



Fees and Charges— cost recovery by local government



VICTORIA

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Auditor-General

Fees and Charges — cost recovery by local government

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Victorian Auditor-General's Office
Auditing in the Public Interest

The Hon. Robert Smith MLC
President
Legislative Council
Parliament House
Melbourne

The Hon. Jenny Lindell MP
Speaker
Legislative Assembly
Parliament House
Melbourne

Dear Presiding Officers

Under the provisions of section 16AB of the *Audit Act 1994*, I transmit my performance report on *Fees and Charges—cost recovery by local government*.

Yours faithfully

A handwritten signature in black ink, appearing to read 'D D R Pearson'.

D D R PEARSON
Auditor-General

14 April 2010

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Audit summary

Background

Local councils provide a wide range of services to their communities, often for a fee or charge. The nature of these fees and charges generally depends on whether they relate to compulsory or discretionary services. Some of these, such as statutory planning fees, are set by state government statute and are commonly known as 'regulatory fees'. In these cases councils usually have no control over service pricing.

User fees and charges are a significant source of income for councils, each year totalling around \$900 million; on average, 14 per cent of all council revenues.

The *Local Government Act 1989* (the Act) gives councils the power to set these fees and charges to offset the cost of their services. A widely accepted public sector pricing principle is that, fees and charges should be set at a level that recovers the full cost of providing the services, unless there is an overriding policy or imperative in favour of subsidisation.

In so doing, councils must apply principles of sound financial management and need to consider a range of 'Best Value' principles including service cost and quality standards, value-for-money, community expectations and values, as well as balance the affordability and accessibility of their services.

Councils must also comply with the government's *Competitive Neutrality Policy* for significant business activities they provide and adjust their service prices to neutralise any competitive advantages when competing with the private sector.

The 2006 *Inter-governmental Agreement Establishing Principles Guiding Inter-Governmental Relations on Local Government Matters* further commits councils to demonstrate sound public governance through fiscal management, to develop appropriate pricing regimes and to improve their strategic planning.

This audit assessed whether councils are effectively managing the cost of their community services, particularly those that have an associated fee or charge.

The service costing and pricing policies and practices of a sample of services—waste management, aged care, preschool and child care, and recreation—were examined at four randomly selected councils:

- Whitehorse City Council
- Frankston City Council
- City of Ballarat
- Campaspe Shire Council.

Conclusion

The councils examined are not effectively managing the full costs of the services they provide. Further, they are not basing their fees and charges on any clear understanding of these costs, or of the other societal, economic and legal factors that must be taken into account when establishing prices for community services.

While the results relate directly to the councils we examined, the consistency of our findings is considered indicative of practices in other councils. In this context, the audit has identified a number of issues that should be considered by all councils in service costing and fee setting.

Findings

None of the four councils had adequate policies on service costing and fee setting. None provided sufficient guidance to staff on the procedures required to achieve good practice. Frankston and Campaspe had policies on service pricing, but while they made general references to cost recovery and fee setting principles they did not offer any detailed guidance.

The lack of common corporate policies and guidance coupled with the devolved responsibilities at each council has led to individual business units developing their own approaches to fee setting and cost management. While service fees and costs were centrally reviewed, in most cases these procedures were not adequately documented and fell short of good practice.

All councils had financial systems that captured the direct cost of services. However, only Campaspe had a system for systematically identifying and allocating all its indirect costs to service areas to establish their full cost. But while Campaspe had knowledge of its full costs, it did not apply this when setting its service fees and charges. The absence of full costing at the three other councils precluded these considerations. In effect, none of the councils accurately determined the full extent of subsidisation of services.

Additionally, there was insufficient assurance that the four councils had paid adequate attention to Best Value principles in determining their user fees and charges. While these principles require councils to:

- set service cost and quality standards
- consider value for money
- consider community expectations and values
- balance the affordability and accessibility of their services

there was no evidence of critical analysis of these issues in support of local fee setting decisions.

There was also a lack of staff awareness at councils about the requirements of the Competitive Neutrality (CN) policy. While some councils had considered CN obligations for some activities, none were able to provide adequate evidence to fully substantiate their associated 2008–09 statements of compliance. In the absence of adequate evidence these statements provide little assurance of compliance or that appropriate actions were taken to achieve CN when setting fees and charges for significant council business activities.

All councils regularly monitored the financial and operational performance of their services. However, management reports at Whitehorse, Frankston and Ballarat are limited to the extent they report only on the direct, not full, cost of services.

Furthermore, none of the councils had reports that enabled senior management and council to fully assess the efficiency of their services, the extent to which they are subsidised, and the extent to which revenue from fees and charges collected recovered service costs.

Analysis of variances was rudimentary and unsophisticated, comparing budgeted to actual revenues and expenses. There was no analysis of the unit cost of each service against cost standards, nor of any underlying price or quantity variations.

Similarly, while each council reviewed their fees annually as part of their budgetary process, in most cases these reviews were not adequately supported by information on full costs, or by rigorous analysis of the accessibility, affordability and efficiency of services, or of the actions required to meet CN requirements. Instead, most fees and charges are adjusted based on movements in the Consumer Price Index or the results of price benchmarking with other councils or private providers. While these are relevant considerations, adjusting fees based on these factors alone does not constitute strategic fee setting.

Recommendations

Number	Recommendation	Page
1.	Councils should develop and endorse central policies on service costing that provide guidance to staff on: <ul style="list-style-type: none"> principles of cost recovery and their relationship to service delivery objectives the methodology for costing council services and the associated rationale. 	19
2.	Councils should review and, where necessary, enhance their current cost allocation practices by: <ul style="list-style-type: none"> developing a costing model and related processes to allocate indirect costs recognising and reporting the full cost of their services. 	19
3.	Councils should strengthen oversight of service costs by: <ul style="list-style-type: none"> setting cost standards based on efficient costs regularly reporting to senior management and council on the efficiency and full cost of their services and relate this to fees and charges collected. 	19
4.	Councils should develop and endorse central policies on fee setting that provide guidance to staff on: <ul style="list-style-type: none"> principles for fee setting and their relationship to service delivery objectives appropriate fee setting methods, including factors to be considered in determining the required level of cost recovery procedures for assuring compliance with competitive neutrality requirements procedures for monitoring service costs and fees and charges. 	28
5.	Councils should strengthen fee setting practices to assure that decisions are evidence-based and demonstrate consideration of: <ul style="list-style-type: none"> both the direct and indirect cost of goods and services to establish the full cost Best Value principles including accessibility, affordability and the efficient cost of services Competitive Neutrality policy requirements. 	28
6.	Local Government Victoria (LGV), in consultation with stakeholders, should develop guidance for councils on setting fees and charges.	28

Audit Act 1994 section 16— submissions and comments

Introduction

In accordance with section 16(3) of the *Audit Act 1994* a copy of this report, or relevant extracts from the report, was provided to the Department of Planning and Community Development, Whitehorse City Council, Frankston City Council, City of Ballarat and the Campaspe Shire Council with a request for comments or submissions.

The comments and submissions provided are not subject to audit nor the evidentiary standards required to reach an audit conclusion. Responsibility for the accuracy, fairness and balance of those comments rests solely with the agency head.

Submissions and comments received

RESPONSE provided by the Secretary, Department of Planning and Community Development

The following is an extract of the response by the Secretary, Department of Planning and Community Development (DPCD). The full response is provided in Appendix B of this report.

The Department believes the report presents fairly and is balanced.

Recommendations one, two, three, four and five

The Department supports the first five recommendations which are addressed specifically to local government.

Recommendation six

With regard to the sixth recommendation, which is addressed to Local Government Victoria:

- *The Department will continue to work with the local government sector on developing guidance and improving council's practices, including the setting of fees and charges, in order to enhance their operation and financial sustainability;*

RESPONSE provided by the Secretary, Department of Planning and Community Development – continued

- *The Local Government Act 1989 (the Act) allows councils the ability to determine the setting of fees and charges that reflect their community's requirements and socio-economic circumstances. This is achieved through the council planning process and is then further detailed in the annual budget. The Act requires councils to consult with their communities as part of both the planning and budget processes which provides the opportunity to make submissions on the content and the level of rates and fees and charges to be raised;*
- *Democratically elected councillors are responsible for making financial decisions about the level of revenue, including fees and charges, required to meet their communities' need for services; and*
- *In considering this recommendation it is important that the audit and any subsequent guidance materials do not restrict or mandate council's pricing practices, consultative processes or ability to reflect community needs, economic circumstances and service requirements.*

RESPONSE provided by the Chief Executive Officer, Whitehorse City Council

The following is an extract of the response by the Chief Executive Officer, Whitehorse City Council. The full response is provided in Appendix B of this report.

Cost management

Council generally agrees with the observations and recommendations in this section. Whitehorse Council will evaluate the merits of a full service costing model, however, it is likely that the 'pro rata approach' will be most appropriate as provided by the MAV Overheads Model.

The conclusion on page viii makes an assertion that the councils 'are not effectively managing the full costs of the services provided' when in fact the direct costs of programs, and all other costs, are reviewed and reported on a monthly, quarterly and six monthly basis to management and Council. This is in addition to the annual reporting process and mandatory external audit of financial statements. We are concerned that this statement may be misinterpreted having an unintended impact on the reputation of the Local Government Sector.

Pricing community services

Council generally agrees with the observations and recommendations made in this section. We acknowledge the need to establish a formal pricing policy. Determination of service full cost will provide an additional piece of information for consideration in setting service prices, with the final price being a balance of financial, regulatory, and community wellbeing considerations.

Further comment by the Auditor-General

Managing service costs effectively extends beyond setting budgets for, and tracking, direct costs. The report highlights that cost management involves understanding all costs, both direct and indirect; how these costs behave over a range of possible service volumes; and whether these costs are efficient.

RESPONSE provided by the Acting Chief Executive Officer, Frankston City Council

The following is an extract of the response by the Acting Chief Executive Officer, Frankston City Council. The full response is provided in Appendix B of this report.

Recommendation one

Our Council will develop central policies on service costing and provide additional guidance to staff on the application and use of these policies. These policies will cover the principles of cost recovery and the methodology for costing council services.

Recommendations two and three

Council will investigate a cost allocation model that will enable us to allocate indirect costs and identify the full costs of the services we provide. The complexity of this allocation model will be determined following a cost benefit review of the model options.

Once this cost allocation model has been implemented, we commit to reporting to Senior Management and Council about the full cost of their services and the fees and charges income collected. This information will be used to support annual adjustments to the fees and charges and to monitor whether council resources are being managed adequately and services are being provided at an appropriate cost and quality.

Recommendation four

Council will develop central policies on fee setting and provide additional guidance to staff on the application and use of these policies. These policies will cover the principles of fee setting, appropriate fee setting methods, procedures for ensuring compliance with competitive neutrality requirements and procedures for monitoring services costs and fees and charges.

Recommendation five

Council will endeavour to make decisions about fee setting practices that are evidence based and under consideration of the full costs of service provision, Best Value principles and Competitive Neutrality Policy requirements.

Recommendation six

I look forward to Local Government Victoria's development of guidance materials on the setting of fees and charges and will review these in line with our changes when it becomes available.

RESPONSE provided by the Chief Executive Officer, City of Ballarat

The following is an extract of the response by the Chief Executive Officer, City of Ballarat. The full response is provided in Appendix B of this report.

The audit is welcomed by the City of Ballarat and the findings are currently being reviewed with the aim to improve the performance of the City of Ballarat's operations.

The City of Ballarat acknowledges the lack of written policies which is now being addressed, in part, through the current budget process. Like most Council's, decisions on various fees and charges were made in the past and documentation has not been updated over time. This audit has highlighted the need for the City of Ballarat to update this documentation. During the Council's budget process, all issues such as fee setting has been centralised, this centralised process provides direction to management on issues relating to fee setting competitive neutrality etc. This audit has again highlighted the need for this process to be documented.

The City of Ballarat has two different costing models. The first is used for the daily management of the budget, the second for determining the appropriate cost of a service, depending on the rules governing the costs allowed to be included. It is believed that one costing system to meet all requirements of Council is not appropriate or viable.

In relation to Competitive Neutrality Policy the City of Ballarat is of the opinion that all relevant processes for those significant businesses are in place that satisfies the relevant guidelines. Following this audit, these processes will be reviewed, documented, and modified where necessary.

It is believed that all appropriate factors have been taken into consideration when adopting fees and charges, it is appropriate that the numerous fees and charges of Council be reviewed in detail and documented to ensure that the evidence of all decisions are up to date.

RESPONSE provided by the Chief Executive Officer, Campaspe Shire Council

The following is an extract of the response by the Chief Executive Officer, Campaspe Shire Council. The full response is provided in Appendix B of this report.

Recommendation one

Council acknowledges the importance of establishing an overall framework to provide guidance to staff. Campaspe service managers have been utilising various fee setting methods, providing benchmarked prices and analysing the market's capability to pay. Notwithstanding this, Council acknowledges that this occurs in the absence of an overall policy framework and this needs to be addressed.

Recommendation two

Council notes this recommendation. Campaspe operates a detailed cost allocation model and will continue to refine and enhance this to ensure that all costs are appropriately allocated.

RESPONSE provided by the Chief Executive Officer, Campaspe Shire Council – continued

Recommendation three

Council supports this recommendation and notes that the Financial Sustainability Review will assist in developing appropriate cost standards for each service delivered by Council.

Recommendation four

Council supports this recommendation and notes that fee setting methodology is linked strongly to the reasons why a service is delivered. Once this has been formally determined (as per the Financial Sustainability Review) fee setting methodologies can be determined and endorsed by Council.

Recommendation five

Council supports this recommendation. Council operates an indirect cost allocation model and thus has the opportunity to understand the full costs of each service.

These will be considered when establishing an appropriate fee setting methodology as per the Financial Sustainability Review. In addition the Financial Sustainability Review will be delivered in accordance with Best Value and Competitive Neutrality principles. Once this project has been completed, policy will be refined to ensure that Council's obligations continue to be met.

Recommendation six

Council strongly supports this recommendation. Formal advice assists Council in considering relevant issues and outlining to the community the rationale for policy positions.



1 Background

1.1 Introduction

1.1.1 Types of fees and charges

Councils offer a wide range of services to their communities, often for a fee or charge. The nature of fees and charges generally differs depending on whether they relate to compulsory or discretionary services.

Compulsory services attract unavoidable charges and can include such services as garbage collection, disposal, recycling and other special charges usually imposed on residents through rates notices. Discretionary services are those that residents can choose to use or not, such as recreation services, child care, applications for planning and building approvals and human services. In most cases councils provide these on a fee-for-service, or user-pays basis rather than funding them entirely out of rates and other general revenues.

Some of these fees and charges, such as statutory planning fees, are set by state government statute and are commonly known as 'regulatory fees'. In these cases councils usually have no control over service pricing. Non-regulatory fees and charges, however, are set by councils following consideration of a range of factors.

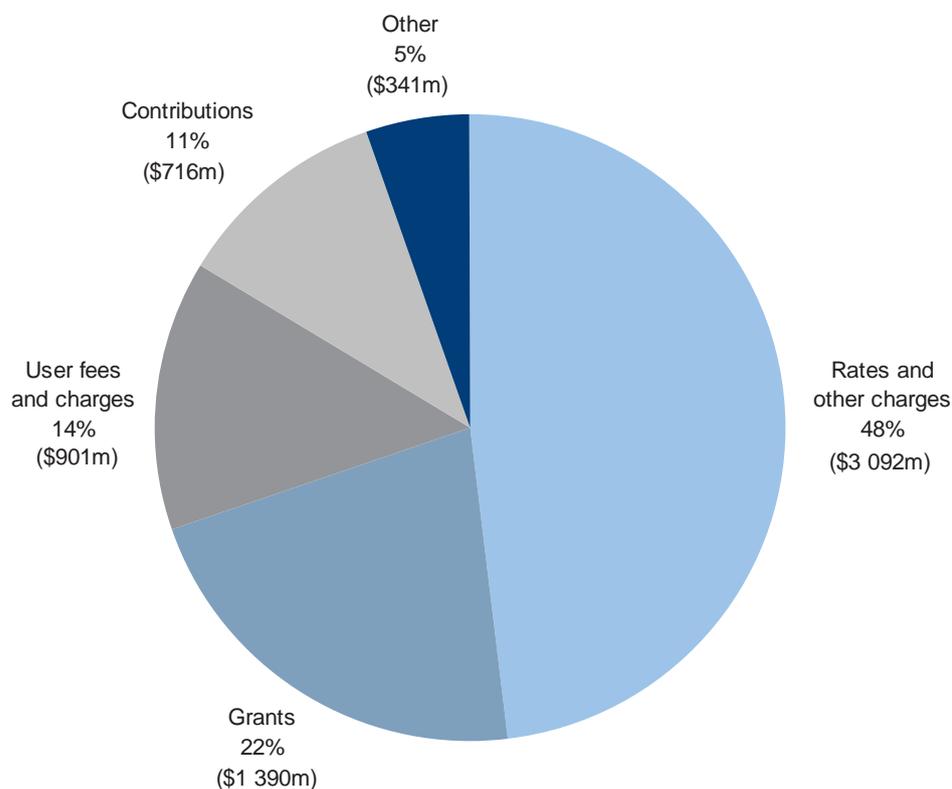
In this report, the terms 'fees' and 'charges' are used generically to cover all user charges and fees-for-service that are set and managed by local councils.

1.1.2 Importance of fees and charges

User fees and charges are a significant source of income for councils. Collectively they represent around \$900 million annually, or an average of 14 per cent of all council revenues.

Figure 1A shows that in 2008–09 fees and charges were the third most significant source of revenue, after rates and other charges, and grants from the Commonwealth and State governments.

Figure 1A
Local Government sources of revenue, 2008–09



Source: Victorian Auditor-General's Office.

Fees and charges are important to ratepayers and to the users of services. From a ratepayer's viewpoint, fee revenue supplements, and therefore ought to reduce, the rate burden. If fees and charges revenue do not keep pace with increases in the cost of service provision, or if fees are set only partially to recover costs, then the cost burden can fall back onto the ratepayer.

From the service user's viewpoint, the fee or charge acts as a price signal about the cost and value of resources used to produce the service. It also creates a user expectation that appropriate service standards will be set and met.

1.2 The regulatory and policy framework

Local Government Act 1989

The *Local Government Act 1989* (the Act) empowers councils to generate revenue from fees and charges by:

- making local laws that provide for determining fees and charges for goods and services, including setting maximum and minimum fees
- declaring a service rate or service charge, or combination of both for providing waste disposal, sewage, or other prescribed services.

Best Value principles

In December 1999, the Victorian Government introduced the *Local Government (Best Value Principles) Act 1999*. The government's objective in implementing Best Value was to improve the delivery of local government services by making them more affordable and responsive to local needs and to encourage councils to engage with their communities in shaping councils' services and activities.

The Best Value legislation has six principles to guide how a service should be monitored and reviewed on an ongoing basis. These principles include being responsive to community needs, ensuring services are accessible by those to whom they are targeted, achieving continuous improvement through regular review, consultation and reporting to the community; and by establishing cost and quality standards for all services. The last is critically important for councils in managing the cost of their community services as it enables them to assess the efficiency and cost-effectiveness of their services and to make informed pricing decisions.

Inter-governmental agreement

In April 2006 the Commonwealth, state and territory Governments, including national and state local government peak bodies, signed the *Inter-governmental Agreement Establishing Principles Guiding Inter-Governmental Relations on Local Government Matters* (IGA).

The IGA aims to address the impacts of cost shifting on local government by improving consultation and achieving greater financial transparency between the three spheres of government in relation to services delivered by councils.

The IGA was further supported and given effect in Victoria by the signing of the Victorian State-Local Government Agreement (VSLGA) in May 2008 by the Minister for Local Government and the President of the Municipal Association of Victoria (MAV) on behalf of all councils.

The IGA commits councils to demonstrating sound public governance through:

- good fiscal management
- consideration of available resources and competing priorities when making service delivery decisions
- improving their practices including strategic planning and development of appropriate pricing regimes.

To be financially sustainable and to achieve the commitments made under the IGA, local governments need access to reliable and relevant information on the cost of their community services. This information is essential for understanding their business, being accountable to ratepayers, and for negotiating effectively with other levels of government on funding.

Competitive neutrality policy

Commonwealth, state and local governments must comply with National Competition Policy (NCP) for the significant business activities they provide. NCP is founded on the April 1995 inter-governmental Competition Principles Agreement (CPA), which in Victoria is further supported by the *Competitive Neutrality Policy Victoria 2000* (CNP).

The aim of the CNP is to create a level playing field by requiring councils to adjust their service prices to neutralise any competitive advantages when competing with the private sector. It is up to each council to determine which of its business activities are significant and accordingly fall under the scope of the policy.

In December 2008 the Victorian Government also issued the *National Competition Policy and Local Government Statement*, setting out its approach to implementing competitive neutrality in local government. The statement identifies the following steps for councils to implement the policy:

- determine whether an activity is a 'significant business activity' and, therefore, subject to the policy
- determine whether the benefits of applying competitive neutrality outweigh the costs
- if there is a net benefit, conduct and document a 'public interest test', which involves public consultation on costed options, consideration of relevant policy objectives including Best Value principles and determining if CN will override the public policy objectives of council.

If the outcome of the public interest test finds that council's policy objectives will be compromised by the application of CN measures, then the council does not need to apply them. Full cost reflective pricing is the most commonly used measure by councils to offset any competitive advantages for their significant business activities. It involves determining the CN adjusted cost of undertaking the activity and applying a pricing structure that reflects the full cost to council.

If a council does not price its services to recover full costs, including CN adjustments, it is subsidising the activity. The government's 2008 policy statement provides that a subsidy must be made transparent and the community resources it consumes need to be justified in public policy terms.

Role of Local Government Victoria

Local Government Victoria (LGV) in the Department of Planning and Community Development (DPCD) plays an important role in encouraging and supporting best practice and continuous development in local government service delivery, organisational performance and governance.

The Act requires councils to submit a copy of their annual budget to the Minister for Local Government through LGV. However, LGV's role does not extend to scrutinising the basis of individual council budgets, service costing nor their fees and charges.

Similarly, under Victoria's 2008 *National Competition Policy and Local Government Statement* local councils are required to either submit an annual certification of compliance with NCP principles to LGV each year or to publish their compliance statement in their annual report. This requirement began in 1995 when NCP was first introduced.

Between 1995 and 2005 the Commonwealth Government made payments to each of the states and territories in recognition of compliance with NCP and Victoria shared its payments with local government under agreements between the state and Victorian councils. During this period councils had to submit a detailed report to LGV supporting their annual attestations demonstrating how they complied with CN in the context of Best Value. These more detailed reports are now no longer required by LGV following the cessation of commonwealth NCP payments in 2005–06.

1.3 Principles for setting fees and charges

Extent of cost recovery

A widely accepted principle for public sector pricing is that where only the user of the service obtains the benefit from that service, fees and charges should be set at a level that recovers the full cost of providing the services, unless there is an overriding policy or imperative in favour of subsidisation.

Full cost represents the value of all the resources used or consumed in the provision of a service. In addition to the costs directly associated with the service, full cost includes an appropriate allocation of indirect, including capital costs.

The principle of full cost recovery was canvassed in chapter 6 of the Productivity Commission's April 2008 report on *Assessing Local Government Revenue Raising Capacity*. At the state level, the April 2007 *Victorian Guide to Regulation*, and the September 2007 *Cost Recovery Guidelines* both issued by the Department of Treasury and Finance (DTF), provide that for both efficiency and equity considerations fees for services should ordinarily recover the full cost to government. The latter guides are intended for the state public sector but the principles are equally relevant to local government.

In April 2009 the MAV released the *Overheads Model—Manual for councils* to assist councils to allocate their indirect costs to services. The manual and associated spreadsheets provide a step by step guide on how to allocate indirect costs in local government.

The requirement to recover the full cost of a service where relevant is likely to encourage more efficient outcomes for a council, by focusing its attention on the efficient cost of service delivery. It should also reduce or avoid the risk of over-consumption of services that could occur if they were provided free of charge. Full cost recovery, where appropriate, also contributes to achieving allocative efficiency—where resources are optimally allocated to benefit society and where the value consumers place on a good or service equals the cost of production.

Considering Best Value and Competitive Neutrality principles

When setting service fees and charges councils need to take into account the efficiency of their services, the requirements of the Best Value principles, and the need to comply with their CN obligations for significant business activities they provide.

At a minimum, this requires councils to apply and monitor meaningful cost standards for their services to take account of efficient costs and to consider the principles of access, affordability and equity.

Adjusting prices to achieve 'equity'

Equity considerations are important factors impacting on local government pricing decisions and for determining the appropriate level of cost recovery for given services. This involves balancing the desire to distribute costs equally to users who benefit from the service with assuring equal access to those with less capacity to pay. These are often competing priorities, which can be further complicated by the need to make appropriate price adjustments to offset any advantages or disadvantages to council arising from it competing with the private sector.

While full cost recovery represents the optimum pricing outcome, it is important to note that there will be situations where it is appropriate for a council to recover less than the full cost, or not to recover costs through fees and charges at all. For example, where:

- full cost recovery is not commercially competitive
- users receive only some of the benefits of the service, with the balance going to external, unrelated third parties
- social policy or access considerations outweigh the objectives of full cost recovery.

To give effect to these pricing principles, and to make informed, rational decisions about the allocation of resources, councils therefore need to be able to answer the following questions:

- Which costs should be recovered?
- How should charges be structured?
- Are cost recovery charges based on efficient costs?

1.4 Audit of fees and charges

1.4.1 Audit objective

The objective of the audit was to examine whether councils are effectively managing the costs of their community services.

Specifically, the audit examined whether selected councils:

- had reliable and relevant information on the full cost of existing and new services
- use this cost information appropriately in their strategic decision making about resource prioritisation, allocation and cost recovery
- regularly monitor the efficiency of service delivery, service costs and relate this to fees and charges collected.

1.4.2 Scope and methodology

The audit examined the service costing and pricing policies and practices of a sample of services—waste management, aged care services, preschool and child care and recreational services—at the following randomly selected councils:

- Whitehorse City Council
- Frankston City Council
- City of Ballarat
- Campaspe Shire Council.

The fees and charges for the selected councils totalled around \$90 million, or 10 per cent of all fees and charges collected by all local governments during 2008–09. Information from previous financial years and subsequent financial years was also reviewed.

The audit was performed in accordance with the Australian Auditing Standards.

1.5 Cost of the audit

The cost of the audit was \$290 000. This is the 'full cost' and includes both direct and indirect labour, a share of corporate overheads allocated on a pro-rata basis, and the costs of printing and distributing this report.

2 Cost management

At a glance

Background

Councils need effective arrangements for managing the cost of their services to assure their communities that services are efficient.

Conclusion

Councils need to improve their management of service costs. Insufficient guidance together with inadequate costing and monitoring practices mean that most councils do not understand the true cost of their services and the extent to which they subsidise them.

Findings

- None of the councils had adequate policies to support effective cost management of their services.
- All councils had systems that captured the direct cost of services, however, only Campaspe systematically identified and allocated its indirect costs to service areas to establish the full cost of service provision.
- Council oversight of the efficiency of service delivery needs to be improved to include information on full costs and service efficiency.

Recommendations

Councils should:

- develop and endorse central policies to provide guidance on service costing
- review and, where necessary, enhance their current cost allocation practices
- strengthen their oversight and monitoring of the efficiency of service delivery.

2.1 Introduction

The cost management framework was examined at each council to assess whether:

- policies and procedures to guide cost allocation methods are adequate
- cost systems produce relevant and reliable information on the full cost of services
- arrangements for monitoring service costs are effective.

Figure 2A summarises the adequacy of councils' cost management frameworks.

Figure 2A
Assessment of councils' costing practices

	Whitehorse	Frankston	Ballarat	Campaspe
Policies/guidelines				
Policies provide sufficient guidance on cost allocation methods and recovery	x	x	x	x
Costing systems and information				
Systems can generate reliable and relevant information on direct cost of services	✓	✓	✓	✓
Councils systematically allocate indirect costs to determine the full cost of services	x	x	x	✓
Monitoring adequacy of service costs				
Arrangements for monitoring service costs are effective	x	x	x	x

Source: Victorian Auditor-General's Office.

2.2 Cost management policies

2.2.1 Conclusion

The councils examined do not have adequate policies to guide staff on effectively managing the full cost of their community services. This represents a weakness in local management arrangements as responsibility for service costing was devolved to individual business units across all councils.

2.2.2 Adequacy of policies and procedures

A comprehensive set of policies and supporting cost management procedures encompasses:

- principles of cost recovery to be applied
- the methodology for costing council services and the associated rationale
- procedures for setting cost standards and monitoring the efficiency of service costs.

None of the councils had corporate policies that adequately addressed all of the above, nor did they provide sufficient guidance to staff on the procedures needed to achieve good practice.

In each case responsibility for managing service costs is devolved to individual business units, each of which had developed their own procedures. These procedures, in most cases, fell short of good practice.

2.3 Council costing systems

2.3.1 Conclusion

With the exception of Campaspe, councils' costing systems did not permit determination of the full cost of services. These councils, therefore, did not have relevant and reliable information on full costs. As a consequence they had not established adequate cost standards, nor determined whether their actual costs of service delivery reflected an efficient cost.

2.3.2 Adequacy of costing systems

Figure 2B sets out the major categories of cost. These components need to be allocated to all service areas in order to establish the 'full cost' of all council services, regardless of whether specific fees and charges are applied.

Figure 2B
Components of cost

Type of cost	Categories	Examples
Indirect		
Costs that are not directly attributable to an activity—often referred to as overheads	Capital	<ul style="list-style-type: none"> • License and maintenance fees for corporate computer software • Depreciation or lease of 'corporate' office buildings
	Administrative expenses	<ul style="list-style-type: none"> • Cost of printing the annual report
	Materials and supplies	<ul style="list-style-type: none"> • Stores and stationery used by corporate services staff
	Labour	<ul style="list-style-type: none"> • Chief Executive Officer and Directors' remuneration
Direct		
Costs that can be readily and unequivocally attributed to a service or activity because they are incurred exclusively for that particular product/activity	Capital	<ul style="list-style-type: none"> • Depreciation or lease costs of specific-purpose buildings, vehicles, computers, and other equipment used directly in delivering services
	Administrative expenses	<ul style="list-style-type: none"> • Transport, accommodation and meal expenses for service delivery staff, service-related publications
	Materials and supplies	<ul style="list-style-type: none"> • Spare parts, inventory, fuel
	Labour	<ul style="list-style-type: none"> • Salaries and wages of 'works unit' employees; payments to contractors and service providers

Source: Victorian Auditor-General's Office.

Allocating direct costs to services is usually straightforward as these costs are normally incurred exclusively for activities that can be directly related to a specific service. Indirect costs, however, are more difficult to allocate accurately as they include overheads which are not specific to individual services. Councils need appropriate methods for identifying and apportioning indirect costs in order to determine the full cost of services.

All councils had systems that captured the total direct cost of services, and some had allocated selected indirect costs to some services. However, only Campaspe had a central system for systematically identifying and allocating its indirect costs to service areas to establish their full cost. None of the three other councils systematically identified or allocated their indirect costs because:

- they considered the effort needed to develop and maintain an attribution model that appropriately distributes indirect costs to service areas to be impractical or unnecessary
- service-line managers perceived they had little capacity to control or influence indirect costs.

Ballarat advised it had an overheads model prior to 2002 that it used for allocating indirect costs to service areas but that it had decided to discontinue its use for the reasons outlined above.

The absence of indirect costing, at these councils, means that they do not know the full cost and, therefore, cannot establish the level of total subsidy for each service. This information is relevant to decisions about the best mix of labour and capital, and the level of corporate support used. Councils that do not fully calculate and allocate their indirect costs are, therefore, not providing the useful information needed by managers to make the best use of their resources. Figure 2C highlights the importance of understanding the indirect costs of services.

Figure 2C
Impact of allocating indirect costs

A 2006–07 business plan for waste management services at one council identified that it consumes approximately \$380 000 in indirect costs. While the council does not allocate its indirect costs, this represents an underestimate of waste management full costs by almost 8 per cent based on the current direct cost of around \$5 million.

Council's financial objective for waste management is to achieve a 'breakeven' position, that is, service charges revenue for waste management equal cost. The 2009–10 budget figures, which exclude indirect costs, forecast a 'surplus' of around \$200 000. However, using the 2006–07 business plan figure as a current estimate of indirect costs produces a deficit of \$180 000.

Source: Victorian Auditor-General's Office.

Although indirect costing is less straightforward it does not have to be complex.

Two widely used methods to allocate indirect costs are:

- **activity-based costing (ABC)**, which links an organisation's outputs or goods and services to the activities used to produce them, and then assigns a cost to each output based on the rate of consumption of associated activities
- the **pro-rata approach**, which allocates indirect costs on a proportionate basis by using measures that are easily available, such as staff involved in the activity as a percentage of total staff, or the service unit's share of total office space.

An overview of each method is provided in Appendix A.

Campaspe's overhead allocation model

Campaspe's overheads model uses the pro rata approach. It identifies a range of indirect costs that need to be allocated to service areas. It distinguishes between indirect costs consumed by service areas and those associated with broader governance functions of council which are not allocated to service areas consistent with Municipal Association of Victoria's (MAV) *Overheads Model*.

The Campaspe model allocates the cost of ten council internal support areas—finance, payroll, human resources, risk management, records management, creditors, debtors, information technology, accommodation and other organisational costs—to over 100 service units.

The model apportions overheads based on cost drivers. For example, the cost of human resources is allocated based on the number of equivalent full time staff in the service area. Similarly, records management costs are allocated according to the number of records assigned to, or generated by, a service area.

In addition, some overhead expenses such as leasing costs for computer equipment paid by the Information Technology (IT) Unit are allocated directly to those units that incur the cost. Only the remaining IT costs are shared across other services according to the driver.

Campaspe updates its model annually to reflect any change in costs and methods for allocation. Council staff advised that it took approximately ten days to develop the model initially, and that it takes around five days annually to manage and update indicating that the process is not resource and/ or labour intensive.

While the scope of the audit did not extend to verifying the accuracy of Campaspe's model it nevertheless represents a useful system for allocating indirect costs that is generally consistent with the MAV's recommended approach.

Figure 2D shows how Campaspe used the model to allocate selected overhead costs to one of its services for the 2009–10 budget. Only a subset of Campaspe's overheads is shown for illustrative purposes.

Figure 2D
Indirect costs allocated to a service, 2009–10 budget

Council activity (overhead groups)	(A) Cost of activity (\$)	(B) Governance discount (\$)	(C) Cost to be allocated (\$) (C=A–B)	(D) Total cost driver units (No)	(E) Family day care service cost driver units (No)	(F) Indirect costs (\$) [F=(CxE) / D]
Finance	408 276	188 196	220 080	Number of live accounts 427	1	515
Payroll	127 433	0	127 433	Number of active staff 422.5	4	1 206
Human resources	329 662	0	329 662	Number of active staff 422.5	4	3 121
Risk management	197 063	167 504	29 559	Number of active staff 422.5	4	280
Records management	188 169	0	188 169	Number of registered documents 22888	27	222
Creditors	173 491	27 300	146 191	Number of live accounts 21 730	1 544	10 387
Debtors	74 095	0	74 095	Number of invoices 108 582	17 207	11 742
Information technology	1 219 065	0	^(a) 1 187 040	Number of computers 240	4	19 784
Accommodation Echuca	443 052	70 672	372 380	Number of Echuca staff EFTs 137	2	5 436
Organisational costs e.g. postage and stationery	442 432	0	442 432	Number of staff EFTs 169	2	5 236
Total indirect costs allocated to a service						57 930

(a) Direct allocation of IT costs of \$32 025 subtracted from total IT cost of \$1 219 065.

Source: Victorian Auditor-General's Office using data provided by Campaspe Shire Council.

2.3.3 Consideration of cost standards and efficient costs

While some councils had benchmarked costs for some key services, none of those examined had established explicit cost standards for all services as required by the Best Value (BV) principles. For example, Whitehorse had benchmarked the unit cost of its Family Day Care and Aged Care services and Ballarat had similarly benchmarked the unit cost of its recreational services using information sourced from participating councils.

Whitehorse had also established cost standards for its Family Day Care, Aged and Disability and elements of its waste collection services based on the per unit cost of service delivered. However, there was no evidence these were developed based on an analysis of optimum efficiency levels taking into account the full service cost, the impact of BV considerations, CN obligations, and desired level of cost recovery. This meant that none of the councils we examined had rigorously determined the efficient cost of their services.

Fixed, variable and average costs

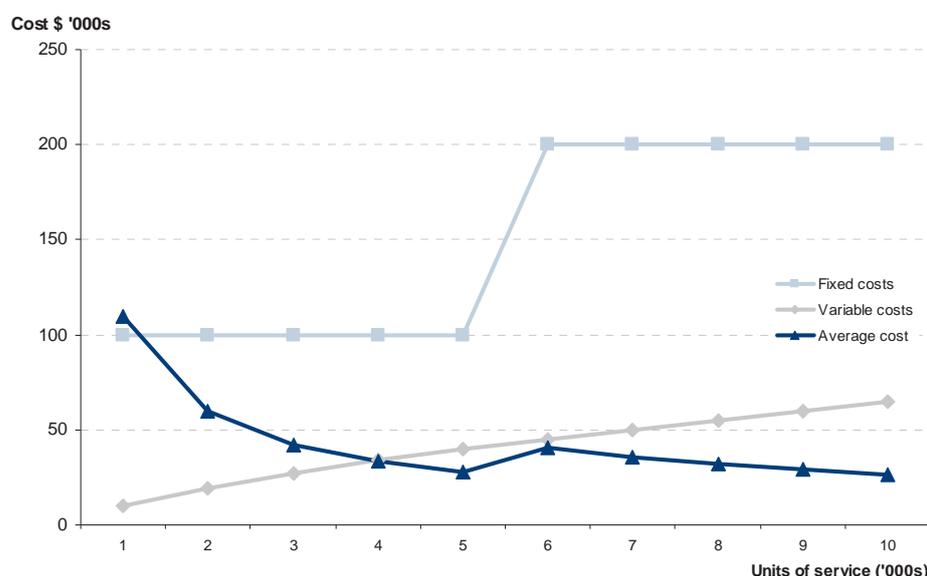
The full cost of services can also be expressed in terms of how different costs are affected by changes in service levels. These are known as fixed and variable costs.

Fixed costs are generally unaffected by service delivery or production levels. For example the cost of operating a council building does not change with moderate increases or decreases in the number of child care places provided. These costs generally remain fixed over the short term, but can increase or decrease at a given point in time, for example when a new child care building is required to accommodate growth.

Variable costs, however, are directly related to the levels of production or service delivery. For example, labour costs will obviously increase as more staff are hired to meet the rising demand from increases in child care enrolments.

Since certain costs are fixed, the cost of each additional unit of service produced or delivered, the marginal cost, is almost always less than the average per-unit cost of production across all units produced. This means that the average cost generally decreases as production or service levels increase. The average cost can be a useful measure, along with other considerations, for determining cost standards and evaluating the efficient cost of services. Figure 2E illustrates the relationship between these cost dimensions.

Figure 2E
Relationship between fixed, variable and average costs



Source: Victorian Auditor-General's Office.

There was no evidence to indicate that councils analysed their service costs in this way so as for example, to determine whether to vary the quantity of services delivered to achieve greater efficiency.

Councils did offer fee concessions to certain service users and applied different fees for different aspects of services. However, there was no evidence that the average or marginal costs were considered in determining whether a differential pricing strategy was appropriate for different users and/or for different peak and non-peak usage periods.

2.4 Monitoring and review of costs

2.4.1 Conclusion

Oversight of service cost-efficiency was inadequate in most councils. Reports to senior management and council do not provide all the information that managers and council need to fulfil their oversight responsibilities effectively. The reports lacked sufficient detail on the efficiency and full cost of services, and annual adjustments to user fees and charges were not supported by evidence-based analysis of the adequacy of service costs.

2.4.2 Oversight

Reporting to senior management and council is pivotal for assuring the efficient use of resources and for effectively managing the cost of community services. Effective reporting will include a detailed analysis of full costs and achievements against targets or benchmarks relating to the efficient cost of services in order to gauge operational efficiency.

All councils have internal reporting processes to monitor financial and operational service performance. Reports are provided to senior management and council, either monthly or quarterly that provide comparisons of actual revenue and expenses against the budget forecast for each service. While these reports contained useful data they did not provide information about whether council resources were being managed efficiently and effectively, or whether services were being provided at an appropriate cost and quality.

The value of these reports at Whitehorse, Frankston and Ballarat from a fee setting and service costing perspective is further limited, as they do not report on the full cost of services. This, coupled with the absence of reporting to council and senior management on explicit cost standards means that these councils are unable to fully assess the efficiency of these services, the extent to which they are subsidised, and the extent to which fees recover service costs.

2.5 Conclusion

There is substantial scope for councils to improve their management of service costs. The absence of policies and detailed guidance for staff, coupled with shortcomings in local oversight arrangements have led to inadequate costing practices and insufficient attention to identifying and analysing full costs.

Three councils did not understand the true cost of their services or the extent to which they subsidise them; and all four are making pricing decisions in the absence of relevant cost information. This is contrary to good practice.

Recommendations

1. Councils should develop and endorse central policies on service costing that provide guidance to staff on:
 - principles of cost recovery and their relationship to service delivery objectives
 - the methodology for costing council services and the associated rationale.
 2. Councils should review and, where necessary, enhance their current cost allocation practices by:
 - developing a costing model and related processes to allocate indirect costs
 - recognising and reporting the full cost of their services.
 3. Councils should strengthen oversight of service costs by:
 - setting cost standards based on efficient costs
 - regularly reporting to senior management and council on the efficiency and full cost of their services and relate this to fees and charges collected.
-

3 Pricing community services

At a glance

Background

Councils need to assure their communities that user fees and charges are set to reasonably reflect the full cost of providing services, unless there is some overriding economic or social policy objective.

Conclusion

There is little assurance that councils are setting their fees strategically to optimise the recovery of their service costs after considering principles of equity, accessibility and allocative efficiency. Better documentation of the evidence supporting fee setting decisions is required to demonstrate they are soundly based.

Findings

- None of the councils examined had adequate policies to support setting appropriate fees and charges.
- Fee setting practices need to improve to consider full costs, adherence to Best Value principles and compliance with Competitive Neutrality (CN) policy.

Recommendations

- Councils should:
 - develop and endorse policies to provide guidance on fee setting and review
 - develop more robust fee setting practices.
- Local Government Victoria (LGV), in consultation with stakeholders, should develop guidance for councils on setting fees and charges.

3.1 Introduction

To assess the fee setting framework at each council, we examined if councils have:

- adequate policies to guide the non-statutory prices they charge for community services
- considered full costs, competitive neutrality requirements and principles of equity, accessibility and allocative efficiency when setting fees and charges
- effective arrangements for monitoring the adequacy of fees and charges.

Figure 3A summarises the adequacy of councils' fee management frameworks.

Figure 3A
Assessment of councils' fee setting practices

	Whitehorse	Frankston	Ballarat	Campaspe
Policies/guidelines				
Policies provide sufficient guidance on fee setting and review	x	x	x	x
Price setting practices				
Principles of equity, accessibility and allocative efficiency are transparently applied to decisions about service pricing	x	x	x	x
Fees and charges are set with an understanding of the full cost of each service, and the efficient cost of service provision	x	x	x	x
Competitive neutrality requirements are complied with where applicable	x	x	x	x
Monitoring adequacy of fees and associated costs				
Arrangements for monitoring the adequacy of fees and charges are effective	x	x	x	x
Fees and charges are appropriately adjusted over time	x	x	x	x

Source: Victorian Auditor-General's Office.

3.2 Fee setting policies

3.2.1 Conclusion

The councils examined do not have adequate policies to guide staff on setting appropriate levels of fees and charges for their community services.

3.2.2 Adequacy of policies and procedures

A comprehensive set of policies and supporting procedures would encompass:

- principles of fee setting and their relationship to service delivery objectives
- fee setting methods, including factors to be considered in determining the desired level of cost recovery
- procedures for assuring compliance with Best Value and Competitive Neutrality (CN) requirements
- procedures for monitoring the adequacy of fees and charges over time.

None of the councils had central policies that adequately addressed all of the above, nor did they provide sufficient guidance to staff on the procedures needed to achieve good practice. Only Frankston and Campaspe had documented policies governing service pricing. While both made general references to principles of cost recovery and fee setting they did not offer detailed guidance to staff nor were they consistently implemented by business units.

The lack of central policy and guidance in the councils examined was a matter of concern as in each case responsibility for managing service costs, including setting user fees and charges, is devolved to individual business units, each of which had developed their own procedures. Although service costs and fees were reviewed centrally, these procedures in most cases fell short of good practice and are discussed in the following sections.

3.3 Council pricing practices

3.3.1 Conclusion

The councils' fee setting decisions lack sufficient rigour, and transparency. In most cases fee setting decisions are not adequately informed by information on full costs, or an evidence-based analysis of the efficiency, accessibility and affordability of services to the community.

There is also a lack of assurance that councils are complying with competitive neutrality requirements, as there is insufficient evidence to support associated attestations by councils.

3.3.2 Setting fees and charges

Consistent with their legal obligations and policy frameworks councils should set fees and charges by taking into account:

- the full cost and efficient cost of providing the services
- their objectives for cost recovery and fee setting
- issues of allocative efficiency, accessibility and affordability of services to the community
- actions needed to assure compliance with CN requirements.

Variable practices within councils

Figure 3B provides an example of how fees were set at one council for selected services. Similar internal differences were evident across the remaining councils.

Figure 3B
Factors considered when setting fees

Service	Fee setting practices
Recreation	Fees are based on recommendations from the contracted service provider. Council staff assess whether they are 'reasonable', but there is no clear rationale for establishing this.
Waste management	The previous year's fee is adjusted based on movements in the Consumer Price Index along with price benchmarking with other service providers.
Child care	Consideration of cost factors, price benchmarking, analysis of demand and client mix, and community affordability
Aged care	Guided by the Home and Community Care pricing guidelines issued by Department of Human Services

Source: Victorian Auditor-General's Office.

In addition to differing fee setting practices between business units at each council, variation was also evident at Ballarat across sports precincts and public reserves. Some clubs and associations were charged seasonal fees and ground usage charges, while other clubs and community groups were exempt from paying fees without a clear reason. These issues have been recognised by council and are currently being addressed.

Consideration of full costs and efficient costs

None of the four councils examined could demonstrate that full costs were considered when setting their fees and charges. Though Campaspe had developed a cost attribution model to determine the full cost of its services, it was not evident that it had actually used this information in its price setting decisions. Councils had not established the efficient cost of their services, and as such this was not systematically considered in fee setting decisions.

Consideration of accessibility and affordability

The *Local Government Act 1989* (the Act) requires councils to apply principles of sound financial management and to consider a range of Best Value principles including value for money, community expectations and values, as well as balance affordability and accessibility of services.

Councils advised that they had informally considered Best Value principles, and there was evidence in some cases that an analysis of local conditions and market forces was undertaken to inform service prices.

For example, Frankston's funding policy and Campaspe's 2009–10 budget identifies that the ability of users to pay and accessibility of services are key factors when setting fees and charges.

Similarly, Whitehorse advised that child care services routinely considered:

- fee benchmarking with local market as well as other local government areas across Melbourne
- occupancy trends and their impact on local demand and prices
- feedback from service managers on issues raised by families relating to cost
- the impact of economic trends such as unemployment rates, interest rates on demand
- national and state government policies governing fees.

As stated in Part 2, Whitehorse had also established useful cost standards for some of its services, in particular Family Day Care and Aged and Disability services and there was evidence that it had benchmarked its performance on some of these measures with other similar councils and/ or providers. These were positive initiatives, however there was insufficient documentation to demonstrate how they influenced fee setting decisions.

The lack of transparent analysis when setting user fees and charges across the four councils we examined meant there was insufficient assurance they had implemented their own policy statements, or had sufficient regard to Best Value principles.

Consideration of competitive neutrality

To comply with CN policy councils need to identify their significant business activities and adjust their prices where relevant to neutralise any competitive advantage when competing with the private sector. They also must be able to demonstrate compliance with the requirements of the policy.

Each council is responsible for determining if their business activities fall within the CN policy, and this must be done on a case-by-case basis. The subjective nature of this assessment means it is important for a council to document the basis of its decision.

There was evidence that Whitehorse, Ballarat and Campaspe had assessed selected services for compliance with CN policy and that they consult with service managers annually to identify any changes that may affect compliance for these services.

However, none of the councils could demonstrate that they had rigorously assessed all of their services for compliance with CN requirements and that this was systematically considered in fee setting decisions.

There was a general lack of awareness among staff responsible for setting fees at most councils about the requirements of the CN policy. While some services had been assessed for compliance, the absence of evidence to substantiate councils' 2008–09 statements of compliance for all of their significant business activities meant that they were unable to demonstrate they had fully complied with and considered their CN obligations when setting all of their fees and charges.

3.4 Monitoring and review

3.4.1 Conclusion

Annual adjustments by councils to user fees and charges were not supported by a rigorous analysis of the implication for their compliance with Best Value principles and CN policy requirements taking into account full service costs.

3.4.2 Reviewing the adequacy of fees and charges

All councils review their fees annually as part of their budgetary process. However, in most cases, these reviews were not adequately supported by information on full costs, or by rigorous analysis of the ongoing accessibility, affordability and efficiency of services, or of the actions needed to meet CN requirements.

Review of 2009–10 council budgets showed that annual pricing decisions for most services were based on movements in the Consumer Price Index (CPI) or on the results of benchmarking with other councils or private sector service providers. While these are relevant considerations, adjusting fees based on these factors alone without adequate consideration of full costs, service efficiency, affordability, equity and accessibility factors means there is insufficient assurance that councils are changing fees strategically, and adequately fulfilling their obligations for sound financial management.

There was an over-reliance on price benchmarking at all councils. Ballarat was particularly active in extensively benchmarking prices for services we examined. This is a useful tool for comparing 'like' services but it has significant limitations when used as the only mechanism for fee setting and review. Benchmarking does not take account of the differing cost structures or differences between councils and other service providers. Benchmarking data should be used after accounting for these limitations because it can distort any subsequent analysis.

Using the CPI to adjust fees and charges as a proxy to match cost increases is also an imprecise method. Changes in input costs for labour, materials and construction costs generally respond differently to the CPI movements. It is possible, therefore, under this scenario that increases in the cost of service provision over time will be greater than the increased revenue from fees and charges, leading to issues of long-term sustainability.

Figure 3C summarises the fee setting approaches outlined in each council's 2009–2010 budget.

Figure 3C
Summary of fee setting approaches in 2009–2010 council budgets

Council	Fee setting
Whitehorse City Council	Existing fees and charges are reviewed in line with market level, or increased by 4 per cent in line with council's business plan
Frankston City Council	Most fees increased in line with CPI
City of Ballarat	Existing fees and charges set at the medium range for the state or increased at 4 per cent
Campaspe Shire Council	Fees and charges increased in line with CPI or market forces

Source: Victorian Auditor-General's Office.

3.5 Conclusion

Shortcomings in local policies and management practices meant that each council was unable to demonstrate it was optimising the recovery of costs through strategic fee setting and, therefore, that it was effectively implementing principles of sound financial management.

Better policies, reporting and governance arrangements are needed to strengthen local management and oversight, and to achieve greater transparency and accountability for service costs and fee setting decisions.

Recommendations

4. Councils should develop and endorse central policies on fee setting that provide guidance to staff on:
 - principles for fee setting and their relationship to service delivery objectives
 - appropriate fee setting methods, including factors to be considered in determining the required level of cost recovery
 - procedures for assuring compliance with competitive neutrality requirements
 - procedures for monitoring service costs and fees and charges.
 5. Councils should strengthen fee setting practices to assure that decisions are evidence-based and demonstrate consideration of:
 - both the direct and indirect cost of goods and services to establish the full cost
 - Best Value principles including accessibility, affordability and the efficient cost of services
 - Competitive Neutrality policy requirements.
 6. Local Government Victoria (LGV), in consultation with stakeholders, should develop guidance for councils on setting fees and charges.
-

Appendix A.

Cost attribution methods

Activity based costing

Activity based costing method is the most accurate way of allocating indirect costs. It works by examining the activities undertaken, determining what drives or causes the activities to be used in the production process, and then allocates costs on the basis of the resource consumption of each activity.

Figure A1, adapted from the Department of Treasury and Finance's *Cost Recovery Guidelines*, illustrates the application of activity based costing in allocating human resource costs of \$300 000 (indirect costs) between two services. The example identifies the main activities of the human resources department, the cost of each activity based on an estimate of the time spent on it, and how indirect costs are allocated based on the intensity of the activity for each service area (i.e. the cost driver).

Figure A1
Example of activity based costing method

Main functions of the human resource unit	Estimated % of time spent on each of these functions	Cost of activity (\$)	Cost driver that has the greatest influence on the level of each activity	Number of cost drivers			Allocation of indirect cost to recreation services (\$)	Allocation of indirect cost to child care services (\$)
				Total	Recreation services	Child care services		
Recruitment	30	90 000 (30% x \$300 000)	Number of positions advertised	20	5	15	22 500 (5/20 x 90 000)	67 500 (15/20 x \$90 000)
Selection	20	60 000 (20% x \$300 000)	Number of interviews	50	20	30	24 000 (20/50 x \$60 000)	36 000 (30/50 x \$60 000)
Payroll	50	150 000 (50% x \$300 000)	Number of employees	100	40	60	60 000 (40/100 x \$150 000)	90 000 (60/100 x \$150 000)
Total	100	300 000					106 500	193 500

Source: Victorian Auditor-General's Office—adapted from the Department of Treasury and Finance's cost recovery guidelines.

Using the activity based costing method, the allocation of the council's total human resource (indirect) costs between services are \$106 500 for recreation services and \$193 500 for child care services.

Pro-rata approach

It is not always practical to use the activity based costing method because it can be too labour-intensive and costly to identify actual resource usage of different activities within a service. In these cases the pro-rata approach is an appropriate alternative.

Using the same information used in Figure A1, a simple pro-rata method could allocate the total \$300 000 cost of the human resource department between the two council services using the number of staff employed in each service as a basis of allocation of human resource costs. Figure A2 shows that this approach results in allocating \$120 000 of council's human resource costs to recreation services and \$180 000 to child care services—a similar allocation to that achieved under activity based costing.

Figure A2
Example of pro rata costing method

Service	Number of staff	Allocation of indirect costs (\$)
Recreation services	40	120 000 (40 staff/100 x 300 000)
Child care services	60	180 000 (60 staff/100 x 300 000)
Total	100	300 000

Source: Victorian Auditor-General's Office—adapted from the Department of Treasury and Finance's cost recovery guidelines.

The Municipal Association of Victoria's Overheads Model

In April 2009 the Municipal Association of Victoria (MAV) released its *Overheads Model* to assist councils in allocating their indirect costs. The model recognises that indirect costs make up a sizeable proportion of each council's total costs, and that omitting them from any form of business analysis leaves unsatisfactory results.

The MAV model uses the pro-rata approach and comes with a standard set of spreadsheets that can be populated by an accounting professional in three days. It identifies six distinct overhead groups—Finance, Accommodation, Human Resources, Information Technology, General Office, Chief Executive Officer and Directors—as appropriate in local government that can be varied as needed depending on each council's structure.

The MAV model apportions the indirect (overhead) costs based on an assessment of the expenses and the underlying forces that drive them and allocates the cost of council's six overhead groups across all services areas.

The model excludes allocating expenses relating to governance, such as councillor remuneration, on the basis that local government governance goes well beyond what occurs in the private sector. This is consistent with the approach adopted in DTF's *Cost Recovery Guidelines*. It also advocates directly allocating some overhead expenses when the cost can be clearly linked to a specific service. For example, software costs incurred by IT for payroll should be directly allocated to payroll. Only the remaining IT costs should be shared across services according to the cost driver.

Appendix B.

Audit Act 1994 section 16— submissions and comments

Introduction

In accordance with section 16(3) of the *Audit Act 1994* a copy of this report, or relevant extracts from the report, was provided to the Department of Planning and Community Development, Whitehorse City Council, Frankston City Council, City of Ballarat and the Campaspe Shire Council with a request for comments or submissions.

The comments and submissions provided are not subject to audit nor the evidentiary standards required to reach an audit conclusion. Responsibility for the accuracy, fairness and balance of those comments rests solely with the agency head.

Submissions and comments received

RESPONSE provided by the Secretary, Department of Planning and Community Development



Department of Planning and Community Development

Ref CSEC001647

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Australia
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Dr Peter Frost
Acting Auditor-General
Victorian Auditor General's Office
Level 24, 35 Collins Street
MELBOURNE VIC 3000

31 MAR 2010

Dear Dr Frost

AUDIT ACT 1994, S16(3) – PROPOSED AUDIT REPORT: FEES AND CHARGES – COST RECOVERY BY LOCAL GOVERNMENT

Thank you for your letter of 23 March 2010 enclosing a copy of the proposed report on the performance audit your office undertook on 'Fees and Charges – Cost Recovery by Local Government' and the opportunity to provide formal comments for inclusion in the report.

The Department has reviewed the proposed report, as was the case with the preliminary draft report provided in 15 March 2010 for final confirmation of issues, facts and context, and believes the proposed report presents fairly and is balanced.

In regard to the series of six recommendations contained in the proposed report, which remain unchanged from the preliminary report, the Department wishes to reiterate the comments dated 19 March 2010 in response to the preliminary report.

Specifically, the Department's comments are:

The Department supports the first five recommendations which are addressed specifically to local government.

With regard to the sixth recommendation, which is addressed to Local Government Victoria:

- a) The Department will continue to work with the local government sector on developing guidance and improving council's practices, including the setting of fees and charges, in order to enhance their operation and financial sustainability;
- b) *The Local Government Act 1989* (the Act) allows councils the ability to determine the setting of fees and charges that reflect their community's requirements and socio-economic circumstances. This is achieved through the council planning process and is then further detailed in the annual budget. The Act requires councils to consult with their communities as part of both the planning and budget processes which provides the opportunity to make submissions on the content and the level of rates and fees and charges to be raised;
- c) Democratically elected councillors are responsible for making financial decisions about the level of revenue, including fees and charges, required to meet their communities' need for services; and



**RESPONSE provided by the Secretary, Department of Planning and Community
Development – continued**

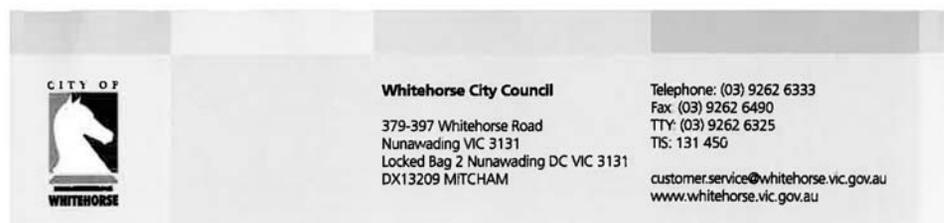
- d) In considering this recommendation it is important that this audit and any subsequent guidance materials do not restrict or mandate council's pricing practices, consultative processes or ability to reflect community needs, economic circumstances and service requirements.

Thank you for the opportunity to comment on the report.

Yours sincerely


Yehudi Blacher
SECRETARY

RESPONSE provided by the Chief Executive Officer, Whitehorse City Council



6 April 2010

Mr Des Pearson Auditor General
Victorian Auditor General's Office
L 24, 35 Collins Street
MELBOURNE VIC 3000

Dear Mr Pearson,

Re: VAGO Performance Audit: Fees and charges-cost recovery by local government

The following comments are Council's response to the VAGO *Performance Audit: Fees and charges-cost recovery by local government*.

General comments

Whitehorse City Council is committed to maintaining the community's confidence in Local Governments ability to manage their costs. Whitehorse Council maintains a transparent and robust performance monitoring regime, for all costs, including the setting of annual budgets and monthly financial monitoring. Regular review of resource requirements using a monthly forecast review process and reporting to the community is critical to the accountability to our residents.

Whitehorse City Council believes in maintaining a balance between the reports absolute emphasis on full cost recovery and best value principles of accessibility and affordability of services to our community.

The report only briefly mentions 'statutory fees', we acknowledge that they were beyond the intended scope of the audit. Whitehorse believes that it should be highlighted that the statutory fees are not adjusted to reflect even the direct cost of service provision with no avenue to recover the shortfall. This also applies to the Home and Community Care program where guidelines provide a range limit for charges that can be levied for the services provided. It is noted that this category of service represented a significant component of the services examined in the audit undertaken by the Victorian Auditor General's Office. Clearly the inclusion of indirect costs will highlight the full extent of the subsidy provided, but have no bearing on price charged.

Cost Management

Council generally agrees with the observations and recommendations made in this section. Whitehorse Council will evaluate the merits of a full service costing model, however, it is likely that the 'pro rata approach' will be most appropriate method as provided by the MAV *Overheads Model*.

The conclusion on page viii makes an assertion that the councils "are not effectively managing the full costs of the services provided", when in fact the direct costs of programs, and all other costs, are reviewed and reported on a monthly, quarterly and six monthly basis to management and Council. This is in addition to the annual reporting process and mandatory external audit of financial statements. We are concerned that this statement may be misinterpreted having an unintended impact on the reputation of the Local Government Sector.

**RESPONSE provided by the Chief Executive Officer, Whitehorse City Council –
continued**

Pricing Community Services

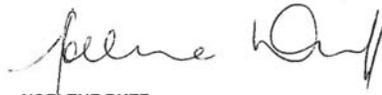
Council generally agrees with the observations and recommendations made in this section. We acknowledge the need to establish a formal pricing policy. Determination of service full cost will provide an additional piece of information for consideration in setting service prices, with the final price being a balance of financial, regulatory, and community wellbeing considerations.

Council has an ongoing program of Best Value service reviews as outlined in its Annual Report. The reviews are conducted in the context of the Local Government Act which requires Council to take these cost, quality and efficiency principles into account when reviewing its services under best value:

- The need for services to deliver against agreed quality and cost standards
- Accessibility of services to those who need them
- Services being responsive to changing community needs
- Continuous improvement in the delivery of services
- Community consultation on services and activities
- Regular annual reporting to the community on Council's performance

Council has completed its five year program of service reviews and is committed to its ongoing strategic Best Value service review.

Yours sincerely



**NOELENE DUFF
CHIEF EXECUTIVE OFFICER**

RESPONSE provided by the Acting Chief Executive Officer, Frankston City Council



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7 April 2010

Dr Peter Frost
Acting Auditor-General
Victorian Auditor-General's Office
Level 24, 35 Collins Street
MELBOURNE VIC 3000

Ref: A799817

Dear Dr Frost

Proposed Audit Report – Performance Audit of Fees and charges – cost recovery by local government

I refer to the proposed report on Fees and Charges cost recovery by local government. Thank you for the invitation to provide formal comments for inclusion in the report.

I accept the six recommendations in the report are an opportunity for our Council to review and improve our fee and charge setting process, and improve the information we collect and make available to Senior Management and Council about the cost recovery of the services we provided.

Our response to each recommendation is stated below:

Recommendation one

Our Council will develop central policies on service costing and provide additional guidance to staff on the application and use of these policies. These policies will cover the principles of cost recovery and the methodology for costing council services.

Recommendations two and three

Council will investigate a cost allocation model that will enable us to allocate indirect costs and identify the full costs of the services we provide. The complexity of this allocation model will be determined following a cost benefit review of the model options.

RESPONSE provided by the Acting Chief Executive Officer, Frankston City Council – continued

Once this cost allocation model has been implemented, we commit to reporting to Senior Management and Council about the full cost of their services and the fees and charges income collected. This information will be used to support annual adjustments to the fees and charges and to monitor whether council resources are being managed adequately and services are being provided at an appropriate cost and quality.

Recommendation four

Council will develop central policies on fee setting and provide additional guidance to staff on the application and use of these policies. These policies will cover the principles of fee setting, appropriate fee setting methods, procedures for ensuring compliance with competitive neutrality requirements and procedures for monitoring services costs and fees and charges.

Recommendation five

Council will endeavor to make decisions about fee setting practices that are evidence based and under consideration of the full costs of service provision, Best Value principles and Competitive Neutrality Policy requirements.

Recommendation six

I look forward to Local Government Victoria's development of guidance materials on the setting of fees and charges and will review these in line with our changes when it becomes available.

Thank you for the opportunity to respond to your report.

Yours sincerely



Mick Cummins
Acting Chief Executive Officer

RESPONSE provided by the Chief Executive Officer, City of Ballarat

City of Ballarat Town Hall
PO Box 655 Ballarat Telephone: 03 53 205 500
Victoria Australia 3353 Facsimile: 03 53 334 189



Date: 7 April, 2010

Our Ref: GKLS

Your Ref:

Dr Peter Frost
Acting Auditor General
Victorian Auditor-General's Office
Level 24, 35 Collins Street
MELBOURNE VIC 3001

Dear Dr Frost,

Re: Proposed Audit Report – Fees and Charges

The audit is welcomed by the City of Ballarat and the findings are currently being reviewed with the aim to improve the performance of the City of Ballarat's operations. Council views any audit as an opportunity to continuously improve Council's Governance and operational delivery.

The City of Ballarat acknowledges the lack of written policies which is now being addressed, in part, through the current budget process. Like most Council's, decisions on various fees and charges were made in the past and documentation has not been updated over time. This audit has highlighted the need for the City of Ballarat to update this documentation. During the Council's budget process, all issues such as fee setting has been centralised, this centralised process provides direction to management on issues relating to fee setting competitive neutrality etc. This audit has again highlighted the need for this process to be documented.

The City of Ballarat has two different costing models. The first is used for the daily management of the budget, the second for determining the appropriate cost of a service, depending on the rules governing the costs allowed to be included. It is believed that one costing system to meet all requirements of Council is not appropriate or viable.

In relation to Competitive Neutrality Policy the City of Ballarat is of the opinion that all relevant processes for those significant businesses are in place that satisfies the relevant guidelines. Following this audit, these processes will be reviewed, documented, and modified where necessary.

It is believed that all appropriate factors have been taken into consideration when adopting fees and charges, it is appropriate that the numerous fees and charges of Council be reviewed in detail and documented to ensure that the evidence of all decisions are up to date.

Yours faithfully,

Anthony Schinck
Chief Executive Officer



Printed on Australian made environmentally sustainable paper using soy based inks.

RESPONSE provided by the Chief Executive Officer, Campaspe Shire Council

KS:MO

30 March 2010

Dr Peter Frost
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Dear Dr Frost

**Re: Audit Act 1994, s16(3) – Proposed Audit Report
Fees and Charges – Cost Recovery by Local Government**

Council was pleased to be nominated to participate in the December 2009 Fees and Charges audit and notes its recommendations.

During long term planning associated with preparing the 2009/10 budget, Council identified medium to long term financial sustainability concerns. Given this, Council initiated, and advised the community of, a comprehensive Financial Sustainability Review. Included in this is a full consideration of Council's fees and charges. The review's required outcomes are:

- (a) A full understanding of services delivered, the costs associated, revenue achieved and Council subsidy required;
- (b) An associated understanding of why the service is delivered, key customers and the service level required to deliver. This will be developed in conjunction with the community using an appropriate engagement model.

The information gathered through the above process will be crucial in order to determine Council's fee setting methodology for each service.

Council's response to each recommendation is outlined in turn.



**RESPONSE provided by the Chief Executive Officer, Campaspe Shire Council –
continued**

-2-

Recommendation 1

Councils should develop and endorse central policies on service costing that provide guidance to staff on:

- Principles of cost recovery and their relationship to service delivery objectives
- The methodology for costing council services and the associated rationale.

Council acknowledges the importance of establishing an overall framework to provide guidance to staff. Campaspe service managers have been utilising various fee setting methods, providing benchmarked prices and analysing the market's capability to pay. Notwithstanding this, Council acknowledges that this occurs in the absence of an overall policy framework and this needs to be addressed.

Recommendation 2

Councils should review and, where necessary, enhance their current cost allocation practices by:

- Developing a costing model and related processes to allocate indirect costs
- Recognising and reporting the full cost of their services.

Council notes this recommendation. Campaspe operates a detailed cost allocation model and will continue to refine and enhance this to ensure that all costs are appropriately allocated.

Recommendation 3

Councils should strengthen oversight of service costs by:

- Setting cost standards based on efficient costs
- Regularly reporting to senior management and council on the efficiency and full cost of their services and relate this to fees and charges collected.

Council supports this recommendation and notes that the Financial Sustainability Review will assist in developing appropriate cost standards for each service delivered by Council.

Council and Senior Management are provided with detailed financial reports on a monthly and quarterly basis. These reports include business commentaries that discuss financial trends, issues and performance to date. However it is acknowledged that this reporting is at a cost centre level, not at a service level. Reporting on a service basis is supported and appropriate models will be implemented in upcoming months. It is also noted that the Model Budget published by the Institute of Chartered Accountants includes a net cost for each service and it is Council's intention to migrate to this approach.

**RESPONSE provided by Chief Executive Officer, Campaspe Shire Council –
continued**

-3-

Recommendation 4

Councils should develop and endorse central policies on fee setting that provide guidance to staff on:

- Principles for fee setting and their relationship to service delivery objectives
- Appropriate fee setting methods, including factors to be considered in determining the required level of cost recovery
- Procedures for assuring compliance with competitive neutrality requirements
- Procedures for monitoring service costs and fees and charges.

Council supports this recommendation and notes that fee setting methodology is linked strongly to the reasons why a service is delivered. Once this has been formally determined (as per the Financial Sustainability Review) fee setting methodologies can be determined and endorsed by Council.

Recommendation 5

Councils should strengthen fee setting practices to assure that decisions are evidence-based and demonstrate consideration of:

- Both the direct and indirect cost of goods and services to establish the full cost
- Best Value principles including accessibility, affordability and the efficient cost of services
- Competitive Neutrality Policy requirements.

Council supports this recommendation. Council operates an indirect cost allocation model and thus has the opportunity to understand the full costs of each service. These will be considered when establishing an appropriate fee setting methodology as per the Financial Sustainability Review. In addition the Financial Sustainability Review will be delivered in accordance with Best Value and Competitive Neutrality principles. Once this project has been completed, policy will be refined to ensure that Council's obligations continue to be met.

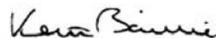
Recommendation 6

Local Government Victoria (LGV), in consultation with stakeholders, should develop guidance for councils on setting fees and charges.

Council strongly supports this recommendation. Formal advice assists Council in considering relevant issues and outlining to the community the rationale for policy positions.

Thank you for the opportunity to comment on this draft report.

Yours faithfully



**KEITH BAILLIE
CHIEF EXECUTIVE OFFICER**

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Reports tabled during 2009–10

Report title	Date tabled
Local Government: Results of the 2008–09 Audits (2009–10:1)	November 2009
Public Hospitals: Results of the 2008–09 Audits (2009–10:2)	November 2009
Towards a 'smart grid'— <i>the roll-out of Advanced Metering Infrastructure</i> (2009–10:3)	November 2009
Responding to Mental Health Crises in the Community (2009–10:4)	November 2009
Management of the Community Support Fund (2009–10:5)	November 2009
Auditor-General's Report on the Annual Financial Report of the State of Victoria, 2008–2009 (2009–10:6)	November 2009
Water Entities: Results of the 2008–09 Audits (2009–10:7)	November 2009
Maintaining the Integrity and Confidentiality of Personal Information (2009–10:8)	November 2009
Vehicle Fleet Management (2009–10:9)	November 2009
Managing Offenders on Community Corrections Orders (2009–10:10)	November 2009
Portfolio Departments and Associated Entities: Results of the 2008–09 Audits (2009–10:11)	December 2009
Making Public Transport More Accessible for People Who Face Mobility Challenges (2009–10:12)	December 2009
Use of Development Contributions by Local Government (2009–10:13)	December 2009
The Effectiveness of Student Wellbeing Programs and Services (2009–10:14)	February 2010
Tendering and Contracting in Local Government (2009–10:15)	February 2010
Management of Concessions by the Department of Human Services (2009–10:16)	February 2010
Irrigation Water Stores: Lake Mokoan and Tarago Reservoir (2009–10:17)	March 2010
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