

Department of Treasury and Finance

South Australia

**A Guide to the Implementation
of Competitive Neutrality Policy**

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Abbreviations

ABS	Australian Business of Statistics
CAPM	Capital Asset Pricing Model
COAG	Council of Australian Governments
CPA	<i>Competition Principles Agreement (April 1995)</i>
CSO	Community service obligation
DPC	Department of Premier and Cabinet
DTF	Department of Treasury and Finance
GBE	Government business enterprise
GTE	Government trading enterprise
Hilmer Report	Report by the Independent Committee of Inquiry into National Competition Policy, <i>National Competition Policy (August 1993)</i>
IC	Industry Commission
NCP	National Competition Policy
NCC	National Competition Council
PFE	Public financial enterprise
the Policy	Government of South Australia, <i>Competitive Neutrality Policy Statement (June 1996)</i>
PTE	Public trading enterprise
ROR	Rate of return
WACC	Weighted average cost of capital

GLOSSARY

Commercialisation	a model of structural reform which aims to increase the commercial orientation of government business activities. The model is designed specifically to introduce a broad commercial orientation, without the costs of incorporation such as new legislation and the establishment of a board of directors.
Community Service Obligation (CSO)	arises when a government specifically requires a government business enterprise to provide a concession, a service or to carry out an activity which the enterprise would not elect to do on a commercial basis, and which the government does not require other businesses in the public or private sectors generally to undertake, or, which the government business enterprise would only do commercially at higher prices. The defining characteristic of a CSO is that it meets a specified public policy objective, benefiting the community rather than fulfilment of business's commercial objectives.
Competitive Neutrality	The objective of competitive neutrality is to remove net competitive advantages that arise solely through ownership differences between a public sector organisation and one from the private sector.
Cost Reflective Pricing	the least private sector equivalent policy measure. It can be implemented in conjunction with structural reform (resulting in greater private sector equivalence) or without any organisational restructuring. It involves calculation of the cost of outputs adjusted for any competitive advantages and disadvantages due to government ownership and setting a price for the output using the "competitively neutral cost" as a starting point.
Corporatisation	a model of structural reform which replicates as closely as feasible the commercial objectives,

incentives and sanctions of a private firm, while retaining government ownership of the business.

Debt Guarantee Fees

a fee which is intended to eliminate the competitive advantage a government business activity obtains over private sector competitors through receiving cheaper finance as a result of a government guarantee. The fee applies to the face value of debt outstanding, but may vary according to the level of debt and an assessment of risk.

Deprival Value

methodology for valuing assets representing the entire loss, both direct and indirect, that might be expected to be incurred by an entity if that entity were deprived of the asset at reporting date. In principle, physical non-current assets should be valued at the current cost of replacing the future economic benefits, except where an asset would not be replaced. An asset which would not be replaced may be measured by its current net market value, or the net present value of the cash flows to be generated from its continued use and eventual sale or its current cost, depending on the circumstances.

Ringfencing

the process whereby the accounting for the individual activity and all associated costs and outputs are identified and separated from other activities within the agency.

Government Business Activities

activities which are mainly producing goods and services for sale in the market with the intention of maximising profit and financial returns to their owners, or at least of recovering all or a significant proportion of their operating costs.

Government Guarantee

an undertaking by the government to cover the liability of an entity in the event that it is unable to meet its debt servicing obligations.

Marginal Costs

additional costs incurred in producing an extra unit of output.

National Competition Policy (NCP)

the Council of Australian Governments (COAG) in February 1994 agreed to the principles of competition policy. The major State obligations under NCP are as follows:

Consider establishing an independent source of prices oversight advice for Government Business Enterprises.

Implement competitive neutrality principles to remove any net competitive advantage enjoyed by government businesses arising as a result of their public sector ownership

Implement agreement on structural reform, if privatising or introducing competition to a public monopoly.

Undertake review of all anti-competitive legislation by 2000.

Determine how to apply the principles of the Agreement to local government.

Implement COAG Agreements on National Electricity Market, Free and Fair Trade in Gas, Reform of Australian Water Industry, Road Transport Reform.

Net Competitive Advantage

estimated costs of identified advantages less estimated costs of identified disadvantages existing in relation to the goods or services supplied.

Non-Commercial Activities

activities the agency undertakes but which, on a purely commercial basis, it would not otherwise undertake.

Private Sector Equivalence

nominal imposition on government enterprises of Commonwealth, State and Territory taxes, charges, duties and other imposts; debt guarantee fees; and regulations to which private sector

businesses in the same market are normally subject.

Target Rate of Return

an appropriate commercial rate of return on assets (or equity) which reflects the cost of capital from the owners perspective.

Tax Equivalent Regime (TER)

An arrangement in which State enterprises and business units within State government departments are required to pay the equivalent of income and wholesale tax and other taxes and rates which they would otherwise be liable for under Commonwealth, State and Local government laws if they were not State owned entities.

Weighted Average Cost of Capital (WACC)

An approach under which the cost of equity is calculated in accordance with a Capital Asset Pricing Model (CAPM) using the following inputs:

- a risk free rate of return (normally the 10 year Commonwealth Treasury bond rate);
- a market risk premium for the additional risk attached to the equity investments verses debt;
- a factor to represent the volatility of the investment as compared to the total equity market.

1 Executive summary

The South Australian Government is undertaking competitive neutrality reforms. These reforms include ‘corporatisation’, ‘commercialisation’ and ‘cost reflective pricing’. This paper provides agencies responsible for implementing competitive neutrality with guidance on the major steps and issues involved in implementation.

The paper draws on existing South Australian Government policy statements on competition policy and public sector reform and on draft papers developed by the Department of Treasury and Finance (DTF). It also draws on papers by the National Competition Council (NCC) on issues in implementing competition policy.

1.1 Introduction to competitive neutrality

Competitive neutrality policy applies to the business activities of publicly owned entities, that is the business activities of Government that are producing goods and/or services for sale in the market place with the intention of making a profit and providing financial returns to their owners.

The objective of the competitive neutrality policy is to remove competitive advantages and disadvantages that arise solely through the ownership differences between public sector and private sector organisations. Other differences such as the relative size, managerial and workforce skills, assets, technology, experience and culture add to the competitive market economy and are not issues to be dealt with in the application of competitive neutrality policy.

Section 2 provides an introduction to the concept of competitive neutrality and outlines various measures commonly proposed to achieve the objectives of competitive neutrality.

The application of competitive neutrality policy is designed to enhance efficiency by removing any distortions in resource allocation which would otherwise reduce the overall economic welfare of the community. The policy also has an equity objective through ensuring a consistent basis for competition across the two ownership sectors.

1.2 Selection of the appropriate measure

Competitive neutrality can be achieved through the implementation of one of the following categories of measure:

- corporatisation
- commercialisation, or
- cost reflective pricing.

The appropriate competitive neutrality model to be applied to an agency will depend on a number of factors including the costs and benefits of applying the policy, the

organisational context of the activities exposed to competition, the level of resources used in the supply of the good or service, and any special requirements such as increased accountability.

Section 3 proposes criteria for selecting between the various measures and identifies the costs and benefits to be taken into account in a decision to apply competitive neutrality measures. Section 3.1 sets out a decision tree for determining which level of competitive neutrality to be applied, depending on the benefits and costs associated with its application.

Section 3.1.6 provides a schematic summary of the selection matrix for a significant business activity when determining which measure to apply, whether it be pricing reform, commercialisation or corporatisation. The selection criteria is explained in detail in the body of this section and summarised in the matrix. It is also important to consider the costs and benefits of a particular measure in the medium to long term.

The relevant benefits would include:

- increased market contestability that will result in incentives for lowering costs in markets traditionally dominated by public sector businesses;
- improved assessment of the performance of government business
- better use of the community's resources; and
- better clarification and performance monitoring of non-commercial objectives.

The costs to be considered in the assessment will include:

- the cost of enabling legislation;
- the cost associated with managerial and cultural change;
- the cost of calculating the relevant tax equivalents, debt guarantee fees etc; and
- the cost of administering and monitoring compliance with the changes.

The process of selection of the appropriate level of competitive neutrality may involve the management of individual agencies, the relevant Minister and DTF.

1.3 Implementation of the appropriate measure

The implementation of competitive neutrality reforms will depend on which model is to be applied. In the following sections the characteristics of the three models are described including details on the major steps to implementation. At the conclusion of each section is a one page checklist that will provide a quick reference on the major steps to be taken. The relevant detail can be found in the following sections:

- Section 4 - Corporatisation
- Section 5 - Commercialisation

- Section 6 - Cost reflective Pricing

1.3.1 **Corporatisation**

Corporatisation is the preferred path to competitive neutrality under the Competition Principals Agreement. It is characterised by an entity with:

- clear and non conflicting objectives;
- managerial responsibility, authority and autonomy;
- effective performance monitoring;
- effective rewards and sanctions related to performance; and
- competitive neutrality in input and output markets.

It will involve the introduction of additional ‘private sector equivalent’ measures including the imposition of commonwealth and State taxes (or their equivalence), the payment of debt guarantee fees and compliance with regulations appropriate to the private sector.

The South Australian preferred model for corporatisation is set out in *the Public Corporations Act 1993* which is discussed in the body of this paper. The steps for implementation include the preparation of enabling legislation, business plans and performance agreements, the determination of an appropriate capital structure, the identification of Community Service Obligations, the valuation of assets in accordance with the deprival value method and the establishment of performance monitoring targets.

1.3.2 **Commercialisation**

Commercialisation implements structural reform of an entity, but falls short of full corporatisation. Commercialisation may include many, but not necessarily all, of the following attributes:

- definition of commercial and non-commercial activities (in a business plan);
- clear, commercial performance targets;
- separate definition and funding of non commercial activities;
- removal of regulatory functions from the entity;
- valuation of assets based on deprival value
- introduction of commercial gearing;
- payment of tax equivalents to the Treasurer;
- payment of applicable guarantee fees to the Treasurer;

- defined reporting requirements;
- ring-fenced (ie. separated) accounts from the host agency (if any); and
- a dividend policy based on agreed indicative payout ratio reflecting the cash needs of the owner government and the business.

Commercialisation will result from the implementation of the above steps as defined in detail in the body of this paper.

1.3.3 Cost reflective pricing

Application of cost reflective pricing principles involves the calculation of various cost advantages and disadvantages arising from government ownership, so as to determine the net competitive advantage. This net advantage must then be taken into account in the determination of output pricing using the “cost reflective cost” as a starting point. This policy only applies if the cost exceeds the benefits to be derived from application. In order to minimise the costs of application certain rules of thumb are provided in this paper.

The process of costing will involve:

- definition of the output, including measurement, verification and purpose of the output;
- costing the output which will include full attribution of all costs, such as direct costs, overhead costs, IT support, administration and depreciation applicable to the output;
- estimating the net competitive advantages (if any) resulting from government ownership; and
- estimating an offsetting accounting adjustment for the net competitive advantage.

The competitive advantages are explained in detail in the body of the paper, but these include the absence of a requirement to earn a return on capital employed, exemption from certain taxes, council rates and stamp duty, less than commercial rates for borrowings and exemption from compliance with regulatory legislation.

Competitive disadvantages should be offset where appropriate and may include costs associated with employment and superannuation, the lack of flexibility in managing operations and onerous accountability and reporting requirements.

Cost reflective pricing will be reflective of costs to a large extent, especially over the long term but will also take into account elements such as what the market will bear, the level of competition, the degree of technology advantages available to service providers and market pricing strategies.

Opportunity exists for agencies to depart from full cost pricing where there is unused capacity for example and this is explained further in section 6.9 however it should be recognised that an agency should attempt to recover its costs over the medium to long term.

1.4 Issues in implementation

Various issues may arise in the implementation of the competitive neutrality reforms, with the more important ones discussed in Section 7. They include:

- determination of the appropriate rate of return on capital employed which is discussed further in Appendix 1;
- valuation of assets which will include the adoption of a deprival valuation methodology;
- determination of the period for recovery of competitively neutral costs;
- identification of the base for cost recovery; and
- adoption of private sector pricing practices, including adoption of practices recognising other than full cost only in the short term.

These should be considered in relation to the main objective of competitive neutrality pricing, that is to cost and price outputs such that any net competitive advantage relating to government ownership is effectively offset.

1.5 Case study

Finally a hypothetical worked example has been provided in Section 8 to show the processes involved in adopting competitive neutrality reforms for a particular agency. Not all of the processes adopted in this case study will apply to every agency implementing the reforms, and consideration should always be given to the costs and benefits of performing the necessary calculations.

1.6 Further information

Implementation of competitive neutrality reforms are required to meet the objectives of government. This paper sets out the application and implementation of these reforms.

Further information may be obtained from the publications included in the list of references attached to the end of this paper.

2 Introduction to competitive neutrality

The Government of South Australia is a party to the *Competition Principles Agreement* (CPA), one of three inter-government agreements underpinning the National Competition Policy (NCP). The CPA commits the Government to ensure there is competitive neutrality where significant government businesses compete, or there is potential competition, with the private sector.

Competitive neutrality policy applies only to the business activities of publicly owned entities, not to the non-business non-profit activities of those entities. The South Australian Policy states:

Business activities of Government are defined as those activities which are mainly producing goods and services for sale in the market with the intention of maximising profit and financial returns to their owners, or at least of recovering all or a significant proportion of their operating costs.

Typically, business activities will be structured so that they retain their own receipts and make a profit. Customers of the business activity will not be prevented by law or policy from choosing any alternative supplier in the marketplace. Government business activities which provide goods or services to other Government agencies are included in the definition if the purchasing agency is free to choose an alternative supplier from outside Government.¹

The identification of activities to which competitive neutrality should be applied is sometimes difficult where the business activities are part of a broader range of activities undertaken within an agency. Such activities may be partly or even predominantly tax-funded, but also receive a portion of revenue from charges on users of the goods or services provided. The policy may cover entities which currently provide goods and services at below the costs of production, or some part of production which is provided free.

The provision of goods and/or services by government agencies through a competitive tendering and contracting process may involve bids from an in-house provider team. The Government encourages its agencies to market test their services by exposing them to competitive tender, although this is not a requirement under the CPA. The Policy states that where in-house tenders are allowed in the tendering out of the provision of goods/services previously produced by Government, the business unit or entity submitting the tender is conducting a business activity.²

¹ Government of South Australia, *Competitive Neutrality*, June 1996, p. 11.

² Policy Statement, p. 11.

The concept of competitive neutrality, its objectives and the main measures intended to achieve it are outlined in this section.

2.1 The concept

Distortions in competition can arise where government enterprises or agencies participate in a competitive (or potentially competitive) market. A government business activity may have an overall advantage or disadvantage due solely to its government ownership. The advantage/disadvantage will influence production and pricing decisions of the government agency.

The basic concept underlying competitive neutrality is that the market competitiveness of an enterprise should not be enhanced or impaired by virtue of its ownership arrangements. Competitive neutrality policy measures deal with such distortions to achieve a situation where government or private ownership is neutral in its effect on competition.

Whether issues of competitive neutrality exist depends on the potential for competitive advantage or disadvantage arising solely from the type of ownership. Competitive neutrality concerns exist where all of the following conditions apply:

- a difference exists between a public sector business and a private sector business providing a particular good or service; and
- the difference (for example exemption from certain taxes) is due solely to the government ownership of the public sector organisation; and
- the difference constitutes an advantage or disadvantage for the public sector organisation in providing the good or service in the market.

Some competitive advantages or disadvantages exist between public and private sector organisations that are not attributable to the type of ownership. Differences in workforce skills, equipment and managerial competence, which contribute to differing efficiency across organisations, are not the concern of competitive neutrality policies.

As the *Hilmer Report* observed:

Competition policy does not require that all firms compete on an equal footing; indeed, differences in size, assets, skills, experience and culture underpin each firm's unique set of competitive advantages and disadvantages. Differences of these kinds are the hallmark of a competitive market economy.³

³ Report by the Independent Committee of Inquiry, *National Competition Policy*, (Hilmer Report) August 1993, AGPS, Canberra, p. 293.

The types of differences that are potential competitive advantages or disadvantages are set out below.

2.1.1 Potential advantages

In general terms, advantages are costs (or other factors affecting the supply of goods or services) which would be faced by a government business if it was in private sector ownership, but which it does not incur as a result solely of its government ownership.

Examples of potential competitive advantages are:

- no requirement to cover the cost of the capital the business utilises (ie. earn a rate of return);
- exemptions from various Commonwealth, State and local government taxes, such as:
 - wholesale sales tax,
 - fringe benefits tax,
 - stamp duties,
 - land tax, and
 - council rates;
- exemptions from legislation/regulation that affect the same activity when carried out by a private sector business;
- access to various corporate overheads free of charge, or at rates below the actual cost of provision; or
- tied clients from elsewhere in the public sector or the opportunity to cross-subsidise commercial activities from Budget-funded activities elsewhere within the department.

This is not an exhaustive list and agencies should review all of their circumstances and the markets they supply to identify further advantages peculiar to their own circumstances.

2.1.2 Potential disadvantages

In general terms, disadvantages are costs (or other factors affecting the supply of goods or services) incurred by a government business as a result solely of its government ownership, but which it would not face if it was a private sector business.

Examples of potential competitive disadvantages are:

- accountability and/or reporting requirements which have no equivalent for a private sector business supplying the same goods or services;

- restrictions on financial structure and financial management which have no equivalent in the private sector;
- less flexibility or discretion in managing operations arising from the policies and/or practices of central or public-sector wide supervisory agencies;
- higher levels of employer superannuation contributions or award-prescribed remuneration; or
- provision of non-commercial goods and/or services without compensation.

This is not an exhaustive list. However, care should be taken not to assume that differences in these aspects automatically constitute a competitive disadvantage. The key factor in assessing whether a disadvantage exists is that the constraint (on financing, operations, etc) is both externally imposed on the agency **and** exceeds that likely to be faced by a private sector business supplying the same goods or services.

2.2 Efficiency and equity objectives

The objective of competitive neutrality policy is to remove or offset any net competitive advantage government businesses have in competing with other market participants, where such advantages are due solely to government ownership. The target of policy is the set of competitive advantages/disadvantages unique to government owned business activities. There are both efficiency and equity aspects of this objective.

The efficiency ground for the policy is primarily that the existence of a net competitive advantage for a government business may enable it to price below more efficient or equally efficient (private sector) competitors. This may be possible, for example, because the government business does not have to earn a rate of return reflecting the cost of its capital, enjoys exemption from taxes or immunity from regulatory requirements. If a less efficient government business takes business from a more efficient firm because of such advantages, or the advantages hinder the entry of new competitors into a market, resources in the economy are not being used in their most efficient use. This distortion of resource allocation reduces the overall economic welfare of the community.

While competitive neutrality policy involves the full attribution of all costs actually incurred by a government business, including overheads, depreciation, cost of capital and so on, the policy is not about simple cost recovery. It is fundamentally about the efficient allocation of resources through efficient pricing by government businesses. Efficient pricing involves setting prices to reflect competitive market prices or, where a market is not competitive, the full costs of supply. The goal is the elimination of resource allocation distortions arising from public ownership of business activities.

The equity ground for the policy rests on the notion that advantages accruing uniquely to government-owned businesses are ‘unfair’ to private sector firms competing in the same market. This could be regarded as particularly so in relation to exemptions from

taxes, the private sector payment of which indirectly contributes to the funding of government business activities. In a competitive tender situation, any net competitive advantage arising from government ownership should be eliminated in relation to the tendered activity and, specifically, an in-house bidder should not be unfairly advantaged relative to its external competitors. There are issues in both the tender *process* (regarding access to information, influence over tender evaluation and contract management) and the *in-house bid* (full cost attribution and competitive neutrality adjustments) that need to be addressed to achieve competitive neutrality.

The equity objective is to achieve a consistent basis of competition across the two ownership sectors, without interfering with those differences in size, assets, skills and organisational culture which are inherent in the competitive process.

2.3 Competitive neutrality and public sector reforms

The Government of South Australia *Competitive Neutrality Policy Statement* (the Policy) published in June 1996 notes:

Policies to remove or offset net competitive advantages resulting from public sector ownership represent part of a continuum of measures to foster greater efficiency in the operation of the public sector⁴.

There is an overlap between the objectives and measures of competitive neutrality policy and some pre-existing policies and reform measures of State governments. For South Australia, these include:

- the three broad models for the structural reform of Government business set out in the Government paper *Structure of Government Business Activities* (March 1995);
- the model for corporatisation embodied in the *Public Corporations Act 1993*;
- Tax Equivalent Regime Policy; and
- the Government Management Framework.

These measures, which preceded the formalisation of a separate competitive neutrality policy, are integral to the implementation of the policy. The common thread to all of these policies and reform measures is the shared objective of increasing the commercial orientation, or ‘commerciality’ of government business activities and, thereby, the efficiency of these businesses and resource allocation within the South Australian economy.

⁴ Government of South Australia *Competitive Neutrality Policy Statement*, June 1996, p. 5.

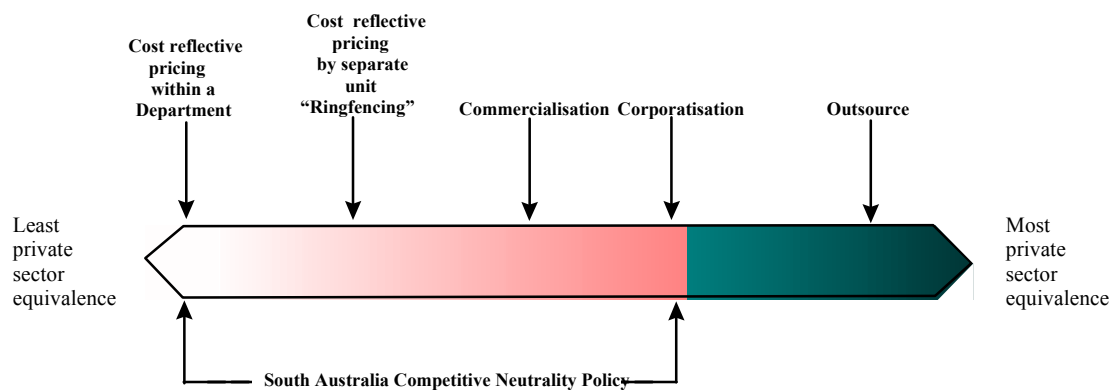
2.4 How competitive neutrality is achieved

There is a range of possible measures that could be adopted to achieve competitive neutrality. The common thread is that all measures are intended to replicate, to varying degrees, private sector business circumstances. Criteria for selecting between the various measures in particular circumstances are discussed in Section 3.

2.4.1 A continuum of 'private sector equivalence'

With the objective of competitive neutrality being the elimination of resource allocation distortions arising out of *public* ownership of significant business activities, it follows that the policy framework should seek the adoption of measures which focus on making the activities more like *private* sector businesses, or 'equivalent' to the private sector. Thus, the various structural and administrative measures available to governments can be regarded as points along a continuum of private sector equivalence, with outsourcing at one extreme and cost reflective pricing (without any reorganisation) at the other. Diagram 2.1 depicts this continuum. The main distinguishing features of the particular measures indicated in the diagram are explained briefly in the following sections.

Diagram 2.1: Competitive neutrality measures and private sector equivalence



2.4.2 Organisation restructuring for greater commerciality

There are many options within the broad category of measures that involve the restructuring of organisations to impose greater commerciality on government business activities. The options range from the (least private sector equivalent) establishment of **separate business units** with separate operating accounts within a Departmental structure, through **commercialisation** with full recovery of all costs incurred in

supplying outputs and separate balance sheet and rate of return requirements, to **corporatisation** which replicates as closely as feasible the commercial objectives, incentives and sanctions of a private firm, while retaining the enterprise in government ownership. The entire range of costs which would apply were the business in private ownership are imposed on the corporatised entity. Implementation of these structural measures is discussed in Sections 4 and 5.

Of course, the outsourcing to private sector firms of a business activity would remove the need to consider issues of competitive neutrality. It is important to note that the CPA is 'neutral with respect to the nature of ownership of business enterprises'. Competition policy is not intended to promote either public or private ownership.

Measures involving structural reform of government business activities have in common the intention to *remove* the sources of net competitive advantage. This distinguishes them from measures relating to pricing of government outputs which attempt only to *offset* any net competitive advantage.

2.4.3 **Pricing reform**

The adoption of certain pricing principles is the other major type of measure designed to achieve competitive neutrality. For significant business activities where corporatisation, commercialisation and the additional measures imposed in conjunction with it are inappropriate, the objective of competitive neutrality is to ensure that the prices charged for goods and services will take account, where appropriate an estimate of net competitive advantage including taxes, debt guarantees and regulatory costs and full costs attribution for these activities. Under pricing reform to achieve 'cost reflective pricing', the intention is to *offset* any overall competitive advantage a government business may have, thus preventing it pricing below equally efficient private firms.

Cost reflective pricing may be implemented with some structural changes, such as establishment of a separate business unit, or some greater degree of commercialisation, or without any structural change. **Price reform is essentially an accounting approach to competitive neutrality.** It involves:

- adjustments to the accounting of costs of supply; and
- price setting utilising the adjusted costs as a reference point or benchmark for prices.

Costing for competitive neutrality and the steps in implementing cost reflective pricing are further examined in Section 6.

3 How to select the appropriate measure

Criteria are needed for selecting the measure(s) most appropriate for achieving competitive neutrality in a particular case. Several factors need to be taken into account. This section provides broad guidelines for the decision. The criteria only provide a *prima facie* indication of the measures most appropriate to apply. The decision to actually implement a particular measure requires a further step in each case — an assessment of the benefits and costs of doing so.

If the costs of the approach indicated *prima facie* by the criteria appear likely to exceed the benefits, consideration should be given to a lesser private sector equivalent measure, for example pricing reform only, instead of corporatisation or commercialisation. This may reduce the costs of implementation, but still achieve sufficient benefits to outweigh the (lower) costs. Implementation of the lesser reform would then be justified.

Diagram 3.1 illustrates the broad decision-making process for implementing competitive neutrality measures. The initial decision to be made is to select which measure along the continuum towards private sector equivalence — cost reflective pricing, commercialisation (of varying degrees) or corporatisation — is most appropriate for the significant business activity in question. The *prima facie* selection then needs to be confirmed by a cost/benefit assessment.

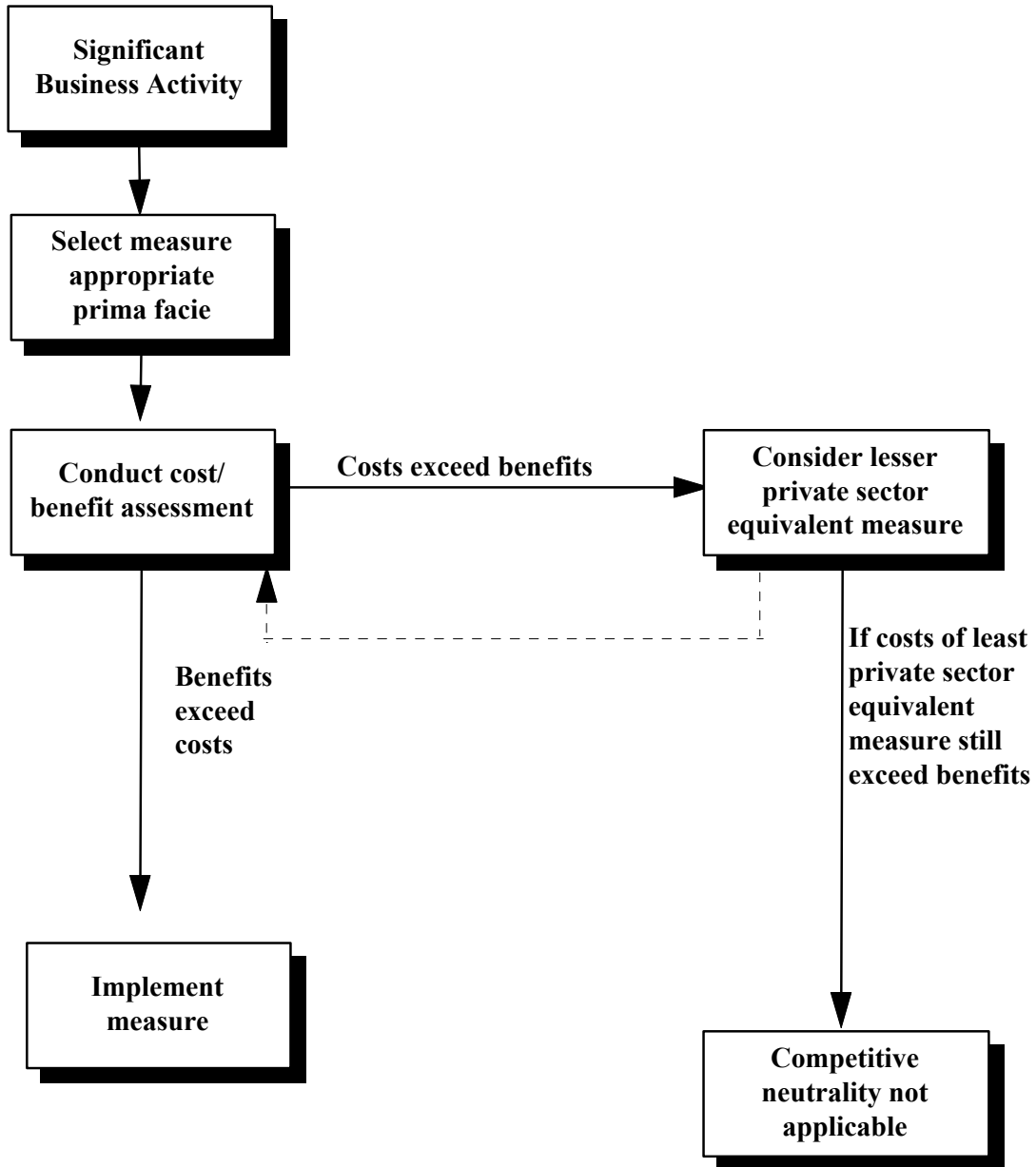
3.1 Relevant factors in selecting measures

Consideration of several particular factors relating to the nature and circumstances of the significant business activity in question will assist in determining which competitive neutrality measure(s) to apply. The factors relevant to the selection decision are likely to include:

- the organisational context of the activity;
- the size of resources utilised in supplying the goods/services (eg. total assets, annual expenditure level);
- the existence of particular characteristics of the activity which confer a higher than normal priority to obtaining efficiency; and
- special requirements for greater than normal accountability.

These are discussed briefly in the diagram below.

Diagram 3.1: Decision tree for implementing competitive neutrality measures



3.1.1 Organisational context of the activity

How predominant business activities — as distinct from regulatory, policy advisory or community service obligations (CSOs) — are in the total activities of an entity is a factor relevant to selecting between the main measures. Where commercial activities are the principal activity and occupy most or all of the entity, corporatisation and the full range of additional private sector equivalence measures (Tax Equivalent Regime, debt guarantee fees, commercial rate of return and private sector regulation) are indicated.

An issue as to the feasibility of separating commercial and non-commercial activities, including the identification of CSOs and measurement of the cost of providing CSOs, may arise where corporatisation is indicated. Corporatisation for full private sector equivalence requires that commercial and non-commercial activities be separated and CSOs explicitly identified, separately costed and directly funded by the Government.

Where the significant business activity: is only part of broader functions of the entity undertaking the activity; has several objectives to achieve; and occupies only part of the entity, a less extensive organisation restructuring is appropriate. Commercialisation or measures to address specific competitive advantages or disadvantages is more likely to be indicated. Separability of commercial and non-commercial activities will still be required, at least as a separate business unit within the broader host, for commercialisation. In principle, the treatment of CSO activities require their identification, costing and separate funding as under corporatisation.

3.1.2 Size of the resources employed

The larger the business activity the more likely corporatisation and associated measures is the appropriate approach to achieving competitive neutrality. Larger scale operations will be more likely to generate larger benefits to overcome the likely higher costs associated with corporatisation. The scale of operations could be indicated by annual expenditure or revenue levels, asset base and workforce size.

Corporatisation involves the greatest implementation costs of the main competitive neutrality measures. Transaction costs associated with incorporation, new or amended legislation and regulations, administration of tax equivalent and debt guarantee payments and the expenses of a Board structure, in combination suggest that only the relatively large business activities are suitable for corporatisation.

Smaller business activities are more suited to the less costly process of commercialisation (of which there are varying degrees). ‘Medium’ size business activities are more appropriately commercialised and ‘small’ activities, which may be incidental to the main activities of an agency, are more suitable for pricing reform either with or without some administrative reorganisation. Alternatively it may be possible to target specific advantages or disadvantages and remove these, for example, by

removing exemption from regulatory requirements normally applying to private sector businesses in the same market.

3.1.3 Efficiency objectives

Where there are particular concerns about the efficiency of a business activity, the measures effecting a greater degree of private sector equivalence — corporatisation for large activities or commercialisation for medium size activities — are indicated because of the direct incentives and sanctions related to performance that can be applied. Pricing reform and administrative reorganisation alone are unlikely to deliver the extent of efficiency gains that arise from full exposure to a private sector environment. A higher than normal priority for obtaining efficiency gains may be determined because of past poor performance and the consequences for the regional or State economy of continued poor performance.

3.1.4 Accountability objectives

Where there are particular concerns of accountability in relation to the performance of the activities in question, the corporatisation approach may be more appropriate. Similarly, if external confidence in the existence of competitive neutrality is a strong issue, corporatisation is preferred. This measure provides enhanced transparency through the formalisation of reporting requirements on the Board and management. (However, this potential for greater transparency will not be realised if corporatised entities excessively claim ‘commercial confidentiality’ to frustrate reasonable parliamentary or public scrutiny.) Confidence in the existence of competitive neutrality will be improved by corporatised operations and the imposition of the additional private sector equivalence measures.

Commercialisation may be more appropriate where these potential additional benefits of corporatisation are not sufficient to outweigh the extra costs it imposes on agencies. This is likely to be so particularly for smaller scale activities.

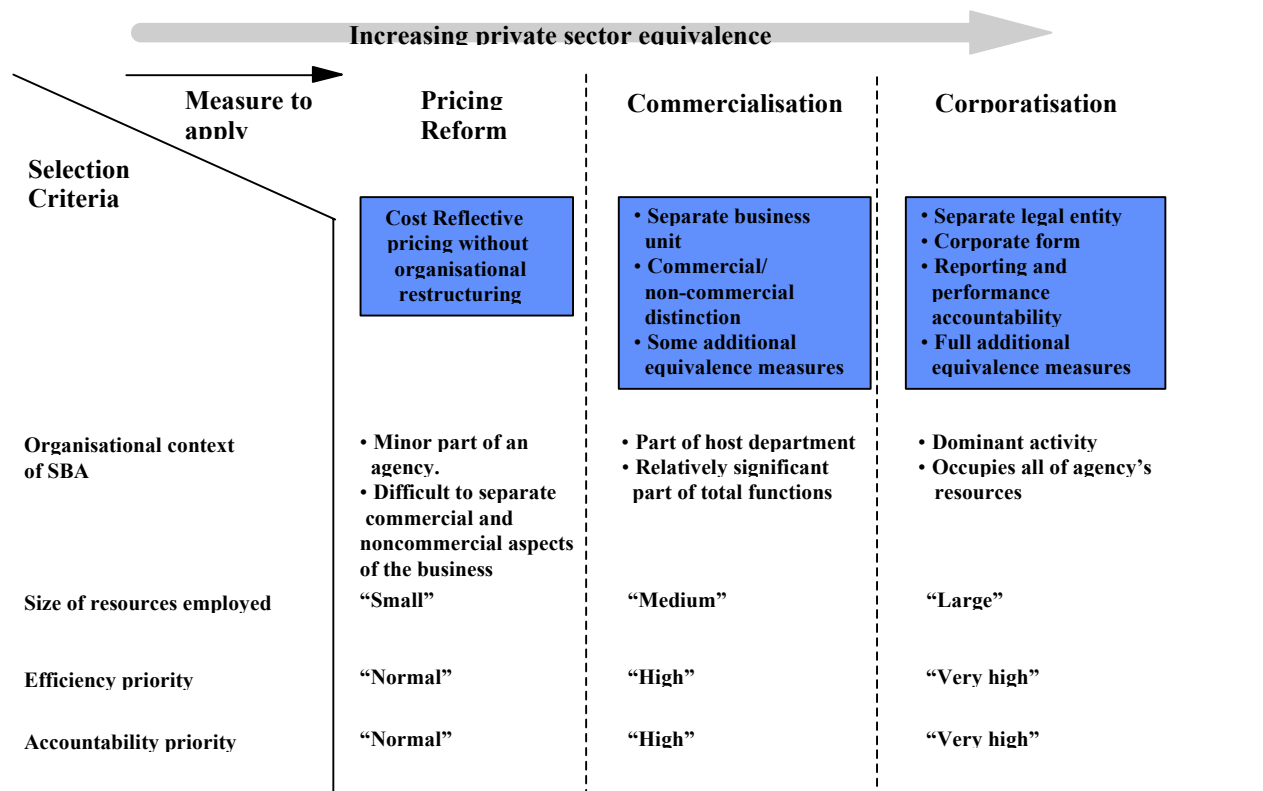
3.1.5 In-house bids in competitive tenders

Although contracting is not a requirement of the NCP, both organisational restructuring measures and pricing reform are potentially applicable to situations where an in-house team bids in competitive tenders. Separation of the in-house team from the contract-letting agency is preferable because of the additional equity issue in tender processes. On equity grounds in-house teams should not have advantages over external bidders in terms of access to information, tender evaluation and contract management. The costs of any structural reform need to be taken into account, of course, where the contracts in total are of relatively low value. Considerations of probity, prudential management and risk minimisation need to be taken account of in any situation where there is an in-house bid for the provision of goods/services to government.

3.1.6 Summary of criteria for selecting measures

Diagram 2.2 provides a schematic summary of the criteria relevant to selecting the competitive neutrality measure appropriate to the particular circumstances of a significant business activity (SBA). The primary criteria probably relate to the organisational context and size of resources used by the SBA, although if a special priority is attached to efficiency and/or accountability improvements for a small to medium SBA, a decision may be made to override the other criteria which indicate a lesser reform.

Diagram 2.2: Matrix for selection of competitive neutrality measure to apply to SBA



3.2 Assessment of costs and benefits

The decision to implement a specific competitive neutrality measure depends on the expected benefits outweighing the expected costs. The CPA only requires governments

to implement competitive neutrality measures ‘...to the extent that the benefits to be realised from implementation outweigh the costs’.⁵

3.2.1 *Benefits*

South Australian Policy sets out the following benefits to be considered in cost/benefit assessments.

- Increased market contestability which enables competition in the markets traditionally dominated by public sector businesses. This in turn produces incentives for lowering costs and achieving greater choice for consumers.
- Improved assessment of the performance of government businesses in comparison with competitors. This increases the incentives for the business to operate efficiently encouraging better use of the community’s scarce resources.
- Owner governments can better clarify non-commercial objectives and thereby determine whether the business is effectively meeting these objectives.

The generic benefits from implementing competitive neutrality are the benefits to the community which accrue from increased efficiency and better resource allocation. The focus when assessing benefits should be directed to the wider public benefit in South Australia, not to the benefits to the entity concerned although these should also be taken into account. Given this perspective, if the result of applying the Policy is that a government business activity cannot compete with the private sector effectively (and consequently ceases to undertake the activity), a benefit nevertheless accrues to the public as a whole because demand is satisfied by more efficient producers.

In practice, the anticipated benefit of efficiency gains (particularly allocative efficiency) is likely to be diffused and may take some time to be realised. The potential for realisation of technical efficiency gains within an organisation where only accounting competitive neutrality adjustments are made (as in pricing reform) will be less than where tax equivalence and dividend payments are actually made to the Government. Compared to the costs of implementation, benefits will be less observable and more difficult to calculate.

3.2.2 *Costs*

The Policy suggests that the possible costs to be balanced against these benefits include:

- legislative and regulatory amendment;
- management and culture changes;

⁵ The [Inter-Governmental] Competition Principles Agreement, April 1995, clause 3(6)

- obtaining information and undertaking analysis to assess appropriate levels for tax equivalents, debt guarantee fees or pricing principles; and
- administration of tax equivalent and debt guarantee frameworks, and compliance and the monitoring of compliance.

These are mainly what might be generically termed ‘transaction costs’ and arise directly from, or are associated with, the process of implementing competitive neutrality measures. Some of these will be only one-off costs.

In a situation where a government agency considers that the adoption of a particular competitive neutrality measure would incur the cost of compromising another policy objective, the agency will need to:

- 1 clearly identify the other policy objective that is to be achieved and ensure that the policy objective has official endorsement (for example, stated by a Minister or in an official policy document);
- 2 provide evidence that the achievement of the stated policy objective would not be possible if the particular competitive neutrality measure under consideration was adopted; and
- 3 demonstrate that there are no alternative means available which would achieve the public policy objective without compromising competitive neutrality.

3.2.3 *Weighing up costs and benefits*

Weighing up the costs and benefits of implementing the Policy is a difficult task. The CPA refers to factors which should be taken into account in weighing costs and benefits but does not address the weighting which governments should apply to such factors and the extent to which the interests of the whole community should be traded-off against the interests of particular groups.

In general, the costs of implementing competitive neutrality are more immediate, focused on the entity itself and more quantifiable. The benefits are longer term (perhaps very long term), diffuse in that the benefit of improved resource allocation accrues to the community as a whole and is less quantifiable.

The transaction costs an agency may face in implementing competitive neutrality may be substantial in the initial year. However, one year is too short a timeframe to view such costs and a more appropriate perspective is to amortise them over several years. In this context, the transaction costs are likely to be small relative to overall expenditures relating to the significant business activity. The effect of implementing the Policy on other policy objectives will vary from case to case. Due to its resource allocation objective, the Policy implicitly accepts that some public sector business activities may not be able to compete with the private sector and, consequently, may be discontinued by the Government.

4 Implementing corporatisation

Under clause 3 of the CPA, corporatisation is the preferred path to competitive neutrality for significant government business enterprises classified as PTEs or PFEs by ABS. The key generic characteristics of a fully corporatised PTE have been described as:

- clear and non-conflicting objectives;
- managerial responsibility, authority and autonomy;
- effective performance monitoring by the owner-government;
- effective rewards and sanctions related to performance; and
- competitive neutrality in input and output markets.⁶

In addition to the structural change of corporatisation, clause 3(4) requires the imposition of **additional private sector equivalence measures** including:

- full imposition of Commonwealth, State and Territory taxes or ‘tax equivalent systems’;
- debt guarantee fees (to offset the advantage of government guarantee); and
- regulations to which private sector businesses in the same market are normally subject.

The decision to corporatise an agency will normally be made by Cabinet on advice from the relevant Minister, DTF and the agency. Corporatisation basically adopts the principles of corporate governance and introduces commercial principles similar to those faced by private enterprise. A board of directors responsible to the Minister is appointed. The board may include directors from the private sector however each member is chosen for their expertise in business administration or commercial knowledge of a specific industry and not as representatives of interest groups. The introduction of directors from the private sector assists in the establishment of a greater commercial focus for the corporatised entity. The stakeholders of a corporatised government business entity are normally the Minister responsible for the portfolio that the entity falls within and the Treasurer.

Corporatisation is aimed at improving decision making and accountability and the private sector model is used as a basis for determining key roles and responsibilities. In many cases however, the private sector model is not a perfect fit for government

⁶ The CPA ‘notes’ that a possible approach to corporatisation is the model developed by the inter-governmental committee responsible for GTE National Performance Monitoring. This is a reference to *Discussion Paper No 1, ‘Characteristics of a Fully Corporatised GTE’* prepared by the Special Premier’s Conference Task Force on Monitoring Performance of GTEs, August 1991.

businesses since the government has many policy interests in its businesses beyond those of a shareholder of a private company. The corporation model does not seek to deny these broader policy interests but seeks to have them achieved in the most efficient manner.

Corporatisation provides for the portfolio Minister to have effective policy control at the strategic level, and this is achieved by delegating operational, commercial decisions to the business.

Greater commerciality in public sector businesses may also require the disaggregation of businesses that are vertically integrated in the public sector. The market power that can be exercised by a vertically integrated industry may represent a significant barrier for new entrants to the market, preventing effective competition. Where such barriers exist, it may be necessary for government to implement some structural reform of the industry, including regulation and/or the introduction of ‘open access’ to any facilities with ‘natural monopoly’ characteristics that may exist and are essential for competition. The implementation of this reform may result in the entry of new participants into the market, promoting competition and market-driven pricing.

4.1 Public Corporations Act model

In South Australia, the Government’s preferred model for corporatisation of PTEs is set out in the *Public Corporations Act 1993*. This is generic corporatisation legislation. It provides for a clearly defined set of accountability mechanisms and stakeholder roles to be applied consistently across activities in the public sector. The structure may be created as a statutory entity under separate, agency-specific legislation, but it also will be subject to the provisions of the Public Corporations Act.

Accountability and responsibility arrangements are reflected in a revised governance model in which a CEO reports to a board appointed by the corporation’s owners — in this case the Government. However, not all provisions of the PCA need to be applied — some provisions can be excluded through enabling legislation.

The Public Corporations Act sets out the rules for the conduct, reporting and responsibilities for a corporatised entity owned by the Government. In particular, it requires:

- commercial operations to be conducted in accordance with commercial principles and the performance of non-commercial operations in an efficient and effective manner (section 11 of the Act);
- a ‘Charter’, to be prepared by the Minister responsible for the corporation and the Treasurer, setting out the nature and scope of commercial operations, investment, borrowings etc, and describing the non-commercial operations including arrangements for their costing and funding (section 12);

- a 'Performance Statement' setting out various performance criteria and operational targets (section 13);
- the board of directors to be responsible to the relevant Minister and report such information as requested by the Minister in writing (section 14);
- the corporation to pay to the Treasurer, an equivalent amount of tax, duty and rates as would be payable if the corporation was not an instrumentality of the Crown (section 29); and
- directors to:
 - exercise reasonable care and diligence in the performance of their duties (section 15);
 - act honestly (section 16);
 - remain financially independent of any transactions of the corporation (section 17);
 - have no financial interest in the shares of the corporation (section 18); and
 - disclose any conflict of interest to the board (section 19).

4.2 Steps to implement corporatisation

Initially a decision by Government is required as to the appropriate form of corporatisation and under which legislation the corporatised entity will be incorporated. As indicated in section 4 the structure and regulatory arrangements affecting the Corporation would be a matter for Government to decide. The steps that may be appropriately carried out *at the agency level* in conjunction with Departments of Treasury and Finance and Premier and Cabinet, after the decision to corporatise has been made by the Government, are briefly described below.

4.2.1 Prepare legislation

The business or agency would prepare legislation to enable the incorporation of the business. Such legislation will require the consideration of:

- the objectives and functions of the new entity;
- the structure of ownership;
- the ownership of assets;
- the level of control over assets and the decision for replacement etc. to be exercised by the business; and
- other legislation to which the business would be subject.

4.2.2 Remove regulatory functions

A conflict of interest would occur if the regulation of business activities or part of the industry was to be conducted by a competing entity, that is a GBE. For this reason, the regulatory controls associated with an industry should be moved to a non-competing government department or independent regulator.

4.2.3 Prepare Charter

The new entity should have a charter which sets out:

- the strategic direction for the Corporation; and
- the functions and limitations of the Corporation.

4.2.4 Prepare business plan

The new entity should have a business plan that includes:

- forecast financial performance (profit and loss, balance sheet and cashflows);
- a plan on the service delivery of the corporation;
- a plan for the start up, transfer and closure of any applicable divisions or service areas that will not form part of the new corporation;
- a plan for the marketing and delivery of service and other aspects;
- a capital expenditure plan;
- an internal transfer pricing regime;
- a public relations strategy; and
- a plan for the management of the human resources of the corporation.

4.2.5 Prepare Performance Statement

The performance agreement will define the pre-determined performance criteria required by the Minister, including:

- target rate of return on assets (an appropriate rate of return reflecting cost of capital and assuming explicit funding of CSOs and a commercial debt/equity structure) (refer appendix 1 for a target rate of return);
- forecast output targets and how the corporation plans to achieve them; and
- other non-commercial goals to be attained.

4.2.6 **Determine capital structure**

The appropriate capital structure will be determined in conjunction with DTF having regard to the type of industry and the associated business risks.

The capital structure and the resulting debt to equity ratio will enable the appropriate dividend payout ratio to be determined based on the capital and debt needs of the business, and should reflect that of similar private sector businesses having regard to its level of operations and comparable risk. Annual dividend recommendations should be made by the Boards of the government businesses and based on a percentage of the after tax profits agreed with government over a rolling three to four year period.

This structure will improve comparability of performance with private sector businesses and provide commercial incentives when managing the cost of capital and dividend policies.

4.2.7 **Identify and cost CSOs**

It is a requirement of the Public Corporations Act that the provision of CSOs will be set out in the charter of a public corporation. It is important that these obligations are identified, costed and explicitly funded to ensure that there is sufficient performance comparison for the commercial activities of the business. This, of course, requires agreement by the Government.

The process for dealing with a CSO can be summarised as follows:

- identify all non-commercial activities that are part of Government policy and obtain agreement on these from the relevant Minister;
- prepare a plan for the delivery of each CSO on a contractual basis. This will require the separate costing of the provision of the CSO. Options for managing the delivery of a CSO are set out in the Government of South Australia document, *Community Service Obligations: Policy Framework* (December 1996);
- identify the costs of delivering the CSO as set out in *Community Service Obligations*; and
- negotiate the funding of the CSO with the relevant Minister through:
 - funding of costs from the consolidated revenue account; or
 - lowering the rate of return required on assets employed by the corporation.

Following identification and current costing of a CSO, continuous monitoring of the delivery of the CSO and relevant costs will need to be reported to the relevant Minister to ensure that the CSO obligations are being met. Subsequent monitoring and reporting

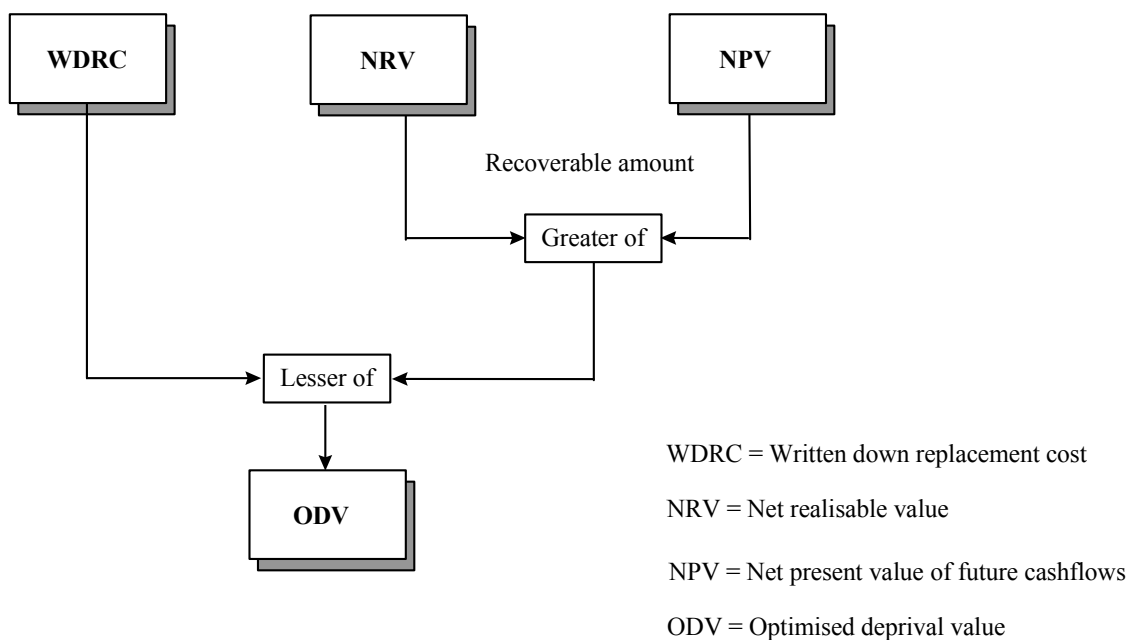
may provide additional data on costs and delivery criteria which can be used to adjust the future costing and funding of CSOs.

4.2.8 Value assets

In March 1995, DTF issued an accounting policy statement requiring all physical non-current assets to be valued in accordance with the 'deprival value method' in the first reporting period ending on or after 30 June 1996. The deprival value method is widely recognised in the public sector as the most appropriate methodology to value the tangible assets of a commercial business.

The application of this methodology involves the determination of the written down replacement cost, the net realisable value and the net present value of future cashflows associated with each asset. The application of the methodology is summarised in Diagram 4.1.

Diagram 4.1: Summary of Deprival Value method of asset valuation



The deprival valuation methodology involves the determination and application of recoverable amounts which is dependent upon the Minister directing that the entity is free to make a commercial decision on asset replacement.

4.2.9 *Establish performance monitoring*

In conjunction with the responsible Minister and DTF, the agency should agree the necessary performance monitoring criteria including the measurement of actual performance against the Performance Statement mentioned above, and the frequency of reporting these measurements.

4.3 **Summary of implementation issues: ‘checklist’**

The checklist on the following page summarises the steps which address the generic issues in the corporatisation process. This provides agencies with a quick reference for the range of matters to be addressed where corporatisation is the appropriate measure to achieve competitive neutrality.

‘Checklist’ for major implementation steps

- Consider appropriate structural and regulatory arrangements to apply to Corporation (eg pricing, access)
- Establish separate operating entity
- Determine Corporate Structure -form of entity and its scope of operations
- Identify assets and activities to reside in the entity
- Establish board
- Address tax planning
- Determine and implement industrial relations strategy
- Draft and enact appropriate enabling legislation
- Address separation/transfer of regulatory functions that conflict with commercial operations
- Financial Arrangements
 - Value assets based on deprival value
 - Identify and cost any CSO requirements
 - Determine appropriate debt and equity structure
 - Draft charter
 - Draft performance statement
 - Establish performance monitoring system
 - Determine dividend policy
 - Establish internal transfer pricing regime
- Establish and implement reform public relations strategy

5 □ Implementing commercialisation

The implementation of other structural reform of significant business activities, but short of corporatisation, is commonly referred to as ‘commercialisation’, although this encompasses varying degrees of private sector equivalence. It involves at least the establishment of a separate commercially orientated business unit to conduct the activity.

Commercialisation can encompass a range of measures, but essentially these amount to a lesser degree of private sector equivalence than exists under corporatisation. Some elements of the corporatisation model will apply under commercialisation. Commercialisation also aims to increase the commercial orientation of a government business activity. However, a key difference is that the entity conducting the business activity does not have a board. It is not a separate legal entity distinct from the owner-government. Commercialisation is often referred to as a less comprehensive type of structural reform, compared to corporatisation. Nevertheless it still complies with the ‘Competitive Neutrality Policy and Principles’ set out in clause 3 of the CPA because it seeks to eliminate net competitive advantages arising from ownership.

The commercialisation model of structural reform is designed specifically to introduce a broad commercial orientation, without the costs of incorporation such as new legislation and the establishment of a board of directors. This may be appropriate where the significant business activity is undertaken by a section of a government department, and the business activity represents only a portion of the total output of the agency.

5.1 Features of a commercialised entity

Commercialisation involves a number of measures which would provide clearer accountability for delivery of business outcomes, but not to the extent of delegation of such responsibility to a Board. A commercialised government business activity has many (but not necessarily all) of the following features:

- defined commercial and non-commercial activities (business plan);
- clear commercial performance targets;
- where non-commercial activities are undertaken, where possible, these are separately defined and funded;
- no regulatory functions;
- valuation of assets based on deprival value;
- commercial gearing;
- payment of tax equivalents to the Treasurer;
- payment of applicable guarantee fees to the Treasurer;

- defined reporting requirements;
- ring-fenced (ie. separated) accounts from the host agency (if any); and
- a dividend policy based on an agreed indicative payout ratio reflecting the cash needs of the owner government and the business.

5.2 Steps to implement commercialisation

The application of commercialisation involves a number of steps. The establishment of clear non-conflicting objectives and the creation of sufficient managerial responsibility, authority and autonomy to undertake the business activity will be incorporated in the decision by Government to commercialise. Major steps in implementation at the agency level include the following depending on the organisation or agency:

- review of market structure/removal of regulatory requirements;
- preparation of a business plan (and/or charter) (as per section 4.2.3 and 4.2.3);
- preparation of performance statements (as per section 4.2.4);
- identification of commercial and non-commercial operations and the application of CSO funding (as per section 4.2.6);
- valuation of assets (as per section 4.2.7);
- introduction of commercial pricing practices including the recovery of a return on capital employed (discussed in more detail in Section 6);
- performance monitoring of the enterprise;
- the establishment of investment appraisal procedures;
- introducing of commercial gearing; and
- preparation of a dividend policy.

5.2.1 *Separate commercial from non-commercial activities*

The separation of commercial and non-commercial operations of an agency will be required if competition is to be promoted and to enable the application of commercial performance criteria. Such separation will facilitate accurate costing of the activities actually or potentially subject to competition. This requirement is driven in part by agencies required to meet CSOs as well as other non-commercial activities.

The procedure of separating these activities and the financial and other information associated with this is sometimes referred to as “ringfencing”. Ringfencing relates to the process whereby the accounting for the individual activity and all of its associated costs and outputs are identified and separated from other activities within the agency.

5.2.2 *Remove regulatory functions*

A conflict of interest would occur if the regulation of business activities or part of the industry was to be conducted by a government business. For this reason, the regulatory controls associated with an industry should be moved to a non-competing government department or independent regulator.

5.2.3 *Separate accounts for the commercialised entity*

The separation of the accounts from the host entity, known as “ringfencing” will help in the identification, control and administration of costs and assets used in the commercialised business.

5.2.4 *Introduce commercial gearing*

Commercialisation may involve the introduction of different gearing levels within the business that is competing in the market place. The actual gearing level achieved will reflect the need for the best mix of debt and equity funding relevant to the risk associated with the business.

5.3 *Summary of implementation issues: ‘checklist’*

The checklist on the following page summarises the steps which address the generic issues in the commercialisation process. This provides agencies with a quick reference for the range of matters to be addressed where commercialisation is the appropriate measure to achieve competitive neutrality.

‘Checklist’ for major implementation steps

- Define commercial activities through development of a business plan
- Define commercial operations
- Define non-commercial operations and how to deal with them
- Remove any regulatory functions that may conflict with commercial operations
- Value assets in accordance with deprival value
- Install appropriate commercial gearing
- Define performance targets and measures
- Define reporting requirements
- Payment of tax equivalents to the Treasurer
- Payment of debt guarantee fees to the Treasurer
- Ring fence accounts from host entity
- Prepare a dividend policy to reflect the payout ratio needs of the owner government

6 Implementing cost reflective pricing

The least private sector equivalent measure available is cost reflective pricing. This can be implemented in conjunction with structural reform (resulting in greater private sector equivalence) or without any organisational restructuring. In the latter case this measure is essentially an accounting exercise. Implementing cost reflective pricing basically involves two main steps:

- 1 calculating the cost of outputs, adjusted for any competitive advantages and disadvantages due to government ownership; and
- 2 setting a price for the output using the 'cost reflective cost' as a starting point.

The major steps involved in adjusting for competitive neutrality are discussed below.

6.1 Define outputs

Outputs are the goods and/or services produced and delivered by government businesses for customers, or users external to that department or agency. It is necessary to establish the characteristics of a good or service, in other words define the output, in such a way that appropriate costing and identification of associated competitive advantages and disadvantages can be completed.

Consideration of the following factors listed below will assist in developing a description of outputs:

- What is the purpose of the output?
- What is the context within which the output is used or consumed (relevant policy issues, government directives, standards or principles of operation)?
- How is the output measured and verified?
- If there is uncertainty, what is specifically *excluded* from the output?

Grouping of outputs into classes may be more practical for costing purposes where outputs have similar attributes, are supplied to similar customers or categories of customers and contribute to a common service objective of the agency.

6.2 Fully attribute costs of outputs

The cost reflective pricing principles require full attribution of all costs incurred in the production of a good or service output. The objective of establishing an appropriate full cost benchmark for pricing purposes is to measure the real resource or opportunity cost of supplying the goods or services in question. Attribution of costs should take full account of:

- all direct costs such as labour, materials and premises;
- indirect costs (overheads) such as personnel services, IT support, administration; and

- depreciation of physical assets utilised.

To this **fully costed base** should be added an **estimate of the net competitive advantage** — estimated costs of identified advantages less estimated costs of identified disadvantages — existing in relation to the goods or services supplied. This will include factors such as Commonwealth and State taxes, debt guarantee fees and the costs of regulation on an equivalent basis to private sector competitors.

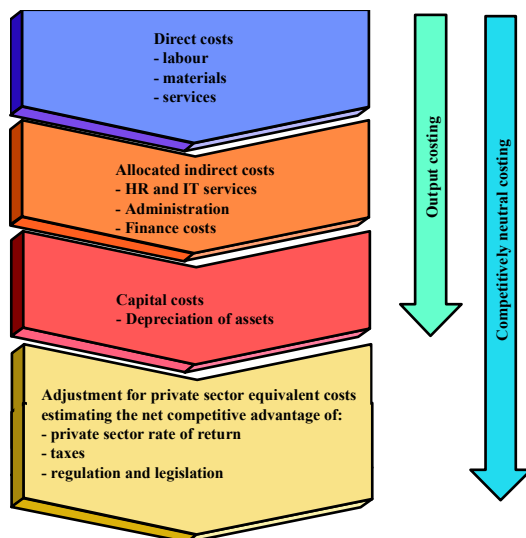
There have been substantial reforms to financial management in the public sector in recent years, particularly the move to accrual accounting and the introduction of output budgeting. These reforms are relevant to full cost attribution and the following components of financial management relevant to full costing should be in place:

- accrual accounting;
- output costing (currently under implementation); and
- asset valuation.

To fully cost the outputs of an agency or department, the costs identified in Diagram 6.1 should be considered, calculated and allocated, where relevant, to particular outputs.

The policy framework recognises that commercial businesses must sometimes temporarily depart from cost reflective pricing. Sections 6.7 to 6.9 deal with these circumstances.

Diagram 6.1: Steps towards cost reflective costing



Further information on the costing of outputs is included in the South Australian DTF document, *Guidelines for Costing Outputs* (June 1997).

6.3 Estimate ‘net competitive advantage’

After the full cost of an output has been estimated, two further steps are required to arrive at the competitively neutral cost which provides a reference point for the subsequent pricing decision:

- 1 identify and assess competitive advantages and disadvantages; and
- 2 estimate the accounting adjustments necessary to offset these.

The outcome is the net competitive advantage involved in the supply of the particular output.

Identification and quantification of the advantages and disadvantages arising out of public sector ownership is a key step in the costing of outputs for competitive neutrality. A list of some potential advantages and disadvantages is set out in Sections 2.1.1 and 2.1.2, respectively. This is not an exhaustive list and each agency will need to identify and assess the relevant differences in the context of its own particular circumstances.

There may be cases where an agency considers that general government reporting requirements and the lack of flexibility in management places it at a disadvantage when compared to private sector business, in other words it cannot ‘run it like a business’. These constraints may include for example, dual auditing processes or compliance with the provisions of ‘freedom of information’ legislation.

Where an agency considers that these disadvantages are significant, application of *structural reform* that reduces the associated cost, or preferably removes these constraints should be considered first. If this is not appropriate, then identification and quantification of the disadvantages should be carried out for the purposes of costing outputs. With any disadvantage, the onus of proof lies with the department or agency claiming the disadvantage.

6.4 Estimate offsetting accounting adjustments for advantages

Quantification of the adjustments referred to above may in some cases be difficult or the significance of the advantage or disadvantage may be disproportionate to the costs of quantifying the difference and the application of rules of thumb may therefore be appropriate. Studies conducted in other States indicate various orders of magnitude for advantages and disadvantages. The magnitude of a particular type of advantage or disadvantage is likely to differ between business activities. The following information offers some guidance for calculating offsets for the advantages and disadvantages listed in Section 2.1. Advantages are examined first, in Sections 6.4.1 to 6.4.9, then disadvantages are discussed in Sections 6.5.1 to 6.5.3.

6.4.1 Lack of requirement to achieve a return on capital employed

One of the differences normally encountered between the public and private sectors is that the public sector has traditionally not been required to earn a rate of return on the capital employed.

To achieve competitive neutrality a business should include in its costs, the rate of return necessary for the capital employed having regard to the cost of risk free capital and a margin to represent the business risk associated with the particular industry. Calculation of this rate of return is covered in more detail in Section 7.1.

6.4.2 Exemption from income tax

It can be argued that a competitive advantage arises for government owned entities from their exemption from company income tax.⁷ This issue is completely overcome by the application of a *before-tax* target rate of return on assets when establishing the competitively neutral cost of outputs. Refer to Section 7.1 for more detail of the recommended approach.

6.4.3 Exemption from wholesale sales tax

The first step is to assess whether a government owned agency has an exemption from sales tax due solely to government ownership:

- (1) Identify the relevant goods by examining the agency's own purchases associated with the particular output in the relevant period.
- (2) Determine whether the purchase of those goods, given their nature and use in, would be subject to sales tax, if purchased by a private sector business.⁸

If the output involves purchases on which a private sector business would incur sales tax, but the public sector agency does not, the next step is to estimate the amount of sales tax liability a private sector purchaser would incur. This requires that a 'notional' wholesale price be determined. For this purpose a retail margin of 10 per cent is assumed.

- (3) Estimate the notional wholesale purchase price of the relevant good by:

⁷ Any advantage associated with this exemption can be offset through either the imposition of an income tax equivalent regime (either notionally or involving actual payments) or the use of a pre-tax rate of return as recommended in Section 7.1. A cost/benefit assessment of the application of tax equivalence payments to smaller business activities is likely to indicate that imposing an income tax equivalence regime is **not** warranted.

⁸ This step may involve consulting the sales tax schedules or obtaining professional tax advice.

- (a) ascertaining a common retail purchase price (which includes sales tax) of each good; and
 - (b) dividing the retail price by 1.1 (reflecting the assumed 10 per cent retail margin) to obtain a notional wholesale price.
- (4) Calculate the amount of the tax liability by multiplying the notional wholesale price (including sales tax) by the sales tax rate for the good (expressed as a decimal fraction) divided by 1 plus the sales tax rate (expressed as a decimal fraction).⁹
- Sales tax= wholesale price including sales tax x (sales tax rate/1+sales tax rate)
- (5) Include the amount of the estimated sales tax liability in the cost of the relevant good (in effect capitalising the tax amount with the asset) for the purpose of calculating depreciation charges, where the utilisation of the good extends beyond the current period;

OR

- (6) where the good is consumed in the current period, adjust total output cost by adding the estimated tax liability (in effect treating the tax as an immediate expense).

6.4.4 Exemption from State land tax and/or council rates

Two alternative approaches exist to estimating an adjustment to costs to offset an exemption from land tax or local council rates, where an agency owns the land it occupies:

- one is to impute a commercial rent for the relevant land;
- the other is to calculate the amount of land tax or rates that would apply, but for the exemption.

Where the costing of outputs imputes a commercial market rent for land and buildings used in producing the output, and this is done by a qualified valuer, it may be assumed that the imputed rent covers all relevant costs including the costs of land tax and local council rates. The first alternative of estimating a commercial rent and imputing that amount to output costs may be preferred where the activity producing the relevant output is located in only a part of a larger building owned by an agency.

⁹ As a generalisation most capital equipment and motor vehicles will be subject to the general rate of 22 per cent. The rate for household-type goods is 12 per cent.

The steps in imputing rent involve: identifying premises utilised in supplying the output; obtaining an expert assessment of the commercial rental value of the premises; allocating the rent to the relevant output on an appropriate basis (for example, space occupied, revenue generated), where premises are shared between outputs; and adjusting the total output cost by adding the estimated rent. It is important to note that where a commercial rent is imputed, the value of land and buildings should be *excluded* from the asset base value to arrive at total assets for the purpose of calculating the amount of return on assets. This will avoid double counting of return amounts.

The alternative approach is to calculate the land tax or rates liability directly. Where the government agency owns land relevant to an output, but does not pay land tax and/or rates and does not impute a commercial rent, the tax/rates liability that would be incurred if it was owned by a private sector business should be calculated. This involves: obtaining a municipal council valuation of the unimproved site value; applying the appropriate land tax charge to the value; and allocating the estimated land tax to the relevant output. In contrast to the first option, where the second option is adopted it is important that any relevant land and buildings owned by the agency are *included* in the valuation of assets for the purpose of calculating a rate of return amount.

6.4.5 *Exemption from stamp duty*

The broad steps in the adjustment to offset exemption from stamp duty are similar to those for offsetting exemptions from sales tax. They involve first **identifying** transactions (eg. leases, registrations of motor vehicles, insurance, property purchases) associated with the relevant output that would be dutiable but for exemption due to government ownership.

The next step is to estimate the duty applicable to each transaction. Where the duty relates to a purchase involving a non-current physical asset (for example property for use as premises to provide the output), the amount of the estimated stamp duty should be included in the cost of the relevant asset for the purpose of calculating any depreciation charges. (In the case of leased assets the stamp duty is similarly amortised over the period of the lease.) Where the duty relates to a transaction not involving a non-current physical asset (for example an insurance premium), the estimation process involves adjusting the relevant total output cost by adding the estimated duty liability.

6.4.6 *FBT and/or payroll tax*

Government owned business entities are generally not exempt from FBT, although there may be some exemptions. FBT is a particularly complicated tax and therefore agencies which are exempt from FBT are advised to obtain professional tax advice on how this tax would apply if they were a private sector business.

Government owned business entities are generally not exempt from payroll tax, although there may be some exemptions. For agencies which are exempt there are

circulars available from the State Taxation Office which will enable an assessment to be made of the payroll tax liability which would be generated if the exemption were to be removed.

6.4.7 *FID and debits tax*

Any competitive advantage arising from exemption from these two taxes will be a very small advantage. For this reason and simplicity the adjustments for FID and debits tax can be made under an approximation by combining them into a single adjustment based on 0.11 per cent of sales revenue from the output.

6.4.8 *Government guarantee of agency debt*

The government has already commenced a process where agencies are charged an appropriate fee in accordance with their particular credit rating. The associated fees are set out in the *Guarantee Fees* Position Paper.

6.4.9 *Exemption from compliance with legislation and regulations.*

To estimate this competitive advantage, agencies will have to estimate the costs of compliance with particular legislation or regulations likely to be incurred by a private sector competitor operating in the same market. There is not likely to be a general advantage of this type. It will probably arise only in relation to the particular circumstances of isolated instances. Agencies will need to review their operations and market carefully to identify this type of advantage.

6.5 *Estimate offsetting accounting adjustments for disadvantages*

Potential public sector disadvantages are briefly listed below. Given that these potential disadvantages do not exist across the public sector generally, responsibility rests on the agency or department to prove the existence of the particular disadvantage, and substantiate its estimate of the associated cost to the agency.

6.5.1 *Cost of employment and HR functions in private enterprise*

An agency will be required to calculate the costs associated with any additional HR functions, supported by evidence of the process that is not applicable to the private sector.

6.5.2 *Cost of superannuation*

Whilst it is recognised that government agencies may face higher statutory charges for superannuation than comparable private sector businesses it should not be assumed to be the case in every circumstance. Each difference should be assessed on a case-by-

case basis. More importantly, any disadvantage should be considered in the calculation of total labour costs when making comparisons with the private sector.

Where the cost of calculating individual superannuation costs might exceed the benefit of the information, DTF will provide a superannuation rate as a rule of thumb.

6.5.3 Additional accountability, reporting requirements and less flexibility in managing operations

Where an agency considers that they face certain disadvantages because of reporting and accountability requirements or compliance with the provisions of 'freedom of information' legislation that are not faced by similar businesses in the private sector, they should first consider any structural reform that might remove those disadvantages. If these disadvantages cannot be removed through reform, the agency should identify and quantify the costs associated with the compliance with the requirements and include them when determining the net competitive advantage.

6.6 Competitively neutral cost and cost reflective pricing

The estimation of a competitively neutral cost of the outputs is only the first step in the pricing of those outputs. It provides only a reference point or benchmark for the price setting decision. A distinction needs to be drawn between costing and pricing principles in any market. In a monopoly market, costing can have a strong influence on pricing, but in a competitive market, competition will determine pricing sometimes independently of the associated fixed and variable costs.

The pricing of an output will depend on a number of factors, in addition to the competitively neutral cost estimated as above, including:

- what the market will bear (which may change over time);
- the level of competition between service providers;
- any technological advantage available to other service providers; and
- market strategic pricing behaviours, such as the introduction of loss leaders or cross product subsidisation, subject to the prohibitions of certain behaviours under the *Trade Practices Act 1974*.

Prices should be set to achieve competitive neutrality in the medium to long term. This policy may allow for less than full cost recovery in the short term, but this obviously cannot be sustained by a viable commercial business for an extended period of time. Supply of services at less than a full cost in the medium to long term is not in accordance with the objective of competitive neutrality.

It is important that the difference between the process of costing and the pricing decision be understood. Price may be set independently of cost where a market is

competitive. The cost of supplying a particular output when compared to its realised sale price may result in:

- a profit if the selling price is greater than the cost; or
- a loss if the selling price is less than the cost.

The concept of cost reflective pricing applies also to tender bids by in-house teams under a competitive tender process. In practice, an in-house bidder should be required to apply the full cost attribution model and relevant adjustments for any net competitive advantage to determine the competitively neutral cost as a benchmark for its bid.

6.7 Costing and pricing where there are non-commercial outputs

Most public sector entities provide multiple outputs. The commercial outputs¹⁰ of activities are, in some cases, produced in association with non-commercial activities. Non-commercial activities are those the agency is directed to undertake by Government, but which on purely commercial criteria it would not otherwise undertake. However, a distinction should be made between these and certain loss-making activities which it is normal business practice to undertake because they are 'good for business' or in some way promote the long term commercial objectives of the agency. These will be at the discretion of the agency itself, rather than imposed by Government, for example, through Ministerial direction.

The non-commercial activity will involve a requirement to supply an output or outputs that would otherwise not be supplied. Supply of these outputs will involve costs, but direct costs should be capable of identification separate to those costs involved in the supply of commercial outputs. A difficulty may arise in relation to costs that are common to both types of outputs. This requires a means of allocating common costs between the two types of outputs. If the basis of costing outputs and, in particular, allocating common costs is sound, the fact that an agency produces both commercial and non-commercial outputs should not require further consideration on competitive neutrality grounds. In general, the principle of direct budget funding should be observed wherever businesses are required to carry out non-commercial functions or meet non-commercial objectives.

6.8 Pricing in a competitive market

As noted above, costs may have little effect on pricing in a competitive market where market forces strongly influence the price of an output. These market forces will provide an incentive to improve the efficiency of operations and investment by the agency. If the price is set by a market, and full cost recovery against that price cannot

¹⁰ Commercial activities in the sense that outputs are sold.

be achieved over the medium to long term, then it is likely that the supply of that output is unsustainable. In this case, the agency should consider:

- reducing costs through structural reform or seeking alternative cost reduction methods;
- outsourcing the supply of certain input services;
- identifying any CSO requirements and seeking separate Government funding of CSOs;
- ceasing supply of the particular output.

Further advice may be sought from DTF and the relevant Minister after the above items have been investigated.

6.9 Pricing in the absence of a competitive market

The key pricing principle for agencies is that pricing should reflect full attribution of all costs and the net effect of any adjustments for competitive advantages/disadvantages. As a general rule, where comparable market prices are not available, prices should broadly be set in line with forecast full costs over the pricing period. This does not mean that prices are necessarily mechanically set directly on costs. Other considerations enter the pricing decision. Full costs are more a starting point in the pricing decision-making process than the final outcome of that process.

Short term departures from full cost prices may be appropriate where there is excess productive capacity or where there is a significant shortage of capacity. Short term marginal costs should guide pricing in the former case. In the latter case the price could be set above full cost, at a level which would ensure demand matching available capacity.

Where the cost of supply varies according to fluctuations in demand, for example during a day or between seasons, or according to the different demand patterns of customers, it is appropriate to set different prices. Full cost recovery *overall* should still be the objective for total supply. To avoid the possibility of cross subsidisation, customers should at least be charged the marginal costs associated with their supply.

Further detail on these principles appropriate to the achievement of efficient pricing are set out below.

6.9.1 Full costs — a starting point for pricing

Public sector entities should aim to cover the full costs of their business activities over the medium to long term. If full cost recovery is not achieved in any particular year, more than full cost recovery should be achieved in some of the remaining medium to longer term periods.

In any one year, it may be efficient to depart from full cost pricing. Where such a departure applies, prices should be set to at least recover *marginal* or *incremental* costs. Marginal costs are those additional costs incurred in producing an extra unit of output. Incremental cost is the cost per unit of output associated with a larger increase in output, perhaps of the order of 5 per cent or more of the previous total.

6.9.2 *Departure from full cost — (i) unused capacity*

Departure from full cost pricing by pricing lower than full costs may be economically efficient where:

- there is significant unused productive capacity; and
- the cost of this capacity is essentially fixed in the short term.

Lower than full cost pricing will have the effect of boosting demand, thus helping to increase the utilisation of existing capacity. In this situation, however, it is important to determine carefully what costs are truly fixed for the period. In general, labour costs are unlikely to be fixed costs in relation to a given output as opportunities for alternative deployment of staff resources within an organisation or to other public sector organisations will probably exist.

A special circumstance exists where the Government requires that a certain level of capacity be maintained, even though it may not be fully utilised over time. For example, the emergency services frequently are not fully occupied on emergency work, but must maintain the capability of dealing with a level of emergencies that may be reasonably expected to occur. It would be appropriate in these circumstances to encourage greater utilisation of an emergency service's facilities for non-emergency work, provided this did not interfere with the ability to respond to emergencies.

It would also be efficient to price the supply of non-emergency services by the agency on a marginal cost basis, provided demand did not exceed the available capacity. An expansion in capacity to handle non-emergency work would not be justified where prices were set just to cover short run marginal costs.

6.9.3 *Departure from full cost — (ii) excess demand*

Pricing higher than full costs may be appropriate where demand significantly exceeds existing capacity to supply. This may be a continuing characteristic of demand in the market or perhaps a seasonal characteristic of demand. An example of the latter is demand for accommodation facilities associated with a holiday period or a particular event. Pricing above full costs in circumstances of excess demand will both help to ration the available supply and promote creation of the extra capacity which is needed in the longer term. Extra revenue generated by the higher prices can be used to boost capacity. In addition, the higher returns available may encourage private sector firms to consider supplying the relevant goods or services and to enter the market.

6.9.4 Pricing for peak periods of consumption

Where the unit costs of supply vary according to the time of day or the type or category of customer, it will be efficient to set different prices. However, while the contribution to total costs may vary between category of customers, the aim should still be to recover full costs over the pricing period. For example, 'peak period' customers should be charged higher prices than 'off-peak' customers, if it is necessary to outlay additional resources to create the capacity to cope with the peaks of demand. In some cases, the cost of supply will be influenced by the volume purchased by individual customers. In these cases it is appropriate that prices reflect these cost differences by allowing discounts for higher volume purchases.

6.10 Summary of implementation issues: 'checklist'

The checklist on the following page summarises the steps which address the generic issues in cost reflective pricing. This provides agencies with a quick reference for the range of matters to be addressed where pricing reform is the appropriate measure to achieve competitive neutrality.

‘Checklist’ for major implementation steps

- Identify outputs
- Identify all costs appropriate to outputs
- Assess target rate of return for inclusion in competitively neutral cost
- Value assets according to deprival value method
- Calculate the potential advantages and disadvantages of government ownership for example:
 - exemptions from various taxes such as sales tax, FBT, stamp duties, land tax and council rates
 - exemptions from compliance with regulations applying to the private sector
 - access to corporate overheads at less than a market rate
 - financial effect of having tied clients
 - onerous accountability requirements beyond those applying in the private sector
 - restrictions on financial structure
 - lack of flexibility in management
 - higher levels of superannuation contributions
- Calculate the competitively neutral cost (full output cost adjusted for advantages/disadvantages listed above) for the outputs
- Determine a price path (for phasing in changes) that recovers full cost in the medium to long term
- Consider alternatives, if competitively neutral cost exceeds market prices

7 Issues in implementing pricing reform

The major thrust in cost reflective pricing is to cost and price outputs such that the advantages and disadvantages relating to government ownership are effectively offset.

Major issues, some of which are new, others of which have been addressed already by the public sector, include:

- determination of the appropriate rate of return on capital employed;
- valuation of assets;
- determination of the period for recovery of costs;
- identification of the base for cost recovery; and
- adoption of private sector pricing practices.

These are discussed briefly in turn below.

7.1 Determining target rate of return amount

In the past, the public sector generally has differed from the private sector in that it has not been required to factor the (opportunity) cost of capital into its costs of supplying goods and services. A clear competitive advantage is afforded to the public sector if there is no requirement to recover the cost of capital in its pricing of outputs.

The proposed approach to approximating the cost of capital is to estimate a ‘weighted average cost of capital’ (WACC). This estimate measures the return expected by an investor and financier for a given risk and a given mix of debt and equity. Because the underlying risk of each business enterprise will differ, it is difficult to generalise when calculating the weighted average cost of capital.

The method of calculation is set out in more detail in Appendix 1.

7.2 Valuation of assets

Once a weighted average cost of capital is estimated as a basis for setting a target rate of return to be incorporated in the competitively neutral cost, it should be applied to the value of the total assets of the business to determine the amount of the competitive neutrality adjustment to costs. Application to the total asset base is suggested, in preference to non-current assets only, so as to ensure that an appropriate return is also earned on the current assets including cash and receivables.

It is generally accepted that the appropriate methodology used to value government and infrastructure non-current assets is the application of the deprival value method as discussed in Section 4.2.7. This adopts current market values of assets. A circular argument may develop where the deprival value method results in a value based on the NPV of future cashflows applicable to an asset. In this case optimised written down

replacement cost may be more appropriate in price setting. If the valuation base used in the process includes a current value approach, that is, to value the assets each year, then the rate of return applied for target setting is effectively a 'real' rate, rather than a nominal rate of return, as the current value for assets has already made the necessary adjustment for inflation. Appendix 1 shows that a reasonable ex ante target rate of return to incorporate in competitively neutral costing in such circumstances is about 7 per cent.

The only time where it is inappropriate to apply a target rate of return on the assets of a business is where the business is labour intensive and the level of plant, equipment and property is insignificant (or where the property services are supplied by way of operating lease). This is the only circumstance where it would be appropriate to add a 'margin' calculated as a percentage of the full output cost.

Margins vary significantly between industries depending on their relative risk. We recommend that each individual agency be responsible for the determination and support of their own margin calculation. If it is not appropriate for an agency or department to calculate their own margin, a margin of about 7 per cent could be initially considered as a rule of thumb.

7.3 Period for recovering competitively neutral cost in prices

Public sector entities should aim to cover the full cost of their business activities over the medium to long term. If full cost recovery is not achieved in any particular year, then an amount representing more than full cost recovery will be required in subsequent years.

Recovery of full costs in the short term is not always representative of the commercial principles of pricing and does not allow for the establishment of new goods and services in a market place where, for example, pricing policies may have to allow for the establishment of market presence.

Where less than full cost recovery requires a shortfall to be financed, such finance costs will require recovery in future periods. Any projected shortfall should first be financed within the agency through the use of available working capital before any application for assistance is made to the Minister and DTF.

7.4 Basis of recovering costs — output or organisation?

As a general rule, costs should be recovered on the total outputs of the commercial activities of the entity in question. This practical approach to output costing requires care to be exercised to ensure that cross subsidy issues do not leave an agency open to issues concerning anti-competitive behaviour covered by the Trade Practices Act. In making the decision on whether costs should be recovered over the total or only part of the commercial outputs of an agency, that agency may consider the likelihood of

complaints from private sector competition and categorise its output and associated costs accordingly.

It may be that only some of the outputs of the government business enterprise experience competition in the market place, and it may therefore be appropriate for those outputs to be separately costed and priced rather than grouping with other outputs of the business. This will ensure that sufficient detail is used in the costing of outputs that may be subject to complaint.

7.5 Appropriateness of private sector pricing practices

Public sector businesses may adopt normal commercial pricing practices, *subject* to the overriding principle of recovery of competitively neutral costs in the medium to long term in compliance with the objective of competitive neutrality. Private sector firms recover other than full cost in their pricing strategies, but only in the short term. Pricing based on the recovery of marginal costs are acceptable practices in the limited circumstances of the short term, but cannot be sustained in the medium to long term in a commercial enterprise. The circumstance where marginal (or incremental) cost pricing is appropriate was explained in detail in Sections 6.9.1 and 6.9.2.

8 Case study on pricing reform: ‘State Printing and Publishing’

The case study provides a fictional example of the implementation of competitive neutrality. The case study does not represent the actual circumstances of a particular government business. The example concentrates on the processes in implementation of competitively neutral costing and pricing, rather than the precise estimation of the entity’s competitively neutral cost. Where practical, estimates of an offsetting adjustment are provided. Observations on pricing are provided in light of the preceding examination of competitive advantages and disadvantages and competitive neutrality pricing principles. Reference is made to the relevant preceding Sections of this guide as aspects of implementation are worked through.

8.1 Case study scenario

The case study is a South Australian Government business known as ‘State Printing and Publishing’ (‘SPP’) — a business unit within the Department of Administrative Affairs (DAA). SPP has been identified as a ‘significant business activity’ by the Government, in consultation with the Minister for Administrative Affairs. Because its annual revenue is not in excess of \$2 million and its assets are less than \$20 million it is regarded as a ‘Category Two’ activity and is not a priority for the application of competitive neutrality. Nevertheless, the DAA is required to include in its 1997-98 annual report a statement on the decisions made on competitive neutrality policies to be applied to SPP.

The case study outlines the activities of SPP and some key market and accounting information necessary to make an assessment of its current competitive neutrality position. Structural changes appropriate in SPP’s context are discussed and notional accounting adjustments necessary to offset its competitive advantages and disadvantages are identified.

8.1.1 *SPP role and activities*

The broad role of SPP is to provide printing, publishing and distribution services and advice for documents of Parliament, departments and statutory authorities. Until now the Government has required that parliamentary departments, government departments and statutory authorities source certain printing and publishing requirements from SPP alone.

SPP's activities can be broadly placed into three categories:

- **‘core printing’** — printing of all parliamentary documents, including legislation and those government documents which are urgent or ‘sensitive’, departments and authorities are tied to SPP for core printing;
- **‘general printing’** —printing all other material intended for use exclusively within the author agency, departments and authorities are *not* tied to SPP for general printing; and
- **‘publications preparation and sales’** — processing of all documents which are intended for use other than solely within the client agency, including those intended for sale to the public, departments and authorities are tied to SPP for all publishing activity. Examples of this category are reports, information papers and brochures.

Table 8.1 below summarises SPP’s publishing process. SPP does not necessarily undertake all of these steps itself. The author may do some or all of steps 2 to 5 and a volume of printing (steps 4 to 10) are contracted to the private sector.

Table 8.1: SPP’s publishing process

Steps in Publishing	Possible sources of provision of step		
	Author	Publisher	Printer
1. Authorship (by Govt. department or agency)	X		
2. Word processing	X	X	
3. Editing	X	X	
4. Layout design	X	X	X
5. Production of camera ready copy	X	X	X
6. Making photographic plates			X
7. Setting up printing press			X
8. Printing the document			X
9. Collating, trimming and binding			X
10. Delivery to client			X
11. Warehousing	X	X	
12. Marketing	X	X	
13. Distribution	X	X	
14. Retail sale	X	X	

8.1.2 *SPP's outputs*

SPP has two main groups of commercial outputs:

- (1) printing and publishing services (outlined in steps 2 to 10 of Table 8.1); and
- (2) government-authored publications.

The services outputs are sold to author departments, also referred to as 'clients', who present SPP with documents to be published. The publications outputs are sold to consumers through SPP's shopfront, its subscription service or through private sector general bookshops. Copies sold by SPP are produced by it over and above the number ordered for printing by the author department. Publications are classified into two sub-groups — 'general publications' and legislation.

8.1.3 *SPP's markets and competition*

The markets for SPP's major output groups and the potential competitors to SPP in each market are identified below.

8.1.3.1 *The market for printing and publishing services*

The market for SPP's services output is all printing and publishing by State funded bodies. These bodies include government departments and agencies, State Parliament, and GBEs. The total revenue from printing services in 1996-97 was \$288,000. 53 per cent of the total was core printing. SPP is required to print all core work offered to it and all core printing is performed internally. SPP's capacity is limited by Government direction to that required for core printing. The excess of 'general printing' over SPP capacity is allocated to private printers. SPP contracts about 80 per cent of general printing to the private sector.

Table 8.2: SPP Revenue, 1996-97

Revenue source	\$
Publishing services	400,000
Printing	288,000
Publications	163,000
<i>Total</i>	<i>851,000</i>

SPP would face competition for core printing from private sector printers, if its clients were 'untied' from it. For general printing there are many alternative private sector printers. Departments and agencies also have the option of in-house printing. Barriers to entry into the printing industry are low, particularly at the smaller end of the market which uses photocopying technology.

Currently all departments and budget-funded agencies are tied to SPP for all publishing. Revenue from publishing services sales direct to clients in 1996-97 was \$400,000 (see Table 8.2). Publishing alternatives for these tied clients are private sector publishers and in-house facilities (covering steps 2-5 in Table 8.1).

8.1.3.2 *The market for general publications*

SPP retails copies of clients' publications. SPP's total revenue from retail sales of these publications was \$141,000 in 1996-97. This is a negligible amount in the Australian book market of about \$1.26 billion. For some SPP publications there are no substitutes available from the private sector, for example the report of a particular South Australian Government commission of inquiry. The majority of demand for SPP publications is from Commonwealth, State and local government departments and agencies. The demand which SPP experiences for a publication will depend partly on whether, and how, the author department directly distributes the publication.

While there is no privately-produced equivalent for some publications, there are existing alternative *distributors and retailers* of SPP publications. Private sector bookshops, subscription and mail order businesses are potential competitors to SPP's shopfront and subscription service.

8.1.3.3 *The market for legislation*

Revenue from sales of legislation accounted for \$22,000 in 1996-97. Combined with revenue from sales of general publications outlined above, total revenue from publications outputs was \$163,000. SPP has three private sector competitors in the publications of South Australian legislation — Butterworths, CCH Australia Ltd and the Law Book Co. However, these companies reproduce only about five per cent of the legislation (by title) that SPP supplies. SPP's market share for these titles is unknown, though it is probably small. For the remainder of legislation titles, SPP's market share is 100 per cent.

8.2 **The appropriate competitive neutrality measure to apply to SPP**

The first step in implementation is to consider in *prima facie* terms which competitive neutrality measure to apply. Section 3.1 indicated some factors relevant to the selection decision and Section 3.2 pointed to the need for a cost/benefit assessment. A decision tree is provided in Diagram 3.1.

The factors relevant to selection identified in Section 3 are:

- the organisational context of the activity;
- the size of resources utilised;

- the existence of particular characteristics which confer a higher than normal priority to obtaining efficiency; and
- special requirements for greater than normal accountability.

8.2.1 *Corporatisation not appropriate*

Briefly considering the above in relation to SPP suggests that corporatisation of SPP is not appropriate. SPP is a minor part of the DAA with annual commercial revenue of only \$851,000 — a fraction of DAA's \$150 million annual expenditure — and total assets of \$590,000. It employs eight staff. In addition, SPP is directed to perform several activities of a CSO nature¹¹ that would be impossible to organisationally separate from its commercial activities, although they could be separately identified, costed and funded (see below). On one interpretation, commercial activities are not the principal activity of SPP because of these CSOs and the fact that only 35 per cent of revenue comes from the sale of publications to the public and the sale of services where government agencies are free to choose an alternative provider outside Government.¹²

There are no particular concerns about present SPP efficiency that would override the prima facie indication (from a consideration of organisational context and size) that corporatisation is not appropriate. As noted in Section 8.1.3.1, about 80 per cent of general printing through SPP is already contracted out to competitive private sector printers and all general printing, whether performed internally by SPP or contracted out, is charged at 'market rates'. SPP has some comparative data through this association with private printers to benchmark the efficiency of its own operations for core printing. There are also no special requirements for accountability that would justify corporatisation in this case.

8.2.2 *Aspects of commercialisation relevant*

While corporatisation is not indicated in this case, consideration needs to be given to less comprehensive and costly structural reform measures. SPP is a separate business unit conducting printing and publishing activities and already has some of the features of a commercialised entity listed in Section 5.1. It has its own separate accounts and organisational structure. Further steps could be taken to achieve some of the other

¹¹ Activities it would not undertake on commercial grounds.

¹² Section 8.1.3.1 noted that 53 per cent of SPP's printing revenue of \$288,000 came from tied clients. All clients are tied for publishing services and SPP revenue from publishing totalled \$400,000. Thus 'tied revenue' is \$552,640, representing 65 per cent of SPP's revenue. The definition of 'business activity' in the Government's Competitive Neutrality Policy Statement (June 1996) excludes activities providing goods or services to other Government agencies where the purchasing agency is not free to choose an alternative supplier from outside Government (p.11).

features of commercialised entities — particularly, clearer separation of commercial and non-commercial activities. Also, some other measures to target and remove specific competitive advantages and disadvantages are available. The impact of removing tying arrangements and consideration of the application of tax equivalents are the obvious measures in this category. These are discussed below.

8.2.2.1 Identification, funding and costing of SPP's CSOs

The Government, through a direction of the Minister for Administrative Affairs, requires SPP to provide certain services which it would not choose to provide on a commercial basis. The beneficiaries of these are the public, Parliament and the printing industry generally. SPP has identified those services it is specifically directed to provide and estimated the cost of providing these services. These are summarised in Table 8.3.

Table 8.3: Identification and costing of services provided under direction

Ministerial directions on services	Cost in '96-97 (\$)
Compile catalogue of publications to facilitate public access	17,700
Collate daily statements made by Ministers and Opposition Leaders	14,800
Prepare and distribute recommended standards for Government publications	27,000
Make all legislation available to the public	34,000
<i>Total</i>	<i>93,400</i>

SPP should seek to obtain Government agreement to the identification of these CSOs and direct Budget-funding of its provision of these services. This will facilitate a clearer separation of commercial and non-commercial activities — a key feature of commercialised entities.

8.2.2.2 Additional measures for greater commerciality

South Australian policy is to expand the coverage of its tax equivalence regime to business operations located within Government departments and to apply debt guarantee fees to some government business units that are not corporatised. Decisions to apply these measures will be made centrally in accordance with Government guidelines on their application. These measures are intended to remove the competitive advantages arising from exemptions from certain taxes and the implicit Government guarantee of the debts of its businesses. The measures involve physical payments to the Treasury.

The alternative approach to addressing these advantages, as explained in Section 6.4, is to offset these through notional accounting adjustments under the reforms constituting

cost reflective pricing. In practice, implementation of competitive neutrality in an entity similar to SPP would involve consideration of whether the tax equivalence regime and debt guarantee fees should apply. For the purpose of the case study exposition it is assumed that SPP does not meet the criteria for their application and the accounting adjustment approach is adopted.

8.2.2.3 *Tied clients*

Current arrangements under which author departments must source their core printing and all publishing services from SPP are noted in Section 8.1.1. This tying arrangement may represent a substantial competitive advantage to SPP. Government may have specific policy objectives associated with tied clients. Generally, business activities which have tied clients are not eligible for the policy framework. However, where the business has integrated contestable clients as well as tied clients, the achievement of competitive neutrality would be facilitated by one of the following:

- ringfencing the “tied client” component of the business
- removal of the tying arrangement; or
- pricing arrangements which reflect it.

Ringfencing will only be possible where costs elements are assessable and reasonably transparent. Where the business has a high proportion of fixed costs spread over the client base or where marginal costs are increasing at higher levels of production, ringfencing will not be possible because it will not be possible to allocate these costs. For SPP, which has a high proportion of fixed costs, the allocation of these costs is likely to be too difficult. Removal of this arrangement is a separate policy matter for Government.

8.2.2.4 *Removal of direction to use Australian-made paper*

SPP operates under a Government direction which affects its costs. When sourcing paper it is required to give preference wherever practicable to Australian-made paper. Australian paper costs approximately 10 per cent more than equivalent paper sourced from Brazil and Indonesia. SPP uses mostly Australian paper in practice, despite the availability of these cheaper substitutes. Consequently it faces a cost disadvantage relative to potential private sector competitors who are not similarly constrained. The extra cost incurred was estimated to be \$15,500 in 1996-97.

Presumably there are public policy objectives that the Government wishes to attain by the restriction. However, the restriction should be assessed for its efficacy in achieving that objective and whether it is necessary to impose a cost burden on SPP to achieve it.

If the restriction continues it could be regarded as being of the nature of a CSO and the Government should directly fund SPP.

8.2.3 Pricing reform main competitive neutrality measure

Prima facie, the most appropriate approach to implementing competitive neutrality in the case of SPP is the implementation of cost reflective pricing in conjunction with the individual measures discussed above. The steps in implementing cost reflective pricing are set out below and follow the scheme of implementation contained in Section 6. Sections 8.3 and 8.4 deal with the estimation of competitively neutral costs as a reference point for pricing. Section 8.5 examines SPP's approach to pricing.

8.2.4 Cost/benefit assessment of implementing the selected measure

Having selected the competitive neutrality measure that appears to be most appropriate, the next step is to undertake a cost/benefit assessment to check that the likely benefits of implementation exceed the costs.

The transaction costs of the two measures addressing the advantage of tied clients and the disadvantage of the direction to use Australian paper are likely to be negligible. There may be some other cost to consider, possibly impediments to the achievement of other public policy objectives. In the case of the direction on sourcing Australian paper inputs, the issue of whether this direction is the most efficient way to support the local paper manufacturing industry is a separate consideration for Government. In any case SPP's paper purchases are negligible in the context of the total Australian market for printing papers. Allowing SPP to source paper on a normal commercial basis at the most competitive price available is unlikely to significantly impair the realisation of the Government's industry policy.

The other competitive neutrality measures indicated are the identification, costing and funding of CSOs and pricing reform. The main costs of these are the transaction costs associated with developing cost estimates, negotiations with Government on the funding issue and changing prices. While these may be significant initially, they are likely to be largely one-off costs. From a perspective of amortisation over several years, they are not likely to be significant.

The benefits of the competitive neutrality measures will be greater efficiency in the provision of printing and publishing services to departments and agencies. The untying of core printing and all publishing from SPP may achieve cost savings for departments and agencies through access to alternative suppliers. SPP will be forced to obtain efficiency gains in its operation to retain business. Whether retail consumers of government publications would obtain lower prices is problematic, given the absence of alternative suppliers of some government publications such as certain legislation.

With implementation costs likely to be relatively small and the prospect of lower costs and efficiency gains through competition between suppliers, the benefits of implementation are expected to exceed the costs.

8.3 SPP's competitively neutral cost

A necessary base for implementing reforms to achieve cost reflective pricing is to estimate SPP's full costs adjusted for any *net* competitive advantage it has. This provides a reference point for pricing decisions.

8.3.1 Definition of outputs

The first step is to define SPP's outputs so that full costing of these can be undertaken. The outputs are defined in two groups in Section 8.1.2 and the market context of these is described in Section 8.1.3.

8.3.2 Full attribution of costs

The costs associated with SPP's two commercial outputs are broadly:

- costs in producing and supplying to author departments copies of document;
- costs in printing extra copies for sale and associated distribution and selling costs.

For retail items, SPP incurs the 'run-on' printing cost and all the costs involved in selling and distribution, such as storage, freight and the operating costs of the shopfront and mail order service.

The total annual cost of SPP's commercial outputs (including all direct and allocated indirect costs) was estimated to be \$837,000 in 1996-97. It undertakes non-commercial services at the direction of the Government and these are costed at \$93,400 as indicated in Table 8.3. Because SPP is a business unit of a larger department — the DAA — issues associated with the allocation of corporate overheads are important. DAA provides a range of corporate services to SPP. In arriving at the total cost estimate considerable care is required to ensure that the costs of these are appropriately and fully allocated to SPP.

8.3.3 *Competitive advantages*

8.3.3.1 *No requirement to cover cost of capital.*

SPP does not currently include any amount in its output costing to reflect the cost of capital applicable to actual or potential private sector competitors.¹³ The approach to reflecting the opportunity cost of capital recommended in Section 7.1 is to estimate a rate of return amount based on the value of total assets employed in the provision of outputs. SPP's total assets are valued at \$590,000 on a written down replacement cost basis (that is, a current valuation). Ten per cent of SPP's costs relate to non-commercial activities.¹⁴ A rough allocation of assets between commercial and non-commercial activities, to provide an asset base to apply the rate of return to, is 90 per cent of \$590,000, or \$531,000 are commercial. Applying the recommended rate of return of 7 per cent to this figure gives an estimated rate of return annual amount for SPP's outputs of \$37,170.

8.3.3.2 *Exemption from sales tax*

SPP obtains a general exemption from sales tax on the equipment and materials it purchases for use in printing and publishing by virtue of being part of government. However, there is also some limited exemption from sales tax on particular goods used in printing by private sector printing businesses.¹⁵ SPP would need to carefully examine the uses of the goods purchased to assess whether a private sector purchase of the same good for the same use would be exempt or not and, in turn, whether a competitive advantage accrues to SPP.

SPP is also exempt by virtue of its government status from sales tax on the motor vehicle it uses. This exemption is not available to a private sector printing and publishing business. SPP changes over its motor vehicle every 12 months. The estimated value of the exemption from sales tax on the purchase of SPP's motor vehicle is calculated assuming a common retail price of \$20,000. The notional wholesale price is \$18,000 ($\$20,000 - (\$20,000 \times 0.1)$) and the total amount of the tax liability is \$3,246 ($\$18,000 \times (0.22/1.22)$), which is derived by applying the tax rate for non-luxury motor

¹³ Note that the relevant cost of capital is not the actual cost of capital to government, but an approximation of the likely cost of capital if the government business were a private sector business in the same market.

¹⁴ Calculated by: $(\$93,400[\text{CSOs cost from Table 8.3}]/(\$93,400 + \$837,000)) \times 100$.

¹⁵ A private sector printing business would fall within the conditional exemption items within the 'goods for use in business or industry' category of Schedule 1 of the *Sales Tax (Exemptions and Classifications) Act 1992*. Items 23 and 24 of Schedule 1, entitled 'Activities relating to printing' and 'Printing plates' respectively, are relevant in this regard.

vehicles of 22 per cent. The amount of \$3,246 should be capitalised and depreciated with the asset. A proportion of the depreciation charge would be allocated to SPP's commercial outputs.

SPP made further purchases of goods (not exempt when purchased by a private sector business in the same market) with retail prices totalling \$16,000 for use in both non-commercial and commercial activities during the 12 months period and beyond. The total hypothetical tax liability is \$2,597.¹⁶ An allocation of this amount between the commercial and non-commercial uses is required and the allocated amount should be capitalised and depreciated with the asset. A proportion of the depreciation charge should be allocated to the cost of the commercial output.

8.3.3.3 *Exemption from stamp duties*

Relevant stamp duties which SPP is exempt from include stamp duty on the motor vehicle used by it. Stamp duty that would be incurred, but for the exemption, on a new motor vehicle with a purchase price of \$20,000 is \$570.¹⁷ This amount should be capitalised and depreciated with the asset.

8.3.3.4 *Exemptions from FID and debits tax*

SPP is exempt from FID and the bank accounts debits tax. SPP's commercial revenue in 1996-97 was \$837,000 and the same amount is forecast for the current period. Section 6.4.7 recommends combining the two exemptions and calculating 0.11 per cent of forecast sales receipts to be an approximate adjustment amount. In this case the amount is \$921.

8.3.3.5 *Exemption from land tax*

SPP operates from premises located near Adelaide. The land site value is \$85,000. SPP does not pay land tax on the land it occupies. If it was a private sector business occupying the same site, it would pay \$123 in annual land tax.¹⁸ Of this hypothetical tax amount, an amount of \$111 is allocated to costs on the basis that 90 per cent of SPP's activity is commercial.¹⁹

If SPP imputed a commercial rent to costs, no competitive neutrality issue would arise in relation to land tax (or council rates). However, if a commercial rent was imputed by

¹⁶ Calculated by: $(\$16,000 - (\$16,000 \times 0.1)) \times (0.22/1.22) = \$2,597$.

¹⁷ Stamp duty on motor vehicle registration of a vehicle with a value more than \$2,000 is \$30 plus \$3 for every \$100, or part thereof, of the excess over \$2,000.

¹⁸ Calculated by: $0.35\% \text{ of } (\$85,000 - \$50,000) = \$123$.

¹⁹ Calculated by: $\$123 \times 0.9 = \111 .

SPP it would also have to remove the relevant land and buildings from the asset base for the calculation of the return amount in 8.3.3.1 above. On the other hand, if SPP made some allowance for premises, but not at a commercial rent the amount should be deducted from costs to avoid double counting.

8.3.3.6 *Exemption from local council rates*

The local council rates properties at 0.9150 cents in the dollar of the valuation of land and buildings per annum. Assuming the valuation for rating purposes is \$230,000, the hypothetical rate amount for SPP would be \$2,105. On the allocation basis adopted for land tax, the amount of the competitive neutrality adjustment for SPP's exemption from local council rates is \$1,895.²⁰

8.3.4 *Disadvantages*

The disadvantage of having to source Australian-made paper due to a Ministerial direction is proposed to be addressed by removing the direction. Assuming that is done there is no need for a notional offsetting adjustment to costs.

Similarly the competitive disadvantage of being required to undertake non-commercial activities is best dealt with by direct budget-funding of the activities. SPP has costed these at \$93,400 in 1996-97 and should negotiate their funding with the relevant Government central agency. Other disadvantages where an offsetting adjustment may be required are discussed below.

8.3.4.1 *Higher employer superannuation contributions*

SPP, as part of a government department under the public service superannuation scheme, is required to contribute a higher level of employer superannuation payments, compared to the minimum requirement on private sector printers and publishers. SPP's average level of employer superannuation contribution is 10 per cent of salaries. This is 4 percentage points higher than the minimum obligation of 6 per cent that a private sector firm would face under Commonwealth superannuation guarantee legislation. *Prima facie*, a case exists for deducting from total output cost an amount equivalent to 4 per cent of SPP's total salary payments. This amount is \$7,490.²¹

Before an adjustment for the evident difference in minimum employer superannuation contributions is justified, it must be considered in the totality of remuneration components and minimum levels required under law. SPP staff are employed under legislative terms and conditions. In contrast, employees of a private sector printer may

²⁰ Calculated by: $\$2,105 \times 0.9 = \$1,895$.

²¹ This is calculated by: average annual salary is \$26,000, 8 staff, 90% of staff activity related to commercial outputs, thus 4% of $(\$26,000 \times 8 \times 0.9) = \$7,490$.

not be employed under an industrial award and only obtain the benefit of a 6 per cent employer superannuation contribution. If that were the case, minimum legal obligations in relation to salary payments also may not exist. Only long service leave may be subject to legislative prescription. Given this situation, SPP has an arguable case that it faces no legally prescribed *minimum* levels of other (non-superannuation) remuneration components that are likely to be *lower* compared to a private sector provider of the same output. A deduction from total costs to offset the argued competitive disadvantage is assumed to be defensible for the purposes of this case study.

8.3.4.2 *Other disadvantages claimed by SPP — various restrictions on operations*

Further information on the extent of SPP resources involved in meeting the various requirements listed below, and on likely private sector practices, is required before SPP's claimed disadvantages could be assessed for their validity. They are listed to indicate the type of matters that may arise for assessment as to whether a difference with the private sector constitutes a competitive disadvantage. In most cases the appropriate response is to investigate the possibility of changing arrangements in order to remove the source of any potential disadvantage, rather than attempt to offset it. The claimed disadvantages raised by SPP are:

- government purchasing requirements and other financial and operational accountability requirements which are claimed to have no equivalent in a private sector business, an example of the latter is extensive procedures for recruiting staff set by DAA;
- commercial publishers may freely reproduce Acts, Statutory Rules, Bills and Explanatory Memoranda by using SPP-typed material as camera ready copy or by reproducing it by optical character reader to avoid keyboarding;
- competitors can publish integrated (consolidated) law, while SPP is only authorised to sell legislation as it was as last consolidated by the Attorney-General plus all the subsequent amendments; and
- SPP is not authorised to publish legislation until it has received the Royal Assent, usually at least several days after legislation is passed in Parliament, while its competitors are able to publish immediately having developed their product from draft legislation.

8.4 **Net adjustment to total cost**

Table 8.4 summarises the estimates of advantages/disadvantages above and expresses each as a proportion of the total commercial output cost before competitive neutrality adjustments. The notional adjustment to costs required to offset SPP's **net** competitive advantage, as a percentage of total costs, is estimated to be 3.9 per cent. SPP's

‘competitively neutral cost’ estimate for its commercial outputs is obtained by increasing its total cost estimate by 3.9 per cent to \$869,640.

Table 8.4: Summary of quantifiable advantages/disadvantages

Advantage or Disadvantage	Advantages (add)		Disadvantages (deduct)	
	\$	% of costs	\$	% of costs
Amount for cost of capital	37,170	4.4		
Exemption from sales tax	*			
Exemption from land tax	111	0.0		
Exemption from council rates	1,895	0.2		
Exemption from FID and debits tax	921	0.1		
Exemption from stamp duties	**			
Higher employer superannuation			7,490	0.9
Various claimed restrictions			not quantified	
<i>Total</i>	<i>40,097</i>	<i>4.8</i>	<i>7,490</i>	<i>0.9</i>
Net	32,607	3.9		

* Sales tax not incurred due to exemption is estimated at \$3,246 for the motor vehicle plus \$2,597 allocated between commercial and non-commercial uses. The resulting total amount should be added to the valuation of assets for depreciation purposes.

** Stamp duty liability not incurred due to exemption is estimated at \$570 (0.06% of total cost). This amount should be added to the valuation of assets for depreciation purposes.

8.5 Cost reflective pricing

As discussed in Section 6.6, the estimate of the competitively neutral cost is only a reference point or benchmark for SPP’s price setting decision. Before examining the implication of this for SPP’s pricing its present approach to pricing is outlined.

8.5.1 SPP’s present approach to pricing

SPP’s price structure broadly reflects the categorisation of costs:

- author departments pay a price for publication of their documents and the supply of the requested number of copies; and
- the public pay a price for individual copies of these publications at retail sale.

The prices charged by SPP to clients for the printing and publishing of documents vary according to whether the work is ‘core’ or ‘general’. The prices charged to clients for

core printing are approximately 10 to 15 per cent higher than for non-core work, due to higher labour costs involved in night work to meet urgent deadlines.

For general printing jobs, which do not require other publishing services, the printing price is a 'market rate', whether the job is performed by SPP or contracted out to a private sector printer. For non-core publishing, SPP adds a surcharge of 15 per cent on top of the market printing price to reflect the 'value added' by SPP in the publishing process. In the private sector such publishing services are included in the printing price to the customer and are not separately charged.

SPP is subject to the following Ministerial directions regarding the terms of supply of particular items:

- no charge for Ministers' and Opposition Leaders' statements to Members of Parliament;
- no charge for State Directory to Members;
- no charge for Ministerial Directory to Members;
- charge \$10 per annum subscription rate for Hansard; and
- no charge for a copy of each publication to the National Library and State and university libraries.

SPP has no directions from the Government on pricing for general retail sale of publications and legislation. SPP prices its retail products by use of a formula comprised of the run-on cost of a publication multiplied by a 'pricing factor'. The factor, currently 6.5, is calculated to ensure that on average it recovers all the costs it incurs in the retail sale and distribution of publications and legislation. As noted above, there is no rate of return on assets or profit margin factored into costs or the pricing factor of 6.5. To reach a recommended retail price, the product of the run-on cost and the factor is rounded to the nearest pre-determined price point.

8.5.2 Cost reflective pricing

South Australian policy requires prices to reflect full costs adjusted for any net competitive advantage. Pricing decisions should take into account the 3.9 per cent increase in the cost level due to the competitive neutrality adjustments and, therefore, be based on the medium to long term recovery of an annual cost of \$869,640 in 1996-97 terms.

SPP may, however, from time to time choose to depart from the cost-based price benchmark to meet market prices, without going below them. An important proviso is that market prices are set competitively. If the Government, as a matter of its own policy assessment decides to remove the tying arrangement and require SPP to compete with private sector suppliers, this would expose SPP to the pressures of competition in supplying services to departments and agencies. In relation to its retail sale of

legislation and other publications, SPP should avoid setting prices that exploit any market power it may possess in relation to particular publications.

SPP should estimate the loss to revenue attributable to the directions to price below cost and seek to negotiate direct budget-funding of these requirements. Alternatively, the directions to price in a non-commercial manner should be removed by the government.

Appendix 1 - Calculation of a cost of capital

As introduced in section 7.1, the proposed approach to approximating the cost of capital is to estimate a 'weighted average cost of capital' (WACC). This estimate measures the return expected by an investor and financier for a given risk and a given mix of debt and equity. The cost of debt is relatively straightforward and relates to long term interest rates with a margin for risk. In determining a rate of return target to be applied in estimating the competitive neutrality adjustment, it is important that the cost of any interest paid in respect to the financing of the business activities is removed to avoid double counting.

Under this approach the cost of *equity* is calculated in accordance with a Capital Asset Pricing Model (CAPM) using the following inputs:

- a risk free rate of return (normally the 10 year Commonwealth Treasury bond rate);
- a market risk premium for the additional risk attached to equity investments versus debt; and
- a factor to represent the volatility of the investment as compared to the total equity market.

Because the underlying risk of each business enterprise will differ, it is difficult to generalise when calculating the weighted average cost of capital. *The Structure of Government Business Activities* paper (March 1995) states that a government business will be required to earn a target rate of return determined by the Minister and DTF, having regard to the relevant risk of the business and other market conditions.

The draft DTF paper *Commercialisation/Corporatisation* (31 July 1997) refers to the 'Treasurer's Commercialisation minute of October 1994' which proposes as a guide for initial consideration an 'after-tax rate of return on equity...in the order of 8 per cent real'. This guidance rests on the very important assumptions that there is explicit funding of CSOs and a commercial debt/equity structure exists. To the extent that CSOs are not explicitly funded, a rate *lower* than the potential target would be appropriate. With a company income tax rate of 36 per cent, the before-tax real return on equity would be 12.5 per cent.²² This provides the equity component of a WACC approach.

The following are parameters regarding interest rates for calculating the cost of *debt* component in a WACC approach to the cost of capital:

- a real risk free rate of return of 4.5 per cent (CPI indexed rate); and

²² Calculated by $8x(1/(1-t))$, where t is the company income tax rate, in this case assumed to be the nominal rate of 36 per cent.

- a debt premium of 1.5 percentage points.

These parameters produce a real return on debt of 6.0 per cent.

A weighted average cost of capital is then estimated based on the appropriate gearing of the business enterprise. Assuming a gearing of 50 per cent (the debt/equity ratio), to combine the return on debt and return on equity components, to obtain the WACC-based cost of capital estimate produces an estimate of 7 per cent in real terms.²³

Public sector businesses may, as a result of their government ownership, be able to secure higher debt to equity ratios, and obtain cheaper debt capital due to the government guarantee of borrowings. However, for the purposes of competitive neutrality the relevant ratio is one that would be likely to apply to a private sector business in the same market.

The before-tax, real rate of return of 7 per cent could be used where the calculation of a more specific rate of return is not feasible for an individual agency. The before-tax rate represents a “rule of thumb” to apply to a *current value* valuation of total assets (not historical cost valuation). If the assets employed in the business activity are only valued on an historical cost basis, a higher rate of return would be necessary to compensate for the lack of adjustment for inflation in the asset valuation. A further important qualifying assumption of this rule of thumb is that CSOs are explicitly funded. If they are not, a lower rate, whether applying to a current valuation (real rate) or an historical valuation (nominal rate), is appropriate.

Expressing the rate in before-tax terms is appropriate, and preferable in a competitive neutrality context, because after-tax returns are a function of the interaction of profit and the income tax regime. Profit is, in turn, a function of prices actually received in the market for the output and the costs of supply. The role of a rate of return in competitively neutral costing is to act as a guide, or ‘benchmark’, for decisions about the allocation of resources and pricing. Setting an after-tax rate of return target is less appropriate because it would effectively presume in advance a certain tax structure and level of prices that the costing exercise is intended to act as a guide to.

The income tax rate in the equation for calculating the before-tax rate of return assumes the full nominal company income tax rate of 36 per cent. It could be argued that a particular private sector business with a lower effective tax rate in competition with a government entity (which adopts the suggestion above) could obtain an advantage by factoring this lower effective tax rate into its pricing. Thus, it could set its prices aiming at a particular *after-tax* return target that translates into a lower before-tax factor

²³ The formula is: return on assets = (return on equity x proportion of equity in capital base) + (return on debt x proportion of debt in capital base). In this case the real return on debt is 6.0% (4.5% risk free) plus 1.5%(debt premium). Real return on equity is 8 per cent. The formula gives a real WACC estimate of in this case of 7.0%.

in costs because of the lower effective tax rate. If its prices are cost-based, it may obtain a price advantage over the government entity.

While some particular corporations may manipulate their affairs to minimise tax and obtain very low effective tax rates, it is not clear that *on average* effective tax rates are greatly below the nominal rate. The Australian Stock Exchange *1996 Financial and Profitability Study* shows that the ‘all company average’ effective tax rate estimate has been only a few percentage points below the nominal rate over recent years. In any case, the policy response is not to distort public sector pricing by attempting to emulate the minority of private sector cases where effective tax rates are much lower than the statutory nominal rate.

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