



*Commonwealth
Competitive
Neutrality*



Australian Institute of Sport Swim School

Investigation
No. 2



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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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20 October 1999

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 Commonwealth Competitive Neutrality Complaints Office's investigation into the Australian Institute of Sport Swim School.

Yours sincerely

Mike Woods
Commissioner

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Abbreviations

AIS Australian Institute of Sport

AISSS Australian Institute of Sport Swim School

CCNCO Commonwealth Competitive Neutrality Complaints Office

KPFC Kippax Pool and Fitness Centre

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 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 relevant government business activities:

- charge prices that reflect their full costs of production;
- incur costs for government taxes and charges;
- pay commercial rates of interest on borrowings;
- generate commercially acceptable returns;
- are not advantaged or disadvantaged in performing 'non-commercial' activity at the direction of the Government;
- comply with 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 about Commonwealth business activities 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 particular government activities which have not been exposed to competitive neutrality, should be.



1 The complaint

1.1 Nature of complaint

On 16 July 1999, the Kippax Pool and Fitness Centre (KPFC) lodged a competitive neutrality complaint against the AIS Swim School (AISSS) with the Minister for Sport and Tourism and the Australian Institute of Sport (AIS). The Minister forwarded that complaint to the Commonwealth Competitive Neutrality Complaints Office (CCNCO), where it was received on 13 August. The complaint was subsequently endorsed by the Kaleen Health and Fitness Centre.

In summary, KPFC claimed that:

- the AISSS enjoys a competitive advantage because it is subsidised by its government owner and its costing and pricing policy does not comply with, nor satisfy, competitive neutrality principles;
- it is inappropriate for the AIS to replicate swim school services already available in the private sector; and
- if the AISSS continue its commercial activities, it should adopt a corporatisation model for this purpose in order to satisfy its competitive neutrality obligations.

The CCNCO met and held discussions regarding the complaint with the complainant (KPFC), AIS management and the manager of the AISSS.

Background

The AISSS is a commercial activity of the Australian Sports Commission (which operates under the name Australian Institute of Sport when performing certain functions). The AISSS offers learn to swim classes, recreational swimming, aqua-aerobics and other aquatic activities using AIS facilities when these are not required by elite athletes for training or competitions.

The Commission is a Commonwealth body, constituted under the *Australian Sports Commission Act 1989*. That Act establishes that a core function of the AIS is to establish, manage, develop and maintain facilities to assist the development of elite

sportspersons. That Act requires it to allow individuals and community groups to have access to and make use of AIS facilities, and also provides for the AIS to engage in activities such as providing commercial services to persons using facilities at the AIS.

Prior to the AISSS operating at the AIS facilities in Belconnen (ACT), the AIS leased access to the facilities to three separate private swim school operators. In 1991, the AIS decided to replace the multiple operators with one swim school under its direct responsibility (ie the present AISSS).

Since 1996, the AISSS has been operating under the commercialisation guidelines of the Board of the Australian Sports Commission. These guidelines were developed in accordance with public sector reforms designed to improve the accountability and transparency of commercial activities by governments.

1.2 Role of the CCNCO

The Commonwealth Government's *Competitive Neutrality Policy Statement* (CoA 1996) does not identify the AISSS as an organisation automatically exposed to competitive neutrality. Nor do the annual revenues of the AISSS exceed the \$10 million threshold that would automatically expose a Commonwealth Government business activity to competitive neutrality.

Accordingly, in relation to this complaint, the role of the CCNCO is to determine whether the AISS should be exposed to competitive neutrality and, if so, which competitive neutrality arrangements should apply.

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

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

2 Assessment of issues

2.1 Is the AISSS a government business activity?

In assessing whether the AISSS should be required to implement competitive neutrality arrangements, the Office is first required to determine whether the activity is a business activity.

The Commonwealth Competitive Neutrality Policy Statement provides three criteria for deeming an activity to be a business activity:

- there is user-charging;
- there is an actual or potential competitor (ie users are not tied solely to the business); and
- managers of the activity have a degree of independence in relation to the provision and pricing of the activities goods and services.

Information provided by the AISSS and the complainant indicate the operation of the AISSS satisfies each of these criteria. Fees are charged for the various activities offered by the AISSS. The complainant (KPFC) and other privately operated swim schools operate in the same catchment area as the AISSS. Moreover, there are no 'tying' arrangements which would prevent competition for customers between the AISSS and these various swim schools. Finally, the Act under which the AISSS effectively operates provides independence from government control and allows the AIS management to exercise discretion over the provision and pricing of the commercial activities offered by the AISSS.

Accordingly, the CCNCO is satisfied that the AISSS meets the Commonwealth Government's policy definition of a business activity.

As the AISSS operates under the direct control of the AIS, a Commonwealth entity constituted under the *Australian Sports Commission Act 1989*, the complaint clearly falls within the jurisdiction of the Commonwealth Government's policy and complaint mechanism.

2.2 Should the AISSS be subject to competitive neutrality arrangements?

The Commonwealth Government's policy statement on competitive neutrality specifies four areas for consideration when assessing whether a government business activity should be subject to competitive neutrality arrangements. These are whether:

- the business activity has a significant [net] competitive advantage resulting from government ownership;
- the business activity has a substantial degree of market power in a market;
- the pricing behaviour of a government business has had the effect of eliminating or substantially damaging a competitor, preventing entry, or preventing or deterring competitive conduct in that or any other market; and
- it would be cost-effective to apply competitive neutrality principles to the activity.

Does the AISSS have a significant [net] competitive advantage resulting from government ownership?

The complainant alleged that the AISSS has a significant advantage over private competitors because 'the [AISSS] fee structure does not reflect the full cost of providing the service'. KPFC claimed this is because the AISSS's costs are being 'subsidised' by its government owner and its costs are artificially low because it does not comply with the competitive neutrality principles endorsed by the Commonwealth Government.

Is the AISSS 'subsidised' by its government owner?

The AISSS would be 'subsidised' if it did not recover in full the costs that should be attributed to its operations. To assess if this is occurring, the CCNCO examined the budgeted and actual costs and revenues of the AISSS operations. At this level, the Office found all costs were fully recovered.

However, where government budget-funded and business activities share facilities (as do AIS and the AISSS), the potential exists for commercial costs to be 'cross-subsidised'. It is therefore important to assess whether the costs allocated to the AISSS accurately reflect the costs its use of these shared facilities imposes on the AIS.

In determining the portion of costs from shared facilities that the AISSS should bear, it is crucial to appreciate that the AIS pool facilities were constructed and are operated primarily to meet the core purpose of the Australian Sports Commission (ie to service the development of elite athletes). In these circumstances, the costs of providing the AISSS services are therefore the *extra* costs that result from providing those services — that is, the costs that would be avoided by not supplying AISSS services. (This ‘avoidable cost’ method of allocation is outlined more fully in CCNCO (1998a) *Cost Allocation and Pricing*). This same principle may also apply to some swim schools which hire all, or part, of privately owned (or privately operated) pool facilities which predominantly exist for other users (eg pools which are part of health clubs).

The costs associated with shared facilities (such as capital charges, heating and chemical treatment of pool water and administration overheads) are embodied in a facilities rent charge to the AISSS. This is despite such costs being primarily incurred to meet the core purpose of the AIS pool and (to a lesser extent) community access obligations and, to a large extent, being incurred even if the AISSS were to cease its activities. The incremental (or avoidable) cost arising from AISSS activities relates only to its use of the facilities — such as any additional chemical treatment and heating expenses, or from replacing alternative commercial users of the facilities. (This would also be the case where private swim schools use a relatively minor portion of an existing pool’s capacity).

The information available to the CCNCO indicates that the facilities rent charge levied by the AIS more than recoups the avoidable cost of providing and operating the facilities used by the AISSS. This charge represents the third largest cost item for the AISSS after direct labour and transport costs.

After examining the costs and revenue of the AISSS, the CCNCO is satisfied that the AISSS’s costs are not being subsidised by the AIS.

This finding is consistent with the commercialisation guidelines of the Australian Sports Commission that require it to enter into commercial ventures only where there is a perceived net financial benefit. The policy also requires that commercial projects be wound down if they do not achieve an agreed profit level.

Is the AISSS advantaged by not applying competitive neutrality?

The complainant also drew attention to a wide range of possible advantages that government businesses may enjoy, and alleged that the AISSS benefited from some of these advantages. These advantages were:

-
- exemptions from Commonwealth and Territory taxes;
 - not having to earn a commercial rate of return;
 - enjoying debt costs on loans which reflect the Commonwealth Government's credit rating rather than one related to the market risk of the activity; and
 - not being subject to the same regulations (and associated costs) as private swim school operators.

As the AISSS has no debt, and has accumulated surplus earnings to cover any negative cash flow, the issue of any advantage from being able to borrow at the Commonwealth Government rate is not relevant to the current operation of the AISSS.

The complainant alleged that exemption from Commonwealth and ACT taxes and charges would confer a significant commercial advantage upon the AISSS. The most likely taxes and charges of any significance are payroll tax, sales tax and property taxes and rates.

Wage and salary costs are the main expense in operating the AISSS, and an exemption from payroll tax could potentially confer upon it a competitive advantage. In practice, though, the AISSS payroll is below the ACT payroll tax threshold of \$800 000. It therefore receives no advantage in this regard.

With regard to general operating expenses, the CCNCO could identify only minor purchases of equipment and supplies that may have been exempt from sales tax. Any advantage received by the AISSS in this regard would be minimal and are more than offset by the recovery of costs in the pricing structure of the AISSS. The imminent introduction of the goods and services tax will, in any case, eliminate any minor advantage the AISSS might enjoy.

Of more importance to the complainant was the apparent exemption of the AISSS from rates and taxes levied by the ACT Government and the competitive advantage this conferred. The avoidable cost principle noted above is relevant here in assessing the significance of any exemption. Any such costs would be incurred as a direct result of the AIS providing facilities for elite athletes. Were the AISSS to cease operation, these costs would remain in full. The value of avoidable rates and taxes applicable to the operation of the AISSS is therefore zero, and it would receive no advantage from any exemption.

The CCNCO considers the AISSS receives no significant competitive advantage from its tax-exempt status.

The complainant alleged that the current status of the AISSS means that it is not required to earn a profit or a commercial rate of return on its assets. Its current status also means that it is immune from bankruptcy or takeover. This, KPFC stated, gave the AISSS a competitive advantage over private competitors.

However, the AISSS is subject to the commercialisation guidelines of the Australian Sports Commission. These guidelines clearly state that if a commercial project cannot cover its costs and requires 'subsidisation' from the AIS to continue, or if it ceases to achieve an agreed profit level, then the Commission will close it down. In addition, financial statements for the operation of the AISSS provided to the CCNCO by the AIS indicate the AISSS is covering all costs attributable to that activity and is running at a profit. In doing so, the AISSS is earning a pre-tax rate of return in excess of that which would be required to comply with any competitive neutrality principles.

Accordingly, the CCNCO considers the AISSS derives no competitive advantage in this regard as a result of its government ownership.

The KPFC specifically referred to the potential benefit the AISSS derives as a result of its exemption from regulatory requirements with which the KPFC, and other private competitors, must comply. Specifically, it referred to regulations regarding air conditioning and pool water quality and the licence fee and costs associated with complying with these regulations.

As a Commonwealth Government organisation, the AIS is not legally subject to these regulations. ACT Health Department records show the AIS was not licensed by them for the operation of cooling towers or warm water facilities and, accordingly, had not paid an annual licence fee of \$200 nor provided an annual certificate of compliance with ACT regulations.

However, at issue is not whether the AIS is subject to ACT regulations (and associated compliance costs). Rather, at issue is whether the AIS incur equivalent costs and whether the AISSS should incur a portion of these costs.

A core objective of the AIS is to provide facilities to support the development of elite athletes. Achieving this requires that those facilities be provided in an effective and efficient manner. The management of the AIS has a powerful incentive to ensure that air conditioning and pool water are of sufficient quality to not jeopardise the health and well being of their primary clients — the elite athletes. To do so, the AIS operates, maintains and systematically tests the equipment needed to ensure that the health and safety of pool users is not at risk. The costs of doing so are comparable to the costs incurred by private pools to meet ACT licensing requirements. (Whether the AISSS should bear some of these costs is a cost

allocation issue. Under the avoidable cost methodology, the AISSS need only bear the additional costs directly related to its use of the pool facilities.)

Government ownership in this case does not mean the AIS avoids such costs. Exemption from ACT environmental or health regulations is therefore not a source of competitive advantage.

On the question of whether the AISSS has a net competitive advantage arising from its government ownership, the AIS and the AISSS drew the CCNCO's attention to the significant disadvantages the swim school suffers as a result of operating at the AIS facilities. These related to the temperature of the pool water and the intermittent unavailability of the facilities.

As a consequence of the AIS pool existing to primarily serve the development needs of elite athletes, the temperature of the water in the two pools used by the AISSS is maintained at a level dictated by the needs of those athletes. For both the 50 metre and 25 metre pools, this temperature (25.5 and 26.5 degrees Celsius, respectively) is significantly below the levels at competing private swim schools. The water temperature at the Kippax Pool, for example, is 28 degrees, while at the nearby Kaleen Swim Centre it is 29 degrees in their main pool and 33 degrees in their small pool.

However, while the CCNCO accepts these lower temperatures represents a disadvantage in attracting and maintaining customers, it is not convinced this is a disadvantage resulting from government ownership. It is a disadvantage resulting from the AIS pool facilities being operated primarily for elite athletes. This disadvantage would also arise if the AIS was owned and operated by a private organisation.

The AIS and the AISSS also referred to the lack of certainty regarding the availability of pool access for swim school activities as a major competitive disadvantage. The AISSS can only use the AIS pool facilities when there is no prior claim on them. Usually this would be by elite athletes for their training or competitions, but may also include when the Australian Sports Commission has provided public access to satisfy its community service obligation to open the facilities for public use. Many of these prior claims are regular and scheduled. But there are also significant periods when the demands of the athletes or public access clash with swim school activities. At such times, the AISSS is forced to cancel its activities. As an example, the Australian Sports Commission recently provided for school swimming carnivals to have access to the AIS pools for a two week period in November/December 1999 and again for two to three weeks in February/March 2000. For these periods, the AISSS has had to cancel its classes.

This lack of certainty regarding pool access is undoubtedly a commercial disadvantage faced by the AISSS. However (as with water temperature) this is not a disadvantage resulting from government ownership, but from the owner pursuing its core objective. However, where the Australian Sports Commission provides the pool facilities for general public use (displacing the AISSS), this is a disadvantage resulting from government ownership. It is a community service obligation imposed on the AISSS as a result of a directive in the enabling legislation of the Australian Sports Commission.

The CCNCO considers the AISSS enjoys no significant competitive advantage as a result of its Commonwealth Government ownership.

Market power and pricing behaviour

The AISSS is one of a small number of swim school businesses in its catchment area. Sales revenue suggests the AISSS has a significant (but by no means dominant) share of the swim school market within its catchment.

The AISSS has the appeal of being located at, and associated with, the AIS, which confers a degree of 'name brand' advantage. At the same time, operating at the AIS facilities means it must make do with pool temperatures significantly below those of its competitors and suffer from scheduled and unscheduled interruptions in its access to pool facilities.

Budgeted and actual financial data for 1998-99 provided by the AIS to the CCNCO indicate the pricing of AISSS activities is based on the full recovery of attributed costs, and includes an element of profit. As noted above, the CCNCO found no significant cost advantage accruing to the AISSS as a result of its government ownership.

Accordingly, the CCNCO considers the basis on which the AISSS costs and prices its activities is consistent with normal commercial behaviour.

In summary, the AISSS clearly competes with private swim schools. However, there is no evidence to suggest that its pricing behaviour has had the effect of eliminating or substantially damaging a competitor, preventing entry, or preventing or deterring competitive conduct in that market. There is also no basis for the claim that its operation results in an inefficient allocation of resources. Rather, by using spare capacity in an asset otherwise under-utilised, the operation of the AISSS is entirely consistent with the efficient use of the community's resources.

Cost-effectiveness of applying competitive neutrality

The current practice of the AIS in identifying and allocating costs to the operation of the AISSS is consistent with that which would be required under competitive neutrality. Current cost recovery and pricing levels in fact exceed the minimum required under competitive neutrality.

The complainant held that if competitive neutrality were to apply to the operation of the AISSS, it should be applied via the corporatisation model. In the CCNCO's view, the scale of the AISSS activities and its current treatment of costs suggest the corporatisation approach is unnecessary and unwarranted.

On the other hand, the cost of formally requiring the AISSS to implement competitive neutrality arrangements via a full cost recovery approach would be negligible. The only additional requirements would be minor reporting arrangements and minor adjustments to its costs from including a notional tax equivalent on a small number of cost items. (The latter, at current levels of activity, would be redundant with the introduction of the goods and services tax.) Applying competitive neutrality would, however, ensure that the AISSS would not gain any competitive advantage from its tax-exempt status in the future and would pre-empt a possible source of inefficient resource allocation.

In view of the negligible costs and potential benefits from applying competitive neutrality principles to the AISSS, the CCNCO considers it would be cost-effective to expose the AISSS to competitive neutrality.

2.3 Summary of findings and recommendations

The CCNCO has found that:

- the AISSS meets the definition of a business activity within the meaning of the Commonwealth Government’s competitive neutrality policy statement;
- the AISSS enjoys no significant net competitive advantage from its Commonwealth Government ownership;
- the current costing and pricing practice of the AISSS is consistent with, and exceeds, that required were it subject to competitive neutrality principles;
- the AISSS receives no significant competitive advantage from its current tax-exempt status;
- the AISSS has a significant share of the market for swim school activities within its catchment area, but its pricing practice is consistent with normal commercial behaviour and has not had the effect of eliminating or substantially damaging a competitor, preventing entry, or preventing or deterring competitive conduct in that market, nor has its operation been inconsistent with efficient resource allocation; and
- subjecting the AISSS to appropriate competitive neutrality arrangements would involve negligible costs while ensuring the AISSS would not gain any unreasonable competitive advantage in the future from its government-owned status.

Accordingly, the CCNCO recommends that the AISSS be subject to competitive neutrality principles. It also recommends that these arrangements take the form of full-cost pricing rather than the corporatisation model.



References

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