Department of Local Government

PRICING & COSTING FOR COUNCIL BUSINESSES

A Guide to Competitive Neutrality

New South Wales Government

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CONTENTS

1. INTRODUCTION

The purpose of the Guidelines

These Guidelines assist councils to apply the principle of competitive neutrality. The principle is part of national competition policy, which is being applied to government businesses at all levels throughout Australia.

The framework for the application of national competition policy to councils is found in the Government's *Policy Statement on the Application of National Competition Policy to Local Government*, sent to all councils in August 1996. It was developed in co-operation with the Local Government and Shires Associations.

The Government has rejected a prescriptive approach to competition policy in councils. This is stated clearly in the *Policy Statement* (see paragraph 3.3). It is recognised that, to be effective, competition policy must provide cost-effective benefits in the wide range of councils from small rural to large urban. These Guidelines on competitive neutrality build on that approach.

Underpinning competitive neutrality is the need to have an effective costing system in place for business activities. This is essential in any case for the management of any council activity. For this reason, these Guidelines are divided into two main areas. Parts 1-6 establish the principle of structuring and costing for competitive neutrality, including determining business activities, application of tax equivalent regime payments and so on. Parts 7-10 discuss general costing and pricing practices, which are applicable to both business and non-business activities.

These Guidelines fulfil the Government's commitment in the *Policy Statement* to provide assistance to councils on competitive neutrality (see paragraphs 4.40 - 4.45).

The Principle of Competitive Neutrality

The principle of competitive neutrality is based on the concept of a 'level playing field' between persons competing in a market place, particularly between private and public sector competitors. Essentially, the principle is that government businesses, whether Commonwealth, State or local, should operate without net competitive advantages over other businesses as a result of their public ownership (see *Policy Statement*, paragraph 4.1).

The underlying philosophy is that a 'level playing field' will enhance competition. Competition can promote greater efficiency and lower costs to government and the community. The government recognises that policies to enhance competition may have social impacts. However, if the application of competition policy is thought to impose net costs on the community, and this is supported by a benefit/cost analysis, then an exemption from the application will be allowed. The conduct of benefit/cost analyses is discussed in more detail below.

Government agencies may receive a number of competitive advantages which private sector competitors will not have, or may not include certain costs which the private sector includes in pricing. The *Policy Statement* identifies the main elements of competitive advantage which councils have and which they are required to address. These Guidelines address these elements and apply them to council business activities.

Councils also have a number of competitive disadvantages compared with the private sector. These include limitations on borrowings, reduced flexibility to respond to market pressures, requirements for additional public accountability, specific legislative duties and community service obligations. The Government has been conscious of these issues in developing these Guidelines.

It is important to note that competition policy does not require that individual businesses compete on an equal footing. Councils and other government agencies will have advantages through size, buying power, specialist expertise, assets etc, in the same way that the private sector will have its own characteristics.

It is also stressed that the principle of competitive neutrality applies only to the business activities of councils and not to their non-business, non-profit activities.

What are councils' obligations?

The *Policy Statement* sets out the minimum requirements that councils must comply with as well as those areas where councils are encouraged to adopt the principle. The requirements in the *Policy Statement* are based on the principle of competitive neutrality developed in the *Competition Principles Agreement (CPA)* signed by the Council of Australian Governments in April 1995.

The *Competition Principles Agreement* gives each State and Territory the discretion to decide how the objectives of competitive neutrality in council businesses may best be achieved. Compliance with the principle is required unless it can be demonstrated that the costs of implementation outweigh any benefits for the community (see *Competition Principles Agreement*, cl 3(6)).

In relation to local government, it is accepted that some business activities will have a significant economic impact. The threshold of $2M annual sales turnover/ annual gross operating income has been chosen, in consultation with local government, as a reasonable measure of economic significance for the purpose of applying a corporatisation model and pricing requirements. In these cases, the benefits of applying competitive neutrality are expected to outweigh the costs. Businesses over this threshold are called Category 1 business activities.

Conducting benefit/ cost analyses

As referred to above, councils must consider the benefits and costs of applying the competitive neutrality principle to a business activity. For Category 1 business activities, it is generally expected that the benefits will outweigh the costs. Councils are therefore required to apply the competitive neutrality principle to a business of this size.

If a council believes that the application of the competitive neutrality principle to a Category 1 business will be detrimental overall, it must conduct a benefit/cost analysis which shows a net cost. The analysis must be independently carried out, rigorous and public. It must examine the economic and social benefits and costs to the entire community as well as looking at the impact on council itself and the local community. In conducting a benefit/cost analysis, council must, at a minimum, take into account the factors which are listed in clause 1(3) of the *Competition Principles Agreement*. These are:

- government legislation and policies relating to ecologically sustainable development
- social welfare and equity considerations, including community service obligations
- government legislation and policies relating to matters such as occupational health and safety, industrial relations and access and equity
- economic growth and regional development, including employment and investment growth
- the interests of consumers generally or of a class of consumers
- the competitiveness of Australian businesses, and
- the efficient allocation of resources.

A council's business activities may be significant in a local or regional context, regardless of the $2M threshold for adoption of specific requirements. Business activities under this threshold are called Category 2 businesses. In the treatment of these businesses council must still be guided by the general expectation that "when councils compete in the market place they should do so on a basis that does not utilise their public sector position to gain an unfair advantage over a private sector competitor" (*Policy Statement*, paragraph 4.30). Councils are required to adopt competitive neutrality with as many Category 2 businesses "as is practicable" (Policy Statement, paragraph 4.27).

In determining the level of 'competitive neutrality' it will apply to a business activity under $2M, council will need to balance the economic, social and environmental costs. These factors are listed in clause 1(3) of the *Competition Principles Agreement*, although this is not exhaustive. These and other factors are also discussed in the Department's *Competitive Tendering Guidelines*. Although raised in the context of competitive tendering the issues are also relevant to competitive neutrality.

Setting up a complaints mechanism

Council must have sound reasons for any decision it comes to. An actual or potential competitor of a council business may make a complaint if it believes that it is being adversely affected through a failure to adopt competitive neutrality. Councils are required to establish a complaints handling mechanism for competitive neutrality issues and the Department of Local Government will also have a role in receiving complaints. This is discussed further below (see Part 4). The complaints mechanism will be a vital source of information on the status of competitive neutrality reform and the need for further effort.

The specific requirements of competitive neutrality for councils are summarised below. They are explained in more detail in these Guidelines.

Type of Business Activity		***Timeframe***
***Category 1* - annual sales turnover $2M pa and above.**	***Category 2* - annual sales turnover less than $2M pa.**	
Establish a complaints handling system for competitive neutrality issues	Establish a complaints handling system for competitive neutrality issues	From 1 July 1997
Separate internal reporting for business activity	Council may determine the extent of separation of the activity	From 1 July 1997
Apply full cost attribution, including: ❖ tax equivalent payments ❖ debt guarantee fees ❖ return on capital	Adopt full cost attribution where practicable. Can use % 'rule of thumb' margin	Phased implementation from 1 July 1997 and full implementation on 1 July 1998
Make subsidies to business activities an explicit transaction	Make subsidies to business activities an explicit transaction	Phased implementation from 1 July 1997 and full implementation on 1 July 1998
Comply with the same regulation as the private sector	Comply with the same regulation as the private sector	Councils already comply. Not applicable

The Benefits of Competitive Neutrality

The benefits of competitive neutrality flow to the council and the community. The adoption of these practices in government businesses should result in:

- pricing policies which are fairer and more cost reflective;
- better allocation of resources; and
- decisions being made with a clearer knowledge of true costs.

It is important to understand the benefits of competitive neutrality flow to the wider economy as well. Competitive neutrality is an integral part of the wider national competition policy reforms. The reforms seek to engage the forces of 'competition' to promote greater efficiencies in the Australian economy. Improved functioning of businesses, and government businesses in particular, will create a positive return to Australian society. In 1995 the then Industry Commission sought to quantify those benefits in *The Growth and Revenue Implications of Hilmer and Related Reforms,* (1995), estimating an overall gain to the economy from implementing the reforms at 5%, or some $23 billion.

The importance of costing systems

Underpinning the principle of competitive neutrality is the need to have effective costing systems. Prior to the calculation of tax equivalent regime payments and so on, council will need to know the full costs and revenues of a business activity.

This will have broader benefits than merely to comply with competitive neutrality. Regardless of competition policy, costing is essential for strategic planning, budgeting and performance measurement. The principle is also applicable to many other situations such as benchmarking, determining best practice, performance evaluation, assessing new services, budgeting and benefit/cost analyses.

The introduction of effective costing mechanisms will come at its own price in time and effort. However, for Category 1 businesses (annual sales turnover $2M per year and above), this cost is justified. As a general statement, this is also true of Category 2 businesses. Good costing systems are part of any successful business operation.

For this reason, the second part of these Guidelines contain a detailed discussion of costing systems for council activities. While the specific requirements of competitive neutrality are discussed first in these Guidelines, this is on the understanding that effective costing systems are the foundation for the requirements. The information on costing systems is necessarily broad and should not replace expert assistance in the more complex aspects and cases.

Other Competition Policy Guidelines

Two other guidelines on competition policy issues have also been published, which are complementary to this document. They are:

- ***Guideline on competitive tendering*** (released January 1997). This deals in detail with the implications of competitive tendering for councils and the processes involved.

- ***Competitive neutrality supplement to the Department of Local Government's Practice Note No. 9 "Complaints Management in Councils"***. This deals with setting up a complaints mechanism to address queries about the competitive neutrality of council's business and will be released shortly.

2 COMPETITIVE NEUTRALITY PRINCIPLE - IDENTIFYING BUSINESS ACTIVITIES

The principle of competitive neutrality applies to council business activities only. It does not apply to non-business, non-profit activities. As a first step, council needs to look at the wide range of functions it performs to determine what its business activities are.

Activities which should be regarded as businesses

The *Policy Statement* sets out a small number of activities which are classified by the Australian Bureau of Statistics as business activities. Council should therefore regard these activities as businesses. They are:

- water supply
- sewerage services
- abattoirs
- gas production and reticulation.

Other activities

There are a number of issues that Council must consider in determining whether an activity should be classified as a "business".

One of the first matters for consideration will be the objectives that council has for the activity. Other factors are listed below. They are not exhaustive. Nor is a council obliged to consider an activity as a business because it satisfies one or more of the criteria. Council has a discretion as to whether it will treat an activity as a business (apart from those activities classified by the Government Statistician, above). However, council must be able to justify any decision if requested by the community (or if a complaint is made in relation to unfair competition). The issues include:

- ***Is the activity intended to make a profit?*** An activity which is intended by council to make a profit clearly has a strong business element to it.

- ***Does council bid for external contracts?*** Any activity in which council bids for external contracts should be regarded as a business activity. For example, council's staff may tender for external contracts as well as providing internal services. Despite the in-house element of the activity, the decision to tender externally means that the council should regard the whole of the activity as a business, unless the internal unit and external bidders are completely separate.

Similarly, if a council unit intends to or has participated in a competitive tendering process called by council, the activity of the unit should be regarded as a business activity.

- ***Is the activity provided on a fee for service basis?*** A wide range of activities could be included in this. Once again, council will need to balance this element with others in any decision.

- ***What economic impact does the activity have?*** For example, a small scale activity, possibly included within a larger function, may not have a significant effect on the local or regional economy. It may also be inefficient to separate it from the larger function.

- ***What is the nature of the activity and how important is it to customers?*** A particular type of activity may be difficult to treat as a business, for example some community service functions. The reverse may also be true in relation to some activities.

Categorisation of Business Activities

Once council has determined what activities it will treat as businesses, it will need to look at what "category" of business the activity will fall into for the purposes of competitive neutrality. The categories are based upon the "annual sales turnover (annual gross operating income)" of the activity. Business activities grossing over $2M per year must be treated as Category 1 businesses. Businesses under this threshold are Category 2 businesses.

The $2M threshold has been set as a 'rule of thumb' measure of the significance of those activities for the purpose of applying a 'corporatisation model' and pricing requirements.

"Annual sales turnover"

The revenue that is included in the calculation of annual income is taken to consist of annual gross operating revenue of the business activity. This may include:

- rates and annual charges
- user charges and fees for service
- interest from investments
- operating grants and contributions
- proceeds on the sale of assets; and
- other operating revenue.

Category 1 businesses

Category 1 businesses must comply with certain minimum standards.

For Category 1 businesses councils must:
❖ adopt a 'corporatisation' model; ❖ apply full cost attribution including: - tax equivalent regime payments - debt guarantee fees, where the business benefits from council's borrowing position by comparison with commercial rates - return on capital invested; ❖ make explicit any subsidies paid to the business; ❖ operate within the same regulatory framework as private businesses.

Category 2 businesses

Councils have more flexibility in relation to Category 2 businesses. However, these may range from very large operations (eg, provision of substantial caravan parks) to businesses which are merely incidental to another activity (eg, hiring videos through the library). Some businesses will therefore be comparable with Category 1 businesses.

For Category 2 businesses councils must:
❖ must make any subsidy to the business explicit as part of the calculation of costs; ❖ should apply full cost attribution where practicable; ❖ are free to determine the extent to which the business will be separated from other associated mainstream activities; ❖ must operate within the same regulatory framework as private businesses.
"When councils compete in the market place they should do so on a basis that does not utilise their public sector position to gain an unfair advantage over a private sector competitor" (*Policy Statement*, paragraph 4.30)

Although council has some discretion in the treatment of Category 2 businesses, it must still abide by the broad principle and intent of competitive neutrality. Council should be sensitive to the impact that the business could have on the local and/or regional business community. The principle of competitive neutrality is still as applicable in these businesses as in larger ones.

As one way of simplifying the application of pricing requirements, council could adopt a 'rule of thumb' percentage to a business activity's cost which approximates tax, debt fees and so on. The level of tax and other overheads will depend to some extent on the nature of the market in which the business operates. Other elements such as separation for reporting and management are good business practices in any case.

The closer in scale a business is to a Category 1 operation, the stronger the argument for separation and the full application of the principle. The stronger also will be the community's expectations as to accountability.

Council will need to balance the economic and social costs and benefits in treating an activity as a Category 2 business. This will include those factors listed in clause 1(3) of the *Competition Principles Agreement*. Other issues involving the community benefit of carrying out the activity as a business or non-business may also be relevant, as well as the costs to the council associated with applying the competitive neutrality principle.

Example

Sandy Beach Council currently provides tourist information services. The tourist office is housed in a Council building which also contains other Council activities. Information is provided free to visitors, but a fee is charged to service industries for advertising and promotion in brochures and other publications. Council intends that the fee cover all costs of the promotional service. Overall, Council subsidises the information centre through administration and use of facilities. Its current gross operating income, including subsidies and user charges, is $300,000 per annum. If treated as a business, it would therefore be a Category 2 business activity.

There is another private organisation outside the area which also offers promotional services to local businesses, through tourist listings on the Internet and publication of holiday booklets, and which organises direct mailing services.

In deciding whether this activity is a business, some of the factors which will be important are:

- ***The objectives of the service*** - In this case, Council intends to benefit the local community by attracting as many people as possible to stay in the area. Ultimately, Council would like the tourist centre to pay for itself, but not necessarily make a profit. Other services are mooted, such as the retail of souvenirs etc.

- ***The community/ public benefit*** - Council considers that there is direct and continuing community benefit to all residents through increased revenue into the area, emphasis on preserving local beauty spots and better environmental management.

- ***The cost*** - For Sandy Beach Council there will be significant organisational costs to treat the activity as a business, in areas such as staff training, consulting with unions as to new work practices, new financial hardware, demand for better facilities to be able to be more efficient etc.

- ***The scale*** - The tourist centre as a whole is a small to medium activity in the scale of the local community. Only the promotion of local businesses is currently run on a cost recovery basis. This is only 50% of the centre's workload.

- ***Revenue raising*** - Council currently charges local businesses on a cost recovery basis for promotional services.

- ***The competition*** - Council is aware that a private sector competitor is operating in the area, which also provides employment in the area. It is aware of the importance of competing fairly with others and of the possibility of a complaint being made about the Council's practices.

In this case, it is possible that Sandy Beach Council could justify a decision to regard the activity:

- as a business;

- as a non-business in the short term, but develop a plan to gradually recognise the operation as a business over the next 3-5 years;

- as a non-business.

Whatever decision is made, the Council must be able to provide sound reasons.

3 COMPETITIVE NEUTRALITY PRINCIPLE - APPLYING THE 'CORPORATISATION MODEL'

A Category 1 business must comply with the "corporatisation" requirements set out in the *Policy Statement* (unless an independent benefit/cost analysis proves otherwise).

With Category 2 businesses, Council has a broader discretion to separate an activity if appropriate.

The *Policy Statement* provides that:

"Corporatisation does not necessarily mean that the business activity must be formally or legally incorporated as a separate organisation. However, the business must be capable of being separately identified within the operations of council and have its accounting and other operations structured in such a way as to provide a distinct reporting framework for its operations to council" (paragraph 4.18).

Firstly, it is emphasised that council does not have to form a corporation or other separate legal entity (although it may choose to). Further, there is no particular internal business structure which is required by national competition policy.

The requirement for corporatisation will be satisfied if:

- the business is capable of being separately identified within the operations of council; and
- it has a separate internal accounting and reporting framework to council.

Accordingly the format of a council's organisational and reporting structure may vary from council to council. No single "model" can be promoted as an optimal organisational or operational structure in all cases.

Internal Reporting

Corporatisation requires separate financial and management reporting for internal purposes only. The intention is to ensure that the 'owner' of a business is given accurate information on individual activities for decision-making purposes.

Separate internal reporting for business activities will include the same issues which other activities of councils report on. For example, this will include management issues such as human resources, tendering, compliance with legislation etc. It will also encompass financial and strategic reporting which is individual to the business.

This means that councils may need to review their management structure, or the management responsibilities of staff, so that it is clear who is required to report on certain issues. The traditional reporting structure adopted by councils has tended not to be based on separate activities. Local government unions and any other council employee groups will need to be consulted regarding workplace issues.

The need for separate business reporting may require councils to look at their costing systems to make sure that they can provide an accurate, activity-specific, picture of costs. This could also flow on to examining the adequacy of council's financial technology. Regardless of competitive neutrality, financial/ accounting reporting for business activities is essential to good business practice.

Lastly, councils will be accountable for their implementation of the competitive neutrality principle through the complaints mechanisms required by competition policy and through annual reporting. This is discussed below.

Strategic and Business Planning

Closely tied to internal reporting is planning. Successful businesses engage in strategic planning, and have performance targets to meet and report on. Business activities should have clear and non-conflicting management objectives.

Strategic planning will also involve looking at council's charter and broader social objectives as well as detailed business activity planning. The planning process could include:

- defining a mission and developing long term corporate objectives (10-15 years),
- establishing medium term management plans aimed at achieving those objectives (3 years),
- developing business plans (particularly for Category 1 businesses) with cost (budget) and pricing (revenue plans) strategies,
- translating broad program objectives into detailed service specifications,
- ensuring that services are delivered effectively and efficiently,
- benchmarking performance in order to pursue continuous improvement, and
- dealing equitably with and responsibly to clients and the public.

Some of these issues will already have been taken up in statutory plans, such as management plans under the Local Government Act 1993 (discussed below). Consultation with unions and other relevant groups will be important in business planning, as it is with other council activities.

Other issues

Accountability

Council will always remain accountable for a business to the community. Council members and staff will continue to have responsibility for ensuring that a service is being carried out effectively, or that ratepayers' funds are being used responsibly.

Competitive neutrality for council businesses will add focus to the provision of a transparent system of financial reporting and accountability. This is for the benefit of both the council, to ensure informed decision-making, and the community.

In addition, various members of the public, the business community and council itself will have differing concerns which will need to be heard and balanced. All interests must be recognised and decisions will be open to scrutiny, firstly through management plans and annual reports, but also through council's complaints mechanism.

Confidentiality of business information

Councils should maintain open meetings and provide public access to as much information as possible. As a minimum, council must comply with the requirements under the Local Government Act for the financial reporting, annual reporting and management planning of activities, including business activities. Outside these requirements, there may be legitimate situations where commercial sensitivity of business information will dictate limiting public disclosure of some information. Councils are responsible for determining the appropriate balance of disclosure of their business operations, after complying with the reporting and disclosure requirements of the Act.

Council should note that these issues are also currently being considered as part of the Government's review of those sections of the Local Government Act relating to public access to council information.

It is noted that confidentiality of commercial information refers to public access to that information. It does not relate to withholding information from the council body. The council is the owner of any business activity, and like any private sector board of directors is entitled to information regarding the running of the business in order to make strategic decisions.

4 COMPLAINTS HANDLING SYSTEMS AND EXTERNAL REPORTING

Complaints Handling Systems

The *Policy Statement* requires council to establish a complaints handling system for competitive neutrality complaints (paragraphs 4.36-4.39). Council should already have a mechanism for all types of complaints. The Department has previously published Practice Note No.9 "Complaints Management in Councils" to assist councils in setting up a general system.

The addition of competitive neutrality complaints will require little change to an existing system which is effective. Information on handling these types of complaints is provided in the Department's "Guideline on the Management of Competitive Neutrality Complaints" to be released shortly.

The importance of a complaints system for competitive neutrality issues should not be underestimated. It will indicate that council is not only able to deal effectively with complaints, but will provide a check for council that it is complying with the spirit and requirements of the *Policy Statement*.

Any complaint received by the State Government will be referred to the relevant council for handling. The Department of Local Government will pursue any complaints which have not adequately been resolved by council, or where the complainant requests a review by the State Government and the Department regards this as reasonable.

Local government is therefore given the responsibility of resolving complaints in the first instance, with review by the State Government where warranted. This system of complaints handling will be reviewed annually for 2 years to determine whether it is adequate or another system is warranted. Council's complaints mechanism will provide vital information on local government's efforts to comply with competitive neutrality. Accurate reporting is also needed so that the State Government may fulfill its reporting obligations to the Commonwealth on competition policy.

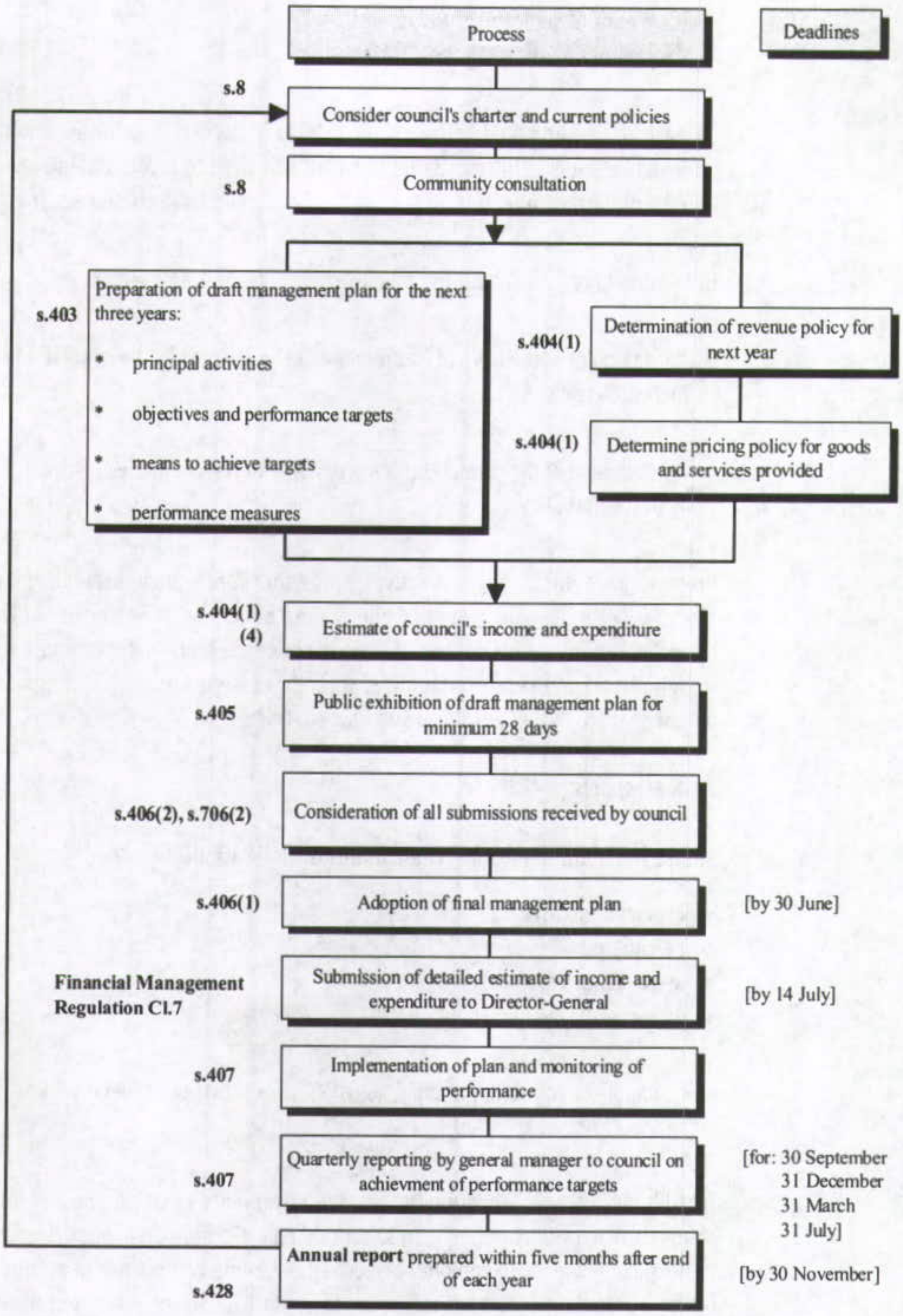
External Reporting

Council must comply with the external reporting requirements of the Local Government Act, regardless of competitive neutrality. The discussion below centres on the reporting of business activities, within the context of the whole of council's activities. In addition, the *Policy Statement* requires some matters regarding competition policy to be reported in council's annual report.

Management Planning (s.403)

It is worth reiterating the overall planning cycle in respect of management plans:

The Management Planning Cycle



Within management plans council must include a statement of:

- the objectives and performance targets,
- the means of achieving those targets, and
- the manner of assessing those targets,

for each of its "principal activities" (s.403(1)). Category 1 businesses should be viewed as principal activities. This means that council will need to incorporate Category 1 businesses into the management planning process for the plan that will commence from 1 July 1998.

In relation to revenue planning, management plans must also include:

- "a statement of the types of fees proposed to be charged by the council and the amounts of each such fee", and

- "a statement of the council's pricing policy with respect to the goods and services provided by it" (s.404(1)).

Proposed prices for all business activities must therefore be included in the management plan, along with a statement regarding the pricing policy for those activities. This need not be extensive, but should indicate on what basis a price has been set, for example, full cost recovery, marginal cost recovery, or subsidised through community service obligation payments or otherwise. (See Part 6, Subsidies and Part 10, Pricing.)

Annual reports (s.428)

Similarly, for annual reports, council must include a statement of:

- expenses incurred,
- revenue raised,
- assets acquired, and
- assets held,

"for each of the council's principal activities" (s.428(2)(a)). Category 1 businesses should be viewed as principal activities.

In addition, council is required to provide a summary of its progress in implementing the competitive neutrality principle in its annual report (*Policy Statement*, paragraph 4.46). This must make reference to complaints received regarding competitive neutrality and the results of those complaints. As outlined in the table on page 4, there is a staged timetable for the implementation of the competitive neutrality principle. As a result, the minimum requirements for annual reporting are staged.

Annual reports for the 1997-1998 year must include:

- a list of all business activities identified as Category 1;
- a statement regarding the establishment of a complaints handling mechanism for competitive neutrality complaints, including a summary of complaints raised and results of those complaints;
- a statement of expenses, revenues and assets acquired and held for each Category 1 business.

Council may of course include additional information.

Annual reports for 1998-1999 and following years must include:

- a list of all business activities identified as Category 1;
- a statement that each of the pricing requirements (tax equivalent regime payments, rates of return and debt guarantee fees) have or have not been applied to each business. This does not require Council to state the amounts of those calculations;
- a list of all business activities identified as Category 2;
- a statement of expenses, revenues and assets acquired and held for each Category 1 business, as per s.428(2)(a);
- a comparison of actual performance during the year with the projected performance of Category 1 businesses, including an explanation of any difference, as per s.428(2)(b).

The requirements for management plans and annual reports can be summarised as:

Year	Plan	
	Management Plan	Annual Report
1997-1998	——	❖ list businesses identified as Category 1 ❖ s.428(2)(a) - statement of expenses, revenues and assets acquired and held for Category 1 businesses. ❖ statement of establishment of complaints mechanisms and summary of complaints
1998-1999	❖ s.403(1) - statement of objectives, performance targets, means and manner of achieving targets for Category 1 businesses ❖ s.404(1) - statement of pricing policy and proposed prices for all business activities	❖ s.428(2)(a) - as for previous year ❖ summary of complaints received ❖ statement of application of pricing requirements to Category 1 businesses ❖ list Category 2 businesses ❖ s.428(2)(b) - comparison of planned to actual performance for Category 1 businesses
1999-2000 and following years	❖ as for previous year	❖ as for previous year

Financial reporting

Separate accounting for individual business activities is consistent with the operation of Australian Accounting Standard (AAS27) "Financial Reporting by Local Governments" and the Code of Accounting Practice and Financial Reporting (Code). Business-based accounting will not interfere with the operation of these overarching requirements. For example, AAS27 requires that councils report by both nature/type and function/activity. The Standard allows for either format to be presented in the council's 'Operating Statement', with the alternative method shown in the notes to the accounts.

Given the importance of separate internal reporting by activity in competitive neutrality and the requirement to report by 'principal activity' in the annual report, councils are required to present their operating statement in activity form. Those activities should reflect the major activities undertaken by the council and as a minimum include Category 1 businesses. The most practical form of disclosure would be based on the council structure which should also then reflect its major business activities.

The prime financial reports of the council should also be referenced to notes which provide detailed analysis of the performance of various activities for the year. The notes would indicate the net revenues earned for the period including dividends paid to it or subsidies provided (as discussed later in these Guidelines).

The financial reporting requirements are included in the Code which will be amended to include the additional disclosure requirements required by the *Policy Statement*.

5 APPLYING COMPETITIVE NEUTRALITY PRICING REQUIREMENTS

One of the elements of competitive neutrality is the inclusion of private sector pricing factors within government business pricing. This seeks to place private and public competitors on a more equal footing in the market. The pricing factors which are identified in the *Policy Statement* are taxation equivalent regime payments, debt guarantee fees, and rates of return on capital invested. A further factor which will affect pricing is the requirement to comply with legislation in the same manner as private enterprise. However, councils already comply with relevant regulations, so this cost is already incurred.

For Category 1 businesses council is required to apply full cost attribution to business pricing. That is, council must determine the full costs of carrying out the activity, including tax equivalent regime payments etc and then calculate a price based on full cost recovery. Council is expected to apply full cost attribution to Category 2 businesses where practicable. As stated on page 8 a 'rule of thumb' approximation may be made. In either Category, council may decide to subsidise the actual price charged once this calculation has been made. This is discussed further in Part 6.

Each of the price elements is discussed below.

Taxation Equivalent Regime (TER payments)

Councils are required to apply TER payments to all Category 1 business pricing. They should be applied where practicable to Category 2 businesses. These Guidelines identify some of the major Local, State and Federal Government taxes which council may need to consider.

Some areas of council are already liable for the payment of some taxes, for example payroll tax. It is assumed that council currently includes these taxes in its pricing calculations. The system of TER payments requires a calculation of those taxes for which council is not liable. Once a calculation is made, a TER payment is made from the business activity to the owner of the business, ie council. In local government, TER payments do not represent an actual cashflow outside the council, but must nevertheless be recognised through a payment from the business activity to the council. TER payments do not affect any actual exempt status of local government under tax laws.

Councils are required to disclose TER payments for internal reporting for Category 1 businesses, and Category 2 businesses where practicable. Financial reports contained in the Code of Accounting Practice and Financial Reporting will also be altered to reflect the requirements of competitive neutrality.

For more information on these taxes, council should refer to the Australian Tax Office

(Commonwealth taxes) or the Office of State Revenue (State taxes). It is possible, in the ongoing implementation of competition policy, that the Office of State Revenue may take a more formal role in assisting councils at some future point.

These Guidelines contain information current at the time of writing. Council will need to check specific tax rates with relevant agencies etc before calculation of TER Payments.

Taxes for which Councils are already liable

Council is already liable to pay some taxes on some activities, for example payroll tax on water and sewerage functions. These taxes are <u>not</u> part of TER payment calculations because they have already been paid. Council need only calculate TER payments for business activities where it is exempt from payment.

Taxes that council may already pay for some activities are:

- Fringe benefits tax (Commonwealth)
- Sales tax (Commonwealth)
- Financial Institutions Duty (State)
- Payroll tax (State).

Commonwealth Taxes - a Note about Income Tax

Income tax is levied ex post on profits of a business. While income tax should not be considered a specific cost for the purpose of pricing a good or service, it needs to be taken account of in terms of assessing the rate of return required on capital invested. Accordingly, the return on capital invested discussed on page 23 needs to be set at a pre-tax level as would be applied by a private sector competitor - that is it should include a provision equivalent to the corporate income tax rate, currently 36%.

Commonwealth Taxes - Sales Tax

Council will already be paying sales tax on some items. However, it may also enjoy exemptions.

Sales tax is a tax that is generally charged on the wholesale value of goods. It is charged on goods which are produced in or imported into Australia, unless they are specifically exempt from the tax. The tax is a single stage tax which is designed to fall primarily on sales by manufacturers or wholesalers to retailers and is payable on the *"taxable value"*, being the equivalent of a fair wholesale price.

Goods are subject to sales tax at the rate of 12%, 22%, 26%, 32% or 45%, unless they are exempt. The general rate of sales tax is currently 22%. Generally, council will not need to assess sales tax liability on a transaction by transaction basis. For costing an activity, council should determine an average tax rate which most commonly applies to the range of goods in question and apply that to the whole of that business's transactions. However, there may be significant items for which the tax will need to be calculated separately, but these should be exceptions to the rule.

Councils would be aware that there may be some activities which do not incur sales tax. For example, child care centres run by council are exempt from sales tax. Since child care services in the private sector are also sales tax exempt, sales tax will not need to be included in costing.

Also, sales tax is not payable by the private sector in certain cases where a contractor is undertaking work for council. For this reason, if council is assessing the cost of an 'in-house' service provider as compared to the private sector, then sales tax may not need to be included. However, where council is costing a tender bid for an external contract which is not sales tax exempt, sales tax will need to be included.

State Taxes - Land Tax

Each State and the ACT imposes land tax in respect of land owned in that State or Territory as at a particular date, usually 30 June or 31 December. Land tax is charged by the NSW Government on land owned at midnight on 31 December each year. Any land (or interest in land) that is owned with an unimproved value equal to or above a prescribed value is taxable.

Council should contact the Office of State Revenue for the current taxable threshold and tax rates. The current maximum land tax payable in NSW is 1.85% + \$100 on the unimproved value over \$160,000. Land tax will only be relevant where a business activity owns land or where the land may be owned by council but a business activity has exclusive use (eg water and sewerage facilities, land development, caravan parks). If the business activity owns or exclusively uses more than one piece of land, the land is 'grouped' and tax calculated on total property owned.

State Taxes - Stamp Duty

Each State and Territory imposes duties on certain documents and transactions. The rates vary on the type of document or transaction. Taxable transactions include transfers of property, business assets and shares and units, insurance business, leases on land, and mortgages and charges.

Council should contact the Office of State Revenue for the current rates of duty on various transactions, if stamp duty is relevant to a council business transaction.

Other taxes or charges

Other State or Commonwealth agencies may charge fees to the private sector for which local government is exempt. If this is the case, council will clearly need to include these charges as TER payment calculations.

Local Government Rates and Charges

Local government rates are based on the Valuer-General's valuation of land and are net receivables rather than payables to councils. For costing purposes, councils currently rate such activities as water supply, sewerage services and domestic waste management services. Gas supply and abattoirs are also charged rates.

Category 1 businesses will need to include a calculation of rates and charges unless the activity is rate exempt under ss 555-558 of the Local Government Act. If the business operates within council's administrative centre for example, council should have a costing system which reliably allocates a proportion of overheads to the business, including rates.

Consolidation of financial reports has in the past eliminated internal transactions such as these, which has prevented public disclosure of such charges. Therefore, while consolidation will continue for external reporting, council will need to disclose these transactions for internal reporting purposes.

Loans and Debt Guarantee Fees

Debt guarantee fees are intended to offset any advantage that a government business, because of its public ownership, may have over the private sector when borrowing money. Debt guarantee fees are therefore designed to ensure that government businesses face "true" commercial borrowing costs, in line with competitors. This in turn assists government businesses to compare and match the performance of private sector competitors of similar risk.

With security gained over council income (cl.29, Local Government (Financial Management) Regulation 1993), lenders are willing to provide loans to local government at highly competitive rates. A debt guarantee fee will be relevant where council has provided or intends to provide loan funds to a business activity.

To calculate a debt guarantee fee, council will need to treat its business activities as 'stand alone' enterprises and ask what borrowing rate the activity may receive in the market. This will depend on a number of factors including the type of business, amount borrowed, period of the loan and so on. The difference between the commercial rate and the council's borrowing rate is the debt guarantee fee. There are also instances where a council may have a surety from another source (ie. State government), where a loan is raised at a discount to that of the market.

In most cases the cost differential between the 'commercial rate' and the 'government rate' will be insignificant and council will not need to include a debt guarantee calculation. However, in other instances, debt financing may be a significant factor or have been obtained under special conditions. In these cases, council should explore the materiality of the cost and whether it should be included in the business's accounts. A debt guarantee fee may then be notionally 'paid' from the business activity to the owner-council.

Return on Capital Invested

Category 1 businesses are expected to generate a return on capital invested. The return will be in the form of a pre-tax profit, part of which will equate to the corporate tax rate and part of which will be paid as a dividend to the council as the owner of the business (*Policy Statement*, paragraph 4.21). The appropriate level of return to be factored in is a difficult issue, and is discussed below.

The formula for calculating rates of return on investments is:

$$\frac{\textbf{Net Income}}{\textbf{Investment}}$$

where investment is - assets, owners' equity or invested capital in the business.

A more complete expression of the formula for local government is:

$$\frac{\text{Operating result before capital amounts}}{\text{Written down replacement cost of property, plant and equipment.}}$$

The purpose of a rate of return

The advantages of a rate of return will in part depend on whether the business is operating as a monopoly (eg, water and sewerage) or in a competitive market. In a competitive market, a rate of return is a measure of the quality of the investment which the owner has made. Factoring a rate of return into pricing will only be successful if the business controls other costs to keep the price comparable with competitors. In other words, rates of return can be an effective measure of efficiency and profitability where competitors cannot increase prices merely to generate the return.

In monopoly businesses, such as water and sewerage supply, rates of return will have a different purpose. The main purposes are both as a measure of efficiency while ensuring that the business is generating a return sufficient to cover costs and replace assets needed to maintain service standards. If the rate of return is negative, operating revenues are insufficient to cover the operating costs of the business and survival rests on running down or selling existing assets, or else increasing prices.

The level of return

The *Policy Statement* states that for Category 1 businesses a rate of return comparable to the private sector should be aimed for (paragraph 4.21). However, in setting a rate of return, a number of factors will be particularly important:

- ***The nature of the market*** - in a competitive market, rates of return have a direct relevance as a measure of efficiency and profitability, given that a competitor is not able arbitrarily to increase prices to generate the return, but must find other cost savings to generate the return.

The closer the market is to a monopoly, the less price constraint a business has. The purpose of a return changes. Council should not set a rate of return in isolation, but consider this in the context of other efficiency measures such as benchmarking etc. Council will also have less guidance in finding an appropriate level of return in the private sector, given that it is conducting a monopoly.

Water and sewerage pricing raises specific issues and is discussed separately below.

- ***Reflection of a rate of return in pricing*** - Competitive neutrality requires that council businesses operating in a competitive market should be required to achieve a long term rate of return, in line with the 'risk profile' of their business, just as private competitors must do. An exemption from this requirement would require a benefit/cost analysis to be undertaken showing, from a community perspective, that the costs of complying exceed the benefits. The benefit/cost analysis could also be used to respond to possible complaints from competitors.

  However, in both monopoly and competitive business markets, councils should not arbitrarily increase prices merely to gain a rate of return. Neither the council nor the community would benefit in such a case, because rates of return are not linked in any way to increasing efficiency in the business, reducing other costs, and projections of long-term asset replacement. Instead, rates of return will be viewed by the community only as a revenue-raising exercise without justification. <u>Rates of return must be linked to increased efficiency measures which may generate the return.</u>

- ***The drive for efficiency*** - as has been emphasised above, rates of return are not to be viewed in isolation, but as part of the measure of efficiency, and hence profitability, which can be achieved by a business. Other measures such as benchmarking, performance targets, and workplace reform should be considered together with rates of return.

Water and sewerage business activities

A number of particular issues are associated with water and sewerage supply activities which do not apply to other business activities. Rates of return should be seen in a different context in relation to water and sewerage.

The Independent Pricing and Regulatory Tribunal (IPART) discussed rates of return in its Report on *Pricing Principles for Local Water Authorities, September 1996*. It made the observation that in a monopoly market, council water supplies are theoretically able to set prices to achieve arbitrary rates of return. The purpose of a rate of return in these circumstances is not arbitrarily to inflate prices. Rather it is to ensure the long-term survival of the operation at an appropriate standard of service and measure of efficiency in providing the service. As important in water pricing, is the issue of identifying the full costs of providing the service, including replacement and environmental costs.

The Tribunal stated:

"...local water operators should modify their costs and charges to at least cover operating and administration costs in the immediate future. Minimum business cost recovery, including financial costs and some contribution to renewals, is required for sustainable business operations. Where augmentations are called for, a positive real rate of return test should be applied. In recovering these costs, environmental costs need to be examined" (p27).

The Tribunal's final recommendation is:

"Recommendation 4.4

The Tribunal considers that positive real rate of return targets can be appropriate in choosing and charging for new investments in water services in country towns, provided other measures of cost effectiveness are established and informal price restraint is imposed through yardstick competition" (p27).

The Council of Australian Governments has agreed to reforms in the water industry which are part of broader competition policy and are tied to the States receiving their 'competition payments' from the Commonwealth for implemention of competition policy. As a result there will be further developments in water reform and pricing over the next few years. This may affect the calculation of rates of return and other pricing elements of water and sewerage functions.

Dividend Policy

Council's businesses under competitive neutrality will operate with a high degree of autonomy in the conduct of commercial pursuits. Nevertheless, the Council retains ownership of the business and can reasonably expect to receive a return on invested funds comparable with that enjoyed by private organisations. Looked at in another way, council is using ratepayers' monies to fund business activities and ratepayers should therefore expect to receive a rate of return on the investment of their funds.

Investors would normally expect to earn a rate of return which is commensurate with the level of risk - the higher the risk, the greater the return. In a market situation the return on invested capital should be equal to or better than a return on a Commonwealth 10 year bond. This represents the minimum return investors would expect. A higher return would be expected on more risky investments.

Private organisations generally pay dividends as a result of capital growth and generation of profits. Competition principles are based on the concept of determining a pricing policy which will provide revenues in excess of expenses.

The determination of dividends is notional only in that they are not "paid out" to shareholders. Dividend payments will be included in pricing calculations, with the qualifications discussed above concerning the arbitrary increase in prices to achieve a return. A dividend is then 'paid' from the business to the owner council. The disclosure of notional dividends and notional rates of return would also be part of a council's reporting and performance monitoring process.

The effect of the Local Government Act 1993

The Local Government Act contains some provisions governing the calculation of charges and the use of money received. These will affect the way in which council applies these pricing requirements.

Section 409

Section 409 will affect the way in which Council can pay dividends, debt guarantee fees and TER payments in some cases. Section 409(3)(a) states:

"money that has been received as a result of the levying of a special rate or charge may not be used other than for the purpose for which the rate or charge was levied".

This also applies to any other money received for a specific purpose under any piece of legislation (s.409(3)(b)), or money received via Government grant (s.409(3)(c)).

This is relevant to those council businesses which are funded through special rates (under s.495) and charges (s.501), for example water supply and sewerage services. At present, section 409 prevents councils from transferring dividend payments and TER payments from the business to council's general revenues. These revenues may be used for many purposes. Any dividends or TER payments on a water and sewerage business, for example, must therefore be paid into the water and sewerage business activity and used only for that purpose. Legislative amendments may be considered to address this issue.

Section 504 - domestic waste management charges

In addition to s.409, domestic waste management charges are regulated by s.504. That is, a council:

- must not subsidise domestic waste management services, but may provide an internal loan from ordinary rates, and

- must calculate charges so the income does not exceed the "reasonable cost" of council providing domestic waste services.

If council's domestic waste service is a Category 1 or 2 business, the competitive neutrality pricing principle must be applied consistent with s.504. The pricing requirements may be applied consistent with s.504 by observing the following:

- council is not able to subsidise a domestic waste business activity but may provide an internal loan from ordinary rates funds;

- council can include TER payments, dividends etc as part of the "reasonable cost" of providing a domestic waste service. In addition, the allocation of overheads and other indirect costs should be included as part of the "reasonable cost" of the service.

6 SUBSIDIES

Council will only need to show subsidies for those activities it treats as a business. Non-business activities funded out of ordinary rates, often subsidised, will not have to disclose subsidies.

After the costs of a particular activity have been determined, including TER payments, debt guarantee fees and rates of return, council will need to calculate a price based on full cost recovery for the business. As a business activity, it would be expected that council would wish to recover costs, or at least marginal costs. However, the council may decide that because of the activity's social significance, for example, full costs will not be passed on to all or some users. Council may therefore determine that part of the costs of the activity will be met from council funds as a subsidy to meet nominated community service obligations (CSOs) or other subsidies. Prices will therefore be set at a rate lower than full cost recovery.

The *Policy Statement* (paragraph 4.23) allows council to subsidise businesses for whatever purpose. However, such subsidies must be fully disclosed as an explicit transaction. They will also then be visible for the purposes of pricing the service. Council's pricing policy (whether full or partial cost recovery, whether subsidised etc) should also be shown in its management plan (as discussed at pp.14 - 16)

A subsidy may take various forms. For the purposes of disclosure for national competition policy, subsidies have been divided into two broad groups:

- ***Community service obligation subsidies***. These are subsidies for identified CSO's. For example, they may include pensioner rate rebates, subsidised childcare places for low income families, subsidised recreation classes for pensioners at the leisure centre etc. CSO payments involve council in assessing the functions and purpose of any business activity (through strategic planning) and then identifying any services which it wishes a business to continue to carry out, but for which it decides that the business will not recover costs on a commercial basis.

  For example, assume council has a community centre, which it treats as a business (Category 1 or 2). The centre runs the meals on wheels service, childcare services, a senior citizens bus, gym classes and a gym equipment shop. Council may decide that the meals on wheels service, childcare and bus should not be provided on a full cost recovery basis, but as a community service. The gym classes and shop will be run as profit making ventures. Council will need to show the CSO subsidy to the business for each of the activities of meals on wheels, childcare and the senior citizens bus.

  If council has contracted out or competitively tendered for a service, it may have already been required to calculate CSO costs to ensure that the internal or external provider carries out a community service. This should have also be included in any contract.

- ***Other subsidies***. These will include a wide range of costs borne by council instead of the business activity, such as 'free' use of equipment, use of central services etc. As part of competitive neutrality, council will need to identify these costs for businesses. It may then pay a subsidy to the business to cover all or part of these costs.

Council is required to report each individual CSO subsidy and the total of any other subsidies paid to a business in its internal financial reporting. Some businesses may have only one CSO placed on them, while others may have more than one. Therefore, if more than one obligation is placed on the business, each will need to be identified separately.

Therefore, whilst it is recognised that local government is responsible for making decisions which affect the determination of pricing policies and the supplier of services, there is also an expectation that the impact of those decisions is adequately disclosed to the council at least, if not to the community. Councils may choose to provide services as part of a business, free of charge or at subsidised rates. Where a decision is taken to provide a subsidy, the subsidy must be clearly identified in financial reports and included in the calculation of costs.

Councils are required to make subsidies explicit for both Category 1 and Category 2 businesses.

7 COSTING - GENERAL PRINCIPLES

This and following Parts of these Guidelines apply to all of a council's activities. In these Parts, methods and principles of costing an activity are discussed. The need for accurate costing exists independently of national competition policy. However, these Guidelines will have immediate application to the business activities of council - the principle of competitive neutrality relies on an effective costing system for business activities.

Council business activities need an effective costing system to implement competitive neutrality.

Introducing an effective costing system will take time, effort and money. The level of funding will depend on the current accounting system which council has in place, computer software and hardware, level of expertise in the council and so on.

What are the benefits of an accurate costing system?

Cost centre managers depend on effective costing systems for a range of essential purposes, including:

- ***Planning*** - in both the short term (to determine costing and revenue policies) and longer term (organisational and strategic). This planning will also incorporate the management planning process, eg revenue policies for goods and services (s.404(1), Local Government Act).

- ***Budgeting*** - business unit / activity budgets. This will also involve compliance with s.404 and cl.6 of the Local Government (Financial Management) Regulation 1993.

- ***Performance*** - comparison of actual to planned costs must be reported to determine the efficiency/performance of managers and the organisation as a whole. This will also be relevant to the financial reporting process (s.418, Local Government Act).

- ***Pricing*** - in order to set equitable and competitive prices, managers need to know all costs involved (direct and indirect) in providing the service.

- ***Contract preparation & tendering*** - managers are required to prepare accurately costed specifications when considering a project.

- ***Controlling*** - costs should be monitored to ensure value for money is received within the service specifications designed for an activity.

- ***Benchmarking*** - best practices in the industry will tend to establish benchmarks for performance. These may be between councils, between industry and council or between units within the council.

- ***Reporting*** - the implementation and progress of competitive neutrality will require internal reporting, including cost information.

General Principles - Total (Full) Costing

Full costing refers to the recovery of all direct and indirect costs involved in providing goods and services.

At the least, council needs to calculate the full cost of its business activities. The reasons for this have been listed above. In relation to competitive neutrality principles, full costing is implicit in determining a pricing policy. This does not mean that council must charge the full cost of the service, once it has been calculated.

In addition, Australian Accounting Standard (AAS27) "Financial Reporting by Local Governments" goes some way to requiring the allocation of indirect costs as it requires the disclosure in the financial report of *"...expenses for the reporting period which are reliably attributable to that function"*. This applies to both business and non-business activities.

General Principles - 'Cost Allocation'

To develop a costing system, council will need to allocate costs to an activity. 'Cost allocation' is the term used to describe the expenditure debited to a service area for a share of indirect costs. Thus the full cost of a service involves charging direct costs and a "fair share" of indirect costs that are incurred in providing the service. To maintain the integrity of apportioning costs, indirect costs must be allocated on "a reliable basis". That is, a causal relationship between the allocation method and the service delivery must be demonstrated.

The basis of cost allocation is at the discretion of council, and should be clearly stated. The methods should be within accepted accounting standards and consistent with accepted commercial practice.

Lastly, it is recognised that there will be some indirect costs which cannot be appropriately apportioned to specific activities, such as audit fees. Council may choose not to allocate these costs directly to services, temporarily. Instead, council may choose to charge these to an "Administration" service centre. These types of costs, which should be minimal and not material, can subsequently be spread over specific activities using a simple, but reliable allocation basis, such as total expenditure.

However, when council is comparing internal and external providers, these costs must be identified and allocated so that a meaningful comparison can be made between providers.

Resource sharing

A number of individual councils are currently working to establish reliable ways to allocate indirect costs to an activity. Councils could establish joint project teams to develop methods, particularly in smaller councils. Councils should contact each other, work through the regional organisation, or contact the Local Government and Shires Associations to pursue this.

General Principles - Allocating the cost of Governance

Governance costs are indirect costs which cannot and should not be allocated to a specific activity. These costs would exist even if all council services were 'contracted out'. Identification of governance or democracy costs is very important, as they cannot be provided other than by the council.

Whilst various views exist as to what should be included in costs of governance, there is general agreement that the scope of democracy costs would include:

- meetings of the council and of corporate policy making committees, and attendance at them, as long as they are not responsible for the management of specific services;
- the salaries and expenses of elected members;
- chief executives, except for any time they spend on specific services or direct service operations for which they are specifically responsible;
- general accounting work, including the preparation and publishing of statements of accounts, corporate budgets and annual reports (also includes processing of freedom of information requests and other public accountability requirements);
- subscriptions to local authority associations and attendance at conferences and meetings;
- the costs of local elections;
- the staff, accommodation and services needed to support all the meetings, personnel and activities described above.

(derived from "The Management of Overheads in Local Authorities", CIPFA, London, 1991, p.5.)

Costs arising from these governance functions should not be allocated to any particular activity.

Costing Methodologies

There are many costing methods which can be applied to determine the cost of providing goods and services. However, the method most often considered appropriate in local government is activity based costing. Council may choose the costing system which best suits its needs.

Different set-up costs will be associated with each costing system. Council will need to weigh the costs of each, how council wishes to use the system, the degree of sophistication required, and the broad strategic plan for council.

Whatever method is used, council must ensure that all data collection and costing systems are consistently applied and provide a complete audit trail. Calculations and assumptions should be documented and made transparent. The issue of materiality should also be considered to assist in determining council policies and procedures.

Activity based costing (ABC)

Activity based costing is a relatively new costing system. It is not intended to promote one type of service provider over another.

It allocates indirect costs through the use of 'cost drivers'. Cost drivers identify different aspects of the organisational support given to activities. They are selected to reflect the closest causal relationship to the cost they are being used to trace. For example, a cost driver for grass cutting may be the fuel cost of mowing a particular park.

Together, cost drivers make up the full cost, both direct and indirect, of providing a service. The proportion of costs allocated to an activity is based on activity's use of those 'cost drivers' (eg, fuel). ABC is therefore used to allocate both direct and indirect costs to an activity. The process minimises any arbitrary basis of allocations across service areas or no allocation at all.

An 'activity' is identified as a discrete area of service within the council, such as grass cutting, debt collections etc. A business such as the operation of a saleyard will involve a number of distinct activities identified in a costing system.

To implement ABC councils will be required to identify:

- their separate areas of service provision, eg, saleyards, library services
- the separate costing activities that are involved in providing the service
- "cost drivers" (the method of identifying the level of support services used by each of the activities).

Cost drivers must be carefully selected to ensure they reflect the closest causal relationship to the cost they are being used to trace. More than one cost driver may be available, eg, staff training costs may be based on number of people in a unit or based on rent/ lighting costs of the floor space occupied by staff. The cost drivers may be:

- direct (for those activities which relate solely to one service)
- duration based (to capture the length of time it takes to perform an activity, ie. plant hours etc)
- transaction based (to capture the number of times an activity is performed, ie. number of invoices raised, number of people paid etc)
- service characteristic based (to capture the number of times a particular service characteristic of a product occurs, ie. number of times parks are mowed, watered, etc).

8 COSTING A SPECIFIC ACTIVITY

Unlike statutory financial accounting, there are no hard and fast rules that regulate the costing process. Consequently, costing is a matter of being 'appropriate' rather than being absolutely right or wrong. It is an imprecise process that requires equal amounts of technical knowledge and commercial common sense.

The appropriateness of a costing system will depend on the purpose of the costing exercise and the degree of accuracy required. Other factors, such as the capability of the accounting system and the cost of achieving a high degree of accuracy, will also be relevant.

The steps

There are a number of steps which are common in any process of costing activities. They include:

- **Defining the activity to be costed**
- **Defining the level of service and service quality**
- **Defining the relevant costs**
- **Undertaking the costing**
  - **Using the accounting system**
  - **Identifying direct and indirect costs**
  - **Identifying costs not closely associated with the activity**
  - **Equipment and other capital items**
  - **Aggregating the costs**

Defining the activity to be costed

This first step in the costing process essentially determines the accuracy of the costing system. It involves:

- identifying a council activity and the tasks which make up the activity,
- noting where the tasks start and finish, and
- confirming or specifying the standard of service required.

Council's organisation structure may be a good starting point in determining what activities it operates. As required by competitive neutrality, council will need to identify Category 1 and Category 2 business activities as a minimum. (There is a different timetable applying to each Category (see p.4).)

A broad activity may be further split into smaller activities, for example "Public Works and Services" may include road construction and maintenance, bridge construction, buildings etc. It is up to council to determine how it wishes to identify an activity.

Within an activity, once identified, there will be discrete tasks, for example in Financial Services there may be payroll processing, budgeting, financial reporting, investing, loan finance, accounts receivable and so on.

Defining an existing activity may be fairly straightforward. It will involve more thought if council is altering an existing activity or undertaking a new one. Where there is uncertainty, it may help to identify what is specifically excluded from an activity.

Defining the level of service quality

Once activities have been defined, the level of service quality needs to be specified. This is necessary in order to define and cost the service.

This may be a more simple process with some activities. For example, one may define an activity such as mowing a park once per week to a length of 50mm. The service is clearly defined and easily assessed for adequacy of performance. Obviously other services are more complicated and need more thought.

Defining service quality is crucial in a wider context also. It is essential, in ensuring best value for the ratepayers' dollar, that council know the level of service that it requires from its staff as well as its contractors. Defining service quality will involve consideration of council's broad goals, its objectives for the activity and budgetary priorities. These should reflect the community's needs so that the ultimate quality specified satisfies community requirements.

Once quality has been determined, costing the provision of that service and the subsequent performance analysis becomes a much more straight forward task.

Defining the relevant costs

It is important to include only relevant costs in the calculations and these may differ with the purpose of the costing. For example, if the primary purpose of a council business activity is the sale of products, all the production and overhead costs will be relevant to setting prices; whereas if sales are quite incidental, only the marginal costs of production may be relevant. If costing is being undertaken specifically for the purpose of competitive tendering, the relevant costs will be different again, flowing from the need for a fair comparison between providers.

Undertaking the Costing

This will involve an identification of direct and indirect costs, using a nominated costing system and a reliable means of allocation, as discussed in Part 7.

Using the accounting system

Council's accounting system will contain valuable information which can be used to identify costs. This information can also be used as the basis of costing a new or altered activity. Using the accounting system will be preferable to developing costs from scratch, because it is based on historical information rather than prediction.

The accounting system might collect costs by activities, departments, products, processes, by geographical areas or by any other criteria. Costs might also be collected in a few, large cost centres or more numerous, smaller ones, for example, at the level of the entire personnel department or alternatively at the sectional levels of recruitment and training within personnel.

Regardless of their configuration, accounting systems are usually structured to accomplish a set number of tasks and are relatively inflexible in the short term. If the activity to be costed does not fit neatly into the existing accounting structure, costing is initially more time consuming.

Identifying direct and indirect costs

As discussed in Part 7, council will need to allocate both direct and indirect costs to an activity.

The accounting system should have an accurate picture of direct costs allocated to an activity. Depending on the accounting system which council has in place, it may be difficult to identify all indirect costs through this means.

Regardless of the costing system which council chooses (ie activity based costing, net avoidable costing etc), the degree of accuracy in allocation of indirect costs can vary.

The degree of accuracy will depend on:

- The allocation basis - allocations of costs should be based on the single factor which best explains how costs behave or change. This relates to the previous discussion of a 'reliable basis' of allocation.

- The breadth of the cost object in the accounting system - the broader the cost object the less likely costs can be allocated accurately.

For example, the allocation of personnel overhead costs to a cleaning activity will be more accurate if:

- the components of personnel (say, recruitment and training) are treated separately within the accounting system than if they are amalgamated; and
- different cost drivers are used for recruitment (number of recruits, for example) and training (number of courses attended) than if one cost driver, headcount, is used to allocate personnel costs as a whole.

However, whether the increase in accuracy is worth the extra cost involved to obtain it is a matter of judgement to be exercised at the time. All the assumptions underlying the allocations should be stated clearly in the costing documents.

Identifying costs not closely associated with the activity

Costs not obviously associated with the activity may be overlooked unless a check is made of all likely cost factors. An examination of the accounting system will provide a check list of costs that may be relevant. However it cannot be assumed that current accounting information adequately lists all relevant costs. Councils must review their accounting and reporting processes to ensure all relevant costs are effectively captured.

Equipment and other capital items

The cost of the existing activity needs to reflect the true cost of using equipment. The relevant costs not only relate to typical maintenance and repairs but also include the future provision of asset replacement. One approach is to annualise this by estimating the annual cash payments required for replacement, in effect calculating the annual provision required which will provide the necessary funds for replacement.

Council may wish to consider the depreciation expense calculated as a guide to future cash requirements, but remember that depreciation is a sunk cost which may be based on the original cost, and therefore has limited use. Where assets are maintained at current replacement cost and regularly revalued, the depreciation expense will more closely equate to the future cash provision.

Aggregating the costs

From this position it should now be possible to cost the activity. The costs will include:

- direct costs - ie. those traced directly to the activity being costed;
- indirect costs - ie. those costs which are not traced directly to the activity and other relevant costs of the activity;
- tax equivalent calculations for business activities, if required;
- rate of return for business activities, if required;
- debt guarantee fees for business activities, if required.

9 COSTING AND COMPETITIVE TENDERING

Introduction

Council should refer to the Guideline on Competitive Tendering issued in January 1997 for a full discussion of the issues surrounding competitive tendering.

This Part of these Guidelines is intended to assist council in costing in-house tenders and in making meaningful comparisons between internal and external providers. Council should already have undertaken in-depth consideration of the issues before deciding to undertake competitive tendering.

If a council has chosen to use this process, it must ensure that the economic costs of the in-house service provider are fully calculated. These should be calculated according to the principles and procedures outlined in these Guidelines.

Once tenders have been received by in-house and external providers, council must then analyse and compare the costs of the various providers. Cost will be only one of the final criteria upon which a service provider is chosen. The final choice of service provider will be based on a number of criteria covering social and employment implications, quality of service, the capability of the tenderers and other relevant factors. These are explained more fully in the Guideline on Competitive Tendering.

Costing 'in-house' tenderers

The full cost of an in-house bid will include:

- all direct and indirect costs of the service. In the context of competitive tendering it is vital to have an effective costing system which reliably allocates indirect costs.
- taxation equivalent calculations, where relevant, as discussed in Part 5, "Applying Competitive Neutrality Pricing Requirements".
- debt guarantee fees, where relevant, based on the benefit which council's borrowing position may bring to the in-house tenderer, as discussed in Part 5.
- rates of return on capital, where relevant, as discussed in Part 5.

An in-house tenderer should include all these pricing components in costing a bid.

Costs relevant to making comparisons with external bids

Once tenders have been received by the council, there are a number of cost factors which council will need to calculate and balance with each other, in addition to the quoted price for the service.

The basic principle is that council should calculate all relevant costs. All future costs which impact on the efficiency of the tender options are relevant. Past costs are irrelevant because they are sunk costs. That is, regardless of the decision, they are irretrievable. These include the cost of developing specifications, and inviting and assessing tenders. Past costs would have been relevant in an initial decision about the cost/ benefit of undertaking competitive tendering.

A number of relevant costs are listed below. Some will reflect added costs of accepting an external provider, others will reflect costs which the council may avoid through contracting out.

New costs if the service is contracted - These will include costs involved in monitoring a contractor's performance, administration costs in payment of contractor's fees, enforcement of the contract etc.

Avoidable costs - These are costs which would not occur (ie would be avoided) as a result of contracting out. Avoidable costs can be categorised as:

- costs which are likely to be automatically avoided if the activity is contracted out, typically the costs closely associated with the activity;

- costs which may be avoided but which require management action to realise the savings, for example the costs of the activity's use of facilities or of payroll services/ recruitment. These costs need to be highlighted to council as dependent on future action. They are not automatically avoided if an external provider is accepted. They may also involve costs of their own to realise any savings.

There are clearly some costs which are not going to be avoided if a service is contracted, for example corporate overheads, democracy costs etc. These costs are irrelevant for the purpose of competitive tendering.

The in-house costs of contracting out

Whilst the avoidable cost of the activity is the main relevant cost, it is also necessary to take into account the in-house costs which would be incurred as a result of contracting out. These costs are less likely to be sourced from the accounting system because they have not yet been incurred and may need to be estimated from scratch. Such costs would include such once off-costs as:

In-house transition costs - These are costs that would arise from a changeover to a contractor, for example reorganisation of accommodation, human resources costs in dealing with affected staff, and training costs for affected staff.

From a costing perspective, redundancy costs have no bearing on the relative efficiency of options and are not relevant at this stage of consideration. However, they will of course be very relevant in the final determination, and are taken into account before a final decision is made. Redundancy costs are specifically dealt with below.

Initial cost analysis of bids

At the same time as calculating the costs to council associated with each bid, council will also need to evaluate the various proposals to put them on a common basis with each other. For example, each alternative needs to be presented on a cash basis and consistent economic forecasts must be used.

Another factor will be both the quantity and timing of cash flows required by a contractor. Timing of cash flows is important because there is an opportunity cost (benefit) associated with payments that are required later rather than sooner. The larger the funds involved, the greater the impact of timing of payments. In some contracts, the issue will not arise, or will not be significant. Council may determine how to treat this issue as it sees fit.

If it is 'material', council can address timing of payments in different bids by using discounted cash flows. This method brings back future cash flows to a present day equivalent through 'discounting'. The quantity and timing of payments is reduced to a single figure, the 'net present value' (NPV), and this may be used to compare all tenders.

If council chooses to use this method, it will need to determine what 'discount rate' it will apply to payments and how it will treat inflation. There are differing views on appropriate rates etc. Regardless of this, council should make clear what assumptions it has used and apply these consistently.

Interpreting the initial analysis

Where council has used this method to compare tender bids, the output of a discounted cash flow for each alternative is a single number, the NPV. For the external tenders the NPV of the change-over costs (excluding redundancy costs) must be added. The NPV of each alternative can then be ranked and, prima facie, the lowest NPV is the preferred option on cost grounds.

Assessing the bids

Once the bids have been put on a common basis, and the costs to council of internal and external bids have been calculated, council can assess the bids.

Redundancy and other transitional costs

At this stage, the once-off, transitional, costs of contracting out should be considered. These will include:

- redundancy, redeployment and transfer payments;
- plant, equipment and facilities; and
- information technology.

Estimating once-off costs creates one of the difficulties in determining the best provider of services and must be carefully considered and assessed. The transitional costs of an external provider may be substantial and outweigh any costs savings in contracting out.

In relation to redundancy costs, assumptions will need to be made about how long the benefits of contracting out will persist, in order to consider at what point redundancy and other costs will be recouped from cost benefits.

Financial risks

Council will also need to consider the risks that may be incurred by instituting a change in the provision of a service. The risks include having to meet the cost to the council if the new service provider fails to perform, and the costs of an unforeseen delay in the change-over. The risks increase markedly if the change-over involves the introduction of new, unfamiliar technology or processes.

In some cases there may be justification to quantify the risk of changing over to a new service provider and to add that factor to relevant bids. This will probably require expert advice. There may also be problems associated with alternative suppliers or the council's re-entry to the market if a particular supplier fails or if monopoly pricing eventuates.

Contractors' liability

When negotiating contracts for the supply of goods and services, council should consider the need for insurance indemnity from contractors. Where appropriate, council should be indemnified for loss arising from the use of the goods and services to the community, public risk arising through use of buildings, plant or vehicles and general insurance risks such as fire and structural damage. Council may be seriously exposed to risk and higher premium costs if these are not dealt with in contract negotiations.

Other factors

The Guidelines on Competitive Tendering discuss a number of other factors which will be vital to consider, together with cost, in deciding on an internal or external provider. These include:

- social and employment impacts of contracting out on the community;
- consumer protection;
- employment issues such as equal employment opportunities, occupational health and safety, industrial conditions;
- accountability and probity issues.

10 PRICING

The result of effective costing systems and the application of the competitive neutrality principle for business activities will be in council's pricing policy.

The following elements will be part of a pricing policy for a business activity:

- reliable allocation of total costs, both direct and indirect (see Parts 7 and 8);
- tax equivalent calculations, where relevant (see Part 5);
- debt guarantee fees where relevant (see Part 5);
- rate of return on capital, if relevant (see Part 5);
- any relevant pricing principles issued by the Independent Pricing and Regulatory Tribunal.

As stressed throughout these Guidelines, a council need not set a price which seeks to recover all these costs. Council has full discretion to subsidise prices, in consultation with the community through the management planning process. It is important, though, that council be aware of the full cost of a service before setting prices.

There are a number of pricing methods which council may consider in developing a pricing policy.

Full Cost Pricing

The principle behind full cost pricing is that of total cost recovery. That is, recovery of all direct and indirect costs involved in the provision of a service. Full cost pricing also involves the recovery of the financial cost of capital tied up with service provision. This cost of capital is typically calculated by incorporating depreciation of assets employed (so long as the depreciation expense is calculated on current values of assets).

Full cost pricing therefore requires:

- identification of direct and indirect costs;
- valuation of assets.

The Code of Accounting Practice and Financial Reporting (the Code) requires local governments to value non current assets on a written down current or replacement cost and revalue assets at least every five years. Therefore councils already have some information available to calculate the cost of capital. However, two practical considerations in determining the cost of capital exist. Firstly, five yearly revaluations are not annually updated to reflect current values for cost recovery purposes, and secondly, some valuations which include assets controlled by local government under AAS 27 guidelines are valued at other than market values.

Rate of Return Pricing

In addition to pricing to recover operating and capital costs of services provided, councils can also include in price some component for a 'return of invested capital'. This in effect means that in addition to full cost pricing the council is seeking not only to recover cost but to earn some profit.

For Category 1 businesses councils are expected to calculate a rate of return on capital invested. The return would result in a dividend which is payable to the council as the owner of the business. See Part 5 for a discussion of rates of return.

Partial Cost Pricing

Partial cost pricing, as the name suggests, refers to providing services at a price which recovers less than the full cost incurred in service delivery. In effect the council would be factoring into the price some determined level of subsidisation. The competitive neutrality principle requires that, for Category 1 and Category 2 businesses, any subsidies paid are made explicit (see Part 6).

In most circumstances where a partial cost pricing approach is adopted, council aims to recover only direct costs of providing services so that the community may benefit or so that a user pays policy can be established. Council may structure prices to recover even less than direct cost recovery. However this may lead to demand being placed on those subsidised services such that the burden placed on other services is substantial.

Situations where partial cost pricing may be suitable include:

- determination by council to allow benefits to accrue to the community rather than particular users;
- as a short term strategic approach to stimulate demand for a service;
- where the service is targeted to specific individuals - particularly low income;
- where there is some limitation, legislative or otherwise, on charging full costs; or
- where council wants to encourage specific development.

Market/Reference Pricing

Market or reference pricing refers to setting a pricing structure based on current market fee structures. The market reference price is usually determined by examining alternative prices of surrounding service providers and may have little relationship to the cost of providing the service.

It is essential that adequate costing of services is undertaken even if the market is not capable of sustaining rate of return or full cost recovery. This is because, as previously stated, the extent of any subsidy made in providing the service must be explicitly stated.

Market pricing therefore has its place in developing market strategy and serves as a basis from which to enter a market in competition with other providers, but is not by itself complete in a competitive environment unless a full understanding of the costs of service provision is made.

Incremental/Marginal Cost Pricing

Sometimes council may have the opportunity to undertake additional private work in areas where it provides the same service for itself. This typically occurs for works on private land under s.67(1) of the Local Government Act, eg road making or land clearing. The costs associated with providing these services are those in addition to those costs already incurred by the council - that is they are an incremental or marginal cost. An understanding of all costs, fixed and variable, direct and indirect, must be made before prices can be established.

Setting prices under the Local Government Act

Council has a range of fee setting options under the Act. They include:

- For services provided, which are not otherwise regulated. As a general comment, council may set flat fees, differential fees, volume based fees etc under this section.

- Chapter 15 - a wide range of rating and charging options for specific services. Rates can encompass a standard 'base amount' in addition to ad valorem calculations, and charges may be determined differentially (s.541), volume based, time based etc (s.539).

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