



Sustainability Victoria

FirstRate5

Competitive Neutrality Assessment – Final

(February 2017)

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Executive Summary

Purpose of this Report

This report has been prepared to assess whether Sustainability Victoria's current cost recovery model for FirstRate5 properly takes into account the Victorian Government's Competitive Neutrality Policy.

As part of developing this report, Pitcher Partners Consulting (PPC) also developed a Competitively Neutral Cost Model that will assist Sustainability Victoria to achieve its cost recovery objectives and assess ongoing compliance with the Competitive Neutrality policy as circumstances change.

No competitive neutrality complaint has currently been made in relation to FirstRate5. This report also does not consider the application of the Public Interest Test.

The Competitive Neutrality Policy

The Victorian Government's Competitive Neutrality Policy was released in October 2000. The competitive neutrality policy is designed to improve economic efficiency by removing any unfair competitive advantages or disadvantages for publicly owned entities engaged in significant business activities.

Publicly owned entities engaging in significant business activity can achieve competitive neutrality through corporatisation, commercialisation of the business, or alternatively through full cost-reflective pricing.

Is FirstRate5 a 'Significant Business'?

FirstRate5 is a business activity: it results in the sale of service; there are actual competitors; the FirstRate5 team has a degree of independence in its day-to-day operations (although prices are set in consultation with the relevant Minister); and, the costs of the business are predominantly met by users of the software through a price on certificates generated.

FirstRate5 is also a significant business in the market for residential performance assessment software. FirstRate5 is the market leader in Victoria and has a substantial impact on the market.

Are FirstRate5 prices Competitively Neutral?

Is Sustainability Victoria's Cost recovery model consistent with the Fully Distributed Cost model?

Sustainability Victoria seeks to operate FirstRate5 on a cost recovery basis. Annual budgets are developed for the operation, with projected revenues and estimated costs. Actual revenue and cost outcomes are tracked against the Annual budget.

To date, these budgets have only captured the direct costs associated with FirstRate5, including primarily royalties paid, labour costs and consulting costs. Based on data provided by Sustainability Victoria, results for the 2015-16 financial year show a modest Gross Operating Surplus

To ensure consistency with the Fully Distributed Cost, Sustainability Victoria should consider explicitly including reasonable allocations of indirect costs in its cost recovery model.

Estimates of these indirect costs have been developed in order to assess the estimated Net Surplus / Deficit. Based on these estimates, the net result for 2015/16 (before competitive neutrality adjustments) was a very small Net Surplus.

Adjusting for competitive advantages and disadvantages

The main competitive advantage identified relates to Cost of Capital. A standalone small business operator that purchased FirstRate5 – or invested resources into developing equivalent software – would be expected to seek a return on this capital investment. A competitive neutrality adjustment was made for this, based on a reasonable (and conservative) estimate of the value of the FirstRate5 software.

The FirstRate5 team currently also benefits from various corporate services provided by Sustainability Victoria free of charge. A competing private businesses would be required to meet these costs.

If, however, Sustainability Victoria includes a reasonable allowance for indirect costs as recommended in the Competitively Neutral Cost Model, then no further competitive adjustment should be necessary.

Alternatively, a reasonable estimate of the costs associated with providing these services to a privately owned small business could be included as a competitive advantage from public ownership.

Finally, no non-price competitive advantages were identified. FirstRate5 and its competitors are all subject to national regulation, which is not within the control of Sustainability Victoria. We are not aware of any information or channel to market that the FirstRate5 team has access to through Sustainability Victoria that provides a material competitive advantage in the residential performance assessment software market.

A Competitively Neutral Price?

Based on the revenue and costing data provided by Sustainability Victoria, it is our assessment that – based on current costs and revenues and a conservative estimate of the value of the FirstRate5 software – current certificate prices are slightly below the implied competitively neutral price.

We recommend that Sustainability Victoria consider these estimates of indirect costs and competitive neutrality adjustments for FirstRate5 when reviewing and advising the Government on the appropriate prices for FirstRate5 generated certificates.

	AMOUNT (\$)
GROSS OPERATING SURPLUS / (DEFICIT)	130,000
<i>INDIRECT COST ADJUSTMENTS</i>	-120,000
NET SURPLUS / (DEFICIT)	10,000
<i>COMPETITIVE NEUTRALITY ADJUSTMENTS</i>	-32,000
TOTAL SURPLUS / (DEFECIT)	(22,000)

Note: Figures are rounded and approximate. [Detailed figures are provided as commercial-in-confidence in Appendix 2].

Sustainability Victoria also noted that a number of FirstRate5's key costs are expected to change. In the event that the direct and/or indirect costs associated with FirstRate5 were to increase, this would also impact the competitively neutral price (and the breakeven price).

We recommend that Sustainability Victoria use the Competitively Neutral Cost Model developed by PPC to assess the impact of changing costs on FirstRate5's financial outcomes. This could be done as part of the annual budgeting process for FirstRate5.

What would be the most appropriate 'Measure' to achieve Competitive Neutrality?

As there were no identified 'non-price' competitive advantages, the benefits of Corporatisation or full commercialisation over full-cost reflective pricing would be minimal. The costs of Corporatisation or full commercialisation would be high relative to the size and revenue of the FirstRate5 business.

Therefore, we recommend that Sustainability Victoria consider adopting full cost-reflective pricing as the most appropriate measure to ensure competitive neutrality. This should include a reasonable estimate of indirect costs, as well as taking into account the identified competitive neutrality adjustments.

Should the Government decide that it wants to set the price for FirstRate5 certificates *below* the competitively neutral price(s), then Sustainability Victoria should consider whether the costs of the most appropriate competitive neutrality measure exceed the benefits of achieving competitive neutrality.

If the benefits of the measure outweigh the costs, then Sustainability Victoria should consider the Public Interest test to determine the appropriateness of the Government's preferred price, in accordance with the Competitive Neutrality policy. (Assessment of the Public Interest test is outside the scope of this report.)

1. Background

The FirstRate5 Software is Victoria's leading residential thermal performance assessment software. It is used by the majority of industry participants to rate the energy efficiency compliance of residential dwellings to the 6-star standard under the National Construction Code of Australia (NCC).

The standard applies to all new homes, as well as major renovations and extensions. Under current regulatory requirements, homes are required to have a minimum of 6 out of 10 stars.

The FirstRate5 software integrates the 'Chenath' calculation engine developed by the Commonwealth Scientific and Industrial Research Organisation (CSIRO) to estimate the annual heating and cooling energy. It can be used to rate an existing design or as an interactive tool to optimise the design beyond compliance.

Sustainability Victoria (and its predecessor organisations) has developed and supported house energy rating software for over 20 years. It was originally a voluntary tool to compare the energy efficiency of house plans. The primary purpose of this was to support the Government's policy objectives of encouraging energy efficient housing, rather than as a commercial endeavour.

Following a review of the energy rating software, in 2014 Sustainability Victoria made substantial changes to the FirstRate5 software, including improvements to the user interface, updates to ensure compliance with the latest Nationwide House Energy Rating Scheme (NatHERS) protocol, and the introduction of a 'fee-per-certificate' pricing model.¹

The FirstRate5 operation is managed by a small team of Sustainability Victoria staff, supported by specialist contractors delivering operational support, software development and IT support for users.

Since May 2014, Sustainability Victoria has operated FirstRate5 under a 'cost recovery model', seeking to cover the full direct costs of the FirstRate5 operation each year (including any software development) through revenue from the FirstRate5 software – that is, the sale of energy efficiency certificates.

Purpose of this Assessment

The Victorian Government has requested that Sustainability Victoria ensure that its cost recovery model for FirstRate5 properly takes into account the Victorian Government's Competitive Neutrality Policy.

No Competitive Neutrality complaint has currently been made in relation to FirstRate5.

Sustainability Victoria has engaged Pitcher Partners Consulting to independently assess and document whether there are any competitive neutrality issues in relation to the FirstRate5 operation, and provide advice on practical steps that Sustainability Victoria should take to ensure that FirstRate5 meets the requirements of the competitive neutrality policy.

A secondary purpose of the engagement was to build a Competitively Neutral Cost Model that would allow Sustainability Victoria to evaluate the impacts of *changing* costs and revenues of the FirstRate5 software.

This will help Sustainability Victoria to achieve its full cost-recovery objectives and better assess ongoing compliance with the Competitive Neutrality Policy as circumstances change.

¹ Prior to this, Sustainability Victoria sold a perpetual licence to install the FirstRate5 software for a one-off price.

Approach and limitations

In consultation with Sustainability Victoria, PPC developed a Competitively Neutral Cost Model, which estimates financial outcomes and the implied competitively neutral price for certificates under a 'current' and 'alternative' scenario. The model includes:

- Estimated revenue, based on existing prices and an average of historical volume of certificates
- Direct costs related to the business activities of FirstRate5, based on actuals for the 2015-16 year, existing contract rates (e.g. royalties, contractor rates) and, for the purposes of the 'Alternative Scenario' only, budgeted outcomes for the 2016-17 financial year
- An estimate of indirect costs, based on financial figures available and a reasonable proportional allocation of corporate overhead costs, using the method agreed with Sustainability Victoria
- Estimated competitive neutrality adjustments, based on discussions with Sustainability Victoria, the Office of Better Regulation, and our application of the competitive neutrality policy to the information provided.

PPC did not independently *audit* the financial information provided in relation to the FirstRate5 operation. This report relies on the accuracy and completeness of the information provided by Sustainability Victoria.

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Timing

Planning and Scoping:	October 2016
Review of documentation	November 2016
Developing Competitively Neutral Cost Model	November 2016 – January 2017
Draft Report:	February 2017
Final Report	February 2017

2. The Competitive Neutrality Policy

Victoria's *Competitive Neutrality Policy* Victoria was released in October 2000. The objective of competitive neutrality is:

...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)

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

Competitive neutrality only applies to the significant business activities of publicly-owned entities, and not to the non-business, non-profit activities of those entities (DTF 2000).

In Victoria, 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 Competitive Neutrality Policy provides for three measures that publicly-owned entities can use to achieve competitive neutrality — corporatisation, commercialisation, and fully cost-reflective pricing. (Appendix A provides a further description of these measures.)

Under the Competitive Neutrality 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 any 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.

The most appropriate competitive neutrality measure should only be implemented if the expected benefits of doing so (such as improved efficiency) exceed the estimated costs of implementing the measure.

The competitive neutrality measure is then only required to be implemented where it is in the public interest. Where implementation of the most appropriate competitive neutrality measure (for example, fully cost-reflective pricing) jeopardises other public policy objectives, the government entity must undertake a public interest test to justify not implementing full cost-reflective pricing.

The potential application of the Public Interest test is outside the scope of this report.

Application of the framework

Consistent with the Competitive Neutrality Policy, if a complaint against a government business is lodged, then the relevant evaluating body (currently the Commissioner for Better Regulation) investigates the complaint and determines the extent to which the agency's actions comply with the Policy.

This evaluation would draw on the Government's policy implementation advice, currently reflected in the *Competitive Neutrality Guide to Implementation* ('Implementation guide') (DTF 2000).

As stated previously, no complaint has currently been made against FirstRate5. This report documents the assessment undertaken by PPC on behalf of Sustainability Victoria.

3. Assessment of FirstRate5

3.1 Does the Competitive Neutrality Policy apply?

The threshold issue for determining whether the competitive neutrality policy applies is to establish whether the relevant activity (i.e. FirstRate5) is a 'significant business' as defined in the policy.

Is FirstRate5 a business?

The following factors are used to assess whether the activity is a business:

- (i) The activities of the entity result in the sale of a good or service.
- (ii) There is an actual or potential competitor.
- (iii) The managers of the activity have a degree of independence in relation to the production or supply of the good or service and the price at which it is provided.
- (iv) Whether the costs of providing the goods or services are being predominantly met by users.

FirstRate5 sells residential thermal performance assessment software. The software is a certificate generation system that can be used to assess whether residential dwellings satisfy the 6/10 star rating required by law. The activities of FirstRate5 result in the sale of a service.

There are two other competing providers of residential thermal performance software in the market: AccuRate (run by CSIRO) and BERS Pro (operated by a private sector provider).

As managers of FirstRate5, Sustainability Victoria staff have independence over its day to day operations. Based on actual and projected financial outcomes, the project team sets the price in consultation with the Minister for Energy, Environment and Climate Change.

For the past two and a half years, Sustainability Victoria has sought to operate FirstRate5 on a full cost-recovery basis through the sale of certificates to its users. The costs of FirstRate5 are therefore predominantly met by users.

Conclusion: Despite not having full independence on the pricing of certificates, in our view the FirstRate5 operation would still be considered a business for the purposes of the Competitive Neutrality policy.

Is FirstRate5 a significant business?

The following factors are used to assess whether the activity is a significant business:

- (i) The size of the business relative to the market.
- (ii) The influence or competitive impact of the business activity in the relevant market.
- (iii) The resources the business activity commands and the effect of poor performance.

FirstRate5 has a majority share of the residential thermal performance software market in Victoria. Furthermore, with revenues above \$1 million, FirstRate5's operations clearly exceed the 'benchmark' of \$500,000 identified in the guidance note *Identifying significant business activities for competitive neutrality* (VCEC 2012). For these reasons, FirstRate5 is a relatively large business in the residential thermal performance software market.

FirstRate5 is also seen as the industry standard in Victoria. Due to its status as a market leader and its large market share, FirstRate5 has a substantial competitive impact on the market.

Sustainability Victoria currently employs a small project team, supported by specialist contractors, and procures relevant services (such as web hosting) to support the FirstRate5 operation. Poor performance of FirstRate5's operations would have a substantial impact on users in the market.

For the reasons stated above, FirstRate5 is considered a significant business in the market for residential performance assessment software.

3.2 Current financial operations of FirstRate5

Sustainability Victoria seeks to operate FirstRate5 on a cost recovery basis. All of the FirstRate5 revenue comes from the sale of certificates for new homes and existing homes, as well as certificates for alterations and additions to existing homes.

The FirstRate5 project team develops annual budgets for the FirstRate5 operation, with projected revenues (based on estimated number of certificates sold and the price per certificate) and estimated costs.

Past budgets have generally been based on full recovery of **direct costs** only. (These direct costs include the full costs of contractors and consultants for the development and support of the software. These contractor and consulting costs are based on commercially procured services, which would be expected to reflect the providers' direct and indirect costs in providing those services.)

Based on actual results provided for the 2015-16 financial year, the FirstRate5 operation was operating at a modest Gross Operating Surplus.

One of the purposes of this report is to assess whether the current financial model and pricing is consistent with the Fully Distributed Cost model, and whether any Competitive Neutrality adjustments should apply.

Direct costs

Royalties to CSIRO

Sustainability Victoria paid royalties to CSIRO for use of the Chenath engine, which drives the energy calculations within FirstRate5. The royalty is paid per certificate generated. This is one of the major cost drivers for FirstRate5.

The royalty agreement between CSIRO and Sustainability Victoria is the result of commercial negotiations between the two parties. Access to the Chenath engine is not exclusive: competitors in the market also use the Chenath engine to drive energy calculations (but with their own user interface).

CSIRO's commercial relationships with third parties are confidential, but CSIRO has indicated to Sustainability Victoria that it does not receive a favourable royalty agreement as a result of its public ownership.

Sustainability Victoria is currently in negotiations with CSIRO for a new royalty agreement. Any changes to the royalty rate should be reflected in the Competitively Neutral Cost Model.

Salaries

A small project team of Sustainability Victoria staff managed the FirstRate5 operation, including a project manager to oversee software development, as well as the team manager. These staff undertake and oversee the commercial activities associated with FirstRate5, as well as non-commercial activities (such as advising Ministers on policy-related issues, and contributing to Sustainability Victoria's non-business activities). Only the time spent on business activities should be included in the Competitively Neutral Cost Model (based on an estimated FTE-equivalent).

To preserve individual privacy, the Competitively Neutral Cost Model uses the mid-point between the highest and lowest salary ranges for VPS Grades from the Victorian Public Service Enterprise Agreement 2016 (Schedule B). On-costs for superannuation, payroll tax and WorkCover premiums are also calculated.

Sustainability Victoria noted that the number of staff allocated to FirstRate5's business activities may increase. Any increase in staffing levels should be reflected in the Competitively Neutral Cost Model.

Contractors and Consultants

Sustainability Victoria outsourced the majority of support, delivery, maintenance and development services to external contractors at commercial rates. This includes online technical support for users of the FirstRate5 software. Currently, contractors are the largest cost for FirstRate5.

The FirstRate5 team also periodically used consultants for specific services associated with the development and operation of FirstRate5, such as developing a user guide. (Consulting costs to support non-business activities should be excluded from the Competitively Neutral Cost Model.)

IT costs (direct)

The FirstRate5 budget includes IT costs directly associated with the development and operation of FirstRate5, including costs for web hosting, web content, web systems and business applications.

Marketing and promotions

This refers to any costs associated with the marketing and promotion of FirstRate5, or access to distribution channels that would not otherwise be available to a privately owned operation (e.g. a large customer database held by a department).

Currently the costs for marketing and promotions for FirstRate5 are very small. However, there is the potential for these costs to increase in the future. Any increase in marketing and promotion costs should be reflected in the Competitively Neutral Cost Model in the future.

Administration and legal fees (direct)

The FirstRate5 budget includes direct administration costs, mainly consisting of bank charges in relation to purchases of certificates, as well as small amounts for printing, stationary and postage costs. Legal (and probity) fees directly related to FirstRate5 are also included in the annual budget.

Travel and Accommodation

This includes travel and accommodation costs for Sustainability Victoria staff travelling for FirstRate5-related business. This includes domestic travel and taxi costs. Travel costs were small.

Indirect costs

Finance, Human Resources and IT support services (Shared Services)

The FirstRate5 team is supported by Sustainability Victoria's general corporate services, including Finance, HR and IT support (including provision of IT equipment and software).

Past Budgets have not included an allocation for indirect costs related to these shared corporate services.

Based on the methodology agreed with Sustainability Victoria, PPC has estimated and included a reasonable allocation of these (salary and non-salary) indirect costs, based on the FTE share of the FirstRate5 operation compared to the total FTE of Sustainability Victoria.

Rent and Outgoings

Past budgets have not included an allocation of rent and outgoings for the FirstRate5 team, or contractors when working on site. Using the 'share of FTE' method describe above, a reasonable allocation of rent and outgoings was included.

Other corporate overhead costs

In addition to the specific costs above, the Competitively Neutral Cost Model makes allowance for inclusion of additional indirect costs, such as business insurance costs, utilities, repairs and maintenance, estimated using the 'share of FTE' method described above. (One indirect cost was able to be estimated based on an incremental cost change from when FirstRate5 changed its pricing structure in 2014.)

Reasonableness of estimates

To assess the reasonableness of these allocations – and to determine if any competitive neutrality adjustments might be required – PPC compared these allocations against 'typical' costs for shared services, based on our experience with small organisations and budgeting for teams within larger organisations. This desktop research indicated that the estimated allocation of indirect costs was reasonable and comparable with the costs a privately-owned operator would face (depending on its choice of location and structure).

PPC notes that any increase in the number of staff working on FirstRate5 may also require an adjustment to the allocation for shared services, rent and outgoings, and some corporate overhead costs.

Consideration of the Avoidable Cost methodology

In instances where the primary activity of an agency is non-commercial, it may be appropriate to use the Avoidable Cost methodology. When using this method, the agency only has to consider the extra (direct) costs that the agency could avoid if the activity in question was not undertaken, as well as indirect costs that are specifically affected by the commercial activity.

For the agency as a whole, Sustainability Victoria's core role is not commercial. There is a reasonable case that Sustainability Victoria could apply the Avoidable Cost methodology for FirstRate5. This would remove the need to consider most indirect costs, other than those that are specifically affected by FirstRate5 (such as insurance premiums or any specialist equipment purchased by the agency).

However, the shared resources that also support the FirstRate5 business operation would not necessarily be operated at spare capacity in the medium to longer term. The impact of FirstRate5 on space and resourcing requirements could be taken into account by Sustainability Victoria, for instance when considering its lease arrangements or as part of a review of required staffing levels for its various corporate services.

Therefore, considering the long term nature of FirstRate5, and also in order to take a more conservative approach, the following analysis does not use the Avoidable Cost method for calculating the competitively neutral cost of output.²

Net financial outcomes

The following table sets out the estimated gross operating profit/loss of FirstRate5 for the 2015-16 Financial year, as well as the estimated Net surplus/(deficit) after taking into account estimated indirect costs.

	AMOUNT (\$)
GROSS OPERATING PROFIT (LOSS)	130,000
<i>INDIRECT COSTS ESTIMATE</i>	<i>-120,000</i>
NET SURPLUS / (DEFICIT)	10,000

Note: Figures are rounded and approximate. [Detailed figures are provided as commercial-in-confidence in Appendix 2].

3.3 Competitive Neutrality advantages and disadvantages

This section considers some of the potential competitive advantages and disadvantages of public ownership for the FirstRate5 business.

Competitive advantages of public ownership

Cost of Capital

The cost of capital reflects the opportunity cost of funds provided to government agencies. The Competitive Neutrality Policy states that government agencies are expected to earn a rate of return to cover the opportunity cost of capital. The Implementation Guide states that agencies should seek to make a reasonable rate of return on the depreciated value of (physical) assets used in the business.

In the case of FirstRate5, the business has minimal physical assets. The key asset is the FirstRate5 software.

Applying the principles of the Policy (and noting that the Implementation Guide was originally drafted in 2000), it would be appropriate for the purposes of assessing competitive neutrality that a government entity should consider seeking a reasonable rate of return on the value of core software assets used in a business.

² Using the Avoidable Cost method, indirect costs would be substantially smaller. As a result, the Net Surplus would be larger (close to the Gross Operating Profit), and would exceed the total competitive neutrality adjustments. In other words, applying the Avoidable Cost method, the Prices for FirstRate5 certificates in 2015-16 were slightly higher than required to be competitively neutral.

As part of its current cost recovery approach, Sustainability Victoria seeks to recover development costs in the year in which they are incurred. However, initial development costs incurred *before* the implementation of the cost recovery policy have contributed to building the market value of the FirstRate5 software. It is unlikely that these costs have been recovered either through depreciation or through seeking a rate of return on their capitalised value.

Furthermore, as development costs (and other costs) incurred before the implementation of the cost recovery policy were not separately estimated, recorded and depreciated over time, it would be costly and difficult to estimate the current depreciated value of the FirstRate5 software from historical financial information.

Therefore, the agreed alternative was to include a reasonable estimate of the current value of the FirstRate5 software.

Sustainability Victoria has acknowledged that there is ongoing uncertainty in assessing the market value of the FirstRate5 software, particularly in light of the Australian Building Codes Board's decision (which was ultimately not pursued) to consider changing the performance requirements of the National Construction Code in 2016. (The next opportunity for any change to the Code occurs in 2019.) These changes – if they had been introduced – would have impacted the market value of all NatHERS-based tools, including FirstRate5.

The Government chose to terminate a recent market process that sought expressions of interest from the market to purchase FirstRate5. The Australian Building Codes Board's decision was announced while this market process was underway.

Based on the (confidential) information obtained in this recent market process, and taking a conservative approach³ to reflect the uncertainty, a reasonable estimate of the value of the FirstRate5 software was included in the Competitively Neutral Cost Model.

Therefore, a competitive neutrality adjustment to achieve a reasonable rate of return on the undepreciated value of the FirstRate5 software has been included in our estimates. The estimates used a real rate of return of 8 per cent, consistent with the Implementation Guide (and comparable with more recent advice from DTF in the Government's Investment Lifecycle Guidelines).

Corporate overheads

The FirstRate5 team currently benefits from various corporate services provided by Sustainability Victoria free of charge. A competing private businesses would be required to meet these costs.

The proposed Competitively Neutral Cost Model includes an estimate of the cost of these corporate overhead services. As noted above, the estimated costs are comparable with the costs a privately-owned operator would face.

If Sustainability Victoria includes a reasonable allowance for these indirect costs in the Competitively Neutral Cost Model, then no further competitive adjustment should be necessary. Alternatively, a reasonable estimate of the costs providing these services to a small privately owned team could be included as a competitive advantage from public ownership.

Land taxes and local government charges

The Competitive Neutrality Implementation Guide states 'if the calculation of full costs includes a documented and defensible estimate of commercial rent' no adjustment has to be made for land tax and local government rates.

The proposed allocation of rent and outgoings is based on a proportional allocation of the commercial rent paid by Sustainability Victoria. Therefore, no further competitive adjustment should be necessary.

³ For the purposes of this analysis, taking a conservative approach meant using a higher estimated value than the actual offers received from the market.

Alternatively, if Sustainability Victoria does not include an allocation for rent and outgoings, then an estimate of the commercial rental cost should be included as a competitive advantage for FirstRate5. This could be based on a small business renting basic commercial space for a team of around 5 to 6 people.

Promotion and marketing

FirstRate5 maintains a separate website from Sustainability Victoria's website. FirstRate5's website and logo include references to Sustainability Victoria, reflecting the actual origins of the software. We were advised that Sustainability Victoria does not actively market FirstRate5 or provide it with access to any customer database or other distribution channel of the Agency.

There is a link to FirstRate5 on Sustainability Victoria's website, but it is not prominent and we are not aware that it is a major driver of traffic to FirstRate5. Sustainability Victoria could consider updating this section of its website to include a link to the NatHERS website (which contains a description of the Accreditation Protocol and links to all currently accredited software).

Accident Compensation Levy (WorkCover)

Sustainability Victoria pays the WorkCover premium for its employees who work on FirstRate5. There is no basis to assume that WorkCover premium costs would be materially different for a private sector operator of FirstRate5.

Capital financing

Sustainability Victoria fully funds the FirstRate5 operation from its operating budget, and has not needed to borrow. Therefore, no adjustment has been made for lower costs of financing.

Competitive disadvantages of public ownership

Higher Accountability costs or Regulatory Requirements?

Both FirstRate5 and its competitors have identical requirements for the energy rating software, the main requirement being that they both need to be NatHERS approved. The 6/10 star reporting system is also used by both FirstRate5 and its competitors, to align with the Government's regulatory requirements.

As is common with publicly owned companies, Sustainability Victoria potentially has greater accountability, regulatory and agency specific requirements placed on it than if the business was in private hands. However, these costs are likely to be small and no adjustment was included.

Employment remuneration

Sustainability Victoria is subject to the Victorian Public Service Enterprise Agreement 2016, which establishes the pay and conditions for staff. However, the majority of work done on the development and operation of FirstRate5 was undertaken by external contractors. Furthermore, there is no compelling evidence that salary costs for the FirstRate5 team would be higher (or lower) than if the business was in the private sector. Therefore, no competitive neutrality adjustment was included.

Payroll Tax

The Competitively Neutral Cost Model currently applies payroll tax on all of the salaries of Sustainability Victoria staff attributed to the FirstRate5 business. However, businesses are not required to pay payroll tax if their annual payroll is under the tax-free threshold of \$575,000.

If FirstRate5 were operated by a standalone small business, it is likely that the business would benefit from the payroll tax-free threshold. Therefore, relative to the most likely scenario for a private operator, Sustainability Victoria is arguably at a small competitive disadvantage of *up to* just under \$28,000 (although based on current salaried staff, the current disadvantage is only around \$8,000).

Net impact of Competitive Neutrality adjustments

The following table summarises the impact of the net Competitive Neutrality adjustments on the total surplus or deficit of the FirstRate5 operation. As the table shows, the net impact of competitive neutrality adjustments is to change the small net surplus into a small total deficit.

(It should be noted that the competitive neutrality adjustment is sensitive to the estimated value of the FirstRate5 software.)

	AMOUNT (\$)
NET SURPLUS / (DEFICIT)	10,000
COMPETITIVE NEUTRALITY ADJUSTMENTS	-32,000
TOTAL SURPLUS / (DEFECIT)	(22,000)

Note: Figures are rounded and approximate. [Detailed figures are provided as commercial-in-confidence in Appendix 2].

3.4 Implications for the Competitively Neutral price

Notwithstanding that FirstRate5 is estimated to have made a small total deficit in the 2015/16 year, the size of the deficit relative to the overall revenues of FirstRate5 mean that the impact on the implied competitively neutral price is very small.

Sustainability Victoria should consider the outcomes of the Competitively Neutral Cost Model, as well as any anticipated changes in costs, in reviewing the appropriate price for certificates generated by FirstRate5.

Recommendation

To ensure compliance with Competitive Neutrality policy regarding full cost reflective pricing Sustainability Victoria should undertake the following tasks:

1. Include indirect costs explicitly in future budgets for FirstRate5 (such as by using the Competitively Neutral Cost Model).
2. Consider the Competitive Neutrality adjustments described above in determining the competitively neutral cost of output, in particular the adjustment for cost of capital.
3. Update the Competitively Neutral Cost Model over time to reflect any changes in direct and indirect costs, or net competitive advantages.

4. Complying with Competitive Neutrality

4.1 Potential Competitive Neutrality measures to ensure compliance with the Policy

Consistent with the Policy, there are three common measures to address potential competitive neutrality issues:

- corporatisation,
- commercialisation, or
- full cost-reflective pricing.

For a description of these methods, see Appendix 1.

4.2 Assessing the benefits and costs of alternative measures

Corporatisation

Corporatisation would involve the creation of a separate legal entity to operate and maintain the FirstRate5 software independent from Sustainability Victoria.

Corporatisation is generally the most appropriate measure when the business has statutory monopoly functions, and/or for relatively large commercial operations. Corporatisation, however, is relatively costly. In this case, the initial and ongoing costs of establishing a separate legal entity would likely be substantial relative to the total revenue of FirstRate5.

FirstRate5 does not have a statutory monopoly; nor is it a particularly large commercial operation. Furthermore, no non-price competitive advantages have been identified.

Overall, it is likely that the costs involved in corporatisation would outweigh the benefits.

Commercialisation

Commercialisation would involve organising FirstRate5's activity along commercial lines without creating a separate legal business entity.

The main benefit of commercialisation is that it is less costly than corporatisation and can still address non-price concerns such as competing objectives or competitive advantages from access to information.

Some aspects of commercialisation have already been implemented for FirstRate5, such as the preparation of separate budgets and the commercial pricing model, as well as separation of much of the operational functions to contractors. However, there has not been a detailed separation of accounts, separate financial reporting, formal application of commercial business plans or performance targets, nor the application of a tax equivalent regime. Key FirstRate5 staff also undertake business and non-business functions.

Full commercialisation, including more formal separation of accounts, would still be relatively costly to implement compared to the size of the FirstRate5 business.

Given the relatively small size of FirstRate5, as well as the fact that no non-price competitive advantages have been identified, it is considered that the costs of full commercialisation would outweigh the benefits – at least in the short to medium term.

If the size of the operation were to continue to grow, or there were legitimate concerns raised about conflicting objectives or other non-price competitive advantages, full commercialisation (including greater separation of cost accounts and staffing) could be re-considered.

Full Cost-Reflective Pricing

This measure would involve taking into account all of the (direct and indirect) costs that can be attributed to the provision of FirstRate5, as well as the cost advantages and disadvantages of public ownership.

Full cost-reflective pricing would offset any net competitive advantages a government business may benefit from. This would ensure that resource allocation decisions are made on the basis of comprehensive and accurate costings.

Since no non-price competitive advantages have been identified, full-cost reflective pricing would achieve most of the benefits of commercialisation or corporatisation, but at a substantially lower cost.

4.3 Recommended measure

Based on the scale of the FirstRate5 operation, and the lack of any identified non-price related competitive advantages from public ownership, Sustainability Victoria should consider adopting Full Cost-Reflective Pricing as the most appropriate measure to meet the Competitive Neutrality Policy requirements at lowest cost.

Given the Government's existing policy to seek full cost recovery for FirstRate5, the marginal additional cost of implementing full cost-reflective pricing is likely to be small, provided that cost effective methods for developing reasonable estimates of indirect costs and competitive neutrality adjustments are available.

- The proposed 'share of FTE' method for estimating the majority of indirect costs is relatively cost effective, and appeared to produce reasonable estimates.
- Using the estimated valuation for the FirstRate5 software, Sustainability Victoria could consider adopting a depreciation method for future years (taking into account re-capitalisation from investments in development), rather than needing to periodically estimate the value of the software for the purposes of estimating a Cost of Capital adjustment.

(As noted previously, consideration of the Public Interest Test is outside the scope of this report.)

Recommendation

1. Sustainability Victoria should consider adopting Full Cost-Reflective Pricing as the most appropriate measure to ensure competitive neutrality for the FirstRate5 software.
2. Sustainability Victoria should consider using an appropriate depreciation method for the value of the FirstRate5 software (starting from the estimated value included in the Competitively Neutral Cost Model)
3. Should the Government want to set the price(s) for certificates below the estimated Competitively Neutral price(s), then Sustainability Victoria should consider the Public Interest test to determine the appropriateness of the Government's preferred price(s), in accordance with the Competitive Neutrality Policy.

Appendix 1 – Competitive Neutrality Measures

The Competitive Neutrality 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 Competitive Neutrality 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 Competitive Neutrality 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’ (DTF 2000).

The Competitive Neutrality 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 (DTF 2000):

- 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.

Commercialisation is less costly than corporatisation. It is, thus, likely to be the preferred model for addressing Competitive Neutrality 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.

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 Competitive Neutrality 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 Competitive Neutrality 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 Competitive Neutrality issues when the government business is small and the issue does not warrant taking on the relatively large costs involved in corporatisation or commercialisation.

Appendix 2 – Summary P&L (confidential)

Not for publication.

Appendix 3 – References

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

Department of Treasury and Finance (DTF) 2000, *Competitive Neutrality Guide to Implementation*. Government of Victoria, Melbourne.

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