

Competitive Neutrality Complaint Investigation

Final report

Hobsons Bay City Council —

Child care centres

27 January 2015

Victorian Competition and Efficiency Commission

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Key points

- The Victorian Competition and Efficiency Commission (the VCEC) received a complaint against Hobsons Bay City Council (the Council) on 8 September 2014. The complaint alleged that the Council had departed from the correct application of Victoria's *Competitive Neutrality (CN) Policy* by not applying a fully cost-reflective pricing structure to the Council's long-day child care service conducted at Altona North Children's Centre and Altona Meadows Children's Centre.
- The VCEC concluded that the Council's long-day child care service is a significant business under the CN Policy and therefore is in scope of the CN Policy.
- The VCEC considered a range of information provided by the Council, including its *Child Care Public Policy Review* (prepared by KPMG) and financial data, which form the basis of the VCEC's conclusions.
- The VCEC has concluded, given the estimated loss of \$1 049 450, the Council's pricing of its long-day child care service is not fully cost reflective and does not comply with the CN Policy.
- The VCEC has recommended that, to comply with the CN Policy, the Council either implement a plan to introduce fully cost-reflective prices or conduct a public interest test to justify why the prices charged for the services should not cover all of the relevant costs:
- The Council has informed the VCEC that it has reviewed its involvement in the provision of long-day child care and is considering several options including exiting the service (via contracting out). Should the Council choose to exit the direct provision of long-day child care services the CN Policy would no longer apply because the Council is not the service provider.

1 Competitive Neutrality Policy

The objective of competitive neutrality (CN) is set out in Clause 3(1) of the *Competition Principles Agreement* (CPA) as:

... the elimination of resource allocation distortions arising out of the public ownership of entities engaged in significant business activities: Government business should not enjoy any net competitive advantage simply as a result of their public sector ownership. These principles only apply to the business activities of publicly owned entities, not to the non-business, non-profit activities of these entities. (COAG 1995)

CN is achieved by removing unfair competitive advantages or disadvantages that result solely from government ownership of a business activity (Government of Victoria 2012).

Consistent with the CPA, the CN Policy applies only to the significant business activities of publicly-owned entities, and not to the non-business, non-profit activities of those entities (DTF 2000). The VCEC has posted a guidance note — *Identifying significant business activities for competitive neutrality* — on its website to assist

interested parties in determining whether or not an activity is a significant business and therefore in scope of the CN Policy.

It is the responsibility of government agencies and councils to determine if their business activities fall within the scope of the CN Policy. If the policy does apply, then the government agency or council must implement CN measures for its business activities, where it is in the public interest to do so. The CN Policy provides for three measures to implement CN — corporatisation, commercialisation, and fully cost-reflective pricing (Appendix A provides a further description of these measures). Fully cost-reflective pricing is the CN measure that local government most commonly applies, because most local government operations are too small to corporatise or commercialise.

Under the CN Policy, prices should reflect the full cost of producing a good or service, after any adjustments for competitive advantages or disadvantages due to government ownership. There should also be equalisation of non-price related competitive advantages — for example, where a government business has exclusive access to information not available to competitors when it is relevant to the activity.

Fully cost-reflective pricing is only required where it is in the public interest. Where implementation of fully cost-reflective pricing jeopardises other public policy objectives the government entity must undertake a public interest test to justify subsidising the activity to comply with the CN Policy.

Options to achieve compliance with CN Policy

In practice, there are two options that government entities might take to comply with CN Policy when it has been identified that CN costs have not been fully recovered:

- (i) to eliminate the CN subsidy by increasing prices and/or by reducing production costs to achieve a fully cost-reflective pricing structure
- (ii) to conduct a public interest test to demonstrate that the CN subsidy is justified where it is considered that the application of fully cost-reflective pricing would compromise other public policy objectives.

Alternatively, government entities may choose on other grounds (for example, financial viability) not to provide the service themselves, for example by contracting the service out to a non-government provider.

1.1 Role of the VCEC

Consistent with the CN Policy, if a complaint against a government business is lodged, the VCEC determines the extent to which the agency's actions comply

with CN Policy (Government of Victoria 2012, p. 11). The VCEC has investigated this complaint consistent with the CN Policy and the *Competitive Neutrality Guide to Implementation* ('Implementation guide') (DTF 2000).

The VCEC has no authority to investigate other concerns of complainants, for example:

- policy decisions of government entities (for instance, decisions over how tax revenues are raised)
- those relating to anti-competitive behaviour that is covered by the *Competition and Consumer Act 2010* (Cth)
- probity issues arising from tendering processes of government agencies or local governments.

The VCEC is not able to recommend any compensation or termination of contractual arrangements. Compliance with CN Policy is about achieving CN or justifying departure from CN, and the VCEC makes recommendations to achieve this end only. VCEC reports are not intended to form the basis of, or contribute to, compensation claims.

Further information on the role of the VCEC is available in the *Conventions for the Competitive Neutrality Function* on the VCEC's website.

1.2 Investigation process

The VCEC received a complaint against Hobsons Bay City Council (the Council) on 8 September 2014. It undertook desktop research and sought information from the Council to (i) help form a view as to whether or not the complaint is in scope of the CN Policy, and, where so, (ii) to determine the level of compliance and, (iii) where relevant, what action the Council may need to take to achieve compliance.

After considering the facts and issues, the VCEC wrote to the complainant on 3 October 2014 to advise that it had accepted the complaint for investigation. The VCEC also wrote to the Council and the then Department of Transport, Planning and Local Infrastructure (DTPLI), which was responsible for overseeing local government, to advise that it had received and accepted a complaint for investigation. The VCEC received the information it requested from the Council to help progress the investigation on 28 October 2014. Additional information was requested and received from the Council on 21 November 2014.

On 12 December 2014, the VCEC issued a confidential draft investigation report to the complainant, the Council and to Local Government Victoria (within DTPLI) for comment. The complainant and Local Government Victoria

acknowledged the report but did not provide substantive comment. The Council provided additional costing data and explanation of costs. The VCEC considered these responses before preparing this final investigation report.

2 The complaint

The complaint concerns the Council’s long-day child care activities conducted at the Altona North Children’s Centre (ANCC) and the Altona Meadows Children’s Centre (AMCC). The complaint was lodged by the owner operator of a private child care centre in the municipality.

The complaint alleged that the Council has departed from the correct application of Victoria’s *Competitive Neutrality Policy* by not applying a fully-cost reflective pricing structure to the long-day child care services at both of its centres. Specifically the complainant alleged:

- the Council subsidises its two centres by about \$450,000 a year
- the Council is exempt from having to pay rates on its centres, which is a cost advantage over private competitors who are required to pay rates

The complainant also raised concern about a possible non-price advantage that employees at the centres are on Council awards and are paid approximately 20% more than the industry award wages thereby allowing the Council to attract and retain the best educators. However, as there is no evidence that the Council is advantaged, this concern will not be investigated.

The VCEC has investigated the cost concerns raised in the complaint and other costing or CN issues that emerged during the investigation.

3 Background

This section provides an overview of the Hobsons Bay City Council’s child care services, how the Council has considered the CN Policy and, where relevant, what measures it has implemented to apply CN to its services.

3.1 Council child care services

The Council runs two long-day child care centres in Altona Meadows and Altona North for children from birth to school age. The ANCC provides 54 places and operates along the theories from Reggio Emilia. The AMCC accommodates 57 places.

In addition, the Council coordinates a family day care service that provides small group care for children from birth to 12 years old in a home environment and runs an occasional care service two mornings a week during the school term for

children under six. The Council also provides and maintains buildings and infrastructure to not-for-profit providers of long-day care services which compete with both the Council and private centres.

As discussed above, it is the Council's two long day child care centres which are subject to complaint and under investigation.

3.2 Competitive neutrality measures adopted between 2005-2014

The Council advised the VCEC about how it has considered CN issues and what actions it has taken to apply the CN Policy to its long-day child care activity. These include:

- completing a National Competition Policy audit (Day Neilson, July 2002) of long-day child care services that identified the Altona North and Altona Meadows children centres as significant business activities for the purposes of CN policy.
- conducting a full cost-reflective pricing exercise (2003) which identified that the two Council child care centres are being subsidised.
- developing a Council *Child Care Public Policy Statement* (July 2005) and undertaking a public interest test (conducted by Maddocks in 2005) to justify subsidising the service.

The *Child Care Public Policy Statement* stated that the Hobsons Bay community needed access to 'affordable, high quality and responsive childcare services' and accordingly the Council chose to continue to subsidise the operation of its two centres to meet these objectives. The Council did however envisage staged fee increases "with a view to eliminating the operational subsidy over a three to five year period" — which the Council believed would demonstrate fiscal responsibility as well as meet its public policy objectives.¹

When considering application of the CN Policy in 2005, the Council recognised that eliminating the operational subsidy alone would not achieve full cost recovery because a CN subsidy (due to other cost advantages) would still exist. Following this, the Council conducted a public interest test to satisfy CN Policy obligations to demonstrate a need for the CN subsidy. However, over time the Council's operational and CN subsidies have increased. This will be discussed further in section 5.

¹ *Report on Public Interest Test for Childcare Centres – For Hobsons Bay City Council*, Maddocks December 2005, page 15.

3.3 Recent developments

The National Quality Framework (NQF) for child care and early learning began on 1 January 2012² and includes the following elements:

- Quality — the NQF establishes a National Quality Standard that sets a national benchmark and includes an assessment and rating process about the quality of child care and early learning services.
- Affordability — eligible families are assisted with the cost of child care through the Child Care Benefit program.
- Priority access — long-day child care service providers are required to provide child care in line with Priority of Access Guidelines.

In 2014, in recognition of the changes brought in by the NQF and the significant operational losses, the Council contracted KPMG to review its *Child Care Public Policy Statement* and the Council's role in the long-day care sector. KPMG delivered a report to the Council in October 2014. Key findings included:

- The combined underlying loss from operating the two Council centres amounted to \$640 000 in 2013-14 and “the Council has limited opportunity to address the high level of losses”.³
- Factors “outside of the Council's control play the main role in achieving the objectives described in its *Child Care Public Policy Statement*” (that is the NQF).⁴
- “The Council's participation in the market is both costly and diverts scarce community funds from areas where the Council can support vulnerable families and their children.”⁵

The KPMG report examined options for the Council's future involvement as a direct provider of long day child care services: (i) maintain the services as is, (ii) transition both services to an alternative provider, (iii) transition either one of the services to an alternative provider, or (iv) close the services. However, KPMG did not consider the option of fully cost-reflective pricing consistent with the CN Policy for on-going provision of long-day child care services.

The KPMG report has been taken to the Council, but Council has deferred a decision on its future approach to long-day care services until 2015.

² In 2009, COAG endorsed a National Quality Framework for child care and early learning for most Long Day Care, preschool/kindergarten, Family Day Care and Outside School Hours Care services in Australia which aims to raise quality and drive continuous improvement and consistency in child care and early learning services and school age care.

³ KPMG Hobsons Bay City Council Child Care Public Policy Review KPMG, October 2014, p 30, p. 34.

⁴ KPMG Hobsons Bay City Council Child Care Public Policy Review KPMG, October 2014, page 51.

⁵ KPMG Hobsons Bay City Council Child Care Public Policy Review KPMG, October 2014, page 5.

In November 2014, a draft *Early Childhood Education and Care Policy* was presented at the Ordinary Council Meeting. The Council Meeting directed that the community be consulted before a Council decision in 2015 on whether to adopt the draft policy. The draft policy is intended to replace the Council's 2005 *Child Care Public Policy Statement*.

The draft statement acknowledges the Council's CN obligations, stating: "All councils must comply with the government's *Competitive Neutrality Policy* for the significant business activities they provide ...". However, it does not identify which of its child care services is in scope of CN Policy or which measures have been taken to demonstrate compliance with the Policy. How public policy objectives are considered under the CN Policy is discussed in section 6.

4 Does Competitive Neutrality Policy apply?

The threshold issue in any CN investigation is establishing whether the government activity subject to the complaint is a significant business for the purposes of the CN Policy. As noted above, the Council previously assessed its two long-day child care services to be significant business activities. However, this assessment was undertaken in 2002 and, given changes to the market and regulatory environment, the VCEC believes it is necessary to reassess whether the Council's long-day child care services are a significant business.

The significant business test asks the following questions:

- (1) Is the activity a business?
- (2) If the activity is a business, is the business significant?

Factors that would indicate the Council's long-day child care activity is a business are whether:

- *The activities of the entity result in the sale of a good or service.* A fee is charged for the child care services provided at AMCC and ANCC.
- *The costs of providing the goods or services by the entity are predominantly met by users.* The Council operates AMCC and ANCC on a commercial basis with the intention to recover costs from users, even though these services are subsidised by the Council.
- *There is an actual or potential competitor.* There are ten private for-profit and four community not-for-profit long-day child care service providers within the Hobsons Bay municipal boundary.
- *The managers of the activity have a degree of independence in the production of the good or service and its price.* The Council has independence in the operation and pricing of each service, and services are subject to the same

Commonwealth and State policy and regulatory framework as private competitors.

In terms of the tests outlined above, the VCEC finds that the Council's long-day child care operation is a business activity in the context of the CN Policy.

On the question of significance, the following factors are taken into account.⁶

- *The size of the relevant business activity in relation to the size of the relevant market.* As noted above, the Council operates two of the 16 long day child care services within the municipality — AMCC and ANCC.
 - Together the Council centres generate \$2.3 million in income and incur \$3.1 million in total expenses (discussed further in section 5.1.2). The VCEC *Conventions for the Competitive Neutrality Function* state that a government business activity that has annual revenue above \$500 000 will be in the scope of the investigation process.
 - The Council centres offer 111 places which is approximately 8 per cent of the total (1390) places in the municipality. The Council centres provide for 208 children from 178 families.
 - The Council's market share is higher in localised geographic areas. ANCC provides 54 (14%) of the 395 places in the postcode 3025 area, and AMCC provides 57 (18%) of the 311 places in the postcode 3028 area.
 - Based on previous trends, if the Council continues to operate the services and does not expand them, the Council's share of the market is likely to shrink as the overall market grows.
- *The influence or competitive impact of the business activity in the relevant market.*
 - The provision of long-day care is a low-margin operation. The subsidy provided by the Council to its services could influence the price-quality mix of the services provided by competing businesses (that are not subsidised).
 - There is an oversupply of places in Altona North (postcode 3025) creating competitive pressures that may disadvantage other providers that do not have access to a subsidy.
 - Of the 10 private centres, five are run by independent sole operators, two by service providers that operate other centres outside the municipality, and three are operated by the same service provider. Given low-margins some of the centres, particularly the independent

⁶ Government of Victoria 2012, p. 5; *Identifying significant business activities for competitive neutrality: Guidance note*, VCEC 2012.

sole operators, may not have the capacity to sustain on-going losses as the Council centres are able to do.

- There is an undersupply of places in Altona Meadows (postcode 3028) but the information is not available to determine whether this could be attributed to underinvestment by private providers due to a reluctance to compete against a subsidised loss-making competitor.
- The waiting lists at the two Council centres appear substantial (205 at ANCC and 210 at AMCC at June 2014) given their placements and capacity.⁷
- The parents at both Council services consider that their choice to use the Council services was in part driven by the perception that the quality at the Council centres was higher than elsewhere.⁸ This perceived quality difference may be derived from the additional resources provided by the subsidy.⁹

In the past, the Council has viewed its child care centres as a significant business for the purpose of the CN Policy. This is consistent with the treatment of child care centres run by other councils. As noted in section 3, however, the child care market has changed and as the above discussion indicates, the extent of influence of Hobson Bay City Council's long-day child care centres is declining. While the size of each centre appears to be significant in their immediate locality they appear to have less influence from a municipal-wide perspective. A degree of judgement has, therefore, been required to determine whether the Council's long-day child care centres still satisfy the significance test for the purpose of the CN Policy.

Although the influence of the Council's activity appears to be diminishing, there are indications that it continues to have an influence on decisions made by parents and competitors. The potential of the Council's activity to influence the market — particularly the price-quality mix, and entry/exit decisions of some other providers — also appears to be real. Thus, on balance, the VCEC has concluded that at this time the Council's long-day child care activity is a significant business for CN purposes.

5 Costing and pricing issues

The CN Implementation Guide summarises the procedure for determining competitively neutral costing and pricing:

⁷ KPMG Hobsons Bay City Council Child Care Public Policy Review KPMG, October 2014, pp. 29, 32

⁸ KPMG Hobsons Bay City Council Child Care Public Policy Review KPMG, October 2014, p. 40

⁹ KPMG Hobsons Bay City Council Child Care Public Policy Review KPMG, October 2014, p. 3

- define the output (the good or service)
- attribute full costs to the production of the output, including the cost advantages and cost disadvantages of public ownership
- derive the net CN adjusted cost.

Only after these steps have been taken is it possible to determine a fully cost-reflective pricing structure, or whether existing pricing is fully cost-reflective.

The focus of assessing a CN costing exercise is to determine whether the exercise satisfies CN obligations (section 5.1), whether Council’s pricing fully recovers the competitively neutral cost of its significant business activity (section 5.2), or whether any remaining subsidy has been justified on public interest grounds (section 6).

5.1 Competitive neutrality costing exercise

The Council provided the VCEC with two sets of financial data — data published in the KPMG report and later, upon request, more up-to-date data from the Council’s financial department.

5.1.1 KPMG report on council child care

KPMG estimated the total loss of the Council’s child care operation for the year to June 2014 as \$640 895. In calculating the loss KPMG considered:

- the loss reported on the Council’s financial accounting system.
- an industry benchmark of non-wage and non-rental costs of 8 per cent of child care service costs to estimate the cost to the Council of ‘insurances, utilities, building repairs and maintenance, depreciation, building rental, IT/HR/Payroll/Accounting services, and direct management (including supervisor salary).’ These are costs attributed to the Centres out of the Council’s central costs.
- the opportunity cost of the capital invested in each centre.

KPMG’s estimates captured a range of facility, administrative and management costs ‘absorbed in the Council’s central costs’ that were not charged to the centres. Although the KPMG study was not undertaken for CN purposes, by adjusting the cost base to allow for an industry benchmark, some CN advantages appear to have been captured. However, because these CN advantages have not been explicitly identified, the VCEC is unable to verify that this is a competitively neutral cost base.

Further, the exercise does not include possible CN disadvantages which, if material, might mean the estimated total loss is overstated.

The table below sets out the losses that KPMG identified for the two Council centres.

	\$ reported loss	\$ benchmark adjustment ¹⁰	\$ opportunity cost	\$ total loss
ANCC	93 629	130 000	50 000	273 629
AMCC	167 266	150 000	50 000	367 266
Total	260 895	280 000	100 000	640 895

KPMG estimated that ANCC loses approximately \$20 per place per day and at AMCC the loss is \$26. In costing the Council’s long-day child care service KPMG noted that it is ‘difficult to quantify’ the total value of costs not accounted for in the Council centres.

5.1.2 Council competitive neutrality costing

The Council advised the VCEC that since KPMG presented its report, the Council’s finance department was able to extract additional costing data (actual rather than estimated costs) and CN cost adjustments. More detailed analysis of costs enabled the Council to revise the total loss/subsidy to \$1 049 450 for the year ending June 2014. The Council identified:

- The difference between total income and direct expenditure (employee costs, materials and consumables and utilities) – referred to as the reported loss.¹¹
- Building and maintenance costs — largely comprising contracts for maintenance of the child care facilities and grounds.
- Supervision and support — additional employee costs apportioned to the long-day child care services from Council costs in providing broader child care and early learning support services.
- Corporate overheads — the Council finance department reviewed the corporate overheads attributable to its long-day child care service and applied an 8 per cent multiplier to direct expenditure on childcare services.
- CN advantages — the Council identified adjustments for commercial rent, payroll tax, and included depreciation up to 2013-14 when the facilities were fully depreciated. Under the CN Policy adopting an estimated commercial

¹⁰ KPMG Hobsons Bay City Council Child Care Public Policy Review KPMG, October 2014, pp 30, 34.

¹¹ Materials and consumables cover a range of costs including: purchase of food, bank fees (for use of electronic payment methods for parents), purchase of equipment, such as toys, equipment and consumables for children as well as office chairs, telephones, computer equipment, software maintenance fees, cloth nappy and removal of disposable nappy services, office stationary, printing, and membership of peak bodies (Early Childhood Australia).

rent means that separate adjustments for council rates and land tax are not required.

The costs and loss are shown in the following table.

\$ Reported loss	\$ Building maintenance	\$ Supervision and support	\$ Corporate overheads	\$ CN advantages	\$ Total loss
ANCC					
102 264	107 551	45 167	95 037	134 348	484 367
AMCC					
174 601	107 551	45 167	103 141	134 623	565 083
Total					
276 865	215 102	90 334	198 178	268 971	1 049 450

The VCEC is satisfied that the Council followed the CN pricing guidelines to identify and calculate the cost base of its long-day child care service and that the analysis indicates that the long-day child care service operates at a substantial loss.

5.1.3 Competitive neutrality adjusted cost and pricing

On the basis of a \$1 049 450 total loss/subsidy, it should be possible for the Council to estimate the annual subsidy per child place averaged across both centres (111 places) and, assuming no cost reductions, further calculate the weekly and daily fee increase required to achieve fully cost-reflective pricing. The Council provided the VCEC with pricing data showing that the daily fee for long-day care has increased by 27% in three years between 2011-12 and 2014-15.

5.2 Pricing conclusion

Based on the revenue and costing data provided by the Council, the VCEC has concluded that the Council pricing of its long-day child care service is not fully cost-reflective as required under the CN Policy. The VCEC has therefore concluded that the Council has not fully complied with the requirement of the CN Policy.

6 Complying with Competitive Neutrality Policy

Having estimated the annual loss attached to the operation of the long-day child care activity, the Council can comply with the CN Policy by implementing fully cost-reflective pricing. If, however, the Council considers fully cost-reflective pricing would jeopardise public policy objectives the CN Policy permits

subsidisation of activities as long as a public interest test has been completed that demonstrates why a subsidy is required to achieve the stated objectives.

The CN Policy states that to satisfy the formal requirements of the Policy, a public interest test should, at a minimum:

1. clearly identify the policy objective(s) that is to be achieved and ensure that the policy objective(s) has official endorsement (for example by a Minister, a local government body or in an official policy document);
2. demonstrate that the achievement of the stated policy objective(s) would be jeopardised if the particular competitive neutrality measure under consideration was implemented; and
3. determine the best available means of achieving the overall policy objectives, including an assessment of alternative approaches.

The public interest test should be undertaken in consultation with the community through an open and transparent process. At the conclusion of the process, the conduct and outcomes of the public interest test should be made publicly available. (Government of Victoria 2012, p. 9)

As discussed in Section 3, in 2005 the Council developed its *Childcare Public Policy Statement* and conducted a public interest test to justify the departure from applying fully cost-reflective pricing to its child care service.

However, given changes that have occurred in the market since that time, including the introduction of the national standards (section 3), the analysis of that exercise is outdated. In recognition of these changes the Council released its draft *Early Childhood Education and Care Policy* statement for consultation in November 2014.

The draft *Early Childhood Education and Care Policy* statement sets out the role the Council plays as a planner, resource provider, service provider, partner and broker, advocate and supporter and community capacity builder. The statement also sets out a broad range of objectives including recognising the community need for access to affordable, high quality and responsive early childhood education and care services.

However, the draft *Early Childhood Education and Care Policy* statement does not demonstrate how subsidising Council-provided long-day care services contributes to its objectives. In other words, it does not state how the Council's policy objectives would be compromised if it were to price its long-day child care service at ANCC and AMCC to be fully cost-reflective.

6.1 Complying with Competitive Neutrality Policy conclusion

The VCEC has concluded that the draft *Early Childhood Education and Care Policy* statement does not satisfactorily demonstrate why the fees charged for long-day child care services at ANCC and AMCC are not fully cost-reflective, or why cost reflective prices would jeopardise the Council's public policy objectives. Further, the Council has not undertaken a public interest test to determine how it might achieve both its public policy objectives and CN Policy objectives and, therefore, is currently not compliant with the CN Policy.

Recommendation One

That if the Council chooses to continue to operate the child care services it should, within three months from the date of receipt of the VCEC's final investigation report:

EITHER

- (1) begin implementing a credible plan to adjust the prices it charges for these services to fully cover CN adjusted costs, with fully cost reflective prices to be achieved as soon as practicable**

OR

- (2) complete a public interest test that meets the requirements of the CN Policy.**

Should the Council undertake a public interest test, it would need to take the following steps:

- Clearly identify the policy objectives attached to the provision of long-day child care services at the Council centres**
- Demonstrate how the policy objectives would be compromised if fully cost-reflective pricing were implemented**
- Determine the best available means of achieving both the Council policy objectives and CN Policy objectives.**

That the Council consult with the VCEC for guidance when undertaking this exercise.

7 Conclusions

In its investigation of the allegations made against the Hobsons Bay City Council and its provisions of long-day child care services at the Altona North and Altona Meadows children's centres the VCEC considered:

- (1) whether the Council's long-day child care service is a significant business to determine if it is within scope of Victoria's CN Policy.
- (2) whether the CN costing exercise was correctly undertaken.
- (3) the specific cost concern raised by the complainant — the inclusion of rates in the Council's costing exercise — as well as other possible costs that the Council may not have included.
- (4) the Council's public policy objectives attached to the operation of the two long-day child care centres.

The VCEC reached the following conclusions.

- The Council's long-day child care services conducted at ANCC and AMCC is a significant business and therefore in scope of Victoria's CN Policy.
- The Council's costing exercise shows that the Council made a loss and subsidised its long-day child care service by \$1 049 450 for the year ending June 2014.
- The Council's costing information initially provided to VCEC did not identify the full CN cost of the long-day child care activity. The Council provided additional information that satisfied the VCEC that its CN costing exercise was correctly completed.
- The significance of the subsidy clearly demonstrates that the Council's long-day child care is not compliant with the fully cost-reflective pricing principle in the CN Policy.
- The Council's draft *Early Childhood Education and Care Policy* statement (November 2014) recognises the CN Policy but does not identify how the long-day services achieve specific policy objectives and whether the service requires a Council subsidy to achieve these.

To assist the Council to achieve compliance with CN Policy, the VCEC has recommended that, should the Council choose to continue providing the service, it either implement a plan to adjust its prices to be fully cost-reflective or conduct a public interest test to achieve compliance with the Policy.

The VCEC will follow-up with the Council three months after the finalisation of this report to determine whether the recommendation in the final report has been implemented. The VCEC is available before that time to provide advice, if required, to help the Council comply with the CN Policy.

8 References

COAG (Council of Australian Governments) 1995, *Competition Principles Agreement – 11 April 1995 (as amended to 13 April 2007)*, Canberra.

DTF (Department of Treasury and Finance) 1994, *Community Service Obligations, Policy Statement and Background to Policy*, Melbourne.

— 2000, *Competitive Neutrality Guide to Implementation*, Melbourne.

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

Hobsons Bay City Council 2005 *Child Care Public Policy Statement*, Melbourne.

— Ordinary Council Meeting Minutes 18 November 2014, 7.1.1 Childcare Public Policy Review Outcome, (accessed 24 November 2014)

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Appendix A: CN measures

The CN policy provides three measures for implementing competitive neutrality — corporatisation, commercialisation, and full cost-reflective pricing.

Corporatisation

‘Corporatisation involves the creation of a separate legal business entity to provide the relevant goods and services’ (Government of Victoria 2000, p. 7). The following characteristics of a corporatised entity are described in the CN Policy:

- clear and non-conflicting objectives;
- managerial responsibility, authority and autonomy;
- independent and objective performance monitoring; and
- performance-based rewards and sanctions.

Corporatisation is the preferred way to address CN issues when the government agency operates a business in a market in which it has statutory monopoly functions. Full separation through corporatisation ensures the agency does not face conflicting objectives between its statutory monopoly functions and commercial objectives.

Commercialisation

Commercialisation ‘involves organising an activity along commercial lines without creating a separate legal business entity’ (Government of Victoria 2000, p. 7).

The CN Policy notes that commercialisation is typically achieved by applying a set of ‘commercial practices’ to the business functions of a government agency. These practices may include:

- clear delineation of commercial and non-commercial activities, typically through a business plan;
- clearly defined commercial performance targets and financial reporting requirements;
- separate accounting for, and funding of, non-commercial activities;
- separation of regulatory functions from commercial activities;
- an appropriate financial return on the assets used in the commercial activity;
- application of a tax equivalent regime; and
- appropriate financial arrangements for allocating profits from the commercial activity. (Government of Victoria 2000, p. 7)

Commercialisation is less costly than corporatisation. It is, thus, likely to be the preferred model for addressing CN issues when the government agency does not have statutory monopoly functions or decision-making powers that significantly

affect the profitability of its business and competitors, or when the costs of corporatisation are high relative to the benefits. Examples of where commercialisation can be an effective instrument for achieving CN include council-operated aquatic and recreation centres.

Full cost-reflective pricing

Full cost-reflective pricing takes into account all the costs that can be attributed to the provision of the good or service (including the cost of capital), as well as the cost advantages and disadvantages of public ownership. The CN Policy notes:

The intention of full cost reflective pricing is to offset any net competitive advantages a government business may enjoy, thereby ensuring that resource allocation decisions are made on the basis of comprehensive and accurate costing. (Government of Victoria 2000, p. 7)

Full cost-reflective pricing, without corporatisation or commercialisation, may be sufficient if the main CN issues relate to cross-subsidies between commercial and non-commercial activities of government entities. It does not, however, address non-pricing concerns. It is the preferred model for addressing CN issues when the government business is small and the issue does not warrant taking on the relatively large costs involved in corporatisation or commercialisation. An example of where full cost-reflective pricing may be an effective measure to achieve CN would be the operation of a small cafeteria in a public hospital.