



**COMMONWEALTH COMPETITIVE NEUTRALITY
COMPLAINTS OFFICE**

**COMPETITIVE NEUTRALITY INVESTIGATION
INTO PROVISION OF COUNTER TERRORIST
FIRST RESPONSE SERVICES BY THE
AUSTRALIAN PROTECTIVE SERVICE**

**REPORT NO. 1
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The Commonwealth Competitive Neutrality Complaints Office

The Commonwealth Competitive Neutrality Complaints Office is an autonomous unit within the Productivity Commission. It was established under the *Productivity Commission Act 1998* to receive complaints, undertake complaints investigations and advise the Treasurer on the application of competitive neutrality to Commonwealth Government activities.

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Abbreviations

AAA	Airports Association of Australia
AFP	Australian Federal Police
APS	Australian Protective Service
BAD	Bank Accounts Duty
BARA	Board of Airline Representatives of Australia
CCNCO	Commonwealth Competitive Neutrality Complaints Office
CPA	Competition Principles Agreement
CTFR	Counter Terrorist First Response
EBIT	Earnings Before Interest and Tax

1 The complaint

1.1 Competitive neutrality

Competitive neutrality is a policy which aims to promote efficient competition between public and private businesses. It seeks to ensure that significant government businesses do not have net competitive advantages over their private competitors simply by virtue of their government ownership. The Commonwealth and all State and Territory Governments have agreed to implement this policy as part of their commitment to the National Competition Policy Reform Package.

The Commonwealth's approach is outlined in its 1996 *Competitive Neutrality Policy Statement*. Competitive neutrality automatically applies to Commonwealth Government Business Enterprises, share-limited trading companies and designated Business Units. Application to other businesses is assessed on a case-by-case basis.

The Commonwealth's competitive neutrality arrangements require that applicable government business activities: charge prices that reflect their full costs of production; incur costs for government taxes and charges; pay commercial rates of interest on borrowings; generate commercially acceptable returns; are not (dis)advantaged in performing 'non-commercial' activity at the direction of the Government; comply with regulations that apply to private businesses; and are accountable for their commercial performance.

The Commonwealth Competitive Neutrality Complaints Office is located within the Productivity Commission and is responsible for administering the Commonwealth's competitive neutrality complaints mechanism. The Office can receive complaints from individuals, private businesses and other interested parties about Commonwealth business activities. Complaints and investigations can cover three broad forms: that an exposed government business is not applying competitive neutrality requirements; that the requirements — although complied with — are not effective; or that particular government activities which have not been exposed to competitive neutrality, should be.

1.2 Nature of the complaint

The Australian Protective Service (APS) is a Division within the Commonwealth Attorney-General's Department. Among other functions, it provides Counter Terrorist First Response (CTFR) services at 11 major Australian airports. The purpose of CTFR is to deter terrorist attacks at airports and make a first response in the event of an attack. It involves patrols by a uniformed and armed security force at airport passenger terminals and on the regular public transport apron areas whenever larger aircraft are loading and unloading. CTFR is separate from other security measures such as normal community policing at airports and the electronic security screening of passengers and hand baggage in the terminal areas. It has been government policy that the APS supply all CTFR services (except at Canberra airport where the Australian Federal Police provide CTFR).

In 1998, the APS increased its charges for CTFR in order to comply with competitive neutrality policy. According to the APS, charges have increased by about 5 per cent, or on average \$2.60 per person hour.

On 24 September 1998, the Board of Airlines Representatives of Australia (BARA) wrote to the CCNCO claiming that the APS should not apply competitive neutrality policy to its charges for delivery of CTFR services at airports. On 28 September 1998, the Airlines Association of Australia (AAA) wrote to the CCNCO making the same claim.

BARA and the AAA contend that the supply of CTFR services does not qualify as a business for the purposes of competitive neutrality because there is no actual or potential competitor to the APS for the delivery of those services, and airports cannot choose the level of service they purchase or the provider.

The complainants also claim that the Commonwealth should fund any increased costs arising from the requirement that the APS provide CTFR services. More broadly, they contend that the APS should have to compete for CTFR contracts against other law enforcement agencies and/or private security companies that have the necessary competence and fulfil the statutory requirements for CTFR coverage. In these circumstances, the complainants consider that they would be able to acquire CTFR services at lower cost.

The letters from BARA and the AAA to the CCNCO are attached at appendix A.

1.3 Role of the CCNCO

This complaint is concerned primarily with whether competitive neutrality should apply to the CTFR function. In deciding to investigate this complaint, the Office is satisfied that the complaint:

- is not better handled by another body;
- does not relate to competitive neutrality policies that are being finalised or are currently the subject of review by government; and
- raises issues of substance and with non-trivial resource allocation effects.

The primary role of the CCNCO in this instance is to assess:

- whether competitive neutrality should be applied to CTFR; and, if so
- whether competitive neutrality has been implemented appropriately. This involves assessing the costing of CTFR services by the APS.

However, the complainants also raise two broader issues about the cost base to which the APS should apply competitive neutrality. Firstly, BARA and the AAA claim that allowing private operators to supply CTFR services in competition with APS would reduce the costs to airports and airlines. Secondly, they contend that, if government provision of CTFR services is necessary on wider public interest grounds, part of the cost should be funded from general revenue to reflect the benefits accruing to the wider community.

While the decision as to who should be allowed to provide CTFR functions involves policy issues which go well beyond competitive neutrality considerations, this investigation has provided a number of perspectives on the question of who should pay for CTFR services. These are canvassed in section 2.4.

2 Issues and Discussion

2.1 Background

The Australian Protective Service was formed in 1984 to perform a range of protective security functions previously undertaken by the Australian Federal Police (AFP). These functions now comprise a range of non-contestable core services and some contestable business activities. According to the APS, core services include CTFR and providing protective security at:

- the residences of the Governor-General, Prime Minister and office of the Prime Minister;
- Parliament House in Canberra;
- sensitive establishments, including the Australian/US Joint Defence Facilities at Pine Gap and Nurrungar, the Australian Nuclear Science and Technology Organisation facilities, and Maralinga (the former atomic weapons testing site);
- offices and residences of higher office holders when required; and
- some foreign diplomatic missions.

These services are funded from user charges.

The APS's fully contestable services are provided to Commonwealth agencies and areas of Commonwealth interest in competition with the private sector. They include:

- establishment security and access control;
- security and fire alarm monitoring;
- escorts of valuable and sensitive property;
- protective security risk consultancy services;
- APS training services; and
- bomb appraisal and explosive detection dogs.

These fully contestable services provide only 1 per cent of the APS's revenue.

While the APS considers CTFR to be a core service, it is not readily classifiable to either group. State or Territory police forces and the AFP can now compete to provide these services (see below).

Private operators are excluded from providing CTFR services under Air Navigation Regulations of the *Air Navigation Act 1920*. These regulations require that members of a CTFR force have a power of arrest equivalent to that specified in the *Australian Protective Service Act 1987*. This limits potential CTFR providers to the APS, the AFP or a State and Territory police force.

Previous Commonwealth Government policy has been that the APS provide the service under cost-recovery arrangements (with the exception of Canberra Airport). However, in 1997, a Working Group consisting of representatives from the Department of Transport and Regional Development, the Attorney-General's Department, airlines, airport owners and the Federal Airports Corporation undertook a review of the CTFR function. As a result of the review, the Minister for Transport has advised airports that individual State or Territory police forces and the AFP will also be allowed to supply CTFR services.

Significance of CTFR to the APS

CTFR is one of the APS's larger functions. CTFR services are provided at 11 airports, and involve a total staff of around 250. Total revenue from CTFR is around \$18 million, which is about one quarter of the APS's total revenue.

The APS levies charges on airport operators for CTFR services. Under the *Prices Surveillance Act 1983*, airports can pass on up to 100 per cent of the charge to airline operators. At most airports, airlines pay all CTFR costs. However, at one airport, airlines have been levied for only 75 per cent of the CTFR costs, with the other 25 per cent collected from other airport users. The ACCC has a role to ensure that charges to airlines comply with the Prices Surveillance Act.

2.2 Should CTFR be exposed to competitive neutrality?

BARA and the AAA contend that the CTFR service does not constitute a business activity and that it is, therefore, inappropriate to apply competitive neutrality charges.

The Commonwealth Competitive Neutrality Policy Statement defines an activity as a business if:

-
- there is user charging for goods and services;
 - there is an actual or potential competitor (in the public or private sector); and
 - managers of the activity have a degree of independence in relation to the production or supply of the good or service and the price at which it is supplied.

The APS's CTFR activity clearly meets the first and third criteria. With respect to the second criterion, the Government's decision to allow state and territory police forces and the AFP to provide CTFR services means that the APS now faces potential competition. The CCNCO understands that one major airport has put its CTFR contract to tender and the police force in that State has expressed interest in supplying CTFR services.

In any event, the Commonwealth Government has decided that agencies supplying contestable and non-contestable 'commercial' services should apply competitive neutrality to both areas of activity. The objective of this policy is to ensure that agencies do not subsidise competitive services from their non-contestable commercial operations. This policy decision effectively renders redundant any debate on whether CTFR is a business activity.

The APS was made aware of this policy by the Commonwealth Department of the Treasury in March 1998, and it underpins APS's application of competitive neutrality to CTFR. The CCNCO understands that the Government intends to provide further details on this policy in its forthcoming annual report to the National Competition Council on progress with implementing the Competition Principles Agreement.

Aside from the policy's objective of preventing cross-subsidies between activities, the CCNCO considers that there are a number of benefits in applying competitive neutrality to CTFR:

- it makes the cost of the resources devoted to CTFR explicit and hence allows policy decisions about CTFR to be made in the full knowledge of those costs; and
- it will assist the introduction of efficient competition if police forces chose to enter the market (State Government's are also committed to implementing competitive neutrality for their business activities).

The policy is also consistent with general public sector reforms, such as accrual accounting and applying capital charges to agency's assets to make the full resource cost of providing services transparent.

In view of these considerations, the CCNCO recommends that competitive neutrality should continue to be applied to the APS's CTFR function.

2.3 Has competitive neutrality been appropriately applied to CTFR?

Assessing whether the APS's CTFR activity complies with competitive neutrality raises two issues predominantly related to the costs of providing the service. These are:

- ensuring that CTFR charges are not subsidising, or being subsidised by, other APS services — that is, establishing that the base cost of the CTFR function is appropriate; and
- ensuring that the APS has made the right adjustments to its costs and prices to offset any net advantages conferred on it by government ownership.

Base level of CTFR costs

For an agency like the APS that provides a range of activities, competitive neutrality requires that costs — particularly indirect costs and overheads — are allocated appropriately across individual activities. To achieve this, an agency must know what its costs are, and have an appropriate method to allocate those costs across individual activities.

The APS has operated on an accrual accounting basis since 1991. For CTFR, it prepares monthly profit and loss statements for each airport which identify all direct labour costs and direct administration and operations costs. The APS then allocates National Headquarters costs and other overheads to airports based on the numbers employed in CTFR as a proportion of total APS staff. It follows the same method for allocating overheads to its other contestable and non-contestable services.

The allocation of joint costs between activities — such as head office costs, computer service charges and overheads — is often difficult and somewhat imprecise. In many instances it is possible to justify allocating such costs in a number of different ways which, while consistent with competitive neutrality principles, may imply different levels of charges (see CCNCO 1998 for a discussion of cost allocation methods).

In the APS's case, most of its services are not provided in competitive markets. In the absence of competition to guide how services are priced, full distribution of

overheads to services on a *pro-rata* basis as adopted by the APS is an appropriate method for costing services.

The Office is, therefore, satisfied that the APS has an appropriate financial management system, and has allocated costs in a way that is consistent with competitive neutrality requirements.

Competitive neutrality charges

The APS is exempt from a range of Commonwealth and State input taxes including financial institutions duty, payroll tax, sales tax and bank accounts debits (BAD) tax that would normally apply to commercial operators. The APS is also exempt from explicit rate of return targets. To offset these competitive advantages, the APS has increased its charges for CTFR by a little over of \$1.0 million, as a result of the adjustments shown in table 2.1.

Table 2.1 **Adjustments to CTFR charges for competitive neutrality**
(\$)

<i>Adjustment</i>	<i>Total for 11 airports</i>
<i>For input taxes exemptions</i>	
Payroll tax	495 100
Sales tax	12 700
Financial Institutions Duty	11 600
Bank Accounts Debits tax	10 900
<i>Other adjustments</i>	
Interest payment	51 300
Company tax	351 800
Competitive neutrality adjustment for taxes etc on CTFR share of overheads	115 500
Total	1 050 000

Source: APS

Specifically, the APS has estimated the impact of each input tax at individual airports to account for differences in the tax rates between States. It has also made an adjustment for the taxes that would apply to the CTFR share of corporate overheads, and an allowance for corporate tax and interest on imputed debt.

The APS has demonstrated to the Office that its calculation of input tax charges complies with competitive neutrality.

Competitive neutrality also requires government business activities to pay company tax (or an equivalent payment) and a commercial rate of interest on borrowings. However, there appears to be an element of double counting in the adjustments the APS has made for corporate tax and interest. The adjustments for corporate tax and interest relate to the distribution of profits, or the cost of capital. The cost of the capital is the level of profits that a business must earn to provide a commercial return to its owners and service its debts. If a business earns a commercial rate of return on its assets, it will meet its cost of capital.

The APS does not have a specific rate of return target. However, in 1997-98, in the absence of the competitive neutrality adjustments, CTFR generated earnings before interest and tax (EBIT) of between \$700 000 and \$800 000. This translates to a return on assets of over 10 per cent. In the Office's view, this is a commercial return for an activity with relatively low risk.

Interest represents a return to debt holders and is deducted from the EBIT. Similarly, corporate tax is also paid as a percentage of pre-tax profit (EBIT less interest, after abnormals). If the APS achieves a commercial level of profit, as measured by EBIT, it will generate enough funds meet these commitments. Thus, as long as CTFR generates a commercial rate of return, these additional adjustments for corporate tax and interest are unnecessary to comply with competitive neutrality.

The CCNCO recommends, therefore, that so long as the APS sets charges to earn a commercial rate of return, it remove its adjustments for corporate tax and interest from its competitive neutrality charges. The impact of this recommendation would be to reduce the *additional* charges for CTFR imposed by the APS to comply with competitive neutrality by between 40-45 per cent (a direct reduction of \$403 000 and a substantial reduction in the overhead charge).

The APS has indicated that it included these charges based on its interpretation of its obligations described in *Commonwealth Competitive Neutrality — Guidelines for Managers* (Commonwealth Treasury 1998), and that it is amenable to removing these charges if they are unnecessary.

The CCNCO suggests that in its regular policy advice to agencies and when next reviewing the guidelines, the Commonwealth Treasury seek to remove any scope for misinterpretation in this area.

2.4 Broader issues relating to the cost base

As noted, the complainants raise two broader issues related to the size of the cost base for the APS's CTFR services. Firstly, BARA and the AAA claim that, were

competition from private operators allowed, the cost of CTFR would fall. This implies that the CTFR cost base is higher than it would be if there were no restriction on competition. Secondly, they contend that if the Commonwealth decides that CTFR can only be provided by the APS, AFP or State police forces, then funding should come from government to cover any extra costs that result.

On the first issue, the CCNCO considers that the decision to restrict the provision of CTFR to the APS or police forces is properly a matter for the Commonwealth to make, and not an issue for this investigation. However, the reasons underlying this policy are important to the second issue of who should pay for CTFR. In particular, *if* one of the reasons is that the Government considers that the policy results in wider benefits to the community, there may be a case for taxpayers meeting some of the cost of providing CTFR services.

Based on the primary duties performed by APS officers at airports, CTFR can be viewed as a regulation or community standard designed to protect airline passengers and airport and airline assets. Thus it appears that the *majority* of CTFR benefits are confined to airports (see box 2.1). In this context it needs to be recognised that responsibility for preventing the illegal entry of people and goods (arms, explosives etc) that might lead to criminal activity in parts of Australia other than airports themselves is primarily the responsibility of other agencies rather than the CTFR provider (eg customs and immigration officials).

The fact that the CTFR function is restricted to government providers does not necessarily conflict with the view that the main beneficiaries are at airports. It may be that only officers of the state can effectively perform the CTFR function. As the Working Group Report stated (DOTARD 1998, p.37):

... there is an issue of whether in situations where a power of arrest, the use of coercive force and the expectation that [gun] fire would be returned as a last resort, is appropriate for a private sector firm operating on an airport.

If police-like powers are necessary to perform the CTFR function, it follows that the police or the APS provision of CTFR is simply a necessary part of the regulation to protect airport users and airports. If this was the sole basis for 'police' undertaking the function, it would be appropriate that airports and users pay for the full costs of that function.

Box 2.1 Duties performed under CTFR

CTFR (a uniformed and armed security force) performs two primary roles at airports: response and deterrence.

The CTFR force responds to any act of unlawful interference with aviation. To allow a rapid response, the CTFR force patrols the passenger terminal buildings servicing large aircraft and the regular public transport apron areas.

The deterrence function is also fulfilled by patrols. Deterrence is predicated on the visibility of the force, which is a function of the number of patrolling officers, together with the frequency of patrols.

The main purpose of the CTFR forces response and deterrence capability is to protect aircraft, passenger bags, cargo and the passengers from attack.

Source: DOTARD 1998

However, another view is that the main reason the Commonwealth has restricted provision of CTFR services to officers of the state is because of its importance to national security. As the Working Group report (DOTARD 1998, p.4) noted in relation to the original decision to have the APS provide CTFR services:

There was a belief that it was not appropriate for the CTFR function to be performed by a non-Government agency because of the importance of the function to national security.

The inclusion of CTFR in the National Anti-Terrorist Plan lends some support to this view. The Government *may* consider there are benefits from having the police or APS provide CTFR so it can be fully integrated with other elements of anti-terrorist deterrence.

In these circumstances it could be argued that the wider community derives benefits from having CTFR at airports provided by officers of the state rather than the private sector. *If* this is the case, it would be appropriate for the Commonwealth Government to meet any additional costs that result from the present restrictions that limit the provision of CTFR to the APS, AFP or state/territory police forces.

It is difficult to determine which view underpins the Government's policy. A statement of the Government's reasons for restricting the provision of CTFR to the APS or police forces would clarify whether or not all of the costs of CTFR services should be recovered from airport users.

2.5 Recommendations and findings

The CCNCO recommends that:

- competitive neutrality charges continue to be applied to the APS's CTFR function;
- APS charges not include an additional component for interest and corporate tax. So long as the APS continues to achieve a commercial rate of return (pre-tax) on its CTFR activity, its charges are sufficient to meet capital costs and, accordingly, already includes capacity to meet interest and corporate tax obligations; and
- when next reviewing *Competitive Neutrality — Guidelines for Managers*, and in its regular policy advice to agencies, the Commonwealth Treasury seek to remove scope for misinterpretation over adjustments to agencies' prices for corporate tax and interest payments.

The CCNCO draws attention to its comment that a statement of the Government's reasons for restricting the provision of CTFR to the APS or police forces would clarify whether or not all of the costs of CTFR services should be recovered from airport users.

References

Commonwealth Government 1996, *Competitive Neutrality Policy Statement*, June

CCNCO (Commonwealth Competitive Neutrality Complaints Office) 1998, *Cost allocation and pricing*, CCNCO Research Paper

DOTARD 1998, *Working Group Review of Counter Terrorist First Response Function*, (Report not available for public distribution)

Commonwealth Treasury 1998, *Commonwealth Competitive Neutrality — Guidelines for Managers*

A Complaints letters

Letters of complaint from the Board of Airline Representatives of Australia Inc (24 September 1998) and the Airports Association of Australia (28 September 1998) follow.

B Consultations

In preparing this report, the CCNCO held discussions with:

- Board of Airline Representatives of Australia;
- Airports Association Australia;
- Australian Protective Service;
- Aviation security Branch of the Department of Transport;
- The Protective Security Coordinating Committee within the Attorney-Generals Department; and
- Commonwealth Treasury.

In addition, the CCNCO wrote to State Police forces, the AFP and airports that are not members of the AAA seeking views on the complaint. As at 21 December 1998, replies had been received from:

- Sydney Airport;
- Northern Territory Airport Limited;
- Australian Airports Limited (Townsville Airport);
- Australian Federal Police;
- Northern Territory Commissioner of Police; and
- Tasmanian Commissioner of Police.

References

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