

## 2 Competitive neutrality

Competitive neutrality policy aims to eliminate resource allocation distortions by ensuring 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 to:

- impose on government business enterprises full Australian Government, state and territory taxes, debt guarantee fees and regulations equivalent to those faced by private sector businesses, and corporatise these enterprises 'where appropriate'
- 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.

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. It 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)
- governments are free to determine who should receive a CSO payment or subsidy, but such payments should be transparent, appropriately costed and budget funded.

Governments' application of competitive neutrality yields a range of benefits (box 2.1).

**Box 2.1: Why governments apply competitive neutrality policies**

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 community service obligations (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' 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
- 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**

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 the significance of a government business, for example, including its absolute size and perceived impact on the market.

The 2003 NCP assessment summarised each jurisdiction's approach to applying competitive neutrality principles.<sup>1</sup> In some jurisdictions (Victoria, Queensland, Western Australia and South Australia), competitive neutrality policies and/or coverage has changed since the 2003 NCP assessment. The Australian Government and Tasmania have issued updated competitive neutrality guidelines for agency and government business managers, and the ACT intends to do this too during 2004. These developments are discussed below.

## Australian Government

The Treasury and the Department of Finance and Administration issued new competitive neutrality guidelines for managers in February 2004. While the Australian Government's competitive neutrality policy has not changed since 1996, the revised guidelines improve clarity and help government entities implement the policy. The revised guidelines provide examples of good practice by some agencies, draw on the experience of the Australian Government Competitive Neutrality Complaints Office, and reflect changes to the government's overall financial and governance framework.

## Victoria

In May 2003 the Victorian Treasurer approved a change in interpretation of the competitive neutrality policy in relation to leisure centres owned by local councils. The aquatic facilities within these centres often offer swim classes and recreational swimming. Under the new interpretation, only the first component is considered a business activity, while the recreational component is now viewed as a public amenity to which competitive neutrality does not apply.

The Victorian Government commenced its annual review of local council compliance with competitive neutrality policy in November 2003. Local councils receive 9 per cent of the state's competition payments. In December 2003 the assessment panel announced that all councils complied with state's competitive neutrality policy and were eligible for competition payments. However, payment to nine councils was made provisional on them undertaking training by Victoria's Competitive Neutrality Unit (CNU). Relevant officers within the nine councils have received training, thereby satisfying the eligibility requirement for each council to receive competition payments.

As part of Victoria's educational focus to enhance local government understanding of competitive neutrality policy, the CNU conducted a series of

---

<sup>1</sup> More detailed information on jurisdictions' competitive neutrality policies can be found in Trembath (2002).

competitive neutrality workshops in October 2003, which were attended by 46 of Victoria's 79 councils.

In October 2003 the Victorian Government established VicForests as a state business corporation under the *State Owned Enterprises Act 1992*. VicForests took over the operations of Forestry Victoria, which had been a division of the Department of Sustainability and Environment. According to the government, VicForests will be required to implement an open and competitive sales system for timber and earn an appropriate return to government. This requirement, combined with VicForests' obligation to report separately to Parliament on its financial and operational performance, will facilitate the implementation of competitively neutral pricing and enable greater transparency and accountability of the government's commercial timber harvesting management activities.

On 1 July 2004, the Competitive Neutrality Unit was absorbed into a new independent statutory authority, the Victorian Competition and Efficiency Commission (VCEC).

## Queensland

Queensland completed its extension of competitive neutrality to its 15 TAFE institutes, with full cost pricing now applied to their competitive purchasing and fee-for-service activities. It has continued to encourage local governments (by offering incentive payments, for example) to apply competitive neutrality principles to their business activities, of which there are many. The government reported that the largest 18 local governments, which account for more than 80 per cent of local government business activity, made good progress in extending competitive neutrality principles to their significant and smaller business activities. In the past year the government has focused on smaller local governments. The following outcomes summarise overall progress across all local governments:

- All nine very large businesses ('type 1 businesses') have implemented full cost pricing and eight have been commercialised. Commercialisation requires council businesses to operate separately from the parent council, to make various accounting separations and to include tax equivalents in costs.
- Of the 22 medium size 'type 2 businesses', 16 have implemented all elements of full cost pricing and six have implemented most of the elements. Nineteen have been commercialised.
- More than half of the 630 small businesses of local councils have applied all or most elements of full cost pricing.

In addition, in July 2004 the Queensland Government announced that it would examine whether to establish a forestry corporation under the *Government Owned Corporations Act 1993* to manage commercial timber

production from the state's timber plantations. This business activity is currently constituted as a commercialised business group of the Department of Primary Industries and Fisheries known as DPI Forestry. A corporatisation charter preparation committee is consulting stakeholders and is to report to Cabinet in February 2005. In relation to the liability of DPI Forestry for local government rates, the Queensland Government has advised that a significant proportion of its public plantation estate is leased for grazing, with lessees liable for local government rates, and that DPI Forestry is increasingly renting rather than purchasing land to expand its plantations. Nevertheless DPI Forestry continues not to pay rates, directly or indirectly, on the existing owned plantation estate not subject to grazing leases. The Council looks forward to further progress by Queensland on this matter through its consideration of whether to corporatise DPI Forestry.

## Western Australia

The Western Australian Parliament proclaimed legislation in April 2004 that introduced competitive neutrality amendments to various Acts.

- The Gold Corporation will now pay tax equivalents and a fee for its government guarantee on liabilities.
- The Western Australian Mint no longer enjoys a statutory exemption from rates and taxes.
- The Eastern Goldfields Transport Board will no longer be exempt from certain taxes and rates. (However, the government is yet to address a complaint by a competitor of the board in charter transport services. More information on this complaint is provided below.)
- The State Supply Commission will be required to pay state charges and taxes on behalf of government agencies making property transactions. (The agencies were previously exempt from such charges.)

The government also proposes to introduce legislation to Parliament that will clarify the powers of universities to engage in commercial activities. In the meantime, it has required universities to adopt competitive neutrality principles for their commercial operations and to be subject to Western Australia's complaints process.

## South Australia

In May 2003 South Australia released an updated list of significant government business activities subject to competitive neutrality. Departments conduct regular reviews of agencies to assess whether they should be added to the list.

## Tasmania

Tasmania has reviewed its 1996 policy statement on the application of NCP to local government and released a revised statement in April 2004 (DTF 2004a). The Tasmanian Government also released a related document to guide local governments on the definition of significant business activities for the purposes of competitive neutrality (DTF 2004b). These two policy documents are more comprehensive than the 1996 releases and provide up-to-date information — for example, information on the role of the Government Prices Oversight Commission in hearing competitive neutrality complaints. The documents guide local governments on competitive neutrality compliance matters, including the identification of full cost attribution by, and corporatisation of (where justified by a public benefit test) significant business activities. The documents also provide details on the Government Prices Oversight Commission's complaints investigation processes.

In addition, from 2004-05 Forestry Tasmania will be subject to local government rates on all land used for commercial purposes (as distinct from forest reserves), including plantation and production forests.

## The ACT

The ACT is preparing detailed guidelines for government agencies on aspects of competitive neutrality policy, including the application of tax equivalents to, and full cost attribution by, government businesses. The government expects to issue these guidelines (which will augment its 1996 competitive neutrality statement) in the second half of 2004.

## Assessment of coverage

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

Apart from its government business enterprises, which constitute a large part of government business activity, Western Australia does not expose government businesses to competitive neutrality until they have been subject to a broad 'coverage review'. (This means its complaints mechanism cannot operate until the initial coverage review has occurred.) Western Australia has not required businesses operated by public hospitals, for example, 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 deferred any decision on this matter until the completion of a national inquiry into radiation oncology (the Baume inquiry). The findings of the Baume inquiry were released in September 2002, and the Australian Health Ministers Conference subsequently endorsed the final report that the Radiation Oncology Jurisdictional Implementation Group made in response to the Baume Report.

Western Australia advised the Council that the Minister for Health would consider the response to the Baume report. In mid-2004 Western Australia also advised that 'as a first step' in the process of the Minister determining whether a competitive neutrality review of radiation oncology services should be undertaken, the Department of Health will report to the Minister on whether such services should be considered a significant government business activity and whether a competitive market exists. Subsequently, the Minister for Health has committed to a competitive neutrality review of the radiation oncology services at the Perth public hospital being conducted in July 2005, when the acquisition of two major new assets will add significantly to the size of this government business.

The Council is concerned about the slowness with which Western Australia has addressed this two-year old competitive neutrality complaint and the general issue of applying competition neutrality to health businesses. This slowness has influenced perceptions of the integrity of the jurisdiction's competitive neutrality process. The Council welcomes, however, the Minister's decision to conduct a competitive neutrality review of radiation oncology services at the Perth public hospital in July 2005. It awaits the outcome of this review, and encourages the government to also review whether to subject all business activities of public hospitals to competitive neutrality principles.

Western Australia has not undertaken a competitive neutrality review of the Eastern Goldfields Transport Board, despite a private competitor having made repeated complaints to government about the board's competitive advantages when the board tenders for charter transport services in districts in which the board is permitted to operate. The complainant claims that the board cross-subsidises its charter operations by drawing on the subsidy it receives for its public transport services. Western Australia has advised the Council that the board's annual report does not contain sufficient detail to verify or refute the claim. The absence of a competitive neutrality review prevents the private competitor from making its complaint formally. The Council considers, therefore, that Western Australia should undertake a competitive neutrality complaints investigation.

More generally, the potential coverage of competitive neutrality policies has been partly eroded by governments' slow implementation of competitive neutrality to some businesses in the entertainment or recreational sectors. The Council also encourages governments to remain active in ensuring local government businesses apply competitive neutrality principles, particularly given that a large proportion of competitive neutrality complaints relate to local government businesses.

In the 2003 NCP assessment, the Council scrutinised the application of competitive neutrality principles to state forestry businesses in all states and the ACT. The Council assessed all jurisdictions except Victoria to be well advanced in meeting their CPA clause 3 obligations in this area. The Council noted, however, that the government forestry businesses of New South Wales, Victoria, Queensland and Tasmania were not liable for land rates and related local taxes. This year, the Council welcomes the further progress recently made by Victoria, via the corporatisation of VicForests, although the establishment process is not yet complete. The Council also endorses Tasmania's decision to subject Forestry Tasmania to local government rates, and looks forward to similar progress by Queensland through its consideration of whether to corporatise DPI Forestry.

## 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 2.2 summarises jurisdictions' complaints mechanisms.

### Box 2.2: 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. Competitive neutrality complaints about **Australian Government** enterprises are investigated by the Australian Government Competitive Neutrality Complaints Office, which is located within the Productivity Commission.

In **Victoria**, the Competitive Neutrality Unit considers all complaints, although the unit encourages parties to first seek to resolve the differences themselves. The unit has been absorbed into the new Victorian Competition and Efficiency Commission, which began operation on 1 July 2004. It was previously located in the Treasury. 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 2004 National Competition Policy annual reports

The Australian Government, state and territory 2004 NCP annual reports provided information on recent competitive neutrality complaints that the jurisdictions had investigated.

### Australian Government

A private company made a competitive neutrality complaint to the Australian Government Competitive Neutrality Complaints Office (AGCNCO) in November 2003 to the effect that the Australian Valuation Office (which is a business unit of the Australian Taxation Office) does not adjust its tender bids (for valuation contracts in the public and private sectors) for cost advantages arising from its use of Australian Taxation Office resources, and does not include a tax equivalent component in its costs. In May 2004 the AGCNCO completed its investigation of whether the Australian Valuation Office is applying the government's competitive neutrality requirements appropriately. It found that the Australian Valuation Office is a stand-alone business that does not have access to Australian Taxation Office resources at non-commercial rates, and does not enjoy any significant taxation, regulatory or debt financing advantages. The Australian Valuation Office also makes payments at commercial levels for all types of insurance except professional indemnity insurance, for which the AGCNCO recommended that the government require the Australian Valuation Office to make a competitive neutrality adjustment to its cost base when making tender bids.

### New South Wales

New South Wales' 2004 NCP annual report noted that the government received three complaints about the State Valuation Office (a business unit within the Department of Commerce) over the year to 31 March 2004. In mid-2004 the government referred these complaints to the Independent Pricing and Regulatory Tribunal (IPART) for independent investigation. IPART has completed its investigation and published its determination in early October 2004. IPART found that the State Valuation Office had not breached competitive neutrality principles.

### Victoria

The Competitive Neutrality Unit continued to investigate several complaints that had been made during 2002, and dealt with some that were initiated in 2003. The complaints related to child care, waste collection and community transport services operated by local councils, theatre venue hire by the Victorian Arts Centre Trust, and cemetery trusts. In several cases, the unit concluded that the government businesses had not breached competitive neutrality policy. In the case of cemetery trusts, the investigation has led to

the Department of Human Services conducting a pricing review, which will be followed by the introduction of more transparent pricing of memorialisation goods and services. One local council has reviewed financial data relevant to its waste collection service and made competitive neutrality cost adjustments that satisfy the requirement that the service be fully cost-reflective.

## Queensland

During 2003, the Queensland Competition Authority received a complaint from a legal company which claimed that the Environmental Protection Agency and the Office of State Revenue gave preferential database access to a government business. It investigated the matter and concluded that none of the agencies had breached competitive neutrality.

Queensland's 2004 NCP annual report noted that 637 of the 664 local government businesses subjected or committed to competitive neutrality reform have been subjected to complaint processes (compared with 561 a year earlier).

## 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 appointed an Implementation Advisory Group to review the *Marketing of Potatoes Act 1946*, and tabled the review report in Parliament on 1 July 2004. The report recommended the separation of the corporation's regulatory and commercial functions, and the cessation of its potato exporting. The Act is likely to be amended in 2005 to account for these and other recommendations in the report, and the Potato Marketing Corporation has entered a transition phase during which it will refrain from exporting (apart from honouring existing contracts). The government considers that these changes will address the cause of the competitive neutrality complaint.

The Complaints Secretariat has been considering complaints against government businesses that are not formally required to comply with competitive neutrality principles, including a complaint about the Department of Conservation and Land Management providing trees below cost through funding by the Natural Heritage Trust — the complainant was informed that this pricing is part of government policy to further environmental aims

## South Australia

In May 2002 the South Australian Competition Commissioner received a complaint against Supply SA regarding sales of school stationery. Following

an investigation, the commissioner found that Supply SA's short term pricing was consistent with its obligation to price stationery on a cost-reflective basis. South Australia also received a complaint against Monarto Quarries, which is a subsidiary of the Mount Barker District Council. The complainant queried whether contributed assets were fully accounted for. The complaint was investigated by an independent consultant, and the Mount Barker District Council implemented the consultant's recommendations.

## Tasmania

The Government Prices Oversight Commission received one formal competitive neutrality complaint in 2003. The complainant claimed that a waste disposal authority jointly owned by three local councils was not applying full cost attribution to its services, but the commission found that the waste disposal authority was not breaching competitive neutrality policy.

## The ACT

In the year to 31 March 2004, the ACT's Independent Competition and Regulatory Commission did not receive any competitive neutrality complaints.

## 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, but withdrew the complaint in September 2003.

## Assessment of complaints handling

The Council considers that governments' complaints mechanisms are operating satisfactorily. Nevertheless, competitive neutrality complaints investigations processes could be improved in two areas:

1. 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.
2. 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 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. It considers improvements in the speed with which complaints are investigated and resolved are warranted, and will monitor jurisdictions' performance in this regard.

## **Increasing the scope of competitive neutrality**

Since the CPA was signed in 1995, considerable strides have been made in the application of competitive neutrality to government business enterprises. Several governments, however, have been slow to apply competitive neutrality principles to certain key sectors of the economy, particularly health services and universities.

- Some governments have been reluctant to apply competitive neutrality principles to their health businesses, possibly because they are concerned that the price of these (potentially competitive) services would increase if prices reflected appropriate costs. However, rather than have recourse to hidden cross-subsidies, it would be more appropriate for governments to fully implement CoAG's agreement in 2000 that CSOs should be transparent, appropriately costed and directly funded by government. Such implementation would promote: greater competition in the provision of health services to the community; more choice for consumers; increased efficiency in service provision; and scope for governments to subsidise one or more of the providers of a health service or, alternatively, the users of the service.
- Most governments do not subject their universities to competitive neutrality principles (although Western Australia is amending its university Acts to ensure they adopt the principles). As a result, private contractors and consultants have complained about competition from university based companies or individuals offering prices that private parties consider do not reflect all costs. In addition to disadvantaging private competitors, the lack of competitive neutrality might have contributed to universities' expansion into various economic ventures, some of which have experienced difficulties and contributed to financial problems for universities. With the application of competitive neutrality, universities may be less tempted to establish enterprises that offer prices that do not reflect the full attribution of costs.

## **Delivery of community service obligations**

At its meeting on 3 November 2000, CoAG discussed competitive neutrality issues and agreed that there is no requirement for governments to undertake a competitive process for the delivery of community service obligations (CSOs) and that governments are free to determine who should receive a CSO payment or subsidy. CoAG stated that CSO payments should be transparent, appropriately costed and directly funded by the government. The Council considers that some governments, including local governments, still need to pay attention to these desirable characteristics of CSO payments.

CSOs should not be funded through cross-subsidies within a government business, because such cross-subsidies can handicap the competitiveness of the government business. In addition, to improve the capacity of government businesses to fund cross-subsidies, governments have sometimes established regulations that restrict the competition facing the government business, with a flow-on cost to consumers. These restrictions aim to promote economic rents to 'fund' the cross-subsidies. Governments should also avoid reducing the required rate of return for agencies delivering CSOs, because this affects all facets of the performance of the businesses.

When governments directly fund CSOs, they remove the resource allocation distortions caused by cross-subsidies and regulatory intervention. If governments clearly identify and report CSOs in their budgets and departmental accounts, they facilitate community awareness of the CSOs, comparisons with other community demands on the public purse, and periodic reviews of CSOs. While CoAG agreed in November 2000 that governments are not required to undertake a competitive process for the delivery of CSOs, direct funding and transparency of CSOs tend to highlight to governments the potential advantages of tendering, which can reduce the cost of delivering CSOs and introduce innovative methods for their delivery.

Governments need to take care to appropriately cost and transparently report all CSOs — not just those paid to government business enterprises, but also those paid to any government agency that conducts commercial operations (for example, government-owned cultural institutions).

## **Financial performance of government forestry businesses**

In the 2003 NCP assessment, the Council found that, with the exception of Victoria, all states and the ACT were well advanced applying competitive neutrality principles to government forestry businesses, having corporatised or commercialised these businesses. Victoria was less well advanced but the

government had made a public commitment to the reform of Forestry Victoria, then a division of the Department of Sustainability and Environment<sup>2</sup>.

However, the Council was unable to confidently assess any government as fully meeting its competitive neutrality obligations with respect to public forestry businesses, as none had yet established a track record of earning adequate profits.

## Recent performance

The Productivity Commission has a program of research designed to provide comparable information on the financial performance of government trading enterprises (GTEs). This is the second year its report has included government forestry businesses. It found that the profitability of the sector as a whole, measured as the return on assets<sup>3</sup>, improved from 4.4 per cent in 2001-02 to 7 per cent in 2002-03. Four of the six monitored businesses improved their profitability in 2002-03, while one — Forestry Tasmania — reported a negative return (see table 2.1).

**Table 2.1:** Profitability of government forestry businesses<sup>a</sup>

| <i>Government forestry business</i> | <i>State Forests of NSW</i> | <i>DPI Forestry (Qld)</i> | <i>Forests Products Commission (WA)</i> | <i>ForestrySA</i> | <i>Forestry Tasmania</i> | <i>ACT Forests</i> |
|-------------------------------------|-----------------------------|---------------------------|---|-------------------|--------------------------|--------------------|
| 2001-02 return on assets (%)        | 2.4                         | 10.6                      | 8.7                                     | 4.6               | 1.6                      | 4.0                |
| 2002-03 return on assets (%)        | 0.5                         | 23.8                      | 7.6                                     | 6.8               | -0.6                     | 16.3               |

<sup>a</sup> The correction of errors in earlier forest valuations increased the 2001-02 profit of the Forest Products Commission (WA) by \$10.2 million and decreased the profit of Forestry Tasmania by \$12.25 million. In 2002-03, ACT Forests recognised insurance recoveries following the 2003 bushfire.

Source: PC 2004a.

As noted by the Commission, in 2002-03 the risk-free rate of return, taken to be the 10 year Commonwealth Government bond rate, was 5.4 per cent (PC 2004a, p. 7). Given the market risk inherent in any business it is reasonable to expect government forestry businesses to earn a return significantly above this rate. In 2002-03 government forestry businesses, with the exception of State Forests of NSW (SFNSW) and Forestry Tasmania, exceeded the risk-free rate of return by a significant margin.

<sup>2</sup> As noted, Victoria has since established VicForests as a state-owned enterprise.

<sup>3</sup> The Commission defines return on assets as earnings before interest and tax and after abnormals (including asset valuation changes) over average total assets.

However, the Commission cautions that the profitability results of government forestry businesses can vary dramatically from year to year, due to the recognition under Australian Accounting Standard AAS35 of movements in the market value of their forest assets in the statement of financial performance. Under AAS35, forest assets are valued annually using market prices either of timber as standing currently or as grown to maturity (under a net present valuation technique). Timber prices and, therefore, the valuation of forest assets and the financial performance of forestry businesses, are sensitive to fluctuations in demand. For performance monitoring purposes, annual rates of return need to be assessed in the context of longer-term trends and other relevant information.

## Longer term performance

Some longer term performance information is available for SFNSW, DPI Forestry (DPIF) and Forestry Tasmania which have been established in their current form for some years. This information is not, in the Council's view, yet sufficient to draw firm conclusions about whether these government forestry businesses will in the long run earn returns that recover their cost of capital and, therefore, fully meet the aims and principles of competitive neutrality. Presenting it, however, serves to illustrate some of the difficulties of drawing firm conclusions. Some of these difficulties may be overcome with more intensive scrutiny and analysis. Alternatively, the power of competitive neutrality policy to assure in any timely manner that resources are being allocated efficiently in forestry, where governments operate businesses in this sector, may be limited.

## New South Wales

The average annual return on assets of SFNSW over seven years to 2002-03 is slightly over 1 per cent (New South Wales Treasury 2004). For 2003-04 and the following two years, SFNSW expects an annual average return on assets of around 2 per cent (Government of New South Wales 2004).

The government argues that these apparently poor returns partly reflect heavy investment in expanding SFNSW's plantation estate over the past 10-20 years, which has significantly increased its asset base, and the annual costs of protecting and enhancing the growing stock. It also notes that the available cut can exceed processing capacity in New South Wales at present and that this weakens State Forests' bargaining power in price negotiations with processors. It expects SFNSW's profitability to increase over five to 15 years as processing capacity expands, lifting prices, and as plantations mature and are harvested.

## Queensland

DPIF has earned an average annual return on assets of 11 per cent for the five years to 2002-03 (DPIF 2003). Rolling forward the government expects this five year average to drop to under 7 per cent by 2005-06 (Government of Queensland 2004). With the Queensland Audit Office, DPIF has established its real cost of capital in the range of 6–7.5 per cent. Expected returns currently fall within this range but are sensitive to factors outside the control of DPIF such as historical resource management decisions and current market conditions. DPIF therefore focuses on enhancing the performance of the business through assessing plantation investments against its cost of capital.

## Tasmania

Forestry Tasmania has earned annual returns over the three years to 2002-03 averaging 2 per cent before forest valuation changes (Forestry Tasmania 2003). The government expects similar returns for 2003-04 and the following two years if domestic and export markets remain at their current high levels of demand.

The government expects Forestry Tasmania to meet or exceed its hurdle rate on all new investments, but does not expect it to meet its cost of capital in respect of assets managed for non-commercial purposes, such as parkland.<sup>4</sup>

---

<sup>4</sup> This appears to be a case where the Council comments above on the delivery of community service obligations are applicable.