

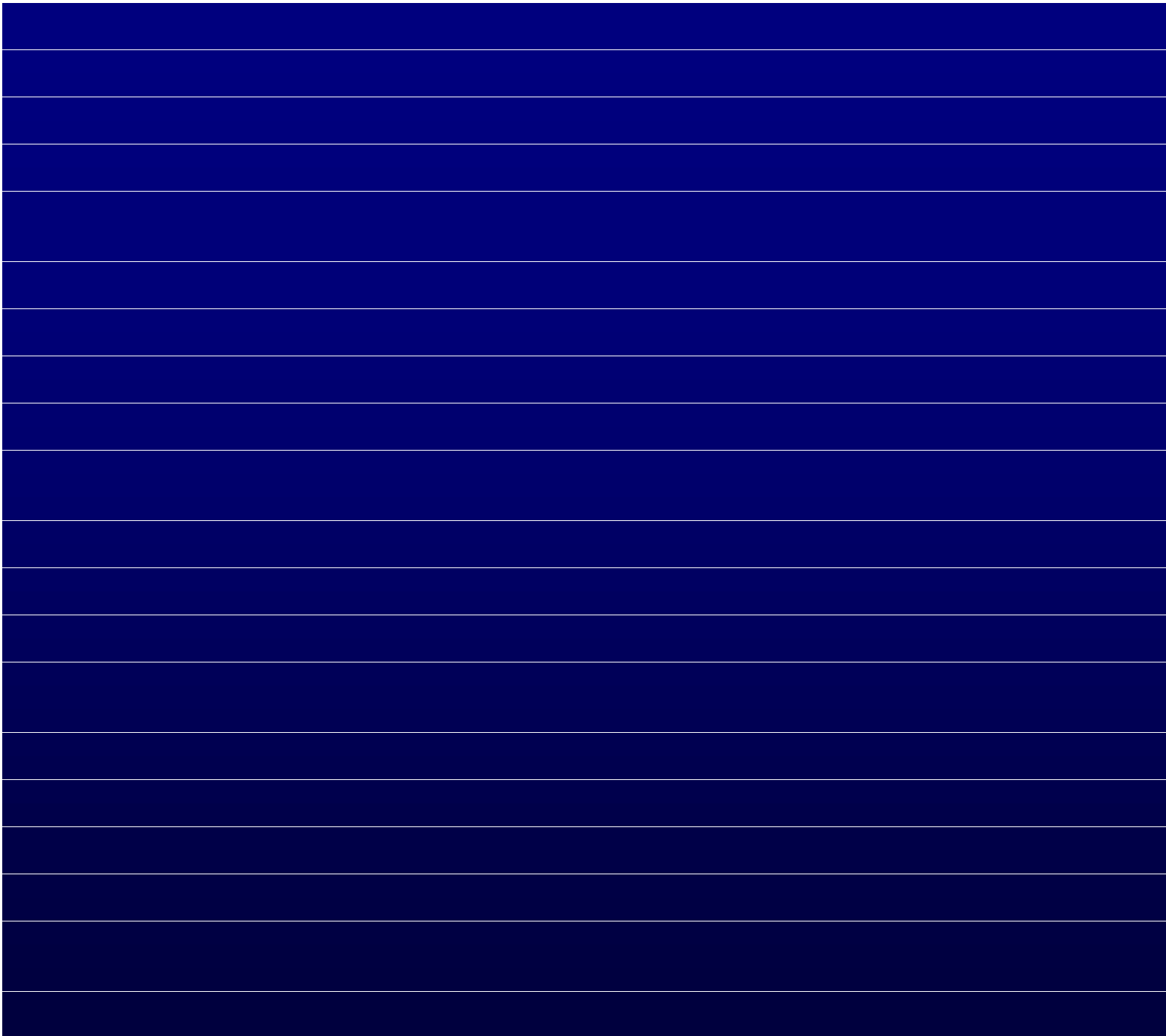


Commonwealth
Competitive Neutrality
Complaints Office



ABC Production Facilities

Investigation
No. 4



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The Commonwealth Competitive Neutrality Complaints Office

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

Information on the Office and its publications may be found on the World Wide Web at www.ccnco.gov.au.



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18 February 2000

The Honourable Joe Hockey, MP
Minister for Financial Services and Regulation
Parliament House
Canberra ACT 2600

Dear Minister

In accordance with section 21 of the *Productivity Commission Act 1998* and the Commonwealth Competitive Neutrality Policy Statement, I have pleasure in submitting the results of the Commonwealth Competitive Neutrality Complaints Office's investigation of the Australian Broadcasting Corporation's television production business.

Yours sincerely

Mike Woods
Commissioner

Competitive neutrality policy

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

The Commonwealth's approach is outlined in its 1996 *Competitive Neutrality Policy Statement* (CoA 1996). Competitive neutrality automatically applies to Commonwealth Government Business Enterprises, share-limited trading companies and designated Business Units. Its application to other businesses is assessed on a case-by-case basis. Further information on the application of competitive neutrality may be found in Commonwealth Treasury 1998, CCNCO 1998a, b.

The Commonwealth Government's competitive neutrality arrangements require that its designated government business activities:

- charge prices that reflect their full costs of production, including a commercial return on capital;
- incur costs for government taxes and charges;
- pay commercial rates of interest on borrowings;
- are not advantaged or disadvantaged in performing 'non-commercial' activity at the direction of the Government;
- are not advantaged by exemption from regulations that apply to equivalent private businesses; and
- are accountable for their commercial performance.

The Commonwealth Competitive Neutrality Complaints Office is located within the Productivity Commission and is responsible for administering the Commonwealth's competitive neutrality complaints mechanism. The Office can receive complaints from individuals, private businesses and other interested parties.

Complaints and investigations can cover three broad areas:

- that an exposed government business is not applying competitive neutrality requirements;
- that the requirements — although complied with — are not effective; or
- that a particular government activity which has not been exposed to competitive neutrality, should be.

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Abbreviations

ABC	Australian Broadcasting Corporation
ABCPPP	Australian Broadcasting Corporation Program Production Portfolio
ABS	Australian Bureau of Statistics
CCNCO	Commonwealth Competitive Neutrality Complaints Office
FDC	Fully Distributed Cost

1 The complaint

1.1 Nature of complaint

The Australian Broadcasting Corporation (ABC) owns production facilities and equipment and employs staff to produce television programs for broadcast on its network. These facilities and staff are housed within a separate division of the ABC — part of the “ABC Program Production Portfolio” (ABCPPP). The ABCPPP also includes a business unit, “ABC Productions”, which tends to provide production facilities and labour to other film and television producers on a commercial basis.

On 4 November 1999, Global Television Pty Ltd wrote to the Commonwealth Competitive Neutrality Complaints Office (CCNCO) alleging that ABC Productions is not complying with competitive neutrality. Global Television claims that ABC Productions’ access to resources purchased for non-commercial production enables it to provide services at lower cost than competitors. Specifically, it alleges that ABC production facilities are not priced to fully cover costs — including an appropriate allocation of capital costs, labour and on-costs — and are not subject to a range of taxes paid by private competitors.

In deciding to investigate this complaint, the CCNCO is satisfied that the complaint:

- is not better handled by another body;
- does not relate to competitive neutrality policies that are being finalised or are the subject of review by government; and
- is neither trivial nor vexatious.

1.2 Jurisdiction of the CCNCO

The Commonwealth Government’s *Competitive Neutrality Policy Statement* (CoA 1996 p. 30) identifies the sale of consumer goods and studio rentals by the ABC as Commonwealth business activities subject to competitive neutrality. This is despite the fact that the turnover for the studio rentals business — ABC Productions — falls short of the \$10 million revenue threshold for automatic application of competitive neutrality.

Separately, the ABC has raised the issue of whether competitive neutrality policy formally applies to its commercial activities. The *Australian Broadcasting Act 1983* provides the ABC with an exemption from most powers of Ministerial direction. Section 78(7) exempts the ABC from the relevant provisions of the *Commonwealth Authorities and Companies (CAC) Act 1997* which enables Ministers to provide directions concerning general government policies to Commonwealth agencies. The ABC also produced a number of court decisions to the effect that it is not an agent of the Commonwealth — with the implication that its commercial activities are not Commonwealth businesses within the jurisdiction of the CCNCO.

Nonetheless, the ABC has stated that it supports the principles underlying competitive neutrality policy and provided information to help the CCNCO in undertaking this investigation.

2 Assessment of issues

2.1 Cost attribution and pricing of ABC production facilities

Global Television has alleged that the ABC has not allocated the appropriate level of costs to bids when tendering for commercial production work and that this results in the underpricing of ABC Productions' services.

In the case of a stand-alone government business — such as a government business enterprise — it is not usually necessary to examine internal costing or pricing policies to determine whether it is complying with competitive neutrality. Such an assessment can be based on its aggregate financial performance; such as the rate of return it earns on assets (including any adjustments for taxation, debt guarantees etc). However, for a business unit that draws heavily on the assets and resources of a non-commercial parent agency, the level of costs allocated to the unit can determine its profitability. In such an instance, a competitive neutrality assessment examines both the level of profits generated and the construction of the cost base.

While this approach involves examining the internal processes of the business in detail, it does not, as a matter of course, require the CCNCO to investigate individual transactions. All businesses, public or privately-owned may, on occasion, pitch prices above or below normal commercial levels. Thus, in the case of the use of the ABC's production facilities, the key question is whether the prices set by ABC Productions generate sufficient revenue to cover all relevant costs. This requires the CCNCO to assess whether:

- there is an appropriate methodology for allocating costs (including relevant capital costs) to the commercial activity;
- there are appropriate accounting and internal control systems to demonstrate that the costing methodology is followed in practice; and
- revenue is sufficient to cover all relevant costs (including taxes that a comparable privately owned business would pay).

Approach to cost allocation

The assets and staff of the ABCPPP are used for both non-commercial and commercial activities. Commercial use through ABC Productions comprises 3 to 4 per cent of total production.

From a competitive neutrality perspective, joint use of resources raises the issue of the allocation of joint costs between the non-commercial and commercial activities. This matter has been examined in the CCNCO's publication *Cost Allocation and Pricing* (CCNCO 1998a).

As outlined in that publication, the CCNCO considers that a government business, using assets and resources which are necessary for the functions of the non-commercial parent agency, will be complying with competitive neutrality if its prices for commercial output exceed the *avoidable cost* of supplying the service. The avoidable cost comprises all the costs which the agency would avoid if the service was not provided (or the additional costs the agency incurs to undertake commercial activity).

Avoidable cost includes direct labour costs (including on-costs), materials costs and capital costs of assets specific to the business. It also includes overheads to the extent that the activity causes these to be incurred — for instance, if a business activity necessitates an increase in corporate personnel staff to handle personnel matters associated with the business. However, if the business uses excess capacity in core assets *that are required* by the parent agency to deliver non-commercial outputs, the avoidable cost of using these assets is often low.

Is ABC pricing consistent with appropriate cost attribution?

Commercial work represents only a small proportion of the ABCPPP's output. According to the ABC, the scope of ABC Productions to undertake commercial work (and hence the revenue from such work) has declined in recent years owing to greater use of facilities for ABC programmes and reductions in staff numbers.

The ABC provided the CCNCO with details of how it determines its costing and pricing of production services.

- Labour is charged at a rate which is set to cover base ABC salary costs and overheads of the employee such as superannuation and workers' compensation. The rate varies depending on the type of labour used. The ABC advised that the rates are the same as those used to cost projects internally. Overtime and penalty-time are charged on top of these rates if these costs are expected to be incurred.

-
- According to the ABC, prices for each production facility and individual item of equipment are set at the prevailing industry rates — the prices charged by competitors — and were last reviewed 7 months ago.
 - The ABC adds a margin exceeding 20 per cent to the estimated project costs to cover a share of ABC Productions’ overheads and other ABC overheads.

The ABC has advised that it will only undertake commercial work if there is an acceptable net profit to the corporation after taking all these costs into account, and claims that its pricing policy has meant that its bids are often towards the upper end of the pricing spectrum.

As part of its investigation, the CCNCO compared prices from ABC Productions’ facilities rate card with the complainant’s rate card (both provided on a confidential basis). Different specifications of equipment of broadly the same type makes such a price comparison difficult (for instance comparing prices of Outside Broadcast Vans of different specifications). The CCNCO also understands that actual charges in the television production industry often differ from those on the rate cards. Nonetheless, for equipment which was reasonably comparable the CCNCO considers that ABC Productions’ rates do not appear to be systematically lower than those of the complainant.

In broad terms, the ABC’s pricing policy accords with a Fully Distributed Cost (FDC) approach, whereby each business unit is allocated a share of overheads on a pro-rata basis (see CCNCO 1998a for a discussion). Yet with 3 to 4 per cent commercial work, few assets are purchased specifically for commercial production. In this situation, using spare capacity in these assets imposes few additional costs on the agency. As such the avoidable cost of their use is likely to be significantly less than the fully distributed cost.

The CCNCO finds that the method of costing labour and facilities used by ABC Productions exceeds the minimum cost benchmark consistent with competitive neutrality principles.

Competitive neutrality also requires prices to include the cost of taxes paid by competing private businesses. Tax issues are discussed in section 2.2.

Internal procedures and financial performance of ABC Productions

Compliance with competitive neutrality requires a government business to have systems in place which ensures that it consistently applies its costing approach in practice.

The ABC's accounting procedures for commercial production activity are based on its internal accounting and costing systems. For its core non-commercial projects, the ABC does not allocate funding to ABCPPP. Rather it provides funding directly to programming divisions — in this case television — which then purchase services from ABCPPP. According to the ABC, the system needs to accurately reflect resource transfers on a project-by-project basis within the ABC and therefore also provides a framework for estimating costs of external commercial projects.

For production jobs undertaken by ABCPPP, a budget bid is prepared using a costing pro-forma which contains all possible cost categories. The project bid pro-forma is also used to prepare external bids by ABC Productions. However, in the case of these bids, ABC policy is to require that the project yield an acceptable return to the corporation over and above costs. The ABC provided the CCNCO with copies of the pro-forma and a recently completed bid.

Figure 2.1 outlines the commissioning process for production facilities and staff. The process embodies two primary checks to ensure that commercial work is not undertaken to the detriment of core ABC output. The first check is undertaken by the resource manager within ABCPPP (but outside the commercial business unit). Secondly, bids over \$10 000 must be approved by the commissioning committee which approves both internal and external work.

As also shown in figure 2.1, at the completion of projects the actual cost is compared with the agreed budget. At an aggregate level, the business unit is set an annual target based on expected spare capacity and its performance is monitored against that target.

The ABC provided, on a confidential basis, ABC Productions' profit and loss statement from its 1998–99 end-of-year performance review. It shows budgeted and actual outcomes for the 1998–99 financial year. The CCNCO compared the performance of ABC Productions with other production firms in the industry using data from the Australian Bureau of Statistics. The CCNCO considers that the net margin (ratio of earnings before interest tax and depreciation to revenue) earned by ABC Productions represents a commercial level of performance.

Figure 2.1 **ABC procedures for commissioning new projects**

Source: Supplied by the ABC

As discussed above, ABC Productions' cost base is constructed on a FDC basis. This approach generally attributes a higher level of costs to ABC Productions than a cost base prepared using an avoidable cost benchmark. ABC Productions would, therefore, show a higher level of profits if it attributed costs on an avoidable cost basis.

The CCNCO finds that the ABC's accounting and control system provides a basis for ensuring that:

- *all relevant costs pertaining to bids by ABC Productions are identified; and*
- *its costing and pricing approach is followed in practice.*

Subject to an assessment of the treatment of taxation (see below), ABC Productions generated a commercial level of profits in 1998-99.

2.2 Payment of taxes

Like most Commonwealth entities, the ABC is subject to fringe benefits tax. However, it is not subject to sales tax on equipment purchases or payroll tax on its labour input. The complainant has alleged that the ABC derives a competitive advantage because of its tax-exempt status, as these taxes form part of a private business's cost base and are generally passed on in prices to consumers.

In the case of sales tax, it does not appear that the ABC is exploiting its potential advantage in setting prices:

- the ABC's policy is to align its prices for facilities and equipment hire with other firms in the industry. Although this does not explicitly account for sales tax, by aligning prices with those of a private tax-paying business the ABC is effectively factoring in the effect of sales tax into its prices for major equipment; and
- the ABC has advised the CCNCO that it maintains a separate stock of video tapes for commercial work and pays sales tax on the purchase of this stock.

Payroll tax is levied at different rates among jurisdictions. The existence of tax free thresholds also means that within jurisdictions the effective tax rate typically depends in the size of the business. A business the size of ABC Productions with the majority of its operations in either NSW or Victoria would normally pay a marginal rate of payroll tax of between 6 and 7 per cent. Based on ABC Productions' payroll and the tax free thresholds in these jurisdictions, the average tax rate would be likely to be around 4 per cent of its total payroll. This would imply that the hourly charge for staff (which covers some employee costs that are

not subject to payroll tax) would need to increase by a little over a dollar to reflect the impact of payroll tax.

Prima facie, incorporating a notional allowance for payroll tax in project bids would address any concerns in this area, and this is a measure the ABC should consider.

The CCNCO adjusted ABC Productions' profit and loss statement to assess the impact on profits of including payroll tax in costs. These calculations had a relatively minor effect on the business's net margin and still left it with a commercial level of profits. This in turn means that ABC Productions' prices are currently competitively neutral.

The CCNCO finds that, even allowing for the impact of taxation, ABC Productions generated a commercial level of profits in 1998-99.

2.3 Findings

The CCNCO finds that:

- the method of costing labour and facilities used by ABC Productions exceeds the minimum cost benchmark consistent with competitive neutrality;
- the ABC's accounting and control system provides a basis for ensuring that:
 - all relevant costs pertaining to bids by ABC Productions are identified;
 - its costing and pricing approach is followed in practice; and
- ABC Productions generated a commercial level of profits in 1998-99 (including when costs were adjusted to incorporate taxation).

In conclusion, the CCNCO finds that the allocation of costs to ABC Productions and the pricing of its services are consistent with competitive neutrality principles. Thus, the CCNCO does not consider that any action is required in response to the complaint.

References

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