POSITION PAPER FOR THE REVALIDATION OF THE LEVIES REVENUE COST RECOVERY METHODOLOGY

Table of Contents

INTRODUCTION 4

PRINCIPLES 4

BACKGROUND 4

Current Charging Process 6

KPMG Review 6

Stakeholder Feedback 7

SCOPE 7

ASSUMPTIONS 7

THEME ONE: ALLOCATION OF PROGRAM MANAGEMENT COSTS TO COMMODITIES 8

Option One: Current state 8

Advantages 8

Disadvantages 8

Option Two: Allocated program management on the historical average of direct time 9

Advantages 9

Disadvantages 9

Option Three: Allocate program management on an equal share to commodities 9

Advantages 9

Disadvantages 9

Option Four: Allocate program management based on each commodity's share of levy revenue 9

Advantages 9

Disadvantages 10

Preferred Option 10

THEME TWO: ALLOCATION OF COMMODITY COSTS TO LRBs 10

Option One: Current state 11

Advantages 11

Disadvantages 11

Option two: Equal Share 11

Advantages 11

Disadvantages 11

Option three: Allocation Based on Revenue 11

Advantages 12

Disadvantages 12

Preferred Option 12

THEME THREE: STABILITY OF COSTS / ACCURACY OF ESTIMATES 12
Estimates Become Quotes 13
Re-run Cost Recovery Model Monthly 13
Provide Estimates Later 13
Preferred Option 14
CONCLUSION 14
FEEDBACK 14
GLOSSARY 15
ATTACHMENT A – LIST OF LEGISLATION 16
Imposition legislation 16
Collection legislation 16
Disbursement legislation 16

INTRODUCTION

The following paper outlines options to be considered in revalidating the cost recovery methodology for the levies program. It is intended to promote discussion and response while clearly articulating the department's preferred position.

The paper does not review any of the levies structures, their appropriateness, or the scope of tasks required to administer them. The review and reconsideration of individual levies and of the compliance behaviour of levy agents are matters more properly considered by the peak industry bodies.

PRINCIPLES

Levies are implemented at the request of industries through their representative bodies. Therefore the views of industry representative bodies should be a key consideration in reviewing the basis of the cost of administering levies.

All options will be discussed in the context of the Australian Government Cost Recovery guidelines which state that:

- charges should be linked as closely as possible to the activity or product to be cost recovered
- the system should be cost effective to calculate, collect and enforce
- the compliance costs of paying the charges should not be excessive
- a balance should be struck between certainty, and flexibility to modify the approach to cost recovery if ongoing monitoring indicates that this is desirable
- all aspects of the charging mechanism should be consistent with the policy objectives of the agency
- the charging mechanism should be consistent with other Australian Government policies.

BACKGROUND

The Department of Agriculture is responsible for the effective administration of statutory rural product levies, by collecting and disbursing levies imposed under Commonwealth legislation, on a cost recovery basis, on behalf of primary industries.

Levies are used to help businesses work together, pooling their effort and resources, to find solutions to priority issues. It can support research and development, promotion and marketing, residue testing, and plant and animal health and biosecurity programs.

At present, there are over 90 different levies being distributed to 19 levy recipient bodies (LRBs) who service 54 industry representative bodies (IRBs).

The department is supported by legislation (see Attachment A) which enables it to enforce levy collection, recover levy debt and to carry out a range of compliance activities, as well as recovering all of its costs on an annual basis, charged to LRBs. The program is forecast to cost $5.2 million in 2013-14, a reduction of $0.7 million or 12% from 2012-13. The table below highlights changes in the department's costs from 2010-11.

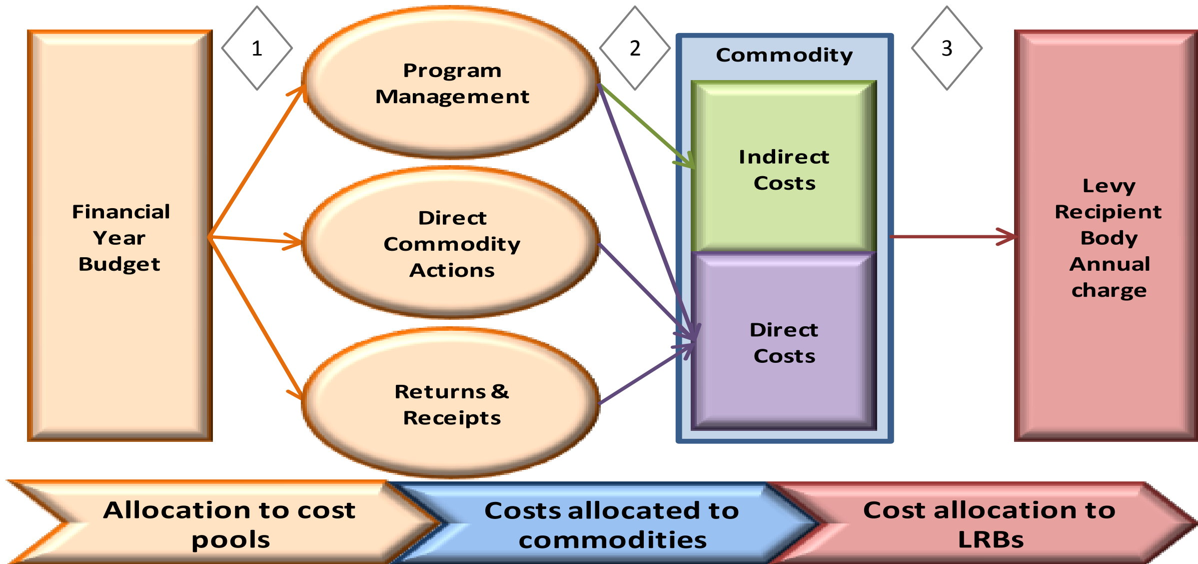
Total costs – 2010-11 to 2013-14

2010-11	2011-12	2012-13	2013-14 (est.)
$6.6 million	$6.2 million	$5.9 million	$5.2 million

In consultation with industry the department reviewed and updated its cost recovery methodology in 2011. The major change was the shift from a revenue-centric model to an activity based costing (ABC) model. The reason for the change was to facilitate a more equitable share of costs to LRBs while minimising any cross-subsidisation. The changes were fully implemented for the first time in 2012-13.

The cost recovery model splits financial data into three cost pools; Program Management, Direct Actions and Returns/Receipts as shown in Figure 1 below. Direct actions include activity, other than processing receipts or returns, that can be directly attributed to commodities or levy agents (any entities that have a liability to lodge returns and make levy payments). This includes operational compliance (record inspections) and strategic compliance activities. The financial data (the budget) is extracted from the department's accounting and budgeting systems (1) and allocated to commodities using the activity recorded as time in the levies business system (2), Phoenix. Costs assigned to commodities (represented by IRBs) are then allocated to LRBs (3), who are invoiced by the department.

Figure 1: The cost allocation process:



The outcome of this cost recovery model is that costs are assigned to LRBs or commodities based on the effort required to undertake levies administration for that commodity. If one commodity is responsible for the effort of 10 per cent of levies management staff, then it will attract 10 per cent of the program's costs.

Current Charging Process

In all iterations of the estimate or cost-charging process, the cost recovery model is provided with inputs which ensure that the department is fully recovering all costs associated with the program from the appropriate area. These inputs include activity and financial data.

At present, the department provides LRBs and IRBs with an estimate of their relevant cost recovery charges twice a year. The first estimates are provided in April using financial information sourced from the department's budget system and the best estimate of the activity profile for each commodity for the next financial year. LRBs are invoiced monthly based on these estimates.

In January, the department updates the activity used in the cost recovery model to provide LRBs and IRBs with a revised estimate of their cost recovery charges. Activity data is profiled from actual data for the current year to date and expected activity for the remaining six months. Financial data is extracted from the department's mid-year budget review. This is intended to better reflect the activities undertaken or planned for the financial year and provide a clearer picture of what charges might look like at the end of the financial year. Invoices are also updated to account for changes in estimated charges.

At the end of a financial year, a final reconciliation takes place to allocate the actual activities (from Phoenix) and program costs (from the financial statements) to LRBs and IRBs. Final invoices are then adjusted to account for any increase or decrease from the estimates provided.

KPMG Review

In 2012, consultants from KPMG were engaged to conduct a review of the cost recovery model. This review is available on the levies website. It concluded that the model aligned with the Australian Government Cost Recovery Guidelines and provided three recommendations to further improve the model. The recommendations (taken directly from the review) were:

1. Accuracy of time recording – ensuring staff are appropriately trained and incentivised to record time spent on levy collection activities accurately and promptly
2. Review indirect cost drivers – proposing that the department consider preferable alternatives to the current FTE time allocation driver
3. Review equal share allocation – proposing that the department review how costs are allocated to LRBs (from commodities) that share a levy.

The department is already addressing the first recommendation through a continual program of monitoring and review to ensure that activity records and times entered by staff into the Phoenix business system reflect the true nature of their work and that they are done as soon as possible after the work is completed. Recommendations two and three will be reviewed in this paper.

Stakeholder Feedback

The most common feedback that the department receives from stakeholders is the perceived instability of costs or inaccuracy of estimates provided to IRBs and LRBs. Due to the nature of the ABC approach, these costs can vary greatly from year to year and estimate period to estimate period when activity is increased/decreased or greater focus applied to certain commodities. As a result, stakeholder budgeting measures can be impacted by the variations in the cost estimates. For this reason, the department is prepared to consider options that may flatten cost estimates over periods of time.

SCOPE

Three themes will be reviewed in this paper to address the issues raised previously:

1. Allocation of program management costs to commodities (response to KPMG recommendation two)
2. Allocation of commodity costs to LRBs (response to KPMG recommendation three)
3. Stability of costs and accuracy of estimates (response to stakeholder feedback).

ASSUMPTIONS

To address the key themes, a number of assumptions will be made for the purpose of clarity and consistency:

- The department overall will recover the full costs of its administration of levies each year.
- While costs are not expected to vary greatly from year to year, all efforts will be made by the department to incorporate cost reductions or efficiencies into the levies business model.
- With the exception of the record inspection and strategic compliance programs (which can be planned prior to providing estimates), activity will be estimated using the most up-to-date activity time data available from the business system, Phoenix.
- The department to the level possible will anticipate increases and decreases in activity across time periods, but is largely dependent on the behaviour of levy agents that is sometimes hard to predict due to factors such as seasonality, organisational or staffing changes within agents, changes to their financial positions, agents' attitudes to paying levies and fluctuations due to agents entering and exiting the levy system.

THEME ONE: ALLOCATION OF PROGRAM MANAGEMENT COSTS TO COMMODITIES

Recommendation two of the KPMG review highlighted potential changes that could be made in the way the department allocates program management costs to commodities. Program management is a category of costs that cannot be assigned to commodities directly and can involve activities like:

- Financial management
- System maintenance
- Internal meetings
- Training
- Intra-governmental reporting
- General administration.

Like any indirect cost, specific drivers are used to allocate these costs to particular cost objects (in this case, levies administration for commodities). The driver used under the current cost recovery methodology is a proportional or FTE approach. This means that the amount of direct activity on a particular commodity will drive the amount of program management that is allocated to the commodity. This review will consider three options for the allocation of program management costs to commodities:

- Option 1: Current state
- Option 2: Allocate program management costs based on a moving three-year average of direct time
- Option 3: Allocate program management on an equal share basis to commodity groups.
- Option 4: Allocate program management based on each commodity's share of levy revenue.

Option One: Current state

This option continues the FTE/proportional approach to allocating program management to commodities.

Advantages

- As the allocation of direct costs is time-based, it is most appropriate to allocate program management on the proportion of that time.
- Requires no change to the model.
- The calculation is simple to administer and explain to stakeholders.
- Most stakeholders are aware of and comfortable with this approach to allocating program management.

Disadvantages

- Is seen by some stakeholders as an unfair distribution of costs between LRBs.
- Causes program management allocation to shift to commodities that have more direct activity in any one year.

Option Two: Allocated program management on the historical average of direct time

This option involves taking a longer-term approach to allocating program management to commodities by using a historical average of direct activity as the proportional factor instead of a one year factor derived from the FTE approach. A three to five year timeframe would be used depending on the amount of data available.

Advantages

- Changes in direct time from year to year will have smaller impacts on costs.
- Smoothing of program management overhead allocated to commodities has the potential to reduce large variations in costs each year.

Disadvantages

- Historical averages will lessen the impact of significant changes to levy collection processes.
- There is less incentive for industries to adjust inefficient collection practices as the immediate financial benefit will be lessened.

Option Three: Allocate program management on an equal share to commodities

This option involves stopping the allocation of program management based on any drivers and charging commodities an equal share of the calculated cost. The idea behind this option is that the overall program management cost does not change significantly. Any changes that occur from year to year would be lessened (per commodity) if every commodity shared it equally.

Advantages

- Program management costs should stabilise at the commodity level.
- Variations in costs would only be linked to the direct activities of levies staff, reducing volatility in year-to-year cost estimates.
- Will overwhelmingly benefit commodity groups that interact with the department on a large scale.

Disadvantages

- Commodities with smaller revenue streams will see their financial viability impacted as the equal share approach may generate costs equal to a significant part of the levy collected.
- May not create incentives to improve the structure or behaviour of levy payers as any improvements will not impact on program management costs.

Option Four: Allocate program management based on each commodity's share of levy revenue

This option involves allocating program management based on levy revenue rather than any drivers linked to the department's activity in collecting and administering levies. Program management costs would align with each commodity's proportion of overall levy revenue. In practice, the commodities with the largest share of levy revenue would pay the largest share of program management costs.

Advantages

- Costs will be allocated to commodities with the greatest ability to pay.
- May have a potentially positive impact on costs for small commodities.

Disadvantages

- Does not reflect that program management primarily supports activities related to direct actions.
- May not create incentives to improve the structure or behaviour of levy payers as any improvements will not impact on program management costs.
- Commodities that do not engage with the department may pay for program management that is disproportionate to the level of interaction they may have with the department.

Preferred Option

The department's preference would be to maintain the FTE allocation approach in Option 1. Using FTE as a driver is the most appropriate method at this point to allocate program management to commodities. This method attributes costs which cannot be allocated to a particular commodity according to the actual effort required to administer the relevant levy. It encourages efforts by industry to: implement efficient levy structures; encourage compliant behaviour by levy agents; and focus their interactions with the department on productive activities.

The historical average method will disadvantage commodity groups that make improvements in their industry by delaying and reducing the financial impact of those improvements.

The equal share apportionment of program management will impact greatly on small commodities with low levels of revenue or levies that are very efficient by charging a disproportionate amount of program management. The viability of smaller industries could be put at risk, while efficient industries could be unfairly punished.

The revenue based model will not reflect the level of actual activity for each commodity so will not create incentives for improvements in levy structures or industry behaviour and support a user pays framework.

THEME TWO: ALLOCATION OF COMMODITY COSTS TO LRBs

For some commodities, the levy collected from producers is distributed to multiple LRBs. This can be for research and development, marketing, biosecurity, residue testing and Animal Health Australia or Plant Health Australia membership purposes. The review of the cost recovery model by KPMG recommended that the way costs are shared amongst LRBs in this situation be reviewed. As of 1 July 2014 (with the consolidation of Wine Australia Corporation and the Grape and Wine Research and Development Corporation into one statutory body) the sharing of levy revenues will only relate to the National Residue Survey (NRS), Animal Health Australia (AHA) and Plant Health Australia (PHA). These bodies share revenue streams with the relevant industry service body (either a statutory RDC or an industry owned corporation). IRBs have also raised this as an issue of concern. In light of this, the department is considering three options:

- Option 1: Current state
- Option 2: Equal share
- Option 3: Allocation based on revenue.

Option One: Current state

The cost sharing arrangements described above currently have cost-sharing models that were built to maintain a level of cost for the NRS, PHA and AHA as a whole, rather than for individual levies, when the cost recovery model was updated in 2012. This option involves continuing the arbitrary allocation of costs to certain LRBs that share levies.

Advantages

- Provides clear guidance to the affected LRBs on how the costs are split.
- No change required as it is already in place.
- Costs should not change dramatically if this option is implemented (assuming a stable level of activity and number of levies).

Disadvantages

- The current allocation percentages need updating at the commodity level, as the level of levy received by some of these bodies is different for each levied commodity.
- Does not have flexibility in the event that certain levy rates are changed (eight levy changes were implemented in 2012-13 with four changes so far in 2013-14).
- Can create some inequality when expenses are not matched by appropriate revenue, and vice versa.

Option two: Equal Share

Under this option, LRBs that share levy revenue from particular commodities will attract an equal share of costs for each commodity, regardless of the percentage of revenue that they share. This is based on the idea that, all things being equal, it costs the department the same to collect one dollar as it does to collect 100 dollars.

Advantages

- Simple to calculate and implement.
- Provides a clear picture of how shared costs are distributed.
- Will greatly benefit organisations that receive a greater proportion of shared levy.

Disadvantages

- Huge proportional shift for LRBs that receive smaller proportions of levy.
- Has the potential to place strain on program funding for some organisations.
- Significant strain could be placed on the financial viability of certain levies as the revenue collected would not cover the department's cost in collecting that revenue. This could force a commodity group to reconsider using levies to fund activities or increase the rate or coverage of a levy to account for the increased cost.

Option three: Allocation Based on Revenue

Under this option, costs for administering levy revenue are shared with LRBs on the percentage of levy they receive. These percentages (levy splits) are currently maintained in the business system, Phoenix, and reflect legislated levy rates.

Advantages

- Strikes a balance between affordability and equity for levies that are shared amongst LRBs.
- Levy splits are maintained and updated in the business system, Phoenix.
- Will have a small, potentially positive impact on the capacity for some LRBs to meet costs.

Disadvantages

- Will require some manual intervention when rate changes are implemented.
- May affect some LRBs unfavourably.

Preferred Option

The department's preference would be to adopt revenue based cost allocation as set out in Option. Of all the options, it provides the most equitable solution to all stakeholders while maintaining ease of calculation and implementation.

In explaining this position, it is important to consider the collection of levy by the department as a service. The service involves collecting money from levy payers and delivering it to LRBs. If a LRB has a greater share of revenue, it can be concluded that that LRB is deriving greater benefit from the department and should incur a greater proportion of costs.

This option further assists in maintaining the viability of levies that have been put in place in partnership with government and industry groups to assist with the funding of future biosecurity emergencies and has been sought by a number of the industries impacted by the cost-sharing arrangements. The Australian Government is encouraging industries to participate in these activities and options which challenge the viability of biosecurity activities and residue testing are undesirable.

Further, it has already been made clear through discussions with stakeholders that the current equal share option would not be widely accepted, and that the current system leads to inequity and confusion.

THEME THREE: STABILITY OF COSTS / ACCURACY OF ESTIMATES

A common theme amongst LRBs and IRBs is the preference for stable costs and accurate estimates. This assists with budget setting, strategic planning and prioritising work across all sectors. As discussed in the principles above, the department is focussed on reducing any "excessive costs" while maintaining flexibility and accuracy in how costs are allocated.

Detailed analysis of the cost recovery model shows a clear link between increases in activity and increases in costs. This has a multiplier effect, at present, when program management is applied as increases in activity will attract a greater proportion of program management as well.

The current environment within levies cost recovery also deals with the fact that the behaviour of levy agents is difficult to predict. Further, since many of these levy agents perceive they have no vested interest in the levy program, it is hard to incentivise them to improve behaviour.

While the department believes that the stability of costs is not an issue for the majority of stakeholders, and that activity data provides a transparent response to any spikes in costs, there are

a number of potential changes that could be made to the way the cost recovery methodology is utilised.

The scenarios that will be listed involve no real change to the cost recovery methodology. They instead, look at options on how the information that comes out of the model is used.

Estimates Become Quotes

One scenario that could be investigated is the modification of the estimates process to remove any revised calculations or reconciliation processes. Estimates will be calculated at the beginning of a financial year using the previous year's activity and financial data, and will be charged on a monthly basis as currently occurs. There will be, however, no revised estimate or final reconciliation process. The split of costs as a result of these inputs will stay the same across the year.

This means that any changes that will have an impact on cost will not take effect until the following financial year. This will include cost reductions or efficiencies made by the department. Unforseen cost increases will also take effect a year later.

Further, timing for LRBs may be an issue as these quotes will need to be provided in June to allow for the data required (full financial year activity and costs) to be finalised and modelled. Using the full previous financial year's data is necessary to ensure that any charges are final and not subject to changes. This could affect LRBs' budgeting and planning.

Re-run Cost Recovery Model Monthly

Another potential opton that is open for consideration is for a monthly reconciliation of the cost recovery model. The goal of this course of action would be to identify and potentially mitigate increases in costs as they occur.

As the current model is not designed for a monthly revision there would be additional work building in the functionality. It would also require significant increases in activity to manage and maintain the new model month-to-month.

Additional reporting would require time and costs could go up to account for these increases in activity. However, these would likely be marginal increases for each LRB as the costs would be shared across all commodities and could create more visibility of changes in costs across the year.

Provide Estimates Later

Estimates have been traditionally provided to LRBs and IRBs two to three months prior to the beginning of the financial year. This was put in place to assist with budget and priority setting for LRBs.

As has been described, there are a number of key inputs that develop costs to be charged to LRBs. They are:

- Financial
  - Budget
  - Actuals
- Activity
  - Timesheets

- National Compliance Plan
    - Record Inspections
    - Strategic Compliance Projects.

The department finalises its budget in May of each year (in line with the government budget process). The national compliance plan is also finalised in May. These are the two factors that the department has the most control over.

Providing estimates before these inputs are finalised increases the risks of these estimates being wrong. A simple way to mitigate this risk is to provide estimates later, but before the beginning of a financial year.

All other inputs (including timesheet data) are driven from outside factors, such as levy agent behaviour, and are largely unpredictable due to the lack of influence industry or the department can exert on levy agents.

Preferred Option

The department does not have a preferred option for addressing the stability of costs and the accuracy of estimates but has outlined issues which should be considered for each option. We are seeking feedback from LRBs and IRBs on the three scenarios, including an indication of their preferred option.

CONCLUSION

The potential options considered in this paper focus on the continual improvement of the levy collection cost recovery process. While not diverting from this policy, it is often difficult to provide certainty to stakeholders while maintaining transparency and equality. Any changes should be considered in the full context of all levies and the bodies that receive and / or distribute it.

When considering the allocation of program management costs to commodities in Theme 1, the department believes the current state set out in Option 1 best aligns the costs to the activities which drive them.

Under Theme 2, the department proposes a change to the methodology in Option 3 which would see commodity costs shared between LRBs in the same proportions as each LRBs share of levy revenue.

In recognition of LRBs' and IRBs' preference for stable costs and accurate estimates, the department has prepared three scenarios for how this could be addressed in the future. Whilst the department does not have a preference, we are seeking stakeholder feedback on which scenario best meets their needs.

The department's preferred options aim to deliver a transparent, equitable and affordable cost recovery model for levy collection.

FEEDBACK

Should you have any comments, Please provide them in writing to levies.management@daff.gov.au by 11 April 2014.

GLOSSARY

Cost Recovery	Cost recovery is the recovery of some or all of the costs of a particular activity
Direct Costs	Costs that can easily be associated with a particular cost object
Indirect Costs	Indirect costs are costs that are not directly accountable to a cost object (such as a particular project, facility, function or product)
Industry Representative Body (IRB)	Bodies recognised by the government as representing the interests of an industry at a national level
Industry reserve	A financial instrument set up to stabilise prices and account for cost recovery surpluses and deficits over a period of time
Levy agent	An entity who pays levy to the department. This can be a producer or an intermediary in the market chain (e.g. wholesaler, processor, exporter) who pays levy on behalf of a producer. Most levy agents are intermediaries.
Levy Recipient Body (LRB)	Bodies set up to administer levy revenues on behalf of industry
Operational Compliance	Compliance program that identifies agent records for inspection to provide assurance of the completion of levy collection
Phoenix	The business system used to facilitate the collection and distribution of levies, manage compliance and record staff time
Strategic Compliance	Compliance program that identifies specific areas of compliance concern and conducts individual projects on that basis

ATTACHMENT A – LIST OF LEGISLATION

Imposition legislation

Primary Industries (Customs) Charges Act 1999

Primary Industries (Excise) Levies Act 1999

National Residue Survey (Customs) Levy Act 1998

National Residue Survey (Excise) Levy Act 1998

Collection legislation

Primary Industries Levies and Charges Collection Act 1991

Disbursement legislation

Australian Animal Health Council (Livestock Industries) Funding Act 1996

Australian Meat and Live-stock Industry Act 1997

Dairy Produce Act 1986

Egg Industry Service Provision Act 2002

Forestry Marketing and Research and Development Services Act 2007

Horticultural Marketing and Research and Development Services Act 2000

National Residue Survey Administration Act 1992

Pig Industry Act 2001

Plant Health Australia (Plant Industries) Funding Act 2002

Primary Industries Research and Development Act 1989

Sugar Research and Development Services Act 2013

Wine Australia Corporation Act 1980

Wool Services Privatisation Act 2000

Note: Further details on the imposition, collection and disbursement of levies and charges are contained in regulations subordinate to the Acts.