**Cost allocation methodology[[1]](#footnote-1)**

**Purpose of this note[[2]](#footnote-2)**

To inform government agencies of the costing methodology options which can be considered when undertaking the competitive neutrality costing exercise for activities that have been identified as being a significant business, and assist government agencies in the selection of an appropriate costing methodology. Two costing methodologies can be considered: the fully distributed cost approach and the avoidable cost approach.

In particular the purpose of this guidance note is to inform government agencies that the avoidable cost method can be an acceptable method of allocating costs for competitive neutrality pricing in relation to business activities associated with non-commercial activities.

**Cost allocation methodologies**

Definitions of the two costing methodologies are provided in the *Competitive Neutrality (CN) Guide to Implementation* (pp. 10-11):

‘**Fully Distributed Cost** – It is expected that full cost attribution will be achieved using the Fully Distributed Cost (FDC) method. This ensures that direct, indirect and competitively neutral costs of producing an output are factored into the full cost base. Direct costs of production include wages and the cost of inputs. Indirect costs (overheads) are typically split among various commercial and/or non-commercial outputs and include electricity, information technology, building security, administration, personnel services and rent. These costs that are included in producing the output should therefore be taken into account.

**Avoidable cost** – In instances where the *primary* activity of an agency is *non-commercial*, it may be appropriate to use *Avoidable Cost (AC)* methodology. Using this method, the agency need only consider the extra (direct) costs that the agency could avoid if the activity in question was not undertaken. In many cases, the indirect costs of an agency will not be affected by the commercial activity of the agency, as overhead costs would be incurred anyway. To the extent that indirect costs are affected by the commercial activity these should be taken into account.’

**Issues**

The CN guide to implementation states: “In most cases, agencies will be required to adopt the Fully Distributed Cost approach to costing outputs”. (p. 11) The OCBR notes that government agencies and – more specifically – councils have adopted the fully distributed cost approach to costing outputs when they might have considered the avoidable cost method.

The correct selection of cost allocation methodology is important as it may impact on whether a government agency is compliant with CN policy or not. The CN guide to implementation states the conditions where the avoidable cost method might be considered:

“An agency must be able to demonstrate that its primary activity is clearly non-commercial and that its indirect [fixed] costs are unaffected by the activity in question, before it chooses to apply the AC approach. This may be achieved through a variety of means, such as a description in the agency’s annual report of its activities, or by a Ministerial Statement as to the role of the government agency.

“Where there are no clear policy statements about the primary activity of the agency, the agency may use the AC approach if it can demonstrate that the substantial majority of its outputs are for non-commercial purposes.” (p. 11)

**A worked example of cost allocation methodology**

The following tables show an example of how the application of the two cost allocation methods permissible under the CN Policy may impact on a Council operating an aquatic recreation centre. The premise upon which the example is based is that the primary use of the aquatic component of the recreation centre is non-commercial (for recreational use) although the facility is also used for commercial use (the operation of learn to swim programs), and therefore the Council has the option to consider the avoidable cost method of allocating costs for CN purposes.

For the purpose of this illustration, competitive neutrality full cost adjustments (e.g. payroll tax, rates, land tax) have not been displayed. This has been done to demonstrate more clearly the effects of the two different capital allocation cost methods on the ability of a council to comply with the CN policy. Government agencies when preparing CN documentation need to include CN full cost adjustments in order to demonstrate their compliance with CN policy.

Table A represents the fully distributed cost method and Table B represents the avoidable cost method.

In both cases, revenue levels have been assumed to be based on market prices and expected demand. It is our experience that prices charged by councils for their business activities associated with their aquatic recreation centres are generally equivalent to market prices.

**Table A – Fully distributed cost methodology**

In this case, fixed costs have been allocated across the three activities – Gym (20%), Aquatic business (e.g. swim lessons) (20%), Aquatic recreation (60%) – on the basis of floor space. (The weighting is 30:70 for ‘water’ costs allocated between aquatic business and recreation activities.)

Under the **fully distributed cost** methodology the council would not be complying with competitive neutrality as its businesses subject to CN (the gym and aquatic business) would together be running a deficit[[3]](#footnote-3). To comply, the Council would have to increase the prices charged for either or both swim lessons and gym programs.

If prices of the gym and aquatic business were adjusted to be significantly more than prices set by the market this might result in revenue loss (due to fall in demand). Subsequently, in this example in order to comply with fully distributed cost pricing the council may have no choice but to cease its aquatic business activities as their variable costs may be more than the revenue generated at the adjusted price. Discontinuing the aquatic business operation would result in the centre operating a greater deficit ($35,000 rather than $30,000 as shown in the table) and requiring a higher subsidy from rate payers[[4]](#footnote-4).

Further, it may also result in lessened overall competition in these services and lower service levels in the region. Community welfare derived from the benefits from the provision of learn to swim programs may be compromised as a result of lower service levels. Where the aquatic centre operates in regional Victoria, the adoption of the fully distributed cost method may see a significant portion of consumers unable to access these services.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Fully Distributed Cost** | | | | |
| **Revenue / Costs** | **Gym** | **Aquatic business** | **Aquatic recreation** | **Total centre** |
| **Revenue** | **37,000** | **17,000** | **46,000** | **100,000** |
|  |  |  |  |  |
| **Expenditure** |  |  |  |  |
| **Fixed costs** |  |  |  |  |
| Water | 0 | 3,000 | 7,000 | 10,000 |
| Security | 1,000 | 1,000 | 3,000 | 5,000 |
| Admin staff | 4,000 | 4,000 | 12,000 | 20,000 |
| Cost of capital | 7,000 | 7,000 | 21,000 | 35,000 |
| **Variable costs** |  |  |  |  |
| Water treatment | 0 | 2,000 | 8,000 | 10,000 |
| Swim instructor | 0 | 7,000 | 0 | 7,000 |
| Gym instructors | 10,000 | 0 | 0 | 10,000 |
| Other | 15,000 | 3,000 | 15,000 | 33,000 |
|  |  |  |  |  |
| **Total Cost** | **37,000** | **27,000** | **66,000** | **130,000** |
|  |  |  |  |  |
| **Surplus/deficit** | **0** | **-10,000** | **-20,000** | **-30,000** |

**Table B – Avoidable cost methodology**

Under the **avoidable cost** method, the aquatic business would not need to include the fixed costs (pool area, change room etc) associated with the aquatic business as these costs would have been incurred even if a swim school did not operate. The Council would only need to consider any extra variable costs that the Council could avoid if the aquatic business activity was not undertaken (e.g. swim instructors, extra water treatment, etc).

In this case, the Council will not need to increase its prices of swim lessons to be CN compliant as the fixed costs are allocated to the aquatic recreation activity. Allocating the fixed costs that are unavoidable to aquatic recreation allows the Council to price its aquatic business at market rates. Application of the avoidable cost method enables the Council to avoid being placed in the position of having to cease its aquatic business operations (and as a result forego revenue and reduce community welfare outcomes), as may occur under the fully distributed cost method.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Avoidable cost** | | | | |
| **Revenue / Costs** | **Gym** | **Aquatic business** | **Aquatic recreation** | **Total centre** |
| **Revenue** | **37,000** | **17,000** | **46,000** | **100,000** |
|  |  |  |  |  |
| **Expenditure** |  |  |  |  |
| **Fixed costs** |  |  |  |  |
| Water | 0 | 0 | 10,000 | 10,000 |
| Security | 1,000 | 0 | 4,000 | 5,000 |
| Admin staff | 4,000 | 0 | 16,000 | 20,000 |
| Cost of capital | 7,000 | 0 | 28,000 | 35,000 |
| **Variable costs** |  |  |  |  |
| Water treatment | 0 | 2,000 | 8,000 | 10,000 |
| Swim instructor | 0 | 7,000 | 0 | 7,000 |
| Gym instructors | 10,000 | 0 | 0 | 10,000 |
| Other | 15,000 | 3,000 | 15,000 | 33,000 |
|  |  |  |  |  |
| **Total Cost** | **37,000** | *[-15,000]*  **12,000** | *[+15,000]* **81,000** | **130,000** |
|  |  |  |  |  |
| **Surplus/deficit** | **0** | **5,000** | **-35,000** | **-30,000** |

**References and further reading**

DTF (Department of Treasury and Finance) 2000, *Competitive neutrality guide to implementation*, Melbourne

DTF (Department of Treasury and Finance) 2003, Amendment to Competitive Neutrality Policy, *Application of CN Policy to Council owned Aquatic and Leisure Centres*, Melbourne

Government of Victoria 2012, *Victorian government competitive neutrality policy*, Melbourne

1. An appropriate citation for this paper is (update the reference) OCBR 2016, *Cost allocation methodology: Guidance note*, Melbourne [↑](#footnote-ref-1)
2. This guidance note has been prepared to provide guidance on matters pertinent to the application of the Victorian Government’s *Competitive Neutrality Policy*. The guidance note should be read with section 2.2.1 ‘Adopting a costing methodology’, of the *Competitive Neutrality (CN) Guide to implementation*. [↑](#footnote-ref-2)
3. Aquatic recreation (i.e. swimming) has not been subject to CN pricing since July 2003 following an amendment to CN policy approved by the Treasurer. [↑](#footnote-ref-3)
4. In this case, if the Council closed its aquatic business operation the operating deficit would increase from $30,000 to $35,000. The increased deficit, $5,000 is the difference between the revenue generated from the aquatic business, $17,000, less the variable costs associated with this business, $12,000. [↑](#footnote-ref-4)