

2 Competitive neutrality

Competitive neutrality policy aims to ensure that government businesses do not enjoy any competitive advantages over private companies as a result of their public ownership. Clause 3 of the Competition Principles Agreement (CPA) sets down governments' competitive neutrality obligations, requiring governments, 'where appropriate', to:

- corporatise large government enterprises and impose full Commonwealth, State and Territory taxes, debt guarantee fees and regulations equivalent to those faced by private sector businesses;
- implement the same measures for other 'significant' government business activities or ensure the prices that those activities charge for goods and services account for tax or tax equivalents, debt guarantee fees and equivalent regulations, and reflect full cost attribution;
- publish competitive neutrality policy statements (by June 1996); and
- publish an annual report on the implementation of competitive neutrality principles, including allegations of noncompliance (complaints).

Each government is free to determine its own agenda for implementing competitive neutrality principles and is required to implement the principles only to the extent that the benefits are expected to exceed the costs. Clause 7 of the CPA requires governments to apply competitive neutrality principles to local government business activities.

The Council of Australian Governments (CoAG) refined aspects of competitive neutrality at its November 2000 meeting. CoAG agreed that:

- the National Competition Council's assessment of governments' application of competitive neutrality to government businesses over which they have no executive control (such as universities) should be based on a 'best endeavours' approach;
- the term 'full cost attribution' could cover a range of methods, including fully distributed cost, marginal cost and avoidable cost;
- governments are not required to establish a competitive process for their delivery of community service obligations (CSOs); and
- governments are free to determine who should receive a CSO payment or subsidy, but such payments should be transparent, appropriately costed and budget funded.

Benefits of competitive neutrality

The aim of competitive neutrality is to ensure Australia's resources are used efficiently by removing any net competitive advantage that public businesses accrue from their government ownership. The application of competitive neutrality principles allows resources to flow to efficient government and private businesses as a result of merit rather than any artificial advantage from public ownership.

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 private sector participation in industries, thus promoting competition with flow-on benefits to consumers. Competitive neutrality also promotes a more dynamic culture within government businesses, partly as a result of the stronger discipline for transparency and accountability. Government businesses cannot rely on the advantages of public ownership, which often encourage complacency and reduce incentives to improve performance. The application of competitive neutrality principles thus contributes to greater efficiency, better services and cost-reflective prices for users. In this way, competitive neutrality underpins and complements the performance monitoring regimes that many governments have introduced for their businesses in recent years.

With a competitive neutrality policy in place, governments can better assess the future of their businesses. Full attribution of costs, for example, often leads governments to reassess whether they wish to provide a good or service directly through a government business, allow competitive bidding for the provision of the good or service, or withdraw from the market.

In a similar manner, competitive neutrality can assist governments to address issues surrounding the provision of CSOs. Full cost attribution and greater transparency provide better quality information to governments, which can thus make more informed decisions about whether to fund a CSO directly (thus removing a competitive disadvantage faced by the government entity) or consider its competitive provision.

Governments' progress in implementing their obligations

The Council assesses each government's compliance with its competitive neutrality obligations by accounting for:

- 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 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.

Competitive neutrality coverage

Governments' interpretation of the phrases 'significant business activities' and 'where appropriate' in CPA clause 3 has largely driven the scope of activities to which governments have applied competitive neutrality principles. Also influencing the scope of competitive neutrality is subclause 3(6), which requires governments to implement competitive neutrality principles to the extent that the benefits outweigh the costs. In this context, subclause 1(3) states that governments weighing up the benefits and costs shall account for the following matters 'where relevant':¹

- 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.

The competitive neutrality policies that different jurisdictions have adopted reflect the degree of discretion provided by the CPA. Governments have adopted various criteria for establishing an entity's significance, for example, including the entity's absolute size and perceived impact on the market.

Assessment of competitive neutrality principles

The following sections summarise each jurisdiction's approach to applying competitive neutrality principles.

¹ The CPA states that governments are not limited to considering these matters. At the CoAG meeting of November 2000, governments agreed that they should document decisions in which they apply these subclause 1(3) matters.

The Commonwealth

The Commonwealth requires its business enterprises, companies, business units and other significant business activities to implement competitive neutrality principles. Nonsignificant businesses (those with a turnover of less than A\$10 million) are not formally required to apply competitive neutrality. However, all businesses are subject to the complaints mechanism which allows complaints to be directed to the Commonwealth Competitive Neutrality Complaints Office if a competitor (or other party) considers that a Commonwealth Government business is not complying with competitive neutrality principles. In line with CPA subclause 3(6), Commonwealth policy states that competitive neutrality should be implemented where the benefits exceed the costs.

Competitive neutrality implementation by the Commonwealth Government involves:

- the corporatisation of significant government business enterprises;
- 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;
- compliance with those regulations to which private sector competitors are normally subject;
- the pricing of all goods and services provided in contestable markets to account for all direct costs attributed to the activity and the competitive neutrality components; and
- explicit government direction to deliver CSOs on a noncommercial basis.

New South Wales

New South Wales applies competitive neutrality to all State-owned companies and other significant government businesses. At the local government level, businesses that have an annual gross operating income higher than A\$2 million must adopt a corporatisation model and apply full cost attribution, while businesses below that income threshold must apply full cost attribution and make subsidies explicit.

The Government assumes that the economic and social benefits of competitive neutrality exceed the costs. The onus is thus on a government business to demonstrate that it should not apply competitive neutrality principles because the costs would exceed the benefits. (The Council is unaware of any government business in New South Wales that has sought to use this exemption mechanism.)

The New South Wales corporatisation model is guided by the principles set in 1988 by the Steering Committee on Government Trading Enterprises. These principles include: clear and nonconflicting objectives; managerial autonomy and responsibility for the board of the enterprise; performance evaluation by the government; and rewards and sanctions. Corporations law applies to State-owned companies.

State-owned companies and other significant government businesses apply commercial targets for rates of return based on estimates of the weighted average cost of capital for each business, dividends (reflecting private sector practice) and capital structures. They pay State taxes, Commonwealth tax equivalents and risk-related borrowing fees, and are subject to regular performance monitoring. The Government explicitly funds any CSOs that the government businesses deliver.

Victoria

In Victoria, significant government businesses are determined according to the importance of a business in its market, as measured by its size, its competitive impact and the resources that it commands. The Victorian Government requires the estimation of the potential benefits (usually ongoing) of applying competitive neutrality principles to include: increased market contestability, the improved performance of its businesses and the improved capacity to assess whether its businesses are meeting noncommercial objectives. The costs (usually transitory) to be addressed include: legislative and regulatory changes; the analysis required to set appropriate tax equivalents and debt guarantee fees; and the administration of these financial distributions.

Victoria recommends that a public interest test be applied where the application of competitive neutrality principles may compromise other Government policy objectives. Apart from the matters listed in CPA subclause 1(3), other public interest considerations include any economic development impacts on the local community, and the impacts on the State and national economies.

Measures to achieve competitive neutrality in Victoria include corporatisation, commercialisation and full cost-reflective pricing. The model for corporatisation in Victoria is similar to that in other jurisdictions. The Victorian approach to commercialisation involves organising an activity along commercial lines without creating a separate legal entity.

Queensland

Queensland classifies the significance of government businesses according to the scale of a business and its impact on the market. It applies an indicative expenditure threshold of A\$10 million as a guide to significance. The Government requires local governments to subject their larger businesses to

competitive neutrality, while using financial incentives to encourage smaller council businesses also to apply competitive neutrality principles.

Queensland applies three competitive neutrality models to significant business activities: corporatisation, commercialisation and full cost pricing. The first two models apply typically to larger government businesses. Pricing based on full cost attribution is used by government business activities that are proceeding to corporatisation or full commercialisation while in direct competition with other providers, and by those that are not suited to a full corporate structure (usually because they are small).

Western Australia

Western Australia determines the significance of a government business on the basis of its market's importance to the State economy. At the local government level, government businesses with turnover of A\$200 000 or more are potentially subject to competitive neutrality.

Western Australia provides for its significant government business activities to be commercialised or corporatised. Corporatisation is the preferred approach for the largest public trading enterprises, particularly energy and water utilities. Commercialisation has been applied to transport and port authorities.

For smaller significant businesses, for which commercialisation or corporatisation may not be cost-effective, the following features apply: taxes or tax equivalents and debt guarantee fees; equivalent planning and environmental approval requirements; and the payment of dividends to, and the funding of CSOs from, the Consolidated Fund. Western Australia has reviewed smaller government businesses to determine whether a competitive neutrality approach would be in the public interest. Recent reviews resulted in the application of competitive neutrality principles to the Gold Corporation, prison industries and the Valuer-General's Office.

The Government endorsed a review of universities in February 2003, which recommended that university businesses adopt competitive neutrality principles, including commercial pricing policies and complaints hearing mechanisms. In June 2003, the Government endorsed the recommendations of the competitive neutrality review of TAFE colleges. The Government proposes to ensure that TAFE ancillary services are not provided to the public at subsidised prices. However, the Government has decided that competitive neutrality will not apply to WestOne and TAFE International and certain activities of other TAFE colleges. In August 2003, the Government endorsed a recommendation of the competitive neutrality review of the WA Sports Centre Trust that the fitness centres at Challenge Stadium and Arena Joondalup should adopt full cost pricing principles.

South Australia

South Australia uses a government business's impact on its market as the principal determinant of significance. Corporatisation, commercialisation and full cost pricing are applied to significant businesses. The appropriate model for each government business is determined on a case basis, accounting for resources used in the business's supply of the good or service; accountability considerations; and cost-benefit comparisons. The extent to which business activities dominate the total activities of the government entity is a key factor; where they are the main activity, corporatisation and the full range of private sector equivalence measures are preferred. Most councils are involved in small-scale business activities, so cost-reflective pricing is the most common approach to competitive neutrality at the local government level.

Tasmania

In Tasmania, all State and local government business enterprises, public trading enterprises and public financial enterprises apply corporatisation principles if the benefits are expected to exceed the costs. The significance of other government entities for competitive neutrality application is based on an entity's impact on its market. In consultation with the Local Government Association of Tasmania, the Government is undertaking a review that will more clearly identify significant local government business activities and ensure that local governments' competitive neutrality obligations are clearly expressed in the competitive neutrality policy statement.

The ACT

In the ACT, the impact of a Government business on its market is the primary determinant of whether the business is significant. Under ACT policy, competitive neutrality principles apply not only when a business is significant, but also when competitive neutrality would be in the public interest. Competitive neutrality is considered to be a valuable tool for encouraging improved efficiency and resource allocation.

Northern Territory

The Northern Territory considers all Government business divisions and business enterprises to be significant businesses. The Northern Territory's 1996 competitive neutrality policy statement indicates that only the larger businesses, such as the Territory Insurance Office, the Power and Water Authority and the Darwin Port Authority, would be corporatised. The Government commercialises smaller Government businesses, but also considers corporatisation on an individual case basis.

Assessment of coverage

Most jurisdictions have committed to full cost attribution for their significant business activities. Ideally, their costing approaches should:

- require significant government businesses to recover full costs over the medium to long term. 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 depreciation and reflect a target rate of return;
- base targets for commercial rates of return on the weighted average cost of capital of each significant business activity, so as to reflect the cost of the business activity's equity and debt;
- acknowledge that other costs may be relevant, even if not explicitly mentioned in the CPA. Local government rates and charges (or equivalents), for example, are an element of the full cost price; and
- require significant businesses to recover all costs in the medium to long term, while allowing them to practise marginal pricing in the short term (or to practise commercial pricing strategies) in response to market conditions.

Governments have struggled to deal with some issues, however, especially those relating to the application of marginal pricing or competitive pricing strategies in the short term. A Council staff discussion paper considers these issues (Trembath 2002).

The Council considers that the potential coverage of governments' competitive neutrality policies is generally satisfactory. New South Wales' approach provides for the greatest potential coverage because that Government assumes that competitive neutrality principles apply unless an individual government business presents a case that the costs exceed the benefits.

Nevertheless, coverage could be improved. Western Australia has not required businesses operated by public hospitals to apply competitive neutrality principles. The Council has raised this matter with the Government on several occasions since mid-2002, when a private radiation oncology company advised the Council of its concerns about competing with the radiation oncology department of a Perth public hospital. The Western Australian Health Minister has deferred any decision on this matter until the completion of a national review into radiation oncology. The findings of the Baume inquiry into radiation oncology were released in September 2002, and the Australian Health Ministers' Conference asked the Australian Health Ministers' Advisory Council in November 2002 to provide the conference with reform proposals by 30 November 2003. Notwithstanding this specific review of radiation oncology, the Council considers that Western Australia should review whether to subject business activities of public hospitals to competitive neutrality principles.

More generally, the potential coverage of competitive neutrality policies has been partly eroded by governments allowing slow policy implementation by some government businesses (for example, some businesses in the entertainment or recreational sectors). Also to enhance coverage, the Council encourages governments to ensure local government businesses apply competitive neutrality principles. (A large proportion of competitive neutrality complaints relate to local government businesses.)

For this 2003 NCP assessment, the Council scrutinised the application of competitive neutrality principles to forestry operations in all States and the ACT (see volume 2, chapter 1). The Council assessed all jurisdictions except Victoria to be well advanced in meeting their CPA clause 3 obligations, but could not be confident of full compliance because government forestry businesses are yet to establish track records of earning adequate profits. The Council noted that most government forestry businesses are not liable for land rates and related local taxes and charges (some jurisdictions are reviewing this matter). The Council also notes that governments may need to require government forestry businesses to disclose the timber prices that they assume for forest valuation purposes to be confident that the aims of competitive neutrality are being achieved.

Effective processes for handling complaints

CPA clause 3 requires governments to have a mechanism for considering complaints that particular government businesses are not appropriately applying competitive neutrality principles. All governments have instituted complaints processes, and their NCP annual reports document allegations and actions taken in response. Some governments require complaints to be made first to the relevant government business and then to an independent complaints body. In some jurisdictions, the independent body considers a complaint only if the relevant Minister(s) decides that this action is appropriate. Box 2.1 summarises jurisdictions' complaints mechanisms.

Box 2.1: 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 for government entities. Such bodies include **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 Government's** complaints unit is the Commonwealth Competitive Neutrality Complaints Office, which is located within the Productivity Commission.

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Box 2.1 continued

In **Victoria**, the Competitive Neutrality Unit (located in Treasury) considers all complaints, although the unit encourages parties to first seek to resolve the differences themselves. 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 against only government businesses that are subject to competitive neutrality principles. In most States, complaints against local government businesses must be made first to the local government and then to the complaints body of that State.

Complaints highlighted in the 2003 NCP annual reports

The Commonwealth, State and Territory 2003 NCP annual reports indicated that some governments received competitive neutrality complaints in 2002 and 2003, and several governments completed their consideration of complaints made in earlier years.

The Commonwealth

The Commonwealth Competitive Neutrality Complaints Office did not receive any competitive neutrality complaints in 2002 or the first quarter of 2003, although the Commonwealth Government's 2003 NCP annual report describes a complaint received in November 2001. A representative of several hire and recruitment companies submitted a complaint against OzJobs, which is a business division of Employment National. OzJobs offers recruitment and personnel services. The complainant alleged that the Commonwealth Government subsidises OzJobs and that OzJobs does not pay payroll tax and insurance premiums on a basis equivalent to that of its private sector competitors. The Commonwealth Competitive Neutrality Complaints Office finalised its report in May 2002, finding that OzJobs met all of its competitive neutrality obligations and that no action was necessary in response to the complaint.

New South Wales

New South Wales' 2003 annual report states that no new competitive neutrality complaints were received over the year to March 2003.

Victoria

The Competitive Neutrality Unit in Victoria investigated several complaints in 2002, many of which related to the business activities of local governments, including child care centres, leisure centres, community transport services and waste collection services. Complaints were also made against a Government department, a Government water retailer and cemetery trusts.

Some of the complaints were made in 2001. Several investigations were completed expeditiously, but the period of investigation in a few cases was more than a year. Several investigation reports concluded that the government businesses breached competitive neutrality principles, and the relevant businesses have subsequently rearranged their affairs. The Competitive Neutrality Unit has followed up on several businesses' adjustments. Some investigations are ongoing.

Queensland

The Queensland Competition Authority and the Queensland Treasury did not report any competitive neutrality complaints in 2002. A small number of complaints were received by other Government agencies and local governments, and resolved after initial discussions. The Department of Main Roads received a complaint from a commercial road paving company about the department's commercialised service delivery business. The complainant is concerned about the prices paid by the business under a standing offer arrangement. The department engaged a consultancy firm to investigate this complaint, and the complainant has been advised of the findings. The consultants found no evidence that the department's commercialised service delivery business had a purchasing advantage.

Queensland's 2003 NCP annual report noted that for 92 of the 653 local government businesses that are subjected or committed to competitive neutrality reform, the local government 'parent' has not established valid complaints hearing processes. The Queensland Government believes that this number will fall during 2003-04.

Western Australia

A private company that exports potatoes to Mauritius submitted a complaint to the Western Australian Complaints Secretariat that the Potato Marketing Corporation had undercut the private company's export prices as a result of competitive advantages arising from the corporation's monopoly status in the domestic market. The Government recently conducted a NCP review of the *Marketing of Potatoes Act 1946* and advised the private complainant to resubmit its complaint if the review does not address its concerns. Following the completion of the review, the Minister for Agriculture announced on 5 August 2003 that the Government would not change the Act. As of late August, the complainant had not resubmitted its complaint.

The Complaints Secretariat has been considering complaints against government businesses that are not formally required to comply with competitive neutrality principles. Apart from the earlier complaint by the radiation oncology company, these complaints include:

- a complaint about the Department of Conservation and Land Management providing trees below cost through funding provided via the

Natural Heritage Trust — the complainant was informed that this pricing is part of Government policy to further environmental aims; and

- a complaint about a product manufactured in prisons — the Government has since introduced full cost pricing throughout its prison industries program.

South Australia

The South Australian Competition Commissioner carried over unfinished investigation of three 2001 complaints to 2002.

- Investigating a complaint about the Public Transport Board's provision of buses to special events, the Competition Commissioner reported in March 2002 that the board is not a significant business activity and therefore is not required to apply competitive neutrality principles.
- The Competition Commissioner reported in June 2002 that State Flora's nursery revegetation and forestry seedling propagation and sale activities at Murray Bridge constitute a significant business activity and thus should use cost reflective pricing. This pricing approach was implemented on 1 June 2003.
- The Competition Commissioner reported in December 2002 that penguin tours operated on Kangaroo Island by National Parks and Wildlife SA in competition with a private operator comprised a significant business activity and that cost-reflective pricing should apply. The complainant then approached the Council on several occasions, starting in April 2003, to express concerns about the slowness of the complaints investigation and implementation of the Commissioner's recommendations. More than 18 months elapsed between the complaint being made in November 2001 and the Government entity introducing a new pricing approach on 1 July 2003. The Council considers that the South Australian Government should seek to ensure complaints investigations and the implementation of recommendations occur expeditiously.

Tasmania

The Government Prices Oversight Commission did not receive any formal competitive neutrality complaints in 2002, but during that year it advised an earlier complainant, Ambulance Private, about an investigation completed in 2001. The relevant Minister directed the Department of Health and Human Services to make changes in line with the investigation report.

The ACT

In December 2002, the Independent Competition and Regulatory Commission provided the ACT Government with its final report on a 2000 complaint

relating to horse agistment. Government-owned paddocks comprise around 20 per cent of the total ACT agistment market, and the current contractor (chosen following a competitive tender) is a private company that does not enjoy any advantages in taxes, charges, borrowings or regulations. The commission concluded that the Government has met its competitive neutrality obligations in providing horse agistment facilities.

The Northern Territory

The Northern Territory Treasury received a competitive neutrality complaint in June 2003 relating to Data Centre Services, which is a government business division that provides data storage and other information technology services to the public sector. A private data services provider lodged a formal complaint that Data Centre Services had not fully reflected its costs in its bid for a tender. The Northern Territory Treasury is investigating the complaint.

Assessment of complaints handling

The Council considers that Commonwealth, State and Territory complaints mechanisms are operating satisfactorily. Nevertheless, competitive neutrality processes could be improved in two areas.

- Some jurisdictions provide for Ministers to decide whether an independent body should hear complaints. Such an arrangement may reduce the degree of independence with which a complaint is considered, and increase the time between the complaint's lodgement and resolution.
- Complaints must be dealt with expeditiously and effectively; otherwise, the complainant may be adversely affected and confidence in the competitive neutrality arrangements may be undermined. Complaints processes appear to have been inordinately slow in some cases.

While these concerns do not indicate widespread systemic failures, the Council encourages governments to consider options for accelerating investigation processes and any subsequent actions. The Council expects improvements in the speed with which complaints are investigated and resolved, and will be monitoring jurisdictions' performance in this regard.

Financial performance of government trading enterprises

In the 2002 NCP assessment, the Council noted that many government trading enterprises had low rates of return on capital. The Council considered that such low returns might reflect a range of factors — such as weak market

conditions or high inherited costs — but also, in some instances, the nonapplication of competitive neutrality principles such as full cost pricing.

For the 2003 assessment, the Council asked governments to provide the reasons for some government businesses earning rates of return below the risk-free government bond rate. Governments indicated in their NCP reports that a wide range of factors affected rates of return, including:

- the regulation of prices and higher costs than regulators provided for in price determinations;
- increases in asset and equity bases in particular years as certain government trading enterprises sought to expand and upgrade their operations;
- changes in the accounting treatment of leased assets;
- ports holding land required for future port development that is not currently in productive use;
- drought conditions adversely affecting water corporations; and
- the demand for services being less than expected.

The Council is satisfied that these influences help to explain the identified low rates of return but notes that such factors may require responses by the enterprises to address such sources of underperformance over time.