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Hon David Cunliffe
Chairperson
Regulations Review Committee
Parliament Buildings
Wellington

Email: Ciara.Lee@parliament.govt.nz

Dear Mr Cunliffe

COMPLAINT REGARDING SHIPPING (CHARGES) AMENDMENT REGULATIONS 2014 AND MARINE SAFETY CHARGES AMENDMENT REGULATIONS 2013

1. I refer to the Auditor-General's letter of 6 November 2015 saying that we would undertake some further work in respect of charges by Maritime New Zealand (MNZ).

Summary

2. **Issue 1** – MNZ provides commercial operators with a range of public, private, and club goods and services. MNZ has been very deliberate when determining the nature of the services it provides, whether they are public, private, or club activities, and how the goods and services should be funded. Where appropriate, MNZ has obtained relevant external advice to help determine the nature of the activities it provides and the appropriate funding arrangements.

3. **Issue 2** – MNZ has done considerable work on the amount of revenue it should collect from international shipping and domestic operators in both its 2012 Funding Review and its mid-point funding review carried out in 2015. However, MNZ acknowledges that it still lacks reliable data on important aspects such as relative risk between different ship categories. The methodology that MNZ uses to allocate the Maritime Levy across different classes of levy payers has not changed substantially since 2008 and needs to be reviewed.

4. **Issue 3** – Our audit work confirmed that the raw data from MNZ's financial and time costing systems was appropriately used to determine its base hourly rate of $205 (plus GST). Our audit work also identified two variances with the underlying data, relating to the possible overstatement of hours and expenditure within the financial modelling process, which we discuss in paragraph 21. However, we note that any overstatement of hours would have resulted in the base hourly rate being less than if a lower number of hours were included and the possible overstatement of expenditure would not have been material to the base hourly rate calculation.

5. MNZ used the information from its financial modelling process to determine its base hourly rate. Our audit work confirmed that MNZ's fully costed base hourly rate was approximately $231 (plus GST). However, MNZ settled on a rate of $205 (plus GST) but, at the time of determining this rate, did not document how it finally calculated the rate (see issue 6).

6. **Issue 4** –Both the number of commercial operators and the number of vessels entering the Maritime Operator Safety System (MOSS) regime are less than originally forecast. Consequently, MNZ received less than forecast revenue from its MOSS activities that resulted in it having to reduce its operating expenses. There were various reasons for fewer operators and vessels entering MOSS than forecast, including operators delaying their entry into the MOSS regime and MNZ's database including operators who were no longer operating.

7. **Issue 5 –** The allocation of MNZ's fixed costs was reasonable. We also saw no evidence of these costs being "gold plated".

8. **Issue 6** – At the time MNZ determined its final base hourly rate, it did not document how it calculated the rate. Also, MNZ was unable to subsequently demonstrate to us how the rate was calculated.

Issue 1 – The split between public, private and club goods

9. The Committee is interested in the extent to which fee-payers are accessing public, private, or club goods.

10. MNZ extensively canvassed the issue of public, private, and club goods in its October 2012 Funding Review (the funding review) and revisited the matter in its Proposals to Make Changes to Maritime New Zealand Fees and The Maritime Levy for 2016-19, 20 November 2015 (the mid-point funding review).

11. In particular, the mid-point funding review considered whether the costs for MNZ's regulatory and compliance work (including its MOSS and SeaCert assisted compliance work, MOSS and SeaCert risk analysis, operational policy and standards development work, and negotiation of international agreements) were being recovered from the most appropriate sources (that is, whether those who benefitted from its regulatory and compliance work were paying for the services).

12. To assist with this work, in 2015 MNZ obtained detailed advice from a consulting firm, Castalia Strategic Advisors[1], on the economic characteristics of MNZ services, the extent to which specific services comprised public and/or private goods, and the funding options available for specific services based on their characteristics.

13. As a result of its mid-point funding review analysis, MNZ has made changes to the way it intends to fund some of its activities to better reflect the public/private benefits associated with those activities. For example, MNZ proposes:

   - to fund its "assisted compliance work" through the Levy[2] on the basis that the risks and benefits of that work largely accrue to the wider industry, rather than particular individuals;
   - to fund its enquiry work about rules for entry, renewal, and audit work from the Levy as, again, MNZ has determined that the benefits associated with these services largely accrue to the wider industry, rather than particular individuals; and
   - to fund additional work required in respect of SeaCert applications by moving the SeaCert hourly rate to $192 (plus GST)[3] from 1 July 2016 on the basis that costs associated with its SeaCert application work provide direct benefit to the individuals applying for certification.

14. Having considered the funding review, the mid-point funding review, and background documents, our observation is that MNZ has been very deliberate and considered when determining the nature of the services it provides (that is, whether they are public, private, or club goods/services) and, consequently, who should pay for those services. This has included obtaining appropriate external advice and relying on that advice where appropriate.

15. Also, MNZ has been transparent in its determinations. For example, the mid-point funding review provides detailed information about who MNZ considers are the beneficiaries of its services and, on the basis of those assessments, sets out its proposed funding options.[4]

Issue 2 – The disparity between international shipping and domestic costs and charges International shipping and domestic costs and charges

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[1] The advice was dated July 2015.
[2] The Maritime Safety Levy under the Maritime Transport Act 1994 and Marine Safety Charges Amendment Regulations 2013.
[3] $221 GST-inclusive.
[4] The mid-point funding review, pages 75-76.

16. The Committee is interested in the disparity, if any, between international shipping and domestic shipping costs and charges. For example, the Committee has queried whether domestic shipping is essentially subsidising international shipping costs.

17. We consider that the main issue here is that some New Zealand shippers, such as domestic SOLAS[5] passenger operators, may be concerned that they are paying more than their fair share of the Levy. In particular, parts of the sector may be saying that, although the total amount of the Levy collected from all classes may be correct, the proportion recovered from such operators is too high. Essentially, the matter is largely one of the allocation of the Levy between different classes of operators.

18. In this respect, we note that:

- The funding review determined that there was a misalignment between MNZ's funding sources and its activities and that MNZ should increase its revenue from fees and reduce the Levy. Domestic commercial operators received a levy reduction of about 45% ($802,000) from 1 July 2013 and international commercial operators were to receive a levy reduction totalling 25% ($4.1 million) over the 6-year period 2013/14 – 2018/19.
- MNZ uses a variety of different methods to allocate the Levy on the different categories of levy payers. For example: international container/cargo ships are charged on dead weight tonnage and number of ports visited; international cruise ships are charged on passenger capacity and number of port visits; interisland ferries are charged on the basis of passenger capacity; and New Zealand fishing vessels are charged on the basis of vessel size. The current levy methodology was implemented in 2008.
- Some New Zealand vessel owners, in particular the domestic SOLAS passenger operators, have been critical of MNZ's method of allocating the Levy between operator categories and have suggested that it results in a cross-subsidisation between different New Zealand shipping sectors. This has been estimated by Interislander to be "up to $300,000" for the New Zealand passenger ship sector alone.[6]
- Alternative options for allocating the Levy were reviewed as part of the funding review, but the levy allocation and charging basis was not changed. This was due in large part to the lack of reliable data about relative risk between operator categories. However, MNZ said in the funding review that it would review the cost allocation, as MNZ was moving toward a risk-based, intelligence-led approach to its regulatory work, and this would allow MNZ to review the Levy as part of its mid-point funding review in 2015/16 to apply from 2016/17 onwards[7].
- MNZ again discussed the levy allocation method in the mid-point funding review and accepted that some members of the maritime industry believed that they are paying too great a share of the Levy based on the benefits, risk, and cost attributed to them. Again, MNZ considered that it did not yet have the data to revisit the levy allocation method. MNZ proposed that the current levy allocation would remain in place until 2018/19 and that work would start in 2016/17 to reassess it under the full funding review in 2018/19.[8]
- MNZ accepts that the current levy allocation basis needs to be reviewed. MNZ has told us that, as a consequence of the mid-point funding review, it intends to undertake this review, subject to the Minister of Transport's agreement.

Issue 3 – Audit work on initial cost assumptions in the 2011/12 funding review

19. We have performed the audit work as set out in paragraph 3 of our letter of 6 November 2015 which included reviewing the financial information MNZ used to determine its base hourly rate and whether that information flowed through to the hourly rate calculation.

20. Broadly, MNZ adopted two steps to determining its base hourly rate:

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5 Safety of Life at Sea.
6 See, for example, Interislander submission of 19 November 2012 to the 2012 funding review, paragraphs 2.2 – 2.4.
7 MNZ New Zealand Funding Review Consultation Background Document, October 2012, pages 30-31.
8 MNZ Proposals to Make Changes to Maritime New Zealand Fees and the Maritime Levy for 2016-19, page 49.

- Step 1 – MNZ contracted a professional services firm, Ernst & Young, to develop a model (the Model) to provide information on MNZ's cost of effort across MNZ's various activities, outputs, and sub-outputs. The Model used an annualised 4-month dataset from February to May 2011 (updated with a six-month dataset), adjusted for seasonal adjustments and miscoding reallocations. The Model separated the expenditure into direct and indirect costs at a sub-output, activity, and project level. This was done according to some very specific rules set out in the Model (for example, rules relating to cost allocations).
- Step 2 – MNZ subsequently used the financial information flowing from Step 1 to determine the base hourly rate. It did this by transferring the Step 1 financial information into spreadsheets and using that information to calculate its base hourly rate.

21. Our findings in respect of Step 1 are:

- Our audit work confirmed that the raw data from MNZ's financial and time costing systems was generally appropriately used to determine its base hourly rate. However, our audit work identified two variances with the data used in the Model which were:

    1. MNZ staff time information we obtained for 2010/11 did not reconcile to the information used in the Model. For example, staff time information in the Model totalled 80,716 hours, which was 5,492 hours (7.3%) more than that recorded in MNZ's time recording system. Our further detailed review, and discussions with MNZ management, did not reveal any obvious reasons why the two sets of data differed, and MNZ was unable to demonstrate the overall effect of this difference. We were also unable to determine the overall effect of this difference.

        An overstatement of hours in the Model would have resulted in the base hourly rate being less than if the lower number of actual hours was included (by increasing the number of hours from which MNZ's costs could be recovered).

    2. The Model used financial data for a four-month period that was then annualised, giving annualised expenditure of $30,433,122. MNZ subsequently applied a "seasonal" adjustment to the annualised expenditure data that reduced the expenditure input into the Model to $28,911,465. This was $1,075,481 higher than the total actual expenditure for the relevant financial period, which was $27,835,984. This variance would relate to multiple cost codes, some of which would not be recovered through the base hourly rate, and therefore be removed from the modelling.

        We have not recalculated the effect of the variance on the base hourly rate but consider that, although there may have been an overstatement of expenditure, the amount overstated was not material to the base hourly rate calculation. This conclusion is based on MNZ seeking to raise only between 10% (2013/14) and 17% (2018/19) of its revenue through fees, with its other revenue being raised through the Levy and Crown funding. This would have reduced the effect of any overstatement of expenditure in the Model on the base hourly fee calculation.

        Based on the high level recovery percentages and taking into consideration the variance in the hours noted above (and without MNZ rerunning the full funding model), the estimated impact on the base hourly rate would not be significant. We also consider the variances of this quantum would not to have a significant impact on MNZ final decision on the base hourly rate.

        We have concluded that MNZ's approach to estimating the annualised expenditure is reasonable given the information they had at the time of the modelling.

- Fixed costs were allocated on a reasonable basis.
- MNZ's control environment was "effective" from 2011 to 2014, and we did not identify any significant deficiencies. We concluded that the financial information relating to each year fairly reflected MNZ's operations in all material respects.

22. Our findings in respect of Step 2 are:

- The raw data derived from Step 1 flowed appropriately through to the Step 2 spreadsheets and calculations.
- At the time of calculating the base hourly rate, MNZ considered whether certain work hours should be excluded from its base hourly rate calculation. These hours related to a range of overhead activities (administration and advice), some contractor time (health and safety policy development), and seafarer complaints.
- MNZ did not document whether it excluded any, or all, of this time when it calculated the base hourly rate.
- We were also unable to determine whether MNZ excluded any of this time. However, we reviewed the hours concerned and consider that, in determining the base hourly rate, it would not have been unreasonable for MNZ to exclude these hours. If MNZ had excluded all the hours concerned, its fully costed maximum hourly rate would have been approximately $231 (plus GST).
- At the time of calculating the base hourly rate, MNZ also considered whether it should make a number of adjustments which, if made, would have reduced the final hourly rate to as low as $177 (plus GST). These adjustments are set out in Figure 1 below.

Figure 1 – Effect of adjustments on the base hourly rate

	Original raw data from Step 1 and overhead adjustments (plus GST)	Write-off of the Navigator IT system (plus GST)	Efficiency adjustments (plus GST)	Recharge adjustments (plus GST)
Incremental effects		-$13	-$19	-$22
Hourly rate change	$231	$218	$199	$177

The adjustments in Figure 1 were:

a. IT impairment – MNZ considered whether there was any impairment of value associated with the Navigator system (the IT system used by MNZ for ship registrations) but made a decision not to write off any of the system's value. Based on our financial audit work, we considered this decision to be reasonable. A decision to write off the system's value would have reduced the base hourly rate (by reducing the amount of MNZ's costs, being depreciation of the Navigator system that needed to be recovered).

b. Efficiency adjustments – MNZ proposed making a number of efficiency adjustments across a range of activities relating to the certification of seafarers and compliance. These related to MNZ's work on seafarer certification and monitoring and compliance activity. Incorporating efficiency adjustments into the base hourly rate calculation, as may have been done, would have reduced the base hourly rate (by reducing the amount of MNZ's costs to be recovered by fees). We note that the funding review states that the base hourly rate calculation required MNZ to make efficiency gains of around $1 million over a six-year period.[9] Also, MNZ has an email on file that indicates that some efficiency adjustments were incorporated into the final rate.

c. Recharge adjustments – these related to transferring some costs to be recovered by the Levy, such as uncharged advice. MNZ was unable to confirm whether these adjustments had been made. Any decision to make recharge adjustments would have reduced the base hourly rate (by reducing the amount of MNZ's costs to be recovered by fees).

- MNZ did not document the extent to which it took into account, any of these adjustments when determining its final base hourly rate of $205 (plus GST).

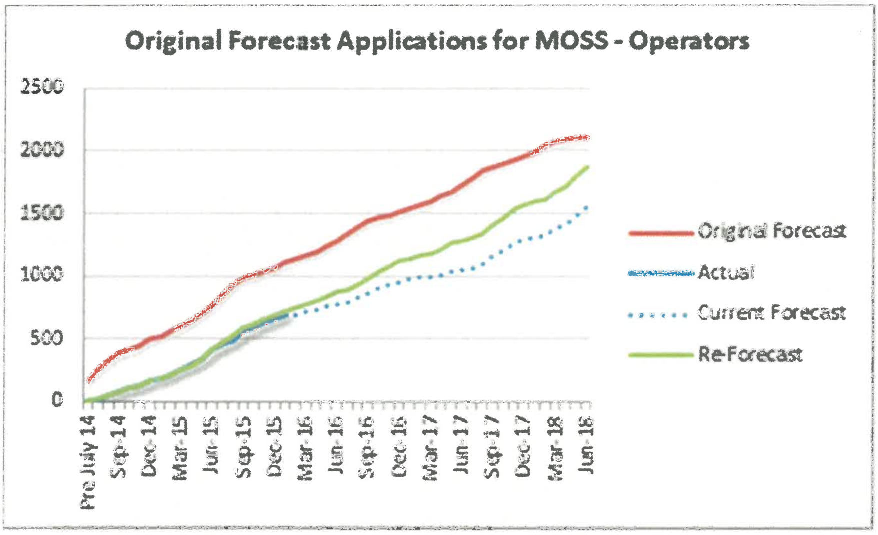
9 Paragraph 177 of the funding review.

Issue 4 – Forecast number of vessels entering the new MOSS regime

23. The following figures show information relating to:

- The number of MOSS operators expected to enter the regime compared with forecasts (Figure 2); and
- The number of vessels expected to enter the MOSS regime compared to forecasts (Figure 3).

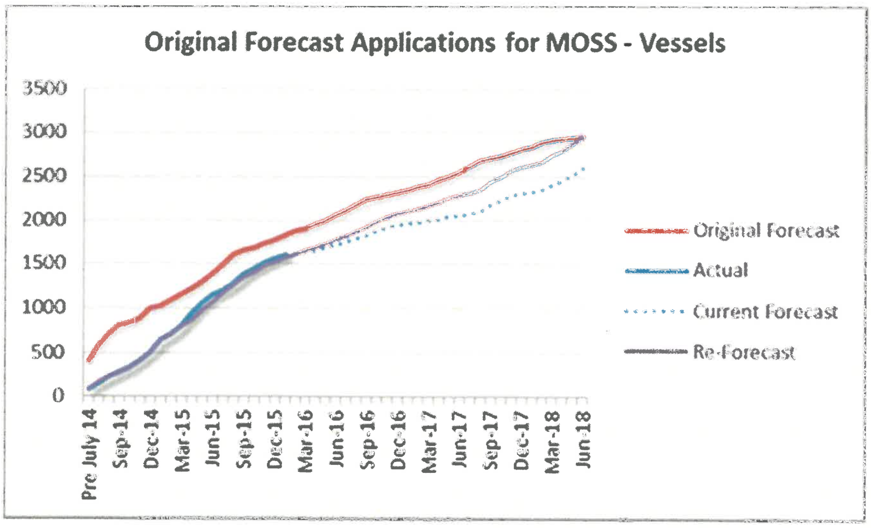
Figure 2



Original Forecast – the forecast from 2013; Actual – actual numbers as at 31 January 2016; Current Forecast – the forecast that MNZ is currently reporting against; Re-Forecast – a previous forecast from 2014/15.

24. Figure 2 shows that the actual number of operator applications to enter into the MOSS regime as at the end of January 2016 is less than all forecasts. For example, MNZ originally forecast that 1101 operators would have entered MOSS by the end of January 2016, but the actual number was 699. We note that the percentage of operators in the MOSS regime is now 44%.

Figure 3



Original Forecast – the forecast from 2013; Actual – actual numbers as at 31 January 2016; Current Forecast – the forecast that MNZ is currently reporting against; Re-Forecast – a previous forecast from 2014/15.

25. Figure 3 shows that the number of vessels entering the MOSS regime was less than all forecasts. For example, it was originally forecast that 1829 vessels would have entered the MOSS regime by the end of January 2016, but the number actually entering was 1607. We note that the percentage of vessels in the MOSS regime is now 61%.

26. As a result of the number of operators and vessels entering MOSS being below original forecasts, MNZ received less revenue from its MOSS activities than forecast. This required MNZ to reduce its operating expenses which included having some personnel vacancies.

27. MNZ has told us that there are a number of factors that have led to the numbers of operators and vessels entering the MOSS regime being below estimates, including:

- There was an initial rush of operators enrolling under the previous Safe Ship Management regime (thereby delaying their entry into the MOSS regime);
- At the time of MNZ making its original forecasts, the information contained in MNZ's database may have included operators and vessels that were no longer operating. This would have led to over-estimates; and
- Some operators are choosing to reconfigure their operating arrangements (that is, operators merging operations or grouping more vessels under a single operation as opposed to individual operations).

Issue 5 – Whether fixed costs were allocated appropriately and whether costs were being "gold plated"

28. We reviewed MNZ's allocation of its fixed costs as part of its cost allocation process.

29. We consider that MNZ's fixed costs were allocated appropriately and we saw no evidence that MNZ allocated a disproportionate amount of its fixed costs to the costs of its services to be recovered by fees.

30. We also saw no evidence of these costs being "gold plated".

Issue 6 – Lack of documentation and fee-setting

31. MNZ provided us with full access to all its documentation relating to how it set its base hourly rate.

32. However, at the time MNZ determined its final base hourly rate, it did not document how it calculated the rate. Also, MNZ was unable to subsequently demonstrate to us how the rate was calculated.

Yours sincerely

Greg Schollum
Deputy Controller and Auditor-General