



*Australian Government
Competitive Neutrality
Complaints Office*

Australian Valuation Office

AGCNCO
Investigation
No. 11

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The Australian Government Competitive Neutrality Complaints Office

The Australian Government 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 Australian Government business activities.

Information on the Office and its publications can be found at www.ccnc.gov.au or by contacting Media and Publications on (03) 9653 2244.



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 Australian, State and Territory Governments have implemented this policy as part of their commitment to the National Competition Policy Reform Package.

The Australian Government's approach is outlined in its 1996 *Competitive Neutrality Policy Statement* (CoA 1996). The recently released *Australian Government Competitive Neutrality - Guidelines for Managers* (CoA 2004) provides further implementation details.

Competitive neutrality requirements automatically apply to Australian Government Business Enterprises, designated business units of budget sector agencies and all in-house units that tender for competitive contracts. It may apply to other businesses if the benefits outweigh the costs.

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

- charge prices that fully reflect costs;
- pay, or include an allowance for, government taxes and charges such as payroll tax, the goods and services tax and local government rates;
- pay commercial rates of interest on borrowings (or include an allowance equal to the benefit of any government guarantee);
- generate commercially acceptable profits; and
- comply with the same regulations that apply to private businesses (such as the Trade Practices Act and planning and environmental laws).

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

- an exposed government business is not applying competitive neutrality requirements;
- those arrangements are ineffective in removing competitive advantages arising from government ownership; or
- a particular government activity which has not been exposed to competitive neutrality should be.



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1 The complaint

1.1 Nature of complaint

The Australian Valuation Office (AVO) is a business unit operated by the Australian Taxation Office (ATO). It employs around 130 staff and has 11 offices located across Australia.

The AVO provides a range of valuation services, on a fee for service basis, to government departments and agencies and the private sector. These services include:

- appraisals of property and other assets for government housing and welfare agencies (examples include large scale valuations for State and Territory housing authorities and the valuation of the assets of applicants for Centrelink benefits);
- special purpose valuations of property for capital or rental value, connected to acquisitions, disposals, leases or financial statements;
- plant and equipment valuations; and
- corporate valuations for consolidation and taxation purposes.

Centrelink is at present the AVO's largest client.

On 4 November 2003, Herron Todd White Pty Ltd wrote to the Australian Government Competitive Neutrality Complaints Office (AGCNCO) alleging that the AVO is not complying with competitive neutrality. Specifically, the complainant alleges that the pricing regime used by the AVO in tendering situations *systematically* fails to adequately reflect the full costs of service provision. Herron Todd White claims that the AVO's pricing fails to adjust for a number of key cost advantages which accrue from its position within the ATO, including:

- access to resources such as IT and telecommunications at reduced rates;
- reduced commercial rents, accommodation search costs and fit-out costs as a result of being co-located with the ATO; and
- diminished search and compliance costs in relation to professional indemnity insurance, given AVO's 'government' status.

Herron Todd White further alleges that the pricing regime employed by the AVO fails to include a tax equivalence component, and that the AVO cannot be earning a rate of return which accords with normal commercial standards. The complainant concludes that:

... the AVO is establishing a price regime that is predatory, as it cannot be matched in the long term by its market competitors who seek only a reasonable return on investment. Eventually the AVO will force out competition and be either a monopolistic provider or through its actions will have established a market oligopoly.

In deciding to investigate this complaint, the AGCNCO is satisfied that the complaint falls within the purview of the Australian Government's competitive neutrality complaints process (see below) and:

- 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 CN status of the AVO

The Australian Government's *Competitive Neutrality Policy Statement* (CoA 1996 p. 30) identifies the provision of valuation services on a commercial basis by the AVO as a Commonwealth business activity subject to competitive neutrality. The AVO's operating revenue — \$18 million in 2002-03 — lies well above the \$10 million revenue threshold for the automatic application of competitive neutrality. As such, the AVO has been subject to competitive neutrality requirements since 1996. This complaint therefore concerns whether those requirements have been applied effectively, not whether they should be applied.

2 Assessment of issues

At the core of Herron Todd White’s complaint is the allegation that the AVO’s pricing of tenders does not reflect the full cost of providing the services concerned, and hence does not comply with CN principles. In investigating this claim, the AGCNCO considered three broad issues:

- whether the AVO operates as a stand alone business;
- whether its cost base includes adjustments for any taxes or charges that it is exempt from by virtue of its government ownership; and
- whether it earns a commercial rate of return.

2.1 Is the AVO a stand-alone business?

In cases where a government business is a demonstrably separate entity — 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 generally be based on its aggregate financial performance; such as the rate of return it earns on assets (including any adjustments for taxation exemptions, 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 have a pervasive impact on its profitability. In such circumstances, a competitive neutrality assessment examines both the level of profits generated and the construction of the cost base.

A threshold issue in investigating the complainant’s allegations of systemic underpricing, therefore, is whether the AVO is a stand-alone business. Herron Todd White alleges that it is not, and that although the AVO has full accounting separation from the ATO, it nevertheless derives significant cost advantages by being part of the ATO.

Nature of the AVO's relationship with the ATO

In the course of investigating this claim, the AGCNCO considered the structure of the AVO's operations and the extent to which it shares resources with, and is subject to the control of, its parent organisation, the ATO.

As noted previously, the AVO is a business unit operated by the AVO. Its operations are managed separately via strategic and business plans (with sub-plans for different elements of its operations, such as resources, marketing and IT). It reports to the ATO on its progress against its business plan on a regular basis.

The AVO has its own budget and does not receive Commonwealth funding. It also has full accounting separation from the ATO (that is, it has its own balance sheet, profit and loss and cash flow statement), and is audited separately to the ATO by the Australian National Audit Office (ANAO). Its annual financial results are publicly reported within the ATO Annual Report series.

The AVO does share human resource and payroll services with the ATO. However, it pays the ATO for these services at a level which reflects the cost of their provision.

Also, the AVO:

- has its own PABX facilities and independently manages its own telecommunications systems using employees or contractors which it engages;
- employs and manages a separate IT infrastructure, with the acquisition and development of IT assets managed and funded internally;
- is not co-located with the ATO in any of its sites of operation, and does not receive property services, such as those connected with search and fit-out requirements, from the ATO; and
- pays for information searches, on normal commercial terms, from either State Government providers or data resellers.

In its response to the complaint, the AVO advised that, in relation to the procurement of materials including cars, computer hardware, computer software and stationary, it may enjoy a small advantage as a result of being government owned.

On investigation, however, the AGCNCO has determined that such advantages are not significant in competitive neutrality terms. The AVO, ATO and other government organisations do not receive tax or other special exemptions in relation to such purchases. Further, any fleet or volume discounts enjoyed by the AVO are similar to those enjoyed by many medium and large sized businesses in both the

private or public sector, and are therefore more accurately described as advantages of scale rather than advantages of government ownership.

The AGCNCO finds that the AVO operates as a stand-alone business and does not receive a competitive advantage through access to ATO resources at non-commercial rates.

2.2 The AVO's cost base

As noted above, competitive neutrality requires government businesses to bear all of the costs associated with taxes, regulations and the like in a similar fashion to their private sector counterparts. In this context, the complainant alleges that the AVO is not subject to an equivalent level of taxation or regulation and has access to debt finance at concessional interest rates.

Taxes, regulatory requirements and debt financing

In relation to taxation requirements, the AVO advised the AGCNCO that it is subject to the same GST, FBT and PAYE taxation arrangements as other taxpayers.

As part of its implementation of competitive neutrality, the AVO makes tax equivalence payments for payroll tax and corporate tax. Payroll tax adjustments are based on the valuation rules prevailing in each jurisdiction and are subject to audit by the ANAO. Income and company tax payments, based upon prevailing corporate tax rates, are paid annually to the Department of Finance and Administration (DOFA).

As part of the Australian Government, the AVO does not pay stamp duty on accommodation leases. However, using the current stamp duty rate in New South Wales (35 cents per \$100 of lease value) as an example, the total reported value of lease obligations of the AVO in 2002-03 would only yield a total stamp duty requirement of approximately \$7000. Thus, while the exemption from stamp duty is an advantage to the AVO, relative to its total turnover of over \$18 million annually the financial benefit would not materially affect pricing outcomes.

The AVO must fully comply with relevant regulatory requirements across jurisdictions. These include registration and licensing requirements for AVO valuers which are identical to those faced by the private sector.

With regard to debt financing, the AVO currently has no long-term debt (having fully repaid its debt capital to DOFA in 2001).¹ As such, the AVO currently faces no requirement for debt equivalence adjustments.

The AGCNCO finds that the AVO appears to gain no material advantages in the areas of taxation, regulation or debt financing as a result of it being government owned.

Insurance costs

The AGCNCO examined a broad range of insurance costs faced by the AVO and its competitors. On investigation, the AVO was found to make insurance payments at commercial levels in relation to public liability, property loss and fraud, fidelity, workers' compensation and third party motor vehicle coverage.

The AGCNCO finds that the AVO meets its competitive neutrality obligations in relation to payments for insurance costs in the areas of public liability, property loss and fraud, fidelity, workers' compensation and third party motor vehicle coverage.

Professional indemnity insurance

Herron Todd White also raises professional indemnity (PI) insurance as a potential source of advantage accruing to the AVO. It suggests that the AVO's connection with the Australian Government reduces the probability that it will face a PI insurance claim, and that, for equivalent valuations, the AVO therefore faces markedly lower indemnity insurance costs than its major competitors.

The AVO currently incurs PI insurance costs in the order of \$45 000 per annum, or approximately 0.25 per cent of gross annual turnover.

In examining whether this premium is set on a competitively neutral basis, the AGCNCO consulted with representatives from Comcover (the Australian Government's self-managed insurance fund which has provided PI coverage to the AVO since 1998), the AVO and several private insurance brokers.

Consultations with private insurers who specialise in the valuation industry indicate that PI costs are an increasingly significant component of industry overheads. While this partly reflects an economy-wide trend towards increased PI premiums, escalating costs have also been a consequence of a number of high profile legal

¹ Prior to repayment, AVO paid interest to DOFA based on a rate structure agreed with the former Department of Administrative Services.

cases where valuers have been successfully sued for damages.² Currently, PI premiums for large private firms of valuers undertaking work with a moderate level of risk attached to it are typically equivalent to 7 to 10 per cent of gross annual turnover. Thus, there is a substantial difference between the PI insurance premium of the AVO (0.25 per cent) and its private competitors.

Clearly, part of this disparity in premiums can be justified by differences in the risk profile of the work undertaken by the AVO and that of many of its commercial competitors. Valuations undertaken by the AVO for asset test and financial reporting purposes, for example, would seemingly have a lower risk of claim when compared to most other forms of valuation work. This suggests that, in constructing a competitively neutral cost base for the AVO's services, it would be inappropriate to simply apply the industry benchmark PI rate.

Notwithstanding the differences in the risk profile of the AVO relative to private sector valuers, the basis on which the current premium has been determined suggests that some increase is warranted on competitively neutrality grounds. During its investigation, the AGCNCO was advised that, on insuring with Comcover in 1998, the AVO was charged a premium equivalent to 90 per cent of that previously charged by the private insurer. Annual premium adjustments have occurred since then, based on the premium pool requirements of Comcover and increases in reinsurance and administration costs. However, the premium previously charged by the private insurer may well have taken into account that the AVO was government owned, and therefore faced a lower risk of being sued — especially as the majority of its work was (as now) performed for other government agencies. Thus, it is likely that the premium would have been lower than that which could have been obtained by a private valuer performing the same work.

A determination of the magnitude of adjustment required to the AVO's PI premium lies beyond the remit of the AGCNCO's investigation. Accordingly, the AGCNCO recommends that the Department of Treasury and the Department of Finance and Administration initiate a process, drawing where relevant on information obtained from the AVO and other key stakeholders (for example, Centrelink), to determine what PI premium should be incorporated into the AVO's tender prices to meet competitive neutrality requirements.

The AGCNCO notes that Centrelink — the AVO's biggest customer — currently requires valuers who perform assets test work under contract to hold professional indemnity insurance, even though the risks attaching to that work are apparently low. An adjustment to the AVO's PI premiums would ensure that Centrelink's

² For example, *I & L Securities Pty Ltd v Herron Todd White Valuers (Brisbane) Pty Ltd* 2002 [High Court of Australia 41 2, 2 October 2002] .

decision to continue with this approach, vis a vis the alternative of self-insurance, is made on an appropriate basis.

The AGCNCO recommends that the Department of Treasury and the Department of Finance and Administration institute a process, drawing as appropriate on information obtained from the AVO and other key stakeholders (for example, Centrelink), to determine what competitive neutrality adjustment should be made to the AVO's cost base for professional indemnity insurance.

2.3 Rate of return issues and the AVO

Herron Todd White alleges that the AVO is not setting prices in a way which fully reflects the costs of provision, inclusive of a return on assets. It states:

We believe that the Australian Valuation Office (AVO) is bidding prices at tender for contract work that are below the industry break-even price, where break-even is cost recovery only with nil return on investment.

As noted, for a stand alone government business, the aggregate rate of return performance over time is a critical indicator of whether its pricing is competitively neutral. This implies that, as with private businesses, some transactions could yield very high returns while others could yield low, or even negative, returns.

Herron Todd White provided examples of bids on which it considered the AVO had priced at an uncommercially low level. In turn, the AVO provided a range of recent counter examples, where it had been undercut by private and government competitors. These claims and counter claims underscore the point that, while often triggering complaints, individual transactions do not provide a sound basis for assessing compliance with competitive neutrality.

An acceptable rate of return target for the AVO?

The target rate of return on assets for the AVO should be broadly equivalent to that of its competitors. The most common approach to setting return targets in the private sector is by reference to the business weighted average cost of capital (WACC). Approaches used to estimate the WACC have been dealt with extensively in previous AGCNCO publications (in particular CCNCO 1998).

Based on the analysis in that publication, for a business like the AVO with a low to average level of market risk, a nominal pre-tax target rate equivalent to the long term government bond rate plus 3 to 5 percentage points would appear to be broadly

appropriate. At current interest rates, this would equate to a pre-tax target rate of return of 8 to 10 per cent.

Rate of return performance of the AVO

The AGCNCO examined the audited annual accounts of the AVO. They show that, with the exception of 2002-03, the AVO has met or exceeded the aforementioned rate of return target in recent years (table 1) based on its current level of expenditure (inclusive of current PI premiums).

Table 2. AVO financial outcomes 1998-1999 to 2002-03 (\$ '000)

| | 1998-1999 | 1999-2000 | 2000-01 | 2001-02 | 2002-03 | 2002-03 (AVO estimates excluding restructure) |
|-----------------------------|-----------|-----------|---------|---------|---------|--|
| Operating revenue | 18,173 | 18,056 | 17,742 | 19,120 | 18,379 | 18,379 |
| Operating expenditure | 15,790 | 16,571 | 16,812 | 18,056 | 18,049 | 17,549 |
| Profit/(Loss) before tax | 2,383 | 1,485 | 930 | 1,064 | 330 | 830 |
| Shareholder equity and debt | 4,220 | 4,718 | 5,045 | 5,417 | 3,965 | 3,965 |
| Return on total assets (%) | 13 | 11 | 8.3 | 8.3 | 3.3 | 8.4 |

Source: ATO Annual Report (1999, 2000, 2001, 2002, 2003).

Moreover, as the AGCNCO has previously argued, failure to achieve the target in a particular year does not, of itself, indicate a failure to comply with competitive neutrality. As for private businesses, annual returns for government businesses will fluctuate over time. Notably, since 1998-99, the AVO's *average* annual rate of return on assets of 8.7 per cent falls within the target range.

The AGCNCO also notes that the relatively low return achieved by the AVO in 2002-03 was partly a reflection of some one-off costs of restructuring. Such restructuring has presumably been undertaken to improve returns in future years — again underscoring the importance of looking at rates of return over time rather than for individual years.

That said, a future adjustment to the AVO's cost base to incorporate a competitively neutral charge for PI insurance would, without offsetting price increases, see the AVO's rate of return fall. Hence the AVO's satisfactory rate of return performance in recent years must be viewed in the context of a cost base which has been reduced by virtue of the organisation's government ownership.

The AGCNCO finds that the AVO has in the last five years generated a rate of return, based on current levels of expenditure, that is consistent with competitive neutrality principles. However, this satisfactory rate of return performance must be viewed in the context of a cost base which has been reduced by virtue of the organisation's government ownership.

2.4 Findings

The AGCNCO finds that the AVO:

- operates as a stand alone business and does not receive a competitive advantage through access to ATO resources at non-commercial rates;
- appears to gain no material advantages in the areas of taxation, regulation or debt financing, as a result of it being government owned;
- meets competitive neutrality obligations in relation to payments for insurance costs in the areas of public liability, property loss and fraud, fidelity, workers' compensation and third party motor vehicle coverage; and
- has in the last five years generated a rate of return, based on current levels of expenditure, that is consistent with competitive neutrality principles.

However, in the area of professional indemnity insurance, the AGCNCO finds that:

- an increase is required, on competitive neutrality grounds, in the current professional indemnity insurance premium paid by the AVO. As such, it recommends that the Department of Treasury and the Department of Finance and Administration institute a process, drawing as appropriate on information obtained from the AVO and other key stakeholders (for example, Centrelink), to determine the extent of the increase required.

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