Charging fees for public sector goods and services

This is a good practice guide published under section 21 of the Public Audit Act 2001.

June 2008
Last year, the Regulations Review Committee asked me to consider providing an update to our 1989 publication *Guidelines on Costing and Charging for Public Sector Goods and Services*. My staff have worked with the Committee in preparing this new good practice guide, which replaces our 1989 publication.

This new guide discusses our expectation that public entities set fees in keeping with the principles of authority, efficiency, and accountability. It sets out the matters that we expect public entities to consider when calculating the costs of providing goods or services and setting the associated fees. It will form the basis on which my staff carry out any work to review how a public entity has set fees, whether on my account or in assisting the Regulations Review Committee.

My staff have also worked with the Treasury in producing this guide, because the Treasury produces complementary guidelines in this area.

I trust this guide will help those public entities that have a statutory authority to charge fees for the goods and services they are obliged to provide.

K B Brady  
Controller and Auditor-General  
18 June 2008
Foreword from the Regulations Review Committee

The review of regulations that set fees for goods and services is core business for the Regulations Review Committee. The role of the Committee is to ensure on behalf of Parliament that the Executive exercises its delegated law-making power responsibly. It performs this function through reporting on issues of principle to the House of Representatives, through regular examination of new fees regulations, and through hearing and reporting on complaints from the public related to fees regulations.

The Regulations Review Committee welcomes these updated guidelines from the Controller and Auditor-General. While the principles relating to cost recovery remain the same, there have been many developments since the original guidelines were published in 1989. We note that the Treasury produced complementary guidelines in 2002 that must also be taken into account when setting fees.

The process of setting fees for goods and services provided by public entities requires particular care. It must ensure that constitutional principles relating to taxation are observed, that fees do not exceed the costs of providing the services, and that fees are set in a fair and transparent manner. Guidance on these matters is set out in the updated guidelines with clarity and concision.

The Committee has worked closely with the Office of the Auditor-General on developing principles for setting fees for public sector goods and services. When reviewing fees regulations and complaints that relate to such regulations, the Committee’s first consideration is whether the regulations are consistent with the Auditor-General’s guidelines. The Regulations Review Committee therefore recommends these guidelines for the consideration of all public entities involved in the fee-setting process.

Dr Richard Worth
Chairman
Regulations Review Committee

18 June 2008
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Part 1

Introduction

1.1 This guide is intended for all public entities\(^1\) that have statutory authority to charge a fee\(^2\) for the goods or services that they are obliged to provide. Examples are issuing a passport, or issuing a driver licence.

1.2 This guide sets out our expectations of how public entities should set fees. Our expectations are based on three principles:

- authority;
- efficiency; and
- accountability.

1.3 This guide describes these principles, discusses how they should be applied, and sets out the steps and matters that we expect public entities to consider when quantifying the costs of providing goods or services and setting the associated fees.

1.4 This guide updates and replaces our 1989 publication *Guidelines on Costing and Charging for Public Sector Goods and Services*.

Cost-recovery focus

1.5 A fee should be set at no more than the amount necessary to recover costs, unless the entity is expressly authorised to do otherwise.

1.6 Setting a fee that recovers more than the costs of providing the goods or services could be viewed as a tax. Unless expressly authorised by statute, this would breach the constitutional principle that Parliament’s explicit approval is needed to impose a tax.\(^3\) Accordingly, any authority given to a public entity to charge a fee is implicitly capped at the level of cost recovery.

1.7 For example, specific authority is required to charge a fee that would recover more than the cost of providing a good or service – to generate additional revenue, impose a penalty, limit access to or demand for a service, or meet social objectives.

1.8 On the other hand, while an entity might have legislative authority to operate full cost-recovery, sometimes fees are deliberately set to recover less than the full cost of providing the good or service. These are policy choices for the Minister or governing body of the entity to consider.

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1 “Public entities” are those entities within the Auditor-General’s mandate, and defined in section 5 of the Public Audit Act 2001.

2 For simplicity, we use the terms “fee” and “fees” in this guide to also cover other forms of charges for goods and services.

3 See section 22(a) of the Constitution Act 1986.
Scope of this guide

1.9 This guide does not apply to levies or contractual payments.

Levies

1.10 A levy differs from a fee for a specific good or service; it is more akin to a tax, but one that is charged to a specific group. It is usually compulsory to pay a levy. Levies charged to a certain group or industry are usually used for a particular purpose, rather than relating to specific goods or services provided to an individual. For example:

- road user charges, which are levies put towards the upkeep of New Zealand roads, are charged on diesel vehicles and vehicles over a certain weight (other motorists contribute to road maintenance costs through an excise duty on the price of petrol); and
- building levies, paid by an applicant for a building consent based on the estimated value of the building work to which the consent relates, are paid to the Department of Building and Housing for its building-related services.

Contractual payments

1.11 In this guide, a fee is authorised by statute, and set by a public entity to recover some or all of its costs in producing goods or services that it is required by statute to provide. In a contractual relationship the entity is simply selling a good or service.

1.12 Public entities do not need statutory authority to enter into contracts for commercial transactions. Such transactions are voluntary for both parties rather than being a matter of statutory duty.

1.13 An example of a normal commercial transaction is the Department of Internal Affairs’ provision of professional translation services to businesses, central and local government, and private individuals. The Department is not obliged to provide these services. The amount charged by the Translation Service is a contractual payment agreed to by the recipient, and not a fee within the scope of this guide.

1.14 In the local government context, the Dog Control Act 1996 contains detailed provisions setting out the basis on which local authorities can charge fees for dog registration. But a local authority does not need equivalent empowering provisions when it hires out a hall or community facility for an afternoon; that is a simple matter of contract and there is no obligation on the authority to hire it out. The first is covered by this guide; the second is not.
Other interested parties

1.15 Other parties with a role in ensuring that public entities are setting fees lawfully and appropriately include the Regulations Review Committee and the Treasury. This guide has been produced in conjunction with both of them.

1.16 The Regulations Review Committee (the Committee) is the parliamentary select committee with the role of scrutinising regulations, including regulations that set fees. The Committee asked the Auditor-General to produce updated guidelines on the subject. This good practice guide updates and replaces our previous guidelines, and takes account of the Committee’s past scrutiny of fees and its previous reports on the subject.

1.17 In 2002, the Treasury published its *Guidelines for Setting Charges in the Public Sector* (the Treasury Guidelines), which were an updated version of its 1999 guidelines. The aim of the Treasury Guidelines is to ensure that entities take proper account of efficiency, equity, fiscal, and other policy concerns as they prepare charging regimes.

1.18 This guide and the Treasury Guidelines are complementary. Both the Treasury and the Auditor-General are concerned that entities do not set excessive fees. However, the Treasury Guidelines discuss issues that the Auditor-General has no mandate to comment on, such as the policy considerations about who should be charged a fee and whether an entity should recover less than the full costs of providing a good or service. We recommend that public entities also refer to the Treasury Guidelines.
2.1 In setting a fee for providing goods and services, we expect public entities to be guided by three principles:
   • authority;
   • efficiency; and
   • accountability.

2.2 In this Part, we describe the principles and how they should be applied.

Authority

2.3 A public entity must have legal authority to charge a fee for the goods or services that it is legally obliged to provide. A public entity will usually be funded for the costs of providing goods or services that it has an obligation to provide, and needs specific legal authority to act outside this.

2.4 That authority will be in an Act of Parliament. The authority may relate either directly or generally to the activity being carried out. The legislation will usually include an empowering provision that authorises the entity or the Governor-General to set the amount of a fee through regulation, rather than specify the amount in the primary legislation.

Scope of the empowering provision

2.5 The entity needs to clearly identify and understand the scope and any constraints or limitations of the empowering provision before taking any steps to decide how much to charge.

2.6 The scope can vary substantially, which will affect the nature and extent of costs that can be recovered, as well as the type of fees that can be charged. Some empowering provisions contain specific rules about how fees are to be set. Further, the legislation might require the entity to charge a fee, while other statutes might state that charging is discretionary.

Over-recovery of costs

2.7 In general, the statutory authority to charge a fee will not extend to allowing over-recovery. This can cause difficulties if a public entity is trying to recover a deficit from a previous period of under-recovery. The entity can manage these issues if there is enough scope in the statutory authority, and if it is clear that at an administrative level the surpluses and deficits are being managed within a reasonable budgeting framework for managing costs and setting fees over a period of time.
2.8 Memorandum accounts, for example, are a device for tracking surpluses and
deficits against forecasts, with the aim of balancing revenue and expenditure over
time. Beyond this general system, any attempt to fund a deficit through current
fees need to be carefully considered. The attempt to do so might result in current
consumers being charged more than the costs of providing the goods or services
they receive, or in a lack of equity between current and future consumers – which
could be outside the scope of the legal authority. The entity should get specific
legal advice before setting fees to recover such costs.

2.9 Some statutes set out how any over-recovery is to be treated. It is always
important to have regard to the legislative context in which the fees are to be set.

Cross-subsidisation

2.10 Cross-subsidisation occurs when the fees collected for providing one category of
goods or services cover some of the costs of providing goods or services in another
category. As a result, the costs of some goods or services are being over-recovered
while others are under-recovered.

2.11 Whether cross-subsidisation is lawful and appropriate will depend on the
particular legal authority under which the fees have been charged. A public entity
could have the authority to set various fees for the different goods and services it
provides, with this authority deriving from a number of empowering provisions in
different statutes. The empowering provisions must be broad enough to permit
the entity to lawfully cross-subsidise, especially when the entity is considering
cross-subsidising between goods and services provided under different statutes.

2.12 For example, the Department of Internal Affairs charges for many of its activities,
including passports and licences for gaming machines.\(^1\) A cross-subsidy could
exist if the Department over-charged for passports and used that income to
cover some of the costs of providing gaming machine licences. Alternatively, the
Department could over-charge for an adult’s passport, and use that income to
cross-subsidise the cost of a child’s passport.

2.13 The extent to which a cross-subsidy is lawful will always depend on the wording
of the empowering provisions and the particular circumstances of the entity. An
entity may need to obtain legal advice if it is unclear about the purpose and scope
of its ability to charge fees, including any questions about cross-subsidies.

2.14 Any cross-subsidising must be clearly authorised and transparent, and the reasons
for doing so clearly documented. External review organisations, such as the
Regulations Review Committee, may consider the appropriateness of the entity’s
approach for charges set by regulation.

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\(^1\) Fees are set under the Passports Act 1992 and Gambling Act 2003 respectively.
Policy and other considerations affecting the amount of the fee

2.15 The reason for setting fees at any particular level is often guided by policy considerations, and could be subject to various imperatives. While an entity might be able to recover its costs fully, it may choose not to. This is a policy decision for the entity. We expect any policy decisions about charging less than the fee needed to recover costs to be explicitly included in the methodology used to set the fees.

2.16 The capacity to charge less than full cost-recovery depends on the availability of some other source of funding, such as an appropriation or rates revenue, or on the ability of the entity to cross-subsidise. Not all entities will have this flexibility.

2.17 The fees set for civil court proceedings are an example of charging less than full cost-recovery because of policy considerations. These fees are not set to recover all of the relevant costs because to do so was considered likely to inappropriately limit access to justice. These fees were considered by the Regulations Review Committee, which concluded that some of the proposed increases to fees would create barriers to accessing the court system.\

2.18 Entities considering the appropriateness of charging fees at a particular level should refer to the Treasury Guidelines, which contain useful discussion on the objectives for charging fees and appropriate charging methodology.

Efficiency

2.19 Public entities have a responsibility to understand and monitor their costs in order to ensure that they are operating efficiently. By “efficient” we mean producing as many goods or services as possible to the desired level of quality from a given quantity of resources, and thereby achieving value for money.

2.20 A crucial factor in measuring efficiency is having an accurate understanding of the costs – both direct and indirect – of the goods or services being provided. Without knowing these costs the entity cannot assess whether it is obtaining value for money.

2.21 Accurately establishing the costs of producing something is a useful exercise in managing and controlling those costs and identifying inefficiencies, which in turn can lead to improved use of public resources. This is important regardless of whether the consumer meets the costs of providing the good or service.

2.22 The discipline of monitoring costs can also help to ensure that charges are being set lawfully and appropriately because it will identify any over-recovery of costs.

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Regular reviews

2.23 Because costs are not static, it is important that fees are reviewed regularly to ensure that they remain appropriate and that the assumptions on which they are based (for example, volumes of demand or cost increases) remain valid and relevant.

2.24 The appropriate timing for the reviews will need to be determined by the public entity, considering the particular circumstances and changes in costs and demand. The entity should also take into account the costs involved in the review itself.

2.25 We suggest that a review takes place at least every three years.

2.26 One approach is to carry out a simple review each year and a more comprehensive review at longer intervals. The comprehensive review should include the method of allocating direct and indirect costs, estimating future costs, determining fee structures and levels, and considering whether assumptions remain valid. It might be enough for a simple review to look at just the costs for which there have been known, regular, or significant changes (for example, salary increases for the relevant staff).

2.27 Failing to review and adjust fees to reflect changing circumstances can lead to under- or over-recovery of costs. Frequent adjustments to the level of charges are not ideal, but adjustments should be made where a clear trend of under- or over-recovery emerges. Operating memorandum accounts (discussed in paragraphs 3.53-3.58) is one way of evaluating whether a review might be needed, and can also assist with avoiding overly frequent changes.

2.28 Management might sometimes be able to evaluate efficiency by benchmarking costs, or components of costs, with similar goods or services available in the market, such as administration or printing services.

Accountability

2.29 A public entity is accountable to Parliament and the public. To be accountable, entities need to ensure that their processes for identifying costs and setting fees are transparent.

2.30 Transparency and accountability are achieved in several ways:

• through consulting the public about new fee regimes before they are introduced;

• by recording the surpluses and deficits associated with the entity’s fee regimes; and
2.31 The Auditor-General can also review the way in which entities set fees.

Consultation with the public

2.32 We would usually expect a public entity to disclose its costs and charging practices to give the public an opportunity to comment on and question them. This imposes a discipline on the entity not to pass on inefficient costs to consumers. It also helps the consumers to understand and accept the charging practices. The entity should consult in a way that is practical and appropriate to the nature and significance of the changes.

2.33 For the consultation to be effective, the public – with an emphasis on current or potential consumers – should be provided with enough information to understand the policies and the underlying cost data from which the fees have been determined. The consultation process should allow enough time to enable genuine and considered feedback, and be more than mere prior notification. The feedback obtained from the consultation should be considered by the public entity with an open mind before final decisions on charges are made. Case law outlining the elements of consultation exists, such as the Wellington International Airport case.3

2.34 Consultation with consumers can also provide the entity with information to help tailor what it produces in response to consumers’ needs. It can also better inform investment decisions and other changes, and can sometimes prompt the entity to reconsider decisions that consumers did not support.

2.35 In some instances it could be difficult for an entity to consult on proposed changes to fees before they are implemented. For example, the entity might expect that highlighting proposed fee changes would lead to a significant surge in demand for the goods or services before the changes are implemented, with associated cost and resource issues. This would not occur with all types of fees (for example, consulting on fee changes for an annual practising certificate that members of a profession are required to hold is unlikely to materially change the level or pattern of demand).

2.36 An entity needs to have good reasons if it decides not to consult the public on its fees. The entity should consider the transparency and benefits that can be gained from consultation on the one hand, with the increased costs and resources

needed to meet the increased demand, or other perceived negative consequences, on the other. It might also be possible to tailor the consultation to minimise the risks, for example by consulting only a stakeholder group.

Recording the revenue from fees

2.37 To be accountable, an entity needs to know how much revenue is being generated from its fees relative to its costs. Memorandum accounts are one method of gathering this information.

2.38 A memorandum account is a notional account that records the accumulated balances of surpluses and deficits incurred in providing goods and services. The account will provide support for the entity’s practices for charging fees, and can show when fees might need to be reviewed.

2.39 Although fees should be set to recover costs in the short term, in most instances there will be some variation between the costs incurred and revenue received, and what was forecast for the period. It is difficult, if not impossible, for forecasts to be completely accurate. Even with the best of intentions, an entity might under- or over-charge for a period. Memorandum accounts can provide a mechanism for tracking and smoothing the recovery of costs over time, and acknowledge that some smoothing between periods will be needed.

2.40 Under the Treasury Instructions 2007, except where the entity has prior approval from the Treasury, government departments must use memorandum accounts to record the accumulated balance of surpluses and deficits incurred in providing fully cost-recovered goods and services.4

2.41 Our expectations for memorandum accounts are set out in paragraphs 3.53-3.58. Memorandum accounts are also discussed in the Treasury Guidelines.

Regulations Review Committee’s grounds of review

2.42 As well as the terms of its legal authority to charge a fee, a public entity should also consider good practice and the Standing Order grounds that the Committee considers when it reviews regulations.

2.43 The Committee will consider whether a regulation setting a fee ought to be drawn to the attention of Parliament on one or more of the grounds set out in Standing Order 315(2). The grounds most likely to be relevant to fees are discussed in broad terms below. More detail can be found in the Regulations Review Committee Digest.5

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5 The Regulations Review Committee Digest details all the matters considered by the Committee under Standing Order 315(2): http://www.victoria.ac.nz/NZCPL/Regs_Review/Index.aspx.
Not in accordance with the general objects and intentions of the statute

2.44 The first ground is that the regulation is not in keeping with the general objects and intentions of the statute under which it is made (Standing Order 315(2)(a)). The Committee considers whether the regulation is consistent with the intentions of the Act as a whole, and whether the authority in the Act authorises the making of such a regulation.

2.45 Fees must be imposed under clear statutory authority. A fee imposed by regulation could be objectionable if it is so high that it defeats the purpose of the enabling statute. A fee that is not based on costs and would result in over-recovery would also not be in keeping with the enabling statute.

2.46 For example, in 1998 the Committee considered a regulation prescribing a migrant settlement services fee that applicants for residence visas or permits had to pay. About half of the fee was to be used for providing English language tuition for speakers of other languages. All applicants had to pay the fee, regardless of whether they needed English language tuition. The Committee recommended that the regulation be revoked because it could be viewed as a tax. Therefore, it was not in keeping with the general objects and intentions of the enabling statute.

Trespasses unduly on personal rights and liberties

2.47 Standing Order 315(2)(b) refers to a regulation that trespasses unduly on personal rights and liberties. The Committee considers whether there is a trespass on a right or liberty and, if so, whether it is undue or reasonable. In the context of fees, the Committee considers whether the fees:

- are unjustified in the circumstances;
- clearly reflect unacceptably inefficient operation by the relevant entity;
- include a component irrelevant to the person paying, unless there is enough justification for doing so; or
- are set at a level that will defeat the purposes of the legislation.

Unusual or unexpected use of powers

2.48 A further ground is that the regulation appears to make some unusual or unexpected use of the powers conferred by the statute under which it is made (Standing Order 315(2)(c)). Essentially, this ground involves considering similar issues about whether the regulation is in keeping with the general objects and intentions of the statute. If the consumers are paying for something that they do not receive, then the regulation setting the charges could constitute an unusual or unexpected use of the power. This is how the Committee considers the need for equity between current and future consumers.
2.49 An example is the Committee’s report into licence fees that flight crews and aircraft maintenance engineers have to pay.\(^7\) The fees included a portion towards the cost of research into training methods for pilots. The Committee concluded that it was an unreasonable and unexpected use of the regulation-setting authority because current pilots would not receive any benefit from the research and therefore should not be required to contribute to the costs of the research. An individual should not be required to pay if they are not going to get the benefit of the resource being paid for.

2.50 A further example illustrating this is the Committee’s report into licensing fees for gaming machines.\(^8\) The charges, based on full cost-recovery, substantially increased the previous fees that licence holders had to pay. The Committee thought that requiring all licence holders, regardless of their size, to pay the same level of charge was an unusual or unexpected use of the authority, even though the statute covering gaming machines did not permit differentiated fees.

**More appropriate for parliamentary enactment**

2.51 The final ground discussed here is that the regulation contains matter more appropriate for an Act of Parliament (Standing Order 315(2)(f)). This is based on the principle that statutes should set out the policy and substance of the law, and regulations should be limited to detail and implementing the policy.

2.52 This ground could be breached if increases to charges are so significant that they represent a substantive shift in policy that the Committee believes should be debated by Parliament. It would also be breached if the charges recovered more than the costs (because the presumption is that Parliament could not have intended a charge that amounts to a tax to be levied through regulations). For the same reason, a charge imposing a penalty (such as a late payment penalty) would need specific authority.

2.53 An example of this ground is the Committee’s consideration of regulations from 1990 that significantly increased civil aviation fees.\(^9\) One of the fees was an international operator’s fee charged to the aviation industry, which in part covered the cost of New Zealand’s membership of an international governmental organisation. The Committee concluded that the cost of this membership should be paid for out of general taxation because the benefits flow to the wider community. It was not a service provided only to the aviation industry.

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9 Report on the Inquiry into the Civil Aviation Charges Regulations 1990, 4 September 1990, AJHR I16B.
Judicial review

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

Review by the Auditor-General

2.55 The Auditor-General can examine the process used by a public entity in setting fees. This is part of the Auditor-General’s role in providing assurance to Parliament that public entities are operating in a manner consistent with Parliament’s intentions. The examination of the entity’s process might be done to provide advice to the Regulations Review Committee on whether fees being set by regulations have been determined in keeping with the relevant guidelines. The process might also be looked at as part of the annual audit or through one of the Auditor-General’s other roles, such as carrying out an inquiry.
In this Part, we discuss in more detail the three principles described in Part 2, and the steps and matters that we expect public entities to consider in setting fees.

The circumstances under which a public entity charges fees for goods or services can vary. An entity could charge fees for two different goods or services, with different legal authorities and separate policy justifications and cost structures.

Therefore, this Part does not set out a single standard that entities must adhere to when setting fees. Instead, it considers the basic information that an entity ought to have, so that it can set fees lawfully, give due attention to efficiency considerations, and satisfy the need for public accountability.

We expect that, in setting a charge, the public entity will consider four main questions:

- What legal authority does it have to charge fees?
- What is the justification for charging a fee?
- Is it clear how the costs have been calculated?
- Are the entity’s decisions, charging system, and revenue and costs for that system clearly documented and transparent?

What legal authority does the entity have to charge fees?

When considering the authority to charge a fee, the entity has to understand the purpose and scope of its authority to charge. The entity also needs to know whether the fees are consistent with this authority and within its scope.

If necessary, the entity should seek legal advice on these matters.

Purpose and scope of authority

A fee must be consistent with both the purpose and scope of the legal authority.

Some entities have authority to charge fees under different sections of one statute, and under different statutes. The legal authority can differ both substantially and subtly between the different provisions.

Some cost elements could be recoverable under one empowering provision, but not under another. For example, for one service there could be enough authority to include the costs incurred for related policy advice or investigatory and regulatory activities, but for another the authority could be more limited. It is important to check the precise terms of each empowering provision.
3.10 For example, the empowering provision for local authorities to charge fees for various services, including certificates, permits, and consents, in the Local Government Act 2002 provides that fees must not recover more than the reasonable costs incurred by the local authority. Fees charged by a local authority under section 36 of the Resource Management Act 1991 for resource consents and other services are also to be fixed in the manner set out in the Local Government Act, and must follow the special consultative process set out in the Local Government Act.

3.11 A public entity's overall sources of funding may be relevant to the interpretation of its statutory authority to recover costs through charging fees.

3.12 The entity's understanding of its legal authority should be fully documented, perhaps in a policy manual or similar background document or file.

What is the justification for charging?

3.13 If a public entity is authorised – but not obliged – to charge a fee, the entity should consider its justification for charging. If the entity considers that charging a fee is justified, the entity also needs to decide what proportion of its costs it aims to recover. That is, does the entity understand what it is seeking to achieve, or to avoid, in setting fees?

3.14 Judgements about the justification for charging a fee are for the entity to make, based on sound information and assumptions. The discussion in the Treasury Guidelines about identifying the options for charging fees, options for who to charge, and objectives for charging, can help entities in making these judgements.

3.15 The entity needs to be aware that its reasons and decisions are open to review by the Regulations Review Committee, the courts, and the Auditor-General.

Is it clear how the costs have been calculated?

3.16 The fees for a particular good or service should reflect the costs estimated to be incurred by the public entity in producing that good or service.

3.17 Establishing the cost of a good or service involves:

- identifying the different goods or services being produced;
- identifying the resources used in producing each good or service;
- estimating the volume of each good or service to be produced in a given period; and
- estimating the volume and cost of resources required to produce each good or service in that period.
3.18 As an entity considers its cost structures, it should consider:
   • issues of efficiency, including administration and collection efficiencies (the transaction costs in managing a fee charging regime should not be out of proportion to the sums involved); and
   • how to deal with capital expenditure, fixed assets, and depreciation (see paragraph 3.34).

3.19 Once all this information has been gathered, the entity is in a position to decide what fees to charge for each good or service.

3.20 The entity should continually consider:
   • its authority to charge fees and the context for the charging; and
   • how much it has invested in the process used to allocate costs and set fees—the more goods or services it charges for and the more revenue it generates, the more thorough and considered the analysis should be.

Identifying what is being produced, and the resources used in its production

3.21 An entity should identify the range of goods and services it produces before it decides how they should be grouped for costing and charging purposes. They should be grouped on a reasonable and logical basis. At times, it may be more practical to divide complex products into smaller components; sometimes it may be easier to group several related products together for costing purposes.

3.22 Once the goods and services have been identified and grouped logically, the entity needs to determine and cost the resources used in producing them. These resources will usually be a mix of labour, materials, overheads, fixed assets and related costs, and any other relevant costs.

3.23 The entity should ensure that its cost analysis identifies the costs incurred in related functions or roles of the entity, so that a clear choice can be made about whether to allocate these costs to the production process and to recover them through the fees it charges.

3.24 For example, an entity that regulates a profession or occupation might charge an annual practising fee to its members. The entity could also have a role in providing ongoing education or training to the industry’s members, the costs of which it recovers from the members. The entity will need to ensure that its cost analysis appropriately identifies all likely or reasonably expected costs from all of its functions and roles.
3.25 An entity will generally not be authorised to explicitly build up a reserve from its fees for no reason other than to have funds generally available in case they may be needed in the future. As discussed earlier, given the nature of forecasting demand and costs, we recognise that an unintentional over-recovery could occur. A surplus can arise for many reasons, including because the actual demand varied from that forecast. An unintentional surplus differs from one brought about by an entity that has set fees with the intention of creating a general reserve.

3.26 It is also important to differentiate between the deliberate building up of a general reserve and prudent financial management, which includes reasonable provision for all likely foreseeable costs. An entity should consider all likely costs that could occur within the forecast period when performing a costing analysis. What is reasonable will depend on the circumstances of each entity.

**Costing the use of resources**

3.27 Cost is a monetary measure of the resources used in producing something. Sound methodologies that identify the cost of resources, and allocate the costs to individual goods or services, are essential aspects of good charging practice. The entity should have a system in place to collate the cost information. The type of systems developed should take account of the context and should be in proportion to the level of revenue and costs that the entity needs to track.

3.28 In identifying the resources, and hence the cost, involved in providing the forecast volume of goods or services, the entity has to use the best information available to it and make reasonable assumptions about prospective information.

3.29 It could be appropriate to use sampling to determine standard rates. A standard rate is the average amount of resource expected to be used to produce or contribute to a particular good or service, such as the standard labour or materials cost for each item. A standard rate could be appropriate where fluctuations in the amount of resources used are small. Equally, if costs will vary depending on the way in which a good or service is delivered (for example, the cost may be significantly cheaper if the service is delivered online), the entity may need to consider whether that is significant enough to be reflected through the costing or fee setting process.

**Some types of costs**

3.30 Typical costs that are incurred in producing goods or services are outlined below.

3.31 Labour:

- The cost of labour includes remuneration costs (such as salaries, wages, and superannuation), and other employment-related costs such as fringe benefit tax and ACC levies.
• Time is often an appropriate basis for allocating labour costs to different activities. If employees work on more than one good or service, the entity will need to determine how to allocate their time. The entity could gather this information by recording the time spent by employees on different goods or services, by determining this on a sample basis, or by an informed estimate.

3.32 Materials:
• The average quantity of materials required to produce something can be determined based on past experience, estimates if there is no historical information, or a practice run. The quantity of material includes any usual scrap or wastage.
• Where volumes and costs of materials used in a given period are already known, the standard material cost for an item could be determined by dividing the estimated total material cost by the estimated number of individual items produced in the period.

3.33 Overheads:
• Overheads include all services received or purchased from other divisions or sections of the organisation, or from third parties (such as rent, telephone, and travel costs).

3.34 Fixed assets, depreciation, and other costs related to capital:
• It is generally not appropriate to include capital expenditure (the purchase of fixed assets, such as land, buildings, other physical construction, and equipment) in the calculation of costs for setting fees. Recovering the costs in the year they were incurred can treat current and future consumers inequitably – one group will be paying for something (such as an enhanced IT system) that they may not get the benefit of, which will not usually be appropriate.\(^1\) Also, these capital expenditure costs are recovered through depreciation.\(^2\)
• Accordingly, the cost of a good or service should include depreciation charges on the relevant fixed assets. Depreciation is calculated based on either the purchase cost of the asset or the asset’s fair value, depending on the accounting policies of the entity.
• Other costs include the capital charge that the Treasury levies on certain types of entities, such as departments, based on the level of taxpayers’ funds held by these entities. Where levied, the capital charge represents a cost to the entity and should be included in the cost calculation.

3.35 In determining their costs, entities should be careful to avoid including expenses funded through other means in their analysis for charging fees.

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2. Depreciation is a term used to describe the consumption of service potential embodied within an asset during the asset’s useful life.
Direct and indirect costs

3.36 The costs discussed above can have a direct or indirect relationship with the goods or services being produced. Direct costs – those that can be traced to a single product (such as labour costs to provide a service or the materials that go into making a good) – should be allocated to that product. Other direct costs can include the costs of external services, depreciation, and the capital charge levied by the Treasury.

3.37 Conversely, some costs can contribute to producing a product but are not incurred exclusively for that purpose (like rent or electricity costs). Indirect costs should be allocated to goods or services being produced based on the extent to which the indirect cost contributes to, or was caused by, the good or service. Where a causal relationship is not readily identifiable (such as the salaries of chief executives) the costs should be allocated systematically across the various goods or services. Possible allocation bases include their relationship with direct costs, number of staff, volume of service, and office space used.

3.38 The method of allocating costs should be formulated at the top level of the entity, to ensure that all relevant indirect costs of the organisation are included and only charged once. However, managers directly in charge of the activities concerned, as appropriate to the entity, should make the actual assessment of costs.

3.39 It is the relationship of a cost to the good or service that will usually determine whether or not it is a direct cost. The type of cost, or the part of the organisation that incurs the cost, is less relevant. However, this might not always be clear, and there is scope for the entity to decide the most appropriate analysis. For example, legal costs could be treated as direct costs if they can be specifically identified with the particular good or service, or it may be more practical to allocate them as part of the indirect overhead costs.

3.40 Allocating indirect costs might not always be straightforward, but the entity should make a reasonable and logical assessment of indirect costs and their allocation against goods or services. This should take account of the type of entity and its overall structure, to determine what level of cost allocation is appropriate. The context could suggest that a comprehensive allocation of overheads is not appropriate or necessary (for example, for a relatively small service line in the context of a large entity).

Estimating the volume to be produced in a given period, and the volume and cost of resources required to do so

3.41 The entity should estimate the future demand for each good or service in the period for which it is carrying out the analysis. Sometimes this can be accurately
forecast from previous experience; at other times it will be less clear and the entity will need to make assumptions about the different factors that might affect the demand.

3.42 Once the entity has information about the forecast volume, it can estimate the required resources and their costs.

3.43 When quantifying the costs of the resources that will be needed to meet the expected demand, the entity should take into account fixed and variable costs:

- fixed costs are stable within a certain volume range and change only when significant changes in volume occur; and
- variable costs change continuously with changes in volume.

3.44 The entity will need to make assumptions about the prices that it expects to pay for the resources that it will need to produce the goods or services. The entity should make reasonable and logical assumptions about the level of resources needed to produce the goods or services, based on the best information known and on anticipated changes (such as inflation).

3.45 The entity will need to determine a logical period on which to base the cost analysis. If the entity usually carries out reviews every three years, that could be an appropriate period. The analysis will also depend on the extent of information available about future costs and forecast demand. Whatever period the entity chooses for the analysis, it should review the analysis at least every three years.

Determining the basis for setting and charging fees

3.46 Once an entity has identified its cost structures and individual cost components, and has estimated the volume of demand and therefore the costs that will be incurred, it can decide how to set its fees. At this point, it will need to factor in any policy choices that have been made about the proportion of costs to be recovered through the fees.

3.47 The fees will need to include GST.

Deciding how to set the fees

3.48 Fees can be expressed as a monetary amount for each good or service produced, or each unit of resources (such as an hourly rate), or a combination of resources (such as an hourly rate plus materials).

3.49 The appropriate basis for charging a fee will depend on the nature of what is being produced. If the goods or services are standardised, it may be as simple as dividing the total costs by the estimated volume to be produced. However, if
the costs incurred in producing individual goods or services vary significantly, an average cost might not be the best method. More specific charges may be needed according to what is being provided.

3.50 The fees should, wherever possible, be set before the goods or services are produced. If not, the incentive for management to control costs could be reduced. In addition, consumers should know the fees in advance so that they can decide whether they want to incur the costs associated with the goods or services.

Are the entity’s decisions, charging system, and revenue and costs for that system clearly documented and transparent?

3.51 A public entity that charges fees should have:

• a documented approach to its charging system that refers to the legal authority for charging, the scope of the charging ability, its rationale for charging (with appropriate reference to the Treasury Guidelines), and any other sources of revenue including revenue from the Crown, along with its approach to costing;

• a sound cost-allocation process appropriate to the entity and the fees;

• for each charge-setting exercise, a clear audit trail showing the assessment of costs incurred and forecast demand, and how the fees have been arrived at; and

• a record of its consideration of the principles and questions contained in this guide – with the extent and level of detail depending on the scale and significance of the goods or services being produced and their cost.

3.52 An entity that has this information will be able to demonstrate to external reviewers that it has a rational and reasonable process for identifying the costs of its activities and setting its fees.

Monitoring revenue from fees charged

3.53 Once the entity has set the fees to be charged, it should monitor and record the revenue generated from its fees. It can do so using memorandum accounts or a similar method.

3.54 Treasury instructions outline the circumstances in which memorandum accounts are to be used by government departments. The Treasury updates these instructions periodically. The current version is the online edition of the Treasury Instructions 2007, available from the Treasury website.
3.55 The Treasury Instructions 2007 state that, except where government departments have obtained approval for alternative arrangements from Treasury, government departments must use memorandum accounts to record the accumulated balance of surpluses and deficits incurred in providing goods and services for which they charge fees.

3.56 The Treasury Instructions 2007 also state that government departments must present their memorandum accounts in their statements of intent and annual reports. This disclosure should include a summary of movements in each memorandum account, opening and closing balances, and comparative information.

3.57 Where an entity (whether or not they are a government department) uses memorandum accounts, it is good practice for the entity to:

- Provide a separate line item for each group of fees, based on the legal authority for the fees. For example, information about fees established under separate statutory provisions should have separate memorandum accounts.
- Show in each account an opening balance, the movements during the period, and a closing balance. This will indicate whether over- or under-recovery is occurring.
- Give an explanation of the characteristics of each account, and provide the basis for charging.
- Where over- or under-recovery is occurring, give an explanation of what the entity is doing to smooth year-by-year variations in the fees charged.

3.58 The memorandum account starts with an opening balance and is adjusted each year by the end-of-year surplus or deficit for the fees covered by the memorandum account.
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- Public sector purchases, grants, and gifts: Managing funding arrangements with external parties
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- Guardians of New Zealand Superannuation: Governance and management of the New Zealand Superannuation Fund
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Good practice guide