3 Competitive neutrality

Traditionally, many government business activities were able to obtain certain advantages over their private sector rivals simply as a result of their public sector ownership. These advantages included, for example, exemption from income tax, the lower costs of borrowing enabled by government guarantees, and exemption from regulation that affected the private sector. Such distorting advantages favour resources flowing to the public sector business regardless of that business's level of efficiency. It is in the interests of efficiency, therefore, to remove such distortions so resources are used where they are most valued. NCP competitive neutrality principles aim to remove resource allocation distortions by ensuring that significant government-owned businesses face the same commercial environment as that of their private sector counterparts.

Clause 3 of the Competition Principles Agreement (CPA) obliges the Commonwealth, State and Territory governments to introduce competitive neutrality, where it is in the public interest, for significant government business activities. Clause 7 extends the obligation to significant local government business activities. The Commonwealth and the Australian Capital Territory have no local government sectors. In addition, as part of the first tranche NCP assessment, the National Competition Council accepted that the relatively small size of local government businesses in the Northern Territory meant that these businesses need not apply competitive neutrality principles under CPA clause 3.

Sometimes competitive disadvantages relate to public ownership; for example, government businesses may have additional accountability and reporting requirements and higher superannuation costs than those of their private sector competitors. Governments may address such disadvantages, but the CPA does not require them to do so. Clause 3(7) of the CPA allows jurisdictions to retain regulation that applies to a government business (but not to the private sector) if the jurisdiction considers the regulation appropriate.

Competitive neutrality obligations under the NCP

Competitive neutrality obligations under the CPA involve:

- the adoption of a corporatisation model for significant government business enterprises classified as 'public trading enterprises' and 'public financial enterprises', and, where appropriate, for significant business

activities that government agencies conduct as part of a broader range of functions;

- the payment of full Commonwealth, State and Territory taxes or tax equivalent payments;
- the payment of debt guarantee fees to offset the competitive advantages provided by government guarantees;
- compliance with regulations to which private sector companies are normally subject; and
- the investigation and public reporting of allegations that significant government businesses are not implementing competitive neutrality principles appropriately.

Government businesses, like their private sector counterparts, must earn sufficient revenue to cover their costs. The CPA states that significant government business activities should set prices for their goods and services that 'reflect full cost attribution for these activities'. The Council of Australian Governments (CoAG) defines 'full cost attribution' as accommodating a range of costing methods, including fully distributed cost, marginal cost and avoidable cost, as appropriate in each case (CoAG 2000).

In addition to labour, raw materials and the competitive neutrality elements listed above, costs include the cost of capital, which is met if a government business earns a commercial return on assets over a reasonable period of time. Other costs may also be relevant, even if not explicitly mentioned in the CPA. All jurisdictions' competitive neutrality policy statements note that local government rates and charges (or equivalents), for example, are an element of the full cost price. Unless government businesses undertake full cost attribution, they may be able to operate at lower profit levels than their competitors can, and thus be able to undercut their competitors even if less efficient.

Assessing jurisdictions' progress in implementing their obligations

In line with CPA clause 3 and the efficient resource allocation objective of competitive neutrality, the Council assesses jurisdictions' NCP compliance by looking for:

- a jurisdiction's application of competitive neutrality principles to all significant government business activities (including local government businesses) to the extent that the benefits from application outweigh the costs;

- a jurisdiction's delivery of governments' social objectives in a way that is consistent with competitive neutrality obligations — that is, the delivery of clearly defined and costed community service obligations (CSOs) that are directly funded by government;[1] and

- a jurisdiction's use of effective processes for investigating and acting on complaints that significant government business activities are not applying appropriate competitive neutrality arrangements.

The Council has consistently emphasised the importance of effective competitive neutrality arrangements. In the June 1997 first tranche NCP assessment, the Council said:

> *As the reform process continues, the Council will look in more detail at matters related to the effectiveness of jurisdictions' reform programs. This will encompass, in particular, consideration of the effectiveness of approaches to corporatisation, including performance monitoring arrangements, application of full cost pricing principles and delivery of CSOs.* (NCC 1999a, p.57)

In relation to complaints handling, the Council noted the importance of an effective, generally accessible mechanism, stating that for the second and third tranche NCP assessments it would take account of:

> *... the degree of independence of the mechanism, the intended scope of coverage including the nature of complaints which can be lodged, the transparency of reporting of complaints and findings and the ease of access for complainants.* (NCC 1999a, p.58)

The Council considers that governments should give their complaints bodies scope to investigate competitive neutrality complaints about all public businesses, particularly where the government does not require all businesses to apply competitive neutrality. Even where businesses are small (so the net benefit from applying competitive neutrality principles may not be clear), the investigation of complaints can provide the government with useful advice about appropriate policy action. In the first tranche assessment, regarding the scope of coverage of complaints mechanisms, the Council stated that it considers:

> *... the handling and reporting of all non-trivial competitive neutrality complaints as important rather than only those about businesses to which competitive neutrality principles are applied*. (NCC 1999a, p.58)

[1] At its meeting on 3 November 2000 CoAG determined that governments, in implementing competitive neutrality requirements under the CPA, are free to determine who should receive a CSO payment or subsidy, which should be transparent, appropriately costed and directly funded by government (CoAG 2000).

Full coverage of significant businesses

Now five years after the publication of competitive neutrality policy statements, the Council expects that all significant businesses (including at local government level) should be subject to competitive neutrality where appropriate, as intended by CPA clause 3. In the two earlier NCP assessments, the Council accepted that it was appropriate for governments to apply competitive neutrality principles to their larger businesses as a transitional measure. However, the Council has always regarded business size thresholds as arbitrary and relatively inflexible measures of significance, and has consistently noted that significant businesses should be identified on the basis of their effect or potential effect on their relevant market(s).

Mechanisms are available to jurisdictions to ensure that thresholds-based prioritisation does not inadvertently exclude below-threshold businesses that have a significant impact on their markets. The Commonwealth, for example, uses its competitive neutrality complaints handling mechanism to investigate concerns that a business has not been exposed to competitive neutrality (with the possibility of a recommendation to the relevant Minister that competitive neutrality principles be applied). Western Australia initially made use of size thresholds to prioritise the implementation of competitive neutrality, but subsequently reviewed smaller government businesses to determine whether there is a net public benefit in applying competitive neutrality principles.

Consistent with this approach, the Council required for 2001 NCP compliance that:

- competitive neutrality principles be in place for all government business activities that have a significant impact on their relevant market(s), to the extent that the benefits from application outweigh the costs; and

- all transitional arrangements, such as the phased introduction of competitive neutrality principles to smaller State and Territory businesses and local government businesses, be substantially complete.

While this assessment focused on those businesses that jurisdictions' policy statements identified as being significant, the Council sought evidence of jurisdictions' progress in applying competitive neutrality principles to businesses below the threshold size, where such businesses have a clear effect on their market. The Council looked for governments to have some means of (a) identifying these businesses and (b) considering whether it would be appropriate to apply competitive neutrality principles.

Queensland's 1996 competitive neutrality policy statement classifies businesses as 'significant' for the purpose of implementing competitive neutrality principles on the basis of size thresholds such that:

- competitive neutrality principles are applied to declared 'significant' State Government businesses (those with annual expenditure above $10 million) and complaints can be made about only these businesses; and

- at local government level, only significant businesses (those with annual expenditure above $5 million) are required to conduct a public benefit test for the application of competitive neutrality principles. Smaller local government businesses are given financial incentives to apply a voluntary code of conduct based on competitive neutrality principles. As with State Government businesses, complaints can be made about the activities of only those businesses that apply competitive neutrality principles.

Queensland acknowledged that questions concerning the scope of competitive neutrality policy might arise in its 1997 NCP annual report. That report indicated there may be potential for the competitive neutrality complaints mechanism to apply to a broader range of business activities than it does at present. The 1997 report also stated that the current approach had been chosen to limit the application of the complaints mechanism until more experience is gained in administering it for the State's significant business activities.

Queensland considers that it is not necessary to apply competitive neutrality principles to State Government nondeclared business activities as reforms can be applied to these businesses on a case-by-case basis dependent on a net public benefit. Moreover, Queensland believes that its approach to applying competitive neutrality to local government business activities, involving a combination of prescription and incentives, is resulting in appropriate coverage of these businesses.

Queensland advised that its competitive neutrality complaints guidelines apply to complaints that would be excluded on the basis of size thresholds from consideration under the *Queensland Competition Authority Act 1997*. These complaints may be dealt with in the first instance by the Queensland Treasury in consultation with the relevant department. In addition, under section 10(e) of the Act, the Premier and Treasurer have the capacity to refer competitive neutrality matters to the Queensland Competition Authority for investigation where they consider this to be appropriate. Matters referred to the authority may include Government business activities that are not significant in terms of the 1996 policy statement.

Queensland reported that competitive neutrality is being introduced to the Public Trust Office (as recommended by a review) and that it will soon consider reviews of the benefits of applying competitive neutrality to the TAFE sector and Workcover. Queensland also reported that a competitive neutrality review concluded there is no reason to alter the sole provision of superannuation for Queensland public sector agencies via Qsuper (see chapter 20).

Victoria applies competitive neutrality to its government business activities except in a small number of minor cases. Victoria's annual NCP report listed the exceptions and provided explanations for them. In some cases the businesses are not in competition with private industry and in several others the businesses were reviewed and found to be small in relation to the size of the market, with a correspondingly minor competitive impact on their markets.

Western Australia reported that competitive neutrality principles do not apply to the Lotteries Commission of Western Australia or to the Government Employees Superannuation Board. In both cases reviews concluded that the application of competitive neutrality was not in the public interest. However, Western Australia advised it anticipates revisiting the competitive neutrality status of the Government Employees Superannuation Board in 2001, given the recent introduction of choice in superannuation fund membership for government employees. The application of competitive neutrality principles to the Lotteries Commission of Western Australia is discussed in chapter 23.

Tasmania reported that the Port Arthur Historic Site Management Committee although required to price in accordance with full cost attribution principles, has an exemption from the payment of income tax equivalents and dividends. Tasmania stated that the exemption is under review and that the Government is considering the most appropriate structure for the committee. No other jurisdictions reported any exceptions to the application of competitive neutrality policy and the Council assumes that competitive neutrality principles apply to all significant businesses in these jurisdictions.

Particular structural arrangements in some jurisdictions mean that failure by certain government businesses to apply competitive neutrality principles is *not* noncompliance. Where businesses are not subject to Executive control (for example universities and part privatised businesses where the relevant government is a minority shareholder and the privatisation took place before the NCP), CoAG directed that the Council should consider governments' compliance with CPA clause 3 on a 'best endeavours' approach (CoAG 2000). Under this approach, the relevant government must provide at least a transparent statement of competitive neutrality obligations to the government businesses not subject to Executive control. The Council looks for governments, under the best endeavours approach, to actively encourage businesses not under Executive control to apply competitive principles. Jurisdictions stated in their NCP annual reports that they do this.

Clearly defined and costed CSOs

The NCP agreements, while seeking to achieve benefits through competition, do not affect governments' ability to establish and deliver broader social objectives, including the delivery of CSOs. However, it is important to clearly define and cost CSOs to achieve the efficient resource allocation objective of CPA clause 3. Without careful and systematic identification and implementation of CSOs, it is difficult to determine whether the prices charged by a government business reflect full cost attribution (as required by clause 3) or contain an element of subsidy (or penalty) due to government ownership. Visible CSOs enable private firms to readily identify CSO payments to government-owned competitors and adjust their business decisions accordingly.

Further, the ability of complaints processes to resolve pricing complaints expeditiously can often depend on governments clearly defining and costing

CSOs. If this is not done, the complaints procedure may become unnecessarily protracted, potentially disadvantaging the parties to the complaint.

All governments acknowledged, in their competitive neutrality policy statements and related pricing guidelines, the need to clarify the objectives and specify the noncommercial obligations of their businesses. Governments' policies and guidelines generally emphasise the importance to effective public policy of clear identification, definition and costing of CSOs and explicit funding from the purchasing agency's budget. CoAG also recognised the appropriate treatment of CSOs for competitive neutrality purposes, stating that governments are free to determine who should receive a CSO payment or subsidy, which should be transparent, appropriately costed and directly funded by government (CoAG 2000).

Western Australia, Tasmania, the ACT and the Northern Territory identify and cost CSOs in their annual budget process. In New South Wales, Victoria and Queensland, the relevant government business provides details of CSO payments in its financial and annual reports. Victoria also summarised CSO arrangements for all agencies in the supplementary tables of its 2001 NCP annual report. Similarly, the ACT listed all its CSO payments in its 2001 NCP annual report. South Australia reported that its *Public Corporations Act 1993* requires that, where relevant, the arrangements for CSOs be set out in the charter of a public corporation, including their nature and scope and costing and funding. In relation to entities subject to cost reflective pricing, South Australia advised that, in general, there is direct budget funding of non-commercial functions. South Australia also advised that a CSO working group has been formed to improve aspects of CSO policy arrangements. The Commonwealth's policy is that CSOs should be funded from the purchasing portfolio's budget, with costs determined as part of a commercially negotiated agreement.

Under NCP, the Council does not assess whether CSO objectives are appropriate — that is a matter for governments. Rather, governments' provision of public information about their CSOs enables the Council to confirm that CSOs are specified and funded such that effective and transparent provision of CSO services is encouraged, with minimal impact on the efficient provision of other commercial services. Public reporting of information about CSO arrangements is important in verifying that governments' policy approaches are consistent with the efficient resource allocation objective of CPA clause 3.

Investigation of alleged noncompliance

Under the CPA, governments are obliged to investigate allegations of noncompliance with competitive neutrality principles and report annually on those allegations. All governments implemented procedures for investigating allegations of noncompliance. Generally, these procedures place responsibility for handling allegations of noncompliance either with independent competition authorities or with Treasuries or other policy areas. Sometimes, a jurisdiction uses a combination of these approaches, whereby a policy unit

evaluates whether the relevant Minister(s) should refer the allegation to the competition authority. Allegations about noncompliance by local government businesses are usually initially considered by the local government business owner. Complainants have recourse to either the State complaints process or the relevant department of local government if the matter is not resolved.

The way in which a jurisdiction structures its complaints mechanism is not a matter for NCP assessment. Under the CPA, governments determine their procedures for dealing with complaints. The central NCP question is whether governments are ensuring the appropriate application of competitive neutrality principles through timely and effective handling of alleged noncompliance.

State and Territory NCP reports indicated that every government received new competitive neutrality complaints in 2000.[2] The Commonwealth Competitive Neutrality Complaints Office (CCNCO) is investigating a complaint against the Australian Road Research Board Transport Research, a company that is partially controlled by all jurisdictions. New South Wales and the Northern Territory are involved in this matter, but received no other new complaints in 2000. The Commonwealth received two further complaints. A complaint concerning security vetting by a business unit within the Attorney General's Department was resolved by negotiation and a complaint concerning the Bureau of Meteorology's services to aviators is under investigation by the CCNCO.

Victoria temporarily suspended its complaints investigations in 2000 pending the Government's review of its competitive neutrality policy. Victoria released its new policy in October 2000, at which time consideration of 18 complaints had been suspended. Following release of its new policy, the Victorian Government wrote to all parties to the complaints, asking them to endeavour to resolve remaining matters in the context of the new policy. If the matter could not be resolved by the parties, the complainant was then able to reinstate the complaint formally with the Victorian competitive neutrality complaints body. Victoria's complaints body had three matters on hand at 31 December 2000 — two complaints that had been reinstated and one new complaint. The Council accepts that the temporary suspension did not compromise Victoria's compliance with CPA clause 3.

The Queensland Competition Authority completed investigations of three competitive neutrality complaints that ENERGEX enjoyed a competitive advantage as its internal service providers were not subject to the same regulatory requirements as private service providers. In two cases the authority found that the allegations could not be substantiated. However, in the third case the authority found that ENERGEX is not subject to the same public and employee safety requirements as those applying to its private sector competitors and a breach of competitive neutrality policy had occurred.

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[2] Complaints lodged by Capricorn Capital against National Rail Corporation and FreightCorp in 1999 and 2000 are discussed in chapter 10.

Queensland's 2001 NCP report did not indicate that any competitive neutrality complaints had been made to the Queensland Treasury.

Western Australia received eight complaints, only one of which was the subject of further investigation. The complainant (an advocate of the use of alternative fuels) alleged that Western Power and AGL had received an interest free loan. However, Western Australia's investigation found that this was not the case and the complaint was dismissed. The other seven complaints did not fall within the scope of competitive neutrality because the businesses about which the complaints were made were either not government businesses or were not subject to competitive neutrality.

South Australia received five complaints, two of which were resolved when the agency ceased the activities that were the subject of complaint. South Australia suspended one investigation pending sale of the relevant government business. Investigation of two complaints was in progress at the time of this assessment.

Tasmania reported that five complaints were lodged with the Government Prices Oversight Commission (GPOC), the State's competitive neutrality complaints mechanism. GPOC upheld two of these. The first concerned the setting of noncommercial room rates at a student hostel. GPOC concluded that, while this involved a relatively insignificant amount in the relevant Government department's budget, it created the potential to affect the regional student hostel market. In the second case, involving a complaint by a private ambulance business, GPOC recommended that competitive neutrality principles apply to the patient transport services provided by the Tasmanian Ambulance Service (subject to a public benefit assessment). GPOC dismissed two complaints because it found the businesses concerned were not significant government businesses. GPOC is considering the other complaint.

Three complaints were lodged in the ACT. In the first case, a complaint that a Government-owned leisure facility did not pay some taxes was upheld. The complex is now run on commercial grounds and is being prepared for sale. Complaints concerning Government contracting of a leisure centre and alleging Government subsidisation of long-stay day childcare were not upheld by the ACT's complaints body.