2 The Competition Principles Agreement reforms

Signed by all governments in 1995, the Competition Principles Agreement (CPA) establishes the principles for governments to apply in reviewing and reforming legislation, reforming public monopolies and applying competitive neutrality. Legislation (including new legislation) should not restrict competition unless the benefits of the restriction to the community outweigh the costs, and the objectives of the legislation can be achieved only by the restriction. CPA clause 1(3) lists public interest matters to consider in the comparison of community costs and benefits, but the comparison can account for other factors as well. This chapter describes the National Competition Council's approach to legislative reviews that have not been completed.

The CPA clause 4 sets down that governments should remove regulatory functions from a public monopoly before introducing competition into its market. Before privatising a public monopoly, a government should review matters set down in clause 4, including the appropriate commercial objectives of the monopoly, the merits of separating any natural monopoly elements from potentially competitive elements of the monopoly, and the most effective means of separating the monopoly's regulatory functions from commercial functions.

The CPA clauses 3 and 7 establish the principles for applying competitive neutrality to significant business activities, including at the local government level. All governments have made considerable progress in introducing competitive neutrality to their businesses and those of their local governments. The Council is concerned, however, about the slow processing of some competitive neutrality complaints.

Achieving effective legislation

The National Competition Policy (NCP) introduced several measures aimed at improving the effectiveness of Australia's regulatory arrangements via the three NCP agreements: the CPA, the Conduct Code Agreement and the Agreement to Implement the National Competition Policy and Related Reforms. This section focuses on the obligations in CPA clause 5 and discusses the questions that the Council considers in assessing governments' compliance.

Clause 5 of the CPA obliges governments to review and, where appropriate, reform all existing (at June 1996) legislation that restricts competition. It

requires governments to remove restrictions on competition unless they show the restrictions are warranted — that is, that restricting competition benefits the community overall (being in the public interest) and that the restriction is necessary. Clause 5(1) states:

> *The guiding principle is that legislation (including Acts, enactments, Ordinances or regulations) should not restrict competition unless it can be demonstrated that:*
>
> *(a) the benefits of the restriction to the community as a whole outweigh the costs; and*
>
> *(b) the objectives of the legislation can only be achieved by restricting competition*. (CoAG 1995)

The CPA clause 5 originally set a target date of 2000 for governments to complete all reviews and (appropriate) reform activity. The Council of Australian Governments (CoAG) decided in November 2000 to extend this target date to 30 June 2002 (CoAG 2000).

Clause 5 also obliges governments to review regularly any restrictive legislation against the guiding principle; reviews are to occur at least once every 10 years. This obligation is designed to ensure that regulation remains relevant in the face of changes in the circumstances that gave rise to the legislation originally and/or changes in government and community priorities over time. Finally, clause 5 specifies that governments must ensure new legislation that restricts competition (that is, all restrictive legislation enacted after June 1996) is accompanied by evidence to demonstrate that the restrictions are consistent with the CPA clause 5(1) guiding principle. This is an ongoing obligation for governments.

Governments' CPA legislation review and reform commitments represent an extremely comprehensive reform effort over a relatively short period. The Commonwealth and the eight States and Territories will have reviewed more than 1800 pieces of legislation by the time they complete their programs. The scope of legislation being reviewed is broad, encompassing, for example, legislation regulating agricultural marketing arrangements, forestry, fishing, transport services (including taxis), professions and occupations, compulsory insurance arrangements, retail trading hours, liquor licensing, the education sector, gambling activities, the communications sector, and planning, construction and development services. Subsequent chapters of this report discuss governments' compliance with the CPA legislation review and reform obligations.

Two obligations in other NCP agreements also aim to improve the effectiveness of Australia's regulatory base. The first obligation is that governments must ensure decisions taken by Ministerial councils and national standard-setting bodies (entities aimed at improving Commonwealth–State/Territory coordination) are set according to the principles and guidelines endorsed by CoAG. The CoAG principles and guidelines reflect the CPA guiding principle: they seek minimum necessary

standards, accounting for economic, environmental, and health and safety concerns. Governments' compliance with this obligation is discussed in chapter 15. The second obligation — an ongoing commitment under the Conduct Code Agreement — is that governments must notify the Australian Competition and Consumer Commission (ACCC) of legislation or provisions in legislation enacted or made in reliance on s. 51(1) of the *Trade Practices Act 1974* (the TPA). Governments' compliance with the Conduct Code Agreement is discussed in chapter 16.

Assessing governments' compliance with the CPA clause 5: the Council's approach

Under the NCP agreements, receipt of NCP payments by each State and Territory depends on the extent to which each jurisdiction has complied with the competition policy principles in the CPA, including its progress towards completing reviews and implementing appropriate reforms of legislation that restricts competition. The 2002 NCP assessment considers review and reform activity by governments up to and including 30 June 2002 — the date set by CoAG for completing reviews and implementing appropriate reforms. The Council concentrated on regulation that is likely to have more significant impacts on competition, prioritising the assessment of areas where reform would provide the greatest benefit to the community.

The Council considers both review activity and reform implementation when assessing governments' compliance. It looks for robust and objective reviews because these increase the likelihood of policy outcomes that are in the public interest. The Council also looks for governments to implement review recommendations expeditiously, unless a government can demonstrate that review recommendations are not in the public interest. It considers too whether new legislation restricting competition is in the public interest.

Prioritising review and reform activity: focusing on regulation with greater impacts on competition

In the 2001 NCP assessment, the Council identified several areas of regulation likely to have nontrivial impacts on competition (see box 2.1). The Council asked governments to review and reform these matters as 'priorities' — that is, to complete review and reform activity in these areas as soon as possible and by no later than the CoAG target date. The Council recognised the significant resource demands on governments from completing all reviews and implementing reforms, and considered that the greatest benefit to the community would arise from prioritising review and reform activity to address as soon as possible the restrictions with a greater impact on competition.

Accordingly, the Council based the 2002 NCP assessment of compliance on governments' progress in completing reviews and implementing appropriate reforms in the higher impact areas identified in 2001. This approach acknowledges that governments might not have completed review and reform activity in other, lower priority areas by 30 June 2002. The prioritisation in 2001 therefore created a two-stage process for assessing review and reform activity: the 2002 NCP assessment would consider the priorities identified in 2001, while the 2003 NCP assessment would finalise all remaining legislation review and reform matters.

Prioritising the assessment also allows the Council to deal with information deficiencies arising because the date of the Council's 2002 report coincides with the target date for governments to complete the review and reform program. This coincidence of timing means that governments' 2002 NCP annual reports, which are the Council's primary data source for the 2002 NCP assessment, do not contain details of governments' activity between the release of the annual reports and the finalisation of the Council's assessment report. While the Council has taken steps to obtain information about governments' activity on the outstanding priority issues since the annual reports were released, it has been unable to obtain a complete picture on every piece of legislation. The 2003 NCP assessment, which will take place in mid-2003 and will rely on governments' annual reports covering activity to at least 31 December 2002, will not suffer from such difficulties.

Governments occasionally have added to their original (1996) review programs when they identify restrictive legislation that was not originally scheduled for review. The Council accepts that governments may need time beyond the CoAG target to complete these extra reviews. For later additions to governments' legislation review programs, the Council assesses clause 5 compliance on a case basis.

Box 2.1: Priority legislation areas

Primary industries
Barley/coarse grains
Dairy
Poultry meat
Rice
Sugar
Wheat
Fishing
Forestry
Mining
Food regulation
Agricultural and veterinary chemicals
Quarantine
Bulk handling

Communications
Australian Postal Corporation Act 1989: third party access regime
Broadcasting Services Act 1992 and related legislation
Radiocommunications Act 1992

Fair trading legislation and consumer legislation
Fair trading legislation
Consumer credit legislation
Trade measurement legislation

Insurance and superannuation services
Workers compensation insurance
Compulsory third party motor vehicle insurance
Professional indemnity insurance
Public sector superannuation: scheme choice

Health and pharmaceutical sector
Chiropractors
Dentists and dental paraprofessionals
Health Insurance Act 1973 (Commonwealth)
Medical practitioners
Medicare provider numbers for medical practitioners
Nurses
Occupational therapists
Optometrists, opticians and optical paraprofessionals
Osteopaths
Pathology collection centre licensing
Pharmacists
Physiotherapists
Podiatrists
Psychologists
Radiographers
Speech pathologists
Traditional Chinese medicine

Legal sector
Legal profession

Planning, construction and development services
Planning and approvals
Building regulations and approvals
Related professions and occupations, such as architects

(*continued*)

Box 2.1 continued

Retail regulation
Shop trading hours
Liquor licensing
Petroleum retailing

Social regulation
Education services
Gambling
Child care services

Transport services
Road freight transport: tow trucks, dangerous goods
Rail services
Taxi and hire cars
Ports and sea freight
International liner cargo shipping (part X of the TPA)

Objective and robust reviews

Throughout the life of the NCP, the Council has emphasised the link between high quality reviews and well-considered, effective policy outcomes. Open, independent and objective review processes provide the best opportunity to identify and assess all costs and benefits of restrictions on competition and to implement regulations (including alternatives to restrictions) that best achieve the community's goals.

The Council has consistently encouraged governments to adopt independent review processes. Governments sometimes argue, however, that the inclusion of stakeholders representatives on review panels is necessary to achieve the best review outcome — that is, to achieve adequate participation by the stakeholder group, to gain access to relevant information and expertise, and to find compromises between conflicting interests. The Council's experience, however, is that it is often difficult for direct stakeholders to reach agreed positions on key issues. There is also considerable doubt that agreements between directly interested parties will fully reflect the interests of the wider community.

The Council strongly supports the approach proposed by the Commonwealth Office of Regulation Review (ORR). In commenting on how interested parties may be best involved, the ORR stated:

> *One issue, which has arisen, is the appropriateness of industry and other stakeholder groups being represented on review bodies. While this may offer some advantages, it can also alter perceptions about the impartiality of such reviews and the validity of their findings. In general, if direct representation by industry or other groups were considered desirable, a preferable approach would be to include them on a reference group.* (PC 1999c, p. xviii)

The Council notes that CoAG has drawn attention to the need for properly constituted and rigorous reviews. CoAG asked the Council to consider, when assessing whether jurisdictions have complied with the CPA clause 5 guiding principle has been met, whether review conclusions are within a range of outcomes that could reasonably be reached based on the information available to a 'properly constituted review process'.

Also important is a rigorous analytical approach, whereby the review considers all relevant evidence and reaches conclusions and recommendations that are logically drawn from that evidence. There is a danger that policy actions in line with review findings and recommendations based on flawed analysis or incomplete evidence may not satisfy the CPA guiding principle. The Council's approach in assessing compliance, therefore, is to look for evidence that reviews:

- had terms of reference based on the CPA clause 5(9), supported by publicly available explanatory documentation such as an issues paper;
- were conducted by an appropriately constituted review panel able to undertake an independent and objective assessment of all matters relevant to the legislation under review, including restrictions on competition and public interest matters;
- provided for public participation (including participation by directly interested parties) through appropriate consultative processes;
- assessed and balanced all costs and benefits of existing restrictions on competition and considered alternative means of achieving the objective of the legislation;
- considered all relevant evidence and reached reasonable conclusions and recommendations based on the evidence before the review; and
- demonstrated a net public benefit where there are recommendations to introduce or retain restrictions on competition.

In assessing compliance, the Council accounts for whether flaws might have compromised the review's recommendations. Flaws can occur for a number of reasons, such as where the review terms of reference do not encompass relevant questions, the review analysis is deficient and leads to recommendations that are inconsistent with the evidence, or the review fails to consider relevant evidence. In this 2002 assessment, the Council has identified (a) reviews where the direct representation of stakeholder groups on review panels appears to have adversely affected the quality of review recommendations, and (b) reviews where analytical flaws raise a question about recommendations and, consequently, about whether policy actions in line with the recommendations would meet the CPA guiding principle.

The need for governments' responses to address the CPA clause 5 guiding principle

Testing whether restrictions on competition are warranted — that is, assessing benefits and costs to the whole community — involves governments considering the public interest factors in the CPA clause 1(3) (including the likely impacts of reform on specific industry sectors and communities). The community-wide perspective means that restrictions must benefit the whole community, not just particular groups. In assessing compliance with the CPA clause 5, the Council looked for governments to have provided at least a statement of the findings/recommendations of relevant reviews, and a clear and comprehensive explanation of their response to the review and its supporting rationale. (CoAG emphasised the importance of governments explaining their decisions, stating that they should document the public interest reasons for a decision or assessment and make them available to interested parties and the public.)

Because NCP reviews are required to assess and balance the costs and benefits of restrictions, arguments supporting a restriction usually arise through the evidence and recommendations of the relevant review. Moreover, open public policy-making offers a public benefit, which is enhanced where members of the public can participate in the review of legislation and have access to the review report. For these reasons, the Council has encouraged governments, as part of their public interest explanations, to make their review reports publicly available (recognising, however, that the NCP agreements do not require the public release of reports).

Queensland's approach, which it applies to all CPA obligations and which it explains in its 2002 annual NCP report, is that reform should not occur unless the net community benefits from reform can be clearly demonstrated (Queensland Government 2002, p. 12). Queensland considers that to undertake reform where there is no clear net community benefit would amount to implementing competition for competition's sake, and would be contrary to the intent of the NCP. The presumption underlying CPA clause 5 favours competition, so governments wishing to retain a legislative restriction in compliance with the CPA need to demonstrate that the restriction provides a net community benefit. Queensland's approach, therefore, may be potentially at odds with the CPA clause 5 guiding principle. The Council discussed its concerns with the Queensland Premier, who explained that there is no difference in practice between Queensland's approach and the CPA guiding principle.

Implementing appropriate reform

The CPA guiding principle means that governments must do more than review restrictive legislation; they need to change their legislation if restrictions cannot be justified. That is, governments must not only conduct rigorous and objective reviews, but also implement appropriate reform.

Appropriate reform implementation involves governments removing restrictions on competition from their legislation unless the restrictions meet the CPA guiding principle. Governments may, therefore, retain legislative restrictions on competition, but then are obliged to show that the restriction(s) is warranted via a robust net community benefit case.

Appropriate reform implementation may include, where justified by a public interest assessment, having a firm transitional arrangement that extends beyond 30 June 2002 (CoAG 2000). The Council considered in this 2002 assessment that governments have met their CPA obligations, even if they did not complete reforms by 30 June 2002, where they:

- presented a robust net community benefit case to support the (temporary) retention of restrictions beyond June 2002; and
- announced a transitional strategy for removing the restriction within a reasonable period from June 2002 (for example, by 'locking in' the reform through legislation).

In this assessment, the Council looked for governments to ensure reform outcomes that restrict competition have regard to review recommendations (assuming reviews were properly constituted and conducted). For compliance, governments need to provide a public interest rationale for competition restrictions that is supported by relevant evidence and robust analysis.

- Where a government has introduced or retained competition restrictions on the basis of review recommendations, but the review does not provide clear reasoning and argument to support its recommendations, the Council has looked for the government to make transparent the evidence and logic underlying its decision.
- Where a government has introduced or retained competition restrictions, but this approach is not reasonably drawn from the recommendations of the review, the Council has looked for the government to provide a rigorous supporting case, including a demonstration of flaws in the review's analysis and reasoning.

The CPA guiding principle does not mean that governments must always conduct a full public review before reforming restrictions. Governments sometimes repeal redundant legislation after preliminary scrutiny shows that the legislation provides no public benefit. Such action meets the CPA objectives. Similarly, a government may choose to disregard a review recommendation supporting a restriction or seek to achieve policy outcomes via an approach other than that recommended by a review. Where a government has not implemented the recommendation of a properly constituted rigorous review, however, the Council has looked for the government to provide a robust net community benefit argument, explaining why the approach recommended by the review is inappropriate.

Different regulatory approaches across jurisdictions

The NCP provides for the possibility of different governments using different regulatory approaches to similar problems. Different governments may evaluate the various factors differently and thus reach a different conclusion on the appropriate approach. Given that Australia is essentially one national market, however, there is a strong argument that uniform or consistent regulation across jurisdictions is likely to benefit the community by reducing regulatory imposts on businesses and service providers, and ultimately leading to lower prices to consumers. The Council looks for governments to be cognisant of the approaches adopted in other jurisdictions, particularly where these involve removing restrictions on competition.

The NCP facilitates greater legislative consistency in various ways. First, the CPA offers scope for national reviews. It provides that a government, where one of its reviews has a national dimension or effect on competition (or both), should consider whether the review should be a national review. Twelve national reviews have been scheduled under the NCP. Nine have been completed, although the relevant governments still have to undertake the necessary legislative action in most cases. Progress with national reviews is discussed in chapter 15.

Apart from national reviews under the NCP, governments have implemented mutual recognition since 1993. Mutual recognition is aimed at creating a regulatory environment that will 'encourage enterprise, enable business and industry to maximise their efficiency, and promote international competitiveness' (CoAG 1998). The Commonwealth *Mutual Recognition Act 1992* and related State and Territory mutual recognition legislation aim to achieve a national market in goods and services via two principles:

- that goods that may be sold legally in one State or Territory may be sold in a second State or Territory, regardless of differences in standards applying to goods in the relevant jurisdictions; and

- that a person who is registered to practise an occupation in one State or Territory be able to register to practise an equivalent occupation in a second State or Territory.

Questions of mutual recognition may arise where occupations are registered in some, but not all jurisdictions. The NCP assessment implications are discussed in chapter 6 (health and pharmaceutical services), chapter 8 (other professions and occupations) and chapter 13 (planning, construction and development services).

New legislation that restricts competition

The CPA clause 5(5) obliges governments to ensure proposals for new legislation that restricts competition are accompanied by evidence to show that the legislation provides a net benefit to the community and that the

restriction is necessary to achieve the objectives of the legislation. Clause 5 therefore has two broad elements: it establishes the program of review and reform of existing restrictive legislation against the CPA guiding principle, and it requires governments to ensure all subsequent restrictive legislation meets the guiding principle.

The obligation regarding new legislation has been an ongoing obligation for governments since the signing of the NCP agreements in 1995. In response, all governments have established arrangements for 'gatekeeper' scrutiny of the competition impacts of new and amended legislation. Box 2.2 summarises these arrangements in each jurisdiction.

The Council considers each government's performance against the CPA clause 5(5) obligation in each NCP assessment. In this 2002 assessment, the Council considered new legislation in the priority areas to check that gatekeeper scrutiny is ensuring new legislation meets the CPA guiding principle and therefore addresses governments' policy objectives as effectively as possible. Subsequent chapters discuss relevant legislation.

Box 2.2: Arrangements for scrutiny of new restrictive legislation, by jurisdiction

Commonwealth Government

A Regulation Impact Statement (RIS) must be prepared for all new and amended legislation regulation with the potential to restrict competition or impose costs or confer benefits on business. The RIS must clearly identify a problem and relevant policy objectives, and assess the costs and benefits of alternative means of fulfilling the objective. The ORR advises on whether the RIS process requirements have been met, including advising the Government on whether the RIS provides an adequate level of analysis. The ORR also provides guidance and training to agencies on the preparation of RISs.

New South Wales

All agencies developing or amending legislation that restricts competition are required to assess competition effects. The Cabinet Office scrutinises all proposals for new legislation that restricts competition to ensure that there is evidence demonstrating that new restrictions are consistent with the CPA guiding principle.

Victoria

Victoria assesses all proposals for new restrictive legislation against the public interest test. The assessment accounts for the CPA clause 5 guiding principle of the benefits of the restriction to the community as a whole outweighing the costs, and the objectives of the legislation only being achievable by the restriction. Cabinet submissions on legislative proposals include a NCP Impact Assessment section. The Department of Treasury and Finance advises the Treasurer and Cabinet on NCP issues, and assists departments on NCP matters.

Queensland

Before Cabinet consideration, all new (including amending) legislation that restricts competition must be subject to a public benefit test. In 2001, Queensland introduced 18 pieces of legislative amendment, or new legislation, that had been subjected to scrutiny under its legislation gatekeeping arrangements.

Western Australia

The Department of Treasury and Finance advises agencies on NCP obligations and encourages agencies to consider NCP principles at an early stage of preparing new law. Western Australia's legislative process contains a mechanism to ensure Treasury and Finance is formally informed of progress on new legislation. Where Treasury and Finance considers a proposed new law has the potential to restrict competition, it liaises with the proponent agency to ensure the law is appropriately reviewed. Reviews of new legislation are conducted in the same way as reviews of existing legislation. Since 1996, the gate-keeping process has identified 80 proposals for new laws that contain potential restrictions, including 15 in 2001.

The Department of Treasury and Finance may present its advice to the Cabinet directly if it considers that the agency proposing the new legislation has not appropriately addressed NCP issues.

South Australia

All agencies considering new legislation or amendments to existing legislation are to follow a process developed by the Department of Premier and Cabinet and endorsed by departmental chief executives. The process requires agencies developing policy to consider restrictions on competition; to show in Cabinet submissions seeking approval to draft legislation that competition issues have been considered; and to address competition issues in the second reading speech of Bills to Parliament.

(*continued*)

Box 2.2 continued

Tasmania

Tasmania's gatekeeping process examines all proposals for new legislation including against NCP principles. The gatekeeper process has assessed more than 500 legislative proposals since 1996.

The ACT

The ACT Government requires regulatory impact statements to be prepared on all proposed new or amended legislation and subordinate legislation (for example, regulations) or government direction, as part of the policy development process. Cabinet submissions must indicate whether their recommendations have any competition policy implications. The Department of Treasury advises departments in the preparation of the regulatory impact statements.

The Northern Territory

In the Northern Territory, all Cabinet submissions on legislative proposals must comment on whether the proposed legislation includes new restrictions on competition. If so, the proposing agency must analyse the community benefits and costs of the restriction and whether the restriction is the only way to achieve the objective of the legislation.

Structural reform of public monopolies

Protection of some public monopolies from competition, through regulation or other government policies, has allowed structures to develop that do not readily respond to market conditions. Rectifying strategies include removing the relevant legislative restrictions and applying competitive neutrality principles, but these reforms will not always be sufficient to establish effective competition. Structural reform may be needed to dismantle a government business that has developed into an integrated monopoly. Such reform involves splitting the monopoly (or parts of it) into smaller entities, including splitting the competitive or potentially competitive elements from the monopoly elements.

Structural reform is particularly important where a public monopoly is to be privatised. Privatisation without appropriate reform will result in a private monopoly supplanting the public monopoly, with few real gains and potentially considerable risks.

Obligations relating to the structural reform of public monopolies are set out in clause 4 of the CPA. Under this clause, governments agreed to relocate regulatory functions away from the public monopoly before introducing competition into the market served by the monopoly. The aim is to prevent the former monopolist enjoying a regulatory advantage over its (existing or potential) competitors.

Clause 4 also sets out review obligations aimed at ensuring that reform paths lead to competitive outcomes. Before introducing competition into a sector

traditionally supplied by a public monopoly or privatising a public monopoly, governments have undertaken to review:

- the appropriate commercial objectives of the public monopoly;
- the merits of separating potentially competitive elements of the public monopoly from the natural monopoly elements;
- the merits of separating potentially competitive elements into independent competing businesses;
- the best way of separating regulatory functions from the monopoly's commercial functions;
- the most effective way of implementing competitive neutrality;
- the merits of any community service obligations (CSOs) provided by the public monopoly, and the best means of funding and delivering any mandated CSOs;
- the price and service regulations to be applied to the relevant industry; and
- the appropriate financial relationship between the owner of the public monopoly and the public monopoly.

In this 2002 assessment, the Council considered each jurisdiction's structural review and reform activity (including the location of industry regulation) where competition is to be introduced to public monopoly markets or where privatisation is proposed or under way. Subsequent chapters discuss particular structural reform matters. In particular, the Council considered that government decisions regarding the Western Australian electricity sector, Sydney Airport and South Australian ports generated clause 4 obligations.

Competitive neutrality

Competitive neutrality involves placing significant government business activities on the same footing — for taxes, interest costs and regulations — as their actual or potential private competitors, to the extent that the benefits to be realised from implementation outweigh the costs. It encourages governments to corporatise their significant government business enterprises and ensure the prices charged by other significant government businesses reflect full cost attribution.

Competitive neutrality aims to ensure Australia's resources are used as efficiently as possible, by removing from public businesses any net competitive advantage due to public ownership. Competitive neutrality allows

resources to flow to efficient government and private businesses. Publicly owned businesses will attract resources if they merit them, rather than because they have artificial advantages associated with government ownership. These resource allocation effects mean that community economic welfare is maximised from a given level of resources.

By placing government business activities on a similar competitive footing to that of their actual or potential private competitors, competitive neutrality establishes conditions for increased participation in industries, thus promoting competition with flow-on benefits to consumers.

The increased transparency and accountability associated with competitive neutrality encourage improved performance by government businesses. The businesses cannot hide behind the protection given by the advantages that they previously enjoyed, which often encouraged complacency about their efficiency. Improved performance contributes to better services and lower prices for users of the services, and reduced demands on taxpayers. In these ways, competitive neutrality supports the effectiveness of the performance monitoring regimes that many governments introduced for their businesses in recent years.

There are other important benefits of competitive neutrality. Governments that own the businesses are in a better position to assess the future of the business, and recognise the costs of community service obligations (CSOs) that previously government businesses might have provided through cross-subsidies. This recognition leads to improved government decision-making about CSOs. Competitive neutrality helps owner governments to make better informed decisions about the future of their entities. Full attribution of costs often leads governments to assess afresh whether they wish to provide a good or service directly through a government business, to allow competitive bidding for the provision of the good or service, or to vacate the area of production.

Clause 3 of the CPA obliges all governments to introduce competitive neutrality, where it is in the net public interest, for government business enterprises and for other significant government business activities. Clause 7 of the CPA extended these obligations to significant local government business activities.[1] Governments were required to establish principles for identifying significant government business activities to which competitive neutrality should be applied, and a mechanism for hearing complaints of noncompliance with competitive neutrality principles and policy. The capacity of individuals or firms to make complaints is important to the robustness of competitive neutrality arrangements.

[1] The Commonwealth and the ACT do not have local government sectors. The Council agreed in its 1997 NCP assessment that the relatively small size of local government businesses in the Northern Territory obviated a need to apply competitive neutrality principles to local government business activities. Local governments in the Northern Territory are small and provide relatively few services themselves, instead providing services via contractors.

Clause 3 of the CPA allows for competitive neutrality not to apply to small government business activities, on the ground that the costs of implementing competitive neutrality for such businesses are likely to exceed the benefits. Most jurisdictions determine significance on a case basis, with reference to turnover thresholds and market impacts.

All governments have made good progress in implementing competitive neutrality. Each released its policy in 1996 and some have subsequently revised the policy. Many governments have also issued specific policy statements covering the application of competitive neutrality to local government business activities. The CPA gives each government the freedom to define and establish its own competitive neutrality arrangements (within the requirements of the CPA clause 3). As a result, differences in approach and emphasis have arisen among jurisdictions. These differences in competitive neutrality policies and application can highlight possible best practice, helping governments to enhance their policies in recent years.

Competitive neutrality obligations under the NCP

Clause 3 of the CPA defines the competitive neutrality obligations for governments. The following are the principal elements of this clause.

- For those significant government business enterprises that are classified by the Australian Bureau of Statistics as public trading enterprises and public financial enterprises, jurisdictions are required to adopt ('where appropriate') a corporatisation model and to 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 will ('where appropriate') implement the principles applicable to public trading enterprises and public financial enterprises, *or* ensure that the prices charged for goods and services take account ('where appropriate') of taxes or tax equivalents, debt guarantee fees and private sector equivalent regulations and reflect full cost attribution for these activities.

- The principles for public trading enterprises, public financial enterprises and other significant business activities need be implemented (in each case) only to the extent that the benefits outweigh the costs.

- Each government was required to publish a competitive neutrality policy statement by June 1996 (including a complaints mechanism), and must report annually on the implementation of the competitive principles, including allegations of noncompliance.

In November 2000, CoAG clarified some practical implementation issues and 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, a 'best endeavours' approach could be adopted. CoAG stated that this would require governments, at a minimum, to provide a transparent statement of competitive neutrality obligations to the business.

- Governments are not required to undertake a competitive process for the delivery of CSOs, and are free to determine who should receive a CSO payment or subsidy, which should be transparent, appropriately costed and directly funded by government.

- A range of costing methods, including fully distributed cost, marginal cost and avoidable cost, satisfy the term 'full cost attribution' in clause 3.

Governments' progress in implementing their obligations

The Council assesses each government's compliance with the competitive neutrality principles in the CPA by considering:

- the government's application of competitive neutrality principles to all government business enterprises and significant government business activities (including local government businesses) to the extent that the benefits from application outweigh the costs; and

- the government's use of effective processes for investigating and acting on complaints that significant government business activities are not applying appropriate competitive neutrality arrangements.

The Council has consistently emphasised the importance of effective competitive neutrality arrangements. In the 1997 NCP assessment, the Council said:

> *As the reform process continues, the Council will look in more detail at matters related to the effectiveness of jurisdictions' reform programs. This will encompass, in particular, consideration of the effectiveness of approaches to corporatisation, including performance monitoring arrangements, application of full cost pricing principles and delivery of CSOs.* (NCC 1999a, p. 57)

The concept of full cost attribution to significant business activities is a central aspect of competitive neutrality. An optimum of the current approaches applied by governments may have the following features.

- In addition to labour, raw materials and the competitive neutrality elements listed above (taxes or tax equivalents, debt guarantee fees and the costs of regulation equivalents), costs include a targeted rate of return, costs of noncurrent assets used and depreciation.

- Targets for rates of return are based on the weighted average cost of capital of each significant business activity, which measures the cost of the business activity's equity and debt.

- Other costs may also be relevant, even if not explicitly mentioned in the CPA. All jurisdictions' competitive neutrality policy statements note that local government rates and charges (or equivalents), for example, are an element of the full cost price. Unless government businesses undertake full cost attribution, they may be able to operate at lower profit levels than their competitors can and thus undercut them even if less efficient.

- Significant business activities 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.

While the CPA does not explicitly link the delivery of CSOs and competitive neutrality, the ways in which CSOs are delivered can have a significant bearing on competitive neutrality outcomes. The Council takes into account the extent to which CSOs are clearly defined, costed and directly funded by government (in line with the CoAG agreement of November 2000).

In relation to complaints handling, the Council noted the importance of an effective, generally accessible mechanism, stating that for the 1999 and 2001 NCP assessments it would take account of:

> *... the degree of independence of the mechanism, the intended scope of coverage including the nature of complaints which can be lodged, the transparency of reporting of complaints and findings and the ease of access for complainants.* (NCC 1999a, p.58)

The Council considers that governments should give their complaints bodies scope to investigate competitive neutrality complaints about all public businesses, particularly where the government does not require all businesses to apply competitive neutrality. Even where businesses are small (so the net benefit from applying competitive neutrality principles may not be clear), the investigation of complaints can provide the government with useful advice about appropriate policy action. Allowing complaints to be heard about all government businesses can sometimes establish that the impact of that business in the market is greater than previously thought.

Coverage of competitive neutrality principles

The Council monitors the coverage of the competitive neutrality principles in each of the jurisdictions. Now, six years after the publication of competitive neutrality policy statements, the Council expects that all significant government businesses (including at local government level) should be subject to competitive neutrality where appropriate, as intended by the CPA clause 3. In the first two NCP assessments, the Council accepted that it was appropriate for governments to apply competitive neutrality principles to their larger businesses as a transitional measure. The Council has always regarded business size thresholds as arbitrary and relatively inflexible measures of significance, however, and has consistently noted that significant businesses should be identified on the basis of their effect or potential effect on their relevant market(s).

While several governments apply minimum revenue thresholds for the purposes of defining *significant* business activities, governments also commonly account for the impact of a business on the markets in which in which it operates. Some governments allow competitive neutrality complaints to be made about any government businesses, which is a mechanism for ensuring an independent government entity could consider any significant impacts on private competitors.

Particular structural arrangements in some jurisdictions mean that failure by certain government businesses to apply competitive neutrality principles is *not* noncompliance. Where businesses are not subject to executive control (for example, universities and part privatised businesses where the relevant government is a minority shareholder and the privatisation took place before the NCP), CoAG directed that the Council should consider governments' compliance with CPA clause 3 on a 'best endeavours' approach. In several cases, governments have informed the Council that they have alerted entities over which they do not have executive control to the government competitive neutrality policies. CoAG indicated that this was a minimum requirement; there are additional possible steps for entities outside executive control. Governments have implemented some of these steps, including:

- making competition policy staff available to deal with queries to assist the entities' introduction of competitive neutrality;
- preparing information packages specific to the application of competitive neutrality to these entities;
- offering to deal with complaints; and
- holding regular meetings with the entities to review competitive neutrality implementation.

The Council Secretariat has received several inquiries from private companies about competition from university entities in bidding for contracts for research or educational work. Some inquiries have concerned universities'

provision of commercial recreational services. These inquiries underline the value of jurisdictions encouraging universities to apply competitive neutrality principles in their business activities through measures such as those described above.

The Council Secretariat has also received several inquiries about the business activities of local governments, especially with regard to recreational facilities. While it is appropriate for local governments to subsidise recreational services they see as a community priority, jurisdictions could consider encouraging local governments to transparently report such subsidies (in order to facilitate community knowledge of the local government's policy) and to regularly review the significance of their business activities.

Box 2.3 summarises government policies on defining significant government businesses. Box 2.4 provides information on particular government entities to which States and Territories recently extended (or are considering) the application of competitive neutrality.[2]

Box 2.3: Governments' approaches to defining significant government businesses

The **Commonwealth** applies competitive neutrality principles to all government business enterprises and their subsidiaries, other share-limited trading companies and all designated business units, competitive tendering and contracting bids, and other business activities with commercial receipts exceeding $10 million per year, while those businesses below $10 million per year are assessed for significance on a case basis. A commercial business activity with a turnover of less than $10 million may be required to implement competitive neutrality arrangements if an investigation by the Commonwealth Competitive Neutrality Complaints Office upholds a complaint that it is benefiting from its government ownership. (The Government does not apply tax equivalents to SBS because it is seen as incurring certain competitive disadvantages, such as limited advertising time. The Council considers such a 'trade-off' between advantages and disadvantages to be unusual, and recommends that these arrangements be reviewed.)

In **New South Wales**, competitive neutrality is applied to Public Trading Enterprises, State-owned corporations and General Government Businesses, where significant business activities are defined on a case basis. At the local government level, competitive neutrality is applied as follows: Category 1 businesses (which have annual sales turnovers/annual gross operating income higher than $2 million) must adopt a corporatisation model and apply full cost attribution. Category 2 businesses (less than $2 million annual gross operating income) are free to determine the extent of separation from mainstream activities, but must apply full cost attribution and make subsidies explicit.

In **Victoria**, the determination of significance for a government business (or a local government business) is based on the importance of the business in the market as measured by its size, competitive impact and the resources that it commands. Victoria does not apply competitive neutrality principles to some businesses — including businesses that do not compete with private companies; business activities that are small in relation to their markets in terms of size and competitive impact; and businesses that have mainly advisory or regulatory functions. Local government businesses in Victoria are subject to full cost attribution on a case basis.

(*continued*)

[2] Chapter 4 refers to competitive neutrality in the forestry sector.

Box 2.3 continued

Queensland classifies State Government businesses as 'significant' (for the purpose of implementing competitive neutrality principles) according to the scale of the business and its impact on the market. Queensland applies an indicative framework in assessing significance — that is, an expenditure threshold of $10 million is used as a guide to significance. Larger local government businesses are also subject to competitive neutrality, while financial incentives are used to encourage the application of competitive neutrality principles to smaller council businesses. Several smaller Queensland councils are still considering the application of competitive neutrality reforms to their business activities.

Western Australia determines significance on the basis of the importance to the State economy of the market in which the government business activity takes place. At the local government level, businesses with turnover of $200 000 or more are potentially subject to competitive neutrality.

South Australia uses impact on the market as the principal determinant of significance. Most councils are involved in small-scale business activities and cost-reflective pricing is the most common approach to competitive neutrality at the local government level.

In **Tasmania**, all GBEs, public trading enterprises and public financial enterprises at the State government and local government level apply corporatisation principles. The significance of other entities for competitive neutrality application is based on impact on the market. Tasmania is currently undertaking a review that will seek to more clearly identify significant business activities at the local government level. Tasmania expects to have revised by mid-2002 its policy statement on the application of competitive neutrality policy to local government.

In the **ACT**, the impact of the business on the market is the primary consideration in determining whether a government business activity is significant. All ACT government businesses are subject to competitive neutrality requirements.

The **Northern Territory** considers all 'government business divisions' and government business enterprises to be significant businesses.

Box 2.4: Instances of extended application of competitive neutrality

In its previous NCP annual report to the Council, **Queensland** reported that competitive neutrality is being introduced to the Public Trust Office in stages. The latest NCP annual report confirms that the Public Trust Office has fully implemented the first-stage reforms during 2001 and full cost pricing. The next stages of reform are being implemented during 2002.

Following a review in 2001, the Queensland Government endorsed the application of competitive neutrality principles to TAFE institutes — where they compete directly with private providers on price — and the implementation of a full cost pricing model for competitive purchasing and fee-for-service programs by February 2002. Legislation is being introduced to establish a new statutory authority to undertake the regulatory functions currently administered by WorkCover Queensland.

Western Australia reported in its 2002 NCP annual report that the Government is considering a competitive neutrality review of native forest timber operations (completed by independent consultants). The State completed a competitive neutrality review of the Valuer-General's Office in November 2000, which recommended that the office operate according to competitive neutrality principles. The office has introduced the change by pricing on a competitively neutral basis. Western Australia is drafting legislation to apply competitive neutrality to the Bunbury and Busselton Water Boards. The Government expects to complete competitive neutrality reviews of TAFE colleges and universities in 2002.

(*continued*)

Box 2.4 continued

South Australia reports that the then Government decided in late 2001 not to apply the *Public Corporations Act 1993* to the Public Trustee, and that competitive neutrality compliance options are being considered. In the case of Medvet Science, which is a subsidiary of the Institute of Medical and Veterinary Services, most commercialisation reforms have been implemented, with the exception of tax equivalents. This exception is under review.

Tasmania reported that the review of the exemption of the Port Arthur Historic Site Management Authority from income tax equivalents and dividends was completed in March 2001. The Government decided to exclude the authority from the national tax equivalents regime because it does not consider that the authority participates in a contestable industry and because there are public interest considerations (namely, conserving a major part of Australia's history and bringing tourists to the Tasman peninsula, which suffers from high unemployment).

The **Northern Territory** Government applied the Government-owned corporations framework to the Power and Water Corporation from 1 July 2002 while the application of the framework to other Government Business Divisions is to be considered on a case basis during 2003.

Defining and funding CSOs

The ways in which governments use their businesses to deliver CSOs can have a significant impact on resource allocation. Where public sector businesses are required to fund CSOs through cross-subsidies, they can be handicapped compared with private sector competitors. By increasing the prices of goods and services that fund the CSOs, cross-subsidies can hold back demand for goods and services. In some cases, funding through cross-subsidies has been supported by regulations that restrict competition for the government business, or by leniency in the rate of return required of the business. Such measures have reduced the achievement of competitive neutrality.

In November 2000, governments recognised (in the CoAG forum) that it is preferable for CSOs to be clearly identified, funded from the Budget and reported by the government. This approach eliminates resource allocation distortions, enhances community awareness of the CSOs and allows a better comparison with other demands on the public purse. Without careful and systematic identification and implementation of CSOs, market participants and taxpayers cannot determine whether the prices charged by a government business reflect full cost attribution (as required by the CPA clause 3) or contain an element of subsidy (or penalty) due to government ownership. Visible CSOs enable private firms to readily identify CSO payments to government-owned competitors and adjust their business decisions accordingly. Further, the ability of complaints processes to resolve pricing complaints expeditiously often depends on governments clearly defining and costing CSOs.

All governments acknowledged, in their competitive neutrality policy statements and related pricing guidelines, the need to clarify the objectives and specify the noncommercial obligations of their businesses. Governments'

policies and guidelines generally emphasise the importance to effective public policy of clearly identifying, defining and costing CSOs and explicitly funding them from the purchasing agency's budget.

The Council has no role in assessing whether CSO objectives are appropriate — that is a matter for governments. Rather, governments' provision of public information about their CSOs enables the Council to confirm that CSOs are specified and funded such that effective and transparent provision of CSO services is encouraged, with minimal impact on the efficient provision of other commercial services. Public reporting of information about CSO arrangements is important in verifying that governments' policy approaches are consistent with the efficient resource allocation objective of the CPA clause 3.

Box 2.5 summarises the governments' approaches to the delivery of CSOs.

Box 2.5: Community service obligation policies

The **Commonwealth's** annual NCP report notes that the 'intention' of competitive neutrality is to encourage 'more effective and transparent provision of CSOs', with 'minimal impact' on the efficient provision of other commercial services. The Commonwealth's policy is that CSOs should be funded from the purchasing portfolio's budget, with costs determined as part of a commercially negotiated agreement. If direct funding would entail proportionately large transaction costs (more likely to be the case with small government businesses), however, then portfolio Ministers can opt to purchase CSOs by notionally adding to the provider organisation's revenue result to calculate the rate of return. Where this is done, CSOs should be costed as if funded directly from the portfolio department's budget.

In **New South Wales** and **Queensland**, the relevant government business provides details of CSO payments in its financial and annual reports. Where any commercialised government business unit in Queensland delivers a CSO, the Government pays the unit and a CSO Agreement formally recognises the arrangement.

In **Victoria**, government business enterprises are required to disclose CSO obligations and funding in their corporate plans, and some are reporting on them in their annual reports. Victoria summarised CSO arrangements for all agencies in the supplementary tables of its 2002 NCP annual report. Many Victorian CSOs are funded by the Budget, but some entertainment or arts venues carry internally the cost of concessional entry fees.

Western Australia, Tasmania, the **ACT** and the **Northern Territory** identify and cost CSOs in their annual Budget process. In Western Australia, various means of funding CSOs are allowed, but direct Budget funding is the preferred approach. In Tasmania, the Government purchases CSOs from government business enterprises, and clearly identifies, justifies and separately accounts for those CSOs. The ACT's 2002 NCP annual report provides a table and costing of all of its CSOs.

South Australia's *Public Corporations Act 1993* requires, where relevant, that the arrangements for CSOs be set out in the charter of a public corporation, including the CSOs' nature, scope, costing and funding. The CSOs of commercialised South Australian entities are identified and costed. In relation to entities subject to cost-reflective pricing, South Australia advised that there is generally direct Budget funding of noncommercial functions. South Australia advised that a CSO working group is continuing its work to improve some procedural aspects of CSO policy arrangements, particularly purchaser–provider arrangements and the provision of information to the Government to assist its decisions on the approval and funding of CSOs.

Investigation of alleged noncompliance

All governments have instituted complaints processes and, in their NCP annual reports, document allegations and actions taken in response. Some governments require complaints to be made in the first instance to the government business that is the subject of the complaint, and then to an independent body or to the competition policy unit. In some jurisdictions, the independent body considers complaints only if the relevant Minister(s) decides this is appropriate.

Design of complaints mechanisms is a matter for each government; the CPA does not prescribe the mechanisms and processes. The question for NCP assessment of compliance is whether complaints are heard expeditiously and effectively, because failure in these regards can be damaging to the complainant and to general confidence in the competitive neutrality arrangements. The Council is concerned about the slowness of some complaints investigations, and encourages governments to consider options for accelerating them. Private businesses should be able to expect quick processing of complaints.

Table 2.6: Complaints mechanisms

In those jurisdictions where complaints can be made to an independent body, that body usually has been established to promote competition, pricing and market conduct outcomes, especially with regard to government entities. Examples of such bodies are **New South Wales'** Independent Pricing and Regulatory Tribunal, the **Queensland** Competition Authority, **South Australia's** Competition Commissioner, **Tasmania's** Government Prices Oversight Commission, and the **ACT's** Independent Competition and Regulatory Commission. In New South Wales, the Premier can refer competitive neutrality complaints about tender bids to the State Contracts Control Board for independent assessment. The Commonwealth complaints unit is the Commonwealth Competitive Neutrality Complaints Office (CCNCO), which is located within the Productivity Commission.

In **Victoria**, the Competitive Neutrality Complaints Unit (located in Treasury) considers all complaints, although the unit encourages parties to seek to resolve the differences themselves in the first instance. In **Western Australia**, the Expenditure Review Committee of Cabinet handles complaints with administrative support from the Competitive Neutrality Complaints Secretariat. In the **Northern Territory**, the Treasury handles complaints.

Some governments allow complaints to be lodged only against government entities that are subject to competitive neutrality principles, while others allow complaints to be made against other government business activities as well. In most States, complaints against local government businesses must be made in the first instance to the local government, and then to the complaints body of that State.

Complaints highlighted in the 2002 NCP annual reports

Commonwealth, State and Territory NCP reports indicated that most governments received new competitive neutrality complaints in 2001.[3]

- At the Commonwealth level, the CCNCO conducted investigations of four competitive neutrality complaints over the nine months to the end of March 2002. The CCNCO's consideration of a complaint against ARRB Transport Research Limited, which has 10 governments as its members, found no evidence that competitive neutrality principles had been breached. The CCNCO suggested, however, that member governments consider specification and funding of non-commercial public interest research undertaken by ARRB.

- A complaint about the Bureau of Meteorology's services to the aviation industry was resumed in May 2001 following a 'stay' previously requested by the complainant. The CCNCO found that a component of these services (those provided in addition to Australia's international obligations) constitute a business activity and should be subject to competitive neutrality and competitive provision. The CCNCO recommended that the Commonwealth should complete its consideration of introducing such competition. The Commonwealth has since decided that the Bureau of Meteorology should continue to be the sole provider of basic meteorological services to satisfy community service and international obligations. The Government also decided to introduce competition in the market for 'value added' weather services during 2002.

- The CCNCO found that no action under competitive neutrality policy is required with respect to land leasing activity at Sydney and Camden airports.

- Investigation of a complaint against Docimage Business Services found that it had made appropriate competitive neutrality cost adjustments.

- During the 1 January 2001 to 30 March 2002 reporting period, the New South Wales Government did not receive any new requests for competitive neutrality complaints to be referred to the Independent Pricing and Regulatory Tribunal or the State Contracts Control Board. The Department of Local Government was not requested to review any actions in response to complaints against local governments.

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[3] A complaint lodged by the Conference of Asia Pacific Express Carriers against Australia Post in 2000 is discussed in chapter 14. Chapter 5 provides information about a 1999 complaint against two rail freight businesses: National Rail, which was jointly owned by the Commonwealth, New South Wales and Victoria, and FreightCorp, which was owned by the New South Wales Government. Both of these rail freight businesses were privatised in February 2002.

- In Victoria, complaints investigations were suspended in late 1999 while the new Government prepared a new competitive neutrality policy. This policy was released in October 2000 and complainants were encouraged to try to resolve their concerns with the government entities about which they were complaining. Some complaints were not reinstated, while the Competitive Neutrality Complaints Unit investigated (or is investigating) others (together with some new complaints). Several of the investigated complaints were against local government business activities, including waste and recycling services, leisure centres, child care centres and livestock exchange. Where the complaints unit has completed its investigation, the councils have made appropriate competitive neutrality adjustments or undertaken to conduct a public interest test, with the complaints unit to prepare a follow-up report. Other complaints have been against State Government businesses, including an interpreting service, a school and a supportive residential service.

- The Queensland Competition Authority completed its investigation of four complaints (by one party) against the Network Services Division of ENERGEX and found that two were substantiated. The Queensland Premier and Treasurer accepted this finding and ENERGEX (in association with the Electrical Safety Office) is taking remedial action. Similarly, aspects of a complaint against Queensland Rail's livestock transportation business, Cattletrain, were substantiated. Subsequently, the open-ended financial arrangements between Queensland Rail and Cattletrain ceased, thus removing the main cause of the complaint.[4] Local governments received no formal complaints, but one informal complaint resulted in the Department of Local Government and Planning requiring a council to establish a complaints-handling process and to deal with the particular complaint. The department has taken steps to ensure all local councils have mechanisms to deal with complaints.

- Western Australia's Complaints Secretariat did not receive any formal competitive neutrality complaints during 2001. It received three informal complaints about Government activities that are not required to apply competitive neutrality principles (a hospital, prisons and a government tree seedling service), and it is investigating them.[5]

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[4] Chapter 5 provides more information on this complaint.

[5] On 1 July 2002, the Council was advised by representatives of a private radiation oncology company in Western Australia of the company's concerns about competition from the radiation oncology department of a Perth public hospital, which it believes reflects advantages arising from the hospital's public ownership. Western Australia's Complaints Secretariat has informed the radiation oncology company that that State's competitive neutrality policy does not apply to health sector businesses. The matter has been raised by the Complaints Secretariat with the Department of Health. The Minister for Health is responsible for instigating any change in the policy regarding application of competitive neutrality to health sector businesses in Western Australia. The Council is discussing this matter with the Complaints Secretariat.

- In South Australia, three complaints were carried over from 2000. The Competition Commissioner's investigations are continuing in two instances, while the third complaint was withdrawn. The Competition Commissioner received five new written complaints during 2001, but found only one to be within the scope of South Australia's legislation relating to competitive neutrality. The Commissioner is still investigating this complaint. Local governments did not receive any complaints in the reporting period.

- Tasmania's Government Prices Oversight Commission received one competitive neutrality complaint in 2001, about Hobart City Council's off-street parking business. The business had not been formally endorsed as a significant business activity, and the matter was referred to the Department of Treasury and Finance. The department discussed the matter with the council, which agreed to separate the financial reporting of its on-street and off-street parking businesses. The commission has advised that this will meet the council's competitive neutrality obligations.

- No competitive neutrality complaints were lodged in the ACT or the Northern Territory during 2001.

Productivity Commission report on financial performance of government trading enterprises

Government trading enterprises (GTEs) are usually larger government businesses, and all governments include most of them in their significant business activities that are subject to competitive neutrality principles.

On 9 July 2002, the Productivity Commission released the third of its series of annual reports on the financial performance of GTEs (PC 2002c). The information used by the Productivity Commission in preparing this report included data provided by States and Territories and extracted from GTE annual reports.

The Productivity Commission's report provides significant information on the application of competitive neutrality by the Commonwealth, State and Territory governments. The report covers the financial performance of 64 GTEs, and found that in 2000-01 only 45 per cent of them earned pre-tax returns of capital that exceeded the 10 year Commonwealth Government bond rate of 5.8 per cent.[6] The Productivity Commission report indicates that average profitability deteriorated in 2000-01 (PC 2002c, pp. 5–6).

[6] The Commonwealth bond rate is typically used as the benchmark for the risk free rate of return, and GTEs should seek to achieve a rate of return that is equivalent to the risk free rate plus a margin for the degree of risk of the business (around 3 percentage points for low-risk businesses and 7 percentage points for high-risk businesses).

The Productivity Commission report comments that the low rates of return could raise competitive neutrality issues, as they may indicate that GTEs are charging lower prices than private competitors. The report acknowledges, however, that low returns could also reflect other factors, such as inherited costs being too high, overvalued assets, and inadequate government payments for CSOs (PC 2002c, pp. 6–8). The Council notes that weak market conditions or inadequate enterprise management may also explain poor returns for some GTEs, at least for a year or two. Noting that the prices of goods and services provided by many GTEs are regulated, the Productivity Commission's report suggests that the poor returns by some GTEs may possibly reflect regulatory error or a tendency of some regulators to favour the short-term interests of consumers (PC 2002c, pp. 8–9 and p. 44). The report comments that regulators must ensure that the asset valuations implicit in their price determinations are robust, because 'appropriate asset valuations are central to the formation of efficient policies regarding both capital investment and pricing regimes', and that GTE managers also should take care in asset valuations (PC 2002c, pp. 44–45).

The Productivity Commission's report provides information on governments' practice in estimating the 'stand-alone' credit ratings of their GTEs (the ratings that they would achieve if they were not government owned and therefore not enjoying an implicit government guarantee of their debt). Each GTE's credit rating determines the debt guarantee fee that it faces on top of its borrowing rate, and is therefore a significant factor in determining the GTE's costs, and thus its pricing and adherence to competitive neutrality. Some jurisdictions commission credit rating agencies to estimate the stand-alone rating. In other jurisdictions, the Treasury makes the estimates for all GTEs or for smaller GTEs (in some cases, the GTEs make their own estimates). Some jurisdictions require the rating assessments to be made more frequently than others. The Productivity Commission report also finds that the some governments apply the debt guarantee fee to a more limited range of GTEs' financial liabilities than other governments, and suggests that this may encourage some GTEs to use certain ways of raising finances to avoid the debt guarantee fee (PC 2002c, pp. 63–66). The variations in governments' debt guarantee policies have implications for competitive neutrality outcomes. The Council will discuss this matter with governments over the period to the 2003 NCP assessment.

Further to the earlier discussion in this chapter on CSOs, the Productivity Commission's report comments that:

> *Direct funding of CSOs improves transparency and makes financial performance easier to assess. This facilitates accountability of GTE management and strengthens incentives to improve financial outcomes.* (PC 2002c, p. 70)

The Productivity Commission notes that most governments argue in principle for an avoidable cost approach (involving estimation of the cost, net of any revenue associated with the CSO, that would have been avoided if the CSO were not provided) to estimating the value of CSOs, but in practice use a range of methods. These methods include revenue forgone (the difference

between the cost of supplying the CSO and the revenue derived from providing the service) and fully distributed cost (PC 2002c, pp. 72–73). The Council's recent staff discussion paper on competitive neutrality suggested that the avoidable cost approach to costing CSOs is the most appropriate method (Trembath 2002, p. 33).

The staff discussion paper also suggested that, under best practice, governments would directly fund CSOs rather than require cross-subsidisation within government businesses. In addition, the government business and the providing government agency would cost and transparently account for CSOs, and each jurisdiction's Treasury would enhance transparency further by publishing a table of all CSOs in its annual budget papers (Trembath 2002, p. 33). Box 2.5 indicates that governments' policies generally require direct government funding and transparent reporting of CSOs. The Productivity Commission reports, however, that there are instances where these policies have not been followed. Its survey of the annual reports of the 64 GTEs it is monitoring found that 27 GTEs reported direct government funding of CSOs, that other GTEs did not disclose direct funding that they had received, and that some governments have required particular GTEs to fund CSOs from their own resources. Some GTEs do not report the activity to which CSO funding relates. In some instances, governments have provided payments for non-commercial activities to GTEs, but neither party has reported them as CSOs (PC 2002c, pp. 73–79).

The Council will be discussing the matters of costing, funding and reporting of CSOs with governments over the period to the 2003 NCP assessment.