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### 3 Community service obligations – funding and capital management

#### **Key points**

- Non-commercial activities performed by government trading enterprises (GTEs) in the pursuit of community benefits, at the behest of government, are termed community service obligations (CSOs)
  - typically the activities would not be undertaken by a business operating under commercial imperatives.
- Substantial emphasis is placed on transparency and accountability in all government CSO policies. These policies are subject to intergovernmental agreements.
- Contrary to their stated policies, not all governments are identifying all CSOs. Governments are generally not reporting funding in a transparent manner. Almost no information is reported on the costs of meeting CSOs.
- Inadequate compensation for CSOs affects the financial performance of a GTE and impairs commercial viability
  - this compromises governance and the integrity of operating government businesses on a commercial basis.
- Underfunding a CSO could result in under-investment or higher prices for commercial services. Service quality could also be reduced.

Community service obligations (CSOs) are non-commercial activities undertaken by government trading enterprises (GTEs) at the direction of government to achieve social policy objectives. They can be as diverse as transport concessions for pensioners, charges for water or electricity set below cost, or the provision of non-commercial ferry services.

The CSO payments identified in this report amounted to \$3.9 billion in 2006-07, accounting for approximately 8.5 per cent of total GTE income.<sup>1</sup> CSO payments are most significant in the rail and water sectors, where they accounted for 30.5 per cent

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<sup>1</sup> Excluding the three GTEs in the 'other' group of GTEs, none of which received CSO payments.

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and 10.2 per cent of total income respectively. However, it should be noted that some CSOs are unreported and unfunded, and others are reported but are also unfunded.

The information discussed in this chapter is drawn from GTE annual reports, State and Territory government budget papers, communication with treasury departments and other relevant policy documents. It is limited to information that is readily discoverable. Consequently, there is an unavoidable bias towards what *is* reported and not what *should* be reported.

In this chapter, current approaches to funding CSOs and the possible effects of underfunding CSOs on capital management decisions are examined. This begins with a review of the definition of CSOs agreed by all governments in 1994. It is contrasted with the definitions contained in current government policies (section 3.1). Current costing, funding and reporting practices are discussed in section 3.2. Finally, the effects of underfunding CSOs on capital management decisions are examined in section 3.3.

### **3.1 Defining community service obligations**

The Steering Committee on National Performance Monitoring of Government Trading Enterprises (Steering Committee) recommended the following definition in 1994:

A community service obligation arises when a government specifically requires a public enterprise to carry out activities relating to outputs or inputs which it would not elect to do on a commercial basis, and which the government does not require other businesses in the public or private sectors to generally undertake, or which it would only do commercially at higher prices. (SCNPMGTE 1994, p. 8)

This definition has been directly adopted in South Australia, Western Australia, and the Northern Territory's CSO policy statements. The ACT's budget papers also quote the Steering Committee definition.

The four remaining States have their own definitions. However, they all include minor variations on the defining elements of CSOs. Each policy contains some reference to a government requirement, although there are differences in the strength of the language used. For example, Victoria and Tasmania call for a specific government directive, whereas Queensland only requires the CSO to be

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‘clearly purchased by the Government’. There is a consensus that a CSO must be a non-commercial activity and provide benefit to the community.<sup>2</sup>

The Queensland policy statement includes some private-sector activities as CSOs. This is contrary to the Steering Committee definition, which specifies CSOs are carried out by public enterprises.

## Why identify CSOs?

The identification of CSOs assists GTEs with their financial performance, as well as benefiting government and the broader community. Although the former is most relevant to a discussion of capital management decisions, considerations of the latter inform an analysis of how well CSOs are identified and the incentives for good capital management.

Humphry (1997) observed that earning a commercial rate of return should be one of the Government’s principal objectives for its GTEs:

All capital tied up in GTEs has an opportunity cost in that it could be utilised to reduce debt or applied to some other public service. For any investment, the government’s opportunity cost of capital is the same as the private sector’s. (p. 12)

Undertaking non-commercial activities (at the direction of government) without appropriate CSO funding detracts from the commercial objective because it usually requires resources to be allocated away from commercial activities.

An implicit CSO occurs where government does not publish the details of all the required non-commercial activities (Humphry 1997). Further, any unfunded portion of the costs of providing a recognised CSO can also be considered an implicit CSO (PC 2002a). Such implicit CSOs ‘adversely affect the profitability of GTEs, resulting in lower dividend streams and a less valuable asset’ (Humphry 1997, p. 18). This argument also holds for underfunded CSOs.

Mandatory identification of CSOs and the transparent reporting of costing and funding methods guards against such outcomes. It not only promotes good governance but also reduces incentives to underfund CSOs. It helps clarify what constitutes ‘appropriate’ funding, as both the public and intended service recipients are made aware of the cost to society of pursuing social objectives through GTEs.

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<sup>2</sup> Businesses could offer concessions to identifiable user groups for sound commercial reasons. It is difficult to determine the extent to which a GTE would offer concessions in the absence of a government requirement to do so.

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Transparency is defined as a glossary term in NSW Social Policy as:

Access by the public to information about the activities of Government agencies; especially the correct identification of costs and benefits associated with the delivery of goods and services. (NSW Government 1994, p. 55)

Transparency is referred to in every State and Territory government's policy document pertaining to CSOs (box 3.1). The Australian Government has no explicit policy regarding CSOs. The two Australian Government GTEs monitored in this report — Airservices Australia and Australia Post — identify the cost of providing CSOs but these are not reimbursed by the Commonwealth.

**Box 3.1      Emphasis on transparency in policy**

**New South Wales** — 'to ensure transparency, costs should always be reported in a sufficiently disaggregated form to enable both policy-makers and the public to evaluate the merits of each program' (NSW Government 1994, p. 29).

**Victoria** — transparency and full disclosure are discussed in the government policy, particularly to assist in improving accountability for both community service obligation (CSO) provision and government trading enterprises (GTEs) themselves.

**Queensland** — 'a high degree of transparency and accountability' (Queensland Treasury 1999, p. 3) is listed as a key objective of CSO policy.

**South Australia** — a key guideline is that 'CSO payments will be transparent and clearly reported' (SA Government 2004, p. 4).

**Western Australia** — GTEs are required to report on CSO provision. This includes an assessment of performance and detailed costings.

**Tasmania** — the policy objectives include improving the transparency of CSO service delivery. The corresponding policy outcome of implementing the policy is expected to be 'greater accountability to the Parliament and the community due to transparency of cost and price information' (Tasmanian Government 1996a, p. 9).

**ACT** — budget papers include a statement that 'the separate identification of CSOs provides transparency on the full cost of services, and the financial implications of Government decisions in the provision of services to specific targeted groups in the community' (ACT Treasury 2007, p. 66).

**Northern Territory** — government policy 'is aimed at clearly identifying the non-commercial functions performed by GTEs, making the functions transparent, and making their delivery accountable to the community' (NT Government (ud), p. 1).

*Sources:* ACT Treasury (2007); NSW Government (1994); NT Government (ud); Queensland Treasury (1999); SA Government (2004); Tasmanian Government (1996a, 1996b); Victorian Treasury (1994); WA Treasury (2000).

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## 3.2 How are CSOs costed, funded and reported in practice?

The main aim of CSO policy is to prevent the imposition of non-commercial obligations from adversely affecting the financial performance of a GTE. The full cost of the service obligation must be estimated in order to determine the required level of funding. Public reporting is necessary to increase transparency and make boards and government accountable.

### Costing

The 2002 report in this series observed that ‘an appropriately costed CSO does not represent a subsidy to the GTE — it is a fee for service’ (PC 2002a, p. 69).

The method used to ascertain the cost of CSOs and the required funding determines how successfully the commercial and non-commercial activities of a GTE are separated from each other. There are three major methods — avoidable cost, fully-distributed cost and stand-alone cost.

Adoption of the avoidable cost method was advocated by the Steering Committee, although some caveats were included in their recommendation, particularly regarding decreasing cost considerations. The NSW, Victoria, Queensland, WA, Tasmania and NT policies all endorse the avoidable cost method.<sup>3</sup> However, the NSW policy is to use fully-distributed costs under some circumstances.

*Avoidable cost* includes all costs that could have been avoided had the CSO not been provided, net of any revenue generated (CCNCO 1998). The Steering Committee considers that:

In contrast to marginal cost as the cost of an additional unit of output, avoidable cost is used practically as an average cost of a given range of output. It includes all costs associated with the provision of the given additional block of output. These include the average incremental variable costs of the extra output and the estimated additional capital costs per unit where additional capacity is associated with implementation of a CSO. (SCNPMGTE 1994, p. 17)

Any common costs that would have been incurred anyway are excluded.<sup>4</sup> Further, an allowance must be made for returns that could have been achieved if the

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<sup>3</sup> Queensland’s CSO policy does not refer directly to costing, but the avoidable cost method is adopted in the Commercialisation of Government Service Functions in Queensland: Policy Framework (Queensland Treasury 1994). No policy document is available for the ACT.

<sup>4</sup> Common costs are those which are shared by the commercial activities of a GTE and CSO provision. These could include capital and administrative costs, and other overheads.

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resources had been used commercially. Where additional capital is required, a costing should include an appropriate return on capital.

Despite general agreement on the appropriateness of the avoidable cost method, details on how to estimate it are often absent from policy statements. In particular, the treatment of capital costs, return on capital and normal profit, and common costs is not fully elaborated in many cases (box 3.2).

Under the *fully-distributed cost* method, the total cost incurred by the GTE is allocated to all its activities, including all overheads and capital costs. As such, it typically results in estimates that are larger than those produced using the avoidable cost method.

### **Box 3.2 Recognition of costing elements in policy statements**

#### **Capital costs**

The importance of including capital costs devoted solely to the provision of community service obligations (CSOs) is acknowledged in the NSW, Victorian, Queensland, WA, Tasmanian and NT policies.

#### **Return on capital and normal profit**

These costs receive the least recognition in the various policy documents. New South Wales, Queensland, Western Australia, Tasmania and the Northern Territory all mention that a return on capital should be included in costing. However, only New South Wales and Tasmania discuss the need to consider normal profit.

#### **Common costs**

There is unanimous agreement among the jurisdictions that common costs should not be included in avoidable cost. However, where there are significant common costs it may be appropriate to fund a CSO above the avoidable cost level. For example, the NSW policy states that where common costs are significant, the fully-distributed cost method should be favoured over avoidable cost. This is on the basis that unless the GTE receives compensation for these concessions the activity would no longer be commercial. For example, where concessions are provided to consumers who would still otherwise use the service, application of the avoidable cost method would shift the common cost burden onto remaining non-concession consumers. The Victorian policy also allows for departure from the avoidable cost method where there are significant common costs.

*Sources:* NSW Government (1994); NT Government (ud); Queensland Treasury (1999); SA Government (2004); Tasmanian Government (1996a, 1996b); Victorian Treasury (1994); WA Treasury (2000).

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The fully-distributed cost method might be considered to be comparatively fair as all users share the burden of fixed costs which cannot be directly allocated to one activity (SCNPMGTE 1994).

The *stand-alone cost* method evaluates what a CSO would cost if it were the only activity undertaken. This implies all common costs are attributed to the CSO, not just a share, generally resulting in an even larger cost estimate than that obtained under the fully-distributed cost method.

## Funding

Community service obligations can be funded directly through budget appropriation. Alternatively, a government could require its GTEs to internally fund CSOs and choose to accept a lower rate of return on the GTE's assets or charge higher prices for its commercial services. However, this is contrary to the agreed policy of operating GTEs on a fully commercial basis.

There is a high degree of agreement among jurisdictions that CSOs should be directly funded from the budget. The relevant policy documents from New South Wales, Victoria, Western Australia, Tasmania and the Northern Territory all advocate direct funding. Those from Queensland and South Australia do not indicate a preference.

Despite requiring additional taxation, direct funding from the budget has several advantages:

- *Efficiency* — prices for non-CSO functions can be set to reflect the cost of the commercial services supplied by the GTE. This is particularly important for economic infrastructure as the services produced are in many cases inputs into other economic activities.
- *Transparency and accountability* — the level of funding is publicly notified and subject to scrutiny in budgetary processes.
- *Equity* — following a government decision to provide a CSO, funding is sourced from general tax revenue so the cost of social policy is shared by the whole community.

Although direct funding is typically the preferred method, it is apparent that internal transfers and the acceptance of a lower rate of return continue to occur.

Internal funding occurs where the cost of the CSO is covered from GTE revenue. It distorts pricing if the CSO is funded through higher charges for GTE customers.

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Alternatively, acceptance of a lower rate of return avoids a transfer from GTE customers but reduces a GTE's own retained earnings.

It was not possible to determine the extent to which internal transfers and the acceptance of a reduced rate of return are used. Some information about CSO funding is available through the annual reports of GTEs and government budget papers, but this was insufficient. Investigating unreported CSOs was beyond the scope of this review.

An alternative to funding CSOs is to include non-commercial service provision in commercial contracts for a package of services. For example, State Transit Authority began using Metropolitan Bus System Contracts on 1 July 2005 (chapter 7). Contract payments that took into consideration costs, patronage and performance levels replaced CSO payments.

Although service contracts have the advantage of not having to cost CSOs accurately, they do not fully address the tension between government ownership and service procurement. Further, transparency can be reduced as the total contract cost obscures the cost of achieving the social objective.

## Reporting

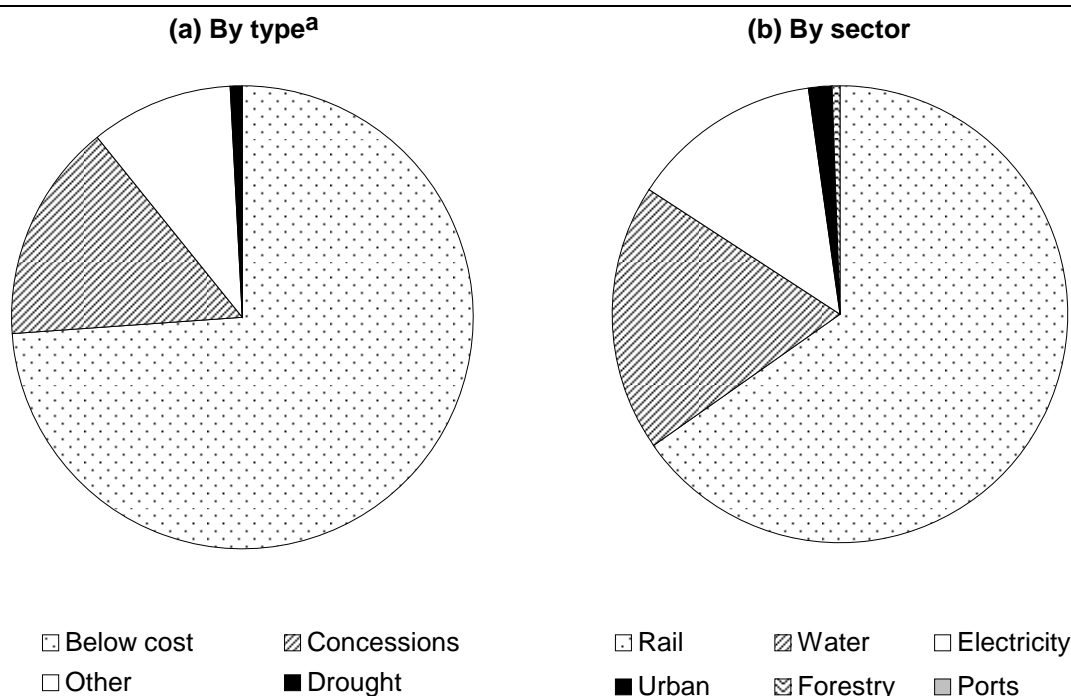
In 2002, the Commission observed that 'most GTEs did not disclose details of how CSOs were costed or arrangements relating to the payment of the CSO by government' (PC 2002a, p. 75). This continues to remain the case despite the emphasis placed on transparency in government policies. This omission cannot be excused on the grounds of transition to new arrangements with many of the policy documents discussed in box 3.1 having been in place for over ten years.

Of the 86 monitored GTEs, 40 received CSO funding in 2006-07. Three of these did not disclose the funding in their annual reports — Metro Tasmania, TransAdelaide and Western Power. Further, Dampier Port Authority stated in its 2006-07 annual report that it received CSO funding but no amount was specified.

Services provided at below cost comprised the largest proportion (73.9 per cent) of total disclosed CSO funding (figure 3.1a) in 2006-07. Funded concessions and rebates comprised 15.4 per cent. The rail and water sectors receive most of the CSO funding, with 65.2 per cent and 19.1 per cent respectively (figure 3.1b).

Drought-related CSO funding accounted for less than 1 per cent of the total. However, this funding formed a material proportion of total income for three water GTEs in 2006-07 — Goulburn–Murray Water (17.9 per cent), Grampians Wimmera Mallee Water (13.9 per cent), and State Water (2.5 per cent).

Figure 3.1 **Community service obligation payments received by monitored GTEs, 2006-07**



<sup>a</sup> **Below cost** includes payments to government trading enterprises (GTEs) that relate to the provision of an activity or service below the cost. It excludes concessions made for targeted groups. **Concessions** includes payments to GTEs that relate to the provision of concession rates for pensioners, students, and other targeted groups. **Other** includes payments to GTEs for community service obligations that do not fit into the below cost, concessions or drought categories. **Drought** includes payments to GTEs that relate specifically to drought relief.

Sources: GTE annual reports and government budget papers.

The clarity of CSO payment information in State and Territory budget papers varies considerably. Western Australia and the Northern Territory both itemise CSO payments in their budget papers. Western Australia did disclose payments to Western Power but no mention could be found of CSO payments to Dampier Port Authority. New South Wales, Victoria, Queensland, South Australia and Tasmania either aggregate CSO payments or present a combined figure with other subsidies and grants.

The NSW and SA Governments allocate a section of their budget papers to a discussion of GTEs (although this does not mention CSOs in the NSW budget papers). In addition to budget papers, the SA Government also publishes an annual ‘transparency statement’ regarding water and wastewater prices that identifies and describes individual CSO payments and the funding provided. However, this reporting does not extend to transport and forestry.

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There are many inconsistencies in the identification and funding of CSOs. Some GTEs provide CSOs but do not identify them as such. For example, the three Victorian urban water GTEs provide pensioner concessions and other rebates without labelling them as CSOs.

Similar activities performed by GTEs that may be regarded as CSOs are not consistently reported or funded as such. For example, concession rates for targeted user groups, such as pensioners, students or those living in caravan parks are provided by many electricity, rail, urban transport and water GTEs. They do not all receive CSO funding for providing these services.

Government trading enterprises can receive CSO funding for some activities but not others. Southern Rural Water acknowledged the receipt of CSO funding for pensioner concessions in its annual report. However, in its water plan (submitted to the Essential Services Commission in October 2007), it requested that pricing arrangements continue to include ‘a component in excess of the direct costs of storage, operation and maintenance’ (SRW 2007, p. 73). This excess is employed, among other things, in funding other CSOs, including the management of recreation facilities. No mention is made of these internally funded CSOs in Southern Rural Water’s annual report.

### *Costs or costing estimates*

Little information is available about the costing of CSOs, making it difficult to assess the adequacy of CSO funding. Only Darwin Port Corporation and Forestry NSW reported the costs and the associated funding that they received. Airservices Australia, Australia Post and Hobart Water just reported costs.

Cost reporting is generally limited to an aggregate amount for all CSOs or itemised against each CSO provided by the GTE. The exception is Australia Post, which publishes an avoidable cost estimate of \$97.3 million for its CSOs — funded internally within the letter service (Australia Post 2007).

The failure to report both costing and funding arrangements together is inconsistent with the emphasis placed on transparency in government CSO policies.

## **3.3 Investment and incentive issues**

Imposing inadequately funded CSOs on GTEs affects their allocation of resources. CSOs are by definition non-commercial activities that GTEs would not undertake in the absence of a requirement to do so.

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Financial losses caused by underfunded (or unfunded) CSOs lower a GTE's return on assets and can also lead to decreased cost recovery if operating expenses are increased without a corresponding increase in operating revenue (through higher than necessary customer charges). Profitability reflects a business's capacity to generate earnings from the capital invested in its activities. Low profitability is a strong indication that the community's assets are not being put to their best use. The implications of low profitability for capital management are discussed in detail in chapter 4.

An entity will only invest in infrastructure if the expected returns to investing exceed the minimum acceptable rate of return. Low earnings on existing capital could reduce expectations about the returns to new investment. Similarly, incentives for a government to fund investment could be reduced if a GTE is receiving low returns on existing assets. Moreover, the ability of a GTE to undertake investment from retained earnings is reduced.

If the GTE is being insufficiently compensated for its efforts, managers could be unwilling to devote resources to CSO provision. This is likely to cause the provision of CSOs to be under-resourced. In the short term, this could result in a deterioration of service quality and inadequate maintenance of assets used for CSO provision.

Conversely, overfunding could create an incentive for the GTE to increase the provision of the CSO beyond the government's intention. For example, if funding for the provision of concession travel is profitable for a transport GTE, it may attempt to stimulate demand among those eligible for the concession. This could cause a reallocation of resources from the commercial activities of the GTE.