Commonwealth Competitive Neutrality Guidelines for Managers

© Commonwealth of Australia 1998

ISBN 0 642 26143 1

This work is copyright. Apart from any use as permitted under the *Copyright Act 1968*, no part may be reproduced by any process without prior written permission from AusInfo. Inquiries should be directed to the Manager, Legislative Services, AusInfo, GPO Box 84, Canberra ACT 2601.

Copies of this publication are available for purchase, usually the day following issue, from Government Info Shops which are located in all Australian capital cities. Copies can also be ordered from

Mail Order Sales
AusInfo
GPO Box 84
CANBERRA ACT 2601

Printed by AGPS, Printing division of CanPrint Communications Pty Ltd

TABLE OF CONTENTS

SECTION A: BACKGROUND 1

Types of Government Activities Subject to Competitive Neutrality Arrangements........ 1

Responsibilities of Portfolio Ministers........ 5

Purpose of this Publication 6

Further Information about Competitive Neutrality 6

SECTION B: OVERVIEW OF COMPETITIVE NEUTRALITY POLICY PRINCIPLES 7

Allocating the Direct Costs of a Function 8

Rate of Return Requirement........ 9

Taxes & Tax Equivalent Regimes 9

Regulatory Neutrality 10

Debt Neutrality 10

SECTION C: APPLICATION OF COMPETITIVE NEUTRALITY 13

Setting a Commercial Rate of Return........ 13

Transitional ROR Arrangements........ 15

Measuring Returns: Assessing Performance 15

Measuring the Economic Rate of Return........ 16

Variations from Target Return Requirements........ 16

Allocation of Returns 16

Community Service Obligations (CSOs) 19

Community Service Obligations and the ROR Requirements 19

Taxes and Tax Equivalents........ 21

Types of Taxes Paid by Commonwealth Businesses........ 21

Types of Commonwealth Commercial Tax Payers 22

Direct Taxes 23
CAC Bodies 24
Large In-House Businesses 26
Small In-House Business Activities 28
Indirect Commonwealth Taxes..29
CAC Bodies 29
Large In-House Businesses 29
Small In-House Business Activities 30
State Taxes 30
Inter-Jurisdictional Taxation Issues 30
TER Payments 31
Debt Neutrality 32

SECTION D: COMPETITIVE NEUTRALITY COMPLAINTS MECHANISM 35

SECTION E: COMPETITIVE NEUTRALITY AND COMPETITIVE TENDERING AND CONTRACTING 37

Competitive Neutrality Contacts .... **Error! Bookmark not defined.**

SECTION A: BACKGROUND

All Australian Governments expressed a commitment to implementation of competitive neutrality principles in the *Competition Principles Agreement 1995* (CPA). Following this, the Commonwealth released its own *Competitive Neutrality Policy Statement* (CNPS) in June 1996. These Guidelines offer assistance in putting into practice the principles of the CNPS.

Competitive neutrality (CN) requires that government business activities do not have net competitive advantages over their private sector competitors simply as a result of their public ownership. This will help ensure that resources available for public expenditure are used in the most efficient manner possible. Subjecting government businesses to CN arrangements will also improve transparency and accountability by presenting costs in a comparable manner to that of the private sector. CN will assist public sector managers to more accurately assess whether the government should retain responsibility for certain business activities or whether alternative means of service provision should be considered. In this sense, CN is related to, and plays a role in, the processes set out in the Department of Finance and Administration publications, *The Performance Improvement Cycle* and *Competitive Tendering and Contracting*.

Types of Government Activities Subject to Competitive Neutrality Arrangements

The CNPS applies CN to all 'significant' Commonwealth business activities. This 'significance' threshold is generally a commercial turnover exceeding $10 million per annum. However, some types of business activity, such as GBEs and Business Units, are always considered significant regardless of turnover.

Activities are classified as a 'business' for the purposes of CN if they meet the following criteria:

- there must be charging for goods or services (not necessarily to the final consumer);

- there must be an actual or potential competitor (either in the private or public sector) ie purchasers are not restricted by law or policy from choosing alternative sources of supply; and

- managers of the activity have a degree of independence in relation to the production or supply of the good or service and the price at which it is provided.

These criteria operate to exclude from CN Government functions which are budget funded service delivery activities where there is no distinction between the purchaser and provider of the service. Where there is separation between the purchaser and provider, such as in the case of competitive tendering with an 'in-house' bid, the provider activity may be regarded as subject to CN if it is a business activity and falls above the 'significance' threshold.

The CNPS addressed the scope and application of CN arrangements for Commonwealth Government commercial business activities. In general, the CNPS indicated that CN arrangements would specifically apply to:

- all Government Business Enterprises (GBEs) and their subsidiaries;

- Commonwealth share-limited companies;

- Commonwealth Business Units[1];

- bids by all Commonwealth Government 'in-house units' for Competitive Tendering and Contracting (CTC) contracts[2]:
  - CTC units with turnover under $10 million still have to earn commercial returns, but may incur other CN costs on a notional basis;

- commercial business activities not in the above categories that are undertaken within (non-GBE) statutory authorities or Departments with commercial turnover of at least $10 million per annum:
  - commercial business activities with turnovers under $10 million will not initially be subject to the CN implementation arrangements, but

---

1 A Business Unit is a separate commercial activity within a Department of State that has access to the Commercial Activities Fund of the Commonwealth Public Account.

2 That is, activities subject to the Competitive Tendering and Contracting Guidelines issued by the Department of Finance and Administration.

particular activities may be subject to CN following complaints to the Commonwealth Competitive Neutrality Complaints Office (see below). (These activities may choose to apply CN, on the same basis as applies to CTC activities under $10 million, in order to prevent complaints.); and

- all future Commonwealth commercial business activities meeting the above criteria.

How CN is applied to significant businesses varies between different types of business. GBEs, the largest, most commercial and most independent businesses, should have CN arrangements approved by both the Minister for Finance and Administration and the relevant portfolio Minister. Business activities within departments or statutory authorities (in-house business activities), which are smaller and less independent, only need to have CN arrangements approved by their portfolio Minister. CTC activities involving less than $10 million annual turnover only need notionally apply CN.

A second major CN difference is how taxation laws and policies apply to various corporate forms. GBEs are subject to all taxes (or State tax equivalents in some cases). In-house business activities are subject to tax equivalents, rather than taxes, in most instances. CTC activities under $10 million pay notional tax equivalents, in most cases.

The major types of businesses subject to CN, and the different ways CN is applied to them are summarised in Table 1 below. (Note, this is only a schematic overview, there are certain exceptions — for example, Business Units already pay fringe benefit taxes.)

Table 1: Principle Elements of CN Application

	What are they?	CN implementation arrangements	Tax neutrality arrangements
CAC[3] businesses	All GBEs & share-limited companies. All other commercial activities where turnover exceed $10 million per annum.	For all GBEs, the Minister for Finance and Administration needs to agree on CN implementation. For all other activities CN implementation is responsibility of portfolio Minister only.	Pay all direct taxes. Pay all indirect taxes or taxation equivalents (subject to SOPI[4]).
Large in-house businesses	All Business Units. CTC units and other business activities where commercial turnover exceed $10 million per annum.	CN implementation is responsibility of portfolio Minister only.	Pay tax-equivalent 'dividends' instead of income taxes (in addition to normal dividends). Pay taxation equivalents instead of indirect taxes.
Small in-house business activities	CTC units with turnover under $10 million. Other activities on a voluntary basis.	Units should earn commercial returns, other CN costs notionally added to tender price.	Units under $10 million may include all taxes as notional cost elements for bids.

The CN implementation arrangements should be applied to all Commonwealth Government business activities listed above no later than 1 July 1998. In addition, all GBEs should be subject to tax from 1 July 1997[5].

---

3 CAC stands for 'Commonwealth Authorities and Corporations Act 1997', the legislation that governs entities which are owned by the Commonwealth, but legally separate to it.

4 SOPI is the 'Statement of Policy Intent' which defines arrangements for inter-jurisdictional taxation.

5 The Government has agreed to defer the implementation of taxation to the Export Finance Insurance Corporation until 1 July 1998 pending the outcome of a review process.

Commonwealth Competitive Neutrality Complaints Office

The Government has established an independent complaints body known as the Commonwealth Competitive Neutrality Complaints Office (CCNCO) within the Productivity Commission. The role of the CCNCO is to receive complaints, undertake complaint investigations and provide independent advice to the Treasurer on the application of CN to specific Commonwealth business activities subject to complaint.

Any interested party may make a complaint to the CCNCO where they believe Commonwealth business activities maintain a competitive advantage as a result of government ownership (see Section D for more detailed information on the complaints mechanism process).

The CCNCO will report annually to the Treasurer on the operation of the complaints mechanisms, including allegations of non-compliance. This information will be incorporated into the Treasurer's annual report on the implementation of CN which is required under the CPA.

Legislation to establish the CCNCO's parent body, the Productivity Commission, has yet to pass through the Senate. However, the CCNCO has been set up within the Industry Commission by administrative arrangements and has been able, so far, to provide informal advice and clarification to enquirers.

Responsibilities of Portfolio Ministers

Portfolio Ministers have responsibility for ensuring that CN arrangements are implemented for all commercial business activities within their portfolio. Ministers should consult with the Minister for Finance and Administration on CN arrangements for business activities within their portfolios that have a commercial turnover greater than $10 million per annum.

Ministers will report on the application of CN within their portfolios to the Prime Minister and the Treasurer in July each year.

The report must outline:

- implementation procedures;
- competitive neutrality payments made to the consolidated revenue fund (CRF);

- accountability arrangements for each business activity; and
- details of complaints against business activities within their portfolios.

The information in these reports will be incorporated into the Treasurer's annual report on CN which is required under the CPA.

Purpose of this Publication

This publication provides detailed CN implementation guidelines to assist public sector managers conform with the Commonwealth Government's CN policy.

This publication is intended to complement the publications *The Performance Improvement Cycle: Guidance for Managers* and *Competitive Tendering and Contracting: Guidance for Managers,* both released as exposure drafts in May 1997. The Commonwealth *Competitive Neutrality Policy Statement (CNPS) 1996* also provides information on CN principles.

Further Information about Competitive Neutrality

If you require any further information regarding implementation of CN arrangements please consult with the Department of Finance and Administration or the Department of the Treasury (see contact names at the end of this publication.)

SECTION B: OVERVIEW OF COMPETITIVE NEUTRALITY POLICY PRINCIPLES

The central principle of CN is that government business activities should not enjoy net competitive advantages over their private sector competitors simply by virtue of public sector ownership (eg through tax exemptions or other advantages conferred by the Government).

The purpose of this section is to outline the steps that a manager needs to take to ensure that a business or activity complies with CN. Section C provides more detailed information about each of the key dimensions of CN.

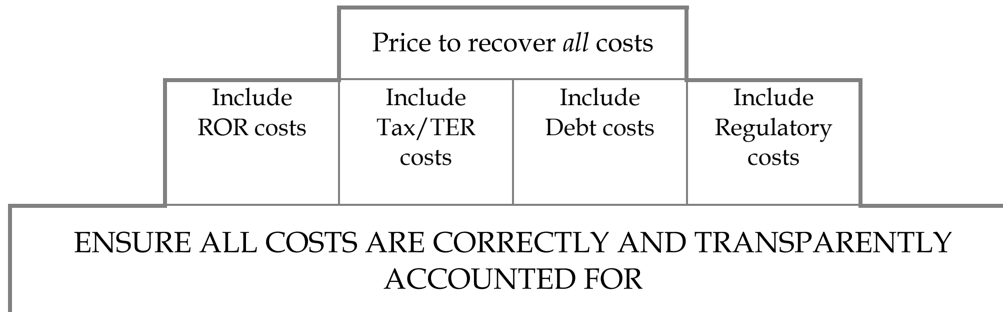
Applying CN essentially requires making Government business pricing decisions comparable with private sector organisations. This involves two steps, first, identifying all direct costs and, second, adding CN components where necessary (see Figure 1 below).

- The first step is correctly identifying the direct costs of a function;
  - this is achieved by ensuring *accountability* and *transparency* of business operations. In all cases, the central principle is to identify all costs attributable to a business or activity.

- The second step involves identifying and adjusting for relevant costs or margins that apply in the private sector and which may not be fully accounted for in the direct costs to Government, including:
  - achieving a *commercial rate of return* (ROR) on assets;
  - payment of all relevant Commonwealth and State *taxes*, or imposition of *Tax Equivalent Regimes* (TERs);
  - *regulatory neutrality* including, wherever possible, compliance with all relevant Commonwealth and State laws or regulations; and
  - *debt neutrality* including charges to account for implicit or explicit government guarantees on commercial or public loans.

Each of these principles are discussed below.

Figure 1: Applying a Competitive Neutrality Costing Regime



Allocating the Direct Costs of a Function

It is necessary to separate business activities from other government activities to ensure that Budget-funded activities do not effectively cross-subsidise[6] commercial operations. Section C deals in more detail with costing issues.

Managers should be particularly careful where an in-house unit and the parent share major assets, especially if the costs of these assets are joint costs. (Joint costs, as opposed to separable costs, are those not directly attributable to particular levels of commercial outputs.) Thus, detailed accounts and an appropriate cost-allocation mechanism are important for in-house units.

The accounting arrangements for all other commercial business activities subject to the CN arrangements should be augmented, where necessary, to provide for greater transparency. This is necessary to ensure that shared non-commercial activities do not cross subsidise commercial activities. Section C of this publication provides more details on the accounting requirements for these business activities.

---

6 Cross-subsidisation is undesirable as it is not a transparent use of government funds and places private sector competitors at a disadvantage.

Rate of Return Requirement

CN requires that publicly owned businesses should make a commercial rate of return (ROR) on the assets used in conducting the activity. A commercial rate of return is one that is comparable to that earned by the majority of firms in that industry.

- If public businesses were not required to earn a commercial ROR they would be able to undercut their private sector competitors by factoring lower profit margins into their prices/bids. Such undercutting would not be a reflection of lower cost structures.

- CN does not require publicly owned businesses to achieve the required rate of return on every transaction or bid. A publicly owned business may engage in normal commercial behaviour where the profit (or loss) earned varies from transaction to transaction provided that the business earns a commercial rate of return on a yearly basis and that low prices are not due to cross-subsidisation from Budget funded activities.

Managers are required to calculate an appropriate rate of return on capital employed. The ROR must be at least sufficient to justify the long-term retention of assets in the business. Section C provides details on how to calculate an appropriate rate of return target.

If a government business is unable to achieve commercial rates of return in the medium term, the responsible agency, in consultation with the Department of Finance and Administration, will need to examine realistic and attainable options to improve performance. Alternatively, the Government may consider divestment of the activity. The Department of Finance and Administration's *Performance Improvement Cycle: Guidance for Managers*[7] document provides more information on this subject.

Taxes & Tax Equivalent Regimes

Government business activities should bear a similar tax burden as their private sector competitors. Private sector corporations are subject to Commonwealth, State and local taxes. Managers should ensure that

---

7 The Government may also choose to sell government businesses in certain circumstances.

appropriate taxation arrangements are in place to pay taxes imposed on the business and to comply with TER arrangements.

Tax equivalent regimes (TER) have been established where taxes are not directly payable, for example, commercial activities within a Department of State. The application of CN taxation arrangements will vary according to the type of business. More detailed implementation arrangements are outlined in Section C.

Regulatory Neutrality

As far as practicable, government businesses should operate in the same regulatory environment as private sector competitors. For example, managers of government trading businesses should ensure that their activities comply with local planning, building and environmental laws. Similarly, government financial activities should be subject to the same prudential requirements as private businesses.

Where there are difficulties subjecting Commonwealth entities to particular regulations, such businesses should make allowance for any resultant cost advantages. For example, if a government insurance business does not have to maintain a certain level of capital securities, it should still notionally pay the capital servicing charges it has thus avoided. Similarly, if a Commonwealth business is exempt from local government charges, the business should pay these charges on an *ex gratia* basis. (A charge is a fee related to a service level, such as per unit of water consumption. Local government taxes are discussed in the chapter below on taxation.)

Debt Neutrality

Financial markets confer lower borrowing rates on government owned entities as a result of explicit government guarantees or perceptions of implicit government support. This competitive advantage has been addressed to date by application of borrowing levies under the *Commonwealth Borrowing Levies Act 1987*. However, this system involves significant compliance costs.

In future, Ministers will determine debt neutrality charges for CAC businesses within their portfolios, where those businesses borrow from private financial markets. For non-corporatised businesses (eg in-house business units) that borrow from the CRF, Portfolio Ministers in consultation with Finance and

Administration, will apply commercial interest rates to those borrowings. Further details are in Section C.

General

Managers should ensure that they have considered each of these elements when undertaking commercial activities. Failure to have fully considered these issues may lead to the possibility of a complaint being lodged with the CCNCO.

SECTION C: APPLICATION OF COMPETITIVE NEUTRALITY

SETTING A COMMERCIAL RATE OF RETURN

This section outlines the determination of an appropriate rate of return (ROR).

In the private sector, acceptable ROR are dictated by the demands of holders of equity and debt capital (eg lending institutions and share holders). In the public sector, the government is owner of both debt and equity capital. ROR targets will be set by the 'owner' differently according to the type of business activity.

- *GBEs* will have their commercial ROR requirements determined by their shareholder Ministers.

- O*ther significant businesses* with turnover exceeding $10 million will have their ROR targets set by the relevant portfolio in consultation with the Department of Finance and Administration.

- *Small in-house CTC units* (less than $10 million annual receipts) will have their ROR set by the parent agency. Auditable notional arrangements may be used for these units.

Under their current governance arrangements, GBEs are already required to earn commercial rates of return. All other activities subject to CN should be earning commercial returns by no later than 1 July 1998.

An inappropriately low ROR may give rise to a complaint to the CCNCO in the Productivity Commission.

The principles involved in calculating an appropriate ROR target are drawn from the work of the Steering Committee on National Performance Monitoring of Government Trading Enterprises (1996) *An Economic Framework for Assessing the Performance of Government Trading Enterprises*. Managers may wish to consult this publication for a more detailed elaboration of these principles. It is

in the interest of managers to assure that their accounting systems can provide the information required by the ‘owner’ to set an appropriate ROR.

A target ROR should be set to equal the overall cost of capital for an organisation, ie the average cost of debt (usually interest) and equity capital (eg dividends) weighted by usage. This is the *Weighted Average Cost of Capital* (WACC).

The ROR target = WACC = $R_e(E/V) + R_d(D/V)$ where:

- R_e is the required rate of return on equity (including any risk premiums);
- R_d is the required rate of return on debt (including any debt neutrality charges);
- V is the market value of total assets (ie debt plus equity);
- E is the market value of equity; and
- D is the market value of debt.

Each of these factors need to be calculated in order to estimate an appropriate WACC. A full description of how to calculate an appropriate WACC is contained in *An Economic Framework for Assessing the Financial Performance of Government Business Trading Enterprises*.

If the business does not achieve a ROR of at least the required target, then the owner of the business should assess whether current arrangements are appropriate. The measurement of achieved rates of return is explained below. Figure 2 (below) provides an overview of determining costs of capital, setting return targets and assessing performance against targets.

- The Department of Finance and Administration *Guide to Commercialisation* provides a useful guide on the financial statements and accounting systems necessary to estimate commercial ROR requirements. Readers should consult the *Guide to Commercialisation* for a more detailed account of these issues, and for a more complete discussion of the definitions of the above terms.

Managers should be aware that the asset valuation methodology employed may have a significant bearing on a business’ cost structure. The *Guide to Commercialisation* provides further detail on costing methodologies.

Transitional ROR Arrangements

A number of Commonwealth businesses are faced with a cost disadvantage as a result of Public Service employment conditions. The proposed new Commonwealth employment directions and associated flexibility will provide potential to address these disadvantages over time.

Under specific circumstances (see below), Commonwealth businesses may have lower transitional ROR targets to accommodate employment cost disadvantages for up to a maximum period of three years. The Minister for Finance and Administration or the Department of Finance and Administration may agree, where public sector employment conditions warrant, that corporatising or commercialising entities meet transitional ROR targets for up to the first three years following corporatisation or commercialisation.

- This does not imply that all organisations subject to CN will have access to transitional ROR arrangements. Only activities that are being corporatised or restructured along commercial lines will initially have access to transitional arrangements.

The transitional ROR arrangements would be such that the required ROR would rise to the benchmark over the transitional period. The business activity will need to identify rapid but realistic and attainable adjustments to labour and other input costs.

The cost of estimating the ROR requirements using this methodology, especially for small in-house CTC activities, may be significant. This may particularly be the case where the in-house unit has few physical assets or significant intangible assets. Under these circumstances, a proxy estimate of the ROR requirement can be used. A reasonable proxy rate would be the 10 year Government bond rate plus 3.5 per cent[8] — ie for 1997-98 a return target of 10 per cent should be acceptable.

MEASURING RETURNS: ASSESSING PERFORMANCE

Once the ‘owner’ has established a target rate of return, it is the responsibility of the business to meet this target. To ascertain whether the firm is meeting the return target, its profits need to be measured against its assets.

---

8 This implies that the activity’s assets are composed of debt and equity in equal portions, with an equity premium of 7 per cent.

The recommended method for measuring profits against assets is the 'Economic Rate of Return' (ERR). This differs from an accounting rate of return in that it is a pre-tax rate, and includes certain other variables.

Measuring the Economic Rate of Return

ERR measures the increase in the (market) value of assets plus net cash receipts, as a percentage gain over asset value at the start of the period. Most of the information needed to calculate an ERR should be readily obtainable from an organisation's financial statements.

- ERR differs from accounting measures, such as return on assets (ROA), in that it allows for capital increases as well as profits, and is measured on a pre-tax basis.
- The publication *An Economic Framework for Assessing the Financial Performance of Government Trading Enterprises* provides a detailed description of the methodology for calculating ERR.

VARIATIONS FROM TARGET RETURN REQUIREMENTS

In a number of circumstances, actual returns may not match target rates. Actual returns will be dependent on a whole range of variable economic factors. Thus, the actual short-run (s-r) rate of return may not exactly match the s-r ROR target. A two to three-year average commercial ROR could be an appropriate target in most cases.

If the business consistently fails to meet return targets over such a period, the business's performance should be examined. Managers should consider the processes outlined in *The Performance Improvement Cycle: Guidance for Managers*.

ALLOCATION OF RETURNS

Corporatised businesses in competitive markets should be given some discretion in how they choose to distribute returns. Private firms choose to distribute returns to shareholders as either dividends or increased equity, on the basis of maximising long-run income.

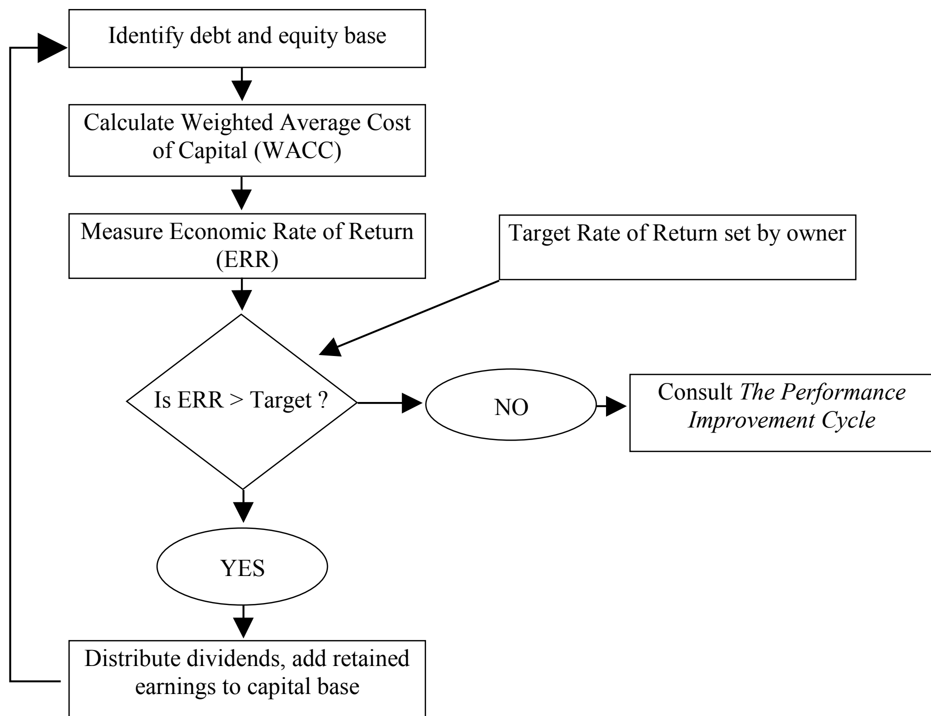
A public business may prefer to retain more of its profits and pay lower dividends than a private counterpart. However an effective rate of return monitoring regime, together with full compliance with CN, should prevent the business from becoming over-capitalised.

- In less competitive situations, it may be appropriate for the Government shareholder to set a dividend rate. If such rates are set, there should be safeguards to ensure the business activity retains sufficient funds to maintain its investment base in order to be capable of earning higher dividends in subsequent periods.

- The Government's *Governance Arrangements for Government Business Enterprises* recommends a dividend payment of at least 60 per cent of profits for GBEs. The Department of Finance and Administration *Guide to Commercialisation* recommends a benchmark dividend/retained earnings ratio of 50 per cent for Business Units.

For significant businesses above $10 million and GBEs, dividends distributed by the business should be paid to the CRF through arrangements with the Department of Finance and Administration. The Government has agreed that the ABC and SBS can retain any dividends from their commercial activities. (CTC and other business activities within Departments that do not have access to trust accounts may not have the ability to retain any profits.)

Figure 2: Rate of Return Targets


Identify debt and equity base
Calculate Weighted Average Cost of Capital (WACC)
Measure Economic Rate of Return (ERR)
Target Rate of Return set by owner
Is ERR > Target ?
NO
Consult *The Performance Improvement Cycle*
YES
Distribute dividends, add retained earnings to capital base

COMMUNITY SERVICE OBLIGATIONS (CSOS)

Community Service Obligations and the ROR Requirements

CSOs arise when the Government requires a business to carry out activities or processes:

- that the organisation would not elect to do on a commercial basis, or that it would only do commercially at higher prices; and
- that the Government does not, or would not, require other organisations in the public or private sectors to undertake or fund.

If an organisation wishes to have an activity recognised as a CSO, it must be explicitly directed to carry out the activity on a non-commercial basis by legislation, Cabinet decisions or publicly available (eg included in annual report) directions from shareholder Ministers.

An activity may be a CSO even if could be profitable at prices or quantities other than those set by Government direction.

- Examples of CSOs include where the Government directs organisations to charge prices below costs, mandates particular standards of service for a given cost, or requires organisations to use local inputs which are more expensive than other options.

Costs of government are not, in themselves, CSOs. These include costs associated with government ownership (for example, servicing Parliament and employment conditions of staff) as well as Government policies such as industrial democracy, safety standards and environmental controls. Allowance for these factors should not be included in determining rate of return targets.

CSOs should be funded from the purchasing portfolio's Budget, with costs negotiated as part of a commercially negotiated agreement. CSOs should include similar CN requirements as other activities. For example, CSO activities should be able to pay taxes and earn a rate of return (just as if they had been contracted out).

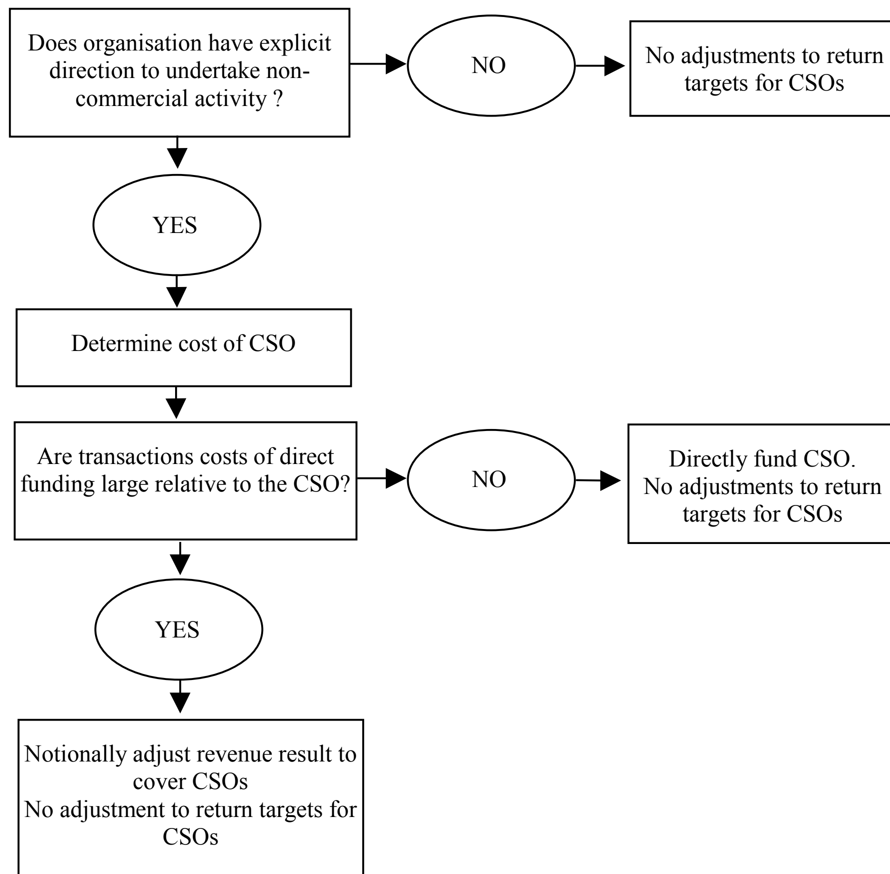
Government businesses will need to seek decisions from the Government about the continuation and funding of any unfunded CSOs prior to June 1998.

In some cases, direct funding of CSOs may entail unreasonably large transactions costs (eg from the more stringent verification required for the

spending of public money). In such circumstances, Ministers may choose to ‘purchase’ CSOs from enterprises by notionally adding to the organisation’s revenue result, for the purposes of calculating achieved rates of return. Where this happens, CSOs should still be costed as if they were directly funded. In all cases, the notional adjustment should be transparently recorded in an auditable manner. CSOs which are not ‘purchased’ on the above basis cannot be used to adjust rates of return measurements. Figure 3 (below) provides an overview of identifying and funding CSOs.

If a Portfolio Minister declines to fund a CSO, the business concerned could still supply these services as ‘good corporate citizens’. However, just like private companies which act as good corporate citizens, the public business should still meet its rate of return targets.

Figure 3: Community Service Obligations



Taxes and Tax Equivalents

CN requires public business activities to bear a similar tax burden to their private sector competitors. Preferably, government business activities should face the same tax liabilities in the same forms as their competitors. Managers are responsible for ensuring that their organisations are meeting their CN tax obligations as set out below.

Types of Taxes Paid by Commonwealth Businesses

There are essentially two different forms of taxation. Taxation on income, or direct taxation, and taxation on inputs, or indirect taxation.

Direct taxes are only levied by the Commonwealth. Direct taxes include income tax, capital gains tax (CGT) and fringe benefits tax (FBT).

Indirect taxes can be levied by either Commonwealth, State or local governments. Indirect taxes levied by the Commonwealth include wholesale sales tax (WST) and customs and excise duties. Indirect taxes levied by State and local governments include payroll taxes, stamp duties, financial institutions duty (FID), land taxes and rates.

Taxation under CN policy varies according to the type of business and the form of taxation. For CN purposes, there are three categories of government businesses:

i) 'CAC businesses';

ii) Large in-house businesses'; and

iii) 'Small in-house business activities'.

There are also three broad tax categories:

i) direct taxes;

ii) Commonwealth indirect taxes; and

iii) State taxes (including local government taxes).

Managers should ensure that each of these taxes has been considered and appropriately applied.

Types of Commonwealth Commercial Tax Payers

This section divides Commonwealth business activities into three tax-payer categories:

- ‘CAC businesses’. This category includes businesses that are legally separate from the Commonwealth and can thus be subject to taxation laws, including all GBEs, Corporations Law companies and their subsidiaries. These bodies are known as ‘CAC businesses’, from the *Commonwealth Corporations and Authorities Act 1997,* which governs them. Such businesses have to make actual tax payments to satisfy tax neutrality, and can also be subject to State taxes or TERs in some cases.

- ‘Large in-house businesses’. These are significant business activities that are distinct in an accounting sense, but legally part of another entity. This category includes all Business Units. The category also includes in-house Competitive Tendering and Contracting (CTC) units and other significant commercial activities (ie turnover exceeds $10 million per annum) that operate from within Departments. These businesses are not taxed directly, as it is not feasible under tax laws for the Commonwealth to levy taxation on itself. Moreover, while they have accounting separation from the Commonwealth, these businesses do not legally own property or hold money in their own right. Hence, under CN policy, in-house businesses operate under a ‘taxation equivalent regime’ (TER) and pay ‘taxation equivalents’ to the Commonwealth Public Account. Such businesses are known as ‘FMA’ agencies, from the *Financial Management and Accountability Act 1997,* which governs them. This category also includes significant CTC and other commercial activities that operate from within non-commercial CAC bodies — eg ABC Enterprises within the Australian Broadcasting Corporation. Under CN policy, such activities should become subsidiaries rather than in-house units. In the interim, while it may be possible to tax the parent body, it will generally be more effective to treat these businesses as if they were FMA activities.

- ‘Small in-house business activities’. This category includes CTC activities that have a turnover of less than $10 million per year (and other activities

with turnover under $10 million on a voluntary basis)[9]. (GBEs, Business Units and share-limited Corporations Law companies must comply with CN even if some possibly do fall below the $10 million threshold.) Such businesses only notionally add taxes to their costs, and hence prices, rather than actually paying them.

Table 2 (below) provides an overview of the relationships between the various types of taxation and corporate form outlined above. Further details are set out by tax category below.

Table 2: Who Pays What Taxes and How ?

	Direct Taxes	Commonwealth Indirect Taxes	State Taxes
CAC[10] businesses	Full tax payments	Full tax payments	Full tax payments[11] (or TERs)
Large in-house businesses	TER (full FBT payment)	TERs (full WST payment)	TERs
Small in-house business activities	Notional tax payments (full FBT payment)	TERs (full WST payment)	Notional tax payments

DIRECT TAXES

Payment of direct taxes by CAC businesses is a straightforward matter. For in-house businesses, special taxation-equivalent regimes, with less accuracy but less compliance costs, have to be established. Small in-house business activities, to the extent they are subject to CN, use the same model as in-house businesses, but only notionally pay taxes.

---

9 Note that commercial activities (excluding CTC) with a turnover of less than $10 million a year will generally not be subject to CN arrangements, including tax arrangements, but they may do so on a voluntary basis to avoid complaints.

10 CAC stands for 'Commonwealth Authorities and Corporations Act 1997' after the legislation that governs entities, which are owned by the Commonwealth, but legally separate to it.

11 Discussions are currently underway on possible reciprocal taxation arrangements under which State and Territory taxes would be payable directly. Until arrangements have been concluded with the States, TERs will operate.

CAC Bodies

CAC bodies should pay all taxes, both direct and indirect. (There are some exceptions at present with respect to taxes levied by States, Territories and Local Governments, these are discussed below.) Where a GBE's enabling legislation provides exemption from Commonwealth taxes, such exemptions should be removed. Where a GBE's enabling legislation provides exemption from State and local taxes, the legislation should also provide for such exemptions to be removed.

Income Tax

Newly tax-liable businesses will need to establish processes with the ATO to ensure they comply with the requirements for lodgement of returns, payment of tax and compliance with the law. Income tax payments are to be made in accordance with normal procedures.

Fringe Benefits Tax

Nearly all statutory authorities and GBEs are already subject to fringe benefits tax. Managers should confirm whether their organisation is liable to FBT.

Community Service Obligations

Payments from the Government for CSOs should be treated as income in the normal sense, and should be subject to all tax burdens on the same basis as a business' other receipts. Equally, expenditure by the business on delivering the CSO would be tax deductible. This treatment should facilitate CSOs being put out for tender in the future should the Government so decide.

Transitional Arrangements

Transitional arrangements for exempt entities that become taxable, including the treatment of assets for capital gains tax purposes and the treatment of depreciable assets, will be in accordance with Division 57 of the *Income Tax Assessment Act 1936* and the corresponding and subsequent provisions of the *Income Tax Assessment Act 1997*.

In addition to transitional issues, there are a significant number of other implementation issues to be addressed in applying tax to commercialised

activities of Commonwealth organisations. Some examples include:

- defining at a detailed level, where that is appropriate, the coverage of a tax equivalent regime and related procedures, including audit compliance with tax arrangements;
- modification to business computer systems and processes to account for taxation payments; and
- training and skills development for staff to increase awareness of the taxation consequences of transactions.

Accordingly, Commonwealth organisations that are becoming liable to either income tax or TERs should seek legal advice and the advice of the Department of the Treasury and the Australian Taxation Office early in the conversion process to ensure consistency with relevant taxation legislation and competition policy principles.

Large In-House Businesses

As discussed above, it is not feasible for the Commonwealth to tax businesses that operate on the Commonwealth Account. Hence, a tax equivalent regime is needed to maintain tax-neutrality between these businesses and their private competitors. The defining feature of a tax equivalent regime is that it is administered, and its revenue collected, by the government that owns the entity.

There are a number of possible models for collecting tax under a tax equivalent regime, ranging from arrangements that model the operation of the tax law very closely (described as a substantive tax equivalent regime model) to more approximate arrangements that may, for instance, use accounting profits as a base for calculating tax liabilities in respect of income tax (described as an accounting profit model).

Setting up, monitoring and complying with an exact copy of the current income tax regime for in-house business tax-equivalents would be very expensive. However, for direct tax equivalents, a lower degree of accuracy is needed than for indirect tax equivalents. This is because direct taxes are usually levied after a business has made most of its operating decisions and earned the resultant income. In contrast, indirect taxes are levied on basic inputs and affect all subsequent business decisions. Thus a less accurate tax-equivalent regime will suffice for direct taxes — providing ROR targets ensure that public businesses have correct incentives in other decision making.

However, failure to achieve a reasonable degree of accuracy for direct taxes may result in a perceived lack of competitive neutrality.

'Taxation Dividends'

The direct tax TER that has been adopted for in-house businesses is tax-equivalent dividends, generally paid at the corporate tax rate on accounting profits or taxation income. This concept could perhaps best be illustrated by the example of a Business Unit that earns $10 million gross profit one year. Instead of paying say 30 per cent of profits to the government as tax, it pays this $3 million as a tax-equivalent dividend. The business would then split its $7 million 'after-tax' of profit between regular dividends and retained earnings (at say 50 per cent each). Thus it would pay a normal dividend of $3.5 million to the government (as owner of the business), and retain $3.5 million. Total dividends paid to the Government would be $6.5 million.

Under these arrangements, in-house businesses should pay tax equivalent dividends roughly equivalent to actual taxes paid in their industry. Therefore, if an in-house business believes that the corporate tax rate is somehow inappropriate, it may make a case for an alternative benchmark to the Department of the Treasury and Department of Finance and Administration. Similarly, they should attempt to have roughly equivalent regular dividend/retained earnings ratios to the majority of their competitors.

Less than exact equivalence can also be accepted to the extent that this mechanism is self-correcting. If the in-house business pays less pre-tax dividends in one year, it will still have to meet ROR targets the next year on its now higher retained earnings.

Consolidation

In-house commercial activities should not be consolidated where there is more than one within an agency, ie each in-house commercial activity should be defined as a stand-alone operation. Accordingly, each in-house activity will have to meet its own ROR target, and pay tax-equivalent dividends on this target. Under-performing units cannot be 'carried' by successful ones. Losses made by one in-house commercial activity will not be available to reduce the tax-equivalent dividends of another. This will reduce complexity, and appropriately focus any privatisation decisions on individual commercial activities.

Shared Costs

Often, where an in-house unit shares costs with its parent, these costs will have an associated tax liability. For example, a parent Department may purchase a mainframe computer for use by both itself (60 per cent) and a Business Unit (40 per cent). If the Business Unit agrees to contribute 40 per cent of the purchase price[12], it would be entitled to claim 40 per cent of the mainframe's depreciation against its income tax (equivalent) liability. (But it should also pay 40 per cent of the WST or make a tax equivalent payment of the same amount, see below.)

The general principle here is that tax liabilities (eg depreciation, WST or payroll taxes) should be shared on the same basis as joint costs are allocated.

Fringe Benefits Tax

Business units are already subject to fringe benefits tax under the *Fringe Benefits Tax (Application to the Commonwealth) Act 1986*. Most other in-house commercial activities are also already subject to FBT. Other significant in-house businesses not already paying FBT should make provision for FBT in their tax-equivalent dividends.

Timing Arrangements

Taxation arrangements for in-house commercial activities should be implemented with effect by no later than 1 July 1998. The additional period available to in-house activities is recommended to enable them to put into place appropriate accounting procedures.

Small In-House Business Activities

Small in-house business activities should follow the principles outlined above for in-house businesses. For example, rather than attempt to calculate and notionally pay full taxation liabilities, such businesses would calculate and notionally pay tax-equivalent dividends. The guiding principle here is that the cost of calculating liabilities (and other CN costs) should be kept in proportion to the (notional) amounts involved.

---

12 Technically, Business Units do not own assets in their own right.

- Business activities should note that the Department of Finance and Administration may agree to a reduction in parent agency funding to account for notional taxes and commercial dividends.

INDIRECT COMMONWEALTH TAXES

CAC Bodies

The direct application of WST to GBEs and Statutory Authorities for newly-corporatised or created CAC bodies will be straightforward. All CAC bodies created after 1987 are automatically liable for WST unless their enabling legislation specifically excludes them. CAC bodies should also pay customs and excise duties.

Large In-House Businesses

In-house commercial activities should cease claiming sales tax exemptions by quotation, or utilising sales tax or other input cost advantages related to their public ownership, effective by no later than 1 July 1998 (unless sales-tax exemptions are available for reasons other than public ownership).

Purchases

An in-house commercial activity within a department or FMA agency can begin paying wholesale sales tax on its purchases simply by ceasing to quote an exemption, because the tax is actually paid by a third party, namely the wholesaler.

In-house businesses, located within CAC bodies already liable for indirect taxes, should directly pay WST, excises, duties and any other indirect taxes that may arise. Other in-house businesses located within exempt CAC bodies should follow the same arrangements as for those activities located within FMA agencies.

It may be administratively more efficient for in-house businesses to pay TERs based on surveys of their actual use of inputs instead of quoting an exemption as this will avoid boundary problems such as activities minimising tax by obtaining inputs through their parent agencies. (However, the

cost-effectiveness of calculating and paying TERs should also be weighed up.) Similarly, where a Business Unit produces goods for internal consumption, rather than for sale, taxation legislation does not apply. Payment of the equivalent of tax on these goods could be achieved by WST TER from the Business Unit to CRF, if necessary. Businesses that wish to explore this option should seek advice from Treasury.

Shared Inputs

The situation is a little more difficult where an in-house activity has inputs it shares with its parent agency. For example, if a parent Department purchased a mainframe computer, it would not have to pay WST. But if 40 per cent of the computer's usage is intended to be used by a Business Unit, the Business Unit should pay 40 per cent of the WST or a sales tax TER equivalent to 40 per cent of WST on the mainframe. As outlined in the section on direct taxes above, tax liabilities should be apportioned on the same basis as costs are allocated (ie under Activity Based Costing or Long-Run Net Avoidable Cost).

Small In-House Business Activities

Non-significant business activities subject to CN arrangements should cease claiming sales tax exemptions by quotation by no later than 1 July 1998 (unless WST exemptions are available for reasons other than government ownership).

State Taxes

Inter-Jurisdictional Taxation Issues

In principle, the Commonwealth's commercial activities should be subject to the same State taxes as their private sector competitors. Where a Commonwealth business activity was paying State taxes before 1 July 1997 it will continue to do so. However, newly created or corporatised CAC businesses will be subject to TERs instead of State taxes. This may require an exemption from State taxes and charges in the CAC business's enabling (or other) legislation. Where such an exemption is legislated, it should make provision for the direct payment of State taxes in the future through regulation.

Discussions are currently under way on possible reciprocal taxation arrangements under which State and Territory taxes would be payable directly to the taxing government. Commonwealth policy as to whether newly created or corporatised CAC businesses should pay TERs instead of State taxes is subject to change as negotiations with the States continue. Hence, portfolio departments should consult the Department of the Treasury when creating or corporatising CAC businesses.

The situation for in-house businesses will depend upon whether they are located in an FMA agency or a CAC body. Being part of the Commonwealth *per se* (as opposed to being owned by the Commonwealth), FMA activities are not subject to taxation by another jurisdiction. Accordingly, they should pay State tax-equivalents to the Commonwealth.

There are no such difficulties in imposing State taxes directly on in-house businesses operating within CAC bodies, provided the CAC body is not exempt. If the CAC body is exempt then the same arrangements should apply as for in-house businesses operating within FMA agencies. However, departments or parent bodies should consult the Department of the Treasury on the best option when creating such businesses.

As with all taxes (other than WST on direct purchases), small in-house business activities need only notionally account for State taxes.

TER Payments

It is more important that State TERs for indirect tax closely approximate actual tax arrangements than with income tax TERs. This is because State taxes are imposed on inputs and may affect business decisions more than an equivalent direct tax. State taxation rates are readily available and the tax bases are defined in a relatively straightforward way.

However, as with income TERs, an exact State TER would involve duplication of a tax system that is already in place and the administrative complexities in setting up such a regime take a significant time to settle. Therefore, State TERs will be self-assessed, with regard to cost-effectiveness of high accuracy. It is possible competitors may complain if TERs appear to diverge too widely from actual State taxes. TER payments will be monitored by the Audit Office as part of routine audits.

All existing CAC businesses should have been paying either State taxes or State TERs as of 1 July 1997. In-house businesses should be paying State TERs by no later than 1 July 1998.

DEBT NEUTRALITY

Public businesses may derive a competitive advantage from being able to borrow at lower cost than private firms. When banks lend to private firms, the interest rates they charge include a mark-up on the 'risk-free' rate to cover the possibility of default. However, lenders often reduce this mark-up for public businesses, because they perceive (correctly or incorrectly) that governments will not permit their businesses to default on liabilities. Thus, even a highly risky government business may be able to borrow at cheaper rates than a comparatively safe private business.

Even without an explicit guarantee, public businesses are often still able to borrow at rates reasonably close to government rates due to implicit guarantees.

A debt-neutrality charge of 12.5 basis points has been applied to certain GBEs under the *Commonwealth Borrowing Levy Act 1987.* Under CN policy, the arrangements in the *Commonwealth Borrowing Levy Act* have been replaced by debt-neutrality charges. The Borrowing Levy was set to zero on 16 December 1997.

- The replacement debt neutrality charge will apply by no later than 1 July 1998 for those businesses not currently subject to the Borrowing Levy. For those businesses subject to the Borrowing Levy, the replacement debt neutrality charge applies from when the Borrowing Levy was set to zero.

The benefits public businesses derive from being able to borrow at close to government rates depends on how risky lenders would perceive the business to be *without* being owned by the government. Some businesses may benefit greatly from government ownership, for example, a public business that runs at a chronic loss may not be able to borrow at all if it did not have a government guarantee. On the other hand, an inherently safe public business, such as a large utility with a legislated monopoly, may still be able to borrow at low interest rates if it was privatised.

Businesses will be required to pay a debt-neutrality charge on all borrowings. The charge should reflect the difference in the cost of borrowing with an

implicit government guarantee and the cost of borrowing as a stand alone entity. Managers of businesses or activities will generally not have control over the debt-neutrality charge. Figure 4 provides an overview of identifying the need for, and setting of, debt neutrality charges.

Significant business activities which borrow from markets should have any debt-neutrality charges set by their shareholder Ministers (based on credit rating advice, see below).

Significant business activities which borrow from the Budget will not have to pay debt-neutrality charges. Instead, they will have their interest rates determined by the Department of Finance and Administration (based on credit ratings advice, see below). These interest rates would also be used for calculating CN costs where activities do not actually borrow, but have a shadow debt/equity structure. Small in-house CTC units (less than $10 million annual receipts) should have their debt-neutrality charge set by the parent agency. Auditable notional arrangements may be used for these units.

The debt neutrality charge will be paid to CRF through accounts set up by the Department of Finance and Administration.

Debt Charges and Credit Ratings

Significant business activities seeking to borrow should obtain independent annual credit ratings. These credit ratings should be conducted as if the business was not publicly owned. That is, the rating will establish the rate the business would be able to borrow at on its own merit. If the business can actually borrow at cheaper rates (due to its public ownership) it is still free to do so, but it should pay a debt neutrality charge to CRF based on the difference.

Credit rating requires more information than did the former Borrowing Levy. Reforms to both GBEs and financial markets have significantly reduced the cost of obtaining this information. However, there is still a need to balance costs and benefits. Accordingly, if a business' liabilities will not exceed $10 million for more than 90 days in the current financial year, it may conduct its own credit rating internally and not use an independent external rating agency. A business that chooses to rate internally should make its underlying assumptions and methodologies available to the Department of Finance and Administration or the Commonwealth Competitive Neutrality Complaints Office on request.

Finally, if the business' liabilities will not exceed $1 million for more than 90 days in the current year, the business need not incur the costs of assessing and collecting a debt neutrality charge.

Debt charges should apply to all forms of liability (eg including liabilities such as finance leases and derivatives) incurred by public businesses. Otherwise, businesses would have an incentive to substitute into forms of liability on which there were no debt charges. However, providing it can show *prima facie* that it is not obtaining cheaper access from its public ownership, a business need not apply debt charges to non-traditional liabilities such as derivatives.

How large should debt charge margins be?

Table 3 (below) provides a broad indication of the benefits of implicit guarantees for government businesses according to their 'stand-alone' credit rating. Debt charges should be set according to the size of these benefits.

- ➢ However, debt charges could be reduced for businesses that mostly use short-term local borrowings, or increased for those that mostly borrow long-term offshore.

Table 3: Borrowing Benefits from Public Ownership

Stand-alone credit rating (Standard & Poor's)	Benefit of borrowing at AAA under implicit guarantee (basis points)
AAA	0
AA+	2
AA	5
AA-	10
A+	30
A	50
A-	70
BBB+	90
BBB	100

Explicit Guarantees

As noted above, it is general government policy not to issue explicit guarantees on new liabilities. Where such explicit guarantees are issued, agencies should apply a higher debt neutrality charge than would otherwise be provided.

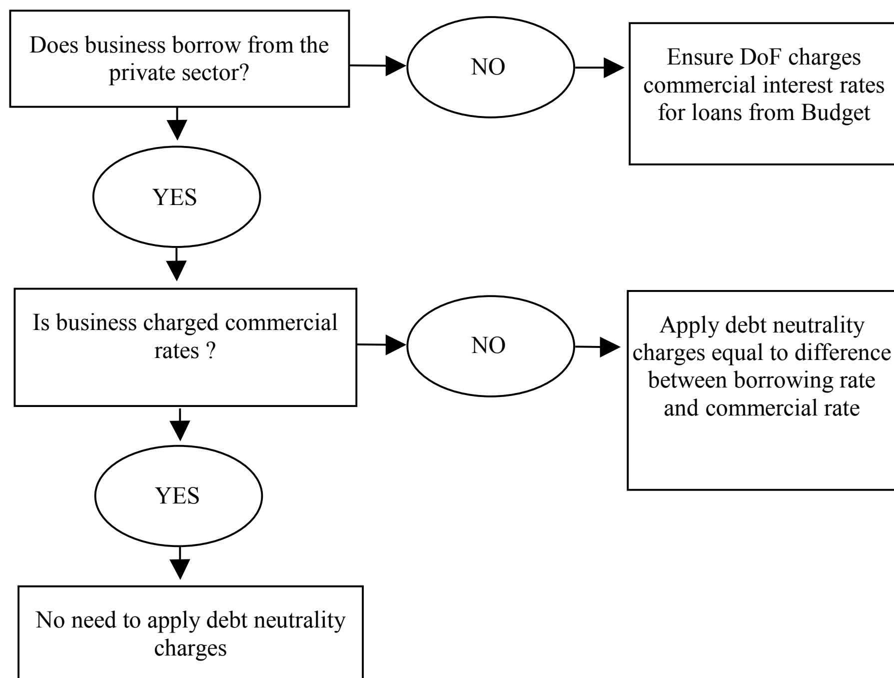
Timing

Debt-neutrality charges should be reviewed as often as is necessary to take account of any changes in conditions.

Reporting

In their annual reports to the Treasurer on competitive neutrality matters, Ministers should note the credit ratings of significant business activities within their portfolios.

Figure 4: Debt Neutrality



SECTION D: COMPETITIVE NEUTRALITY COMPLAINTS MECHANISM

The Commonwealth Competitive Neutrality Complaints Office (CCNCO) has been established within the Productivity Commission to receive complaints, undertake complaint investigations and provide independent advice to the Treasurer on the application of competitive neutrality to Commonwealth business activities. Any interested party may lodge a complaint with the CCNCO on the grounds that:

- a Commonwealth business activity has not been exposed to CN arrangements (including a business below the relevant 'significance' threshold);
- the Commonwealth business activity is not complying with CN arrangements that apply to it; or
- the current CN arrangements are not effective in removing a Commonwealth business activity's competitive advantage, which arises due to government ownership.

Where the CCNCO (after preliminary investigations) considers that competitive neutrality arrangements are not being followed, it may directly advise government business entities where there are inadequacies in their competitive neutrality arrangements and on how they can improve compliance with the policy. Alternatively, if a suitable resolution of a complaint cannot be achieved by this advisory role, the CCNCO may recommend appropriate remedial action or that the Treasurer hold a formal public inquiry into the matter.

Following either preliminary investigations or a formal public inquiry, where the CCNCO believes a complaint has merit it may recommend appropriate action. However, the Portfolio Minister may still decide that the costs could exceed the benefits of applying particular aspects of CN to a business - for example, if the businesss is to be privatised - but could be called upon to justify that decision. Commonwealth business entities will not be subject to penalties for non-compliance with competitive neutrality principles, nor can the CCNCO award or recommend damages to parties who have lodged complaints that have been supported by the CCNCO. However, the ability for

any interested party to lodge complaints with the CCNCO and to have those complaints investigated, ensures that managers, Portfolio Ministers and the Government can be held publicly accountable for the full implementation of competitive neutrality principles.

The CCNCO has released draft guidelines which provide more information on the operations of the complaints mechanism.

SECTION E: COMPETITIVE NEUTRALITY AND COMPETITIVE TENDERING AND CONTRACTING

CN considerations should be applied to all 'in-house activities' participating in CTC activities. (Once the decision is taken to put an activity to tender, that activity should be regarded as a commercial activity — ie CN applies even if the activity is not necessarily 'business-like'.) CN considerations should also be applied when market testing an agency's in-house functions.

All in-house bids should earn a commercial pre-tax ROR on the assets proposed to be used in the activity. Also, if CTC specifications (or the nature of the contract activity itself) require private contractors to undertake public liability insurance, all in-house bids should notionally include an amount equivalent to the premium the private contractor would be forced to pay.

To ensure that in-house business units compete on a comparable basis to their private sector competitors, for CTC bids less than $10 million the following amounts must be notionally added to their CTC bids:

- *Commonwealth Indirect Tax TERs* — an amount equivalent to the wholesale sales tax (WST), excises, customs duties etc, it would otherwise have to pay if it were not exempt from Commonwealth taxes;

- *State Indirect Tax TERs* — an amount equivalent to the stamp duty, payroll tax, Financial Institutions Duty (FID) etc, it would otherwise have to pay if it were not exempt from State taxes;

- *Public Liability Insurance Premiums* — (see above); and

- *Full cost recovery* — the in-house unit should include all costs (including shared and joint costs) associated with providing the service identified in the tender specification.

Adding in the above CN components ensures that in-house bids reflect the full cost of providing the relevant goods and services. (Note, where plant and facilities are to be made available to all bidders as Government-furnished, in-house bids would not need to include a rate of return on such capital.)

Further details on CTC activities are provided in *Competitive Tendering and Contracting: Guidance for Managers*.