



National Competition Council

**Competitive Neutrality: Scope for
Enhancement**

Staff Discussion Paper

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the National Competition Council

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The National Competition Council

The National Competition Council was established on 6 November 1995 by the *Competition Policy Reform Act 1995* following agreement by the Commonwealth, State and Territory governments.

It is a federal statutory authority which functions as an independent advisory body for all governments on the implementation of the National Competition Policy reforms. The Council's aim is to 'help raise the living standards of the Australian community by ensuring that conditions for competition prevail throughout the economy which promote growth, innovation and productivity'.

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Executive overview

Competitive neutrality seeks to remove, or adjust for, any advantages that government businesses enjoy as a result of their public sector ownership. It contributes to improved resource allocation and economic outcomes because it encourages resources to be used where they provide most value.

Clause 3 of the Competition Principles Agreement (CPA), signed by all Australian governments in 1995, encourages governments (where appropriate) to pursue competitive neutrality by:

- corporatising significant government business enterprises (embracing the imposition of full taxes or tax equivalents, debt guarantee fees and regulations similar to those facing the private sector); and
- implementing the same principles for government business activities that are part of a broader agency function, or imposing full taxes, debt guarantee fees, equivalent regulations and full cost attribution in pricing.

Clause 3 provides governments with discretion in determining the nature of their competitive neutrality policies, especially with the range of government business activities that must adopt competitive neutrality, the approach (or model) to achieving competitive neutrality, the mechanism for handling complaints and the application of competitive neutrality in local government. This paper reviews different government policies in these areas and suggests possible best practice approaches. It seeks to assist governments to judge whether further development of their competitive neutrality policies would be beneficial.

This paper also discusses matters outside the scope of the CPA that are pertinent to the effective delivery of competitive neutrality. These include: community service obligations, competitive tendering and contracting, government entities not subject to executive control, and resource allocation among private entities. The Council of Australian Governments (CoAG) referred to community service obligations and government entities not subject to executive control in the communiqué that was issued following its meeting on 3 November 2000. CoAG gave guidance to the National Competition Council on accounting for these factors in assessing compliance with competitive neutrality requirements.

Scope of competitive neutrality

The suggested best practice model for determining the scope of competitive neutrality involves all government activities that charge users and trade in goods or services being identified as *businesses*. The identification of

significant government business activities should refer to the following conditions:

- that all government business enterprises be treated as significant businesses.
- that significance of other business activities depends on their impact on the relevant market(s); and
- that activities' status of significance or nonsignificance be regularly reviewed.

The suggested best practice model for achieving competitive neutrality would have the following features.

- All stand-alone government business enterprises should be corporatised.
- Other major government business activities should be commercialised.
- The corporatisation and commercialisation models should incorporate removal of advantages arising from government ownership and include requirements for full cost attribution and commercial rates of return over the medium term.
- Other (smaller) government businesses should be subject to full cost attribution in their pricing and the imposition of taxes or tax equivalents, debt guarantee fees and equivalent regulations.
- Exempting government businesses from applying competitive neutrality should be avoided. Any exemptions would require individual businesses to convince the government that the costs would exceed the benefits.

Costing and pricing

Prices set by corporatised entities usually are competitively neutral. The prices set by commercialised entities, some of which draw on the resources of parent government agencies, should incorporate accounting adjustments made to achieve full cost attribution for taxes or tax equivalents, debt guarantee fees, rate or return targets and other competitive neutrality factors. The avoidable cost method of setting prices would help to ensure competitively neutral pricing outcomes for commercialised entities. For other significant business activities, this pricing method is also preferable and again adjustments should be made for all advantages and disadvantages of public ownership.

Complaints mechanism

A possible best practice approach to hearing allegations of noncompliance would have the following features:

- the hearing of complaints by an entity separate from the government businesses that could invoke complaints;
- a requirement that complainants, in the first instance, approach the government business about which they are complaining, but then have the capacity to approach the jurisdiction's complaints body if they cannot gain satisfaction from the business;
- the potential for all government businesses to be the subject of complaint; and
- transparency.

Some people may be prepared to make a competitive neutrality complaint only if they remain anonymous. This would imply that they would not wish to approach the government business about which they are complaining, which commonly is a first step in raising a complaint. Governments could consider allowing such complainants the option of approaching their complaints bodies in the first instance.

Governments could consider the scope for making their complaints handling processes more similar, given that many businesses operate in more than one jurisdiction.

Competitive neutrality in local government

Features of best practice similar to those described above should apply to the business activities of local government.

Community service obligations

Community service obligations (CSOs) should be identified and funded by the Government, transparently reported by the government businesses delivering the obligations and in the Government's budget papers, costed by the avoidable cost method, and subject to monitoring and review. While CoAG decided in November 2000 that there is no National Competition Policy (NCP) requirement to undertake a competitive process for the delivery of CSOs, governments find that such an approach sometimes reduces the costs of delivering CSOs and encourages innovative delivery methods.

Competitive tendering and contracting

Competitive tendering and contracting is not required under the CPA. Where it is used, however, it complements the delivery of competitively neutral outcomes; in turn, competitive neutrality policies contribute to competitive tendering and contracting processes. Private companies competing with publicly owned businesses for government tenders have more confidence in the tender process if their publicly owned competitors are corporatised or subject to competitive neutrality obligations.

Government business activities not subject to executive control

Significant entities such as universities have a substantial degree of management independence from governments in most jurisdictions. CoAG suggests a 'best endeavours' approach to encouraging competitive neutrality in such entities. This involves, at a minimum, the provision of government competitive neutrality policies to these entities. In addition, governments could make staff available to respond to entities' queries, prepare information packages specific to the activities of the entities, meet with the entities regularly, request regular reports from the entities, and undertake joint reviews with the entities of their competitive neutrality policies.

Resource allocation among private entities

Competitive neutrality as defined by the CPA is concerned with adjustments for the advantages that government businesses may enjoy as a result of their public ownership in comparison with private competitors.

Government decisions sometimes have differential impacts on private participants in the same industry, similar to the differential public/private sector impacts that competitive neutrality seeks to address. Such decisions can give rise to resource allocation concerns. Governments are entitled to support particular firms from time to time, but should be mindful of ramifications in terms of even-handedness or 'rewarding' poor performers. Transparency and public interest tests should underpin any such decisions.

1. Introduction

Competitive neutrality (CN) is a key aspect of the Competition Principles Agreement (CPA) which all jurisdictions signed in April 1995. As stated in clause 3 of the CPA:

The objective of competitive neutrality policy is the elimination of resource allocation distortions arising out of the public ownership of entities engaged in significant business activities: Government businesses should not enjoy any net competitive advantage simply as a result of their public sector ownership. (NCC 1998, p. 17)

Competitive neutrality is a concept that several governments had accepted and partly implemented before the CPA was signed. It involves the exposure of government businesses to the disciplines of the market, so private and public enterprises that compete with each other (actually or potentially) do so on the same footing in terms of government obligations such as taxes and regulations, and price their goods and services at levels that fully cover costs. Government business entities should not be able to enjoy advantages from their public ownership.

All Australian governments have made substantial strides in defining their CN policies (which the CPA required them to do by June 1996) and in implementing and, in some cases, refining these policies.

Because the CPA gives each government the freedom to define and establish its own CN arrangements (within the requirements of the CPA clause 3), differences in approach and emphasis have arisen across jurisdictions. These differences are expected, given the freedom allowed by clause 3, and offer some advantages. They provide input into a possible enhancement of CN policies. Comparison of CN practices may assist jurisdictions in identifying best practice, which may suggest refinements to their CN policies and practices. The differences also lead to some costs, however. Private enterprises are often represented across more than one Australian jurisdiction, and a more consistent approach (based on best practice policies) may reduce confusion and contribute to improved resource allocation. A more consistent approach also may provide scope for economies in the administration of CN.

This paper has the objective of assisting governments to judge whether further development of their CN policies would be beneficial. The paper is intended also to encourage consistency of CN approaches and outcomes across jurisdictions, and to contribute to community awareness of governments' CN obligations under the NCP.

At its meeting in November 2000, the Council of Australian Governments (CoAG) agreed that the National Competition Council's (the Council's) assessment of governments' compliance with the CPA's CN requirements

should involve a ‘best endeavours’ approach to assessing those circumstances in which a government business is not subject to the executive control of a party (government). This ‘would require parties, at a minimum, to provide a transparent statement of CN obligations to the entity in question’. The CoAG communiqué also referred to costing methods that may satisfy the full cost attribution approach to pricing specified in the CPA, as an option for significant business activities (other than government business enterprises) to achieve CN. In addition, the communiqué commented on the delivery of community service obligations (CSOs). This paper explores some implications of the CoAG decisions for the application of CN.

In preparing this paper, the author has taken into account the comments and views provided by jurisdictions in response to an issues paper which the Council provided to each government’s Competition Policy Unit (CPU) in December 2001.

2. Benefits of competitive neutrality

Governments’ delivery of competitively neutral practices in recent years has made an important contribution to improved economic outcomes. CN generates the following benefits.

- By eliminating (or at least minimising) the various artificial advantages (arising from government ownership) that government entities may enjoy in competition with private sector companies, CN enhances the allocation of community resources. CN allows resources to flow to those producers who are most efficient. This allocation maximises the community economic welfare from a given level of resources.
- Placing government business entities on a similar competitive footing to that of their actual or potential private competitors also addresses concerns about even-handed treatment of government and private enterprises.
- CN encourages improved performance by government businesses. Increased transparency and accountability by government businesses facilitate improvement in their performance. Businesses cannot hide behind the protection given by advantages that they previously enjoyed. Such advantages often contributed to government businesses becoming complacent about their efficiency. Improved performance means better services and lower prices for users of the services of the business (and reduced demands on taxpayers). CN supports the effectiveness of performance monitoring regimes, which Australian governments have introduced for many of their businesses in recent years.
- By improving the incentives for government businesses to operate efficiently, CN can improve the bottom lines of those businesses and lead to a flow (or an improved flow) of distributions to the government in the form of tax equivalents, dividends and debt guarantee fees. Thus, CN can play a useful part in improving the fiscal outcomes of owner governments.

- CN's requirement for government entities to face comparable costs and regulations to the private sector (that is, to face market incentives) means that the owner governments make better informed decisions about the future of those entities. Full attribution of costs often leads governments to assess afresh whether they wish to provide a good or service directly through a subsidiary entity, to introduce tenders to allow competitive bidding for the provision of the good or service, or to vacate the area of production.
- CN can establish the basis for governments to address systematically issues surrounding the provision of CSOs. The attribution of full costs in goods or services provision by a government entity tends to increase the pressure on the government owner to identify transparently the CSO, which the entity traditionally may have supplied (for example, discount transport fares for pensioners). The discrete and transparent identification of the CSO is usually followed by a government decision to fund the CSO directly, which removes a competitive disadvantage faced by the government entity. The government can also consider the case for competitive provision of the CSO. In recent years, for example, the public transport system in Melbourne has been provided on a basis akin to a large-scale CSO, whereby the franchise to operate a particular public transport service has been awarded to the company that bids for the lowest subsidy from the State Government. Such competitive provision can significantly reduce the cost of delivery of the CSO.

The benefits of CN are exemplified by the numerous instances of increased participation in markets previously dominated by government business activities that enjoyed advantages arising from their public ownership. This increased participation has arisen sometimes from the CN complaints processes indicating sources of unfair advantage, and often from the general introduction of CN policies. Governments have benefited from the more appropriate allocation of resources to their business activities and from the role of CN in complementing their monitoring of the efficiency of government business activities.

As stated by the Queensland Government (1996b), CN 'will make the true costs and level of performance of Government businesses transparent and will facilitate better decisions regarding their operation by both managers and Government owners alike'. In its 2001 annual report to the Council on National Competition Policy (NCP) implementation, the Western Australian Treasury commented that 'the application of competitive neutrality to all significant government businesses is an integral part of the State's ongoing reform of government-owned businesses, to increase efficiency and generate benefits to the community'.

3. Scope of competitive neutrality

The scope of activities to which governments apply CN has been driven largely by the interpretation of the phrases ‘significant business activities’ and ‘where appropriate’ in clause 3 of the CPA. It also reflects this clause’s reference to CN implementation being required only to the extent that benefits outweigh the costs. Clause 3 forms the basis of the CN policies and practices adopted by each government. Its essential elements are as follows.

- For those significant government business enterprises (GBEs) that are classified by the Australian Bureau of Statistics (ABS) as public trading enterprises (PTEs) and public financial enterprises (PFEs), jurisdictions are required to adopt (‘where appropriate’) a corporatisation model and impose Commonwealth, State and local government taxes or tax equivalents, debt guarantee fees and those regulations to which the private sector is normally subject.
- Where a government agency undertakes ‘significant’ business activities, the government is required to implement (‘where appropriate’) the principles applicable to PTEs and PFEs, or ensure the prices charged for goods and services account for (‘where appropriate’) taxes or tax equivalents, debt guarantee fees and private sector equivalent regulations, and reflect full cost attribution for these activities.
- Each government is free to determine its own agenda for the implementation of CN principles.
- The principles for PTEs, PFEs and other significant business activities need only be implemented (in each case) to the extent that the benefits outweigh the costs.
- The Commonwealth Government and each State and Territory Government were required to publish a CN policy statement by June 1996 (including a complaints mechanism), along with annual reports on the implementation of the CN principles.

In November 2000, CoAG reviewed implementation of CN to clarify some practical implementation issues. As indicated in section 1, CoAG agreed that governments could have regard to the following factors in applying clause 3.

- Where a government business (for example, a university) is not subject to the executive control of a government, it may adopt a ‘best endeavours’ approach.
- A range of costing methods, including fully distributed cost, marginal cost and avoidable cost, satisfy the term ‘full cost attribution’ in clause 3.
- Governments are not required to undertake a competitive process for the delivery of CSOs, and they are free to determine who should receive a CSO

payment or subsidy, which should be transparent, appropriately costed and directly funded by government.

The principles in CPA clause 3 have proven resilient and have contributed greatly to the adoption of productive CN policies by all levels of government in Australia. The use of the phrases ‘where appropriate’ and ‘significant’ have contributed to that resilience, because they recognise the different circumstances in different jurisdictions such as size of the economy, population density, urban and remote locations, and the diversity of enterprises. Inevitably, governments (including local governments) have interpreted these phrases in different ways. There is scope for assessing whether there is a best practice approach applicable by most, if not all, governments.

3.1 Definitions of significant business activities

Jurisdictions have carefully considered the definition of significant business activities. The following snapshots summarise each government’s definition of ‘businesses’ and ‘significant’.

Commonwealth

Government business activities:

- must be user charging;
- must be an actual or potential competitor; and
- must allow managers a degree of independence in production or supply, and price decisions.

Significant business activities include:

- all GBEs and their subsidiaries;
- other share-limited trading companies;
- all designated business units; and
- other activities that are businesses and that have commercial receipts exceeding \$10 million per year.

New South Wales

Government business activities:

- must have some form of government ownership;
- must be engaged in trading in goods and/or services; and
- must have a large measure of self-sufficiency.

Significant business activities include:

- State-owned corporations; and
- other businesses that are monitored by the NSW Treasury on a quarterly or half-yearly basis.

Victoria

Government business activities:

- result in the sale of a good or provision of a service, either directly to a purchaser or through an arms length contract with another party or parties; and
- are set up such that users make a significant contribution to costs.

Significant business activities are determined, on a case basis, by:

- the importance of competition in their relevant market;
 - their ‘relevant market’ can normally be identified on the basis of competing goods or services and possibly in terms of the geographic area in which sellers and consumers operate;
 - their importance in the market is assessed by referring to the size of the business activity in the relevant market, their competitive impact in that market, the resources they command and the effect of poor performance; and
- the costs of providing the goods and services (that is, the extent of user charging).

Queensland

Government business activities:

- fall within the ABS definition of a PFE or PTE; and/or
- trade goods or services as their predominant activity, meet a substantial part of revenue from user charges and are predominantly commercially focused.

Significant business activities are determined by:

- the scale of operation, as indicated by annual expenditure. Queensland refers to a threshold of \$10 million, but the threshold does not necessarily have to be met;
- the significance of their market share; and
- the impact of poor performance on the Queensland economy.

Western Australia

Government business activities:

- produce goods and services for the market;
- charge users for goods and services; and
- are required to recover all costs or a significant proportion of the costs from the supply of the good or service.

Significant business activities are determined by:

- the extent of competition (or potential competition) between the public and private sectors in the market;
- the significance of their market to the Western Australian economy; and

- whether their annual revenue base or turnover is more than \$10 million, or their asset base exceeds \$10 million.

South Australia

Government business activities:

- fall within the ABS's definition of PTEs and PFEs; **or**
- produce goods and services for sale in the market.
- have a commercial or profit making focus; and
- charge users for the goods and services.

An activity is not a business activity if it provides goods or services to government and, for reasons of policy or law, has no competition from alternative suppliers. Other exclusions are when the government intends the activity's predominant role to be regulatory or policy-making, or when public policy outcomes are the main priority.

Significant business activities:

- are determined by their size and influence in the relevant market; and
- are divided into two categories — Category 1 and Category 2 — which have been identified and gazetted. Category 1 businesses earn revenue greater than \$2 million or have assets greater than \$20 million. Category 2 businesses are all other significant businesses. In general, a business activity is 'significant' when it has sufficient market power to create a competitive market impact (other than a trivial impact), and the size of the business activity relative to the market is more than trivial.

Tasmania

Government business activities:

- include PTEs, PFEs and GBEs. Tasmania's definition allows for some PTEs or PFEs to be described as GBEs, and some others not to be described in this way; and
- can be any activity for the supply of goods and services to a market which is actually or potentially contested.

Significant business activities are determined, on a case basis, by:

- whether GBEs, PTEs and PFEs are government businesses to which the corporatisation model applies; and
- their impact of the activity on the relevant market.

Australian Capital Territory

Government business activities:

- are government organisational units that produce goods and services that could be sold or tendered in the marketplace;
- extend to the provision of goods and services to other parts of the public sector;

- include specialist activities located within Government departments, separate legal entities such as statutory authorities and Territory-owned corporations; and
- may include CSOs that private organisations could provide under contract.

Significant business activities are determined by:

- whether they are a separate legal entity;
- whether their predominant activity is trading goods and services, or they can earn a significant part of operating revenue from user charges.
- a predominantly commercial or profit making focus;
- an actual or potential significant impact on the relevant market; and
- their impact on the Territory economy if they perform poorly.

Northern Territory

Government business activities:

- recover a proportion of costs through user charges; and
- supply goods and services to external clients or to the Northern Territory Government.

Significant business activities include:

- GBEs (except the Territory Insurance Office¹); and
- significant business activities that have been designated as Government Business Divisions (GBDs) under the Financial Management Act. GBDs are defined as an activity or group of activities that recover a significant proportion of their operating costs through user charges and that are so classified by the Treasurer.

3.2 Determining whether a business is 'significant'

The benefits of CN suggest that its application should be as wide as possible. Interpreting the word 'significant' in 'significant business activities' contributes to the range of government business activities subject to CN.

Comparison of the approaches described above indicates that most governments require a government activity to charge users and trade in goods or services to be considered a *business* activity. Some governments take into account other factors, such as managers' independence, self-sufficiency and the delivery of CSOs. If managers are given a degree of independence, that indicates that they are probably conducting a business. Self-sufficiency and the presence of CSOs are not particularly relevant to the actual or potential

¹ The Territory Insurance Office is a corporatised public financial enterprise and is subject to CN policy.

competition of government activities in markets, however, and should not determine whether a government activity is subject to CN principles.

Regarding the definitions of *significant* business activities (SBAs), most governments believe that their GBEs² should be considered as significant. The definition of GBEs differs among governments, but at a minimum embraces those entities that the ABS classifies as PTEs or PFEs.

Some governments refer to the size of the entity in terms of receipts or assets, and compare these with a threshold. Use of a threshold size can have some drawbacks: the threshold is largely arbitrary, and the size of an entity can change quite significantly (such as where a business activity that is not considered significant grows because its competitive advantages resulting from government ownership are not addressed). Several governments refer to the size of the business relative to the market and its competitive impact. These factors can change quite quickly and the competitive impact is not always easy to assess. Despite these limitations, the size of the entity relative to the market is a reasonable indicator of significance and its potential impact on competitors. If threshold and relative size criteria are used, then the classification of business activities into significant and non-significant activities should be regularly reviewed.

Some governments also assess the effects of possible poor performance by an entity. The performance of government entities is the main reason that governments have government business monitoring arrangements in place. By such monitoring, governments are recognising that poor performance by any government business constitutes a waste of community resources. The impact of possible poor performance does not appear to be a useful arbiter of an activity's significance and thus of whether CN should apply. CN arrangements can contribute, however, to improvements in entity efficiency and thus can complement performance monitoring arrangements.

Several governments leave scope for assessing the significance of business activities on a case basis. This approach has merit because the circumstances of an activity — in terms of its absolute and relative size; the taxes, interest rates and regulations it faces; and its actual or potential impact on the market — can all change. Some governments allow CN complaints to be heard against all government businesses. Complaints can point to significance.

In summary, best practice for establishing the significance of government business activities would appear to involve the use of three features. This enables the determination to be simple, with minimal requirement for making interpretations, and enhances flexibility. The suggested features of the process for determining significance are that:

² Some Governments give their large stand-alone enterprises different descriptors than GBEs — for example, 'State-owned corporations' (SOCs) in New South Wales and 'Government-owned corporations' (GOCs) in Queensland.

- all GBEs (including entities that the ABS classifies as PTEs or PFEs) be considered to be significant business activities;
- for assessing other government business activities for significance, the impact of the activity on the market be important; and
- the status of significance or non-significance be regularly reviewed. Government business activities that are expanding their share of the market usually should be considered as active competitors and classified as significant. Declining share does not suggest non-significance. This process should be supported by a robust and well-publicised complaints mechanism that allows people to suggest that government activities that are not considered significant should be so classified.

3.3 Implementing competitive neutrality 'where appropriate'

CPA clause 3 states that governments will adopt a corporatisation model for PTEs and PFEs 'where appropriate'. Corporatised government businesses are usually stand-alone entities; that is, the entities are essentially defined by their business activities, and the business activities provide all of the revenue of the entities. Corporatised entities are found typically in the areas of electricity generation, transmission and distribution, gas distribution, ports, water and sewerage services, public transport, non-urban rail, forests, defence enterprises and postal services. Provided corporatised entities are required to pay taxes or tax equivalents, dividends and debt guarantee fees, face the same regulations that face private sector entities (this is usually the case), and earn a commercial rate of return, their pricing can usually be assumed to be commercially based.³ There should be no requirement for the separate definition and application of a full cost attribution model. The operation of the corporatised entity in the commercial environment, on a stand-alone basis, necessitates its coverage of all costs in its pricing.

Regarding other significant business activities — that is, those which are not PTEs and PFEs — clause 3 requires that:

- governments adopt a corporatisation model and impose taxes and tax equivalents, debt guarantee fees and regulations comparable to those applying to the private sector 'where appropriate'; or
- ensure that the prices charged for goods and services take account 'where appropriate' of taxes or tax equivalents, debt guarantee fees and regulations and reflect full cost attribution for these activities.

³ If the corporatised business is required to provide a CSO, then government should fund the CSO separately (see section 5). Provided this is the case, the business's pricing of its other (commercial) activities remains commercially based.

The phrase ‘where appropriate’ gives governments considerable room for interpretation. Governments’ decisions on the application of corporatisation, taxes, debt fees and full cost pricing (all important features of CN) help define quite fundamentally the scope of CN in each jurisdiction.

The other aspect of clause 3 that has a fundamental impact on the scope of CN is subclause 3(6) which requires governments to implement CN principles to the extent that the benefits outweigh the costs. Several governments appear to use this subclause to determine the range of activities to which CN is applied — in other words, to help them interpret the words ‘where appropriate’. Subclause 1(3) of the CPA states that where the CPA calls for the benefits and costs of a policy to be considered (as in subclause 3[6]), the following matters shall be taken into account ‘where relevant’:

- government legislation and policies relating to ecologically sustainable development;
- social welfare and equity considerations, including CSOs;
- government legislation and policies relating to occupational health and safety, industrial relations, and access and equity;
- economic and regional development, including employment and investment growth;
- the interests of consumers generally or a class of consumers;
- the competitiveness of Australian business; and
- the efficient allocation of resources.⁴

At the CoAG meeting of November 2000, governments agreed that they should document decisions where they apply these subclause 1(3) matters.

The CN policies that different jurisdictions have adopted with regard to these aspects of clause 3 largely reveal governments’ interpretations of ‘where appropriate’. The following snapshots summarise these policies.

Commonwealth

GBEs and other significant business activities are to implement CN. Non-significant businesses may apply CN on a voluntary basis or be required to do so as a result of complaint being upheld by the Commonwealth Competitive Neutrality Complaints Office (CCNCO). In line with CPA subclause 3(6), the Commonwealth’s CN policy states that CN need be implemented where benefits exceed costs.

CN implementation in the Commonwealth involves:

- the corporatisation of significant GBEs;

⁴ The CPA states that governments are not limited to considering these matters.

- the payment of all relevant Commonwealth and State direct and indirect taxes or tax equivalents;
- the payment of debt neutrality charges or commercial interest rates;
- the attainment of a commercial rate of return on assets (which indicates the Commonwealth's approach to full cost attribution);
- compliance with those regulations to which private sector competitors are normally subject; and
- explicit direction, via legislation, government decision or direction, to entities to carry out CSOs on a non-commercial basis. The purchasing portfolio's budget should directly fund the CSOs.

New South Wales

CN applies to all State Owned Companies (SOCs) and other significant business activities (which are other businesses monitored by NSW Treasury). The State Government assumes that the economic and social benefits of CN exceed the costs, leaving the onus on a government business to demonstrate that CN costs exceed the benefits if it argues that CN should not be applied in its case.⁵

CN implementation involves:

- a corporatisation model which is based on the SOC approach, guided by the principles set in 1988 by the Steering Committee on GTEs: clear and non-conflicting objectives for each GTE to achieve; managerial autonomy and responsibility for the board of the GTE; performance evaluation by the government and accountability; rewards and sanctions; and the establishment of competition and CN. Corporations Law applies to company SOCs. (Similar features characterise the corporatisation models that some other jurisdictions have adopted.);
- SOCs and other significant government businesses are subject to:
 - the application of commercially based targets for rates of return based on estimates of the weighted average costs of capital (WACC) for each business (this indicates the model for full cost attribution used in New South Wales), dividends (reflecting private sector practice) and capital structures;
 - regular performance monitoring;
 - the payment of State taxes and Commonwealth tax equivalents;
 - the payment of risk-related borrowing fees; and
 - explicitly funded CSOs;
- Equivalent regulation; and
- Subjecting in-house bidders in competitive tenders and contracts to CN.

⁵ NSW Treasury comments that it is not aware of any State Government business that has sought to use this mechanism for CN exemption.

Victoria

Significant businesses (to which CN is applied) are determined on a case basis. Victoria's CN policy statement advises government entities on the assessment of costs and benefits, which is a condition for the application of CN. Victoria also recommends that a public interest test be applied if entities believe CN application may compromise other government policy objectives.

Cost–benefit assessment

The assessment of the potential benefits (usually ongoing) of applying CN to entities should include:

- increased market contestability;
- improved performance of government businesses and thus better use of the community's resources; and
- improved capacity for government to assess whether the government businesses are meeting non-commercial objectives.

The costs (usually transitory) to be addressed include:

- legislative and regulatory changes; and
- the analysis required to set appropriate levels for tax equivalents and debt guarantee fees, and administration of the regimes for these financial distributions.

Public interest test

Government agencies should undertake public interest tests if they believe that the application of CN would compromise other government policy objectives. The CN policy document refers to the matters listed in subclause 1(3) of the CPA noted earlier. It also notes that other matters can be considered, including:

- local policies relating to economic development;
- impact on the local community; and
- impact on the State and national economies.

The public interest test should be conducted transparently in consultation with the community.

Possible measures to achieve CN in Victoria are corporatisation, commercialisation and full cost-reflective pricing. Corporatisation or commercialisation may be unsuitable where the scale of the government business activity is small relative to the non-commercial or regulatory functions of the agency. Victoria considers this to be quite likely in the case of local government business activities. The CN policy statement makes it clear that GBEs — which, in Victoria, include PFEs and PTEs as defined by the ABS — are to be corporatised (provided the benefits outweigh the costs). For

those GBEs where it is assessed that corporatisation would not result in a net benefit for the community, Victoria notes that the CPA requires the application of taxes or tax equivalents, debt guarantee fees and equivalent regulations.

The model for corporatisation in Victoria is similar to that in other jurisdictions, involving:

- the creation of a separate legal business entity;
- clear and non-conflicting objectives;
- managerial responsibility, authority and autonomy;
- independent and objective performance monitoring; and
- performance-based rewards and sanctions.

In addition, the requirements of commercialisation (see below) are features of corporatisation. The Victorian approach to commercialisation involves organising an activity along commercial lines without creating a separate legal entity. Commercial practices are applied, including:

- clear delineation of commercial and non-commercial activities, typically through a business plan;
- commercial performance targets and financial reporting requirements;
- separate accounting for, and funding of, non-commercial requirements;
- separation of regulatory functions from commercial activities;
- an appropriate financial return on the assets used in the commercial activity;
- the application of a tax equivalent regime;
- debt guarantee fees; and
- financial arrangements for the allocation of profits from the commercial activity.

Victoria's approach to full cost-reflective pricing accounts for:

- all the costs that can be attributed to the provision of the good or service;
- the cost advantages and disadvantages of public or local government ownership; and
- the aim of government agencies and local governments to recover the full costs of their whole-of-business activity over the medium to long term.

Queensland

Queensland also applies three CN models of reform to SBAs: corporatisation, commercialisation and full cost pricing. The first two models are understood to apply, typically, to larger government businesses, while pricing based on full cost attribution applies to SBAs that are proceeding to corporatisation or full commercialisation while in direct competition with other providers, or that are not suitable for the introduction of a full corporate structure (usually because they are small).

Corporatisation covers:

- separation of the monopoly elements of a Government-owned corporation's commercial activities to facilitate a more competitive industry structure;
- dismantling of barriers to competition;
- divorcing Government-owned corporations of regulatory functions;
- neutralising advantages and disadvantages resulting from government ownership (for example, charging guarantee fees);
- imposing long-term rate-of-return targets on Government-owned corporations and requiring them to make tax equivalent payments and pay dividends. All Government-owned corporations fall under the national tax equivalent regime administered by the Australian Taxation Office;
- transparent funding and reporting of CSOs, and the establishment of service contracts for CSO provision; and
- prices oversight of those Government-owned corporations that retain monopoly power.

Commercialisation is not as extensive a reform process as corporatisation, and may precede corporatisation for some agencies. Commercialisation covers government agencies charging for the goods and services they produce and adopting (to varying degrees) other features of the commercial environment (minor cost recovery, simple user charging, full competition with the private sector).

Queensland's 1996 CN policy statement indicates that a pricing policy would be applied to significant business activities that are either proceeding towards commercialisation or corporatisation, or not suitable candidates for such corporate structures. Full cost pricing in Queensland covers prices based on operating costs, costs of non-current assets used, taxes and tax equivalents, costs of debt financing, and a return on equity consistent with the private sector in the medium to long term.

Western Australia

As in several other jurisdictions, the CN policy statement in Western Australia provides for removing the competitive advantages of the government's SBAs through commercialisation or corporatisation.

Corporatisation is the State's preferred approach for its largest PTEs, particularly energy and water utilities. The main features of corporatisation are as follows.

- The entity has a principal commercial objective.
- The government funds CSOs.
- The entity's board and executive are responsible for its day-to-day running.
- The Government has input into the entity's annual planning cycle and monitors its performance.
- The entity pays full taxes or tax equivalents (including State and local government taxes) and debt guarantee fees, and is subject to equivalent regulations.

- The entity prepares financial reports according to the Corporations Law.

Commercialisation is applied to transport and port authorities.

For smaller SBAs, the CN policy statement notes that commercialisation or corporatisation may not be cost-effective. In these cases, the following features apply to the activities:

- taxes or tax equivalents and debt guarantee fees;
- planning and environmental approval arrangements;
- the payment of dividends to the Consolidated Fund; and
- the payment of CSOs from the Consolidated Fund.

PTEs are assumed to follow appropriate commercial pricing and are not subject to official pricing principles. Other government agencies undertaking a business activity are required to charge prices for goods and services that fully reflect: the costs of supply, including the costs of labour, materials and services directly used in the production process; an appropriate share of indirect labour costs, materials and services; accommodation costs; capital costs including depreciation of fixed assets and a commercial return on operations; and adjustments to the business's cost structure to account for any advantages or disadvantages arising from tax, debt or regulatory arrangements. Agencies can price goods or services at marginal cost. Where agencies are operating in a competitive market, they can set prices according to market dictates.

South Australia

South Australia also applies the models of corporatisation, commercialisation and full cost-reflective pricing to government business activities. The Government chooses the appropriate model for each entity on a case basis, accounting for:

- the level of resources used in the supply of the good or service. The larger the business activity of the entity, the more likely is corporatisation considered to be appropriate for achieving CN and for achieving sufficient benefits to cover the costs of corporatisation. Medium-sized businesses are more likely to be commercialised, with smaller businesses subjected to the less extensive model of pricing reform;
- accountability considerations (given that accountability and external confidence are likely to be enhanced by corporatisation);
- the extent to which business activities dominate the total activities of the entity. Where they are the main activity, corporatisation and the full range of private sector equivalence measures are preferred; and
- cost–benefit comparisons.

The CN policy statement notes that the CPA regards corporatisation as the preferred approach to the delivery of CN. It describes the CPA as indicating corporatisation for PFEs and PTEs, and the introduction of taxes and tax

equivalents, debt guarantee fees and comparable regulations to the private sector for these GBEs, provided the benefits outweigh the costs.

The CN policy documents guide agencies on accounting for the costs and benefits in assessing the case for implementing CN. The potential benefits are described as:

- increased market contestability, producing incentives for lowering costs and greater choice for consumers;
- improved assessment of the performance of government businesses, thus increasing their efficiency and contributing to better use of the community's resources; and
- better clarification of non-commercial objectives.

Possible costs include:

- legislative and regulatory amendments;
- management and culture changes;
- information and analysis to assess appropriate tax equivalents, debt guarantee fees and pricing principles; and
- the administration of tax equivalents, debt guarantee fees and general compliance.

As in Victoria, South Australian CN policy statements explicitly acknowledge that the cost–benefit comparisons should account for the factors listed in subclause 1(3) of the CPA, including ecologically sustainable development, welfare and equity, and regional development.

The CN policy describes the principal features of corporatisation as:

- the entity having clear and non-conflicting objectives; managerial responsibility, autonomy and authority; effective performance monitoring; and effective rewards and sanctions related to performance;
- legislation to enable incorporation of the business and the appointment of a board of directors responsible to the Minister; and
- private sector equivalent measures, including the imposition of Commonwealth, State and local government taxes (or a tax equivalent regime), the payment of debt guarantee fees and compliance with regulations appropriate to the private sector.

Commercialisation also involves structural reform of the entity, but not to the extent of full corporatisation. The key difference is that the entity conducting the business activity is not established as a separate legal entity and does not have a board of directors. Commercialisation may include many, but not necessarily all, of the following features:

- the definition of commercial and non-commercial activities (in a business plan);
- clear, commercial performance targets;
- separate definition and funding of non-commercial activities;
- the removal of regulatory functions from the entity;

- valuation of assets based on deprival value;
- the introduction of commercial gearing;
- payments of tax equivalents to the Treasurer;
- payments of applicable guarantee fees to the Treasurer;
- defined reporting requirements;
- ringfenced accounts from the host agency (if any); and
- a dividend policy based on an agreed indicative payout ratio reflecting the cash needs of the owner government and the business.

The South Australian Government applies full cost-reflective pricing where it believes that corporatisation or commercialisation are not appropriate. This approach ensures the prices charged for the goods and services account for (where considered appropriate) taxes and tax equivalents, debt guarantee fees and private sector regulation equivalence, and reflect full cost attribution for the goods and services.

The following are key features of full cost-reflective pricing in South Australia.

- accounting to neutralise the cost advantages and disadvantages arising from government ownership, where:
 - advantages may exist with respect to required rate of return, tax and regulation exemptions, and access to corporate overhead services; and
 - disadvantages may include accountability, reporting and financial management requirements not faced by private sector competitors, higher levels of superannuation, and public sector rules;
- the determination of an appropriate market price, which must be equal to or above the competitively neutral cost; and
- prices that are underpinned by long-term costs, but that also account for what the market will bear, the level of competition, the degree of technology advances available to service providers, and market pricing strategies.

Tasmania

Tasmania's CN policy statement describes the application of CN principles (through commercialisation, corporatisation or full cost attribution) as most appropriate when the government business entity operates in a strong and mature market with private competitors. The statement notes, however, that CN can improve resource allocation in a non-contested market.

In Tasmania, the corporatisation model applies to GBEs, PTEs and PFEs.⁶ Other government entities engaging in SBAs are subject to CN principles, with corporatisation or full cost attribution pricing models applying where

⁶ In Tasmania, some PTEs and PFEs are considered to be GBEs and others are not, while GBEs include some entities other than PFEs and PTEs.

appropriate after cost–benefit assessments. (The Tasmanian document refers to the matters listed in CPA subclause 1[3]).

Corporatisation is defined and implemented similarly to that in other jurisdictions, and incorporates the payment of taxes and tax equivalents, debt guarantee fees and dividends. In the case of dividends, each GBE is required to earn commercial returns that are sufficient to justify the long-term retention of assets and to pay commercial dividends.

Commercialisation is applied to activities where the Government believes this is the appropriate approach given the nature and size of the business, the extent to which it delivers policies, and its market environment.

Tasmania’s full cost attribution model has the following features.

- The government agency accounts for the total cost of the resources used in providing the activity, irrespective of who pays for those resources.
- The direct cost of providing the activity is included, together with a proportional share of indirect costs.
- Tax equivalents, guarantee fees, costs of capital and the cost of complying with regulations applying to the private sector are all included.
- Adjustments are made for any input disabilities arising from public ownership.

Australian Capital Territory

The ACT’s CN policy statement indicates that its CN principles apply not only to SBAs but also wherever CN would be in the public interest. CN is considered to be a valuable tool to encourage improved efficiency and resource allocation. The CN policy statement refers to the comparison of benefits and costs (outlined in subclause 3[6] of the CPA), and the matters to be taken into account (as listed in subclause 1[3]).

Corporatised entities generally are subject to the following CN principles:

- commercial target rates of return, capital structures and dividend payments;
- full payment of Territory taxes and Commonwealth income and sales tax equivalents;
- loan guarantee fees;
- the same regulatory regime as applies to private enterprises;
- explicit funding for CSOs (which should provide an identified community benefit and be subject to agreed standards of performance and delivery); and
- independent performance monitoring.

The ACT does not consider corporatisation to be appropriate for those entities that need some Government funding to help them meet their operating and investment requirements, although the CN policy recognises that commercialisation may help to expose such entities to commercial practices

and market disciplines. Commercialised entities may operate as statutory authorities with their own enabling legislation, or as semi-autonomous business units within a parent agency. The ACT Government subjects commercialised entities to the same costing and pricing principles, taxation and debt guarantee requirements and appropriate regulations that apply fully corporatised businesses.

The CN policy states that full cost attribution applies to all Government agencies to encourage good resource use and transparency about the cost of providing services.

Northern Territory

The Northern Territory's 1996 CN policy statement indicates that only the larger GBEs or GBDs, such as the Territory Insurance Office, the Power and Water Authority and the Darwin Port Authority, would be corporatised. The main features of corporatisation are that:

- each corporatised entity is a separate legal entity established by legislation; and
- each complies fully with GBD commercialisation policies (see below).⁷

Commercialisation is adopted for the other GBDs because they are small in size, and the Government considers the appropriateness of corporatising other GBDs on a case basis. The principal features of commercialisation are as follows.

- GBD prices reflect the full cost of resources used (including tax equivalents and debt charges), and are subject to independent review by Treasury and approved by Cabinet.
- GBDs pay the cost of resources used, including employee costs (superannuation, workers compensation and leave entitlements), property rental, insurance, and legal and auditing costs.
- The NT Treasury Corporation charges debt guarantee fees and pays GBDs commercial rates of interest on cash balances held.
- GBDs are required to earn a return on equity, accounting for potential or actual competition in the market and any CSOs that impose pricing constraints. CSOs may be funded through a reduction in the required rate of return.
- GBDs are required to identify and cost all CSOs (defined according to the definition developed by the Steering Committee on National Performance Monitoring). Approved CSOs are to be funded from the Budget or through a reduction in the required rate of return.

⁷ The Northern Territory Government is considering a shareholder model of corporate governance for the larger GBEs on a case basis, under the Territory's Government Owned Corporations Act 2001. The Power and Water Authority is expected to become the Territory's first Government Owned Corporation during 2002-03.

- GBDs have adopted commercial accounting practices including accrual accounting and deprival valuation for non-current physical assets.
- GBDs annually report on performance to Cabinet.
- Each GBD has established an audit committee and a formally approved and published charter of operational objectives and strategies, which states the scope and standards of service to be supplied.
- Where appropriate, GBDs have established management advisory boards.

The national tax equivalent regime applies to the Northern Territory's largest GBEs (Territory Insurance Office, Power and Water Authority), and the Territory's own tax equivalent regime is applied to other government businesses.

3.4 Possible best practice in interpreting 'where appropriate'

Clause 3 uses the phrase 'where appropriate' on three occasions, providing governments with room to move in corporatisation and the application of taxes or tax equivalents, debt guarantee fees and equivalent regulations in the case of GBEs and potentially significant business activities (or in the application of full cost pricing as an alternative in the case of significant business activities).

There is a degree of similarity across governments in the scope of CN – that is, in the interpretation of the phrase 'where appropriate'. All jurisdictions apply corporatisation or commercialisation principles to their GBEs. Definitions of GBEs vary, but only in a minor way. GBEs generally accord with PTEs and PFEs, as classified by the ABS and provided for in CPA clause 3. The corporatisation and commercialisation models have similar characteristics across jurisdictions, including the operation of an entity on a stand-alone basis (in the case of corporatisation) or as a major commercial component of a government agency (in the case of commercialisation), and the requirement for the entity to pay taxes/tax equivalents and debt guarantee fees and to face equivalent regulations.

Typically, jurisdictions adopt a full cost pricing model (rather than corporatisation or commercialisation) for other significant business activities that are not classified as GBEs. Some jurisdictions consider the grounds for corporatising or commercialising these smaller entities on a case basis.

A key difference among governments arises in their use of cost-benefit analysis as provided by subclause 3(6) of the CPA. Some governments actively promote this option, with the objective of determining whether it is appropriate to apply CN. Other governments do not promote such analysis, requiring instead that all significant government businesses apply CN; the onus falls on individual businesses to demonstrate that the costs would exceed the benefits.

The benefits of CN are likely to be sustained, while the costs are usually associated with CN's introduction and thus are short lived. There is a good case, therefore, for maximising the application of CN across GBEs and SBAs. This suggests that a best practice approach would be to encourage application as a good management practice, rather than to undertake extensive cost-benefit analyses, which risk becoming 'trawling' exercises with a view to making a case for not applying CN. The latter approach would tend to diminish the extent of CN and its benefits, and raise doubts about the commitment to removing differences in the treatment of public and private agencies.

The following characteristics are a suggested best practice approach for identifying government entities to which CN should apply (that is, to address the 'where appropriate' issue).

- All stand-alone GBEs should be subject to a corporatisation model.
- All major government activities that are not stand-alone should be subject to at least a commercialisation model.
- The corporatisation and commercialisation models should incorporate the removal of all advantages enjoyed by government businesses as a result of government ownership (including any tax, interest rate and regulatory advantages), and ensure full cost pricing occurs through the entity's participation as a stand-alone entity in the market or is required by the government, and that the entity is required to earn a commercial rate of return on its assets over the medium term.
- Other government agencies conducting significant business activities should be subject at least to full cost attribution in their pricing (see section 4 for information on this pricing) and to taxes or tax equivalents, debt guarantee fees and equivalent regulations. The case for commercialisation or corporatisation of these activities should be reviewed periodically, to provide more certainty that CN outcomes will be achieved and to enhance accountability.
- Exceptions to the application of CN should not be encouraged. The best practice model would involve application of CN to all government business activities. Any exceptions would require individual business activities to convince the relevant Government that the costs would exceed the benefits.

4. Costing and pricing

4.1 Requirements of CPA clause 3 and practices of governments

As described in the preceding section, all governments have adopted a corporatisation or commercialisation model for larger government businesses, and have imposed tax and tax equivalents, debt guarantee fees and equivalent regulations on these entities.⁸ The operation of these entities in commercial environments, and the requirement to earn a commercial rate of return, usually ensures that all of their costs are reflected fully in their prices and that competitively neutral outcomes are achieved. These entities therefore adhere to the all-important pricing aspect of CN. This approach is consistent with CPA clause 3.

Clause 3 requires governments to apply (where appropriate) a similar model for smaller agencies that are described as significant business activities (for CN purposes), or to ensure prices account for taxes or tax equivalents, debt guarantee fees and equivalent regulations, and reflect full cost attribution. The CoAG communiqué of November 2000 states that full cost attribution accommodates ‘a range of costing methodologies, including fully distributed cost, marginal cost, avoidable cost, etc., as appropriate in each particular case.’

Most jurisdictions have committed in their CN policy statements to full cost attribution for their SBAs. Section 3 provided some information on the practices of jurisdictions in this regard. An optimum of the current approaches applied by jurisdictions may have the following key features.

- SBAs are required to recover the full costs of the business activity over the medium to long term. Costs include operating costs (including a share of any indirect operating costs of the parent agency), costs of non-current assets used, taxes and tax equivalents, debt financing costs (including debt guarantee fees), depreciation, return on capital targets, and adjustment to account for any advantages arising from public ownership that are not covered by the above factors.
- Targets for commercial rates of return are based on the weighted average cost of capital (WACC) of each SBA, which measures the cost of the business activity’s equity and debt.

⁸ Subclause 3(7) of the CPA states that a government is not required to remove a regulation from a GBE or government agency (that does not apply to the private sector) if the government considers the regulation to be appropriate.

- SBAs are required to recover all costs in the medium to long term, while having the freedom to practise marginal pricing in the short term (or to practise commercial pricing strategies) in response to market conditions.

That is, the current practices of jurisdictions provide some guidance to optimal full cost pricing. There are some issues that governments have to deal with, especially with applying marginal pricing or competitive pricing strategies in the short run. What is the definition of short run? What is the optimal time period over which costs should be measured? Should there be a constraint on the adoption of variable pricing strategies by SBAs? Where the activity is a unit within a larger government agency, how should the overhead costs be distributed to that activity? What should be the basis for setting the targets for return on capital? Work undertaken by the CCNCO in the Productivity Commission (CCNCO 1998a and 1998b) provides useful commentary on these and other issues, and is discussed in section 4.2. The importance of these issues is sometimes overrated, however; it is not appropriate to seek to be too exact in dealing with them at the expense of implementing competitive neutrality.

4.2 Guidance by the CCNCO

The CCNCO has considered the following possible measures of the full costs incurred by a business activity that is part of a larger government agency.

- *Fully distributed cost* measures all the costs incurred by the business activity directly, together with a share of the agency's overheads and capital costs. The CCNCO considers that this has the disadvantage of potentially overstating the costs incurred by the business activity, because the share may not accurately reflect the activity's imposition on the agency's costs. This overstatement would result mainly from some overhead costs being attributed to the business activity when the agency would incur them even if the activity did not happen. In this situation, if revenue achieved in the marketplace does not exceed the fully distributed cost, then the agency may close down the business activity even though it could be viable.
- *Avoidable cost* measures all the costs the agency would save ('avoid') if the business stopped operating. The CCNCO believes that this is a more accurate measure of the activity's costs to the agency. The CCNCO argues that the avoidable cost method is preferable from an economic efficiency (resource allocation) point of view, because it provides an estimate of the minimum level of revenue per unit (that is, price) required to justify production.
- *Marginal cost* is the cost of producing an additional unit of output. The CCNCO has several concerns with this measure which are difficult to resolve. *Short-run marginal cost* may be the best measure of the costs of producing an additional unit, but there is no firm view on what length of time defines the short run, what defines a unit of production and how to deal with joint costs (costs shared by the agency and the business activity).

Depending on the length of the period used, capital costs may not be measured (very short period) or may show up as large cost increments (if the period chosen coincides with a major investment). The use of *long-run marginal cost* would pick up capital costs that reflect increments to productive capacity; again, however, measurement problems arise with the choice of period and the incremental unit of production.

The CCNCO prefers the avoidable cost measure, which covers the costs of resources used directly by the business activity and the additional cost incurred by the government agency when the business activity uses its resources. The CCNCO notes that some governments nevertheless use fully distributed costing (which could result in less than optimal output by government business activities), and that some governments suggest the marginal cost method without providing guidance on dealing with the measurement problems.

The CCNCO provides guidance on the use of its preferred method (avoidable cost). The time period should be long enough to enable capital costs to be captured. The capital budgeting cycle would be appropriate for capital-intensive business activities, while a typical business planning period of three to five years would be appropriate for other activities. The capital costs associated with an asset owned by a government agency should be allocated to the business activity according to the activity's use of the asset. The CCNCO also argues that avoidable cost should be measured for the business activity as a whole, rather than for each of the separate products that the activity may produce. Measuring cost at the activity level provides the same pricing flexibility across products as enjoyed by private companies.

The CCNCO believes, if the avoidable cost is measured in this way, that the test for compliance with CN involves revenue equalling or exceeding avoidable cost. The business activity must earn a commercial rate of return on the assets used exclusively by the business activity.

The CCNCO notes that commercial businesses seek to measure their WACC for the purposes of setting a commercial rate of return. It can be difficult to measure the WACC, partly because subjectivity has to be applied to estimating the market risk ('beta factor') for a particular business activity. The CCNCO suggests that WACCs could apply to smaller government businesses (in the terminology of this paper, SBAs) in the following ranges:

- low-risk businesses: the long-term bond rate plus 3 percentage points;
- average-risk businesses: the long-term bond rate plus 5 percentage points;
and
- high-risk businesses: the long-term bond rate plus 7 percentage points.

4.3 Possible best practice in full cost attribution in pricing

For those GBEs that have been corporatised (usually the medium to large GBEs), their pricing usually is competitively neutral, provided they are required to meet targets for rates of return that are commercially based. For these enterprises, every effort should be made to estimate the WACC, because this is an important underpinning to competitively neutral outcomes in the pricing strategy of these businesses. In addition, the process of calculating the WACC (especially the risk factor) provides useful information about the business to the GBE's management.

Corporatised GBEs are usually stand-alone businesses that derive all of their revenues from the market and do not derive any of their productive resources (for example, accommodation, personnel management) from a larger agency. Some commercialised government entities, however, draw on the resources of larger 'parent' agencies, and there may be concerns about the pricing of those resources. In these cases, the prices that commercialised entities charge cannot be assumed to be consistent with CN outcomes. Competitive neutrality adjustments (for the imposition of taxes and tax equivalents, debt guarantee charges, equivalent regulations and rate of return targets) should be made to the prices charged by these entities. Best practice suggests that the avoidable cost method should be required of such entities, as suggested below for other SBAs.

In the case of other SBAs, which usually are located within a larger government agency, the best practice approach to full cost attribution would be similar to that for commercialised entities and have the following features.

- The avoidable cost approach is used.
- The period over which costs are measured should relate to the capital budgeting cycle of the entity. In most cases, the normal business planning period of three to five years would be appropriate.
- All relevant costs are measured, including direct and indirect operating costs, the costs of non-current assets used, taxes and tax equivalents, debt financing costs (including debt guarantee fees), depreciation, rate of return targets, and adjustments to account for any advantages derived from public ownership.
- The SBA should be subject to the same regulations that apply to private sector equivalents, and should account for the cost of complying with these regulations.
- Preferably, the rate of return targets should be based on individual estimates of the SBA's WACC. Estimation is difficult in some cases, and the use of an indicative level for the WACC (depending on the market risk of the business) as described at the end of section 4.2 would be appropriate.

- If the SBA is a multi-product unit, then it should be free to price each products differently, provided the revenue of the SBA as a whole equals or exceeds its avoidable costs.

5. Community service obligations

5.1 Competitive neutrality implications

CSOs are goods or services that governments require specific government businesses (and sometimes specific private enterprises) to provide to sections of the community, and that would not be provided under commercial arrangements. Examples of CSOs that have been required by Australian jurisdictions include: concessions for pensioners, students and rural communities for public transport and utility services; non-commercial land development; and rent subsidies for public housing.

The CPA does not make an explicit link between the delivery of CSOs and CN. The way in which CSOs are delivered, however, is generally accepted to have a significant bearing on CN outcomes. The reason for CN is the enhancement of resource allocation. The ways in which CSOs are delivered can have significant effects on resource allocation. In past years, governments often delivered CSOs by requiring their agencies to provide them, generally at a cost to the particular agency. A public transport entity, for example, might have been required to provide concessional fares for students and pensioners without receiving any funds from the government. This necessitated the entity effectively cross-subsidising the concessional fares from within its own business; other passengers were carrying the burden of the subsidies. The cost of this concession might not have been reported by either the government or the entity.

Funding CSOs through cross-subsidies within a government business can handicap the business compared with private sector competitors. In the example of public transport, the competitors include other modes of urban transport, particularly private cars. By increasing the prices of the goods or services that subsidise the CSOs, cross-subsidies can hold back demand for those goods and services. At the same time, cross-subsidies sometimes have had to be supported by regulations that restrict competition for the government business, thus underpinning the returns for that business. These types of distortion impede the achievement of CN.

As noted above, cross-subsidies usually have not been accompanied by reporting, so transparency has been poor. This meant that the community is unaware of the cost and thus cannot assess whether it wishes to continue with the support. On occasions, the parent government has reduced the required rate of return from the agencies delivering the CSOs.

Direct funding by the government of a clearly identified and reported CSO enhances transparency and removes the resource allocation distortions caused by cross-subsidies and supporting regulations. It also is usually accompanied by reporting of the CSO by both the government (as purchaser of the CSO) and the government business (as provider). This reporting facilitates community awareness of the CSOs and thus comparisons of these services with other community demands on the public purse. It also encourages periodic reviews of CSOs.

Another substantial advantage of direct funding of CSOs is that it sometimes can provide the scope for governments to put the CSO provision to competitive tender. The tender would be awarded to the public or private entity that believes it can provide the good or service for the least cost to the public purse. This approach would require the public entity to be subject to the corporatisation or full cost attribution models described in section 4, and for the bidders to be committed to meeting minimum performance/service standards set by the government (necessitating a monitoring arrangement).⁹ CoAG decided in November 2000 that formal compliance with the NCP does not require a competitive process for the delivery of CSOs. Governments find, however, that such an approach sometimes reduces the cost of delivering CSOs and introduces innovative delivery methods.

The funding of CSOs calls for estimation of the costs of provision. The key concept in this estimation is avoidable cost; that is, it is necessary to estimate:

...the revenue no longer received or costs no longer incurred if the CSO service were no longer supplied. In other words, costs and revenues associated with CSOs should be attributable on the basis of causality. On these grounds, the fully distributed cost and stand-alone cost approaches (which ignore this concept) are unsatisfactory. (Western Australian Treasury Department 2000 , p. 6)

The Western Australian Treasury (2000) describes the measurement difficulties associated with the marginal cost method (as outlined earlier in this paper), and argues for use of the avoidable cost approach. Most other jurisdictions support the use of this costing method, although some also allow for the fully distributed cost approach. The Western Australian Treasury (2000, p. 7) suggests that long-run avoidable cost should be used because ‘it makes provision for the cost of capital employed in delivering a CSO and the cost of consuming the assets involved in providing the CSO’. (The cost of the CSO is the difference between the avoidable cost of delivering the CSO and any revenue derived from providing the service.)

⁹ These are characteristics of the provision of urban transport services in Melbourne, where franchises to offer particular train or tram services have been awarded for several years to those companies that bid for the lowest government subsidies.

5.2 Possible best practice

All Australian governments have made substantial progress over the past several years in introducing comprehensive policies for the identification, transparency and funding of CSOs. There are, nevertheless, some differences in approach.

The following are the main features of a suggested best practice approach to CSOs.

- The parent government agency or department identifies possible CSOs, and applies them only if the Cabinet agrees. This ensures all competing demands for use of government funds are taken into account.
- The Government directly funds CSOs. There are no cross-subsidies or associated regulatory restraints.
- The government business and the providing government agency cost and transparently account for CSOs. The jurisdiction's Treasury's provision of a table of all CSOs in its annual budget papers would enhance transparency.
- The long-run avoidable cost approach is used for estimating the cost of CSO delivery.
- The performance of the government business in providing the CSO is subject to regular monitoring, at least by the government department or agency that originally argued for the CSO, and preferably also by the government enterprise monitoring unit (which is located in the Treasuries of most jurisdictions).
- The Government conducts regular reviews (every few years) of the case for provision of each CSO. Changing circumstances can reduce (or increase) the case.
- Where CSOs are subject to provision by public tender, the government entities bidding to deliver the CSOs are either corporatised or subject to full cost attribution.¹⁰

¹⁰ On occasions, governments fund certain private companies to provide CSOs without undertaking a tender process. The CoAG communiqué of November 2000 allows for this approach. Competitor firms sometimes complain of unfair treatment. Provided the level of funding is based on an appropriate costing method, then the providing firm should not earn above-normal profits from the CSO delivery.

6. Allegations of non-compliance with competitive neutrality policy

6.1 CPA requirements

The CPA requires governments to have a mechanism for considering complaints that government agencies are not appropriately implementing CN policy (subclause 3[8]), and to publish an annual report that includes information on allegations of non-compliance (subclause 3[10]). All governments have instituted complaints processes and document allegations (and actions taken in response).

The CPA provides freedom for governments to design their complaints mechanisms according to their own priorities. All governments have viewed the complaints mechanism as a reinforcement of the main features of the CN principles. Subclause 3(10) underlines this view by highlighting:

- subclause 3(1), which defines the objective of CN policy as eliminating resource allocation distortions arising from competitive advantages that public sector businesses may enjoy as a result of government ownership; and
- subclauses 3(4) and 3(5), which are concerned with the adoption of corporatisation, taxes and tax equivalents, debt guarantee fees and equivalent regulations for GTEs and GFEs, and the adoption of these features or full cost pricing for other significant business activities.

6.2 Principal features of jurisdictions' complaints mechanisms¹¹

Given the context of CPA clause 3, there is broad similarity across jurisdictions in their complaints mechanisms. The differences reflect their responses to a range of issues. In establishing their complaints mechanisms, governments have considered a range of issues, including:

- whether the complainant must be a competitor or potential competitor of the relevant government business, or a concerned individual or organisation;

¹¹ The mechanisms for dealing with complaints about local government businesses are discussed in section 8 below.

- whether to establish an separate body to assess CN complaints, to give the role to an already established separate body or to establish a complaints entity within a government department such as the Treasury (ensuring it is distinct from any business unit of a government department or agency that could be the subject of a complaint);
- whether, in the first instance, complainants should be required to make contact with the body about which they are complaining before approaching the independent or separate complaints entity;
- whether the complaints body should deal with complaints relating to only GBEs and SBAs, or whether complaints about other government businesses also should be heard (perhaps assuming that an entity that is the subject of a complaint should be considered significant after all); and
- the process for addressing complaints, involving issues such as taking and requesting information, inquiries, feedback, follow-up action (including enforcing rulings on complaints), the decision-makers, appeals and transparency (including the availability of the complaints unit's reports to parties other than the complainants and the entities that are the subject of the complaint).

Nature of complainant

Allowing any party to make a CN complaint maximises the scope for governments to be alerted to CN and related issues.

Separate complaints entity

In a number of jurisdictions, CN complaints are considered by independent entities that have been established to promote competition, pricing and market conduct outcomes, especially with regard to government bodies. Examples of such bodies are the Queensland Competition Authority (QCA), New South Wales' Independent Pricing and Regulatory Tribunal (IPART), South Australia's Competition Commissioner, Tasmania's Government Prices Oversight Commission (GPOC), and the ACT's Independent Competition and Regulatory Commission (ICRC). The positioning of the complaints-handling role in such entities reflects that there are typically insufficient complaints to justify the establishment of a specialist body dealing solely in complaints. It also reflects the expertise of these entities in undertaking transparent inquiries into competition issues involving government bodies.

Some other governments have established complaints units in their Treasuries. The units usually comprise Treasury officers who also undertake other duties in relation to competition policy. The Commonwealth has established a complaints body within the Productivity Commission.

Both approaches would appear to meet CPA objectives, provided governments ensure complaints units within government departments are separate from the government body that is the subject of the complaint.

Role of the relevant government business

Some governments require complainants to make contact initially with the body about which they are complaining. This has some advantages, particularly when a misunderstanding or poor information has generated a complaint. In these cases, the government body can overcome the complaint by providing better information or rectifying the matter.

Where the government business satisfactorily deals with complaints, in the interests of transparency and assisting other government businesses to learn from its experience, it should report the nature of the complaint and the solution to the relevant complaints body. This information also should be included in the annual report of the jurisdiction's annual report on implementation of the CPA.

Where governments encourage or require complainants to approach the relevant government business in the first instance, they allow the complainants to follow up with the complaints unit if they are not satisfied.

Coverage of the complaints mechanism

Some governments allow complaints to be lodged against only government entities that are subject to the CN principles (GBEs and other SBAs), while others allow CN complaints to be made against other (smaller) government business activities as well. The latter approach is arguably preferable, because a complaint indicates that a government business is having a significant effect on private sector competitors. Further, public confidence in the CN mechanisms generally and the complaints process is likely to be greater when all government businesses can be subject to complaint. In addition, full coverage is likely to more comprehensively alert the complaints body to emerging CN issues.

Complaints-handling process

The process of the CCNCO, which is located in the Productivity Commission, involves the following steps.

- After receiving a complaint, the CCNCO makes a preliminary investigation into whether CN arrangements should apply to the Commonwealth business.

- If the CCNCO believes that CN principles are not being observed at all or fully, it advises the business and recommends steps to implement or improve compliance.
- If this advisory approach does not resolve the issue, the CCNCO can prepare a formal investigation report which may recommend appropriate action or that the Commonwealth Treasurer make an inquiry into the matter.
- After conducting preliminary investigations or public inquiries, the CCNCO makes recommendations to the Parliamentary Secretary to the Treasurer, who passes the CCNCO's report to the portfolio Minister for consideration. The CCNCO also publishes its reports.
- No penalties apply to government businesses for non-compliance with CN principles, but the capacity of parties to lodge complaints (and for these to be reported by CCNCO) increases the CN accountability of the business and the portfolio Minister.

NSW's complaints process contains features that are similar to aspects of the Commonwealth's process. Some differences are that the New South Wales Premier refers CN complaints about an SBA to IPART. IPART's report can recommend changes in the government business's conduct to facilitate compliance with CN, and any policy changes for consideration by the relevant Minister. IPART's report should be completed within 10 weeks of the complaint being received, and the portfolio Minister should respond within eight weeks of receiving the report. Both IPART's report and the Minister's response must be made publicly available.

In Victoria, the CN Complaints Unit is located in the Victorian Department of Treasury and Finance. It receives complaints directly from the private company or person making the CN complaint about a government business. The CN Complaints Unit conducts its investigation on the best available information, taking information from all involved parties. Its reports are provided to these parties and published on the unit's website.

In Queensland, affected parties can make complaints to the QCA about alleged breaches of CN principles relating to tax equivalents, debt guarantee fees and regulatory equivalence. The QCA provides its report (including recommendations) to the Premier and Treasurer, and it is also made available for public inspection at the QCA offices. The Premier and Treasurer either accept or reject the QCA's advice within 90 days, and the QCA informs the complainant and the SBA of the Ministers' decision. If the complaint is not about tax equivalents, debt guarantee fees or regulations, then the Premier and Treasurer, in consultation with the portfolio Minister, deal with it. Such a complaint may be about CSOs, subsidies, pricing or tied clients. The Premier and Treasurer may ask the QCA to investigate such complaints. In these instances, the Premier and the Treasurer advise the complainant, relevant SBA, the portfolio Minister and the QCA of their decision and any remedial action. The decision is posted on the Queensland Treasury website.

6.3 Possible best practice

The following are the main features of a suggested best practice approach to the CN complaints mechanism.

- Any party can make complaints.
- Complaints are heard by a body that is removed from the businesses that could be the subject of complaint, and their parent agencies or departments. There is merit in this body being experienced in dealing with pricing, market conduct and other competition issues. The complainant is not charged fees.
- Complainants are required to approach initially the government business about which they are complaining. If they cannot gain satisfaction from the business, they may approach the jurisdiction's complaints body.
- All government businesses are potentially the subject of complaint, not just those classified as GBEs or SBAs.
- A complaints-handling process provides for the reviewing body to request information from all affected parties (while respecting commercially confidential information) and to make public recommendations (and provide reasons) to the relevant portfolio Minister (within a defined period), who should decide on a course of action within a set period and make the decisions public.

Some people may be prepared to make a competitive neutrality complaint only if they remain anonymous. This would imply that they would not wish to approach the government business about which they are complaining. Governments could consider allowing such complainants the option of approaching their complaints bodies in the first instance.

Governments could confer on the scope for making their complaints hearing processes more similar, better reflecting that many Australian private businesses operate in more than one jurisdiction (as do several Commonwealth businesses). Increased similarity in CN complaints processes would make them more understandable for these entities, and promote equity, certainty and predictability.

The CCNCO has investigated some complaints relating to national bodies of which all jurisdictions are members.

7. Competitive tendering and contracting

Competitive tendering and contracting is not required under the CPA, but it can complement the delivery of competitive neutrality outcomes. An effective CN policy can contribute significantly to confidence in the fairness of a government's competitive tendering and contracting when government businesses are allowed to bid for government tenders.

Private bidders for government tenders are more likely to consider that government bidders do not have unfair advantage if government businesses are known to be subject to CN policies in each jurisdiction. In particular, adherence to the CN principles in clause 3 of the CPA would be a minimum to underpin confidence in jurisdictions' competitive tendering and contracting.

Private companies would (in most instances) be comfortable with competing for government contracts with corporatised government entities, provided the government bodies face taxes or tax equivalents, debt guarantee fees and equivalent regulations. In the case of commercialised government businesses and SBAs, confidence in competitive tendering and contracting would be enhanced if those businesses/SBAs are also required to meet these obligations and practise full cost attribution so their bids for tenders reflect all costs and commercial rates of return.

Where government businesses issue tenders, any in-house bidders from within the businesses should be separate entities in terms of accounting, administration, personnel and physical location, and should be required to follow the features of CN (as described above).

In outlining a framework for government businesses bidding for government work, the Industry Commission noted that:

The introduction of an effective form of organisational separation is central to the maintenance of confidence in the legitimacy of in-house bids.

... Where an in-house team wins a tender, it should be managed, at the very least, as a commercially autonomous unit, with its own set of commercial accounts and formally separated from all aspects of contract management.

... Corporatisation is the preferred approach to achieving competitive neutrality, but may not be appropriate in all cases.

... Where in-house teams operate under a corporatisation framework, issues of competitive neutrality are largely resolved. However, ... there may be cases where corporatisation is not appropriate. In these cases, alternative measures to promote competitive neutrality, ensuring

recognition of the full economic costs of resources used by government businesses, are required. (Industry Commission 1996, pp. 296–303)

The Industry Commission refers to the removal of advantages and disadvantages that government bidders may face, together with the need for the pricing of such bidders to reflect all of their costs.

Governments have recognised the role that CN policies can play in supporting competitive tendering and contracting processes, and vice versa. The following descriptions provide examples of this recognition.

The Commonwealth's CN policy statement states:

Where in-house providers supply a service under contract there is a need to ensure that appropriate competitive neutrality arrangements and management practices are in place. As a rule, in-house tenders will need to be prepared in isolation from those in the organisation responsible for evaluating tenders and awarding contracts; and reflect full cost attribution, including taxation, return on capital and all relevant overheads. (Commonwealth Government 1996, appendix B)

In Victoria, CN has been built into the Government Purchasing Board's guidelines so the prices tendered by government businesses reflect the full cost pricing approach of that State.

In the Northern Territory, government businesses are not permitted to participate in government tenders without the agreement of the Procurement Review Board. Where government businesses are permitted to bid, their tenders must incorporate CN principles. Tenders include an actual tender price (the contract value that is paid if the government business is successful), and a notional price that includes CN adjustments. The tender is assessed on the basis of the notional price, and the tender bid documents of government businesses must include a certification by the accountable officers that CN principles have been followed.

New South Wales has made provision for its State Contracts Control Board to consider CN complaints about tender bids made by government businesses. The board follows a complaints-handling process similar to that of IPART for other CN complaints (NSW 2002).

8. Competitive neutrality in local government

8.1 The importance of applying competitive neutrality principles to local government

Local governments in Australia provide an extensive range of services, embracing activities such as garbage collection, recycling, roadworks, street cleaning, child minding, libraries and entertainment facilities, water distribution and sewerage, gas distribution, parks management, and cattleyards. Local governments operate small, medium and (in some cases) large business activities, and there is good reason for them to apply CN principles. The importance of applying CN principles to local government is reinforced by the fact that local governments often issue tenders for the provision of services (and it is desirable for any in-house bidders to be subject to CN principles), and may participate in competitive tenders in other local government areas.

Governments recognised the importance of applying CN to local government business activities in clause 7 of the CPA, which states that the principles set out in the agreement (including the CN principles described in clause 3) are to apply to local government.

8.2 Government policies

Most States have introduced CN policies for local government that broadly reflect their policies for their State government businesses.¹² In New South Wales, some council businesses fall under the ABS definition of a PTE and automatically must comply with CN principles, while other business activities are determined on a case basis to need to comply with CN principles. The criteria applied in New South Wales for determining whether CN applies to a local government business activity are:

- council businesses tendering for road construction work;
- the existence and extent of competition for the activity; and
- the nature, importance to customers and economic impact of the activity.

¹² The ACT has no local government. In the Northern Territory, local government business activities remain small, with limited functions compared with most jurisdictions (for example, garbage collections and swimming pool operations).

There are two categories of significant business activity at the local government level in New South Wales.

- *Category 1 businesses* have an annual turnover of \$2 million or more. They are considered suitable for corporatisation because their economic impact is likely to be significant. For such entities, the Government prefers that the typical CN principles are applied, including corporatisation, debt guarantee fees (if the council has borrowed on behalf of the business at favourable rates), a return on capital comparable to that set in similar private businesses, equivalent regulations, taxes or tax equivalents, and explicit reporting of any subsidies. The onus is on the council to run a public cost-benefit analysis to support a case for not applying CN principles.
- *Category 2 businesses* have an annual turnover of less than \$2 million. The State's 1996 policy document for the application of NCP to local government comments that some of these business activities are very small (for example, photocopying sales at the council headquarters), while others are quite important (for example, the hire of plant and equipment, the operation of significant recreation facilities, and land subdivision). The Government encourages local governments to apply full cost attribution to as many category 2 activities as is practicable.

Regarding complaints about CN issues at the local government level in New South Wales, councils are the first point of contact and are responsible for establishing their own complaints-handling process. The Department of Local Government deals with complaints that the councils cannot resolve.

In Victoria, the Government issued in January 2002 a revised statement of policy on NCP and local government. Several aspects of this statement mirror the State's approach to its own business activities. Councils are guided to assess their activities as businesses if they have the following characteristics.

- Goods or services are sold in competition (actual or potential) with other providers.
- The activities are undertaken primarily for commercial purposes. They involve the application of commercial systems, accounting and marketing, and tendering to supply external contracts.

The significance of a council's business activity in Victoria is indicated by its market impact, as shown by:

- the size of the business in relation to the overall market;
- its competitive impact in the market; and
- the resources it commands and the effect of poor performance.

Councils' assessments of significance must be documented.

The councils must remove competitive advantages arising from council ownership, which can relate to taxes, regulations, government guarantees on debts, concessional loans and rate-of-return requirements. As with the level of State government business activities, the CN measures Victorian local governments can adopt for their business activities are corporatisation, commercialisation and full cost pricing. (Section 3 discusses the main features of these approaches in Victoria.)

The Victorian CN policy document reports that full cost-reflective pricing is the most commonly used CN measure at the local government level, and recommends the use of the fully distributed cost method (see section 4.2). The avoidable cost approach is described as appropriate ‘only where a council can demonstrate that the majority of its activities are non-commercial and that its indirect costs (overheads) remain unaffected by the activity in question’.

Consistent with clause 3 of the CPA, councils can argue (in documented cases) that the benefits of introducing CN policies are outweighed by the costs, given the matters described in subclause 1(3) of the CPA. Victoria also encourages its councils to account for the State’s ‘Best Value Principles’, which relate to performance in accordance with quality and cost standards, responsiveness to community needs, accessibility of services to the community, continuous improvement and regular consultation with the community.

The CN Complaints Unit in the Victorian Treasury deals with CN complaints regarding local government in Victoria, using processes similar to those that apply to complaints about State government businesses.

In Queensland, local governments have a total annual expenditure of more than \$3 billion and control significant public infrastructure. They are diverse in population and service delivery capacity; for example, Brisbane City Council represents 750 000 people, while some rural shires serve just a few hundred or a few thousand people. Local government business activities in Queensland include water and sewerage services, solid and liquid waste management, off-street parking, land development, caravan parks, venues for entertainment, arts and sports, quarries, cattleyards and aerodromes.

Two types of business activity are subject to CN principles that are consistent with CPA clauses 3(4) and 3(5) reforms:

- *Type 1 business activities* have a current expenditure, in the case of water and sewerage enterprises combined, greater than \$30.4 million per year or, in the case of other enterprises, greater than \$18.3 million per year.
- *Type 2 business activities* have a current expenditure, in the case of water and sewerage combined, greater than \$8.6 million per year or, in the case of other enterprises, greater than \$6.1 million per year.

While types 1 and 2 activities relate to only 15 per cent of local governments in Queensland, they cover a high proportion of overall local government business activity. Local governments identify type 1 and 2 activities on an annual basis.

For type 1 activities, if shown to be appropriate through a public benefit test, each local government is expected to implement a corporatisation model and/or a tax equivalent regime for the business activity, as well as impose debt guarantee fees and regulations equivalent to those applied to the private sector. The *Local Government Act 1993* requires full cost pricing.

For type 2 activities, similar reforms are to be implemented where appropriate. Queensland's CN policy paper states that:

Councils should note that full cost pricing will not prevent local governments from subsidising the prices of goods and services, provided the subsidies are treated as explicit CSOs which are funded separately by the parent local government with full disclosure in the council's annual report. (Queensland Government 1996b, p. 24)

For smaller business activities (known as type 3 businesses) that are undertaken in direct competition with the private sector and that are not type 1 or type 2 activities, a separate reform process is applied. The Queensland Government encourages such businesses to apply a voluntary Code of Competitive Behaviour, embodying principles of at least full cost pricing, accountability and transparency. The code is most applicable where the local government activity competes with the private sector, or where the council seeks outside bids for service delivery and the council business activity submits a tender.

The Code of Competitive Behaviour for type 3 business activities, released by the Queensland Government in December 1996, has the following features.

- Financial incentive exists for councils that adopt the code.
- A formal assessment of the public benefits and costs is not required for type 3 businesses.
- Council business activities should be conducted so no undue advantage arises; such advantages may exist in the areas of exemption from Commonwealth and State taxes, local government rates and charges, no requirement to earn a commercial rate of return, and lower borrowing costs. These factors should be identified and imputed in costing and pricing decisions. A similar process should apply to any disadvantages.
- For pricing purposes, the following costs represent those that should be included in the full cost attributable to a product or service provided by local government activities: operating costs, capital costs (for example, depreciation and amortisation), taxes and tax equivalents; debt financing costs; and an adequate after-tax return on equity.
- Councils may subsidise the operations of a type 3 business activity to meet social, equity or environmental goals. The code does not prohibit such subsidies, except where tendering in open competition for projects on State or council controlled roads. Any subsidies should be transparent.
- Price discrimination may be acceptable if it recognises the advantages of scale, encourages economic development, or meets social goals or CSOs. It should be transparent.

Queensland local governments operating SBAs are required to conduct public benefit assessments to consider the case for applying one of three CN reforms – corporatisation, commercialisation or full cost pricing. Up to 2001, the 18 largest local governments had identified 30 SBAs. In addition, in 11 cases, local governments elected to apply higher level reforms to their smaller business activities as if they were significant. In addition, local governments identified 170 type 3 SBAs that compete directly with the private sector. Depending on the degree of implementation of reforms, local governments are allocated funds under the Financial Incentive Package; up to early 2001, 34 local governments had commenced reforms of their type 3 activities.

Once a local government applies a CN reform to any local government business activity, it must establish (under the Local Government Act) a process to deal with complaints about breaches of CN. If the relevant local government cannot resolve a complaint, competitors are able to approach the QCA to address NCP non-compliance matters. Only genuinely disaffected parties can lodge complaints which are limited to those activities that are subject to CN reform following a public benefit assessment. The ground for complaint is whether the activity is operating on a competitively neutral basis.

Local governments with type 1 and 2 businesses advise the Department of Local Government and Planning annually on their implementation of CN.

In Western Australia, the corporatisation model and tax, debt and regulation equivalents are applied to any local government businesses that the ABS classifies as PFEs or PTEs. The equivalents regime must apply to other business activities with an annual income of more than \$200 000. CN applies where the benefits are estimated to exceed the costs.

In South Australia, the May 2000 clause 7 statement on the application of competition principles to local government makes it clear that CN principles should be applied, where appropriate, to SBAs conducted by local governments unless the costs of implementation are estimated to exceed the benefits. SBAs are classified as business activities with an annual revenue of more than \$2 million or assets of more than \$20 million (category 1), or all other SBAs (category 2). The corporatisation or commercialisation models are recommended for larger SBAs, with cost-reflective pricing being recommended in the clause 7 statement for smaller business activities such as caravan parks. Most councils in South Australia are involved in small-scale business activities, and cost-reflective pricing is the most common principle being applied. Four councils are conducting some category 1 businesses and typically using the commercialisation approach. Local governments are encouraged to establish their own mechanisms for handling CN complaints; the complaint must be separate from the party or matter that is the subject of the complaint. Where resolution cannot be achieved, the Government may appoint a Competition Commissioner to investigate the matter.

In Tasmania, local governments are required to corporatise those PTEs where a public benefit assessment indicates that the benefits exceed the costs, and

apply full cost attribution to all other SBAs. Several councils have applied full cost accounting to all of their SBAs. CN complaints on local government business activities can be made with the Government Prices Oversight Commission. Tasmania is currently revising its policy on the application of CN to local government.

8.3 Possible best practice

The following are the main features of a possible best practice approach to the application of CN to local government.

- The criteria for defining of *significant* business activities should be similar to those for government activities, involving consideration of the activity's impact on the market.
- The status of significance should be reviewed regularly, with expansion of market share being an important indicator.
- Corporatisation should be the preferred approach for larger local government business activities. In other cases, commercialisation or full cost pricing is appropriate. All advantages and disadvantages arising from government ownership should be removed.
- The features of a best practice approach to full cost pricing described in section 4.3 are appropriate for local government businesses as well.
- Complaints should be considered by the local government in the first instance, but with a body separate from local government to be available if the local government cannot resolve the complaint or if the complainant wishes to go beyond the council.

9. Government business activities not subject to executive control

Some entities fall within the broad legal ambit of governments, but are not subject to the executive control of government. The size of some of these entities is substantial. Universities are a prime example. They compete actually or potentially with private tertiary institutions in education, and with private research entities in research and development. In addition, they play a large role in providing accommodation, catering and convention facilities.

CoAG recognised the difficulty which governments face in applying CN to entities which are outside the executive control of governments, but accepted

the importance of applying CN principles in this area. CoAG's communiqué of November 2000 encouraged a 'best endeavours' approach.

In several cases, governments have reported that they have alerted entities over which they do not have executive control (in particular, universities) to their CN policies. Each jurisdiction could continue to contribute to CN outcomes with such entities by undertaking the following steps.

- In providing the government's CN policy statements to the entities, ensuring representatives of the competition policy unit in each jurisdiction explain the benefits from adopting CN and the main features of the jurisdiction's CN policy.
- Making competition policy unit staff available to deal with queries which would assist the entities' introduction of CN policies.
- Preparing information packages specific to the application of CN to these entities, especially to universities (reflecting their size and diversity, and the importance of their activities in terms of education, research, tendering, contracting and the leasing of facilities). Governments have prepared packages to assist local governments to implement CN; such packages for the tertiary education sector could play a very useful role in the sector's CN implementation.
- Establishing regular meetings (say, once a year) between competition policy units and the leaders of the entities, to update the entities on the jurisdiction's CN policies.
- Requesting that the entities provide reports on their CN implementation to the competition policy units at each of these meetings.
- Undertaking a joint review of the ways in which CN policies can contribute to improved information flows and resource allocation outcomes in the entities.
- Offering to assist CN implementation, including the estimation of full cost prices.
- Encouraging these entities to introduce competitive tendering and contracting principles that are based on those of the government. At a minimum, any in-house bidders should be separate from that part of the entity that is responsible for evaluating tender bids. The in-house bidders also should bid prices that reflect full cost attribution.
- Offering to deal with CN complaints that the entities cannot deal with successfully.
- Offering to adjudicate in any challenges to tender decisions.

10. Resource allocation among private entities

Under the CPA, CN is concerned with removing resource allocation distortions that arise from government entities having advantages or disadvantages, as a result of their public ownership, compared with potential or actual private sector competitors. In some industries, government decisions on pricing, subsidies and access to resources appear to have differential impacts on private sector participants in the same industry. These decisions could be considered to have effects similar to those that CN policies seek to address. While there is no obligation under the NCP, there is a case for governments to consider carefully the impacts of such decisions on firms in an industry.

The resource allocation effects of such policies can be significant, with investment being discouraged in those sections of the industries not enjoying support from the government decisions. Consideration of the resource allocation effects of such decisions and provision of information would inform the public and the governments. Increased transparency would assist governments to undertake public benefit tests of the case for supporting a government entity.

In material provided to assist the development of this paper, one government commented that for some years its Treasury has broadened the consideration of 'competitive neutrality' implications to instances where government assistance may be provided. This is particularly the case when an industry participant requests assistance, such as grants or tax relief.

The following are examples of government decisions that could have differential impacts on private sector participants in an industry and resource-distorting effects.

- State forest agencies make decisions about access by timber companies to native (hardwood) forests, and the cost of the extracted timber to those companies. There appears to be a case for the relevant governments to review the impact of these allocation and pricing decisions, to assess whether the decisions lead to any disparities in access of companies to timber in native forests, and whether they discourage hardwood plantation companies. These possible effects are sometimes claimed, and reviews of the governments' policies may clarify the impacts on resource allocation. In its 2001 report on CN in forestry, the CCNCO commented that:

... there have been longstanding concerns that underpricing by State forest agencies hampers the development of private plantations ...

Log prices play a key role in determining the value of forest assets and are a major determinant of forestry agencies' financial performance. To some extent, log prices are at agencies' discretion. This raises the

question of how the market value of logs is most appropriately determined. ...

There are few recent studies available to gauge whether underpricing is still prevalent. ... However, .. it is likely that reforms implemented over the last decade or so have reduced the frequency of log sales at less than their potential market value. ...

Underpricing of logs from State forests can have adverse effects on the establishment and ongoing operations of private wood producing enterprises. However, the impact of underpricing can only be determined on a case by case basis. ...

Pricing policies and the terms on which harvesting licences are allocated are generally confidential ... The limited information available in Australia denies the community information on a very significant natural asset and inhibits scrutiny of the pricing practices of State forest agencies ... The absence of public information on market prices and conditions ... may constitute an impediment to private investment in forestry ... (CCNCO 2001, pp. 1–44)

- On occasions, Australian governments provide specific subsidies or other support to particular companies. In some cases, it is argued that the support is necessary to ‘kick start’ a research and development project, or a new product that will have benefits for the community as a whole. In other cases, governments provide support under duress, where a company argues that support is necessary to ensure the continued presence of the company in the jurisdiction, or its new capital investment in that jurisdiction rather than another. Such support is likely to raise concerns among competitors about the ‘competitive neutrality’ or ‘even-handedness’ of government policies across the industry. Governments also need to account for the issue of ‘moral hazard’ in those instances where support is given to poorer performing entities. Resource allocation considerations suggest that governments should not intervene too often in markets on the basis of the relative efficiencies of firms. Governments have the right to support particular firms, but such instances should be few and the circumstances underpinning the governments’ decisions should be transparently communicated. Governments should undertake public interest tests to underpin their decisions.

11. Getting the most from competitive neutrality policy

This discussion paper covered a wide range of CN issues. It reviewed important aspects of CN implementation by governments since the CPA was signed in April 1995 and governments’ CN policy statements were issued in 1996. Six years later, it is timely to consider the different approaches which

have been adopted and the scope for drawing on the best ideas of these approaches. This paper also sought to offer fresh ideas, especially to supplement the CN policies in place.

Suggestions for possible best practice approaches were provided in the sections on the scope of CN, costing and pricing, complaints mechanisms, and CN in local government. Governments are invited to consider whether adopting aspects of these suggested best practice approaches would enhance their CN policies.

Other sections concerned with aspects not explicitly covered by the CPA — namely, CSOs, competitive tendering and contracting, government entities not subject to executive control, and resource allocation among private entities — suggested approaches that governments may find useful in enhancing their CN implementation.

There may be merit in jurisdictions considering an ‘audit’ of the effectiveness of their CN policies — that is, a review of their CN implementation against their existing CN policies, and a review of these policies against the best practice suggestions in this paper. Such a thorough review every few years is likely to pay dividends, because the implementation of CN is quite complex and some important aspects may be overlooked as a result of the many demands on governments.

The paper is also intended to contribute to greater public awareness of CN and the role that CN can play in improving resource allocation and economic outcomes.

Abbreviations

ABS	Australian Bureau of Statistics
CCNCO	Commonwealth Competitive Neutrality Complaints Office
CN	Competitive neutrality
CoAG	Council of Australian Governments
CPA	Competition Principles Agreement
CPU	Competition Policy Unit
CSO	Community service obligation
GBD	Government Business Division (Northern Territory)
GBE	Government business enterprise
GPOC	Government Prices Oversight Commission (Tasmania)
ICRC	Independent Competition and Regulatory Commission (Australian Capital Territory)
IPART	Independent Pricing and Regulatory Tribunal (NSW)
NCC	National Competition Council
NCP	National Competition Policy
PFE	Public financial enterprise
PTE	Public trading enterprise
QCA	Queensland Competition Authority
SBA	Significant business activity
SCCB	State Contracts Control Board (New South Wales)
SOC	State owned company (New South Wales)
WACC	Weighted average cost of capital

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