Stage 2 Cost Recovery Impact Statement

Two dairy levies under the Animal Products Act 1999

SCOPE

MPI consulted on proposals to increase charges on five levies: the poultry levy, the domestic bee levy, the exporter bee levy, the dairy standards processor levy, and the dairy export levy. This Cost Recovery Impact Statement (CRIS) only covers the dairy levies.

AGENCY DISCLOSURE STATEMENT

This CRIS been prepared by the Ministry for Primary Industries.

It provides an analysis of options to address surpluses that have accumulated under the dairy standards processor levy and the dairy export levy.

Cost recovery principles

Options considered in this paper have been developed in accordance with the cost recovery principles of Transparency, Justifiability, Efficiency and Equity defined in relevant legislation and MPI's cost recovery guidance.

MPI has not undertaken a full review of services which reduces information available to industry to assess the proposals. However, MPI and industry agree that the benefits of a timely repayment of the surplus based on MPI's best estimates outweigh the benefits of greater transparency that would be provided under a full review and that such a review can be conducted in future.

Impact analysis

Estimates of the immediate financial impact of options on the market and at the business-level are presented. As the levy changes are minor relative to the size of the industry, the CRIS does not contain a full analysis on the market impacts or on demand for MPI services over the longer term.

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10/06/2021

EXECUTIVE SUMMARY

As at June 2020, the dairy standards processor levy and the dairy export levy have considerable surpluses – $1.2 million and $0.8 million respectively. These surpluses have resulted from planned expenditure and services not occurring as forecast. Without changes these surpluses are expected to grow – to $3.5 million and $2.8 million respectively by June 2025.

MPI and industry's preferred option is to reduce the two ongoing levies (by 13% and 38%) to prevent future accrual of surpluses under these levies. MPI and industry are also progressing work on a one-off return payments (of up to $1.1 million and $0.8 million) to eliminate the surpluses. This approach best meets MPI's Efficiency and Equity principles by returning money to industry as quickly as possible so that they can use it for other purposes.

Industry noted that the proposals contained limited information around revenue and expenditure over time. MPI has taken this feedback into consideration for future reviews. Neither MPI nor industry consider that the collection and provision of this information should delay the implementation of the preferred option.

The proposed approach results in the following benefits to industry:

Dairy standards processor levy – Up to a $1,100,000 one-off repayment benefit and a $656,000 per annum benefit (in the form of reduced cost) from July 2021.

Dairy export levy – Up to a $800,000 one-off repayment benefit and a $521,000 per annum benefit (in the form of reduced cost) from July 2021.

STATUS QUO

The dairy industry over time

Dairy production steadily grew until 2015 as national herd size and yield averages increased. Since 2015 there has been an observed plateau. The real (consumers price index-adjusted) price of dairy production has been variable showing no clear long-term trends.

Figure 1: Dairy production

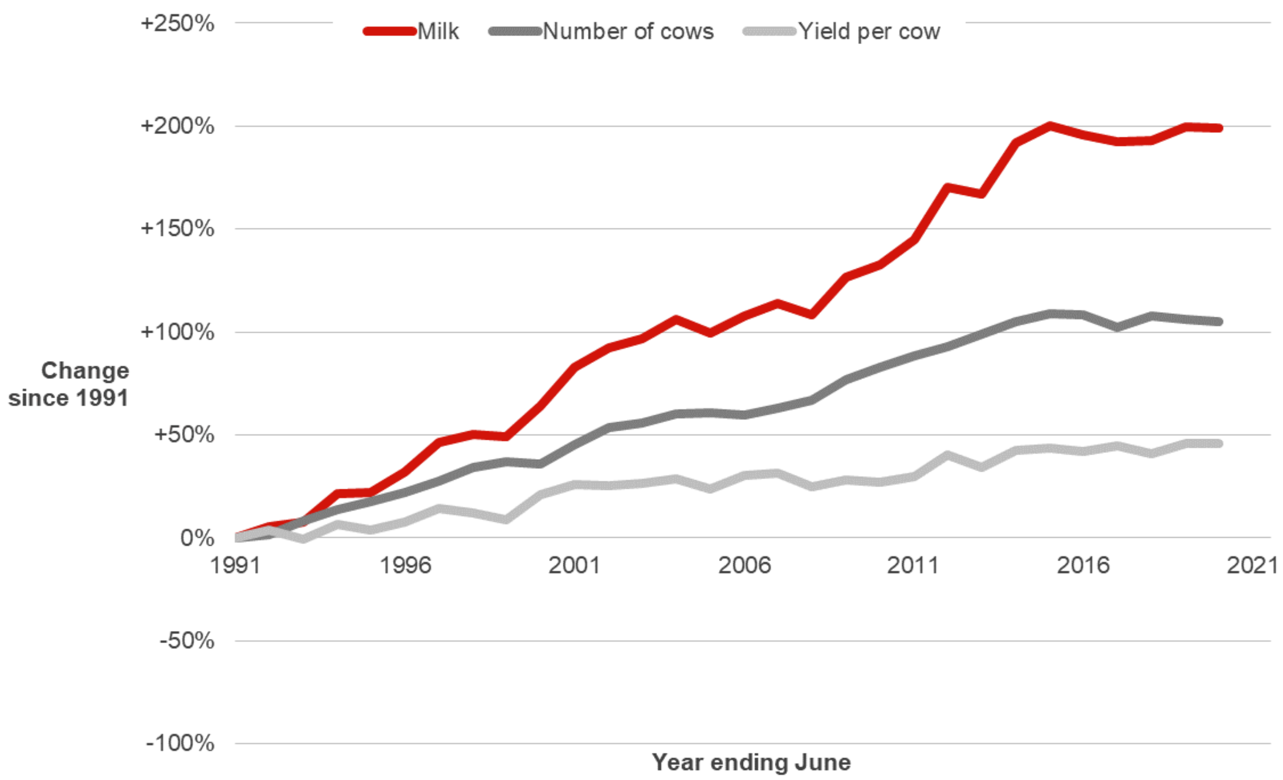
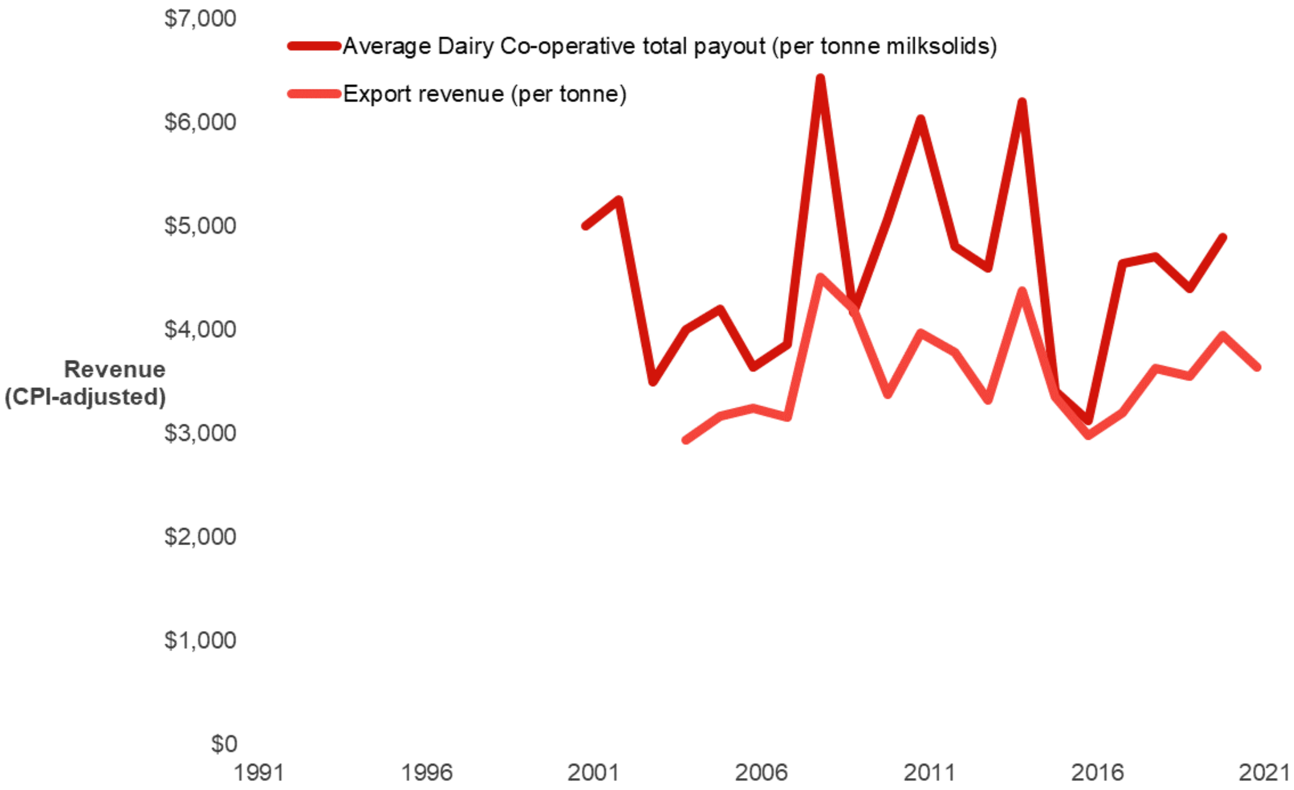


Figure 2: Dairy prices



Impact of Covid-19

Submissions noted that Covid had brought extra costs in terms of supply chain management and freight. Although unverified for dairy in particular, disruption and higher freight costs have been reported more generally in the news, and was a common theme across industry submissions received during recent consultation.

MPI's *Situation and Outlook for Primary Industries* document (December 2020) states:[1]

> *New Zealand's dairy export revenue is forecast to fall 4.6 percent to $19.2 billion for the year ending June 2021. Expectations for another strong production season are expected to be offset by weaker global dairy prices, as markets continue to deal with the impacts of the COVID-19 crisis. For New Zealand's dairy farmers, this is expected to translate into lower farmgate milk prices for the current season. However, strong underlying demand, particularly from New Zealand's largest trading partner China, should support strong sector profitability over the medium term.*

MPI's services, charges, and the regulatory framework

Cost recovery in general

Cost recovery funds the services that protect New Zealand from biological risks, ensure our food is safe to consume and export, and that help ensure the sustainability of our natural resources. These outcomes allow our primary sector to grow the value of its exports, which currently generate over $48 billion per annum (2019/20). Typically, approximately 30% of MPI's departmental funding comes from cost recovered revenue. With the emergence of COVID-19, this is expected to be approximately 20% ($150 million) in 2020/21, largely due to the drop in revenue for border biosecurity levies on arriving travellers.

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[1] https://www.mpi.govt.nz/dmsdocument/43345-Situation-and-Outlook-for-Primary-Industries-SOPI-December-2020

In line with best practice guidance, MPI generally undertakes a thorough review of each cost recovery regime at least once every three years.

Additionally, MPI aims to set fees and levies at levels that ensure memorandum accounts trend towards zero over a three-year period. To achieve this, fees and levies may also be updated outside this normal three-year review cycle if a material surplus or deficit accumulates in a memorandum account.

MPI takes a principles-based approach, as set out in the 'Cost Recovery Principles and overall approach to cost recovery' section, to both its thorough reviews and its out-of-cycle reviews.

What regulated services are covered by this CRIS?

The Animal Products Act 1999 (the APA) applies to the production and processing of all animal products including but not limited to meat, fish and shellfish and dairy products. The APA influences a wide range of businesses servicing both domestic and export markets.

MPI provides a range of regulatory services under the APA that aim to minimise and manage risks to human or animal health arising from the production and processing of animal material and products. In addition, the APA covers services that facilitate the entry of animal material and products into overseas markets. These services include:

- standards development (domestic and export);
- market access services; and
- system and assurance monitoring.

The services are club goods

A 'club good' is one where people/businesses can be excluded from services (e.g. have to join a 'club'), but once in the club, are able to use of the services without reducing the service and benefits available to other members (the benefits are 'non-rival').

The benefits of standards and market access are available to any business that chooses to operate in the domestic or export market. One business making use of the standards or access does not prevent another business from making use of the standards or access. The benefits of standards and access are, therefore, non-rival. Businesses, however, can only receive these benefits if they comply with the regulatory requirements (the service is excludable).

To encourage businesses to only demand or use services that they value highly enough it is economically efficient to, wherever possible, recover the costs of providing club goods from those who benefit from the services.

How are the levies regulated?

In general

The Animal Products Act 1999 (APA) allows MPI to recover costs in accordance with the principles of Transparency, Justifiability, Efficiency and Equity (see the 'Cost Recovery Principles and overall approach to cost recovery' section of this CRIS).

Levies are set in the Animal Products (Fees, Charges, and Levies) Regulations 2007.

Those that benefit from standards, market access and monitoring are the businesses that supply domestic and export markets, and ultimately the customers of those businesses. Economically-efficient cost recovery would see businesses pay in proportion to the benefits they receive. However, it is generally difficult to establish the precise level of benefit a business receives from a service. As a result, MPI uses an appropriate proxy (such as units produced or exported) to quantify the benefits its services provide to each business. This approach is consistent with MPI's cost recovery policy and best practice guidance from the Treasury.

Additional requirements for changes made part-way through a financial year

Any changes to the charges in 2021 will be made part-way through the financial year (1 July 2021 to 30 June 2022). The APA contains additional requirements being that the Minister is 'satisfied' that 'agree or substantially agree' with the changes.

How are the levies set?

MPI calculates the total costs (direct and overheads) in the relevant business unit. The business unit is responsible for standards and market access for many products and industries.

For the dairy industry, large processors are levied on a different basis than small processors. The issues and options considered here relate only to the levy paid by large processors. The Dairy Standards Processor Levy is charged to approximately 17 large dairy processors and the Dairy Export Levy is charged to approximately 38 large dairy processors.

Both the Dairy Standards Processor Levy and the Dairy Export Levy have a total revenue target, where each processor's share of the cost is proportionate to their share of industry's milksolids production. That is, if a large processor collects 20% of the milksolids collected by all large processors, the processor will pay 20% of the total cost of the levies.

Current charges

Figure 3 presents the current charges.

Figure 3: Current charges

Levy	Current rate
Dairy standards processor levy	$4,935,867 recovered across the industry per year
Dairy export levy	$1,355,100 recovered across the industry per year

Review of cost recovery charges

MPI regularly reviews cost recovery across each of the systems it administers to ensure that settings remain appropriate. Regular updates allow changes to be well signalled and avoids sharp, unexpected changes.

As a result of regular reporting on the levies, both MPI and industry identified that surpluses were accumulating under levies on large processors and should be addressed. No problems have been identified with levies on small processors.

Cost Recovery Principles and the overall approach to cost recovery

This section summarises MPI's Cost Recovery Principles, how they relate to each other, and what this means for the overall approach to cost recovery.

MPI's Cost Recovery Principles

MPI's four Cost Recovery Principles are:

- Transparency – costs are transparent;
- Justifiability – costs are reasonable;
- Efficiency – net benefits are maximised; and
- Equity – costs are fair.

These principles are set out in MPI's cost recovery guidelines[2] and in the Animal Products Act 1999.[3]

The principles build on each other with Transparency and Justifiability providing a foundation to the consideration of, and sometimes trade-offs between, Efficiency and Equity. Essentially, MPI can only cost recover if it has sufficiently met the Transparency and Justifiability principles.

Once the Transparency and Justifiability principles are met, the Efficiency and Equity principles say that the beneficiaries of services should generally pay for services. That is, beneficiaries pay 100% of costs unless there is a strong efficiency or equity reason suggesting otherwise.

Appendix 1 contains a fuller description of the principles and how they relate to each other.

Overall approach to cost recovery

The requirement to meet a level of Transparency and Justifiability and the default of beneficiary pays results in the following overall approach:

Customers/beneficiaries generally pay

Customers/beneficiaries should generally pay for the services they demand.

Charging beneficiaries encourages them to demand or use only the services that they value highly enough. If the cost is subsidised by others, then beneficiaries will demand more services (with the cost being met by others). The extra demand on services from subsidisation is inefficient as it results in a greater use of resources during production than people would otherwise be willing to pay for.

Charging beneficiaries helps ensure MPI service volumes or quality are not higher than is economically efficient.

When beneficiaries might not pay

Beneficiaries might not pay full costs in four situations:

Transparency and justifiability

The first is where MPI has not sufficiently demonstrated that it is doing all it reasonably should to keep costs low (cannot meet the Transparency and Justifiability principles).

In this situation it may be appropriate for MPI to:

- change fees/levies to the level that can be justified for the time being; and
    - cover the remainder of costs; or
    - recover the deficit from a future time period after further work is undertaken;
- guarantee that prices will not exceed a certain level over the next period;
- charge fees at a fixed level, rather than variable with time, to encourage efficient service delivery.

Administration costs

The second is where the administrative costs of charging (e.g. invoicing, collection) are excessive compared the revenue raised or the efficiency gain of precisely charging beneficiaries.

Externalities

The third is where there are externalities. Externalities are positive or negative impacts on third parties from the demand and supply of a good or service. MPI primarily deals with negative externalities. An example is the risk that arises from consumers demanding, and importers supplying, overseas products. A negative externality on a third party is the biosecurity risk from pest incursions on domestic

[2] https://www.mpi.govt.nz/dmsdocument/30855/direct

[3] https://www.legislation.govt.nz/act/public/1999/0093/latest/whole.html#DLM35716

farmers. Charging importers for MPI activities to reduce the risk encourages importers to reduce the risk and, therefore, need for the service.

Equity

The fourth is where the Government determines that there are equity (fairness) reasons why the Government or some other party should contribute to costs.

PROBLEMS

What is the nature of the problem?

Surpluses

In order not to over- or under-charge industry for services, MPI aims to have accounts in balance within any three-year period.

Surpluses have arisen in the dairy accounts. Surpluses are an efficiency problem – either the levy is too high for a given level of service delivered to industry at any point in time, or the level of service is too low, or a combination.

The dairy levies were increased in the 2018/19 year to recover deficits at the time and with the intention of funding future services. However, service levels and expenditure did not increase by the degree expected and surpluses have accumulated and are forecast to grow further.

It is inefficient and inequitable to charge industry for services that have not been provided. Industry experiences a cost (a loss of economic efficiency) from the reduction or delay in economic value that would have created if it was able to use that money.

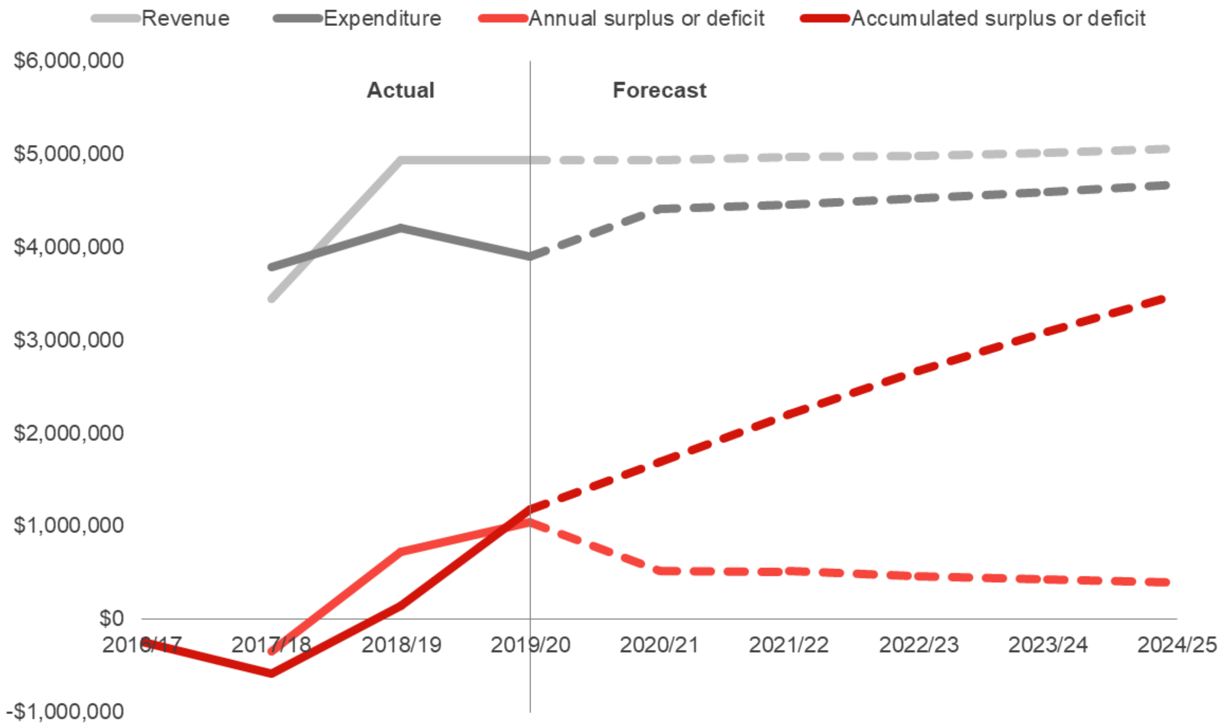
What is the size of the problem?

Dairy standards processor

Historical annual surpluses, including an annual surplus for the 2019/20 financial year of $1,036,000, have contributed to an accumulated surplus of $1,172,000 as at June 2020. The accumulated surplus is forecast to grow to $1,694,000 by June 2021 and $3,385,000 by June 2025.

Figure 4 shows the history of revenue, expenditure, and annual and accumulated deficits through to 2019/20 and forecasts through to 2024/25. Expenditure was running higher than revenue prior to 2018/19. The levy was increased in the 2018/19 year to recover the deficit and with the intention of funding further services. However, expenditure did not increase by the degree expected and surpluses have resulted. Expenditure is expected to increase from recent levels in line with general cost inflation and demand (proxied by GDP growth).

Figure 4: Dairy Processor Levy, revenue and expenditure, 2016/17 to 2024/25

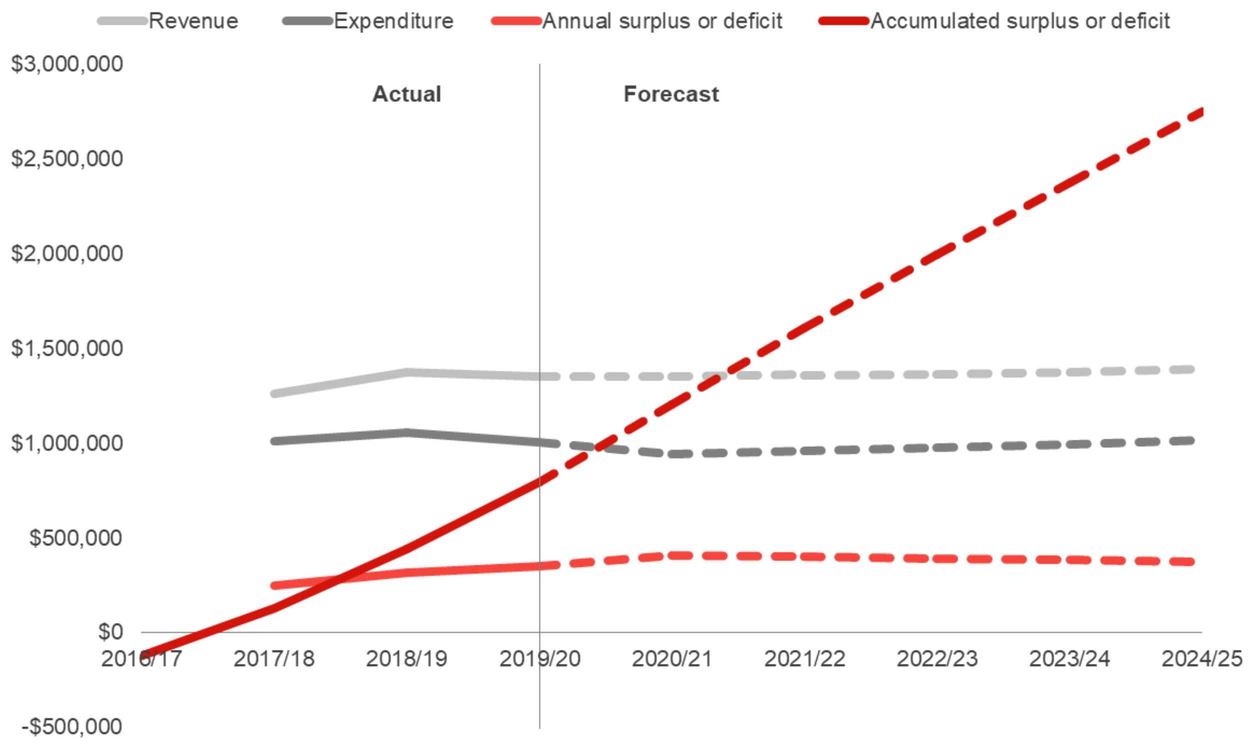


Dairy export levy

Historical annual surpluses, including an annual surplus for the 2019/20 financial year of $352,000, have contributed to an accumulated surplus of $793,000 as at June 2020. The accumulated surplus is forecast to grow to $1,203,000 by June 2021 and $2,754,000 by June 2025.

Figure 5 shows the history of revenue, expenditure, and annual and accumulated deficits through to 2019/20 and forecasts through to 2024/25. Expenditure was running higher than revenue prior to 2018/19. The levy was increased in the 2018/19 year to recover the deficit and with the intention of funding further services. However, expenditure did not increase by the degree expected and surpluses have resulted. Expenditure is expected to increase from recent levels in line with general cost inflation and demand (proxied by GDP growth).

Figure 5: Dairy Export Levy, revenue and expenditure, 2016/17 to 2024/25



OPTIONS

This CRIS analyses two options:

- Status quo – The dairy standards processor levy and the dairy export levy are unchanged and the surpluses set out above are retained by MPI.
- 'Eliminate the surplus' – For both levies, a one-off return payment is made to those who contributed to the accumulated surpluses[4], and the ongoing levy is reduced so that a surplus does not re-emerge.

Figure 6 details the status quo and 'Eliminate the surplus' option for both the dairy standards processor levy and the dairy export levy.

Figure 6: Options

Option		**Dairy standards processor levy**	**Dairy export levy**
Status quo	Current levy	$4,935,867 recovered across the industry per year	$1,355,100 recovered across the industry per year
Eliminate the surplus	One-off return payment	$1,100,000 returned	$800,000 returned
	New levy	$4,279,580 recovered across the industry per year (13% reduction)	$834,567 recovered across the industry per year (38% reduction)

Discarded options

Internally within MPI, an option to return only 50% of the surplus was briefly considered to smooth revenue to anticipated higher expenditure following a future review. However, this option was not considered viable as it would charge past levy payers for future services and therefore not meet the beneficiary pays principle (under the Efficiency principle). In addition, associated issues regarding

[4] The surplus is returned via credit notes to the processors that have directly contributed to the surplus. It is up to the processors to then determine what to do with that money, including whether to further redistribute it to farmers.

Justifiability, Transparency (as it was not consulted on) and Equity were also identified with this option. This option is not considered further in this CRIS.

ASSESSMENT

This section assesses the options against MPI's Cost Recovery Principles using the approach set out in the 'Overall approach to cost recovery' section. In doing so, this section also draws on and responds to submissions.

The magnitude of impacts on the industry are not material to the assessment of options. For reference, these impacts are available in Appendix 3.

Summary assessment

The status quo for both the dairy standards processor levy and the dairy export levy result in the surpluses continuing to grow. This option is not preferred as, by charging businesses more than is required, it does not meet the Efficiency and Equity principles.

The 'Eliminating the surplus' option returns almost all the surplus to those that paid it and reduces the levies to levels where a surplus is not expected to re-emerge. Not charging businesses more than is required and returning surplus money to businesses to use for other purposes best meets the Efficiency and Equity principles.

A future review of services would help to improve the accuracy of forecasting expenditure and levies to inform the levy settings. However, MPI and industry share the view that this should not delay a prompt repayment of the current surplus together with a reduction in the levy fees to avoid future accumulation of surplus.

The 'Eliminating the surplus' options result in the following benefits to industry:

- A $1,100,000 one-off benefit and a $656,000 per annum benefit (in the form of reduced cost) from July 2021 across payers of the dairy standards processor levy.
- A $800,000 one-off benefit and a $521,000 per annum benefit (in the form of reduced cost) from July 2021 across payers of the dairy standards processor levy.

Submitters consider the beneficial impact of returning the surplus to be significant at a business level. However, the impact on the market prices and quantities will be negligible.

The change in forecasted trajectory of revenue and surplus under "Eliminate the surplus" option is shown in Figure 8 and Figure 9 for the dairy standards processor levy and the dairy export levy respectively.[5]

[5] The numbers behind these charts can be found in Appendix 2.

Figure 7: Dairy standards processor levy – change in revenue and surplus

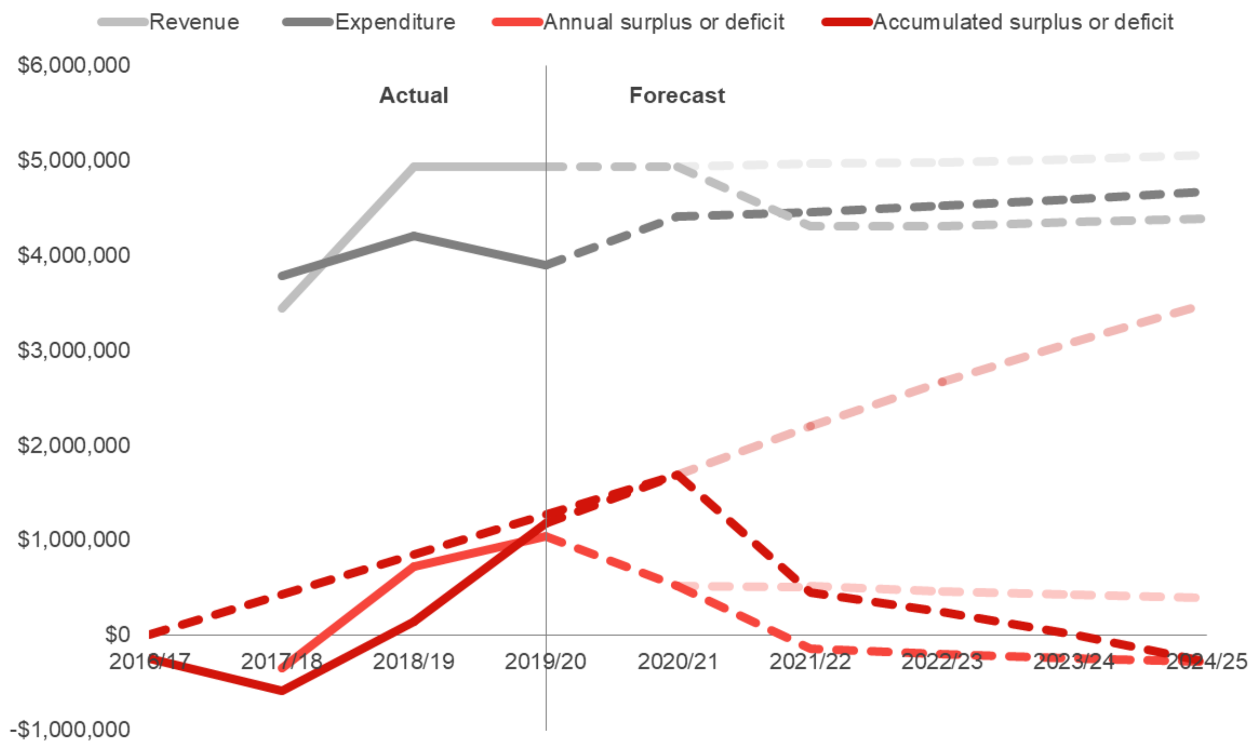
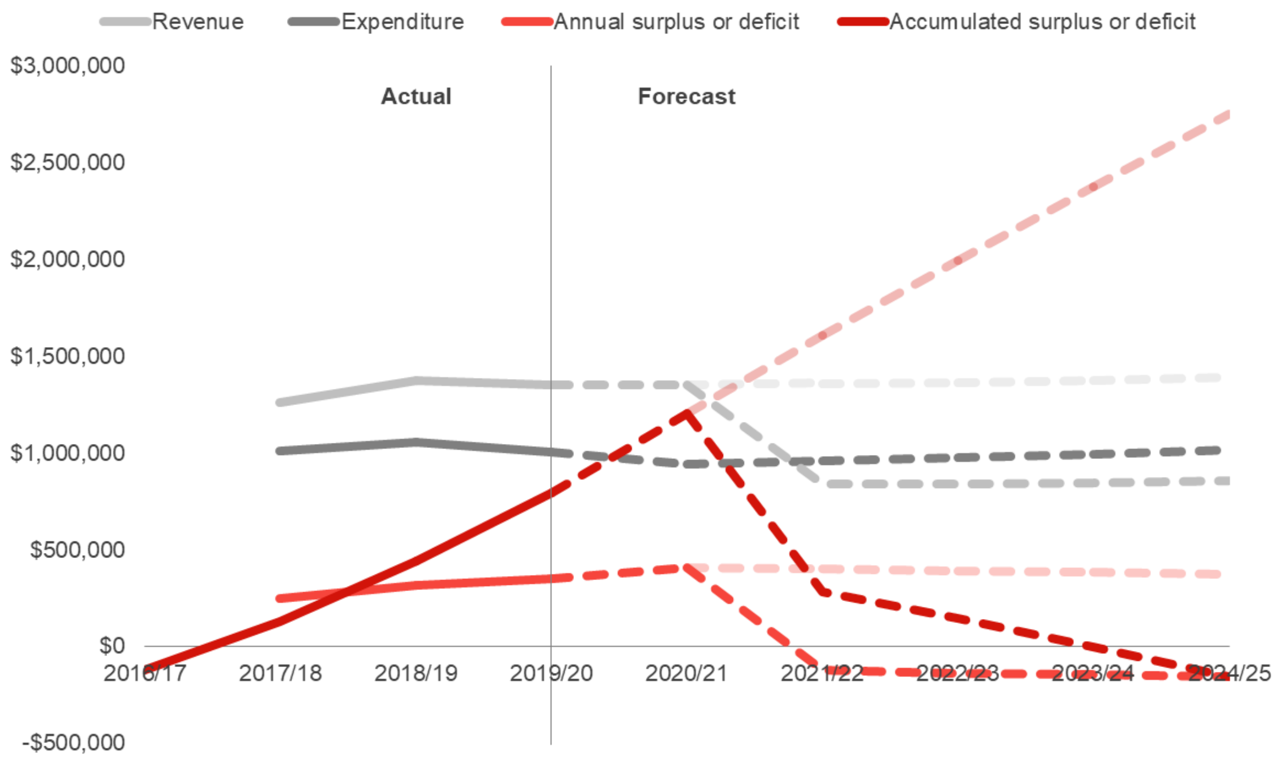


Figure 8: Dairy export levy – change in revenue and surplus



Fuller assessment

Beneficiaries pay

The default approach to cost recovery is that beneficiaries pay for services they receive. The inverse of this is that parties should not pay for services that are not received. Therefore, any surplus (arising from services not provided) should be returned to those that contributed to it and the levy reduced to a level that better matches actual services provided.

The longer the surplus takes to return, the greater the cost of lost opportunities for industry to spend the money elsewhere.

The 'Eliminate the surplus' option meets this element. The status quo does not.

Transparency and Justifiability

To perfectly demonstrate that the ongoing levy rate (to cover future expenditure) is justified, MPI would need to draw on a business case (or something similar setting out MPI's processes and the costs needed to run them) for recently developed services or, in the case of an established service, taking an old business case and accounting for changes to factors that affect revenue and costs. MPI has not yet done this kind of review[6] but intends to in the near future along with considering what new services might be offered.

Submitters noted the lack of information and requested more information in future. Submitters also queried whether the proposed reduction in revenue should be greater. The proposed expenditure path is MPI's best estimate based on current available information. MPI and industry agree that returning the surplus and lowering the ongoing levy should not be delayed at this time.

Although more information from a future review would better support the Transparency and Justifiability issues, 'Eliminate the surplus' remains the preferred option of both MPI and industry to address the problem.

Administration costs

MPI's cost recovery regime operates, with industry approval, on a basis of frequent reviews to ensure significant surpluses and deficits do not arise or are addressed quickly when they do.

It is administratively easy for MPI to change the levels of charges. It is expected to be administratively easy for businesses to change their accounting settings too. The minor administration costs of frequent changes are already factored into MPI's approach of frequent reviews and changes.

There are greater administration costs from doing a change now and then implementing changes in future (after a fuller review) as a result of re-running government processes and consultation rounds. However, these costs are trivial compared to the efficiency costs of not returning the surplus and allowing it to build further over time.

No other administration cost issues have been identified.

'Eliminate the surplus' remains the preferred option of both MPI and industry.

Externalities

Standards and market access provide industry and their customers with private benefits.

There are no externalities and 'Eliminate the surplus' remains the preferred option.

Equity

Covid has disrupted businesses and supply chains and has increased freight costs. With more time, MPI might have considered options that increased the revenue target over time (from lower than needed in 2021/22 to higher than needed in later years) to provide more relief to industry in the immediate period.

MPI does not consider that delaying the return of the currently-identified surplus outweighs any benefit of designing and consulting on additional options. Industry has also not proposed other options and has said that it wishes that the surplus be returned promptly.

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[6] Appendix 4 sets out contributing factors and their importance.

No Equity issues have been identified that are detrimental to the ‘Eliminate the surplus’ option. It therefore remains the preferred option.

Consultation

MPI formally consulted on the current surplus that has accumulated under each levy and the proposed option ‘Eliminate the surplus’. Consultation occurred through a consultation document published online and sent to key industry participants. The consultation period lasted four weeks. Other discussions have occurred prior to and since formal consultation.

Industry, including Fonterra, The Dairy Companies Association of New Zealand and The New Zealand Food & Grocery Council, support the proposal. The Dairy Companies Association of New Zealand and The New Zealand Food & Grocery Council had concerns about the quality of information accompanying the proposal. These concerns are addressed in the ‘Assessment against the principles’ section along with the acknowledgement that a full review in future will improve the accuracy of forecasting expenditure and levies to inform the levy settings. MPI and industry agree that returning the surplus and lowering the ongoing levy should be progressed without delay to address the current problem.

Additional requirements for changes made part-way through a financial year

As noted in the ‘How are the levies regulated?’ section of the ‘Status quo’ section, there is an additional requirement for changes made part-way through a financial year. This requirement is that the Minister needs to be ‘satisfied’ that affected parties ‘agree or substantially agree’ with the changes.

The Animal Products Act 1999 emphasises that the Minister needs to be satisfied. As such, this CRIS does not say whether the Minister should be satisfied or not.

The ‘Consultation’ section covers submitters views. In all submissions and other correspondence, industry has expressed a preference to have the surplus returned.

Conclusions and recommendations

The dairy standards processor levy and the dairy export levy are in surplus and those surpluses are expected to grow over time.

MPI and industry’s preferred option is to reduce the two ongoing levies (by 13% and 38%) to mitigate against future accrual of surpluses under these levies. MPI and industry are also progressing work on a one-off return payments (of up to $1.1 million and $0.8 million). By minimising the risk that businesses pay for services they do not receive, this approach best meets the Efficiency and Equity principles.

While more information about the proposals and about projected future spending could have been provided with more time, the associated benefit would not have outweighed the benefit of returning the surplus and reducing the levy. Investigating contributors to cost changes and the link between expenditure, revenue and levies will provide better information to inform future reviews of levy settings.

Implementation plan

If agreed the changes proposed will be made through amendments to the Animal Product (Fees, Charges, and Levies) Regulations 2017, which will then be publicly notified in the New Zealand Gazette. Implementation will apply from 1 October 2021 and MPI will notify fee payers of the new rates that will apply prior to this. In addition, MPI will update its application forms and other material to include the appropriate rates.

Levies are collected from processors rather than individual farmers to minimise administration costs. Administrative costs of changes levies are expected to be negligible on the part of MPI and industry.

MPI understands that industry prefers to have as early an indication of fee changes as possible so they can build them into contracts with customers. MPI will continue to endeavour to progress cost recovery changes as early as possible.

Monitoring and evaluation of services

MPI recognises that performance reporting is a critical component in providing transparency to industry and other interested parties, as well as ensuring ongoing system efficiency. This is explicitly acknowledged in the policies and guidance on our Principles.

To improve transparency, MPI has worked with industry to create a framework for reporting on the performance of cost-recovered services for all sectors. This has involved publishing annual reports about MPI's performance for the primary sectors. Performance reporting is an area for ongoing development for MPI – the annual reports currently focus on transparency around financial data and there is scope to use them to report against performance metrics (once developed).

Review of cost recovery settings

MPI monitors the financial performance of all cost recovered systems it administers on an ongoing basis throughout the year. In line with best practice guidance, we generally undertake a thorough review of each cost recovery regime at least once every three years. This ensures that cost recovery regulatory settings remain appropriate. Reviews consider both cost recovery policy settings (who should pay for services, and how) and the rates of fees and levies.

Fees and levies may also be updated outside this review cycle if a material surplus or deficit accumulates in a memorandum account. MPI aims to set fees and levies at levels that ensure memorandum accounts trend towards zero over a three-year period.

Appendix 1: MPI's cost recovery principles

MPI's four Cost Recovery Principles are:

- Transparency – costs are transparent
- Justifiability – costs are reasonable
- Efficiency – net benefits are maximised
- Equity – costs are fair

These four principles appear in the Animal Products Act 1999 and the Wine Act 2003.[7]

The legislative definitions and interpretation of these are set out under each of the four principles below.

Transparency

Legislation

'Costs should be identified and allocated as closely as practicable in relation to tangible service provision for the recovery period in which the service is provided.'

Interpretation

'Transparency' means providing adequate information to people such that they can understand charges and have an opportunity to input into their calculation and setting.

'Identified and allocated…' means presenting the costs in a way that people can see what services generate what costs and when. 'Allocated' does not mean 'charged'. How costs are charged is a result of consideration of all the principles.

Justifiability

Legislation

'Costs should be collected only to meet the reasonable costs (including indirect costs) for the provision or exercise of the relevant function, power, or service.'

Interpretation

'Reasonable costs' are those necessary to deliver the service at the demanded quantity and quality.

Efficiency

Legislation

'Costs should generally be allocated and recovered in order to ensure that maximum benefits are delivered at minimum cost.'

Interpretation

Efficiency is made up of several elements:

(1) Costs should be the lowest necessary to meet customer demand. Customers can include businesses, members of the public, and the Government including other agencies. Meeting customer demand might involve treating different customers differently.

(2) Costs should be charged to:

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[7] https://www.legislation.govt.nz/act/public/1999/0093/latest/whole.html#DLM35716
https://legislation.govt.nz/act/public/2003/0114/latest/DLM223236.html

(a) Who benefits from the service – If the customer pays, they have the incentive to demand only those services that provide them benefit compared to other things they might purchase. If parties other than the beneficiary pays, then the beneficiary will demand more services than otherwise.

(b) Whose behaviour can reduce the need and cost of the service – Typically both the supplier (MPI) and the customer will be able to do things to reduce the need and cost of the service. For example, MPI could adopt innovative technologies to reduce labour costs, while businesses might locate in urban, rather than rural, areas to reduce distance from market (including MPI's services).

If MPI has transparently justified its costs, it will not normally be appropriate for MPI to contribute to the costs.

Where there are externalities, it may be efficient to charge the third party as well, or instead of, charging the customer/beneficiary.

(3) Charges should account for administrative costs – sometimes it will be administratively prohibitive to charge according to (2)(a) or (2)(b) so a simplified approach is warranted.

(4) Charges should be competitive neutral – MPI should not use any dominant market position to charge inflated prices and make more than a fair economic return.

Equity

Legislation

'Funding for a particular function, power, or service, or a particular class of functions, powers, or services, should generally, and to the extent practicable, be sourced from the users or beneficiaries of the relevant function, power, or service at a level commensurate with their use or benefit from the function, power, or service.'

Interpretation

The Government will usually deem it fair that beneficiaries pay.

On other occasions, the Government will determine that other fairness considerations mean that another party contributes to the costs. For example, sometimes industry will be happy to support parts of its industry. Other times, Governments will want to provide additional support.

Relationship between the Cost Recovery Principles

The principles build on each other with Transparency and Justifiability providing a foundation to the consideration of Efficiency and Equity. Figure 9 summarises the relationship between the principles.

Transparency and Justifiability come before considering Efficiency and Equity

The APA says about Justifiability that MPI can only recover reasonable costs.

While the Transparency principle itself doesn't have a similarly strong statement, the very next clause says that costs should not be recovered unless there's been adequate consultation with affected parties including 'sufficient time and information to make an informed contribution'. Adequate consultation can only happen if MPI has been transparent.

With language of 'should not' and 'only', Transparency and Justifiability require[8] some minimum standard to be met. In contrast, Efficiency and Equity are to be achieved 'generally'.

This sequential approach to the principles, rather than considering the principles simultaneously, makes sense. It is not possible to be confident that the efficient way of cost recovering has been

[8] The Animal Products Act 1999 and Wine Act 2003, however, also say that failure to consult sufficiently does not affect the validity of cost recovery charges.

identified if costs have not been sufficiently justified, or affected parties have not had a reasonable opportunity to test the costs.

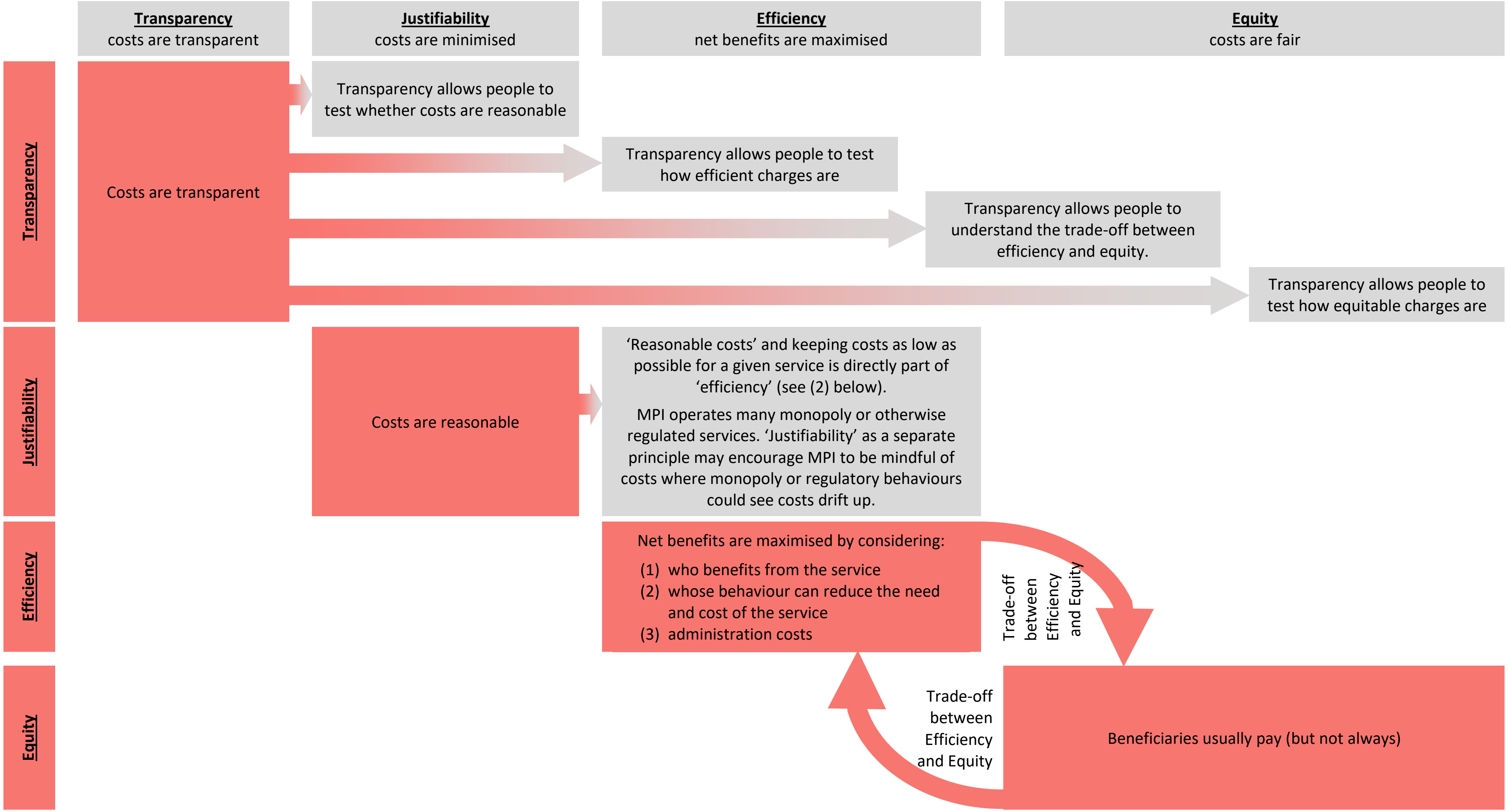
There will sometimes be trade-offs between Efficiency and Equity

The ‘generally’ in the Equity principle means that a Government might decide to charge someone other than the beneficiary. The ‘generally’ in the Efficiency principle means that cost recovery settings will not always maximise benefits and minimise costs.

This also makes sense. If the Government determines that it is more equitable pay for a service through Crown funding rather charging beneficiaries or those whose behaviour can reduce the need for the service (see (2)(a) and (2)(b)), then the cost recovery setting will not be maximising net benefits.

The two ‘generally’s allow for trade-offs to be made between Efficiency and Equity.

Figure 9: Relationship between the Cost Recovery Principles



Appendix 2: Actual and forecast revenue and expenditure

Figure 10: Dairy standards processor levy ($000)

	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25
Status quo								
Opening balance	-242	-589	137	1,172	1,694	2,208	2,664	3,090
Revenue	3,441	4,936	4,936	4,936	4,970	4,975	5,020	5,065
Expenditure	3,789	4,209	3,900	4,414	4,457	4,520	4,594	4,670
Ending balance	-590	137	1,172	1,694	2,208	2,664	3,090	3,485
One-off refund and lower the target revenue								
Opening balance	-242	-589	137	1,172	1,694	447	241	-1
Revenue	3,441	4,936	4,936	4,936	4,310	4,314	4,353	4,392
One-off refund					1,100			
Expenditure	3,789	4,209	3,900	4,414	4,457	4,520	4,594	4,670
Ending balance	-590	137	1,172	1,694	447	241	-1	-278

Figure 11: Dairy export levy ($000)

	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25
Status quo								
Opening balance	-121	126	441	793	1,203	1,607	1,996	2,378
Revenue	1,259	1,374	1,355	1,355	1,365	1,366	1,378	1,391
Expenditure	1,012	1,059	1,003	945	960	977	996	1,015
Ending balance	126	441	793	1,203	1,607	1,996	2,378	2,754
One-off refund and lower the target revenue								
Opening balance	-121	126	441	793	1,203	283	147	0
Revenue	1,259	1,374	1,355	1,355	840	841	849	856
One-off refund					800			
Expenditure	1,012	1,059	1,003	945	960	977	996	1,015
Ending balance	126	441	793	1,203	283	147	0	-158

Estimated financial and economic impacts

Introduction

This section sets out the immediate financial impact of options on the market and at the business-level, and then considers how the financial impact feeds through to changes in prices and volumes over the medium- to long-term.

Summary impact assessment

Returning the surplus will allow businesses to spend the money in other ways. Submitters consider the impact of returning the surplus to be significant at a business level. The impact on the market prices and quantities will be negligible, however.

Fuller impact assessment

Immediate market-level impacts

Figure 12 shows the immediate financial impact on industry and MPI of each option.

Figure 12: Immediate market-level impact

Option	Impact on MPI	Impact to industry
Dairy standards processor levy		
Status quo	MPI continues to hold onto the surplus.	No impact relative to the status quo. There is an opportunity cost to industry of being unable to use the money available under the proposed option.
One-off refund and lower the target revenue	The surplus is eliminated.	$1,100,000 one-off benefit. $656,000 per annum benefit (reduced cost) from lower levies from July 2021.
Dairy export levy		
Status quo	MPI continues to hold onto the surplus.	No impact relative to the status quo. There is an opportunity cost to industry of being unable to use the money available under the proposed option.
One-off refund and lower the target revenue	The surplus is eliminated.	$800,000 one-off benefit. $521,000 per annum benefit (reduced cost) from lower levies from July 2021.

Immediate business-level impacts

Figure 13 indicates the ongoing impact on the change to the ongoing dairy export levy on a representative low volume exporter with about 1,400 tonnes exported and a representative high volume exporter with 19,200 tonnes exported. About 97% of exports by mass is by exporters with 19,200 tonnes or more. Figure 13 does not include the one-off return of surplus.

MPI has not been able to source similar data for the dairy standards processor levy in time for this CRIS.

Figure 13: Annual financial impact on representative producers

Option	Low volume producer	High volume producer
Status quo	No impact relative to the status quo. There is an opportunity cost to industry of being unable to use the money available under the proposed option.	No impact relative to the status quo. There is an opportunity cost to industry of being unable to use the money available under the proposed option.
Eliminate the surplus	$210 benefit (reduced cost) per annum from July 2021.	$2,900 benefit (reduced cost) per annum from July 2021.

Medium- to long-term market-level impacts

Changes in unit charges are changes in business costs. This feeds through to business margins and, over the medium- to longer-term, to market prices and quantities. Competition means that changes in costs for processes will feed through to changes in prices throughout the value chain, including at the farmgate (i.e. costs changes are at least partially passed through).

When prices rise/fall, the quantity demanded for New Zealand production including exports falls/rises. This causes a decrease/increase in production at an industry level. Businesses will, on average, sell less/more. The business-level impact can range from all businesses producing less/more, or some businesses exiting the market and remaining businesses producing the same.

The scale of the impact depends on the size of the cost (price) increase and the elasticity of demand (how price sensitive overseas customers are) and supply (how easily the industry can scale up and scale down production over the long term).

While industry submissions described the return of the surplus as having significantly positive impacts at the business level, the proposed changes are small in the context of total industry costs and, therefore, the impact on volumes and prices.

For example, the dairy export levy reduces by $521,000 per annum. This compares to export revenue of $20.135 billion. If all of the cost reduction was passed through to export prices, the reduction would be 0.003%. These is a negligible impact, therefore the wider market impacts are not analysed further.

APPENDIX 4: FACTORS THAT AFFECT REVENUE AND COSTS

Figure 14: Potential contributing factors

Factor	How important is this factor?
(a) Higher or lower than anticipated (or needed) volumes	MPI has negligible control over this factor. Volumes are a result of demand for product and producers' ability to supply it. Usually[9] in the case of levies, higher volumes generate more revenue, and reduce the average costs of the club good. It is important to be transparent so that the contribution of volumes versus other factors is understood, and so that industry can plan for the future using timely information about how revenue is tracking against cost (and thus the likelihood of future levy changes). Because MPI has negligible control, this factor is not significant to questions about whether costs should be 100% recovered.
(b) Cost inflation	Inflation is the general increase in costs over time. The control MPI has over this factor is negligible. It is important to be transparent so that the contribution of cost inflation versus other factors is understood, and so that industry can plan for the future using timely information about how revenue is tracking against cost (and thus the likelihood of future levy changes). So long as MPI makes best endeavours in forecasting and collecting revenue, MPI has negligible control and this factor is not significant to questions about whether costs should be 100% recovered.
(c) MPI-specific increases in the costs of particular inputs beyond inflation	It is more important, compared to (c), that MPI be transparent about these costs. This information is likely to be held by MPI, rather than public like general information, and MPI is likely to have greater levels of control from time to time in the level of cost (e.g. wage settlements). If MPI is not transparent, there is a risk that MPI hides cost increases to avoid hard choices and questions about whether costs should be 100% recovered could be raised.
(d) Level of resource required for a given service	While MPI has little and some control over (b) and (c) respectively, it has complete control over (d). It is very important that MPI is transparent about the level of effort/resource required to deliver services, including different ways of delivering the same outcome. For example, while export requirements are set by overseas countries, careful design can reduce regulatory costs. If MPI is not transparent, risks of cost inefficiencies or missed productivity improvements arise and questions about whether costs should be 100% recovered could be raised.
(e) Service levels	It is very important that MPI is transparent about choices around service levels. While export requirements are set by overseas countries, the actual countries New Zealand ends up having agreements with is a matter of choice. MPI and industry have significant control here. There is even more control for domestic standards, where the design of the standard is more within MPI's control (in consultation with industry). If MPI is not transparent, costs might not be as low as they can be, and service levels might be too high and legitimate questions about whether costs should be 100% recovered could be raised.

[9] The dairy levies are a revenue target rather than on units or numbers of processors, so variability in actual revenue is very small.