

SageBush public finance resources

Understanding memorandum accounts

SageBush's public finance resources support public sector leaders to understand and manage financial challenges.

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Memorandum accounts

Government services are largely funded from taxation, but they may also be funded through fees. A fee aims to recover the costs of service provision from users of the service. The concept behind this is user pays – those who use or receive benefit from a service or those whose actions create the need for government involvement should pay.

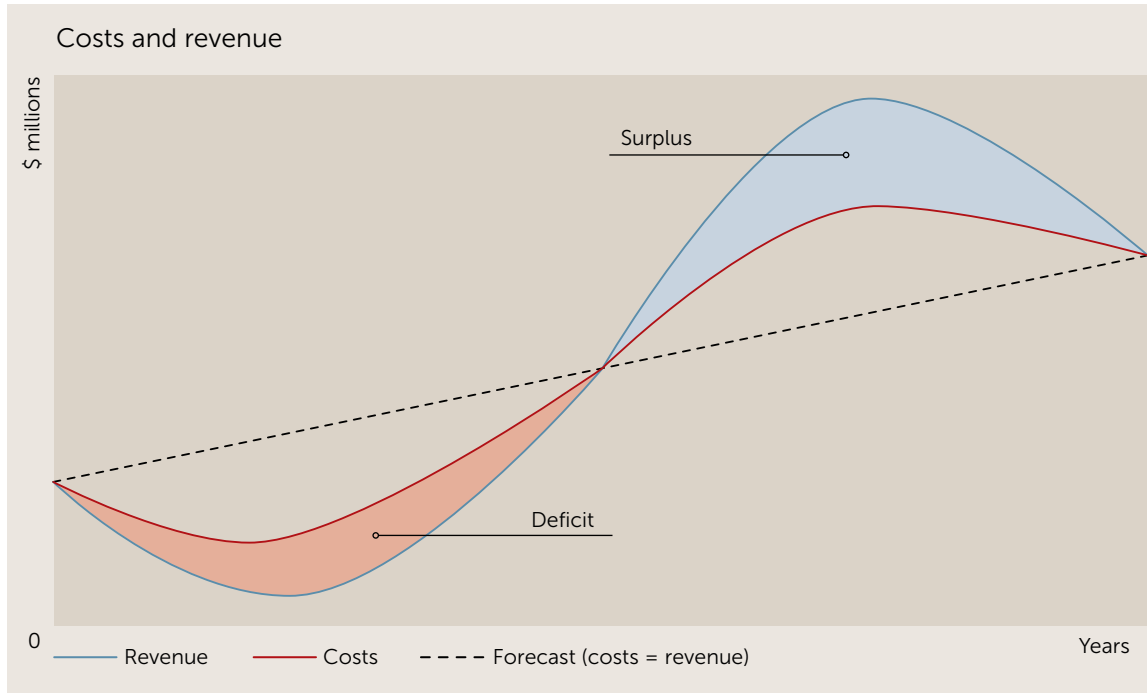
The ability to charge fees for services also carries constraints. All public sector agencies charging fees on a full cost-recovery basis are required to operate memorandum accounts (unless prior approval for alternative arrangements has been obtained from the Treasury).

This guide explains memorandum accounts, how they operate, possible risks and how they can be managed.

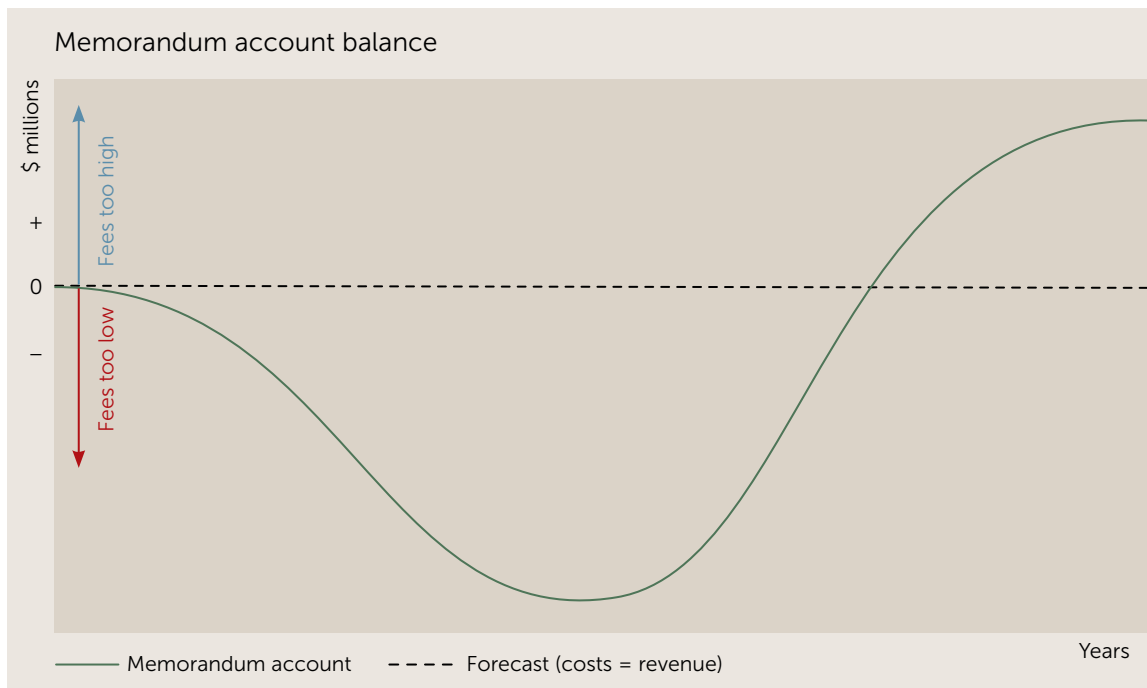
What is a memorandum account?

Fees for services should be set to recover costs over a 3–5-year timeframe based on forecast service delivery volumes. It is important that fees are not set at levels higher than cost because this could be deemed to be an unlegislated tax and unlawful. However, it is difficult, if not impossible, for forecasts to be completely accurate. In most instances, there will be some variation between actual and forecast costs and revenue.

If volumes are lower than forecast, there will be a funding deficit (total revenue will be less than the cost of providing services). If volumes are higher than forecast, there will be a funding surplus (total revenue will exceed the cost of providing services). Similarly, labour rates and other costs may vary from forecasts.



This is where memorandum accounts come in. Memorandum accounts record the accumulated balances of surpluses and deficits incurred in providing goods and services on a cost-recovery basis so that fees can be set in line with costs over time. A positive memorandum account balance at any point in time indicates that fees may be too high and should be dropped. A negative balance indicates that fees may be too low and should be increased.



What are the benefits?

At a societal level, charging fees for services increases the equity of the taxation system because the user pays and the burden on taxpayers is reduced.

At the agency level, charging fees enables demand-related cost pressures to be managed more effectively. If demand for services increases, total fee revenue also increases and the agency is able to fund the increasing cost of providing the services. If demand falls, total revenue falls, but so do total costs. Over time, fees can be adjusted to ensure that total costs align with total revenue.

Reporting memorandum account balances also increases transparency and provides assurance to fee payers and other stakeholders that fees are in line with costs. It also supports engagement with stakeholders when fee changes are required.

What are the risks?

Charging fees for services on a full cost-recovery basis and operating a memorandum account raises a number of risks:

- **Fees are significantly higher than the cost of providing services and may be challenged** – scrutiny may occur through the Office of the Auditor-General (OAG), Regulation Review Committee and/or judicial review processes. Charging fees that are higher than the current year cost of providing the service is not necessarily a problem if it can be shown that fees are set on a long-run, full cost-recovery basis and are supported by a clear charging policy and memorandum account management plan. However, overcharging can result from a lack of management oversight and appropriate remedial action. Having effective monitoring and reporting systems in place is therefore important.
- **Cost allocations do not reflect the real cost of providing services, and charges are set incorrectly** – accurate allocation of costs is important because it reduces the risk of third parties bearing the cost of other activities that should be funded by the Crown or other third-party-funded activities. It also ensures that the Crown is not inadvertently subsidising a service that should be paid for by third parties. As well as ensuring that costs are borne by the correct party, accurate cost allocation is important to ensure that fees are set at the right level.
- **Cross-subsidisation may occur and may be unlawful** – cross-subsidisation occurs when the fees collected for providing one good or service cover some of the costs of providing another good or service. As a result, the costs of some goods or services are being over-recovered while others are under-recovered. Whether this is unlawful will depend on the particular legal authority under which the fees have been charged.
- **Large memorandum account balances can cause adverse impacts on an agency** – deficits can cause liquidity issues, which could force the agency to reduce capital or other expenditure and/or request a funding top-up from the Crown. Surpluses may require fees to be reduced, causing previous users of the service to be dissatisfied because they have been overcharged.

How do we minimise the risks?

A number of things can be done to realise the benefits, manage the risks, and meet Treasury and OAG expectations:

- **Regular fee reviews** – volumes and costs are not static, so it is important that fees are reviewed regularly to ensure that the assumptions on which they are based remain valid and they are set at appropriate levels. A simple review should be undertaken each year and a comprehensive review every 3 years. Failing to review and adjust fees to reflect changing circumstances can lead to under-recovery or over-recovery of costs.
- **Monitor the memorandum account** – agencies should ensure that there is regular monitoring of memorandum account balances on either a monthly or quarterly basis. This will highlight how revenue and expenditure for a particular service is tracking against budget, whether pricing and costing of the service is realistic and whether the account balance is trending as forecast.
- **Plan to reduce surpluses or deficits** – regular monitoring of memorandum account balances will also allow plans to be put in place to reduce significant surpluses or deficits. To do this, managers can implement regular service pricing reviews, perform sensitivity analysis for different economic conditions and assess the viability of funding deficits from the agency's balance sheet. Increasing deficits may indicate the need for a fundamental review of cost structures, and increasing surpluses may require fee reductions.
- **Establish robust cost-allocation systems** – a robust cost-allocation system allows an agency with a memorandum account to accurately apportion direct and indirect costs to a particular service. This is important because it reduces the risk of third parties bearing the costs associated with other activities that should be funded by the Crown. It also ensures that the Crown is not inadvertently subsidising a service that should be paid for by third parties.
- **Demonstrate operational efficiency** – in a monopoly-provider situation, it is important that the agency is able to show that cost pressures are being managed and not just passed on through fee increases. Agencies should therefore have policies and processes in place to realise operational efficiencies and to pass these on to fee-payers.
- **Clearly document processes** – agencies should clearly document its fee-setting and management processes, in particular:
 - its approach to its charging system that makes clear the legal authority for charging, the scope of and rationale for charges and any other sources of revenue
 - the cost-allocation process, with clear assumptions
 - the fee-setting process
 - audit trails showing the assessment of costs incurred (where applicable) expected to be incurred and forecast demand and the way in which the charges have been determined
 - lines of accountability for the activity being cost recovered and the related charges
 - processes for implementation, monitoring and review.

Should more services be funded from fees?

There is no simple answer to this question. It will require careful examination of the policy objectives behind the services, the economic characteristics of the service, and any impacts on current and potential users of charging fees. Active input will need to be sought from a range of disciplines across the agency – Policy, Operations, Ministerial Services, Communications, Legal and Finance. These teams must work together to consider three guiding principles:

- **Authority** – a public entity must have legal authority to charge a fee for the goods or services that it is legally obliged to provide. That authority will be in an Act of Parliament and will usually allow the fee to be set through regulation rather than specifying the amount in the primary legislation. The scope of the legislation can vary substantially, which will affect the nature and extent of costs that can be recovered as well as the type of fees that can be charged. Some empowering provisions contain specific rules about how fees are to be set. The key point is that the authority will (generally) not allow over-recovery of costs or recovery of costs not specifically related to the provision of the activity or service.
- **Accountability** – public entities are accountable to Parliament and the public. To be accountable, they need to ensure that their processes for identifying costs and setting fees are transparent. Transparency and accountability are achieved in several ways:
 - Consulting the public about new fee regimes before they are introduced.
 - Reporting the surpluses and deficits associated with the entity’s fee regimes.
 - Reviewing the use of the powers to set fees under regulation through the Regulations Review Committee or judicial review processes.
- **Efficiency** – fees are often charged for services delivered in a monopoly-provider situation. It is therefore important that public sector agencies are operating efficiently and providing value for money to people using their services. Measuring efficiency requires an accurate understanding of the costs – both direct and indirect – of the goods or services being provided and the benefits from investment in business processes and systems. Without knowing these costs, the agency cannot show that fees are set at the right level or assess and demonstrate that it is providing value for money.

Treasury provides two cost-recovery impact statement (CRIS) templates to assist agencies to develop proposals for cost-recovery regimes. These are designed specifically to help elicit the information required to meet regulatory impact analysis requirements and to ensure that decision makers are fully informed when setting up a cost-recovery regime and setting cost-recovery levels. Of course, the relevant Vote Minister will need to support any cost-recovery proposal and be aware of the accountability and efficiency requirements.

Further information

- Authorising the charging of fees and levies, Legislative Advisory Committee Guidelines: 2018 Edition, Chapter 17, <http://www.ldac.org.nz/guidelines/legislation-guidelines-2018-edition/issues-particularly-relevant-to-empowering-secondary-legislation/chapter-17>
- Charging fees for public sector goods and services, Office of the Auditor-General (2008), <http://www.oag.govt.nz/2008/charging-fees>
- Guidelines for Setting Charges in the Public Sector, The Treasury (2017), <https://treasury.govt.nz/publications/guide/guidelines-setting-charges-public-sector-2017-html>
- Memorandum accounts in central government, Office of the Auditor-General (2013), <http://www.oag.govt.nz/2013/central-govt/part11.htm>
- Regulatory institutions and practices, New Zealand Productivity Commission, (June 2014), Chapter 12, <https://www.productivity.govt.nz/sites/default/files/regulatory-institutions-and-practices-final-report.pdf>
- Treasury Instructions 2018, The Treasury, <https://treasury.govt.nz/sites/default/files/2018-07/trsy-instruc-18.pdf>

Please contact us
if you would like to talk
about specific challenges
your agency is facing.



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