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Mrs Helen Owens
Presiding Commissioner
Cost Recovery Inquiry
Productivity Commission

Dear Mrs Owens

COST RECOVERY INQUIRY

I wish to submit some comments on your recent draft report on Cost Recovery by Commonwealth Agencies.

By way of background, I am making this submission to the Inquiry as a practitioner of cost recovery, having worked on the policy and implementation of cost recovery in several Federal Government areas and in foreign countries since the mid 1980's. These include Departments, Agencies, Statutory Authorities and GBE's. I may be the only person whose work in implementing cost recovery in the Federal Government sphere has been explicitly validated by the High Court of Australia (Monarch Airlines V AirServices Australia, HCA 62 of 1999).

There are many issues that must be properly addressed in making the transition from the abstract consideration of the broad economic and social issues relating to cost recovery to the detailed policy and implementation of a fair, equitable and legal system of recovering the costs of Government-provided services and regulatory regimes. Cost Recovery is not widely understood, may well be inconsistently applied and certainly warrants thorough examination.

Having read some of the submissions to the Inquiry and the transcripts of the Public Hearings, it appears that the usefulness of public input to this Inquiry has been quite variable. It is hardly surprising that many of the submissions have essentially been expressions of dissatisfaction about having to pay for services provided by, or activities of, Government.

Rather than buy into that debate at this point, I have provided (see attached) a range of comments on the draft Report's coverage of the detailed principles and processes that need to be followed when cost recovery is implemented. These comments are drawn from lessons learned over the years in developing the policy for cost recovery and undertaking its implementation.

There are many points that I could raise, but I have tried to focus on the main issues of relevance.

A few statements and conclusions in the report are factually incorrect and I will try to address these as well.

I hope that these comments are of use to the Inquiry.

Yours sincerely,

Chris Barnes
5 June 2001

The Application of Cost Recovery by Government Departments and Authorities

The circumstances within which Government Agencies operate can vary by so much from one case to another that it is almost impossible to develop definitive *detailed* guidelines for the application of cost recovery. While it is relatively straightforward to identify and discuss in the abstract the broad principles of cost recovery, the task becomes much more complex when seeking to apply those general principles to the specific circumstances of individual agencies. In the end, the successful application of cost recovery by one agency may take a quite different form from what would be appropriate for another agency, even though both may be similar in their general role and objectives.

Cost Recovery is probably unevenly applied and guidelines are needed, and can be developed up to a point; beyond which common sense, rather than rigid rules, must be used to apply those principles and guidelines to specific situations.

That said, the following issues are fundamental to the successful application of cost recovery:

Legal Framework

The legal constraints applying to cost recovery are not well understood and must be explored in detail when developing guidelines for the application of cost recovery.

While not a lawyer, my understanding of the situation is as follows:
The legal constraints on cost recovery appear to be Constitutional, as follows:

- To be cost recoverable by way of a fee for service:
  - The activity must amount to a service to an individual, and
  - The fee applicable must bear a reasonable relationship to costs incurred or to be incurred in providing the service;

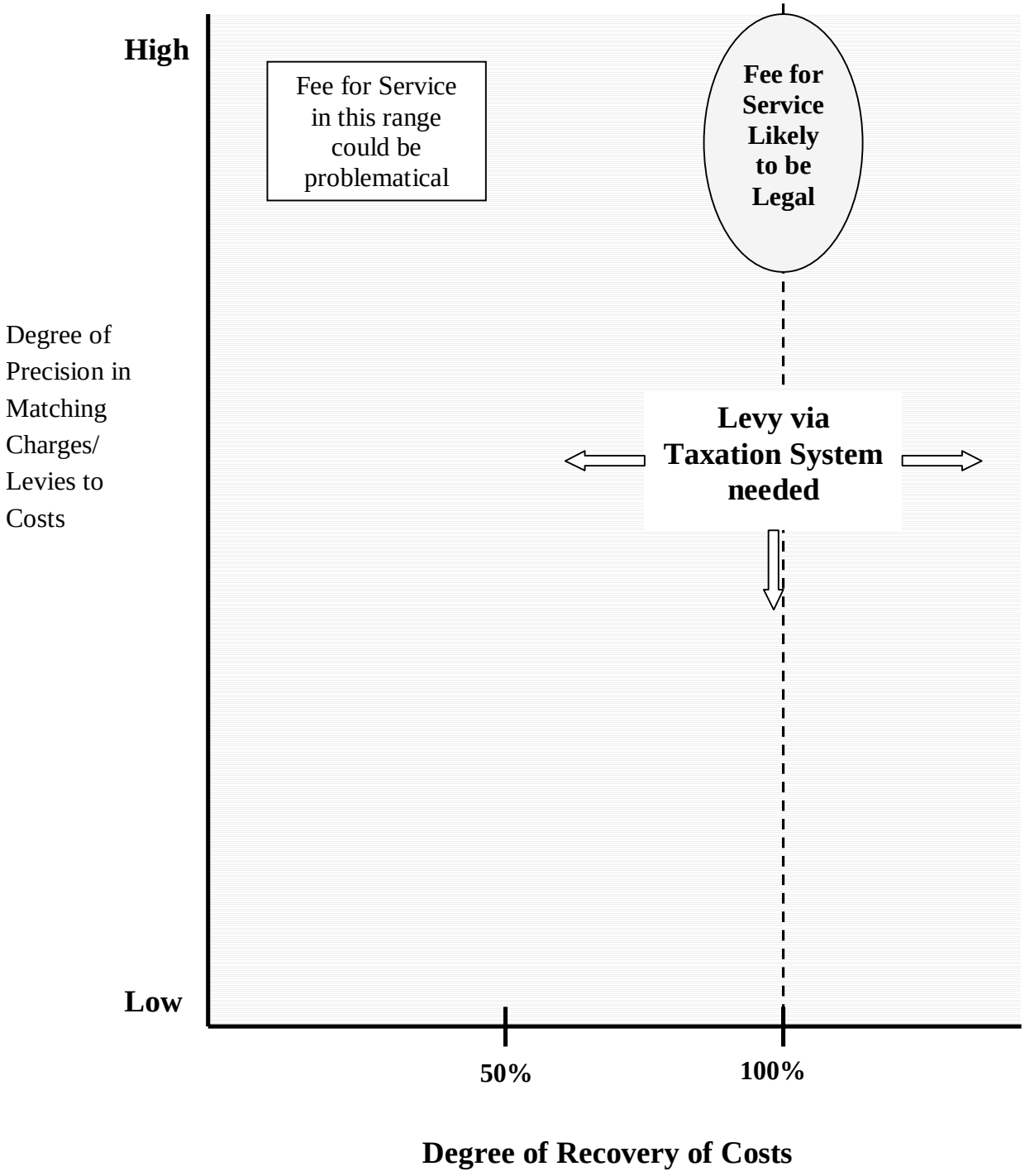
  There may be a question about the legality of a <u>fee for service</u> where full cost recovery is not being achieved and the target is a (possibly arbitrary?) sum of money or percentage of costs - no such legal constraint would apply to levies, of course.
- If no service is provided to individuals and/or the applicable fees do not reasonably reflect costs, then the costs can only be recovered, if desired, by way of levies (ie, via the taxation system).
- The development of policies (such as regulatory standards), as an example, is generally regarded as not a service to an individual and is thus only cost-recoverable by way of levies.

Is a service being provided to an individual?
If so, then that service is a *candidate* for direct fee for services - there can be other reasons why a fee for service is not appropriate for cost recovery of a service and a levy structure is required. If not, then a levy/tax approach must be used to recover costs.

The use of levies or fees for service for cost recovery is often a legal imperative, not a matter of choice.

The following diagram illustrates the points above as to whether fees for service or levies should be used to recover costs.

Possibility Range for Combinations of Degree of Cost Recovery and Precision of Matching Charges with Costs



Notes: - 100% cost recovery includes the cost of funds employed;
- Recovery of less than 100% of costs, but with a high correlation between costs and charges, may be acceptable, but simply seeking a revenue target could be problematical.

Conceptual Matters

There are several conceptual issues that could be explored in more detail.

Basis of Charges/Levies in a Safety Regulation Context

Cost recovery should be applied in such a way that it is not a disincentive to safe operations even where a fee for service is involved. This can sometimes be achieved by applying recovery on a broader basis such as incorporating those costs in a more broadly defined fee for service or by the use of some form of broad-based levy.

Equity

Cost recovery should always strive to be equitable, even when applied by way of levies where there is no underlying legal requirement for the charges concerned to bear a reasonable relationship to costs.

The Nature of Regulatory Bodies

It is easier to apply Cost Recovery to Regulatory Agencies once it is recognised that such agencies typically have four main areas of activity:-

- Setting of Standards
  - This is policy work by nature, has almost no elements that could amount to services to individuals and should be cost recovered by way of levies;
  - One exception may be an application for a standard to cover a patented product where the applicant would be the only beneficiary of its approval;
  - It *may* be possible to charge a fee for service for the processing of an application for a variation to standards even though the result would benefit a wide range of industry participants - ie, the service concerned is just the processing of the application and the costs recoverable would be less than the total cost of developing and promulgating the standard;
- Monitoring of Compliance with Standards - both scheduled and random audits
  - Scheduled audits could conceivably be regarded as a (mandatory) service necessary to be in business and thus cost-recoverable by a fee for service, although levies may be preferable in practice;
  - Random audits are analogous to something like random breath testing and cannot be regarded as a service. A broad-based levy or funding from Consolidated Revenue would be appropriate for this activity;
- Implementation of Standards (issue of approvals, licences, qualifications)
  - These are typically services to individuals and are thus candidates for cost recovery by way of fee for service;
- Education/Remedial Action - eg, in response to the results of monitoring of compliance with standards
  - advice, education/publicity campaigns, investigation, prosecution
  - these activities would not normally amount to services to individuals and thus should be cost recovered by way of broad-based levies or funded from Consolidated Revenue.

Does the Aim of Generating a Profit Amount to Taxation?

The High Court in 1999 found that the charges applied in 1991 by the then Civil Aviation Authority did not amount to taxation even though they were set at a level that was expected to generate an operating profit.

There should be no mystery about this decision. An agency seeking to earn a surplus or profit via fees for services does not automatically mean that its cost recovery amounts to taxation. As long as the level of profit merely reflects the aim of achieving an appropriate share of a

reasonable return on funds employed (ie, value of assets applied), weighted for the risk of the enterprise concerned, it should not be regarded as taxation (in the sense of revenue raising). Only when profit clearly exceeds that which represents a reasonable return on funds employed should it be regarded as taxation rather than cost recovery.

The seeking an appropriate rate of return on funds employed is entirely normal. If an enterprise is fully funded by debt (ie, borrowed funds) then there is an interest expense on that debt and a reasonable return on funds employed has been achieved without needing any profit to be achieved. Were the same enterprise to be funded by a mixture of debt and equity capital or fully by equity capital (ie, with no debt), then it incurs less or no interest expenses and must earn some profit in order to be able to pay a reasonable return on the level of equity funding concerned.

A profit or surplus that is excessive; ie, far more than needed to pay a reasonable return on funds employed, would run the risk of being regarded as a tax and therefore the cost recovery mechanism concerned would most likely need to be by way of levies, rather than fees for service.

There are, of course, fluctuations in demand that can produce unplanned surpluses. This should not cause any concern, as it is the intended result that matters, given that forecasters are generally wrong to some degree.

Who should pay?
The report identifies "beneficiaries" and "regulated" as possible subjects of cost recovery. This debate can be clarified by considerations of equity and by discussing overlaps between the regulated and beneficiaries.

There is also a question of how best to define the role of regulators and this can influence considerations of who should pay when cost recovery is applied. It can be argued that industries are only regulated in order to protect the well-being of the consumers of that industry's products and, in some cases, the community at large, from the risks that the industry in question creates by its very existence. There are situations where it is not just the users of the products of that industry that need to be protected from these risks, as non-users may also be at risk.

The question of who should pay becomes clearer when considering the matter in terms of what is being done and the equity issues concerned (which is, by the way, consistent with the legal constraints on cost recovery):

- If a service is being provided to an individual, then why should anyone but that individual, who, by definition, is receiving something of actual or potential economic benefit (even if it is compulsory to accept the service) pay the costs concerned (ability to pay is a separate issue)?
- If the concept of regulators existing to protect the consumer/community is accepted, then seeking to recover costs from the regulated becomes very compelling.

In any case, it may simply be more administratively difficult to cost-recover from the beneficiaries of regulation of an industry, where the beneficiaries are considered to be the customers of the industry, than it would be to cost recover from the industry itself.

Of course, cost recovery should not be applied where the industry concerned is immature (see comments below on ability to pay) and where it is simply not administratively feasible to do so.

Some industries receive a direct benefit from regulation as they may, for example, use favourable inspection reports from the regulator as a selling point and can even command higher rates of charge than their competitors. In addition, cost recovery can benefit industry in other ways, eg, by ensuring the regulator has sufficient resources to minimise delays in providing services or in development of new standards. This would not mean that the regulator would become captive to the industry, however.

Practical Issues

Ability to Pay/Barriers to Entry

It is possible that recovery of the costs of regulation may not be appropriate where an industry is relatively small or new. There needs to be consideration of the proportion of the overall costs of regulation against the size (in monetary terms) of the industry concerned. It would have been useful if the Inquiry had provided some objective information about the cost of regulating specific industries and the sales volume and number of participants in each of those industries.

Where an industry is considered to be able to pay for the costs of regulation, then suggesting that regulatory cost recovery is a barrier to entry or a major impediment to business is generally a case of a separate issue altogether. Not to cost-recover simply because a small proportion of industry participants cannot afford regulatory charges would miss out on the revenues from those that can afford to pay. The issue here is really that those few small organisations should seek subsidy assistance for their operations in general, with that decision dependant on the merits of individual cases.

Willingness to Pay

Industry participants, when consulted on the introduction of cost recovery for them, are certainly never going to open the chequebook and say, "Fine, how much do you want?" They will always object to paying, although will generally accept cost recovery, with reluctance, if it is applied in an equitable manner. Mature industries that carry risks of operation will accept that regulation is an unavoidable part of being in business. Their real main concern is usually that the cost recovery is equitable and does not result in any major cross-subsidies, particularly of their competitors. It is a natural reaction not to want to pay or to seek to have someone else pay.

Sometimes opposition to cost recovery will not be genuine or will be for reasons other than what is stated. Industries will always oppose increases in cost recovery as a matter of course, as they will probably consider a lack of opposition on their part would run the risk of encouraging further, perhaps unjustified, increases.

Feasibility and Balance

Most cost recovery regimes carry with them a significant administrative cost. Cost recovery is inappropriate if the administrative cost concerned is out of proportion to the sum being raised. There also should be a balance between improving the equity of cost recovery and the likelihood of increased administrative costs - costs both for the agency concerned and for those paying. There is no overall benefit in improving the equity of cost recovery - eg, by more precisely matching fees to costs, if there is a resultant *significant* rise in administrative costs (that, of course, also have to be recovered) that is out of proportion to the degree of improvement in equity. It is also possible that the costs of administering cost recovery can be excessive for those paying, which is also something to avoid, if possible.

Possibility of Cost Recovery Resulting in Excessive Regulation
Some submissions to this Inquiry have suggested that cost recovery could result in "gold-plating" by regulatory agencies. In my experience, the reality is quite the opposite, as cost recovery makes the regulator accountable for its cost structure and is much more likely to reveal inefficiencies and reduce, rather than increase, costs. I have found that some agencies are more likely not to want to cost recover, or, at least, not to want to recover 100% of costs, as they would then have to justify their cost structure and rates of charge.

Some Public Sector Executives are not familiar with the realities of fully distributed costs and are reluctant to go through the processes of detailed consultation and justification of their costs.

Definitional Matters

The report may benefit from clearer definitions of a number of terms that are fundamental to the subject matter:

Agencies: This term needs to be clarified to distinguish between those agencies that are an organisational unit of, and therefore legally indistinguishable from, a Commonwealth Department and those that are Statutory Authorities (ie, legally independent entities), as the latter have more flexibility in a financial management sense than a Department.

Beneficiaries: Are beneficiaries meant to be:

- the general taxpayer;
- the user of the products of the industry in question;
- members of the industry concerned; or
- Some mix of two or more of the above?

The term needs to be carefully defined (see comments elsewhere on "who should pay?").

Taxes: This term is used in a couple of ways: for cost recovery applied via the taxation system and for situations where general revenue raising is being applied. It would be clearer if the former were described as "cost recovery levies" and the term "taxes" used only where there is major over-recovery of costs.

Policy: There are levels of "policy" work, some of which are reasonable candidates for cost recovery and other less so. Some policy work is directly related to regulatory activities, such as the development of standards (and is thus a reasonable candidate for cost recovery, by way of levy only) from the industry concerned. Other policy work can be further removed from the actual regulatory function concerned and would be less of a candidate for cost recovery.