

## Competitive Neutrality Quick Reference Guide

- These guidelines are intended to be a supplement to the legislation and guidelines issued to date by the Department of Local Government and Planning, and the Local Government Association.
- Each item relates back to the checklist which is based on the legislative requirements and scheme guidelines monitored by the Queensland Competition Authority. The Key steps are the action items to be included in the Action Plan.
- Each item has been deliberately limited to a one page outline of the key issues and steps so as to provide a succinct overview of best practices.
- This Quick Reference is not intended to provide all the details which have already been issued by the Association and Department. Cross-references are provided to those more detailed guidelines.
- The guidelines provide best-practice outlines of ways to embed good business management practices into Councils in order to obtain the greatest benefit at minimum ongoing cost.
- The suggested method of implementation is to integrate the business management practices into the accounting systems in an automated manner as far as practicable. Councils are, of course, not legally required to change accounting practices in order to formally introduce Full Cost Pricing. However, it is considered that add-on mechanisms such as manual calculations or use of FCP models external to the accounting system will be less cost-effective in the long run.
- The term 'Full Cost Decision-making' (FCD) has been included instead of 'Full Cost Pricing' (FCP) which is the term used in the Legislation, since it more accurately reflects the intent of this process. Many Councils have misunderstood FCP to mean that prices to the community must dramatically increase to cover additional cost factors at the expense of community service needs. The intent of the reforms is to ensure that Councils take all the costs into account when making decisions about services to the community, thereby making a fully informed decision.
- In some cases, the suggested approach is much simpler than alternative technically pure, but often impractical, methods. For example, rigorous optimisation of assets would require an enormously expensive exercise and a separate asset system to implement, which would provide negligible benefit unless the Council was intending to actually reconfigure its assets on an optimized basis. Instead, a method utilizing asset management processes and funded depreciation is outlined which is cost-effective and integrates asset management to the accounting system and the decision-making process.
- These guidelines are aimed at Type 3 business activities. Higher standards apply to commercialised and corporatised businesses. Generally, Type I and II businesses would need to meet all of these guidelines, as well as additional management and reporting processes and more sophisticated treatment of overheads and tax equivalents
- These guidelines are aimed at Councils which have more than 1000 water connections but are smaller than the largest 18 Councils. Smaller Councils are likely to find that some items are not material, and simpler approaches may be possible.

# The purpose of Full Cost Decision-making

## **FCD is intended to ensure that:**

- Councils have the information available to make fully informed decisions for the benefit of the overall community, and make efficient use of Council resources. (**Informed decisions**);
- Consumers are given appropriate pricing signals so that they are encouraged to make the best use of Council services/facilities, and avoid any under or over-use. (**Pricing signals**);
- Council managers work within a management framework which encourages them to manage resources efficiently. By incorporating all of the costs that private sector counterparts incur, Council is able to compare the cost of internal service provision with alternative sources and ensure that the most cost-effective service provision is provided to the community. (**Management efficiency**);
- The community is aware of Council decisions made on its behalf; the full cost of those decisions, and is able to assess the efficiency of Council services. (**Decision-making transparency**);
- Subsidies made by the Council are transparent and for the benefit of the overall community. (**Subsidy transparency**);
- Management of the Council assets and infrastructure is efficient. By being aware of the value of the assets, as well as the annual cost required to maintain the asset condition, Council is able to ensure that the assets are maintained in optimal condition for the current and future generations. (**Asset management**).

## **FCD does not require:**

- Outsourcing or competitive tendering. Councils retain full choice as to whether services are best provided by the Council workforce, the private sector or other alternatives. The only requirement is that Council makes these decisions in full awareness of the full comparable costs. (**No outsourcing requirement**);
- Reduction in council services. Council is able to retain current service levels, provided it is satisfied that community is receiving value for money, and that the community requires that level of service at its full cost. (**No service reduction requirement**);
- Charging exorbitant prices. Council is able to continue to subsidise services and charge less than the full cost, provided it is satisfying a carefully considered and fully costed community service obligation, and the decision making process is transparent to the community. Adjustments are included to ensure that consumers are not over-charged. (**No exorbitant prices**).
- Increased administration costs. Most of the additional costing information requirements can be automated within the financial computer systems and the decision-making processes can be accommodated within existing administrative processes such as the budget process. The BMAP project is liaising with Local Government software vendors to ensure that the required automation is available. One off setup costs should be more than offset by the Financial Incentives Package. (**No increased administration costs**).

# N1 Council Resolution

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## Ideal Standard

Council has resolved to apply the Code to this business activity.

## Outline/Summary

The Local Government Act requires each Council to annually review its and nominate its business activities (*this is the first step in the process as required by Local Government Act (LGA) s765*).

This step is a prerequisite to accessing payments under the Local Government Financial Incentive Payments Scheme. It simply requires the Council to resolve to apply the Code of Competitive Conduct to the business activity. However, in practice, many Councillors are reluctant to adopt the code without knowing the implications on the prices which need to be charged on a FCD Basis. Therefore, Council officers (eg. Finance staff or appointed consultants) should ideally undertake a pricing exercise to identify the likely impact. Refer N3 for the steps to ensure that prices set are reasonable, and not unnecessarily high. (*Prices are reasonable where they reflect the full cost of service provision. The management decisions that occur as a result of having this information must take into consideration community issues such as Community Service Obligations.*)

The Local Government Act requires each Council to annually review and resolve to apply the Code to its business activities, including those to which the code has already been applied. (I.e. this must be resolved each year for each business activity. This must be done during the year, to apply the following year). It is suggested that a standard resolution could be included in the budget resolutions, so as to streamline the annual review process.

The suggested resolution is “Council resolves to apply the Code of Competitive Conduct to its xxx business activity in 2002/03”.

To get the extension of time to implement the reforms the following resolution is suggested Council resolves to implement the Code (or remaining elements of the Code that have not been fully implemented) by 1 July 2003 generally in accordance according with the timetable outlined in the report.”

## Key Steps

1. Undertake FCD impact calculations;
2. Present report to Council;
3. Adopt the Code of Competitive Conduct by Council resolution; and
4. Review and identify business activities annually.

## Further Information

LG Act s765 – annual identification of business activities as per s762;

LGA s763 – compulsory resolution to apply CCC to roads businesses; and

LGA s766 – resolution to apply CCC to identified business activities.

## QCA Documentation Standard

Council resolution. Budget document (Statement on activities to which the CCC applies)

## N2 Management and Reporting Changes

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### Ideal Standard

Council's Annual Report and Financial Statements has provided evidence of changes to financial reporting and management arrangements in terms of separation and autonomy for the purposes of applying the Code.

### Outline/Summary

The extent of management and reporting autonomy depends on the size of the Council, with larger Councils requiring more sophisticated processes. Good management processes require an activity to be managed by a responsible officer who has clear responsibilities, authority and accountabilities. Clear responsibilities need to be outlined in the operational plan and organisation chart. Clear authorities need to be outlined in the delegations to the officer. Clear accountabilities need to occur in the budget and annual report/financial statements. As part of this review, regulatory functions should be separated from operational areas regulated wherever practicable, particularly in medium and larger Councils.

It is important to ensure that the Roads and Other Roads business activities are accounted for separately, and comply with the legislative definitions (refer Glossary).

Ideally the Corporate Plan should reflect a desire to continually improve Council efficiency and management practices, including an intention to apply the Code of Competitive Conduct to business activities where there is a benefit to the community.

### Key Steps

1. Amend the operational plan and chart of accounts so that each activity which is applying the code is separately identified. Separate regulatory and business activities, and Roads and Other Roads activities;
2. Review and amend management responsibilities, delegations and accountabilities;
3. Each of these activities should be shown in the budget separately, and a statement is included in the budget in accordance with LGFS s97; and
4. A statement should be included in the annual report/financial statements in accordance with LGFS s99.

### Further Information

LGFS s97, LGFS s99

### QCA Documentation Standard

Budget, Annual report and financial statements, Organisation chart, Delegations.

### Legislation

LGFS s97, LGFS s99

## N3 Full Cost Decision-Making Framework

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### Ideal Standard

Prices have been set on the basis that projected total revenue, including CSO's, covers the full cost of providing the goods and services.

### Outline/Summary

The purpose of implementing Full Cost Decision-making (FCD) is to ensure that Council's decisions are made in awareness of the full cost of those decisions, and that prices for activities which affect the market place are set on the same basis as for the private sector. These prices should therefore provide appropriate financial and economic signals to consumers.

In order to simplify accounting controls, it is advisable to make use of natural/standard accounts to control transactions across the organisation and ensure they are balanced. Ideally, the FCD adjustments outlined in these guidelines should be charged to the business activity and credited to a central area such as the Finance Department and the funds used to pay for CSO's or services. However, within the business activity, the CSO cannot simply be a balancing item between the current revenue level and the full cost of the activity.

Initially, the inclusion of costs which have never been considered before, may lead to prices which would appear to be unreasonably high. If this occurs, the following issues need to be considered or reviewed:-

### Key Steps

1. Does the valuation of the asset base for pricing purposes, exclude the value of contributed or donated assets and remove the value of redundant assets? (see Guideline N6)
2. Can the amount of funded depreciation used for pricing purposes be reduced to the level required to be funded to maintain the asset condition (renewals annuity), rather than the straight-line accounting method (see N7)?
3. Is the depreciation amount based on an economic life assumption (see N7)?
4. Have appropriate cost drivers been used in the allocation of administration and overheads? Have any costs of governance been incorrectly allocated to the business (see N5)?
5. Has the right rate of return target been applied, taking account of the current level of interest rates (see N8)?
6. Can the capital structure be improved (see N8)?
7. Alternatively, can a dividend be paid to water customers (see N8) or can general rates be reduced to compensate for the increased prices (eg, so that the overall increase in the average rate bill is in line with inflation)?
8. Can the price changes be phased in over a period of up to five years? (Where initial full cost pricing estimates signal significant price increases a plan to phase in the introduction of needed increases within a five year period is allowed.)
9. Is the business carrying out any Community Service Obligations, and if so, has a payment for this been included in the revenue, which would reduce the prices which need to be charged? Has the business activity been appropriately defined and non-commercial activities excluded (see N11)?
10. Are there other neutrality adjustments which can be made (see N12)?

### Further Information

PG (all), TA (all), LGAQ-FCP (all), TA1, LGAQ 2.2, 3, 15, Local Government Bulletin 0601

### QCA Documentation Standard

Budget, Chart of accounts or use of Full Cost Pricing software

## N4 Direct and Indirect Costs

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### Ideal Standard

Direct and indirect costs are included in the accounts for each activity. **Outline/Summary**

Direct and indirect costs are the business activity's operational costs as identified within the council's budget and annual financial statements. Councils financial reporting systems need to be able to attribute operating costs to the business activity. It is unwise to simply increase direct costs by a nominal percentage, unless the percentage can be justified and verified.

Direct costs are normally already included in the costs of an activity. These are costs which can be directly attributed to an activity, such as labour and materials.

Indirect costs are costs which relate to an activity but which need to be spread across an organization to ensure they are included in the cost of an activity. The most basic of these include electricity, telecommunications, other utilities, as well as labour oncosts. Other indirect costs are covered in other guidelines, such as administrative and overhead costs (N5).

It would normally be difficult to change the way these costs are recorded during the financial year, unless a major budget review and amendment is undertaken. It would usually be preferable to introduce these changes in a new budget.

To keep control of these expense items, it is usually preferable to assign a standard or natural account number to each indirect expense type, so that the total cost can be monitored even though the costs have been apportioned to the relevant activities or jobs.

### Key Steps

1. Identify any direct and indirect costs which are not charged to relevant activities,
2. Change the budgets accordingly for the next budget;
3. Amend accounting processes and documentation for the new financial year; and
4. Train relevant employees involved in the new procedures, and issue relevant instructions.

### Further Information

PG 2.5.2, 2.5.3, 3.4.3, 3.4.4

### QCA Documentation Standard

Budget, Chart of accounts or use of Full Cost Pricing software

## N5 Administration and Overhead Allocation

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### Ideal Standard

Council has adopted an appropriate method for fully allocating administrative and overhead costs. Cost drivers have been identified.

### Outline/Summary

Businesses operating in the market-place need to recover administrative and corporate overheads in their prices, and FCD applies the same principle. However, the cost of governance (including all or most of the CEO's office) in the public sector is unique and not comparable to the private sector. Therefore, the costs of a business need to incorporate administrative and corporate overheads, excluding the cost of governance.

Traditionally, some method of overhead cost allocation has been used to spread overheads over the business activities of many Councils, however this has often been on a high level basis or an arbitrary figure not reflecting a reasonable estimate of relative costs. Depending on the objective of Councils, several methods of cost allocation can be utilized. Since overheads can consume a large part of the Council budget, with no direct service delivery benefit to the community, many Councils have implemented sophisticated methods such as Activity Based Costing or Service Level Agreements to get better control of these overheads, with annual savings of up to 20% being achieved. However, if the objective is simply to reflect the full cost of each activity for decision making purposes, a simplified process can be used based on apportionment by cost-drivers. (A cost driver is the variable which generally governs the cost of administrative overheads, eg. The number of PCs governs the cost of IT). LGAQ's FCP guide provides a useful set of benchmarks and suggested cost drivers.

Ideally, apportionment of corporate overheads should be based on the following principles:

- Exclude governance costs (preferably by having a separate budget item);
- Allocate the costs on the basis of the most applicable cost-driver;
- Apply materiality tests to ensure that the process is as simple as possible (smaller and medium-sized Councils only need to use a few simple cost-drivers);
- Include capital costs for services with significant assets (eg. IT and Buildings);
- Utilise automatic journals to automate the process wherever possible;
- Annually review the apportionment methods and cost driver variables ;
- Maintain separate natural/standard accounts to ensure the ledger is balanced; and
- Ensure that total administrative overheads in the business are in the range of 7 to 15% of total operating costs. Overheads outside this range need to be reviewed.

### Key Steps

1. Identify each of the corporate and administrative overheads to be allocated;
2. Exclude Governance costs, and the CEO's costs related to Governance;
3. Modify the accounting records if necessary to distinguish between governance and other corporate and overhead costs;
4. Identify a cost driver for each of the activities to be allocated using Activity Based Costing or the suggested simplified list of cost drivers;
5. Determine the number of units in each cost driver for each Council activity;
6. If possible, set up automatic monthly journals to allocate the actual cost of non-governance corporate and overhead costs to each activity in proportion to the activity's share of costs associated with the each cost driver (Oncost and plant hire systems can be used to allocate costs if the system has no automatic journal process);
7. Implement related budget changes and advise the management in each activity;
8. Review the reasonableness of the resultant overheads in each business; and
9. Review annually as part of the budget process.

### Further Information

LGAQ-FCP 4, 5, 6, 14

### QCA Documentation Standard

Budget, Chart of accounts or use of Full Cost Pricing software

## N6 Asset Valuation

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### Ideal Standard

Valuation of assets held by the activity is based on deprival method and includes optimisation. Contributed assets have been identified and appropriately treated.

### Outline/Summary

Councils are already required to value their assets on a deprival value basis, and this is subject to external audit. **Deprival value** is the cost of replacing the asset if the Council is deprived of the asset. To this extent it includes an element of optimisation. However, in reality most assets are recorded at replacement value, since there is little practical information on the optimal way assets could be replaced if the Council is deprived of them. Optimisation and Contributed assets are primarily of importance to Water and Sewerage.

The purpose of **optimisation** is to ensure that the asset base on which the activity sets its rate of return does not result in overcharging customers for any inefficiencies or excess capacity in the asset base. Although the accounting standards do not cater for optimisation, council's decision making processes needs to consider optimisation to ensure that current prices reflect efficient asset needs and the avoids any over-capitalisation in the future. However, apart from the following simple adjustments, in most cases the costs of establishing a separate asset register based on optimized valuation will outweigh the benefits, and a similar outcome can be achieved through modifying the funding of depreciation (see N7). Note that depreciation of excess assets should also be excluded from pricing decisions. For businesses with significant infrastructure assets, such as water and sewerage, the optimisation of the asset base should at the minimum:

- remove any redundant assets, i.e. not likely to be used or replaced; and
- remove any excess capacity in the network having regard to usage trends (i.e. peak demand and allowance for growth).

**Contributed assets** (which include all assets either provided or funded by developers or the Government) should be excluded from the asset valuation for the purposes of calculating the rate of return required. The rationale for this is that consumers should not be required to pay for a rate of return on assets which were not funded by the Council. The *Integrated Planning Act* (IPA) requires councils to establish streamlined planning processes and addresses the future treatment of contributed assets. (It is not unusual for 40%-60% and up to 80% of water and sewerage assets to have been contributed). It is expected that councils will have sufficient information to identify recent contributions, but will experience problems with assets prior to 1994. Therefore it is recommended that councils introduce a policy solution to identifying and treating contributed assets prior to 1994. It may also be useful to include in the Valuation policy a statement such as "a proportion of the valuation of assets has been adjusted for pricing purposes"

**Reports:** These adjustments can be achieved by adopting a report on the estimated level of contributed and optimized assets which should be excluded from the need to obtain a return on investment. From this starting point, the actual funding sources should be added each year. Several approaches have been used for contributed assets as follows:

- identifying assets contributed (cash or physical assets from developers or government) ;
- identifying areas where development was funded by developers government; and
- relating the funding source to the age of the asset.

### Key steps

1. Value all Council assets on a deprival basis subject to QAO audit;
2. Prepare Officer's Report estimating the value of excess and contributed assets (WS&S);
3. Adjust the asset base for pricing purposes to exclude contributed and excess assets.

### Further Information

PG 3.4.5.3, 3.4.5.4, 3.8

### QCA Documentation Standard

Audited Financial statements, Budget, Officer's report/s, Valuation policy

## N7 Depreciation

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### Ideal Standard

Depreciation of assets directly or indirectly used in the activity has been based on optimized deprival values allocated over the assets' useful life and is included in cost and prices.

### Outline/Summary

The cost of consumption of the assets used by an activity is an important element of the costs of providing a service. This is normally reflected in the depreciation amount, however the depreciation applied to meet the Accounting Standards will often overstate the amount required to maintain the assets in optimal condition. This can be rectified by applying a renewals annuity approach or reviewing depreciation on the basis of an economic life assumption. In some Councils the assets remained 'owned' by the Council rather than the business activity, and the assets are leased to the activity. Where this occurs, the appropriate depreciation cost needs to be incorporated into the lease charges. Older areas may find that the existing level of asset replacement funding is insufficient to maintain the asset condition. In such cases, Councils may find it useful to review their capital structure (see N8) to free up capital funds for asset replacement. Note that depreciation on excess assets (optimised) should be excluded from prices, but not depreciation on contributed assets.

**Water and Sewerage** assets are networked, long-lived, expensive, and have user demands which are widely spread. Therefore, Councils are encouraged to manage water and sewerage assets through a Strategic Asset Management Framework (SAMF) that includes Total Management Plans(TMP). Recent developments have advocated the adoption of asset consumption or a depreciation charge that is based on the actual physical and economic characteristics of the assets rather than the accounting depreciation. For instance new Government guidelines recommend a form of renewals annuity to be calculated and managed. In determining a 'renewals annuity' the SAMF/TMP will need to provide:

- Condition-based assessment of assets;
- Estimated total value of services being delivered by the network in aggregate, including quality and health standards;
- Environmental conditions, (e.g. soils types, ground movement, water corrosiveness of water, pollutant load effects of sewerage disposed, etc); and
- The impact that IPA requirements may have on development of the network.

The TMP/SAMF should estimate the annual amount (annuity) that reflects the costs of managing the existing asset base to maintain the current levels of service. Council can then resolve in the budget only to fund the annuity in place of the accounting level of depreciation. For the purpose of pricing, this level of funded depreciation can then be used instead of the accounting depreciation. This approach avoids the need for a separate asset register on an optimised basis, and it links the engineering, financial and decision-making processes.

**Other activities** – generally depreciation under the accounting standards would be applied in decision making, unless the Council has an Asset Management Plan which provides an alternative renewals annuity which could be applied in the same manner as above.

### Key Steps

1. WS&S - Determine the renewals annuity required to maintain asset condition (preferably under a SAMF and TMP or Asset Management Plan);
2. WS&S - Amend Councils' depreciation policy (in the revenue policy) to fund depreciation on a renewals annuity basis where applicable;
3. WS&S - Adopt the budget on a renewals annuity basis for funded depreciation, and implement related accounting transactions; and
4. Apply the accounting depreciation to pricing decisions if there is no renewals annuity.

### Further Information

PG 3.4.5.6, TA 5, LGAQ-FCP 7

### QCA Documentation Standard

Budget, Chart of accounts or use of Full Cost Pricing software, TMP/SAMF

## N8 Rate of Return

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### Ideal Standard

The business activity has an appropriate return on capital equivalent to the weighted average cost of capital benchmark in the Full Cost Pricing Guidelines (lower standard - The business activity has a target rate of return on capital.).

### Outline/Summary

In making decisions and ensuring pricing decisions are based on the full cost, Councils need to incorporate a rate of return on the net assets in the business activity. Although consumers may have effectively paid for the assets through their payment of Council charges, this is no different to private sector pricing since the assets are owned by the organisation rather than the consumers. Unlike the private sector, the return on assets goes back to the Council and can offset general rates. Differential rating can be applied to adjust for the situation where some ratepayers are effectively paying a return on assets which reduces general rates, and other do not. Councils now may give relevant ratepayers a credit on their rates as a dividend from any profits in the business.

Traditionally Councils have tended to raise loans for non-income generating assets such as roads, and not for business activities like water and sewerage. Although not required, Councils can take the opportunity to review their 'capital structure' by raising a new (preferably interest only) loan in the water and sewerage activity and using the proceeds to repay existing road loans. The Queensland Treasury Corporation have established facilities to arrange appropriate debt financing instruments, subject to prudential covenants. However the Weighted Average Cost of Capital (WACC) calculations used to provide the government guidelines already impute a 50/50 Debt to Equity split, so a physical transfer is not necessary for pricing purposes.

The Government guidelines suggest that for small to medium businesses the pre-tax rate of return on assets may be taken to be 3.5% over the ten-year bond rate. (If a pre-tax rate of return is used for the required rate of return, there is no need to apply an income tax equivalent – see N10). This would currently give a rate of 9% (rounded to the nearest half percentage point). Larger businesses would apply the following returns:

- Water and sewerage 2.1 to 2.7% plus 10 year bond rate;
- Refuse Management 2.3 to 2.9% plus 10 year bond rate;
- Plant and Equipment Hire 2.4 to 3.0% plus 10 year bond rate;
- Road Construction and Maintenance 2.5 to 3.1% plus 10 year bond rate; and
- Cultural / Recreation / Leisure 2.7 to 3.3% plus 10 year bond rate.

Some business activities have negligible or no assets. Such organisations in the private sector often aim for a return on revenue instead of a return on capital. Eg. a 5-10% return on revenue for service companies and 2-5% for construction works. There is no QCA requirement to do this provided the return on capital is incorporated in the lease charges of any indirectly used capital. However, Councils may add a return on revenue if desired, as long as they remain competitive.

### Key Steps

1. Review the capital structure and implement a debt swap up to a 60% debt to equity split, if desired;
2. Apply a rate of return based on the above factors to be achieved over a period of up to five years; and
3. Determine price paths to achieve the required rate of return (taking all FCD factors into account, including CSO's).

### Further Information

PG 2.5.4, 3.4.5, 3.4.5.2, 3.4.5.7, TA 2, 3, 4, 8, LGAQ-FCP 12,  
<http://www.rba.gov.au/Statistics/indicative.html> (for 10 year bond rate)

### QCA Documentation Standard

Budget, Chart of accounts or use of Full Cost Pricing software

## N9 Cost of Indirect Capital Usage

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### Ideal Standard

Business leases some assets from Council or external providers (or some other mechanism has been implemented to include the cost of capital).

### Outline/Summary

In addition to the assets in the business activity, many Council activities use assets which belong to another part of Council. For example- Plant and equipment, buildings, and IT equipment. Buildings and IT equipment will normally be incorporated in the allocation of administrative and overhead costs (N5). Ideally plant and equipment should be charged to the job or activity, and the plant hire rates should include a component for the cost of capital.

The cost of capital is the minimum return that council should require on its financial resources. For instance, at each budget council has choices as to where limited financial resources will be directed, such as building roads, upgrading sewage plants or purchasing more plant and equipment. In making some decisions council will exclude the 'opportunity' to undertake other decisions, i.e. the opportunity cost of using the funds elsewhere. Council needs to be able to measure the opportunity costs of its decisions as the basis for being informed as to the consequence of making certain decisions and being able to monitor the performance of those decisions over time.

Refer to N8 for details on the rate of return which would be applicable.

For council business activities that are 'thinly capitalised' (i.e., have few assets) or hire operational assets from other parts of council or external parties there is the expectation that the hire or charge out rates include a return on the indirect capital component.

Medium and larger Councils often have a separate Plant activity which makes it easier to ensure the cost of capital is included. A simple method is to establish an internal loan from a central Department to the Plant activity to cover the net value of the assets in the Plant activity. (The interest payable on the loan acts as a proxy for a return on capital). In smaller councils, when reviewing the plant hire rates a calculation is needed to ensure that the cost of capital is included. Similarly, a simple method of incorporating full costs in the charge for use of Council Buildings is to charge a market rent based on rental levels in the nearby area. Market rates may be used for charging plant, buildings and other indirectly used capital items.

Councils who perform Main Roads work may already have plant hire rates which already includes this component.

### Key steps

1. Identify all assets used by the activities, including those under the responsibility of another part of the Council;
2. Ensure the charges (apportionment of administration and overheads) or plant hire charges incorporate a component for the cost of capital; and
3. Base cost of capital estimates for council's financial resources on approach outlined in FCP guidelines and DLGP Bulletin 06/01 (This could be achieved by introducing internal loans if appropriate, or charging local hire rates, reviewed on an annual basis and set in the budget);
4. Review the interest rate applied annually to ensure it takes account of prevailing interest rates and the equivalent commercial rate which would be applicable in the private sector.

### Further Information

PG 2.5.4, 3.4.5, LGAQ-FCP 12

### QCA Documentation Standard

Budget, Chart of accounts or use of Full Cost Pricing software

## N10 Tax Equivalents

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### Ideal Standard

Tax equivalents are calculated and incorporated in the budget.

### Outline/Summary

Tax equivalents can be simplified by using automated journal entries, where the activity is charged for the tax equivalent and the revenue is paid to the Finance Department and used to fund CSO's or other service provision. Alternatively, they can be omitted from the accounting system (unless it is a Type I or II business) and the costs added to any pricing calculation.

No adjustments will normally be necessary for smaller councils (under 1000 water connections), except Council rates on all businesses.

Medium sized Councils will normally only need to include payroll tax, land tax, Council rates and income tax on non-w water and sewerage businesses.

- Rates and Land tax – based on UCV (use the most recent UCV or land asset valuation (less 20%)) – This can often be achieved by using the rates system to automatically charge both rates and land tax to the Activity. (Note Land tax is not payable if the combined value of land is below \$100,000);
- Payroll tax – this is already payable for business undertakings such as Water, Sewerage, Garbage, and Cemeteries. Councils need to add 4.75% in the oncost calculations for other businesses, however it is not applicable unless all the Council business activities have a grossed up payroll over \$850,000 pa. (Businesses with payrolls up to \$3.4 Million are also eligible for provisional deductions;
- Income tax – unless it is a type 1 or 2 activity, it is often simplest to apply the pre-tax rate of return (see N8) which avoids the need to apply an income tax equivalent. Otherwise Councils will need to apply the accounting profits method by applying the current tax rate (30%) to the profit shown in the accounts (using the full accounting depreciation or the ATO depreciation rates rather than the renewals annuity). Often the higher depreciation charge will eliminate any income tax cost;
- GST –no adjustment required because it is not applicable as an input cost, however some activities may require charging of GST for services not specified in Division 81 (this would normally already be done); FBT – already incurred by councils, but may need to be apportioned to relevant activities, if it is currently budgeted and paid for centrally;
- Stamp duty – no adjustment is required because it is already payable.
- BAD tax and other minor taxes – no adjustment required because generally these will already be incurred or not be of a material amount.
- Sales Tax – no longer applicable;

### Key Steps

1. Use special rate codes to charge activities for general rates and land tax (if over the threshold);
2. Use the on-cost process for charging payroll tax if above the payroll tax threshold and not already incurred;
3. If a pre-tax rate of return is not used, calculate income tax based on the accounting profits in accordance with guidelines. Incorporate in the annual budget and transfer by automatic journal monthly;
4. Ensure that the correct GST is applied to prices set by Council; and
5. Ensure that FBT is budgeted and charged to the relevant activities in Council.

### Further Information

PG 2.5.5, 3.4.6, TA 6, LGAQ-FCP 8, [www.osr.qld.gov.au](http://www.osr.qld.gov.au)

### QCA Documentation Standard

Budget, Chart of accounts or use of Full Cost Pricing software

## N11 Community Service Obligations

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### Ideal Standard

Council provided evidence that it has a policy for identifying, costing and funding CSO's.

### Outline/Summary

Community Service Obligations (CSO's) are the main way to ensure that the Council continues to provide effective services to the community while being fully aware of all the costs involved. In many cases CSO's are effectively a way of the Council buying services from the business on behalf of the community. If CSO's are to be implemented they should be based on clear objectives of the council. These objectives should be included in the Corporate Plan. Ideally the approach to CSO's should be underpinned by a formally adopted council policy framework. One way to achieve this is to include this in the Revenue Policy in the Budget. CSO payments should be clearly identified in council's budget and disclosed in council's annual report. Ideally, Key Performance Indicators (KPI's) should be developed and monitored to ensure that the policy objectives of the CSO are achieved.

CSO's to business activities should not be used as balancing item designed to meet a total revenue short-fall of an activity not full cost pricing. However it is valid for Council to have a policy of providing a particular community facility (preferably referencing the Corporate Plan) at a similar cost to residents in larger communities and only charging residents similar fees to comparable communities. The CSO would then be equivalent to the difference between the full cost of the activity and the revenue from benchmarked fees in comparable councils. The value of a CSO is the benefit to the community from the concessional provision of services to the community. The main purpose of the CSO process is to ensure that Council makes a conscious decision as to the value of the service, and helps highlight any inefficiencies. Note that the relevance of a CSO to the community can change over time, and therefore CSO's need to be continually reviewed. See guidelines by the LGAQ and DLGP for explanation of valid CSO's. However, it is not valid to have CSO's for a road business tenders, or to specify the CSO which are costs which a private company operating as a good corporate citizen would incur, or involves accepting a lower rate of return than the market would require a private business to achieve. The main requirement of CSO's are:-

1. There is an adopted policy requirement resolved by Council;
2. The CSO and the business activity are fully costed.

As an alternative to CSO's it may be useful to separate any non-commercial functions from the business activity. For example the cost of maintaining a historic cemetery is not a business activity and could be separated from the business, instead of providing a CSO to cover this cost.

The suggested resolution is "Council resolves to disclose the identified community service obligation relating to xxx provided by the xxx business activity, with that CSO to be incorporated in the revenue policy, budget and annual report to be reviewed on a periodic basis".

### Key Steps

1. Council implements a CSO policy framework based on the council's corporate objectives;
2. Council resolution to provide a CSO in a particular activity;
3. Identify the cost of meeting the CSO;
4. Develop the budget to pay the CSO amount to the activity providing the service, possibly funded from the additional rate of return from the activity; and
5. Document the CSO's in the Budget and Financial statements as per LGFS s94/LGFS s95.

### Further Information

PG 2.5, 3.7, TA 7, LGAQ-FCP 13.

### QCA Documentation Standard

Budget, Chart of accounts or use of Full Cost Pricing software, Council resolutions

## N12 Other Neutrality Adjustments

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### Ideal Standard

Council provided evidence that adjustments have been made for advantages and disadvantages of public ownership.

### Outline/Summary

Council business activities receive advantages and disadvantages by virtue of being publicly owned. A major thrust of competition reforms is to ensure that council owned business activities do not receive a 'material' benefit or cost because of public ownership. Competitive neutrality adjustments are made to an activity's costs reflecting the estimated difference between the actual operating costs of the business activity compared to an equivalent privately owned business activity.

The Queensland Government debt guarantee fee is a CN adjustment accommodated within the CAPM/WACC estimate used for return on capital. The LGAQ FCP guidelines recommend an adjustment equivalent to 0.2% of the debt value. However, this adjustment is not required if a pre-tax rate of return (see N8) is used. Otherwise it will need to be charged to relevant business activities, ideally using a natural account to control the costs across the Council.

Other advantages of public ownership that could be adjusted include:

- Access to Council ratepayers and customers;
- Cash-flow security arising from the Council non-business activities;
- Special access to Council information;
- Exemption from regulations applied to competitors;
- Lower workers compensation premiums; and
- Tied clients.

Disadvantages of public ownership include:

- Higher levels of employees remuneration including superannuation (currently 12% compared to 8% in 2007/2 and 9% in 2002/3 under the SGC levy);
- More onerous purchasing policy restriction; and
- Retention of surplus employees.

In practice, many of these advantages and disadvantages are immaterial or are difficult to quantify.

### Key Steps

1. If not applying a pre-tax rate of return, adjust the budget and accounting procedures for the benefit of the State Government debt guarantee, using automatic journals, using a separate natural account; and
2. Review the significance of any other advantages or disadvantages of public ownership, and adjust by applying automatic journals for any material CN adjustments which can be reasonably quantified.

### Further Information

PG 2.5.6, 3.4.7, LGAQ-FCP 9, 10.

### QCA Documentation Standard

Budget, Chart of accounts or use of Full Cost Pricing software

## N13 Complaints Process

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### Ideal Standard

Council provided evidence that a process for receiving and investigating competitive neutrality complaints is established.

### Outline/Summary

A complaints process needs to be established to deal with competitive neutrality complaints against the business activity undergoing the reforms. For significant and roads business activities only, councils have the option of appointing the QCA as the referee for their complaints processes. The only exemption from the need for a complaints process is if the council has received accreditation from QCA. Currently no council is exempted in this way. The annual report should indicate the existence of any complaints received and the outcome of the review process for those complaints

The complaints process must be formally documented and adopted by resolution and comply with the requirements of Chapter 11 of the LGA. The main steps in processing a complaint are:

1. Acknowledge receipt of the concerns in writing, and refer the person expressing the concerns to the review officer;
2. The review officer will seek to establish the facts relating to the concerns expressed by the person. Investigation of the matter may involve meeting with the person, collecting data, and holding further meetings;
3. The review officer will develop a proposed response to the concerns and seek, within a reasonable time, the person's views on the proposed response;
4. The review officer will provide a report to the chief executive officer on the concerns, which shall include the proposed response to the person, and the person's views on the proposed response; and
5. The chief executive officer shall make a response, or shall direct the review officer to make a response to the person.

### Key Steps

The preliminary procedure for affected persons to raise concerns about alleged failure of business activities to comply with the relevant competitive neutrality principles, and for clarifying and, if possible, resolving those concerns is:

1. Pass the necessary Council resolutions to implement a complaints process; and
2. Appoint a review officer or officers (either by the Council or delegating to the CEO the power to appoint review officers).

### Further Information

(s.793, LGA), A manual describing how to set-up a competitive neutrality complaints handling process is available for purchase for \$44 from the Department.

### QCA Documentation Standard

Council resolution, and records system. Annual Report.

## N14 Ongoing

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### Ideal Standard

To be assessed in the final assessment year unless Council has provided evidence of implementing an externally accredited compliance process, including KPI performance monitoring and reporting.

### Outline/Summary

To obtain the greatest benefit from the business management practices, Councils need to ensure that the reforms are embedded into their ongoing processes. For this reason, the above suggested practices are based on automated integration of FCD into the accounting and budgeting processes and integration between the asset management, accounting, and management practices.

Councils should adopt, contingent on operating size, a management system that ensures the elements of full cost pricing and the associated changes to management information systems are able to be sustained beyond the LGFIPS. The management system should be broadly compliant with AS3806, which provides the following broad guide to implementation:

- policy pronouncement expressing ongoing commitment;
- management responsibility and accountability for compliance and performance;
- adequate resourcing of the management systems;
- integrated systems that support continuous improvement;
- integrated systems that handle complaints;
- ongoing education of the organisation and stakeholders, including ratepayers; and
- a systematic approach to monitoring and assessing performance over time.

Linking TMP's and asset management plans to the budget and accounting systems not only assists FCD but also improves the management of assets under Council control. Similarly, ensuring clear management responsibility, authority and performance monitoring improves management performance.

### Key Steps

1. Ensure that the Corporate planning is linked to all of council's operations;
2. Ensure that Operational and business activity planning is congruent;
3. Ensure management information systems include critical full cost pricing elements;
4. Develop financial and non-financial performance standards and KPI's for business activities
5. Establish ongoing monitoring and adjustments of the process based on transparent KPI's and benchmarking;
6. Link the TMP/Asset Management Plans to the budget and accounting procedures;
7. Incorporate KPI's on the Operational Plans, and monitor and report to Council.

### QCA Documentation Standard

Budget, Chart of accounts or use of Full Cost Pricing software, TMP/SAMFs, Operational Plans, Reports to Council.

# W1 CoAG Water Reforms

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## Ideal Standards

1. Council has completed a Two-part tariff report.
2. Council has resolved to apply the COAG Water reforms and advised the QCA.
3. Council has a two-part tariff structure with an access charge and usage charge.
4. Approximately half of the water revenue comes from the usage charge (unless it can be proven that the LRMC is lower).
5. The assessment of Full Cost Recovery forms part of the full cost decision-making for the water and sewerage business activity. If the Business is a Type I or II, the Council is applying commercialisation to the water and sewerage business activity.
6. Council has identified any cross subsidies by consumer type.
7. Council has provided evidence that CSO's have been identified, costed and funded.
8. Council has provided evidence that a process has been established for ongoing performance.

## Outline/Summary

Councils not currently applying two-part tariffs need to complete a Part A report, while Councils currently applying two part tariffs should complete a Part B report. Councils which still have a 'free' water usage allowance within their water prices are not regarded as having a two-part tariff, and should complete a Part A report. The Simplified Guidelines issued by DLGP contain the required details of these reports. These guidelines also contain a simplified spreadsheet to assist with the calculations for the Part A report.

The part A report is really a cost-benefit study for the implementation of two-part tariffs. Generally, the major costs arise from the installation of meters (if not already installed) and the benefits arise from deferral of system expansion costs and related operating costs resulting from reduced water consumption. Another potential major benefit is in assisting in the reduction of water losses in the system.

The Part B report is for Councils which currently have a two-part tariff, and is a review of the effectiveness of the tariff.

Councils with less than 1000 water connections are not required to undertake these reforms, although Incentive payments are available. The legislation requires all other Councils to comply.

The suggested resolution is "Council resolves to accept the recommendation to implement two-part water tariffs in 2002/03 as per the design principles outlined in the report, xxx".

**Tariff Structure:** The tariff structure should remove any free allowance, and ensure that approximately 50% of the revenue comes from the usage component of the tariff. As a rule of thumb, unless Councils can demonstrate that the Long Run Marginal Cost (LRMC) is covered by the usage charge, QCA will accept tariffs which generate 30-60% of the water revenue via the usage tariff, and will give some recognition to tariffs which raise over 25% from usage.

**Full Cost Recovery:** This is similar to Full Cost Pricing or Decision-making, with the exception that a positive rate of return (eg. over \$1.00) is required.

**Cross-subsidies:** The Queensland test for cross subsidies is to compare the total water price on a per kilolitre basis 'Average cost per kilolitre' (base charge plus consumption charge divided by the volume of water used) with the Long Run Marginal Cost (LRMC). A cross-subsidy is deemed to exist if any consumer class is paying an average cost per kilolitre higher than the LRMC, while another class has an average cost per kilolitre below the LRMC. The average cost per kilolitre is calculated by adding the base and consumption charges for an entire consumer class and dividing the amount by the amount of water consumed by that consumer class. Any discount for early payment should be taken off.

The LRMC is calculated by adding the marginal or variable cost to the increased cost of bulk supply and augmentation on a per kilolitre basis. According to the DNRM guidelines,, for a water scheme from a Councils own water supply, the LRMC may be approximated by using the average cost of providing these services where it can be assumed that the average will be close to the LRMC. For purchased water schemes, the guidelines suggest that the external bulk supply price may be used as an indicator or the LRMC for storage and its augmentation costs. The Council would need to also add its system delivery augmentation costs to determine the total LRMC.

Consumer classes are the major consumer groups such as residential, commercial and industrial.

Cross subsidies results should be reported to Council and incorporated in the annual report.

The suggested resolution is “Council resolves to disclose identified water and sewerage cross subsidies in the 2001/02 Annual Report”.

**CSO’s** As per FCD requirements, however note that NCC and QCA require evidence that the application of this framework is leading to CSO’s that are clearly defined, have an explicit public benefit objective, are transparently reported and are consistent with the aims of CoAG pricing reforms.

**Ongoing Reforms:** Similar to N14 above.

## Key Steps

1. Complete Part A or Part B report
2. Council resolves to apply the COAG Water reforms and advise the QCA.
3. Council implements a two-part tariff structure with an access charge and usage charge.
4. Ensure approximately half of the water revenue comes from the usage charge (unless it can be demonstrated that the LRMC is lower).
5. Ensure that the assessment of Full Cost Recovery forms part of the full cost decision-making for the water and sewerage business activity. If the Business is a Type I or II, the Council is applying commercialisation to the water and sewerage business activity.
6. Identify any cross subsidies by consumer group, report to Council, and incorporate in the Annual Report.
7. Provide evidence that CSO’s have been identified, costed and funded.
8. Provide evidence that a process has been established for ongoing performance.

## Further Information

DLGP – Evaluation of Introducing and Improving Two-Part Water Tariffs For Local Governments in Queensland – Simplified Guidelines, Sept 2000.

DNRM– Guidelines for Identification and Measurement of Cross-Subsidies, Sept 1998

Project Report and Case Studies for Cross-Subsidies and Inefficient Water Pricing: Identification and Reporting to Achieve Better Outcomes, Oct 1998

## Documentation Standard

Council report and resolution. Budget document, Two-part Tariff report, Annual Report.

## Summary of Documentation (if applicable/available)

- 1) 2000/1 QCA Annual Return
- 2) Corporate Plan
- 3) Operational Plan
- 4) (1999/2000) Annual Report including audited financial statements
- 5) (2000/1) Annual Report including audited financial statements (draft of Annual Report if available)
- 6) Budget 2001/2
- 7) Revenue and Expenditure printout (at least 2 levels below budget document)  
(note – this will already be provided by Practical Computer Systems if applicable and permission was granted)
- 8) Revenue Policy (if not included in Budget document)
- 9) Valuation Policy
- 10) Organisation Chart (for whole Council – at least showing management of each of the business activities)
- 11) Delegations to the managers of the business activities
- 12) Council Resolutions (if applicable):
  - i) Adopting the code for particular business activities
  - ii) Community Service Obligations
  - iii) Two Part tariffs
  - iv) Complaints process
- 13) Records procedures for competitive neutrality complaints process
- 14) Full Cost Pricing software – if applicable
- 15) Officers Report/s on optimisation of Asset Valuation and Contributed Assets
- 16) TMP/SAMF for water and sewerage – if applicable (particularly renewals annuity for maintaining asset condition)
- 17) Routine reports to Council on business activity performance
- 18) Two-part Tariff report/s

## Glossary and Acronyms

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ATO	Australian Taxation Office
BAD Tax	Bank Accounts Debit Tax
CCC	Code of Competitive Conduct under the LGA
CoAG	Council of the Australian Governments
CEO	Chief Executive Officer of the Council
CN	Competitive Neutrality
CSO	Community Service Obligation
DLGP	Dept, Local Government and Planning
FBT	Fringe Benefits Tax
FCD	Full Cost Decision-Making
FCP	Full Cost Pricing
GST	Goods and Services Tax
IPA	Integrated Planning Act
IT	Information Technology
KPI	Key Performance Indicators
Large Council	Largest 18 Councils (with Type I or II businesses)
LGA	Local Government Act
LGAQ	Local Government Association, Qld
LGFIP	Local Government Financial Incentive Package
LGFS	Local Government Finance Standard
LRMC	Long Run Marginal Cost
Medium Council	Over 1000 water connections, but not in the largest 18
Other Roads	All road activities not included in 'Roads' activity S. 761 (this includes Council's own roads works (non-market tested), private developer works, and sole provider works for the State Government.
PC	Personal Computer
PG	DCILGPS –Full Cost Pricing in Queensland Local Government – Practical Guide
QAO	Queensland Audit Office
QCA	Queensland Competition Authority
QTC	Queensland Treasury Corporation
Roads activity	State controller roads works other than sole provider works (RMPC, APPC). It does not include private works, but does include National roads and market testing of Council's own road works
SAMF	Strategic Asset Management Framework
Small Council	A Council with 1000 Water connections or less
TA	DCILGPS –Full Cost Pricing in Queensland Local Government - Technical Appendices
TMP	Total Management Plan
Types I, II, III	Sizes of Business Activities for the purpose of NCP.
UCV	Unimproved Capital Value – issued by Dept Natural Resources and Mines
WACC	Weighted Average Cost of Capital