

Identifying significant business activities for competitive neutrality¹

Purpose of this note

Promote government agencies' awareness of the need to assess and review the business status of activities conducted by government entities, and summarise the criteria that may be applied in determining the significant business status of public activities.

Background

Under the Competition Principles Agreement signed by the Commonwealth, State and Territory Governments in 1995, Victoria is obliged to apply competitive neutrality policy and principles to all significant business activities undertaken by government agencies and local governments (i.e. government entities).

Determining what constitutes a significant business is, therefore, the key threshold question in applying the policy. This will indicate when government entities need to implement competitive neutrality measures, and signal to interested private parties whether a government activity is in scope of Victoria's *Competitive Neutrality Policy* (the Policy).

The Policy, together with the *Competitive Neutrality Guide to Implementation* (the Guide), outlines factors that government entities need to consider to help determine whether an activity is a significant business. The Office of the Commissioner for Better Regulation (OCBR) has consolidated and clarified these factors by developing explicit criteria that government entities can apply to test the significant business status of public activities.

When does a significant business assessment need to be conducted?

Government entities are responsible for determining whether they are engaging in significant business activities (Government of Victoria 2012, p. 3). Potential competitive neutrality complaints can be averted by government agencies pro-actively reviewing activities, documenting their assessment of whether an activity is a significant business and, where necessary, adopting appropriate competitive neutrality measures.

From time-to-time, it might be appropriate to review the business status of public activities in light of changing circumstances. The following are among the trigger points that might help government entities identify the need to review an activity's status.

1. *Maturing market.* Government entities may provide goods or services in markets that are small and undeveloped (and, therefore, unprofitable for private firms). This could change as the market matures and grows (e.g. due to population growth, technological change and/or demand growth).
2. *Change of government policy.* The business status of a government activity might change if government policy changes to increase contestability or remove a statutory monopoly.
3. *Changes to the structure of the activity.* A government entity primarily undertaking non-commercial activities may expand an existing commercial activity or expand into a new commercial activity where competitive neutrality applies.

¹ An appropriate citation for this paper is OCBR 2016, *Identifying significant business activities for competitive neutrality: Guidance note*, Melbourne.

These trigger points are not exhaustive. Government entities ought to be aware of specific circumstances that might influence the significant business status of their activities and, therefore, warrant a review of their status.

Assessing the significant business status of a public activity

Drawing on the Government's framework documents, the OCBR has developed criteria to assess the significant business status of activities that have been subject to competitive neutrality complaints.² These criteria could also inform government entities when assessing of whether their activities constitute a significant business.

What is a 'business'?

Four factors are considered to determine whether an activity is a business. If the answer to each question is 'yes' then the activity is considered a business.

(i) Do the activities result in the sale of a good or service?

The sale of a good or service involves a financial transaction — that is, a good or service is provided by the government entity (the seller) in exchange for payment by the buyer. Examples of activities that result in a sale include:

- operating a retail outlet (e.g. selling or hiring healthcare equipment to the general public)
- delivering commercial services, beyond those required by government regulation (e.g. a metropolitan water authority providing plumbing services to the general public)
- participating in tender processes (e.g. submitting bids in a tender to provide goods or services to another party, including to another government entity).

It is not always obvious whether an activity results in a sale. For example, a government entity may market test an activity and an internal business unit within the entity may participate in the tender process. In this case, although there may be no formal transaction, in substance there is an intent to sell a good or service.

(ii) Are the costs of providing the goods or services of the entity predominantly met by users?

In applying this criterion, regard must be had to whether the Government's policy intention (for example, as indicated through funding policies) is that the costs of provision mostly be met by end users. Government programs that are funded directly from the budget are not activities for which the costs of provision are met — or intended to be met — by customers.

In the absence of an explicit Government policy such as this, the premise is that the costs of goods and services sold to the general public, are to be met by the end user (even if, in practice, costs are not fully recovered). For example, recreation centres operated by local councils typically set entry fees and other charges that recover a significant proportion of the costs of the centre and related activities.

² Significant business assessments are included in completed competitive neutrality investigation reports that are available on the 'Competitive Neutrality Investigation Reports' page of the OCBR's website (www.betterregulation.vic.gov.au).

(iii) Is there an actual or potential competitor?

In applying this criterion, consideration must be given to the following.

- Whether there is at least one other entity that could sell goods or provide services that are reasonable substitutes for those offered by a government entity. Relevant issues include the nature of the goods and services provided, and the geographical proximity of competing providers.

Goods and services offered by a government entity and private operators need not be identical to be 'substitutable'. For example, council-owned recreation centres and privately-owned fitness centres may both offer gym facilities and run fitness programs that are substitutes, although the equipment used or programs may differ.

- The timeframe over which competitive conditions are considered. Although there may be no other service providers currently, as competitive conditions change — consumer tastes, community needs, population — there may be scope for a competitor to enter the market.

In some cases, a government activity will not have any actual or potential competitors, such as where:

- the activity is undertaken in an undeveloped or immature market, where there is little or no incentive for private businesses to operate
- there is a statutory monopoly where regulation prohibits other parties from undertaking the activity
- involvement by private operators is not prohibited by law but limited in practice by other Government policies — for example, where a government entity is exclusively responsible for delivering community service obligations and receives funding for delivering these activities (through the government entity itself or by contracted private third party service providers).

(iv) Do the managers of the activity have a degree of independence in producing or supplying the good or service and the price at which it is provided?³

In applying this criterion, consideration is given to whether there are legislative or policy constraints that substantively limit the government entity's autonomy to determine the price of the activity, the volume produced or the way the activity is provided. Constraints may arise from a range of sources, including regulation, government policy statements and/or Ministerial directions.

Where potential constraints are identified, it is necessary to consider their overall effect on the government entity, such as by considering the following.

- The practical effect of the constraint on the government entity. For example, a requirement for the Minister to approve pricing arrangements for the public activity may, on the face of it, appear to constrain price flexibility. If, however, the manager of

³ This criterion is specified in the *Australian Government Competitive Neutrality Guidelines for Managers* (February 2004), but not in the Victorian Policy, or Guide. This criterion is, nonetheless, consistent with the significant business considerations outlined in Victorian Policy and Guide.

the activity has unconstrained discretion in determining the recommended prices, and the Minister historically has approved the recommendations, then this suggests a degree of managerial independence in price setting.

- How broadly the identified constraints apply. For example, a government entity may have the authority to set the level of production and prices of some but not all of its activities.

In the absence of substantive constraints on their decision-making, government entities are assumed to have the authority to set the level of production of goods or services and prices and the independence requirement will be satisfied.

Case study: Ambulance Victoria

In considering a complaint regarding non-emergency patient transport (NEPT) services provided by Ambulance Victoria (AV), the former Victorian Competition and Efficiency Commission (VCEC) found that AV had independence over the pricing of these services but faced government-imposed constraints on the way the services were provided. These constraints included (i) an obligation to act as a 'fail safe' provider for NEPT services, and (ii) Government policy and funding commitments to maintain service and staffing levels in specific locations.

On balance, the VCEC concluded that these constraints were substantial enough for the independence criterion not to be met. The activity was, therefore, found not to constitute a business for competitive neutrality purposes.

What is 'significant'?

The concept of 'significant' for the purposes of the Policy must be considered in the context of the market in which the activity operates. The market can be viewed as the product space and geographic area in which competition does, or could, occur.

Two factors are used to determine whether the business is significant.⁴

(i) *The size of the relevant business activity in relation to the size of the relevant market.*

In applying this criterion, consideration needs to be given to whether the scale of the public business activity is larger than or comparable to its private competitors. The size of the activity relative to the overall size of the government entity is not relevant to this criterion.

Relevant factors include:

- the category and number of goods and services offered in competition with private sector providers
- the volume of sales and revenue generated relative to other competitors
- the number of actual or potential competitors.

⁴ The Policy and Guide note the following as another possible factor: '*resources the business activity commands and the effect of poor performance*'. The OCBR believes this factor is sufficiently reflected in other criteria so as not to warrant its inclusion as a separate criterion.

Each of these, and any other relevant, factors needs to be considered on a case-by-case basis, in conjunction with the other characteristics of the market. For example, a government business activity may have a large number of competitors and may not be the largest business in the overall market but may, nonetheless, be considered 'significant'. This could be the case if, for example, there is a large number of small operators but two very large operators, one of which is the public activity (i.e. the market is segmented).

Case study: South East Water

South East Water is licensed under the Water Industry Act 1994 to supply water to customers and also performs statutory roles under the Act (which are outside the scope of competitive neutrality). South East Water also offers general plumbing services for water and sewerage systems, an activity that was subject to a CN complaint. Although these services were small relative to the overall size of South East Water, they were larger than many competing plumbing businesses in South East Water's network area. The former VCEC, thus, concluded that this aspect of the significance test was satisfied.

(ii) The influence or competitive impact of the business activity in the relevant market.

The influence or competitive impact of a government business activity might be demonstrated by considering:

- the ability of the public business activity to affect the behaviour of competitors in the market
- the impact of the public business activity on the operation of competing private businesses.

Its influence may be exerted in a number of ways, including the following.

- The mix and price of goods and services sold — for example, bundling different products and offering them at a discounted price.
- The delivery channels through which products and services are distributed — for example, being able to influence access by competitors to customers or having preferential access to customers.
- Supply sources — for example, if the public activity is part of a government-wide purchasing program that enables it to obtain supplies more cheaply than its competitors.
- Promoting the public activity, such as through paid advertising or sponsorship arrangements.
- Financial capacity to sustain loss-making activities — for example, larger government entities may be more able to absorb short-term financial losses than are private competitors.

The government entity's ability to exert influence in these ways may reflect:

- innate factors that enable it to be more efficient or profitable than are privately-owned competitors — such as the size and scope of operations, product or process innovation or the skills of its employees

- advantages deriving from its government ownership (so-called competitive neutrality advantages). (Where the 'significant business' test is satisfied, and a complaint is made against a government entity, the focus of the investigation is on these advantages, not the innate factors.)

Case study: Port of Echuca paddlesteamers

Privately-owned and Council-owned paddlesteamers carry passengers on short river cruises from the Port of Echuca. The Port of Echuca Authority, a Committee appointed by the Campaspe Shire Council, manages Port operations including the Council's paddlesteamers, heritage museum and several other activities.

The former VCEC considered a complaint about the Port Authority's decision to offer a bundled paddlesteamer river cruise and museum product rather than a stand-alone river cruise activity. The private river boat cruise operator was not able to offer its customers the same option. The Port Authority was therefore able to influence the market by offering a combined product with intent to increase patronage of the Council's boats.

Conclusion

Responsibility for determining whether or not a public activity is a significant business resides with the government entity that owns the activity. The OCBR may, however, review this assessment if it has received a formal competitive neutrality complaint.

In general, the government entity that owns the activity will be best placed to make significant business determinations. This guidance note has been prepared to assist government entities to make these determinations. Further advice may be sought from the OCBR where this is needed.

References and further reading

Government of Victoria 2012, *Competitive Neutrality Policy*, Melbourne

Department of Treasury and Finance 2000, *Competitive Neutrality Guide to Implementation*, Melbourne