Competitive Neutrality Guide to Implementation

State Government Victoria
Department of Treasury and Finance

Competitive Neutrality Guide to Implementation Victoria 2000

Prepared by: The Department of Treasury and Finance

Foreword

In April 1995, the Commonwealth, State and Territory governments signed three interrelated agreements which collectively underpin National Competition Policy (NCP).

The Victorian Government is committed to the ongoing implementation of NCP in a considered and responsible manner. This means that public interest considerations should be taken into account explicitly in any Government decisions on the implementation of NCP.

Under the *Competition Principles Agreement*, Victoria is obliged to apply competitive neutrality policy and principles to all significant business activities undertaken by government agencies and local governments. The Victorian Government will fulfil this obligation and also meet its wider responsibility to the community by requiring competitive neutrality be applied only where it is in the public interest to do so.

Competitive Neutrality Policy Victoria (CN Policy) sets out the new Victorian approach to competitive neutrality.

Competitive neutrality involves achieving a fair market environment by removing or offsetting any competitive advantages or disadvantages due to public ownership of the government business. However, competitive neutrality does not override the range of social, environmental, economic and regional responsibilities of Government agencies, which must be taken into account in determining whether the application of CN Policy is in the public interest.

The application of CN Policy can improve the accountability and transparency of Government agencies when engaging in a range of commercial activities. This will improve the ability of agencies to deliver key outcomes in an efficient and effective manner. Business confidence and investment should also improve as private sector firms compete on a more equal footing with government agencies.

This Guide has been prepared to assist agencies to implement the policy outlined in *CN Policy*, released in 2000. The Guide updates the previous version released in May 1997 and should be read in conjunction with the new CN Policy.

Competitive neutrality also applies in local government but councils will apply it in an operating environment provided by the Best Value Principles (BVP) as set out in the *Local Government Act 1989*. A separate guide will be developed, in consultation with the sector, to assist councils to apply competitive neutrality within the BVP context. These guidelines will be developed after the Minister for Local Government releases the BVP framework.

CN Policy recognises that Government agencies and local governments have responsibility for achieving an array of social, environmental, economic and regional objectives. In applying competitive neutrality, agencies and local government first determine whether a business activity is "significant" or not. Following this step, an agency or local government considers the costs and benefits of introducing a competitive neutrality measure. If the benefits are greater than costs, agencies or local government would then need to consider whether implementation of a competitive neutrality measure is in the public interest.

A public interest test provides a means by which the objectives of competitive neutrality can be balanced with the key priorities and public policy objectives of the government agency such as those considered under BVP in local government. A public interest test is introduced under the CN Policy framework.

Many of the updates in this Guide reflect issues raised by stakeholders that have applied CN Policy. In particular, the Guide has been simplified with practical step by step instructions on how to make particular competitive neutrality cost adjustments. These adjustments need to be undertaken only after the government agency or local government has considered the steps outlined above. The Guide will be updated over time to reflect changes in taxation, regulatory and institutional factors that impact on the application of competitive neutrality.

I commend this Guide to you as an important aid to ensure that the Government's competitive neutrality pricing principles are translated into effective and practical implementation strategies.

Ian Little
Secretary
Department of Treasury and Finance

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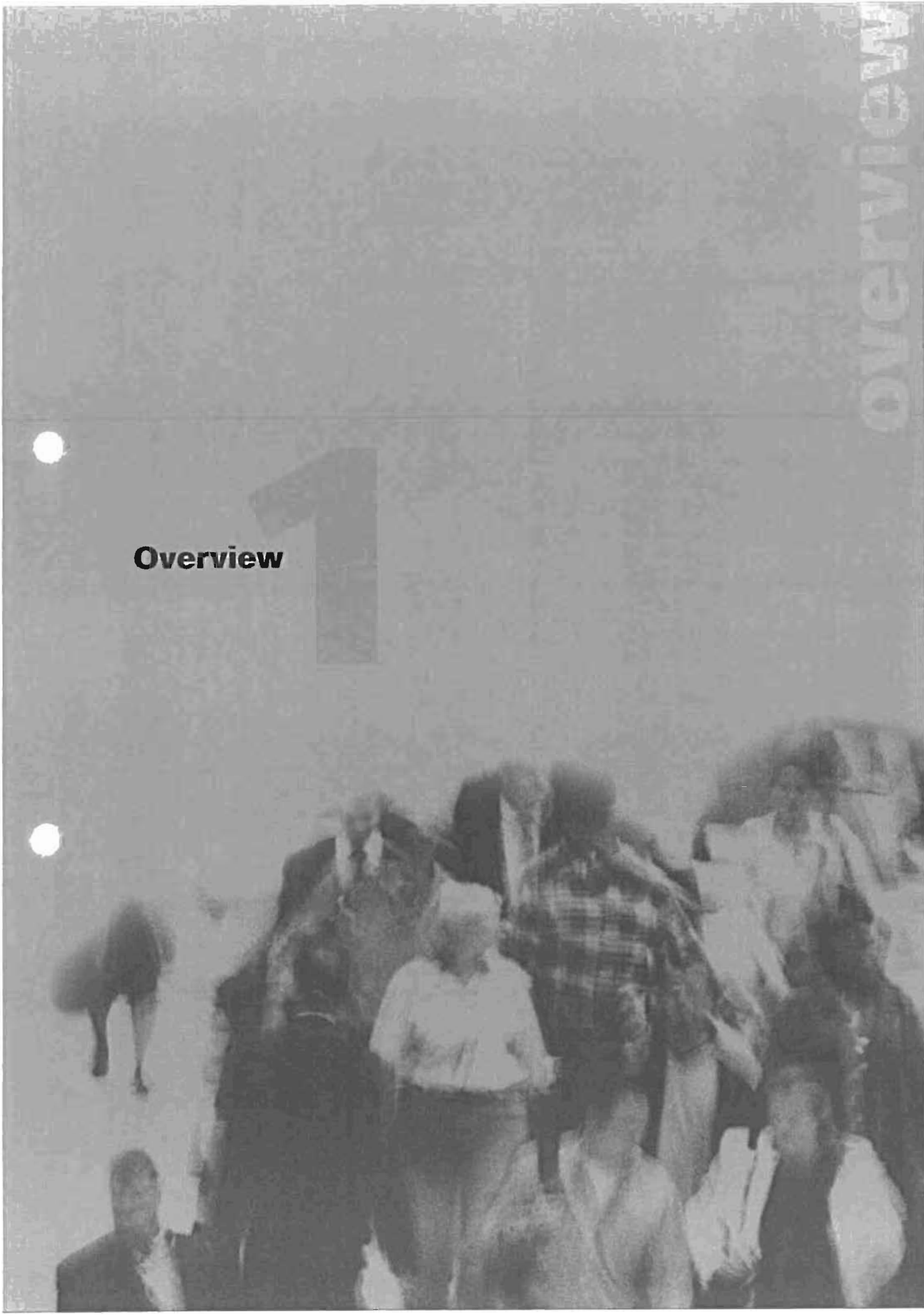

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Overview

Overview

1.1 Scope and Purpose of the Guide

This Guide, which accompanies the new *Competitive Neutrality Policy Victoria (CN Policy)*, has been developed to assist government departments, agencies and local government entities in:[1]

- meeting the documentation and evidentiary requirements of the new policy on competitive neutrality; and
- adopting an appropriate competitive neutrality measure. In particular, calculating the competitively neutral cost adjustments to derive the appropriate full cost base for setting the price of a relevant good or service. This Guide focuses on full cost reflective pricing as the primary tool for implementing competitive neutrality as the other two structural responses namely corporatisation and commercialisation are less frequently used. Guidelines on how to implement corporatisation and commercialisation have been set out in other Victorian Treasury publications such as *Assessing Corporatisation Proposals and Implementing Corporatisation Proposals* (1997).

The Guide is intended to serve as a "how to" manual on the practical steps that agencies should take in making full cost calculations. The elements of the cost adjustments are current at the date of publication. Agencies should be aware, however, that the nature of these adjustments will vary with changes in the scope of the recognised or allowable competitive advantages and disadvantages. Agencies should also note that the introduction of the Goods and Services Tax (GST) on 1 July 2000 and the concurrent abolition of wholesale sales tax has simplified some of the steps in making full cost calculations. (However, a methodology, to be applied in relation to assets purchased pre 1 July 2000, has been retained in this Guide for the calculation of adjustments involving wholesale sales tax. See Appendices 1 and 3).

1.2 What is competitive neutrality and why is it important ?

Under Clause 3(1) of the *Competition Principles Agreement*, the objective of competitive neutrality is...

> "the elimination of resource allocation distortions arising out of the public ownership of entities engaged in significant business activities: Government business should not enjoy any net competitive advantage simply as a result of their public sector ownership. These principles only apply to the business activities of publicly owned entities, not to the non-business, non-profit activities of these entities."

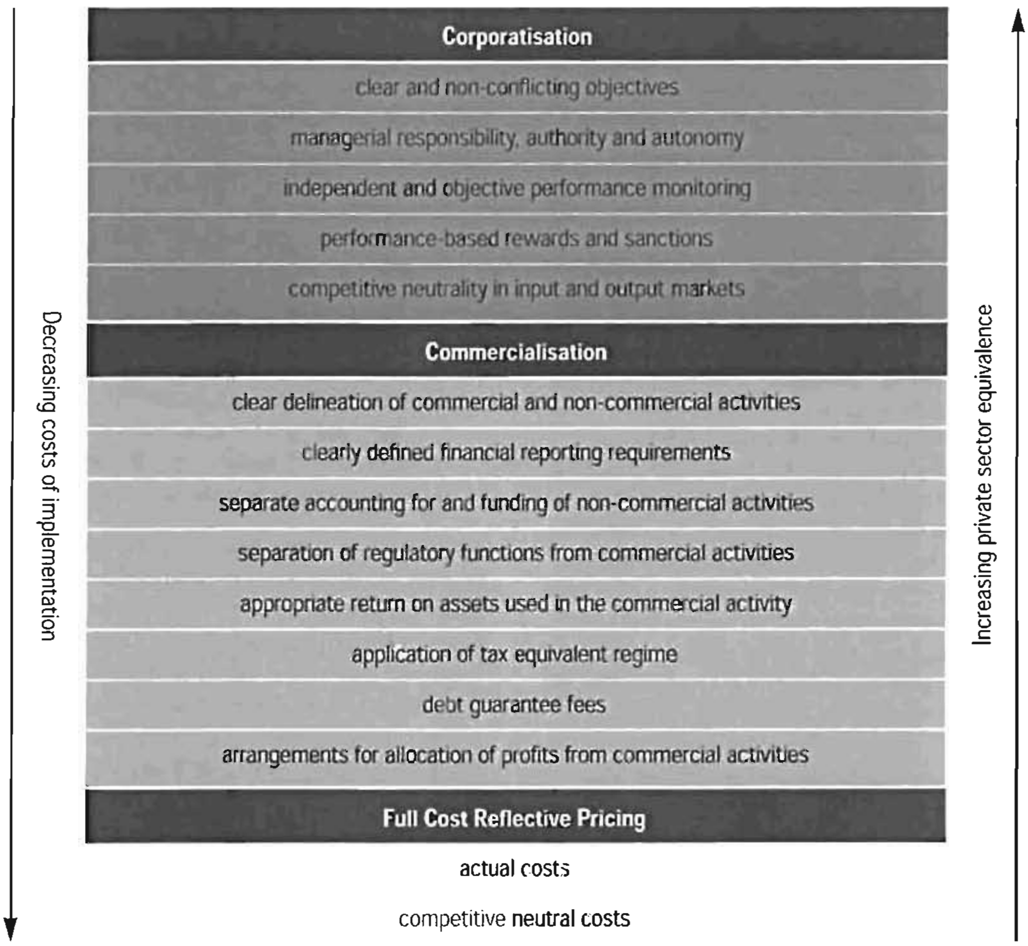
It is common for private businesses (including both for profit and not-for profit entities) to coexist with government businesses in a variety of markets. They do not always compete on equal terms. Such inequalities arise from a variety of circumstances and it is the goal of CN Policy to offset these where appropriate. The inequalities of concern arise from differences in tax treatment, differences in the need to provide a return on investment, and related cost advantages or disadvantages which might impact on the prices that are set by government businesses.

The aim of CN Policy is to account for these differences in such a way that where governments undertake significant business activities in markets, they do so on a fair and equitable basis. CN Policy measures are designed to achieve a fair market environment without interfering with the innate differences in size, assets, skills and organisational culture which are inherent in a mixed economy. Differences in workforce skills, equipment and managerial competence, which contribute to differing efficiency across organisations, are not the concern of CN Policy.

Competitive neutrality can benefit all Victorians by enhancing the confidence of business to make decisions on investments in the State and private decisions as to what to buy and sell.

[1] For ease of exposition, the terms "government agency" or "agency" will be used interchangeably throughout this Guide to refer to a Government Department, a public sector agency or a local government entity.

Box 1.1: Implementation of competitive neutrality



1.3 Competitive neutrality in the local government environment

For local government the Best Value Principles (BVP) as set out in the *Local Government Act 1989* provides the operating environment in which the application of CN Policy must be considered. When applying BVP councils should incorporate competitive neutrality requirements in a common process. Decisions on competitive neutrality must be documented in a manner sufficient to satisfy the accountability and transparency expected under both BVP and CN Policy. Separate guidelines will be developed to assist councils to apply CN Policy within a BVP context.

1.4 Policy implementation

Implementation of the CN Policy has been streamlined into three simple steps:

- Government departments, agencies and local governments are responsible for determining, on a case by case basis, whether its business activity is "significant" in the relevant market and therefore subject to the policy.
- Where the business activity in question falls within the scope of the policy, the responsible government agency should then weigh up the expected benefits and costs of introducing an appropriate *measure* to achieve competitive neutrality. The relevant measures include corporatisation, commercialisation or full cost reflective pricing (see Box 1.1). This Guide deals only with the measure of most common application, namely full cost reflective pricing.

- Once the government agency has concluded that the expected benefits of introducing the relevant competitive neutrality measure outweigh the costs, it should then consider whether implementation of that measure is in the public interest. This *public interest test* provides a means by which the objectives of competitive neutrality can be balanced with the key priorities and public policy objectives of Government.

The last two steps are not necessarily sequential and may be interactive depending on the nature of the business.

The CN Policy emphasises documentation and public availability of decisions taken through open and consultative processes. This is to ensure that a government agency's deliberations with respect to policy implementation are transparent and accessible to all Victorians. It also helps to facilitate the task of assessing CN Policy compliance in the event of an investigation triggered by a complaint.

1.5 What is a "significant" business activity?

Consistent with the *Competition Principles Agreement (CPA)*, CN Policy applies only to the *significant* business activities of publicly owned entities, and not to the non-business, non-profit activities of those entities. Activities which do not result in the sale of a good or provision of a service – either directly to a purchaser or through an arms length contract with another party or parties – should not be regarded as "business activities."

The CPA does not provide a definition of "significant business activities". For the purpose of CN Policy, the concept of "significance" is predicated on the importance of competition in the relevant market. In determining whether its business activity is significant or not, an agency should assess – on a case-by-case basis – the nature and extent of the relevant market as well as the probable nature and extent of the competition within that market.

The "relevant market" can normally be identified on the basis of the competing goods or services (ie. substitutes) which could reasonably be used interchangeably by most customers or consumers. In addition to this, the relevant market may also be identified in terms of the geographic area or areas in which sellers of a good or service operate and to which consumers can practically turn for the good or service in question.

The question of whether a business activity is significant or not in the relevant market can only be determined on a case-by-case basis. Some of the factors which could be considered in this regard include:

- the size of the relevant business activity in relation to the size of the relevant market;
- the influence or competitive impact of the business activity in the relevant market;
- the resources the business activity commands and the effect of poor performance; and
- whether the costs of providing the goods or services by the entity are being predominantly met by users.

An activity should not be regarded as significant or insignificant solely because of its size relative to the overall size of the government business.

A government agency should document its determination as to whether a business activity is, or is not, within the scope of CN Policy. This documentation should be defensible and will be subject to scrutiny in the event that an investigation is triggered by a complaint.

Agencies and local governments should consult the Competitive Neutrality Complaints Unit, located in the Department of Treasury and Finance, if they require assistance in this regard.

1.6 Assessment of benefits and costs of introducing a competitive neutrality measure

Following a determination by a government agency that an activity is "significant", it should consider the expected benefits and costs of introducing an appropriate competitive neutrality measure.

The decision to implement any specific competitive neutrality measure depends, in the first instance, 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."

For the purpose of CN Policy, an assessment of the potential benefits of applying competitive neutrality measures should include, but is not limited to, the matters outlined below:

- increased market contestability which enables competition in the markets that have been traditionally dominated by public sector businesses. Such contestability produces incentives for businesses to lower prices and provide greater choice for consumers;
- improved performance of government businesses in comparison with competitors. Competitive neutrality increases the incentives for the business to operate efficiently thereby encouraging better use of the community's scarce resources; and
- owner governments can better clarify non-commercial objectives, and thereby determine whether the business is effectively meeting these objectives.

In evaluating the beneficial impact of competitive neutrality measures, it is important to remember that the benefits from greater competition will generally arise year after year so that there is a stream of benefits which must be considered. For this reason they may be more difficult to establish than are costs.

For the purpose of CN Policy, an assessment of the potential costs of applying competitive neutrality measures should include, but is not limited to:

- legislative and regulatory amendment;
- 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.

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.

Competitive neutrality measures need not be applied in situations where costs exceed benefits, that is, when the stream of competitive costs incurred over time is greater than the corresponding stream of benefits accrued over the same period.

After examining competitive neutrality costing and assessing net financial benefits of a competitive neutrality measure, the government agency will need to undertake a *public interest test* if it considers that another policy objective or objectives of Government would be compromised by the implementation of a competitive neutrality measure.

In general, the costs of implementing competitive neutrality measures are more immediate, faced by the public business itself and more measurable. The benefits, which tend to accrue over the medium to longer term and diffuse across the community as a whole, are less easily quantified.

It is important that any comparison of costs and benefits is undertaken on the same basis. This can be done by amortising costs over the period for which the benefits are expected to accrue, or converting both the cost and benefit streams to their current values so that they can be compared properly. In this regard, the costs of implementation in most cases are likely to be small relative to overall expenditures relating to the significant business activity.

The cost-benefit assessment should be documented and made available in the event that an investigation is triggered by a complaint.

1.7 The Public Interest Test

Once a government agency or local government has determined that the activity in question is subject to CN Policy and the expected benefits of introducing the relevant competitive neutrality measure outweigh the costs, it would then need to consider whether implementation of the measure is in the public interest.

The CN Policy recognises that government agencies and local governments have responsibility for achieving an array of social, environmental, economic and regional objectives. Government agencies should conduct a public interest test to ensure that CN Policy is implemented responsibly and sensitively, by incorporating recognition of these other public policy objectives.

The CPA provides some guidance on the matters which may be taken into account in assessing whether the introduction of competitive neutrality measures is in the public interest. These include:

- government legislation and policies relating to ecologically sustainable development;
- social welfare and equity considerations, including community service obligations;
- government legislation and policies relating to matters such as occupational health and safety, industrial relations and access and equity;
- economic and regional development, including employment and investment growth;
- the interests of consumers generally or a class of consumers;
- the competitiveness of Australian business; and
- the efficient allocation of resources.

It is important to note that this is an open-ended list so that other relevant matters may be considered as appropriate. These may include, for example:

- local or regional policies relating to economic and business development, employment, quality of goods and services, including timeliness of supply;
- impact on the local or regional community; and
- impact on the State and national economies, if any.

In addition, other considerations made by a council during the implementation of its *Best Value* program in accordance with the *Local Government Act 1989* may be relevant.

Where a government agency considers that the implementation of a competitive neutrality measure would compromise other public policy objectives, it will need to conduct a public interest test in order to demonstrate the case for not implementing the measure in question. If implementation of a competitive neutrality measure is shown to be **not** in the public interest, then the business activity in question – such as a childcare centre – is exempt from CN Policy.

To satisfy the formal requirements of CN Policy, the test should, at a minimum:

1. *Clearly identify the public policy objective(s) for the government business undertaking.*

   These policy objectives refer to those which are promulgated or endorsed by Government, a Minister or a local government body. Supporting documentation could be in the form of an official policy statement in the business plan of a government agency or a formal resolution of a local government. (See also section 2.4.1.)

Box 1.2: Example of application of Competitive Neutrality Policy Victoria

Background

A government agency owns and operates a fitness and swim centre. Activities at the centre include gymnasium services and access to the swimming pool The purpose of the facilities is to provide the general public with user pays fitness activities. Also as part of the government's occupational health and safety objectives, the centre provides government employees with similar services.

Recently the government agency considered whether it should continue providing services at this centre or sell the facilities to the private sector. As part of the decision making process, the government agency considered the application of *Competitive Neutrality Policy Victoria*. The following is a summary of the government agency's consideration of competitive neutrality principles

Significant business activity

The fitness and swim centre is very popular with the local community with visitation rates increasing. It is located close to government offices and a major shopping complex. At present no similar facilities exist within a 12 km radius. The government agency has invited expressions of interest from the private sector to build, own and operate similar facilities The costs of providing the services are being predominantly met by users of the centre. The government agency has determined that the fitness and swim centre is a "significant business activity".

Costing and pricing

The government agency has adopted the fully distributed costing methodology to determine prices. This method ensures that the direct, indirect and competitively neutral costs are factored into the full cost base. Prices are set to recover competitively neutral costs over the medium to long term.

Public interest test

Being located close to new growth suburbs, demand for services at the fitness and swim centre is expected to increase. The government agency is keen for the services to continue Also, to maximise benefits to the community the government agency has undertaken to minimise price increases that may result from an increase in demand for services at the centre.

2. *Demonstrate that achievement of the stated policy objective(s) would be jeopardised if the particular competitive neutrality measure under consideration was implemented.*

   The relevant competitive neutrality measures include corporatisation, commercialisation and full cost reflective pricing. (See section 2.4.2 for further discussion.)

3. *Determine the best available means of achieving the overall policy objectives, including an assessment of alternative approaches.*

   In undertaking this aspect of the test, the government business should identify other means of achieving the overall policy objectives (including those pertaining to competitive neutrality); and assess the relative merits of the alternative approaches.

   The determination of the best available means may involve a qualitative assessment of the priorities assigned to – and by implication, the trade-offs arising from – the competing policy objectives. (See section 2.4.3)

Under CN Policy, the public interest test should be undertaken in consultation with the affected community through an open and transparent process. The government agency is best placed to determine, on a case-by-case basis, the level, nature or scope of the consultation having regard to the complexity of the issues and the impact on the community. In local government, council's consultation in relation to public interest may be incorporated in consultation processes undertaken for *Best Value* purposes.

At the conclusion of the consultation, the processes and outcomes of the public interest test should be documented and made publicly available. Information that is commercial-in-confidence may be excluded, provided a statement specifying reasons to support the claim is noted in the public documentation. (See Appendix 13.4 for discussion of commercial-in-confidence.)

1.8 Competitive Neutrality Complaints Unit

In order to respond to concerns arising in relation to competitive neutrality and its application, the Victorian Government has set up the Competitive Neutrality Complaints Unit (the Complaints Unit) so that it can make sure that government businesses compete fairly with private businesses. The Complaints Unit is required to investigate all complaints fairly, independently and rigorously and present a finding on the basis of the best available information.

The Complaints Unit will discuss complaints with complainants (affected persons or businesses) and in the first instance suggest a direct approach to the government agency to resolve the issue. If the matter cannot be resolved and a complaint is lodged in writing, the Complaints Unit will consult with both parties and assess whether the government agency does have an unfair advantage impacting on the complainant. Complaints will be assessed in accordance with the CN Policy.

When a complaint is received, the Complaints Unit will seek verification from the government business as to its compliance with the CN Policy. Where a formal investigation is necessary, the government business and the responsible government department and/or local government will be notified of the investigation.

The onus is on the government business subject to a complaint to demonstrate compliance with CN Policy. Relevant documentation must be made available to the Complaints Unit, to either verify or assess the extent to which the government business has complied with CN Policy. For local government it is expected that application of the BVP will incorporate the necessary auditable documentation to meet this need.

If a complainant or government business believes that the Complaints Unit has overlooked a piece of information relevant to the investigation, they may write to the Complaints Unit and request further consideration of the issue. The Complaints Unit will investigate further where new facts, or information relevant to the inquiry, are brought to its attention.

There is no fee for lodging complaints and, where possible, the Complaints Unit will seek to finalise complaint investigations within eight weeks of receipt of a written complaint. When an investigation is finalised, the Complaints Unit will notify the complainant, the subject of the allegation and the responsible government department or local government of the findings of the investigation, and provide each with a copy of the preliminary investigation report. Subject to any comments received and further investigation required, the report will be finalised and may recommend, where needed, a change of action in the government agency's business.

The Complaints Unit will liaise with the complainant, and the subject of the allegation, as to whether they consider any information to be commercial-in-confidence (see appendix 13.4). Investigation reports completed by the Complaints Unit will then be made publicly available on the Unit's website: ***www.vic.gov.au/ncp/cn_findings.htm***

Where non-compliance with the CN Policy is established, the Complaints Unit will notify the relevant Departmental Secretary, or the Chief Executive Officer, of this finding and the actions which the government business should take to comply with the CN Policy. Three months after the investigation is finalised, the Complaints Unit will request written advice as to progress on compliance.

The Complaints Unit will not recommend any compensation. The Complaints Unit does not assess anti-competitive behaviour that is already covered by *the Trade Practices Act/Competition Code of Victoria.*

The Complaints Unit will investigate complaints from an affected person or business as well as from industry or community groups. The Complaints Unit will document all conversations and meetings relevant to the inquiry. All documentation received and created by the Complaints Unit is subject to the normal operation of the *Freedom of Information (FOI) Act 1982* (Vic).

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Implementation of Competitively Neutral Pricing Principles

Implementation of Competitively Neutral Pricing Principles

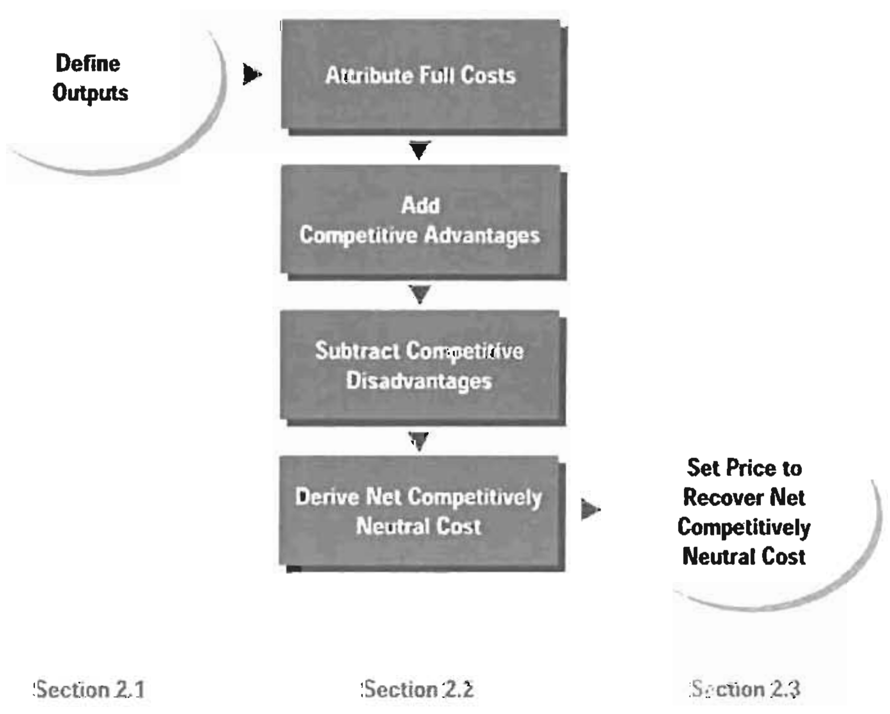
The intention of competitively neutral costing and pricing is to offset any net competitive advantages arising from public ownership that a government business may enjoy, thereby ensuring that resource allocation decisions are made on the basis of comprehensive and accurate costing.

For the purpose of CN Policy, the key requirement of full cost-reflective pricing is that government agencies should aim to recover the full costs of their whole business activity over the medium to long term.

2.1 Defining the output

Output definition involves defining the good or service and specifying the characteristics and elements of that good or service in such a way as to enable appropriate costing and identification of competitive advantages and disadvantages arising from government ownership. For example, where an activity is the subject of competitive tender, the tender brief should define the output(s) being purchased.

The procedure for competitively neutral costing and pricing is summarised in the following figure



Box 2.1: Example of Grouped Outputs

Education sector

A TAFE College provides a range of vocational training courses related to the hospitality industry These include food preparation, food service, tourism and hotel management. Other educational institutions also provide hospitality industry training services in competition with the TAFE College Provided that as a whole, the College can recover the competitively neutral cost of providing services over the medium to long term, the College may price each course, or group of courses, to take into account factors such as demand and competition.

The focus is on the outputs of activity rather than on inputs or the processes associated with the activity. Outputs are the goods and services produced and delivered by an agency for customers outside the agency. Customers are any people, organisations or other departments external to the agency who purchase, use or consume products or services provided by it.

The following factors will assist in developing a clear description of the output:

- what is the purpose of providing 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?

Outputs of a particular agency may be grouped and it may be more practical to apply the steps to a group of outputs, rather than many individual outputs. However, the following criteria should be observed when grouping outputs. Output groups should have the following characteristics:

- similar attributes;
- outputs with similar customers or categories of customers; and
- outputs contributing to a common service objective of the agency.

2.2 Calculate the competitively neutral cost of the output

Full cost-reflective pricing takes into account:

- all of the costs that can be attributed to the provision of the good or service;
- the cost advantages of public ownership; and
- the cost disadvantages of public ownership.

2.2.1 Adopting a costing methodology

Fully Distributed Cost - It is expected that full cost attribution will be achieved using the *Fully Distributed Cost (FDC)* method. This ensures that the *direct, indirect* and *competitively neutral* costs of producing an output are factored into the full cost base. *Direct costs* of production include wages and the cost of inputs. *Indirect costs* (overheads) are typically split among various commercial and/or non-commercial outputs and include electricity, information technology, building security, administration, personnel services and rent. These costs that are incurred in producing the output should therefore be taken into account.

Avoidable Cost - In instances where the *primary* activity of an agency is *non-commercial*, it may be appropriate to use *Avoidable Cost (AC)* methodology. Using this method, the agency need only consider the extra (direct) costs that the agency could avoid if the activity in question was not undertaken. In many cases, the indirect costs of an agency will not be affected by the commercial activity of the agency, as overhead costs would be incurred anyway. To the extent that indirect costs are affected by the commercial activity these should be taken into account.

Further, the only competitive neutrality adjustments that need to be taken into account under the AC approach are those adjustments which result in competitive advantages and disadvantages in the production of the commercial output.

Box 2.2: Examples of competitive advantages

Advantage	*Description*
Accident compensation levy	Levied on employers to cover WorkCover expenses.
Capital financing	Cheaper financing due to a lower risk premium where the agency is backed by an explicit or implicit government guarantee.
Corporate overheads	Access to various corporate overheads free of charge, including office accommodation, pay-roll services, human resource services, marketing and IT services.
Cost of capital	Requirement to earn a rate of return on funds which could otherwise be used elsewhere.
Debits tax	Levied on all debits of not less than $1 to taxable accounts
Financial Institutions Duty (FID)	A financial institution that receives money is liable to pay FID in respect of each receipt of money except where it is for the credit of an exempt bank account.
Land tax	Annual tax based on total unimproved value of Victorian land owned by a taxpayer.
Local government rates and charges	Imposed on land by local governments.
Pay-roll tax	Levied on firms whose annual pay-roll is over $515,000.
Stamp duty	Duties are charged on a number of transactions, including those involving tradeable instruments, property and hiring.

Note: Wholesale sales tax used to be levied on the wholesale cost of certain goods. This tax was abolished when the GST was introduced on 1 July 2000. For calculations relating to pre GST costings refer to Appendix 3.

An agency must be able to demonstrate that its primary activity is clearly non-commercial and that its indirect costs are unaffected by the activity in question, before it chooses to apply the AC approach. This may be achieved through a variety of means, such as a description in the agency's annual report of its activities, or by a Ministerial Statement as to the role of the government agency.

Where there are no clear policy statements about the primary activity of the agency, the agency may use the AC approach if it can demonstrate that the substantial majority of its outputs are for non-commercial purposes.[2]

In most cases, agencies will be required to adopt the FDC approach to costing outputs.

2.2.2 Calculate the actual costs incurred in producing this output.

Where the FDC approach is being used, agencies need to establish a full cost base which attributes all costs incurred in the production of the output. This is the base to which adjustments for competitive advantages and disadvantages are made. If agency outputs are not fully costed a vital first step is to ascertain and allocate all relevant costs and set up appropriate accounts. This needs to be done before proceeding to competitively neutral costing and pricing.

The full cost base will include:

- all direct costs such as labour, materials and premises;
- indirect costs (overheads) such as personnel services, information technology support, administration; and
- depreciation of physical assets.

[2] As a general rule, the agency will be required to demonstrate that a significant proportion of its outputs is non-commercial before the AC approach can be used. The Competitive Neutrality Complaints Unit will accept evidence of input use (ie what proportion of inputs are used in the non-commercial activity) or output use (ie what proportion of outputs are non-commercial, what proportion of patronage is non-commercial) in deciding whether the FDC approach or the AC approach is appropriate.

2.2.3 Add Competitive Advantages[3]

To the fully costed base, agencies should add an amount calculated for each identified competitive advantage relevant to the output. The principal competitive advantages which are likely to accrue as a result of government ownership are summarised in Box 2.2. Further detail is provided in Chapter 3.1.

While the Guide covers most of the likely competitive advantages, agencies should review all of their activities and the markets they supply to identify further differences peculiar to their own circumstances. The key criterion is *whether the difference is solely due to government ownership of the public sector agency.* Where a difference is identified which is partly due to government ownership and partly due to other factors, it is the part of the difference which can be attributed to government ownership which is the competitive advantage to be costed.

2.2.4 Subtract Competitive Disadvantages

If agencies consider that they are disadvantaged in their business activities by arrangements imposed on them by government (for example, accountability costs and private sector 'small business' exemption from pay-roll tax), they should give consideration to ways of directly removing or altering the particular requirements. (For example this could be achieved by removing exclusivity arrangements or considering alternative structural and ownership arrangements.)

The key factor in assessing whether a disadvantage constitutes a competitive neutrality issue is that the constraint (on the conduct of the public business) is externally imposed on the agency and it exceeds that likely to be faced by a private sector business supplying the same goods or services.

Box 2.3: Examples of competitive disadvantages

Disadvantage	***Description***
Accountability costs	Greater accountability costs due to public sector reporting and regulatory requirements
Agency specific requirements	Compliance with Commonwealth and State legislation, regulations or directives.
Corporate overheads	Limited flexibility in reducing or restructuring corporate overheads.
Employment remuneration	Public sector has different employment and industrial relations requirements

[3] A separate adjustment to offset company income tax and capital gains tax is not recommended. This advantage is better dealt with through the use of a *before-tax rate of return* (Refer to Chapter 3, Section 3.1 and Appendix 2). Because company income tax is levied on profits, this adjustment cannot be accurately calculated in most cases. Similarly, factors such as the shared use of capital with non-commercial activities means that capital gains tax would be difficult to calculate accurately.

After consideration of these options if agencies believe they face unavoidable cost disadvantages, these should be clearly identified and the magnitude of the cost burden should be estimated for the purposes of determining net competitive advantage.

Box 2.3 summarises some potential competitive disadvantages faced by government agencies. Further detail is provided in Section 3.2.

Once an initial estimation and adjustment has been made, it is recommended that this adjustment, expressed as a percentage of total costs, be reapplied to total costs in subsequent periods, **unless there is a significant change likely to have an impact on the estimated net adjustment**. For example, a significant change might result from a change in the recommended rate of return, a change in the valuation of assets, or a change in statutory rates of tax. This will need to be judged by the agency on the basis of information obtained during the initial calculation.

As well, agencies may develop shortcut approaches to estimating particular cost components. Therefore, an actual calculation may not be made in each case, but an estimated figure could be determined based on experience gained from making similar calculations elsewhere. Agencies might be able to determine from experience the proportion of expenditure associated with commercial projects that is likely to be spent on sales tax exempt goods, and accordingly develop a rule of thumb. Similarly, experience might enable an agency to develop shortcuts in relation to estimating costs associated with transactions attracting stamp duty. The reasons for selection of any shortcuts should be documented, defensible and reviewed when appropriate.

2.3 Setting the Competitively Neutral Price

Once the competitively neutral cost of an output has been determined, *the agency must set a price for its output to ensure that it fully recovers the competitively neutral cost over the medium to long term.*

In setting the price for the good or service in question, the government agency may have regard to a number of economic factors that include, but are not limited to:

- the level of demand for the good or service;
- the level of competition between service providers; and
- short term pricing strategies involving the use of "loss leaders" or cross-subsidisation, subject to the prohibitions of certain pricing behaviour under the *Trade Practices Act 1974*.

Where agencies are involved in producing a number of commercial outputs, it is the commercial operations as a whole which should achieve full cost recovery in the medium to long term: full cost recovery is not required for each output produced. Therefore, different commercial activities can cross subsidise each other, provided that revenue is no less than the total competitively neutral cost of all the activities.

2.4 Applying the Public Interest Test

In some situations, government may direct an agency to provide a particular output at less than full cost recovery in order to achieve a policy goal in the public interest. These goals can be social, economic or distributional in nature. In these cases, it is not the intention of CN Policy to override these goals.

Once a government agency has determined that the activity in question is subject to CN Policy and the expected benefits of introducing the relevant competitive neutrality measure outweigh the costs, it would then need to consider whether implementation of the measure is in the public interest.

Where a department, agency or local government considers that the implementation of a competitive neutrality measure would compromise other public policy objectives, it will need to conduct a *public interest test* in order to demonstrate the case for not implementing competitive neutrality measures. To satisfy the formal requirements of CN Policy, the test should, at a minimum, identify the (endorsed) policy objective(s), demonstrate the risk to that objective created by the competitive neutrality measure and assess options to achieve overall policy objectives as discussed below.

2.4.1 Identification of policy objectives

The agency must clearly identify the policy objective(s) that is (are) to be achieved and demonstrate that the policy objective(s) has official endorsement. This evidentiary onus can be satisfied by documents showing the exercise of ministerial discretion, clear policy statements in annual reports, official directions or other public documents.

It is not sufficient for the agency to merely state that it has engaged in a particular activity that happens to be in the public interest for a period of time.

2.4.2 Competitively neutral price and public policy objectives

The onus is on the agency to demonstrate that the achievement of the stated policy objective(s) would be jeopardised if the particular competitive neutrality measure under consideration was implemented. The agency should provide evidence of the process used to assess that the competitive neutrality measure would jeopardise the stated public policy objective.

For example, the agency might show that the setting of a competitively neutral price over the medium or long term would not enable the agency to achieve a particular public policy objective due to reduced affordability amongst the target clients. The policy may focus on a particular market sector and the specific features of that sector may require a higher quality of service than the private sector market would provide for the price. To demonstrate this, the agency might establish its actual costs and competitively neutral costs for a particular product or service then explore whether or not a pricing strategy to cover these costs can meet the relevant objective(s).

In some cases, the public policy objectives may be achieved at a competitively neutral price.

Box 2.4: Example of TAFE Institute Pricing

A TAFE Institute produces a training course for a competitively neutral cost of $17,913. A 'break even' fee of $1,800 per student based on 10 enrolments gives full cost recovery. 12 students enrol for the training course.

If the training course in question was the only commercial output produced by the Institute, fees would need to be set to achieve full cost recovery for the course over the medium to long term.

However the Institute also produces a number of short courses which it sells in a competitive market for around $120 per student. The Institute will therefore need to cost the short courses, taking account of the relevant competitive neutrality adjustments. The cost for short courses is $12,000 after taking into account competitive neutrality adjustments. This is based on an estimated enrolment of 100 students.

The Institute receives 75 enrolments for short courses. The shortfall of $3,000 ($120 x 25 students) with the short courses is met by the 2 additional enrolments in the training course ($1,800 x 2 = $3,600).

The Institute derives an overall cost for the delivery of the bundle of training courses which constitutes the full cost recovery benchmark which it should recover over the medium to long term. This provides the Institute with flexibility to price above estimated costs for courses or services where there is strong demand, and to reduce prices for courses where demand is lower, subject to the overriding requirement to cover the Institute's full costs across its activities over the medium to long term.

2.4.3 Alternatives to meet the policy objective

In cases where it is clear that the setting of a competitively neutral price cannot meet particular public policy requirements, agencies need to assess alternative ways of achieving these objectives to determine the best available means of achieving the overall policy objectives. The consideration of alternative options in a transparent manner has the potential to improve the allocation of the scarce resources of the agency and the community in general.

Alternative options to below full cost reflective pricing include:

- *rebates* – whereby particular members of the community can claim a rebate when using a particular facility such as a local government pool;
- *reduced rates and charges* – where a broad section of the community enjoys a particular activity which is also provided by private competitors in the vicinity, a reduction in general government rates and charges will increase the purchasing power of consumers. This may make it feasible for them to afford to pay more to use a particular private facility, while being no worse off; and
- *provision of substitutable outputs* – some outputs may be cheaper to provide but just as effectively meet the particular public policy objective which is in the public interest.

The analysis of these alternative options, including the option of retaining a transparent public subsidy, should be undertaken in consultation with the community through an open and transparent process. At the conclusion of the process, the conduct and outcomes of the public interest test should be documented and made publicly available. Information that is commercial-in-confidence may be excluded, provided a statement specifying reasons to support the claim is noted in the public documentation.
(See example in Box 2.5)

Box 2.5: Applying Competitive Neutrality Policy

A number of government agencies have jointly established a regional office facility that includes a conference facility. The departments share the rent and overhead costs on the basis of staffing levels and space, and the conference facility, which is managed as a separate cost centre, is charged on the basis of usage. The regional managers have been approached concerning community access to the conference facility for weekends and evenings when the facility is not used by the government departments.

The regional managers examine the issue of whether or not to charge and if so how much to charge. They realise that the suggested interest in the use of the facility is such that it could be regarded as a significant business and competitive neutrality issues must be considered. They decide to examine the options of charging on a full cost and an avoidable cost basis. The rental on the facility is covered by the funding of the departments and would not be affected by the additional use. However, the conference facility manager would be required to work additional hours to supervise the facility, including access, operation of equipment and security. Utility costs (such as power for heating and lighting) as well as a proportion of maintenance and cleaning would constitute avoidable costs. In order to determine the most appropriate pricing approach the regional managers decide to consult with the community to ascertain the likely usage and capacity to pay.

Following public consultation the regional managers find that there are three categories of potential users and two potential competitors and a demand depending on fees which would have the facility in use 20 evenings and 10 full weekend days. The user categories are:

- some business related functions, where participants would be paying to attend;
- community groups which have been paying a minimal fee to use the church hall; and
- community groups which have no financial basis but would value the ability to convene meetings and would clean up after their functions.

The second competitor is the local hotel, which has a smaller room used for meetings and private functions such as wedding receptions. The hotel has allowed some fee free access to its room where the group dines there as well and is anxious not to lose catered functions to the conference facility.

The regional managers establish a three-tier pricing regime: full cost, avoidable cost and fee free, with fee free access limited to demonstrably public interest use. To ensure that the facility is not competing unfairly with the hotel and the church, those categories of users which would normally pay for the use of the church hall or the hotel venue will be charged either full cost or avoidable cost depending on the category of users. In addition, the hotel will be allowed access to cater on a commercial basis for conference facility users. Further, efforts will be made to promote a coordinated partnership approach to the booking of all three facilities.

In this case the government agencies have balanced the issues of public interest and competitive neutrality in making facilities accessible to the local community. The expected usage is such that the receipts from "full cost paying use" and "avoidable cost use" will more than cover the avoidable cost of total external usage. The agencies are also able to use the entrance foyer to publicise their programs, increasing public awareness to potential clients.

In summary, the following is a checklist to assist with the *public interest test* process:

- Identify the policy objective(s) to be achieved and provide supporting documentation, such as a statement by a Minister or local government body, or official policy documents.
- Demonstrate that the achievement of the stated policy objective(s) would be jeopardised if the particular competitive neutrality measure under consideration was adopted.
- Determine the best available means of achieving the overall policy objectives, including an assessment of alternative approaches.
- Document the conduct and outcomes of the "public interest test" and make the documentation available to the public. Information that is commercial-in-confidence may be excluded, provided a statement specifying reasons to support the claim is noted in the public documentation.

cost adjustments

3

Making Cost Adjustments

Cost Adjustments

Making Cost Adjustments

This chapter outlines the steps necessary to make particular cost adjustments. These cost adjustments are added to (subtracted from) the cost base in arriving at a competitively neutral cost. A numerical example demonstrating these steps is outlined in Chapter 4.

3.1 Competitive neutrality advantages

3.1.1 Actual cost of producing output

All costs attributable to producing the product or service are determined as a first step using either the fully distributed cost (FDC) method or the avoidable cost (AC) method. This amount is referred to as the cost base. This process should also involve determining the cost of capital for assets used in the production of the good or service. These assets may have been purchased exempt from stamp duty or sales tax and if so stamp duty and wholesale sales tax adjustments must be added to the asset costs and depreciated in arriving at the written down value of the assets.

3.1.2 Goods and Services Tax and wholesale sales tax

On 1 July 2000 the Goods and Services Tax (GST) effectively replaced the wholesale sales tax. The GST is a value added tax on the consumption of most goods, services and property in Australia, including imports. The GST does not apply to exports of goods and services consumed outside Australia.

See Appendix 1 for further details on the GST.

Note: An adjustment for exemption from wholesale sales tax may apply for assets purchased prior to 1 July 2000. The requirement for this adjustment will progressively reduce as more assets are purchased under the Goods and Services Tax regime.

Description

Sales tax is an indirect tax previously imposed on the wholesale price of goods used as inputs (prior to 1 July 2000) to produce the good or service.

Calculation

Step 1 Identify goods purchased which would ordinarily be subject to sales tax. Only include those goods which would be subject to sales tax if purchased by a private sector business.

Step 2 Establish a common retail price for the goods.

Where a government agency has purchased goods sales tax exempt, they are paying a retail price, where no sales tax was charged at the wholesale level. In most cases, this price will be less than a common retail price (which includes sales tax charged at the wholesale level).

A common retail price for goods (where sales tax was paid at the wholesale level) can be ascertained by the following methods:

- by consulting a survey of retail prices; or
- by grossing up the price which the government agency paid for the goods by 22 per cent.[4]

Step 3 Deduct 10 per cent from the common retail price.

This calculation approximates the wholesale price for the good including sales tax.

Step 4 Calculate sales tax:

$$\text{sales tax} = \text{wholesale price including sales tax} \times \frac{\text{sales tax rate}}{\text{1 plus sales tax rate}}$$

As a general rule, most capital equipment would have been subject to 22 per cent sales tax. Therefore, in most cases:

$$\text{sales tax} = \text{wholesale price including sales tax} \times (22/122).$$

[4] This can be done where the sales tax levied would have been 22 per cent and a percentage mark-up from the wholesale level to the retail level is assumed.

Step 5 If the sales tax adjustment relates to a fixed capital asset (a non-current physical asset) then the sales tax amount should be added to the purchase price of the asset and then depreciated in line with the appropriate depreciation rates for that asset. Sales tax applying to consumables should be added as an expense adjustment to the cost base.

Further information

Refer to Appendix 3 for further information about sales tax rates that applied prior to the introduction of the GST on 1 July 2000.

3.1.3 Stamp duties

Description

A State Government tax imposed on a wide variety of transactions, including land transfers, leases of land, marketable securities and mortgages.

Calculation

Note: The stamp duty adjustment is handled differently depending on whether or not it relates to a non-current (depreciable) asset.

Step 1 Identify transactions associated with the output that would be dutiable but for the government exemption.

Step 2 Calculate the duty applicable to each transaction.

Step 3 If the stamp duty relates to transactions involving a non-current physical asset, include the amount of the duty in the cost of the asset for the purposes of calculating depreciation and the written down value of the asset for the purpose of the cost of capital adjustment. Otherwise, add the estimated duty to the other competitively neutral cost adjustments to the cost base.

Further information

Refer to Appendix 6 for further information about stamp duty.

3.1.4 Cost of capital

Description

The cost of capital reflects the opportunity cost of funds provided to government agencies. Government agencies are expected to earn a rate of return to cover the opportunity cost of capital.

It should be noted that capital markets generally use nominal rates. Any consideration of the Weighted Average Cost of Capital (WACC) relating to private sector usage, needs to be made with the knowledge that any comparisons should be made with due consideration to differences in cash flows and the basis of the rate determination. Nominal rates require after tax cash flows. CN Policy uses before tax cash flows, and hence, real rates as the basis of the rate of return determination.

The real (before tax) rate of return on capital, based on a WACC for the purpose of competitive neutrality pricing, remains at 8 per cent.

Calculation

Note: If the calculation of full costs includes an estimation of a commercial rent, no adjustment needs to be made for land or premises.

The agency should provide an estimate of commercial rent. This can be done through an examination of comparable rental properties, real estate documentation stating potential rental value of the premises or, should they currently pay rent, evidence that any existing rental contract is at arms length.

Step 1 Calculate the total asset base.

The total asset base is the sum of total current assets (eg working capital, debtors, stock) plus total non-current assets (eg written down value (WDV) of physical assets) owned and employed in the production of relevant output, as shown diagrammically.

Note: the WDV of physical assets should be adjusted for any stamp duty and sales tax exemption.

Step 2 Calculate that part of the total asset base used to produce the commercial proportion of the relevant output for which a competitively neutral price is required.

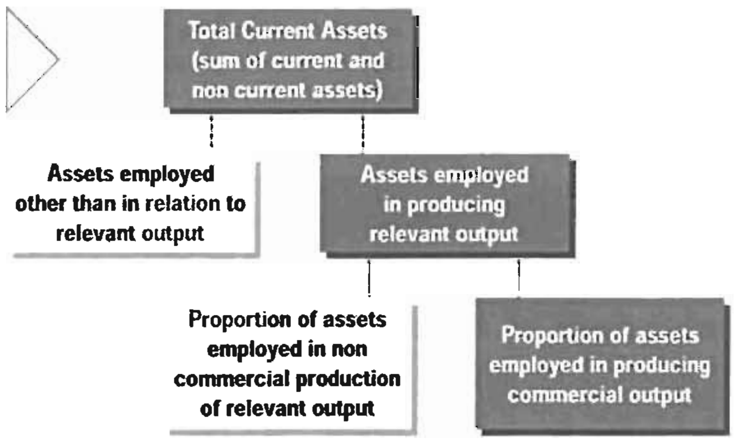
This will involve multiplying the value of total assets by the percentage use of these assets in producing the relevant output for which a competitively neutral price is required. Where a specific asset is used only for commercial activity the value of this asset should be excluded from proportional calculations and added in separately in full.

If the total assets are wholly used to produce the relevant commercial output, the rate of return percentage is applied to the whole base.

Step 3 Calculate the cost of capital amount.

Multiply the relevant proportion of the total asset base by the real cost of capital for the current year. For this example, multiply the proportion of total assets (current plus fixed) by 0.08 (8 per cent).

Identification of relevant assets



Step 4 Determine the net cost of capital adjustment.

Subtract from the cost of capital amount (calculated at Step 3) any costs already associated with the funds used to purchase assets.

This includes any interest owing on a bank loan to purchase assets as well as servicing costs arising from any government capital charge (such as a financial accommodation levy). Alternatively the cost of assets purchased with a fully commercial loan can be excluded from the asset base used for the cost of capital calculation.

Step 5 Add the calculated amount to the cost base.

Further information

Refer to Appendix 2 for further information about the cost of capital.

3.1.5 Land tax

Description

An annual tax levied by the State Government, based on the total unimproved value of all Victorian land owned by a taxpayer.

Calculation

Note: If the calculation of full costs includes a documented and defensible estimate of commercial rent, no adjustment needs to be made.

Step 1 Obtain a municipal valuation of the site value of the relevant land.

Step 2 Multiply the site value by the relevant "equalisation factor" (ratio which reflects the change in land value since the last general valuation) to derive the unimproved value of land.

Step 3 Ascertain the percentage of land directly attributable to the relevant business activity.

Step 4 Using the land tax scales, calculate land tax which would be assessed on the land relevant to the business activity.

Step 5 Add the amount to the cost base.

Further information

Refer to Appendix 4 for further information about land tax rates.

3.1.6 Local government rates

Description

Levied by local governments on land-holders within their municipalities.

Calculation

Note: If calculation of full costs includes a documented and defensible estimate of a commercial rent no adjustment needs to be made.

Step 1 Obtain the relevant municipal valuation used for rating purposes for properties used in the business activity.

Step 2 Obtain from the local government an estimate of the rates that would apply.

Step 3 Assess rates apportioned to the premises used relevant to the business activity.

Step 4 Add the amount to the cost base.

Further information

Refer to Appendix 5 for further information about local government rates.

3.1.7 Financial Institutions Duty (FID) and debits tax

Description

FID is a State government tax levied on the receipts of all financial institutions. Debits tax is levied on all debits transactions of accounts with cheque-drawing or payment order facilities.

Calculation

For administrative simplicity the adjustments for FID and debits tax can be combined into a single adjustment based on 0.1 per cent of sales revenue from the output.

Step 1 Forecast likely sales revenue from output for the current period.

This forecast can be based on the revenue earned from the commercial output over the previous financial year.

Step 2 Multiply the forecast by 0.001 (0.1 per cent).

Step 3 Add the amount to the cost base.

Further information

Refer to Appendices 7 and 8 for further information about FID and debits tax.

3.1.8 Pay-roll tax

Description

Levied by the State government on Victorian wages paid by an employer to its employees.

Calculation

Step 1 Determine whether the agency's commercial activities are exempt from pay-roll tax.

To determine whether or not it is exempt from pay-roll tax, an agency needs to calculate the total salaries of all personnel engaged in producing the commercial output. Where this is not possible, agencies need to make this calculation on a pro-rata basis, using the commercial output as a proportion of total output as a guide.

Step 2 If an adjustment is required (and the salaries paid total more than $515,000 per annum or $42,917 per month), subtract $515,000 from the total salaries cost.

Step 3 Multiply the difference by 0.0575 (pay-roll tax rate).

Step 4 Add this amount to the cost base for a competitive advantage or subtract it from the cost base for a competitive disadvantage.

Further information

Refer to Appendix 9 for further information about pay-roll tax.

3.1.9 Accident compensation levy (WorkCover Insurance)

Description

WorkCover is compulsory insurance for injured workers, which must be taken out by all Victorian employers.

Calculation

Step 1 Does the commercial unit bear the levy or is it paid by the parent entity?

Step 2 If the WorkCover insurance is paid by the parent entity, add the relevant proportion of the levy to the cost base.

Further Information

Refer to Appendix 12 for further information about WorkCover insurance.

3.1.10 Advantages in borrowing funds and exemption from the Financial Accommodation Levy (FAL)

Description

Lower interest rates on loans obtained by government agencies which are not obliged to pay the FAL.

Calculation

Step 1 Entities need to obtain an estimate of interest rates on borrowings by private sector businesses undertaking the same activity. This information should be used as a benchmark against which interest on their loans can be measured.

The private sector rate may vary according to the nature and length of the loan.

Step 2 Subtract the public sector rate from the private sector rate.

Step 3 Multiply the difference between the two rates by the size of the loan. This should provide the additional interest payment that the entity would pay if it were a private sector business.

Step 4 Add this amount to the cost base.

Further Information

Refer to Appendix 12 for further information about this issue.

3.1.11 Additional private sector regulations or requirements

Description

Regulations or requirements that apply to a private sector business but not its public sector equivalent carrying out the same activity.

Calculation

Note: This adjustment requires a comparison of compliance cost differences between the public and private sector in meeting regulatory requirements in a particular area. For example, more rigorous corporate governance requirements for the private businesses (such as under the *Corporations Law*) should be compared with equivalent corporate governance requirements for the public sector. Where public sector requirements are more rigorous than private sector requirements (for example privacy requirements), they will need to be the subject of separate adjustments to reduce the cost base.

Step 1 Identify any additional requirements for private sector competitors.

Step 2 Estimate the cost of these requirements, considering cost factors such as labour and materials, accounting costs and broader corporate controls.

Step 3 Add this amount to the cost base.

Further Information

Refer to Appendix 12 for further information about this issue.

3.1.12 Free or below-cost access to corporate overheads

Description

A public sector business should take account of all the overhead costs involved in producing a good or service.

Calculation – Fully Distributed Costing (FDC)

Step 1 Establish what the entity is currently paying in overhead costs to produce the output.

Step 2 Calculate overheads for the output using the FDC approach.[5]

Step 3 Subtract total in Step 1 from total in Step 2. This will give the difference between overhead costs apportioned across all commercial and non-commercial activities and the costs the entity is actually paying.

Step 4 Add this amount to the cost base.

Further Information

Refer to discussion of FDC and AC methodologies in Chapter 2 and Appendix 10.

3.2 Disadvantages

As a starting point, there is a presumption in the costing guidelines that the public sector does **not** face conditions which would constitute a competitive disadvantage vis a vis a private sector competitor. For example it is arguable whether higher superannuation costs simply compensate for lower public sector salaries. In effect the government has to employ people in a competitive labour market, superannuation is part of the salary package, and there is no reason to presume that the salary package is not competitive. Similarly, the extent of additional costs of accountability should be carefully assessed, as accountability requirements may be equivalent.

Notwithstanding this presumption, the cost disadvantages faced may be very real and agencies should set out clearly the basis for the determinations they make.

[5] Where the agency is making cost adjustments on an avoidable cost basis, they will be required to account for the overheads if it is an avoidable cost.

3.2.1 Superannuation

Description

Superannuation includes a contribution paid by employers into a fund to provide an income for workers after their retirement. While the legal requirement for employer contributions is eight per cent of an employee's salary, some public sector employees receive higher levels of superannuation payments under defined benefit schemes.

Calculation

Step 1 Identify superannuation contributions to those employees on defined benefits schemes.

Step 2 Subtract from this total the equivalent of an eight per cent superannuation contribution (0.08 multiplied by the relevant wages).

Step 3 Subtract this amount from the cost base.

Further Information

Refer to Appendix 11 for further information on Superannuation.

3.2.2 Government awards

Description

A public agency may find that its wages and/or salaries are higher than the private sector competitor. However, this cost disadvantage can *not* be reflected in the competitively neutral price unless the employer can demonstrate that it is bound *by law* to pay a higher award than the private sector. If it is simply industry practice for the public agency to pay higher wages, but this is not reflected in award conditions, this is not considered to be a disadvantage accruing as a result of public ownership.

Calculation

Step 1 Identify statutory wages costs of those employees to whom the agency is required to pay a higher wage by law.

Step 2 Subtract from this total the award costs for equivalent private sector employees.

Step 3 Subtract this amount from the cost base.

3.2.3 Inherited higher cost structure

Description

Government agencies which have recently been commercialised or corporatised may inherit higher or less efficient cost structures than their private sector counterparts. This disadvantage may persist for several years while the entity re-structures and modifies its cost structure to reflect better that of its competitors. While this process is taking place, organisations may legitimately take this into account when determining competitively neutral pricing. *The onus is on the entity to demonstrate how it is competitively disadvantaged as a result of a greater cost structure.*

This disadvantage will also include an agency's lack of flexibility in restructuring overheads compared to the private sector (for instance a requirement that the commercial operations occur in a particular building for which overheads are high).

Calculation

Step 1 Identify costs not borne by a private sector business in the same activity, and which are directly attributable to the inherited cost structure of the recently re-structured business.

This may include excess personnel or the use of larger commercial facilities than is necessary.

Step 2 Calculate these additional costs taking into account factors such as labour, materials, and overhead costs.

Step 3 Deduct the total from the cost base.

3.2.4 Accountability costs and legislative and regulatory restrictions

Description

These costs may arise because government agencies face accountability or regulatory requirements not imposed on private sector competitors undertaking the same activity (eg. quarterly reporting to government).

Calculation

Step 1 Identify activities resulting from accountability, legislative or regulatory requirements, not borne by private sector businesses.

Step 2 Determine the cost of each of these activities, taking into account factors such as labour, overheads, materials and accounting costs.

Step 3 Deduct this total from the cost base.

Case Study 4

Case Study

4.1 Hypothetical example of the application of competitively neutral pricing principles

A government agency controls and operates a fitness centre called Apollo. The principal purpose of the facility is to provide the general public with a range of user pays fitness activities (60 per cent). However, the centre is used to improve the fitness of government employees as part of the government agency's occupational health and safety objectives (40 per cent). The activities provided at the centre are:

- gymnasium services – comprising weight training facilities and circuit classes; and
- aquatic activities – comprising access to the pool as well as swimming lessons.

A private sector competitor operating a gymnasium facility has lodged a complaint with the Competitive Neutrality Complaints Unit that the government owned fitness centre has not applied competitively neutral pricing principles.

4.1.1 The output

The commercial outputs of the leisure centre can be grouped into two broad output groups: gymnasium services and aquatic activities.

4.1.2 Calculate the actual costs incurred in producing this output

The government is required to use the FDC Approach to costing its outputs because the principal purpose of the facility is commercial. The actual equivalent (pre-tax) costs incurred in operating the leisure centre for both commercial and non-commercial purposes are:

■ Electricity	$20,000
■ Wages	$600,000
■ Other expenses	
Bank loan interest on equipment	$9,600
Miscellaneous expenses*	$10,000
Depreciation	$72,500
Total Cost	$712,100

[* *The miscellaneous expenses include the lease of a car for use by the leisure centre. If the centre owned the car it would need to be included as an asset and adjustments made for cost of capital and stamp duty. The details at 4.1.4 demonstrate the calculation of the stamp duty, which would affect the depreciation amount included as expenses, if the vehicle was owned. The adjustment is not made to the cost in this case as for the purpose of this example the vehicle is leased.*]

However, as only 60 per cent of the costs are incurred for a commercial purpose, the cost of producing the commercial output is $427,260.

Cost of producing commercial output is $427,260

Potential advantages

4.1.3 Exemption from sales tax

Note: An adjustment for exemption from sales tax applies to all assets purchased prior to 1 July 2000. The requirement for this adjustment will progressively reduce as more assets are purchased under the Goods and Services Tax regime.

Step 1 Calculate sales tax.

Comment: The gym equipment, which would normally be subject to sales tax, was purchased sales tax exempt for $200,000.

Step 2 Establish a common retail price for the goods.

Comment: The gym increases its purchase price by 22 per cent:

$200,000 x 1.22 = $244,000

Step 3 Deduct 10 per cent (estimated mark-up) from the common retail price:

$244,000 - $24,400 = $219,600

Step 4 Calculate sales tax.

Sales tax =

$$\text{wholesale price including sales tax} \times \frac{\text{sales tax rate}}{\text{1 plus sales tax rate}}$$

Sales tax =

$$\$219{,}600 \times \frac{22}{122}$$

$$= \$39{,}600$$

Step 5 This amount is added to the capital cost of the equipment for the purpose of calculating depreciation and cost of capital. The depreciation adjustment for the sale tax, using the same basis as the asset depreciation, for the current period, would be $7,425.

Sales tax adjustment amount is $39,600, with a depreciation adjustment of $7,425.

4.1.4 Exemption from stamp duties

Note: For the purpose of the hypothetical example for Apollo, the motor vehicle is leased at commercial rates and consequently no adjustment for stamp duty is required. The calculation below is provided for agencies owning vehicles as depreciable assets.

If the motor vehicle was an asset, the government agency would be exempt from stamp duty on the motor vehicle used by the leisure centre. Suppose the centre changes its motor vehicle every 12 months. For the exemption, stamp duty on a car with a retail value of less than $35,000 is $5 for each $200 or part thereof. The vehicle has a retail value of $25,000.

Stamp duty on vehicle = $25,000/200 x $5 = $625.

This amount of $625 should be capitalised and depreciated with the asset.

4.1.5 Cost of capital

The assets of the leisure centre are:

■ Land	$500,000 (UCV)	$500,000
■ Buildings	$500,000 (cost)	$430,000 (WDV#)
■ Gym equipment	$200,000	$112,500 (WDV#)
Add sales tax adjustment	$39,600	$22,275 (WDV#)
Less commercial loan component	($80,000) (cost)	($45,000) (WDV#)
■ Cash in the bank	$100,000	$100,000

(WDV# calculated using appropriate depreciation rates for the asset types, in this example over two years.)

The centre has taken out a bank loan for the gym equipment of $80,000 at a commercial interest rate of 12 per cent. As a consequence, the capital value of the equipment financed by that loan should not be included in the cost of capital adjustment. (This capital value does not include any adjustment for sales tax.) This means that the written down value of the gym equipment for the cost of capital adjustment reduces to $89,775.

Step 1 Calculate the total asset base.

Comment: The total asset base after adjusting for sales tax is $1,339,600. After deducting commercially financed equipment, the relevant fixed asset base has a written down value of $1,019,775 plus the working capital amount of $100,000. However, while only 60 per cent of the fixed assets (land, building and equipment) has a commercial purpose, all of the cash in the bank is used as working capital for commercial operation purposes.

Step 2 Calculate the portion of the total asset base used to produce the commercial output.

$1,019,775 (land, buildings and gym equipment) x 0.6 + $100,000 (cash in the bank) x 1

$611,865 + $100,000 = $711,865

Step 3 Multiply the relevant proportion of the total asset base by the cost of capital for the current year:

$711,865 x 0.08 = $56,949

Cost of capital adjustment is $56,949

4.1.6 Exemption from land tax

Step 1 The site value of land is $500 000 according to the local government.

Step 2 The "equalisation factor" as determined by Land Victoria is 1 therefore the unimproved value of land remains the same as the site value as returned to local government at the last general valuation.

Step 3 60 per cent of the land is directly attributable to relevant business activity.

Step 4 The unimproved value of the land is greater than $85,000, therefore land tax will apply. (see Appendix 4 for current rates).

The rate is:

$200 + 0.002 x $300,000 = $800.

Therefore, the relevant adjustment for land tax directly attributable to the business activity is:

$800 x 0.6 = $480.

Land tax adjustment is $480

[6] Because cash in the back relates solely to the commercial activities.

4.1.7 Exemption from local government rates

Step 1 The relevant capital improved value of the property (ie. premises and land) is $1,000,000 for rating purposes according to the local government.

Step 2 The local government rate is 0.008 times the value of the property per annum:

0.008 x $1,000,000 = $8,000

Step 3 The portion allocated to the relevant output is 60 per cent:

$8,000 x 0.6 = $4,800

Local Government rates adjustment is $4,800

4.1.8 Exemptions from FID and debits tax

Step 1 Forecast likely sales revenue from output.

The gym's revenue for the most recent financial year was $450,000 and this figure can be used as a forecast for the current period. Applying the rule of thumb combining the adjustment for these two exemptions, 0.1 per cent of sales revenue should be applied.

Step 2 Multiply the forecast by 0.001 (0.1 per cent).

FID and Debits tax amount is:

$450,000 x 0.001 = $450

FID and debits tax adjustment is $450

4.1.9 Pay-roll tax

Step 1 Because total annual salaries are greater than $515,000, pay-roll tax must be paid. The total staff salaries are $600,000. The amount on which pay-roll tax would be payable is:

$600,000 - $515,000 = $85,000

Step 2 Multiply the difference by 0.0575:

$85,000 x 0.0575 = $4,887.50

Pay-roll tax adjustment is $4,887.50

4.1.10 Accident Compensation Levy (WorkCover insurance)

Apollo has already paid a levy for WorkCover insurance. This is part of the "miscellaneous costs" category.

4.1.11 Other potential advantages

Apollo estimates that it does not benefit from any requirements or regulations not shared by its private sector competitors, nor does it have access to free or below-cost overheads.

Potential disadvantages

- Higher superannuation costs; and
- higher accountability costs.

As a starting point, there is a presumption in the costing guidelines that the public sector does not face conditions which would constitute a competitive disadvantage vis a vis a private sector competitor.

To the extent that cost disadvantages are identified, there is also an onus on the agency to seek to minimise the additional costs of public provision. Apollo will therefore need to:

- establish a case that it does face higher costs solely due to government ownership;
- investigate arrangements for removing the source of the high cost; or
- if the cost disadvantage is unavoidable, estimate the magnitude of the cost burden to offset against the estimated competitive advantages.

4.1.12 Superannuation

Several employees (equivalent to 20 per cent of salaries) receive an additional two percent of their salary as superannuation under a defined benefit scheme.

Step 1 Superannuation equivalent to 10 per cent of salary (rather than the statutory 8 per cent) is paid on 20 per cent of the total salary cost (ie. $600,000 x 0.2 = $120,000).

Therefore, the contribution to defined benefits schemes is:

($120,000 x 0.08) + ($120,000 x 0.02) = $12,000.

Step 2 If Apollo contributed only the statutory 8 per cent to superannuation, the total would be:

$120,000 x 0.08 = $9,600

Step 3 The difference between the two is:

$12,000 - $9,600 = $2,400

Step 4 Only 60 per cent of this cost is for commercial purposes. Therefore the adjustment is:

$2,400 x 0.6 = $1,440

Superannuation adjustment is - $1,440

4.1.13 Accountability costs

Step 1 As a result of government requirements, Apollo must prepare a quarterly report for departmental compliance with the Financial Management Act. This is in addition to ordinary annual reporting requirements. This is not a cost faced by its private sector competitors.

Step 2 It takes the accountant 5 hours to complete each quarterly report. The accountant's hourly pay is $25. Therefore, 20 hours (5 hours x 4) is spent each year completing the report, a total of $500. Apollo estimates that each report also uses $25 of materials such as ink and paper (4 x $25 = $100).

Therefore, the cost of this requirement is:

$500 + $100 = $600

Step 3 Only 60 per cent of this activity is for commercial purposes. Therefore the relevant adjustment amount is:

$600 x 0.6 = $360

Accountability adjustment is - $360

4.1.14 Net adjustment to total cost

Box 4.1 Summary of Competitive Neutrality Cost Adjustments

Net adjustment can be summarised as follows:

Cost of producing commercial output		**$427,260.00**
Adjustments		**$**
Depreciation on sales tax adjustment	7,425	
Exemption from stamp duties (*)	-	
Amount for cost of capital	56,949	
Exemption from land tax	480	
Exemption from local government rates	4,800	
Exemption from FID and debits tax	450	
Exemption from pay-roll tax	4,887.50	
Additional superannuation costs	(1,440)	
Accountability costs	(360)	
Net adjustment required		*$73,191.50*
Full competitively neutral cost		*$500,451.50*

* *Note: If the motor vehicle had been an asset, an amount of stamp duties not incurred due to the exemption was estimated at $625. This amount would need to be added to the valuation of assets for depreciation purposes and would be allocated to the cost of the commercial output.*

The **net** competitive neutrality adjustment to cost as a percentage of the full cost base is estimated to be 17 per cent.

4.1.15 Competitively neutral pricing

Under CN Policy, prices should reflect the full competitively neutral cost of producing a good or service.

Currently, Apollo's income is $450,000. The competitively neutral cost of providing fitness services is $500,451.50. In this example, Apollo has not fully implemented a competitively neutral price for its gym and pool facilities. To comply with CN Policy, the fitness centre will need to earn a further $50,451.50.

It is the choice of the management of Apollo centre on how this may be achieved. Competitive neutrality requires that full cost recovery is achieved in aggregate on the pool and gym activities. For instance, it is acceptable for the centre to decide to provide aquatic activities at below cost, provided that the revenue from the gymnasium services is sufficient to cover both its own competitively neutral cost as well as sufficient additional revenue to cover the competitively neutral cost of the aquatic activities.

GLOSSARY

Avoidable costs (AC): a cost methodology which can be used by non-commercial agencies, whereby only the incremental costs of producing an output are considered in establishing a competitively neutral cost base. Using this method, the agency generally need only consider the extra (direct) costs that the agency could avoid if the activity in question was not undertaken. (To the extent that indirect costs are affected by the commercial activity these should be taken into account.)

Competitive neutrality measure: a specific action to achieve competitive neutrality. These include corporatisation, commercialisation and full cost reflective pricing.

Competitive Neutrality Policy (CN Policy): a policy designed to offset or remove any net competitive advantages of publicly-owned businesses resulting from government ownership.

Competitively neutral cost: the total cost of producing a good or service after taking into account competitive neutrality cost adjustments.

Competitively neutral price: the price set by a government-owned business for its outputs to recover fully the competitively neutral cost over the medium to long-term.

Current asset: an asset which is cash or can be readily converted to cash (eg. cash in bank, accounts receivable).

Defined benefits scheme: the superannuation system under which the total benefit is related to factors such as years of service and average salary. Payments under these schemes tend to have an accrual rate above that mandated by current legislation.

Direct costs of production: costs which can be directly and unequivocally attributed to an activity.

Fully distributed costs (FDC): a cost methodology which ensures that the direct, indirect and competitively neutral costs of producing a good or service are factored into the cost base.

Government business enterprise (GBE): a term used to describe any stand-alone business owned by government at Commonwealth, State/Territory or local level.

Indirect costs of production: costs which are not directly attributable to a particular activity. These are often referred to as overheads.

Non current asset: an asset which is not readily converted to cash (eg. equipment, vehicles).

Opportunity cost: the return which could be gained by employing resources in the next best alternative activity.

Rate of return: (in this context) the percentage return required by government on the total assets employed by an agency to undertake a business activity.

Weighted Average Cost of Capital (WACC): the cost of funds to government agencies, which takes into account various classes of debt and equity capital. WACC takes into account factors such as the appropriate return on debt and equity and a risk free rate of return.

5 Appendices

National Indirect Tax Reform

A1.1 A New Tax System

Under national tax reform, a range of existing indirect taxes will be replaced by a Goods and Services Tax (GST). This will have implications for competitive neutrality pricing.

How will the GST work?

The GST will be a multi-stage value added tax where tax is applied at each stage of the production chain. Government and businesses will be eligible to claim a rebate for the GST with the tax only "sticking" at the final point of sale to consumers.[7]

Box A1.1: Example of the GST

For example: A timber merchant adds value of $100. Sells timber to a furniture maker for $110 (including 10 per cent GST). The merchant remits $10 to the ATO. The furniture maker claims an input tax credit for $10. He adds $50 in value and sells it to a final consumer for $165 (including $15 GST). He remits $15 to the ATO.

There are three types of treatment of supplies under the GST:

- *taxable supplies* – where GST is charged on supplies (eg sales), but input tax credits are allowed for the GST on inputs used to make supplies.
- *GST-free supplies* – where GST is not charged on sales of goods and services that are input GST-free. However, sellers of GST-free goods and services will not be entitled to claim input tax credits for any GST paid on business purchases.
- *input taxed supplies* – where GST is not charged on sales of goods and services that are input taxed. However, the seller will not be entitled to claim input tax credits for GST paid on business purchases.

The nature of tax reform

The Commonwealth Government has proposed that the GST will replace the following taxes:

- sales tax – from 1 July 2000;
- Financial Institutions Duty – from 1 July 2001; and
- stamp duties on marketable securities – from 1 July 2001.

The various state governments will also consider abolishing debits tax by 1 July 2005. The abolition of the remaining business stamp duties has been deferred.

The phased nature of the abolition of these taxes will mean some of the competitive advantage of government entities will gradually decline from 1 July 2000. This will be reflected in a reduction in the size of any competitive neutrality adjustments required by the policy.

Impact on competitive neutrality

The main impact of national tax reform on competitive neutrality arises from the abolition of Sales Tax. Removal of this tax will significantly enhance competitive neutrality because the Sales Tax provides specific concessions to particular government organisations. These exemptions are described in Schedule 1 of the *Sales Tax (Exemptions and Classifications) Act 1992* (see also Appendix 3).

However, unlike the Sales Tax, the GST tax generally does not provide concessional treatment to particular *entities* engaged in creating commercial supplies. Rather, the nature of GST treatment will depend on whether a *supply* is taxable, GST-free, or input taxed. Therefore, government agencies that are currently exempt from sales tax, will not be exempt from GST by virtue of their government ownership.

[7] Refer to the Commonwealth Government's policy statement *Tax Reform: Not a new tax a new tax system*, August 1998.

Transitional competitive advantages

Over the phase-in period of the GST (2000-01 and 2001-02), there still may be cases where the GST has competitive neutrality implications. For example, under section 20 of *A New Tax System (Goods and Services Tax Transition) Act 1999*, there is to be a gradual phase in of input tax credits for motor vehicles. This means that for businesses:

- no input tax credits are allowed for motor vehicles purchased in the first year of the GST;
- 50 per cent input tax credits are allowed in the second year; and
- full input tax credits are allowed in the third year.

This provision is designed to reduce the incentive for entities to delay purchasing motor vehicles until after the GST start-date. However, where an entity was able to purchase a motor vehicle Sales Tax exempt, it will not be subject to this transitional provision.

As a result, government agencies, which purchase motor vehicles Sales Tax exempt now, will be able to claim full input tax credits for vehicles purchased immediately after the introduction of the GST. Competing private sector entities will have to wait for 2 years before they can claim all their GST on purchased vehicles. This competitive advantage will accrue to government agencies that were previously exempt from sales tax until 1 July 2002.

A1.2 Other implementation issues relating to the New Tax System

Compliance costs

Some government agencies will provide taxable and GST-free supplies following 1 July 2000. Taxable supplies would include those supplies provided in competition (or potential competition) with the private sector, while GST-free supplies may include the provision of services such as water and sewerage.

Some of these government agencies may face higher GST compliance costs than competing private sector businesses which simply charge a uniform tax rate on all their sales and receive input tax credits on their purchases. However, such costs are likely to be offset by the larger size of many government agencies. Further, for government agencies that engage in taxable and GST-free supplies there should be no additional compliance burdens on the acquisition of business inputs.[8]

Even where the additional GST compliance costs are considered to be significant for the government agency, this is still not a competitive disadvantage for the purposes of competitive neutrality adjustments. While a government agency may be obliged to provide particular services which a private sector competitor does not, costs should be kept separate from the taxable activity which competes with the private sector. Accordingly, the government agency may choose to consider appropriate structural arrangements to ensure that GST compliance costs are able to be apportioned according to the nature of the activities.

Cash flow

Under the GST legislation, government businesses will be required to remit GST on a monthly basis if their turnover is over $20 million. Competing private sector businesses with a turnover of between $50,000 and $20 million will be able to remit quarterly. This can provide the private business with a greater cash flow advantage, as they will be able to hold GST collections for a greater period until remittance to the Australian Taxation Office. This cash flow benefit increases with business interest rates in the economy.

However, the potential disadvantage of monthly GST remittances stems from the size of the organisation. As it does not stem specifically from government ownership and it is not a competitive disadvantage from a competitive neutrality perspective, it should not be taken into account in making competitively neutral cost adjustments.

[8] Refer to p. 6 of the Regulation Impact Statement for the introduction of a Goods and Services Tax (Explanatory Memorandum for A *New Tax System (Goods and Services Act) 1999)*.

Rate of Return

The Department of Treasury and Finance is responsible for setting the rate of return to apply to business activities of government agencies under the Victorian Government's CN Policy. The Department of Treasury and Finance advise that the approach to be adopted in calculating a rate of return for the purposes of competitive neutrality is to calculate a real before tax return based on the WACC with reference to total assets.

Rate

The real (before tax) rate of return on capital for the purpose of competitive neutrality pricing is currently 8 per cent.

Application

The asset base to which the rate is to be applied can be defined as:

- total current assets (eg working capital, debtors, stock); plus
- total non-current assets (eg written down value of physical assets), owned and employed in the production of the relevant output.

Where lease, rent or hire options are pursued, the cost of using the asset would normally be reflected in the payments made to the owner of the assets and reflected as a direct cost in calculating the full competitively neutral cost of service delivery.

To avoid double counting, it is important that the amount of any Government Financing Charge or other interest expense already allocated to an output is first deducted from the estimate of total cost, before the amount representing the rate of return is calculated.

Valuation of assets

The valuation of the non-current physical assets component of total assets, to which the rate of return is to apply should be the written down replacement cost in accordance with the 'Deprival Value Method'. For further explanation of the approach to valuation of assets refer to the Department of Treasury and Finance publication *Recognition and Valuation of Non-Current Physical Assets* issued in January 1995. Assistance can be obtained from the Budget and Financial Management Division of the Department of Treasury and Finance.

Sales Tax

Application

Under national tax reform, the wholesales sales tax has been replaced by the Goods and Services Tax (GST). An adjustment for previous exemption from wholesale sales tax may apply for assets purchased prior to 1 July 2000. The requirement for this adjustment will progressively reduce as more assets are purchased under the Goods and Services Tax regime.

Wholesale sales tax was a tax imposed by the Commonwealth Government on goods imported into Australia and goods that were manufactured and consumed in Australia. The tax was imposed on the last wholesale sale of goods going into use for the first time in Australia. Sales tax was imposed on 'assessable' goods which were the subject of an 'assessable' dealing, unless an exemption applied.

Exemptions

The scheme of exemptions was complex. There were categories of exemptions based on the use of the goods ('conditional' exemption) or the nature of the goods ('unconditional' exemption). The essential point is that, depending upon the circumstances, **both government owned agencies and private sector businesses could obtain exemptions from sales tax**.

Under Schedule 1 of the *Sales Tax (Exemptions and Classifications) Act 1992*, goods purchased for use by the following entities were exempt from sales tax:

- public transport authorities (item 64);
- State Government bodies (items 126, 127 or 128);
- public hospitals (item 140); and
- local government bodies (item 127).[9]

Schedule 1 also exempted certain goods for use in business or industry (business inputs) relating to mining, primary production, manufacturing, transport, storage, research and development. Building materials, irrigation and water supply materials, fuels, food and drink for human consumption, clothing and footwear, human health and hygiene products, books, magazines and newspapers and scientific and educational goods were also exempt.

In relation to the local government sector, exemption applied to goods used in a work and/or supply contract where ownership passed to the local government under the contract. For example in the fitting out of a local government occupied building or parts used in the repair of local government equipment or vehicles. Sales tax exemption did not extend to machinery, equipment or tools, which were purchased for use in carrying out local government contracts where the private contractor retained ownership. An exception existed in relation to earth moving contracts. Machinery, implements and apparatus, other than general purpose road vehicles, which were expected to be used mainly in earth moving contracts for governments for at least a period of two years could be purchased free of sales tax.

Rates

As at March 1997 rates of sales tax were:

- 12 per cent for household goods;
- 22 per cent for non-luxury motor cars and other goods not covered by other rate categories (this is the 'general rate');
- 41 per cent for alcoholic wines and 37 per cent for spirits, etc.;
- 32 per cent for luxury goods (eg. jewellery, watches) [NB. For most schedule 5 items, excluding fur skins and some jewellery, the sales tax rates reduced to 22 per cent from 29 July 1999]; and
- 22 per cent up to the luxury depreciation limit and 45 per cent on the balance for luxury motor vehicles.

The category of purchases which was not exempt for private sector businesses which is most likely to be relevant for competitive neutrality is the category encompassing non-luxury 'motor vehicles' and 'other goods'. This category had a tax rate of 22 per cent (the general rate).

[9] A rule of thumb is: if a body is established by State legislation and the Government has some control over it, then it is likely to be exempt from sales tax. This includes the following public bodies: libraries, museums, art galleries, fire brigades, harbour or marine boards, infant welfare bodies. Local government bodies include authorities established to carry out functions for local government.

Land Tax

Application

Land tax is an annual tax levied by the State Government and is based on the total unimproved value of all Victorian land owned by a taxpayer. The unimproved value of land is the site value provided by the municipality multiplied by the relevant "equalisation factor". The equalisation factor is a ratio supplied by Land Victoria which reflects the average change in the value of land within the municipality from the time of the last general valuation at a date set by the Treasurer. For the 2000 assessment year, no tax is payable on total land holdings of an unimproved value of less than $85,000.

Exemptions

Exemptions from land tax apply in relation to all Crown land, although where land is leased from the Crown, the lessee may be liable for land tax. Other specific exemptions are available for land vested in municipalities, public statutory authorities and, in some instances, for bodies providing or promoting outdoor sporting, recreation, cultural or similar outdoor activities.

Note, certain specific public authorities (such as the Urban Land Authority) are not exempt.

Please refer to the information provided on the website of the State Revenue Office (www.sro.dtf.vic.gov.au) for further details.

Rates

The scale of land tax in Victoria as at March 2000:

Unimproved land value	**Tax rates in 2000**
$0 - $84,999	Nil
$85,000 - $199,999	$85 **plus** 0.1% in excess over $85,000
$200,000 - $539,999	$200 **plus** 0.2% of excess over $200,000
$540,000 - $674,999	$880 **plus** 0.5% of excess over $540,000
$675,000 - $809,999	$1,555 **plus** 1% of excess over $675,000
$810,000 - $1,079,000	$2,905 **plus** 1.75% of excess over $810,000
$1,080,000 - $1,619,999	$7,630 **plus** 2.75% of excess over $1,080,000
$1,620,000 - $2,699,999	$22,480 **plus** 3% of excess over $1,620,000
$2,700,000 and over	$54,880 **plus** 5% of excess over $2,700,000

Comment

Land tax does not have to be factored into the competitively neutral price where a government agency is paying full commercial rent.

Local Government Rates

Application

Rates are levied by local governments on land holders within their municipalities.

Exemptions

Crown land and land used by State government and local government bodies is often exempt from rates and charges levied by local governments. The amount of rates levied depends on the valuation of the land; charges relate to the provision of particular services by the local government (for example, garbage collection).

Rates

Rates are determined by individual local governments.

Comment

A competitive neutrality adjustment does not have to be made where the government entity is paying commercial market rent. This is because the rent should embody the costs borne by the landowner, which include the cost of rates.

Stamp Duties

Application

Stamp duty is a State government tax levied under the *Stamps Act 1958* and was traditionally imposed on documents necessary to evidence such things as share and land transfers. However, in Victoria the regime now applies to a wide range of transactions which include; transfers of real property, leases of land, trusts, settlements, hiring of goods, mortgages, debentures and other securities, shares and other marketable securities, insurance and acquisitions of motor vehicles.

Exemptions

Exemptions from stamp duty in relation to most categories are available to public sector agencies. For example, specific exemptions are available in relation to particular transactions:

Conveyances of real property and land:

- a grant of Crown land by the Crown;
- transfers to the Crown or various named bodies; and
- transfers to or in trust for religious, charitable or educational bodies.

Leases or agreement for lease:

- any lease granted to Her Majesty or various named government bodies;
- any lease granted or assigned to a municipality pursuant to powers conferred by Part XLA of the *Local Government Act 1958*; and
- any lease entered into for a religious, charitable or educational purpose or body.

Mortgages, bonds, debentures and covenants:

- any mortgage by Her Majesty or various named government bodies; and
- any mortgage given for a religious, charitable or educational body or purpose.

Rates

Rates of stamp duty are small percentages levied once-off on particular transactions. For example, the most common rate of duty for a definite term lease exceeding $130 per annum is 60 cents per $100 or part thereof of the entire value of the lease.

Comment

Under national tax reform, stamp duties on marketable securities quoted on a recognised stock exchange will be abolished from 1 July 2001.

Financial Institutions Duty

Application

The State Government under the *Financial Institutions Duty Act 1982*, levies Financial Institutions Duty (FID) on the receipts of financial institutions with annual deposits in excess of $5 million. Virtually all financial institutions directly pass on the tax to their customers.

Exemptions

FID is generally not payable on receipts credited to exempt bank accounts. The following bodies can hold exempt bank accounts:

- government departments;
- local government organisations;
- state schools;
- public or non-profit hospitals; and
- charitable institutions (other than a tertiary educational institution).

Rates

FID is levied at the rate of 0.06 per cent with a maximum duty of $1,200 per receipt.

Comment

FID is to be abolished following the introduction of the GST. It is expected to cease from 1 July 2001.

Debits Tax

Application

Debits tax applies to all debit transactions to accounts with cheque drawing facilities. Debit transactions include direct debits and over-the-counter withdrawals, as well as cheque, EFTPOS and automatic teller machine withdrawals. Financial institutions and account holders are jointly liable for debits tax, although it is usually passed on by the financial institution to the account holder. The tax is levied per withdrawal on a sliding scale, based on the amount of the withdrawal.

Exemptions

Exemptions from debits tax are available in relation to accounts held by the following:

- State government authorities;
- State government departments;
- local government bodies;
- public hospitals (and non-profit hospitals);
- universities, colleges and schools (including kindergartens); and
- charitable institutions.

Exemptions do not apply where the sole or principal function of the account holder is to carry on an activity in the nature of a business (whether or not for profit). The term "business" has been defined as a trade or commercial enterprise operating as a going concern. If an agency supplies goods to the public for payment, the agency may be regarded as carrying on an activity in the nature of a business (except where an activity forms a minor or insignificant part of the function of the agency).

Rates

Debit tax varies according to the value of the debit to your account. The current rates are:

Not less than $1 but less than $100	$0.30
Not less than $100 but less than $500	$0.70
Not less than $500 but less than $5,000	$1.50
Not less than $5,000 but less than $10,000	$3 00
$10,000 or more	$4 00

A general guide is that the rate is 0.04 per cent.

Comment

Following the introduction of the GST, debits tax is expected to cease from 1 July 2005.

Pay-roll Tax

Application

Pay-roll tax is levied by the State government under the *Pay-roll Tax Act 1971*, on the Victorian wages paid by an employer to its employees. A business is required to register and pay tax if it employs staff in Victoria and its total Australian wages exceed the general exemption level of $515,000 over a financial year (or $42,917 per month). For the purposes of the tax, the definition of "wages" includes:

- wages;
- salaries;
- remuneration;
- commissions;
- bonuses;
- allowances;
- fringe benefits, within the meaning of the Commonwealth *Fringe Benefits Tax Assessment Act 1986*;
- employer (pre-tax) superannuation contributions;
- payments to some contractors (where a person is deemed to be an employee for the purposes of the *Pay-roll Tax Act*); and
- remuneration paid to company directors.

Exemptions

Businesses which fall under the following categories are exempt from pay-roll tax:

- public and non-profit hospitals;
- non-profit, non-government schools providing education at or below secondary level;
- municipalities (with the exception of wages paid to employees engaged in activities specified under section 10(1)(e) of the *Pay-roll Tax Act* or as defined under section 9 Prescribed activities in the *Pay-roll Tax Regulations 1998*.) (See Box A9.1);
- public benevolent institutions;
- charitable bodies (other than schools, educational institutions or instrumentalities of the State); and
- religious institutions.

Box A9.1: Activities of local government for which there is no pay-roll tax exemption

Section 10(1)(e) of the *Pay-roll Tax Act* provides a general exemption to pay-roll tax with exceptions specified as:

"(i) for or in connection with; or

(ii) for or in connection with the construction of any buildings or the construction of any works or the installation of plant, machinery or equipment for use in or in connection with –

the supply of electricity of gas, water supply, sewerage, the conduct of abattoirs, of public markets, of parking stations, of cemeteries, of crematoriums or of hostels or of any other activity that is a prescribed activity"

Other prescribed activities are set out under Section 9 Prescribed activities in the *Pay-roll Tax Regulations 1998*.

Section 10A of the Act states that the exemption does not apply to local government business entities unless the body corporate is a wholly-owned subsidiary (within the meaning of the Corporations law) of the local government.

Therefore, if a local government conducts a commercial activity – such as the operation of a leisure centre – it will be exempt from pay-roll tax if it is wholly owned by the local government.

In addition, certain payments are not subject to pay-roll tax. These include:

- payments to most apprentices and registered trainees;
- compensation payments to injured workers but not amounts paid in excess of the amounts prescribed as compensation;
- some termination payments and payments made as compensation for loss of employment; and
- payments to people on leave to work in the Defence Forces.

As noted above, businesses have exemption for the first $515,000 of annual pay-roll payments.

Rates

As of 1 July 1999, the rate of pay-roll tax in Victoria is 5.75 per cent of pay-roll payments in excess of $515,000.

Comment

Competitive neutrality adjustments are still appropriate even where the competitor is below the pay-roll tax threshold. This is not a potential difference arising from government ownership, but one of size of the organisation.

Free or Below-Cost Access to Corporate Overheads

Whether access to corporate overheads will be a competitive advantage to be taken into account in establishing a competitively neutral cost for the commercial output will depend on whether the Fully Distributed Cost (FDC) approach or the Avoidable Cost (AC) methodology is used.

If the entity is required to apply FDC in costing its commercial outputs, overhead costs will have to be apportioned between commercial and non-commercial outputs. However, whether overhead costs need to be taken into account under the AC approach will depend on the variability of the overhead cost.

For example, assume the overhead of electricity is fairly constant during the week and an additional commercial activity which requires commercial space does not materially affect electricity consumption. If the entity is able to apply AC methodology, the electricity costs are unlikely to be apportioned to the output. Therefore, not paying for the electricity is not a commercial advantage as no adjustment is required under the AC approach.

In contrast, where the commercial activity requires the use of overheads which are variable – such as additional electricity on weekends – the variability of the overheads may be sufficiently significant for it to be taken into account under the AC approach.

However, overheads will be required to be taken into account in all cases under the FDC approach.

Superannuation

Superannuation is a contribution paid by employers into a fund to provide an income for workers after their retirement.

Both private sector and public sector employers are now required to pay the same compulsory superannuation contribution (eight per cent of an employee's salary as of 1 July 2000), as mandated under the *Commonwealth Superannuation Guarantee (Administration) Act 1992.*[10] However, some public sector employees receive higher levels of superannuation payments under defined benefit schemes (public sector superannuation schemes which preceded the implementation of the 1992 Act). The principal defined benefit schemes include the State Superannuation Fund at the State level and the Public Sector Superannuation Scheme and Commonwealth Superannuation Scheme at the Commonwealth level.

There is an evidentiary onus on the agency which claim a competitive disadvantage to demonstrate how the nature of their superannuation obligations exceed those in the private sector.

Further, while additional superannuation requirements in the public sector may be a legitimate competitive disadvantage, it should be recognised that superannuation is only one element of the overall remuneration package. Accordingly, other aspects of government remuneration may constitute a competitive advantage to the agency – for example where government awards are lower than private sector awards or where government employees can lease Australian vehicles at concessional rates as a result of discounts given by vehicle manufacturers to government employees. These advantages may be the subject of a separate competitive neutrality adjustment.

[10] Most public sector superannuation schemes were exempted from this requirement under the Act, but under a Heads of Government Agreement entered into by State and Commonwealth Governments in 1996, the public sector complies with the major principles of the legislation, including the compulsory contribution.

Other Competitive Advantages and Disadvantages

A12.1 Accident compensation levy (WorkCover Insurance)

Any employer of workers in Victoria whose annual remuneration is $7,500 or above must have a WorkCover insurance policy. Employers must pay a premium for the policy to one of agents authorised by the Victorian WorkCover Authority. In 1998-99, the average premium was 1.9 per cent of total remuneration. Individual WorkCover premiums depend on the size of the pay-roll, the industry risk, and the claims costs of the past year plus estimated claims costs for the coming year.

While all public sector employers are required to have a WorkCover policy, the premium may be made either *directly* by the entity in question, or *on behalf of the entity by its supervisory agency.* WorkCover insurance will therefore be a potential competitive advantage where entities have not directly paid the premium. If entities do not normally receive funding from the supervisory agency which has paid their premium, this may be a competitive advantage. Similarly, where entities do receive funds from the supervisory agency which paid their premiums this may not be an advantage if the funds received have a component reduced to reflect the WorkCover insurance paid on their behalf.

Additional information can be obtained through the Victorian WorkCover Authority:

Level 24, 222 Exhibition Street
Melbourne VIC 3000

tel: (03) 9641 1555
fax: (03) 9641 1222
Email: ***info@workcover.vic.gov.au***

A12.2 Advantages in borrowing funds and exemption from the Financial Accommodation Levy

Government-owned entities may be able to obtain loans at a more favourable interest rate because of their ownership status. The Financial Accommodation Levy (FAL) is paid by Government Business Enterprises (GBEs) to the Treasury Corporation of Victoria, through which borrowings are made. The FAL is intended to account for the difference between normal commercial interest rates paid by private businesses, and rates paid by GBEs who, by borrowing through the Treasury Corporation, have the benefit of a State Government guarantee on their loan.

However, the FAL only applies to significant GBEs. Smaller entities are not able to borrow through the Treasury Corporation. While this may not provide access to an explicit State Government guarantee on loans, their public ownership provides an implicit Government guarantee, including local government activities. This is generally reflected in advantageous interest rates compared to private sector businesses in the same activity.

A12.3 Additional public or private sector regulations or requirements

There may exist particular legislation or regulation for a specific activity that applies only to private sector businesses undertaking that activity. Complying with such regulation may impose costs that a public sector agency engaged in the same activity does not incur. Conversely, the private sector may have a comparative advantage regarding other regulations where public sector requirements are more onerous.

Agencies are encouraged to review all aspects of their activities to determine all legislation/regulation that affects the same activities when carried out by a private sector business. If such a review identifies any legislation/regulation that applies to a private sector business, but not to the government agency, the best option is the elimination of the difference through amendment of the legislation. Until legislative amendment occurs, grounds for a competitive neutrality adjustment may exist.

The adjustment for a competitive neutrality advantage requires identification of:

- particular regulatory requirements which are more onerous for the private sector than the public sector (such as corporate governance requirements under the *Corporations Law*); and
- quantification of the differences in compliance costs between these requirements and the equivalent requirements faced by the public sector (such as those under the *Financial Management Act 1994*).

Conversely, where a competitive neutrality adjustment is sought for a regulatory requirement which places the agency in a comparative disadvantage, the agency:

- must demonstrate that regulatory requirements in a particular area – such as information controls under the *Privacy Act 1988* – are more onerous relative to the requirements faced by the private sector; and
- that these additional requirements have had a measurable impact on the cost structure of the government agency relative to equivalent private sector competitors.

Often, any decreasing cost adjustment for a competitive disadvantage claimed by the public sector agency may be more than offset by an increasing cost adjustment for a competitive advantage in another area.

Specific Competitive Neutrality Issues

Government agencies and complainants have raised a range of issues regarding the application of CN Policy. Many of these issues can be summarised as follows.

A13.1 Contracts pre-dating CN Policy extending beyond 1 July 1997

The Government's competitively neutral pricing principles will continue to apply where a third party manages Government premises, for example under a management contract.

Where the contract for management was signed *prior* to the application of competitive neutrality policy (1 July 1997), there will be no breach of competitive neutrality policy at the time of concluding the contract.

However, following the application of CN policy, the Government agency is obliged to apply the Government's policy *in so far as it is capable of operation within the terms of the contract.* For example, where a government agency has contracted out the management of a government facility, the government agency should – where possible – use existing contractual obligations to require the third party to take into account competitively neutral costs of provision of service when setting fees and charges.

Where a contract is nearing expiry, an alternative approach is to renegotiate competitively neutral prices upon renewal of the contract.

A13.2 Use of avoidable cost methodology

In some cases, government agencies may utilise assets in the provision of goods and services which are not for commercial return. This could occur where the output is consistent with a stated public policy objective of the entity. These assets may also be used for commercial purposes, in competition with the private sector.

If a business unit can earn revenue to equal (or exceed) its avoidable costs, it will impose no costs on the non-commercial agency in which it is housed. It will also be generating a commercial return on its own assets. Where non-commercial agencies have assets with spare capacity, the avoidable cost method will allow such capacity to be used commercially, rather than potentially have it lie idle.

Avoidable cost comprises:

- the *additional cost* to the parent agency of the business unit using its resources (assets and overheads); and
- the costs of resources used exclusively by the business unit (including capital costs).[11]

Box A13.1: Example of the application of avoidable cost methodology

A hospital has a catering facility which is used to prepare and distribute food as a key part of the care of patients of the hospital. The catering facility is consistent with the stated (and obvious) public policy objective of providing recuperative care for patients. The facility also sells takeaway in competition with the private sector. The avoidable cost methodology would only require that pricing reflect avoidable costs, ie those costs which would not have been incurred if takeaway food was not provided As the building and cooking facility would have already existed to provide patient food, a rate of return on these assets does not have to be taken into account in setting a competitively neutral price Rather, the key incremental costs that have to be taken into account are the costs of food preparation. These include the additional food and labour costs

[11] Refer to the paper by the Commonwealth Competitive Neutrality Complaints Office (CCNO Research Paper), *Cost Allocation and Pricing*, October 1998, pp. 7 – 22.

A13.3 Exclusive use of government advertising media

Whether exclusive use of Government advertising media constitutes a competitive advantage stemming from Government ownership will depend on whether the restriction is consistent with normal commercial practices or whether it stems from a regulatory advantage which the Government business has relative to its private sector competitors.

Where advertising access, for example, is denied to competitors in a manner consistent with normal commercial practices, there is unlikely to be a breach of competitive neutrality pricing principles. For example, where a local government grants exclusive advertising in its general notices to local government owned organisations, this would be analogous to a business preventing competitors advertising in its internal newsletter. This situation can be contrasted with exclusive use of directional signage. Even where a Government owned entity has made payments for the privilege of placing signage in a particular location – such as near a footpath – the denial of this access to a private sector competitor will be a breach of CN Policy. This is because the local government is using its regulatory powers to provide local government owned facilities with exclusive access to a particular advertising location. This therefore constitutes a regulatory advantage for competitive neutrality purposes.

The materiality of such action will depend on the extent to which commercial payments are made by the entity for the right to advertise in such a location and the availability of substitutable locations in which the private sector competitor may advertise.

A13.4 Commercial-in-confidence

A recent Public Accounts and Estimates Committee report (35th report to the Parliament - March 2000) found that commercial-in-confidence has been used too broadly by the public sector as a means of preventing disclosure of a wide range of information. Victorian Civil and Administrative Tribunal (VCAT) - has assumed the external review function previously exercised by the Administrative Appeals Tribunal (AAT) has an overriding discretion to grant access to most categories of exempt documents if it concludes that the public interest requires such disclosure.

The CN Policy allows that information that is commercial-in-confidence may be excluded, provided this is noted in the public documentation. However, use of this exclusion must be balanced with the public interest of disclosure and transparency. Consequently use of claims of commercial-in-confidence to prevent the disclosure of information must be justified. (NB. Competitive Neutrality Complaints reports are not subject to VCAT/AAT review as they do not constitute administrative decisions or determinations.)

In general, it will be appropriate for agencies to withhold information on the basis that its disclosure will harm their own affairs (as opposed to those of third parties) only where the information falls within the scope of section 34(4) of the *Freedom of Information Act (FOI)*. This section requires that agencies must be able to demonstrate that the information contains:

- some trade secret; or
- in the case of an agency engaged in trade and commerce information of a business, commercial or financial nature that would, if disclosed, expose it unreasonably to commercial disadvantage.

Another provision of relevance is section 36(b) of the FOI Act, which exempts from disclosure documents containing instructions issued to, or provided for the use or guidance of, officers of an agency on the procedures to be followed in various processes including:

- negotiation;
- the execution of contracts; and
- other similar activities relating to the financial, property or personnel management and assessment interests of the Crown or agency.

The VCAT has evolved a broad test of public interest that attaches significance to the role of transparency in promoting public debate and participation. The test also upholds the need to ensure proper standards of public administration by facilitating the disclosure of documents that reveal evidence of iniquity or wrongdoing.

In the light of the strong policy reasons that favour the transparency of such information, the Committee expressed the view that "there should be a specific requirement for .... parties to identify those parts that are claimed to be confidential and to specify their reasons for making such claims". Therefore for the purpose of competitive neutrality processes, information that is commercial-in-confidence may be excluded, provided a statement specifying reasons to support the claim is noted in the public documentation.

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