NCP

National Competition Policy Implementation in Queensland

Full Cost Pricing Policy

A QUEENSLAND GOVERNMENT
POLICY STATEMENT

AUDAX · AT · FIDELIS

QUEENSLAND GOVERNMENT

CONTENTS

Overview 2

1 Introduction

1.1 Application of Full Cost Pricing 3
1.2 Relationship with other Competitive Neutrality Policies 3
1.3 Guiding principle 4
1.4 Status of the Policy 4

2 Implementing a full cost pricing policy 5

2.1 Distinction between costing and pricing 5
2.2 Components of a full cost pricing policy and how they are valued 7
2.2.1 Cost benchmark 9
2.2.2 Pricing decision 12
2.3 Treatment of Community Service Obligations (CSOs) and Government Service Obligations (GSOs) 14
2.4 Structural reforms required 14
2.5 Accounting system required 15
2.6 Reporting requirements and compliance 16

Appendix 1 Costing Definitions 17

Appendix 2 IdentifyingCommunity Service Obligations and Government Service Obligations 18

Who to contact for further information 23

Overview

The purpose of this policy is to provide guidance to departments on implementing a full cost pricing policy for significant business activities (SBAs), as required under National Competition Policy (NCP) and the Queensland Government's Public Finance Standards (PFS).

The Full Cost Pricing (FCP) Policy applies to SBAs that aren't either a government owned corporation (GOC) (in accordance with the *Government Owned Corporations Act*) or a fully commercialised business unit (in accordance with the *Commercialisation of Government Services Functions in Queensland Policy Framework*[1]).

The FCP Policy aims to achieve competitive neutrality between public and private sector businesses by ensuring that prices charged by SBAs reflect a similar cost structure to that faced by a private sector competitor. In setting prices under the FCP policy, the SBA must meet all fixed and variable costs (including tax equivalents), and must achieve an appropriate rate of return on equity. This rate of return must be achieved over the medium term.

All SBAs are subject to the competitive neutrality complaints mechanism administered by the QCA. This mechanism allows private and public sector organisations in competition with SBAs to complain that an SBA is not complying with the principle of competitive neutrality.

[1] Queensland Treasury, October 1994

1 Introduction

1.1 Application of Full Cost Pricing

The Full Cost Pricing (FCP) Policy applies to SBAs[2] that aren't either a government owned corporation (GOC) or a fully commercialised business unit (in accordance with the Commercialisation of Government Services Functions in Queensland Policy Framework[3]).

1.2 Relationship with other Competitive Neutrality Policies

The FCP Policy is one of a suite of policies designed to place government activities on a competitively neutral basis when competing with the private sector. Other competitive neutrality policies under NCP include commercialisation and corporatisation.

Separate from the National Competition Policy, the Queensland Government is introducing competition into the provision of general government services by a competitive tender process. Under this approach, the right to provide a service is awarded to the external provider (through a contract) or "in-house" service delivery unit (through a service agreement) which has submitted the best competitive tender to deliver that service for a specified period at a specified price. This process of competitive service delivery (CSD) is likely to result in the creation of innovative and more efficient ways of producing and delivering services to the public.

Where competition is introduced in this way, in-house units will bid against private providers on a competitively neutral basis. The proposed *"Competitive Service Delivery For Budget Sector Agencies Policy"* states that an in-house bid must be prepared to the same specification as other bids and work should not be awarded in-house except on the basis of a bid. There must be clear separation between the in-house bid team and those conducting the tender process in order to avoid conflicts of interest. The CSD Policy provides Costing Guidelines to assist in the preparation of in-house bids.

It should be noted that Section 3 of the CSD Costing Guidelines do not apply to gazetted SBAs.

[2] The definition of a SBA is provided in section 3.1 of the Queensland Government's Policy Statement on competive neutrality - Competitive Neuatrality and Queensland Government Business Activities. This statement also lists those government activities which have, to date, been identified as SBAs, or candidate SBAs. An activity will formally become a SBA by gazette notice. For further information on the application of full cost pricing, readers are referred to this Statement and the Queensland Governmnet's Public Finance Standards (PFS)- in particular, PFS 320.

[3]Queensland Treasury, October 1994

1.3 Guiding principle

The guiding principle underlying the FCP Policy is that a government business should not enjoy any net competitive advantage (or disadvantage) in respect of its private sector counterparts simply because of its public sector ownership. That is, the policy aims to achieve competitive neutrality between public and private sector businesses.

Application of this principle requires the removal of the special advantages and disadvantages resulting from government ownership so that any edge in competition should result solely from superior management and operational factors. Where cost comparisons with private sector organisations are required, it is essential that those comparisons be on a similar basis and be credible. Otherwise, competition may be undermined leading to distortions in market efficiency.

Under the FCP Policy, the principle of competitive neutrality is met by ensuring that prices charged by SBAs reflect a similar cost structure to that faced by a private sector competitor so that it is subject to the same pressures from competition as its private sector equivalents.

While this aim is best achieved by ensuring that prices, in all situations where an SBA is competing, are based on the full cost of supplying a product, the policy does allow sufficient flexibility for SBAs to price in a competitive manner according to market conditions. For example, the policy permits the setting of "loss-leader" prices provided that a prescribed rate of return is achieved in the medium term.

Where a SBA enjoys special privileges or advantages (arising from its public ownership) over the private sector, a compensating upward revision of SBA costs would be appropriate to ensure a 'level playing field' is maintained.

1.4 Status of the Full Cost Pricing Policy

The policy is incorporated by reference into the Queensland Government's Financial Management Standards. The Standards require that relevant SBAs must apply the policy.

These Standards are subordinate legislation under the *Financial Administration and Audit Act*. Accordingly, while the policy itself does not have any legislative status, the Standards impose a statutory obligation upon SBAs to comply with the policy.

2 Implementing Full Cost Pricing

This section focuses on the practical considerations of implementing full cost pricing. It addresses:

- the concepts of costing and pricing;
- components of a full cost price and how they are valued;
- treatment of community service obligations;
- structural reforms required; and
- reporting and compliance measures.

2.1 Distinction Between Costing and Pricing

It is important to distinguish between the terms 'costing' and 'pricing' as they are quite different notions.

Costing involves determining the value of resources consumed in the production of goods or the provision of a service. Costing's role in pricing is to act as a benchmark against which pricing and production decisions can be made.

Pricing refers to the process of determining a figure at which products or services will be exchanged in the marketplace. The focus on pricing is on the income received from the exchange of the good or service. While cost is an important consideration in pricing, optimal pricing policies will also fully reflect additional market and competitive considerations as well as the need to achieve a rate of return on equity invested.

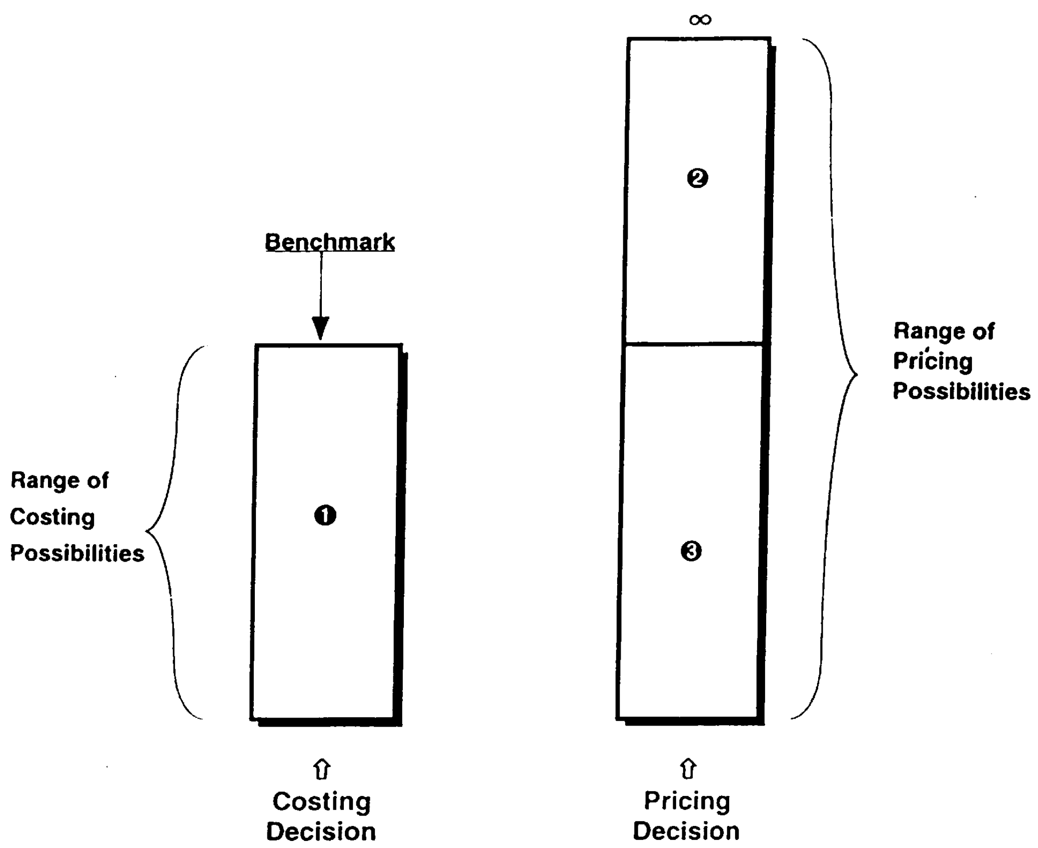
Thus, in a competitive market, pricing is not independent of other suppliers and the value that consumers place on products. This should ensure that there are price disciplines on SBAs which will not allow pricing to be determined solely on a "cost plus" basis.

The FCP Policy uses full cost to establish the cost benchmark for pricing decisions. However, the policy recognises that SBAs operate in a commercial environment and, therefore, does not prevent the use of marginal cost or avoidable cost for specific pricing decisions if appropriate but this must be with the established benchmark and must be consistent with achieving the required rate of return. The use of techniques such as 'Activity Based Costing' is permitted by the Policy where such a system ensures that all costs (both direct and indirect) are fully allocated to cost pools and then to specific goods or services.

The relationship between costing and pricing is depicted in Figure 1. Costing definitions are provided in Appendix 1.

Figure 1

Costing and Pricing Contrasted



Dependent, amongst other things, upon the cost object, decision to use full cost, marginal cost or avoidable cost, and decision as to how to allocate indirect costs where appropriate.	Dependent upon considerations such as value added, demand elasticity, competitive behaviour, market positioning, cost etc. NOTE: Cost is only one of the many relevant factors in pricing.

❶ This represents the cost benchmark determined on the basis of full cost, marginal cost, avoidable cost etc. NOTE: This policy requires that full cost be used as the benchmark.

❷ Assuming that full cost is used as the benchmark, average prices set within this range give rise to a profit. Any profit derived may, however, be illusory where the cost benchmark used is something less than full cost.

❸ Assuming that full cost is used as the benchmark, average prices set within this range give rise to a loss. Whilst prices in this range may cover variable costs and make a contribution to non-variable costs, they generally cannot be sustained in the long-term.

2.2 Components of a full cost pricing policy and how they are valued

In the private sector prices are set so that, as a whole across the enterprise, they recover the full cost of the provision of all goods and services and taxes and similar charges plus a suitable return on the owners' investment.

In commercial practice the price of every individual good or service does not necessarily reflect the full costs of the provision of that good or service and taxes and similar charges plus an element for return on the owner's investment. Prices are set so that, as a whole across the enterprise, they recover the full cost of the provision of all goods and services and taxes and similar charges plus a suitable return on the owners' investment.

This concept is incorporated in this policy through the establishment of a cost "benchmark" for each SBA. The benchmark must take into account all costs incurred in producing and delivering the goods and services, as well as taxes and other Government charges faced by the private sector competitor or equivalent business, credit margins and guarantee fees. Prices must incorporate this benchmark plus a return on investment similar to that required by the owners of the private sector competitors or equivalent businesses.

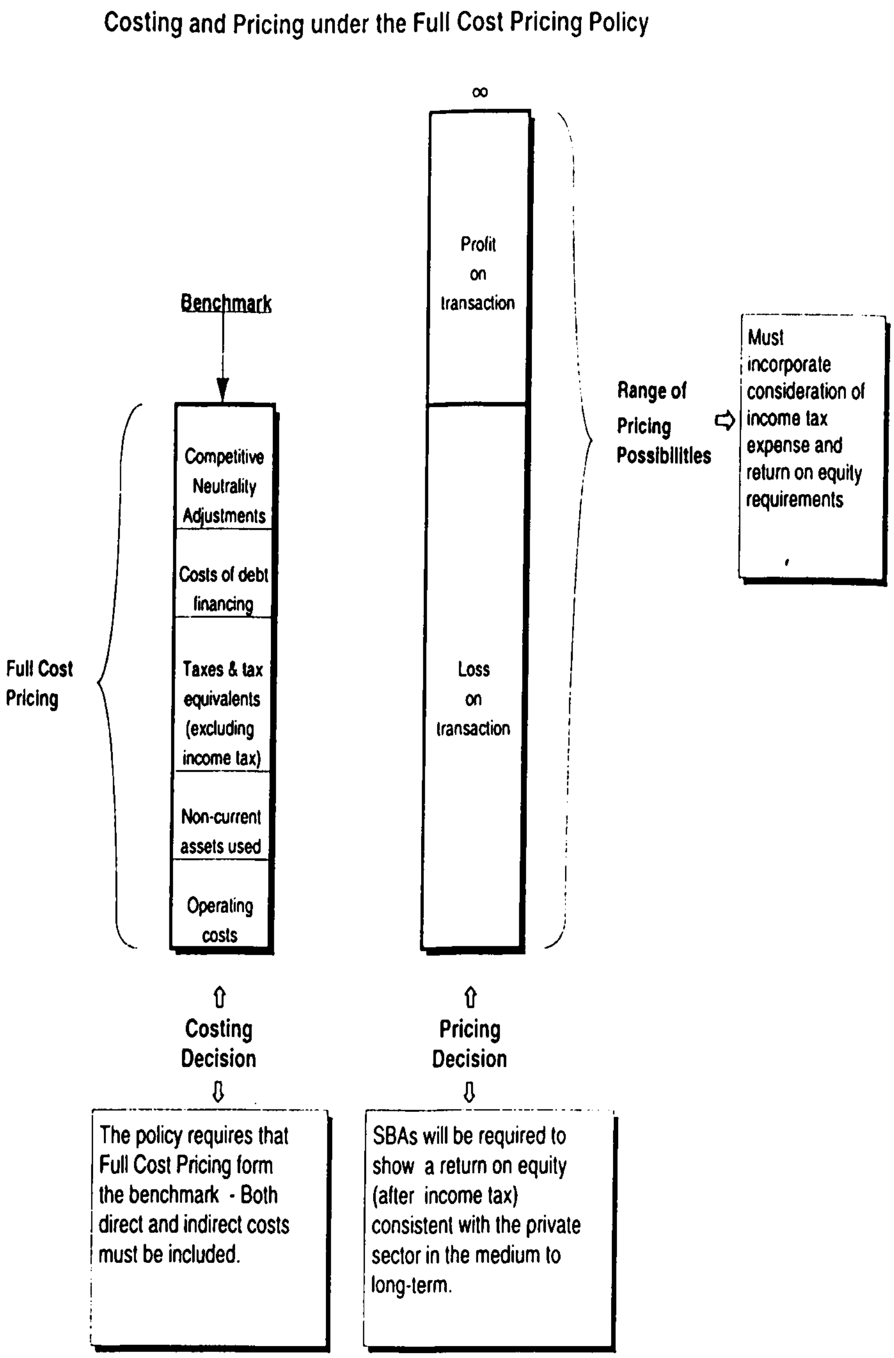
The cost benchmark is to be based on the costs listed below and the rate of return should be set over the medium term. This allows the relevant SBAs to adopt commercial principles and practices and to make commercial decisions in the same manner as their competitors and equivalents.

Each SBA to which this Policy is to apply is to be examined separately to set the benchmark and each SBA must price commercially. The term over which the rate of return is to be met should be not less than one year or more than three years which will allow the relevant SBAs to establish the required commercial structures. In most cases it is anticipated that the SBAs will be corporatised or fully commercialised within three years and the FCP Policy will cease to apply when that occurs.

The overall approach is depicted in Figure 2.

Figure 2

Costing and Pricing Under the Full Cost Pricing Policy



2.2.1 Cost Benchmark

The cost benchmark must include:

a. Operating Costs

Operating costs for SBAs include the following types of expenditure:

- Salaries/wages (plus on-costs)
- Consultancies
- Electricity and water
- Quality assurance
- Office consumables, eg. paper, stationery
- Insurance
- Lease payments
- Communications
- Printing and copying
- Furniture and fittings
- Incidentals
- Workers compensation
- Raw materials and equipment
- Training and development
- Freight and cartage
- Office machines and equipment
- Uniforms
- Office accommodation
- Repairs and maintenance
- Travel
- Cleaning
- Advertising
- Motor vehicles
- Regional or central office charges

The above list is indicative of the types of expenditures that fall within this category and is not meant to be exhaustive.

b. Non-current assets used (capital costs)

Depreciation and amortisation for the consumption or loss of the service potential embodied in the SBAs non-current assets with limited useful lives should be calculated using the principles outlined in the section on depreciation in the publication entitled Recording and Valuation of Non-Current Physical Assets in the Queensland Public Sector[4].

Non-current assets should be valued using the principles in the sections on valuation and revaluation of assets in that publication.

c. Taxes and Tax Equivalents

The imposition of full taxes or tax equivalents forms an important part of complying with the principle of competitive neutrality. Accordingly, the following costs will be required to be included in calculations of full cost by SBAs:

- Sales tax
- Stamp duty
- Council rates
- Land tax
- Payroll tax
- Capital gains tax
- Federal debits tax and other statutory bank charges

[4] Queensland Treasury, October 1994

The above list is not exhaustive. Other government charges or taxes of a similar nature to those listed above are also to be included.

Note: Income tax has specifically been excluded from the costing portion of the overall pricing process. The FCP Policy requires that income taxes be explicitly considered as a part of the pricing decision. This treatment has been adopted on the basis that income tax expense is a direct function of the price charged for the SBAs product or service. Similarly, income tax must be considered by the SBA in any analysis of the minimum overall price levels necessary to generate the required return on its equity. Refer to section 2.2.2.

d. Costs of Debt Financing

This policy requires that SBAs bear the cost of debt in a manner similar to their private sector counterparts. Where a SBA does not pay interest at full commercial rates in respect of its borrowings, it will be necessary to determine whether that situation is the result of its affiliation with government or whether that is an arrangement that might normally be available to businesses in the private sector. SBAs will only be required to impute an interest charge on such debt where the advantage arises solely because of the nexus between the SBA and the government. The amount of the charge should reflect the advantage of borrowings being guaranteed by the Government. Assistance in determining the amount can be obtained from Queensland Treasury's Government Owned Enterprises Unit.

The cost of debt to a SBA will generally be comprised of the following components:

a. a base amount of interest payable to Queensland Treasury Corporation (QTC) on an arm's length basis at the preferential rate applicable to government activities; and

b. an additional margin equivalent to the difference between the above rate and the rate at which the SBA would be able to borrow in the market on a stand alone basis.

These interest payments will be required to be paid to QTC on a normal commercial basis. It is anticipated that the additional margin will be collected by QTC and returned by QTC to the consolidated fund for redistribution.

The additional margin payable will be determined by assigning a credit rating to SBAs on a stand-alone basis. QTC is able to provide a range of data on the costs of debt for entities with various credit ratings. Credit ratings for each SBA will be assigned by the Queensland Treasury in consultation with the SBAs and the portfolio Department. Where appropriate, external advisers may also be used.

All interest incurred by the SBA on both short-term and long-term debt should also be included in the full cost calculation. Interest costs will generally form part of the overhead of the SBA and will be required to be fully absorbed by the SBA's products or services.

e. Competitive Neutrality Adjustments

Where benefits (other than those accounted for in the cost components above) arising out of public ownership exist, these should be identified and either removed or appropriate adjustments to the cost benchmark made.

Competitive neutrality adjustments should not be made to the costs incurred by a SBA where those adjustments do not seek to undo an artefact of the SBAs public sector ownership. For example, cost structure advantages arising from prudent management practices within a SBA should not be reversed merely because the same advantages have not accrued to private sector competitors. The key on this point is to differentiate between those advantages or disadvantages that arise merely because of the SBAs public ownership and those that form part of the normal variability in management practices and cost structures within any given group of organisations competing in a common marketplace.

Some examples of additional benefits enjoyed by public sector businesses are:

- Crown indemnity where provided in respect of insurance;
- tied clients;
- intellectual property ;
- Worker's Compensation premiums may be lower for state as premiums calculated on basis of a government wide average rather than industry type;
- possible lack of tendering costs for government.

Where practical, these factors should be identified, quantified and equivalents paid by the SBA which will ensure that they are taken into account in costing calculations and pricing decisions.

On a similar basis, any disadvantages that a SBA might incur because of public sector ownership should be either removed or accounted for by adjustment to the cost base.

Note: Disadvantages may also be accounted for by adjusting the rate of return required. However, it would be expected that this would be a transitional arrangement only.

Examples of disadvantages include:

- Public Sector requirements in respect of employment conditions and security of tenure (inflexibility);
- inability to adjust staffing numbers for peaks and troughs;
- requirement to provide services in areas where it may not be economic to do so (NB Such a requirement would normally be considered a CSO. Refer to section 2.3 for information on how CSOs are treated);
- requirement to employ a higher percentage of apprentices;
- preferential arrangements may lead to less favourable credit terms for government departments; and
- provision of support from parent organisation at less than full cost in private sector.

Each factor is to be addressed on an individual basis and should be isolated and costed if possible. They may qualify as Community Service Obligations (CSOs) or Government Service Obligations (GSOs) (see section 2.3) and should be funded as such or explicitly funded as a competitive neutrality adjustment i.e. where there are identifiable, measurable, significant funds flows.

In other cases, i.e. where they can not be reliably measured or are not significant, they should be identified and eliminated where possible. Where they have a significant impact on the SBA's actual financial performance, they may be taken into account during performance monitoring.

2.2.2 Pricing decision - capital structure, rate of return requirement and payment of dividends

Capital Structure

As SBAs are required to operate in the same manner as private sector competitors, they are to be set up with similar capital structures. Traditionally Government business activities have not been structured along the lines of the private sector - that is there has been no defined capital structure consisting of both debt and equity. It is this structure that provides a basis for determining whether investment in a business is worthwhile - an informed investor will normally only invest in an enterprise if the returns on the investment (adjusted for the riskiness of the investment) outweigh returns from alternative investments.

A number of SBAs will not have a formal capital structure on which to base the returns on investment or costing of their capital. Implementation of this policy will require that the SBA in consultation with Queensland Treasury and the portfolio Department, establish a capital structure which reflects the general characteristics of other industry participants. This process will generally involve the use of external resources (either data or consultants or both) to determine industry norms.

Once an approximation of industry norms has been established and an appropriate capital structure for the SBA decided upon, the new capital structure will be formally set in place via a restructuring of the SBAs finances. This will generally involve formally establishing loan facilities with QTC for the full amount of the loan and attributing the balance to equity held by the Government. Where it is not cost effective to put such a structure in place, appropriate proxy arrangements will be considered.

Return on Equity

SBAs, to which the FCP Policy applies, are required to price their goods and services at a level that provides a return on equity (after income tax equivalents) no less than the estimated cost of equity over a medium to long term which is to be determined on a case by case basis in consultation with Queensland Treasury and the portfolio Department. It is anticipated that a rolling term of three years will be used as a proxy for medium to long term.

Establishment of the cost of equity requires a knowledge of the following:

c. the risk free rate of return on investment (the yield on long term Commonwealth Government bonds is normally adopted);

d. the return on the market (generally treated as being in the range of 6-8% depending on the length of the time series of returns data used for the calculation); and

e. the "beta" risk of the relevant investment.

SBA betas will not be easily discernible as the is no market in the equity of SBAs. Similarly there may no market in the equity of private sector competitors as they may be companies not listed on the ASX, partnerships, trusts or sole proprietors. Estimates of beta risk will be determined by the SBA, the portfolio Department and Queensland Treasury. It is anticipated that consultants may also be used in this process.

Payment of Dividends

Dividends represent the dispersal of profits to owners and arrangements for the payment of dividends to the Government will be determined on a case by case basis in consultation with Queensland Treasury and the portfolio Department. This Policy does not require that each SBA generate a return equal or greater than their cost of equity capital in every year of operation and, similarly, the level of dividends may vary from year to year. Factors which will be taken into account when determining the dividend payable include the level of profit for the year, investment requirements and the level of cash reserves.

Dividends are to be paid to the Consolidated Fund in accordance with a timetable agreed with Queensland Treasury. In some cases, the funds may be treated as general revenue and in other cases, they may be directed to specific programs. The treatment will be decided on a case-by-case basis.

Income tax

The FCP Policy requires that income taxes be explicitly considered as a part of the pricing decision. This treatment has been adopted on the basis that income tax expense is a direct function of the price charged for the SBAs product or service. Similarly, income tax must be considered by the SBA in any analysis of the minimum overall price levels necessary to generate the required return on its equity.

SBAs applying the FCP Policy are to use the substantive ITAA Tax Equivalent Model (as outlined in the Treasurer's Tax Equivalent Manual) when calculating taxes for costing purposes. Further guidance is contained in the Treasurer's Tax Equivalent Manual. Each SBA should calculate the tax expense for pricing purposes based on its business plan.

The disposition of tax equivalent payments is the prerogative of the Government. It may decide that, although the Government service provider is a SBA and should be subject to full competitive neutrality, the equivalents and other adjustments should be paid back to the relevant Program so as not to dilute the Program funds. The Government may also decide that the adjustments should be paid to General Revenue. This will be decided on a case by case basis on the advice of the Treasurer and the portfolio Minister.

Once this has been established, the SBA will pay these equivalents and other adjustments to the relevant accounts in accordance with the policies agreed between the relevant SBA, CEO of the portfolio Department (if the SBA is a departmental business unit), the portfolio Minister and the Treasurer prior to the commencement of each financial year.

2.3 Treatment of Community Service Obligations and Government Service Obligations

These are similar in nature and are basically "non-commercial" activities that the Government requires a SBA to carry out. CSOs normally refer to services provided by SBAs which provide services to the public while GSOs refer to activities provided by SBAs which do not normally provide services to the public. Further details are contained in Appendix 2.

Full details and any agreed CSO and GSO activities, including the description, arrangements for measuring the effectiveness of their delivery, agreed funding levels, costing and payment arrangements will be agreed between the relevant SBA, CEO of the portfolio Department (if the SBA is a departmental business unit), the Portfolio Minister and the Treasurer prior to the commencement of each financial year.

2.4 Structural reforms required

While the FCP Policy does not, strictly speaking, require any structural reform to occur, it is highly advisable that departments consider implementing the following reforms in order to ensure compliance with the principle of competitive neutrality.

Separation of policy and regulatory functions from commercial activities

Generally private sector businesses do not have policy and regulatory functions. A SBA with these functions would normally enjoy an advantage over its private sector competitors through being able to have prior knowledge and an inordinate influence on policy changes and regulation of competition. It is essential that these functions be removed from SBAs to ensure competitive neutrality.

Separation of government as purchaser from government as provider

In situations where the SBA is one of a number of providers of a service to the government, departments should ensure that there is a clear separation between the department's role, on behalf of the government and the community, as purchaser of the good or service in question and its role as provider of the service through the SBA. This is particularly important where purchasing is by way of a competitive tender process.

The separation of these two roles assists in complying with the principle of competitive neutrality. The separation means that there is less likelihood of the SBA obtaining a competitive advantage by virtue of its government ownership and is subject to the same competitive pressures as its competitors.

2.5 Accounting system required

The establishment of a cost benchmark requires a bringing to account of all costs incurred in producing the good or service in question. This necessarily requires that appropriate accounting systems are in place.

The adoption of accrual accounting plays an important role in enabling SBAs to properly identify the full costs of producing goods or delivering services. Cash based accounting systems will, without significant additional work, fail to capture all of the costs associated with operating a SBA.

Accrual accounting systems will, however, ensure that the majority of data needed to support a full cost pricing polcy is gathered as a part of the normal accounting process. By capturing non-cash expenses such as depreciation and amortisation, accrual accounting helps ensure that all appropriate expenses are incorporated into costings. In addition, the process of relating expenditures to the period to which they relate helps improve the accuracy of costings. This is an issue in that expenditures (superannuation payouts and capital purchases, for example) relate to periods other than that in which the cash outlay is made.

Accordingly, the FCP Policy requires that SBAs adopt an accrual accounting system. It should be noted that the adoption of such a system is also a requirement of the Public Finance Standards.

2.6 Reporting requirements and compliance

Each SBA is to be subject to a cost/pricing monitoring regime to ensure compliance with the FCP Policy.

Details of the regime will be agreed between the with the portfolio Department and Queensland Treasury, but essentially the portfolio Department will have prime responsibility for the implementation of the cost/pricing monitoring regime.

The reporting requirements for the cost/pricing regime will be tailored to individual SBAs. Reporting requirements will be established by Queensland Treasury and the portfolio Department in conjunction with the SBA and should be on a three monthly basis along the lines of the requirements for GOCs and fully commercialised business units. They should be sufficient to allow assessment of the SBAs compliance with the FCP Policy and include the SBAs plans for ensuring that they are able to generate the required return on equity over the required period. Should a SBA fail to achieve the required results, the portfolio Department, in conjunction with Queensland Treasury, will make recommendations to the portfolio Minister and Treasurer on any action required.

Competitive Neutrality Complaints Mechanism

In addition to the reporting requirements set out above, compliance with the full cost pricing policy and the principle of competitive neutrality will be indirectly monitored by virtue of the fact that all SBAs are subject to the competitive neutrality complaints mechanism, administered by the proposed Queensland Competition Authority (QCA)[5]. This mechanism will allow for private and public sector organisations in competition with SBAs to lodge complaints on the ground that the SBA in question is not compliant with the principle of competitive neutrality.

These complaints will be investigated by the QCA which will then make recommendations to the Ministers responsible for implementing NCP. The Ministers responsible will then consult with the Minister responsible for the SBA over what action to take.

SBAs may apply to the QCA to have their pricing policy formally accredited as complying with the FCP policy and the principle of competitive neutrality.

Prices Oversight

Where the SBA enjoys a legislated or natural monopoly, the NCP prices oversight mechanism, administered by the QCA, has jurisdiction to ensure that monopoly prices are not charged.

[5] Details of how the complaints mechanism works will be set out in the proposed *Queensland Competition Act*.

Appendix 1

Costing Definitions

Full Cost. Full costing describes the process of accumulating the total costs of the business unit (including those not directly attributable to particular activities) and allocating them to all of the activities undertaken by the unit. Under full costing, indirect costs and overheads are fully absorbed into the costs of activities.

Full cost may be defined on a per unit basis (average full cost) or in relation to the business unit *in toto.*

The measurement of full cost provides a key benchmark in that it represents the minimum level of revenue that can be generated by firms in the private sector if they are to remain viable in the long term. Full costs therefore have an important role to play in public sector organisations with a strong business or commercial bias.

Marginal Costs. Marginal costing refers to the development of a cost benchmark on the basis of the additional costs incurred in producing one additional unit of output rather than on the average cost. Marginal costs will generally include all direct variable costs of production together with indirect variable costs, where appropriate. Marginal costing turns on the distinction between fixed and variable costs and allows determination of whether the gains from producing an extra unit of output exceed the costs of producing it.

Marginal costs will generally be less than average full cost in relation to a specific cost objective as marginal costing will not include fixed costs. Short run marginal cost data is particularly useful from a managerial perspective in situations where marginal output decision making is required (for example, where average full cost is calculated on the basis of a particular capacity utilisation and that level of utilisation has already been met or exceeded).

It is important to note that fixed costs will often become variable costs in the mid to long-term. Short run marginal costing will therefore exclude a number of fixed costs that would not be excluded if the analysis were being done on the basis of long run marginal costs.

Avoidable Costs. Avoidable costs are those that would be avoided if an operation were suspended or closed down. Where an operation did not already exist, avoidable costs would be those associated with establishing and maintaining the additional operation.

Many of the concepts in respect of avoidable costs are similar to those of marginal costing. However marginal costing focuses on the change in costs arising from an additional unit of output whilst avoidable cost takes a more macro approach by focussing on the costs of adding or deleting an entire function or operation.

Appendix 2

Identifying Community Service Obligations And Government Service Obligations

The following descriptions relate to significant business activities (SBAs) which have not been corporatised. Treatment of Community Service Obligations (CSOs) for SBAs that are government owned corporations is contained in the *Government Owned Corporations Act 1993*.

Community Service Obligations

CSOs are non-commercial activities which SBAs are directed to pursue by the Government. They are activities which would not be undertaken in a "purely commercial environment. CSOs often relate to the equity objectives of the Government and they do not normally include regulatory or policy functions.

It is useful to make a distinction between CSOs which are specifically imposed by the Government and arrangements adopted as "good business". It is a legitimate business practice to subsidise certain "non-commercial" activities in the interest of overall business. Such activities would be a matter for the SBA and would not receive any Government funding. As well, CSOs would not be defined by the effects of general legislation (e.g. general environmental or industrial relations legislation).

There are five basic types of CSOs (although other examples are possible):

f. where the Government considers it desirable that certain products be supplied to all users at a uniform or affordable price regardless of the cost of provision. Uniform electricity tariff is an example of this type of CSO;

g. where the Government has its welfare objectives met by requiring SBAs to provide price concessions to users who are considered to be disadvantaged, e.g. various pensioner concessions;

h. the Government may require a SBA to provide, in effect, industry assistance. For example, port or other infrastructure may be provided on regional development grounds at prices below that which would be commercially warranted if considered in isolation;

i. the Government may require SBAs to purchase certain specific goods and services as inputs; and

j. the Government may require SBAs to abide by environmental, consumer, cultural, heritage or similar policies beyond those which generally apply.

Need for Clarity. Some activities, which have in the past been treated as CSOs, are the result of explicit Ministerial or bureaucratic directions. Some may have originated in this manner, but are now largely based on tradition. In this respect, there may be confusion about the extent to which established practices are related to current Government objectives. Uncertainty about the scope of CSOs might result in the over-provision of the CSO as the SBA sought to ensure that the Government's requirements were met.

If the CSO requirement is not clear, it will be difficult for the costs and revenues of commercial services to be adequately monitored and for the SBAs performance and compliance with the Full Cost Pricing Policy to be assessed. Vague CSO directions will also make it difficult for the Government to determine whether its social objectives are being met.

As the community's elected representatives, Ministers have responsibility for certain social objectives. Consequently, CSOs should not emanate from SBAs and should be explicitly directed by Ministers. To achieve clarity of objectives and ensure accountability, social objectives would be specified for SBAs in explicit agreements in the form of CSOs. This should help ensure that matters which were properly and fully political were determined by the community's elected representatives. Management would have the responsibility for implementing - but not deciding - social objectives.

Any non-commercial roles traditionally performed by "candidate" SBAs would be evaluated prior to confirmation as SBAs to determine if they offer the best and least-cost effective means of achieving the Government's social objectives. Explicit alternatives are to be examined and these are discussed further in the Queensland Government's White Paper - Corporatisation in Queensland[6].

Costing and Funding. SBAs will be responsible for estimating the costs of CSOs in conjunction with Queensland Treasury and the Portfolio Department (if applicable). Ministers will be responsible for developing appropriate consultative arrangements in relation to the identification, costing and funding of CSOs. CSO costs should, where possible, be estimated on an avoidable cost basis, with the onus of proof being on the SBA and the information being available for full Government and public scrutiny. Avoidable costs will simply be all costs (including capital costs) that would be avoided if the specific CSO in question was not provided by the SBA. They would also include the administrative costs of measuring and maintaining the CSO. Further explanation is contained in the Queensland Government's White Paper - Corporatisation in Queensland.

[6] Queensland Treasury, March 1992

Although the avoidable cost methodology should be applied as a general principle, there is the flexibility to adjust it where practical difficulties prevail. As well, although transparency is to be achieved as much as possible, the SBA will not be required to make public commercially sensitive data.

In order to deal with the problem of over-estimating the cost of providing CSOs, SBAs will be required to separate the assets and costs which are required for their provision. Where an agreement can not be reached on costs, the NCP Steering Committee and, if necessary, Cabinet will arbitrate.

Several options for funding have been considered and these are discussed in the Queensland Government's White Paper - Corporatisation in Queensland. Although funding for specific CSOs will be agreed for each financial year, the preferred option is for a fee paid to an SBA for the provision of CSOs funded directly from the Budget. Compared with funding from cross subsidies, or requiring a lower rate of return, this arrangement would be more likely to generate intense scrutiny of the services to be provided by a CSO, as part of the regular budgetary process and cost/pricing monitoring regime, and to emphasise the requirement for detailed verification of the costs involved. It is also more consistent with a commercial contractual approach to business. Direct funding will also enable the removal of artificial entry barriers, which would be needed to support cross subsidisation. Where direct funding is not practicable, other options such as cross subsidies and a lower rate of return will be considered. The effects of different funding arrangements are discussed in the Queensland Government's White Paper - Corporatisation in Queensland.

Direct funding will also provide the opportunity for direct subsidy schemes for affected groups. The delivery of CSOs through more direct means should facilitate the achievement of social objectives in a more focused and efficient manner.

The responsibility for allocating CSO funds to SBAs will lie with the Department with the prime responsibility for the policy goal being targeted. This will enhance accountability and allow the Government to assess whether the way in which each CSO is delivered is the best means of achieving the Government's social objectives.

With direct funding, the CSO becomes a revenue item in the accounts of the SBA.

Government Service Obligations

The Commercialisation of Government Services in Queensland Policy Framework[7] broadly defines a government service obligation (GSO) as:

"any specific Government directive to a business unit which induces a material departure from otherwise commercial decisions regarding the conditions of supply of services".

[7] Queensland Treasury, October 1994

A GSO activity is intended to satisfy a specific objective of the Government and, as such, would generally not be undertaken (at least not in the manner directed) as an element of normal commercial business.

The term covers activities that provide a direct benefit to specific sections of the community (e.g. prices held below market levels). These type of activities are often termed Community Service Obligations. However, a number of SBAs do not (as a general rule) directly service the public and activities falling into this category may not be encountered.

It also captures a range of activities which do not provide tangible benefits to a defined group but which government still considers to be desirable from a broad community perspective (e.g. external lighting of government offices, occupation of high cost heritage listed buildings, etc).

Guidelines for Identification of GSOs. While GSOs need to be assessed on a case by case basis, there are a number of important conditions which will need to be satisfied before a CSO activity will be considered for CSO funding. These are:

k. <u>Material and Binding Government Directive</u>. There must be an explicit Government directive for the performance of a specified activity. Further, the scope of the activity must be such that it will justify the effort involved in separately measuring and funding it as a GSO.

   While the existence of an explicit Government directive is a necessary condition for an activity to be recognised as a GSO, this in itself may not be sufficient. A distinction needs to be drawn between GSOs and directions and mandates of a regulatory nature. The latter relates to compliance with a range of legal and regulatory requirements which are not specific to the SBA (e.g. environmental controls). That is, they are generally applicable to any entity undertaking similar activities. Compliance with this type of direction will not be funded.

l. <u>Non-commerciality</u>. The activity must be one that would not ordinarily be undertaken by an entity operating to a commercial objective. That is, it should not be capable of being performed in a manner which would provide an acceptable rate of return.

   An activity which would be commercially viable in the absence of inefficient practices would not be eligible for GSO funding unless such inefficiencies are being imposed upon the SBA by way of explicit Government directive.

   Also, GSOs must be differentiated from non-commercial type activities which are typically a cost of being in business or activities that a commercial firm might ordinarily undertake to promote "good business". These types of activities are to be funded from operating revenues.

m. Clear Policy Objective. The activity must be performed to satisfy a clearly defined policy objective. This ensures that only activities which the Government sees as a priority would continue to be undertaken.

Ideally, the policy objective will be defined in a manner which allows for flexibility in the method by which the service is delivered so that the most effective outcome is achieved at the most efficient cost.

Broad Public Sector Costs

It is recognised that the financial performance of SBAs will be influenced by a number of operating conditions that are unique to the public sector (e.g. public service employment and industrial relations conditions - although enterprise bargaining provides a framework for introducing more commercial employment arrangements). However, these are broad conditions applying across Government as a whole. They do not represent specific non-commercial directives imposed on business units and, hence, do not fall within the GSO category.

In this regard, viewed in isolation, these factors might be seen as constraints on performance. However, at the same time, the Government ownership of SBAs bestows on them certain advantages which would prove in practice difficult to full remove (e.g. the shield of the Crown, implicit underwriting of solvency, transition periods of monopoly, familiarity with Government procedures providing a competitive edge, etc).

Accordingly, any public sector "constraints" will need to be considered in the context of any inherent advantages enjoyed by the SBA. The obvious difficulty involved with accurately measuring these effects (either in isolation or on a net basis) would suggest that they will best be accounted for through agreed adjustments to target rates of return. It is however anticipated that such adjustments will be the exception rather than the rule and any resulting concessional arrangements will be phased out over time.

Further explanation is contained in the Commercialisation of Government Services in Queensland Policy Framework.

Who to contact for further information

Should further assistance or clarification of any matter be required, departments may contact Treasury's Government Owned Enterprises Unit:

Government Owned Enterprises Unit
Queensland Treasury
Level 1
Executive Annexe
102 George Street
BRISBANE Q4000

Telephone: (07) 3225 8259
Facsimile: (07) 3224 6457