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ABC Model and Pricing Model

Methodology Review and Assumptions Testing

New Zealand Customs Service

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Mr Kevin Martin

New Zealand Customs Service
The Customhouse
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Wellington, 6011

28 January 2019

Fee setting methodology and assumptions testing

Dear Kevin

In accordance with the terms of reference dated 12 December 2018, we attach our draft report on our assumptions testing and methodology review for the activity based costing and pricing model.

Thank you for your feedback on the draft report which we have taken into consideration. Please contact us if you would like to discuss any aspect of this final report.

Our report should be read in conjunction with the important notice set out in Appendix A.

Yours sincerely

PricewaterhouseCoopers Consulting (New Zealand)

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Executive summary

The New Zealand Customs Service (Customs) is updating its cost recovery framework in order to provide a clear and transparent basis for recovering costs from users. This framework looks to build on work Customs has undertaken over the past year to develop a detailed understanding of the costs of delivering its services and the drivers of those costs.

We have been asked to:

- Review the Activity Based Costing (ABC) and pricing methodology against best practice guidance and government guidance – contained within the Treasury Guidelines and OAG Good Practice Guide.
- Test assumptions used within the ABC and pricing models' and the consistency of those assumptions with the defined ABC methodology.

The scope of this review is limited to the end-to-end process of calculating user charges – as outlined in two documents prepared by Customs – *ABC Costing Methodology* (ABC methodology) and *Pricing and Fee Setting Methodology for Cost Recovery* (Pricing methodology) documents. It does not look at the wider process of undertaking a fee review.

We have not tested any models or calculations undertaken in developing the ABC costing activities, nor have we tested the pricing model and calculations. As a result, this report does not provide a comment on the validity and accuracy of any specific costing or pricing outputs from the model prepared by Customs.

Methodology review

Customs have undertaken a comprehensive activity based costing exercise, adopting a detailed bottom up approach to developing a view of the specific cost of activities. Significant effort has been spent to understand the cost drivers for individual activities, and Customs have implemented systems and processes that enable it to update cost profiles in an efficient manner. This detailed bottom up approach to costing with targeted cost drivers is consistent with ABC best practices. In addition, the cascade approach to allocating Corporate Services costs is logical, and in line with similar approaches undertaken in other government agencies.

We have assessed the methodologies against a best practice framework comprised of six main principles – Equity, Efficiency, Effectiveness, Authority, Accountability and Consultation. This framework has been distilled from the Customs and Excise Act 2018 (the legislation), government guidance, and ABC methodologies best practice.

When developing costing and/or pricing methodologies there are inherent trade-offs that need to be made between these principles. For example, a comprehensive detailed costing methodology improves accuracy of attributing costs (Effectiveness), but can create transparency issues for external stakeholders not familiar with the process (Accountability). Where trade-offs have had to be made, the stance that Customs has taken has been worked through in a logical and defensible manner.

Assumptions testing

We have assessed the assumptions underpinning the costing and pricing approach.

For the ABC, the key assumptions relate to the selection of cost drivers that have a direct impact on the allocation of costs across operating activities. Due to the level of detail contained in the ABC system, and the inherent knowledge required to understand individual activities across Customs, we have relied on a high-level 'sense check' of the driver assumptions used and tested these with key Customs staff. The nature of the drivers in relation to the operational activities, and the manner in which these drivers were identified and attributed was logical and not unreasonable.

Assumptions underpinning the pricing methodology relate to how costs are grouped into fee groups, and subsequently pathways, the choice and use of data underpinning the fee, and cost and volume growth projections. Based on discussions with Customs staff, the attribution of costs into fee groups was performed on an item by item basis and agreed with key internal stakeholders. The basis for determining the individual user fee has remained consistent with the previous fee review and is based on internal data.

For projection purposes, where possible Customs have relied on externally sourced analysis, such as MBIE data, in the first instance. Where this information is not available, Customs have relied on historic internal data and used statistical modelling to project the future assumptions. This is a reasonable approach to determining future volumes for pricing purposes. It should be noted, we have not reviewed the statistical model as this was out of scope.

Conclusions and observations

The approach Customs has undertaken to ABC and pricing is comprehensive and based on sound logic and reasoning. Where trade-offs have had to be made between the best practice principles and guidance, Customs have provided us with a justification that is defensible and not unreasonable.

We have not highlighted any recommendations for improvements. Any potential changes would primarily be related to a trade-off decision that has been made between underlying principles. Those trades-offs we did provide commentary on did not raise significant concerns.

We have noted that while the present approach appears sound, and processes have been put in place to manage costing going forward, for some cost categories, such as depreciation, it will be essential that these processes are embedded and operating effectively in future years to minimise potential inconsistencies and misalignment of costs in the future.

Background

Context

Customs role is to protect and promote New Zealand through world-class border management. Its primary purpose is to stop any dangers, hazards or threats from entering New Zealand. Under the Customs and Excise Act 2018, Customs also has the authority to recover costs relating to the importation and exportation of goods.

Customs is currently reviewing its cost recovery framework in order to provide a clearer basis to explain and justify charges to users. Customs is also considering moving from its current partial cost recovery approach to a full cost recovery approach. As part of this review, Customs has developed a principles based Cost Recovery Framework, a comprehensive service-costing model (the ABC model) and a pricing model (the pricing model).

Through an independent review, Customs wants to gain comfort that the ABC pricing models' methodology and assumptions are reasonable and in line with best practice principles and guidance.

Activity based costing and price setting methodology

Pricing and fee setting within a government context is fundamentally about adopting an approach that aligns and attributes delivery costs of an agency to the services/outputs that it is responsible for. These costs are used to allocate a charge to users that reflects the costs of delivering individual services in a transparent manner.

There are broadly two cost types that need to be considered within any costing/pricing methodology.

- Direct costs – costs that are specifically incurred in delivering the individual service/output.
- Indirect costs – costs that are 'shared' across the agency between individual services in delivering its activities. These may be either a core need to deliver activities, such as IT expenditure, or a general cost for the organisation to operate that does not directly impact on activities, such as audit expenditure.

From a cost allocation perspective, direct costs have a clear causal link to services. As long as the underlying links are accurate, this is a simple matching exercise. For indirect costs, there is a greater need to understand cost drivers and provide transparency over how these costs have been allocated. Decisions made on the cost allocation drivers used must also be understood to ensure that the end charge is fair and reasonable.

Scope of work

There are three potential elements to undertaking a costing methodology and/or pricing and fee review.

1. Methodology review – review the broad approach and thinking/theory underpinning how an agency will allocate costs and price services/outputs against best practices.
2. Assumptions testing – testing the specific assumptions used, such as growth and allocation drivers, against the methodology.
3. Model testing – testing the specific costing/pricing models to assess the logic of the modelling against the proposed methodology, identify potential calculation errors within the modelling, and test that the assumptions used flow through correctly into the intended results.

For the purposes of this engagement, Customs has requested PwC to focus on the first two review elements and:

- review the ABC and pricing methodology against best practice guidance and government guidance – contained within the Treasury Guidelines and OAG Good Practice Guide.
- test the ABC and pricing models' assumptions and the consistency of those assumptions with the defined ABC methodology.

We have not tested any models or calculations undertaken in developing the ABC costing activities, nor have we tested the pricing model and calculations. As a result, this report does not provide a comment on the validity and accuracy of any specific costing or pricing outputs from the model prepared by Customs.

Approach

We have reviewed the ABC methodology and the Pricing methodology documents. We have also conducted multiple meetings with the teams in charge of these models to get a more thorough understanding of their processes, and tested specific decisions made around potential approaches. This has included collecting additional information prepared by wider teams, such as the volume forecasting methodology.

Limitations

This report has been prepared solely for the purposes stated herein and should not be relied upon for any other purpose. We accept no liability to any party should it be used for any purpose other than that for which it was prepared.

This report is strictly confidential and (save to the extent required by applicable law and/or regulation) must not be released to any third party without our express written consent which is at our sole discretion. This consent would not be unreasonably withheld and would be granted in a timely manner.

To the fullest extent permitted by law, PwC accepts no duty of care to any third party in connection with the provision of this report and/or any related information or explanation (together, the "Information"). Accordingly, regardless of the form of action, whether in contract, tort (including without limitation, negligence) or otherwise, and to the extent permitted by applicable law, PwC accepts no liability of any kind to any third party and disclaims all responsibility for the consequences of any third party acting or refraining to act in reliance on the Information.

PwC has not independently verified the accuracy of information provided to us, and have not conducted any form of audit in respect of the organisation for which work is completed. Accordingly, we express no opinion on the reliability, accuracy, or completeness of the information provided to us and upon which PwC has relied.

The statements and opinions expressed herein have been made in good faith, and on the basis that all information relied upon is true and accurate in all material respects, and not misleading by reason of omission or otherwise.

The statements and opinions expressed in this report are based on information available as at the date of the report.

We reserve the right, but will be under no obligation, to review or amend our report, if any additional information, which was in existence on the date of this report was not brought to our attention, or subsequently comes to light.

This report is issued pursuant to the terms and conditions set out in the Consultancy Services Order dated 12 December 2018.

Best practice fee setting

Best practice fee setting encompasses:

- complying with the relevant empowering legislation and regulations
- aligning with published guidance on charging within the public sector, in particular: The Treasury's guidelines for setting charges in the public sector (the Treasury's Guidelines)[1], and the Office of the Controller and Auditor-General's charging fees for public sector goods and services (the OAG's Good Practice guide)[2]
- adhering to commonly used economic principles relevant to cost recovery.

The guidance contained in the relevant documents identified above is broadly complementary and, in combination, forms a comprehensive picture of cost recovery best practice within a New Zealand public sector environment. We have distilled this material into a framework against which to assess the ABC model and the pricing model. This framework also directly aligns with Customs' Cost Recovery Framework.

Customs and Excise Act 2018

Under Sections 408 and 409 of the Customs and Excise Act 2018, Customs is able to charge fees to meet, or partially meet, the costs and expenses incurred by the agency in relation to the importation and exportation of goods when performing its duties. The legislation allows for specific fees to be set in regulations.

The current regulations were set in 2012, and Customs has informed us that these may be updated as part of the review. Note, this review does not provide legal guidance on the specific activities that costs can be recovered for by Customs under the legislation and regulations, and is limited to reviewing the methodology undertaken based on the determinations made by Customs.

Treasury guidelines for setting charges in the public sector (the Treasury's Guideline)

The Treasury's Guidelines provide general instructions to shape the process of cost recovery for public sector organisations. The Guidelines cover the process from end-to-end, much of which is out of scope of this review. However we have included the relevant key considerations in the framework against which to measure the ABC and pricing models' methodology.

Controller and Auditor General – Charging fees for the public sector goods and services (the OAG's Good Practice guide)

The OAG's Good Practice guide provides guidance for public entities charging fees. The guidance provided is detailed and sensible and provides greater depth and detail to provide further context and support to the requirements identified in the Treasury's Guidelines. We have used the Good Practice guide as supplementary guidance.

[1] The Treasury, 2017

[2] The Office of the Controller and Auditor-General, 2008

Assessment framework and principle alignment

The table below summarises the principles against which we have assessed Customs ABC and pricing methodology.

Principle	*Description in document*
Equity	Sections 1.3, [illegible] of the Treasury Guidelines and [illegible] of the OAG's Good Practice Guide describe the multiple equity dimensions in a cost recovery framework. These dimensions include the principle that those who benefit or give rise to a cost or risk from a good/service should pay; that goods/services that benefit future generations should be paid for by those future generations.
Efficiency	Sections 1.3 of the Treasury Guidelines and 2.19-2.28 of the OAG's Good Practice Guide discuss efficiency as ensuring the agency is achieving value for money (including minimises administration and compliance costs), understanding when cost recovery is an appropriate funding option, and reviewing costs in a regular fashion (three yearly cycle deemed generally appropriate).
Effectiveness	Sections 1.3, 5.6 of the Treasury Guidelines discusses effectiveness being achieved when resources are allocated in a way that contributes to the outcomes being sought, and enabling the cost recovered activity (and the relating cost recovery approach) to be delivered to a level of quality that is appropriate for the circumstances.
Authority	Sections 1.3 of the Treasury Guidelines and 1.5-1.8, 2.3-2.18 of the OAG's Good Practice Guide describes authority as having legal authority to charge a fee for the good/ service provided. These sections also note that over-recovery and cross-subsidisation need specific legal authority.
Accountability	Sections 1.3 of the Treasury Guidelines and 2.29-2.31 of the OAG's Good Practice Guide describe accountability as being achieved through acting in a transparent manner when setting fees and charges. Transparency is achieved by having all costs, their drivers and components, available to stakeholders. It is also achieved by recording surpluses and deficits associated with fees charged, as this affects the equity of current versus future payers.
Consultation	Sections 1.3 of the Treasury Guidelines and 2.32-2.36 of the OAG's Good Practice Guide describe the need for the agency to engage in meaningful consultation with stakeholders, and provide an opportunity for stakeholders to contribute to the policy and design of the cost recovery activity. Relevant to consultation is the principle of simplicity which is achieved if the cost recovery regime is straightforward, well documented and understandable to relevant stakeholders.

Overview of assessment against the framework

Overall the Customs ABC and Pricing methodology strikes a good balance between the six principles. A number of trade-offs must be made as improved alignment of one principle can mean reduced alignment with another. Customs have opted for a more detailed, data driven and highly technical approach that makes costing allocations explainable and defensible. The table below summarises alignment with each principle. Further commentary is provided in the final section of this report ("Our Observations") and includes alternative interpretations for consideration by Customs.

Principle	*Commentary*
Equity ✓	[illegible]
Efficiency ✓	Nothing in the material reviewed suggests Customs has an issue with efficiency however, the 12 year time period between review is notable as a departure from best practice. This issue will disappear once the three year review cycle begins. The detailed costing approach and Customs move towards real time analysis also improves alignment with this principle.
Effectiveness ✓	The detailed data driven approach and parallel use of these detailed outputs for management purposes make clear how resources are used and enables management to allocate resources to achieve desired outcomes. The Customs methodology makes the link between costs and the delivery of services clear.
Authority ✓	Section 413 and 414 of The Customs and Excise Act 2018 gives broad powers to Customs to set and collect fees. The Customs ABC and Pricing methodology aligns with the powers granted within the Act.
Accountability ✓	The very granular approach taken by customs provides a high level of detail to stakeholders and forces Customs to be accountable for costs. However, the sheer complexity of the approach may reduce transparency to certain stakeholder groups that lack detailed knowledge if explanations are not clear. Good alignment with this principle.
Consultation N/A	The wider fee setting process that includes stakeholder engagement was out of scope for this review. However, Customs has stated that a consultation plan has been developed. Not Applicable for this review.

Customs' approach to fee setting

Customs has adopted a two-stage approach to fee setting through the development of the ABC model and Pricing model. Costs are allocated to the centres that incur the costs through the ABC Model, and are then incorporated into specific fees through the Pricing model.

The fee setting follows a five step process:

Step 1	**Categorise costs in ABC model**	Costs are attributed to three broad categories: directly attributable costs, corporate service costs, and business sustaining costs.
Step 2	**Allocate costs across activities**	Directly attributable costs and corporate service costs are allocated across the activities that consume those particular services.
Step 3	**Business sustaining costs are assigned on a basis of cost**	As business sustaining costs are not directly applicable to services, they are allocated across services through the pricing model proportionately according to the total cost of each service or activity.
Step 4	**Activities are categorised further into specific fee groups**	The activity costs created by the ABC model are then broken down further in the pricing model by levy group and pathways to accurately allocate costs to the specific services using them.
Step 5	**Divide total allocated costs by volume to calculate final fee**	The total allocated costs are divided by volume, which is usually actions completed, to get the final fee/levy that will be charged for a service.

The methodology underpinning the first two steps is covered under the ABC Costing methodology. Steps 3 – 5 are covered under the Pricing and Fee Setting methodology.

Activity Based Costing methodology

Methodology

Step 1: Categorising costs

Customs have attributed its costs to three categories. These categories are treated differently for cost allocation purposes:

- Directly attributable costs are directly allocated to the cost centre that is involved in the delivery of the good/service.
- Corporate service (indirect) costs that can be attributed are indirectly allocated to cost centres using specific cost drivers.
- Business sustaining costs are attributed across cost objects based on service cost.

Corporate service costs reflect expenditure by costs centres that are not directly related to specific services, such as Information Technology.

Business sustaining costs represent expenditure that is required for Customs to operate effectively but does not clearly relate to the core activities/services that Customs provides to fee payers.

Step 2: Allocating costs across activities

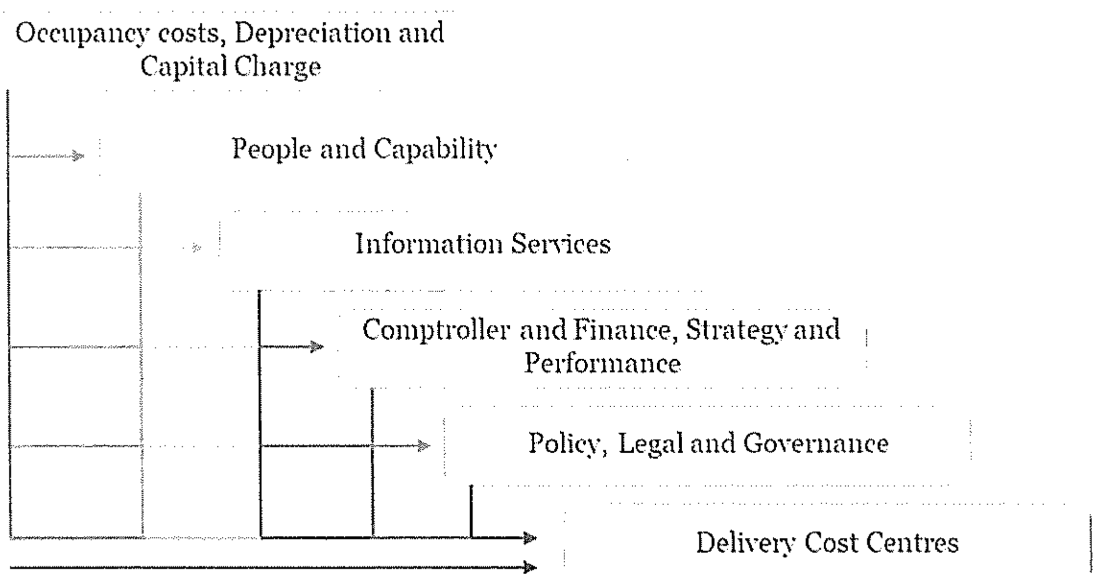
Directly attributable

Directly attributable costs are allocated to the activities that have used these resources in a straightforward fashion. These are allocated using a relevant base such as hours spent on the activity, or volume of the activity.

Corporate services

As corporate service costs are not directly related to outputs, they utilise an alternative allocation methodology. These costs are allocated using a cascade technique, where costs flow down through the cost centres until they have been fully allocated to delivery activities (cost centres). This step down approach provides a logical method to enable centralised costs to be allocated correctly to the cost centres that utilise them, and is in line with similar approaches undertaken in other government agencies.

This cascade method is summarised in the diagram below:



The majority of costs from each cost centre flow directly to the delivery cost centres.

Costs flow down through the corporate service providers, with allocation from each provider flowing directly to the delivery cost centres and other lower level corporate service providers. Corporate service providers have each of their services costed, which are then assigned to those who consume them on a causal basis. The relevance of the driver to the cost provider will have a significant effect on the distribution to the direct cost centres.

The order in which the cascade takes place can have a minor impact on the ultimate allocation percentages. For Customs, the cascade order has been determined based on which lower level cost providers maximise the use of higher level cost providers,(e.g. occupancy costs have been placed at the top, as every other service provider uses the property and incur occupancy costs).

This allocation methodology results in costs being attributed to develop a specific cost profile of defined 'cost objects'. These cost objects are then used in the pricing model.

Business sustaining

Business sustaining costs have been kept separate within the ABC costing methodology, and have not been allocated to cost centres or specific activities. These are considered within the pricing methodology.

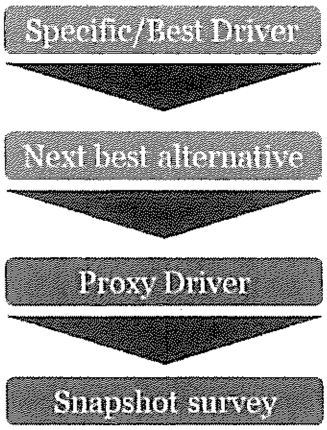
Key assumption considerations

The key assumptions underpinning the pricing methodology relate to the selection of applicable cost drivers for each individual cost type. The choice of driver will have a significant impact on the allocation of costs across the costs centres.

Driver type

Customs have adopted a highly detailed approach to ABC, in which they have worked across the business to develop a comprehensive set of cost information, and to understand the activities that individual parts of the organisation perform. This information has been used to develop a comprehensive list of cost drivers.

Cost drivers have been selected using the following hierarchy:



Driver that perfectly captures an activity (i.e. an accurate and complete value).

Driver that imperfectly captures an activity (e.g. an aggregated value).

A substitute driver that is a reasonable approximation of, and is highly correlated with what is being measured.

A bespoke sample measurement used to represent a larger population value (e.g. counting a value for a week and multiplying by 52 to represent an annual value).

Where there is sufficient data on the underlying cost driver of the activities performed, this has been used to attribute costs. If this driver, or driver data, is not available, Customs have looked to use alternative cost drivers that reasonably reflect the drivers of these costs. If a specific or next best driver is not available, a proxy driver (e.g. number of FTEs) has been used to attribute costs. Very rarely a snapshot survey was undertaken to create a specific set of driver data. This is the least preferred option and requires significant additional effort to perform the bespoke analysis.

Approach to testing these assumptions

We have reviewed Customs' approach to determining the drivers and selected a sample of cost centres, costs and their applicable drivers as identified in the ABC system. Due to the level of detail contained in the ABC system, and the inherent knowledge required to understand individual activities across Customs, we have conducted a high-level 'sense check' of the driver assumptions used by analysing a random sample of drivers and tested these with key Customs staff.

Customs have analysed each individual aspect of their organisation, tying every activity to a relevant driver. The list of drivers is extremely detailed, and after a review of the Activity Dictionary inside the Costing methodology document we have determined that activities appear to be allocated on the basis of drivers that are relevant for that specific activity. Customs have approached this using a very detailed and sensible method.

Pricing methodology

Methodology

Step 3: Allocating business sustaining costs

Business sustaining costs are not directly related to any services, and are not used by business areas to deliver their services. Business sustaining costs cannot be allocated using a standard ABC protocol. The pricing model spreads these costs across all output costs proportionately according to the total cost of each service or activity.

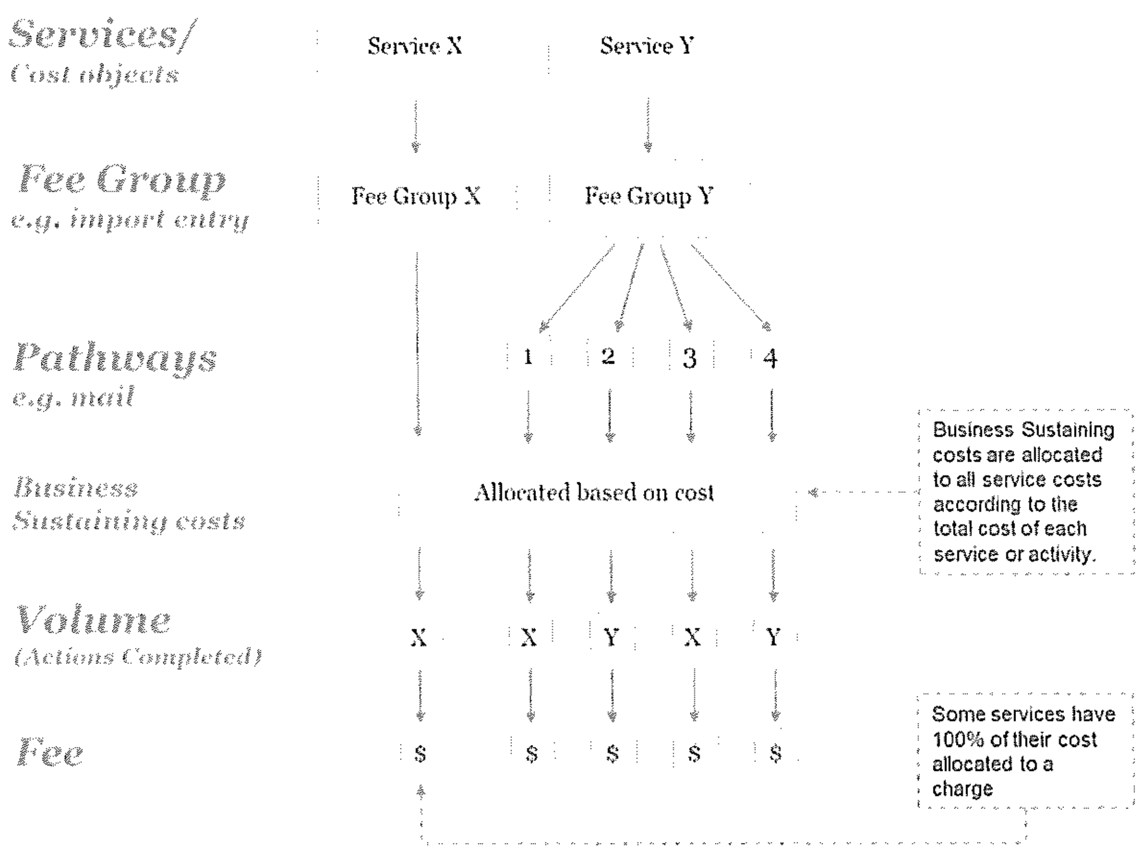
Step 4: Categorising outputs into specific fee groups

The pricing methodology sees outputs categorised into one of four fee groups and a levy group:

- Import Entry Transaction
- Export Entry Transaction
- Inward Cargo Transaction
- Outward Cargo Transaction.
- BCL (Border Clearance Levy)

These are then split into more specific pathways, such as mail or airline cargo. This process determines the overall cost incurred on each specific chargeable service over the fee period.

The Pricing Model is summarised in the diagram below:



Step 5: Determining a fee per transaction

Costs per transaction are calculated based on the service volumes. The individual transaction fee is determined by taking the total cost by activity type and by pathway, and dividing it by the number of transactions projected to occur over the next three years. For example:

- For the mail pathway it considers the number of inward packages being checked
- For the cost of goods imported by air it considers the number of reports relating to cargo on an aircraft.

The underlying transactional basis for fee charging is consistent with the previous methodology, and is widely accepted by users.

Key assumption considerations

The key assumptions underpinning the pricing methodology relate to the following costs and volumes:

- Current state costs – The total current costs incurred by Customs, divided into unique cost baskets and allocated to activities, and subsequently to fees.
- Current state volumes – The total current level of activity undertaken by Customs, broken into a large number of individual activities, used as drivers to allocate costs.
- Cost growth projections – reflects expected changes in remuneration over the forecast period leaving other costs constant in nominal terms. This results in a reduced likelihood of cost over-recovery but increases the likelihood of under-recovery.
- Volume growth projections – reflects expected changes in demand for Customs services over the forecast period.

Current state costs

Current state costs are taken directly from Customs internal accounting system. These costs have been divided into individual activities in a detailed manner and assigned attributes to allocate them to the correct fee(s) group. These values were provided and spot checked and did not reveal any abnormalities.

Current state volumes

Current state volumes are based on the most recently available values from internal Customs systems. Customs provided examples of highly detailed volumes inputs broken down by activity type, user type and geographic location. Customs has generally used the highest level of detail for activity and user type where available. However, it has sought to keep fees the same across the country by ignoring geographic location.

Cost and volume growth assumptions

Customs provided a list of assumptions used in their forward growth projections. Where possible, Customs have relied on externally sourced analysis for its volumes assumptions, such as MBIE data. This is a sensible approach and considers who is best placed to provide specific data and information. Where reliable assumptions are not readily available from external sources, Customs have relied on historic internal data and statistical modelling to project the assumption forward.

This approach is a reasonable way to source assumptions for future projections and we would not recommend any changes to the current methodology.

We did not review the underlying statistical modelling or projections model itself as this was out of scope.

Our observations

We have split our observations into three areas:

- general observations – observations on the overarching approach to costing/pricing
- specific ABC observations
- specific Pricing observations.

General observations

Customs have adopted a highly granular approach to ABC, in line with ABC best practices. There is a comprehensive understanding of each business unit, and the key drivers of cost, across the organisation. This has multiple benefits to Customs outside of developing a pricing methodology for fees, and enables Customs to make informed decisions on its activities on a regular basis, manage wider stakeholder expectations, and build transparency into Customs activities and the cost of delivering them.

Consistency in documentation

There are currently two documents outlining the end-to-end process for determining import and export fees for Customs activities. Each of these documents serves a different purpose, but are intrinsically intertwined. We noted a number of inconsistencies between the two documents in the way it refers to elements of the costing/pricing process. For example, there are references to cost objects, outputs and services. These have been discussed with Customs who are now in the process of making changes to better align the two documents.

Detailed approach

The methodology Customs uses to sum up, assign and allocate costs to create prices is highly granular, with costs identifiable by individual activity and even by geographic location. These costs are then summed up to a limited number of unique charges.

This approach has come about due to two considerations. Firstly, greater detail in the costing methodology enables Customs to assign costs to the intended activity and, hence, the intended fee paying group in an accurate and equitable manner. Secondly, the costing outputs and associated data are also used for internal management accounting purposes necessitating this high level of detail.

The drawback of such a detailed costing and pricing methodology is that the increased complexity may make it more difficult for some stakeholders to understand, hereby reducing transparency. Due to the dual use of these outputs, such a trade-off is sensible.

Allocation of Costs

Customs have split their costs into three categories, each of which are dealt with differently. Direct costs are allocated specifically to the relevant service. This follows best practice as the people using the service are the ones being charged for these costs.

Corporate Service costs are more complicated, as they are not directly related to output. Accordingly, it's harder to equitably allocate these costs, creating grey areas. The approach that Customs has taken towards these costs is detailed and sensible. The costs are allocated to fees using a method that follows best practice and relevant principles.

Business sustaining costs have been spread across services in proportion to other costs, because they are not linked to any specific service related activity. Customs have taken the logical and straightforward approach towards the allocation of these costs.

Specific ABC observations

Depreciation allocation process

Customs adopts a centralised approach to holding fixed assets, and the applicable depreciation expense is not passed on to the business within the general ledger. For the purposes of the ABC process, the team has identified and tagged each asset to its respective activity to ensure that the costs of using that asset is being incurred by the activity using it. This approach enables the current depreciation charge to be appropriately allocated and helps ensure that business managers are aware of the full cost of delivering their activities.

To ensure that this continues going forward a process has been put in place that tags each new asset acquired to the relevant activity. This is a sound approach to managing depreciation and is designed to prevent misalignment or misallocation of depreciation in the future. In many entities this allocation process is often lacking, and if maintained will prevent the need for an asset allocation process to be undertaken at each fee review.

Capital charge allocation

Capital charge within a NZ government context reflects a charge on the taxpayer funds held by a government agency. There is no definitive approach to apportion or allocate capital charge to a business, however any approach should look to best align the taxpayer funds contribution to the respective parts of the organisation.

Customs have decided to apportion this capital charge related expenditure based on the historical cost of the assets held in the fixed asset register. This approach would reflect that assets are initially acquired through a capital injection (through taxpayer funds) and is a reasonable method of attributing capital charge. However, a historical cost basis runs a risk for Customs that in the event there are assets on the books that are beyond their useful lives or obsolete (i.e. have a zero-net book value), they would still have an impact on apportionment of the costs.

An alternative allocation method would be to use the net book value of fixed assets. The net book value would act as an alternative proxy for taxpayer funds, and therefore net capital, which is inherently a net position for the Crown in the Crown's balance sheet that moves with asset acquisitions, disposals and use over the assets lives. A historical cost basis would not consider the latter element.

Specific pricing observations

Equity impacts

Best practice fee pricing should be structured in such a way as to ensure that costs are allocated to, and paid for by, the individual or group that receives the benefit or potential to benefit from a service, or that the individual or group that creates the risk driving the need for a service bear the cost of the service.

For a number of costs outlined in the Pricing methodology document on pages 8-15, it could be argued that the fee payer groups that costs are assigned to are neither the beneficiaries of the service nor the risk drivers of the service being costed. This is particularly true for activities that relate to investigating illegal activity and seizing illegal items. Under this interpretation the risk drivers are individual passengers travelling or transporting goods illegally and people or entities shipping goods illegally. This is a very small subset of passengers and goods importers and exporters but, when caught, these individuals are easily identifiable. When considering who the beneficiary is under this interpretation, ultimately the wider New Zealand public benefits as the service being provided is the protection of all New Zealanders.

There are two potential issues with seeking to recover costs from this group, possibly through legal action. Firstly, it is unlikely that all individuals driving costs are caught and identified leaving a large pool of costs still unallocated. Secondly even where the cost driver is identified they are unlikely to be willing and able to pay in many cases as they may be imprisoned, excluded from entry to New Zealand or simply lack the funds to pay. The beneficiary of the service under this interpretation is the wider NZ public.

An alternative interpretation is that those wishing to travel or ship goods internationally need a functioning customs service that enables efficient international travel and shipment and that the benefit of these services is the ability to transit the border efficiently. This interpretation would make those wishing to travel or ship goods the beneficiaries of efficient boarder clearance as well as the risk drivers, as every border transit increases the need for the service in a reasonably linear manner. The service being consumed under this interpretation is an efficient border crossing.

Under the first interpretation, it would be appropriate to only partially cost recover, where possible from identified individuals and entities creating cost and to seek the remaining costs from the Crown. Under the second, it would be appropriate to seek full cost recovery from the fee payers. Both options are viable under the wording in the legislation. Customs have considered the issue and have sought out and received specific legal advice to clarify their position and have opted to use the second interpretation. This approach is both reasonable and prudent.

Business sustaining costs and materiality

Business sustaining costs generated by external organisations, primarily from within government (e.g. responding to OIA requests) are not included in the basket of costs that are allocated to fee payers but are instead recovered through Crown funding. This aligns with the Equity principle as the fee payers are spared these costs that they neither benefit directly from, nor drive the need for.

A certain level of business sustaining costs (e.g. Statutory Reporting) are considered part of normal business for any public organisation and if costs are not excessive, it is not unreasonable to include these costs, along with other overheads into the basket allocated to fee payers.

Were business sustaining costs to be materially higher than would normally be expected, it may be unreasonable for fee payers to bear these costs and Customs might seek to recover costs from the party generating the costs.

The approach taken by Customs is consistent with Treasury advice and is a logical and efficient method to split and allocate business sustaining costs.

Unusual or unexpected use of powers

The OAG's Good Practice Guide 2.48-2.50 explains unusual or unexpected use of powers. This section refers to charging for something that the fee payers do not receive and specifies that such a use of fee charging powers may be considered unusual, creating grounds for review.

Offshore investigations and upstream disruption costs, described on page 11 of the Customs Price and Fee setting document could fall into this category. The Customs methodology spreads this cost across travellers and goods but the activity relates to investigations of people and goods prior to them becoming an active traveller or an active goods movement occurring. This has the effect of charging fee payers for an activity that is not consumed by the fee-payer group and where the ultimate benefits accrue to NZ as a whole rather than to the fee-payer group.

While the exact nature of these activities is clearly confidential, through discussion with Customs about the general nature of these activities, we understand that upstream disruption results in fewer threats ever getting to the border and that the nature of those threats is frequently at the severe end of the risk spectrum. Were the offshore investigations and upstream disruption activity to cease, the total risk to New Zealand would increase and frontline border services would come under increased pressure driving up costs for those activities.

Because the fee payer groups are essentially the same, it makes sense to select the lowest risk and most cost effective way method of combatting these threats. The approach taken by Customs to invest in this activity has clear benefits for New Zealand as a whole and for the fee payer groups when total costs are considered. When taking this holistic view, allocating offshore investigation and upstream disruption costs to fee payers is reasonable.

Appendix A – References of Customs' documents

Answers to PWC 2nd set of questions 22nd Jan 2019 (1).docx – Received 22nd Jan 2018

Cost Objects.xlsx – Received 20th December 2018

Cost recovery forecasting outputs Oct18 - v2 ABC.xlsx –Received 16th Jan 2019

Costing Methodology v0.3.docx – Received 30th November 2018

Forecasting Volume Methodology.pdf – Received 16th Jan 2019

Import entries historic data.xlsx – Received 16th Jan 2019

Pricing and Fee Setting Methodology.docx – Received 30th November 2018

PWC Questions to Customs Final.docx– Received 18th Jan 2019

R Script IEs.docx – Received 16th Jan 2019

Summary of ABC Model v.1.pptx – Received 20th December 2018

Summary of Pricing Model v0.2.pptx – Received 20th December 2018

Appendix B – References of publicly available documents

Controller and Auditor General's good practice guide for charging fees for public sector goods and services.

Treasury's guidelines for setting charges in the Public Sector.

Customs and Excise Act 2018

Appendix C – Important Notice

This report has been prepared solely for the purposes stated herein and should not be relied upon for any other purpose. We accept no liability to any party should it be used for any purpose other than that for which it was prepared.

This report is strictly confidential and (save to the extent required by applicable law and/or regulation) must not be released to any third party without our express written consent which is at our sole discretion.

To the fullest extent permitted by law, PwC accepts no duty of care to any third party in connection with the provision of this report and/or any related information or explanation (together, the "Information"). Accordingly, regardless of the form of action, whether in contract, tort (including without limitation, negligence) or otherwise, and to the extent permitted by applicable law, PwC accepts no liability of any kind to any third party and disclaims all responsibility for the consequences of any third party acting or refraining to act in reliance on the Information.

PwC has not independently verified the accuracy of information provided to us, and have not conducted any form of audit in respect of the organisation for which work is completed. Accordingly, we express no opinion on the reliability, accuracy, or completeness of the information provided to us and upon which PwC has relied.

The statements and opinions expressed herein have been made in good faith, and on the basis that all information relied upon is true and accurate in all material respects, and not misleading by reason of omission or otherwise.

The statements and opinions expressed in this report are based on information available as at the date of the report.

We reserve the right, but will be under no obligation, to review or amend our report, if any additional information, which was in existence on the date of this report was not brought to our attention, or subsequently comes to light.

This report is issued pursuant to the terms and conditions set out in the Consultancy Services Order dated 12 December 2018.