

Submission to the Productivity Commission

Department of Transport and Regional Services

This paper is a Submission on issues and possible solutions in determining if, how and from whom to cost recover, rather than a description of current arrangements for cost recovery in the Transport and Regional Services portfolio.

The Transport and Regional Services portfolio covers a variety of agencies with a variety of cost recovery processes. We understand the Commission has sought and is receiving advice from the agencies about their arrangements via a questionnaire; and we do not repeat what we believe will be provided in that process.

General Position

The Department generally is a supporter of effective cost recovery arrangements for services provided to users in a commercial environment. There may be services provided in a broader public policy environment that are appropriate for cost recovery, but the choice of which and how much is far more problematic and often ideological. In the absence of a market, cost recovery may achieve little by way of efficiency. The Department is more familiar with cost recovery which supports the efficient provision and consumption of services (or goods eg certain publications or data sets).

Cost Recovery Principles

The following principles have been drawn together from experience, primarily ie they do not purport to form part of a template currently in use. Nevertheless, officers of the Department are called upon by the Government to initiate or assess in policy advice proposals for cost recovery from time to time, and would tend to follow these concepts.

In assessing the need or applicability of the introduction of a cost recovery regime there are a number of underlying principles which need to be addressed. These cover the range of social, administrative, legal and political but the key areas for consideration are:

- determination of **what costs** are attributable to the service(s) being charged for
- methodology for **distributing the costs** across the range of users
- availability and efficiency of **pricing and collection mechanisms**
- **legal restrictions** to applying a cost recovery mechanism
- assessment of impact of cost recovery on industry/users, with **particular reference to the objective for charging**

- **political/social considerations**, which should be drawn to the attention of the Government *where it has a role in determining the desirability of introduction of cost recovery*.

What costs are attributable?

There is an understandable tendency in establishing cost recovery to adopt a form of full costs (ie historical, or depreciated or some kind of optimised return-based valuation) and allocate this across users on the basis of groups who broadly are responsible for those services being provided. While potentially defensible, and still common, the variety of valuation and grouping options available in such approaches tends to allow users to suggest alternative (and often quite reasonable) proposals, driven often by protecting their own interests. It also reflects an unhealthy pre-occupation with requiring *current* consumers to pay for *past decisions* on investment, at a time when pricing/cost recovery was not evident. And the valuation process can prove to be circular ie the best indicator of value is discounted value of revenue earned from the asset – but with no revenue, estimates are used. Estimates tend to reflect the interests of the estimator (the current debate between users and owner at Sydney Airport values land at somewhere between zero and a very large number, both supported by economic theory and expert valuers).

A more reasonable and practical approach, particularly when dealing with a charge levied for a service in what might be called a ‘continuing agency’ ie where there is a core business separate and likely to continue, is to adopt a form of avoidable cost.

For example, in pricing access to interstate rail lines (other than the few high-rent bulk traffic lines), access providers have to find a reasonable basis for charges, for both incumbents and new entrants. The preferred outcome might be to strike a price which at minimum covers the costs avoided if the line was shut down; and preferably contributes (as traffic grows) to justifying both cost and a rate of return on future investment. Such a structure has proven practical and intuitively acceptable to users. It seems to be a useful model for determining the costs in a variety of non-market, commercial circumstances. It may, as well, allow a market (and thus genuine prices) to more readily emerge.

Although the economic/accounting theory seems reasonably agreed, the identification and agreement on the level of avoidable costs associated with a service provided by a government agency is complicated by a number of issues including

- the integration of the service provider within an overall bureaucracy or organisation
- the differences in treatment of costs across different levels of Government
- ability to spread costs associated with peak capacity supply
- the potential for over servicing (and overcharging) by Government organisations unconstrained by market force

- the real or perceived cost padding which industry (or individual users) believe exist with a Government organisation and
- the distribution of costs between different classes of users (discussed below) or different services.

Distribution of costs across the range of users

The Department in the 1980s was responsible with the then Department of Finance for the development, attribution and distribution of the costs of air traffic control and related services across a highly diverse and largely disinterested set of aviation users, both commercial and non-commercial. Experience from that process suggests identification and acceptance of costs levels is a necessary part of the process; but the much larger and more persistent issue is to gain acceptance amongst diverse users of a reasonable distribution (the importance of it being a reasonable distribution, not merely an objective one, is noted under legal issues). This issue persists today, in the form of continuing policy debate over *the degree to which* location-specific pricing should continue to be pursued in aviation.

Except in the circumstances where there is a single user of a Government agency's product, the distribution of avoidable costs across the range of users involves argument. We noted above a common approach of attempting to group users according to either rate or scope of consumption of the service. Thus a charging system might offer the choice of a flat fee for a year's consumption or a per/minute or per/activity basis; with the latter designed to attract small users and the former an option for large users. Such a system probably has not much to offer in allocative efficiency. It is often driven by equity. Equity is a serious consideration when introducing charges for a service previously unpriced.

Selection of the methodology may impact disproportionately on different user types because of the size of the user, and the lack of ability to offset the costs against revenues generated through consumption of the service. To this end, the Department believes that it is critical to analyse what the end market characteristics are to ensure that the methodology utilised for distribution of the costs does not cause unexpected (or unwanted) industry or social effects.

This is particularly so where the service being consumed relates to personal safety. It is an observable fact that regardless of the benefits to safety to be gained by consuming a service eg obtaining an accurate map or weather forecast before a flight, individuals will often fail to see the benefit. In the case of a subsequent search for a lost aircraft or vessel, it is society which pays the cost. There can be quite a reasonable argument made to suggest that, rather than pay for such a service, the consumer should be induced (with a subsidy if a regulation is ineffective) into consuming it.

In terms of distribution methods there are a number of options for Government agencies to choose from including:

- cross subsidies between different user types, within an overall cost recovery level

- apportionment of costs in line with the direct use of a product
- use of a real or implied CSO (Consumer Service Obligation payment) for certain classes of users whilst obtaining 'full' cost recovery from other users.

There are commercial precedents for judgements which do not involve simple attribution of cost incurred to each user. Were the insurance industry to function by passing on costs associated with each individual policy holder to that policy holder, it would be self-defeating: no one would take insurance. By sharing burdens, a socially desirable end in an active commercial environment can be achieved efficiently.

The insurance approach is an option, to deal with cost recovery of safety services. For example, taking search and rescue, were the cost of an individual maritime search, for example, passed back to the 'user' involved then at minimum insult would be added to injury and more probably the user would refuse to pay. Even the most minimal search is very expensive. However, an 'insurance' charge levied on the cost of provision of a year's search and rescue service, and distributed across the whole of the potential users of the service, may well prove to be a feasible option. Monitoring and collection of such a charge could be problematic (see below).

Distribution and equity issue also arise in location-specific pricing, which is common in aviation. Similarly, peak and off-peak consumption can raise serious clashes between efficiency and equity.

Availability, efficiency and effectiveness of pricing mechanisms

Introduction or application of any cost recovery mechanism needs to be administratively efficient. To achieve this, the means for levying a charge should normally be simple, direct and open to inexpensive collection and enforcement. This reduces the burden for user and Government agency alike.

Many areas potentially open to charging fail the test of administrative burden – where the cost of collection and enforcement outweighs the revenue. This may not however be sufficient reason not to charge eg where the charge is levied to deter misuse or excessive use of a service. Determination of the objective for charging eg in some cases, not so much to raise revenue but to reduce the cost of an unreasonable amount of service demand is vital.

Use of an existing charging system is an option which may allow for cost recovery processes which, on a stand-alone basis, cannot justify collecting the revenue to nevertheless proceed.

For example, motor vehicle registration systems are now used to collect revenues for 3rd party insurance. Insurance for a range of safety functions could be tied to registration charges in other transport areas, where available.

Bundling of charges in this way is administratively efficient. It may however be argued that it leads to enforced consumption of services. Potentially, such an approach should only be used where the social desirability of consumption outweighs that concern.

More broadly, in establishing a pricing mechanism it is critical that the structure of the payment does not provide an incentive for the user to act in a fashion which directly reduces the public benefit or safety.

For example, again to use the example of rescue services, introducing a charge to recover the cost of maritime search and rescue which was linked to the sales price of an EPIRB (a location signal device) has been suggested. If the charge was high, this may have the perverse effect of reducing the consumption of this otherwise desirable safety product. In turn, this could increase to cost of rescues. Locating vessels without an EPIRB is more difficult.

Legal ability to apply a cost recovery mechanism

Undoubtedly, other submissions will draw attention to the current legal restraints on cost recovery at the Commonwealth Government level. The most recent case law on the matter is drawn from a dispute between Airservices Australia and a foreign airline over the validity of charges levied by Airservices. This followed a statutory lien being placed on a leased aircraft by Airservices, the restriction in effect requiring the payment of charges before the aircraft could return to the lessor.

The High Court decided, after successive rulings to the contrary in the Federal Court, that Airservices' charges were legally valid. The validity was being questioned inter alia on the basis that the charges were not reasonably related to costs; and as a result amounted to taxation; thus should have been levied by the Commonwealth as a Tax Bill in the Federal Parliament, rather than as general legislation.

This case may have had serious implications for other Commonwealth businesses whose charges, not being levied as taxes, necessarily must also be related reasonably to costs; yet who charge on the basis of aggregated sets (particularly in networks, as with air traffic control) of services. The Attorney General intervened in the High Court in support of the view that this principle was being observed by Airservices, due to these broader ramifications.

For the purposes of the Productivity Commission's inquiry, the significance of the lies in illustrating that care must be taken in setting charges to ensure that this principle is observed; and to note that it is not only a question that the Government and the ACCC must be satisfied that charges are reasonably related to costs – so must the courts.

The Federal Court views on the matter make interesting reading. The ability of a network provider to disaggregate charges was relevant to its view. This is much more difficult to achieve in a practical sense than the aim is to suggest that it must be done; and certainly when driven down to the point of minimal difference. Even the High Court differed on the degree to which charges need not be related to costs before they amount to taxation.

Political/social desirability of introduction of cost recovery mechanism

In a commercial environment, the desirability of charging is necessarily taken as a given. In a public policy environment, it may be more or less an option. Where the

service falls in between the two environments – and this is quite a grey area – the scope for undertaking cost recovery can be bounded by

- the judgements of Boards, where the enabling legislation sets up such a structure
- the effect of budget constraints (internally, and from the Commonwealth Budget itself)
- the policy interests of the Government
- the imminent or new development of markets associated with the regulatory function.

The first three factors are well understood.

In the last case, the development of competitive neutrality monitoring and the growth of businesses (public sector enterprises in some cases, but more usually new private businesses eg those adding value to government information or substituting for previously public sector activities) create complexities. These may favour cost recovery; but they may also discourage it. New businesses may see themselves being put out of business by governments charging for previously 'free' services. Alternatively, their clients may take the product direct from the Government provider – and charges of failure to act neutrally in a market may arise.

Department of Transport and Regional Services

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