

A SOCIAL PROGRAM POLICY

FOR

NSW GOVERNMENT TRADING ENTERPRISES

July 1994
NSW Government

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PREFACE

A fundamental objective of the Government's microeconomic reform agenda is to improve the economic efficiency of its Government Trading Enterprises (GTEs).

By improving economic efficiency, additional resources are provided for use by the Government to pursue its core social and regulatory objectives without necessarily having to resort to increasing taxes. The economic efficiency objective is to be achieved primarily by creating a comprehensive financial policy framework with appropriate incentive structures designed to promote sound commercial behaviour on the part of GTEs.

This Social Program policy is an important element of the overall GTE policy framework. It is designed to improve the accountability of GTEs for both commercial performance and the delivery of social programs.

A "Social Program" in the context of this policy is an activity undertaken by a GTE to address a social objective identified by the Government. In a sense, these programs differ from other Government programs only because they have not been through the Budget process and hence have not been subjected to the scrutiny applied to other social expenditures.

As a consequence, the delivery of social programs through GTEs is impaired because there is no assurance that programs continue to be relevant to the needs of beneficiaries and the Government's social priorities. In addition, there are often no defined service standards and there is generally inadequate monitoring of service delivery. Economic inefficiencies arise because Social Programs are funded through cross subsidies which distort production and investment decisions by GTEs and consumption decisions by the public. The result is less money to spend on core social policy objectives and in many cases, undesirable, unintended impacts.

The policy will be implemented in stages and the Government will review the results of each stage. Stage I, which will conclude in 12 months, will require all GTEs to identify and analyse non-commercial activities and to identify and describe those that are to be proposed as social programs in a submission from their Minister to the Treasurer. Following appropriate assessment, the Treasurer will advise the Minister of the results i.e. social program proposals that have been accepted by the Government subject to Stage II assessment.

The policy refers to the possibility of "purchasing" Ministers being assigned policy responsibility for social programs which are currently the responsibility of a Minister whose portfolio includes the relevant GTE. No change to current Ministerial responsibility for any social program will occur in Stage I. If a case for any change is identified, this will be addressed in Stage II, but will need to be further considered by the Government.

Stage II will involve detailed examination of the purposes, processes and resources of each social program in order to maximise appropriateness with respect to Government policy and efficiency and effectiveness of delivery, before the final decision is made about whether or not to fund it.

However, Stage II - implementation will require extensive consultation with program stakeholders if it is decided to proceed. Stage I must, of course, be completed before sufficient information will be available to inform a decision on the further implementation of the policy. It will involve a number of case studies which will facilitate key issues being identified and addressed in a detailed way.

A small implementation team will be established in Treasury to co-ordinate identification and evaluation of social programs and to consult with relevant Ministers, stakeholders and agencies.

This policy is an essential component of the financial policy framework for GTEs, which the Government has put in place to secure the benefits of micro economic reform. However, it is possible that ultimately, the most important benefits will flow from improvements in the appropriateness and effectiveness of social policy expenditures.

Peter Collins QC MP
Treasurer

OVERVIEW

For the purposes of this Policy, "Social Programs" ("SPs") are non-commercial activities of Government Trading Enterprises of (GTEs) which have social objectives. Such programs are generally known as "Community Service Obligations" ("CSOs") and there is a significant literature in Australia on this topic. However, the term CSOs is, strictly speaking, applied from the perspective of a GTE which "delivers" social benefits in the form of programs purchased by the Government.

From the Government's perspective, the focus should be on achieving desired social objectives, regardless of whether the GTE is the preferred delivery vehicle or not. This view is consistent with the Government's approach to separating the roles of "purchaser" and "producer" of services to the public.

This Policy focuses on the SPs which historically have been delivered by GTEs and addresses the means by which the Government may continue to deliver (or enhance) social benefits while pursuing its policies of commercialisation, which aim to give GTE managers a profit motive.

The term CSO is retained in a technical sense to describe those social programs which continue to be delivered by GTEs and which will be funded through the Budget.

In the past, SPs have been undertaken by GTEs without clear direction or specification of social objectives and largely with internal funding through cross-subsidies. This has impaired economic performance without adequately addressing the needs of disadvantaged groups in the community.

Economic inefficiencies arise because cross-subsidies distort production and investment decisions by GTEs and consumption decisions by the public. At the same time, benefits of social programs delivered by GTEs are sometimes poorly targeted and there is generally inadequate monitoring of service delivery. The result is less money to spend on core social policy objectives and, in many cases, undesirable environmental impacts.

The progressive commercialisation of GTEs has led to increased pressure on management to achieve improved returns on the investment of public funds, as well as to increased management autonomy. The Government's SP Policy aims to improve both the delivery of social policy programs and GTE performance through the identification and explicit funding of SPs. Programs currently funded through the Budget as "CSOs" (ie social programs delivered by GTEs) constitute around \$1 billion, equivalent to 5% of total Budget outlays.

The Policy provides for potential SPs to be identified and costed by GTEs and reviewed by the relevant purchasing Minister. If the Minister considers that an activity meets the criteria of a SP, it may be assessed for funding through the Budget. Approved SPs (including CSOs) will then be subject to the same political, Parliamentary and Budget scrutiny as all other expenditure proposals.

Funding will depend on the Government's prioritisation and Budget constraints. If a proposed SP does not have clear social policy objectives, if the objectives are not a Government priority, or if it fails to adequately address its objectives, it will not be funded. This process may create savings that can be applied to higher priority programs.

Implementation of the SP Policy will result in the effective separation of commercial and non-commercial activities of GTEs, with CSOs being formally contracted between the GTE and the relevant portfolio Minister.

It is expected that increased transparency and accountability for expenditures will lead to the development of clearly stated policy objectives and the evaluation of options for achieving these objectives. In short, the focus of policy on SPs will be shifted from the delivery vehicle to the needs of clients. It is hoped that the Policy will thereby stimulate a better co-ordinated cross-portfolio approach to social policy development and program delivery.

A clear policy on SPs will protect the interests of disadvantaged groups by making the funding, range, level and quality of services more explicit and transparent. Setting standards for services delivered under SPs will enable beneficiaries to become aware of their rights and entitlements. Moreover, Budget funding for proposed CSOs will mean that beneficiaries will become valued clients of GTEs. There will then no longer be a risk that CSOs will be marginalised relative to the commercial objectives of GTEs.

There are also significant benefits for the management of GTEs. Contracting for CSOs will allow for improved GTE performance measurement. As CSOs will be contracted and paid for through the Budget, GTE managers will no longer be required to provide CSOs on a non-commercial basis. GTE managers will be accountable for the performance of all activities, including CSOs, on a commercial basis.

The expected result is a continuation of the decline in Government charges and increase in dividends that has occurred over the last decade. Dividend payments from GTEs make a significant contribution to the Government's ability to fund social programs.

Some of the key principles set out in this paper in regard to identification, costing and contracting have already been applied to a number of existing SPs, particularly in the transport area. This paper provides a comprehensive framework intended to ensure that a uniform and consistent approach is applied across all Government agencies.

In order to allow time for the identification, costing, review and Budget funding for SPs, it is proposed to phase in implementation of the Policy. All non-commercial activities of GTEs will be identified and costed over the first two years. Funding will be made transparent, either directly through the Budget, or through continued internal funding which is approved by the Treasurer under transitional arrangements. Within five years all approved SPs should be directly funded through the Budget.

In order to ensure adequate public and Parliamentary scrutiny, details of all existing and potential SPs will be published in the Annual Reports of GTEs and will be made available to interested parties during the review process.

1. BACKGROUND AND POLICY CONTEXT

The Social Program (SP) Policy aims to establish a framework within which the social policy objectives of Government may effectively be pursued while progressing the commercialisation of GTEs. This section clarifies some of the underlying assumptions behind SP Policy development.

1.1 BACKGROUND

1.1.1 The Historical Legacy

In the past, Government Trading Enterprises (GTEs) have been established to overcome perceived market failure and to achieve social objectives. These objectives include providing services at "affordable" prices, promoting regional development, fostering growth in "strategic" industries, or assisting more "deserving" members of the community (a form of income redistribution). In many cases, the GTEs are statutory monopolies.

The statutory authority model allows GTEs and their Ministers to pursue non-commercial (ie political) objectives which are largely funded internally by cross-subsidies.

Existing arrangements create a number of problems as follows:

- * a significant proportion of the Government's social policy expenditures are not subject to direct scrutiny by Cabinet, Parliament and the public, which is afforded by the Budget process. As a result, the Government is unable to prioritise spending or monitor the effectiveness of SPs;
- * the lack of transparency of arrangements outside the normal budgetary process has permitted special interests to benefit at the expense of the wider community. These special interests include some GTE customers, employees and management. (The latter two groups benefit from an expansion of their organisation's activities.);
- * the lack of transparency results in individual classes of GTE customers generally being unaware of the extent of "subsidy" or "tax" contained in prices paid for GTE services, thus clouding judgements as to the value of the service;
- * the pursuit of social objectives by GTE management has given GTE managers unclear and conflicting objectives, a situation which is often used to excuse poor performance;
- * cross-subsidies are a poor means of funding SPs. They distort production and pricing decisions, leading to inefficient use of resources. They are also a blunt and ineffective means of addressing social policy objectives; and
- * the existence of cross subsidies is used as an argument for the continued protection of monopolies, which do not necessarily best serve the public interest. (The preservation of monopoly is needed to prevent alternative suppliers from servicing those customers forced to bear the cost of the subsidy.) Conversely now that the national microeconomic reform agenda is increasingly focusing on competition policy, exposing GTEs to competition highlights the need to remove cross subsidies.

Problems of Cross-Subsidies

A cross-subsidy is essentially a concession to selected users funded by a tax on all other users. It has no real advantage over direct Budget funding but has several significant disadvantages.

In the first place it is inequitable. A cross-subsidy maybe progressive for eligible recipients, but it will necessarily be regressive for those who are just outside the criteria of eligibility. Furthermore, GTEs in different parts of the State have different proportions of customers eligible for subsidies. For example, it is often argued that concessions to eligible groups of electricity consumers should be financed by cross-subsidies. Effectively all consumers in a particular region would pay an additional amount, or tax, to cover the cost of such concessions. It is clearly unjust for the majority of people in a poorer region to pay a higher tax on electricity consumption than those in a richer region.

The reliance on cross-subsidies to deliver social benefits also tends to focus policy on the limited range of delivery options available through the GTE from which the funding is obtained these will not necessarily be the options that best address the needs of clients. For example if electricity price concessions are granted only to customers of an electricity utility, other electricity consumers, such as residents of caravan parks are inequitably treated because they receive no assistance.

The elimination of cross-subsidies will enable GTEs to pay larger dividends, which can be applied to a range of social policy options. A Minister may choose to provide continued funding for an existing subsidy from the Budget, but will also have the option of using alternative delivery vehicles for the social policy objective.

The prevalence of cross-subsidies in the past has arguably been due largely to the ease with which a hidden tax can be imposed on the public compared with an explicit tax. The hidden nature of the tax element substantially reduces accountability.

The legitimacy of the social policy goals implicit in SPs is not at issue. Rather, the key questions are as follows:

- * are the original goals relevant? and
- * can they be more effectively met by other means without compromising economic efficiency?

1.1.2 GTE Reform

The Government is committed to microeconomic reform of GTEs to improve their commercial performance.

By improving the efficiency of its GTEs, the Government will be better able to deliver important social outcomes, such as: faster employment growth as the NSW economy becomes more cost competitive; better standards of service by GTEs in key areas including electricity, water and transport; and enhanced funding of core Government services from the proceeds of GTE dividends and tax payments. Examples of core services are health, education, law and order, and environmental protection.

As mentioned above, some of the barriers to improved economic efficiency arise from the pursuit of social objectives by GTEs. Indeed, the need for a SP Policy was originally identified in the context of improving the management of GTEs by enhancing performance monitoring.

The "CSO" issue has attracted considerable attention throughout Australia. A "Steering Committee on National Performance Monitoring of Government Trading Enterprises" established under the aegis of the Council of Australian Governments (COAG), includes among its objectives the achievement of national standards in this area. A key requirement in performance monitoring is setting standards for the identification and costing of SPs which are delivered by GTEs.

Another COAG initiative which strengthens the case for these policy changes is the adoption of the Hilmer report on competition policy. GTEs will increasingly be exposed to competition, and will lose the ability to force customers to bear the cost of cross-subsidies, which was afforded through the monopoly status they previously enjoyed. This will make it imperative for alternative methods of funding SPs to be found.

New South Wales has been at the forefront of Australia in the development of a comprehensive financial policy framework for GTEs. The SP Policy is a key element of this framework. Currently, the value of programs administered by GTEs and funded through the Budget as CSOs is around \$1 billion. Around three quarters of this expenditure is in transport services. It is expected that further substantial amounts will be made transparent during the process of implementing this Policy.

1.1.3 Getting Better Value for Government Expenditure on Social Policy Programs

The implications of the SP Policy for social policy expenditures are potentially more important than the GTE reform aspects. The scope of the SP Policy must therefore encompass the management and review of social policy expenditures, in addition to the original concern with GTE performance monitoring.

The Policy is consistent with on-going Government efforts to review all expenditure programs to ensure that policy objectives are clearly stated, programs are effective in achieving policy objectives, and expenditures are transparent.

Implementation of the SP Policy will require the review and evaluation of SPs on a "whole-of-Government" basis. It is hoped that this will stimulate the development of more broadly based and better co-ordinated social policy objectives. This is consistent with the Government's themes of "community service" and "policy co-ordination with a cross-portfolio approach".

1.2 SCOPE AND SUMMARY OF POLICY OBJECTIVES

The Policy provides a uniform framework for the identification, costing, review, evaluation, funding, contracting and reporting of SPs and CSOs. The definition of SPs and CSOs includes non-commercial services provided direct to the public, as well as services provided to Government agencies.

The Policy generally applies to all GTEs as defined by the Government's Monitoring Policy for Government Trading Enterprises published in October 1992. A key criterion in the definition of a GTE is that it receives at least 50% of its total income from trading operations. This test must, however, be applied with some flexibility as it is more important to establish whether an agency is predominantly driven by commercial objectives, rather than applying a strict test of financial self-sufficiency.

The SP Policy is an integral part of a comprehensive policy framework for GTEs in the NSW Government which also covers financial distributions (ie dividends and tax equivalent payments), capital structure and financial monitoring.

The key objectives of the SP Policy are to:

- * provide a framework for the effective separation of commercial and non-commercial activities of GTEs so that management may be given clear and non-conflicting objectives, thus enabling it to be held accountable for both commercial performance and the delivery of social programs;
- * subject social expenditures by GTEs to the Budget process, thereby making them transparent and enhancing Parliamentary accountability; and
- * provide a framework to improve the effectiveness of SP expenditures through the application of appropriate review and evaluation processes.

This Policy sets out the fundamental principles together with implementation arrangements for the next five years. It is intended to augment this document with detailed guidelines on identification, costing, review/evaluation and contracting of Social Programs. These guidelines will be incorporated in technical manuals to be developed by Treasury based on case studies undertaken jointly with GTEs. It is planned that these will be published in the first year of implementation of the policy.

1.3 SOCIAL POLICY CONTEXT

This Policy does not deal with social policy objectives as such, but rather provides a policy framework for funding, contracting and evaluating social programs which are delivered by GTEs. Social policy objectives are the responsibility of the relevant purchasing Minister.

1.3.1 Strategies for the Implementation of Social Policy

The key management strategies that will enable the realisation of social policy objectives follow:

- * Clarity of Social Policy Objectives: Any expenditure, or forgone revenue, should have an explicitly stated objective in terms of social or community benefit.
- * Focus on Outcomes: Government programs should be assessed, not simply in terms of expenditure and service outputs, but also in terms of welfare outcomes for beneficiaries. Outcomes must be related to stated objectives.
- * Parliamentary Accountability: Social policy expenditure should be the responsibility of the appropriate Ministers, who are directly accountable to Parliament. The provision of services should not be at the discretion of GTE management.
- * Efficient Use of Government Resources: Clear objectives and comprehensive evaluation allow costs of service provision to be minimised.
- * Appropriate Allocation of Responsibility: The current *de facto* responsibility for SPs is with portfolio Ministers and GTE managers, whose principal interests lie in the management of operations, customer service, and regulatory compliance. This means that accountability for social policy expenditure is diluted.
- * Co-ordination of Policy Delivery: To ensure that social expenditure has the greatest possible benefit for social welfare outcomes, a co-ordinated cross-portfolio approach is needed.
- * Client Entitlements: Beneficiaries of SPs should have clearly defined and stated entitlements to standards of service. At present, many SP beneficiaries have no recourse if the delivery of services is inadequate.
- * Client Focus: Under the SP Policy, the funding and policy-making responsibilities will be separated from service delivery. This will reinforce the role of Ministers as advocates of clients, without having a conflicting role of defending the performance of the GTEs that deliver services. Ministers will be free to choose between alternative delivery vehicles, including the private sector. This will provide an element of competition in satisfying the needs of clients. SPs will no longer be regarded as marginal activities by GTEs but rather they will be explicitly contracted.

1.4 THE CONTEXT OF MICROECONOMIC REFORM

It is important that the SP Policy be considered in the context of the Government's policy framework for the Commercial and Budget Sectors. The Government of New South Wales comprises two sectors:

- * The Budget Sector: delivers core social programs such as health and education and is funded by State taxes, regulatory fees and Commonwealth Grants; and
- * The Commercial Sector: GTEs and other agencies in the Commercial Sector provide goods and services on a commercial basis. They also make payments to the Consolidated Fund. Agencies in the Commercial Sector derive their income largely from user charges. These supplement tax revenues and allow greater Budget expenditures on core social programs.

The Purchaser-Producer Model

There has been a consistent move by the Government towards separating the functions of policy development and funding from service delivery. The key principles are embodied in the “purchaser-producer” model - where a Budget Sector agency is seen as the purchaser of services, for ultimate provision to customers. This model applies to the relationship between the Budget Sector and the Commercial Sector, just as it does between the Budget Sector and the private sector.

Purchasing decisions should not necessarily be purely on the basis of cost, but should include such factors as reliability of supply, willingness to accommodate a customer's special requirements, etc. These are, of course, precisely the factors that often justify internal sourcing in many other organisations, including commercial enterprises. Where services continue to be provided by Government-owned enterprises, they should be subject to a rigorous test of value for money.

The benefit is that the “purchaser” department can focus solely on its core task of developing and monitoring programs to meet the needs of its clients. It will not be driven by the mechanics of delivering services. There are, of course, some areas where programs must be delivered directly by the funding agency, but where alternatives exist they should be considered.

Under the Government's microeconomic reform program, GTE managers have clear commercial objectives and their performance is judged primarily on their financial results. (Subject, of course, to an exacting accountability framework including price and environmental regulation, as well as customer service standards.)

Under this management regime, increased management autonomy must be accompanied by increased accountability for achieving results.

The Budget Sector, on the other hand, is essentially concerned with developing policy and managing Government expenditures on social and other programs funded from the public purse. Budget Sector managers are more directly controlled and are more directly accountable to Parliament.

1.5 BUDGET IMPACT

The growth in demand for Budget funding for proposed SPs will have a cost to the Budget; but this cost will be associated with a commensurate increase in the net income from GTEs because they will no longer fund these SPs internally. The SP Policy of itself has no particular net revenue implications for Government as a whole in the short run. (The impact on the Consolidated Fund, assuming a financial distribution pay-out ratio of less than 100%, is discussed in Section 6.) The immediate effect of the Policy will be to enable Ministers to consider a wider range of options in addressing social policy objectives.

In the longer run the Policy will lead to more efficient GTEs, with a greater capacity to contribute, through dividends, to the Government's core social programs. The Government's Financial Distribution Policy and the SP Policy together provide an important means to improve the targeting and funding of social policy expenditure in NSW. Through explicitly funding SPs from the Budget and through increased financial distributions from GTEs, these policies will effectively increase both Budget expenditures and revenues.

1.6 PRICING POLICY

The pricing of Government monopoly services is regulated under the Government Pricing Tribunal Act 1992. The effect of Government Pricing Tribunal (GPT) decisions has generally been to promote price structures that are more closely aligned to costs and to progressively eliminate cross-subsidies.

The SP Policy will facilitate the replacement of cross-subsidies with more effective delivery mechanisms for social policy. However, it should be emphasised that the SP Policy does not require the removal of all cross-subsidies, only that they be made transparent.

2. OPERATIONAL MODEL

This section outlines the broad operational arrangements for achieving the objectives of the Policy. Detailed implementation arrangements are outlined in Section 8.

2.1 INCENTIVE STRUCTURES

As discussed above, the purchaser-producer model for Government agencies eliminates a number of serious management problems by ensuring that each area of Government has clear objectives and by reducing the scope for conflicts of interest within agencies.

Under the purchaser-producer model, the Government seeks to meet its social objectives by purchasing specified services from the supplier, which could be a GTE, private firm, Government Department or Community Sector organisation.

As the owner of a portfolio of investments in GTEs, the Government has an interest in ensuring that it does not receive sub-commercial returns on its investment. To look at it from another perspective, the Government has an interest in ensuring that GTEs do not waste capital that could better be used elsewhere.

Furthermore, in the interests of maintaining efficient GTEs, the Government seeks to remove incentives for GTEs to expand activities away from their agreed core businesses.

The operational requirements of this Policy deal with these complications by providing a structure with appropriate incentives for GTEs. Therefore, the discussion below focuses on commercial activities of GTEs as well as on potential SPs.

The Policy also addresses the need for prioritisation of proposed SPs currently provided by GTEs to enable funding through the normal Budget process. The Policy provides the necessary framework for the Budget Sector to purchase SPs at "arm's length" from GTEs.

SPs of GTEs which are already funded from the Budget have not been treated as Budget Sector programs in the past and have not necessarily received the same degree of scrutiny as normal Budget Sector programs. Implementation of the Policy will involve bringing all proposed SPs into the Budget process on the same footing as other Budget Sector programs.

2.2 KEY POLICY ELEMENTS

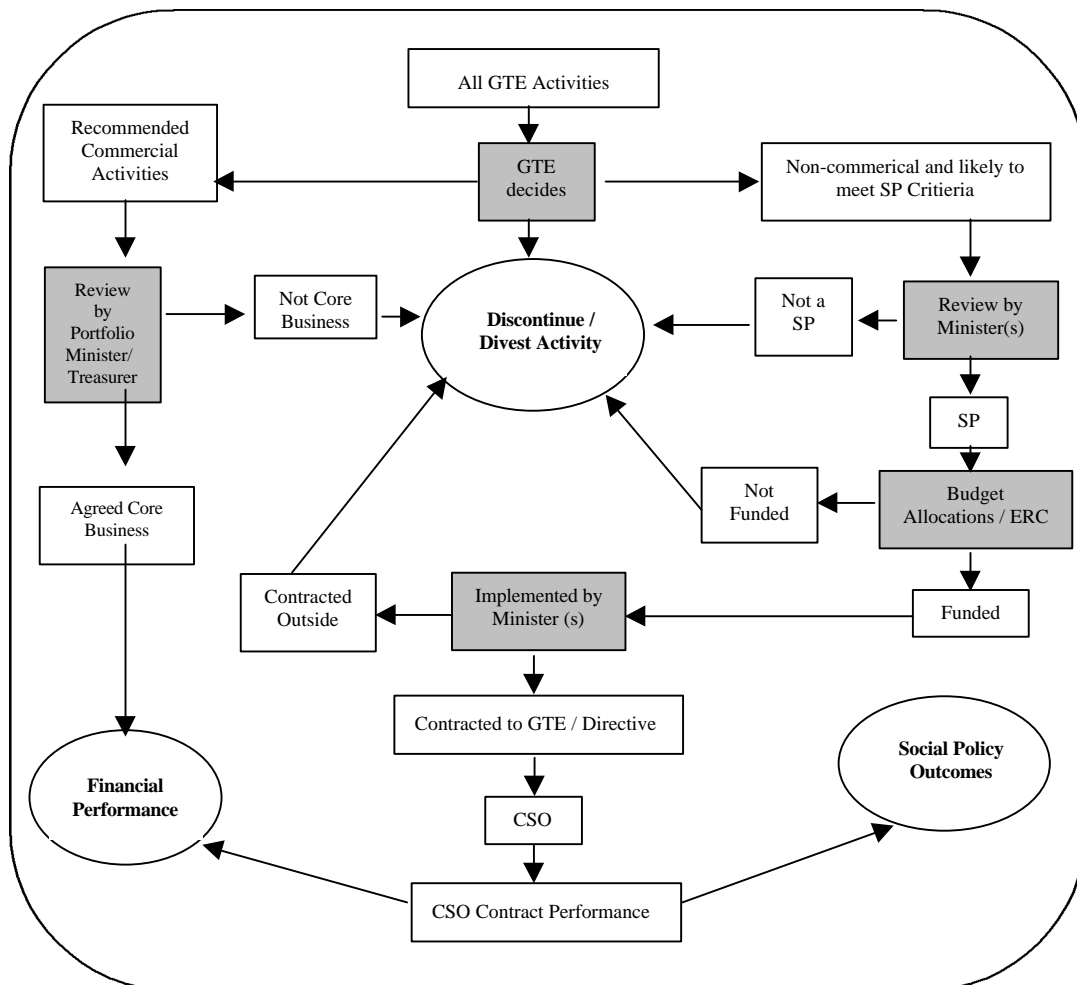
The key elements of the SP Policy outlined in this section are illustrated in Figure 1.

2.2.1 Preliminary Identification

GTEs should review their activities according to the classification criteria set out in Chapter 3, having regard to the following:

- * all commercial activities must be subject to the financial disciplines on which the Government's financial performance targets are based;
- * activities which are nominated as potential SPs and which are not subsequently accorded Budget funding should be discontinued; and
- * the cost of providing agreed CSOs will be taken into account in negotiating appropriate financial targets for GTEs.

Figure 1 - Overview of SP Model Arrangements



2.2.2 Review by Minister

Once GTEs have reviewed their activities and nominated commercial activities and SP proposals, the results should be sent to the portfolio Minister for review (with a copy to Treasury for information).

The fundamental elements of this review follow:

- * **Commercial Activities:** Activities nominated by GTEs as "commercial" will be reviewed in the light of the Government's role as owner of the business. The key issue is whether a particular activity falls within the core business activities agreed between the Government and the GTE. These are intended to ensure that the business risks entailed by the GTE's activities are acceptable and that appropriate rates of return are achieved. The Treasurer should be consulted by the portfolio Minister when determining core business.

Outcome: Commercial activities agreed as being either part of core activities and subject to full commercial disciplines or discontinued.

- * **Non-Commercial Activities:** Having first identified all non-commercial activities, GTEs will need to decide which activities are likely to attract Budget funding and should therefore be proposed as SPs, including those that are likely to become CSOs.

These SP proposals will then be reviewed by the portfolio Minister. (In Stage II of the implementation process (see Section 8) the Government may address the issue of whether social policy responsibility should be allocated to a Minister other than the Minister whose portfolio includes the GTE. For example, it may be decided that the Minister for Land and Water Conservation should have responsibility for flood mitigation, while the Water Board, in the Planning portfolio, has operational responsibility for operating flood mitigation dams.)

The review will consider such factors as the continued relevance of a proposed SP to the Government's social policies; the effectiveness of the program in its current form in achieving the desired social outcomes; and whether alternative programs could achieve the same objectives more cheaply.

Outcome: Non-commercial activities are either nominated as SP proposals and Budget funding sought or discontinued. (This will be subject to appropriate transitional arrangements over the implementation period.)

2.2.3 Method of Funding

Ultimately, all agreed SPs approved by the Expenditure Review Committee will be funded through Budget allocations. However, in some cases a transition period may be necessary to allow for the development of new programs or the re-design of existing SPs to a point where they can be submitted for Budget funding. Continued internal funding through cross-subsidies may be permitted during a transition period of specified duration, with the explicit approval of the Treasurer as well as the portfolio Minister.

2.2.4 Budget Allocation

SP proposals will be subject to the same scrutiny as other Budget Sector expenditure proposals. This will involve all the steps of the Budget process, including annual Ministerial portfolio reviews and a thorough program evaluation to address the appropriateness of SP objectives, as

well as the effectiveness of the SP in achieving these objectives. Alternative vehicles for program for delivery should be considered.

The results of program evaluations will be included in Budget submissions to Treasury. Budget allocations will be made to purchasing Ministers who will then enter into funding arrangements with portfolio Ministers to deliver the approved CSOs. It should be noted that, at least in the first stage of implementation, the relevant portfolio Minister will fulfil both roles.

2.2.5 Implementation by Minister

On receiving advice of allocations (or approval for alternative arrangements), the purchasing Minister will be in a position to negotiate arrangements or enter into contracts for the delivery of a SP. Should the Government decide to procure services from the GTE, then it may be necessary for the portfolio Minister to negotiate a contract on behalf of the purchasing Minister if these roles are split.

If an arrangement already exists for Budget funding, implementation may simply mean the renewal of contracts with revisions as needed to comply with this Policy. However, in the case of SPs which have not previously been funded from the Budget or enhancements to existing Budget programs, formal directives will need to be issued and contracts negotiated for the first time.

As a practical matter GTEs will, of course, need to give attention to contract conditions in proposing CSOs (ie Social Programs proposed to be delivered by GTEs). Negotiations will therefore need to proceed in parallel with the Budget process.

2.2.6 Contract Performance

As will be made clear in subsequent sections of this paper, the contract price for CSOs and their actual cost will necessarily differ to some extent. While cost estimates will clearly be an important factor in contract negotiations, other factors such as "best practice" benchmarks will also have an impact.

The cost will be an actual outcome rather than a claim for reimbursement and it will therefore impact on a GTE's financial performance. The careful specification of CSO contracts initially, and ensuring their fulfilment later, is vital to the achievement of both financial and social objectives.

2.2.7 SP Model Outcomes

As illustrated in Figure 1 on page 11, the SP arrangements are expected to provide three outcomes:

- * improved performance in achieving social objectives of the Government;
- * improved financial performance of GTEs; and
- * "non-commercial" activities which are not contracted to GTEs to perform will be discontinued, or phased out by GTEs under appropriate transitional arrangements.

3. DEFINITIONS

This section provides definitions of commercial and non-commercial activities, to assist with the identification and classification of SPs and CSOs. These classifications will be required in applying evaluation and costing methodology, as discussed in later sections.

3.1 DEFINITION OF GTE ACTIVITIES

“GTE activities” refer to all decisions of GTE management which have financial implications. They cover all expenditures, including revenue forgone by price concessions or from refraining to undertake certain actions. They can refer to inputs and outputs in respect of GTE operations.

3.2 CLASSIFICATION OF GTE ACTIVITIES

GTE activities may be classified as "commercial" or "non-commercial".

A commercial activity is generally one in which both operating and capital costs are covered by associated revenues, where the cost of capital is understood to include a return on equity invested by the Government.

There are two other conceptual tests which should be applied to determine whether an activity is commercial:

- * What would the organisation do if it were not required to follow a particular Government directive, but was free to act commercially? and
- * What would a private sector firm, unconstrained by non-commercial considerations, do in the circumstances?

These tests must be applied with some discretion. A purely commercial organisation would take advantage of a monopoly situation to charge whatever the market would bear. Public sector enterprises which are monopolies are subject to price regulation by the Government Pricing Tribunal. Furthermore, they are subject to an exacting accountability framework including the Parliamentary Public Accounts Committee, the Auditor General and the Independent Commission Against Corruption, as well as the regulatory framework applying to their particular industry. This accountability framework ensures that in pursuing their commercial charter, GTEs do not abuse their monopoly position by acting inconsistently with the public interest.

3.3 COMMERCIAL ACTIVITIES - SOME SPECIAL CASES

3.3.1 Regulatory Requirements

The cost of complying with the regulatory framework under which a GTE operates should be regarded as simply a cost of doing business and hence part of its commercial activities. For example, Environmental Protection Authority licence requirements concerning effluent from sewage treatment plants are regulatory requirements imposed on the Water Board. They are not "extra" cost impositions on the Water Board, but rather form part of the very reason for the Water Board's existence.

In most instances regulatory requirements are legally mandated and apply to whole industries, ie private organisations as well as GTEs. Labour laws and occupational health and safety laws fall into this class. In some cases where an industry has no private sector participants, either through regulation or because the industry is a natural monopoly, such regulations may apply only to a GTE. Another example of a regulatory requirement is industrial awards which, for historical reasons, are often specific to the public sector.

Some regulatory requirements, which apply to public sector organisations, such as reporting and administrative requirements, have counterparts in the private sector. Others, such as the Freedom of Information Act, do not, but are a necessary part of public administration in a democratic society.

Yet other public sector regulatory requirements, such as Equal Employment Opportunity (EEO) and the Ethnic Affairs Policy Statement, represent efforts by the Government to lead society as a whole by example. The intention is that the principles behind these regulations should ultimately be incorporated in the commercial management practices of all organisations, public or private. It is noteworthy that many leading private sector firms adhere to EEO although they are not obligated to do so. This not only allows them to claim a higher degree of social responsibility, it is also widely regarded as sound business practice because it selects the most talented people and ensures that all employees feel that they are valued by an organisation.

There may be cases where the cost of conforming to the regulatory framework of the Government imposes a very significant burden on a GTE in comparison with private sector competitors or public sector counterparts in other jurisdictions. In such cases, it may be reasonable to identify relative cost disabilities which may be taken into account in evaluating performance relative to private sector benchmarks. This is covered below under "other cost impositions" in the section on non-commercial activities.

3.3.2 Good Corporate Citizenship

While private sector firms act primarily in the interests of their shareholders, there are many other "stakeholders" to be considered, such as employees, customers and the community. Modern management recognises that firms have a degree of responsibility to all stakeholders, which simply acknowledges that companies have the same basic social responsibilities that good citizens would regard as a normal part of their private lives.

Examples of expenditure that falls into the category of "good corporate citizenship" includes, the cost of maintaining a reasonable standard of appearance around buildings or other installations;

various employee programs; sponsorships and contributions to community activities; and the provision of recreational facilities around dams. Expenditures in these areas which are currently funded as CSOs can only continue to be funded as CSOs if management is prepared to discontinue them after an appropriate transition period and the relevant purchasing Minister seeks funding through the Budget.

Discretion for expenditure in the "good corporate citizens" category lies with the GTE management. The test as to whether spending to meet social responsibilities is appropriate should be one of reasonableness. Some of the outcomes expected from such expenditure are a high level of staff motivation, high productivity and quality standards, and strong customer loyalty, all ultimately leading to improved financial performance. "Good corporate citizenship" expenditures can be assessed in terms of their success in achieving these outcomes and need to be balanced by the requirement to meet financial targets.

3.3.3 Commercial Price Discrimination

Commercial enterprises often offer concessions for a variety of groups such as children and senior citizens. These concessions are generally motivated by profit maximisation - managers hope that the positive effect on total revenue due to increased patronage will exceed the negative impact of reduced charges. Concessionary pricing is not, therefore, necessarily a non-commercial activity.

3.3.4 Demand Management

In the case of some GTEs which face increasing marginal costs of production, (ie the cost of the last unit produced is more than the average cost), the cheapest way of meeting increased demand may be through demand management. For example, it may pay to subsidise consumers to install water or energy-saving equipment. In these circumstances, demand management is not a CSO but is undertaken for purely commercial reasons. Demand management techniques have been extensively developed in the USA by privately owned utilities for commercial reasons (although it must be acknowledged that utility investment in demand management has often been heavily influenced by the regulatory framework in the US).

3.3.5 "Head Office" Requirements

The SP Policy needs to be understood within the context of the Government's "holding company model" for GTEs. This requires the Government to assume responsibilities analogous to the head office of a diversified group of subsidiaries. The head office will set down commercial policy requirements for subsidiaries, thereby discharging its responsibility to shareholders. The cost of such compliance is clearly a commercial activity and not a CSO. An example is financial management reporting to portfolio Ministers and the Treasurer.

3.4 NON-COMMERCIAL ACTIVITIES

Non-commercial activities may be assigned to four categories (the first three are referred to collectively as social programs):

- * Community Service Obligations;
- * Quasi-CSOs;
- * Community Services; and
- * Other Cost Impositions.

3.4.1 Community Service Obligations

To be proposed and approved as a CSO (ie a SP delivered by a GTE) an activity must satisfy the following criteria:

- * it would not be pursued by a GTE operating on a purely commercial basis;
- * it has a specified social objective;
- * there is an explicit Government directive to the GTE that the activity should be pursued; and
- * funding is from the Budget, or internal funding over the transitional period has been approved by the Treasurer.

The term "explicit Government directive" should be understood to include activities that are the logical result of explicit Government directives. It should also be noted that arrangements for internal funding will only be approved on a transitional basis. A CSO is, by definition, a SP that will be delivered by a GTE; were it to be contracted to the private sector (or indeed undertaken by a Government Department or non-profit organisation), it would not be a CSO, but a Budget funded social program.

3.4.2 Quasi-CSOs and Community Services

A non-commercial activity which fulfils the first three of the above criteria, but for which no funding arrangement has been made, is designated a "Quasi-CSO". A non-commercial activity which has a social objective but no explicit Government directive should be identified as a "Community Service". Quasi-CSOs and Community Services should be evaluated as SP proposals during the implementation period of the Policy. (The latter only if the GTE proposes that the activity should continue.)

3.4.3 Other Cost Impositions

The category "other cost impositions" is a residual classification. It captures any non-commercial activity for which there is an explicit Government directive to a particular GTE, or a significant unintended impact on a particular GTE of a general directive, which results in a cost disability relative to private sector organisations or GTEs in other jurisdictions, but which is unlikely to attract Budget funding.

The grounds for claiming a cost disadvantage due to Government ownership would appear to be fairly limited. As noted above, the costs of complying with regulatory requirements specific to

Government agencies will not normally be accepted as cost impositions for the purpose of the SP Policy.

In cases where cost impositions can be demonstrated, there may be a valid claim for their recognition for the purpose of performance monitoring. It is not envisaged that such cost impositions will be funded from the Budget in the future, unless needed to fund the continuation of operations in the form of a general operating subsidy.

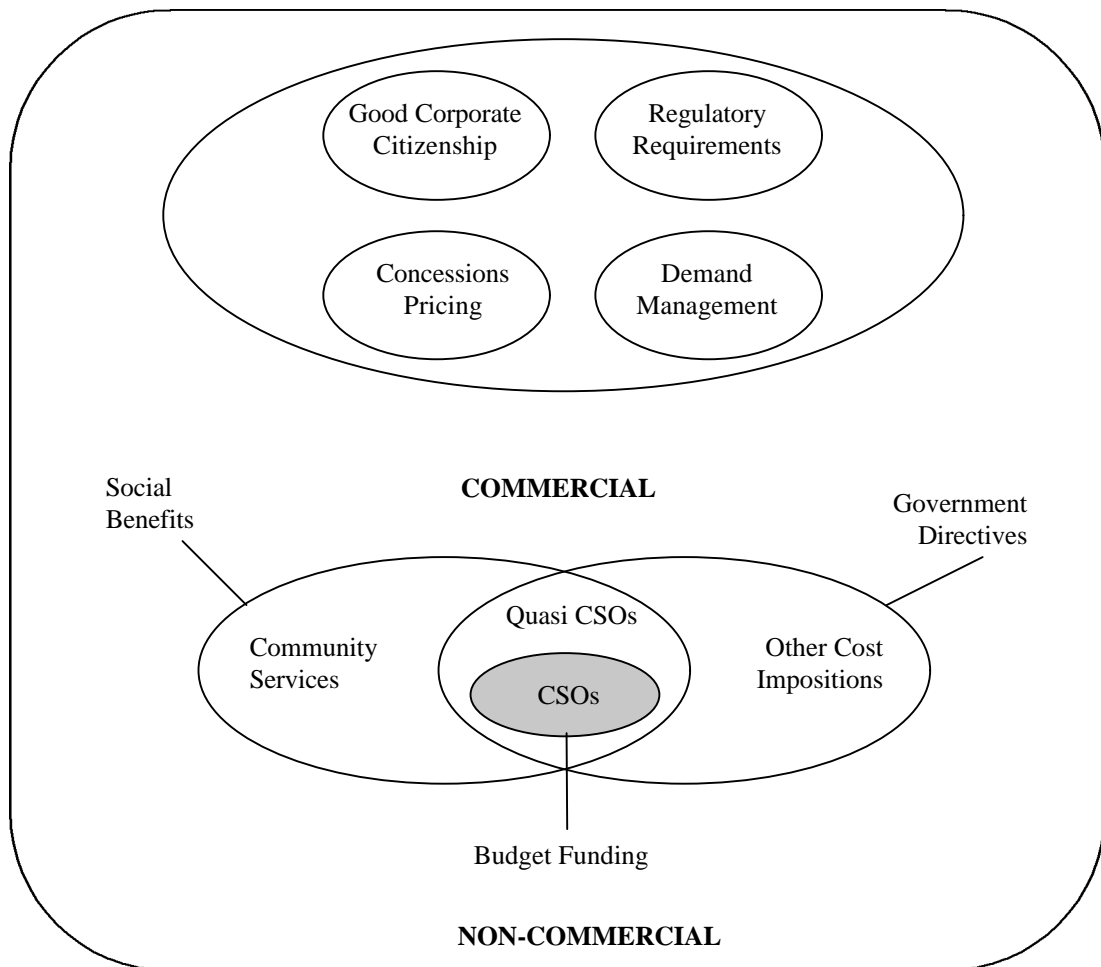
3.4.4 Imposition of Pricing Policies

There are a number of cases where pricing structures (as opposed to price levels) do not correctly reflect the underlying costs of service provision. For example, the relative charges for access and consumption of water or electricity may not reflect the relationship between the respective underlying costs. Pricing structures often have significant distributional consequences and could therefore be proposed as SPs if imposed by the Government.

Such cases would probably occur in monopoly industries, whose pricing would generally fall under the purview of the Government Pricing Tribunal (GPT), which is actively pursuing price reform. Because of the role of the GPT, the Government will not normally be issuing directions to GTEs in regard to policies on pricing monopoly services.

Claims by GTEs that existing subsidised services should be funded as SPs must be supported by a case demonstrating that pricing reform either falls outside the ambit of the GPT, or is unlikely to be achieved in a reasonable time. The portfolio Minister and the Treasurer may then give consideration to internal funding of this cost imposition.

**Figure 2 - Classification of GTE Activities
(Before Policy Implementation)**



Note that the set of commercial activities includes, of course, core business, but this is not shown as the intention is to highlight those activities which need to be distinguished from non-commercial activities.

3.5 SUMMARY OF DEFINITIONS

As illustrated in Figure 2, the activities of GTEs at present can be divided into commercial and non-commercial activities.

Within the category of commercial activities there will be some which may not seem to be commercial at first sight, but which on closer examination are justifiable on commercial grounds. Examples include expenditures such as good corporate citizenship activities, demand management activities, concessionary pricing and regulatory responsibilities.

CSOs are non-commercial activities of GTEs which are carried out pursuant to a Government directive, have a clear social benefit, and are funded from the Budget.

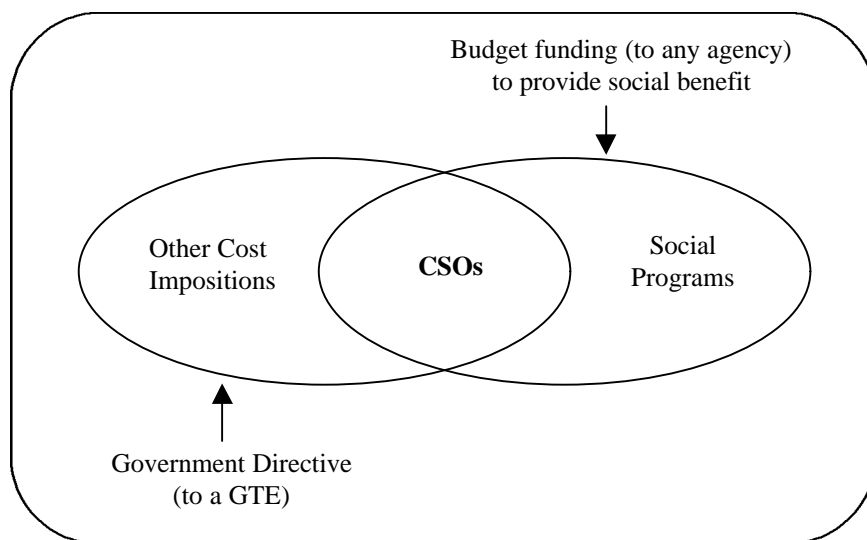
Activities that fail to meet the criterion of Budget funding are designated "Quasi-CSOs". Those which fail the test of having a Government directive, in addition to being unfunded, are

“community services”. These transitional categories are not expected to continue beyond the period leading to the full implementation of the Policy.

All Quasi-CSOs, Community Services and CSOs are referred to collectively as "Social Programs". Those Social Programs which, on full implementation of the policy, are no longer provided by GTEs may be distinguished from other social programs provided by Government only on the historical basis that they were previously delivered by a GTE.

After this transitional period, the division of non-commercial GTE activities will be as set out in Figure 3.

**Figure 3 - Non-Commercial Activities of GTEs & Other Agencies
After Policy Implementation**



3.6 CLASSIFICATION OF SPS AND CSOS

It is useful to identify types of SPs (and therefore CSOs) for purposes of exposition of the Policy in subsequent sections.

3.6.1 Classification by Costing Criteria

In regard to costing criteria, SPs can generally be classified into the following categories:

- * Subsidised Price Concession: Subsidised access to services that would otherwise be provided on a commercial basis; and
- * Subsidised Operation: A service that would not otherwise be provided on purely commercial grounds being provided free of charge, or for a charge that does not cover the cost of providing the service.

One can speak, somewhat loosely, of the first class as being a concession on the price of core services provided by GTE. The second class relates to additional activities that a GTE would not undertake at all except as a public service. The appropriate costing method will be different in each case. (See Section 4). It should be noted that the distinction between a subsidised price concession and a subsidised operation is not always clear.

3.6.2 Classification by Evaluation Criteria

SPs can also be divided into the following categories based on evaluation criteria:

- * SPs with specific benefits to individual clients: These can generally be evaluated using standard program evaluation techniques; and
- * SPs with general benefits to the community: These include both input disabilities, a requirement that a GTE use inputs of a particular type or from a particular source, and subsidies whose justification is based on externalities - for example, the general operating subsidy of the State Rail Authority (SRA). They cannot be directly assessed using program evaluation techniques but will generally require an evaluation from the perspective of a particular specialist discipline.

The above two categories are consumer goods. There are also:

- * Producer goods: The evaluation of activities that result in outputs that are used in the production process of another Government agency is a straightforward exercise in cost accounting.

These categories are illustrated with some examples in Table 1.

**Table 1 - Summary of Classification of SPs
With Examples**

	<i>Subsidised price concession</i>	<i>Subsidised operation</i>
<i>Specific benefits to individuals</i>	<i>Rebates on water and electricity charges</i>	<i>Uneconomic water and electricity lines</i>
<i>General benefits to community</i>	<i>General subsidies in transportation</i>	<i>Communications in remote areas</i>
<i>Producer goods (other Govt agencies)</i>	<i>Government properties exempt from utility charges</i>	<i>Roads provided by GTEs for other Government agencies</i>

The approach taken to evaluation of SPs will differ depending on the type of benefits involved. (See Section 5). Here again, there may be SPs which cannot be neatly placed into any of these categories, but have elements of each.

3.7 GENERAL OPERATING SUBSIDIES

The existence of externalities is a common justification for general operating subsidies. The intent of the Policy is to identify these externalities and to target the payment of the subsidy as effectively as possible.

An example is the operating subsidy paid to the State Rail Authority (SRA). There are clearly benefits to the community resulting from encouraging rail as an alternative to road (health, congestion, greenhouse, etc), but they are generally unquantified and unspecified. It may be possible to address these externalities more effectively by ensuring that subsidies to the SRA are targeted to address specified externalities. The subsidies can then be nominated for funding from the Budget as CSOs.

Untargeted general operating subsidies should be eliminated by the end of the transition period.
They cannot be funded as CSOs.

4. COSTING

Costing guidelines are needed to ensure the accurate reporting of SP costs. In addition, because all CSOs will ultimately be provided under contract, the costing guidelines will assist in the negotiation of contracts.

Where there is an alternative market for the particular product of the GTE that is the subject of a SP proposal, there is no need to enter into a discussion of appropriate costing methods. The appropriate measure is market value or opportunity cost. In most cases, however, market values will not be available and it will be necessary to use an alternative approach.

This Section outlines the principles which should be followed in costing SPs. Treasury will develop a detailed technical manual in consultation with GTEs which will draw on the results of a number of case studies.

GTEs are required to complete preliminary costing of proposed SPs for Stage 1 submissions (see Section 8) ie, before a decision is made about how the SP will be delivered and by which agency. Therefore, costing should be done on the assumption that the GTE will continue to deliver the SP in its current form, plus improvements which the GTE believes are necessary.

4.1 ALTERNATIVE COSTING METHODS

There are three different approaches to costing that should be used depending on circumstances:

- * Avoidable Costs: Those costs which would not be incurred if the activity were not undertaken. This is a practical adaptation of the concept of marginal cost. The concept of avoidable cost focuses on identifying all costs associated with the provision of an additional "block" of output (as opposed to an additional unit of output).

The "block" concept recognises the lumpy nature of cost functions. For example, the increased cost of a rail fare concession is only the ticketing cost until the capacity of an existing service is reached. Beyond that, the cost of an additional service must be met.

Avoidable costs are therefore a measure of the incremental costs over a given range of output. These costs include incremental operating costs, together with capital costs if there is a direct requirement for additional capacity associated with the activity. Joint costs, whether capital or operating costs, are included only if they would not otherwise have been incurred.

Fully Distributed Costs: This approach involves allocating the total costs of an enterprise to all the different activities that it undertakes, including joint or common costs not directly attributable to particular activities.

- * Forgone Revenue: This is simply the number of concession units of a service or product consumed, multiplied by the difference between the full price and the concession price. (For example, in the case of bus tickets, the forgone revenue would be the number of concession tickets sold multiplied by the difference between full and concession fares.)

Avoidable Cost Vs. Fully Distributed Cost

Costing SPs (especially those that may become CSOs) presents conceptual as well as practical problems; notably those of allocating joint costs - ie the cost of resources which contribute to the production of more than one product or service. These may include operating expenses as well as capital items.

*Subsidised Operations: If a GTE is directed by the Government to perform some extra activity that it does not already perform and would not be likely to perform in the future in the normal course of its commercial activities, the appropriate costing method is **avoidable cost**. In this case, none of the joint costs are allocated to the proposed CSO. The GTE should not expect to receive any compensation for the use of publicly owned assets which would otherwise have been idle. Nor should Budget Sector agencies be discouraged from finding ways of adding to the welfare of citizens by using idle resources where there is likely to be little or no extra cost to the public purse.*

Price Concessions: A price concession is defined as a reduction in the price charged to certain consumers of a core activity of a GTE - a "core activity" being a service which the GTE would have provided on a commercial basis in the absence of funding from the Budget though at a higher price.

*In many cases of price concessions, costing must clearly be on a **fully distributed** basis. Avoidable costing cannot be used, as it relies on the assumption that the joint input would be provided in any case. But this assumption is often wrong. In some areas of transport, for example, all activities are subsidised; there are no strictly commercial activities. In the absence of the various subsidies received by the passenger transport industry, many of the existing services would not be operating. So the cost of providing transport at concession fares is not just the marginal cost of ticketing. It must include a part of the cost of providing the transport service as well.*

Moreover, the use of avoidable costing for concessions on the price of core commercial activities would defeat one of the very purposes of the SP Policy: to improve the performance monitoring of GTEs by enhancing the comparability of performance statistics - over time within a given GTE, and across GTEs within the same industry.

If the avoidable cost method were applied to determining payments for proposed price concession CSOs, the profitability of a GTE would rise and fall with the introduction or the discontinuation of a CSO, and with every variation in the terms of the contract for a CSO. Meaningful comparisons of profitability over time would be impossible. In making comparisons across the industry, the profitability of a GTE would depend on the number of CSO beneficiaries it has in its client base. GTEs which provide few CSOs would appear to perform better than GTEs with many CSO clients.

The costing method should ensure that CSOs have no effect on the apparent performance of GTEs. This can be achieved by using avoidable costs for subsidised operations and fully distributed costs for price concessions.

4.1.1 Full Cost

Whatever method is used, the costing should reflect the full cost including an appropriate return on capital used (both equity and debt). The cost should also include a contribution towards additional overhead cost due to the requirement for a GTE to perform a CSO.

Margin to be Earned on CSOs

It has been suggested that GTEs should be permitted to earn a “profit” on the provision of CSOs, as there would otherwise be little incentive for commercially oriented GTE managements to give due attention to CSO clients. Since the policy requires a full costing of the proposed CSOs including the cost of capital (using the method appropriate to the circumstances), the issue of incentives being eroded does not arise. Under the costing principles outlined here, the return on CSO activities will be the same as the general return on the operations of the GTE as a whole. (Where capital is not employed, a normal economic profit should be included in the full cost using an appropriate margin such as return on sales or turnover.) Performance incentives should therefore be unaffected.

4.2 FORGONE REVENUE COSTING AND EFFICIENT COSTS

In principle, the pricing of proposed SPs (including CSOs) should be based on efficient costs (ie costs assuming that production is efficient based on industry benchmarks), and efficient pricing (ie where costs are appropriately allocated across products).

However, GTEs may not have efficient operations at present. The costing of proposed SPs must therefore recognise actual costs, in order to ensure that proposed SPs receive sufficient income to continue operations. As already stated, this Policy requires that all untargetted general operating subsidies be eliminated by the end of the transition period.

The Government Pricing Tribunal (GPT) is committed to benchmarking and assessing efficient costs in a number of important GTEs over the next few years. It would generally be an inappropriate duplication of effort to anticipate that exercise by estimating efficient costs at an earlier stage for the sole purpose of costing proposed CSOs. The GPT is also attempting to induce GTE management to achieve efficient costs over time, by putting pressure on prices.

The forgone revenue method of costing is therefore the best approach for costing proposed price concession CSOs in the short term. It does not require any extra information, and therefore significantly eases the compliance burden of the SP Policy.

Funding based on forgone revenue costing assures GTEs of sufficient income to continue meeting their various obligations in the short term. It also permits a gradual introduction of CSO prices based on efficient costs.

If GTEs are successful in achieving efficient costs, it is expected that, within a few years, forgone revenue costing will closely approximate the fully distributed cost of many proposed CSOs. (Providing, of course, that general price levels reflect efficient costs.) However, if there is insufficient progress towards the introduction of efficient prices by the GPT, it may be desirable at some later stage to require that efficient costs be used as the costing basis for CSOs, rather than the forgone revenue approach.

4.3 ADJUSTING FOR PRICE-ELASTICITY OF DEMAND

The cost of a price concession is the change in net revenue which would result from the introduction of a CSO. When calculating net revenue forgone one cannot, for example, simply multiply the number of concession tickets sold by the amount of the discount. In the absence of the concession, not all of those tickets would necessarily have been sold. In other words, there may be a significant "price-elasticity of demand". In cases where there is a decreasing marginal cost in providing a service, the simple calculation of forgone revenue may need to be reduced to take into account price-elasticity of demand. Concessions for off-peak travel are an obvious example.

In some cases, price-elasticity of demand is great enough (and marginal cost low enough) to result in an increase in net profit as a result of a price concession. In such a case, a price concession would be justified for purely commercial reasons.

Where an industry faces increasing marginal costs, the effect of price-elasticity is to increase the cost of a price concession. For example, a concession on the price of water in a metropolitan area may lead to an increased usage of water. Since the water must be brought into the city from ever greater distances the cost of the marginal litre is greater than the average cost per litre. The cost of a price concession must therefore be adjusted upwards to reflect the above average cost of the extra litres consumed by the beneficiaries of the concession. (The example abstracts from the problem of lumpiness of investment.)

In some cases, such as transport concessions to pensioners, there may be considerable price-elasticity of demand. If so, basing CSO payments simply on the number of tickets sold could result in a significant overpayment for CSOs during off-peak hours (when the marginal cost is low); and a significant underestimation of the cost of providing a concession during peak hours (when marginal cost is high).

Calculating the effect of a price concession on demand can be quite complicated, especially if no data is available on consumption patterns prior to the introduction of the subsidy. However, where large amounts of money are involved, it will be worth undertaking such an analysis if it appears likely that there is a significant price-elasticity of demand. A case-by-case approach may be necessary to address the issue of allocating joint costs.

Implications for Social Policy

The existence of price-elasticity of demand has implications for the use of CSOs as an effective instrument of social policy. A subsidised price concession may have a considerable attraction in cases where there is a significant price-elasticity of demand together with low marginal costs. If demand is elastic, the extra services consumed by the beneficiaries of the CSO may add significantly to their welfare at little additional public expense.

These benefits will occur if:

- * the marginal cost of production is low;*
- * beneficiaries respond to a lower price by consuming more of the service; and*
- * the pricing system is rational, with the concession price set at no less than the avoidable cost.*

Allocating Joint Costs

Having determined that fully distributed costing should be used to cost price concessions, the problem remains: exactly how should the joint costs be distributed? The short answer in economic terms is: in inverse proportion to the price-elasticity of demand. A common-sense English translation of this economic jargon is that each product should absorb as much of the joint cost as demand can bear.

For example, the beef cattle industry has two major outputs - meat and hides. The price of the meat and the price of the hide taken together must be sufficient to cover the cost of rearing a beast and producing the end products (as well as providing a return on investment and risk sufficient to ensure the continuation of the industry).

However, at various times and places, the relative prices of the meat and hides have varied tremendously, depending on the supply and demand for each of these end-products. In densely settled countries the meat tends to be relatively more valuable -and therefore bears more of the production cost. The demand for hides - which are more easily transported - can be catered for from distant sources of production. At the other extreme buffalo in the Northern Territory were, until recently, slaughtered for their hides alone, the meat being discarded because it was worthless for lack of local demand or of transportation to distant markets.

In the case of a competitive market, the relative prices of joint products are set by the market. Even for a monopoly producer, the market has a significant role to play. If a single company had a monopoly on the beef cattle industry and a mandate from Government to charge just enough to return a normal profit on the Government's investment (and not to waste any product), it would set the prices of beef and hides at levels that would clear the market whilst covering costs.

If the price of meat were too high relative to the price of hides, there would be a surplus of meat and a shortage of hides. The company would then adjust the prices to ensure that the demand and supply were in balance. Through this process of adjustment (assuming that the monopolist is an efficient producer) one would arrive at the same prices - and the same implicit allocation of joint costs - as a competitive industry in a free market.

While the above argument provides a satisfying theoretical resolution to the problem, it may not always be terribly helpful in practice. In costing actual CSOs there will be many situations where it will not be possible to ascertain what the demand for the service would be if there were no price concession. It will, more often than not, be necessary to accept an arbitrary element in allocating joint costs.

4.3.1 Separating CSOs Based on Cost Structure

A SP may have very different cost implications in different circumstances. If so, different parts of the SP should be treated as separate programs for the purposes of costing and evaluating.

For example, in the case of a transport fare concession, the cost-benefit balance may be totally different during peak hours than in the off-peak hours. To ensure transparency, costs should always be reported in a sufficiently disaggregated form to enable both policy-makers and the public to evaluate the merits of each part of the program.

4.4 COSTING METHOD TO BE USED

Subsidised operations should be costed using the avoidable cost method.

Price concessions should ultimately be costed based on fully distributed **efficient** costs (adjusted, if appropriate, for additional demand generated by the lower price - see Section 4.3).

However, as discussed in Section 4.2, requiring the immediate introduction of fully distributed costing would have a number of disadvantages, including a significantly greater compliance burden and the need to fund the continued operations of inefficient GTEs.

It is therefore expected that the forgone revenue approach will generally be the best available costing method for price concessions over the implementation period of the Policy. As GTEs improve both the efficiency of their operations and of their pricing structures, costs based on forgone revenues will gradually approach fully distributed efficient costs.

4.4.1 Need for Flexibility

There must be flexibility in costing for a number of reasons:

- * while there is a theoretical justification for using different costing methods, either fully distributed costs and avoidable costs in different circumstances, in many cases the actual difference between results from either approach will be minimal;
- * the distinction between price concessions and subsidised operations is not always clear; and
- * the cost of gathering the data required to estimate costs may not be justified in the case of some smaller SPs.

A more detailed treatment of this issue will be outlined in the technical manual mentioned above.

5. EVALUATION

Program evaluation is an important tool used to assess social programs. It generally starts from the premise that the Government wishes to achieve certain objectives. A program is then designed to deliver these objectives. However, proposed CSOs or SPs will be existing programs within GTEs for which Budget Sector funding will be sought. This means that the preliminary work in describing proposed SPs will have to be done by GTEs, on behalf of their portfolio Ministers.

It will be the responsibility of Ministers, through their portfolio Ministries or Departments, to assess proposed SPs and then seek funding through the Budget process.

This section provides some guidance on the alternatives available for the delivery of SPs and criteria that may be applied to evaluating proposals. This process involves essentially four steps:

- * defining clearly the desired social objectives;
- * identifying program design alternatives to meet objectives;
- * identifying alternative delivery options; and
- * applying evaluation criteria to analyse both design and available delivery options.

5.1 CLARITY OF SOCIAL OBJECTIVES

Clarity of social objectives is an essential starting point for any review or evaluation of a social policy program. The precise policy objectives need to be established so that alternative methods of achieving them may be identified and examined. In addition, wherever possible, policy objectives should be specific about the groups targeted for the provision of benefits or services.

As noted previously, the development of social policy objectives will often require co-ordination on a cross-portfolio basis. The application of program review or evaluation techniques that require clearly stated objectives will assist in achieving such co-ordination.

5.2 ALTERNATIVES IN PROGRAM DESIGN

Once a social need and prospective program beneficiaries have been identified, there are generally a number of alternatives to be considered in program design. For example, if the immediate policy objective is to assist low income households to manage their energy bills, there would seem to be a number of program alternatives:

- * subsidise energy costs directly through rebates on accounts to target households;
- * provide advice on energy consumption patterns and conservation options;
- * subsidise the installation of more energy efficient appliances; and
- * subsidise improvements to the energy efficiency of the housing stock; eg by retro-fitting insulation and weather stripping.

Equity Vs. Income Supplementation

A real problem arises in regard to clarity of objectives in the area of "equity" in pricing GTE services. Many potential CSOs are price concessions for certain classes of customers. If these potential CSOs are to be brought into the Budget, some basic principles will have to be developed to guide decisions as to when price concessions are appropriate.

There are strong arguments for universal access to a number of the services provided by Governments which may be regarded as basic entitlements for all members of society. Examples include a certain level of health care and education, a guaranteed minimum income level and legal assistance to redress wrongs. The term often used to address the issue of what rights citizens have to such services is "equity".

When this term and the associated concepts are extended to more basic products like water and electricity the notion of "equity" becomes less clear. For example; is access to utility services any more essential than food, housing, or clothing? Arguments for "equitable" pricing are often really about income supplementation.

The best approach to "equity" in this context may simply be to give beneficiaries more money, so that they can decide for themselves what they need most. A pensioner may prefer to buy a woolly jumper rather than have subsidised heating, or perhaps choose to eat at the RSL Club rather than using subsidised power to cook at home.

If a case is made for subsidies rather than direct payments, subsidies of goods provided by the private sector should be considered on the same basis as those provided by the Public sector. There is no particular reason why the State should subsidise precisely those services which happen to be provided by GTEs.

5.3 BASIC FRAMEWORK OF PROGRAM EVALUATION

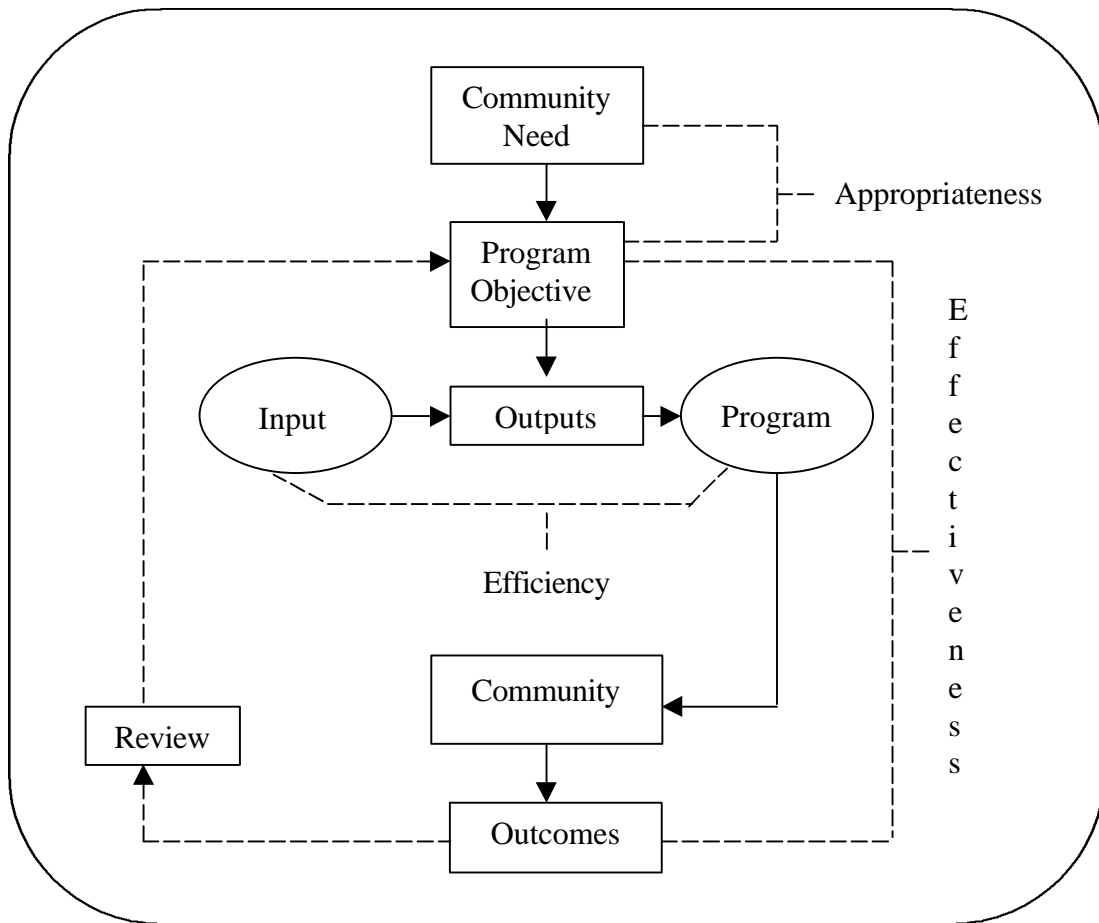
The key concepts of program evaluation (Figure 4) are:

- * **Appropriateness**: Whether the objectives or outcomes of the program reflect real needs in the community and are consistent with the Government's priorities.
- * **Effectiveness**: Whether the program achieves its stated objectives.
- * **Efficiency**: Achieving the maximum outputs for a given level of inputs.

As discussed in Section 5.6, program evaluation should address any significant consequences of a program, unintended as well as planned, including impacts on health, public amenity and costs to other Government agencies, among other things.

There is a well-developed literature on program evaluation that should inform the review and evaluation processes for SP proposals.

Figure 4 – Program Evaluation Concepts



5.4 THE ROLE OF PROGRAM EVALUATION IN THE BUDGET PROCESS

There are unlimited calls on the Government's limited funds. Effective use of program evaluation techniques should assist the Government to prioritise spending. This will generally require the translation of benefits into monetary terms.

It is expected that the increasing use of program evaluation together with effective prioritisation will lead to significant improvements in the management of the Budget process and result in better social outcomes.

5.5 SOCIAL PROGRAMS WITH GENERAL BENEFITS

Some SPs may have benefits to the community as a whole, such as general price concessions and operating subsidies designed to address specific externalities.

SPs in this class cannot be evaluated solely within the framework of program evaluation. They will have to be evaluated *ad hoc*; for example, as problems in regional or urban economics, or within some other discipline. There will, however, be some basic structuring of information and evaluation outputs which can be common to all SPs and CSOs.

Valuing Welfare Outcomes

There are frequently objections to assigning monetary values to social outcomes on the grounds that this is either morally repugnant, or that it tends to pervert programs to address only outcomes that are readily measurable.

In the past, controversy regarding the valuation of social welfare outcomes has often prevented the adoption of valuation techniques for programs. This does not mean that such valuations were actually avoided. All it means is that the social policy maker avoids taking responsibility for them. Rather than valuation and prioritisation being carried out in a considered way by an expert in the area, it is then done by default as part of the Budget process.

Once any program is proposed the Government will implicitly value the outcomes by its decision to either fund the program or not. It makes sense to attempt to develop a more consistent basis for these implicit valuations.

The answer to the second objection is that it is surely better to have programs that effectively address some objectives than programs that are based entirely on subjective criteria.

5.6 EXTERNALITIES

Evaluation should examine not only the direct costs associated with a SP, but also other costs and benefits to:

- * The GTE: In many networks increased activity in one area provides system benefits. For example, additional bus passengers on a route that would not be commercial by itself may feed other lines, whose revenues are thereby enhanced.
- * State Government: Decisions in one area of Government may have cost implications for other Government agencies. For example, a poor public transit system may lead to increased road traffic, which imposes other costs on Government. One obvious effect would be pressure for increased road and bridge funding. Less obvious impacts include greater investments required in water, sewerage, electrical reticulation and a range of other public services due to the reduced density of the city.
- * Society in general: A Government service may have wider impacts on society as a whole, direct and indirect. Encouraging people to ride buses may lead to a reduction in air pollution and the associated costs of increased corrosion, health care and so on. There are also other important non-monetary costs associated with air pollution such as the negative impact on the enjoyment of fresh air and reduced health.

There is also a more difficult class of externalities where there is a very general economic benefit to the community as a whole. Education, for example, benefits not only pupils but the nation. The same may be true of some communications infrastructure.

Many general operating subsidies have traditionally been based upon a perceived, though perhaps poorly expressed, need to address externalities. This is an inadequate basis for spending public funds. Externalities should be analysed and costed as accurately as possible, given the available information, and well-targetted SPs developed to address them effectively.

6. FUNDING

The starting point for considering whether to fund a SP from the Budget is the outcome of the review of proposed SPs by the portfolio, and the purchasing, Minister. If the outcome of the review is a decision to continue the program, funding must be sought through the Budget process as with any other Budget expenditure. This applies whether the program is to be delivered through the GTE or through some other agency.

Proposed SPs that are not funded from the current Budget will be dealt with as program enhancements. Should proposed SPs require capital funding, these costs (together with the required rate of return) should be included in SP submissions. The process will be completed by the issue of Budget allocations by the Treasurer.

Proposed SPs which were funded from the Budget prior to the implementation of this policy, will have to be treated as Budget Sector programs, funded through an appropriate purchasing Minister and subject to the same scrutiny as other Budget Sector programs. Direct funding from Treasury will no longer be available.

6.1 ADVANTAGES OF BUDGET FUNDING

Direct Budget funding has a number of advantages including:

- * **Transparency:** Full and clear disclosure of CSO funding (via the Government's Budget Papers) to facilitate Parliamentary and public scrutiny in the light of competing claims on State resources for other social objectives.
- * **Accountability:** By determining specific objectives, assigning clear responsibility for delivering SPs, obtaining Parliamentary funding approval and ensuring performance monitoring; accountability to Parliament and the public for the non-commercial activities of GTEs is enhanced.
- * **Clarity of Management Focus:** The separation of commercial and social objectives will allow the GTE to focus on its commercial operations and the achievement of financial targets. Commercial and social objectives can therefore be pursued separately without compromising each other.
- * **Equity:** The cost of CSO provision can be spread over all State taxpayers and consumers of GTE services; rather than one group of customers subsidising another simply because the GTE happens to be a convenient means of delivery for the social policy program.
- * **Efficiency in Pricing:** GTEs will be able to set prices on a commercial basis, without being influenced by the need to fund cross-subsidies.

6.2 FUNDING METHODS

The available funding methods are:

- * direct funding through Budget allocations; or
- * indirect or continued internal funding through cross subsidies. (Note that indirect funding still has a direct cost to the Budget through reduced financial distributions.)

CSO Funding Impacts On Budget

While rates of return can be adjusted to allow for avoidable operating costs and capital assets employed (thus satisfying performance monitoring requirements), the achievement of a revenue neutral impact on the Budget under both direct and indirect funding methods warrants further examination. The example below illustrates these impacts for a CSO costing \$100 million, (in a GTE with no debt and a margin for normal profit of 10% per annum).

	CSO with Direct Budget Funding \$m	CSO with Internal GTE Funding \$m
Commercial Revenue	1,000	1,000
CSO Payment	<u>110</u>	<u>-</u>
Total Revenue	1,110	1,000
Commercial Operating Expenses	800	800
CSO Expenses	<u>100</u>	<u>100</u>
<u>Total Costs</u>	900	900
Profit	210	100
Distribution to Government*	147	70
Less CSO Subsidy	<u>110</u>	<u>0</u>
Net gain to Budget	+37	+70

*** Distribution basis assumed: 70% pre-tax.**

It can be seen that, given a CSO cost of \$100m that is currently internally funded by a GTE, a move to direct Budget funding would result in a net additional cost to the Budget of \$33m because, assuming that the distribution basis is unchanged, the GTE's retained earnings increase. However, because the capacity of a GTE to make net payments to the Government is unaffected by the method of funding there is a case for the payout ratio to be adjusted in the direct funding case, so that net payments are unaffected by the method of funding.

Note: The above illustrates a case where the provision of the CSO does not require any additional capital.

6.2.1 Direct Funding

The preferred method of direct funding involves an annual Parliamentary allocation from Consolidated revenue to a purchasing Minister for the budgeted cost of CSOs provided by a GTE. Payments to the GTE will be in accordance with contract provisions. Where separate GTE portfolio and purchasing Ministers are involved, funds will need to be transferred to the portfolio Minister to make contract payments under agreed funding arrangements.

6.2.2 Indirect Funding

There will be a transitional period when the Treasurer may determine that a SP which has not been allocated funding through the Budget process, ie it is a Quasi-CSO, must continue to be funded internally.

In such cases, the GTE will be notionally compensated for the contract cost of a Quasi-CSO by imputing this cost as a revenue for purposes of evaluating financial performance. The revenue forgone through internal funding of the Quasi-CSO will therefore be taken into account for purposes of comparative performance either with other GTEs or benchmark rates of return. However, it should be noted that rate of return targets in the Statement of Financial Performance provided for in the Government's Financial Distribution Policy may be expressed either on a before or after SP basis and provided that this is done consistently, no adjustment to rate of return targets is required as a consequence of indirect funding.

7. CONTRACTING

This section is largely concerned with applying existing Government policies to the special circumstances of proposed SPs. It also provides some guidance for contracting proposed SPs and particularly proposed CSOs.

The relationship between the purchasing Minister and the GTE is that of purchaser and producer. Under the Policy, the services provided by GTEs and purchased by the Budget Sector, should be provided under commercial contracts. There are, however, certain respects in which contracts with GTEs must be treated differently from contracts with the private sector, as discussed below.

7.1 PARTIES TO CONTRACTS

Contracts should be written between a GTE and the portfolio Minister. In the context of the SP Policy, an explicit contract between a purchasing Minister who is not the portfolio Minister and a GTE is inappropriate because the GTE is primarily accountable to the portfolio Minister for its performance. Where a CSO contract exists, the portfolio Minister would then also be responsible for ensuring the contract performance specification is met. This accountability relationship suggests that the portfolio Minister should issue directions with respect to CSOs. However, the purchasing Minister will need to be satisfied with the terms of the contract to ensure that the program produces social outcomes in accordance with objectives.

The alternative model, where agencies negotiate directly with each other, is sometimes seen in private sector internal procurement arrangements. However, it is inappropriate for the public sector since GTEs generally have a degree of monopoly power that would give them an unfair advantage in negotiations. For this reason, it is appropriate that the Government retain the right to direct the GTE to perform a service at a specified price even though this may ensure that contract negotiations are unequal.

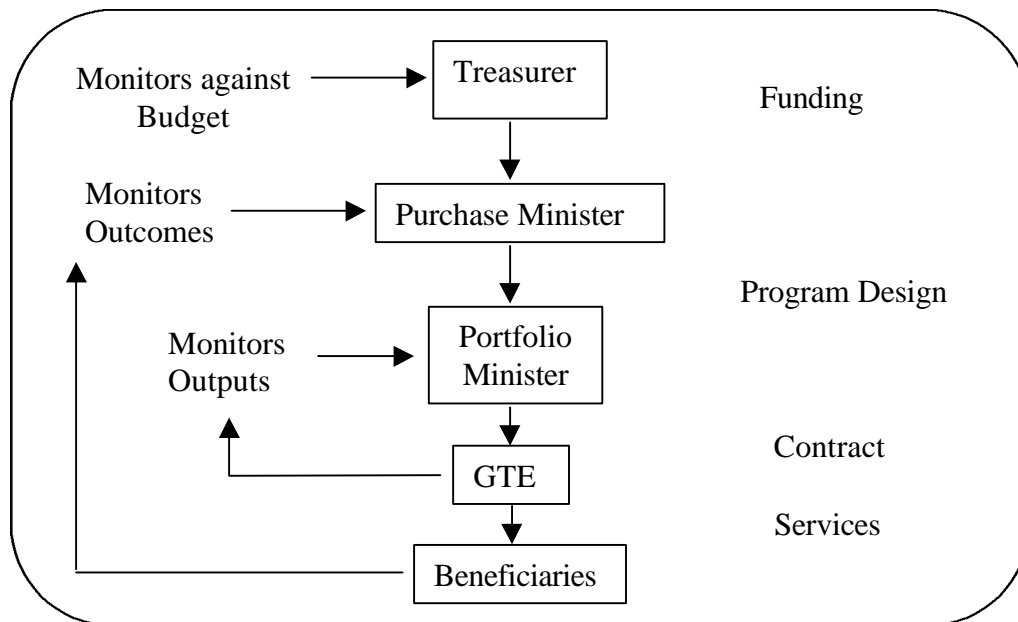
The portfolio Minister will be responsible for ensuring that delivery, performance and quality criteria are met. The purchasing Minister will be responsible for the appropriateness of policy objectives, the achievement of policy outcomes and for implementing funding arrangements with the portfolio Minister.

7.2 ESTABLISHING CSO CONTRACTS

Ministers (or their delegates) need to establish a mechanism that aims to ensure that the GTE, as the service provider, has appropriate incentives to deliver services that meet their requirements. An explicit contract should ensure that, on the one hand, the Minister avoids the problems of poor specification and open-ended commitments; while on the other hand, GTEs are adequately compensated.

Contracts should fulfil the normal criteria dictated by prudent financial management. Treasury will develop a technical paper on contracting which will draw on the results of case studies to be conducted jointly with GTEs. A brief outline of the likely process follows.

Figure 5 – Contracting for CSOs



7.2.1 Pricing of CSOs

The costing methodology developed in Section 4 should form the basis for the negotiation of contract prices for SPs, but it will only be a starting point. Prices should be subject to negotiation along with other contract terms. A thorough knowledge of CSO and SP costs is essential, particularly in the absence of competitive tendering or if long-term contracts are contemplated. The adequacy of costing methodologies will need to be demonstrated. Where available, benchmark or best practice costs should provide a basis for negotiation. Long term contracts should allow for efficiency gains.

In the event that agreement on CSO prices cannot be reached, the Minister may appoint a suitably qualified independent arbiter. Final determination where agreement is not reached with GTEs will be made by the Treasurer. (The State Owned Corporations Act 1989 provides for the determination of a price by an independent person nominated by the Premier.)

7.2.2 Form of Contract

The form of the contract determined by the Minister (or Ministers) will depend on the risks and amounts of funding involved. There will be a trade-off between costs involved in detailed documentation or legal formality on the one hand, and administrative simplicity on the other. As a minimum, a written service agreement including the following information will be required:

- * specification of services to be provided, including scale, quality, etc;
- * financial arrangements, including contract price and agreed provision for variations;

- * roles and responsibilities of client and service provider;
- * contract period and timing of deliverables, contract milestones, etc;
- * arrangements for performance monitoring and evaluation - which will be facilitated by the development of measures of efficiency and effectiveness. (Arrangements should include output and outcome information which can be linked to inputs.); and
- * accounting, reporting and communication arrangements.

Why Regulate the Pricing of CSOs?

The reasons for regulating CSO pricing by monopoly GTEs are exactly, the same as the reasons for regulating prices charged to consumers. If GTEs were permitted to negotiate freely the price of CSOs with other Government agencies they would, in many cases, be in a position to exploit their monopoly power to demand a price that would give them an extraordinary profit. Extraordinary profits by a GTE on the provision of CSOs would derive solely from its position as a monopoly supplier, which is due to the investment of public money by the Government and/or the enactment of regulations restricting private sector competition.

The regulation of monopoly sales to the public counter-balances these monopoly powers. The SP Policy will have the same role in the internal procurement of CSO services from GTEs by other Government agencies.

As the purchaser and producer are both branches of Government there is no equity issue as such, but pricing is an important factor in effectively monitoring GTE performance. Allowing GTE managers to exploit their monopoly powers to improve apparent financial performance would have adverse implications for performance monitoring as it could disguise a deterioration in underlying financial performance. This problem is underscored by the observation that the performance of the GTE would vary according to the number of CSOs it was required to provide.

More important are the implications for the allocation of resources. If a GTE were to charge another Government agency more than the cost of a CSO on one isolated occasion the net cost to the Government would be nil. The additional cost to the purchaser would be offset by additional dividends from the GTE, and/or a net increase in shareholders' funds in the GTE. The importance of internal pricing, however, is as a signal for resource allocation. Overcharging by a GTE would inevitably lead to the under-utilisation by other Government agencies of the GTE's resources, and consequently an inferior welfare outcome for the people of New South Wales.

7.2.3 Transaction Costs

While effective contract arrangements will need to be established for SPs, it is important to avoid costly contract negotiations and administrative arrangements. To this end, consideration will need to be given to the way SPs may be "packaged" under a single contract.

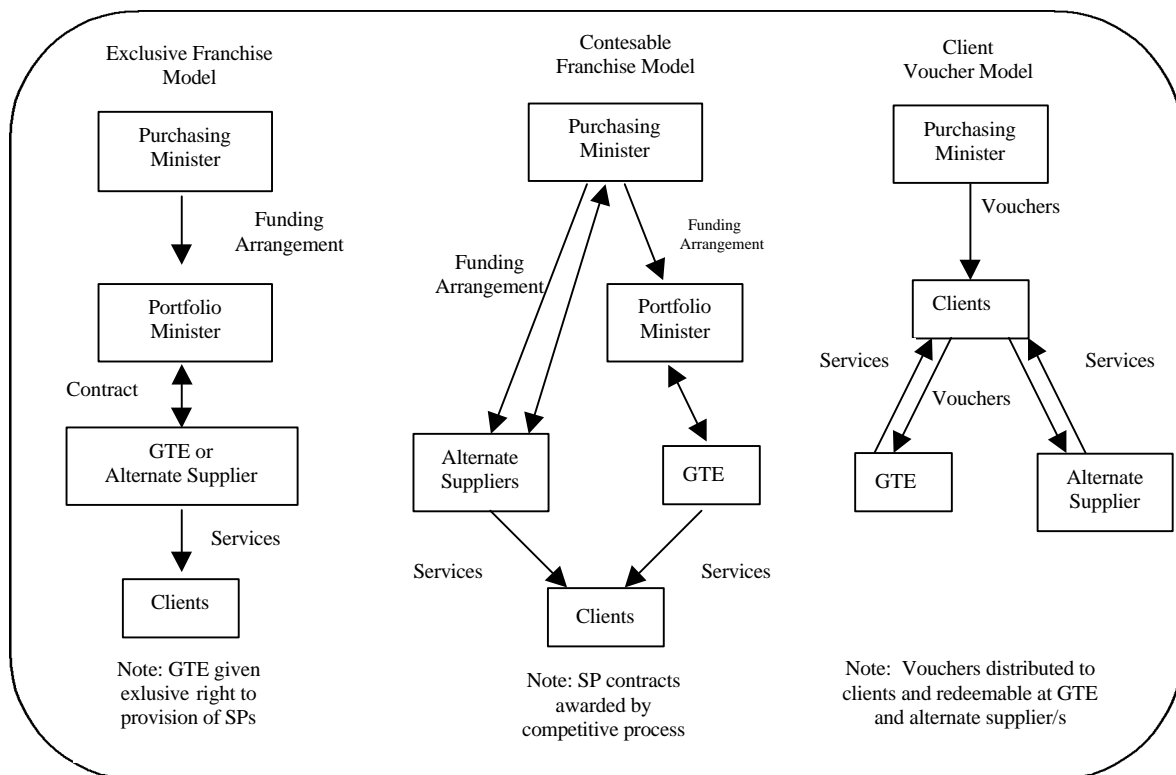
7.3 PROCUREMENT OPTIONS

There are a number of ways for Budget Sector agencies to provide services, including producing them within the agency; contracting with GTEs; contracting out to the private sector or charitable organisations; or funding through vouchers that may be redeemed by a number of providers. The procurement decision is closely tied to program design and internal management structure.

An analysis of procurement options should be prepared as part of the program evaluation process, (except where the cost of such evaluation is clearly not warranted by the circumstances). This evaluation should not be confined purely to cost criteria, but should also address other relevant factors such as: dependability of supply, security, financial impacts on the rest of Government and economic and social impact on the community. The issues examined at this stage will, of course, be precisely those which must be dealt with in a supply contract.

It is in the overall interest of the State for preference to be given to "internal procurement" or contracting with the GTE, especially if the GTE has spare capacity. The GTE would, of course, be expected to show sound commercial judgment by offering a price which, together with a guarantee of service, is calculated to win the business of the purchasing agency.

Figure 6 - Alternative SP Delivery Mechanisms



Note - A comprehensive analysis of alternative program delivery options is presented in the book by David Osborne and Ted Gaebler: "Re-inventing Government - How the Entrepreneurial Spirit is Transforming the Public Sector".

It is important to be conscious of the fact that the move towards contracting out has profound implications not only for procurement practices but also for many other areas of management. Many Government agencies will either have to develop new skills or rely on centralised procurement expertise (the Commercial Services Group, for example). However, contracting presents many opportunities to improve service delivery.

The Client Role in Long Term Supply Relationships

In many cases, contracts for CSOs will have to be over a period long enough to justify the maintenance of a certain level of capital equipment, and the investment in establishing systems to deliver the CSO. This will imply a need for some Budget Sector agencies and GTEs to learn a range of new skills,

Many agencies have not in the past been accustomed to establishing long term supply relationships, which must be handled rather differently to one-off purchases. Successful long term supply relationships generally involve very close co-operation between supplier and client. Often this means that the supplier will reveal, and the client will take pains to understand, financial details such as the cost structure of services contracted for, together with the implications for other operations of the supplier. Such relationships are normal in industries like the automotive sector which demand close co-operation both in manufacturing and in product development. Managers in the automotive sector speak of this co-operation as "team building".

In the case of CSO contracts, where both sides have the same owner, there should be far less justification for one side to withhold information or to seek to protect its business interests in transactions between unrelated parties. Co-operation should be correspondingly closer.

In a long-term supply relationship, it may be appropriate to re-negotiate terms over the course of a contract. The ability to re-negotiate reduces risks to the supplier and allows for flexibility in program development.

Existing purchasing practices of Government agencies are focused primarily on preventing corruption. It will take some time to enhance the existing procedures in order to enable long term supply relationships to be established.

8. IMPLEMENTATION

The Policy will be implemented over a five year transition period. Within two years (ie, by the 1995-96 Budget Cycle), all existing non-commercial activities of GTEs must be identified, costed, evaluated and reported as proposed SPs. However, they will continue to receive transitional funding after the end of this period. Within five years (ie by the 1998-99 Budget Cycle), all non-commercial activities must be contracted and either funded from the Budget or discontinued (except in special circumstances as discussed in Section 3.4).

There will be consultation with client groups and other stakeholders throughout the various stages of implementation.

For proposed new SPs the process will be exactly the same as for any other program for which Budget funding is sought. There is, therefore, no need to outline the procedures in this document.

8.1 OVERVIEW OF THE REVIEW PROCESS

For existing non-commercial activities the implementation process will need to be initiated by GTEs. The key steps in the Review process are illustrated in Figure 7 and outlined below. The review process will essentially consist of two stages (it is emphasised that Stage II processes are indicative only and will be subject to separate approval by Cabinet following completion and review of Stage I):

Stage I Identification; Preliminary Costing & Evaluation:

- * review by GTE of all activities, identification of commercial and non-commercial activities, and nomination and description of proposed SPs including preliminary costing;
- * review by portfolio Minister;
- * submission to Treasury and consideration by the Expenditure Review Committee of Cabinet (ERC) to determine whether proposed SPs are consistent with the Policy and if so, the requirements for any Stage II review;
- * inclusion of proposed SPs (including CSOs, Quasi-CSOs, and Community Services) in annual reports; and
- * a submission by portfolio Minister to the Treasurer for transitional funding as part of an agreed transition program for the 1995-96 Budget.

Stage II Final Costing and Evaluation; Contracting and Funding:

It is emphasised that Stage II will only proceed subject to consideration by Cabinet of the results of Stage I implementation. The key steps are likely to include:

- * review of SP proposals by purchasing Minister;
- * specification of program objectives, outputs, and beneficiaries by purchasing Minister;
- * re-design of the program by relevant Minister or Ministers;
- * submission by the Treasurer of the consolidated SP proposals to the ERC;
- * submission of proposals for Budget funding; and
- * negotiation of contract with GTE by portfolio Minister.

It is expected that all Stage I activities in respect of existing non-commercial activities of GTEs will be completed by the end of the 1995-96 Budget cycle.

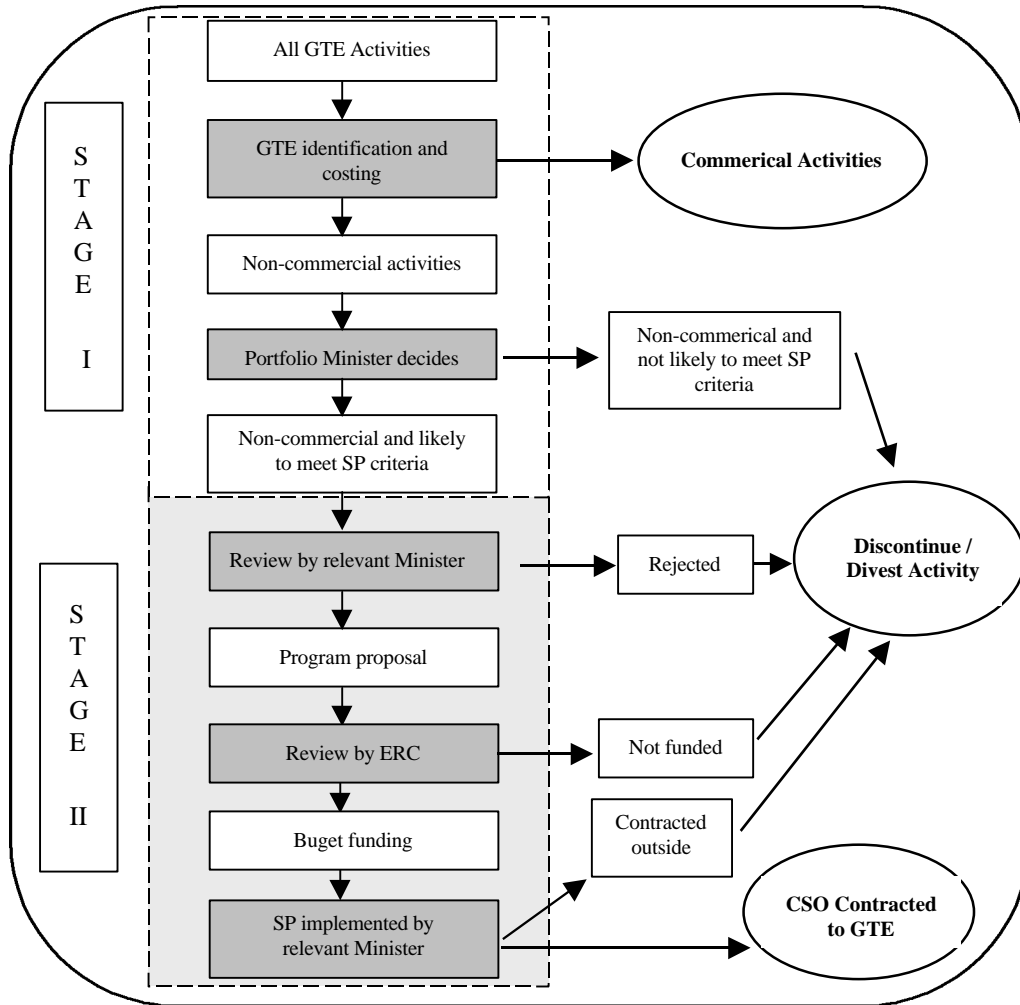
Only those proposals where sufficient preparatory work has been done are likely to have the review process outlined for Stage I completed in the 1994-95 Budget cycle. Most proposals will therefore be submitted in the 1995-96 Budget cycle and transitional funding arrangements are likely to be required in most cases.

It must be stressed that the timing and scope of the review process in each case will be decided by relevant Ministers having regard to their administrative and policy priorities. A considerable degree of flexibility will be required in the way reviews are undertaken, particularly with respect to Stage II activities.

It is desirable to bring proposed SPs within the Budget process as quickly as possible. However, it is important to avoid forcing the pace of change, because if insufficient time is given to evaluate activities, some which are inappropriate may be funded from the Budget as SPs.

Many areas of social policy in New South Wales are currently under review and there is a growing emphasis on cross-portfolio co-ordination. Within this context, it is expected that the introduction of the Policy will result in a more comprehensive examination of the needs of existing SP beneficiaries in particular and social policy needs in general. This process of review and development of social policy will take time. The transitional funding arrangements are intended to allow the necessary time for policy development, while maintaining the discipline of a fixed target date to achieve transparent funding and more accountable reporting for non-commercial activities of GTEs.

Figure 7 - Overview of SP Review Procedure



8.2 REVIEW PROCESS - STAGE I

8.2.1 Identification and Costing of SPs by GTEs

GTEs should review all activities, separating commercial and non-commercial activities, and identifying and costing all proposed SPs. Details of potential SPs and other non-commercial activities, as well as classification and evaluation data, should be provided both to the portfolio Minister and to the Treasurer.

GTEs will also need to collect the information required for a more thorough evaluation by prospective purchasing Ministers as specified in a checklist prepared by Treasury and circulated to GTEs. Treasury's SP Policy Unit will be available to assist in this area.

8.2.2 Review by Portfolio Minister

The Minister responsible for each GTE will review the list of SP proposals provided by the GTE, and will decide which of them appear likely to be maintained by the Government and attract funding from the Budget. The portfolio Minister will also need to assess whether the proposals relate to activities that should more appropriately be regarded as commercial, and the financial impact on rate of return targets of these being continued. The portfolio Minister will provide a submission on proposed SPs to the Treasurer.

8.2.3 Approval of SPs

The Treasurer will submit the consolidated SP proposals to the Expenditure Review Committee (ERC) of Cabinet and will identify which programs are currently funded from the Budget. The ERC will determine whether the proposed SPs are consistent with the Policy and if so, the requirements for any Stage II review.

8.2.4 Deciding on Further Action

If it appears that a non-commercial activity will not be classed as a SP and will not attract Budget funding as a CSO, the portfolio Minister will direct the GTE to discontinue the activity. If appropriate, the activity can be phased out over a period of time, provided that the approval of the Treasurer is sought for funding beyond the 1995-96 Budget Cycle.

If there is a Government directive to the GTE to carry on an unfunded activity, it will be the responsibility of the portfolio Minister to revoke this directive, or to secure its revocation by the relevant authority.

8.3 REVIEW PROCESS - STAGE II

8.3.1 Review by Purchasing Minister

Following review of Stage I implementation by Cabinet (and provided that the Government decides to implement Stage II as proposed), the ERC may re-assign policy responsibility for some proposed SPs to appropriate Ministers.

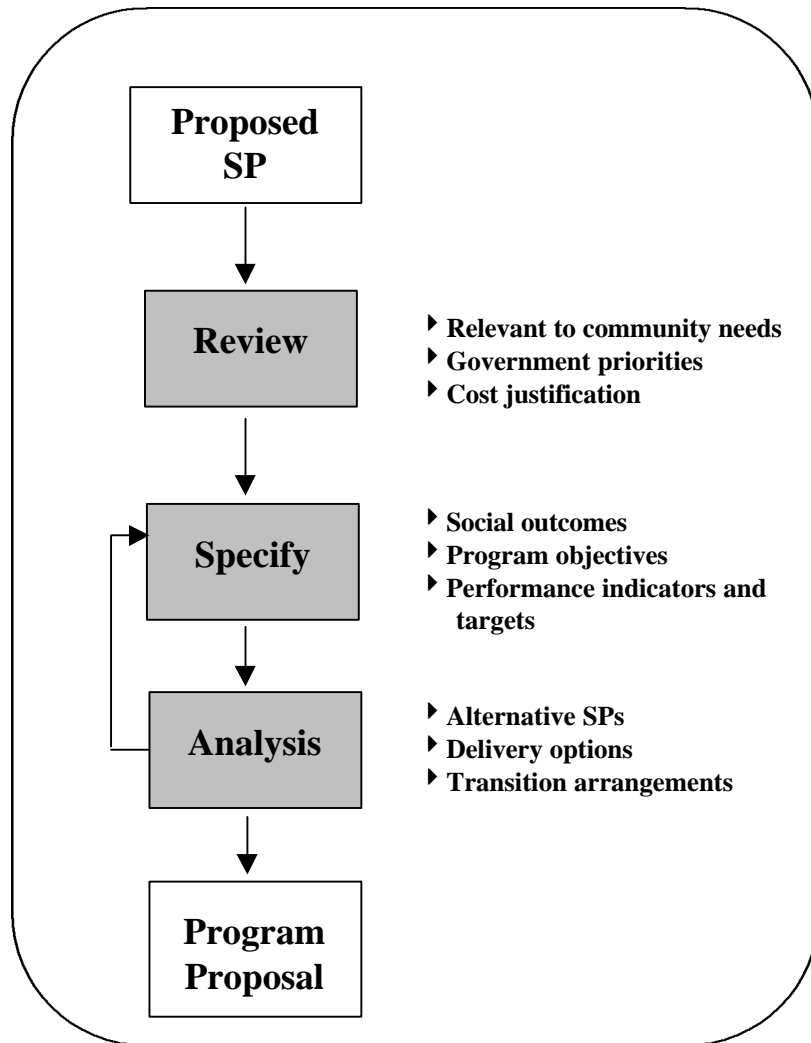
In Stage II the Treasurer will confer with the relevant Ministers to determine how SP proposals will be handled: either through further review and immediate submission for Budget funding; transitional funding while the program is evaluated or re-designed before being submitted for Budget funding, or while alternative programs are developed; or the discontinuation of the program (subject to appropriate phasing out arrangements).

If a proposed SP is identified by the relevant Minister as meriting consideration for Budget funding, further review may be undertaken under the direction of the Minister.

This would normally involve a preliminary review to indicate consistency with the Government's priorities. Subject to a favourable outcome, the Minister may proceed with a thorough evaluation of the program objectives and delivery mechanisms to ensure that the program specification is of a standard acceptable to the Budget process. This may require a significant re-design of the program and assessment of alternative delivery options.

The result will be a program proposal for submission to the ERC, or a decision to discontinue the SP.

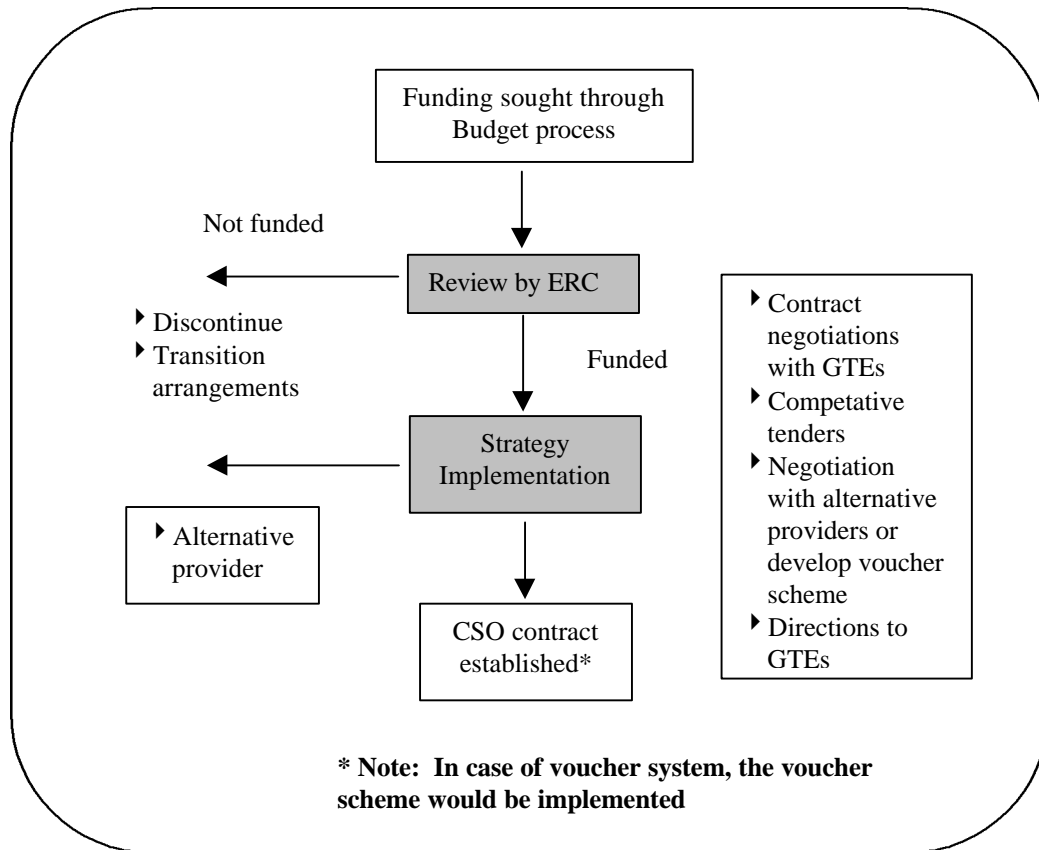
Figure 8 - SP Reviews by Purchasing Ministers



8.3.2 The Budget Process

SPs which are not currently Budget funded will be treated as program enhancements. SP proposals by Ministers (other than for CSOs already explicitly contracted and funded) should be forwarded, along with other proposed program enhancements as part of the normal Budget process. They will then be reviewed by the ERC together with all other program enhancements. (See Figure 9.)

Figure 9 - CSO Funding/Implementation



CSOs which already receive Budget funding have been treated separately from other Budget allocations in the past. When funds are formally allocated to a relevant Minister they will not be treated as program enhancements, but it is anticipated that they will be subjected to a thorough review to ensure that they meet the same standards of program definition and evaluation that other Budget Sector programs are expected to meet.

This review of existing CSOs can be deferred to allow time for the development of a proper policy context, as with SPs which are not currently Budget funded, provided the agreement of the Treasurer is secured. During this period continued Budget funding will be regarded as a transitional arrangement. All SPs must, however, be reviewed by Budget Cycle 1998-99.

8.4 TIMETABLE

The timetable set out below provides milestones for the first year of the implementation period.

Stage I of the implementation process envisages guidelines being developed and refined in the light of experience by GTEs. All SP proposals will need to be brought forward in submissions to Treasury so that they may be assessed and transitional funding approved for 1995-96.

By the end of the 1994-95 Financial Year all non-commercial activities must be either recognised as proposed SPs and approval for transitional funding sought by the portfolio Minister from the Treasurer; or be discontinued.

8.4.2 1995-96 Budget Cycle-Identification; Preliminary Costing and Evaluation

- * GTEs review corporate plans and non-Commercial activities; forward formal recommendations on core business and all proposed SPs to Minister.
July - December 1994
- * All proposed SPs must be identified by all GTEs and preliminary costing and review/evaluation completed.
January 1995
- * Portfolio Ministers complete initial reviews and recommendations. submissions on proposed SPs sent to Treasury.
February 1995
- * ERC determines consistency of proposed SPs with policy. Treasurer advises portfolio Minister of result and Stage II requirements. Portfolio Minister seeks approval for transitional funding proposal from Treasurer.
April - May 1995
- * Treasury prepares report to Government on results of Stage I together with consequence of, and recommendations for, moving to Stage II; Government decides on Stage II and if approved, timing and strategy.
April-May 1995.

8.4.3 1996-97 - 1998-99 Budget Cycles- Final Costing and Evaluation; Contracting and Funding

End of transitional funding arrangements; all proposed SPs must be treated as Budget funded programs ie SPs or CSOs by 1998-99.

8.5 REPORTING

Non-commercial activities of GTEs are ultimately funded from the public purse, either directly from the Budget or indirectly through reduced distributions to the Consolidated Fund. To ensure that levels of accountability consistent with Budget Sector programs are maintained, more detailed reporting is required in respect of CSOs than is the case for the commercial operations of GTEs.

During the implementation period it is important that the greatest possible degree of transparency be achieved in regard to the identification and costing of SPs. This will facilitate appropriate public and Parliamentary scrutiny as well as improvements to GTE performance monitoring arrangements.

8.5.1 First Two Complete Budget Cycles (1994-95 - 1995-96)

During the first two complete Budget cycles after the promulgation of the Policy, all proposed SPs, including proposed CSOs, Quasi-CSOs and Community Services should be identified appropriately and reported in Financial Statements and Annual Reports of GTEs. These reporting requirements will apply to all non-commercial activities that are identified as having some community benefit, even if a decision is later taken to discontinue them.

Receipts for proposed SPs and costs associated with them should be shown as revenues and expenses in the Financial Statements as part of the operating result before extraordinary items.

Additional detailed information in the Annual Report should include:

- * details of contracts that have been established with Ministers, specifying
 - contract price;
 - social policy objective;
 - performance criteria and monitoring arrangements; and
 - key contract conditions including term of contract;
- * the costing basis together with detailed cost estimates;
- * proposed arrangements for program evaluation; and
- * outline business plan or implementation strategy.

These details should generally be reported both in the Annual Reports and Corporate Plans. However, in the case of GTEs with a large number of proposed SPs, it may be desirable to provide only a summary in these reports, and to produce a separate report containing full details of proposed SPs.

Reference to proposed SPs should also be made in the Statement of Financial Performance developed for the purpose of the Government's Financial Distribution Policy and in the Business Plans of GTEs.

All the above information will not be available for every proposed SP in time for publication in the Financial Statements and Annual Reports for the year ended June 1994. However, it is expected that all will be published in the year ending 1995. The minimum requirement for the year ending 1994 will be that all proposed SPs which have been identified together with details which are available at that time will be published in Annual Reports.

8.5.2 Final Implementation Period (1996-97 - 1998-99)

After the end of the two years from the introduction of the Policy, Quasi-CSOs and Community Services funded under a transitional arrangement must be reported in accordance with the above requirements. As discussed above, after five years all transitional funding arrangements will be discontinued. These special reporting requirements will then no longer apply.

8.5.3 Long Run Requirements

After the SP Policy has been fully implemented, those SPs which continue to be delivered by GTEs (ie CSOs) will simply be service contracts. GTEs will have no direct responsibility for their evaluation or funding. The special reporting requirements in regard to CSOs will then need to be reviewed. If appropriate, revised guidelines based on the implementation experience will be published by Treasury.

8.5.4 Accounting Issues

Both actual SP costs and SP payments received from the Government should be included in the aggregate figures for operating expenses and revenues respectively on the face of the Operating Statement, but not separately identified. However, SP expenses and revenues should be separately identified and disclosed in notes to the Financial Statements, together with an explanation of any variance between expenses and contracted revenue.

Thus, any under-payments or over-payments in respect of SP costs will be clearly identified. The note should separately identify the component of the SP price that reflects a return to capital investment.

The practice previously adopted by some GTEs of netting SP costs against financial distributions to the Government must be discontinued forthwith; because it clouds the issue of commercial performance and “bottom line” discipline. Netting SP costs against dividends understates the commercial performance of a GTE (in the GTEs financial statements); and understates the social spending of the Government (in the Government’s Budget Statements).

8.5.5 Reporting of CSOs in Budget Papers

At present a number of payments are made from the Budget under the rubric "Community Service Obligations and Budget Funded Concessions". In the future, the term "Community Service Obligation" (or "CSO") shall be reserved for social programs that conform to the definitions provided in this policy paper. Proposed or approved CSOs and SPs should be separately identified as such in future Budget Papers.

8.6 TRANSITIONAL FUNDING

Transitional funding of proposed SPs refers to either:

- * continued Budget funding without the full review and evaluation process of Budget Sector programs. This option will be available only for programs which are currently funded as SPs from the Budget; or
- * continued internal funding through cross-subsidies. This option will be available only for programs which exist at the time of the promulgation of this Policy but which are not presently funded from the Budget.

Transitional funding for a SP proposal, whatever the present funding source, must be approved by the Treasurer based on the submission by the portfolio Minister. The submission should contain details of the cost and basic information on the characteristics of the program, as well as proposed future sources of funding or arrangements for the discontinuation of the SP.

Because indirect funding has an explicit cost to the Budget, transitional funding arrangements which involve continued cross-subsidies will require the Treasurer's approval. The cost of continued internal funding of proposed SPs will be explicitly taken into account for purposes of performance monitoring, particularly in relation to the use of benchmark rates of return.

8.7 SP POLICY UNIT

A small unit will be established by Treasury to assist Ministries, Departments and GTEs with the first stages of implementation of the Policy. The unit will include experts in the areas of cost accounting, program evaluation, microeconomics and social policy issues.

8.8 CASE STUDIES AND TECHNICAL ASSISTANCE

A number of case studies will be undertaken by the unit on a joint basis with selected GTEs to develop detailed technical manuals on costing, evaluating and contracting SPs.

These manuals will be published by Treasury to provide further assistance with policy implementation.

APPENDIX A

GLOSSARY OF TERMS

Appropriateness - Whether a program's objectives are consistent with community needs, Government policy, etc.

Activities - In this paper the term means all decisions made by GTE management which have financial implications, involved in the process of producing goods and services or otherwise.

Benchmark - A reference point for measuring the productive efficiency of an enterprise; generally based on a comparison with costs of other organisations in the same industry.

Budget Sector - The core Government agencies which are responsible for developing policy and delivering services which are primarily funded from taxes.

Commercial Sector - Comprises all Government Agencies which receive over 50% of their operating revenues from own-source revenues, generally user charges. The Commercial Sector is comprised primarily of GTEs but also includes a number of regulatory agencies.

Contract - An agreement where a contractor provides specified activities for another party (the customer) at an agreed price.

Contract Price - The price at which a contractor will provide specified services or results for the customer pursuant to the provisions of a contract.

Costs

Average Costs - Total costs of production divided by the number of units of output.

Avoidable Costs - Costs that would not be incurred if the subject activity is not undertaken.

Capital Costs - The cost of purchasing capital goods; (goods that are used in producing other goods and services over more than one year).

Cost of Capital - The opportunity cost of investing in capital goods; the percentage return that funds would otherwise have earned in a risk-free investment (eg a bank deposit) plus a premium for any risk associated with the investment.

Economic Costs - The willingness to pay for the use of a resource (being the total cost of production, including cost of capital and opportunity costs). This does not include transfer payments, taxes and subsidies.

Financial Costs - The actual price that an organisation pays for its goods and services. It may include taxes and transfer payments.

Fixed Costs - The cost of inputs whose quantity cannot be varied over the short run.

Fully Distributed Costs - Calculated by allocating all the costs of an enterprise, including joint costs and overheads not directly attributable to particular activities, to all the activities undertaken by the enterprise.

Joint (or Common) Costs - The cost of assets or resources used in producing two or more goods or services.

Marginal Costs - The increase in total costs resulting from the production of one more unit of output.

Opportunity Costs - Expected return from alternative projects that are foregone by devoting resources to the present usage.

Variable Costs - The cost of inputs whose quantity may be varied over the short run.

CSO - See "Community Service Obligation".

Community Service - A Social Program currently undertaken by a GTE with a community benefit, but without a specific Government directive.

Community Service Obligation - A Social Program that will be undertaken by a GTE at the request or direction of the Government, which on purely commercial considerations would either not be undertaken, or if it were, would be undertaken on different terms and conditions.

Cost Imposition - Certain non-commercial activities undertaken by a GTE with a Government directive, but which cannot, or do not, receive Budget funding as CSOs.

Cross-Subsidy - Where some customers are charged a higher price for services in order to subsidise others who receive the same service.

Effectiveness - The degree to which program outcomes meet objectives.

Economic Efficiency - This has two aspects:

Allocative Efficiency - A situation where it is not possible to make one person better off without making another worse off. This does not imply that the distribution of economic benefits is **equitable** (see below), but is a minimum condition for sound policy to satisfy (or to attempt to satisfy). It requires, among other things, that prices be set at the cost of production, so that consumers have no incentive either to waste, or to not consume when they are willing to pay the cost.

Productive Efficiency - Maximising output for a given level of inputs, or minimising inputs for a given output; producing goods and services at minimum cost.

Equity - or 'fairness' - How 'fairly' goods and services are distributed among members of the community.

GTE - See "Government Trading Enterprise"

Government Trading Enterprise - A Government owned organisation engaged in trading goods or services in the market place that earns at least 50% of total income from revenue obtained directly from trading operations.

Monopoly - A situation where there is only one producer of a good or service.

Natural Monopoly - A situation where a second producer would not be able to compete effectively as its costs would be higher than the monopoly producer.

Portfolio Minister - In this paper the term is used to refer to the Minister with portfolio responsibility for a particular GTE.

Pricing Signals - The information contained in the price that is conveyed to the market. An efficient price signal will be equivalent to the cost of production of the goods or service.

Proposed CSO - A non-commercial activity that is considered by a GTE to be a Social Program and, is proposed for continued delivery by that GTE.

Purchaser-Producer Model - A form of Government organisation where the responsibility for making policy and for funding the delivery of programs is separated from the responsibility for producing goods and services.

Purchasing Minister - In this paper the term refers to the Minister who is allocated funds to achieve a social policy outcome, and who purchases services from a GTE or other provider.

Quasi-CSO - A Social Program currently undertaken by a GTE with a community benefit and a specific Government directive, but which does not receive Budget funding.

Rate of Return on Assets - Net profit after depreciation as a percentage of average capital employed in a business; a measure of financial performance.

Rate of Return on Equity - Net profit as a percentage of shareholders' funds.

Regulatory Requirement - An activity undertaken by a GTE to conform to the regulatory framework in which the organisation operates; regarded as a commercial activity.

Social Objectives - Identifiable objectives pursued for the well-being of the community as a whole. The Government is responsible for determining appropriate social objectives.

Social Program (SP) - A non-commercial activity that is currently undertaken by a GTE and, that would be undertaken in future by a NSW Budget funded agency or a community agency or a private sector agency. The term Social Program can be used to include CSOs, Quasi-CSOs and Community Services, particularly in Stage I of policy implementation.

Tax (Economic sense) - A compulsory payment to a Government agency, including charges by GTEs where the charge is not related to consumption. Some charges nominally levied for the provision of goods and services may actually be taxes in an economic sense; for example, water charges based on property values.

Transparency - Access by the public to information about the activities of Government agencies; especially the correct identification of costs and benefits associated with the delivery of goods and services.

Transaction Costs - Costs incurred in entering a transaction. For example, if the provision of the goods or service is contracted out, the transaction costs would include all costs associated with implementing the contract.

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