Stage 2 Cost Recovery Impact Statement

Customs and Excise Bill: Customs valuation rulings: Regulations for cost recovery charge

Agency Disclosure Statement

This Cost Recovery Impact Statement (CRIS) has been prepared by the New Zealand Customs Service (Customs).

It provides an analysis of options for a cost recovery charge for Customs valuation rulings. This is a new service provided for under the Customs and Excise Bill.

The analysis addresses:

- the economic character of valuation rulings in the context of policy objectives
- the level of cost recovery appropriate from partial to full cost recovery
- cost recovery options and a preferred charging structure
- the key cost drivers, assumptions, and revenue and expense alignment
- consultation, likely impacts, and implementation and review.

The following are constraints on the analysis:

- The level and pattern of demand for valuation rulings, and the overall resource intensity per application, is uncertain.

- The effect of rulings on other importers and on the demand for, and cost of, other Customs services, is uncertain.

Anna Cook
Director, Policy [date]
New Zealand Customs Service

Executive summary

Valuation rulings

1 The Customs and Excise Bill (the Bill) provides for a new Customs valuation rulings service.

2 A ruling addresses the application of the law to the applicant's own business arrangements and the import in question. A ruling is very largely for the benefit of an applicant, and is costly to provide. Applicants choose when it is in their interests to receive a ruling.

3 Regulations are required prescribing a charge for rulings, and a time limit within which rulings must be made.

4 This Cost Recovery Impact Statement (CRIS) addresses the charge for rulings. A separate Impact Summary addresses the time limit.

Proposed charges

5 Partial cost recovery is appropriate according to Government's cost recovery guidelines. A ruling is a private good and is largely for the benefit of an applicant. As this is a new service, it is unclear whether there will be any spillover costs of a material nature. However, there will likely be some "learning" for Customs which may result in higher short-term costs.

6 A level of 80 percent cost recovery is proposed. The balance of 20 percent of costs will be met from within Vote Customs. The charging involves: an application fee of $300 (GST inclusive), an hourly charge of $145.60 (GST inclusive), and recovery of any additional agreed actual and reasonable costs. Customs is committed to providing guidance and implementing processes to support the new service.

7 After two years a review of charging will occur.

Status quo

Description of activity and why undertaken

8 A valuation ruling by Customs provides a definitive and binding decision on how Customs considers the valuation methods in Schedule 4 of the Bill should be applied in a particular case. A ruling is specific to the particular facts and circumstances in the application. These details - for example, the importer, its relationship with any related party, and the contract or import transaction – provide the essential facts which underpin a ruling.

9 A valuation ruling removes the risk that Customs will find the value of imported goods in an entry to be incorrect and the associated risk that the importer will face compensatory interest.

Rationale for government intervention

10 Customs has responsibility for overseeing the entry of goods into New Zealand. Valuation rulings provide importers with a further means of meeting their obligations. A small number of countries have a valuation rulings service, and the provision of such a

service has been included in the Comprehensive and Progressive Agreement for Trans-Pacific Partnership text.

11 Support for a valuation rulings service was reinforced in public submissions during the review of the Customs and Excise Act 1996. These submissions were made by interested parties who generally represented importers of high-value consignments subject to duty (mainly tariff and GST). For such importers, a ruling is useful because it makes Customs' view of the duty consequences of a proposed transaction clear before the transaction is entered into.

Statutory authority

12 The Customs and Excise Bill provides for Customs to issue valuation rulings, and for regulations to be made to recover costs and to specify a time limit. The key fee provisions are:

- An application for a valuation ruling must be accompanied by the prescribed fee (if any) and regulations may impose charges for the making of Customs valuation.
- Regulations may prescribe the amounts of the charges or the way they are calculated. Charges may be any of the following: fixed charges, charges based on a scale or an hourly or other unit basis, or charges based on actual and reasonable costs. Regulations prescribing fees or charges may make different provisions for different cases on any differential basis.

New or amended fee?

13 Under regulation 72 the Customs and Excise Regulations 1996 the current fee for a Customs ruling is $40.88 (including GST). These rulings – on the origin of a good, its tariff or excise classification, and whether it is subject to a duty concession - do not include valuation rulings.

14 If, however, the Bill is enacted in its current form, and no new charge or fee is prescribed for valuation rulings, then regulation 72 continues to have effect and the application fee for a Customs valuation ruling will be $40.88 (including GST). This would represent a very low level of cost recovery. To achieve the appropriate level of cost recovery, a new charge needs to be set.

Cost recovery principles and objectives

15 The proposals in this document have been developed in accordance with the mandated Treasury and Controller and Auditor-General guidelines. In particular, Customs has consulted actively and followed an open book process. Close regard has been had to the authority provided by the Bill, an efficient level of charging, and fairness to parties paying for the charge.

Policy Rationale: Why a user charge? What type is best?

Why cost recovery is appropriate

16 Cost recovery is appropriate because:

- A ruling addresses the application of the general law to the applicant's own particular (unique) business arrangements and the commercial proposal (import) in question.
- A ruling is very largely for the benefit of an applicant, and can involve significant costs. Despite this, the benefits of a ruling can also be significant, making a ruling worthwhile. These may reflect wider strategic or global business objectives.
- The provision of the new service is designed to meet potential business demand. Applicants choose when it is in their interests to receive a ruling.

Nature of output

What is a ruling?

17 A valuation ruling provides a binding Customs decision on how to apply the valuation methods in Schedule 4 of the Bill in a particular case. A ruling is specific to the particular facts and circumstances (eg the importer and its relationship with any related parties, contract and import details). A ruling is sought at the election of the applicant. Advance knowledge of Customs' view can be worthwhile; it enables an importer to avoid the risk of getting the valuation wrong and having to pay, for example, a higher duty value and compensatory interest.

Economic characteristics

18 A valuation ruling is excludable (other people cannot use it) and rivalrous (it is specific to the person it was generated for). It is only useful to, and is for the sole use of, the party for whom it was provided. In these respects, a ruling is similar to a passport or a permit.

Merit goods and externalities

19 Where the production of a good generates benefits to other parties (who cannot be prevented from enjoying those benefits) such goods are said to involve positive externalities. A merit good has the property that the community as a whole desires the higher use of the good than would be likely if it were charged for at full cost. That desired higher use reflects the fact that full cost recovery leads to lower output and hence lower benefits for the community.

20 It follows that a valuation ruling is:

- a private good if there are no positive externalities - and should be subject to full cost recovery, or
- a merit good if there are positive externalities - and should be subject to partial cost recovery.

Possible externalities generated by valuation rulings

21 Potential benefits to other parties could include:

- better general knowledge of how Customs applies the legislated valuation methodologies, leading to greater compliance by importers, and greater assurance about duty collection

- general benefits for trade facilitation and trade agreement negotiation due to Customs providing a more complete and sophisticated set of services which are being used actively

- fewer disputes with benefits (lower costs) for Customs, importers, and the legal or justice sector

- benefits for Customs as a result of earlier information (for risk assessment), more accurate entries (lower audit costs), and a reduction in free-of-charge services (at the margin, rulings will substitute for valuation advice).

Evidence of externalities and policy considerations

22 Externality arguments for partial cost recovery should have an evidential foundation as far as possible. There should be a high degree of certainty and materiality to justify the use of externalities to justify partial cost recovery in the case of private goods.

23 The valuation ruling service is new, and there is no history or record of externalities. The new service is an addition to current import entry processes and systems characterised by:

- valuation rules/methods that conform internationally
- strong incentives for voluntary compliance
- the availability of commercial advice, as well as Customs' guidance and advice
- appeal mechanisms that are robust (with relatively few disputes)
- a reasonably high degree of confidence in duty collection.

24 In this context, Customs remains to be persuaded that there are significant spillover benefits to other parties justifying partial cost recovery on a long-term basis.

25 On the other hand, Customs considers there is a policy consideration which supports partial cost recovery at least initially:

- The new service will likely take time to reach full efficiency, and will be reliant on early applications to facilitate its establishment and development. For this reason, it may not be fair for early applicants to bear the initial full costs where these are higher than longer term costs - and where these could stifle uptake and undermine the viability/success of the service.

Full or partial cost recovery?

26 The key points in the discussion above are tabled in **Annex 1**.

27 Valuation rulings are specific to the factual situation of the importer, and to the importation in question. Accordingly, valuation rulings are solely for the use and benefit of the party for whom they are made. As a result, such rulings are "excludable" and "rivalrous" as those terms are applied in the Treasury guidelines. Such rulings meet the test of being a "private good" with the implication that full cost recovery is appropriate in the absence of significant countervailing factors.

28 In summary, Customs considers it appropriate to charge partial cost recovery for valuation rulings up until the first review in two years time. Whether there are clear and

material spillover benefits to other importers, and reduced costs to Customs, can be considered at that time.

Design of cost recovery

29 **Annex 2** addresses the design features or options for partial cost recovery for valuation rulings. In brief, it is proposed that an hourly charge would be payable by the applicant for a valuation ruling. The hourly charge would be based on the full costs to Customs (direct and indirect) of providing valuation rulings. It is proposed that this charge would be supplemented by the recovery of any additional actual and reasonable costs (agreed with the applicant) where these need to be incurred. An application fee would also be required to accompany an application. The application fee would be deducted from the later cost recovery charges invoiced to the applicant, because they would have already paid the application fee.

Assessment of proposed user charge against objectives

30 The proposed partial cost recovery approach supports the objectives for the new service discussed above. In summary, the two principal strengths of the proposed charge are that:

- It matches demand and resourcing (fostering high service performance).
- It results in those benefiting from the service meeting the costs of the service (which promotes fairness or equity in voluntary compliance).

31 There are also challenges:

- Valuation rulings are costly, and it may be difficult to significantly reduce the cost of rulings over time. This makes them affordable only in specific situations where more significant transactions are involved, and where the benefits are proportionate.
- It appears uncommon internationally for customs authorities to seek full cost recovery for valuation rulings. On the other hand, there are no international rules governing cost recovery in this area, and differences in international practice may simply reflect differences in cost recovery policy.

The level of the proposed fee and its cost components (cost recovery model)

Proposed charge levels

32 Partial cost recovery is proposed as follows:

- *A non-refundable application fee of $300 (GST inclusive)*. This fee would be required to accompany applications. This amount would be taken into account in later invoicing for the cost of making the ruling (as below).
- *An hourly charge of $145.60 (GST inclusive)* per FTE hour spent by Customs in making the ruling.
- *The full recovery of any additional actual and reasonable costs*. This covers the risk that an application requires the commitment of additional resources that would not

be efficient to recover via the hourly charge. Where this provision applies, the likely costs would be agreed with the applicant.

- *Recovery from applicants of 80 percent of the total cost to Customs of making the ruling*. The balance of 20 percent of total cost would be met within Vote Customs.
- If applications are withdrawn before a ruling is made, the applicant would be charged for the costs incurred by Customs up until Customs has received notification of the withdrawal.
- GST does not apply to the fee and charge where the service is zero-rated, as in the case of non-resident applicants.

Cost drivers and business activities

33 **Annex 3** describes the cost allocation methodology used by Customs. **Annex 4** provides a summary of the cost drivers and cost calculations for valuation rulings, together with the key assumptions and metrics. For illustrative costing purposes, it is assumed that the first full year of the regime is 2018/19.

34 The cost drivers and business activities are determined by an assessment of the following factors:

Demand for rulings**: **number and type of applications

35 Demand is externally driven, and it significantly affects the total resources (staff and other costs) required. It affects primarily issues of scale and flexibility - ensuring that there is sufficient capability and capacity to operate efficiently.

36 The following factors make it difficult to estimate demand, and how demand may vary over time:

- Valuation rulings are a new service introduced by the Bill, so there is no history or pattern of demand to consider.
- Demand will be affected by the costs applicants face. There is inherent uncertainty on costs until policy settings have been finalised and there is information available on the track record of Customs in making rulings.
- There is uncertainty over the split between the much more complex applications and low/medium complexity applications.
- It is unclear the extent to which applicants who would otherwise have sought valuation advice will instead seek valuation rulings. A ruling is a different product than advice (a ruling provides certainty and is binding for three years), but in some cases valuation advice will provide sufficient assurance for an importer’s situation and purpose so the two products are substitutable to some extent.

37 Feedback from consultation with industry suggests that demand initially may be very low for highly complex valuation rulings. On the other hand, there may be a much higher level of demand for rulings where they are straightforward and can be made quickly and hence at low cost.

38 For initial planning purposes Customs estimates (using figures supplied by industry) that there will be two complex ruling applications each year in the first three years, and

53, 58, and 64 standard (or much less complex) ruling applications over the same period.

The work involved, and the hours per application

Business activities

39 While valuation rulings are a new service, the type of the work involved in making a ruling (especially issues of valuation methodology) is not all new to Customs. This is because Customs currently provides general guidance and non-binding advice on such valuation matters.

40 Unlike valuation advice, however, rulings will be subject to a range of additional requirements including: a time limit for the making of the ruling, be binding on Customs for three years, and involve (as proposed) a material level of cost recovery.

41 As a result, the work involved will differ from that involved in advice. For example, relative to valuation advice, valuation rulings will require additional process management, quality and legal assurance, and administrative/financial management.

Average FTE hours per application

42 The average FTE hours per application is a significant determinant of cost and a key productivity factor. Moreover, it is a factor within the control of Customs, although there are ultimate limits on the extent to which hours per application can be reduced. Where reductions are possible, however, this will have a direct impact on the cost per application and the cost/benefit threshold.

43 Customs has estimated that on average a ruling will require, across all of the staff time involved in making a ruling, 457 FTE hours for a complex application, and 120 hours for a standard application.

44 Feedback from consultation with industry suggests that applicants will be looking for guidance to ensure that their applications are presented in a form which will enable Customs to make rulings as expeditiously as possible.

Average hourly cost

45 To estimate the likely average full cost per FTE hour it is necessary to consider:

Skill levels and skill mix

46 In general, the skills and processes involved in making a valuation ruling will be similar to those involved in making other rulings which Customs currently provides. The main difference is that valuation rulings have the potential to be much more complex on average. This means applications will take longer to research, analyse, evaluate and rule on, and will typically require a higher skill/experience level to meet the required standards of quality and timeliness.

47 The critical skills required to evaluate a valuation ruling application and to make a valuation ruling correspond most closely with commercial law skills (including company, contract, and customs law).

48 In summary, the weighted average skill mix is as follows:

- complex application: Senior Customs Officer level 2 (388.5 hours) and senior legal counsel (68.5 hours) per application

- standard application: Senior Customs Officer level 2 (100 hours) and senior legal counsel (20 hours) per application.

Calculation of hourly charge-out rate

49 For Customs, the annual chargeable hours per FTE is 1,382.

50 As highlighted in Annex 4, the hourly charge-out rate reflects the total hours involved in making the estimated number of rulings, and the cost.

51 Remuneration costs include an annual inflation adjustment of 2 percent based on the relevant collective agreement provisions for Customs staff.

52 Other direct and indirect costs must be added to remuneration costs in order to arrive at total costs. According to Customs current cost allocation methodology, remuneration costs multiplied by 1.85 equals total costs.

53 This results in an average hourly charge of $145.60 (GST inclusive) for valuation rulings over the three-year period. This reflects total costs divided by chargeable hours, plus GST of 15 percent.

Forecast revenue and expenses for valuation rulings

54 The figures in Table 1 below show that revenue and expenses are reasonably aligned because the balance is close to zero by the end of the third year:

Table 1	***2018/19***	***2019/20***	***2020/21***
		(GST exclusive)	
Total revenue	**$ 921,202**	**$ 997,188**	**$ 1,088,371**
Total applicants (80%)	*$ 736,962*	*$ 797,750*	*$ 870,697*
Total Crown (20%)	*$ 184,240*	*$ 199,438*	*$ 217,674*
Total expenses	**$ 903,003**	**$ 997,057**	**$ 1,110,015**
Total applicants (80%)	*$ 722,402*	*$ 797,646*	*$ 888,012*
Total Crown (20%)	*$ 180,601*	*$ 199,411*	*$ 222,003*
Cumulative Balance	**$ 18,199**	**$ 18,330**	- **$ 3,314**

Impact of assumptions on financial estimates (sensitivity analysis)

55 The critical assumptions relate to the demand for valuation rulings and the average FTE hours per application. The hourly charge-out rate is likely to be stable, and not vary significantly under alternative demand scenarios.

Key financial estimates and metrics are:

- The average total cost (GST exclusive) per complex ruling in 2018/19 is about $57,000, and per standard ruling about $15,000. The increase to about $59,000 and $15,500, respectively, by 2020/21 reflects annual 2 percent collective agreement remuneration inflation adjustments.
- The staff required by 2020 is about two-thirds of an FTE for complex rulings, and five and a half FTEs for standard rulings. (The FTE impact is about one-third of an FTE per complex ruling, and just under one-tenth of an FTE per standard ruling.)
- Cost/benefit thresholds (see Annex 4) provide specific examples to illustrate the effects required to make a ruling worthwhile.

Impact analysis

Number of people and businesses affected

56 Valuation rulings (as opposed to non-binding valuation advice) are expected to be sought by a very small number of businesses. In general, those businesses are likely to be large and to be a part of, or related to, larger global enterprises and company networks. It is difficult to quantify the impact beyond the number of applications which have been estimated.

Impacts on importers

57 The provision of valuation rulings will be a new Customs service:

- The availability of a valuation ruling provides an additional means for importers to satisfy the import entry requirements for goods.
- It also provides larger businesses with an additional means of managing or optimising international business arrangements.

58 It is up to the importer to seek a ruling, and rulings will be sought where applicants consider a ruling to be in their best interests (weighing up the costs and benefits). The benefits include assurance that Customs will accept import values for Customs purposes. The benefits will often extend - beyond immediate goods importation issues - to wider strategic or global business objectives.

59 A ruling can involve significant costs in total. Despite this, for some corporates and multinationals the benefits of a ruling can be correspondingly large and make a ruling worthwhile.

60 It will not always be efficient for an importer to seek a ruling even if the ruling is provided efficiently and at minimum cost. There is a cost/benefit threshold which a potential applicant must assess. While certainty is a desirable goal it can be expensive to achieve, and may not always be worth the expense relative to other options. In some cases, advice rather than a binding ruling might be sufficient. Customs proposes to strengthen its guidance and advisory services.

61 The proposed full cost hourly charge will make the cost of obtaining a ruling transparent and enable importers to make informed decisions about the merit of obtaining a ruling.

Impacts and risks for Customs (and the Crown)

New service risks

62 The key risks for Customs relate to demand uncertainty and ensuring the capability to make robust and fit-for-purpose valuation rulings within the prescribed timeframe. A full cost recovery hourly charge together with a provision for the recovery of any additional actual and reasonable expenses, are key elements in managing such risks.

Revenue risks

63 There are no revenue risks.

Effects on demand for services

64 It is difficult to assess the impact of full cost recovery valuation rulings on the demand for other advice products. At the margin, an applicant for a ruling may have sought non-binding advice had a valuation ruling not been available. This will decrease demand for such advice products. On the other hand, the advent of valuation rulings could increase demand for other customs guidance and advice (eg pre-application meetings, non-binding advice for businesses for whom it is not cost-effective to obtain a formal ruling).

Cost recovery comparisons

Inland Revenue (IR) rulings

65 IR currently charges an application fee of $280 (plus GST if any) and an hourly charge of $140 (plus GST if any) for private rulings. IR is also able to recover any additional actual and reasonable costs from the applicant.

66 This fee structure is similar to that being proposed for Customs valuation rulings. IR ruling fees are currently under review.

Targeted consultation

67 Interested parties consulted included: Blackburn Croft & Co, Chartered Accountants Australia New Zealand Limited, Customs Brokers and Freight Forwarders Federation of New Zealand Inc, Deloitte, Ernst & Young, Fonterra, Gull New Zealand Limited, KPMG, New Zealand Food and Grocery Council, PwC, and Russell McVeigh. Consultation included discussion of this CRIS and earlier drafts.

68 Customs included information on the consultation process in Customs Release (Issue 406 of 19 May 2017), a weekly news release to importers, exporters, and travellers. There are an estimated 1,300 subscribers to this service. Consultation included discussion of earlier drafts of this CRIS.

Industry feedback

69 Key points raised during industry consultation were:

- Some applications will be much more complex with corresponding resource implications.
- It is difficult to predict the likely level of demand, which could be low or very low initially for complex applications.

- Low-cost applicants should not subsidise high-cost applicants.
- Enhanced advice and guidance services would be useful, for smaller importers especially.
- Partial cost recovery should be preferred over full cost recovery given the perceived potential for wider benefits (for other importers, and for Customs) from valuation rulings.
- The number of hours spent by Customs in making a ruling is a material driver of cost, and, beyond some level of cost, some rulings will not be affordable.

Review of options in response to feedback

Possible two-tier charging approach

70 Customs considered whether there might be two tiers of hourly charges to take account of differences in complexity. Where complexity impacts on the number of FTE hours involved, this is addressed satisfactorily through an hourly charge. Where, however, complexity impacts on the skill level required (ie, a higher hourly charge) differential hourly charges might be required.

71 There is insufficient evidence at this stage to justify a differential charge. A two-tier approach can be addressed as part of the first review of charges.

Additional guidance

72 Industry suggested a need for small and medium businesses to have access to enhanced guidance on valuation issues, including general as well as more targeted advice. Such assistance could include, for example, pre-application discussions on rulings, and non-binding or indicative advice (similar to IR).

73 It will not always be efficient for an importer to seek a ruling even if it is provided efficiently or at a low cost. In other words, while certainty is a desirable goal it can in some cases be expensive to achieve and may not always be worth it. Customs is committed to providing the necessary guidance materials and processes to support the new regime.

Partial cost recovery

74 Customs recommends partial cost recovery for the initial two years.

Conclusions and recommendations

75 Based on the available information, Customs considers partial cost recovery (80 percent cost recovery) to be appropriate initially. A ruling is largely for the benefit of an applicant. Customs would be able to manage its 20 percent share of additional costs of about $200,000 per annum within Vote Customs (given demand and costing estimates).

76 An hourly charge for valuation rulings, and recovery of any additional actual and reasonable costs, is proposed. The proposed hourly charge is $145.60 (GST inclusive). An application fee of $300 (GST inclusive) is also proposed.

77 Customs will provide the necessary guidance and put in place processes to support the new rulings service. These include managing demand uncertainty and developing expert and flexible capability to deliver the service.

78 A key challenge for Customs is to contain the number of hours per ruling, which is the major cost driver. Efficiency in this context also means ensuring that the resource effort is proportionate and is fit for purpose (given the level of risk).

79 The valuation ruling hourly charge and the level of cost recovery will be reviewed two years after introduction. This will enable the results of Customs' updated activity costing, evidence of the demand, any spillover benefits, and the costs of rulings to be taken into account in the setting of charges.

Implementation plan

Implementation and transitional arrangements

80 The valuation rulings service will begin when the Bill commences. Customs has undertaken a range of preparatory and implementation tasks to ensure the service will be ready to receive applications and make rulings from this time.

81 There are no material transitional issues.

Mitigating implementation risks

82 A range of implementation risks need to be managed relating to demand, processes, guidance, resources, capability, training and systems.

83 Allocating existing and new staff across the existing and new business processes will need to be undertaken in preparation for the new service. This is not considered to materially affect the currently assessed cost per hour of the resources required to undertake valuation rulings.

84 The uncontrollable factors which give rise to uncertainty – level and pattern of demand, application completeness, complexity – impact primarily on:

- the scale and total revenue/costs of the valuation rulings service, and
- how those uncertainties are managed operationally (eg the extent to which full-time staff are employed or specialist skills are contracted in to manage peaks).

85 Customs is working through these and other implementation issues which are being mapped and discussed with internal and external stakeholders. This engagement process includes workshops to share information, identify issues and test thinking relating to the development of guidelines for industry, financial management aspects, reporting to stakeholders, and the development of organisational performance measures.

Minimising compliance costs

86 Valuation rulings provide business with an additional means of complying with their obligations, and assist their decision making. Rulings are not mandatory, and they do not impose unavoidable costs on business. Valuation rulings may be sought by applicants when they consider a ruling is cost-effective.

87 Where rulings are sought, Customs will aim to minimise compliance costs for business by: providing clear guidance to business, encouraging business to submit complete, professionally-prepared and well-reasoned applications, and making rulings within reasonable timeframes.

Interaction with other regulations

88 A separate Impact Summary addresses the time limit for making a valuation ruling which will be prescribed in regulations. There are no significant interactions with other regulations.

Link with enforcement strategy

89 There are no implications.

Monitoring and evaluation

Monitoring

90 A memorandum account or similar mechanism will be set up to facilitate the financial monitoring of the valuation rulings service. (A memorandum account must be used where there is full cost recovery, so is not strictly required here.)

Benchmarking and evaluating

91 Customs will develop standards to measure performance for both management purposes and for assurance to external stakeholders.

Review

92 A review of the application fee and hourly charge will occur after two years. This will enable the results of Customs' updated activity costing, evidence of the demand, any spillover benefits, and the costs of rulings to be taken into account in the setting of charges. As part of this review, Customs will also consider whether the charging approach has had any particular impacts on small or new businesses.

Annex 1: Summary of factors supporting partial or full cost recovery

Supports ✓ Does not support × Unclear ?

Key questions	**Conclusion and reason**	**Full cost recovery**	**Partial cost recovery**
Excludable?	Yes. Other parties are excluded from using a ruling at low or zero cost.	✓	×
Rivalrous?	Yes. A ruling is only useful to the party for whom it was made.	✓	×
Externalities?	Unclear. A ruling may potentially generate externalities justifying partial cost recovery. This will be assessed at the two-year review based on evidence on the effects of the rulings made.	?	?
Policy considerations?	Yes. The new service is being implemented in the face of a range of uncertainties: demand, sensitivity of demand to cost, potential cost reductions over time. Significant cost recovery in this area is not usual internationally, suggesting a cautious approach. There are precedents for not charging full cost during the introduction of new services (eg custom food control plans under the Food Act 2014).	X	✓
Benefits outweigh costs for users?	Yes. Rulings are elective, not mandatory. A ruling gives applicants an additional means of meeting compliance obligations. They will seek rulings when benefits exceed costs. There are no unavoidable compliance costs.	✓	×
Temporary or incidental service only?	No. The service would be ongoing. There is no reason in this case for applicants to bear incremental costs only, and not to bear the appropriate share of fixed costs. This suggests full rather than partial cost recovery is appropriate.	✓	×

Annex 2: Summary of design options for cost recovery charge

Design feature	Comment
Application fee? Yes $300 (incl.GST)	The receipt of an application fee is a useful part of formally recognising that an application has been made. It also discourages frivolous applications. The amount should be more than trivial, but not high. A fee of $300 (including GST) is indicated. This will be deducted from the cost recovery charges in invoicing.
Single fixed charge? No	A single fixed charge would need to be set at the average cost of all valuation ruling applications. This approach would likely result in few applicants bearing the true cost of their applications. High-cost applicants would be subsidised by low-cost applicants.
Differential fixed charges? No	This option is a variant of the previous option: instead of a single fixed charge there would be two or more fixed charges. This approach has the potential to result in applicants' bearing costs closer to the true costs of their applications. However, applications cannot be placed into distinct cost types.
Single hourly charge? Yes $145.60 (incl. GST)	In order to recover correct costs, a single hourly charge would need to be set at the average cost per hour for all valuation ruling applications. An hourly charge of $145.60 (including GST) would be involved. Such a charge will reflect the true costs of making a ruling. An exception will be where an application entails extraordinary or additional costs not included in the standard hourly charge.
Differential hourly charges? No	This option is a variant of the previous option: instead of a single fixed charge there would be two or more fixed charges. This would have merit where a higher cost per hour is involved in some application types. There is insufficient evidence, however, to support this approach. It can be reconsidered during the first review after two years.
Actual and reasonable costs? Yes	This option allows for cost recovery of any extraordinary or additional costs associated with an application not covered in the standard hourly charge. In this way, full costs could be recovered. It is expected that such costs would not arise often, and would be discussed and agreed in advance with an applicant.
Cap on costs? No	This option would allow costs under the preferred cost recovery arrangement to be recovered up to a specified maximum. This provides certainty to applicants as to the highest level of cost they would face. This would not be consistent, however, with applicants bearing the appropriate share of the costs of their applications, or be necessary where the total benefits for applicants are greater than the total costs.
Refund if withdrawal? No	This option would not be consistent with applicants bearing appropriate costs. Instead, costs would count for recovery purposes up until the time Customs receives notice of an application's withdrawal.

Annex 3: Summary of costing of outputs and allocation methodology

Costing policy

As a part of its cost accounting policies, the New Zealand Customs Service (Customs) uses a cost allocation system to determine the costs of outputs.

The objective is to ensure that Customs is able to calculate the costs of its outputs in compliance with Treasury guidelines, legislative requirements, and generally accepted cost accounting principles.

Costing of outputs

Outputs represent the various services or activities which Customs provides and undertakes. These can be described:

- at the most aggregated or strategic level (eg Customs controls the border), or at a very aggregated level (eg Customs protects New Zealand from harm and collects revenue)

- at a more disaggregated level in terms of the specific activities or particular functional areas (eg clearing goods, clearing passengers)

- at the most disaggregated level where the activities represent individual cost centres or objects to which the costs of those activities are allocated.

Cost centres and total costs

Cost centres are useful for internal budget and management purposes. They are also useful for external reporting on cost recovery. The total costs of an output include all direct and indirect costs (including non-cash costs such as depreciation).

- **Direct costs** are charged directly to significant activities. Direct costs are those costs which can directly or appropriately be attributed to an output because the benefits might be limited to the particular output, or the costs might be controlled at the level of the cost centre. These costs can include depreciation and occupancy costs (eg where a particular building or vehicle may be required for the exclusive benefit of a particular team or cost centre).

- **Indirect costs** are charged to significant activities based on cost drivers and related activity/usage information. Indirect costs are those costs that cannot be identified in an economically feasible manner with a specific output. Here, the expenditure benefits more than one output or cost centre, and the expenditure is controlled by a corporate or broader operational group which is responsible for many outputs. For example the salary of a chief executive is a cost which is incurred, for the most part, for the benefit of all outputs within an organisation.

Calculation of total costs

Under the current cost allocation methodology, the ratio of direct staff remuneration costs for valuation rulings work to the total additional costs to Customs of this work, is 1 : 0.85. Thus, the total cost is calculated by multiplying direct remuneration cost by 1.85 as in Annex 4.

Planned update of activity costing

Customs is currently reviewing and seeking to upgrade its costing methodology. This will ensure that the methodology continues to be in accordance with the required standards, and is also able to fully support the higher expectations associated with operating significant cost recovery regimes (for which very detailed costing information is now required).

This work is at an early stage and is expected to be completed within the next 12 to 18 months, and will be available to inform the review of valuation rulings cost recovery after two years from implementation.

Implications of upgrade for costs of valuation rulings

Although it is clear that the upgrade will result in some change to the ways in which cost allocation operates within Customs, it is harder at this stage to indicate what the specific implications are likely to be for the future costing for valuation rulings.

The key issue is the extent to which direct and indirect costs of valuation rulings will be affected as a result of methodology changes. It is possible, for example, that some costs currently allocated organisation-wide will in future be allocated more narrowly and more specifically to some centres.

Whether, as a result, lower or higher costs are allocated to valuation rulings, remains to be seen. Although the valuation ruling work involves few specialist assets relative to other parts of Customs (a possible reduction in costs), it may require more corporate services in the future (eg financial, IT, legal) associated with managing cost recovery for valuation rulings (a possible increase in costs). The net effect should be apparent by the time of the first review of valuation rulings.

Note on use of GST

GST *inclusive* figures are used for the proposed hourly charge of $145.60 and the application fee of $300. The provision by Customs of valuation rulings involves a taxable supply for GST purposes. GST does not apply to the fee and charge where the service is zero-rated, as in the case of non-resident applicants.

GST *exclusive* figures are generally used to illustrate the net cost impacts since GST will typically be neutral for resident businesses seeking valuation rulings. The GST they pay to Customs for rulings will be able to be credited against the GST they collect (on their taxable supplies of goods and services to other businesses and consumers) and pay to Inland Revenue.

Annex 4: Calculation of hourly charge for valuation rulings (including cost drivers, costs, assumptions, key metrics)

		2018/19	2019/20	2020/21
Demand (number of ruling applications)				
Complex		2	2	2
Standard		53	58	64
FTE hours (average per application)				
Complex	(@ 457 hrs /application)	914	914	914
Standard	(@ 120 hrs /application)	6360	6960	7680
Total		7274	7874	8594
Total cost (including overheads)				
Customs officers		$ 739,268	$ 816,095	$ 908,356
Legal staff		$ 163,735	$ 180,962	$ 201,659
Total		$ 903,003	$ 997,057	$ 1,110,015
Total hourly cost	average			
GST exclusive	$126.60	$ 124.14	$ 126.63	$ 129.16
GST inclusive	$145.60	$ 142.76	$ 145.62	$ 148.54
Average total cost per ruling (GST excl)				
complex		$ 56,733	$ 57,868	$ 59,027
standard		$ 14,897	$ 15,195	$ 15,499
Average cost to importer per ruling				
(@ 80% cost recovery; GST excl)				
complex		$ 45,386	$ 46,295	$ 47,221
standard		$ 11,918	$ 12,156	$ 12,400
Net cost to Vote Customs		$ 180,601	$ 199,411	$ 222,003
(@ 80% cost recovery; GST excl)				
Examples of cost/benefit threshold				
(Reduction in Customs value necessary to reduce tariff duty or GST cost* to cover cost of ruling)				
complex	5% tariff duty	$ 907,720	$ 925,900	$ 944,420
	10% tariff duty	$ 453,860	$ 462,950	$ 472,210
	15% GST*	$ 44,171,290	$ 45,055,961	$ 45,957,178
standard	5% tariff duty	$ 238,360	$ 243,120	$ 248,000
	10% tariff duty	$ 119,180	$ 121,560	$ 124,000
	15% GST*	$ 11,599,027	$ 11,830,657	$ 12,068,127

* GST is neutral where there is a matching between GST payments and credits. However, where there is a credit delay, GST imposes an interest cost. It is assumed the mismatch is one month, the interest rate is, say, 8.22% (ie, first mortgage rate plus 2.5%), and GST is 15%.