



COMPETITIVE NEUTRALITY COMPLAINT AGAINST STATE FLORA
under the Government Business Enterprises (Competition) Act 1996

REPORT SUMMARY

being a summary of the contents of the report on the outcomes of the
Competition Commissioner's investigation

June 2002

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1. Investigation origins

On 27 June 1998 the Premier referred complaints by a commercial nursery and seedling propagation business (the Complainant) regarding commercial activities of the State Flora nursery business conducted by the Department for Primary Industries and Resources (PIRSA) for investigation under the competitive neutrality provisions of the Government Business Enterprises (Competition) Act 1996 (the GBE Act).

State Flora had not been identified as a 'significant government business activity' within the provisions of the GBE Act at the time of the complaint. The Commissioner needed therefore to consider whether State Flora should have been so identified and required to observe appropriate principles of competitive neutrality. If so, a further question would be whether State Flora had breached those principles through the activities described in the complaint.

Progress of the investigation was complicated by subsequent events:

- Towards the end of 1998, the Complainant advised that its commercial activities had been absorbed into a new joint venture, but that the Complainant would continue to pursue the complaint in its own right as a continuing entity.
- On 1 January 1999, the Acting Premier referred to the Commissioner a complaint from the Complainant's joint venture partner, for consideration as part of the same investigation. The complaint related particularly to recent substantial new capital expenditure by State Flora.
- In January 1999 the Minister for Primary Industries, Natural Resources and Regional Development announced that the State Flora nursery business would be sold. PIRSA advised the Commissioner that it proposed to put State Flora on the market by the end of April and expected to sell it by the end of 1999.
- Given PIRSA's expectation of an early sale, the Commissioner was reluctant to ask the parties to incur significant costs in continuing the investigation, since State Flora would not be subject to competitive neutrality requirements should it be sold. The parties agreed that it appeared appropriate for the investigation to be suspended pending the outcome of the sale process.
- Sale negotiations did not proceed as quickly as PIRSA anticipated, and expected settlement dates were postponed many times. In view of the extended delay in finalisation of the complaint, all parties were advised in September 2001 that the investigation would be resumed.

- PIRSA subsequently advised that negotiations with the proposed buyer were terminated on 19 October 2001 and that it expected to put the State Flora business back on the market without delay. At the draft report stage it said that State Flora was no longer on the market because of current Government policy ‘that it does not intend privatising any more Government enterprises.’

2. Activities covered by the investigation

State Flora operates nursery activities from two sites – its main propagation centre at Murray Bridge and a retail nursery located within the Belair National Park since 1876:

- The Murray Bridge nursery, on the same site as PIRSA’s regional office and extension services base, caters for both wholesale and retail sales. Its main activity is the propagation of revegetation and forestry plants, principally blue gum seedlings sold in both South Australia and Victoria.
- Belair operates as a retail garden centre offering more than 1,500 species. It also has a nursery gift shop offering books, posters, stationery, tableware and pottery. Customers can also buy tree guards, planting tools, fertilisers, potting soils, bird boxes and other garden products.

The Complainant has operated in the Adelaide Hills region since 1976. After its incorporation into the joint venture, the Complainant said that major investments would be made for renovations and upgrading of its production facilities to concentrate on revegetation and forestry species, and that it would no longer produce ornamental lines.

The further complaint noted above related to investment at that time by State Flora, described by the joint venture partner in these terms:

“ ... State Flora has heard about the capital investment at our nursery and had decided to ‘crank up’ its nursery by purchasing the same state-of-the-art technology seeding line ... This can only be regarded as an overt act of direct and unfair competition.”

The joint venture business subsequently established a facility interstate, mainly to produce and distribute blue gum seedlings for plantation markets in the ‘Green Triangle’ area of western Victoria and south-eastern South Australia.

It claimed that it had been driven to invest and build up the interstate operation because of unfair competition in South Australia from State Flora, adding that delays in the sale of State Flora had caused it to doubt the good faith of PIRSA and/or the Government in its announcement that the business would be sold.

3. Conduct of the investigation

Following receipt of the reference, the Commissioner met separately with the Complainant, PIRSA and State Flora to explain the investigation process. Visits were made to both State Flora nurseries and to the Complainant to see their activities at first hand. Both presented extensive written submissions and supporting documents.

Visits and discussions with both parties to clarify issues raised continued while the investigation was suspended. After resumption of the investigation and receipt of new and updated information, a draft report was sent to the parties in April 2002 for further comment. Additional information from both was considered in the preparation of the final report.

4. Issues raised

The Complainant's submissions raised a number of matters, some of which were not appropriately within the scope of a competitive neutrality investigation because they either occurred prior to the introduction of competitive neutrality principles for government businesses or did not relate to breaches of those principles. The main issues raised, with comments from both parties, are summarised below.

4.1 Unfair pricing

The Complainant claimed there had been tension between private sector native plant growers and State Flora (formerly the Woods and Forests Department's Native Plant Section) dating back to the mid-1970s, with widespread industry resentment directed at 'unnecessary and unfair government competition in what has always been a very difficult market area in which to operate.'

The Complainant said that both Murray Bridge and Belair had been re-equipped and upgraded since 1993, their management and marketing style had become more aggressive and State Flora had entered new market areas. The Complainant said that a survey of all private sector nursery operators engaged in the production of native plants and trading prior to 1993 had shown significant downturns by 1998, as measured by their employment levels. The Complainant's own employee numbers (excluding principals) had been reduced from four or five in 1993 to one in 2002, and it was giving serious consideration to relocating the remaining business interstate.

PIRSA said that wholesale and tender pricing of State Flora's major product lines were determined on a cost related basis and then compared with general industry prices. It claimed that State Flora typically priced 'at the very top end of the market which accords with a market position of excellence in quality and reliability, and with an informal expectation that State Flora should not undercut competitors', adding:

“For the past two years, PIRSA’s primary strategy for addressing its Competition Policy obligations for State Flora has been to try to sell the business to the private sector. During the long period of uncertainty pending settlement, PIRSA has not made any major changes to the operation of the business which are required to bring it onto a more transparent commercial business footing. While recognising the need for changes to make the business more transparently competitively neutral, PIRSA felt constrained by the sale contract. PIRSA was concerned not to make changes to the business that might later be construed as a basis for breach of the sale contract.”

4.2 Operation within a national park

The Complainant complained that State Flora’s operation of a commercial retail garden centre within a national park provided a considerable market advantage not available to private business operators. Visitors to Belair National Park had an incentive to buy from State Flora because they could have their entrance fee refunded after making a purchase. The Complainant said this arrangement amounted to a taxpayer subsidy from national parks operating revenues to bolster and subsidise sales revenue to the State Flora commercial operation.

PIRSA said that the nursery was in practice disadvantaged by having to operate within the park because of its distance from the entrance gate and inconvenience to customers arising from gate fees. Introduction of gate fees in 1987 had caused a significant reduction in customer numbers and revenue and, if not refunded, the gate fee would act as a surcharge on every purchase. PIRSA said also:

“Provided a visit to the nursery was their primary objective in entering the Park, (visitors) can request and are given a refund of the entry fee, even if they make no purchase. The handling of this transaction is of course a net cost to State Flora.”

4.3 Role of revegetation officers

The Complainant said that PIRSA employed a network of revegetation officers throughout the State, with the primary task of encouraging the community to put trees back into the rural landscape. It questioned the competitive neutrality implications of taxpayer funded PIRSA employees acting as sales representatives for State Flora’s commercial nursery operation, claiming that their salaries and operating expenses appeared to be met from a separate PIRSA budget area and not debited to State Flora.

PIRSA said that Regional Revegetation Officers did not act as sales representatives for State Flora. They referred landholders who requested information about sources of products and services to a wide range of providers, of whom State Flora was only one. PIRSA periodically published lists of contractors through Bushcare Landcare news.

4.4 Costing of PIRSA services

The Complainant said it appeared that much of the financial administration and running of the State Flora commercial operation was still undertaken by PIRSA, and not charged out to State Flora at proper commercial rates.

PIRSA responded that the costs of financial and administration services were paid by State Flora and appeared as a line in its accounts.

4.5 Supply of eucalypt seedlings

The Complainant claimed that State Flora had benefited commercially since 1990 by having exclusive access for supply of eucalypt seedlings to landholders in the south east of the State. Private operators had only been recently been able to access that market.

PIRSA responded that *Eucalyptus globulus* plantations in the South East of South Australia involved a range of interests, including at least 10 forestry investment companies operating in the Green Triangle region. It understood that those companies had bought seedlings from nurseries in South Australia, Western Australia, Victoria, Tasmania and New South Wales. State Flora believed it had been only one of a range of suppliers since 1990, and that by 1998 more than 14 nurseries from five states were supplying seedlings to South Australia and western Victoria. Several new seedling suppliers had established or entered the market over the past five years.

4.6 Treatment of trading losses

The Complainant said that trading losses were generally carried forward from year to year and must be accounted for in private sector businesses, but it believed that State Flora's trading losses had been settled by the provision of additional funding. If State Flora's 'real' losses had been carried somewhere else in the department's overall budget, there may have been a breach of competitive neutrality principles.

PIRSA responded that State Flora finances continued to be managed in accordance with departmental standards. State Flora's surpluses formed part of PIRSA's overall finances in a particular financial year. PIRSA was introducing accrual accounting in line with whole-of-government policy, and the carry-over of surpluses and losses by units throughout PIRSA was being considered as part of accrual accounting implementation.

4.7 Capital and equipment costs

The Complainant said it doubted that capital required for the establishment and maintenance of the State Flora enterprise was being fully serviced and repaid, as would be required of a private sector business. It claimed that the cost of developing the Murray Bridge operation was met by a government grant, which meant that State Flora had received a benefit by virtue of its ownership by government.

The Complainant said that State Flora seemed to have a ‘rather large and renewable motor vehicle fleet’, and questioned whether it was purchased on the same basis as would apply in the private sector, particularly with respect to sales tax, and with full operating costs charged to the State Flora current account.

PIRSA responded that as it moved to accrual accounting, the cost of capital would form part of the State Flora accounts.

State Flora was required to use the contracted SA Government fleet provider for its vehicles. Conditions of lease for SA Government vehicles required the vehicles to be returned after a specified time or distance travelled; all costs of this policy and all other vehicle costs incurred by State Flora were debited to the State Flora accounts, as was the case for all equipment, materials and maintenance.

4.8 Rate payments

The Complainant said that it understood State Flora’s Murray Bridge operation was exempt from paying for its mains water supply, presumably because it was government owned and there was no water meter to indicate usage.

PIRSA said that State Flora paid commercial rates on all its water supply, but did not pay council rates in accordance with Government policy. A tax and rates equivalent regime was to be introduced.

5. Competitive neutrality considerations

Obligations on significant government business activities to comply with principles of competitive neutrality proclaimed in 1996 meant that any government activity needed to ensure that it was not open to challenge for ‘unfair’ competition with private businesses:

- First, whether or not the government activity saw itself to be in business, if it was in a position to exercise substantial power within a defined market the activity should have been identified as a significant business. Failure to do so might be in breach of the GBE Act and the National Competition Policy.
- Second, once declared to be a significant government business, the activity was required to adopt appropriate principles of competitive neutrality.
- Third, after these first two requirements had been met, the business activity remained open to challenge if it failed to ‘follow the rules’ established by those principles to ensure that it did not gain a competitive advantage from its government ownership.

The Commissioner therefore focused on three key questions to determine whether State Flora had breached principles of competitive neutrality:

- Is State Flora a business activity?
- Is it operating in competition with private sector business(es)?
- Are its business activities significant within the market(s) in which it operates?

5.1 Business activity

In a simple perception of the term, State Flora is likely to be seen to be 'carrying on a business'. It charges users for its services, and goes about its activities in what is to all appearances a business-like manner.

Such perceptions are reinforced by the definitions that guide competitive neutrality investigations. The Government's Competitive Neutrality Policy Statement current when the initial reference was received included this definition:

"Business activities of government are defined as those activities which are mainly producing goods and services for sale in the market with the intention of maximising profit and financial returns, or at least of recovering all or a significant proportion of their operating costs. Typically, business activities will be structured so that they retain their own receipts and make a profit."

State Flora is an activity producing goods and services for sale in the market with the intention of recovering at least a significant proportion of its operating costs. The definition would not require State Flora to be profitable, even though 'typically' a business would aim to do so.

The Commissioner is convinced that State Flora is a business activity of PIRSA.

5.2 Competition with private sector businesses

The Commissioner believes there is little basis to doubt that State Flora both is, and sees itself to be, in competition with private businesses supplying comparable products in both sectors of its operations.

5.3 Significance of State Flora's business activities

The full competitive neutrality requirements of the GBE Act apply only to a 'government agency engaged in significant business activities.'

The National Competition Council (NCC) suggests that judgments about the significance of particular government business activities should be made in a market context:

"Identifying significant government businesses according to size alone carries a danger that businesses which are significant in their particular

*markets, but nevertheless below some arbitrary threshold size, will be excluded from consideration of pro-competitive reform. Accordingly, the Council sees value in a broader test of significance, involving consideration of the impact of an activity on its relevant market.”*¹

Market definition is commonly addressed along dimensions of product, function, geography and time. In a competitive neutrality context:

- the product dimension requires identification of the goods and services (including possible substitutes) provided by existing and potential businesses;
- the functional dimension would identify the stage in the chain of production and supply to the consumer at which businesses presently or potentially operate within the market;
- the geographical dimension would identify the area(s) over which competing businesses currently, or could, supply; and
- the time dimension would consider the potential for future substitution possibilities (including product changes or new entrants) that could constrain the exercise of significant market power by existing suppliers.

The Commissioner identifies two distinct markets in which State Flora is operating, and has been required to consider whether it is in competition with the Complainant in both:

- propagation and sale of high volume revegetation and forestry seedlings in competition with the Complainant and other private businesses; and
- retail nursery activities in the garden centre within the Belair National Park.

5.3.1 Revegetation and forestry seedlings

Both the Complainant and State Flora are engaged in the production and sale of high volume revegetation and forestry seedlings:

- those products are principally sold in large numbers of single species for the most part at tender or essentially wholesale prices;
- they are destined usually for extensive farm, forestry, roadside or other large-scale plantings by commercial undertakings or government agencies;
- both State Flora and the Complainant focus particularly on the needs of customers in South Australia and neighbouring regions of Victoria (including the Green Triangle where extensive blue gum plantings have been made in recent years); and
- there are strong seasonal demands for the main products that influence nursery production schedules and marketing programs.

¹ National Competition Council, *Competitive Neutrality Reform: Issues in Implementing Clause 3 of the Competition Principles Agreement*, January 1997, p. 10.

Within this market, products are sold as specific plant varieties with differences focused on perceptions of quality and service. There is an obvious potential for substitution between sources of supply and the exercise of buyer choice between those sources is likely to be strongly influenced by price. Interstate nurseries will often need to be seen as potential suppliers and competitors for high volume South Australian projects.

5.3.2 Belair garden centre

State Flora's operation within the Belair National Park is essentially a retail outlet with regard to both the plants offered and associated garden requirements. Its emphasis is on native species, but its customers are usually buying more advanced plants in fewer quantities than those purchasing from the Murray Bridge nursery.

As noted above, Belair's potential competition is from local retail nurseries in and around Adelaide. Competition from interstate propagators will be essentially through wholesale supply to those nurseries; a relatively small proportion of total retail sales is supplied directly to home gardeners from outside the State.

Retail sales by the Complainant are small in volume. The location of its Adelaide Hills operation and its focus on main forestry and revegetation lines differentiate it from the Belair nursery and other retail outlets in the Adelaide region.

5.3.3 Conclusions on market significance

Taking account of the differences summarised above, the Commissioner concludes that State Flora is in competition with the Complainant in the propagation and sale of high volume revegetation and forestry seedlings, but not through its retail nursery activities from the garden centre within the Belair National Park.

The Complainant essentially does not operate at a retail level. For that reason alone its complaint against State Flora regarding the Belair activities might be seen to be unsustainable on the basis that the Complainant is not, in the terms of the GBE Act, '... a person that competes, or seeks to compete, in (that) particular market.'

However, in the context of this investigation the Commissioner concludes that the Belair nursery is not a significant business activity because its size and influence on the retail nursery market do not give it substantial market power.

Nevertheless, in its large volume wholesale and tender sales of revegetation and forestry seedlings State Flora has substantial market power. The number of suppliers and customers at that level is far smaller and State Flora has a substantial competitive impact in the market.

Although State Flora claims that its prices are set generally ‘at the high end’ of the market as a reflection of its high quality standards, the Commissioner believes its pricing behaviour has a substantial effect on the prices that its competitors can achieve, particularly in high volume tender lines where State Flora admits that it has an eye to prices charged by others.

The Commissioner is therefore convinced that State Flora should be identified as a significant government business activity in the revegetation and forestry seedling market. It is in direct competition with private sector businesses and its market strength is sufficient to present formidable competition to established and potential private sector operators of comparable businesses.

5.4 Observance of competitive neutrality principles

Because State Flora has not been declared to be a significant business activity, PIRSA has not identified the competitive neutrality principles that it should observe. The Commissioner believes that:

- because of its annual turnover, State Flora would appropriately be regarded as a Category 2 business for competitive neutrality purposes; and
- again reflecting the size of the business and the costs of implementing alternative measures, State Flora should have been following cost reflective pricing practices.

After careful study of ‘commercial-in-confidence’ cost and pricing information provided by both parties, the Commissioner believes that State Flora is not recovering its full costs through prices charged for its products. There appear to be significant omissions in the items brought to account, particularly with regard to non-operating costs, including overheads arising from the services provided by PIRSA. That view was supported by comparisons able to be made with the Complainant’s detailed costs, also submitted in confidence to the investigation.

State Flora may come close to covering its ‘out of pocket’ costs, but a self-supporting business must as well make adequate allowance for the costs of capital employed in the business and, in the case of a business operating within a larger organisation, for the indirect costs, including supervision, management and services provided by that organisation.

6. Other matters

The Complainant provided many examples that it said supported its claim that PIRSA’s Revegetation Officers, forestry advisers and consultants functioned as *de facto* sales representatives for State Flora. The Complainant claimed that the officers directed enquiries for nursery and forestry seedlings preferentially to State Flora, on occasions suggesting that other privately owned nurseries did not stock the plants sought, or were inferior to State

Flora's production. The Complainant said that it believed such actions were examples of State Flora gaining an advantage over private competitors because of its government ownership, and were therefore in breach of competitive neutrality requirements.

PIRSA has vigorously denied such claims, saying that its officers were charged with encouraging revegetation plantings of native flora and functioned effectively in that role. They frequently nominated private nurseries as potential sources of seedlings, and did not promote State Flora to the exclusion of its private competitors.

In the context of this investigation, the Commissioner is prepared to see the Complainant's complaint as an indication that a substantial element in State Flora's total costs of production and marketing appears not to be brought to account.

State Flora appears to receive the benefit of what amounts to an extensive marketing program for its products at little or no direct cost. If it were true that PIRSA officers preferentially promote State Flora, the Complainant's claim that it is disadvantaged in competition against a government-owned business would gain considerable support.

7. Findings and recommendations

After consideration of the complaint and further submissions from the parties involved, the Commissioner finds that:

- (i) The State Flora nursery revegetation and forestry seedling propagation and sale activities of the Department of Primary Industries and Resources constitute a significant government business activity for competitive neutrality purposes.
- (ii) As a consequence, at the time the matter was referred to the Commissioner, a proclaimed principle of competitive neutrality had been breached, in that PIRSA had not identified State Flora as a significant business activity by June 1997.

Rectification of this breach would require:

- State Flora to be identified as a significant business activity within Category 2; and
- PIRSA to apply competitive neutrality principles as appropriate, in accordance with the Government's June 1996 Competitive Neutrality Policy Statement.

Those requirements mean that another proclaimed principle has not been observed, in that PIRSA should have identified appropriate competitive neutrality principles to apply to State Flora by June 1998.

The Commissioner further concludes that:

- although PIRSA could for administrative reasons choose to place State Flora on a full business basis by the application of the competitive neutrality principle of commercialisation, the principle of full cost attribution pricing would appear to be sufficient and appropriate, given State Flora's annual turnover; but
- to this stage State Flora has not complied with that principle in its pricing of high volume revegetation and forestry products sold in competition with privately owned nurseries.

The Commissioner draws attention to the conclusion in section 5.4.3 that State Flora's retail nursery activities in the Belair National Park do not constitute a significant government business activity for competitive neutrality purposes.