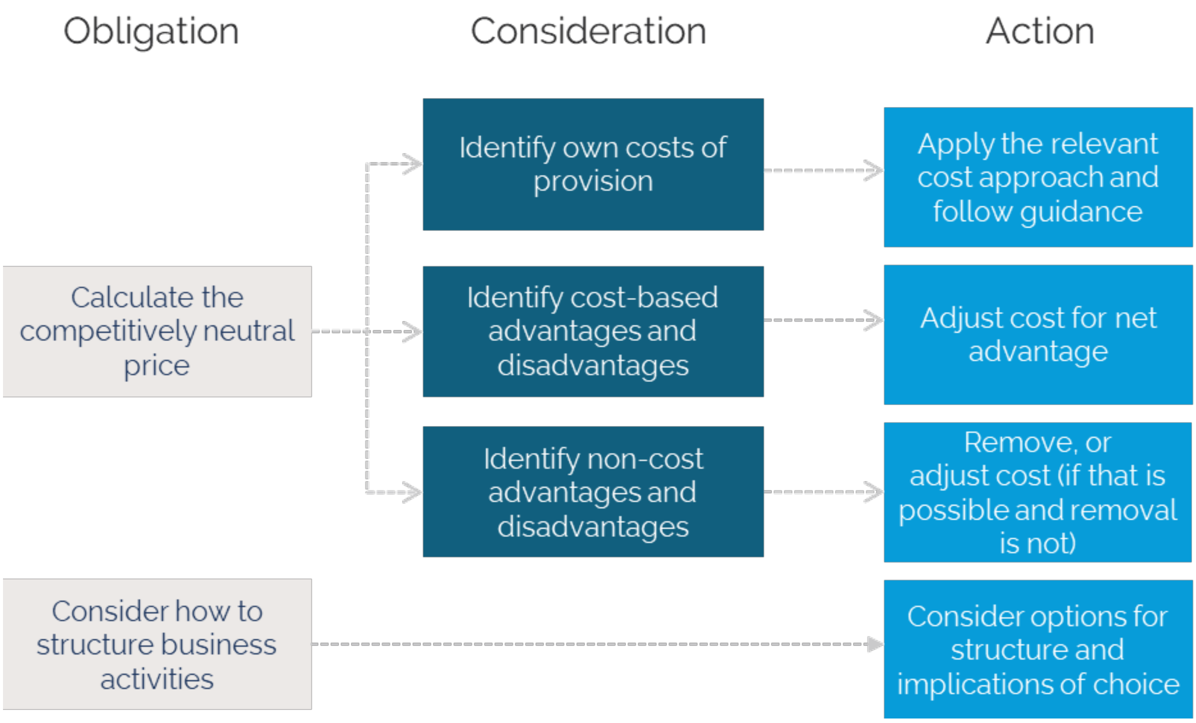
Pricing and business structure for competitive neutrality

6 February 2023

Once a government business activity has been identified as being subject to competitive neutrality principles, certain obligations apply to it. This information paper is written to explain and help you provide feedback on our draft recommendations relating to the key obligations of pricing and considering an appropriate business structure (summarised in Figure 1). This paper outlines these obligations and our draft recommendations to improve them. It also provides information on how you can get involved and provide your feedback. It can be read alone or with the material listed at the end of this paper.[a]

Figure 1 Proposed pricing and structuring obligations



[a] Section 5 of this paper provides more information on what competitive neutrality is and why we are reviewing NSW's competitive neutrality policies.

IPART acknowledges the Traditional Custodians of the lands where we work and live. We pay respect to Elders both past and present. We recognise the unique cultural and spiritual relationship and celebrate the contributions of First Nations peoples.

1 Pricing goods and services provided by government businesses

Application of competitive neutrality principles requires government businesses to estimate a price that is competitively neutral, that is, that includes an adjustment for any net advantages of government ownership. There are several factors that go into estimating the competitively neutral price. Firstly, a government business must estimate the cost base of its business activity, which can be used to make pricing decisions. Then, the cost base must be adjusted for advantages or disadvantages arising from the business' government ownership. This adjusted cost base forms the competitively neutral price.

Once government entities have estimated a competitively neutral price and identified any outstanding non-cost advantages, they can then either factor these into their pricing and supply decisions or undertake a public interest assessment to demonstrate that it would not be in the public interest to do so (see the 'Public interest test' paper).

1.1 Costing approach

The first type of competitive neutrality obligation is ensuring that the government entity undertaking the business activity is adequately estimating the cost of providing the activity.

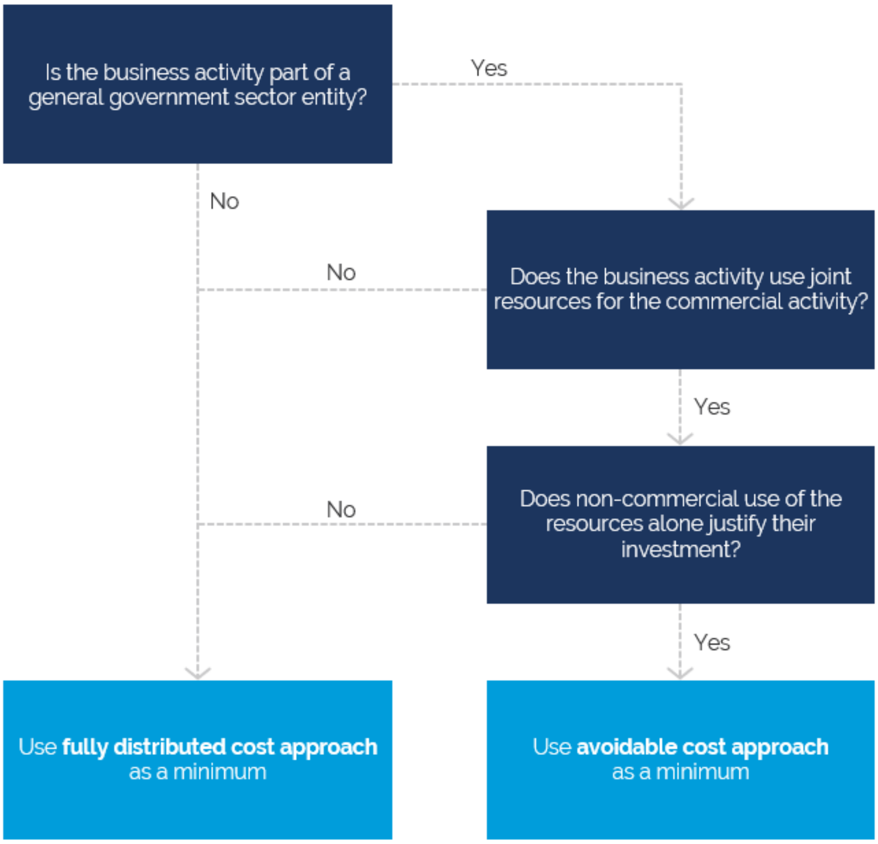
The current competitive neutrality policies do not have firm recommendations on when different costing approaches should be used. We are proposing to make the costing guidance clearer, focusing on 2 main approaches:

1. **Avoidable cost** includes the increase in the entity's costs associated with providing the significant business activity, usually not including a share of joint costs or overheads.
2. **Fully distributed cost** includes direct costs of the business unit as well as a share of the entity's overheads and capital costs.

We are proposing the guidance set out in Figure 1.1 be included in the revised competitive neutrality policy to assist government businesses to identify which costing approach is appropriate given the circumstances they face. Box 1.1 provides two examples of the application of this guidance.

The method to be adopted should depend on the characteristics of the activity and its required resources. The treatment of joint capital costs is a key area of interest, as it is important to ensure that a business activity operated by a general government sector entity is not implicitly subsidised by the entity, which would undermine competitive neutrality (unless it is in the public interest to do so). On the other hand, using the avoidable cost approach can help promote the efficient use of resources with spare capacity.

Figure 1.1 Summary of proposed costing approach guidance



Box 1.1 Examples of application of costing guidance

1. A single-track railway line to a rural community is maintained for social policy reasons, and rail freight using the line is asked to pay only avoidable cost in access fees. A single track is the minimum possible unit of capacity, meaning that spare capacity is unavoidable. Therefore, **avoidable cost** would be appropriate.
2. A council purchases a large building for a new library facility that includes several large unused spaces that it decides to rent out for events. Smaller buildings that would have fit the library were available to purchase at a cheaper cost. In this case the building would be a joint resource. Therefore, **fully distributed cost** would be appropriate to determine the cost of the event space hire.

1.2 Advantages and disadvantages

A key premise of competitive neutrality is that government businesses should not experience a net competitive advantage as result of their government ownership. This net advantage could be made up of both advantages and disadvantages. Typical cost advantages of government ownership include:

- exemption from taxes
- access to loans with more favourable terms and/or lower interest rates
- no obligation to make a profit or rate of return on investment.

It is important to note, however, that not all advantages or disadvantages arise from government ownership.

> Competing businesses may differ in size, assets, skills, experience and culture. While these characteristics may provide (dis)advantages, competitive neutrality principles do not require cost adjustments for them.

Table 1.1 below outlines our proposed guidance on how to address advantages/disadvantages arising from government ownership.

The current competitive neutrality policies do not provide guidance on dealing with non-cost advantages and disadvantages. Non-cost advantages could include preferential access to information or customers, regulatory powers, and bundling of commercial and non-commercial products. Non-cost disadvantages could include more stringent regulation and restrictions on business. We propose that the revised policy includes some high-level guidance for addressing these (also shown in Table 1.1).

Table 1.1 Guidance for addressing different types of competitive (dis)advantages

	Advantage	Disadvantage
Cost-based	Adjust cost to reflect costs faced by non-government competitors	Seek to address disadvantage through policy where possible, if not addressed adjust cost to reflect disadvantage compared to non-government competitors
Non cost-based	Seek to address advantage through policy where possible, if not addressed adjust cost (where possible) to reflect advantage compared to non-government competitors	Seek to address disadvantage through policy where possible, if not addressed adjust cost (where possible) to reflect disadvantage compared to non-government competitors

Most advantages and disadvantages can be adjusted for by assessing the equivalent cost borne by a similarly sized private business. For example, the advantage of exemption from certain taxes can be addressed by including the equivalent tax that would be paid by a private sector competitor in the cost of goods and/or services.

We are also proposing to clarify the guidance on adjusting for a required rate of return on investment. Further detail is set out in Box 1.2.

Box 1.2 Cost of capital and required rate of return

A private sector business must price its goods and services to provide a profit to its owners as well as ensuring it covers the cost of any debts. While government businesses may not have the same need to earn a profit, the government is incurring a similar opportunity cost when it undertakes commercial activities.

The NSW pricing guideline requires government businesses to explicitly account for this by including the opportunity cost of capital. The opportunity cost of capital is determined by the value of the assets used by the entity to provide goods and services and a required rate of return on those assets.

The current guidance for estimating the required rate of return is unclear and differs between state and local government. We propose that government business activities should estimate their target rate of return as a weighted average cost of capital (WACC), using IPART's publicly available WACC model with simplified parameters.

The guidance should also incorporate some flexibility. If a business has limited assets, it may not be appropriate to determine the required rate of return based on a WACC. This was in the finding in IPART's investigation of competitive neutrality complaints against the State Valuation Office. In that case, industry benchmarks were used to determine a reasonable profit margin.

Source: IPART; and IPART Investigation of Competitive Neutrality Complaints against the State Valuation Office, 2004, p 7.

1.3 Setting a price

The competitive neutral price of a good or service provided by a government business is the price needed to cover the competitively neutral cost base.

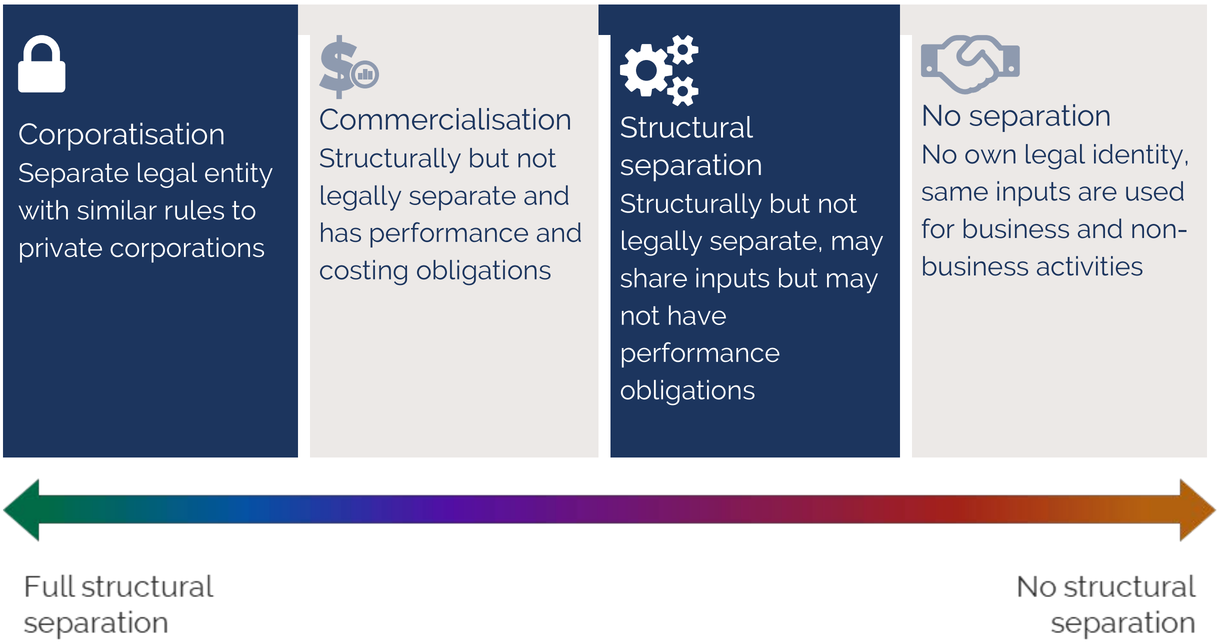
There is some flexibility for government businesses to price below the competitively neutral price, where it is in the public interest. This would require the government business to demonstrate that the proposed pricing structure provides net public benefit, through the application of the public interest test. Guidance for how to apply this test is provided in the 'Public interest test' information paper.

2 Business structure

The options for structuring government business activities fall on a spectrum from full structural separation (where an entity undertakes only business activities) to no separation from general government (where an entity undertakes a mix of business and non-commercial activities using the same set of resources). Figure 2.1 shows this spectrum.

Corporatisation and commercialisation sit at one end of the spectrum. Businesses that have been corporatised or commercialised are governed by NSW Treasury's Commercial Policy Framework. The framework imposes commercial performance and reporting obligations, as well as some level of independence in the operation and management of the business activity.

Figure 2.1 Options for structuring government business activities



The current policies take the decision on how to structure a government business as a choice that has largely already been made. However, the nature of government businesses is likely to change over time and as a result, so may the appropriate structure. We have therefore developed additional guidance on business structure and when each should be considered (summarised in Box 2.1).

Box 2.1 Summary of suggested guidance on business structure

Corporatising or commercialising a business activity removes many of the advantages that the government entity would otherwise have. This is because it imposes equivalent obligations to non-government businesses such as the payment of taxes, commercial objectives and accounting separation from 'non-commercial' activities.

Corporatisation is the highest cost approach due to the various legal requirements. Government entities should decide on an appropriate level of structural separation between their business and non-business activities, considering both the potential benefits of greater independence/separation and the costs.

The larger a government business activity, and the more impact it has on the market, the greater the degree of structural separation that should be considered.

We recommend that the revised competitive neutrality policy includes guidance rather than directing or advising a government entity to adopt a particular corporate structure. This is because:

- Government entities undertaking business activities may not have control over their business structure (for example, NSW Treasury determines which business activities are subject to its Commercial Policy Framework).
- Competitive neutrality is likely to be only one factor that is relevant to the decision to structure a business activity in a particular way.
- The advantages and disadvantages of government ownership can be addressed by other strategies if they are not addressed via corporatisation or commercialisation.
- Corporatisation/commercialisation may not be sufficient to remove net competitive advantage.
- A case-by-case assessment of the costs and benefits of different options would be required to determine what structure would deliver the highest net public benefit.

3 Further information

See our review page for further information and resources about competitive neutrality, including:

- Terms of reference for the review
- Issues Paper
- Draft Report
- other information papers.

4 We want to hear from you

We want to hear about your experiences with the NSW competitive neutrality policies and processes, and your views on our draft recommendations. Hearing the views of a wide group of stakeholders is very important to us.

We have provided a short list of questions for you to respond to below. You can respond to these questions and/or the broader list of questions in the Draft Report, which provides further information on the issues raised here. We are interested in any feedback you can provide. You don't need to answer every question or stick to the questions asked.

How easy will it be to comply with these obligations?

What additional guidance would help?

Have your say

Your input is critical to our review process.

You can get involved by making a submission, submitting feedback or attending a public hearing.

Submit feedback »

Contact the review team »

Attend the public hearing »

We are accepting written submissions on our Draft Report until 24 February 2023 and are holding a public hearing on 13 February 2023. You can express your interest in attending our public hearing on our website. If you have any questions regarding the review, are interested in meeting with us or would like to speak to the review team, please contact Ineke Ogilvy.

5 Background

We are reviewing NSW's competitive neutrality policies and processes. Our review is identifying issues and concerns with current competitive neutrality policies and analysing opportunities to improve them. We have considered how the policies compare to best practice and recommend potential improvements in our Draft Report.

Competitive neutrality policies and processes aim to ensure that government businesses do not have a competitive advantage over other businesses because of their government ownership

Government businesses might compete across a range of industries, including in manufacturing, laundry services, construction (including roads), waste disposal, gyms and fitness, tourism services, printing, childcare and aged care.