New South Wales
TREASURY

GUIDELINES FOR PRICING OF USER CHARGES

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Guidelines Paper

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PREFACE

The NSW Government has 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 Reform.

Competitive neutrality policy ensures that publicly owned businesses do not enjoy any net competitive advantage purely as a result of their public sector ownership. Its application helps eliminate resource allocation distortions associated with pubic sector ownership and should ultimately foster an improved standard of living.

The Policy and Guidelines Paper for Pricing of User Charges has been developed to assist agencies to price the goods and services that are sold into markets in competition with private sector or other government suppliers in a competitively neutral way. The Treasury acknowledges the assistance provided by The Cabinet Office and the Independent Pricing and Regulatory Tribunal (IPART) in finalising this document.

The Guidelines should be read in conjunction with the 2001 *"NSW Government Policy Statement on the Application of Competitive Neutrality"* that is being released by The Cabinet Office. The Guidelines replace the NSW Treasury Working Paper (TWP 97-1) *"Pricing Principles for User Charges"* issued in October 1997.

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Acting Secretary
NSW Treasury
June 2001

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EXECUTIVE SUMMARY

In many instances Government agencies supply goods and services on the open market in competition with private sector and other government businesses. Agencies entering into this type of commercial arrangement are required to price their goods and services on a competitively neutral basis.

Competitive neutrality means the elimination of competitive advantages or disadvantages that arise solely through the public ownership status of an entity. Its purpose is to ensure that goods and services are produced efficiently. This may not be the case if, for example, public sector entities have lower costs simply as a result of their public ownership.

The commitment to implement competitively neutral pricing arises from the Competition Principles Agreement signed by the Commonwealth and all the States and Territories. Government agencies that are part of the NSW Government's Commercial Policy Framework already price goods and services on a competitively neutral basis.

This Policy and Guidelines Paper provides guidance to all other NSW Government agencies on pricing goods and services on a competitively neutral basis. The Guidelines do not apply in setting taxes, fines and regulatory fees. These revenues can be distinguished from user charges in that they impose a degree of compulsion on the purchaser. There is little discretion in whether to participate in the transaction and an equivalent good or service is not provided in exchange for the payment.

Agencies should set the price of a good or service, sold in a competitive market, at a level that at least covers the **avoidable cost** of its production. Avoidable costs are those that would be avoided if a good or service is not produced.

The costs to consider in determining a price should include:

- ♦ the costs actually incurred by the agency; and
- ♦ an estimation of additional costs that the agency would incur if it were in private ownership.

These estimated additional costs include:

- the cost of capital that would be incurred if an agency had to fund its own assets through borrowings or investment from the owners; and
- taxes and other charges which apply to the private sector but not to public sector entities.

The approach adopted in these Guidelines is consistent with the Productivity Commission's *Cost Allocation and Pricing*[1] paper and current practice in the Commonwealth Government.

Competitive neutrality pricing does not have to be applied where the agency can demonstrate that the benefits to be gained from implementation are less than the costs. Agencies should document this exercise as they will be required to present such information if a competitive neutrality complaint were to be made.

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

GUIDELINES FOR PRICING OF USER CHARGES

In many instances Government agencies supply goods and services on the open market in competition with private sector and other government businesses. Agencies entering into this type of commercial arrangement are required to price their goods and services on a competitively neutral basis.

1. Purpose of the Guidelines

The purpose of these Guidelines is to assist NSW Government agencies to price goods or services sold into competitive markets in a competitively neutral way. The revenue earned from such sales is generally referred to as "user charges."

These Guidelines apply to user charges that raise revenue through a discretionary transaction that obligates the supply of an approximately equivalent value good or service in return.

The 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 in the purchaser not having a choice to participate in the transaction and an equivalent good or service is not provided in exchange for the payment. For example, a fee to practice a particular profession such as a solicitor is a regulatory fee because, without this, the person cannot practice in this State and no equivalent good or service is provided in return.

Further details regarding the classification of revenues can be obtained from the NSW Treasury Analyst for your agency.

These Guidelines should be read in conjunction with the 2001 *"NSW Government Policy Statement on the Application of Competitive Neutrality"* (to be released by The Cabinet Office).

The Guidelines do not apply to businesses that are operated by local government. Their "guidelines" are set out in a separate policy document, *"NSW Government Policy Statement on the Application of National Competition Policy to Local Government"* issued in June 1996.

2. National Competition Policy and Competitive Neutrality

In April 1995, the Council of Australian Governments ratified the National Competition Policy (NCP), including the Competition Principles Agreement (CPA) signed by the Commonwealth and all the States and Territories of Australia. One of the aims of NCP is to promote an economically efficient use of resources by increasing the extent that public sector providers of goods and services are exposed to competition.

A key commitment of the New South Wales Government under National Competition Policy is the application of competitive neutrality to *significant* NSW Government businesses competing in markets[2] or operating in contestable markets.

An objective of competitive neutrality is to achieve an efficient allocation of resources between public and private businesses. This requires fair pricing and the elimination of resource allocation distortions. For government business activities, this means offsetting any net competitive advantages that arise simply as a result of public ownership.

Typically, this means factoring into the price of a good or service an allowance for the following:

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

Details on how to determine competitively neutral prices are included later in these Guidelines.

2.1 Who Should Apply These Guidelines?

The CPA requires <u>all</u> government agencies undertaking *significant* business activities in competitive or contestable markets to act in a competitively neutral way.

The definition of a *significant* business activity is an important issue. 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, its influence on the relevant market, the resources it commands and the effect of any poor performance.

[2] See: *NSW Government Policy Statement on the Application of Competitive Neutrality 2001*

The New South Wales Government has established a Commercial Policy Framework that encompasses the following elements:

- the application of commercially based targets for rates of return, dividends and capital structures;
- regular performance monitoring (usually by NSW Treasury on a quarterly basis);
- the payment of State taxes and Commonwealth tax equivalents;
- the payment of risk related borrowing fees;
- the explicit funding of "Social Programs" or Community Service Obligations (CSOs); and
- regulation equivalent to that faced by private sector companies.

The Commercial Policy Framework applies to most Public Trading Enterprises (PTEs), Public Financial Enterprises (PFEs) and some Non Budget Dependent General Government Sector agencies. Compliance with the elements of the Commercial Policy Framework ensures that these agencies act in a competitively neutral way.

Accordingly, these Guidelines apply to *significant* business activities of:

- **Budget Dependent General Government Sector agencies; and**
- **Public Trading Enterprises (PTEs), Public Financial Enterprises (PFEs) and Non Budget Dependent General Government Sector agencies that are outside the Commercial Policy Framework.**

The Government's Policy Statement on Competitive Neutrality recognises that the economic and social benefits of implementing competitive neutrality prima facie outweigh the costs. However, the Policy Statement 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.

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:

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

Under the CPA, Governments are free to deliver social programs (or community service obligations) provided that any CSO payments or subsidies are transparent, appropriately costed and directly funded by government. The CPA encourages a greater awareness of the way that social programs are defined, delivered and costed.

2.2 Why Agencies Need to Adopt Competitively Neutral Pricing

The NSW Government is eligible to receive quarterly Tranche payments from the Commonwealth for complying with the requirements of competition policy. Competitive neutrality requirements are part of that compliance. The Government is required to report annually to the National Competition Council on the application of competitive neutrality and to report on allegations of non-compliance. The Council in turn makes an assessment of the extent of compliance and makes recommendations as to the payment to be made to New South Wales.

Pricing of contestable goods and services should be transparent and cost reflective. This ensures that Government agencies compete on an efficient basis with the private sector.

The 2001 *"NSW Government Policy Statement on the Application of Competitive Neutrality"* outlines the scope for an actual or potential competitor of a government business to make a complaint on the grounds that it is being adversely affected or denied a market opportunity because of a government business' net competitive advantage resulting solely from its government ownership.

The party lodging a complaint must first approach the relevant government agency to clarify and attempt to resolve the matter. However, if the complainant is not satisfied with the response of the agency it can request that the matter be considered by the relevant complaints handling body.

In line with CPA requirements, the Government has established complaint procedures and independent third party complaint mechanisms[3] to consider and investigate complaints (that have not been resolved in the first instance). Information on the complaints handling process is provided in the 2001 *"NSW Government Policy Statement on the Application of Competitive Neutrality"*.

Therefore agencies competing in markets need to document the basis of their costing and pricing, and be prepared to respond to issues raised by complainants and to provide information to the relevant complaints review body if requested to do so.

Where the agency has determined that the benefits to be realised from the implementation of competitive neutrality pricing are outweighed by the costs it must be able to provide information to support this decision.

The Government will use the discretion granted by the CPA to ensure the adoption of competitive neutrality principles best meets the conditions in New South Wales without contravening either the letter or the spirit of National Competition Policy.

[3] The NSW Government has three mechanisms for dealing with complaints against significant Government business activities:

- The State Contracts Control Board is responsible for investigating competitive neutrality complaints relating to tender bids made by NSW Government businesses in response to an invitation for tenders(except those relating to Local Government);
- The Independent Pricing and Regulatory Tribunal is the independent body responsible for investigating all other competitive neutrality complaints; and
- The Department of Local Government is responsible for investigating competitive neutrality complaints in relation to council businesses.

3. Development of Agency Costing Systems

It is recognised that some agencies may not currently have adequate costing systems and procedures in place to easily determine a competitively neutral price for whatever goods and services they sell into markets.

For example, it is difficult to envisage how many agencies can determine costs accurately without an integrated financial management system that incorporates those functions of the agency which are the main cost. For most agencies in the General Government sector, where employee related costs are the main cost driver, the financial and human resource systems need to be integrated for appropriate costs to be produced.

The NSW Treasury has commenced development of a comprehensive strategy to assist agencies to implement effective costing systems. Under the strategy agencies will be assisted to:

- assess the current status of their costing systems;
- identify the most appropriate costing systems; and
- provide practical strategies to move from the current status to the desired position.

At this stage, the application of these *Guidelines for Pricing of User Charges* may involve manual calculation for many agencies.

3.1 Costs Versus Benefits

The degree of effort required to comply with these principles should take account of the significance of the activity relative to the size of the market. For example, greater effort should be expended ensuring competitive neutrality for laundry services provided externally by a hospital, particularly if this service is significant in terms of the local market. On the other hand, photocopying services provided to the public as part of the normal operations of a departmental library are unlikely to represent a significant business activity. A simple proxy for the latter may be to apply similar charges to those that would be levied by a commercial photocopier.

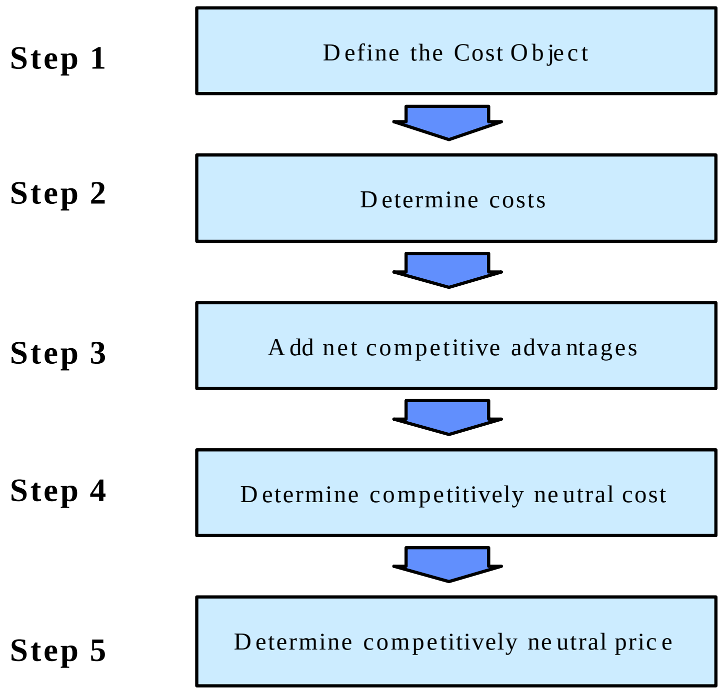
4. Applying Competitively Neutral Pricing

The application of competitively neutral pricing involves:

- determining the competitively neutral cost of the relevant goods or services by
  - identifying the cost derived from the accounting system; and
  - adjusting for the competitive advantages and disadvantages arising from Government ownership;
- setting the price of the goods or services to cover those costs (including a required rate of return).

The steps required are summarised in Figure 1 below.

Figure 1: Stages in Establishing Competitively Neutral Prices for Goods and Services



The adjustments required to derive the competitively neutral cost of the relevant good or service are addressed in the section "*Costs That Need To Be Included In Agency Prices*".

The determination of the appropriate cost allocation basis, both actual costs incurred by the agency and any notional costs, for goods or services subject to competitive neutrality is a critical issue.

An objective of competitive neutrality is to achieve an efficient allocation of resources between public and private sector businesses. It requires that government businesses set prices that at least cover costs (including a return on capital and all relevant taxes). The CPA describes this as “full cost attribution”.

Following a recent review of the CPA, the term “full cost attribution” has been defined to accommodate a range of costing methodologies, including fully distributed cost, marginal cost, avoidable cost etc as is appropriate to particular circumstances.

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.

Avoidable costs, on the other hand, are those costs that would be avoided by an agency if the good or service was not provided. If an entity could earn revenue equal to or in excess of its avoidable costs it would not impose any costs on any non-commercial activities of the agency. Avoidable costs are a close proxy for marginal costs because the cost saved by not producing a product or service is usually the same as the additional cost of making the product or service available, at least from a longer term perspective.

The 2001 *“NSW Government Policy Statement on the Application of Competitive Neutrality”* has adopted the position that the efficient allocation of resources will be achieved if the prices charged for goods and services at least cover their avoidable costs. This approach is consistent with the Productivity Commission’s *“Cost Allocation and Pricing”* paper (referenced earlier) that advocates the use of an avoidable cost allocation method.

The approach taken in this Policy and Guidelines Paper 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. In effect, the fully distributed cost approach results in the allocation of overhead costs that would have been incurred anyway in running the non-commercial activities of the agency.

It is important to recognise, however, that the covering of avoidable costs represents a minimum price that desirably should not continue beyond the short term unless there are other public policy reasons for doing so. In most circumstances (i.e. other than the provision of goods and services on an ad hoc basis) agencies in the longer term should endeavour to charge prices that cover the fully distributed costs of production.

Specific issues relating to the use of the avoidable cost approach are addressed later in this Policy and Guidelines Paper under the section “*What is Full Cost Attribution?”*.

5. Costs That Need to be Included in Agency Prices

Under present arrangements there are certain costs that may not be included in agency charges that would be included in charges of private sector organisations providing similar goods or services. These costs represent the competitive advantages of Government ownership and therefore should be added to the costs actually incurred by the agency to determine a competitively neutral cost.

These costs generally fall into two main categories:

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

Individual agencies should make their own assessment to see if there are any further differences that might apply to their own particular industry.

It is generally assumed that there are no inherent competitive disadvantages of Government ownership that require deductions from the fully attributed cost to determine a competitively neutral cost.

There are, however, arguably instances where agencies are at a comparative disadvantage to their private sector competitors. For example, they may find it harder to achieve cost reductions by reducing the number of employees. It is generally considered that such disadvantages can, and should, be addressed administratively and should not require the notional adjustment of costs.

Managers responsible for the production of goods and services should be able to produce in the most efficient manner possible, including establishing appropriate staffing levels. The extent of surplus staff arising from this approach can then be identified and treated as a separate issue for the agency as a whole. Such costs vary throughout the economy by industry and agency, and achievement of a truly competitively neutral approach in this regard will be difficult.

Agencies should review their own operations to determine if there are any competitive disadvantages of Government ownership and if so how these should be accommodated.

5.1 Cost of Capital

A private sector organisation has to incorporate into its pricing structures the cost of debt and a return to its owners commensurate with the risks assumed by them in investing in the business. These inclusions compensate the owners of the business for the opportunity cost of investing in the business. This opportunity cost is the return that they could have earned from the next best available investment.

The Government is incurring a similar opportunity cost. The purpose of allocating a return on capital employed is to explicitly include a cost that is implicitly assumed by the Government. The opportunity cost of capital is a function of the value of the assets employed by the agency in providing the good or service and the Government's required rate of return on those assets.

Agencies are currently not required to compute the return on capital employed on an ongoing basis. Generally, it would be appropriate to apply a notional percentage charge to the actual fully attributed cost of the activity rather than go through the rigours of frequent weighted average cost of capital calculations. The notional charge would, however, need to be periodically reviewed, particularly where it is known that there has been a change in circumstances, such as a tax rate change.

Calculating Return on Capital Employed

For those business units in which capital is a significant input in the operations, it may be appropriate to calculate a required return on capital based on the Weighted Average Cost of Capital (WACC) in order to ensure that costs are materially correct. The WACC should be calculated in accordance with the guidance in NSW Treasury's *"Guidelines for Financial Appraisal"* (TPP 97-4).

In order to calculate the WACC of the business unit's activities it is necessary to assign the activity an appropriate risk weighting. This recognises that the Government would require a higher rate of return on business units incurring a higher degree of risk in order to be appropriately compensated for assuming that risk. Agencies that need to calculate the WACC should determine the appropriate rate in conjunction with their Treasury Analyst (who can provide an indication of the Government's expectations in this regard).

For those business units in which capital is insignificant, materially correct costs can be determined by using a single standard rate. For administrative simplicity, the suggested rate to use is the Commonwealth Bonds ten year indicator rate (which can be found in the "Markets" section of the *Australian Financial Review*).

Value of Assets Employed

In accordance with Treasury policy, non-current assets of an agency are valued at the written down replacement cost of a modern equivalent asset. Care should be taken when using this as a factor in determining the return on capital employed, as the written down replacement cost valuation approach is generally not adopted in the private sector. In the private sector, historic cost, which is generally a lower amount, is normally used.

As the value of assets used would be higher for Government agencies, the resultant cost of capital would also be higher. An adjustment may need to be made in calculating the return on capital employed to ensure that the Government agency is not placed at a competitive disadvantage to the private sector.

5.2 Taxes and Charges

Most Government agencies are exempt from a range of taxes and other charges. Competitive neutrality requires that, where taxes and charges are not currently paid on business activities, the notional incidence should be calculated and factored into the price.

Agencies should examine their own particular circumstances to determine the particular taxes from which they are exempt but which may be borne by their potential private and other public sector competitors.

Specifically, the following taxes are often not currently paid by Government agencies and should, if material, be included in the cost of goods and services priced under these Guidelines:

- ***Land Tax****:* Only those agencies that own land on which the production/sale of a good or service occurs need include this cost. Agencies which utilise rented properties should assume that this is included in the rental payment;
- ***Other State Taxes****:* This range of taxes is listed in the Budget papers. Costs should be included where a significant cost is impacted by these additional charges. The main duties which impact agency costing are:
  - ***Contracts and Conveyances Duty*** which should be included for land trading activities of Government agencies and in the assets base utilised for return on capital calculations where owned land and buildings are a significant cost driver. It should be noted that the Ministerial Council, which was set up under the auspices of the Inter governmental Agreement on the Reform of Commonwealth-State Financial Relations, is to review by 2005 the need for the retention of certain stamp duties;
  - ***Motor Vehicle Registration Certificates Duty***. This should be included where motor vehicle running costs form a significant cost;
  - ***Debits Tax*** is currently not payable by many Government agencies but should be included in a competitively neutral price (Debits Tax is to be abolished by 1 January 2002, subject to NSW not being adversely affected under the compensation arrangements of the Intergovernmental Agreement); and
  - ***Local Council Rates***. This cost should be treated on the same basis as land tax.

The combined notional cost of these taxes and other charges for many agencies may well be a very small proportion of the total cost of the activity (in many cases less than 1%). In effect, the total notional cost of these charges may be immaterial compared with the effect of minor changes of assumptions regarding cost allocation bases.

Where such costs are immaterial, and this can be demonstrated, then they may be left out of the calculation of the competitively neutral cost of an activity.

As payroll tax is paid by all State agencies and is already included in the cost, there is no need for it to be included under this category.

5.3 Goods and Services Tax (GST)

Under the New Tax System most goods and services became subject to the GST from 1 July 2000. Therefore, agencies need to adjust the prices of government goods and services to reflect the impact of the GST. The NSW Government's policy in this regard is set out in NSW Treasury Circular TC00/06, *"Pricing of Government Goods and Services to Reflect the Impact of the Goods and Services Tax".*

It should also be noted that many fees and charges of a regulatory nature are excluded from the GST by the Commonwealth Treasurer's Division 81 Determination. More information on the application of Division 81 can be obtained by contacting NSW Treasury direct (Contact: Mr Ben Lathwell on 9228-3222).

6. What is Full Cost Attribution?

As noted previously, an objective of competitive neutrality is to achieve an efficient allocation of resources between public and private sector businesses. It requires that government businesses set prices that at least cover costs (including a return on capital and all relevant taxes). The Competition Principles Agreement describes this as "full cost attribution."

The *"NSW Government Policy Statement on the Application of Competitive Neutrality"* has adopted the position that the efficient allocation of resources will be achieved if the prices charged for goods and services at least cover their avoidable cost. If an entity could earn revenue equal to or in excess of its avoidable costs it would not impose any costs on any non-commercial activities of the agency.

The application of avoidable costs and some practical issues related to their use, are addressed below. In addressing these issues it is important to understand the four types of commercial operations (excluding those under the Commercial Policy Framework):

1) Stand alone business unit that does not share any common assets or other resources with another entity (e.g. a government trading enterprise that is not part of the Commercial Policy Framework);
2) Business unit of a general government sector agency, that provides a range of goods or services;
3) General government sector agency that provides a commercial good or service on an *ad hoc* basis (e.g. by using the surplus capacity of a computer system acquired to support the agency's core government services); and
4) In-house business unit that tenders for the provision of internal services under the Government's Service Competition Policy.

6.1 Stand Alone Business Unit

The owners of a private sector business require that business to provide them with a commercial rate of return on their investment.

Accordingly, if a stand alone government owned business unit, such as a public trading enterprise, were required to earn a commercial rate of return then it would be considered to be pricing in a competitively neutral way. "Stand alone" means that it does not share assets or other resources with other areas of an agency.

In order to achieve a commercial rate of return, a private sector business will have to set prices that will, over the medium term, cover the full cost of service provision, including an appropriate rate of return on the assets employed. However, such businesses have considerable flexibility in pricing individual product lines. For example, market conditions may mean that one product will earn a return in excess of the minimum required by the owner while another product may earn a return below that required. Indeed, a product may initially be priced as a "loss leader" in order to build up brand knowledge and market share.

A government owned business unit should be able to compete on the same basis as a private sector operator. Therefore, a stand alone business unit will be deemed to be pricing in a competitively neutral way if the business unit as a whole is earning a commercial rate of return over the medium term (i.e. around five years).

In such cases, the avoidable cost and the fully distributed cost for the business unit as a whole are the same because of its stand alone nature.

6.2 Business Unit of a General Government Sector Agency

In many cases a business unit is not a stand alone operation; the production of a good or service requires the use of assets (such as a computer system) or other resources (such as support for corporate services) controlled by the non-commercial operations of the agency.

In such cases, it is clear that *direct costs* should be included in the cost of the good or service. Direct costs are those that can be economically traced to a given cost object, in this case the good or service. The key question is the method by which *indirect costs* are allocated to the cost of the good or service. Indirect costs are those that cannot be economically traced to a given cost object; these include capital costs and corporate overheads. These costs need to be allocated to the cost of the good or service.

A private sector operator, which is effectively a stand alone business operation, would have to set prices at a sufficient level to cover the full costs of the business, including a return on the investor's capital. In effect, the full cost of service delivery has to be *fully distributed* over the company's whole product range.

The *fully distributed cost* comprises all direct commercial costs and a share of the agency's overheads and capital costs. For example, a computer system may be used 80 per cent of the time by non-commercial activities and 20 per cent of the time by commercial activities. In a fully distributed cost approach, 20 per cent of the depreciation cost and 20 per cent of the capital charge would be allocated to the commercial activity.

It could be argued that, from an "equity" or "level playing field" perspective, a government agency should be required to set the prices of commercial operations so that they cover the *fully distributed cost* of these activities.

It is important, however, to re-iterate that an objective of competitive neutrality is the efficient allocation of resources. A public sector business unit that uses a fully distributed cost base to set a minimum revenue target could neglect opportunities to efficiently supply goods and services.

In particular, the fully distributed cost approach results in the allocation of overhead costs that would have been incurred anyway in running the non-commercial activities of the agency. Therefore, if the fully distributed cost approach is applied all the time there may be opportunities lost to efficiently supply goods and services (i.e. that generate a positive cash flow).

If a fully distributed cost allocation method were to be mandated, an agency may be forced to cease the production of a good or service that provides a positive economic benefit and that is allowable under competitive neutrality.

In order to overcome this problem, the *avoidable cost* allocation method can be used. Under the avoidable cost method, the cost base of the commercial activities comprises all costs that the agency would avoid if the commercial goods or services were to cease being produced.

In effect, avoidable costs are those that would be saved if the business unit were to cease operations, ie:

- the costs of resources used exclusively by the business unit (including capital costs); and
- the additional cost to the agency of the business unit using its resources.

It is important to recognise that, in order to be considered to be pricing in a competitively neutral manner, prices should cover the avoidable costs of the business unit as a whole and not just of individual product lines. Some costs, which may be unavoidable at the single product level, may be avoidable at the business unit level. For example, the cessation of all of the business unit's activities may result in the vacancy of office space sufficiently large to be sub-let, thereby earning revenue for the non-commercial activities (i.e. avoidable costs). The cessation of one commercial service is much less likely to achieve such savings for the non-commercial operations.

The determination of what costs are avoidable can often involve significant judgement. This is particularly the case when determining whether or not capital costs are avoidable.

Where an agency has made a sound investment in an asset to deliver its core, non-commercial activities, there may be valid reasons why the asset has surplus capacity that can be used for commercial purposes. These reasons include:

- capital investment may be inherently "lumpy" because it may be difficult to acquire an asset whose capacity exactly matches the required usage;
- the agency believes that the demands of the core government programs will increase in the future and therefore there is necessarily excess capacity in the short term; or
- a poor investment decision was made.

In these situations the avoidable capital cost of the commercial activity will be significantly less than the fully distributed cost (the avoidable cost may be zero in some circumstances).

There may, however, be other reasons for the spare capacity such as:

- a change in government policies or priorities; and/or
- a change in the demand for the non-commercial services of the agency.

In such circumstances, the agency may have the option of selling the asset. If the asset is retained for use by the business unit in such circumstances, then the government would expect that a commercial return be earned on the asset, ie allocation of costs on a fully distributed basis may be more appropriate.

6.3 Provision of a Commercial Good or Service on an *ad hoc* Basis

An agency may provide a service on an *ad hoc* basis rather than through an ongoing business unit. For example, an agency may use the spare capacity of the computer system acquired to support its non-commercial activities to generate income by processing the transactions of another entity.

The basic principles for costing *ad hoc* commercial services are the same as for a business unit of a general government sector agency, as noted above. However, as services are provided on an ad hoc basis, rather than as part of an ongoing business, the price of each ad hoc service would need to be determined by the avoidable cost of that good or service.

Appendix A includes an example of how to cost a commercial activity on both a *fully distributed cost* basis and an *avoidable cost basis*.

6.4 In-house Bids Under Service Competition Policy

The New South Wales Government's Service Competition Guidelines include guidance on the costing of in-house bids for service delivery under Service Competition Policy. The net avoidable cost of the in-house bid is to be used when comparing with the bid prices of the external service providers. The Service Competition Guidelines define *net avoidable cost* as costs that would be avoided if performance of an activity were to be transferred to an external party. In other words, the recommended costing approaches for user charges and for Service Competition Policy are consistent.

Figure 2: Assessing Whether an Activity's Prices are Competitively Neutral

Type of Business Activity	Tests to Ensure Activity is Competitively Neutral	Comment
1. Stand alone business unit.	Is it earning a commercial rate of return?	If a commercial rate of return is achieved then prices must cover all costs.
2. Multi-product business unit within a government agency predominantly supplying non-commercial services.	Does revenue exceed the avoidable cost of the business unit?	Avoidable cost includes a rate of return on unit's own assets and the avoidable cost of agency resources provided to the unit.
3. Agency selling a commercial service on an ad-hoc basis.	Does revenue exceed the avoidable cost of supplying the service?	Where an agency sells a single product, the cost of the product and the cost of the commercial activity are the same.
4. Costing in-house bids under Service Competition Policy.	Price set equal to the avoidable cost of supplying the service	For in-house bids, cost usually sets the price rather than forming a floor to prices.

7. Where Can I Get Help?

For further advice and assistance on implementation issues, agencies should contact the relevant NSW Treasury Analyst (in the Resource Allocation Directorates) they deal with on a day to day basis regarding financial matters, ie:

Treasury Analyst
NSW Treasury
Governor Macquarie Tower
1 Farrer Place
SYDNEY 2000

Telephone: (02) 9228 4567

For further technical advice or clarification regarding this policy document, inquiries should be directed as follows:

Nature Of Inquiry	Contact
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Appendix A: Case Study Example Comparing Fully Distributed Costs and Avoidable Costs

A Budget dependent General Government Sector agency has two divisions: one division provides its core government programs and the second provides all corporate support activities for the agency.

The corporate support division is responsible for the operation of the agency's computer system. The annual capital cost of the computer is $150,000. This comprises a depreciation charge of $100,000 and a capital charge of $50,000 (the computer cost $500,000, is estimated to have a useful life of 5 years and the agency has estimated that its cost of capital is 10 per cent).

The computer is operated at approximately 80 per cent capacity. Such under utilisation is common and can arise for a number of reasons including:

- capital investment may be inherently "lumpy" because it may be difficult to acquire an asset whose capacity exactly matches the required usage;
- the agency believes that the demands of the core government programs will increase in the future and therefore there is necessarily excess capacity in the short term; or
- a poor investment decision was made.

The agency has accepted a one year contract to perform the data processing for another organisation. The contract will result in the full use of the remaining 20 per cent capacity of the computer. The corporate support division is expected to employ two extra employees (at an annual cost of $50,000 each) to assist with the extra processing that is required. In addition, the increased activity is expected to generate increased costs, ie telephone, etc ($3,000), electricity ($5,000), travel ($4,000) and training ($5,000).

Table 1 following shows the agency's total annual costs both before and after accepting the commercial contract. The costs include both those that it would find in its own chart of accounts as well as a notional capital charge. The agency has determined that the quantum of taxes such as sales tax, land tax and stamp duties that it would have to pay if it were a private sector business are immaterial.

Table 2 compares the cost of the commercial activity based on the net avoidable cost methodology and on a fully distributed basis. The avoidable cost is $117,000 which is a little over half the fully distributed cost of $214,000. The bases used in the example to allocate costs to derive the fully distributed cost are fairly crude. However, the use of more sophisticated allocation bases, such as those available through an activity based costing system, would not produce a substantially different result.

The fully distributed cost of the commercial activity is higher than the avoidable cost principally because, under the former approach, the activity is allocated a share of costs such as capital costs and rent that would have been incurred even if the commercial contract had not been incurred. It is economically efficient for the agency to accept a contract price above $117,000.

Table 1: Costs of the Agency

	Non-Commercial Activities		Commercial and Non-Commercial Activities	
	$'000	**Employees**	**$'000**	**Employees**
Employee related costs				
service delivery programs	4,250	85	4,250	85
corporate support	750	15	850	17
Other operating expenses				
rent	1,000		1,000	
telephone etc	250		253	
electricity	200		205	
travel	80		84	
training	70		75	
stationery	60		60	
Depreciation and amortisation				
computer	100		100	
Total agency costs (per financial statements)	6,760		6,877	
Add: notional costs				
capital charge	50		50	
taxes and other charges [1]	0		0	
"Competitively Neutral" Cost	**6,810**	**100**	**6,927**	**102**

[1] *The agency has determined that the quantum of taxes such as sales tax, land tax and stamp duties that it would have to pay if it were a private sector business are immaterial.*

Table 2: Comparison of Cost Allocation Methods

	Total Costs $'000	Employee Numbers	Avoidable Costs $'000	FDC $'000	Allocation Basis to Determine Fully Distributed Cost
Employee related costs					
service delivery programs	4,250	85	0	0	*fully allocated to non-commercial activities*
corporate support					
systems support	200	4		40	*allocated based on percentage of use (ie 20 %)*
transaction processing	400	8	100	100	*cost of extra employees can be directly attributed to commeccial activity*
other (Executive etc)	250	5		5	*allocated on the basis of proportion of commercial employees to total (approx 2%)*
Other operating expenses					
rent	1,000		0	20	*allocated on the basis of proportion of commercial employees to total (approx 2%)*
telephone etc	253		3	5	
electricity	205		5	4	
travel	84		4	4	*extra cost can be directly attributed to commercial employees*
training	75		5	5	
stationery	60		0	1	*allocated on the basis of proportion of commercial employees to total (approx 2%)*
Depreciation and amortisation					
computer	100		0	20	*allocated based on commercial use of the computer system (20%)*
Total agency costs (per financial statements)	6,877		117	204	
Add: notional costs					
capital charge	50		0	10	*allocated based on commercial use of the computer system (20%)*
taxes and other charges	0		0	0	
"Competitively Neutral" Cost	**6,927**	**102**	**117**	**214**	

Appendix B: References

1. Some of the arguments and examples included in these Guidelines are based on the *"Cost Allocation and Pricing"* Research Paper published by the Commonwealth Competitive Neutrality Complaints Office of the Productivity Commission in October 1998. The NSW Treasury acknowledges the significant contribution of that Office.

2. NSW Treasury, *"Pricing of Government Goods and Services to Reflect the Impact of the Goods and Services Tax"*, TC00/06, 19 May 2000.

3. NSW Treasury, *"Pricing Principles for User Charges"*, TWP 97-1, October 1997.

4. NSW Treasury, *"Guidelines for Financial Appraisal"*, TPP 97-4, July 1997.

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

6. NSW Government, *"NSW Government Policy Statement on the Application of competitive Neutrality"*, proposed for release in 2001.

7. NSW Government, *"Service Competition Guidelines"*, 1997.

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