DEPARTMENT OF FINANCE AND ADMINISTRATION

SUBMISSION –
GUIDELINES FOR COST RECOVERY IN COMMONWEALTH AGENCIES

EXECUTIVE SUMMARY

- Revenue raising is not a sufficient justification for cost recovery.
- The rationale for cost recovery is to improve the efficiency and effectiveness of government programmes, and hence improve allocation of scarce resources.
- Cost recovery is a sub-set of user charging.
- User charging should not be based on agency costs. As a general rule, charges should mirror market prices. Variations from market prices may be justified on social policy grounds (for example, where externalities impose costs on society that are not captured by the market).
- Cost recovery should be limited to situations where the benefits are exclusively or predominately private benefits.
- The delivery of private benefits is contestible.
- A regulation should only exist (that is, commence and remain in existence) if the benefit from regulation to the community is significant and reasonably immediate in its delivery.
- Agencies undertaking cost recovery practices should ensure that efficiency and effectiveness targets are identified and made publicly available in documents such as the Portfolio Budget Statements.
- Effectiveness targets should demonstrate the practice is delivering significant and reasonably immediate benefits.
- Actual performance against these measures should be reported against and explained in the agency's annual report.
- The Department of Finance and Administration role in reviewing new cost recovery proposals could be extended to include tests for efficiency, effectiveness, significant benefits provided reasonably immediate.

GOVERNMENT REFORM AGENDA

1. The Department of Finance and Administration (DOFA) continues to work with agencies to refine public sector business conduct. Current priorities include:

   - consolidation of the accrual based outcome-output framework;
   - pricing reviews of material Commonwealth agencies to assess the robustness of output pricing; and
   - application of competitive tendering and contracting (CTC) principles and market testing to drive efficient and effective operations.

2. Key changes in recent years have included the devolution of greater responsibility for Commonwealth financial administration to agencies, and the outsourcing of activities that are better provided by external businesses.

RATIONALE FOR COST RECOVERY - INFORMATION AND ADMINISTRATION SECTORS

3. Recovering costs from users reduces the financial burden on the broader community by targeting those who actually receive the benefit.

4. Revenue raising is not a sufficient justification for cost recovery. The rationale for cost recovery is to improve the efficiency and effectiveness of government programmes, and hence improve allocation of scarce resources.

5. The broader objective of improving efficiency and effectiveness demands consideration of four key issues before cost recovery is implemented:

   - efficiency and effectiveness in supply;
   - efficiency in demand;
   - equity in distribution of costs; and
   - appropriateness of continued government service delivery.

6. There is scope for supply side benefits where cost recovery would provide managers and customers with improved information about organisational performance.

   - Internally, cost recovery could facilitate development of financial and service quality targets, and measures of effectiveness.
   - Further, customers are more likely to provide feedback on service quality and effectiveness when they are paying for the service - especially where they do not have access to alternate suppliers. This feedback can be used to better match government services to community needs.
   - Implementing a cost recovery regime could require substantial expenditure by the agency, especially with regard to staff training and capital infrastructure. These costs should be recognised in developing any cost recovery proposal.

7. On the demand side, cost recovery can restrict consumption of government services to economically efficient levels. An efficient "price" will restrict consumption to situations where the benefit of consumption exceeds the cost to the community of providing the service. The issue of pricing is a complex one, however, and is dealt with later in this paper at paragraphs 16-19.

8. Cost recovery can be used to improve equity in the distribution of costs, where the service provides an individual or group with a benefit over and above that which accrues to the broader community. If an individual receives a particular benefit from a programme, it could be fair to ask them to bear a share of the costs.

   - Cost recovery should be limited to situations where the benefits provided by the programme are exclusively or predominately private benefits.
   - The public policy rationale in providing a service should not be compromised by imposing cost recovery. That is, pricing should not inhibit desired patterns of behaviour.

9. The appropriateness of continued government involvement in an activity should be considered when evaluating whether to recover costs from users. If the private sector could deliver the private benefit more efficiently (leading to savings in production and consumption) and effectively, then government businesses should be withdrawn from the market.

   - This situation is likely to arise where the benefits of service delivery are largely private ones.

10. In order to avoid instances of cost recovery with minor impacts, the practice should only take place where the effects on efficiency and effectiveness are significant and reasonably immediate.

RATIONALE FOR COST RECOVERY - REGULATORY SECTOR

11. The rationale for cost recovery mechanisms in the regulatory area is twofold:

   - to improve supply efficiency and effectiveness; and
   - to introduce a price signal identifying an externality impacting on the public good or common.

12. Price signals in a regulatory environment can provide surrogate opportunity cost signals to those who are engaging in conduct which the market of itself cannot regulate via its own price signals.

   - For example, production of a good could impose externalities (such as air degradation) on other firms or individuals. Regulatory price signals can be used to 'internalise' that cost, promoting or fostering socially efficient behaviour.

13. All of the points discussed at paragraph 5 above are relevant to cost recovery in a regulatory context.

14. Regulation differs to the information and administration areas of cost recovery in that not only is there a monopoly supplier of the intervention, but those who are caught by the regulation do not have the right to exempt themselves from involvement.

15. A regulation should only exist (that is, commence and remain in existence) if the benefit from regulation to the community is significant and reasonably immediate in its delivery.

PRICING

16. A first step in pricing any cost recovery activity should be identification of the full cost of the activity. This will assist transparency in valuing the resources used to provide the service.

17. Cost inefficiencies should not be imposed on customers.

18. Where possible, agencies should price based on market value. Where there is no relevant market, agencies should consider developing a proxy market price in the context of commercialisation initiatives, such as private sector benchmarking and CTC. Price should then tend toward that proxy. Price should be considered in the context of a fixed service standard, preferably agreed with customers.

19. Efficient pricing will be difficult where the service provider is in a monopoly supplier position and the consumer has no discretion but to demand consumption (for example, a regulator). Cost recovery should only be implemented in these situations where there is a clear efficiency and effectiveness rationale for doing so.

    - In this situation, a simple mechanism to promote efficiency in pricing is to restrict prices adjustments to ‘inflation less a margin for productivity improvement’ (CPI – X).

GOVERNANCE ARRANGEMENTS

20. Agencies that undertake cost recovery practices need to ensure that efficiency and effectiveness targets are identified and made publicly available in documents such as the annual Portfolio Budget Statements.

21. These targets should demonstrate the practice is delivering significant and reasonably immediate benefits.

22. Actual performance against these targets should be reported against and explained in the agency's annual report.

23. The Department of Finance and Administration is currently responsible for non-taxation revenue estimates, including cost recovery activities. This responsibility could be extended to ensure that, in agreeing cost recovery proposals the review includes tests for efficiency, effectiveness, significant benefits provided reasonably immediate.

24. The Commonwealth has in place a rolling schedule of pricing reviews which focuses on the price 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 where necessary.

LEGAL REGIME FOR COST RECOVERY

25. Cost recovery receipts are typically governed by the net appropriation arrangements established under section 31 of the *Financial Management and Accountability Act 1997*.

    - Net appropriation means that the agency is appropriated an amount to cover total estimated costs for the year, less the estimated amount of eligible receipts for any cost recovery activity.

26. Cost recovery activities, unless included in the Net Appropriation Agreement, are paid into CRF and cannot be retained by the agency. Only receipts that have been included in the formal agreement with DOFA are eligible for retention by the agency.

27. 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.