

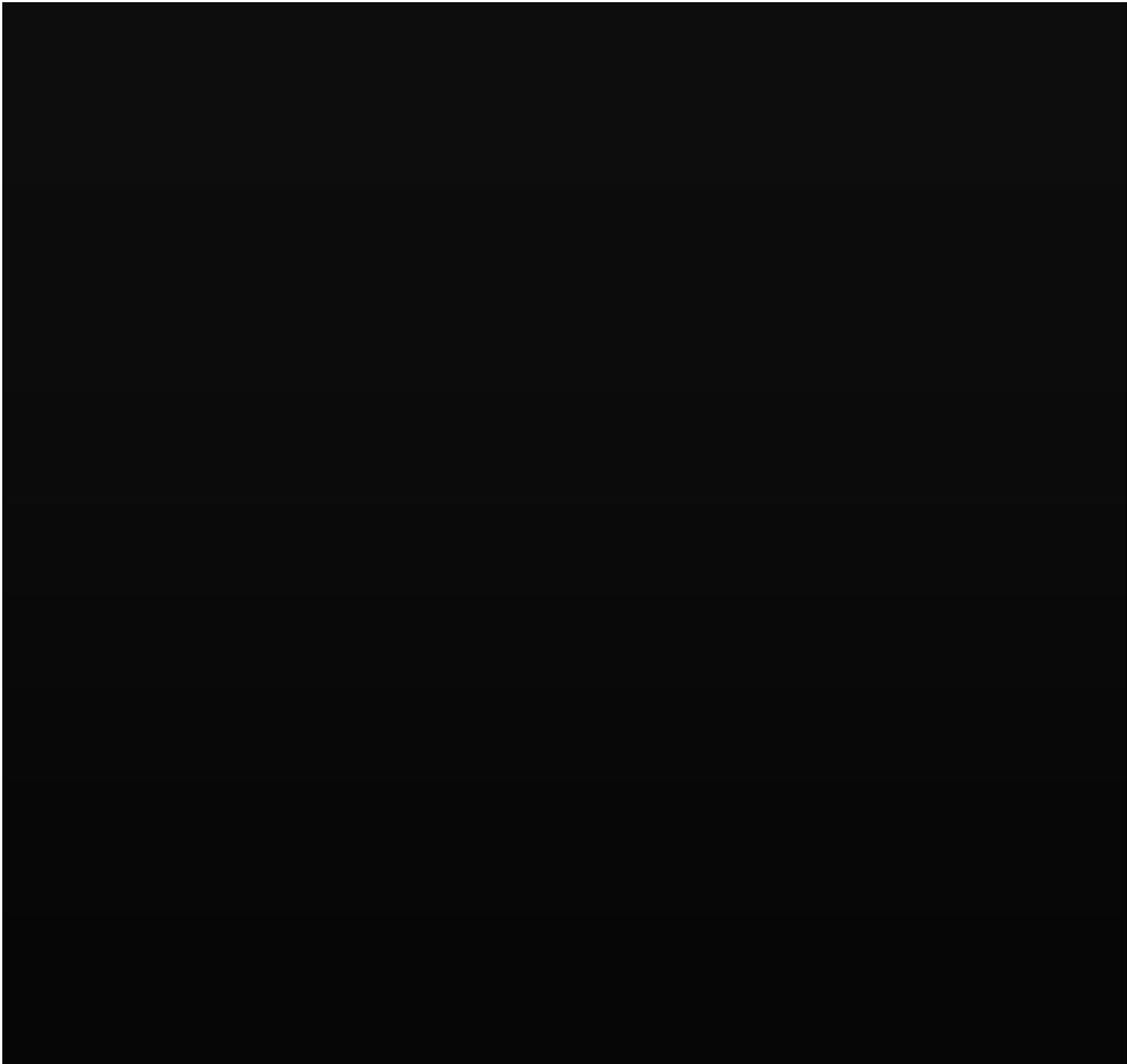


Commonwealth
Competitive Neutrality
Complaints Office



Docimage Business Services

Investigation
No. 9



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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 Minister for Financial Services and Regulation on the application of competitive neutrality to Commonwealth Government business activities.

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



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27 November 2001

The Hon Peter Costello, MP
Treasurer
Parliament House
Canberra ACT 2600

Dear Treasurer

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 into Docimage Business Services.

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 requirements automatically apply to Commonwealth 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 Commonwealth 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;
- 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 Commonwealth Competitive Neutrality Complaints Office is located within the Productivity Commission and is responsible for administering the Commonwealth'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.

CONTENTS

Competitive neutrality policy	IV
1 The complaint	1
1.1 Nature of the complaint	1
1.2 Background	1
1.3 Conduct of the investigation	2
2 Assessment of issues	3
2.1 Focus of assessment	3
2.2 Cost structure of DBS	4
2.3 Pricing structure of DBS	6
2.4 Findings	6
References	9

1 The complaint

1.1 Nature of the complaint

On 5 June 2001, the Legal Services Association Australia (LSAA) lodged a complaint questioning whether Docimage Business Services (DBS) is complying with the Commonwealth Government's policy on competitive neutrality. The LSAA was established for the purposes of defending the economic interests of the legal support services industry. The complaint was prompted by a concern among LSAA members that DBS was increasingly and aggressively expanding its market share within the highly specialised field of providing copying and imaging services to the legal industry.

The complaint from LSAA claimed DBS is able to undercut the traditional market players in the legal copying and imaging market because DBS is not subject to the same costs or tax regime as those service providers in the private sector. In particular, the complaint alleged that DBS is exempt from Commonwealth and State taxes that apply to their private sector competitors — a situation that would confer significant commercial advantage to DBS when competing on price within the market.

1.2 Background

DBS is an in-house competitive tendering and contracting business unit within the Australian Securities & Investment Commission (ASIC).

ASIC uses imaging and document management techniques to support its core functions of maintaining a public database on Australia's 1.2 million companies and pursuing investigations and prosecutions under the Corporations Law. ASIC, through its business unit, DBS, also provides documentary imaging services to a variety of Commonwealth agencies such as the Commonwealth Director of Public Prosecutions, the Australian Federal Police, the National Crime Authority and the Australian Government Solicitor. In addition, DBS provides imaging services to other organisations such as major public and private corporations, private law firms, various universities and local government authorities.

ASIC experiences significant peaks and troughs in the imaging and document management workload associated with its core functions. The uneven nature of this work means that its in-house capacity is in excess of demand for much of the year. ASIC has previously examined the merits of providing for its needs in this manner, and has decided in favour of the in-house provision of such services. DBS uses the document-imaging hardware capacity that would otherwise be in excess of ASIC requirements to bid for competitive tenders and contracts.

DBS's commercial turnover of around \$1–2 million would represent no more than 10 per cent of ASIC's overall document imaging activity. DBS has a small permanent staff — representing less than 1 per cent of ASIC staff numbers — which is supplemented by temporary contract staff recruited on an as and when required basis to produce contract work undertaken by DBS.

The specialised legal market which is the subject of the complaint by LSAA provides about a third of DBS annual revenue, and is a service DBS has been providing to government agencies and the private sector for the past seven years.

1.3 Conduct of the investigation

In the course of its investigations, the Competitive Neutrality Complaints Office (CCNCO) held discussions with representatives of the complainant, ASIC (finance branch), DBS and the unit within the Department of Finance and Administration responsible for reviewing Commonwealth business entities' implementation of competitive neutrality arrangements.

2 Assessment of issues

2.1 Focus of assessment

LSAA considers that the operation of DBS in the specialised legal copying and imaging industry has substantially damaged that industry by eroding the market share of traditional players. Moreover, LSAA alleges that this has occurred because DBS has breached its requirements to operate within the parameters of the Commonwealth Competitive Neutrality Policy. In particular, LSAA alleges that DBS is not subject to the same business costs or tax regime as its private sector competitors, and that this gives DBS a significant commercial advantage in competing with members of LSAA.

LSAA also noted that the provision of such specialised legal copying and imaging services is not a core function that ASIC is required to provide and thus, by implication, is not a business activity that ASIC, through DBS, should pursue.

In response to this view, DBS claimed that its activities provide ASIC with a number of significant advantages. These include allowing ASIC to use its imaging equipment and human resources more efficiently and allowing ASIC to build its expertise in the area of electronic imaging and CD production which, in turn, allows it to better support its core functions. In addition, DBS noted its operations increase employment opportunities in the Latrobe Valley, an outcome consistent with Commonwealth Government regional employment objectives.

The aim of competitive neutrality policy is to ensure that, where there is competition between government business activities and the private sector, there is no commercial advantage purely as a result of government ownership.

Accordingly, the focus of this assessment is not on the consequences of the competition DBS brings to the specialised market for legal imaging and document management. Rather, it is on whether DBS is costing and pricing its output in a manner consistent with competitive neutrality principles — that is, whether, in constructing its costs and setting its prices, DBS:

- fully accounts for all relevant costs attributable to its commercial activities;

-
- includes all relevant actual or notional costs that might apply in order to maintain tax, debt and regulatory neutrality with private competitors; and
 - includes an allowance for a commercial rate of return.

2.2 Cost structure of DBS

The LSAA complaint specifically alleges that DBS is not subject to the same business costs or tax regime as those in the private sector. It also implicitly raises the question of whether DBS (as an in-house unit sharing resources with its parent organisation) has allocated an appropriate level of joint costs to its prices.

In response to the LSAA allegation, DBS provided the CCNCO with details of how it determines its cost and price structure, and provided specific examples of its costing sheets for tenders — not all of which were successful.

Accounting for attributable costs

In order for DBS to comply with competitive neutrality, it must price to recover all appropriate costs. Where an in-house unit and its parent organisation share major assets (as is the case with DBS and ASIC), an appropriate cost allocation mechanism is needed to ensure that budget funded activities do not cross-subsidise the commercial activities of the business unit.

Appropriate methodologies for allocating costs are addressed in the CCNCO's publication *Cost Allocation and Pricing* (CCNCO 1998). In that publication, the CCNCO indicated that a business unit using assets and resources necessary for the function of the parent agency will satisfy competitive neutrality principles if it allocates those costs on an avoidable cost basis. The avoidable cost comprises all the costs that the agency would avoid if the commercial activity were not provided.

As noted, DBS's permanent staff represents less than 1 per cent of ASIC's staff, and its commercial turnover represents less than 10 per cent of the total value of document copying and imaging work conducted by ASIC. Moreover, the ability of DBS to undertake commercial work is subject to the availability of spare hardware capacity not required to meet ASIC's core demands.

In allocating joint costs to its commercial activities, DBS has adopted a fully distributed cost allocation methodology. In the CCNCO's view, this methodology attributes a level of cost significantly greater than that which would result were an avoidable cost methodology used. Hence, the resulting cost base is commensurately greater than that required to comply with competitive neutrality principles.

In 2000, ASIC commissioned an external consultant to review the costing and pricing model for DBS. That review provided assurance to DBS that it was identifying all the direct and indirect costs that it was required to build into its charges.

Tax, debt and regulatory neutrality

LSAA alleged that DBS is exempt from Commonwealth and State Government taxes that apply to its competitors, and that this confers a significant commercial advantage to DBS.

The most significant State Government tax for this business activity is payroll tax. While DBS is not required to pay payroll tax, in constructing its cost base, it builds in an allowance for notional payroll taxes (and any other State Government taxes where appropriate).

With respect to Commonwealth Government taxes, DBS, like most Commonwealth entities, is subject to fringe benefits tax and, following the introduction of the Goods and Services Tax, is subject to the same commodity tax regime as its private sector counterparts. Moreover, although not subject to company tax on its earnings, DBS builds a notional equivalent into its cost structure when determining its prices.

The implementation by DBS of its competitive neutrality obligations regarding the costing of Commonwealth and State Government taxes is therefore consistent with the arrangements outlined in the publication *Commonwealth Competitive Neutrality Guidelines for Managers* (Commonwealth Treasury 1998).

DBS's costs also appear comparable to its private sector competitors with respect to the cost of borrowing and of complying with relevant regulations. DBS applies a commercial rate interest to any borrowings and conducts its commercial activities under the same regulatory environment as its private sector competitors. In this respect, DBS meets the debt neutrality and regulatory neutrality requirements of competitive neutrality policy.

Commercial rate of return

Competitive neutrality requires that publicly owned businesses should make a commercial rate of return on their assets. In the case of DBS, it has a target commercial rate of return and builds this component into its cost base.

Information from LSAA indicates that a net-profit-to-sales ratio of 8–12 per cent would represent a reasonable rate of return in this industry. Information provided by

DBS and the Department of Finance and Administration indicates that the unit's target rate of return and its return estimated for FY2000-01 accord with this industry target. As such, those returns are sufficient to meet DBS's obligations under competitive neutrality.

In sum, the CCNCO finds that DBS has allocated costs to its commercial operations and implemented the relevant competitive neutrality cost adjustments (including for taxation) in a manner consistent with that required of it under competitive neutrality policy.

2.3 Pricing structure of DBS

A specific concern of the complainant was that DBS had won significant market share in the highly specialised market for legal document imaging by selectively undercutting the prices of its competitors. This, the complainant held, was only possible because DBS was operating in breach of competitive neutrality policy.

However, competitive neutrality does not require pricing that will deliver a commercial rate of return on each and every bid. Businesses in all industry sectors may sometimes price individual bids that yield low or negative returns for strategic reasons. Accordingly, competitive neutrality only requires that the pricing regime of DBS is sufficient to cover all costs — including a commercial rate of return — for the aggregate activities of the business.

As noted above, the CCNCO finds that DBS has allocated costs to its commercial operations and implemented the relevant competitive neutrality cost adjustments in a manner consistent with that required of it under competitive neutrality policy. As its pricing policy has been sufficient to recover all these costs and deliver a commercial rate of return, the CCNCO finds that DBS's pricing regime is consistent with its obligations under competitive neutrality.

2.4 Findings

The CCNCO finds that DBS has allocated costs to its commercial operations and implemented the relevant competitive neutrality cost adjustments (including for taxation) in a manner consistent with that required of it under competitive neutrality policy. In this regard, the CCNCO notes that DBS has used a fully distributed cost allocation methodology to attribute its share of joint agency costs, rather than an avoidable cost methodology. This has the consequence of raising DBS's costs significantly above the minimum the CCNCO considers would be necessary to deliver competitively neutral costing.

As DBS's pricing regime is, in aggregate, successfully recovering all relevant costs including a commercial rate of return, the CCNCO finds that DBS's pricing regime is consistent with its obligations under competitive neutrality.

As a result of its investigation, the CCNCO therefore finds that DBS is currently operating in a manner consistent with competitive neutrality policy, and that no action is required in response to the complaint brought against it.

References

CCNCO (Commonwealth Competitive Neutrality Complaints Office) 1998, *Cost Allocation and Pricing*, CCNCO Research Paper, Productivity Commission, Canberra, October

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Commonwealth Treasury 1998, *Commonwealth Competitive Neutrality Guidelines for Managers 1996-97*, AGPS, Canberra