ICRC
independent competition and regulatory commission

Ms Mary Anne Hartley,
President of Industry Panel
By E-mail: industry.panel@act.gov.au

Dear Ms Hartley,

We are writing to inform you of a substantive error and related misstatement in the Industry Panel draft report of 3 December 2014. The error relates to the application of the ACT's policy on competitive neutrality.

The error is to be found at page 104 of the draft report and occurs when the Panel observes approvingly that consideration was given to ACTEW's submission that using a firm-specific approach to calculating the rate of return conflicts with competitive neutrality principles.

As you would be aware, under the 1995 National Competition Policy arrangements, each jurisdiction is required to develop its own policy statement on competitive neutrality. Attached is the ACT's policy statement. The ACT Treasurer in his submission to the Commission dated 12 April 2013 confirmed that the use of a firm-specific approach was in accordance with the ACT's policy. This submission is also attached.

The Commission is at a loss to understand how the ACTEW Board allowed the ACT government's policy on competitive neutrality to be misrepresented in the company's statement of facts and contentions to the Industry Panel.

This error made by the Industry Panel in relation to competitive neutrality infects the Panel's decision to apply the typical firm benchmark.

In chapter 3 of the Panel's draft report there is a section at pages 23 and 24 which purports to provide an overview of National Competition Policy and the ACT's policy on Competitive Neutrality. The draft report misrepresents the National Competition Policy when it asserts that the 1995 Agreement imposes a set of obligation in relation to 'setting prices to earn a commercial rate of return'. This maybe a popular characterisation of the policy but it is factually wrong – the best representation of the policy is to recognise that each government is free to determine its own agenda for the implementation of competitive neutrality principles.

These matters were dealt with in detail at pages 53-62 of the Commission's final report on water and sewerage services.

Yours sincerely

Malcolm Gray
Senior Commissioner
28 January 2015

COMPETITIVE NEUTRALITY IN THE ACT

ACT DEPARTMENT OF TREASURY

October 2010
Final V.2

Version / Purpose

Version	Date	Officer Responsible	Description
Final V.1	September 1996	Office of Financial Management, Chief Ministers Department	1996, Published by Publications and Public Communications, Chief Ministers Department.
Final V.2	October 2010	Kim Salisbury, Director, Economics Branch, Investment and Economics Division	Final version for Under Treasurer approval

Approval

Name	Title	Department	Date
M Smithies	Under-Treasurer	Department of Treasury	October 2010

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PREFACE

In keeping with its commitment to the National Competition Policy and as a requirement of the Competition Principles Agreement the ACT Government is required to publish a policy statement on competitive neutrality.

The absence of direct market competition of many government business and activities raises the potential for productive inefficiencies to emerge in the form of over staffing, poor investment decisions, inefficient work practices, inadequate pricing policies, lack of innovation and poor service delivery.

In this regard the main thrust of the Competition Principles Agreement is to make government business activities more commercial as a means of improving efficiency and to increase competition for government funded services. The Agreement outlines a set of reform principles which are directed towards:

- reducing anti-competitive practices;
- reducing monopolist practices;
- opening public sector business to competition; and
- ensuring that public sector businesses do not have an unfair advantage in the market place.

Competitive neutrality is an integral part of this policy framework. It requires actual or potential competition to be conducted fairly between public and private sector providers. Fair competition entails removing the main advantages and disadvantages of government ownership to create a level playing field.

As a result of removing competitive advantages, government business activities or functions increasingly will be subjected to private sector costing and pricing principles, taxation and dividend requirements, and regulations.

The ACT has already adopted a range of reform measures based on the principles of competitive neutrality including full cost attribution, corporatisation, commercialisation and competitive tendering.

The Competition Principles Agreement provides a strategic framework with which to apply these principles more broadly.

These principles, however, will take some time to be fully implemented. The application of competitive neutrality requires a case by case assessment of each government business to determine an appropriate business and management structure. This may require extensive consultation with the various stakeholders including the community.

In future the ACT will produce an annual report recording progress in implementing the principles of competitive neutrality and any associated reform measures. This report will include details of any complaints received about the application of these principles and the findings of any subsequent investigations.

INTRODUCTION

This policy statement aims to explain the role of competitive neutrality in the ongoing reform of the ACT Public service.

The structure of the paper is outlined as follows:

Section 1

Contains a brief overview of the National Competition Policy and each of the underlying intergovernmental agreements.

Section 2

What is competitive neutrality? Defines and describes the concept of competitive neutrality. Competitive neutrality will:

i) ensure the cost of providing government funded services are transparent and consistent with the cost of activities provided by the private sector;
ii) reduce competitive inequities between the public and private sectors in providing goods and services; and
iii) remove bias that may discourage government agencies from obtaining services from the most cost efficient source.

Section 3

Application of competitive neutrality in the ACT. The ACT will adopt two approaches to competitive neutrality, matched with associated structural and financial reforms such as corporatisation, commercialisation and competitive tendering:

i) full application of the principles of competitive neutrality to significant business enterprise and activities; and
ii) full cost attribution for the general government sector.

Section 4

Associated reform measures. This section outlines a range of structural and financial reforms that will ensure government businesses compete on even terms with the private sector.

i) Corporatisation, where the business is established as an incorporated company under corporations law and subject to the *Territory Owned Corporations Act 1990*. Corporatisation subjects government businesses to similar disciplines, incentives and sanctions as private business enterprises.
ii) Commercialisation may be adopted as either a step toward, or alternative to, corporatisation. The main difference is commercialisation does not involve incorporation under corporations law and in some instances there may not be a separate board. This model would most likely apply to activities where there is a lack of a market, there are substantial community services obligations relative to their overall operations or there is limited experience in operating in a commercial environment.
iii) Full cost attribution. This opens the way to market test many ancillary government business activities or community services through competitive tendering.

Section 5

The Cost Benefit and Public Interest Tests. Competitive neutrality need only apply if the benefits outweigh the costs. The public interest clause in the Competition Principles Agreement also requires an assessment of a broad range of community issues.

Section 6

How will the principles be applied? A government task force will review all business functions and activities to apply the appropriate principles of competitive neutrality. The objective is to achieve more efficient, competitive businesses with the emphasis on markets, customers, planning and efficiency.

Section 7

Complaints Mechanism. The ACT is moving to adopt legislation that will provide for alleged breaches of the principles to be investigated.

Section 8

Implementation Timetable. Identifies the range of business activities to be reviewed during 1996 and 1997.

1. NATIONAL COMPETITION POLICY – AN OVERVIEW

The Commonwealth and all State and Territory governments have agreed to a national competition policy to generate broad based community benefits and improve Australia's competitiveness in international markets.

The National Competition Policy evolved from recognition that ultimately the ability of the Australian economy to continue growing, provide sustainable employment and an improved standard of living depends on how well the productive potential of the economy is utilised.

The National Competition Policy comprises three agreements signed by all heads of government at the Council of Australia Governments meeting of 11 April 1995. The agreements are:

- Conduct Code Agreement;
- Competition Principles Agreement; and
- Agreement to Implement the National Competition Policy and Related Reforms.

These Agreements provide the legislative and policy framework for promoting competition and restricting anti-competitive activities, by establishing the conditions for fair trade regardless of individual bargaining power.

The policy framework specifically provides for the reforms to be considered against broader government and community policy objectives, providing for decisions that would continue to restrict competition where that is assessed as being in the community interest.

Conduct Code Agreement

This agreement provides a legislative framework for a Competition Code to achieve and maintain consistent, uniform and complementary national competition laws and policies applying to all businesses regardless of whether they are publicly or privately owned.

The Competition Code is contained in the conduct rules of Part IV of the *Trade Practices Act 1974* (TPA). It applies to both persons and private and public business activity, excluding government regulatory activities such as the imposition or collection of taxes, levies and fees, non-commercial functions of government and the acquisition of primary products by government.

The Competition Policy Reform Act 1996 applies the Competition Code in the ACT.

Competition Principles Agreement

This Agreement seeks to create a level playing field on which private and public sector organisations may compete fairly to produce benefits for the community. Competitive neutrality is to be achieved by removing market distortions resulting from public ownership, removing anti-competitive legislation and restraining monopolistic and exclusive activity.

The policy focuses on removing the barriers to competition that have primarily existed in the public sector whereas the Competition Code applies the anti-competitive conduct rules to business when competition is in place.

The additional Policy elements include:

- legislation and regulation review;
- prices oversight of public monopolies;
- competitive neutrality policy and principles;
- structural reform of public monopolies; and
- access to services provided by means of significant infrastructure facilities.

Agreement to Implement the National Competition Policy and related reforms

This Agreement defines the terms on which the States/Territories receive competition payments in return for their support in implementing reforms on time and in the manner intended. It sets out the conditions which the States/Territories must satisfy to qualify for Commonwealth financial assistance payments. The National Competition Council (NCC) is responsible for determining whether the States and Territories have met the conditions to which they have agreed.

The Agreement Provides for payments to be made to the States and Territories commencing in 1997-98.

2. WHAT IS COMPETITIVE NEUTRALITY?

The Competition Principles Agreement defines the aim of competitive neutrality policy as:

"*the elimination of resource allocation distortions arising out of the public ownership of entities engaged in significant business activities: Government businesses should not enjoy any net competitive advantage simply as a result of their public ownership. These principles only apply to the business activities of publicly owned entities, not to the non-business, non-profit activities of these entities".* (Competition Principles Agreement subclause 3.(1))

According to the Competition Principles Agreement, each Government will seek to improve efficiency in the public sector by introducing market disciplines and increasing the level of competition for provision of government services. This reform will provide the stimulus to restrain costs, promote efficiency and raise service standards as government business operators strive to at least match the performance of their private sector counterparts.

The aim of these reforms is largely to achieve improved allocations of resources by ensuring that services are delivered by the most efficient provider. The principles of competitive neutrality intend that government businesses should not be able to underprice more efficient private businesses as a result of advantages stemming from government ownership.

Competitive neutrality will result in government business activities or functions assuming similar costing and pricing principles, taxation and financing requirements and regulations as the private sector. The removal of any advantages of government ownership will provide the incentive for government businesses to become more efficient and effective.

In removing any specific advantage it may be necessary to discount any prevailing disadvantages to enable government businesses to compete fairly. For instance there may be a requirement to separately identify and directly fund community service obligations through the budget rather than have these costs absorbed directly by the relevant government business. These cross subsidies are disadvantages because they are not costs which the business would normally incur in pursuit of its commercial objectives.

Certain government businesses may be subject to more restrictive employment practices and additional regulatory requirements than their private sector counterparts. These factors will be assessed, not only to determine the relative efficiency of the particular business activity but also to determine whether these constraints should remain.

As a result of these reforms, not only will private enterprise be able to compete for government business on a fairer basis, but there will be general economic and social benefits resulting from an improved allocation of community resources.

Although the reforms may introduce an element of competitiveness by allowing the private sector access to previously denied markets, there will be less incentive for government funded services to be privatised or contracted out if performance is maintained at satisfactory levels.

3. APPLICATION OF COMPETITIVE NEUTRALITY IN THE ACT

Each Government is free to determine its own agenda for the implementation of the competitive neutrality principles. (Competition Principles Agreement subclause 3(2))

While the Competition Principles Agreement addresses significant business activities, the Territory will apply the principles of competitive neutrality wherever it is considered to be in the public interest. This will encourage improved efficiency and allocation of resources on a broader scale.

All government business activities will be required to fully attribute costs on the same basis as private firms. Subject to the cost/benefit test, significant business enterprises and activities will also be required to:

- pay all Commonwealth and Territory tax or tax equivalent payments;
- pay debt guarantee fees if in receipt of concessional interest rates that reflect their government ownership rather than their commercial status; and
- comply with the same regulations that apply to their private sector counterparts.

4. ASSOCIATED REFORM MEASURES

In each case the relative advantages and disadvantages of providing services through government agencies will need to be identified and integrated with an appropriate measure of reform according to the scale and nature of their business activities.

These reforms include:

- adopting commercial accounting practices;
- separately identifying the cost and quality of government activities;
- extending competitive tendering practices and contractual arrangements; and
- commercialisation or corporatisation of separate government businesses.

Which government businesses are affected?

"Government Trading Enterprises are organisational units within the public sector that produce goods and services which are, or could be sold or tendered in the market place without compromising government's economic or social objectives. The Government Trading Enterprise concept includes units within government departments that are engaged in trading activities and may include social services, the provision of which could be undertaken by such units on the basis of an arm's length contract with government." (Steering Committee in Government Trading Enterprises, 1988)

All Government business operations will be reviewed to ensure that their structure, operational requirements and financial incentives promote efficient practices. This applies to all government organisational units that produce goods and services that could be sold or tendered in the market place. These trading activities extend to the provision of goods and services to other parts of the public sector. These business activities will range from the specialist activities located within government departments, and may include community service obligations that could be provided under contract by private organisations, to separate legal entities such as statutory authorities or Territory Owned Corporations.

According to the Competition Principles Agreement, competitive neutrality need not apply to non-business and non-profit activities. Whilst this may exempt some core government functions such as environmental protection, education, health and safety, justice, law and order, these agencies may contain certain business activities or services that will need to become more competitive by removing any tied business arrangements.

It may be that such business activities will continue to operate as semi-autonomous business units within the parent agency, under a more contestable regime, or be converted into separate commercial entities such as a statutory authority or a territory owned corporation. In any case they will be required to fully attribute the costs of the goods and services they provide. Moreover the goods and services will be provided in a contestable market characterised by competitive tendering and contracting.

Having regard to the objectives of the Competition Principles Agreement, the use of the term 'non-profitable' does not exclude from the application of the principles of competitive neutrality those commercial or business activities that operate at a loss.

These businesses will still be subject to competitive neutrality even though they may not be suitable for corporatisation. Until they are subject to competitive neutrality principles, the real costs and efficiency of their operation will remain obscured and there will be less motivation to improve performance.

For significant Government business enterprises which are classified as 'Public Trading Enterprises' and 'Public Financial Enterprises' under the Government Financial Statistic Classification:

(a) each government will, where appropriate, adopt a corporatisation model for these Government business enterprises; and

(b) impose on the Government business enterprise:

(i) full Commonwealth, State and Territory taxes or tax equivalent systems;

(ii) debt guarantee fees directed towards offsetting the competitive advantages provided by government guarantees; and

(iii) those regulations to which private sector businesses are normally subject, such as those relating to the protection of the environment and planning and approval processes, on an equivalent basis to private sector competitors.

Where appropriate, these provisions will also apply to significant business activities. At a minimum, reforms should ensure that the prices charged for goods and services will take account of the items listed in paragraph 3(4)(b), and reflect full cost attribution for these activities. (Competition Principles Agreement subclauses3 (4) and 3(5))

Corporatisation

In line with government commitments under the Competition Principles Agreement, the Territory will consider corporatising significant business enterprises and activities subject to the provisions of the *Territory Owned Corporations Act 1990*.

Corporatisation exposes government businesses to tax, regulation and costs of finance similar to those in the private sector.

A significant business enterprise is likely to have the following characteristics:

- it is a separate legal entity;
- its predominant activity is trading goods and/or services or is able to earn a substantial part of its operating revenue from user charges;
- it has predominantly commercial or profit making focus;
- it has or could have a significant impact on the relevant market; and
- the impact of poor performance is substantial.

Corporatised entities will be subject to the following principles of competitive neutrality as appropriate:

Setting commercial target rates of return, capital structures and dividend payments;

Corporatisation seeks to subject Government Business Enterprises to disciplines, incentives and sanctions which are effectively the same as those applying to private business enterprises.

The principal objective is based on their commercial performance including target of return.

Dividend payments are determined by considering the need for working capital and the government's revenue requirements. The general minimum dividend pay-out ratio is 50% of after-tax profits.

The capital structure and dividend policy of each entity is assessed to determine whether they are comparable with similar private firms.

Where the business is not subject to full market competition, performance targets are set with control of overall price levels to ensure targets are met by real productivity improvements and not simply by taking advantage of monopoly pricing.

Full Payment of Territory taxes and Commonwealth income and sales tax equivalents;

All Territory owned corporations will be liable to pay all taxes and charges that their competitors area required to pay.

In addition to paying Commonwealth taxes or tax equivalents, Territory owned corporations will be subject to the same Territory taxes and charges that apply to the private sector. These taxes include payroll tax, financial institutions duty, land tax, stamp duties and any rates and charges not already collected.

Loan guarantee fees;

Territory owned corporations may be subject to a borrowing levy that reflects the value of any concessional borrowing rate by virtue of an implied government guarantee. The levy will increase the cost of debt to the level that the business would be required to pay if it was privately owned having regard to its financial position and risk portfolio.

The level of the fee will take into account any new borrowing or capital injections as well as an estimate of the cost that would apply to past borrowings, based on the level of assets held.

Subject to business regulation;

The rules and regulations under which businesses operate influence their efficiency. Regulations can have a major bearing on the cost of inputs, market behaviour and other constraints such as the requirement to meet environmental or occupational health and safety standards.

All government business activity to which competitive neutrality principles are applied will be subjected to at least the same regulatory regime as private enterprises. In some cases the regulatory requirements of public enterprises are more onerous than for private businesses.

Business enterprises will not be responsible for regulatory activities. Regulatory activities will be performed by a separate authority. Government businesses should not determine their own regulatory standards because they may conflict with the business' commercial objectives.

Explicit funding for community service obligations;

The government may require a business to provide services to the community that it would not undertake as part of its normal commercial activity, except at a higher price. These community service obligations will be indentified and directly funded by government. Previously they have often been hidden services and indirectly funded from cross subsidies. Clearly identifying and costing these services will enable business to focus on commercial targets and respond to market based price signals and incentives. The government will be able to determine which services can be effectively and efficiently provided by the public sector.

Community service obligations should provide an identified community benefit and be subject to agreed standards of performance and delivery.

Independent performance monitoring.

It is widely recognised that quality performance will not be sustained unless performance is subject to continuous improvement.

A major incentive for efficient management in the private sector is the regular scrutiny of a company by the equity and debt markets. Such incentives do not apply to public sector businesses, such as territory owned corporations. An alternative set of performance standards are needed that are appropriate to the public sector.

Territory owned corporations will be subject to independent performance monitoring to replicate the external monitoring of private companies. Performance assessment will use performance targets agreed annually between the government and corporate boards. The performance agreement targets will be supplemented by monthly financial statements and non financial benchmarks to ensure service quality.

Corporate entities should be self financing. They must be able to generate sufficient cash flows to be profitable and to raise adequate capital investment funds. They will be required to male returns on capital comparable to private business benchmarks.

For a corporation to achieve maximum operating efficiency, the role of the government as owner should be to define core activities, and determine the financial distribution policy, including the target rates of return and the broad limits on the capital structure.

Commercialisation

Not all government business enterprises should be corporatised. Corporatisation requires organisations to be commercially sound. It is unlikely that businesses reliant on government funding to meet their operating and investment requirements would be considered for incorporation. Such business activities may benefit, however, from increased exposure to commercial practices and market disciplines.

Even if a business is commercially sound it may not be corporatised. It may be more advantageous to introduce competitive tendering for some services and allow all tenderers to bid for access to associated government owned assets.

Commercialised entities may operate as statutory authorities with their own enabling legislation or as semi-autonomous business units within a parent agency. However, while they are not fully subject to market forces, commercialised activities will be subject to the same costing and pricing principles, taxation and debt guarantee requirements and appropriate regulations as fully corporatised businesses.

The essential policy is to ensure that government businesses are efficient, determined by their ability to effectively compete with their private sector counterparts. To achieve that goal it is important to provide incentives for sensible administration thereby benefiting from more commercially competitive service provision. Removing ownership advantages and disadvantages will ensure that the resources are allocated efficiently and allow clear judgements to be made about commercial performance.

Full Cost Attribution

It has not always been possible to compare the performance of government agencies with one another or their private sector counterparts because of different financial controls and management practices.

There have been instances where government agencies either do not know the full costs of their operations or have not fully accounted for these costs. In such circumstances there is no capacity for effective performance management. Making meaningful comparisons with private sector benchmarks is therefore difficult.

Consistent with the principles of competitive neutrality and in order to promote greater accountability and efficiency in the allocation of resources the ACT Government has introduced various financial management reforms which are contained in the *Financial Management Act 1996* and are being applied on a whole of government basis.

These reforms include accrual accounting, separating the purchaser and provider roles within government agencies, improved reporting and monitoring of performance, and the full costing of services to enable more accurate comparisons with external suppliers.

Overall these reforms will enable government agencies to better identify opportunities for services to be delivered in competition with the private sector as the relative advantages and disadvantages of internal and external providers become more apparent.

In particular all government agencies will adopt full cost attribution to encourage rational use of resources and disclosure of the real cost to the community of providing services. That discipline will reduce excess demand for services, stimulate demand for improved services quality and encourage government businesses to charge competitive prices. Where government services are uncompetitive they risk losing their business to more efficient suppliers.

5. THE COST BENEFIT AND PUBLIC BENEFIT TESTS

In pursuit of efficiency and its national competition policy undertakings, the government may decide to corporatise businesses, restructure them along commercial lines or expose them to a more contestable market arrangement. Alternatively the government may decide it is better for some functions to be contracted out or sold. In making those decisions the government is obliged to consider whether their public benefit exceed their costs.

Clause 1(3) of the Competition Principles Agreement states that the following matters should be taken into account in when considering public benefits:

- 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;
- economics and regional development including employment and investment growth;
- the interest of consumers generally or of a class of consumers;
- the competitiveness of Australian businesses; and
- the efficient allocation of resources.

Furthermore, according to Clause 3(6) of the Agreement, the government is only required to apply the principles of competitive neutrality to the extent that the benefits outweigh costs, which may include:

- the transaction and legal costs associated with structural reform such as corporatisation; and
- the increased regulatory costs associated with tax equivalents, debt guarantees, pricing oversight and compliance monitoring.

The benefits will be derived from:

- greater cost awareness and improved cost management;
- better client focus arising from increased competition and financial incentives;
- improved decision making and allocation of resources;
- improved program orientation and policy objectives; and
- improved accountability and performance measurement.

6. HOW WILL THE PRINCIPLES BE APPLIED?

The complete implementation of these reforms will need to be phased in depending on the existing form and state of the particular business activity. It is important that this be undertaken in a coordinated manner and that the reform program is maintained.

A government task force will assist in implementing the principles of competitive neutrality. The task force will review all significant business enterprises and activities on a case by case basis and consider the need to restructure particular business activities. Specific tasks will be indentified to resolve any implementation issues relating to each business function or activity. Situations will arise where special transitional arrangements may need to be adopted because of associated conversion costs or legislative requirements.

The task force will report to government on the scope and timing of reforms including strategies for consultation with the various stakeholders including customers, suppliers, employees, the business community and the general public.

The government will also establish a consultative committee to provide ongoing monitoring and advice on the implementation of competition policy. This committee will include representatives of community, environmental, consumer, union, business and academic organisations.

The terms of reference will enable the consultative committee to monitor:

- the structural reform of government business enterprises;
- the regulatory review process;
- the development of community service obligations;
- competitive tendering and outsourcing; and
- any other matter related to the Competition Principles Agreement or the Competition Code.

7. COMPLAINTS MECHANISM

Each government will publish a policy statement that includes an implementation timetable and a complaints mechanism. (Competition Principles Agreement subclause 3.(8))

All entities to which the policy applies will be subject to a complaints mechanism. Claims will be received from parties alleging direct and material disadvantages as a result of unfair competition from government businesses. The complaints mechanism forms part of a set of mechanisms intended to ensure that the competitive neutrality framework is effective. Other mechanisms include provision for appeals concerning assessments of tax under the tax equivalent regime and prices oversight.

Specific legislation proposing to establish an independent office holder to consider complaints dealing with competitive neutrality will be considered during 1996.

The basic principles to be considered in dealing with complaints include:

- independence;
- ease of access;
- expeditious consideration and resolution of complaints;
- public process; and
- publication of decisions and availability of relevant information.

For more information

Further information can be obtained from Economics Branch, Investment and Economics Division, ACT Department of Treasury, 02 6207 0337.

Competitive Neutrality Complaints in the ACT are now handled by the Independent Competition and Regulatory Commission (ICRC).
Location: Level 2, 12 Moore St, Canberra ACT 2601
Address: GPO Box 296, Canberra City, ACT 2601
Phone: (02) 6205 0799 Fax (02) 6207 5887
Email: icrc@act.gov.au Website: www.icrc.act.gov.au

8. IMPLEMENTATION TIMETABLE

Consistent with the provisions of the Competition Principles Agreement those enterprises classified in the Government Finance Statistics as Public Trading Enterprises and Public Financial Enterprises will be reviewed in 1996-97. The enterprises included in those classes are:

ACT Milk Authority	To be reviewed in 1996-97
ACTEW	Corporatised on 1 July 1995
ACT Forest	Under Review
ACTTAB	Corporatised 1 July 1996
Home Purchase Trust Account	Under Review
Canberra Retail Markets Trust	No longer exists
Canberra Theatre Trust	Under Review
Totalcare	Corporatised on 1 January 1992
Canberra Commercial Development Board	No longer exists
ACTION	Under Review

Subject to the cost benefit and public benefit test the reviews will consider the need to establish:

i) new operational and financial structures including Territory Owned Corporations; and
ii) to ensure the principles of competitive neutrality are being applied including Commonwealth and Territory taxes and tax equivalents, debt guarantee fees and any regulatory requirements.

Other significant business activities currently being reviewed or that will be reviewed during 1996-7 include:

ACT Housing Trust	Under Review
ACT Borrowing and Investments Trust	Under Review
Australian International Hotel School	Under Review
Exhibition Park in Canberra	To be reviewed in 1996-97
ACT Fleet	Under Review
Yarralumla Nursery	To be reviewed in 1996-97
Gungahlin Development Authority	Under Review
Information Technology Services	Under Review
Urban Services – all commercial and public works services	Under Review

The review of housing services will take into account any associated intergovernmental agreements undertaken in the Commonwealth State Housing Agreement.

Eventually all government agencies will be reviewed in order to identify those business functions and activities to which the principles of competitive neutrality should be applied. Each business will be assessed to determine the scope for improving the basis of their operations whilst retaining government ownership and identifying any associated reforms required to achieve this objective.

All government agencies are being surveyed in 1996 to identify the opportunities for additional competitive tendering and contracting of their services and business activities. As part of this process they will be required to market test these programs during 1996-97 and identify any potential savings. It may also be appropriate in some instances to commercialise or corporatise these business activities.

Andrew Barr MLA

DEPUTY CHIEF MINIS1ER

TREASURER
MINISTER FOR ECONOMIC DEVELOPMENT
MINISTER FOR COMMUNITY SERVICES
MINISTER FOR SPORT AND RECREATION
MINISTER FOR TOURISM AND EVENTS

MEMBER FOR MOLONGLO

Mr Malcolm Gray
Senior Commissioner
Independent Competition and Regulatory Commission
PO Box 161
CIVIC SQUARE ACT 2601

Dear Mr Gray

I write in reference to the Independent Competition and Regulatory Commission's Proposed Price Direction for Regulated Water and Sewerage Services.

Please find enclosed the Government's Submission related to the Draft Report released by the Commission on 26 February 2013.

Yours sincerely

Andrew Barr MLA
Treasurer

Enc.

ACT LEGISLATIVE ASSEMBLY

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ACT GOVERNMENT SUBMISSION TO THE INDEPENDENT COMPETITION AND REGULATORY COMMISSION – PRICE DIRECTION FOR THE SUPPLY OF REGULATED WATER AND SEWERAGE SERVICES WITHIN THE ACT

The following Submission is provided in relation to the Draft Rep0li that was released by the Independent Competition and Regulatory Commission on 26 February 2013. This Submission provides the Government's views on certain topics raised by the Commission.

General Comment

The Government thanks the Commission for its work to date. The considerable efforts in developing a new regulatory approach to water and sewerage services pricing and bringing forth recommendations on the governance of ACTEW provide a timely opp0liunity to consider these important issues.

The draft tariffs for 2013-14 proposed by the Commission on 26 February 2013 represent a substantial downward price change and reflect a significant change in position from the Commission. The draft recommendations follow a 16-month process and consistent commentary by the Commission throughout that process (including in its Issues Paper and Consultation Paper) that had suggested pric.e mcreases.

The Government would welcome and support a final determination that provides water and sewerage services price decreases and relief in some measure from cost of living pressures faced by ACT consumers.

In preparing its final determination the Government asks that the Commission also consider the following matters.

Supporting Government policy

In preparing a future pricing path, the Government has asked that the Commission give due consideration to Government policies as they relate to water security, water use and national water initiatives.

Water is an important natural resource for the economic, social and environmental sustainability of the ACT. ACTEW is the monopoly provider of water and sewerage services in the ACT. It is therefore· essential that pricing directions allow sufficient funding for ACTEW to perform its functions. However, it is equally important that these functions are undertaken in an efficient and effective manner and that ACTEW is able to respond to a variety of challenges, including those posed by climate change and the sustainability of the Murray-Darling Basin. Water security continues to be a high priority for the ACT.

ACTEW has now attained future water supply security by extending water supply capacity through the undertaking of significant infrastructure investment as

demonstrated by the construction of an Enlarged Cotter Dam (ECD), the Murrumbidgee to Googong Dam (M2G) project coupled with the capacity to extend supply through water trading arrangements.

These projects have increased the ACT's water supply to meet expected demand at a minimum for 20 years but expected to extend out beyond 30 years. Following decisions in 2009 on the M2G project ACTEW is required to undertake an assessment of supply capacity and storage needs every five years. ACTEW Water incorporates modelling of population growth and climate change in assessing future water demand and investment expenditure.

Under the current Murray-Darling Basin Agreement and the Basin Plan (effective from 2019), there is a limit on the volume of water that the ACT can extract from its own water sources. Discussions are proceeding with NSW to enable water entitlements acquired in NSW to be accessed from ACT storages where the capacity exists and, if and when necessary, allow the ACT to source the entitlements from water in Tantangara Dam. ACTEW Water has already acquired 9.5 gigalitres of high security water entitlements that can be (if necessary) accessed from Tantangara Dam. Under the trading arrangements of the Basin Plan the ACT will be able to undertake further market-based acquisition of entitlements (if necessary) to ensure the water supply for future population growth allowing for weather and climate change.

In pricing water and sewerage services, the ICRC has been tasked to set prices based on costs of supplying and distributing water to the ACT community while considering broader policies of the ACT Government. The Government has a broader interest in recognising the value of water and water security.

The Government promotes the environmental and water security benefits arising from water conservation. The Government does not consider that a downward price movement of the order provided in the Commission's draft determination necessarily aligns with the considerable efforts and gains to date in water conservation in the ACT.

While the consumption of water is relatively price inelastic (over the short term) and is strongly influenced by weather patterns, the Government also looks to the potential longer term behavioural impacts and increasing water consumption from a significant downward price shock. A significant reduction in prices for the provision of water services now may not be an efficient outcome when taking account of the costs to the community over time and increased reliance on non-price incentives for efficient water use. In particular the Government would not wish to see acceleration in water consumption resulting in the Territory approaching the Murray-Darling Basin sustainable diversion limits earlier than expected. This will impose costs such as rationing or additional water entitlement purchases.

In providing its views to the Commission the Government indicates its support for efficient pricing outcomes, appropriate recognition of costs and a fair sharing of costs and benefits across the community and between generations. In particular:

- the Government considers that costs and benefits of water security assets need to be appropriately matched across generations;

- the Government is receptive to looking into a new regulatory model and methodologies subject to a clear outlining of costs and benefits. Therein, in determining a return on equity taxpayers should be adequately compensated for the risks they bear in owning ACTEW;
- pricing outcomes should support the efficient allocation of resources, reflect all relevant costs and maintain the financial viability of ACTEW; and
- the Commission's recommendations on ACTEW governance are significant in their own right and require examination separate from the water and sewerage services price determination process.

Fair Cost Recovery Scheme

The Government appreciates the Commission's work to develop a framework to consider intergenerational equity in the recovery of costs for water security projects, the proposed Fair Cost Recovery Scheme (FCRS). The FCRS represents a significant driver in the draft water services tariff outcome.

While the Government supports the principles of the FCRS in promoting intergenerational equity, it considers that in applying the FCRS to the water security projects it would be more appropriate to use a flat cost recovery profile that attributes a higher relative cost to the current generation commensurate to the benefits which will accrue to that generation. It is the Government's view that the flat cost recovery profile secures a more equitable distribution of costs and benefits between generations. Further, the FCRS should only apply to capital expenditures of a non typical nature, as in the case of the water security assets, the ECD and M2G.

As provided in the Commission's draft determination the FCRS has an increasing cost recovery profile that transfers costs to later generations, with the extent of that transfer dependant on an allowance for growth in population and wages adopted in the model. This is justified on the basis that investment costs should be borne by those who receive the benefits, and those best able to pay for the investments. The impact is substantial; in the case of the ECD the cost difference of the FCRS compared to the traditional method at the end of the life of the asset is around an additional $730 million in nominal terms and $65 million in real terms. These additional costs are borne by the consumers.

Intergenerational equity means that a fair share of the price of capital investment is paid now and in the future, based on the timing of benefits from the investment and the community's ability to pay. The Government considers that current generations will immediately obtain substantial benefit from the additional water security as a result of the investment in the water security projects. The recent drought highlights the value of additional water security in.mitigating the impacts of rainfall variation.

Given the timeframes involved (100 years), it does not appear prudent to assume ongoing increases in population or in wealth and propensity to pay. There needs to be allowance for the likelihood of further planned or unanticipated expenditures of this nature during the 100 year timeframe, and regard for the capacity of future generations to contribute to these further costs (which may be restricted by an

excessive transfer of the cost of current water security projects to those future generations through the FCRS).

The Government considers application of the FCRS should be limited to the ECD and M2G projects reflecting their unique nature and extent of these particular capital expenditures. All other assets should be subject to traditional cost recovery methods..

The Government understands that the operation of the FCRS may affect accounting requirements for ACTEW's assets with the potential for impairment of the water security assets. Ifthe benefits to be derived for the cunent ACT community from the FCRS will be negated by accounting requirements, the application of the FCRS proposal must be reviewed.

It is also important that regulatory appraisal supports effective investment in capital going forward. Therefore, the Commission should examine whether the operation of the FCRS (combined with other possible factors such as biennial assessments) establishes regulatory uncertainty and raises the probability of underinvestment in capital in the future.

The Government is aware that the above mentioned outstanding issues with the FCRS may mean that the FCRS is ultimately not practicable. In such an event, the Government would be open to retaining the traditional methodology for sharing the price of the water security assets over an extended timeframe.

Cost of capital

Methodology

The Government considers that the ICRC's 'firm specific' weighted average cost of capital (WACC) methodology is neutral from a public benefit standpoint compared to the 'typical firm' approach and is therefore acceptable for the purposes of competitive neutrality policy. The intent of both the typical firm and firm specific methods is to derive a cost of capital that provides appropriate returns, reflects costs and supports efficient pricing outcomes. Under the firm specific model, the adoption of a return on equity based on community valuation (see below) allows for consideration of appropriate incentives to maintain a commercial focus in the operations of ACTEW.

Similar to the situation affecting the operation of the FCRS, the Government understands that ACTEW is investigating the possibility that the change in WACC methodology may impair assets.

The Government expects that the Commission will monitor and report on the effects of a change in approach to determining the cost of capital to ensure pricing and resource efficiency, and maintenance of ACTEW's operational incentives.

Typicalfirm versusfirm specific

The method for determining the cost of capital is an important shift in approach included in the draft determination. The Commission proposes to adopt a firm specific-approach to the calculation of the WACC. This compares to the typical firm

approach used currently in the ACT and in other Australian jurisdictions for water and sewerage businesses.

The typical firm approach was intended, among other things, to allow for commercial disciplines and incentives to promote the efficient operation of Government Business Enterprises (GBEs) and subject to independent pricing oversight. This method provides a benchmark against well-managed private firms. The Government recognises the limitations of this approach in the context of a monopoly provider of water services.

Some jurisdictions have been examining their WACC methodologies, primarily the form of the WACC (that is, pre-tax or post-tax, real or nominal), and some have also raised concerns regarding whether their WACC fully reflects the expected cost of capital. However, other Australian governments currently maintain the typical firm approach and seek to benchmark efficient urban water and sewerage service provision as their preferred means for reflecting investor expectations.

Competitive neutrality

Under national competition reforms, Australian governments agreed to apply the principles of competitive neutrality to significant government businesses, and to establish an organisational structure for such businesses that replicates to the extent possible the framework that applies to private firms. In essence this means, where appropriate, providing incentives to GBEs to maintain a commercial focus consistent with that for private firms.

The application of competitive neutrality principles to ACT GBEs is a matter of Government policy. The Government applies the principles of competitive neutrality to the extent that the benefits outweigh costs.

The ACT Government applies competitive neutrality principles to ACTEW. The Government considers it appropriate that ACTEW is subject to measures such as national tax equivalents, Territory taxes and charges, and regulation as per private sector firms. The Government also considers it appropriate to distinguish between dividends (as a return to taxpayers for the risk of public investment), and taxes and charges (including tax equivalents) which provide GBEs with disciplines and incentives in areas, such as investment, consistent with the private sector. In its draft determination, the Commission is supportive of the application of the *Corporations Act 2001 (Cth)* to ACTEW.

The Government notes that ICRC's new firm specific WACC methodology is a change in approach from the existing application of competitive neutrality to ACTEW.

Return on debt

The Government notes that the determination of the return on debt will be subject to further information on actual debt costs provided by ACTEW. The Government understands that this may result in an increase in the rate of the return on debt.

Return on equity

The Commission has sought comment from the Government on an appropriate return on equity, proposing a community valuation approach and consideration in the context of taxation revenue.

Different approaches to determining the return on equity will impact on ACTEW's payments to Government through dividends and tax equivalents which contribute to Territory revenue. The Government will therefore need to consider the impacts of any changes in the broader Budget context as with any of the range of expenditure and revenue risks.

The key consideration for the Government is setting a return on equity that appropriately balances competing objectives that:

- promotes technical efficiency in ACTEW's operations;
- provides commercial incentives to ACTEW consistent with the Government's competitive neutrality policy;
- leads to effective pricing consistent with the Government's water policies; and
- is consistent with broader budgetary settings.

The Government supports the Commission's draft return on equity as a reasonable parameter, given its understanding of returns for other water utilities in Australia and the data referred to by the Commission. In putting forward this view, the Government accepts that ownership of ACTEW creates risk that is borne by taxpayers and requires compensation. Further, the Government notes that the appropriate return on equity to serve these multiple purposes can only be assessed with the benefit of full knowledge of the final outcome of the pricing determination and the consequent impacts on the overall budget. To this extent the Government would seek the opportunity of further discussion with the ICRC on this particular element of the pricing determination. The Government would also support a further examination of the return on equity at the time of the initial biennial adjustment.

ACTEW's financial viability

The Government notes that the pricing determination should not put undue risk on the financial viability of ACTEW (in whole or for a particular business segment) by imposing a substantial and immediate downward impact on revenues. This may have serious implications for operating and maintenance standards and the development of new essential infrastructure. On the basis of efficiency and transparency, pricing outcomes should also avoid cross subsidisation between the water and sewerage business elements.

Depending on the Commission's final pricing determination, consideration should be given to smoothing any substantial price fluctuation to address potential impacts upon ACTEW's business and the ACT Government's service capacity to provide a more stable financial framework for decision making. The Government notes that in asking the Commission to examine all potential regulatory models it had, in part, sought to minimise the effect of significant price fluctuations on stakeholders such as those evident under the previous regulatory model. The Commission has been mindful in

the past of the impacts on consumers of price increases; similar consideration should be given for stakeholders such as ACTEW and the broader ACT community with the impact of a large downward price change. For example, prices should be reasonable, reflecting the need for investment to provide quality of supply and reasonable levels of security to meet population growth and support environmental outcomes.

ACTEW's water business (excluding sewerage services) has not been profitable in 2010-11 and 2011-12, and it is expected that the water business may break even in 2012-13. The water business has therefore not been a contributor to dividends paid to Government over recent times.

Revenue recovery mechanism

The Government accepts the Commission's proposal not to provide a revenue recovery catch up to address under recovery by ACTEW of $238 million in revenue from the prior regulatory period. The Government's expectation is the Commission's regulatory approach will mitigate the reoccurrence of under recovery into the future.

Capital and operating expenditure

Uriarra Village

The Government considers the Uriarra Village water and sewerage projects have been appropriate and necessary, and that ACTEW undertook the projects to the required Government standards. The Government supports the recognition of the costs of those projects in the Commission's pricing determination.

The Government also supports greater transparency in decision making and will review related processes for its Territory-owned companies to facilitate improved procedures, including directions under the *Territory Owned Corporations Act 1990.*

Murrumbidgee to Cotter

The Government notes that in putting forward its draft conclusions on allowed operating and capital expenditures that the Commission has not fully adopted the views of its consultant, Cardno. In terms of historical capital expenditure included in ACTEW's regulatory asset base, Cardno had only excluded what it considered the inefficient costs related to the Uriarra Village sewerage works.

While accepting the Commission's concerns regarding the prudency of the process by which the Murrumbidgee to Cotter (M2C) project – comprising suction and discharge pipelines -was undertaken the Government does not consider that related costs are necessarily inefficient. The Government would prefer to address matters of process going forward through its examination of the governance framework. If as suggested by Cardno, the expenditure is efficient then the Government's preference would be to see the full costs for the M2C included in the regulatory asset base in spite of the historical process that lead to that outcome.

Operating expenditure

The Government understands that allowed operating expenditure in the draft determination is based on the last available audited figures from 2010-11. As such there is substantial likelihood of revision with further information to be provided by ACTEW.

Environmental expenditures

In principle, the Government recognises a need for consumers to bear a fair share of this cost burden, in accordance with the Government's commitment to promote energy efficiency objectives across the ACT. The Government notes that the Commission is seeking further advice from ACTEW in relation to environmental expenditures involving the national carbon price and carbon offsets.

Flexible pricing

The Government notes that the Commission has committed to undertake further review of pricing structures over the regulatory period. Flexibility in pricing was a matter included in the Terms of Reference for the price determination.

The Government looks forward to the Commission's ongoing consideration given its interest in investigating greater pricing choice for consumers. The Government considers there to be an opportunity to examine the progressivity of pricing structures and how they might better support other non-price policy initiatives. Flexible pricing structures may also mitigate the need for less economically efficient responses to supply side matters, such as water restrictions, small-scale private investment and regulatory approaches.

Non-pricing matters

Compliance activity

The proposed regulatory model involves biennial reviews with an increase in ongoing compliance activity. This is a move away from other regulatory reforms in the ACT and elsewhere that have generally sought to reduce red tape and regulatory burden.

The Commission should ensure a clear understanding of the benefits, costs and requirements of a greater compliance model for all stakeholders with its final determination.

The Government understands the objectives of the model include reducing volatility and better managing pricing paths in an uncertain environment. As matters remain to be bedded in over the initial two-year period, the Commission will need to have care that biennial adjustment of significant pricing parameters provides for stable pricing outcomes for consumers. The Government recognises that water demand due to its uncertainty will require regular adjustment. At least initially, the return on equity will require review due to the absence of a prescribed approach to its calculation under a firm specific model.

There will be additional imposts on ACTEW in complying with, and the Commission in undertaking, added performance monitoring. These costs may be subject to trade off against the (higher) costs of less frequently reviews and benefits of improved regulation.

Governance

The Government acknowledges the Commission's draft recommendations in relation to governance of ACTEW and water policy. These matters were not explicitly included in the Terms of Reference and not directly linked to pricing issues. Given the significance of the proposals in their own right, the Government will consider them in due course informed by the outcome of the consultation process and the Commission's final report.

It is important that the Government give priority consideration to the pricing issues to facilitate the finalisation of the pricing determination and establish certainty for the regulatory period commencing 1 July 2013.