



9 September 2015

Hon David Cunliffe
Chairperson
Regulations Review Committee
Parliament Buildings
Wellington

Lyn Provost

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Dear Mr Cunliffe

COMPLAINTS REGARDING THE SHIPPING (CHARGES) AMENDMENT REGULATIONS 2014

1. I refer to your letter dated 8 May 2015 (received in this Office on 21 May), in which you forwarded the Committee's request for comment and advice from my Office in relation to fee-setting under the above regulations. As agreed in my response of 17 July 2015 and your further letter of 23 July 2015, I undertook to advise the Committee on:
 - how Maritime New Zealand (MNZ) derived its office fee (referred to in this letter as "the base hourly rate");
 - whether the base hourly rate meets any of the grounds for the Committee to draw it to the special attention of the House under Standing Order 319; and
 - whether the method used to set the base hourly rate was consistent with the good practice guide we published in June 2008.
2. This letter now provides my advice to the Committee on those matters. I also comment on three other matters:
 - MNZ's loading on to the base hourly rate to fund its new IT system;
 - MNZ's 33% loading on to the base hourly rate to recoup the costs of its off-site visits; and
 - MNZ's Seafarer Certificate (SeaCert) licensing charges.

I looked at these matters because I consider that some issues relating to them have not been fully explained to the Committee or the seafarer community.

Summary

The base hourly rate

3. MNZ undertook a funding review in 2011, which analysed the overall cost structure of MNZ and the underlying costs of specific services and activities. The final financial models produced from this funding review allowed MNZ to understand its current costs, likely future costs, the funding sources for these costs, and the spread of these costs across the maritime sector.
4. MNZ then used the information derived from the funding review to determine the base hourly rate of \$235 (GST-inclusive). MNZ's documentation and recording of how it finally derived the base hourly rate is poor. Nevertheless, the approach adopted by MNZ to determine the base hourly rate was reasonable. This opinion is subject to one proviso, namely that MNZ provide clarification to the Committee about the amount and nature of overhead time included in the base hourly rate.

Standing Order 319

5. We considered Standing Order 319, and whether there is any matter that the Committee may think it ought to draw to the special attention of the House. In particular, we concentrated on the

process MNZ used to determine the base hourly rate, to ensure that MNZ had not set its fees above the level necessary for cost recovery, which may amount to a tax.

6. We consider that it is likely that MNZ set the base hourly rate at a level that did not exceed that necessary for cost recovery. However, our conclusion is subject to MNZ providing the information on overhead costs referred to in paragraph 4 above.

Good practice

7. Our work indicates that MNZ has applied the principles of authority, efficiency, and accountability for the base hourly rate.

Other matters

8. MNZ is introducing a replacement IT system and, consistent with its approach to full cost recovery, applied an IT loading on to both the applicable Maritime Operator Safety System (MOSS) and SeaCert licensing base hourly rates. After MNZ's MOSS consultation document,¹ less IT costs were allocated to SeaCert. The difference may not be clear to seafarers, but is favourable to them.
9. MNZ undertook a reasonable process to determine the effort required to consider SeaCert licensing applications. However, it included some assumptions in its overall cost calculations (for example, relating to the future state of MNZ's business) that MNZ may need to review as part of its mid-point funding review or the full funding review scheduled for 2018.
10. MNZ's 2011 funding review assumed \$1 million of efficiency gains over the six-year period of transitioning to fully applying the base hourly rate. Part-way through that period, some of the predicted gains have been realised.
11. MNZ's 33% loading on to the base hourly rate for off-site visits is reasonable, but may result in under-recovery of costs. This possible under-recovery may also need review.

Our suggestions for the Committee

12. We suggest that the Committee may want to request MNZ to:
 - provide further explanation about the overhead costs included in the calculation of the base hourly rate;
 - provide further information about the \$1 million of efficiency gains predicted for the six-year transition period, which underpins the calculation of the base hourly rate; and
 - review the 33% loading for off-site visits as part of its mid-point funding review, or as part of its full funding review in 2018, to ensure that it is recovering all costs associated with its audit and inspection visits.

What we did

13. In providing this advice, our work included:
 - reviewing MNZ consultation documents, including *Maritime New Zealand Funding Review Consultation – Background Document* and *Proposed fees for MOSS – Invitation to Comment*;
 - reviewing correspondence provided to the Committee, including the Ministry of Transport's letters to the Committee of 22 August 2013, 11 April 2014, 23 July 2014, and 25 August 2015;
 - reviewing MNZ spreadsheets, workshop briefings and relevant minutes that underpinned the determination of the base hourly rate;

¹ *Maritime New Zealand Funding Review Consultation – Background Document* and *Proposed fees for MOSS – Invitation to Comment*.

- discussing the base hourly rate and other relevant matters with current and former MNZ staff and contractors;
 - reviewing Ernst & Young's *Maritime New Zealand Funding Review – Financial Model Overview*; and
 - reviewing the Shipping (Charges) Regulations 2014.
14. We did not review or audit the information underpinning development of the financial models in 2011, as time and the significant resources that would have been required did not allow us to do this. The introduction of MOSS has added significant additional costs to MNZ's operations, which means that the cost allocations done in 2011 may now be outdated.

A. The base hourly rate

Overview

15. MNZ charges for a number of its services, which are sometimes referred to as its "feeable functions". The most common of these functions now relate to MOSS, SeaCert licensing, and marine protection documents.
16. MNZ charges may be fixed (for example, for SeaCert applications) or variable (for example, for audits of maritime activities), but all charges are underpinned by the hourly, or office, rate that MNZ has determined it will charge for these services.
17. The base hourly rate was determined as part of an MNZ funding review in 2011 (the funding review). At the time of the funding review, MNZ's hourly charge-out rates (which formed the basis of its fixed fees and for charging out a range of other activities) had not changed since the last major rewrite of the regulations in 2000.
18. Among other matters, the funding review determined that:
- MNZ was not covering the full costs of providing its functions and should progressively do so. The funding review estimated that the cost of feeable functions in 2012/13 was \$5.5 million, of which only \$1.84 million was recovered. The shortfall of \$3.66 million was met by the marine safety charge levied on commercial ships to pay for services to commercial shipping;²
 - The then average office rate for fees charged was \$105 (GST-inclusive).³ However, the funding review calculated that the actual cost of providing feeable functions was \$265 per hour (GST-inclusive);
 - Through a number of factors, MNZ could reduce the base hourly rate to \$235; and
 - Because the \$235 base hourly rate would be a significant fee increase for the industry, it would be progressively introduced over six years and would first apply in full in 2018/19.
19. Table 1 below sets out the six-year transition path for the base hourly rate, leading to the fully costed base hourly rate first applying in 2018/19.

Table 1
Transition path to fully implemented base hourly rate

Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
\$144 GST-incl	\$166 GST-incl	\$184 GST-incl	\$201 GST-incl	\$218 GST-incl	\$235 GST-incl

² *Maritime New Zealand Funding Review Consultation – Background Document*, paragraphs 65-68.

³ At the time of the funding review, MNZ had three hourly charges – \$63.38 (for administrative staff), \$103.25 (for technical staff), and \$144.13 (for scientific or management staff).

20. However, a number of policy considerations meant that there were several variations to this transition path:
- Applications for SeaCert are fixed at the Year 2 hourly rate (that is, \$166 GST-inclusive plus the \$3 GST-inclusive IT allocation);
 - Fees relating to MOSS have their own transition path, under which the Year 2 rate applies for 2014/15 and 2015/16, and the Year 5 rate applies from 2016/17 to 2018/19. For MOSS, the full hourly rate of \$235 (GST-inclusive) will first apply in 2019/20; and
 - Issue of marine protection documents is charged at the full office rate of \$235 per hour (GST-inclusive) from 2013/14.⁴
21. These variations add significant complexity to MNZ charges, and I have provided a summary of the various fees in the Appendix.

2011 funding review process

22. As part of the funding review, MNZ contracted a professional services firm, Ernst & Young, to develop, among some other models, a model to provide information on MNZ's cost of effort across MNZ's various activities, outputs and sub-outputs. To summarise, the funding model:
- used an annualised 4-month data set from February to May 2011 (updated with a six-month data set), adjusted for seasonal adjustments and miscoding reallocations;
 - separated the expenditure into direct and indirect cost at a sub-output, activity, and project level. This was done according to some very specific rules set out in the funding model (for example, rules relating to cost allocations); and
 - was reviewed and subject to quality assurance processes to ensure that the most appropriate data set was used.
23. The Committee has also been provided with extensive information of the funding review process. For example, the Ministry of Transport's letters to the Committee of 22 August 2013, 11 April 2014, 23 July 2014, and more recently of 25 August 2015. Also, the MNZ's *Maritime New Zealand Funding Review Consultation – Background Document* provides extensive information about the funding review process.
24. We reviewed all this information. Also Ernst & Young produced a Financial Model Overview,⁵ which provided background and details about the methodology they applied during the funding review process. We also reviewed this document.
25. The financial models that were produced allowed MNZ to understand its current cost of effort, likely future costs, the funding sources for these costs, and the spread of these costs across the maritime sector.

How MNZ applied information from the funding review to determine the base hourly rate

26. MNZ subsequently used the financial information flowing from the funding model to determine the base hourly rate.
27. We reviewed MNZ discussion papers, spreadsheets, workshop briefings, and relevant minutes that underpinned the determination of the base hourly rate. Although MNZ's documentation and recording of how it finally determined the \$235 (GST-inclusive) rate was poor,⁶ we note that:
- MNZ needed to recover \$6.7 million in fees from a total of approximately 42,000 hours of work, which gave a rate of \$184 per hour (GST-inclusive);

⁴ MNZ chose a staged approach to the introduction of MOSS, to smooth entry into the regime and to avoid incentivising early entry into the regime. The SeaCert rate was set at a level to keep SeaCert fees steady during the transition to the new certification regime, and to allow the effect of "future-state" assumptions to be gauged over the transition period. The SeaCert fees are currently being reviewed as part of MNZ's mid-point funding review.

⁵ Ernst & Young, *Maritime New Zealand Funding Review – Financial Model Overview*, 16 February 2012.

⁶ MNZ told us that a reason for this was that such decisions were being documented at the same time as it was dealing with the *Rena* grounding.

- if approximately 12,700 overhead hours were excluded from these calculations, the base hourly rate would increase to \$265 per hour (GST-inclusive) due to the amount of fees to be recovered (\$6.7 million) being spread over fewer “chargeable” hours; and
 - the \$265 per hour (GST-inclusive rate) could be reduced through efficiency savings and write-downs of some assets (for example, MNZ’s “Navigator” IT system). The assessed efficiency savings and write-down of assets resulted in the final base hourly rate of \$235 (GST-inclusive).
28. I consider that the approach adopted by MNZ to determine the base hourly rate was reasonable. However, I note that the approach described above effectively recovers from fee payers 12,700 hours of overhead costs, such as administration, advice, and other activities. However, the nature of these costs is not clear, and it has not been possible for me to determine if they are costs that should be recovered in the base hourly rate. Accordingly, we suggest that **the Committee may want to request MNZ to provide it with further information about the overhead costs included in the calculation of the base hourly rate.**
29. The matter has now been further complicated by the introduction of MOSS from 1 July 2014, as the calculations contained in the funding review did not include the cost of MNZ delivering feeable functions relating to MOSS.
30. For example, the introduction of MOSS has significantly increased the amount of resources MNZ requires. For example, MNZ estimated in 2014 that it would require an additional \$4.2 million in 2014/15 and \$3.9 million in 2015/16 to implement and operate the MOSS and SeaCert regimes. These amounts were not included in the funding model but could, potentially, have a significant effect on MNZ’s cost structure.
31. Our good practice guide *Charging fees for public sector goods and services* notes that, because costs are not static, it is important that fees are reviewed regularly to ensure that they remain appropriate and the assumptions on which they are based (for example, demand or cost increases) remain valid and relevant. The guide also suggests that such reviews be carried out at least every three years.
32. I am aware that MNZ is currently undertaking a mid-point funding review. We consider that, ideally, it would be useful for MNZ to incorporate a review of the base hourly rate into that review. However, MNZ has indicated to us that it would be very challenging, and costly, to review the base hourly rate as part of its mid-point funding review. However, it intends to review the base hourly rate in 2018.

B. Standing Order 319

33. Under Standing Order 319, in examining a regulation, the Committee may consider whether it ought to draw to the special attention of the House any one or more of the grounds set out in paragraph (2) of Standing Order 319. As agreed with the Committee, we sought to determine whether any of those grounds applied to the Shipping (Charges) Regulations 2014 – specifically MNZ’s base hourly rate, as prescribed in the first line of Schedule 1 to those regulations.
34. We concentrated on how MNZ calculated the figure of \$235 shown in Schedule 1 as applying from 1 July 2019 onwards, because the earlier years are set to progress towards that figure over six years and it is the base figure for calculating the other components listed in Schedule 1.
35. *Maritime New Zealand Funding Review Consultation – Background Document* provided some information about how the base hourly rate was determined. However, as noted above, determination of the fully costed base hourly rate of \$235 (GST-inclusive) is not as clear as we expected, and final decisions about how the fee was arrived at were not well documented. However, based on our review work, I consider that it is likely that MNZ set the base hourly rate at a level that was not above the level necessary for cost recovery. However, this conclusion is subject to MNZ providing clarification about overhead costs included in the base hourly rate (see paragraph 28).

36. I have reviewed all the other grounds set out in Standing Order 319(2) and consider that there are no other matters that I need to draw to the Committee's attention.

C. Compliance with our good practice guidelines

37. We expected that, in setting the base hourly rate, MNZ would be guided by the three principles set out in our good practice guide *Charging fees for public sector goods and services – authority, efficiency, and accountability*. Overall, we consider that MNZ has applied the principles of authority, efficiency, and accountability in relation to the base hourly rate and we provide some comments on each of these matters below.

Authority

38. The Shipping (Charges) Regulations 2014 were made under the authority of section 445(1) of the Maritime Transport Act 1994. That section allows regulations to be made prescribing, or providing for the fixing of, fees or charges, or both, for the following purposes:
- *to provide funds for the establishment, maintenance, and operation of facilities, works, goods, and services under this Act:*
 - *to meet, or assist in meeting, the costs and expenses incurred by [Maritime New Zealand], the Director, the Maritime Appeal Authority, or the Crown in the exercise of functions or powers, or in the performance of duties, or the provision of services under this Act:*
 - *to meet, or assist in meeting, the costs and expenses incurred by [Maritime New Zealand], the Director, or the Crown in providing goods, services, facilities, or works for maritime purposes or for the purposes of protecting the marine environment.*

Efficiency

39. We note that a Value for Money review by Ernst & Young stated "Our overall conclusion is that MNZ delivers value for money."⁷
40. Our expectation was that MNZ would undertake appropriate and timely reviews of its cost structure, demand for services, and any change in circumstances. A failure to review and adjust fees can lead to an under-recovery or over-recovery of costs. In the case of MNZ, this is particularly important, given:
- the base hourly rate being based on the premise that MNZ would achieve efficiency savings of \$1 million over the six-year transition period, when the extent of the savings to date is unclear; and
 - the increase in MNZ's costs associated with the new MOSS and SeaCert regimes. For example, additional personnel costs in 2014/15 were estimated to be \$4.2 million compared to an existing personnel budget of \$15.5 million (total \$19.7 million), and additional personnel costs in 2015/16 were estimated to be \$3.9 million compared to an existing personnel budget of \$15.7 million (total \$19.6 million).
41. We note that MNZ is in the process of undertaking a mid-point funding review that, among other matters, will review MOSS and SeaCert fees and whether the assumptions on which the base hourly rate set under the funding review remain appropriate given MNZ's experience of demand, and will review the transition period for the MOSS and SeaCert charges.
42. Also, the funding review assumed \$1 million of efficiency gains over the six-year transition period, and MNZ has provided a list of the efficiency gains it has been making. These include consolidating its Wellington office to save rental costs, improved business workflow processes and processes, and outsourcing and sharing staff with other organisations.
43. **The Committee may want to ask MNZ to provide further information about these efficiency gains.**

⁷ *Building a sustainable organisation – Value for money review at Maritime New Zealand*, 8 December 2010, paragraph 1.2.

Accountability

44. We would have expected MNZ to consult with the public on its new fees, which it did.
45. We reviewed *Maritime New Zealand Funding Review Consultation – Background Document* and also the *Proposed fees for MOSS – Invitation to Comment* document.
46. The background document was exhaustive and dealt with a complicated range of issues. However, it was very difficult to understand. We were unable to determine a number of matters from it, including:
 - how the base hourly rate was calculated (we note that some submitters made the point that it was unclear how MNZ set its fees); and
 - how the 33% loading for field visits was determined.
47. *Maritime New Zealand Funding Review Consultation – Background Document* included information to allow the maritime industry to consider relevant matters and make submissions.
48. We also note that MNZ made some changes to its fee proposals as a result of industry feedback on its *Proposed fees for MOSS – Invitation to Comment* document. In particular, the way MNZ charges for a Maritime Transport Operator Certificate was changed from a fixed fee (based on the assessed complexity of a ship owner's operation) to a mixed fee, as suggested by the industry, whereby MNZ specified a fixed fee for administrative effort and charged all other activity on a per-hour basis.

D. Maritime New Zealand's loading on to its base hourly rate to fund its new IT system

49. MNZ is introducing a replacement IT system for its data, processing, and information collection requirements. The IT system is not quite fully developed, and not all efficiency gains have been delivered at this time.
50. Consistent with its approach to full cost recovery, MNZ has applied a \$13.00 (GST-inclusive) IT loading on to the relevant MOSS base hourly rate and a \$3.00 (GST-inclusive) IT loading on to the SeaCert base hourly rate. This is set out in the Appendix.⁸
51. We had understood, and commenced our work on the basis, that 25% of IT costs were to be allocated to MOSS and 16% to SeaCert. This was reflected in both the *Proposed fees for MOSS – Invitation to Comment* document⁹ and the *MOSS Regulatory Impact Statement* document.¹⁰
52. However, MNZ told us that the allocation method used resulted in 24.8% of IT costs being allocated to MOSS and only 5.4% to SeaCert, with the difference being due to MNZ incorrectly describing the allocations in the two consultation documents.

E. Maritime New Zealand's 33% loading on to the base hourly rate for off-site visits

53. Many chargeable MNZ activities are routinely undertaken by MNZ staff out of the office. For example, off-site visits are necessary for the purpose of assessing applications for a Maritime Transport Operator Certificate, and for the auditing of operators.
54. Prior to the funding review, regulations required MNZ to charge actual costs, including charges for the time and cost of travel for off-site visits. For remote locations, these additional charges could often be significantly higher than the costs of the audit inspection itself.

⁸ When the system is fully deployed, MNZ will recalculate how its costs are spread across its business, which is likely to occur in 2018.

⁹ Page 4.

¹⁰ For example, *Proposed fees for MOSS – Invitation to Comment*, 14 October 2013, page 4, "It has been calculated that 25% of the IT system usage will be activity undertaken by MNZ in relation to MOSS. On that basis, 25% of the running costs associated with the system (depreciation, interest, software, and maintenance costs) will be met through MOSS fees. This amounts to \$160,000 per year to be recovered through those fees. SeaCert fees will also reflect the IT usage undertaken by MNZ in respect to SeaCert (about 16% of the costs).

55. However, the funding review provided that: “*Analysis shows that, under a full cost-recovery regime, the costs and time of travel would be covered by a one-third premium added to the office-based rate, and applied to the time actually auditing or inspecting*”.¹¹ Accordingly, the funding review proposed that:
- MNZ activities performed off-site should be 1.33 times the applicable office-based hourly rate; and
 - For second visits relating to the same activity, the actual and reasonable cost of travel and actual time would be billed at the standard applicable office rate.¹²
56. For first visits, MNZ does not explicitly charge for either travel time or the costs of travel. Accordingly, the 33% loading is applied as a “proxy” to recover these costs.
57. The funding review did not disclose how the 33% loading was calculated, so we asked MNZ. We understand that:
- MNZ used timesheet information from February to May 2011 to determine the amount of time Maritime Safety Inspectors (now called Maritime Officers) spent carrying out vessel inspections, both for international vessels under the Port State Control regime and for domestic vessels as required at the time prior to the introduction of MOSS; and
 - The total time across 575 inspections was 4459 hours, of which 1128 hours related to travel.
58. We consider that, with MNZ having determined that it would not charge for the travel time associated with the first off-site visit, this approach is a reasonable estimation of the percentage of time that MNZ spends travelling, and a reasonable proxy.
59. However, we note that the 33% loading is intended to recover both travel time and the costs associated with the travel (transport, accommodation, etc.), but these travel costs were not factored into the 33% loading. Accordingly, MNZ may not be recovering all its travel costs and the 33% loading may mean that MNZ is under-recovering its actual costs.
60. **The Committee may want to ask MNZ to review the 33% loading as part of its mid-point funding review, or as part of its full funding review in 2018, to ensure that it is recovering all costs associated with its audit and inspection visits.**

F. Seafarer Certificate licensing charges

61. SeaCert is the seafarer licensing framework for national and international certificates of competency and proficiency. It also sets out where seafarers can operate in local and international waters.
62. SeaCert fees are a function of:
- a fixed hourly charge of \$169 (GST-inclusive), which comprises the Year 2 office rate of \$166 (GST-inclusive) plus the \$3 (GST-inclusive) IT allocation (see the Appendix);
 - multiplied by the effort required to perform the feeable function.
63. We note that, unlike the MOSS fee and other MNZ feeable functions that will have their base hourly rate progressively increased to \$235 (GST-inclusive), the Sea Cert base hourly rate is fixed at the Year 2 rate, with no “step” increase.
64. MNZ consulted on its proposed SeaCert fees as part of its invitation to comment on its Maritime Rule Part 32: Seafarer Certification¹³. Comments submitted strongly opposed the proposed fees, and MNZ took the opportunity to completely review the time and effort analysis for the fees. It then made adjustments ranging from nil to almost 50 percent¹⁴. Because of the

¹¹ Paragraph 133.

¹² These proposals were subsequently introduced in Regulation 4 and Schedule 1 of the Shipping (Charges) Regulations 2014.

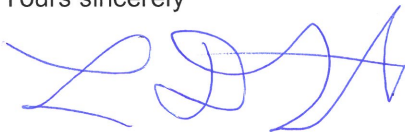
¹³ Report SeaCert Project Steering Group, 16 July 2013.

¹⁴ MOT letter to Regulations Review Committee, 30 June 2015.

significant changes, we decided to review the approach MNZ used to determine the “effort” required for each activity.

65. MNZ analysed the average processing time of each type of application by breaking the application process into individual components of effort in the process – for example, administrative time, technical assessment, and fit and proper assessment. MNZ subsequently grouped approximately 70 different types of application into six different charging bands, based on the degree of effort (measured in hours) required to process each application type.¹⁵
66. In terms of analysing effort and processing times, MNZ took into account five separate matters:
 - administrative effort – estimated time to process each application (for example, file handling, data entry, confirming accuracy of the application);
 - assessment effort – estimated time taken to assess each application (for example, checking the “honesty” component of each application and checking training results);
 - general enquiry – loading of 25% to cover general queries relating to certificate work, not applicable to specific applications;
 - training and assistance provided to inexperienced staff – loading of 20%; and
 - future-state assumptions – loading of 25% of effort to cover costs and processes that would not have been in place when the SeaCert regime was introduced (for example, workflow systems may not be in place, resulting in additional application costs).¹⁶
67. We reviewed MNZ’s assessment sheets for a number of applications (for example, “qualified deck crew” and “skipper restricted waters”) and the time MNZ had allocated to both administrative effort and assessment effort. The time allocated looked reasonable.
68. We understand that, as part of MNZ’s mid-point funding review, it is reviewing its SeaCert time allocations and assumptions.

Yours sincerely



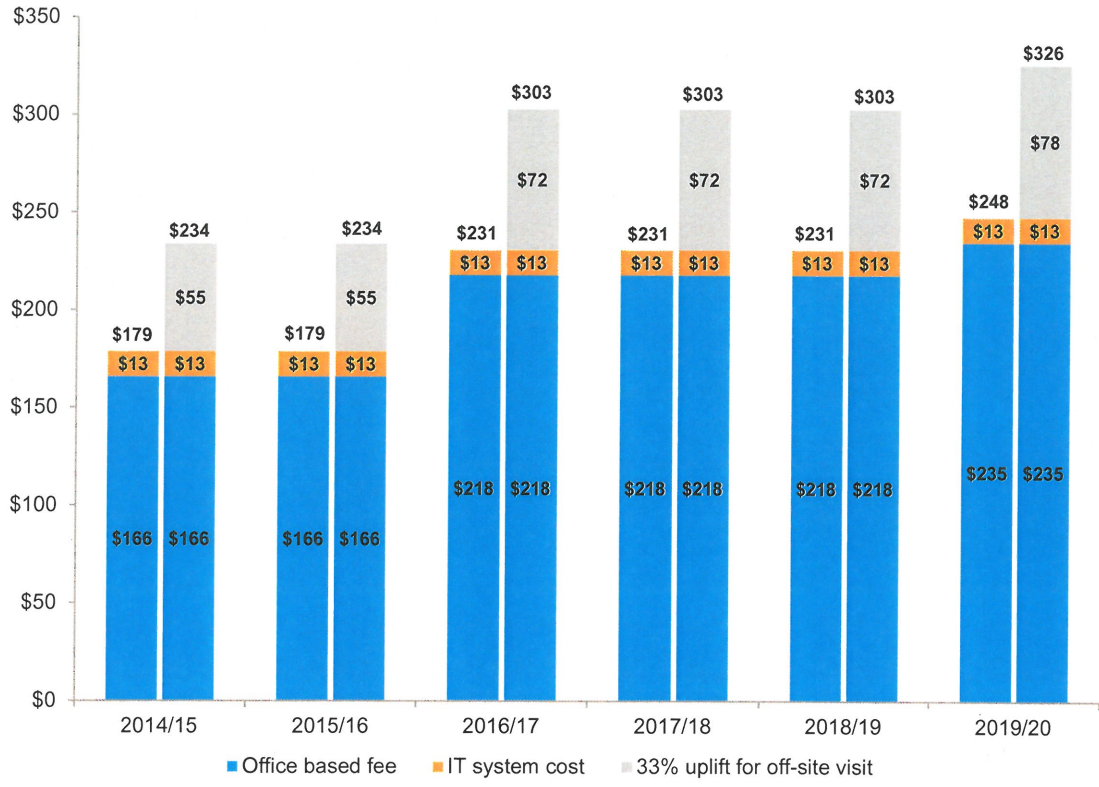
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¹⁵ Cabinet paper on SeaCert. See also MNZ paper, 18 July 2013.

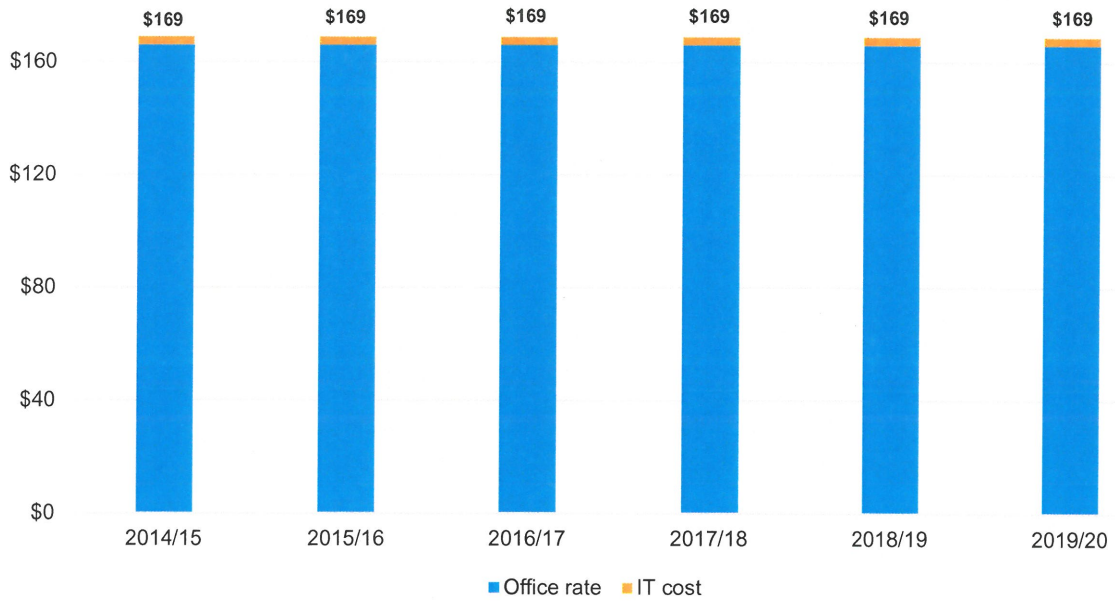
¹⁶ *Seafarer certification – Setting of Application Fees, Analysis and Proposed Fees*, 15 July 2013.

APPENDIX

MOSS fees (GST-inclusive)



SeaCert fees (GST-inclusive)



Other feeable functions (GST-inclusive)

