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The Treasury

Department of Finance and Administration

Australian Government Competitive Neutrality Guidelines for Managers

February 2004

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**Australian Government Competitive
Neutrality Guidelines for Managers**

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GLOSSARY

Agency	Includes both a <i>Financial Management and Accountability Act 1997</i> agency (FMA Act agency) and <i>Commonwealth Authority and Companies Act 1997</i> body (CAC Act body).
Australian Government Competitive Neutrality Complaints Office (AGCNCO)	The AGCNCO (formerly the Commonwealth Competitive Neutrality Complaints Office) has been established within the Productivity Commission to receive complaints, undertake complaint investigations and provide independent advice to the Treasurer on the application of competitive neutrality (CN) to Australian Government business activities.
Avoidable cost (AC)	The cost that could be avoided by an entity in the absence of a specific activity.
Baseline costs	The cost of providing a service by the Agency market testing its services.
Business Operation	A Business Operation (as referred to in suborder 6.2.1 of the <i>Financial Management and Accountability Orders 1997</i>) is a separate activity within a <i>Financial Management and Accountability Act 1997</i> (FMA Act) agency. It is distinct in an accounting, but not a legal sense, and may have access to a Special Account, established by the Finance Minister under the FMA Act, or by another Act, or its own source of revenue through section 31 agreements under the FMA and Appropriation Acts.
Business Unit	All Business Operations are, for the purposes of CN, considered to be Business Units to the extent that the activities undertaken are commercial in nature. A Business Unit is an identifiable part of an FMA Act agency or Department that has a primary objective of trading goods and services in the market, for the purpose of earning a commercial return. The management and accounting structures of a Business Unit are separate from other parts of the overall organisation.
Cash Accrual Management Module (CAMM)	This IT system is used for the drawing down of appropriations into Agency bank accounts and to record deposits and transfers to the Official Public Account (OPA).
Commonwealth Authorities and Companies Act 1997 (CAC Act)	The CAC Act sets out the reporting, accountability and auditing requirements of Commonwealth Authorities and Companies (CAC Act bodies) which are legally separate entities from the Commonwealth.

Commonwealth Authorities and Companies Act 1997 body (CAC Act body)	A Commonwealth Authority and a Commonwealth Company are both CAC Act bodies.
Commonwealth Authority (previously referred to as a Statutory Authority)	A Commonwealth Authority is legally and financially separate from the Commonwealth. As such, it is an authority established by legislation, is a body corporate and holds money on its own account. A Commonwealth Authority is governed by the CAC Act, and is referred to as a CAC Act body.
Commonwealth Company (previously referred to as a Commonwealth Share-Limited Company)	A company established under the <i>Corporations Act 2001</i> in which the Commonwealth has a controlling interest. However, it does not include a company in which the Commonwealth has a controlling interest through one or more interposed Commonwealth Authorities or Commonwealth Companies. A Commonwealth Company is governed by the CAC Act, and is referred to as a CAC Act body.
Commonwealth Competitive Neutrality Policy Statement (CN Policy Statement)	The CN Policy Statement issued by the Australian Government (the Government) in June 1996.
Community Service Obligation (CSO)	<p>A CSO arises when the Government requires a business to carry out activities or processes:</p> <ul style="list-style-type: none"> - that the organisation would not elect to do on a commercial basis or that it would only do commercially at higher prices; and - that the Government does not, or would not, require other organisations in the public or private sector to undertake or fund. <p>If an organisation wishes to have an activity recognised as a CSO, it must be explicitly directed to carry out the activity on a non-commercial basis by legislation, Cabinet decision or publicly available (e.g. included in annual report) direction from shareholder Ministers.</p>
Competition Principles Agreement 1995 (CPA)	The agreement through which all Australian governments committed to the implementation of CN.
Debt	Non-equity capital provided to a business by a third party, often a bank.
Department of State	Legally part of the Commonwealth, a Department of State is established by the Governor General under section 62 of the Constitution. Governed by the FMA Act and referred to as an FMA Act agency.
Equity	Capital invested in a business attributable to the owners of the business.
Finance	Department of Finance and Administration.

Financial Management and Accountability Act 1997 Agency (FMA Act Agency)	Departments of State, Parliamentary Departments and Prescribed Agencies. These are all legally part of the Commonwealth, and are governed by the FMA Act.
General Government Sector (GGS)	The primary function of this sector is to provide public services which are mainly non-market in nature, are mainly for the collective consumption of the community, or involve the transfer or redistribution of income, and are financed mainly through taxes and other compulsory levies.
Government Business Enterprise (GBE)	A GBE is either a Commonwealth Authority or a Commonwealth Company prescribed by the regulations under the CAC Act.
Market testing (previously referred to as Competitive Tendering and Contracting)	The market testing process involves inviting tenders for the provision of relevant services and evaluating those tenders against predetermined selection criteria.
Net present value	A financial method for capturing the current value of future cash flows.
Non-profit company	A publicly owned company that is not carried on for the purposes of profit or gain to its individual members and is, by the terms of the company's constituent document, prohibited from making any distributions, whether in money, property or otherwise, to its members. (section 3, <i>Income Tax Act 1986</i>).
Official Public Account (OPA)	The Official Public Account is the Government's central bank account.
Parliamentary Department	Parliamentary Departments are legally part of the Commonwealth and are FMA Act agencies by virtue of section 5 of the FMA Act.
Prescribed Agency (previously referred to as a Statutory Authority)	A body, organisation or group of persons prescribed by regulation under the FMA Act. Governed by the FMA Act, this is an FMA Act agency, and is legally part of the Commonwealth.
Public sector bids	Refers to bids for a tender from government businesses.
Statutory Authority	Replaced with Prescribed Agency, under the FMA Act, and Commonwealth Authority, under the CAC Act.

ACRONYMS

AC – Avoidable cost

AGCNCO – Australian Government Competitive Neutrality Complaints Office (formerly CCNCO)

CAC Act – *Commonwealth Authorities and Companies Act 1997*

CAMM – Cash Accrual Management Module

CCNCO – Commonwealth Competitive Neutrality Complaints Office (now AGCNCO)

CGT – Capital gains tax

CN – Competitive neutrality

CN Policy Statement – *Commonwealth Competitive Neutrality Policy Statement (1996)*

CSO – Community Service Obligation

FBT – Fringe benefit tax

FDC – Fully distributed cost

FMA Act – *Financial Management and Accountability Act 1997*

GBE – Government Business Enterprise

GGs – General Government Sector

GST – Goods and services tax

NCP – National Competition Policy

OPA – Official Public Account

RBA – Reserve Bank of Australia

RoA – Return on assets

RoR – Rate of return

TER – Tax Equivalent Regime

TNA – Tax Neutrality Adjustment

WACC – Weighted Average Cost of Capital

1. Background

The Australian Government (the Government) is committed to accountable and transparent administration and the efficient allocation and utilisation of public resources. One way to realise this commitment is to apply competitive neutrality (CN) policy to government business activities¹.

CN requires that government business activities not enjoy a net competitive advantage over competitors by virtue of their public ownership. CN applies to significant business activities, provided the benefits of applying CN outweigh the costs.

1.1 A Short History

The origins of CN go back to 1993 when the report by the Independent Committee of Inquiry, *National Competition Policy* (the Hilmer Report), proposed principles for a National Competition Policy (NCP) framework. In April 1995, the Council of Australian Governments considered the report's recommendations.

A key outcome of that meeting was the *Competition Principles Agreement* (CPA) signed by all Australian governments and committing them to, *inter alia*, applying competition principles to government activities. The CPA provided the background for the development of the Government's *Commonwealth Competitive Neutrality Policy Statement* (CN Policy Statement), released in June 1996.

In brief – CN Objective

The central tenet of CN is that government business activities not enjoy net competitive advantages over their private sector competitors (or potential competitors), simply by virtue of their public sector ownership.

¹ The term 'Government' – for the purposes of these Guidelines – refers to the Australian Government.

1.2 Overview

This guide will provide you with practical guidance on:

- Assessing whether CN applies to your business activities;
- What your CN obligations may be and what adjustments may need to be made;
- How those adjustments may be applied, and when a particular approach may be more suitable than another; and
- What is required when reporting on your CN compliance.

CN applies to a diverse range of business activities across the public sector. These Guidelines are designed to provide guidance, not prescriptive step-by-step instructions for every possible scenario. In circumstances where it is possible, a detailed approach has been documented to assist you to comply with CN. More often, however, the Guidelines will explain the expected approach to interpreting CN policy and provide examples for your information.

Ultimately, the practical decisions on exactly how to apply CN to your business will be a matter of discretion for your agency and your responsible Minister. Portfolio Ministers have responsibility for ensuring that CN arrangements are implemented for all business activities within their portfolio.

Agencies should be aware of the issues raised in these Guidelines and take steps to assess obligations and undertake any adjustments that may be required.

Interested parties can lodge complaints with the Australian Government Competitive Neutrality Complaints Office (AGCNCO, formerly the Commonwealth Competitive Neutrality Complaints Office) if they consider that a government business activity is not complying with its CN obligations.

These Guidelines provide you with assistance on how to implement and substantiate any decisions you make regarding CN. This will reduce the risk of a complaint being upheld by the AGCNCO against you and will help you to respond to any question posed by the AGCNCO, should a complaint be made.

2. Policy

2.1 Why Competitive Neutrality?

Government businesses compete with the private sector in a number of ways and in a variety of markets. Government ownership of a business may result in advantages to that business which are not available to the private sector, impeding the ability of the private sector to compete on equal terms.

Advantages to government businesses may include:

- exemptions from taxes, for example income tax, payroll tax, land tax and stamp duty;
- cheaper debt financing, because governments may benefit from low-risk classification or implied or explicit government guarantees, leading to lower borrowing costs;
- the absence of any requirement to make a commercial rate of return (RoR) on assets; and
- exemptions from regulatory constraints or costs, for example planning and environmental regulation.

When you are conducting a government business activity and charging for a service or product, these advantages may translate into lower costs, and therefore lower prices. As a result, your business may operate with a cost advantage that is not available to private sector competitors.

The aim of CN is to offset competitive advantages (resulting from government ownership), enabling a comparable basis for competition between a government business's activities and those of its competitors. CN only applies to significant business activities of agencies. It does not apply to non-business, non-profit activities.

While non-profit entities are not subject to the requirements of CN, it is important to note the distinction between entities that are "non-profit" and "not profitable". Entities that fall under the latter category are not necessarily "non-profit". Entities cannot exempt themselves from CN requirements purely on the basis that they are "not profitable". To be exempt, non-profit entities must be legally required or directed by the Government to operate on a "non-profit" basis.

2.2 What is the impact of Competitive Neutrality?

In brief – Benefits of Competitive Neutrality

- Offsetting net competitive advantages of the public sector over the private sector that result from government ownership;
- Ensuring public resources are used as efficiently as possible;
- Improving the overall performance of government businesses;
- Improving transparency and accountability of government businesses, presenting costs in a way that enables comparison to the private sector; and
- Providing a better basis for agency managers to assess the mode of delivery for government business activities.

CN requires that significant government businesses price their goods and services on a comparable basis to private sector organisations. This involves:

- identifying costs attributable to the business activity; and
- setting prices that take into account all relevant costs (including allowances for a commercial RoR) that would apply to private sector competitors.

Important things to remember about competitive neutrality policy

- CN is only concerned with offsetting net competitive advantages that government business activities enjoy over their private sector competitors simply by virtue of public sector ownership. A key factor is the cost base used to set the price for your business outputs.
- CN does not consider (nor is it concerned with) efficiency issues which are inherent in all competitors – such as differences in size, skills, equipment, managerial competence or culture.
- CN does not require you to restructure the delivery of social programs into competitive market-based mechanisms. However, if you do choose to adopt these service delivery mechanisms, with the involvement of a government service provider, then CN will apply.
- CN does not require you to remove Community Service Obligations (CSOs) from your business. However, if CSOs exist, they should be transparent, appropriately costed, and directly funded by government.

- CN does not imply that your business cannot be successful in competition with private businesses. Your business can achieve success as a result of its own merits and intrinsic strengths, but not as a consequence of advantages flowing from government ownership.
- CN does not promote public or private ownership. It is neutral with respect to the nature and form of ownership of business enterprises.

2.3 Key Agencies

Agencies with key roles in the implementation of CN are Finance, the Treasury and the AGCNCO. Each of these agencies can assist with the implementation of CN policy.

Department of Finance and Administration

The CN Policy Statement gives Finance an advisory role in respect of agencies' implementation of CN arrangements. This is in addition to its role in maintaining an effective CN payments system.

Agencies complete annual CN surveys and provide their responses to Finance. Treasury also uses this information to prepare the Australian Government National Competition Policy Annual Report.

The Treasury

The Treasury advises the Treasurer on CN policy issues, reflecting the Treasurer's Ministerial responsibility for competition policy matters. Treasury also prepares the Australian Government National Competition Policy Annual Report which includes CN reporting material.

Australian Government Competitive Neutrality Complaints Office

The AGCNCO is an autonomous unit within the Productivity Commission. It was established by the Government under the *Productivity Commission Act 1998* to receive complaints, undertake complaints investigations and advise the Treasurer on the application of CN to government business activities.

Interested parties are able to lodge complaints with the AGCNCO against a government business activity in which the Government has an ownership interest.

The main role of the AGCNCO is to receive and investigate complaints. The AGCNCO will make reference to the issues outlined in these Guidelines when deciding whether the activities subject to a complaint need to apply CN arrangements or vary the manner in which those arrangements may already be applied.

Those contemplating making a complaint are encouraged to discuss their concerns with the government business involved and/or the AGCNCO. This will help to clarify whether the concerns fall within the scope of CN policy and may allow for the resolution of matters without the need for a formal investigation.

Formal complaints must be lodged in writing, preferably using the Competitive Neutrality Complaint Form available from the AGCNCO, and staff are available to discuss the preparation of a complaint.

The AGCNCO has produced a range of useful research papers (listed under Section 9.3 of these Guidelines) that can help you understand the application of CN, particularly on cost allocation, pricing and RoR. These papers should help you to assess what you need to do to avoid a complaint being upheld against you.

If a complaint is made, then these research papers will provide an insight to the processes applied by the AGCNCO to assess your pricing decisions. The AGCNCO may also refer to these Guidelines and other documents to determine your compliance with CN.

The AGCNCO also provides advice to agencies' managers on the application of CN policy to their business activities.

3. Are You Subject to Competitive Neutrality?

CN applies to significant government businesses, but only to the extent that the benefits of the arrangements outweigh the costs. A number of entities are automatically considered significant, for example, Government Business Enterprises (GBEs). For further information refer to Section 3.2.

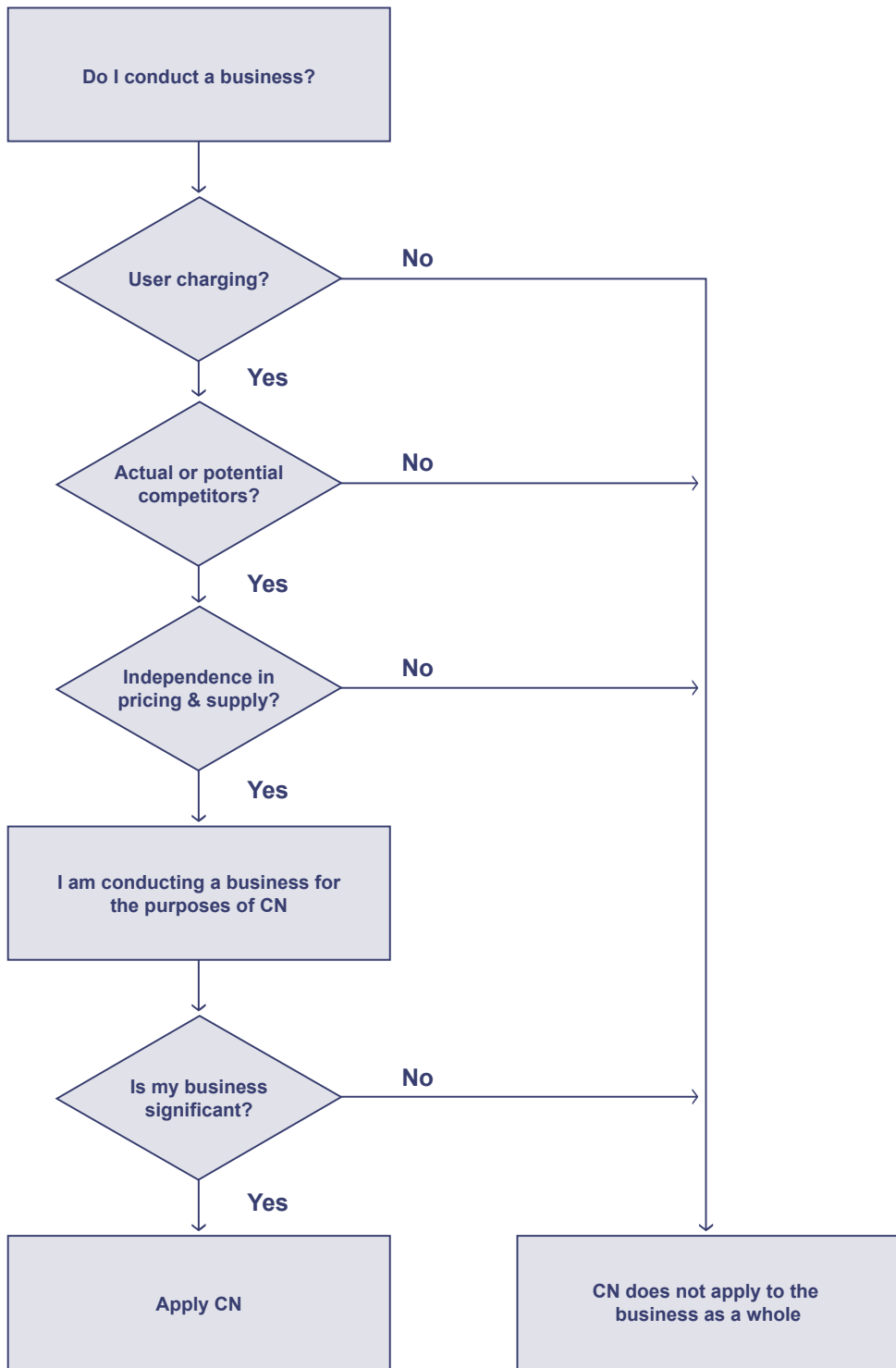
For those not in these groups, it is important that you assess whether you need to apply CN, as any interested party is able to lodge a complaint with the AGCNCO alleging non-compliance. Once a complaint is made, it will be assessed and possibly investigated by the AGCNCO.

The key questions are:

- 1 Am I conducting a business?; and
- 2 Is the business significant?

These issues are discussed in the following sections of these Guidelines.

The following flow chart gives an overview of the questions that you must answer when deciding if CN applies to you. Each step is explained in more detail below.



3.1 Am I Conducting A Business?

Managers need to consider whether they meet the test for a business activity for the purposes of CN.

How do you tell whether you are conducting a business? Activities are classified as a business for the purposes of CN if they meet the following criteria:

1. there must be charging for goods or services (not necessarily to the final consumer);
2. there must be an actual or potential competitor (either in the private or public sector) i.e. purchasers are not restricted by law or policy from choosing alternative sources of supply; and
3. 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 provided.

If you answer **YES** to all these questions, then you are conducting a business and need to consider whether it is a significant business for the purpose of CN.

Charging for goods or services

Do you charge for your goods or services?

Usually, it will be obvious where your activities involve selling a product or service. Note, however, that charging might be considered to exist in less easily identified circumstances, for example, where activities receive licence or membership fees for the services they provide.

If you do not charge for your goods or services, then CN will not apply.

The business test criteria operates to exclude from CN those government functions which are Budget-funded service delivery activities where there is no distinction between the purchaser and provider of the service. For example, notional charging of Budget-funded corporate support or other services is not considered to be charging for the purposes of CN. Where an agency decides to market test its corporate services, its baseline costs should notionally include all relevant CN adjustments.

Common Questions

- Q.** We sell technical publications to the public but don't even cover our costs. Does this count as charging for goods or services?
- A.** Yes.
- Q.** We collect fees (or levies) on behalf of an industry body and keep them in a Special Account before transferring them to the industry body's bank account. Does this count as charging for goods or services?
- A.** No. If you are not charging purchasers, or the industry body, for the work you are doing then this does not count as charging. However, if the Commonwealth has an ownership interest in the industry body then this would count as charging on behalf of the industry body. In this case further investigation should be undertaken to determine whether CN may apply to the industry body.

Internal Charging

- Q.** We provide corporate services to line areas of our department and notionally charge an amount to their budget for these services. Is this charging for goods or services?
- A.** No. The provision of corporate support to Budget-funded service delivery activities is not intended to be captured by CN. Where an agency decides to market test its corporate support services, its baseline costs should notionally include all relevant CN adjustments.

Example – charging for goods or services

A research unit within a department undertakes research on a special field of industry and publishes papers for sale to industry, academic institutions and the public. The research unit charges users for the research papers. In this situation the research unit would satisfy the charging for goods or services test.

Competitors

Do you operate in a competitive, or potentially competitive, environment?

Identifying a competitor, especially a potential competitor, may sometimes be a difficult task. If somebody else is selling the same products or services that you supply to your clients, then it should be evident that you have competitors in your market.

If you don't have other businesses competing directly against you for your clients, then it may not be clear whether you have any actual or potential competitors.

The only time when you won't have any actual or potential competitors is when law or government policy restricts users from choosing an alternative source of supply. In the absence of such restrictions, you should assume that potential competitors exist.

In any situation where law or government policy does not restrict users from choosing alternative sources of supply, potential competitors should be assumed to exist.

Reference:

Reports available from the AGCNCO dealing with the existence of competitors

Meteorological Services to Aviation, Investigation No.7, December 2001.

Sydney and Camden Airports, Investigation No.8, December 2001.

Independence

*Do 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 provided?*

The degree of managerial independence will need to be assessed on a case-by-case basis taking into account the individual situation faced by your business. Typically, if your business's own management has the authority to set the price and level of production or supply of goods or services, then the test for a sufficient degree of independence will be met.

The absence of any restrictions prescribed by law or explicit government policy (including Ministerial direction) will usually be sufficient to demonstrate that you have a degree of independence in relation to the price and level of production or supply for your goods or services.

Any questions on pricing and levels of production or supply arrangements can be discussed with the AGCNCO.

In any situation where the price charged to users and levels of production are not restricted by law or government policy, managerial independence will be presumed to exist.

Common Questions

- Q.** I am bound by a contract to provide products at a certain price or to perform certain activities so I have no control over my prices. Does this mean that I don't satisfy the test for managerial independence?
- A.** No. Contractual obligations on their own are not enough to disprove the presumption that you have sufficient independence to set prices. In cases where your business negotiated the contract, then it will be considered that your business exercised a degree of control at the negotiating stage. If you have any questions or need to discuss pricing obligations resulting from previous contractual arrangements, then you should contact the AGCNCO.
- Q.** If we need to have our prices approved by the Minister, does this mean that we don't have managerial independence?
- A.** No. You may still satisfy the test, and need to apply CN, where Ministerial (or other public official) approval of your prices is required. However, if you are explicitly directed to set your prices at a certain level by the Minister, then you do not meet this test and CN will not apply.
- Q.** If a CSO requires that my prices be set at a particular level, does CN still apply?
- A.** Yes. If your prices are restricted due to the provision of a CSO it does not necessarily follow that CN will not apply to those activities, or to the activity as a whole.

Reference:

Reports available from the AGCNCO dealing with managerial independence

Sydney and Camden Airports, Investigation No. 8, December 2001.

3.2 Is My Business Significant?

If you have determined that you are conducting a business for the purposes of CN, then you must consider whether that business is significant. For CN purposes, significance is not solely determined by the size of your business or the amount of resources utilised by your business. However, the way that CN is applied to your business may vary depending on the size of your operations. This is discussed further in later sections which detail how you apply CN to your business.

The following business activities are considered significant for the purposes of CN²:

- all GBEs and their subsidiaries;
- all Commonwealth Companies;
- all Business Units;
- baseline costing for activities undertaken for market testing purposes;
- public sector bids over \$10 million;
- business activities not in these categories that are undertaken within (non-GBE) Prescribed Agencies and Commonwealth Authorities or Departments, with a commercial turnover of at least \$10 million per annum.

CN arrangements must be applied to significant business activities, but only to the extent that the benefits of the arrangements outweigh the costs. This cost/benefit issue is discussed in Section 3.3.

It should be noted that other business activities (not listed above) are subject to the complaints mechanism and may be required to apply CN if a complaint against them is upheld. These business activities may choose to apply CN on a notional basis, to preclude complaints.

If you are unsure of whether your business activities are significant, then you should contact the AGCNCO for further advice.

² These activities continue to require consideration and application of CN principles if undertaken through such vehicles as joint ventures or partnerships.

3.3 Cost/Benefit Test

CN should be implemented unless the costs exceed the benefits.

Many of the benefits of applying CN are not easily measured in dollar terms. Nevertheless, the benefits to be achieved through the application of CN are substantial. These benefits include:

- the adoption of improved business practices by public sector businesses;
- establishing a better basis for resource allocation decisions by business managers ;
- improved accountability and transparency;
- improved competitiveness of Australia's private sector service provision; and
- the unwinding of cross-subsidies in service provision.

The costs of the application of CN policy should largely be administrative. Costs may include changes to accounting systems, asset valuations, reviews of activities and general administration.

The AGCNCO has recognised that the costs of applying CN principles are generally not significant and build naturally on agencies' existing costing systems³. Consequently, very few businesses that pass the business test will be able to demonstrate that the costs outweigh the benefits.

The general assumption to be applied is that the benefits of CN generally outweigh the costs.

If you are able to demonstrate that the costs of applying CN to your business activity exceed the benefits, you will also need to consider whether these costs largely arise from a particular subset of CN. For example, if the cost of complying with regulatory neutrality exceeds the benefits you should still apply other aspects of CN such as tax and debt neutrality.

Any decision not to apply any aspect of CN to a significant business activity must be approved by the relevant Portfolio Minister.

In preparing your case for exclusion, or partial exclusion from CN, you must conduct an appropriate cost/benefit analysis and retain the documentation relating to your cost/benefit analysis as it may be required by the AGCNCO in the event of a complaint against you.

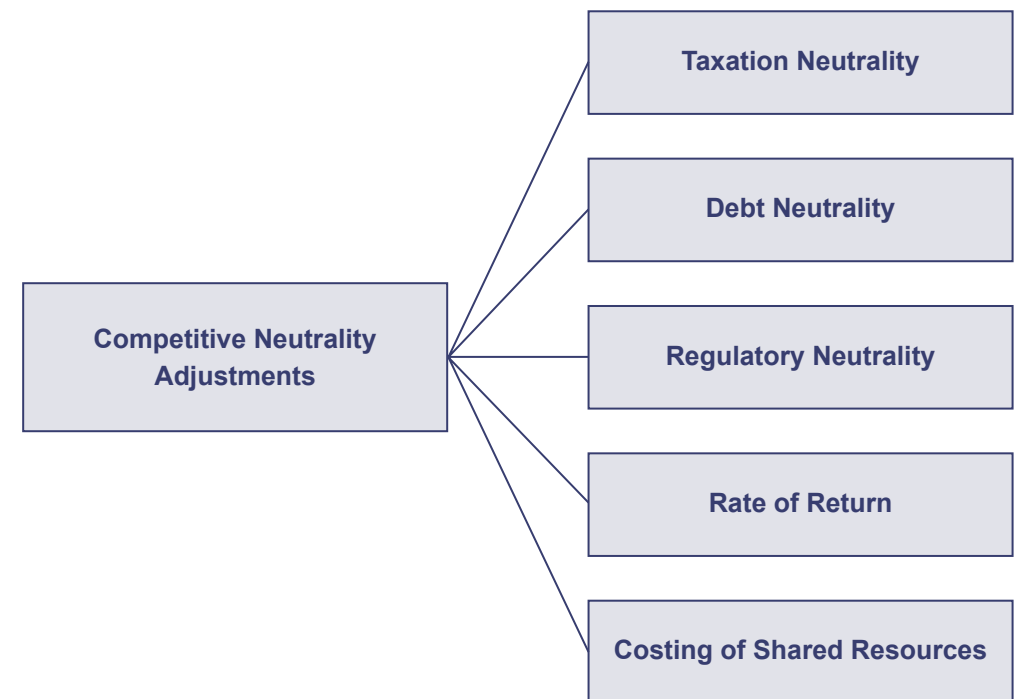
³ CCNCO, *Australian Institute of Sport Swim School*, Investigation No. 2, October 1999.

4. Application of Competitive Neutrality

What do I need to do?

The objective of CN is to eliminate any net competitive advantage that may result as a consequence of government ownership. To accomplish this objective, it is often necessary for significant government businesses to make adjustments to their cost structure. This could be achieved through organisational separation (either accounting or legal) of commercial and non-commercial activities, and the implementation of necessary CN adjustments.

Key areas where you can make adjustments for known advantages are outlined below.



Your cost structure must fully reflect the adjustment for each of these key areas where applicable.

It is important that you document all decisions to support any approach that you adopt.

4.1 Taxation Neutrality

In brief – Taxation Neutrality

Managers are required to factor taxation into the cost base, and therefore prices, of their business activities in order to maintain tax neutrality between the government business and its competitors or potential competitors.

As a government business, you may benefit from taxation exemptions or concessions that are not available to your private sector competitors. As the aim of CN is to ensure that a publicly owned business's costs do not receive an advantage over their private sector competitors, you must ensure that you meet your CN taxation neutrality obligations as explained in this section.

Types of taxation

Taxation is either direct or indirect. This is outlined in the table below.

	<i>What is it?</i>	<i>Who levies it?</i>	<i>Some examples</i>
Direct taxation	Taxation on income	Commonwealth	FBT Income tax, including CGT
		Commonwealth	GST Customs and excise
Indirect taxation	Taxation on transactions or inputs	States/Territories	Payroll tax Stamp duty ⁴ Land tax

In the Guidelines below, the term state taxes is used to cover all taxes imposed by state and/or territory governments.

⁴ With the introduction of the GST, various stamp duties were abolished.

Tax advantages to government business activities

Commonwealth taxation

The Commonwealth cannot be taxed by itself or any other level of government. However, specific legislation exists to make the Commonwealth notionally subject to FBT⁵ and GST⁶. Therefore you will not enjoy any major advantages over your private sector competitors in respect of these taxes.

If you are a business activity conducted within a FMA Act agency, then you are legally regarded as part of the Commonwealth. As such, you are not directly subject to taxes imposed by the Commonwealth, such as income tax or customs and excise.

On the other hand, if you are a government business operated through a separate legal entity (e.g. a Commonwealth Authority or a Commonwealth Company) governed by the CAC Act, you will generally be required to pay all Commonwealth taxes just the same as any other private sector taxpayer. The only exception is where you are specifically exempted from taxation by your enabling (or other) legislation.

Taxation exemptions can be addressed by amending the legislation to remove these advantages or by putting in place a comparable tax equivalent regime (as outlined below).

State and local government taxation

Under the Constitution, states and territories can only levy taxes on Australian Government entities that are legally separate from the Commonwealth.

If you are a business activity in an FMA Act agency, you are legally regarded as part of the Commonwealth. As such, you will not be directly subject to state taxes, such as payroll tax, stamp duty or council rates.

On the other hand, if you are a government business operated through a separate legal entity and governed by the CAC Act, then you should already be paying state taxes. As before, the only exception is where an exemption from state taxes is specifically provided for in your enabling (or other) legislation.

Neutralising tax advantages

Exemptions from, and concessions for, Commonwealth and state taxes can provide your business with a significant advantage not available to private sector organisations.

There are three taxation neutralising systems that may apply to government business activities. These are summarised in the following figure.

⁵ Fringe Benefits Tax (Application to the Commonwealth) Act 1986.

⁶ Div 177 of the A New Tax System (Goods and Services Tax) Act 1999.

Taxation

Actual Tax	Tax Equivalent Regime	Tax Neutrality Adjustment
- CAC Act bodies	- Business Units - Other significant business activities of FMA Act agencies - Significant commercial activities in non-commercial CAC Act bodies - CAC Act bodies with tax exemptions	- Baseline costs when market testing activities - Public sector bids - Other (including voluntary implementation)

Actual tax

Most GBEs and other government businesses that are structured as separate legal entities will already be subject to, and paying, Commonwealth and state taxes. They generally operate under the same taxation system as their private sector competitors and hence no taxation neutrality payments would be required.

Taxation Equivalent Regime

If you are managing a government business activity that operates as a Business Unit, a significant business activity within an FMA Act agency or a CAC Act body that has a tax exemption, then you will operate under a taxation equivalent regime (TER). This category also includes other significant commercial activities that operate from within non-commercial CAC Act bodies.

The TER system requires you to calculate your tax liability in a comparable manner to your competitors and to make an equivalent payment to the Official Public Account (OPA). CN policy requires that in-house commercial activities should not be consolidated where there is more than one within an agency, i.e. each in-house commercial activity should be defined as a stand-alone operation. Accordingly, each in-house activity will have to pay its own TERs. Under-performing units should not be cross-subsidised by successful ones. Losses made by one in-house commercial activity will not be available to reduce the TER payment of another.

Under the TER, you are required to make a tax equivalent payment to the OPA (Refer to Section 6). TER payments may be reviewed by the Australian National Audit Office as part of routine audits.

Taxation Neutrality Adjustments

The taxation neutrality adjustment (TNA) system requires you to calculate your tax liability in a comparable manner to your competitors. However, no actual payment need be transacted. TNAs are notional adjustments to be incorporated into the cost base of a business activity and are taken into account when determining your pricing strategy.

TNAs will apply to baseline costings for all market testing activities. TNAs are also applicable for all public sector bids. Should a public sector bid be successful, the business activity would need to assess the application of CN in accordance with these Guidelines.

Complying with the Taxation Equivalent Regime

It may be very time consuming and expensive to set up, monitor and comply with an exact copy of the current income tax regime. For CN purposes, it is accepted that full compliance reporting will not be required. In other words, you do not have to complete and lodge income tax returns with the Australian Taxation Office, or file returns or lodge documents with state revenue offices. However, you must still undertake the necessary calculations and remit TER payments to the OPA in accordance with any payment schedule that private competitors must meet. The guiding principle for TERs is that the cost of calculating the liabilities should be kept in proportion to the amounts involved.

Actual tax system requires payment to the regular collecting agencies. TER requires payment to the OPA. The tax liability is equivalent in each case. TNAs only require adjustment to cost bases and prices.

Shared costs

The general principle is that tax obligations and benefits (e.g. payroll taxes or depreciation) should be shared on the same basis as joint costs are allocated.

Often, where an in-house unit shares costs with its parent, these costs will have an associated tax benefit. For example, a parent department may purchase a mainframe computer for use by both itself (60 per cent) and a business unit (40 per cent). If the business unit agrees to contribute 40 per cent of the purchase price⁷, it would be entitled to claim 40 per cent of the mainframe's depreciation against its income tax (equivalent) liability.

⁷ Technically, business units do not own assets in their own right.

Types of taxes, and how they are calculated

All business activities are applying taxes such as FBT and GST. However, some business activities may not have experience with the following taxes which need to be considered under CN. Further details on all these taxes, and how to calculate them, are available via the websites listed at the end of the Guidelines.

Payroll tax (state)

As an employer, you will be liable for payroll tax where the total wages from your business activities exceed the threshold specified by the relevant state. Although each state's system has the same basic rules, the liabilities and rates vary depending upon the jurisdiction in which the employee is located. Payments to contractors may also be subject to payroll tax.

Example – Tax neutrality (payroll tax)

Tim is responsible for a significant business activity which is part of an Australian Government department. 150 of the department's 1000 employees are dedicated to providing this business activity.

50 of the staff are based full-time in the ACT with an annual salary cost of \$2 million and the remaining 100 are based in NSW with an annual salary cost of \$4 million. Only the staff involved with Tim's business activity are included in these calculations.

The ACT component of the business activity is liable for payroll tax at a rate of 6.85% of total salaries (including employer funded superannuation payments) as the threshold level of \$1,250,000 is exceeded (based on rates for 2002-03). This equates to a liability of \$51,375 (6.85% x \$750,000).

The NSW component of the business activity is also liable for payroll tax at a rate of 6% as the Australia-wide business related payroll exceeds the threshold level of \$600,000 (based on rates for 2002-03). Using the formula provided by the NSW Office of State Revenue, Tim's liability in NSW amounts to \$204,000 (6% x \$3,400,000).

The total amount of payroll tax due for Tim's business is \$255,375.

Land tax (state)

Land tax is imposed on owners of land in all states and territories except the Northern Territory. It is also levied on the land held under Crown leases (for example, the ACT). The liability accrues to all owners of non-residential property and the owners of residential property that is rented. Principal places of residence and residential property that are not rented are usually exempt from land tax, however this can be subject to qualification in each jurisdiction.

Land tax is based on the value of unimproved land which you hold on 31 December in each year. This value is multiplied by the applicable tax rate. In order for a landowner to accrue a liability, the value of their land must exceed a threshold limit. Further, some states provide various deductions and rebates, depending on the use of the land.

Like other state taxes, the Constitution prevents this from being levied on the Commonwealth.

Stamp duty (state)

Stamp duty is a tax imposed on certain transactions and documents. The most common transactions that attract stamp duty are leases, registration and transfer of motor vehicles, mortgages, cheques and the transfer of property. Stamp duty is calculated either at a fixed rate or on sliding scale rates which apply incrementally in relation to the value of the transaction involved. Following the introduction of the GST and the remission of GST revenue to the states, some stamp duties were abolished.

Income tax (Commonwealth)

Income tax is levied on taxable income (including from capital gains) that is derived by a business during the financial year.

A taxpayer's 'taxable' income is calculated in three steps:

1. Calculate assessable income
2. Calculate allowable deductions
3. Taxable income = assessable income – allowable deductions

4.2 Debt Neutrality

In brief – Debt Neutrality

Managers must adjust their cost base, and therefore prices, where they borrow money at a rate that reflects the credit risk of the Australian Government as a whole rather than a rate reflecting the credit risk of that type of business activity.

Debt funding plays a major and often critical part in meeting the capital requirements of a business. Efficiently managing the cost of debt can provide a business with a competitive advantage. The Government is typically viewed by lenders as representing a low risk for default and is therefore able

to borrow at a relatively low cost. As your business is government-owned, lenders may consider this contributes to a lower risk assessment of your credit worthiness and therefore your borrowing costs may be lower than a similar privately-owned business.

In circumstances where you are able to borrow funds at a lower rate than your competitors (as a result of your government ownership), you will need to make adjustments to the cost of your debt. This is known as debt neutrality. The objective of a debt neutrality adjustment is to place your borrowing costs on par with the borrowing costs that would apply if you were not a government business. In practice, this is done by comparing the cost of your debt against a benchmark cost of debt and identifying the difference.

There are primarily two types of debt considered by CN:

Types of Debt
Budget debt – debt provided from the Commonwealth Budget through the Department of Finance and Administration.
Market debt – debt provided through the capital markets, banks or other financiers.

Budget debt

With some exceptions, General Government Sector agencies that borrow funds are normally required to borrow from the Budget. Budget debt is sourced from the Department of Finance and Administration (Finance) and draws on Commonwealth Budget funds. In general, Budget debt will not require any debt neutrality adjustments, as the appropriate CN adjustments will already be incorporated into your cost of debt.

However, if your debt is not provided to you directly by Finance, for example it may be provided to your portfolio department, which then passes on a proportion of that debt to you for your business activities, then a CN adjustment may be required. You will need to investigate this matter with Finance and your parent agency as your credit risk rating may be different to that of your portfolio department.

Market debt

In general, the market will offer lower rates of borrowing to government business activities that enjoy explicit government guarantees. The market may also offer lower rates of borrowing to government businesses without an explicit guarantee because it considers that government ownership itself reduces the risk of default (i.e. that there is an implicit government guarantee for such business activities). You may therefore be charged a rate of interest that is less than that paid by your competitors purely as a consequence of government ownership.

CN requires that the cost of debt to you is comparable to that of your private sector competitors. CN does not require that your business borrow from the market at a full debt neutral rate. Rather, if you manage a significant business activity and are able to borrow funds at a lower rate than your competitors

as a result of your government ownership, you must pay or notionally include a debt neutrality charge. The amount of any debt neutrality charge must be factored into pricing.

The assessment and payment of a debt neutrality charge may impose administrative costs on a business activity. As CN should apply to the extent that the benefits outweigh the costs, it might be expected that a business need not incur the costs of assessing and paying a debt neutrality charge if that business's total interest bearing liabilities will not exceed \$1 million for more than 90 days in the current financial year.

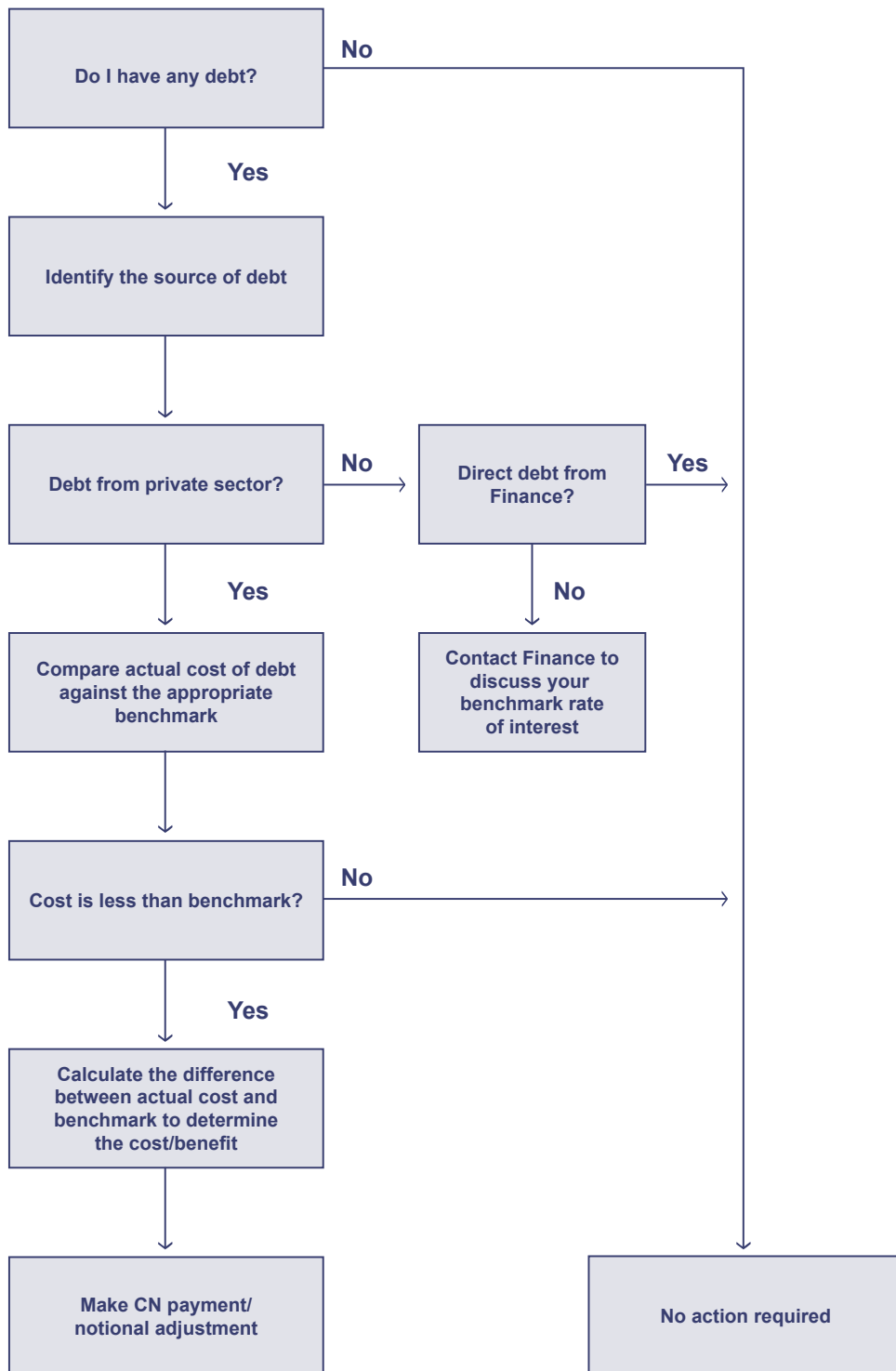
Similarly, the parent agency should set the debt neutrality charge for both baseline costs when market testing its services and public sector bids that are under \$10 million; the amount of this debt neutrality charge should be notionally factored into the baseline costs and the bid respectively.

The debt neutrality principle applies to all types of liability incurred by government business activities (including term loans, overdrafts, commercial paper and bonds, and finance leases). However, providing a business can show *prima facie* that it is not obtaining cheaper access from its public ownership, a business need not apply debt charges to non-traditional liabilities such as derivatives.

Significant business activities that receive a cost advantage in borrowing as a result of government ownership need to make a debt neutrality payment to the OPA. For other business activities, a debt neutrality adjustment may be required. See Section 6.

Debt neutrality charges should reflect the difference in your actual cost of borrowing (cost of debt) and the cost you would incur if you were borrowing as a non-government entity (benchmark cost of debt). Information on the cost of your debt will be available in your business's financial statements and will be based on the amount of debt, interest charges and any other ongoing costs. The benchmark that you use must be for a similar amount, type (fixed/variable) and duration of debt. You must determine the benchmark rate you would receive if a bank assessed your business without the benefits of government ownership.

The following flow chart provides an overview of the process for identifying a debt neutrality liability.



If a complaint is made against you relating to your cost of debt, it will be your responsibility to demonstrate to the AGCNCO that the cost to you is exclusive of any benefits that may be inferred by government ownership.

Calculating the benchmarking rate

Significant business activities should obtain an appropriate annual benchmark rating for any loans calculated as though the business is not publicly owned. This credit rating would establish the rate at which the business would be required to borrow if they were operating as a private sector organisation.

A business activity may incur significant costs in obtaining a credit rating from an external rating agency. As CN should apply to the extent that the benefits outweigh the costs, it might be expected that a business need not incur those costs if its interest bearing liabilities will not exceed \$10 million for more than 90 days in the current financial year. In this case, it could conduct its credit rating internally, but should ensure it retains sufficient records to justify any decision made.

Due to the dynamic nature of the debt market, it is not possible to include specific advice on the amount of the debt neutrality adjustment that may need to be applied. However, the following table provides a broad indication (for early 2003) of the benefits of implicit government guarantees for government businesses according to their stand alone credit rating. Updated figures for the 10 year Commonwealth bond value are published in the Reserve Bank of Australia's *Statistical Bulletin* which can be found on the RBA website (www.rba.gov.au).

Debt	Base Rate	Expected Margin
AAA Rated Bond (based on Standard & Poor's rating)	10 year Commonwealth Bond Rate	0.4 – 0.5 per cent
AA Rated Bond (based on Standard & Poor's rating)	10 year Commonwealth Bond Rate	0.6 – 0.7 per cent
A Rated Bond (based on Standard & Poor's rating)	10 year Commonwealth Bond Rate	0.8 – 0.95 per cent

Approaching your actual provider of debt for a benchmark cost should be avoided as a second independent source is generally considered more reliable and will be given greater credence in the event that a complaint is lodged.

Example – Debt neutrality

Danielle is the manager of a significant business activity which has been given a Standard & Poor's credit rating of A. Recently the business took out a loan with a bank which has an annual interest rate of 4.7%.

It would appear that the market favourably priced the activity's debt, as similarly rated organisations typically have their debt priced at 5.5%.

If the discount in the cost of debt is due to Government ownership, then Danielle's business will need to remit the balance to the OPA. This would require Danielle to calculate the benefit obtained by the discount, 0.8% (i.e. 5.5% minus 4.7%).

Calculating debt neutrality adjustments

To calculate the debt neutrality charge, you will need to identify your actual cost of debt (i.e. interest rate payments on debt) and subtract it from the CN benchmark cost of debt.

For example,

$$\text{Debt neutrality charge} = (\text{CN}_d\% - \text{A}_d\%) \times V$$

Where:

V = Value of debt;

CN_d% = CN benchmark cost of debt; and

A_d% = Actual cost of debt.

Example – Debt neutrality payments

Tim is the manager of a significant business activity which has an average debt of \$7,500,000. His actual cost of debt, or interest rate payable, is 6%. A CN benchmark cost of interest has been calculated at 7%.

Tim calculates his debt neutrality payment in the following manner:

$$V = \$7,500,000$$

$$A_d\% = 6\%$$

$$CN_d\% = 7\%$$

$$\begin{aligned} \text{Debt Neutrality Charge} &= (\text{CN}_d\% - \text{A}_d\%) \times V \\ &= (0.07 - 0.06) \times 7,500,000 \\ &= \$75,000 \end{aligned}$$

Tim therefore needs to forward a payment of \$75,000 to the OPA.

4.3 Regulatory Neutrality

In brief – Regulatory Neutrality

Managers must adjust their cost base, and therefore prices, by an amount equivalent to any advantage they accrue by not being subject to similar regulatory arrangements and obligations as their competitors.

What regulatory advantages might I have?

You must ensure that you don't have any regulatory advantages available to your business as a consequence of your status as a government business. Regulatory advantages may be seen in areas such as:

- exemptions from local planning, building and environmental laws;
- exemptions from prudential requirements;
- preferred treatment by other agencies; or
- amended reporting and/or licensing requirements.

Generally, regulatory advantages will take the form of either an exemption from an obligation to:

- make a certain payment; or
- undertake certain activities or perform activities in a certain manner.

As far as practicable, you should operate in the same regulatory environment as private sector competitors. This may require your business activity to comply with regulations from which it is exempt. Your business may be required to make actual regulatory payments (e.g. local government fees and charges) or to make equivalent payments to the OPA. CN policy is not prescriptive about how or where such payments should be made. This should be determined on a case by case basis.

Where actual compliance is impossible or inappropriate, you should seek to neutralise any cost advantage that is derived from the regulatory advantage your business receives. This may require you to notionally account for regulatory payments or the cost of complying with regulatory requirements when calculating the costs used to determine your business's pricing strategies.

Example – Regulatory neutrality (1)

A business is offering personal security services in a number of states. Each state has different licensing arrangements for armed personnel and security guards. Private sector firms pay the licence fees of their employees which amount to \$500 per security guard (employed within that particular state). If the government business is exempt from such charges, it will need to include an equivalent cost of \$500 per security guard in its costs when determining an appropriate price for the personal security services they intend to offer.

You may need to make an equivalent CN payment. See Section 6 for further details. Significant business activities that receive a regulatory advantage need to either make the actual regulatory payment where possible, make an equivalent payment to the OPA or, where required, notionally include regulatory adjustments in their cost base which are then reflected in prices.

Example – Regulatory neutrality (2)

A business activity operates in an environment where its competitors need to undergo an accreditation process to ensure that they have the appropriate risk management framework in place to deter illegal smuggling through their importing activities. As a government business, the business activity does not need to comply with the accreditation process. The notional costs associated with gaining accreditation will need to be reflected in the business's cost base and pricing decisions.

Reference:

Reports available from the AGCNCO dealing with regulatory neutrality

Australian Institute of Sport Swim School, Investigation No. 2, Canberra, November 1999.

Customs Treatment of Australia Post, Investigation No. 5, Canberra, July 2000.

ARRB Transport Research Limited, Investigation No. 6, Canberra, September 2001.

Meteorological Services to Aviation, Investigation No. 7, Canberra, December 2001.

Sydney and Camden Airports, Investigation No. 8, Canberra, December 2001.

Docimage Business Services, Investigation No. 9, Canberra, December 2001.

4.4 Rate Of Return

In brief – Rate of Return

Managers must ensure that the prices of their goods and services are at least sufficient to earn their business activity a commercial rate of return overall and over a reasonable period of time.

CN policy requires that publicly owned businesses generate a commercial rate of return (RoR) on the assets used in conducting the activity, at least sufficient to justify the long-term retention of assets in the business, and to pay commercial dividends to the Budget from those returns.

All businesses that are subject to CN are required to incorporate a RoR into their operations. Over time, government businesses should earn a RoR equal to the Commonwealth long-term bond rate, plus a margin for risk. In this way, the target RoR should be equivalent to the average RoR of the business's competitors.

Although the profit (or loss) earned may vary from transaction to transaction, a government business should earn a commercial RoR over a reasonable period and Budget-funded activities should not cross-subsidise other activities.

Once a target RoR is established, it is the responsibility of managers to measure the RoR and ensure that this target is met. Managers should document all relevant information for their records, which should be able to withstand close scrutiny if a complaint is lodged with the AGCNCO. This will demonstrate that all reasonable steps towards identifying and applying an appropriate RoR have been taken.

Several methods for setting and measuring rates of return exist. Which one of these a government business might use will depend on individual circumstances.

While the Guidelines focus on the RoR on assets and profit margins, managers should be aware that there are other methods to set and measure rates of return, for example, return on equity and return on accounting profit methods.

This section discusses different ways to set a target (or benchmark) RoR, to measure your business's RoR on assets and then to compare your business's RoR to your target rate. The final part discusses alternative methods to set a target RoR and to measure and compare your business's RoR against competitors where asset based techniques are not appropriate.

A more detailed discussion of the methods presented is provided in the *Rate of Return Issues* publication available from the AGCNCO.

Setting a rate of return

GBEs already have specific arrangements in place to determine their RoR. These are agreed by the Minister for Finance and Administration and the responsible portfolio Minister. The Treasurer is also consulted. Other significant business activities subject to CN are also required to achieve financial targets. The process is comparable to arrangements for setting performance targets for GBEs. The financial targets for non-GBE authorities must be agreed in advance by the responsible portfolio Minister in consultation with the Minister for Finance and Administration. The Treasurer may also be consulted.

For Commonwealth companies, financial targets are to be established and monitored by the responsible portfolio.

Business Units are required to achieve financial targets for some activities (e.g. commercial activities operating in competitive or potentially competitive markets).

Three methods for setting the business's target RoR on assets are outlined below.

The rate of return should, over time, be at least equal to the long-term (10 year) Commonwealth bond rate, as this is the Commonwealth's base level cost of capital, plus a margin for risk.

A business that persistently fails to earn an adequate RoR may not be meeting its CN obligations. Further, the regular financial performance assessment arrangements with your Minister should address the issues of an inadequate RoR.

Reference:

Research papers available from the AGCNCO dealing with rate of return

Rate of Return Issues, Canberra, December 1998.

Weighted Average Cost of Capital

The weighted average cost of capital (WACC) calculates a business's cost of capital, and sets it as the minimum hurdle the business should achieve. It is based on the premise that in order to be financially viable, a business must earn returns above the threshold cost of capital.

As calculating a WACC can be complex and involves business managers exercising a degree of judgement, the following is intended as a general overview.

The WACC is calculated as follows:

$$\text{WACC} = \text{Re} (E / V) + \text{Rd} (D / V)$$

- Re is the required RoR on equity (the risk free rate plus a risk premium). The RoR on equity can be determined by using the capital asset pricing model (CAPM)⁸. Determining the cost of equity for a WACC is often done by reference to financial markets and/or benchmarking similar businesses.
- Rd is the required RoR on debt (including any debt neutrality charges). The required RoR on debt (Rd) represents the business's borrowings costs expressed as a percentage. It reflects the lenders' required RoR.

⁸ For further information on the CAPM, refer to page 7 of the research paper, *Rate of Return Issues*, available from the AGCNCO.

- V is the market value of total assets (i.e. debt plus equity).
- E is the market value of equity.
- D is the market value of debt.

The WACC approach is likely to be appropriate for businesses that have a mix of equity types and undertake activities that are reasonably well established in the private sector (where benchmark data on the cost of equity are available). The WACC approach will also assist business managers to make informed decisions regarding capital and resource allocation so that returns will exceed the cost of capital.

Risk broad-banding

When calculating a WACC is not feasible, but managers are able to estimate a business's level of market risk, determining the target RoR based on broad-banding may be appropriate. Broad-banding is based on typical WACCs for businesses with high, medium and low levels of market risk.

Risk broad-banding applies a benchmark base cost of capital (such as the Commonwealth long term bond rate) and adds a risk premium. The AGCNCO has estimated a reasonable RoR for different levels of risk, shown in the table below (reproduced from page 11 of the research paper, *Rate of Return Issues*, available from the AGCNCO).

Risk Assessment	Base Rate ⁹	Risk Premium ¹⁰	Required pre-tax rate of return ¹¹
Low	10 year bond rate = 5%	3%	8%
Medium	10 year bond rate = 5%	5%	10%
High	10 year bond rate = 5%	7%	12%

The risk premium implicit in the RoR target is determined by the business with reference to the nature of its operations and the environment in which it operates.

Risk broad-banding has advantages over a uniform RoR (see below) as it recognises that different business activities imply different risk profiles. It provides additional flexibility to management in setting RoR targets by reflecting a more accurate cost of the activities being undertaken. This approach may also be applied by a business to its operations to assess the viability of investments or to review profitability targets against established benchmarks.

⁹This example applies an assumed 10 year Commonwealth bond rate of 5% (updated figures for the 10 year Commonwealth bond rate are published in the RBA's Statistical Bulletin which can be found on the RBA website - www.rba.gov.au). However, businesses will need to consider the appropriate base rate according to their own circumstances.

¹⁰ Calculated as the difference between typical WACCs (required pre-tax RoR) for the various risk levels and the 10 year Commonwealth bond rate (the base rate).

¹¹ WACC at various risk broad-band levels.

Uniform rate of return

The uniform RoR is the simplest method available to government businesses and requires that a business generate a set level of return upon its assets. This is a simple and cost effective approach for smaller agencies and is based upon typical WACC calculations for agencies with average market risk. Based on the rate provided in the Risk broad-banding table, which assumes a medium risk level, a margin of 5 per cent over the long-term (10 year) Commonwealth bond rate is an appropriate uniform RoR target.

This method will not capture operational risks unique to certain businesses, which are reflected in the variation of the business's returns relative to the market as a whole. Further, it could over-simplify risk versus return issues. As a general principle, government businesses should also earn returns commensurate with their market risk.

To compare performance against a uniform target, you will need to include all appropriate CN adjustments.

Example – Uniform rate of return

Tania is the manager of a small government business that applies a uniform RoR measure to its operating performance. Assuming that the long-term (10 year) Commonwealth bond rate is currently at 5.0% and the margin for a medium risk business is 5.0%, the target uniform RoR is calculated as follows:

$$\begin{aligned}
 \text{uniform RoR} &= 10 \text{ year bond rate} + \text{margin} \\
 &= 5.0\% + 5.0\% \\
 &= 10.0\%
 \end{aligned}$$

Therefore, the business should earn a RoR on assets of at least 10.0%.

Measuring the rate of return

Having set a target (or benchmark) RoR, a business should determine whether it is meeting this target. This can be done by measuring the business's RoR and comparing it against the target RoR. Three methods for measuring the RoR are outlined below.

Economic Rate of Return

The economic rate of return (ERR) measures the change in the (market) value of assets plus net cash receipts, as a percentage over asset values at the start of the period, and is defined as:

$$\text{ERR} = \frac{\text{net cash receipts} + \text{change in capital value}}{\text{opening market value of assets}}$$

The ERR (which includes both cash income and capital income) is an appropriate measure to compare against the RoR set by an activity's WACC. It allows for capital changes as well as profits, and is measured on a pre-tax basis. Most of the information needed to calculate an ERR should be readily obtainable from financial statements. Your business will be meeting or exceeding its RoR requirements if the ERR is equal to or greater than the target rate.

The ERR is an appropriate measure for businesses which have significant assets. However, many smaller businesses may find it difficult to calculate the ERR and to estimate business-specific costs of capital. For example, there may be inadequate information available on changes in asset values in which case undue reliance should not be placed on the ERR. In these instances, other RoR measures would be more appropriate.

Discounted cash flow analysis

The discounted cash flow (DCF) method forecasts all revenue and expenditure for a period into the future and can be used where returns are variable. The stream of net operating cash flows is normally discounted by the business's target RoR (or WACC) to determine the value of the business. If the net present value (NPV) of the business is greater than zero, then it will be generating enough income to earn a RoR equal to, or exceeding, its target RoR over the life of the project.

Alternatively, you may calculate the internal RoR (IRR) using the net operating cash flows; the IRR is the discount rate which will result in a NPV of zero. Your business will be meeting or exceeding its RoR target if the IRR is equal to or greater than its target RoR. As stated above, the DCF method is particularly useful where the returns of a business are likely to vary over time. This may be the case where a business is in a growth phase, has undertaken a restructure, is prone to strong cyclical influences, and so on.

Accounting Rate of Return

The accounting RoR (ARR) relies on information contained in agencies' audited accounts, and it is therefore likely to be relatively simple and cost efficient to calculate. The ARR is likely to be a satisfactory measure for smaller agencies. However, the approach does have some limitations which are noted below.

There are several types of accounting-based rates of return. One of these methods, the return on total assets, is described below.

Return on Total Assets

Return on total assets (RoA) measures a business's efficiency at generating profits from the assets at its disposal. This is generally expressed as follows:

$$\text{RoA} = \frac{\text{earnings before interest and tax}}{\text{book value of total assets}}$$

RoA is best suited to businesses that require heavy investment in assets and where there is an identifiable relationship between asset levels and returns. The RoA can then be compared to your RoR target.

Agencies should be aware that ARR measures may not be as accurate as other measures in some circumstances, so businesses should carefully consider whether these methods are appropriate. For example, the ARR measures returns during a single period, which would not be appropriate where earnings are volatile or are particularly sensitive to economic cycles. Accounting conventions in areas such as asset valuation and depreciation may also impact on the ARR, meaning that it may not fully capture changes in economic or market values¹².

Alternative methods to set and measure rates of return

Service based businesses with little or no asset base should generally avoid using RoR methods based substantially on return on assets. Further, a RoR on assets measure will generally not be appropriate for business units (within agencies) that do not produce their own balance sheets as a RoR on assets cannot be directly calculated. Profitability margins are often more appropriate for these types of businesses.

Profit Margin

The profit margin approach measures the profit generated by an activity from the volume of business that it writes. This is generally expressed as follows:

$$\text{profit margin} = \frac{\text{earnings before interest, tax, depreciation and amortisation}}{\text{total revenue}}$$

This shows how effectively a business derives its profit from revenue. This measure is effective in assessing returns from service-based businesses with relatively small or no asset bases. It can also indicate to managers when a business is increasing revenue but not maintaining margins, for example when a business drops its price to increase market share.

A business using the profit margin methodology should set its target RoR on a consistent basis by using publicly available profitability data from competitors to enable meaningful comparison. Profit margins cannot be compared to an asset measure RoR.

As with the ARR measure discussed previously, the profit margin approach also measures returns during one period, so where returns are sensitive to economic cycles or are volatile, the profit margin measure may not be as accurate.

¹² Refer to page 20 of the publication, *Rate of Return Issues*, available from the AGCNCO.

Common Rate of Return Questions

- Q.** The prices we charge are restricted by legislation, how is it possible to earn a competitive RoR?
- A.** If your prices are restricted by legislation, then you may fail the test for pricing independence - one of the tests to determine whether you need to apply CN (refer to Section 3.1). [More broadly however, the Government's NCP commitment is to retain legislation that restricts competition only where it is in the public interest, so such restrictions may need to be reviewed. Please consult Treasury if this circumstance applies to your organisation.]
- Q.** Our operations are only small, should we still make an allowance for a commercial RoR?
- A.** Refer to the tests for determining whether you are conducting a significant business. One of the key features of CN is that it only applies where the potential benefits outweigh the administrative costs of doing so. Where market prices are above what is required for a commercial return, the RoR requirements will be met.
- Q.** Where can I find industry benchmark data?
- A.** Benchmark data may be found in business magazines or financial newspapers, or be available from the Australian Bureau of Statistics, industry bodies or specialist business research firms.

Reference:

Reports available from the AGCNCO dealing with rate of return

National Rail Corporation Limited, Investigation No.3, January 2000.

ARRB Transport Research Limited, Investigation No. 6, August 2001.

4.5 Cost Allocation

In brief – Cost Allocation

Agencies should ensure that prices charged reflect full cost attribution for their business activities.

Agencies subject to CN must ensure that their pricing reflects full cost attribution for any business activities. Business activities should be treated, for CN purposes, as stand alone entities and should not be consolidated with other activities. There needs to be organisational separation (either accounting or legal) of commercial and non-commercial activities. It is necessary to separate business activities from other government activities to ensure that Budget-funded activities do not effectively cross-subsidise commercial operations. Cross-subsidisation of these activities is undesirable, as it is not a transparent use of government funds and places private sector competitors at a disadvantage.

One method that has been adopted for cost allocation is the fully distributed cost (FDC) method. The FDC method incorporates all costs that are exclusive to the business and any shared costs on a pro-rata basis. In some circumstances the FDC method can inappropriately inflate the costs of shared resources thus distorting decisions on efficient resource allocation¹³.

Often, a more appropriate methodology for determining the allocation of costs for shared resources is the avoidable cost (AC) method. The correct application of the AC method aims to ensure more efficient asset usage.

The AC method also incorporates all costs that are exclusive to a business. It varies from the FDC method in that it requires a business to account only for those costs that could be avoided if the business ceased operation. In most circumstances, this can be equated to the marginal costs associated with the consumption of any shared resources.

The same principle applies to the allocation of assets and liabilities for the purpose of calculating a RoR. Where a business uses a shared resource, such as a computer network, the proportion of the avoidable costs associated with the business's consumption of that resource should be used to calculate the value of the asset to be attributed to the business.

Sharing of resources may occur when a business activity operates on the same computer system as a parent agency or when other activities such as shared corporate services are being utilised.

Managers should be particularly careful where an in-house unit and the parent share major assets, especially if the costs of these assets are joint costs, (joint costs, as opposed to separable costs, are those not directly attributable to particular levels of commercial output). Thus, detailed accounts and an appropriate cost-allocation mechanism are important for in-house units. Wherever practical, in-house units should have accounting separation from their parent agency.

¹³ For further information refer to page 12 of the publication *Cost Allocation and Pricing*, available from the AGCNCO.

Example – Costing of shared resources (1)

Tim is the manager of a significant business activity within an Australian Government department. Tim's business requires seating for 20 staff and they share a building with the department which has around 500 staff.

The department's property management unit has confirmed that the department currently has no need for the 20 desktops used by Tim's business and that they impose no additional costs on the department in terms of maintenance, security or insurance costs. The property management unit has also confirmed that they would not lease the office space to anyone else.

In this case, the marginal cost of the use of property by Tim's business is zero. All the costs incurred by the department would be incurred regardless of whether Tim's business was present or not.

There is no charge that needs to be recorded for CN.

Example – Costing of shared resources (2)

Danielle is the manager of a significant business activity within an Australian Government department. The department's in-house software development team has developed some customised software to manage its operations. Danielle's business has negotiated with the software developers and has had modifications made to some modules to be used exclusively for her business.

The value of the department's customised application is recognised as \$5 million. The module specifically developed for Danielle's business has been valued at \$250,000. While Danielle's business does use some of the other modules within the customised application, there were no additional development costs attributable to her business needs.

When calculating her asset position, Danielle will only need to include the value of the module developed specifically for her business (i.e. \$250,000).

4.6 Other Possible Adjustments

Insurance

Business activities that may be able to obtain lower insurance premiums than competitors are required to neutralise these advantages through the application of CN principles.

The application of CN to insurance costs is discussed in the report, *OzJobs*, June 2002, available from AGCNCO.

Example – Insurance

A business activity operating within an Australian Government department is evaluating its CN obligations in regard to insurance. The business activity will need to determine a suitable method to allocate an appropriate portion of the department's insurance premium expense to its cost base. It will then need to assess whether CN adjustments to its premiums would be required to make the activity comparable to premiums that would be charged to the business activity as a stand-alone entity, rather than as part of a publicly owned entity. Business activities subject to CN will need to adjust cost bases (and subsequently prices). Significant business activities may also be required to make a CN payment.

Government disadvantages

Sometimes government business activities will suffer from disadvantages and costs due to government ownership, that are not experienced by the private sector. These may also be taken into account for CN purposes. It is important that any claim for a disadvantage clearly demonstrates how the nature of the perceived disadvantage or obligation exceeds the obligations faced by the private sector. Government policy permits any such demonstrated disadvantage to be used to offset competitive advantages, so that CN adjustments (and any associated CN payments) reflect only the net CN advantage.

The following "disadvantages" are often referred to in the context of government:

Superannuation

Government businesses claim that they face higher superannuation costs than their private sector counterparts. It is true that some public sector employees may receive more than the compulsory superannuation contribution which is paid by private sector employers. However, superannuation needs to be considered in light of the total remuneration package which you pay to your employees. While some remuneration components, such as superannuation, may be fixed, there is significant flexibility relating to total remuneration in the public sector, including through Australian Workplace Agreements and Certified Agreements. As a result, adjustments should not be made on the basis of superannuation cost "disadvantage" alone.

Reporting costs

In some circumstances, government businesses may be subject to a greater level of reporting, i.e. to Portfolio Ministers and other agencies. This “disadvantage” would need to be compared against the private sector, which may have reporting obligations that are either similar to those faced by government businesses (e.g. preparation of board reports, Australian Securities and Investment Commission returns etc) or compliance and preparation costs.

4.7 Community Service Obligations

What are Community Service Obligations?

A Community Service Obligation (CSO) exists only where a government business is specifically directed to conduct an activity that:

- the organisation would not elect to do on a commercial basis, or that it would only do commercially at higher prices; and
- the Government does not, or would not, require other organisations in the public or private sectors to undertake or fund.

Examples of CSOs include where the Government directs organisations to charge prices that are below costs, mandates particular standards of service for a given cost, or requires organisations to use local inputs which are more expensive than other options.

An activity is only recognised as a CSO where an organisation has been explicitly directed to carry out the activity by legislation, Cabinet decisions or publicly available (e.g. included in annual report) directions from shareholder Ministers. A government business activity cannot unilaterally decide that they have activities that are CSOs.

An activity may be a CSO even if it could be profitable at prices or quantities other than those set by government direction.

Costs of government are not, in themselves, CSOs. These include costs associated with government ownership (for example, servicing Parliament and employment conditions of staff) as well as government policies such as industrial democracy, safety standards and environmental controls. Allowance for these factors should not be considered as offsetting RoR targets.

An activity is not recognised as a CSO unless there is a specific, documented instruction to an agency to perform that activity from Cabinet, a shareholder Minister or by legislation.

How does competitive neutrality affect Community Service Obligations?

CN does not require governments to remove CSOs from their government businesses. Further, CN policy does not determine who receives a CSO payment or subsidy. However, CSO payments or subsidies should be transparent, appropriately costed and directly funded by the Government.

A best practice approach would be for CSOs to be funded from the purchasing portfolio’s budget, with costs negotiated as if it were part of a commercially negotiated agreement. CSOs should include similar CN requirements as other activities. For example, CSO activities should incorporate CN adjustments (e.g. tax adjustments) and earn a RoR (just as if they had been contracted out).

CSOs should not be financed through cross-subsidies within the business activity. In some cases, direct funding of CSOs may entail unreasonably large transactions costs (e.g. from the more stringent verification required for the spending of public money). In such circumstances, Ministers may choose to “purchase” CSOs from enterprises by notionally adding to the organisation’s revenue result, for the purposes of calculating achieved rates of return. Where this happens, CSOs should still be costed as if they were directly funded. In all cases, the notional adjustment should be transparently recorded in an auditable manner. CSOs which are not “purchased” on the above basis cannot be used to adjust rates of return measurements.

If a Portfolio Minister declines to recognise an activity as a CSO, the business concerned could still supply these services as ‘good corporate citizens’. However, just like private companies which act as good corporate citizens, the public business should still meet its RoR targets.

Costing of Community Service Obligations

A number of methodologies can be used to cost CSOs. Avoidable cost is the preferred method to value CSOs. This is the cost that would be avoided if the organisation was not required to provide the CSO. For further information on CSOs (including costing, funding, defining, identifying and monitoring), refer to the following paper: *Community Service Obligations: Policies and Practices of Australian Governments*, Industry Commission, 1997¹⁴.

¹⁴ Available at www.pc.gov.au

5. Market Testing

Market testing activities (previously referred to as competitive tendering and contracting) are treated as a special category by CN policy. CN considerations should apply when market testing an agency's in-house functions.

A key element to applying CN to market testing activities is to ensure that the tender process does not give an advantage to either public sector bids or baseline costings.

The key elements of CN as they apply to market testing include:

- ensuring that no advantage is available to public sector bids or baseline costing exercises; and
- ensuring visible and auditable accountability arrangements.

Should a public sector bid be successful, the business activity would need to assess the application of CN in accordance with these Guidelines.

All agencies conducting a tendering process must include a requirement for public sector bidders to declare that their tenders are compliant with CN principles.

To ensure that government business activities compete on a comparable basis with their competitors, the following amounts must be notionally included in the cost base of a public sector bid or a baseline costing exercise for activities subject to market testing arrangements.

Taxation neutrality adjustments — an amount equivalent to the taxes that the activity would otherwise have to pay if it were not exempt from Commonwealth and state taxes;

Regulatory neutrality — an amount equivalent to the benefit received through relief from compliance with regulatory obligations that would be applied if the business activity was not publicly owned;

Debt neutrality — an amount equivalent to the differential in borrowing costs between the government business activity and a similar entity that is unable to obtain any advantage as a consequence of public sector ownership;

Pre-tax rate of return — public sector bids and baseline costings should include a provision to earn a commercial pre-tax RoR (note that where plant and facilities are to be made available to all bidders as government-furnished, public sector bids would not need to include a RoR on such capital);

Insurance premiums — where insurance is required by private sector tenderers, public sector bids and baseline costing exercises must incorporate a CN adjustment for equivalent insurance costs into their pricing arrangement; and

Full cost recovery — any public sector bid and baseline costing exercise should include all costs (including shared and joint costs) associated with providing the service identified in the tender specification using the avoidable cost methodology.

Applying CN policy in this way ensures that public sector bids and baseline costing exercises reflect the full cost of providing the relevant goods and services.

6. Competitive Neutrality Payments

In respect of the CN adjustments described in Section 4, you may be required to make CN payments to implement:

- a taxation equivalent regime;
- a debt neutrality adjustment; and
- a regulatory neutrality adjustment.

6.1 Payments

Generally, all CN payments must be paid to the OPA by 1 June in the financial year to which they relate.

Where the total amount payable for the CN adjustment is subject to business activities that will occur after 1 June but prior to 1 July, agencies should estimate the impact of these activities on their CN payments and include them as appropriate. Following the end of the financial year and the finalisation of reporting, agencies will be required to make an adjustment to account for their actual, rather than estimated, CN obligations. Adjustments will need to be processed and transacted with Finance by no later than 30 September of the same calendar year.

The process for making CN payments is summarised as follows:

Step 1: Calculate all CN payments.

Step 2: Make CN payments directly to the OPA by 1 June of the relevant financial year.

Step 3: Notify Finance by 1 June, via CAMM, on whether the payments relate to:

- Commonwealth tax equivalent payments;
- state tax equivalent payments;
- debt neutrality payments;
- regulatory neutrality payments;
- other CN payments.

Step 4: Document all relevant information for your records.

7. Documentation and Reporting Requirements

Each agency should document its deliberations as to whether a business activity is, or is not, within the scope of CN policy. It is good practice to maintain defensible documentation.

Agencies are required to report to Finance annually via a survey on their compliance and implementation of CN with respect to their business activities. Finance will provide the information to the Treasury to assist its preparation of the Australian Government National Competition Policy Annual Report. National Competition Policy information requests by Treasury will not duplicate the CN content of the Finance surveys.

8. Who To Contact For Further Information

8.1 Internet Links

Key stakeholders

Finance:	www.finance.gov.au
The Treasury:	www.treasury.gov.au
AGCNCO:	www.pc.gov.au

Taxes

Australian Government:	www.ato.gov.au
ACT:	www.revenue.gov.au
NSW:	www.osr.nsw.gov.au/taxes
Qld:	www.osr.qld.gov.au
Vic:	www.sro.vic.gov.au/sro
WA:	www.srd.wa.gov.au
SA:	www.treasury.sa.gov.au/revenuesa
NT:	www.nt.gov.au/ntt/revenue
Tas:	www.treasury.tas.gov.au

Other

CAC Act:	www.finance.gov.au
FMA Act:	www.finance.gov.au
<i>Commonwealth Competitive Neutrality Policy Statement (1996):</i>	www.treasury.gov.au
National Competition Policy Agreements:	www.ncc.gov.au

9. Competitive Neutrality Toolkit

9.1 Guide To Agencies

The following documents can be accessed from Finance's website at www.finance.gov.au:

List of Activities determined as Business Operations under *Financial Management Accountability Orders 1997* Order 6.2.1

List of *Financial Management and Accountability Act 1997* agencies

List of *Commonwealth Authorities and Companies Act 1997* bodies

List of Government Business Enterprises

9.2 Key Dates

1 June Notify Finance of any CN payments and forward the amounts as described in Section 6.

30 September Notify Finance of any adjustments to CN payments relating to the previous financial year and forward the amounts as described in Section 6.

9.3 Useful References

Commonwealth Competitive Neutrality Policy Statement, AGPS, 1996.

Australian Government Competitive Neutrality Complaints Office, *Cost Allocation and Pricing*, CCNCO Research Paper, Productivity Commission, 1998.

Australian Government Competitive Neutrality Complaints Office, *Rate of Return Issues*, CCNCO Research Paper, Productivity Commission, 1998.

Department of Finance, *Governance Arrangements for Government Business Enterprises*, 1997.

The Independent Committee of Inquiry, *National Competition Policy* (Hilmer Report), AGPS, 1993.

National Competition Council, *Competition Policy Agreements*, 1995.

National Competition Council, *Compendium of National Competition Policy Agreements*, 2nd Edition, 1998.

Industry Commission, *Community Service Obligations: Policies and Practices of Australian Governments*, 1997.

Steering Committee on National Performance Monitoring of Government Trading Enterprises, *An Economic Framework for Assessing the Performance of Government Trading Enterprises*, 1996.

