New South Wales
TREASURY

POLICY STATEMENT ON THE APPLICATION OF COMPETITIVE NEUTRALITY

Office of Financial Management

Policy & Guidelines Paper

TPP 02-1 January 2002

PREFACE

The *"NSW Government Policy Statement on the Application of Competitive Neutrality"* was first published in June 1996, as required under the Competition Principles Agreement.

This Policy Statement replaces the 1996 Statement and includes updated information relating to the:

- commercial framework applying to NSW Government businesses;
- costing and pricing guidelines for NSW Government businesses; and
- mechanisms for considering competitive neutrality complaints against government businesses in New South Wales (NSW).

The release of this Policy Statement is intended to provide guidance and assistance to government businesses and other parties in giving effect to the NSW Government's commitment to implement competitive neutrality principles as part of National Competition Policy.

In particular, the complaints handling processes described in this Policy Statement impose obligations on both a complainant and the government business that is the subject of a complaint. Accordingly, they should be closely scrutinised by all parties to ensure that complaints handling, investigation and reporting requirements are effectively and efficiently met.

NSW Treasury
January 2002

Treasury Ref: TPP 02-1
ISBN: 0 7313 3144 3

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This publication can be accessed from the Treasury's Office of Financial Management Internet site [http://www.treasury.nsw.gov.au/]. For printed copies contact the Publications Officer on Tel: 9228 4426.

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ABBREVIATIONS

Australian Bureau of Statistics	ABS
Australian Competition and Consumer Commission	ACCC
Australian Taxation Office	ATO
Capital Asset Pricing Model	CAPM
Council of Australian Governments	COAG
Competition Principles Agreement	CPA
Competitive Neutrality	CN
General Government Business	GG
Goods and Services Tax	GST
Independent Pricing and Regulatory Tribunal	IPART
National Competition Council	NCC
National Competition Policy	NCP
New South Wales	NSW
National Tax Equivalent Regime	NTER
Public Trading Enterprise	PTE
Shareholder Value Added	SVA
Social Program Policy	SPP
Statement of Corporate Intent	SCI
State Contracts Control Board	SCCB
Statement of Financial Performance	SFP
State Owned Corporation	SOC
Weighted Average Cost of Capital	WACC
Wholesale Sales Tax	WST

EXECUTIVE SUMMARY

This Policy Statement is intended to provide guidance and assistance to government businesses and other parties in giving effect to the NSW Government's commitment to implement competitive neutrality principles as part of National Competition Policy.

The application of competitive neutrality principles is aimed at eliminating any net competitive advantages accruing to government businesses as a result of their public sector ownership. Such action removes potential market distortions and promotes an efficient allocation of resources between public and private businesses.

Typically, the application of competitive neutrality principles may require adjustments to the price of a good or service that make allowance for the following:

- taxes that may not be paid by a government business but would be paid by a private sector competitor;
- the cost of capital;
- any other material costs not borne by a government business purely as a result of its public ownership status.

This 2002 Policy Statement supersedes and replaces the NSW Government's 1996 Policy Statement. This edition includes updated information on the application of competitive neutrality in relation to:

- the commercial framework applying to NSW Government businesses (Section 2);
- costing and pricing guidelines for government businesses (Section 3); and
- mechanisms for considering competitive neutrality complaints against government businesses in New South Wales (Section 4).

The complaints handling processes impose obligations on both a complainant and the government business that is the subject of a complaint. Accordingly, they should be closely scrutinised by all parties to ensure that complaints handling, investigation and reporting requirements are effectively and efficiently met.

NSW Government businesses are encouraged to read this Policy Statement in conjunction with the NSW Treasury Policy and Guidelines Paper "Guidelines for Pricing of User Charges" (TPP01-02). The latter paper provides guidance to agencies on how to price, in a competitively neutral way, goods and services sold into contestable markets (i.e. potentially involving private sector or other government business competitors).

Both documents provide contact points within The Cabinet Office and the NSW Treasury for inquiries and further assistance on any matter.

1. INTRODUCTION

The *"NSW Government Policy Statement on the Application of Competitive Neutrality"* was first published in June 1996, as required under the Competition Principles Agreement (CPA). This revised edition replaces the 1996 Statement and includes updated information relating to the:

- commercial framework applying to NSW Government businesses (section 2);
- costing and pricing guidelines for NSW Government businesses (section 3); and
- mechanisms for considering competitive neutrality complaints against government businesses in New South Wales (NSW) (section 4).

In 1995 the NSW Government agreed, along with the Commonwealth and other State and Territory Governments, to implement competitive neutrality principles as part of its commitment to National Competition Policy (NCP). This Statement offers a comprehensive guideline for Government businesses and other parties.

In November 2000 the Council of Australian Governments (COAG) considered the findings of a review of NCP Agreements, and the review deadline for anti-competitive legislation was extended to 30 June 2002.

The purpose of competitive neutrality policy is the elimination of resource allocation distortions arising from public sector ownership, where publicly owned business activities compete with the private sector. The intention is that publicly owned businesses should not enjoy any net competitive advantage as a result of public sector ownership.

1.1 National Competition Policy

NCP incorporates three *Inter-Governmental Agreements* between the Commonwealth and the States and Territories, these include the:

- *Conduct Code Agreement;*
- *National Competition Policy and Related Reforms Agreement*; and
- *Competition Principles Agreement*.

Details on the State's obligations under these agreements are provided in the following publications: "*Implementing Competition Policy and Microeconomic Reform in NSW: an Overview by the NSW Government"*, June 1996 and the *"Report to the National Competition Council on the Application of National Competition Policy in New South Wales"* (produced annually).

Under the Competition Principles Agreement (CPA), the NSW Government has been required to:

- ensure that there are independent price oversight of Government businesses which are monopoly, or near monopoly, suppliers of goods and/or services;
- foster competitive neutrality between Government and private businesses where they compete and to publish a corresponding policy statement and implementation timetable by June 1996;
- reform the structure of public monopolies to facilitate competition;
- review and reform legislation which unjustifiably restricts competition and develop a corresponding timetable by June 1996;
- provide third party rights to negotiate access to certain specific facilities; and
- apply the CPA to local councils' business activities and publish a corresponding policy statement by June 1996.

1.2 Competitive Neutrality Obligations

State and Territory Government obligations under the CPA are set out in Clause 3 "*Competitive Neutrality Policy and Principles"* (see Appendix A).

The objective of CPA Clause 3 is to eliminate resource allocation distortions by removing any net competitive advantage/s of significant Government business activities that may arise as a result of public sector ownership.

In general, Government businesses are organisational units which[1]:

- have some form of public sector ownership;
- are engaged in trading goods and/or services;
- have a large measure of self-sufficiency; and
- are subject to Executive control.

The CPA gives States and Territories discretion on how jurisdictions choose to achieve the objectives of Clause 3 objective. For instance, each State and Territory is free to determine its own agenda for the implementation of competitive neutrality principles. This is also true in determining which Government businesses are designated to be reformed as indicated by wording such as '*significant'* and '*where appropriate*' and by the discretion allowed in calculating the benefits and costs of implementation.

The NSW Government is required to report annually to the National Competition Council (NCC) on the application of NCP in New South Wales. Part of this report covers State performance in meeting competitive neutrality requirements. The main ongoing requirement is to publish information on complaints received about non-compliance with competitive neutrality principles. The NCC can recommend that the Commonwealth Treasurer reduce tranche payments to a State or Territory if it is dissatisfied with the level of compliance in meeting NCP obligations.

[1] Note that there are separate guidelines covering the application of competitive neutrality principles to local government business units.

1.3 Application of Competitive Neutrality in New South Wales

The CPA requires Governments to ensure that all Government agencies undertake *significant* business activities in contestable markets act in a competitively neutral way. This Statement represents the NSW Government's policy framework (as referenced in Section 24GA of the *Independent Pricing and Regulatory Tribunal and Other Legislation Act 2000*) for complying with and giving effect to the competitive neutrality requirements laid down in the CPA.

The use of the term 'Government business' in this paper is intended to describe those parts of the public sector that are principally engaged in trading activities, including the provision of goods and services to other parts of the public sector. In this context the term Government business includes Public Trading Enterprises, State Owned Corporations and General Government Businesses.

Public Trading Enterprises

Public Trading Enterprises (PTEs) are self contained organisational units within the public sector that are principally engaged in trading activities that could, in principle, be provided through the market place without compromising the Government's social and economic objectives. PTEs raise the majority of their income from user charges.

Generally, PTEs are businesses that are subject to commercialisation and implementation reforms and measures to improve overall productive efficiency.

Commercialisation reforms involve the adoption of the following measures:

- clear and non-conflicting objectives;
- sufficient management responsibility, authority and autonomy;
- independent, objective performance monitoring; and
- an effective system of rewards and sanctions.

It should be noted that under the Australian Bureau of Statistics (ABS) definitions that are used in this document, the term PTE encompasses State Owned Corporations (SOCs). However, due to their uniqueness as a class, SOCs are often referred to separately where required and are therefore discussed briefly below.

State Owned Corporations

State Owned Corporations (SOC) are PTE that have been corporatised. Conceptually, corporatisation involves the establishment of an arms-length relationship between the Government and the SOC to ensure that boards and management operate within incentive structures that mirror, to the extent possible, those faced by the private sector.

Corporatisation involves the mentioned 'commercialisation' reforms, and also requires the adoption of measures that increase the level of competition in the market the entity is operating. Corporatisation involves developing appropriate legal, regulatory, institutional and market frameworks. Furthermore, corporatisation requires legislation as outlined in the amended *State Owned Corporations Act 1989* to be put in place. Corporatisation is an alternative to full privatisation but can be implemented in conjunction with partial privatisation with some modifications.

SOCs are incorporated under the *State Owned Corporations Act 1989* (SOC Act). The *State Owned Corporations Amendment Act* established two classes of SOC, the:

- 'Company SOC' (established under the *Corporations Act 2001* in the same way as an ordinary public company, albeit through the SOC Act); and
- 'Statutory SOC' (established using enabling legislation and then listed in Schedule 5 of the amended SOC Act. Statutory SOCs are not subject to the *Corporations Act*, but a number of provisions of the *Corporations Act* have been included in the amended Act.

Both classes of SOC have a board of directors, share capital and a memorandum and articles of association (i.e like a public company limited by shares). Unlike a public company, however, the shareholders consist of the Treasurer and one other Minister (or potentially two or more Ministers for a company SOC).

SOCs are subject to certain Federal Statutes such as Part IV of the Commonwealth *Trade Practices Act 1974* that deals with restrictive trade practices. This statute applies to all SOCs as a result of the passing of the *Competition Policy Reform (New South Wales) Act 1995*.

In general, the objectives of SOCs, regardless of class, are to operate:

- efficiently;
- in a way that maximises the net worth of the State's investment;
- in a socially responsible manner;
- in accordance with the principles of ecologically sustainable development; and
- with consideration of regional development.

General Government Businesses

The ABS classifies an "agency" as being part of the General Government sector if it is funded:

- directly or indirectly (via consolidated fund) by taxes or fees or fines;
- through being dependent on other agencies which are directly or indirectly funded by taxes or fees or fines; or
- through having regulatory functions which enable them to raise taxes, fees or fines.

NSW's Treasury commercial framework (see Section 2) applies to those General Government agencies (GG) that are not dependent on the State Budget for funding. The funding sources they use may have the characteristics of a tax. For the purposes of this policy and ease of use, these particular General Government agencies will be referred to as GGs, although this is not a recognised ABS term or abbreviation.

GGs range from relatively autonomous authorities (eg. Sydney Harbour Foreshore Authority) to specific Government departments (eg. Department of Public Works and Services) engaged in trading activities. These activities may include social services, the provision of which could be undertaken by such units on the basis of an arm's length contract with Government. GGs have undergone, to varying degrees, some of the 'commercialisation' steps.

In New South Wales, the competitive neutrality requirements indicated in Clause 3 of the CPA have been applied to all Government businesses that undertake significant business activities, irrespective of ABS classification.

As outlined in Section 2 below, the application of the NSW Government's Commercial Policy Framework ensures that Government businesses comply with competitive neutrality requirements. In addition, GGs that undertake a significant business activity are required to ensure that their pricing of contestable goods and services are both transparent and cost reflective (see Section 3).

The definition of a 'significant' business activity is an important issue for business units within GG sector agencies and for non-corporatised public trading enterprises. The CPA does not formally define the term significant. An assessment of whether a business activity has a significant impact on a market can only be made on a case by case basis. Relevant considerations include the business' size, influence on the market, resources commanded and the effect of poor performance.

Experience has shown that economic and social benefits of implementing competitive neutrality *prima facie* outweigh the costs. The CPA, however, allows for an exemption from the competitive neutrality principles where an agency can demonstrate that the benefits to be realised from implementation are outweighed by the costs. In New South Wales, when an exemption is sought, the onus is on the Government business or parent agency to show and document that the economic and social costs of implementation outweigh the economic and social benefits.

Clause 1(3) of the CPA sets out a range of public interest factors that can be taken into account in making such an assessment.

Under the CPA, Government businesses are free to deliver important and justifiable social programs (or community service obligations) provided that the social programs are transparently subsidised. The CPA encourages a greater awareness of the way that social programs are defined, delivered and costed (see Section 2.1), but does not obligate Governments to use competitive tendering as a means of delivering services.

The *"NSW Government Policy Statement on the Application of National Competition Policy to Local Government"* (June 1996) is the relevant policy document for information on the application of competitive neutrality principles to the business activities of local councils. The Statement should be read in conjunction with the Department of Local Government's *"Pricing and Costing for Council Businesses: A Guide for Competitive Neutrality"*(July 1997).

The NSW Government also recognises that there are circumstances in which a government business is not subject to effective control by the executive Government (e.g. universities). In such circumstances, it is Government policy to encourage the relevant government business to comply with competitive neutrality principles, as outlined in this Statement and in the NSW Treasury publication entitled "*Guidelines for Pricing of User Charges*" (TPP 01-02) (see Section 3).

2 NSW GOVERNMENT'S COMPETITIVE NEUTRALITY INITIATIVES

The CPA requires that significant Government businesses operate without net competitive advantage in relation to other businesses, as a result of their public sector ownership. With respect to significant Government businesses, classified as PTEs or PFEs by the ABS, the CPA requires governments, where appropriate, to:

- adopt a corporatisation model; and
- impose on those businesses full Commonwealth, State and Territory taxes or tax equivalent regimes, debt guarantee fees directed towards offsetting the competitive advantages provided by government guarantees, and equivalent regulations to those affecting private sector competitors.

In New South Wales, most of the required actions to achieve competitive neutrality have been implemented previously through the corporatisation of Government businesses (as previously discussed). Component policies that have been developed to implement the commercialisation and corporatisation principles are outlined below (Section 2.1).

2.1 Commercial Policy Framework

The Commercial Policy Framework has been guided by commercialisation and corporatisation principles that attempt to reflect the environment faced by private sector firms in a competitive market.

All significant NSW Government businesses are subject to the Commercial Policy Framework that is based on the commercialisation and corporatisation principles discussed earlier. This framework provides for the application of:

- commercially based performance targets, dividends and capital structures;
- regular performance monitoring;
- State taxes and Commonwealth tax equivalents;
- risk related borrowing fees;
- explicitly funded "Social Programs"; and
- regulation equivalent to that faced by private sector companies.

2.2 Performance Targets

Government business boards and management have clear performance targets, against which performance is assessed. Performance targets are contained in an annual contractual agreement between the Government business and the Government called a Statement of Corporate Intent (SCI) for SOCs or a Statement of Financial Performance (SFP) for other Government businesses.

Performance targets focus on:

- capital structures;
- shareholder value added; and
- dividends.

The Statements also detail the economic and business assumptions that underlie financial projections and targets.

(i) Capital Structures

New South Wales aims to ensure that Government business balance sheets are commercially sound with capital structures based on appropriate mixes of debt and equity.

A Capital Structure Policy, introduced in 1994, established target capital structures on a case by case basis according to a debt level that:

- supports a good investment grade credit rating (i.e. 'A' or above) over the long term (generally five years);
- enables the financing of an approved capital expenditure program having regard to the current phase of the Government business investment cycle;
- is capable of being repaid within a reasonable period; and
- provides flexibility for relevant contingencies.

The Capital Structure Policy approach usually involves the:

- development of a business profile;
- review of business plans and forecasts;
- analysis of business risks;
- modelling of cash flows;
- sensitivity analysis of key variables; and
- determination of a notional credit rating as a stand alone entity.

This approach enables boards/managers to conduct their businesses with a greater degree of confidence and provides a framework for setting financial targets. It also provides more certainty to boards/managers by constraining the Government's ability to seek excessive dividends. Furthermore, it ensures that investment decisions are made with regard to the true cost of capital of the relevant business.

The Capital Structure Policy for NSW Government businesses is currently under review.

(ii) Shareholder Value Added

Once the capital structure is set at an appropriate level then the focus of management is on attaining a commercial return on that capital.

Shareholder Value Added (SVA) is a value-based measure of business performance, which indicates whether a Government business is generating or eroding value (its worth to shareholders, who are ultimately the NSW taxpayers).

SVA measures the Net Operating Profit After Tax (NOPAT) of a business and deducts a capital charge for the equity and debt capital employed by the business. The capital charge is calculated using the business' Weighted Average Cost of Capital (WACC), which reflects the business' cost of debt and equity and their relative proportions.

Where NOPAT exceeds the capital charge, the business is creating value for its shareholders. Conversely, where NOPAT is below the capital charge, the business is effectively destroying value.

Most significant Government businesses are monitored using SVA, including all State Owned Corporations.

(iii) Dividends

Assuming that debt/equity structures are satisfactory and rates of return are appropriate, the focus is on setting dividends that broadly reflect private sector practice.

NSW Treasury's Financial Distribution Policy deals explicitly with Government's role as shareholder of its businesses. The basic principle underlying the financial distribution policy is that Government businesses should be subject to the discipline of making dividend payments and capital repayments based on an evaluation of whether or not retention of earnings adds value for the shareholder.

A target dividend payment is negotiated as part of the process of developing the SCI or SFP before the commencement of the financial year.

NSW Treasury has adopted a modified residual approach to dividend policy, whereby the level of dividends is a function of forecast profitability, acceptable value-adding investment opportunities and the preferences of the shareholder.

The need to recognise the dividend preferences of shareholders is more pronounced for Government businesses, given that ownership rights are not readily tradeable. In the private sector, shareholders receive dividends but are also able to realise capital returns through the sale of their equity interest. In the case of Government businesses, the ability of the shareholders to realise capital gains is limited to when capital remittances or privatisation takes place. Consequently, the Government as a shareholder has a preference for a high level of dividends relative to capital growth.

From a Government perspective a stable stream of dividends is also seen as desirable as dividends from its businesses are used in part, to finance, services to the community. This does not imply that the projected dividend stream from any business will be stable over the forward estimates period. Certain periods in the investment cycle of an individual business may necessitate a lower dividend or a higher dividend. These impacts need to be clearly understood and negotiated with Treasury, on behalf of Shareholding Ministers, to ensure that the cash and investment requirements of Government businesses are managed on a long term, portfolio basis.

The Financial Distribution Policy for NSW Government businesses is currently under review.

2.3 Performance Monitoring

As with private sector organisations, the efficiency with which Government businesses use community resources is largely determined by the framework within which they operate. Performance monitoring is an important part of this framework and is a key component of sound management practice. NSW Government businesses are subject to a range of monitoring regimes, both internal and external.

Since the early 1990s, NSW Treasury has undertaken regular financial monitoring of commercial Government businesses from a 'shareholder' perspective. Government businesses provide Treasury with quarterly reports, including business plans, operating budgets, cash flow statements, income and expenditure statements, balance sheets and management accounting data. Government businesses also report, on an exception basis, any risks that arise throughout the financial year. The reports are intended to provide early warning of problems that may arise, so that appropriate action may be taken.

The type of financial performance monitoring undertaken by NSW Treasury is necessary to ensure that the Government's commercial interests, as owner of a number of separate businesses across a range of industries, are adequately protected. The need for such monitoring arises because of the interaction of various interests that influence the performance of these businesses. Some Government businesses, particularly Corporations, face competition in the market place. For others, however, performance monitoring also promotes yardstick competition in the provision of Government services that otherwise face little competition. Performance monitoring can act as a powerful internal management tool to examine the reasons for poor performance.

The SCI and the SFP can be likened to an annual contract between the shareholders and management of the business. Essentially the purpose of these contracts is to enhance accountability for performance and provide businesses with certainty as to the shareholders' expectation of financial performance.

The Statements contain, amongst other key matters, financial performance targets and the capital program for a 4-year period, along with the business plan and projected financial statements over a 10-year period. Financial performance targets include shareholder value added (for the majority of Government businesses), debt levels and dividend targets.

In summary performance measures provide:

- information to promote yardstick competition for Government businesses that face little direct competition in input or output markets;
- a means of monitoring public sector managerial performance;
- a powerful internal management tool that can provide information on efficiency;
- a basis for explaining reasons for poor performance and identify appropriate role models; and
- improved accountability safeguards for Parliament and the community.

2.4 Payment of Taxes and Tax Equivalents

(i) State taxes

Since 1 July 1994, all major NSW Government businesses have been progressively required to make direct payments of State taxes, principally payroll tax, stamp duty and land tax. These State taxes were applied to most Government businesses from 1 July 1995 with all commercial Government businesses paying tax equivalents from 1997-98.

(ii) Commonwealth taxes

At the March 1994 Premiers' Conference it was agreed in principle that States and Territories would impose uniform income tax equivalent regimes on all GBEs by 1997, while the Commonwealth would amend its income and sales tax legislation to unambiguously exempt State enterprises from Commonwealth tax liabilities.

Commencing in July 1994, all major NSW Government businesses were progressively required to make income and sales tax equivalent payments to the Consolidated Fund. Such a requirement helped put Government businesses on a competitively neutral footing with private sector businesses.

In 1998 the Commonwealth, States and Territories agreed, as part of the Intergovernmental Agreement to Reform Commonwealth-State Financial Relations, to introduce a National Tax Equivalent Regime (NTER). Under the NTER, State and Territory Government businesses are subject to an income tax equivalent regime, administered by the Australian Taxation Office (ATO) which came into affect on 1 July 2001. The use of the ATO as tax administrator will facilitate a consistent approach across jurisdictions and between the public and private sectors.

With the abolition of Wholesale Sales Tax (WST), States and Territories abandoned WST equivalent payments. All Government businesses pay GST in the same manner as private enterprises.

2.5 Debt Guarantee Fees

NSW Government businesses benefit from the Government's "AAA" credit rating by virtue of their public sector ownership, enabling them to obtain borrowings through the Treasury Corporation more cheaply than comparable private sector firms.

Since 1990, Government businesses with Government guaranteed borrowings have been required to pay a credit-rating-based fee to the Consolidated Fund. The scheme is intended to:

- make up the difference between the interest paid by Government businesses and what they would have paid based on their stand-alone credit ratings;
- correct any distortions in Government business investment and pricing decisions;
- encourage better debt management practices by Government businesses by making them aware of the full cost of borrowing; and
- compensate the Government for the financial risk of guaranteeing debt repayment by Government businesses.

The application of this policy ensures competitive neutrality with private sector businesses of similar risk, which lack government backing and face correspondingly higher borrowing costs.

2.6 Equivalent Regulation

Many Government businesses gain exemptions from certain State legislation and regulations as a result of their status as an entity of the Crown or statutory authority. When a Government business is corporatised as a SOC, it automatically loses this status and therefore its exemption.

While a statutory SOC is an exempt public body for the purposes of the *Corporations Act*, the NSW *State Owned Corporations Act 1989* does contain provisions which reflect those of the *Corporations Act*. The SOC Act also makes provision to have a constitution, which has the same operation and effect as the constitution of a company established under the *Corporations Act.*

The *Competition Policy Reform (New South Wales) Act* also subjects SOCs and other NSW Government businesses to Part IV of the Federal *Trade Practices Act 1974* dealing with restrictive trade practices.

The review and reform, under clause 5 of the CPA, of legislation that unjustifiably restricts competition is closely related to the competitive neutrality principle of imposing private sector equivalent regulation on Government businesses. New South Wales subjects legislation of uncertain competitive standing to a comprehensive review process that includes examination of the net public benefits of retaining or removing competitive restrictions. Remedial action is being taken where legislative restrictions are shown not to be in the public interest (i.e. costs outweigh benefits and/or less competition-restricting methods of achieving the Government's objectives are available).

Consistent with Clause 5(3) of the CPA, New South Wales is required to review, and where appropriate, reform all existing legislation that restricts competition by 30 June 2002.

2.7 Social Program Policy

The Government's Social Program Policy (SPP) is the main policy framework that enables the State vehicle to meet its social justice objectives through transparent payments from the consolidated fund to NSW Government businesses that have either been corporatised or adopted general pricing principles.

The SPP recognises that, in pursuing core social responsibilities, the Government may wish to use Government businesses to achieve certain social justice objectives. The Policy aims to ensure that social programs meet specific and relevant social objectives in a way that does not put the commerciality of the businesses at risk.

The key objectives of the SPP are to provide a framework:

- for the effective separation of commercial and non-commercial activities of Government businesses. This allows management to be given clear objectives, thus enabling it to be held accountable for both commercial performance and the delivery of social programs;
- that ensures social expenditures by government businesses are subject to identified budget funding, thereby making them transparent and enhancing parliamentary accountability; and
- that improves the effectiveness of social program expenditures through the application of appropriate review and evaluation processes.

3 GENERAL PRICING GUIDELINES

3.1 The NSW Government's Approach

The purpose of the NSW Treasury's *Guidelines for Pricing of User Charges* [TPP01-02] is to provide advice on how NSW Government agencies can ensure that goods and services sold in contestable markets are costed and priced in a competitively neutral manner. The following section summarises the key elements of the Guidelines.

3.2 Application of the Guidelines

The Pricing Guidelines apply where goods or services are sold into markets in competition, or potentially in competition, with private sector or other Government suppliers (unless the delivery of a good or service is for a social program purpose).

The CPA requires all government agencies undertaking significant business activities in contestable markets to act in a competitively neutral way. Accordingly, the requirement extends to:

- GGs that undertake a significant business activity; and
- PTEs including those that:
  - undertake any significant business activity; and
  - are not currently subject to price oversight by the Independent Pricing and Regulatory Tribunal (IPART).

The Pricing Guidelines do not apply to taxes, fines and regulatory fees. These revenues can be distinguished from user charges in that there is a degree of compulsion, that is, the purchaser has minimal choice whether to participate in the transaction, and an equivalent good or service is not provided in exchange for the payment.

Competitive neutrality pricing does not have to be applied where the agency can demonstrate that the benefits of introducing competitive neutrality (CN) are outweighed by the costs.

Where this is likely to be the case and CN pricing is not going to be applied, the responsible agency should conduct a formal cost/benefit assessment. Typically many of the costs may fall within the category of "transaction costs". Transaction costs mean that such costs are directly attributable to administrative and management frameworks necessary for the implementation of competitive neutrality measures, for example:

- legislative, regulatory and/or administrative changes;
- necessary changes to management, accounting or costing systems/processes;
- research effort necessary to determining appropriate price adjustments to reflect tax equivalents, debt guarantee fees etc;
- on-going monitoring of compliance; and
- any adverse impacts on the achievement of wider public interests/objectives which are summarised in Section 1(3) of the CPA.

Benefits derived from implementing competitive neutrality are likely to arise from:

- the removal of potential barriers to increased market contestability (these may have arisen from unfair competitive advantages enjoyed previously by a Government business).
- improvements to allocative efficiency which may consequently benefit consumers through lower prices and greater choice; and
- improved incentives for the Government business to operate efficiently.

It is acknowledged that costs of implementing CN are likely to be easier to calculate than benefits, partly because of the up-front nature of much of the associated costs. CN benefits are likely to arise progressively over a longer time frame and given their diffuse nature are difficult to quantify. Therefore, in contrast to CN costs, CN benefits are harder to define and quantify as they accrue over a much longer time frame.

Notwithstanding, any cost/benefit assessment should contain a comparison of costs and benefits on the same basis. This can be achieved by either amortising the costs over the period for which the benefits are estimated to accrue, or by converting both cost and benefit streams to current values.

It is important that the cost/benefit assessment is documented by the business as it may be required to assist in the investigation and resolution of any complaint laid.

It should be noted that where Government policy requires that particular user charges be set at less than full cost recovery (ie. for social programs), the CN principles are still to be applied provided the subsidy is transparent, appropriately costed and directly funded by government. To comply with the transparency requirement, affected agencies should explicitly report on the SPP payment or subsidy in their annual accounts.

3.3 Pricing and Costing approach

There are certain costs that may not be included in agency charges but would be included in the charges of private sector organisations providing similar goods or services. These costs represent the competitive advantages of Government ownership. The Pricing Guidelines require that notional costs be added to the costs actually incurred by the agency to determine a competitively neutral cost.

Notional costs generally fall into two categories:

- the cost of capital; and
- taxes and other charges.

Individual agencies are required to make their own assessments to determine any further cost categories that may be specific to their own particular industry.

Pricing Guidelines are also concerned with the method used to allocate costs (both actual and the notional) to goods and services subject to competitive neutrality.

Section 3(5)(b) of the CPA makes reference to the need for prices to reflect "full cost attribution" for the relevant activities undertaken. Following a recent review of the NCP Agreements it is acknowledged that the term "full cost attribution" covers a range of costing methodologies including fully distributed cost, marginal or variable cost, avoidable cost etc, as appropriate to individual circumstances.

The objective of competitive neutrality is to promote the efficient allocation of resources. The view of NSW Treasury is that competitive neutrality will be achieved if the prices charged at least cover avoidable costs and are consistent with approaches followed by private sector competitors.

Avoidable costs are those costs that would be avoided by an agency if the good or service were not provided. If an entity can earn revenue equal to or in excess of its avoidable cost it will not impose any costs on any non-commercial activities of the agency and will generate a commercial return on its own assets.

This approach is consistent with the Productivity Commission's *Cost Allocation and Pricing*[2] paper that also advocates the use of an avoidable cost allocation method.

Some commentators have argued that pricing should be more comprehensive and be based on fully distributed costs rather than avoidable costs. Fully distributed costs include both the direct costs of the production of a good or service and an allocation of indirect costs, such as capital costs and corporate support.

The approach taken in the Pricing Guidelines is that if a fully distributed cost base is used to set a minimum revenue target then an agency could neglect opportunities to efficiently supply goods and services.

To price in the short term at less than the fully distributed cost (provided avoidable costs are covered) also imbues government businesses with the same flexibility as their private sector counterparts in engaging in loss leader activities. Engagement in such activities should be restricted to special market circumstances, and should not contravene the provisions of Part IV of the *Trade Practices Act* as (addressed in Section 4).

In addition, the fully distributed cost approach can also result in the allocation of overhead costs that would have been incurred anyway in running the non-commercial activities of the agency.

The Pricing Guidelines have application to:

- stand alone business entities;
- multi-product General Government businesses;
- agencies selling a commercial service on an ad-hoc basis; and
- costing in-house bids under Service Competition Policy.

[2] Wilson, S., Douglas, I., and Martyn, B., *Cost Allocation and Pricing*, Staff Working Paper, Productivity Commission, Canberra, 1998.

4 COMPETITIVE NEUTRALITY COMPLAINTS MECHANISM

An actual or potential competitor of a Government business may wish to make a complaint if it perceives it is being adversely affected or being denied a market opportunity because of a Government business' net competitive advantage arising solely from its public sector ownership.

The NSW Government has two mechanisms for dealing with competitive neutrality complaints against NSW Government businesses:

- the State Contracts Control Board (SCCB) for investigating competitive neutrality complaints relating to tender bids made by Government businesses in response to an invitation for tenders (except those relating to Local Government); and
- IPART for investigating all other competitive neutrality complaints.

There is a separate mechanism for dealing with complaints against local government businesses. In accordance with the June 1996 *"NSW Government Policy Statement on the Application of National Competition Policy to Local Government"* such complaints are initially referred to the relevant council for consideration. The Department of Local Government can review the matter if the complainant is not satisfied with the response from the Council. Details on the local government complaints mechanism are provided in the Department of Local Government's *"Guidelines on the Management of Competitive Neutrality Complaints"*(November 1997) and its *"Pricing and Costing for Council Businesses – A Guide to Competitive Neutrality"* (July 1997).

It should also be noted that the role of the complaints mechanisms is different from that of the Australian Competition and Consumer Commission (ACCC). The ACCC is the national agency responsible for the enforcement of the *Trade Practices Act 1974* that covers restrictive trade practices such as the misuse of market power, anti-competitive agreements and predatory pricing. The role of the complaints handling mechanisms specifically relates to the investigation of complaints that allege that an agency has not complied with the requirements of Clause 3 of the CPA. Accordingly, complaints mechanisms will not investigate restrictive trade practices covered by the *Trade Practices Act*.

This Statement contains an outline of the processes that the IPART/SCCB follow in responding to a competitive neutrality complaint.

4.1 Role of the Independent Pricing and Regulatory Tribunal/ State Contracts Control Board Complaints Mechanisms

The role of IPART and SCCB is to investigate complaints that are referred by the Premier and to report the findings and any recommendations of investigations. In making findings and recommendations, the IPART/SCCB will, where a complaint has been substantiated, report on:

- the need for changes to the conduct of the relevant Government business to ensure future compliance with competitive neutrality principles; and
- any consequent policy changes that should be considered by the Minister or Government.

4.2 Scope of complaints

The key principle under competitive neutrality is that agencies put in place arrangements that remove any net competitive advantage arising from public sector ownership. Complaints referred to IPART or the SCCB are to be based on:

- an alleged failure of a Government business to comply with the established competitive neutrality principles in relation to any or all of its public trading activities; or
- the inappropriate manner in which competitive neutrality principles are applied by or to a Government business.

The Premier may also refer to IPART matters regarding adverse or unforeseen consequences of applying competitive neutrality principles.

4.3 Who may make a complaint

Complainants can include individuals, private firms, industry groups or another Government business. The complaint must be made either by the actual or potential competitor or by a person or body authorised to act on their behalf. It is important to note that for a complaint to be successfully forwarded to IPART or the SCCB, the Premier must be satisfied according to a range of matters. These are outlined under 4.4 (*Stage 2*).

4.4 How to make a complaint

A two-stage complaint handling process exists in NSW, as outlined below. Prior to lodging a formal complaint, complainants are encouraged to first discuss their concerns with the Government business involved. This will help to clarify whether, and if so what, competitive neutrality matters are at issue and may resolve some concerns without recourse to a formal complaint. Reference should be made to the NSW Treasury *"Guidelines for Pricing of User Charges"* document, so that the nature of any competitive neutrality issues can be clearly identified.

Stage 1: Investigation and response from the Government business

Complainants are obliged in the first instance to lodge a complaint with the Government business that is the subject of the complaint.

Complaints are to be submitted in writing to the respective Government business and should clearly specify what breaches of competitive neutrality principles are alleged. There are no fees charged for lodging a competitive neutrality complaint. Government businesses are required to respond to complaints in writing, generally within four weeks of receiving a written complaint. If complainants are not satisfied with the response, they may then request the Premier to refer their complaint to IPART or the SCCB for investigation.

Stage 2: Investigation of complaints by IPART/SCCB

Under this policy, requests to the Premier to refer matters for independent investigation must be in writing. A complaint will not be referred to the SCCB or IPART unless the Premier is satisfied that the:

- complaint relates to any or all of the public trading activities of the Government business;
- competitor competes, or seeks to compete, in a particular market with the Government business and is hindered or is likely to be hindered from or in doing so by the matters complained of;
- competitor is materially affected by the matters complained of or is likely to be so affected;
- complaint has been made by the competitor or by a person or body authorised by the competitor to make the complaint on behalf of the competitor; and
- subject matter of the complaint has been raised with the Government business and the complainant has reasonable grounds for not being satisfied with the response to the complaint.

4.5 The investigation process

IPART's and SCCB's assessment of complaints must have regard to the requirements of the CPA (as outlined in this Statement) and any other relevant Government policy statement.

IPART and SCCB are required to notify: the complainant, the Government business, the relevant portfolio Minister, and the Treasurer of the complaint and that an investigation is to be conducted.

Complainants are expected to provide any relevant information that would assist IPART/SCCB in its investigation. Comparable obligations also apply to the Government business that is the subject of the complaint. A complainant's failure to provide information to IPART or SCCB may result in termination of the investigation.

The IPART and SCCB are able to accept and consider confidential information from each of the parties involved in a dispute to assist in the investigation of the complaint. Both complaints handling bodies are required to ensure such information is not divulged to any person, except:

- with the consent of the person who provided the information;
- to the extent that the complaints body is satisfied that the information is not confidential in nature; or
- to a member or officer of the complaints body.

Notwithstanding, circumstances may arise which lead the complaints handling body to conclude that in order for a complaint to be properly dealt with, some confidential information needs to be divulged. Before proceeding to divulge any confidential information provided by a complainant, however, the IPART/SCCB will give the complainant reasonable notice and an opportunity to withdraw the complaint. It should be noted that information provided to both complaints handling bodies in their complaints' investigation roles is exempt from the application of the *Freedom of Information Act 1989*.

IPART and SCCB are required to use their best endeavours to report their findings and any recommendations to the complainant, the Government business and responsible Minister, the Treasurer and the Premier within ten weeks of receipt of the complaint (extensions may be approved by the Premier in special cases). IPART and the SCCB will also make their findings and recommendations publicly available.

4.6 Implementing the findings of an IPART/SCCB investigation

The responsible portfolio Minister is to provide a written response to IPART/SCCB report within 8 weeks. Copies of the response are to be provided to the:

- complainant;
- Government business;
- Treasurer;
- Premier; and
- IPART/SCCB.

The Minister's response will be made publicly available by the IPART/SCCB.

IPART/SCCB recommendations are not binding. However, if a Minister does not adopt the IPART/SCCB recommendations, the written response must include the Minister's reasons for not adopting the recommendations.

4.7 Public reporting on compliance with competitive neutrality

The CPA requires all jurisdictions to publish an ongoing annual report dealing with implementation of the competitive neutrality principles, including allegations of non-compliance and complaints.

IPART, the Department of Local Government and the SCCB will include a statistical summary on complaints and non-compliance in their annual reports and in a report to The Cabinet Office for each calendar year by 31 January.

5 OTHER ISSUES

5.1 Competitive Disadvantages Arising from Government

In making reference to *net competitive advantages* in Clause 3(1) of the CPA there is implicit recognition of the fact that Government businesses can accrue both competitive advantages and disadvantages arising from Government ownership.

The Hilmer Report canvassed examples of both competitive advantages and competitive disadvantages that can arise from a Government business' public sector ownership.[3] With respect to the latter, these span a wide range including:

- restricted investment powers;
- restrictions on diversifying into non-core business areas;
- borrowing plans conflicting with Government Budget strategies;
- restrictions on borrowing locally and overseas;
- restrictions on importing capital or inputs (i.e. buying Australian only, reduced managerial autonomy);
- restrictions on export activities;
- stricter employment and industrial relations guidelines; and
- restrictions on withdrawing from particular services; etc.

While it is a legitimate exercise for Government businesses to identify material competitive disadvantages, government businesses should not focus on estimating every cost disadvantage incurred for the purpose of deducting such costs from their cost base and prices. Instead, agencies should first focus on revising the policies that give rise to the disadvantages if the policies are considered lacking in merit. Only where such policies cannot be revised, should agencies consider reflecting any related cost disadvantage in their cost base and prices.

[3] See Independent Committee of Inquiry, *National Competition Policy* (August 1993), pp. 296, 297.

WHERE TO FIND FURTHER INFORMATION

NSW Government, *Implementing Competition Policy and Microeconomic Reform in NSW: an Overview by the NSW Government*, June 1996.

NSW Treasury (2001), *Guidelines for Pricing of User Charges*, Treasury Policy and Guideline Papers [TPP 01-02].

NSW Treasury (1998), *Financial Monitoring Policy for Government Businesses*, Treasury Policy and Guideline Papers.

NSW Treasury (1998), *Financial Distribution Policy for Government Businesses*, Treasury Policy and Guideline Papers.

Supplementary list

Department of Local Government (NSW), *Competitive Tendering Guidelines*, January 1997.

Department of Local Government (NSW), *Pricing and Costing for Council Businesses; a Guide to Competitive Neutrality*, July 1997.

NSW Government, *NSW Government Policy Statement on the Application of National Competition Policy to Local Government*, June 1996.

Who to Contact – Policy Implementation Inquiries

Nature of Inquiry	Agency and Contact
General Policy Issues	Economic Strategy Branch NSW Treasury: Tel: 02 9228-3429 or 9228-3803 Fax: 02 9228-5747
Complaints Handling Matters	Intergovernmental and Regulatory Reform Branch The Cabinet Office NSW Tel: 02 9228-4324 Fax: 02 9228-4408

APPENDIX: Extract from the Competition Principles Agreement

Competitive neutrality policy and principles

Clause 3

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

(2) Each party is free to determine its own agenda for the implementation of competitive neutrality principles.

(3) A Party may seek assistance with the implementation of competitive neutrality principles from the Council. The Council may provide such assistance in accordance with the Council's work program.

(4) Subject to subclause (6), for significant Government business enterprises which are classified as "Public Trading Enterprises" under the Government Financial Statistics Classification:

  (a) the Parties will, where appropriate, adopt a corporatisation model for these Government business enterprise (noting that a possible approach to corporatisation is the model developed by the inter-governmental committee responsible for GTE National Performance Monitoring); and

  (b) the Parties will impose on the Government business enterprise:

    (i) full Commonwealth, State and Territory taxes or tax equivalent systems;

    (ii) debt guarantee fees directed towards offsetting the competitive advantages provided by government guarantees; and

    (iii) those regulations to which private sector businesses are normally subject, such as those relating to the protection of the environment, and planning and approval processes, on an equivalent basis to private sector competitors.

(5) Subject to subclause (6), where an agency (other than an agency covered by subclause (4)) undertakes significant business activities as part of a broader range of functions, the Parties will, in respect of business activities:

  (a) where appropriate, implement the principles outlined in subclause (4); or

  (a) ensure that the prices charged for goods and services will take account, where appropriate, of the items in paragraph 4(b), and reflect full cost attribution for these activities.

(6) Subclause (4) and (5) only require the Parties to implement the principles specified in those subclauses to the extent that the benefits to be realised from implementation outweigh the costs.

(7) Subparagraph (4)(b)(iii) shall not be interpreted to require the removal of regulation which applies to a Government business enterprise or agency (but which does not apply to the private sector) where the Party responsible for the regulation considers the regulation to be appropriate.

(8) Each Party will publish a policy statement on competitive neutrality by June 1996. The policy statement will include an implementation timetable and a complaint mechanism.

(9) Where a State or Territory becomes a Party at a date later than December 1995, that Party will publish its policy statement within six months of becoming a Party.

(10) Each Party will publish an annual report on the implementation of the principles set out in subclause (1), (4) and (5), including allegations of non-compliance.