Department of Treasury and Finance

South Australia

A Guide to the Implementation of Competitive Neutrality Policy

Revised 2010

Contents

1 Executive summary

The South Australian Government's national competition policy obligations are set out in the 1995 Competition Principles Agreement, which was reviewed by the Council of Australian Governments (COAG) in April 2007. This is an inter-governmental agreement between the Commonwealth, State and Territory Governments, and includes the signatories' obligations with respect to competitive neutrality.

Competitive neutrality has been implemented for Government Business Enterprises. This document is a guide and reference in relation to any issues that arise in the event that new businesses are established, or identified as requiring the implementation of competitive neutrality principles.

This paper also provides agencies that are responsible for implementing competitive neutrality with guidance on the major steps and issues involved in implementation.

Compliance with competitive neutrality policy is reported annually by the Department of the Premier and Cabinet for South Australia. In addition, as part of the COAG Competition and Infrastructure Regulation Agreement (CIRA), the Commonwealth, States and Territories are required to report to Heads of Treasuries (HoTs) annually on the general application of the enhanced competitive neutrality principles in the CIRA.

1.1 Introduction to competitive neutrality

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

The objective of the competitive neutrality policy is to remove competitive advantages and disadvantages that arise solely through the ownership differences between public sector and private sector organisations.

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

The application of competitive neutrality policy is designed to enhance efficiency by removing any distortions in resource allocation which would otherwise reduce the overall economic welfare of the community.

1.2 Selection of the appropriate measure

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

- corporatisation,
- commercialisation, or
- cost reflective pricing.

The appropriate competitive neutrality model to be applied to an agency will depend on a number of factors including the costs and benefits of applying the policy, the organisational context of the activities exposed to competition, the level of resources used in the supply of the good or service, and any special requirements such as increased accountability.

Section 3 proposes criteria for selecting between the various measures and identifies the costs and benefits to be taken into account in a decision to apply competitive neutrality measures.

Section 3.1.5 provides a schematic summary of the selection matrix for a significant business activity when determining which measure to apply, whether it be pricing reform, commercialisation or corporatisation. It is important to consider the costs and benefits of a particular measure in the medium to long term.

The relevant benefits may include:

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

The costs to be considered in the assessment may include:

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

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

1.3 Implementation of the appropriate measure

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

1.3.1 Corporatisation

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

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

It involves the adoption of 'private sector equivalent' measures including the imposition of Commonwealth and State taxes (or their equivalence), the payment of debt guarantee fees and compliance with regulations appropriate to the private sector. Treasurer's Instruction 22 'Tax Equivalent Payments' applies to public authorities and business units that are required to pay tax equivalent payments to the Treasurer.

1.3.2 Commercialisation

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

- definition of commercial and non-commercial activities (in a business plan);
- clear, commercial performance targets;
- separate definition and funding of non commercial activities;
- removal of regulatory functions from the entity;
- valuation of assets based on fair value;
- introduction of commercial gearing;
- payment of tax equivalents to the Treasurer;
- payment of applicable guarantee fees to the Treasurer;
- defined reporting requirements;
- separated accounts from the host agency (if any); and
- a dividend policy as per the ownership framework, as determined by the owner government.

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

1.3.3 Cost reflective pricing

Application of cost reflective pricing principles involves the calculation of various cost advantages and disadvantages arising from government ownership, so as to determine the net competitive advantage. This net advantage must then be taken into account in the determination of output pricing based on full attribution of costs incurred in production as a starting point. In order to minimise the costs of application certain rules of thumb are provided in this paper.

The process of costing will involve:

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

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

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

1.4 Issues in implementation

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

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

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

2 Introduction to competitive neutrality

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

Competitive neutrality policy is based on the principle that significant government businesses should not enjoy any net competitive advantages over private businesses operating in the same market simply as a result of their public sector ownership.[1]

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

2.1 The concept

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

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

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

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

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

> Competition policy does not require that all firms compete on an equal footing; indeed, differences in size, assets, skills, experience and culture underpin each firm's unique set of competitive advantages and disadvantages. Differences of these kinds are the hallmark of a competitive market economy.[2]

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[1] Government of South Australia, Competitive Neutrality Policy Statement, July 2002, p.4

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

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

2.1.1 Potential advantages

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

Examples of potential competitive advantages are:

- no requirement to cover the cost of the capital the business utilises (ie. earn a rate of return);
- exemptions from various Commonwealth, State and local government taxes, such as:
  - goods and services tax (GST),
  - payroll tax,
  - fringe benefits tax,
  - some stamp duties,
  - land tax, and
  - council rates;
- exemptions from legislation/regulation that affect the same activity when carried out by a private sector business; or
- access to various corporate overheads free of charge, or at rates below the actual cost of provision.

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

2.1.2 Potential disadvantages

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

Examples of potential competitive disadvantages are:

- restrictions on financial structure and financial management which have no equivalent in the private sector;
- less flexibility or discretion in managing operations arising from the policies and/or practices of central or public-sector wide supervisory agencies; or
- provision of non-commercial goods and/or services which it would not otherwise provide, at the direction of the government without compensation.

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

2.2 Efficiency objectives

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

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

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

A further efficiency ground for the policy rests on the notion that advantages accruing uniquely to government-owned businesses are ‘unfair’ to private sector firms competing in the same market. This could be regarded as particularly so in relation to exemptions from taxes, the private sector payment of which indirectly contributes to the funding of government business activities.

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

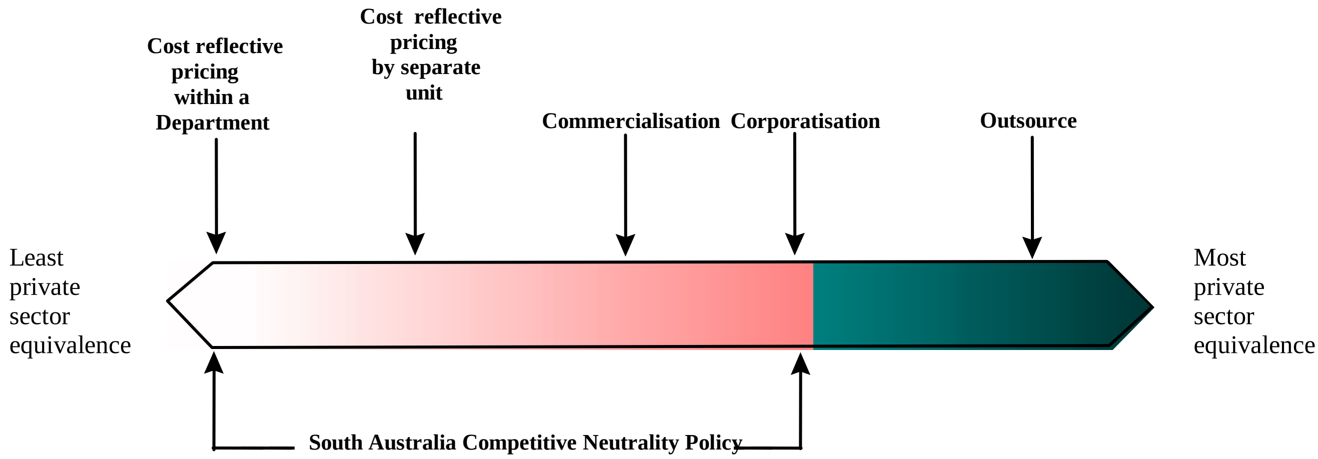
2.3 How competitive neutrality is achieved

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

2.3.1 A continuum of ‘private sector equivalence’

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

Diagram 2.1: Competitive neutrality measures and private sector equivalence



2.3.2 Organisation restructuring for greater commerciality

There are many options within the broad category of measures that involve the restructuring of organisations to impose greater commerciality on government business activities. The options range from the (least private sector equivalent) establishment of **separate business units** with separate operating accounts within a Departmental structure, through **commercialisation** with full recovery of all costs incurred in supplying outputs and separate balance sheet and rate of return requirements, to **corporatisation** which replicates as closely as feasible the commercial objectives, incentives and sanctions of a private firm, while retaining the enterprise in government ownership. The entire range of costs which would apply were the business in private ownership are imposed on the corporatised entity. Implementation of these structural measures is discussed in Sections 4 and 5.

2.3.3 Pricing reform

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

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

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

3 How to select the appropriate measure

Criteria are needed for selecting the measure(s) most appropriate for achieving competitive neutrality in a particular case. Several factors need to be taken into account. The decision to actually implement a particular measure requires an assessment of the benefits and costs of doing so.

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

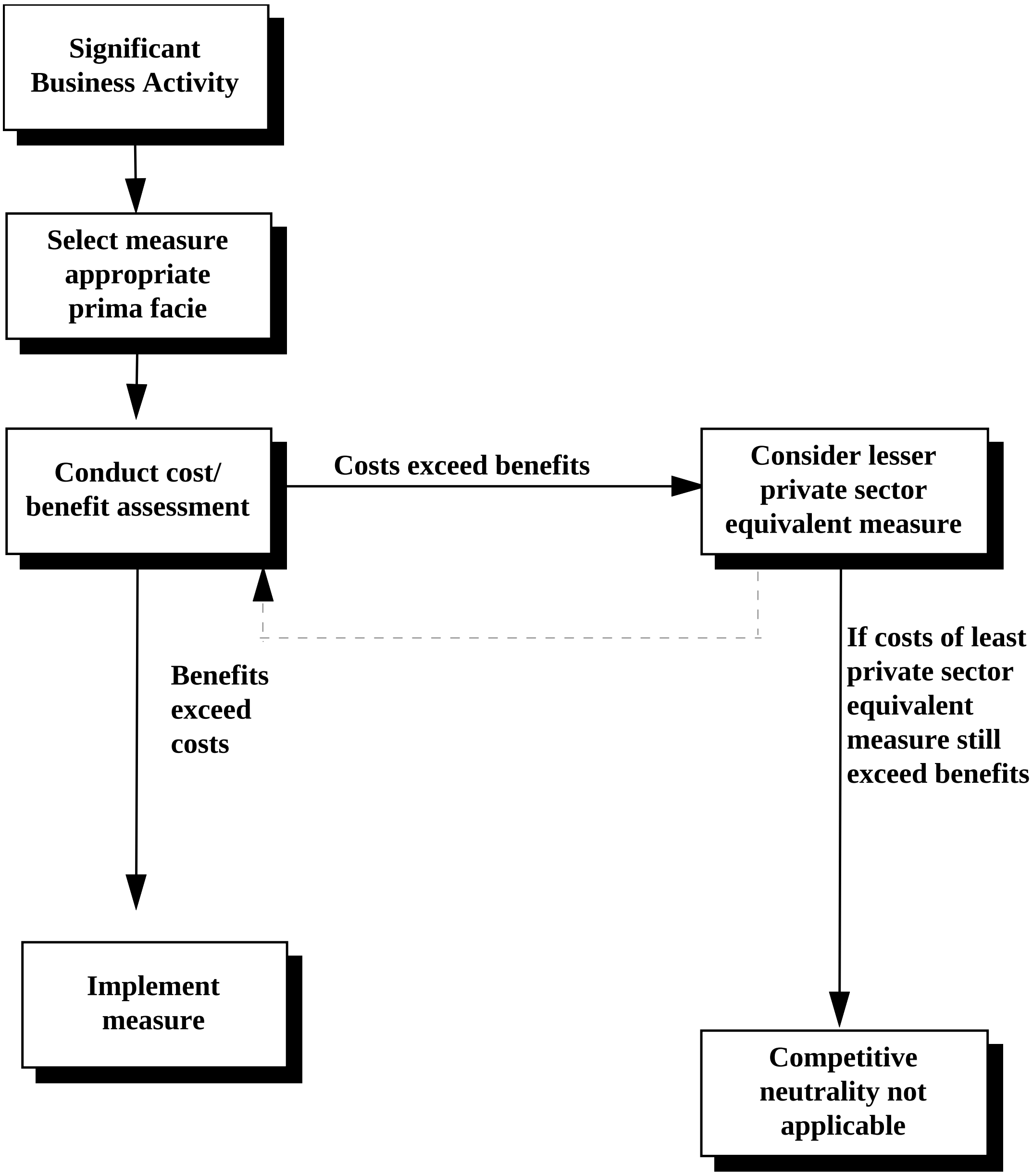
Diagram 3.1 illustrates the broad decision-making process for implementing competitive neutrality measures. The initial decision to be made is to select which measure along the continuum towards private sector equivalence — cost reflective pricing, commercialisation (of varying degrees) or corporatisation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

3.1 Relevant factors in selecting measures

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

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

Diagram 3.1: Decision tree for implementing competitive neutrality measures



3.1.1 Organisational context of the activity

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

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

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

3.1.2 Size of the resources employed

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

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

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

3.1.3 Efficiency objectives

Where there are particular concerns about the efficiency of a business activity, the measures effecting a greater degree of private sector equivalence — corporatisation for large activities or commercialisation for medium size activities — are indicated because of the direct incentives and sanctions related to performance that can be applied. Pricing reform and administrative reorganisation alone are unlikely to deliver the extent of efficiency gains that arise from full exposure to a private sector environment.

3.1.4 Accountability objectives

Where there are particular concerns of accountability in relation to the performance of the activities in question, the corporatisation approach may be more appropriate. Similarly, if external confidence in the existence of competitive neutrality is a strong issue, corporatisation is preferred. This measure provides enhanced transparency through the formalisation of reporting requirements on the Board and management.

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

3.1.5 Summary of criteria for selecting measures

Diagram 3.2 provides a schematic summary of the criteria relevant to selecting the competitive neutrality measure appropriate to the particular circumstances of a significant business activity (SBA).

Diagram 3.2: Matrix for selection of competitive neutrality measure to apply to SBA

Increasing private sector equivalence

Selection Criteria / Measure to apply	Pricing Reform	Commercialisation	Corporatisation
	Cost Reflective pricing without organisational restructuring	• Separate business unit • Commercial/ non-commercial distinction • Some additional equivalence measures	• Separate legal entity • Corporate form • Reporting and performance accountability • Full additional equivalence measures
Organisational context of SBA	• Minor part of an agency. • Difficult to separate commercial and noncommercial aspects of the business	• Part of host department • Relatively significant part of total functions	• Dominant activity • Occupies all of agency's resources
Size of resources employed	"Small"	"Medium"	"Large"
Efficiency priority	"Normal"	"High"	"Very high"
Accountability priority	"Normal"	"High"	"Very high"

3.2 Assessment of costs and benefits

The decision to implement a specific competitive neutrality measure depends on the expected benefits outweighing the expected costs. The CPA only requires governments to implement competitive neutrality measures '…to the extent that the benefits to be realised from implementation outweigh the costs'.[3]

3.2.1 Benefits

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

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

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

3.2.2 Costs

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

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

These costs arise directly from, or are associated with, the process of implementing competitive neutrality measures. Some of these will be only one-off costs.

3.2.3 Weighing up costs and benefits

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

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

The transaction costs an agency may face in implementing competitive neutrality may be substantial in the initial year. However, one year is too short a timeframe to view such costs and a more appropriate perspective is to amortise them over several years. In this context, the transaction costs are likely to be small relative to overall expenditures relating to the significant business activity. The effect of implementing the Policy on other policy objectives will vary from case to case.

4 Implementing corporatisation

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

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

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

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

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

Corporatisation is aimed at improving decision making and accountability and the private sector model is used as a basis for determining key roles and responsibilities. In many cases however, the private sector model is not a perfect fit for government businesses since the government has many policy interests in its businesses beyond those of a shareholder of a private company. The corporatisation model does not seek to deny these broader policy interests but seeks to have them achieved in the most efficient manner.

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

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

4.1 Public Corporations Act model

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

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

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

- commercial operations to be conducted in accordance with commercial principles and the performance of non-commercial operations in an efficient and effective manner (section 11 of the Act);
- a 'Charter', to be prepared by the Minister responsible for the corporation and the Treasurer, setting out the nature and scope of commercial operations, investment, borrowings etc, and describing the non-commercial operations including arrangements for their costing and funding (section 12);
- a 'Performance Statement' setting out various performance criteria and operational targets (section 13);
- the board of directors to be responsible to the relevant Minister and report such information as requested by the Minister in writing (section 14);
- the corporation to pay to the Treasurer, an equivalent amount of tax, duty and rates as would be payable if the corporation were not an instrumentality of the Crown (section 29); and
- directors to:
    - exercise reasonable care and diligence in the performance of their duties (section 15);
    - act honestly (section 16);
    - remain financially independent of any transactions of the corporation (section 17);
    - have no financial interest in the shares of the corporation (section 18); and
    - disclose any conflict of interest to the board (section 19).

These should be used as a basis for determining minimum requirements where separate legislation is enacted.

4.2 Steps to implement corporatisation

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

4.2.1 Prepare legislation

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

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

4.2.2 Remove regulatory functions

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

4.2.3 Prepare Charter

The new entity should have a charter which sets out:

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

4.2.4 Prepare business plan

The new entity should have a business plan that includes:

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

4.2.5 Prepare Performance Statement

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

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

4.2.6 Determine capital structure

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

The capital structure and the resulting debt to equity ratio will enable the appropriate dividend payout ratio to be determined based on the capital and debt needs of the business, and should reflect that of similar private sector businesses having regard to its level of operations and comparable risk. Annual dividends would be paid on actual after tax profits and would be consistent with the approved capital structure bands for the government business. Capital structure plans approved by the Treasurer are required to be set for 4 to 5 years, with an annual review.[4]

4.2.7 Identify and cost CSOs

It is a requirement of the Public Corporations Act that the provision of CSOs will be set out in the charter of a public corporation. It is important that these obligations are identified, costed and explicitly funded. The guidelines for CSOs are set out in the Ownership Framework Policy Guidelines (October 2004)[5]. These guidelines require that:

- avoidable cost methodology will be the basis for determining the costs of CSOs, ie. the sum of all the costs that could be avoided if the product or service were not provided;
- a ‘cost per unit of output’ approach for each CSO activity will be determined;
- the Government would contract to purchase a level of output and agree on a price adjustment mechanism over time;
- CSO payments will be transparent and clearly reported; and
- CSO amounts will be reviewed annually as part of the Budget process.

4.2.8 Value assets

DTF’s Accounting Policy Framework (APF III – Asset Accounting Framework) requires that all public authorities measure noncurrent assets at fair value.

The best indicator of the asset's fair value is the replacement cost of the asset's remaining future economic benefits (which is the lower of its replacement cost or its reproduction cost, less accumulated depreciation, ie its written-down current cost). The replacement cost and reproduction cost of an asset are determined on an “optimised” basis, thereby excluding the cost of replacing or reproducing excess capacity or over-engineering of the asset.

Where assets are valued on an alternative use basis, adequate evidence to support the feasibility of this use is needed, taking into account the cost of achieving this alternate use and the existing natural, legal and socio-political environment in which the entity operates.[6]

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[4] Ownership Framework Policy Guidelines, October 2004, p.5

[5] Ownership Framework Policy Guidelines, October 2004, p.3-4

[6] DTF Accounting Policy Framework III: Asset Accounting Framework, p.37 Reissued 24 March 2009

4.2.9 Establish performance monitoring

In conjunction with the responsible Minister and DTF, the agency should agree the necessary performance monitoring criteria including the measurement of budgeted and actual performance against the Performance Statement mentioned above, and the frequency of reporting these measurements. Refer to Treasurer's Instruction 19: Financial Reporting.

4.3 Summary of implementation issues: 'checklist'

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

'Checklist' for major implementation steps - Corporatisation

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

5 Implementing commercialisation

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

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

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

5.1 Features of a commercialised entity

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

- defined commercial and non-commercial activities (business plan);
- clear commercial performance targets;
- where non-commercial activities are undertaken, where possible, these are separately defined and funded;
- no regulatory functions;
- valuation of assets based on fair value;
- commercial gearing;
- payment of tax equivalents to the Treasurer;
- payment of applicable guarantee fees to the Treasurer;
- defined reporting requirements;
- separated accounts from the host agency (if any); and
- a dividend policy.

5.2 Steps to implement commercialisation

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

- review of market structure/removal of regulatory requirements (as per section 4.2.2);
- preparation of a business plan (and/or charter) (as per section 4.2.3 and 4.2.4);
- preparation of performance statements (as per section 4.2.5);
- identification of commercial and non-commercial operations and the application of CSO funding (as per section 4.2.7);
- valuation of assets (as per section 4.2.8);
- introduction of commercial pricing practices including the recovery of a return on capital employed (discussed in more detail in Section 6);
- performance monitoring of the enterprise;
- the establishment of investment appraisal procedures;
- introducing of commercial gearing; and
- preparation of a dividend policy.

5.2.1 Separate commercial from non-commercial activities

The separation of commercial and non-commercial operations of an agency will be required if competition is to be promoted and to enable the application of commercial performance criteria. The procedure of separating these activities relates to the process whereby the accounting for the individual activity and all of its associated costs and outputs are identified and separated from other activities within the agency. Such separation will facilitate accurate costing of the activities actually or potentially subject to competition. This requirement is driven in part by agencies required to meet CSOs as well as other non-commercial activities.

5.2.2 Remove regulatory functions

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

5.2.3 Introduce commercial gearing

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

5.3 Summary of implementation issues: 'checklist'

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

‘Checklist’ for major implementation steps - Commercialisation

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

6 Implementing cost reflective pricing

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

1. calculating the cost of outputs, adjusted for any competitive advantages and disadvantages due to government ownership; and
2. setting a price for the output based on full attribution of costs incurred in production as a starting point.

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

6.1 Define outputs

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

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

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

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

6.2 Fully attribute costs of outputs

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

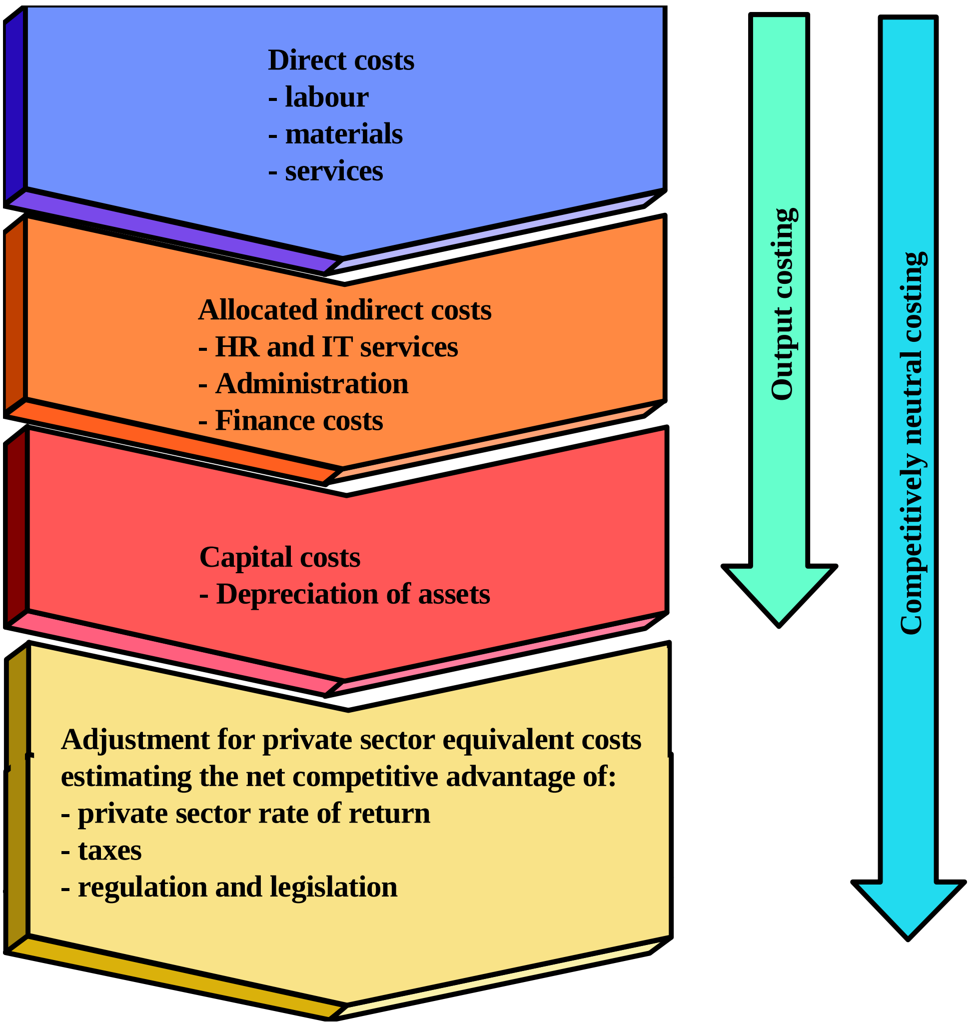
- all direct costs such as labour, materials and premises;
- indirect costs (overheads) such as personnel services, IT support, administration; and
- depreciation of physical assets utilised.

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

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

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

Diagram 6.1: Steps towards cost reflective costing



6.3 Estimate 'net competitive advantage'

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

1 identify and assess competitive advantages and disadvantages; and

2 estimate the accounting adjustments necessary to offset these.

The outcome is the net competitive advantage involved in the supply of the particular output. Identification and quantification of the advantages and disadvantages arising out of public sector ownership is a key step in the costing of outputs for competitive neutrality.

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

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

6.4 Estimate offsetting accounting adjustments for advantages

Quantification of the adjustments referred to above may in some cases be difficult or the significance of the advantage or disadvantage may be disproportionate to the costs of quantifying the difference and the application of rules of thumb may therefore be appropriate. The magnitude of a particular type of advantage or disadvantage is likely to differ between business activities. The following information offers some guidance for calculating offsets for the advantages and disadvantages listed in Section 2.1.

6.4.1 Lack of requirement to achieve a return on capital employed

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

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

6.4.2 Exemption from income tax.

Treasurer's Instruction 22: Tax Equivalent Payments; requires that a public authority or business unit is required to pay the Treasurer a Tax Equivalent Payment that is equivalent to the income tax that a public authority or business unit (if a legal entity) would be liable to pay under the *Commonwealth's Income Tax Assessment Act 1997*. Refer to TI 22 for more information.

6.4.3 Exemption from State land tax and/or council rates

Where an agency owns the land it occupies it is required to pay a tax equivalent payment to offset an exemption from land tax or local council rates. Refer to Treasurer's Instruction 22: Tax Equivalent Payments (Section 22.9) which states that;

- land tax is to be calculated and paid in the same manner as if it were required to be calculated and paid under the *Land Tax Act* (ie using Site Value on a multiple holding basis); and
- local government rates are to be calculated and paid based on applying the local government rate equivalent to the Capital Value and otherwise in the same manner as if they were required to be calculated and paid under the *Local Government Act*.

6.4.4 Exemption from stamp duty

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

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

6.4.5 FBT and payroll tax

Treasurer's Instruction 25: Taxation Policies; outlines the taxation policies that apply to all public authorities, Section 25.8 stipulates:

The Chief Executive of each public authority must ensure that:

- Business Activity Statements are prepared promptly and lodged with the Australian Taxation Office within 21 days of the end of the tax period;
- Fringe Benefit Taxation returns are prepared promptly and lodged with the Australian Taxation Office by 21 May of each year; and
- Payroll Tax returns are prepared promptly and lodged with the Commissioner of State Taxation within 7 days of the end of the tax period.

Government owned business entities are generally not exempt from FBT, although there may be some exemptions.

Government owned business entities are generally not exempt from payroll tax, although there may be some exemptions. For agencies that are exempt there are circulars available from Revenue SA that will enable an assessment to be made of the payroll tax liability that would be generated if the exemption were to be removed.

6.4.6 Government guarantee of agency debt

The government has a process where agencies are charged an appropriate fee in accordance with their particular credit rating. Information in relation to the guarantee fee is available from the Department of Treasury and Finance.

6.4.7 Exemption from compliance with legislation and regulations.

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

6.5 Estimate offsetting accounting adjustments for disadvantages

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

6.5.1 Cost of employment and HR functions in private enterprise

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

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

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

6.6 Competitively neutral cost and cost reflective pricing

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

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

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

Prices should be set to achieve competitive neutrality in the medium to long term.

It is important that the difference between the process of costing and the pricing decision be understood. Price may be set independently of cost where a market is competitive. The cost of supplying a particular output when compared to its realised sale price may result in:

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

6.7 Costing and pricing where there are non-commercial outputs

Most public sector entities provide multiple outputs. The commercial outputs[7] of activities are, in some cases, produced in association with non-commercial activities. Non-commercial activities are those the agency is directed to undertake by Government, but which on purely commercial criteria it would not otherwise undertake. However, a distinction should be made between these and certain loss-making activities which it is normal business practice to undertake because they are 'good for business' or in some way promote the long term commercial objectives of the agency. These will be at the discretion of the agency itself, rather than imposed by Government, for example, through Ministerial direction.

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

6.8 Pricing in a competitive market

As noted above, costs may have little effect on pricing in a competitive market where market forces strongly influence the price of an output. These market forces will provide an incentive to improve the efficiency of operations and investment by the agency. If the price is set by a market, and full cost recovery against that price cannot be achieved over the medium to long term, then it is likely that the supply of that output is unsustainable. In this case, the agency should consider:

- reducing costs through structural reform or seeking alternative cost reduction methods;
- identifying any CSO requirements;
- ceasing supply of the particular output.

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

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7 Commercial activities in the sense that outputs are sold.

6.9 Pricing in the absence of a competitive market

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

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

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

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

6.9.1 Full costs — a starting point for pricing

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

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

6.9.2 Departure from full cost — (i) unused capacity

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

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

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

6.9.3 Departure from full cost — (ii) excess demand

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

6.9.4 Pricing for peak periods of consumption

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

6.10 Summary of implementation issues: ‘checklist’

The checklist on the following page summarises the steps which address the generic issues in cost reflective pricing.

‘Checklist’ for major implementation steps – Cost Reflective Pricing

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

Further information

Department of Premier and Cabinet

www.premcab.sa.gov.au

Competitive Neutrality Policy Statement July 2002

1995 Competition Principles Agreement (Reviewed by COAG in April 2007)

Ownership Framework Policy Guidelines (Community Service Obligations and Dividends - Capital Structure), October 2004

Annual List of Category 1 and 2 Significant Business Activities

Heads of Treasuries Competitive Neutrality Matrix Annual Reports

Annual Reports to the National Competition Council

Department of Treasury and Finance

www.dtf.sa.gov.au

Treasurer's Instructions

Abbreviations

ABS	Australian Business of Statistics
CAPM	Capital Asset Pricing Model
COAG	Council of Australian Governments
CPA	*Competition Principles Agreement* (April 1995)
CSO	Community service obligation
DPC	Department of the Premier and Cabinet
DTF	Department of Treasury and Finance
GBE	Government business enterprise
GTE	Government trading enterprise
Hilmer Report	Report by the Independent Committee of Inquiry into National Competition Policy, *National Competition Policy* (August 1993)
IC	Industry Commission
NCP	National Competition Policy
NCC	National Competition Council
PFE	Public financial enterprise
the Policy	Government of South Australia, *Competitive Neutrality Policy Statement* (July 2002)
PTE	Public trading enterprise
ROR	Rate of return

GLOSSARY

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

Debt Guarantee Fees	a fee which is intended to eliminate the competitive advantage a government business activity obtains over private sector competitors through receiving cheaper finance as a result of a government guarantee. The fee applies to the face value of debt outstanding, but may vary according to the level of debt and an assessment of risk.
Fair Value	methodology for valuing assets representing the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. Fair value is measured having regard to the highest and best use of the asset for which market participants would be prepared to pay, provided that the highest and best use is feasible in the near future. The best indicator of the asset's fair value is the replacement cost of the asset's remaining future economic benefits (which is the lower of its replacement cost or its reproduction cost, less accumulated depreciation, ie its written-down current cost). The replacement cost and reproduction cost of an asset are determined on an "optimised" basis, thereby excluding the cost of replacing or reproducing excess capacity or over-engineering of the asset. Where assets are valued on an alternative use basis, adequate evidence to support the feasibility of this use is needed, taking into account the cost of achieving this alternate use and the existing natural, legal and socio-political environment in which the entity operates.[8]
Government Business Activities	activities which are mainly producing goods and services for sale in the market with the intention of maximising profit and financial returns to their owners, or at least of recovering all or a significant proportion of their operating costs.
Government Guarantee	an undertaking by the government to cover the liability of an entity in the event that it is unable to meet its debt servicing obligations.[9]

[8] DTF Accounting Policy Framework III: Asset Accounting Framework, p.37 Reissued 24 March 2009

[9] Refer to Treasurer's Instruction 20: Guarantees and Indemnities, Reissued 20 February 2007

Marginal Costs	additional costs incurred in producing an extra unit of output.
National Competition Policy (NCP)	in February 1994 the Council of Australian Governments (COAG) agreed to the principles of competition policy. National Competition Policy obligations are set out in the 1995 Competition Principles Agreement which was reviewed by COAG in April 2007.
Net Competitive Advantage	estimated costs of identified advantages less estimated costs of identified disadvantages existing in relation to the goods or services supplied.
Non-Commercial Activities	activities the agency undertakes at the direction of the government but which, on a purely commercial basis, it would not otherwise undertake.
Private Sector Equivalence	imposition on government enterprises of Commonwealth, State and Territory taxes, charges, duties and other imposts; debt guarantee fees; and regulations to which private sector businesses in the same market are normally subject.
Target Rate of Return	an appropriate commercial rate of return on assets (or equity) which reflects the cost of capital from the owner's perspective.
Tax Equivalent Regime (TER)	an arrangement in which public authorities and business units are required to pay a tax equivalent payment to the Treasurer. The payments are equivalent to income tax, land tax, and other state taxes and local government rates that a public authority or business entity (if a legal entity) would be liable to pay were that public authority or business unit not an instrumentality of the Crown in the right of South Australia.[10]

[10] Refer to Treasurer's Instruction 22: Tax Equivalent Payments, Issued 26 September 2005