. An audit of APRA by the ANAO found that some smaller (excluded) superannuation funds had failed to lodge returns with APRA and were therefore not levied (including in subsequent years)

(ANAO 2000c, pp. 14, 49). This raises the potential for smaller institutions to gain a competitive advantage by failing to comply with the regulations.

Overall, the evidence suggests that the effective burden imposed by APRA levies varies depending on the size and specialisation of financial institutions. It also appears that, in some cases, this discrepancy is not based on differences in risk and/or prudential activity and therefore has the capacity to distort the efficient allocation of resources in the economy. Nonetheless, judgments about fine-tuning the charging model need also to take into account the transaction costs associated with complex arrangements.

On a final note, resource allocation would be inefficient if the cost of enforcement exceeded the benefits of having prudential regulation in place: that is, if regulation was not cost effective. According to ASFA, this is the case with superannuation. ASFA estimated that consumer protection and market integrity functions of ASIC have meant a reduction in fund member balances of $10 million over three years. By contrast, aggregate losses suffered by superannuation funds through fraud amounted to only $17 million in the 8-year period to 1996, much of it refunded by the industry itself. It concluded thus:

> In other words, the funding arrangements for ASIC are taking far more out of superannuation funds each year than do any fraudulent activities ASIC is attempting to prevent! (ASFA, sub. 8, p. 7)

Compliance costs for firms

The Commission did not receive direct evidence of high compliance costs resulting from cost recovery by financial regulators. However, it seems likely that the cost of complying with levies and fees rises with the number of such charges. For instance, in the case of NRMA, the payment of four separate levies to APRA is likely to entail much higher compliance costs than would be incurred under a single, risk based, levy model (irrespective of the amount of that levy).

Compliance costs may also be higher — proportionately speaking — for small firms, since they are less likely to have access to sophisticated accounting systems.

Regarding ASIC fees, proposals made by the Treasurer as part of CLERP 7 (CLERP 2000) are aimed primarily at simplifying and alleviating compliance procedures under the Corporations Law. As an example, companies would no longer be required to lodge an annual return with ASIC (although they would still be required to pay an annual fee). These proposals — which are likely to reduce compliance costs — are still being considered by the Commonwealth Government.

Impact on consumers

As explained in chapter 2, the burden of cost recovery will usually be shared between consumers and producers. The former will bear part of cost recovery through higher prices and reduced choice, the latter through reduced sales and possibly profits. This may represent an efficient outcome if both groups are deriving benefits from regulation, or if the regulation acts to internalise external effects.

In the case of current APRA levies, there is a general presumption that the customers of financial institutions are the major beneficiaries of prudential regulation. Their benefits derive from the assurance (explicit or implicit) that their assets are secure and retrievable within these institutions. Given that the joint population coverage of banks, insurance companies and superannuation funds is very broad, it could be argued that the direct beneficiaries and the wider population overlap significantly. This raises the question of how best to apply the beneficiary pays principle in the case of prudential regulation. Funding prudential regulation from general taxation revenue could be inequitable to those persons who are not members of superannuation funds (for example, some self-employed workers) or customers of banks or insurance companies. Further, general taxation funding would overlook the fact that financial institutions themselves, as commercial beneficiaries (in terms of their reputation) of government oversight, might be charged. General taxation funding would be even more inappropriate if financial institutions were charged according to the regulated pays principle. Since prudential regulation is partly designed to avoid a negative spillover (financial contagion), any public benefit that this regulation generates should not be charged to its beneficiaries under that principle (see chapter 2).

In the case of ASIC, the major beneficiaries of regulation governing conduct and disclosure form a somewhat narrower group than APRA's. They are, on the whole, limited to a firm's consumers and its shareholders. This is because, in the absence of third party risk, only the consumers of a firm's product stand to benefit from ASIC's supervision of that firm. For instance, clients of an investment adviser will be able to trust the advice they receive. Members of the general public, however, will not directly benefit from the implicit guarantee ASIC scrutiny provides. In this situation, the beneficiary pays principle justifies the investment adviser's clients bearing the cost of supervision.

Even then, it is not clear that customers of *all* companies and corporations enjoy the same level of benefit from ASIC oversight. Doubts were expressed by a small business representative organisation about the degree of consumer protection afforded to its constituency's customers:

> … essentially small firms do not feel that they get any service for [their fees] because Mrs Bloggs typically doesn't ask to speak to the ASIC if her apples are soft at her greengrocer's shop on the corner. So as a consumer protection device it doesn't really work for us. (COSBOA, trans., p. 542)

Efficiency will be compromised if customers of small and large firms are faced with the same cost of regulation (in the case of passed-on ASIC fees for instance), yet do not derive benefits of equal value.

ASIC's major beneficiaries constituency extends to a firm's shareholders as well as its customers. Shareholders rely on ASIC's supervision to protect them from insider trading and/or fraud. According to the beneficiary pays principle, therefore, it would be efficient for the services of ASIC to be partly funded by a company's shareholders, through reduced profits and dividends.

Apart from benefiting actual customers and shareholders, ASIC's activities can also benefit *potential* customers and shareholders. By accessing ASIC's financial information databases, these groups can check the credentials of companies, advisers, etc. This produces a combination of private and public benefits. Private benefits derive from individuals being able to choose the best transaction. Public benefits are generated when, for instance, savings are directed towards their most productive uses, thus benefiting the wider economy.

The application of the beneficiary pays principle of cost recovery may rest upon the ability of firms to pass on the cost of regulation monitoring and enforcement to their customers (and, in the case of ASIC, shareholders). However, economic distortions on the consumption side will arise if this burden is not passed on in uniform fashion by multi-product institutions to all their customers. For instance, a diversified financial conglomerate may decide to pass on the totality of its cost recovery burden to consumers in one of its markets only, based on the characteristics of demand in that market (such as a lack of competition and strong product differentiation). This could result in, say, insurance subscribers being made to carry the cost of prudential regulation, not just of insurance activities, but also of banking and superannuation activities. Such a shift in the burden of regulation could seriously impair efficiency through, for instance, consumers under-insuring or over-investing in superannuation.

International effects

Given Australia's engagement on the world economic stage, the international dimension of cost recovery by financial regulators is an important one. In the financial services sector, where transactions are increasingly conducted on a

worldwide scale, inappropriately high levies and fees may discourage overseas investment in Australia, with obvious repercussions for the overall level of welfare.[8] In recognition of this, and also due to the lower regulatory costs involved, APRA reduced the levy applying to foreign banks in 2000-01 (table F.2). According to the NRMA, high cost recovery charges may also impair the capacity of domestic institutions to compete internationally (sub. 37, p. 3). However, the Commission did not receive sufficient evidence to be able to substantiate such 'competitiveness' claims.

[8] If high levies are viewed by overseas investors as a reflection of the quality of the supervisory effort in Australia, they may not act as a disincentive.

G Cost recovery in other jurisdictions

This appendix examines other countries' experience of cost recovery. It looks specifically at Canada, Finland, Iceland, New Zealand, Sweden, the UK and the US, which are the countries for which the Commission has been able to find policy documents on cost recovery. A summary of the guidelines of these countries can be found in box G.1.

G.1 Introduction

Although most countries increased their use of cost recovery during the 1980s and 1990s (McMahon 1995; New Zealand Treasury 1998; Hills 1995), there are large differences in how long individual countries have been implementing general policies on cost recovery. For example, the US Office of Management and Budget (OMB) developed a policy document specifically on user charges in 1959. It appears that most countries listed above either created or revised their policy documents in the 1990s to reflect cost recovery's increasing role (box G.1). This inquiry represents the Australian Government's first attempt at developing a comprehensive approach to cost recovery at the Commonwealth government level for regulatory and information agencies. It may also have implications for other types of agencies and other jurisdictions, including State Governments. Box G2 contains a summary of the current guidelines available at the Australian State Government level.

Box G.1 **Overseas guidelines for cost recovery**

Canada — *Cost Recovery and Charging Policy* (Treasury Board of Canada Secretariat 1997b) provides guidelines to Canadian government agencies on their charges. It contains some information on the economic issues surrounding cost recovery and limited information on accounting and costing matters. *User Charging in the Federal Government — A Background Document* (Treasury Board of Canada Secretariat 1997a) contains a detailed discussion of economic issues. The Canadian guidelines seem to support relatively low levels of cost recovery.

Finland — *User Charging for Government Services Act* (1992) provides guidelines to Finnish government agencies on their charges. There is a lack of other documents that explain the broader rationale for this legislation in the English language so it is difficult to speculate on the coverage of economic, accounting and costing issues. The legislation promotes the use of cost recovery, but lists many possible exemptions including: health care and other welfare services; administration of justice; environmental protection services; education; and general cultural activities.

New Zealand (NZ) — *Guidelines for Setting Charges in the Public Sector* (NZ Treasury 1998) provides guidelines to NZ government agencies on their charges. It contains some information on the accounting, costing and economic issues surrounding cost recovery. It is not clear how broadly the NZ guidelines promote the use of cost recovery. The guidelines examine the economic principles that may make cost recovery inappropriate but provide limited practical advice on how these principles should be applied. The guidelines state that the potential beneficiaries of government activities, and individuals, groups or firms that require regulation ('risk exacerbators'), should be subject to cost recovery. They also spell out when regulated firms should be charged for imposing negative spillovers on the community.

OECD — *User Charging for Government Services* (OECD 1998) contains 'best practice guidelines' for OECD countries. It also contains case studies on the approaches taken in particular countries, describing the user charges of a government agency within that country to illustrate how the cost recovery policy is implemented in practice. The guidelines promote user charges only if they are implemented under appropriate circumstances, such as where there is clear legal authority, determination of full costs and consultation with users.

UK — *The Fees and Charges Guide* (UK Treasury 1992) provides guidelines to UK government agencies on their charges. It contains detailed accounting and costing information but little information on economic issues. The guide appears in favour of full cost recovery and does not attempt to address circumstances when full cost recovery is inappropriate, other than stating that partial cost recovery is permissible with Ministerial agreement.

US — *Circular No. A-25 Revised* (OMB 1993) provides guidelines to US federal government agencies on their charges. It contains limited information on the accounting, costing and economic issues surrounding cost recovery. It appears to encourage cost recovery strongly, and states that full cost recovery is appropriate from identified recipients of government activities, irrespective of whether all or some of the benefits are passed onto others.

Box G.2 **Australian State government guidelines for cost recovery**

Some Australian States have produced guidelines on cost recovery.

New South Wales — The New South Wales Treasury is developing *Guidelines for Pricing of User Charges*. It will be published later in 2001. Its emphasis will be on ensuring that government agency user charges accord with competitive neutrality principles. It will also define user charges as excluding taxes, fines and regulatory fees because of the degree of compulsion in these transactions. This document is unlikely to focus on best practice for cost recovery by regulatory agencies.

Victoria — The Victorian Department of Treasury and Finance has produced a paper entitled *Guidelines for Setting Fees and Charges Imposed by Departments and Budget Sector Agencies, 2001-02* (2000). It contains advice on costing, charging and competitive neutrality compliance. It advocates full cost recovery as a general rule. It states that less than full cost recovery may be appropriate where there are conflicting policy objectives, the activity contains public good characteristics or the activity relates to regulation (it identifies regulatory fees as being distinct from other user charges). It states that the 'commercial' supply of good may provide a justification for charging more than full cost. It requires Treasurer approval for changes in charges that will result in a $100 000 difference in revenue and that such changes be identified in departmental business plans. It recommends that government agencies perform an annual review of their charges as part of their business plan.

Tasmania — the Tasmanian Department of Treasury and Finance has produced *Costing Fees and Charges: Guidelines for Use by Agencies* (1998). This document focuses on costing issues but it also discusses how costing information should be translated into charges. The general rule is that charges should be based on full cost recovery. However, it states that less than full cost recovery may be appropriate where there are externalities, conflicting policy objectives or it is difficult to identify the users of an activity. It recommends that government agencies formally review their charges annually and that there be an external assessment bi-annually by the Budget Committee, or another appropriate Committee, or by Cabinet. It also recommends that agencies develop their own specific manuals on fees and charges.

Western Australia — the Western Australian Treasury has produced *Costing and Pricing Government Outputs* (1998). This report contains guidance on costing, pricing and compliance with competitive neutrality principles. It finds that full cost recovery means setting a revenue target for the supply of output and that less than full cost recovery may be appropriate in the presence of positive externalities, government direction or legislative restrictions. It encourages agencies to review annually their charges and include a section on their pricing policies in their annual report.

G.2 Rationales

There are two common objectives for cost recovery in the countries studied. The first common objective is the promotion of a more efficient allocation of resources. User charges may act as a test of market demand, eliminating frivolous demand and helping to bring about an appropriate scale of delivery (Treasury Board of Canada Secretariat 1997b, p. 1). They may also empower the consumer, along a 'user pays, user says' principle, and a more client-focused service may result in greater quality and efficiency (Treasury Board of Canada Secretariat 1997b, p. 1). Cost recovery may bring a greater awareness of a government agency's costs, both internally and externally (Borild 1998, p. 73). Greater cost awareness and consumer power may aid the selection of the most appropriate supplier (New Zealand Treasury 1998, p. 2).

The second widespread objective is the promotion of increased fairness through the beneficiaries of goods and services paying for their consumption instead of the general public. This may also be desirable because it reduces the need for funding from general taxation revenues (Treasury Board of Canada Secretariat 1997b, p. 1).

A number of countries also cited revenue raising as a possible objective for cost recovery, although their approaches were different. Canada's *Cost Recovery and Charging Policy* document specifically precludes the use of cost recovery to raise revenue:

> …charging cannot be used simply as a means of generating revenue to meet the funding requirements of the department or agency. (Treasury Board of Canada Secretariat 1997b, p. 1)

In contrast, New Zealand's *Guidelines for Setting Charges in the Public Sector* seems to encourage the use of cost recovery for revenue raising purposes. One of its objectives for cost recovery is 'reducing reliance on funding from general taxation' (New Zealand Treasury 1998, p. 2). It also states that, as an alternative source of funding to user charging,

> … the working presumption is that recourse to taxation should be avoided except where its advantages can be clearly demonstrated. (New Zealand Treasury 1998, p. 2)

The US OMB appears to see cost recovery as an alternative to budget funding, stating one of its objectives as 'the self-sustainment of Government agencies' supply of goods and services to specific recipients' (OMB 1993, p. 2). Anderson (1991, p. 14) believes that revenue raising has been an important factor behind the increase in user charges in the US.

A revenue raising objective is not explicitly acknowledged in the UK *The Fees and Charges Guide* (UK Treasury 1992), but the use of charges to recover past deficits

of government agencies is encouraged, while the return of past surpluses is discouraged. The guide states that it is the 'normal presumption' that fee levels should be set to recover past deficits, but that previous surpluses should not 'normally be taken into account' (UK Treasury 1992, p. 9).

G.3 Legal authority

The constitutions of many countries restrict the use of cost recovery, particularly with regard to constitutional distinctions between taxes and user charges (New Zealand Treasury 1998, p. 18). Many constitutions require that taxes be implemented through specific legislation and the enforcement of this principle invalidates user charges that have the characteristics of a tax but are not supported by such specific legislation. This is the situation in Australia, Canada, New Zealand, the UK and other countries.

Factors that may be seen as giving user charges the characteristics of a tax include: whether the transaction is voluntary; the strength of the link between the revenue source and use; the size of the user charge; and whether indirect as well as direct costs are recovered (New Zealand Treasury 1998, p. 17). The Swedish Constitution, for example, defines a user charge as being directly related to the services rendered and not exceeding the full cost of those services (Borild 1998, p. 73). These issues are also likely to affect whether a government organisation recovers costs for individual services or across the agency. The guidelines of Canada, Finland, NZ, the UK and the US encourage cost recovery for individual goods and services.

The Finnish parliament has overcome the potential limitations created by the constitutional distinction between a tax and a fee for service by enacting the *User Charging for Government Service Act* in 1992 (Vallinheimo and Joustie 1998a). This Act provides the Finnish government with almost unlimited ability to implement user charges within the guidelines embodied in the Act (Vallinheimo and Joustie 1998b, p. 35).

In the US, it is unclear how far the Constitution places limits on the application of user charges. In 1989, there was a unanimous ruling by the US Supreme Court that user charges are not taxes in the case of *Skinner v. Mid-America, 87-2098*. Anderson (1991, p. 24) took this to mean that user charges are whatever the government says they are — a user fee is different from a tax because Congress has decided that the two are different. Anderson suggested that this was a pragmatic decision, reflecting the extent of user charges in the US local, state and federal governments.

However, in 1998 the US Supreme Court made a ruling that user charges can be taxes, and therefore unconstitutional, in *United States v. United States Shoe Corp.* A harbour maintenance excise tax of 0.125 percent of the value of cargo loaded or unloaded at US ports provides a financing source for certain Army Corps of Engineers harbour improvement projects. It was ruled that the harbour maintenance tax was unconstitutional because the link between the revenue source and its use was too indirect to support its classification as a user fee (Joint Committee on Taxation, 1998, p. 7). There are two possible interpretations of this outcome and it is unclear which is the most applicable:

1. it may be that this ruling is a turnaround by the US Supreme Court from *Skinner v. Mid-America, 87-2098* on the distinction between taxes and user charges; or
2. the Court reached its conclusion based on particular circumstances of this case. The harbour maintenance tax was interpreted as falling under the jurisdiction of the Export Clause of the US Constitution that states 'No tax or Duty shall be laid in Articles exported' (Article I, Section 9, clause 5 of the US Constitution).

Some governments, such as those of Iceland, Sweden and the UK, are unable to charge for services unless the ability to do so has been specifically granted in legislation for a given agency (UK Treasury 1992, p. 2, Borild 1998, p. 74 and Hjalmarsson 1998, p. 52). This results in government agencies having to implement legislation agency by agency because of the lack of general legislation (Hjalmarsson 1998, p. 52). In Canada, there are several types of legal authorities for setting fees and while the *Financial Administration Act* and 'Ministerial Authority to Contract' may side-step this problem, it is likely to still exist under specific departmental legislation. The introduction of cost recovery may be deterred if the agency is required to spend significant resources on developing its policy and enacting the legislation. It may also increase the possibility of inconsistencies in the cost recovery practices of different government agencies — piecemeal legislation may be introduced agency by agency without appropriate reference to some over-arching legislation or policy.

G.4 Governance and accountability

It is important to establish the appropriate level of accountability over government agencies' cost recovery activities. It seems that there is a trade-off between the autonomy of a government agency and its level of supervision. Increasing the level of supervision may create increased assurance of due diligence in the system but may also compromise an agency's ability to respond flexibly to new developments. The level of oversight in a given country can be seen as a reflection of the relative importance that policy-makers place on oversight versus agency independence and

flexibility. There are two methods of accountability possible — those to users and clients and those to government.

Two types of consultation are associated with the various guidelines: consultation in developing the guidelines and consultation required by the guidelines. Countries have taken very different approaches to developing their policy documents. Canada's *Cost Recovery and Charging Policy* document was developed using consultation with nationally-based industry groups, groups representing Canadian individuals, academia, major user-charging departments and the Office of the Auditor-General (Treasury Board of Canada Secretariat 1999, p. 3). In contrast, the *Finnish User Charging for Government Services Act 1992* was produced with no formal consultation with interested parties.

The Canadian guidelines require government agencies to ensure efficient means of consultation with affected parties before and during cost recovery (Treasury Board of Canada Secretariat 1997b, p. 2). The New Zealand guidelines acknowledge the need for some kind of consultation process through user groups or some form of advisory board but it is not a compulsory requirement (New Zealand Treasury 1998, p. 26). In contrast, the Finnish *User Charging Act*, the UK *The Fees and Charges Guide* and the US *Circular A-25 Revised* do not mention consultation with interested parties in setting user charges.

In Canada, the three types of legal authorities that exist for setting fees, specific departmental legislation, the Financial Administration Act and Ministerial Authority to Contract, provide an approval process (Treasury Board of Canada Secretariat 1997b, p. 7). Agencies are required to conduct impact assessments of fee-setting decisions beforehand and periodically. There is also the possibility of raising concerns with the President of the Treasury Board — for example, concerns over any lack of consultation in the fee-setting process (Treasury Board of Canada Secretariat 1997b, p. 5).

In Finland, government agencies are required to publish their pricing decisions in the Official Gazette. This might increase the transparency of such decisions to interested parties, but it appears that interested parties have limited power to raise concerns through a 'watchdog' institution or specified consultation process. The relevant ministry or government organisation is responsible for setting user charges. Furthermore, the government organisation producing the service is entrusted with ensuring that the cost of production and the quality of service are appropriate (Vallinheimo and Joustie 1998b, p. 36).

In Sweden, all government agencies are required to consult yearly with the Swedish National Audit Office about their user charges. This is intended to ensure that user charges are uniform, relevant and do not exceed the full cost of the service over the

service's lifetime (Borild 1998, p. 74). In the US, the OMB is entrusted with performing a variety of oversight functions over agencies' cost recovery activities. However its ability to gauge whether a given level of cost recovery is appropriate might be questioned because of the strongly pro-cost recovery role given to the OMB in *Circular No. A-25 Revised* (OMB 1993).

G.5 Application of cost recovery

In considering the application of cost recovery, full cost recovery or otherwise, there is the question of whether cost recovery should take place at all (see chapter 2). Two issues are found in cost recovery policy documents. First, if that good or service ought to be provided by a government agency and second, the cost to the government agency of implementing cost recovery. For example, the Canadian Guidelines state:

> Cost-recovery can only be initiated where the Government has deemed the activity in question to be a legitimate and necessary role for the federal government, and one that cannot be provided adequately by the private or voluntary sector. (Treasury Board of Canada Secretariat 1997b, p. 2)

The UK *The Fees and Charges Guide* states 'the presumption is that services should wherever possible be provided by the private sector rather than the public sector'. It even calls for 'periodic review' of the necessity for the activity to be provided by government (UK Treasury 1992, pp. 6, 25).

The New Zealand guidelines require government agencies to consider whether the provision of their goods and services could be 'out-sourced' or 'devolved' to the private sector (New Zealand Treasury 1998, p. 10).

Most policy documents acknowledge the impracticality of undertaking cost recovery if the associated administration costs outweigh the benefits from cost recovery. The emphasis given to the consideration of administration costs varies between countries. In the US, the cost of collecting the fee should not be 'unduly large' and in Canada it should not be 'excessive' in relation to the collected revenue.

Full cost recovery

Full cost recovery is the general principle behind the calculation of user charges for statutory services among the countries examined, but there is some variation in how this rule is applied. Statutory services are those activities that are determined to fall within the realm of government, either through legal definition in statutes (UK

Treasury 1992, p.2; Vallinheimo and Joustie 1998b, p. 35), or through inadequate alternative provision in the private or voluntary sector (New Zealand Treasury 1998, p. 2; Treasury Board of Canada Secretariat 1997b, p. 2).

Where charging for inter-governmental services is discussed, the normal rule is that full cost recovery should be applied. In the US, *Circular No. A-97* (OMB 1969, p. 5) states 'such services will be provided only on payment or provision for reimbursement [of] all identifiable direct and indirect cost of performing such services'. In the UK, *The Fees and Charges Guide* states 'charges should normally be set to recover the full cost of the service' (UK Treasury 1992, p. 19). The same policy exists in Finland.

Countries differ in their application of cost recovery in three main ways:

- the definition of 'full cost recovery', in particular the treatment of the cost of capital (see 'rate of return' section);
- the extent that deviation from full cost recovery is allowed on an unintentional or temporary basis (see below); and
- the extent that deviation from full cost recovery is allowed on an intentional or indefinite basis (see 'less than full cost recovery' section).

Countries vary in how far government agencies are allowed to deviate from full cost recovery on an unintentional or temporary basis. In the UK, it is 'legitimate… to apply a degree of tolerance' to the full cost recovery principle (UK Treasury 1992, p. 5). In Sweden, costs only have to be fully recovered in the 'long-run'. A government agency may deviate from full cost recovery in a given year to reflect previous surpluses or deficits (Borild 1998, p. 74). In Iceland, previous deficits must be returned by direct repayments or by fees temporarily lower than the costs and vice versa (Hjalmarsson 1998, p. 42). However in the UK, the retrieval of deficits is encouraged far more than the return of surpluses. It is the 'normal presumption' that fee levels should be set to recover past deficits, but surpluses should not 'normally be taken into account' when setting fees (UK Treasury 1992, p. 9).

Less than full cost recovery

A key distinguishing factor between countries appears to be the extent that partial cost recovery is permissible on an intentional or indefinite basis, particularly with respect to the treatment of public benefits.

Partial cost recovery occurs in the UK subject to agreement among Ministers (UK Treasury 1992, p. 5). However, the circumstances under which ministerial agreement is appropriate is not elaborated on.

Public benefits provide a case for partial cost recovery in New Zealand but 'the loss in public benefits from charging at full cost would have to be significant' (New Zealand Treasury 1998 p. 2). The descriptions of 'public benefits' follow economic definitions and may be difficult for user groups to interpret and to apply in practice.

Deviation from the rule of full cost recovery occurs in Canada if the activity is affected by some public policy objective or contains a mix of private and public benefits. The Canadian *Cost Recovery and Charging Policy* acknowledges the continuum of activities between purely private and purely public goods (Treasury Board of Canada Secretariat 1997b, pp. 3, 6). It identifies four characteristics as useful in determining how far an activity lies between the two ends of the scale:

- the extent to which individuals can be excluded from a good or service for which they have not paid;
- the extent to which charging will influence demand for a good or service;
- the extent to which a mandatory service confers direct benefits with respect to marketability and reduced liability through the mitigation of risks; and
- the relative importance of policy objectives associated with the activity.

In Sweden, the rule of full cost recovery does not apply if the objective of the activity would be adversely affected. For example, Swedish citizens' constitutional right of access to information means that individuals are only charged the cost of executing an order for information services with most information being provided free on the Internet (Borild 1998, p. 74).

The relevant public policy areas that qualify for exemptions in Finland are identified as: health care and other welfare services; administration of justice; education; general cultural activities; and environmental protection services (Vallinheimo and Joustie 1998b, p. 36). This list seems to cover most of the core functions of government and no rationale is given in the legislation for these particular choices.

In the US, the *Circular A-25 Revised* (OMB 1993, p. 4) states that full cost recovery applies to identified recipients of government activities, irrespective of whether all or some of the benefits are passed on to others, including the public in general. This rule does not apply to all government activities, as some government activities qualify for exemption in other documents. *Circular No. A-130* states that user charges for government information products should be set 'at a level sufficient to recover the cost of dissemination but no higher' (OMB 1996, p. 9). The benefits from a free flow of information are argued to outweigh the costs by helping the efficient running of democracy, the accountability of the government sector, the healthy performance of the economy and fostering research. Furthermore, *Circular*

No. A-130 recognises that the government is the largest single producer, collector, consumer and disseminator of information in the US as well as being reliant on public cooperation for its raw data (OMB 1996, pp. 4–5).

Rate of return

Cost recovery may include a rate of return on capital. There are two main reasons why this may be done. The first reason is that the government may seek a return on its capital that is equivalent to what it would receive if the capital was put to its next best use. This opportunity cost of capital is often measured by a long-term bond rate. The second reason is to introduce competitive neutrality in the pricing of government goods and services. This is to ensure that government organisations operating in a commercial environment do not have an unfair advantage over private businesses. This seems to be the case for 'commercial services' – commercial services tend to be provided at the government's discretion rather than required through statutes, as well as being more in direct competition with the private sector (UK Treasury 1992, p. 2).

In the UK, full cost recovery is defined as including a six per cent annual cost of capital. This is defined to be the amount of interest the government could earn on its capital if it was put into an alternative use (UK Treasury 1992, p. 8). In the US, full cost recovery includes an annual rate of return on capital equal to the average long-term Treasury bond rate (OMB 1993, p. 5). One of the objectives of cost recovery in Canada is to 'earn a fair return for the Canadian public for access to, or exploitation of, publicly-owned or controlled resources' (Treasury Board of Canada Secretariat 1997b, p. 2). In Finland, there is no requirement for statutory services to earn a return on their capital, as this only applies to commercial services (Vallinheimo and Joustie 1998b, p. 35).

In general, the inclusion of a rate of return is encouraged for government activities that operate in a more commercial environment. In the UK, commercial activities are expected to recover at least full cost, with adjustments being made for the degree of risk and competition surrounding that activity (UK Treasury 1992, p. 26). The more risk and/or competition involved in the activity, the greater the return expected on the capital assets. In the US, the price for commercial services is supposed to mimic their potential 'market price'. Possible methods suggested for determining the market price include competitive bidding and benchmarking (OMB 1993, p. 5). The Finnish and Icelandic approach to user charging for commercial services is that they should be set through competition in the open market with other sellers and show overall profitability with a return on capital similar to that expected by private investors (Vallinheimo and Joustie 1998b, p. 36; Hjalmarsson 1998, p 52).

In the countries reviewed, it appears general competition legislation had a large influence on policies for charging for commercial service (Hjalmarsson 1998, p 52). Usually the guidelines did not explore whether charging a rate of return is appropriate because of the social costs of a particular activity. This appears to be because the guidelines are on user charges, and matters relating to charging for social costs are deemed to fall under the realms of taxation (New Zealand Treasury 1992, p. 22).

G.6 Trends

Governments across the world appear to have made little effort to accurately calculate cost recovery figures at an aggregate level. The data that are available are frequently dated and incomplete. These factors mean that it is difficult to compare the scale of cost recovery across countries.

In Canada, 17 per cent of government revenue was generated by user fees in 1990 (Sproule-Jones 1994, p. 7). This figure is likely to understate the true extent of user fees because it does not include the revenues of government agencies that operate in a more commercial environment. A government-wide summary shows no apparent increase or reduction in the revenues generated from charges to non-government users between 1994-95 and 1997-98 (Treasury Board of Canada Secretariat 1998). However, there have been trends within categories. It seems that there has been a greater shift towards cost recovery in areas associated with the environment (Canadian Environmental Assessment agency, Environment and Fisheries and Oceans), the law (Federal Court of Canada, Justice, Supreme Court of Canada and Tax Court of Canada), Immigration, Foreign Affairs and International Trade, Finance, and the Canadian Space Agency. There has been a significant reduction in the cost recovery activities surrounding Public Works and Government Services.

Recent information on cost recovery in the US is difficult to obtain. In the period prior to 1990, there was been a relative increase in the reliance on non-tax revenue sources for federal, state and local government (Anderson 1991, p. 19). At a federal level, non-tax revenue represented 17.6 per cent of total revenue in 1970, 21.8 per cent in 1980 and 24.7 per cent in 1985 (Netzer 1992, p. 498). A similar trend can be found in the user charges imposed by American state and local governments but it appears that much of the increase in user charges at the local level took place in the 1970s instead of the 1980s (Netzer 1992, p. 499). User charges declined relatively in the 1960s and early 1970s and rose substantially from 1975 onwards (Netzer 1992, p. 500).

In Finland, the total amount of user charges in the budget sector rose nearly nine per cent, with an increase of FIM540 million, between 1994 and 1995. This rise reflected the implementation by government agencies of the *User Charging for Government Services Act 1992*. Over half of all government services subject to charge under this Act were produced and consumed within government. These inter–governmental charges amounted to nearly FIM2900 million in 1995. Sales to non-government parties amounted to FIM2500 million in 1995 (Vallinheimo and Joustie 1998b, p. 37).

In the UK, charges for public services fell from £7.9 billion in 1978-79 to £7.6 billion in 1993-94 (Hills 1995, p. 32). Earmarked taxes, which are likely to contain some charges that can be viewed as cost recovery items, increased between 1978-79 and 1993-4 from almost £31.1 billion to £47.5 billion.

Overall, it seems that most countries increased the scale of their cost recovery activities over the course of the 1980s and 1990s. In some cases, such as Finland, a significant portion of this increase was due to a rise in inter-governmental charging.

G.7 Case studies

The following case studies show how the previously discussed guidelines have been implemented in practice by various agencies across the world. Overseas cost recovery arrangements for the review of prescription drugs and dietary supplements are described, followed by overseas cost recovery for information agencies.

Overseas cost recovery arrangements for the review of prescription drugs and dietary supplements

Government agencies around the world pursue similar objectives in their review of prescription drugs, but have different cost recovery mechanisms. There are also differences in cost recovery mechanisms for the review of dietary supplements, and it would appear that the objectives differ among countries, as indicated by the diverse regulatory structures for these products.

United States

The Food and Drug Administration (FDA) is responsible for reviewing prescription drugs and dietary supplements in the US. Some inquiry participants have referred to FDA services as being free of charge (MIAA, sub. 12, attachment 2; Awin, sub. 20, p. 1). This is not the case — charges do apply to some FDA services.

The FDA recovers almost 50 per cent of the total costs of drug review (FDA 2000b). The charges were introduced in 1993, under the *Prescription Drug User Fee Act* (PDUFA), and have grown each year. The PDUFA was enacted to supplement FDA resources for the review of human drug and biologic applications and the funds may not be used for other purposes, including activities related to the review process such as the surveillance of post-marketed products. There are four PDUFA fees: full application fee; half application fee; annual establishment fee; and annual product fee. The FDA's ability to collect these charges is tied to written performance goals. In 1999-2000 these charges generated US$122 million. In addition to the PDUFA charges, the FDA has user charges for the Certification Fund, Mammography Quality Standards Act, Export Certification and the Seafood Inspection Program. The amount of revenue generated by these charges has increased over time. There are current proposals to introduce user charges for Food Additive Petitions, Food Export Certification and Premarket Reviews of medical devices in 2001-02 (FDA 2000a).

The FDA is responsible for only post–market surveillance of dietary supplements. Manufacturers do not need to register with the FDA or get FDA approval before producing or selling dietary supplements (FDA 2001).

Canada

The cost recovery mechanisms used by the Therapeutic Products Programme (TPP) reflects the Canadian Government's policy that charges should be set according to the private benefit associated with the activity. This has led to almost fifty different charges for TPP activities related to drug regulation and they comprise: 100 per cent cost recovery for adverse reaction monitoring and for-cause inspections, 70 per cent cost recovery for application reviews and 30 per cent cost recovery for other post marketing costs. In 1998-99 the TPP collected Can$35 million through these charges.

The Canadian government has allocated Can$10 million towards establishing a separate entity, the Natural Health Products Directorate (NHPD), for the regulation of complementary healthcare and dietary supplements. The NHPD is reviewing its current cost recovery policy and although it is anticipated that the NHPD will recover at least some of its costs, it is unclear how far such charges will apply to the review of dietary supplements.

United Kingdom

The Medicines Control Agency (MCA) recovers 100 per cent of all drug regulation costs. Partial costs were recovered following the 1971 amendments to the 1968

Medicines Act. Full cost recovery was initiated in the early 1990s. There are over 50 different charges. In 1999-2000, the MCA collected £28 million and spent £36 million (using carryover revenue).

Dietary supplements fall within the category of 'borderline' products at the MCA, so long as they contain familiar substances and do not contain pharmacological active substances or make medicinal claims. Cost recovery is not imposed for the review of these products.

Cost recovery overseas for information agencies

Some products of national statistical agencies across the world can be substituted for one another, for example, for research purposes. 'Over-pricing' by one agency relative to another may mean that some of its products are not used. This can lead to research and analysis being carried out using statistical information from other countries. This has been a problem in Canada and Australia with US data being used as the basis for policy recommendations.

Statistical agencies of overseas governments divide their products into those that provide a service to the general public and those that are developed for identified groups of users. The services that have a public interest function are charged at less than full cost or not at all, depending on the method of delivery. The differences among countries lie in the scope of services that are categorised as being in the public interest and the methods of charging for the various products.

United States

Much US statistical information is available relatively easily and free of charge through mediums such as the Internet. The general policy on user charges for the US federal government is modified for its information products. *Circular No. A-130: Management of Federal Information Resources*, takes the view that information products provide a number of services to US society and economy, including ensuring the accountability of government, fostering research, and maintaining a healthy economy and a democratic society (OMB 1994, pp. 4–6). It states that information agencies shall:

> … set user charges for information dissemination products at a level sufficient to recover the cost of dissemination but no higher. They shall exclude from calculation of the charges costs associated with original collection and processing of information. (OMB 1996, p. 9)

However, as Sprehe (1996, p. 8) emphasises, it is not clear which services should be classified as 'dissemination products' and it is difficult to separate costs and assign

them between non-dissemination and dissemination products. This allows the agency a degree of discretion over its cost recovery activities.

The US Census Bureau is the US principal statistical agency. The 1997 *Census Bureau Pricing Policy* took a narrow view of which services should be provided free of charge. It stated that the US Census Bureau maximised the use of its data by making 'basic summary tabulations readily and freely available' on the Internet and through selected networks of local institutions and national organisations. Users had to pay for products that contain enhanced access or convenience properties. There is some evidence that the prices may have contained more than dissemination costs. For example, the general price of a pre-existing CD-ROM was US $150 (Census Bureau 1997, pp. 1-5).

However, a 1999 memo on CD-ROM prices reduced the price of a pre-existing CD-ROM from $150 to $65 (Census Bureau 1999, p. 2). It also seems to contain a movement towards the sentiments expressed in *Circular No. A-130* (OMB 1996):

> Our dissemination policy is not to maximise revenues or operate for profit, but to provide information for the public good while recouping marketing and dissemination costs that are not covered through our appropriations. (Census Bureau 1999, p. 1)

Canada

Statistics Canada (Canada's national statistical agency) began to implement user charges in the mid-1980s. Its current cost recovery activities reflect the Canadian Government's policy that charges should be set according to the private benefit associated with an activity.

It is deemed in the public interest that Canadians are 'informed citizens'. This means that all appropriation funded surveys on public policy issues and custom outputs from existing surveys are provided free of charge through the Internet. Information for personal advantage or organisational goals, that is not part of the ordinary programme of Statistics Canada, is supplied on a cost recovery basis. The costs recovered include direct and indirect costs. The charges are set by product group and the price contains almost a 1:1 relationship between direct expenditure and overheads.

H Costing approaches

For efficient and effective cost recovery, agencies must be able to identify and measure the appropriate costs of their outputs. If cost recovery charges are based on the wrong costs, or if the costs of agencies are not carefully allocated among agency outputs, they may distort decisions about the production and consumption of government supplied goods and services.

'Costing' should be distinguished from 'pricing'. The cost of an output is the value of the inputs that have been used in its production, while pricing represents the market value of a product or service. Although the price is influenced by the cost of production, distribution and supply, it is also influenced by demand (DOFA 2000, p. 8). In most instances, cost recovery is not seeking to 'price to market'. When costing an output, it is necessary to define the output, identify and measure the costs of providing the output and select a method for allocating costs to it.

The need to identify and track costs is not unique to cost recovery agencies — all Commonwealth departments and agencies are required to specify and set prices for the outputs they deliver to Government (see chapter 3).

Costing outputs can be useful for promoting transparency. If costing information is available to the public, for example, through the pricing of agencies' outputs, there could be greater scrutiny of the efficiency and effectiveness with which government services are delivered. Where cost recovery is taking place, there could also be greater scrutiny of the cost recovery process. Those who pay the charges will have an interest in placing pressure on agencies for efficient cost recovery practices.

H.1 Defining the output to be costed

Before agencies can set charges, they need to estimate the costs of programs or activities. It is useful for an agency to know what the full costs of a particular output are, regardless of whether it intends to fully recover those costs or not. For example, costing outputs will assist the agency to know how efficiently it is producing those outputs. In addition, costing can be used to identify the component of public funding needed to produce the output while taking into account any cost recovery that could be taking place.

In order to achieve outcomes (end results), governments provide a variety of outputs. In order to cost an output, it first needs to be defined. When defining the output it is usually desirable to:

- specify the objectives of the output and the targets to be met;
- identify the output and associated inputs necessary to produce it (including alternatives);
- identify constraints to producing the output, such as; policy, safety standards and rules; and
- specify quantity and quality characteristics of the output.

Quantitative characteristics may cover physical standards, output volumes, output frequencies, and material, safety, accuracy and reliability standards. Qualitative characteristics cover descriptive standards and would typically state the objective the goods or services are intended to achieve. These include set criteria against which performance can be measured.

Costing outputs will improve an organisation's information on the cost of those outputs and allow it to reflect better those costs in its prices. This could improve the efficiency with which outputs are produced. As prices charged would more closely reflect costs, consumers will be taking account of them in their consumption decisions. Improved production and consumption efficiency will improve allocative efficiency.

If outputs are defined too narrowly, agencies may devote more resources to determining costs than might be gained in subsequent improvements to allocative efficiency. On the other hand, outputs to be costed should not be defined too broadly. Also, if cost recovery of a particular output is to take place, it should be costed separately from outputs that are not subject to cost recovery, such as policy advice.

Some commonly used costing terms are defined in box H.1.

Box H.1 **Cost definitions**

Direct costs are costs that can directly and unequivocally be attributed to an activity. They include labour (including on-costs) and materials used to produce the goods or service.

Indirect costs are costs that are not directly attributable to an activity and are often referred to as overheads. They can include 'corporate services' costs, such as the chief executive officer's salary costs, financial services, human resources, records management and information technology.

Capital costs comprise the user cost of capital and depreciation. The user cost of capital represents the opportunity cost of funds tied up in the capital used to deliver services. It can be measured as the rate of return a firm must earn to justify retention of the assets in the firm in the medium to long term. Depreciation reflects the portions of assets consumed each period in the production of output.

Fixed costs are costs that do not vary with output. Rent and capital are usually fixed costs in the short run.

Variable costs vary with the volume of output of a good or service and typically include direct labour and materials.

Common or joint costs are costs that remain unchanged as the production of different goods is varied. These costs are incurred if any one of the goods is provided. For example, the costs of telephone lines to a house remain unchanged whether they are used for local or long distance calls.

Source: CCNCO (1998a).

H.2 Measuring costs

A number of considerations need to be taken into account when measuring costs. This section examines what cost components should be included in measuring the full cost of an output. It also considers the effect of accrual accounting on the measurement of costs, along with a description of the different capital cost calculation methods. The effects of competitive neutrality are also considered.

The full cost of a unit of output is the value of all resources used or consumed in the provision of that output. These costs may include:

- direct labour, for example, wages and salaries, along with other labour costs such as allowances, long service leave and superannuation;
- direct materials and services, for example, stores, computer services and services obtained on a contract basis;

- an appropriate share of indirect labour, for example, executive, office services, personnel, library and audit services;
- an appropriate share of indirect materials and services, for example, office machinery, advertising, insurance, freight and cartage. In some cases, materials classified as indirect could in fact be direct costs, but attributing them to a particular output may be impractical or too costly, for example, office stationery;
- accommodation, which could be both direct and indirect, for example, rent, repairs and maintenance, cleaning and utility charges; and
- capital costs, such as depreciation, interest on working capital and return on non-current assets (see below).[1] Some of these could be direct costs, where assets are dedicated to the production of particular outputs. Others could be indirect such as assets used by corporate services.

Accrual accounting and output based budgeting

An accrual based budgetary framework, incorporating output based budgeting, was introduced into the Commonwealth public sector with reporting beginning from the 1999-2000 financial year. Previously, agencies within the Commonwealth public sector used cash based accounting, that recognised revenues and expenses when payments were made or received. Accrual accounting recognises revenues and expenses in the accounting period in which they occur, irrespective of when cash is paid or received. The framework requires all agencies to:

- measure resource consumption and revenues on an accrual basis, recognising costs and revenues when they are incurred;
- set prices for outputs they deliver, and identify outcomes to which the outputs contribute;
- levy a capital-use charge on net departmental assets;
- identify performance indicators to monitor performance against outcomes; and
- report performance.

The new framework requires agencies to improve their costing so they are able to price all outputs and monitor and report performance. Department of Finance (DoF), (now Department of Finance and Administration) identified one of the major benefits from the introduction of full accrual accounts as the ability to cost activities properly. It argued that cash accounts are more open to manipulation and are a poor basis for cost comparisons (DoF 1996).

[1] Non-current assets are assets that are not reasonably expected to be: converted to cash, sold, or consumed, within a year of balance sheet date. They include property, plant and machinery.

The move from cash to accrual has had implications for two components that are important in determining full costs of output. Firstly, the measurement of capital has changed. Under the cash based system, the operating statement included the capital expenditures made to acquire assets. However, under the accrual system, depreciation rather than capital expenditure is included in the operating statement. Depreciation reflects the portion of the asset that is consumed each period in the production of output. Secondly, the move to accrual accounting has changed the way employee entitlements are treated. For example, superannuation is now accounted for when it is accrued, rather than when there is an associated cash flow.

Some agencies have recognised these benefits. ABARE commented that:

> The change from cash to accrual accounting means that there is a more realistic account of costs over time and assurance that full account is taken of capital costs. The combination of accrual and market testing/outsourcing changes means that ABARE costings are based on full costs with a competitive market base. (sub. 56, p. 17)

Capital costs

The cost of an output will be influenced by the inclusion of capital costs and the method used. This will in turn influence the level of any cost recovery for that output. Capital costs consist of the user cost of capital and depreciation. The user cost of capital reflects the opportunity cost of capital used in agencies. Capital can be used elsewhere or it can be used to retire debt. The charge would also reflect the cost to the community or taxpayer of government capital raising. To measure the user cost, the asset needs to be valued, and a rate of return applied to the value of the asset. Depreciation reflects the portion of the asset that is notionally consumed each period in the production of output.

Including capital costs in the cost of output would not only ensure that the opportunity cost of capital and depreciation are taken into account, it may also improve asset management, as organisations can no longer treat the use of assets as free once they have been acquired. They will have an incentive to dispose of surplus assets, and to use an efficient mix of assets that takes the user cost of capital into account.

In practice, it can be difficult to value assets and determine a rate of return. What asset valuation method should be used? What is an appropriate rate of return to be applied? How should the costs of poorly utilised assets be included? All components of capital costs, asset valuation, rates of return and depreciation need to be assessed together, as they are interrelated.

Asset valuation methods

There are a number of methods that can be used to value non-current assets (box H.2). The method of valuation chosen may lead to significantly different estimates of the value of capital, and different methods can be more suitable under different circumstances. This in turn can lead to significant implications for cost recovery. Broadly speaking, the methods can be categorised as cost based, value based or a combination.

Cost based methods

There are a number of cost based asset valuation methods that can be used, for example, historic cost, replacement cost, reproduction cost, depreciated replacement cost and depreciated optimised replacement cost (DORC). Historic cost is simpler and less costly to use than more complex asset valuation methods and does not require a subjective assessment of the value of the assets. However, historic cost does not take into account changes in the value of the asset over time through inflation, improvements in technology and changing market conditions. When asset values are rising, historic cost will understate both the value of the assets and the depreciation expenses each period. For these reasons, historic cost may be more suitable for valuing assets that have a short life.

Replacement and reproduction cost are other cost based methods that have the advantage of valuing the asset at the current cost of replacing or reproducing it. The main disadvantage of these approaches is that the asset is replaced with an asset of equivalent service potential, even though the asset may not be the most efficient asset to use. These inefficiencies could arise from factors such as excess capacity or unsuitable location.

DORC takes these inefficiencies into account. However, DORC is more expensive and complex to use and requires more subjective judgement in determining what the optimum asset is.

Box H.2 **Asset valuation methods**

Historic cost values assets at the original cost to the organisation of acquiring the asset, including relevant financing and set up costs. The historic valuation can be adjusted for depreciation, where an asset has a limited life, by subtracting accumulated depreciation. Accumulated depreciation represents the amount of the assets' service potential that has already been used.

Reproduction cost values assets at the current cost required to reproduce the existing asset, mainly in its present form, using the specifications of the original asset.

Replacement cost values assets at the current cost of replacing the asset with a similar asset which can provide equivalent services and capacity.

Depreciated replacement cost adjusts replacement cost to account for asset consumption by subtracting accumulated depreciation

Depreciated optimised replacement cost (DORC) values assets at the replacement cost of an 'optimised' asset, less accumulated depreciation. An 'optimised' asset is one that most efficiently produces a specified level of output. The effect of inefficiencies such as excess capacity, duplication, redundancy and poor location are removed from the valuation.

Fair market value uses the price the asset would sell at in a competitive open market, where both the buyer and seller are 'willing but not anxious'. It reflects the value of an asset in its next best alternative use.

Net present value uses the present value of the predicted cash flows generated from the use of the asset. It involves estimating the future income generated by an asset, and then discounting that income stream at a discount rate that reflects the risks involved in owning the asset.

Deprival value represents the loss that could be expected by an organisation if it was deprived of the service potential or future economic benefits of the asset. If the asset that the organisation is deprived of is to be replaced, the asset should be valued at its market value, replacement cost or reproduction cost depending on the circumstances. If it is not replaced it should be valued at the economic value of the asset, which is the greater of either the asset's net present value or fair market value. Where the asset is surplus to requirements it should be valued at its fair market value.

Optimised deprival value is measured by the lesser of DORC and the economic value of the asset, where the economic value is the greater of either the asset's net present value or fair market value.

Source: SCNPMGTE (1994b); QCA (1999).

Value based methods

There are two main value based methods, fair market value and net present value. One of the main advantages of using fair market value is that the value is based on

factual and observable information and provides a valuation that is verifiable. It represents the command over cash that the asset comprises at reporting date. One of the main disadvantages of this approach is that highly specialised assets that may have been costly to acquire, particularly ones that have characteristics that are specific to a particular owner, may not have a high value placed on them in the market.

Using net present value will overcome this problem. However, there are drawbacks in using net present value as it is difficult to estimate future cash flows and determine an appropriate discount rate. It could be difficult to estimate the future benefits of non-commercial activities such as regulation undertaken by, for example, the Australian Securities and Investments Commission or the Australian Competition and Consumer Commission. There is also a circularity problem as the selected discount rate will, in fact, determine the rate of return on assets.

Hybrid methods

There are two main hybrid methods, deprival value and optimised deprival value, that make use of both value based and cost based valuation methods. Deprival value has the advantage that it provides information on the current costs of providing output and the current value of the assets. It reflects whether the organisation's capacity to continue its present level of output has been maintained. It avoids inadvertent erosion of the entity's operating capacity. Deprival value would have similar advantages and disadvantages to market value, replacement cost, net present value or fair market value, as it is based on a combination of these approaches. Under the Commonwealth Government's resource management framework, agencies are directed to use the deprival model to value assets (DOFA 2001, p. 1-23).

Optimised deprival value takes inefficiency into account, as it makes use of DORC. It would have similar advantages and disadvantages to DORC, net present value and fair market value, depending on which method is used.

Determining the user cost of capital and depreciation

Once a non-current asset has been valued using an appropriate valuation method, the capital cost can be determined by calculating the capital-use charge. The Australian Geological Survey Organisation, CSIRO and ABARE are a few examples of agencies that include a rate of return in their cost recovery charges. They do this as a requirement of competitive neutrality. Agencies that are not fully cost recovered are also required to pay a capital-use charge, although they are

funded for this from appropriations (see below). Depreciation will also need to be calculated.

The user cost of capital

There are a number of ways to determine the rate of return used to calculate the capital-use charge. For example, a uniform rate can be applied across all agencies. This rate can be determined by benchmarking, or the weighted average cost of capital (WACC) can be used (CCNCO 1998b). The user charge should be applied to net assets; that is, assets less liabilities.

A uniform rate of return can be applied across all agencies (although there may be a case for variable risk premiums in some circumstances). For example, the Commonwealth Government currently uses a uniform rate (box H.3). DoF argued that the rate can have both a risk free component and a risk premium (DoF 1991). The risk free rate could be set at the long term bond rate. The risk premium represents risk that cannot be diversified away by undertaking a larger portfolio of projects, for example, risk arising from a project's susceptibility to fluctuations in economic activity. This is a cost that private investors bear and for which they require a higher rate of return. The concepts are based on the capital asset pricing model (CAPM) which is usually applied to private investment decisions. However, DoF argued that the concepts can be usefully applied to the public sector to determine the risk premium. As the government faces lower risk, the risk premium would be lower (DoF 1991).

Box H.3 **The Commonwealth's user cost of capital arrangements**

The Commonwealth Government currently requires all agencies and authorities that are not fully funded through user charges or industry levies to pay a uniform capital-use charge. The rate is set at the risk free long term bond rate (that will vary over time) plus a risk premium. In 2000 the capital-use charge comprised a 6 per cent risk free rate and a 6 per cent risk margin.

The charge is estimated at the beginning of each financial year and included in an agency's price of outputs. The charge is based on net departmental assets at the end of the previous financial year. Administered assets that are not controlled by the agency, but managed by agencies on behalf of the Commonwealth, are excluded. For most agencies and authorities that pay the charge, funding is included in their departmental appropriations.

Source: DOFA (2001).

However, the majority of activities that are the subject of this inquiry cannot be easily characterised as commercial in nature, even though their costs may be

recovered. For example, what is the true opportunity cost of assets devoted to regulating public health and safety issues? In addition, applying a uniform rate would not take into account differences in risk faced by different agencies within government.

Benchmarking to similar private companies or industry averages can be used to determine the rate of return. However, a number of activities that are the subject of this inquiry are statutory monopolies which may make it difficult to find a suitable benchmark. There are also problems associated with benchmarking itself. For example, it can be difficult to isolate specific factors affecting an individual organisation's return from underlying market performance.

The WACC can also be used to determine an appropriate rate of return. The Steering Committee on National Performance Monitoring of Government Trading Enterprises (SCNPMGTE) has outlined the operation of WACC in measuring the performance of GTEs (SCNPMGTE 1996). Broadly speaking, WACC takes into account the costs of debt and equity. These costs arise because interest on debt must be paid by the agency, and those providing equity expect a return on their investment that is commensurate with the risk of the enterprise. The rate of return on equity is determined using the capital asset pricing model (CAPM). WACC has disadvantages, as it is requires more data and knowledge of theory than other methods. There are also problems estimating the return on equity using CAPM.

Regardless of the method used to determine the user cost of capital, there could be problems in allocating these costs where there are indirect or joint capital costs. That is, capital costs cannot be directly attributable to producing a particular type of output. (Cost allocation methods are discussed below.)

Depreciation

Capital costs can also vary depending on how depreciation costs are calculated. A number of methods can be used to calculate depreciation. For example, the straight line method can be used, that allocates equal amounts of depreciation to each full accounting period in the asset's useful life. Alternatively, the reducing balance method can be used, and results in decreasing depreciation each period over the asset's life. Depreciation charges can also be related to use rather than time which can be appropriate where asset usage varies significantly from one period to another. Under the straight line method, capital costs will be lower in earlier periods than under the reducing balance method, all other things being equal. Hence, in earlier periods of the assets useful life, asset valuation methods that subtract depreciation would give a higher valuation using the straight line depreciation method, than using the reducing balance depreciation method.

Competitive neutrality

When government agencies provide services in areas where there is actual or potential competition, cost recovery charges should be consistent with the competitive neutrality requirements contained in the *Commonwealth Competitive Neutrality Policy Statement* released by the Commonwealth Government in 1996 (Commonwealth of Australia 1996). Competitive neutrality could have implications for the determination of costs for some government outputs and in turn affect levels of cost recovery.

Current competitive neutrality arrangements aim to remove artificial advantages and disadvantages, to allow public and private businesses to compete on an equal basis. Competitive neutrality therefore requires that those government agencies and businesses affected to set prices that cover a wide range of costs including a return on capital and all relevant taxes and charges. As a result, when costing outputs, government agencies and businesses should include charges such as company tax, payroll taxes, goods and services tax and stamp duties along with a rate of return (CCNCO 1998b).

Competitive neutrality does not always mean that agencies must charge 'market prices'. In some instances it is appropriate for agencies to charge incremental or avoidable cost (as defined below), to allow for efficient use of idle capacity of government agencies.

Few of the Government agencies within the scope of this inquiry currently undertake significant activity in contestable markets. Some information agencies (such as the Bureau of Meteorology, ABARE and CSIRO) provide commercial as well as non-commercial services. It is less likely that the activities of regulatory agencies would be subject to the competitive neutrality principles, because they do not operate in competitive markets. Some regulatory activities such as assessments and approvals could potentially be contracted out to the private sector. In this case, if the regulatory agency retained an in-house provider in competition with the outsourced providers, competitive neutrality principles could apply.

The existence of a competitive private market for the good or service begs the question of why Government provision is necessary. The rationale for public sector involvement (for example provision of services to certain groups facing discrimination) should be explicitly stated.

H.3 Allocating costs

Once costs have been identified and measured, they can be allocated to units of output. Allocating direct costs to an output is relatively simple. Allocation becomes more difficult where indirect and capital costs are involved. A number of methods can be used to allocate costs. These include using direct costs, fully distributed cost, marginal cost and incremental or avoidable cost. The different approaches lend themselves to different circumstances and will give different results. They will have very different efficiency implications for different activities. This section briefly discusses the different approaches. Appropriate approaches for different circumstances are examined in more detail in chapters 6 and 8.

Direct costs

The simplest way of allocating costs is to allocate only direct costs to a unit of output. However, it means that the full cost of producing the output, for example, overheads, are not being taken into account. In addition, it will not give an indication of the increase in cost involved from producing an additional unit of output. However, agencies may choose to allocate only direct cost to an output where it makes up only a small proportion of their total activities, and makes only a small call on agency overheads. In such cases, the impact of not including indirect costs may not be significant.

Marginal cost

An indication of the increase in cost involved from producing an additional unit of output can be given by marginal cost. Conceptually, marginal cost includes variable costs. Short run marginal cost (SRMC) is the cost of supplying an additional unit of output when at least one of the factors of production, quite often capital or capacity, is fixed. Thus, SRMC excludes costs that are fixed in the short run such as capital costs. It also excludes a range of indirect costs that do not vary in the short run, such as generic advertising or some overheads. SRMC gives the best indication of the cost of producing an additional unit of output at any point in time.

Long run marginal cost (LRMC) is the cost of supplying an additional unit of output when all factors of production such as capacity can be varied. While in the long run by definition, all factors of production are variable, in a multi-product organisation LRMC for a particular output may exclude some indirect or joint costs that do not vary with the production of that output. LRMC includes the cost of capital and can be relevant to investment decisions. For example, if demand is high enough, such

that SRMC is greater than LRMC through scarce capacity being rationed through higher prices, it could indicate that investment in new capacity is needed.

Marginal cost pricing sets the price for a unit of output equal to the additional cost of producing that output. The advantage of this approach is that it will allow prices to reflect the opportunity cost of supplying the output. Therefore, consumers will be equating the marginal cost of producing the output with the benefit they place on consuming an additional unit of the output. Prices will be efficient as production and consumption of the output will be optimal. That is, consumers will be taking the opportunity cost of consuming an additional unit of output into account when making their consumption decisions.

However, there are problems in measuring marginal cost. It can be difficult to specify what period the short run is. It can also be difficult to measure what the increment in output should be, for example, should the increment be a single car or a production run of cars. In addition, there will be problems with allocating joint costs between different outputs and with allocating indirect costs.

There could also be significant price fluctuations leading to customer confusion if marginal cost pricing is used. Capacity is often expanded in large blocks while demand grows more steadily over time. While capacity is fixed and demand is growing prices will rise to reflect the increasing opportunity cost of producing an additional unit of output. That is, scarce capacity would be rationed through higher prices. However, after an increment in capacity has occurred, there will be a reduction in marginal cost as the opportunity cost of producing the additional unit of output will have fallen. Because of the problems with measuring marginal cost, incremental and avoidable cost are often used as proxies.

Incremental and avoidable cost

There are a number of definitions of incremental cost. However, in practice, incremental cost usually refers to the increase in costs attributable to the production of a particular type of good or service rather than the marginal cost of producing an additional unit of that good or service. As such, incremental cost is usually related to larger increments in output, and a longer period of time than SRMC. It is usually a long run concept. Incremental cost can also be measured as the increment in cost of producing a service for a particular customer.

Because incremental cost is a longer run concept, it is usual to talk about long run incremental cost (LRIC). LRIC includes incremental capital costs and incremental indirect costs. However, it excludes indirect and joint costs that remain unchanged whether the product is supplied or not. These costs are often not incremental in

providing additional output. Per unit incremental cost can also be used, and is calculated by dividing the cost of the increment in the type or block of output, by the number of additional units.

Avoidable costs include all the costs that would be avoided if an output was no longer produced by the agency. Direct costs will be included in avoidable cost, as will indirect costs that are avoidable. Indirect costs that remain fixed regardless of whether the output is produced are not avoidable and should not be included, for example, corporate overheads or generic advertising.

In practice, there is generally little difference between avoidable and incremental cost. The cost saved by not producing the output is usually the same as the additional cost of making the product available, at least in the long term.

However, there are a number of issues to take into account when measuring avoidable and incremental cost. What period of time is the long run? The longer the period of time, the greater the number of costs that can be included in incremental or avoidable cost. For example, a lease on office space or equipment could expire in the medium to longer term.

In addition, there are measurement issues associated with allocating capital costs to joint outputs. For example, a particular output may use surplus capacity in assets used to produce another output. In this case, it could be difficult to decide which costs are avoidable.

Moreover, the appropriate level of avoidable cost needs to be estimated. Avoidable cost can be considered at the agency level or in terms of the outputs of the agency. If an agency has only one output, or the outputs are similar, avoidable cost could be taken to be the cost of the agency as a whole, including its total indirect costs. However, if there are a number of outputs, or they are not closely related, it could be desirable to calculate the avoidable cost of each product. This could lead to difficulties in allocating joint and indirect costs.

The Bureau of Meteorology's charging for meteorological services including the use of incremental cost, is outlined in box H.4.

Box H.4 The Bureau of Meteorology's charging for meteorological services

The Bureau of Meteorology (BoM) has four charging categories for meteorological services.

- **free services** include reports of present and expected weather for various locations, including coastal waters, and warnings, made available through the mass media (these services are known as the *basic product set*). These services are also provided free to emergency services;
- **cost of access** is charged for the basic national meteorological service that encompasses basic weather, climate, hydrological and consultative services. (These services are known as the *basic product service*. The basic product service includes the basic product set.) Cost of access is charged for the basic product set when it is not provided via the mass media or the Internet, such as by phone or fax;
- **incremental cost** is charged for services that satisfy international obligations, for example, weather services to the aviation industry; and services to other government agencies, for example, the Department of Defence; and
- **commercial rates** are charged for services that are provided to meet the requirements of a specific user and provided in competition, or potential competition, with the private sector.

For the basic product service (including the basic product set when not provided by the mass media or the Internet), BoM charges only the cost of making access available. The services themselves are provided free of charge. For example, cost of access includes communications and publication costs.

For services where incremental costs and commercial rates are charged BoM includes:

- the cost of additional staff and operating costs involved in providing the service over and above the basic service;
- the costs of any research and development projects undertaken specifically in support of the service;
- capital costs specific to the service;
- costs in establishing a new service or ceasing an existing service; and
- overhead costs — where services provided are on a whole of program basis, such as aviation and defence, BoM charges a portion of overhead costs that is determined pro-rata to output costs. Where services are provided through available capacity, but it is within a basic service program, the overhead component is attributed pro-rata to direct labour costs.

For commercial services BoM also charges a discretionary component in addition to the other costs charged.

Source: BoM (sub. 35, attach. 7, pp. 4.2–4.6).

Fully distributed cost

Under the fully distributed cost (FDC) method, the total costs of an agency are allocated across all outputs. Direct costs are allocated to their respective output, while indirect costs are allocated across all outputs. Regulatory agencies that recover costs for a large proportion of their activities typically use some method of fully distributed costs. Indirect and joint costs can be allocated in a number of ways. For example, they can be allocated on a pro-rata basis according to the number of staff involved in the activity or on the basis of the shares of direct costs devoted to different activities. For example, the Australia New Zealand Food Authority, the Australian Radiation Protection and Nuclear Safety Authority and the Australian Quarantine Inspection Service use a pro-rata approach. Activity based costing (ABC) is a more sophisticated way of fully distributing costs.

Simple pro-rata methods are relatively easy to implement and most agencies will have the financial data available to attribute direct costs to outputs and to identify indirect costs separately. However, it is desirable to allocate indirect costs as closely as possible to the actual pattern of resource usage in producing the output, although there is a trade off involved in terms of the complexity and cost of the system.

Activity based costing

ABC is a form of FDC but is more accurate in how it allocates indirect costs than allocating on a pro-rata basis. ABC links an organisation's outputs to activities used to produce those outputs, which in turn are linked to the organisation's costs. While the form of an ABC system can vary from organisation to organisation, it could typically comprise:

- identification of full costs;
- identification of outputs and the organisation's customer segments;
- identification of all activities that the organisation performs to produce outputs;
- tracing full costs to the activities; and
- identification of cost drivers which link activities to outputs to give a cost per unit of output.[2]

The National Industrial Chemicals Notification and Assessment Scheme, the National Registration Authority, the Therapeutic Goods Administration, the

[2] Cost drivers are factors that affect the level of activity, and hence costs, required to produce a unit of output. For example, cost drivers can include customer numbers or the level of service complexity.

Australian Maritime Safety Authority and the Office of Film and Literature Classification's (OFLC) make use of activity based costing. The OFLC's costing and output pricing model is outlined in box H.5.

Box H.5 **Office of Film and Literature Classification's costing and output pricing model**

The Office of Film and Literature Classification (OFLC) used an activity based costing model in costing and pricing its outputs in 1996. Its model involved a four part process:

- *Identification of the cost pool.* This was done by taking the OFLC's budgeted expenditure for 1996-97 as set out in the Budget papers and adjusting it by excluding 'one off' items, reducing some capital expenditures that could be amortised over future years, and including minor OFLC allocated costs that are not shown in the Budget papers. These calculations resulted in the general cost pool.
- *Attributable cost development.* The general cost pool was apportioned between costs recovered from the industry, and costs of community service obligations that were funded by government. Costs were attributed on the basis of staff activities obtained from a survey that allocated staff time across activities and outputs. Staff time was then converted into salary dollars.
- *Attributable cost allocation.* The cost recovery component from the general cost pool was then allocated. This was done by first allocating direct service delivery costs to major activities within the OFLC. The activities included scheduling, screening and support activities. The breakdown was based on the staff activity survey. Second, statutory and non-statutory cost recoverable services were identified and a projected service volume estimated. The salary dollars by activity for each service were then divided by the number of services performed during the survey. This gave the unit value for each service by activity. Third, OFLC costs were allocated over the activities for each service.
- *Calculation of service costs.* The cost of providing each service was calculated by dividing the cost of each activity for each service by the number of services provided. The cost of each of these activities, for each service, was accumulated to provide the total cost for each unit.

Source: OFLC (1996).

ABC requires more detailed data than the simple pro-rata FDC system. Data are required to determine which activities contribute to certain outputs and in turn how these activities consume resources. As a result, new systems could be needed to record items such as staff time spent on activities and services, customer numbers and indicators of complexity for each service. These requirements are often in addition to data that the organisation already has. Typically, these data are collected by surveys undertaken at regular intervals. Rosters or timesheets could also be used.

The increased complexity of ABC, and the greater need for data mean that the costs of implementing and using the system are higher than under a simpler FDC system.

While an ABC system should be more successful in allocating costs to outputs in a manner that more closely reflects usage by each output, there remain some costs that can only be allocated on an arbitrary basis because of difficulties involved with obtaining reliable survey information. For example, corporate overheads can be difficult to allocate when management time is consumed irregularly by a number of activities. In addition, it can be difficult to record usage of capital equipment accurately where it is used to produce several outputs.

What is the most appropriate method of allocation for different circumstances?

The method of allocating costs will affect the level of any cost recovery charge. For a given circumstance, FDC and incremental or avoidable costs will give different results for the cost of outputs, and hence would have implications for the price and level of cost recovery for the output. If full cost recovery for the output was imposed, the price charged under FDC would be higher than the price charged under incremental or avoidable cost. Similarly, if the level of a price charged for an output under cost recovery was constrained by policy or market forces, at a level below both the FDC and the incremental or avoidable cost, the element of public funding required for that particular output would be greater under FDC than under incremental or avoidable cost approaches.

In some situations FDC and avoidable or incremental cost will give similar results in the costing of outputs. This could occur when joint costs are low. In this case there will be a small increment to cost if a particular output is produced, or costs avoided will be small if the output is not produced. Capital costs will be included under both approaches if the incremental or avoidable cost is measured over the long run.

Different methods will be more suitable under different circumstances. A pro-rata FDC system is a simple way to allocate all costs to an output. However, it does not measure the costs associated with an increase in production that would be measured using incremental or avoidable cost.

It would be desirable to measure increases in costs using incremental or avoidable cost in the short run where there is excess capacity. This capacity could be used if the output is able to earn its avoidable or incremental cost and avoid the capacity being idle. If an output can earn revenue that is equal to or greater than its avoidable or incremental cost, it will not impose an additional cost on the agency. They are

also better methods where capacity has been put in place for a non-commercial purpose which is central to an agency's functions, yet this capacity can be utilised for other purposes without impeding the output of the non-commercial function.

Incremental or avoidable cost can be used where there are large fixed costs that have to be incurred regardless of how many units are produced. For example, many information agencies incur high sunk costs when they collect and compile data required for public policy. However, once this information has been collected the costs of dissemination to many users could be quite low. This information could be made available at incremental cost. In these cases FDC could overestimate the cost of an output because, under FDC, joint costs will be allocated to that output, even though these joint costs will still be incurred if the output is not produced. An incremental or avoidable cost approach would exclude these costs.

On the other hand, FDC could be more appropriate where full costs, including joint costs, are to be recovered. For example, it could be appropriate for the full costs of an industry regulator such as the Australian Prudential Regulation Authority to be recovered from the industry that it regulates. Agencies will need to make decisions about which method is best on a case by case basis, as the circumstances can differ. Agencies will also need to consider competitive neutrality requirements if they are operating in a contestable market.

I Australian Government Solicitor legal advice

The Productivity Commission sought legal advice from the Australian Government Solicitor relating to the Commonwealth's authority variously to impose fees, charges, levies and taxes in different situations. The advice dated 2 March 2001 is reproduced below.

Fees for services and taxes

1. Thank you for your letter of 16 February 2001 seeking advice on issues arising from the Productivity Commission's inquiry into cost recovery by Commonwealth regulatory, administrative and information agencies.

2. Your questions relate broadly to the Commonwealth's authority variously to impose fees, charges, levies and taxes in different situations. You say that the advice will help the Commission to comment generally on the 'legal constraints on the design and operation of cost recovery arrangements' (term of reference 4.(b)). The advice may also be used in the development of suitable guidelines for implementing cost recovery (term of reference 3.(g)).

Advice

3. Your questions, together with my answers, are set out below.

1. What is the difference between a fee for service and a tax? What is the distinguishing feature of a tax Act?

Difference between a fee for service and a tax

4. In non-legal contexts, the expressions 'tax' and 'fee for services' sometimes have overlapping meanings. This is because taxes are sometimes imposed for the specific purpose of raising revenue to finance the delivery of specific kinds of government services and fees for services are sometimes structured and imposed as taxes. For

constitutional purposes, however, the concept of a tax and the concept of a fee for services are mutually exclusive. Section 53 of the Constitution, which deals with the powers of the Houses of Parliament in respect of legislation, expressly draws a distinction between the two kinds of imposts. Moreover, the High Court, usually in the context of considering the application of section 55 of the Constitution (which provides, amongst other things, that a law imposing taxation shall deal only with the imposition of taxation), has specifically characterised a tax partly by reference to certain negative characteristics, which include the requirement that the impost not be a fee for services. The classic definition of a tax, albeit qualified in various respects over the years, is: 'a compulsory exaction of money by a public authority for public purposes, enforceable by law, *and ... not a payment for services rendered'* (emphasis inserted) *(Matthews v Chicory Marketing Board (Vic)* (1938) 60 CLR 263 at 276 per Latham CJ see also *Air Caledonie International v Commonwealth* (1988) 165 CLR 462 at 466-467).

5. A fee for a service may share certain of the positive attributes of a tax. For example, it may (although it may not) be compulsory and enforceable by law. It may be, and often is, imposed by a public authority and for public purposes, for example, where it is imposed in respect of activities which are carried on under the authority of legislation. It is, however, different in one respect from a tax, that is, it is *a payment for services rendered to or at the direction or request of the person required to make the payment (Air Caledonie* at 467). The application of this general distinction has been far from clear in practice, given that the delivery of a service may sometimes be made *the occasion of* the imposition of different kinds of imposts, including taxes.

6. Until recently, in practice, fees for services have been distinguished from taxes on the basis not only of their imposition in respect of a service but also on the basis of their relationship to the costs of delivering the service to the individual paying the fee. This approach was based on a statement in *Air Caledonie* suggesting that there had to be 'a discernible relationship' between the fee and the 'value' of what is acquired (by way of a service) and that to the extent that the fee exceeds that value, the fee could be seen to be a tax (at 467). In the absence of other guidance by the High Court, 'value' was assumed to be measured at the level of the individual paying the fee and in terms of the costs of delivering the service to the individual.

7. In December 1999, the High Court handed down a major new decision dealing with the distinction between fees for services and taxes — *Airservices Australia v Canadian Airlines International Ltd* (1999) 167 ALR 392. The High Court confirmed the need for fees for services to be imposed in respect of services delivered to the persons required to pay the fees. However, it endorsed a more flexible approach to the characterisation of an impost as a fee for services, citing the

relationship between the level of the fee and the costs of delivering the service as an important but not exclusive consideration, especially where the provider of the services has a statutory monopoly on the provision of the services. Another important consideration is that the overall fee structure should not be designed with a general revenue raising purpose. For your information, I attach an Australian Government Solicitor Legal Briefing[1] dealing with the decision, which was prepared shortly after it was handed down. This Briefing summarises the approaches in the various separate judgments, which differed somewhat in emphasis.

8. Apart from confirming the important (though not necessarily exclusive) role of cost recovery in the characterisation of imposts as fees for services, the main significance of the decision is in indicating a more flexible approach to cost recovery than was previously thought acceptable. In particular, the High Court indicated that the relationship to the costs of delivering the service can be manifested at the user group level, especially where the services are highly integrated (cf. networks of services with common infrastructure), rather than at the individual level. That is, the fees can be fixed by reference to the costs of delivering services *to all* of the users of the services rather than by reference to the costs of delivering services to a particular individual. Moreover, the High Court has recognised that there can be a degree of flexibility in fixing charges for particular users or classes of users (differential pricing), subject to broad constraints. Those constraints were variously described in the judgments: 'a rational basis for discrimination' (Gleeson CJ and Kirby J); 'a commercial justification for discriminating between different users' (Gaudron and Hayne JJ); 'reasonably and appropriately adapted means of achieving a legitimate public purpose' (McHugh and Gummow JJ).

9. Importantly, too, the High Court acknowledged that a profit component can be included in a fee structure, providing it does not a have revenue-raising purpose and merely allows for a reasonable rate of return on capital or future infrastructure requirements.

Distinguishing features of a tax Act

10. A tax Act is, of course, an Act which imposes a tax. A tax, as mentioned in paragraph 4 above, is an impost with certain positive attributes and certain negative attributes, one of which is that the impost must not be a fee for services.

[1] Australian Government Solicitor 1999, *Fees for services and their recovery,* Legal briefing number 53; 14 December 1999

11. As also mentioned in paragraph 4 above, the definition of a tax set out in the *Matthews v Chicory Marketing Board (Vic.)*, while a continuing reference point in judicial discussions of what constitutes a tax, has been qualified in various ways over the years. Compulsoriness may be practical as well as legal (see *General Practitioners Society v The Commonwealth* (1980) 145 CLR 542, per Gibbs J at 561). The High Court has also admitted the possibility that an impost constituting a tax may not be in the form of an exaction of *money* as such *(Air Caledonie* at 467). Moreover, the exaction, while made under statutory powers, may not need to be by a public authority, or for public purposes, in order to be a tax *(Air Caledonie* at 467; also *Australian Tape Manufacturers Association Ltd v The Commonwealth* (1992) 176 CLR 480).

12. The High Court has also made it clear that the class of negative attributes which may prevent an impost from being regarded as a tax is not limited to the requirement that the impost not be a fee for services and that indeed the list of negative attributes may not be closed but evolving. In *Air Caledonie* the High Court said (at 467):

> ... the negative attribute — 'not a payment for services rendered' — should be seen as intended to be but an example of various special types of exaction which may not be taxes even though the positive attributes mentioned by Latham CJ are all present. Thus, a charge for the acquisition or use of property, a fee for a privilege and a fine or penalty imposed for criminal conduct or breach of statutory obligation are other examples of special types of exactions of money which are unlikely to be properly characterised as a tax notwithstanding that they exhibit those positive attributes.

13. A tax, even if levied by a non-public authority under a statutory power, must be accounted for as part of the Consolidated Revenue Fund and expended only under an appropriation by Parliament (sections 81 and 83 of the Constitution; *Australian Tape Manufacturers Association Ltd v The Commonwealth* (1992) 176 CLR 480 and *Northern Suburbs General Cemetery Reserve Trust v The Commonwealth* (1992) 176 CLR 555). (The same applies to fees for services if they are received by or on behalf of the 'Executive Government of the Commonwealth' – see section 81 of the Constitution).

14. While the characteristics of a tax are to some extent shifting and it can be difficult sometimes to decide whether a compulsory exaction falls into one of the categories of anomalous compulsory exactions which are not taxes, in most cases it will be a relatively straightforward process to decide whether an impost is a tax.

15. How Parliament itself regards the impost will itself be significant, though not necessarily decisive. Imposts regarded by Parliament as taxes will generally be structured with constitutional requirements in mind, principally, the requirements of section 55 of the Constitution, which, as mentioned above, provides, amongst other

things, that laws imposing taxation shall deal only with the imposition of taxation. Under section 55, a tax Act (or, in other words, an Act imposing taxation) can contain not only provisions specifically imposing a tax but also provisions *'dealing with'* the imposition of tax (such as provisions governing the incidence and rate of the tax). A tax imposition Act cannot, however, contain measures merely *related to* the tax imposed, such as provisions dealing with collection matters.

2. Is there a legal distinction between a levy and a tax? How are these differences important in choosing one instrument over another?

16. A levy is merely another expression to describe a tax, although it is sometimes used to refer to a tax that is imposed on a specific industry or class of persons, rather than a tax of general application. The fact that an impost may be imposed on only a limited class of persons does not prevent it from being regarded as a tax, although the notion of a tax carries with it an implication of a certain threshold of generality (thus an impost on one or more named persons may not be tax, but rather an acquisition of property, which under section 51 (xxxi) of the Constitution, must be on just terms in order to be valid).

17. For political reasons, taxes can also go under other names, such as charges, surcharges and royalties (although some royalties may not be taxes). The nature of the impost will, however, be determined principally by reference to its legal characteristics rather than by what it is called.

3. What legal authority do Commonwealth agencies need to impose fees, charges, levies or taxes? Some agencies appear not to have any fee or charge setting powers explicitly set out in an Act, but nevertheless are involved in some cost recovery. Under what authority can they do this?

18. It is a general principle of English constitutional law received into Australia that there can be no taxation except under the authority of an Act of Parliament *(The Commonwealth v Colonial Combing, Spinning and Weaving Co. Ltd* (1922) 31 CLR 421, per Isaacs J at 433-434). This obviously applies to a tax under any name, including a charge or levy.

19. The position in relation to charging for services is less clear cut. There is no High Court authority on the point but only several old State cases which interpret early English cases. However, those early English cases appear to have been given a wide interpretation in certain respects by a more recent English case, which has not yet been discussed by an Australian court in any jurisdiction.

20. For present purposes it appears unnecessary for me to discuss the various English and Australian cases in detail, but would be happy to do so, if you wish.

Instead, I shall summarise the views which the Australian Government Solicitor holds on this issue.

21. We take the view that the imposition of charges in respect of the performance of statutory duties (including the delivery of services as a matter of statutory duty) needs to be authorised expressly by legislation or by necessary implication from legislation. (This proposition is common ground among the early English cases (notably, *Attorney-General v Wilts United Dairies Ltd* (1921) 37 TLR 884 (Court of Appeal); (1922) 38 TLR 781 (House of Lords), the more recent English case of *McCarthy & Stone (Developments) Ltd v London Borough of Richmond upon Thames* (1991) 3 WLR 941 and the early Australian cases, such as *Schilling v City of Melbourne* [1928] VLR 302.) Thus, statutory authority would be required to impose a fee in respect of, say, an inspection which is required to be performed under statute.

22. The position in relation to the performance of *discretionary* activities is more complicated and it is in relation to this that judicial authority appears to be divided (the recent English case *McCarthy & Stone* appears to take a stricter view than required by the earlier English cases, including *Wilts United Dairies).* Our view generally is that whether charges can be imposed in respect of discretionary activities (including the discretionary performance of services) depends on the nature and authority for the performance of those activities.

23. Discretionary activities can be performed under the express authority of a statute, under general statutory powers (such as under a general statutory incidental power or a general power to enter into contracts conferred under statute) or, in the case of government Departments, in the exercise of the Commonwealth's executive power.

24. In relation to activities carried on under express statutory authority, whether fees can be imposed depends on the nature of the activity. For example, as a matter of statutory interpretation, in the absence of express or necessarily implied legislative authority, it would be unlikely to have been intended that a fee could be imposed in respect of the issue of a statutory licence, albeit issued as a matter of discretion. An express statutory power to conduct activities normally delivered on a commercial basis would, however, not normally preclude the charging of fees, even in the absence of an express legislative authorisation to impose fees. An example might be an express statutory discretionary authority to conduct training courses.

25. In relation to general statutory authority to engage in discretionary activities, such as a general contracting power, we take the view that there is no impediment to the imposition of fees in respect of the activities. The ability to charge fees would be necessarily implied from the ability to do a thing under a contract. The same

applies to the performance of activities under contracts entered into under the Commonwealth's executive power. (There may be exceptional circumstances where charges under a contract could be regarded as taxes, which would be invalid without legislative authority — *Commonwealth v Colonial Combing, Spinning and Weaving Co Ltd ('The Wool Tops Case'*) (1922) 31 CLR 421 443-445; very generally the circumstances would be where there was some suggestion of compulsoriness, either legal or practical, in relation to the entry into the contracts).

4. Some agencies have explicit wording in their Acts to the effect that they may set charges but that the charges must be reasonably related to the expenses incurred and must not be such as to amount to taxation (for example, section 53 of the Australian Communications Authority Act 1997*). What is the consequence of this clause? Does it, for example, quarantine the rest of the Act from being challenged under section 55 of the Constitution if the charge were found to be a tax? Why do not all fee for service arrangements have such legislative backing? And what does 'amount to taxation' mean?*

26. A provision along these lines was considered in *Canadian Airlines,* namely, section 67 of the *Civil Aviation Act 1988.* Unlike the full Federal Court in the decision appealed to the High Court *(Airservices Australia v Monarch Airlines Ltd* (1998) 152 ALR 656), the High Court accepted that there were two separate limbs to the provision, which could overlap but which could also raise separate considerations:

> In some cases, there would be substantial overlapping between the considerations relevant to the first limb and those relevant to the second limb. However, it would be wrong to say, as a universal proposition, that the two limbs could never raise separate issues. The second limb is related to, and should be understood in the light of, section 55 of the Constitution. (per Gleeson CJ and Kirby J at 409).

27. The first limb imposes a statutory limitation on the level at which fees can be imposed, that is, a reasonable relationship to the 'expenses incurred'. This involves a consideration of what is ordinarily included in 'expenses' and whether those expenses have been 'incurred'.

28. The purpose of the second limb is, as you suggest and as confirmed in *Canadian Airlines,* to quarantine the validity of other provisions of the Act from the possible effects of section 55 of the Constitution, which generally (except in relation to amendments inserting a tax) invalidates all the provisions of an Act other than the provision imposing a tax *(Air Caledonie).*

29. In the Federal Court at first instance *(Monarch Airlines Ltd v Airservices* (1997) 72 FCR 534), Branson J decided that the relevant charges satisfied the first limb of the provision but not the second. In the light of the High Court's decision in

Canadian Airlines, in particular, its more flexible approach to cost recovery, it is possible that the first limb might in certain circumstances lead to a narrower result than the second. In most cases, however, the operation of the two limbs will not produce a different result.

30. Some legislation authorising the imposition of fees does not contain a limitation along these lines or contains one limb of the limitation and not the other. This generally merely reflects different practices or differing degrees of caution on the part of drafters. Some drafters rely on the court's interpreting a 'fee' (where it is used in relation to services) as having its ordinary meaning (that is, a fee for services), particularly in the light of the constitutional provisions. A discretion to impose a 'fee' would, in any case, probably be read down within constitutional limits, that is, so as not to authorise the imposition of a tax where this would be contrary to section 55 of the Constitution *(Giris v Federal Commissioner of Taxation* (1969)119 CLR 365, 378). (I note that the inclusion of the second limb in the case of the Civil Aviation Act was by way of a Senate amendment which was described as being designed 'to restore the second element of the protection against surreptitious revenue raising' found in the previous Act dealing with civil aviation (the *Air Navigation Act 1974)* (Senate *Hansard* 1 June 1988 at 3386-3396; see also 27 April 1988 at 1991-1993)).

31. The words 'not to amount to taxation' mean that the fees are to be of such a kind and level as not to constitute taxation for constitutional purposes.

Other comments

32. If the Commission proposes to develop suitable guidelines for implementing cost recovery (term of reference 3.(g)), it would be highly desirable for such guidelines to be cleared from a constitutional point of view, particularly, in relation any construction that is placed on the High Court's decision in *Airservices Australia v Canadian Airlines International Ltd*. We would, of course, be happy to provide further advice, if necessary.

33. Please let me know if you would like to discuss any aspect of this advice or require any further assistance.

The Productivity Commission sought legal advice from the Australian Government Solicitor relating to the cost recovery arrangements administered by the Australian Securities and Investments Commission. The advice dated 6 March 2001 is reproduced below.

Australian Securities and Investments Commission fees — over-recovery of running costs

1. Thank you for your letter of 20 February 2001 seeking advice relevant to particular issues arising from the Productivity Commission's inquiry into cost recovery by Commonwealth regulatory, administrative and information agencies. The issues relate to the cost recovery arrangements administered by the Australian Securities and Investment Commission (ASIC). I provided related general advice on the distinction between taxes and fees for services (including the relevance of cost recovery) in my letter of 2 March 2001.

Background

2. Section 25 of the *Corporations Act 1989* (Cwlth) provides that the regulations may 'prescribe fees (including fees that are taxes) for chargeable matters'. There is no associated separate tax imposition Act (the *Corporations (Fees) Act 1989* was repealed in 1990 with the introduction of national corporations scheme). The schedule to the Corporations (Fees) Regulations ('the Fees Regulations'), which were made under the Corporations Act (Cwlth), sets out numerous charges, without making a distinction between fees and taxes. You state that the charges collected by ASIC are substantial (over $360 million in 1999-2000), and apparently well in excess of the annual costs of operating ASIC. You also state that part of the excess is used to fund compensation payments to the States.

Advice

3. Your particular questions, together with my answers, are set out below.

1. How does this relate to the generally held view that fees should be reasonably related to the expenses incurred? What is the basis for using fees to raise revenue to make compensation payments to the States? What prevents these arrangements from being interpreted as taxes?

Answer in summary

4. My short answer is that, while a fee that raises revenue (including to finance compensation arrangements) rather than merely recovers the costs of delivering a service is likely to be a tax, there is no constitutional prohibition on the imposition of both taxes and fees under the Corporations Act (Cwlth), since it is a law for the government of the Australian Capital Territory and section 55 of the Constitution has no application in relation to such a law, even in so far as it imposes a tax. The Fees Regulations are also applied by the Corporations Act of each of the States (including the Northern Territory) as laws of the State. There is also no requirement equivalent to section 55 of the Constitution in relation to State legislation, except under the Constitution of Western Australia. Western Australia has a separate tax imposition Act to impose the fees in so far as they are taxes.

Whether the fees collected by ASIC include taxes

5. In my letter of 2 March 2001 I discussed the distinction between taxes and fees for services in detail. Even under the more flexible approach to cost recovery adopted by the High Court in *Airservices Australia v Canadian Airlines International Ltd* (1999) 167 ALR 392 (see paragraphs 7-9 of my letter), the recovery of more than the total cost of delivering a service to a user group would generally indicate a revenue raising purpose which would suggest that an impost is a tax rather than a fee for services.

6. In the present case, the fact that the fees collected are in excess of the annual running costs of operating ASIC (which delivers the relevant services) does not of itself indicate over-recovery for these purposes, given that the High Court indicated in *Canadian Airlines* that a fee structure can allow for a reasonable rate of return on capital or future infrastructure requirements (see paragraph 9 of my letter). However, you indicate that part of the excess collections is used to fund compensation payments to the States. On its face that it not a purpose for which a fee (as opposed to a tax) could be imposed. it seems likely therefore that some or all of the fees in the present case are taxes. More information on the fee structure would, however, be required to determine which of the fees were taxes as opposed to fees for services.

7. In any case, the constitutional issue, if any, arises in relation to the provisions *imposing* the fees and taxes collected by ASIC, which, as explained below, are located in the Corporations Act (Cwlth) and State Acts.

National corporations scheme and how fees are imposed

8. The national corporations scheme consists essentially of certain legislation enacted for the government of the Australian Capital Territory, which is then applied by the Corporations Act of each State as the law of the State. The applied legislation is the Corporations Law enacted under the Corporations Act (Cwlth) (see section 82) and regulations in force under section 22 of that Act (both as amended from time to time). While it is section 25 of the Act which expressly authorises the regulations to prescribe fees (including taxes), the Fees Regulations appear to be made under section 22 of the Corporations Act (Cwlth) (see section 22(a) and (b) of that Act and section 1351 of the Corporations Law) and that is the assumption made elsewhere in the Corporations Act (Cwlth) (see section 33) and in the Corporations Acts of the States (see the definition of Corporations Regulations of [the State] in section 3 and sections 6 and 22).

9. The fees (including taxes) prescribed under the Fees Regulations are actually '*imposed*' (together) under section 33 of the Corporations Act (Cwlth) and section 22 of each of the Corporations Acts of the States, except in the case of Western Australia where the fees, in so far as they are taxes, are imposed under the *Corporations (Taxing) Act 1990* (WA). Moreover, the fees are made payable to the Commonwealth under section 1351 of the Corporations Law as enacted in the Corporations Act (Cwlth) and as applied by the Corporations Acts of the States. They are collected on behalf of the Commonwealth by ASIC. The making of compensation payments to the States is presumably dealt with under the formal agreement between the Commonwealth, States and Territories, known as the Corporations Agreement, which underpins the national corporations scheme.

Does there need to be a separate imposition of taxes and fees?

10. If the Corporations Act (Cwlth) were a Commonwealth Act of national application, section 33 (the provision imposing both fees and taxes) would infringe section 55 of the Constitution (which provides, amongst other things, that a law imposing taxation shall deal only with the imposition of taxation). However, that Act is not an Act of national application. Instead, the Act is a law enacted under the Territories power (section 122 of the Constitution), specifically for the government of the Australian Capital Territory in relation to corporations, securities and the futures industry (see long title). It has been established for many years that section 55 of the Constitution does not apply to laws (including taxation laws) made under the Territories power: *Buchanan v The Commonwealth* (1913) 16 CLR 315.

11. There is also generally no provision in State Constitutions equivalent to section 55 of the Commonwealth Constitution, with the exception of the Western

Australian Constitution, section 46(7) of which provides that 'Bills imposing taxation shall deal only with the imposition of taxation'. In discharge of the requirement under the Western Australian Constitution, as mentioned above, fees in the nature of taxes have been separately imposed under the *Corporations (Taxing) Act 1990* (WA).

12. There is no provision equivalent to section 55 in the *Northern Territory (Self-Government) Act 1978*, which vests legislative power in the Northern Territory Legislative Assembly.

13. If comprehensive power over corporations is referred to the Commonwealth by the States (as currently proposed) and the Commonwealth enacts legislation of national application, the provisions of section 55 of the Constitution will, of course, become relevant, and it will be necessary to impose taxes and fees for services under separate legislation.

2. How can regulations struck in accordance with sections 22 and 25 actually prescribe a tax? Would not a specific tax act be required for this purpose?

14. The imposition of taxes must be authorised by Parliament (see paragraph 18 of my letter of 2 March 2001), although Parliament can delegate to the executive (including the Governor-General for the purposes of making regulations) power to prescribe various matters relating to the tax (see *Giris Pty Ltd v Federal Commissioner of Taxation* (1969) 119 CLR 365). That authorisation is provided by section 33 of the Corporations Act (Cwlth) and the corresponding provisions of the State Corporations Acts and the *Corporation (Taxes) Act 1989* (WA). As mentioned in paragraphs 10-12 above, section 55 of the Constitution or an equivalent constitutional requirement does not apply to Commonwealth legislation enacted under the Territories power or to State and Territory legislation, with the exception of legislation of Western Australia.

3. Given that the Corporations Law deals with a large number of matters, including section 25 powers to set fees (including fees that are taxes), how is the Act consistent with the constitutional limitation on tax acts dealing only with the imposition of the tax?

15. See my comments in paragraphs 10-12 above.

16. Please let me know if you would like to discuss any aspect of this advice or require any further assistance.

J Questionnaire

The Terms of Reference require the Commission to report on the nature and extent of current cost recovery arrangements across Commonwealth regulatory, administrative and information agencies. To fulfil this requirement, the Commission approached a number of agencies to complete a questionnaire regarding their current cost recovery arrangements. The questionnaire was sent to all regulatory, administrative and information agencies with separate financial reporting arrangements, and to all departments with coverage of those agencies without separate reporting arrangements. A copy of the questionnaire is attached at the end of this appendix.

The responses of those agencies included in the inquiry case studies (appendices C to F) are summarised in appendix B. All of the responses will be available on the Commission's web site, except those provided confidentially.

Portfolios and agencies

The following Departments and agencies were asked to complete the questionnaire:

Agriculture Fisheries and Forestry

Australian Bureau of Agricultural and Resource Economics

Australian Dairy Corporation

Australian Dried Fruits Board

Australian Fisheries Management Authority

Australian Horticultural Corporation

Australian Pork Corporation

Australian Wine and Brandy Corporation

Department of Agriculture, Fisheries and Forestry

Murray-Darling Basin Commission

National Registration Authority for Agricultural and Veterinary Chemicals

Wheat Export Authority

The Woolmark Company

Attorney Generals'

Administrative Appeals Tribunal

Administrative Review Council

Attorney General's Department

Australian Customs Service

Australian Federal Police

Australian Government Solicitor

Australian Institute of Criminology

Australian Law Reform Commission

Australian Security Intelligence Organisation

Australian Transaction Reports and Analysis Centre

Human Rights and Equal Opportunity Commission

Inspector General in Bankruptcy (Insolvency and Trustee Service)

National Crime Authority

National Native Title Tribunal

Office of Film and Literature Classification

Office of Parliamentary Counsel

Office of the Director of Public Prosecutions

Privacy Commissioner

Communications, Information Technology and the Arts

Australian Broadcasting Authority

Australian Broadcasting Corporation

Australian Communications Authority

Australian Film Commission

Australian Film Finance Corporation

Australian Film, Television and Radio School

Department of Communications, Information Technology and the Arts

National Library of Australia

ScreenSound Australia

Special Broadcasting Service

Defence

Department of Defence

Education Training and Youth Affairs

Anglo-Australian Telescope Board

Australian National Training Authority

Australian Research Council

Department of Education, Training and Youth Affairs

Employment, Workplace Relations and Small Business

Comcare

Department of Employment, Workplace Relations and Small Business

National Industrial Chemicals Notification and Assessment Scheme

National Occupational Health and Safety Commission

Environment and Heritage

Australian Greenhouse Office

Bureau of Meteorology

Department of the Environment and Heritage (Environment Australia)

Great Barrier Reef Marine Park Authority

National Parks and Wildlife

Family and Community Services

Australian Institute of Family Studies

Centrelink

Department of Family and Community Services

Finance and Administration

Australian Electoral Commission

Commonwealth Grants Commission

Commonwealth Superannuation Administration (ComSuper)

Department of Finance and Administration

Office of Asset Sales and Information Technology Outsourcing

Foreign Affairs and Trade

Australian Centre for International Agricultural Research

Australian Government Overseas Aid Program

Australian Trade Commission (Austrade)

Department of Foreign Affairs and Trade

Health and Aged Care

Australia New Zealand Food Authority

Australian Institute of Health and Welfare

Australian Radiation Protection and Nuclear Safety Agency

Department of Health and Aged Care

Health Insurance Commission

Immigration and Multicultural Affairs

Department of Immigration and Multicultural Affairs

Migration Agents Registration Authority

Migration Review Tribunal

Refugee Review Tribunal

Industry, Science and Resources

Australian Geological Survey Organisation

Australian Institute of Marine Science

Australian Nuclear Science and Technology Organisation

Australian Sports Commission

Australian Sports Drug Agency

Australian Surveying and Land Information Group

Australian Tourist Commission

Bureau of Tourism Research

Commonwealth Scientific and Industrial Research Organisation

Department of Industry, Science and Resources

IP Australia

National Standards Commission

Prime Minister and Cabinet

Aboriginal and Torres Strait Islander Commercial Development Corporation

Aboriginal and Torres Strait Islander Commission

Aboriginal Benefit Reserve

Aboriginal Hostels Limited

Anindilyahwa Land Council

Australian Institute of Aboriginal and Torres Strait Islander Studies

Australian National Audit Office

Central Land Council

Commonwealth Ombudsman

Department of Prime Minister and Cabinet

Indigenous Land Corporation

Northern Land Council

Office of National Assessments

Office of the Inspector-General of Intelligence and Security

Office of the Official Secretary to the Governor General

Public Service and Merit Protection Commission

Tiwi Land Council

Torres Strait Regional Authority

Transport and Regional Services

Administration of Christmas Island

Airservices Australia

Albury-Wodonga Development Corporation

Australian Maritime Safety Authority

Civil Aviation Safety Authority

Department of Transport and Regional Services

National Capital Authority

National Road Transport Commission

Treasury

Australian Bureau of Statistics

Australian Competition and Consumer Commission

Australian Office of Financial Management

Australian Prudential Regulation Authority

Australian Securities and Investment Commission

Australian Taxation Office

Australian Valuation Office

Department of Treasury

National Competition Council

Productivity Commission

Reserve Bank of Australia

Royal Australian Mint

Veterans Affairs

Australian War Memorial

Department of Veteran Affairs

PART I

ALL AGENCIES ARE REQUESTED TO COMPLETE PART I

Section 1: Contact details

1.1 Department or agency

1.2 Portfolio

1.3 Reporting and financial arrangements governed by:
(Please indicate with a 'X' whether one or more of the following Acts apply)

	YES	NO
Financial Management and Accountability Act 1997		
Commonwealth Authorities and Companies Act 1997		

Other

1.4 Contact Officer

Position

Phone

Fax

Email

Address

This section asks about your portfolio/agency's TOTAL revenues, charges and costs. All agencies should complete this section, whether or not you consider you undertake cost recovery.

Section 2: Agency revenues, charges and costs
(Please indicate with a 'X' which response applies)

2.1 Has your agency charged any cost recovery fees, levies or other charges in the last five financial years?

YES	NO

Relevant charges include any fees, levies, taxes (including some customs and excise duties earmarked for specific purposes) or other charges which arise from the services, programs or business activities of your agency, and which are collected by your agency, or by another agency on your behalf. For example, application fees, processing charges, consultancy fees, publication sales, special industry duties, excises or levies other than general taxation.

2.2 Were any of the appropriations allocated to your agency in the last five financial years linked (hypothecated) to revenue collected from fees, levies or charges (for example, levies paid to the Consolidated Revenue Fund but earmarked for allocation to your agency)? (Whether the revenue was collected by your agency or by another agency on your behalf).

YES	NO

2.3 Has your agency considered introducing any cost recovery arrangements in the past that were not implemented?
(Please attach any relevant reviews, analysis or other information.)

YES	NO

2.4 Is your agency considering introducing any cost recovery arrangements in the future?
(Please attach any relevant reviews, analysis or other information.)

YES	NO

If you answered NO to questions 2.1 and 2.2, you need not answer any further questions. Thank you for your cooperation. Please return the questionnaire to the Commission (see front sheet for instructions).

If you answered YES to EITHER question 2.1 OR question 2.2 OR both, please complete section 3 below, and Part II on the following worksheet.

Section 3: TOTAL (portfolio/agency) revenues and costs (Please use $'000)

		1995-96	1996-97	1997-98	1998-99	1999-2000
	Revenue from cost recovery (a)					
3.1	Cost recovery revenue retained by your department/agency					
3.2	Cost recovery revenue paid to CRF and appropriated to your deaprtment/agency (or another department/agency) for a specific purpose (annotated, hypothecated or earmarked revenues)					
3.3	Cost recovery revenue paid to CRF and not specifically appropriated to your department/agency (or another department/agency)					
3.4	**Total revenue from cost recovery**	0	0	0	0	0
	Revenue from other sources					
3.5	Other appropriations					
3.6	Other sources (eg. asset sales, dividends, interest)					
3.7	**Total revenue from other sources**	0	0	0	0	0
3.8	**Total portfolio/agency revenue**	0	0	0	0	0

CRF Consolidated Revenue Fund

(a) Include all revenue from fees, levies, excises and other charges which arise from the services or activities of your department/agency, and which is paid to your agency, to another department/agency or to the Consolidated Revenue Fund.

Costs (Please provide aggregate information for your portfolio/agency as a whole in $'000):

		1995-96	1996-97	1997-98	1998-99	1999-2000
3.9	Administered costs (a):					
3.10	Department/Agency costs (b):					
3.11	Other costs (please specify):					
3.12	Total agency costs:					

(a) Administered costs are those which are controlled by Government and managed or oversighted by the department/agency on behalf of the Government (for example, social security payments). (b) Department/agency costs are those costs controlled by the department/agency (for example, employee and administrative expenses).

PART II

If you operated any cost recovery arrangements in 1999-2000, please complete part II of the questionnaire.

Part II asks about each program or activity involving cost recovery. 'Program or activity' refers to a defined output or outcome (for example, 'licensing', 'inspection', 'sale of information' or 'processing applications'.

Please fill out a separate form for each program or activity. Departments may wish to fill out a separate form for each sub-unit within the portfolio for which they are reporting. Similar programs or activities involving similar cost recovery arrangements may be reported in groups.

PART II(a)

Name of sub-unit, program or activity	

Section 4: Program or activity cost recovery arrangements in 1999-2000
(Please use millions of dollars)

	Program or activity	
4.1	Nature of cost recovery arrangement (eg. licence fee, service charge, hypothecated excise tax or levy etc)	
4.2	Basic description of arrangements: (Please attach any relevant documents.)	
4.3	Who pays the cost recovery charges?	
4.4	Who benefits from the program or activity?	

4.5	Do you attempt to measure these benefits? If so, how?	
4.6	Are there alternate providers or substitutes for this program or activity? (Please describe)	
4.7	When was cost recovery introduced?	

PART II(b)

Name of sub-unit, program or activity

Program or activity cost recovery arrangements in 1999-2000 $ '000 (continued)

Program or activity revenues

4.8	Cost recovery revenue paid to CRF earmarked for appropriation to same agency	$			
4.9	Cost recovery revenue paid to CRF earmarked for appropriation to a third party	$			
4.10	Cost recovery revenue paid to CRF and not earmarked for particular appropriation	$			
4.11	Cost recovery revenue paid to CRF (subtotal)	$	0		
4.12	Cost recovery not paid into CRF		$		
4.13	Total cost recovery revenue		$	0	
4.14	Appropriations not related to cost recovery			$	
4.15	Other sources (please specify)			$	
4.16	**Total program or activity revenues**			$	0

Program or activity costs

4.17	Direct costs	$
4.18	Indirect costs (including corporate overheads)	$
4.19	Third party costs (a)	$
4.20	**Total program or activity costs**	$ 0

Administration costs

4.21	What costs are associated with adminsitering the cost recovery arrangements?	$

CRF Consolidated Revenue Fund. Direct costs are those directly related to a particular program. Indirect costs include indirect agency overheads and general running costs. (a) Include third party costs where third parties are involved in a program or activity and their costs are being recovered as part of the cost recovery arrangements.

PART II(c)

Name of sub-unit, program or activity

Section 5: Institutional arrangements

5.1 What was the rationale for introducing cost recovery arrangements for this program or activity? (Please attach sources, eg. legislative objects clauses, press releases, second reading speeches.)	

5.2 What was the legal basis for establishing these cost recovery arrangements: (Please name and attach relevant documents.)

Legislation (eg. s.31 of the Financial Management and Accountability Act, tax or levy acts)	
Subordinate legislation (eg. regulations, standards)	
Co-regulation or quasi-regulation	
Commonwealth/State/Territory agreement	
Voluntary arrangements (eg. codes of practice)	
Other	

5.3 Who was consulted about introducing these cost recovery arrangements? (Please name relevant bodies and decribe the consultation arrangements.)

Commonwealth government (DOFA etc)	
Other governments (state, territory, local)	
Industry	
Consumers	
Other	

5.4 What guidelines were consulted when establishing these cost recovery arrangements? (Please attach source of information, guidelines etc.)	

5.5 Which agency is responsible for the following activities? (Please name relevant agency)

Policy setting	
Price setting	
Administration	
Revenue collection	

5.6 Is there any ongoing consultation about these cost recovery arrangements? With whom? (Please name relevant bodies.)

Commonwealth government (DOFA etc)	
Other governments (state, territory, local)	
Industry	
Consumers	
Other	

5.7 Please describe these consultation arrangements.	
5.8 Have the cost recovery arrangements been formally reviewed? What was the outcome? (Please attach copy of review)	

PART II(d)

Name of sub-unit, program or activity	

Section 6: Price setting arrangements

6.1 How are cost recovery charges determined? (Please attach any relevant documents)

(i) How are charges set? (eg. by formula in legislation or based on 'market prices')	
(ii) Are charges directly related to the costs of particualr activities, or charged on some other basis? (eg. levies on users' turnover, profits or assets)	

6.2 If charges are directly related to the costs of particular activities:

(i) What costs do charges aim to recover? (eg. only direct costs or indirect costs such as overheads)	
(ii) What proportion of these costs do charges aim to recover?	
(iii) Does the charging regime require assets to be valued? (eg. to allow the calculation of user cost of capital or return on assets)	
(iv) If so, on what basis are assets valued? (eg. historic, replacement, deprival or replacement cost)	
(v) Do charges include a user cost of capital?	
(vi) If so, how is it calculated?	
(vii) Do charges include return on assets? (eg. profit)	

(viii)	If so, on what basis?	
(ix)	Do charges discriminate between types of users?	
(x)	If so, on what basis?	
(xi)	Do charges allow for access and equity considerations (eg. waivers, discounts)?	
(xii)	If so, on what basis?	
(xiii)	Other (Please describe other significant features)	
6.3	How are indirect costs allocated for cost recovery arrangements? (For example, activity based costing, according to share of direct costs or other rule.)	
6.4	Are there any price controls on these charges?	
6.5	How often is the level of charges changed?	
6.6	What happens if revenue recovered is greater than costs incurred?	

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