Full Cost Pricing Policy

A Queensland Government Policy Statement

Queensland Treasury 2010
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Overview

The purpose of this policy is to provide guidance to departments on implementing a full cost pricing policy for significant business activities (SBAs) as required under National Competition Policy (NCP) and commercialised business units (CBUs) under the Queensland Government’s Financial and Performance Management Standard 2009.


The FCP Policy assists in achieving competitive neutrality between public and private sector businesses by ensuring that prices charged by SBAs and CBUs reflect a similar cost structure to that faced by a private sector competitor. In setting prices under the FCP policy, the SBA or CBU must meet all fixed and variable costs (including tax equivalents), and must achieve an appropriate rate of return. This rate of return must be achieved over the medium term.

All SBAs are subject to the competitive neutrality complaints mechanism administered by the Queensland Competition Authority (QCA). This mechanism allows private and public sector organisations in competition with SBAs to complain that a SBA is not complying with the principle of competitive neutrality.

This policy document replaces the Full Cost Pricing Policy issued by Queensland Treasury in 1997.

1 Queensland Treasury, 2009.
1 Introduction

1.1 Application of full cost pricing

The Full Cost Pricing (FCP) Policy applies to SBAs that are not government-owned corporations (GOCs) and fully commercialised business units (CBUs) in accordance with the Commercialisation of Government Business Activities in Queensland Policy Framework.

1.2 Relationship with other competitive neutrality policies

The FCP Policy is one of a suite of policies designed to place government activities on a competitively neutral basis when competing with the private sector. Other competitive neutrality policies include commercialisation and corporatisation.

1.3 Guiding principle

The guiding principle underlying the FCP Policy is that a government business should not enjoy any net competitive advantage in respect of its private sector counterparts simply because of its public sector ownership. That is, the policy aims to achieve competitive neutrality, or a ‘level playing field’, between public and private sector businesses.

Under the FCP Policy, the principle of competitive neutrality is met by ensuring prices charged by SBAs and CBUs reflect a similar cost structure to that faced by a private sector competitor so that it is subject to the same pressures from competition as its private sector equivalents.

While this aim is best achieved by ensuring prices, in all situations where an SBA or CBU is competing, are based on the full cost of supplying a product, the policy does allow sufficient flexibility for SBAs and CBUs to price in a competitive manner according to market conditions.

1.4 Status of the Full Cost Pricing Policy

The FCP Policy is incorporated by reference into the Queensland Government’s Financial Performance and Management Standard 2009 (FPMS). The FPMS requires that relevant SBAs and CBUs must apply the Policy.

The FPMS is subordinate legislation under the Financial Accountability Act 2009. Accordingly, while the FCP Policy itself does not have any legislative status, the FPMS imposes a statutory obligation upon SBAs and CBUs to comply with the Policy.

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2 The definition of a SBA is provided in section 3.1 of the Queensland Government’s policy statement on competitive neutrality - Competitive Neutrality and Queensland Government Business Activities. This statement also lists those Government activities which have, to date, been identified as SBAs, or candidate SBAs. An activity will formally become a SBA by gazette notice.
Implementing full cost pricing

This section focuses on the practical considerations of implementing full cost pricing. It addresses:

- the concepts of costing and pricing
- components of a full cost price and how they are valued
- treatment of community service obligations
- structural reforms required
- reporting and compliance measures.

2.1 Distinction between costing and pricing

Costing involves determining the value of resources consumed in the production of goods or the provision of services. The role of costing is to act as a benchmark against which pricing and production decisions can be made.

Pricing refers to the process of determining a figure at which products or services will be exchanged in the marketplace. The focus of pricing is on the income received from the exchange of the good or service. While cost is an important consideration in pricing, optimal pricing policies will also fully reflect additional market and competitive considerations, as well as the need to achieve a rate of return on investments.

The FCP Policy uses full cost to establish the cost benchmark for pricing decisions. However, the Policy recognises that SBAs and CBUs operate in a commercial environment and therefore, does not prevent the use of marginal cost or avoidable cost for specific pricing decisions, if appropriate. However, this must be within the established benchmark and must be consistent with achieving the required rate of return.

The relationship between costing and pricing is depicted in Figure 1. Costing definitions are provided in Appendix 1.
Figure 1
Costing and pricing contrasted

1
This represents the cost benchmark determined on the basis of full cost, marginal cost, avoidable cost etc. NOTE: This policy requires that full cost be used as a benchmark.

2
Assuming that full cost is used as the benchmark, average prices set within this range give rise to profit. Any profit derived may however, be illusory where the cost benchmark used is something less than full cost.

3
Assuming that full cost is used as the benchmark, average prices set within this range give rise to a loss. Whilst prices in this range may cover variable costs and make a contribution to non-variable costs, they generally cannot be maintained in the long-term.
2.2 Components of a full cost pricing policy and how they are valued

In the private sector, prices are usually set so that as a whole across the enterprise, they recover the full cost of the provision of all goods and services, taxes and similar charges plus a suitable return on the owners’ investment.

This concept is incorporated in this Policy through the establishment of a cost benchmark for each SBA or CBU. The benchmark must take into account all costs incurred in producing and delivering the goods and services, as well as taxes and other Government charges faced by the private sector competitor or equivalent business. Prices must incorporate this benchmark plus a return on investment similar to that required by the owners of the private sector competitors or equivalent businesses.

Each SBA or CBU to which this Policy applies is to be examined separately to set the benchmark, and each SBA or CBU must price commercially. The rate of return must be achieved over the medium term. This will allow the relevant SBAs or CBUs to establish the required commercial structures.

The overall approach is depicted in Figure 2.
Figure 2
Costing and pricing under the full cost pricing policy

The policy requires that Full Cost Pricing forms the benchmark - both direct and indirect costs must be included.

SBAs and CBUs will be required to show a rate of return (after income tax) consistent with the private sector in the medium to long-term.
2.2.1 Cost benchmark

The cost benchmark must include:

a. **Operating costs**

Operating costs are the day-to-day expenses incurred in running a business. Some examples of operating costs include salaries, electricity, insurance, raw materials and repairs.

b. **Capital costs**

Depreciation and amortisation should be calculated using the principles outlined in the section on depreciation in the publication entitled *Non-Current Asset Policies for the Queensland Public Sector*.

Non-current assets should be valued using the principles in the sections on valuation and revaluation of assets in that publication.

c. **Taxes and tax equivalents**

The imposition of full taxes or tax equivalents forms an important part of complying with the principle of competitive neutrality. Accordingly, the following costs are required to be included in calculations of full cost by SBAs or CBUs:

- stamp duty
- council rates
- land tax
- payroll tax
- capital gains tax
- GST.

The above list is not exhaustive. Other government charges or taxes of a similar nature to those listed above are also to be included.

**Note:** income tax has been excluded from the costing portion of the overall pricing process. The FCP Policy requires that income taxes be considered as a part of the pricing decision. This treatment has been adopted on the basis that income tax expense is a direct function of the price charged for the SBA’s or CBU’s product or service.

d. **Competitive neutrality adjustments**

Benefits (other than those accounted for in the cost components above) that arise out of public ownership should be identified and either removed or appropriately adjusted for in the cost benchmark.

The key is to differentiate between those advantages or disadvantages that arise merely because of the SBA’s and CBU’s public ownership and those that form part of the normal variability in management practices and cost structures within any given group of organisations competing in a common marketplace.

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3 Queensland Treasury, June 2005
Some examples of additional benefits enjoyed by public sector businesses are:

- Crown indemnity where provided in respect of insurance
- tied clients
- intellectual property
- possible lack of tendering costs for government.

On a similar basis, any disadvantages that a SBA or CBU might incur because of public sector ownership should be taken into account in the cost base.

Examples of disadvantages include:

- inflexibility of public sector requirements in respect of employment conditions and security of tenure
- inability to adjust staffing numbers for peaks and troughs
- requirement to provide services in areas where it may not be economic to do so (such a requirement would normally be considered a community service obligation (CSO), refer to section 2.3 for information on how CSOs are treated)
- requirement to employ a higher percentage of apprentices
- preferential arrangements may lead to less favourable credit terms for government departments
- provision of support from parent organisation at less than full cost in private sector.

Each factor is to be addressed on an individual basis and should be isolated and costed if possible. Certain activities may qualify as CSOs (see section 2.3) and should be funded as such or explicitly funded as a competitive neutrality adjustment i.e. where there are identifiable, measurable and significant fund flows.

In other cases, where they cannot be reliably measured or are not significant, they should be identified and eliminated where possible. Where they have a significant impact on the SBA’s or CBU’s actual financial performance, they may be taken into account during performance monitoring.
2.2.2 Pricing decision – capital structure, rate of return requirement and payment of dividends

a. Capital structure

As SBAs and CBUs are required to operate in the same manner as private sector competitors, they are to be set up with similar capital structures. Traditionally, Government business activities have not been structured along the lines of the private sector, that is there has been no defined capital structure consisting of both debt and equity.

Implementation of this policy will require that the SBA or CBU in consultation with Queensland Treasury and the portfolio department, establish a capital structure which reflects the general characteristics of other industry participants. This process will generally involve the use of external resources (either data or consultants or both) to determine industry norms.

Once an approximation of industry norms has been established and an appropriate capital structure for the SBA or CBU decided upon, the new capital structure will be formally set in place via a restructuring of the SBA’s or CBU’s finances. This will generally involve formally establishing loan facilities with QTC for the full amount of the loan and attributing the balance to equity held by the Government. Where it is not cost effective to put such a structure in place, appropriate proxy arrangements will be considered.

b. Rate of return

SBAs and CBUs must include a return on assets to ensure prices reflect efficient outcomes and provide revenues necessary to promote sustainable investment.

The rate of return is the return expected by investors in capital markets for investments of a given level of risk, and represents the opportunity cost to investors of expected returns on foregone investment opportunities, that is, the expected return from the next best alternative investment. The rate of return plays a central role in rewarding or compensating SBAs and CBUs for past investment, and also in providing guidance as to the return on future investment.

The rate of return therefore, is a forward-looking concept based on expected future risk. The generally accepted approach to establishing the rate of return is to estimate a weighted average cost of capital (WACC) usually by reference to industry benchmarks. The WACC represents the weighted average of the rate of return on equity and the return required to service debt with their respective weights being the shares of equity capital and debt capital in total assets.
c. Equity

SBAs and CBUs, to which the FCP Policy applies, are required to price their goods and services at a level that provides a return on equity (after income tax equivalents) no less than the estimated cost of equity over a medium to long term. It is anticipated that a rolling term of three years will be used as a proxy for medium to long term. Establishment of the cost of equity requires knowledge of the following:

- the risk free rate of return on investment (the yield on long-term Commonwealth Government bonds is normally adopted)
- the return on the market
- ‘beta’ risk of the relevant investment

SBA and CBU betas will not be easily discernible as there is no market in the equity of SBAs and CBUs. Similarly there may be no market in the equity of private sector competitors as they may be partnerships, trusts, sole proprietors or companies not listed on the ASX. Estimates of beta risk will be determined by the SBA or CBU, the portfolio department and Queensland Treasury. Consultants may also be used in this process.

d. Costs of debt

SBAs or CBUs are required to bear the cost of debt in a manner similar to their private sector counterparts. Where a SBA or CBU does not pay interest at full commercial rates in respect of its borrowings, it will be necessary to determine whether that situation is the result of its affiliation with Government or whether it is an arrangement that might normally be available to businesses in the private sector. Borrowing facilities are available to SBAs and CBUs at commercial rates through Queensland Treasury Corporation (QTC). Interest payments are paid to QTC on a normal commercial basis. All profits made by QTC go into the Consolidated Fund of the State of Queensland.

e. Dividends

Dividends represent the dispersal of profits to owners and arrangements for the payment of dividends to the Government will be determined on a case-by-case basis in consultation with Queensland Treasury and the portfolio department. This Policy does not require that each SBA or CBU generate a return equal or greater than their cost of equity capital in every year of operation and, similarly, the level of dividends may vary from year to year. Factors which will be taken into account when determining the dividend payable include the level of profit for the year, investment requirements and the level of cash reserves.

f. Income tax

The FCP Policy requires income taxes be considered as a part of the pricing decision. This treatment has been adopted on the basis that income tax expense is a direct function of the price charged for the SBAs and CBUs product or service. Similarly, income tax must be considered by the SBA or CBU in any analysis of the minimum overall price levels necessary to generate the required return on its equity.

SBAs and CBUs applying the FCP Policy are to use the ITAA Tax Equivalent Model (as outlined in the Treasurer’s Tax Equivalent Manual) when calculating taxes for costing purposes. Each SBA or CBU should calculate the tax expense for pricing purposes based on its business plan.
2.3 Treatment of community service obligations

CSOs are non-commercial activities the Government requires a SBA or CBU to carry out where there is a clear Government direction. Further details are contained in Appendix 2.

Full details and any agreed CSO activities including the description, arrangements for measuring the effectiveness of their delivery, agreed funding levels, costing and payment arrangements will be agreed between the relevant SBA or CBU, CEO of the portfolio department, the portfolio Minister and the Treasurer prior to the commencement of each financial year.

2.4 Structural reforms required

While the FCP Policy itself does not require any structural reform to occur, it is highly advisable departments consider implementing the following reforms in order to ensure compliance with the principle of competitive neutrality.

Separation of policy and regulatory functions from commercial activities

Generally private sector businesses do not have policy and regulatory functions. A SBA or CBU with these functions would normally enjoy an advantage over its private sector competitors by having prior knowledge and an inordinate influence on policy changes and regulation of competition. It is essential these functions be removed from SBAs or CBUs to ensure competitive neutrality.

Separation of government as purchaser from government as provider

In situations where the SBA or CBU is one of a number of providers of a service to the government, departments should ensure that there is a clear separation between the department’s role, as purchaser of the good or service and its role as provider of the good or service through the SBA/CBU. This is particularly important where purchasing is by way of a competitive tender process.

The separation of these two roles assists in complying with the principle of competitive neutrality.
2.5 Reporting requirements and compliance

Each SBA or CBU is to be subject to a cost/pricing monitoring regime to ensure compliance with the FCP Policy.

Details of the regime will be agreed to between the portfolio department and Queensland Treasury, but essentially the portfolio department will have prime responsibility for the implementation of the regime.

The reporting requirements for the cost/pricing regime will be tailored to individual SBAs and CBUs. Reporting requirements will be established by Queensland Treasury and the portfolio department in conjunction with the SBA or CBU and should be on a three monthly basis along the lines of the requirements for GOCs. The reporting requirements should be sufficient to allow assessment of the SBAs and CBUs compliance with the FCP Policy and include the SBAs and CBUs plans for ensuring they are able to generate the required return on equity over the required period. Should a SBA or CBU fail to achieve the required results, the portfolio department in conjunction with Queensland Treasury, will make recommendations to the portfolio Minister and the Treasurer on any action required.

Competitive neutrality complaints mechanism

All SBAs⁴ are subject to the competitive neutrality complaints mechanism, administered by the QCA. This mechanism will allow for private and public sector organisations in competition with SBAs to lodge complaints on the grounds that the SBA in question is not compliant with the principle of competitive neutrality.

These complaints will be investigated by the QCA which will then make recommendations to the Ministers responsible for implementing the Competition Principles Agreement. The Ministers responsible will then consult with the Minister responsible for the SBA over what action to take.

SBAs may apply to the QCA to have their pricing policy formally accredited as complying with the FCP Policy and the principle of competitive neutrality.

Prices oversight

Where the SBA enjoys a legislated or natural monopoly, the prices oversight mechanism administered by the QCA has jurisdiction to ensure that monopoly prices are not charged.

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⁴ This does not apply to a CBU which has not been declared as an SBA under Part 4 of the Queensland Competition Authority Act 1997.
Appendix 1  Costing definitions

**Full cost:** full costing describes the process of accumulating the total costs of the business unit (including those not directly attributable to particular activities) and allocating them to all of the activities undertaken by the unit.

The measurement of full cost provides a key benchmark as it represents the minimum level of revenue that can be generated by firms in the private sector if they are to remain viable in the long term. Full costs therefore have an important role to play in public sector organisations with a strong business or commercial bias.

**Marginal Costs:** marginal costing refers to the development of a cost benchmark on the basis of the additional costs incurred in producing one additional unit of output. Marginal costs will generally include all direct and indirect variable costs of production, where appropriate. Marginal costing turns on the distinction between fixed and variable costs and allows determination of whether the gains from producing an extra unit of output exceed the costs of producing it.

Marginal costs will generally be less than average full cost in relation to a specific cost objective as marginal costing will not include fixed costs. Short-run marginal cost data is particularly useful from a managerial perspective in situations where marginal output decision making is required for example, where average full cost is calculated on the basis of a particular capacity utilisation and that level of utilisation has already been met or exceeded.

It is important to note that fixed costs will often become variable costs in the mid to long term. Short-run marginal costing will therefore exclude a number of fixed costs that would not be excluded if the analysis were being done on the basis of long-run marginal costs.

**Avoidable Costs:** avoidable costs are those that would be avoided if an operation were suspended or closed down. Where an operation did not already exist, avoidable costs would be those associated with establishing and maintaining the additional operation.

Many of the concepts in respect of avoidable costs are similar to those of marginal costing. However marginal costing focuses on the change in costs arising from an additional unit of output whilst avoidable cost takes a more macro approach by focussing on the costs of adding or deleting an entire function or operation.
Appendix 2  Identifying community service obligations

The following descriptions relate to significant business activities (SBAs) which have not been corporatised or commercialised as a commercialised business unit (CBU). Treatment of community service obligations (CSOs) for SBAs and CBUs that are government-owned corporations is contained in the Government Owned Corporations Act 1993.

Community service obligations

CSOs are non-commercial activities which SBAs or CBUs are directed to pursue by the Government. They are activities which would not be undertaken in a purely commercial environment. CSOs often relate to the equity objectives of the Government and do not normally include regulatory or policy functions. The document, Community Service Obligations: A Policy Framework\(^5\), outlines the Queensland Government’s CSO policy framework.

It is useful to make a distinction between CSOs which are specifically imposed by the Government and arrangements which are adopted as good business. It is a legitimate business practice to subsidise certain non-commercial activities in the interest of overall business. Such activities would be a matter for the SBA or CBU and would not receive any Government funding. As well, CSOs would not be defined by the effects of general legislation (e.g. general environmental or industrial relations legislation).

The following five categories would qualify as CSOs (other examples are possible):

- where the Government considers it desirable that certain products be supplied to all users at a uniform or affordable price regardless of the cost of provision (e.g. uniform electricity tariff)
- where the Government has its welfare objectives met by requiring SBAs and CBUs to provide price concessions to users who are considered to be disadvantaged (e.g. various pensioner concessions, but only to the extent that this varies from normal industry practice)
- the Government may require a SBA or CBU to deliver, at no extra charge or below cost, services or service levels which would not be provided on purely commercial grounds (e.g. suburban rail services)
- the Government may require SBAs or CBUs to purchase inputs at levels or types that differ from purely commercial levels in order to achieve other objectives (e.g. employing additional apprentices)
- the Government may require SBAs or CBUs to abide by environmental, consumer, cultural, heritage or similar policies beyond those which generally apply.

\(^5\) Queensland Treasury, 1999
Need for clarity

Uncertainty about the scope of CSOs might result in the over-provision of the CSO as the SBA or CBU seeks to ensure the Government’s requirements are met.

If the CSO requirement is not clear, it will be difficult for the costs and revenues of commercial services to be adequately monitored and for the SBAs and CBUs performance and compliance with the Full Cost Pricing Policy to be assessed. Vague CSO directions will also make it difficult for the Government to determine whether its social objectives are being met.

As the community’s elected representatives, Ministers have responsibility for certain social objectives. Consequently, CSOs should be explicitly directed by Ministers.

Any non-commercial roles traditionally performed by candidate SBAs and CBUs should be evaluated prior to confirmation as SBAs and CBUs to determine if they offer the best and most effective low-cost means of achieving the Government’s social objectives.

Costing and funding

Departments should make a preliminary estimate of the likely costs of delivering the service and therefore, the price that might eventually be negotiated with a SBA or CBU.

Although funding for specific CSOs will be agreed to each financial year, the preferred option is direct funding from the State Budget. This arrangement is more likely to generate intense scrutiny of the services to be provided by a CSO as part of the budget process and cost/price monitoring regime. It is also more consistent with a commercial contractual approach to business. Direct funding will also enable the removal of artificial entry barriers, which would be needed to support cross subsidisation.

The responsibility for allocating CSO funds to SBAs or CBUs will lie with the responsible department. This will enhance accountability and allow the Government to assess whether the way in which each CSO is delivered is the best means of achieving the Government’s social objectives.

Broad public sector costs

The financial performance of SBAs or CBUs may be influenced by a number of operating conditions unique to the public sector for example, public service employment and industrial relations conditions - although enterprise bargaining provides a framework for introducing more commercial employment arrangements. However, these are broad conditions applying across Government as a whole. They do not represent specific non-commercial directives imposed on business units and hence, do not fall within the CSO category.

In this regard, these factors might be seen as constraints on performance. However, at the same time Government ownership of SBAs or CBUs brings certain advantages which would prove in practice difficult to fully remove for example, the shield of the Crown, implicit underwriting of solvency, transition periods of monopoly or familiarity with Government procedures providing a competitive edge etc.

Accordingly, any public sector constraints will need to be considered in the context of any inherent advantages enjoyed by the SBA or CBU. The obvious difficulty involved with accurately measuring these effects (either in isolation or on a net basis) suggests the best way to account for them is through agreed adjustments to target rates of return. Such adjustments will be the exception rather than the rule and any resulting concessional arrangements will be phased out over time.
Who to contact for further information

For further assistance on any matter please contact Treasury’s Economic and Structural Policy Branch:

Economic and Structural Policy
Executive Building
Level 8
100 George Street
BRISBANE Q 4000

Telephone: (07) 3234 1800
Facsimile: (07) 3221 4071