Competitive Neutrality

MAINTAINING A LEVEL PLAYING FIELD BETWEEN PUBLIC AND PRIVATE BUSINESS

Foreword

Most policy makers agree that competitive neutrality is a sound idea and member governments of the OECD have demonstrated their commitment to a level playing field. This commitment has been voiced at the ministerial level on a number of occasions. Most recently on the occasion of the 2011 Commemoration of the 50th Anniversary of the OECD during the Meeting of the Council at Ministerial Level, the Chair remarked, "As the OECD enhances its engagement with emerging economies, it must also continue its groundbreaking work to develop multidisciplinary guidelines for the treatment of state-owned and state-controlled enterprises…whether they are owned by shareholders or states, all companies should operate on a level playing field consistent with the principles of competitive neutrality."

This report responds to this request. It highlights existing competitive neutrality practices and current challenges faced by policy makers committed to level the playing field between public and private business. It provides a catalogue of generally accepted national practices that illustrate implementation of aspects or elements of competitive neutrality and highlights examples of challenges that may be encountered. The report aims to serve as inspiration to governments that are confronted with similar challenges and aim to achieve competitive neutrality. The practices discussed in the report are consistent with the 2005 *OECD Guidelines on the Corporate Governance of State-Owned Enterprises* (OECD, 2005a). The coverage of this report is broader than the Guidelines in that it applies not only to state-owned enterprises, but also other government activity of a commercial nature.

This report is part of an ongoing project on the "State in the Market Place" of the Corporate Governance Committee's Working Party on State Ownership and Privatisation Practices and was developed jointly with the Competition Committee. The Secretariat's draft report was prepared by Hans Christiansen and Sara Sultan of the OECD Corporate Affairs Division and was given final approval and declassified by these respective bodies in April 2012. The development of the report has benefited from comprehensive consultation with the Business and Industry Advisory Committee (BIAC), the Trade Union Advisory Committee (TUAC), other consultation partners and non-member economies. The report may be read in conjunction with two comprehensive stocktaking papers concerning national practices and OECD sources which address aspects or elements of competitive neutrality which are publicly available. (OECD 2012a, 2012b)

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Executive Summary

Competitive neutrality occurs where no entity operating in an economic market is subject to undue competitive advantages or disadvantages. The rationale for pursuing competitive neutrality is both political and economic. The main economic rationale is that it enhances allocative efficiency throughout the economy – where economic agents (whether state-owned or private) are put at an undue disadvantage, goods and services are no longer produced by those who can do it most efficiently. The political rationale is linked to governments' role as universal regulators in ensuring that economic actors are "playing fair" (where state-owned corporate assets are concerned and vis-à-vis other market participants), while also ensuring that public service obligations are being met. Although the political commitment to maintaining a level playing field is generally strong, government commercial activities may damage the competition landscape either due to deliberate or unintentional departures from neutral practices.

I. The building blocks of competitive neutrality

The objective of this report is twofold. First, it identifies the main challenges in obtaining competitive neutrality between public and private entities operating in mixed markets. Second, it sheds light on some of the remedies to these challenges based on actual practices in OECD countries as well as existing OECD instruments and best practices bearing on the topic. It is organised around the following eight "building blocks" that governments should address if they seek to obtain competitive neutrality.

(1) Streamlining government business – either in terms of its structure or corporate form – can have an impact on the playing field.

In sectors with natural monopoly characteristics (e.g. utilities networks), structural separation of competitive from non-competitive functions makes it easier for competitive activities to operate in a market-consistent way; it also facilitates entry in the market (where it potentially exists). However, this may not be the most feasible or efficient option, therefore behavioural remedies should also be considered (e.g. accounting separation).

A separate but related issue is the degree to which government businesses are streamlined. Where government businesses operate on a competitive and commercial basis, some jurisdictions have taken steps to incorporate these businesses, to the extent possible, according to ordinary company law. Where distinct legal forms are required (e.g. for the fulfilment of public service functions) or where commercial activities remains integrally linked with general government, limits should be placed on the ability to expand or diversify business activities. In parallel, setting clear ownership objectives which are reviewed periodically help to increase transparency and accountability surrounding the role and extent of government business activities in the economy. It also helps to clarify the role of state-owned enterprises (SOEs) in providing public policy functions.

(2) Identifying the costs of any given function and developing appropriate cost allocation mechanisms promote transparency and disclosure.

High standards of transparency and disclosure around state-owned entities' cost structures ensure that compensation provided for fulfilling public service obligations is not used as conduit to cross-subsidise commercial activities; and a method by which to ensure goods and services are priced to fully reflect costs. This also means clearly identifying shared costs and attributing liabilities, such as pension liabilities.

For example, the European Union's (EU) *Transparency Directive* requires SOEs (and other entities entrusted with public service obligations) to separate costs and assets between commercial and non-commercial accounts. For unincorporated units of general government which share costs between commercial and non-commercial activities the attribution of costs is even more important.

Oversight and monitoring bodies play an important role in ensuring that remuneration for public service obligations are calculated based on clear targets and objectives. One model pursued by a few governments requires SOEs to disclose information on their ability to meet targets and to explain any deviations from such goals. Where costs imbalances exist, some jurisdictions require a cost adjustment either through direct compensation or factoring actual costs into prices.

(3) Government business activities operating in a commercial and competitive environment should earn rates of return (ROR) like comparable businesses.

Setting appropriate RORs for each separate line of commercial activity is an important factor to safeguard against distorting cross-subsidisation practices and to ensure that private sector competitors cannot be undercut. Methodologies to calculate ROR targets and measure performance vary. Some jurisdictions have identified practices based on reasonable profits and the return on the cost of capital/equity. Among those examples, profits are expected over a "reasonable period of time", which some have identified as five years.

Other jurisdictions allow their SOEs to earn below market rates as a means of compensating for public service obligations. In these cases, SOEs' commercial strategies should be adjusted and accounted for accordingly; additional adjustments may be required in the case of advantages/disadvantages arising from such obligations.

(4) Where the performance of public policy functions is required by government businesses, adequate, transparent, and accountable compensation should be provided.

It is important to ensure that concerned entities are *adequately* compensated for any non-commercial requirements on the basis of the additional cost that these requirements impose. Although some jurisdictions favour thresholds to compensate for any losses incurred by economic operators, where as others support "reasonable profits" which allow for cross subsidisation from profit to loss making activities; the most precise and transparent mode of compensation is direct payments provided from public sector budgets.

Regardless of the compensation arrangements, the calculation should be neutral to ensure full transparency and accountability concerning the cost structure of the entity and to ensure that compensation does not amount to undue subsidies or State aid. The EU rules on State aid set standards in this regard.

(5 and 6) To ensure competitive neutrality government businesses should operate, to the largest extent feasible, in the same tax and regulatory environment as private enterprises.

Where government businesses are incorporated according to ordinary company law, tax and regulatory treatment is usually similar or equal to private businesses. However, some statutory corporations and most businesses operating out of general government are exempt from taxes (consumption and income) and regulations (market regulations and business laws). Differences in treatment between public and private businesses should be removed; where not possible, some jurisdictions confer tax or regulatory treatment equally among market participants.

In many jurisdictions, regulatory exemptions (e.g. exemption from competition laws and policies) are provided as a means to compensate for public service obligations. The rational and conditions for derogations should be made transparent and narrowly established. Furthermore, compliance should be monitored and reconsidered under changing economic conditions – the EU rules concerning the provision of services of general economic interest provide an example in this regard.

Any remaining tax or regulatory advantages/disadvantages can be neutralised through a system of adjustments or compensations as is done in a handful of jurisdictions. The competitive neutrality framework operated by the Australian authorities has the most systematic application of compensatory payments in the OECD area.

(7) Debt neutrality remains an important area to tackle if the playing field is to be levelled.

In most jurisdictions, state-owned businesses are subject to financial market disciplines and are not provided concessionary financing. However, government businesses may still continue to benefit from preferential access to finance as compared with private companies due to their explicit or perceived government-backing. Where debt cannot be accessed on neutral terms, the Australian authorities have pioneered a system of debt neutrality adjustments and compensations.

Where financing is acquired from the state (whether state-owned banks or public budgets), financing should be obtained on commercial terms as benchmarked against market rates. Some jurisdictions provide funding with debt neutrality adjustments already calculated into the cost of debt. Regardless of the source of financing, a system should be in place to ensure effective control of subsidies/State aid received by SOEs. The EU Commission has a unique system which, beyond verifying funding sources of public bodies, may adopt decisions to remove any undue advantages in accordance with its rules on State aid.

(8) To support competitive neutrality, procurement policies and procedures should be competitive, non-discriminatory and safeguarded by appropriate standards of transparency.

Most national policies support principles that ensure competitive, non-discriminatory and transparency procurement. In order to fulfil these criteria, some economies discourage the participation of the state sector in the public procurement processes. In others, public participation is allowable under specific rules governing managed competitions. These rules also concern in-house procurement.

In general, bids should be compared on a like-for-like basis, and differences between bidders should reflected and taken into account. In some cases, public bidders may have advantages that reflect economies of scale; this in principle is not a competitive neutrality problem, but it may nevertheless frustrate governments' attempts to introduce competition in the market.

II. Enshrining a commitment to competitive neutrality

Different jurisdictions address aspects or elements of competitive neutrality in diverse ways through competition, public procurement, tax and regulatory policies or a combination of these policies. Some countries may have made a selective commitment to competitive neutrality, in other words they may not address all the building blocks. While this may often be a second best option, it still may suit the jurisdiction depending on the national context, the extent and nature of public policy functions imposed on SOEs, and the regulatory capacity to enforce and advocate competitive neutrality.

The most effective way of obtaining competitive neutrality is arguably to establish an encompassing policy framework, including suitable complaints handling, enforcement and implementation mechanisms and in consistency with international commitments. Although few countries have done this, the approaches of Australia or the EU are notable examples. Some north European economies have addressed competitive neutrality, by introducing competition law based approaches in parallel with an overall restructuring of the SOE sector to ensure full incorporation of public businesses, including by municipalities and other sub-national levels of government.

III. Structure and approach of the report

The report is separated into three parts. Part A provides a conceptual framework, definitions and economic arguments underpinning the paper. Part B of the report covers each of the eight "building blocks" of competitive neutrality. Part C highlights different national approaches, including the placement of competitive neutrality commitments in legislation and within the national administration.

The report serves as a catalogue of options for ensuring a level playing field between public and private business. It is outcomes based, in that it recognises there are usually several ways in which competitive neutrality can be achieved in practice. For this reason, the report provides a large number of examples of competitive neutrality related experiences from OECD and other economies. These experiences are drawn from a questionnaire-based exercise highlighting national practices and actual cases where issues have arisen. The report is further supported by a synthesis of existing OECD instruments, good practices and related guidance with a bearing on the topic.

Part A

Introduction

About This Report

The aim of this report is twofold: (i) to identify the main challenges in obtaining competitive neutrality between private and public sector entities that are active in the market place; and, (ii) to identify remedies to these challenges based on existing OECD recommendations and country experiences with handling neutrality-related issues in relevant areas. It is supported by two interim reports highlighting national practices (based on a questionnaire) and existing OECD sources reflected in recommendations and guidance. (OECD, 2012a, 2012b)

The report makes no value judgement concerning whether or not governments should be committed to upholding the principle of competitive neutrality. It should, however, be read in conjunction with the *OECD Guidelines on Corporate Governance of State-Owned Enterprises* (the "*SOE Guidelines*", OECD, 2005a), which recommend the maintenance of a "level playing field" among state-owned and privately-owned incorporated enterprises operating on a commercial basis. The scope of the report is wider than the *SOE Guidelines* in the sense that it covers business activities by the public sector, regardless of incorporation or the level of government.

Like the *SOE Guidelines* the report is outcomes-based. It identifies a number of building blocks that governments should address if they seek to obtain competitive neutrality, whilst recognising that there are usually several ways in which this can be done in practice. Part B of the report provides a catalogue of options based on actual practices in OECD and other countries as well as existing OECD recommendations (referred to in the report as the "OECD sources") bearing on competitive neutrality.[1]

The report provides a large number of examples of competitive neutrality related experiences from OECD and other jurisdictions. These are presented in text boxes and fall into two categories: (1) "toolkit" items, describing national practices toward establishing competitive neutrality; and (2) "examples" of actual company or regulatory cases in the recent past. (To help the reader separate, boxes in the first category are shaded.) Country experiences are reproduced for illustrative purposes, without prejudice to whether they should be emulated by others or considered as "best practices". It should be further noted that although the cross-border activities of SOEs have sometimes given rise to concerns of non-neutrality, this report covers "generic" issues related to ensuring a level playing field without specific consideration of nationality.

Concepts and Definitions Applied in this Report

Toward a general definition of competitive neutrality

The concept of competitive neutrality is necessarily as wide-ranging and amorphous as the number of different economic agents that compete in economic markets. Following discussions involving the relevant OECD bodies, the following definition suggests itself:

Competitive neutrality occurs where no entity operating in an economic market is subject to undue competitive advantages or disadvantages.

This definition merits a couple of observations. First, the definition depends on perceptions of what is considered to be "undue." As discussed below, advantages may be granted to commercial entities in compensation for countervailing obligations, which would generally not imply a departure from competitive neutrality. Secondly, the concept of "operating in an economic market" needs to be interpreted broadly enough to encompass potential operations. If commercial entities are, in principle, allowed to compete in a market but in practice prevented from doing so due to undue incumbency advantages, this would normally be considered as a departure from competitive neutrality.

Competitive neutrality may be affected by ownership, institutional forms or specific objectives for certain economic agents. One example would be advantages or disadvantages conferred by governments to business activities controlled by themselves. Another relates to the non-profit sector that in some jurisdictions is active in the market place despite enjoying tax and other advantages. Competitive neutrality is also concerned with the competitive position of government-influenced private entities (e.g. licensed operators, legacy rights, recently privatised companies, national champions, or where the state is a relevant shareholder). In the EU, the concept applies to an enlarged group of entities which includes: (i) private companies entrusted with public service obligations (i.e. services of general economic interest); and, (ii) companies benefiting from special and exclusive rights.

Competitive neutrality in the context of this report

This report focuses specifically on competitive neutrality between public and private entities operating in mixed markets. A "mixed market" is one where state and private entities co-exist or, given the rules and regulations actually in force, might co-exist. The implication is that competitive neutrality is not a concern where, for example, public authorities exert their sovereign right to regulate in deciding that certain good and services shall be provided by the public sector only (or so-called non-liberalised sectors). In this case the goods or services in question are, by government decision, not provided in a mixed market. Provided that there is sufficient transparency about the government decision and public interest that has motivated it, this is usually not considered to be a departure from competitive neutrality.

Conversely, it may be less clear what constitutes a government commercial entity. Some national authorities apply competitive neutrality policies only to the activities of "traditional" state-owned enterprises (SOEs).[2] Others apply competitive neutrality practices to all types of government activities that can be characterised as "commercial" in nature (e.g. where they provide goods and services in a given market), regardless of their legal form or profit objectives. There is no universal definition for what constitutes government 'business' activities; neither is there a clear definition for the demarcation between what constitutes commercial and non-commercial activities (discussed below).

Beyond "traditional" SOEs, the degree to which government activity is considered "business" also matters. Commercial undertakings operated by government departments or autonomous institutions can be a source of non-neutrality. These types of government businesses operate in a majority of OECD countries, and their organisational form may differ depending on the level of government and the type of business activity that is being conducted (e.g. ranging from meteorological services or security services to gift shops at museums). Indeed, navigating the plethora of organisational forms and ambiguity surrounding what constitutes a government "business" further enhances the challenge of policy makers seeking to level the playing field. Policy makers may have to decide on certain "bagatelle limits" for the lowest level of commercial activity by a public entity that they are willing to consider. An example of Australian practices in this respect is provided in Box 1.

Box 1. Toolkit: Application of competitive neutrality framework to government business activity in Australia

Two essential questions are asked by Australian authorities to determine whether government activities are indeed operating on a commercial basis and whether the Commonwealth competitive neutrality framework should be applied. (There are slightly different threshold questions at the sub-national level to determine whether CN arrangements should apply to a particular business activity.)

Is the entity conducting a business?

Activities are classified as a business for the purposes of competitive neutrality (CN) if they meet the following criteria:

1. They must be charging for goods or services (not necessarily to the final consumer);
2. There must be an actual or potential competitor (either in the private or public sector); and
3. 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.

Is the business significant?

If it is determined that the entity is conducting a business, the business must be significant for CN to apply. The following business activities are considered significant for the purposes of CN:

- All government business enterprises (GBEs) and their subsidiaries: All GBEs are either companies or authorities which have been prescribed by Ministerial decision to be GBEs. They are the most commercialised group of legally separate organisations within the Commonwealth sector and can operate in markets which are open to competition.
- All Commonwealth Companies: Commonwealth Companies are statutory corporations, established in legislation as bodies corporate. They are governed both by their separate enabling legislation and by the *Commonwealth Authorities and Companies Act 1997 (CAC Act)*, which imposes reporting and auditing requirements on directors of these entities.
- All Business Units: Business units are established through administrative arrangements where an identifiable part of an agency or Department has a primary objective of trading goods and services in the market, for the purpose of earning a commercial return. Business units' management and accounting structures are separate from other parts of the overall organisation. Baseline costing for activities undertaken for market testing purposes.
- Baseline costing for activities undertaken for market testing purposes.
- Public sector bids over A$10 million.
- Business activities not in these categories that are undertaken within (non-GBE) Prescribed Agencies or Departments with a commercial turnover of at least A$10 million per annum.

Source: Submission from the Australian authorities.

State-owned enterprises and other entities

The applicability of competitive neutrality is broad. For purposes of this report it is applied to the activities of all types of government-owned bodies that are actually or potentially competing with private operators in any market (it may in some cases be discussed in the context of former state-owned enterprises where incumbency advantages may be of concern), and that can be considered as a "commercial entity." For this reason a specific definition of SOE is not strictly needed, as the scope of discussion includes but is not limited to: (i) federal, state or municipal agencies; (ii) federal, state or municipal unincorporated enterprises; and (iii) federal, state or municipally owned corporations (incorporated according to the relevant law).

If, in some jurisdictions, it matters whether a public entity is operating as an SOE or not, further guidance can be found in the *System of National Accounts 2008* (UN/OECD, 2009) guidebook which sets standards from a statistics point of view.[3] If the entity's commercial activity is significant (e.g. accounting for over 50% of its production) then it should be classified, from a national accounting point of view, as a quasi-commercial activity and should maintain separate accounts; otherwise its activity would be considered as part of general government. The South Korean government is in the process of classifying government activity which can be considered commercial in nature, based on the criteria established in the *System of National Accounts*. The process fits into a larger reorganisation of government finance statistics. (Box 2) From a national accounting point of view, although an unincorporated enterprise within a government may be a market producer, if it cannot fit the criteria below it will be classified as a part of general government.

Box 2. Toolkit: 2008 System of National Accounts classifications

Excerpts from the 2008 System of National Accounts, Chapter 4 "Government units as producers"

A government establishment, or group of establishments engaged in the same kind of production under common management, should be treated as a quasi-corporation if the following three criteria hold:

a. the unit charges prices for its outputs that are economically significant;

b. the unit is operated and managed in a similar way to a corporation; and

c. the unit has a complete set of accounts that enable its operating surpluses, savings, assets and liabilities to be separately identified and measured.

Such quasi-corporations are market producers that are treated as separate institutional units from the government units that own them. They are classified, sectored and sub-sectored in the same way as public corporations.

The ability to distinguish flows of income and capital between quasi-corporations and government implies that their operating and financing activities are not fully integrated with government revenue or finance statistics in practice, despite the fact that they are not separate legal entities.

Source: UN/OECD, *et al.* (2009), System of National Accounts 2008, OECD, New York.

"Commercial" and "non-commercial" activities

Where public interest objectives are at stake, departures from competitive neutrality (deliberate or unintentional) may be reconciled. In these cases, the government may impose conditions or obligations which may put SOEs or other public entities at an advantage or disadvantage in the interest of achieving wider policy goals. Governments may do this through the performance of public policy functions. An example of how to interpret what constitutes legitimate public policy functions has been made by the European Union in a Communication issued in December 2011 (EU, 2011) relating to the application of EU rules on State aid and its impact on the internal market (Box 3).

However, there is no commonly agreed definition of what constitutes "valid" public policy functions. Sovereign governments differ in this respect. Public policy functions may range from carving out activities reserved for the public sector, or intervening directly in the market place, and their scope in a given national context must be established between governments and citizens. It falls beyond the scope of this paper to define what constitutes a public policy function, but governments wanting to preserve a competitive business environment need to exercise a significant degree of self restraint and not uncritically justify any intervention in the market place as constituting a public policy function.

In the remainder of this report the term "commercial activities" denotes activities in the market place that do not constitute public policy functions. Likewise, "commercial entities" denotes entities not tasked by the public authorities with carrying out public policy functions.[4]

The Economic Rationale for Pursuing Competitive Neutrality

The main economic rationale for pursuing competitive neutrality is that it enhances allocative efficiency throughout the economy. Where certain economic agents (whether state-owned or private) are put at an undue disadvantage, goods and services are no longer produced by those who can do it most efficiently. This leads to lower real incomes and a sub-optimal use of scarce resources relative to a baseline scenario.

Box 3. Toolkit: A definition of public interest activities in the EU

The European Commission has provided guidance on the requirements concerning the definition of public interest activities (e.g. services of general economic interest in EU terminology), to clarify the distinction between commercial and non-commercial activities (in EU terminology "economic" and "non-economic" activities). In general the concept of a public service is an evolving notion that depends on the needs of citizens, technological and market developments, and social and political preferences in member States. The Commission considers that services classified as public interest activities must be addressed to citizens or be in the interest of society as a whole.

Although the distinction between commercial and non-commercial depends on political and economic specificities in a given Member state, the decision of an authority not to allow third parties to provide a certain service does not rule out the "economic" nature of an activity.[5] Instead of coming up with an exhaustive list, the Commission Communication identifies activities which cannot be constituted as "economic":

- The army or the police;
- Air navigation safety and control;
- Maritime traffic control and safety;
- Anti-pollution surveillances; and,
- The organisation, financing and enforcement of prison sentences.

Other areas which can be considered non-economic are listed below, however they can also be considered economic depending on the way in which they are set-up and structured:

- Social security schemes which are solidarity based;
- Health care which is solidarity based, and which provide universal coverage and non-economic services;
- Public education organised within the national education system (and other activities aimed at improving education, research and development and disseminating research).

Beyond these criteria, the effects on trade matter in a context of determining what constitutes public services, how they are organised and how they are financed. The Commission in several cases has concluded that activities with a purely local character may not affect trade and are therefore exempt from State aid rules. These include:

- Swimming pools used by the local population;
- Local hospitals aimed exclusively at the local population;
- Local museums unlikely to attract cross-border visitors; and,
- Local cultural events, whose potential audience is restricted locally.

Source: European Union (2011), *Communication from the Commission on the application of the European Union State aid rules to compensation granted for the provision of services of general economic interest, OJEU C 8 of 11.1.2012, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2012:008:0004:0014:EN:PDF*.

State-owned enterprises and deliberate departures from competitive neutrality

As mentioned earlier, even as governments are well aware of the economic benefits of competitive neutrality, they may make a deliberate decision to pursue non-neutral practices in the interest of public policy or related functions. The main reasons why governments may sometimes make a conscious decision to depart from competitive neutrality in their SOE sectors are listed below (drawn largely from Capobianco and Christiansen, 2011). Importantly, though, many of the below policy choices can also be pursued by governments, through SOEs, in a competitively neutral fashion:[6]

Maintaining public service obligations. The most commonly heard rationale for protecting SOEs from "excessive" competition occurs in network industries and relates to SOEs' public service obligations – such as maintaining postal and telecommunication services in outlying areas, providing essential utilities at affordable rates, etc. From a strictly economic perspective this does not imply that these companies must remain in the public domain as these objectives could be similarly met through targeted subsidies. (The issue of targeted subsidies is dealt with extensively in Section 4 of Part B of this report.) However, in a world of uncertainty and imperfect contracts, policy makers may judge that they are better able to deliver public service obligations or correct market failures if they continue to maintain a controlling interest in the entities entrusted with their delivery.

SOEs as a tool for industrial policy. Relatively few OECD countries these days appear to be assigning a pro-active industrial policy role to their SOEs– such as, for example, obligations to develop certain capabilities or pursue knowledge and technologies in the broader national interest. Conversely, the practice has remained commonplace in some emerging economies. Many countries do, however, seem to attach "defensive qualities" to their state ownership, aiming to maintain companies alive and in tate hands because of fears of no longer having a national champion (or indeed any indigenous production base) in certain economic sectors. Some of the considerations motivating the internationalisation of SOEs also point in that direction. Several governments encourage foreign operations of state-owned incumbents in the network industries "to protect their revenue streams" faced with increasing domestic competition.

Protecting fiscal revenues. Some SOEs provide consistently large profits (or in some cases revenues) on which the national treasury comes to depend. This has most frequently been the case in the extractive industries, but is also not uncommon in the utilities sectors. From a competitive neutrality viewpoint this may be particularly problematic, because not only does it imply that the government has a strong incentive to shield such SOEs from competition, the high revenue stream itself may depend on monopoly rents.

The political economy of SOEs. Policy makers may feel they need to protect SOEs because of pressures from interest groups or the general public. For instance, SOEs remain a major source of employment in many OECD countries. Also, SOEs are often seen as offering civil service status or higher paid jobs – especially for blue collar employees – and in some countries have more generous retirement arrangements than the private sector. Any failure of the State to shield its enterprises from competition from "low-wage" companies or companies "not maintaining adequate standards of corporate responsibility" could expose politicians to strong public pressures. Whilst formally related to democratic accountability, such mechanisms have the potential to be used by rent-seeking insiders to stifle competition.

Other business undertakings by the public sector and unintentional departures from competitive neutrality

In the case of unincorporated segments of the general government operating in the market place, a certain gap between theory and practice can be detected. The political commitment to maintaining a level playing field is generally strong. Unlike the case of SOEs that have mostly been established as commercial players, government departments selling services in the market place may unwillingly damage the competition landscape. An increasing number of complaints by private businesses alleging non-neutral behaviour by the public authorities of OECD countries relate to such activities.

This apparent contradiction relates to the fact that most such undertakings are established below the central level of government – whether by municipal authorities, other sub-national divisions of the State or by individual government departments. Unintentional departures from competitive neutrality may reflect public officials maintaining the *status quo* due to historical provision by the State, trying to remedy scarce budgetary resources by either generating supplementary flows of income or economising on public procurement practices. In other cases, maintaining public provision of services to rural or less served areas where costs may exceed returns are important public policy concerns and may constitute deliberate departure from competitive neutrality. The objectives of these sub-national decision makers obviously do not extend to the economy-wide competitive efficiency, which can result in goal conflicts between them and the central authorities (as demonstrated in the U.S, for example, concerning the applicability of the state action doctrine where the state or other governmental entity may in some circumstances immunise anticompetitive conduct that would otherwise violate antitrust laws). The tightening of competitive neutrality-related laws and regulation and applicability to the sub-national level in many OECD countries in recent years partly reflects this fact.

Reconciling departures from competitive neutrality in the pursuit of non-commercial objectives

As discussed earlier, it is important to recognise that defining what constitutes non-commercial activity is both an economic and political decision. Any framework for competitive neutrality should acknowledge that some degree of judgement is necessary to make competitive neutrality work in practice. Some issues for policy-makers to consider when putting into place a competitive neutrality framework are cited below:

Commercial versus non-commercial. Firstly, there is no commonly accepted definition for what constitutes "commercial" and "non-commercial" activity. It may seem tempting to try and solve the dichotomy between the advantages of competitive neutrality and the rationales for public provision of services by separating commercial from non-commercial activities into separate entities. Following this logic, entities classified as "commercial" would operate entirely according to competitive principles for the goods and services they offer in the market place, whereas "non-commercial" entities would operate in the public interest according to criteria set by the relevant authorities. However, for several reasons this may not always be economically efficient or feasible. Indeed, it is exactly where commercial and non-commercial spheres of activities overlap (i.e. when public services are or could potentially be offered on a market basis and where such activities remain integrated) where questions of competitive neutrality invariably arise.

Institutions versus activities. Secondly, competitive neutrality essentially relates to individual activities rather than the institutions that execute them. Any given activity may be either competitively neutral or the opposite. Conversely the advantages or disadvantages often accrue to entire institutions. Governments are able to establish entities that – even if perhaps incorporated as ordinary companies – operate entirely in pursuit of public policy objectives and without competing with commercial

undertakings. Establishing wholly commercial undertakings in public ownership is also possible in theory, but may be more complicated in practice depending on how strictly the *SOE Guidelines* (OECD, 2005a) are applied. Commercial activities by public institutions within general government are even harder to separate since they often depend on integration with existing platforms of logistics and support services.

Marketised public services. Thirdly, public service activities can be offered both on a commercial or non-commercial basis. In most OECD economies, public services are not exclusively provided by the State. Increasingly third party operators (either private or non-profit entities) are entrusted with discharging public services and sometimes such services are provided on a market basis. A discussion as to whether they should or should not be offered on a commercial basis is rooted in national policy making and falls beyond the scope of this paper. It should nevertheless be reiterated that good policy-making assumes that public services should bring "value for money" where efficiency and public interest objectives are considered hand-in-hand. If, for example, governments allowed private entrants to deliver a lower quality of services than demanded of the public providers, this would constitute non-neutrality in favour of the private sector. Some aspects of public services may be reserved for State provision, whereas others may be (partially) opened up to competition. No matter the policy choice, the nature of the service and whether it is offered on a commercial basis can indeed have an effect on the competitive landscape.

Commercial and non-commercial activities will continue to co-exist in many publicly controlled entities. These are the entities where the issue of competitive neutrality is the most pertinent. Where a SOE or public institution is subject to advantages (or disadvantages) in consequence of the market provision of specific products or services, additional safeguards to ensure competitive neutrality are usually needed.

Main Challenges in Obtaining Competitive Neutrality

The experiences so far suggest that public authorities committed to maintaining competitive neutrality will need to take three types of measures. First, they will consider the operational form of their business activities with a view to maximising the likelihood of a level playing field. Secondly, if competitive-neutrality policies are to be credibly enforced, sufficient disclosure concerning the commercial activities (not least with respect to full cost identification) needs to be established vis-à-vis regulators and, if reconcilable with confidentiality concerns, toward the general public. Thirdly, a number of potential sources of non-neutrality have been identified, each of which need to be considered individually and collectively. These "building blocks of competitive neutrality" are the focus of Part B of this report. They are summarised below:

1. *Streamlining the operational form of government business.* The operational practices and the legal form under which public businesses operate have implications for competitive neutrality. It is easier to pursue neutrality if competitive activities are carried out by an independent entity, operated at arm's length from general government. Incorporating government businesses (which have a commercial activity and operate in competitive markets) according to the recommendations laid down in the *SOE Guidelines* (OECD, 2005a) would go a long way in achieving this, and could also be useful in countering ad-hoc political interventions that might impede competitive neutrality. A separate but related issue is the structural separation of SOE activities. Other things equal, authorities would want to structurally separate those activities that involve competition in a market from those that do not. However, this may not always be feasible in practice. Also, even where separation is practically feasible it might sometimes not be justified on efficiency grounds.

2. *Identifying the direct costs of any given function.* Where commercial activities are carried out by unincorporated entities a main challenge is that these often share assets with other parts of the government sector – especially if the costs of these assets are joint costs. Developing appropriate cost-allocation mechanisms is then key to ensuring competitive neutrality. At the same time, high standards of accountability and transparency must be maintained among incorporated SOEs. Among other things, this is necessary to ensure that shared non-commercial activities do not provide a conduit for cross-subsidising these enterprises' competitive activities. Where the oversight of competitive neutrality is entrusted with independent agencies (as opposed to the government owners of SOEs) the need for transparency around the operators' cost structure is further accentuated.

3. *Achieving a commercial rate of return.* Competitive neutrality implies that government businesses earn a market-consistent rate of return (ROR) on the assets they use for providing the relevant commercial activities. A market-consistent ROR would be one that is comparable with what is earned by similar firms within the same industry. The importance for competitive neutrality derives from that fact that, if government businesses were not required to earn a commercial ROR, while also benefiting from favourable government support, then they would be able to undercut competition by factoring lower profit margins into their pricing. It should, however, be noted that competitive neutrality does not require government businesses to achieve a given ROR on every transaction or even in each budget period. A ROR requirement does not preclude SOEs from differentiating or varying their profit margins, or having a long-term strategy, in the same way as privately owned enterprises do. Its main purpose is to prevent cross-subsidisation from the government's budget-funded activities.

4. *Accounting for public service obligations*. One of the most challenging issues for competitive neutrality arises where SOEs (or entities entrusted with public service obligations) that operate in a competitive environment are required to carry out non-commercial activities in the public interest. Other things equal this would put them in a disadvantageous position *vis-à-vis* their private competitors, for which reason the *SOE Guidelines* (OECD, 2005a) recommend that such companies be adequately and transparently compensated through the public purse. If SOEs are over-compensated for public service obligations (PSOs) then the playing field obviously becomes tilted in the opposite direction. In practice it may be complicated to decide whether or not certain requirements of SOEs qualify as PSOs.

5. *Tax neutrality.* Tax neutrality implies that government businesses bear a similar burden as their private sector competitors. The implementation of this principle usually differs markedly according to whether or not government businesses are incorporated or operated out of general government. Actual SOEs, whether ordinary stock companies or statutory corporations, generally face direct and indirect tax requirements that are similar to those of any other enterprises. Conversely, general government activities are often not subject to indirect taxes, and it would be legally impossible to impose corporate taxation on the earnings of units of general government in many countries.

6. *Regulatory neutrality*. To maintain competitive neutrality government businesses should operate, to the largest extent feasible, in the same regulatory environment as private enterprises. Some areas where this has been an issue in the past in some countries are (i) earlier access to planning and building permits (not least where municipally owned businesses are concerned) and (ii) a lighter regulatory approach to government-controlled financial sector activities. Regulatory neutrality can be obtained by governments enforcing a non-discrimination policy, but where this is not feasible an assessment must be made of the financial benefits that the government business obtains from its advantages, on the basis of which compensatory payments are made. Further consideration should also be given to the application of competition law and anti-trust provisions to the activities of SOE and other government businesses.

7. *Debt neutrality and outright subsidies.* Debt neutrality implies that SOEs and other government businesses shall pay the same interest rate on the debt obligations they incur as a private enterprise in like circumstances. It is straightforward for governments to ensure that SOEs and government businesses do not benefit from subsidised finance or outright subsidies – not least since the subsidies would normally be provided by the government itself. However, additional problems may arise when government-backed businesses, because of an actual or perceived lower default risk, obtain cheaper finance in the market place than would be available to private operators engaged in similar activities.

8. *Public procurement.* The basic criterions for public procurement practices to support competitive neutrality are: (i) procurement practices should be competitive and non-discriminatory, and (ii) all public entities participating in a bidding process should operate according to the above standards of competitive neutrality. However, some additional issues may arise. Where long-existing SOEs are involved, their incumbency advantages may be such that the entry of competitors is effectively impeded. The advantages may include a stronger position to pre-qualify or bid for contracts in areas where a given SOE has already established a track record; information advantages concerning service levels and costs; and start-up and transition costs for potential entrants – especially where contracts are of limited duration.

Importantly, most of the eight elements of competitive neutrality suggested above are interrelated and need to be considered in unison. The issue of disclosure and cost identification must invariably be considered as a good practice in corporate and public governance. Many issues arise from the non-commercial objectives that state-owned enterprises and other public entities are expected to pursue. In a situation consistent with the *SOE Guidelines* (OECD, 2005a) they would be laid down as public service obligations and compensated via the public budget, but this may not always be practically or politically feasible. Governments often choose to compensate SOEs for competitive disadvantages through exceptions within the areas ranging from debt, tax and regulatory neutrality to public procurement (covered by any of the points 5 through 8 as listed above), but this is considered to be a second best option.

For example, it is common for state-owned entities with weighty non-commercial obligations to be subject to more lenient ROR requirements – or, in the case of entities operated largely in the public interest, no ROR requirements at all. Other examples include derogations from regulation (e.g. competition regulation where natural monopolies are involved) or a more lenient taxation of activities (as for example applied to parts of the postal services) that are carried out partly as an extension of general government. If any of the above elements of competitive neutrality were applied in isolation to such activities there would be a risk of exposing the SOE in question to an undue disadvantage due to under-compensation. If entirely stripped of advantages, the enterprise could become unviable.

This should not be taken to imply that any compensation for non-commercial obligations is as good as the next. For example, it is always easier to obtain competitive neutrality when such obligations are clearly identified and the compensation linked to activities rather than granted to the entity that provides them. Particularly problematic are compensations that are effectively proportional (or otherwise dependent on) not with the public services provided but the business volume of the state-owned entity in question. Examples may, according to context, include lowering rate-of-return requirements, tax exemptions, cheap finance and regulatory/competition derogations. In extreme cases this can provide the state-owned entity with a strong incentive to expand its commercial activities, potentially aggravating the competitive neutrality challenge.

Notes

1. In some cases, existing recommendations, guidance, and best practices may not be directly transferable or applicable to SOEs and/or other government activity that can be considered "commercial" in nature. OECD sources should be considered with a "grain of salt" in that applicability to a competitive neutrality context may not have been the original intention of the authors' of such instruments/good practices. Clarifications are provided at the outset of each subsection where this may be applicable. OECD sources are without prejudice to implementation.

2. For the purposes of this report, where SOE is mentioned it refers to incorporated state-owned enterprise, which has a legal personality pursuant to relevant law (e.g. company law, public enterprise law or specific statutory legislation).

3. The 2008 System of National Accounts (UN/OECD, 2009) is the international standard for national accounts adopted by the United Nations Statistical Commission, and based on an interagency process including the OECD. It is a conceptual framework which is encouraged for use in reporting national and international statistics on national accounts.

4. These terms have been adopted for the purpose of this document. They are without prejudice to other interpretations or definitions found in OECD or international instruments and OECD members' domestic laws. In general, emphasis on the nature of a transaction rather than on its motivation may allow for a more objective assessment of whether a particular activity is commercial. In practice, no one test will normally be dispositive in all circumstances.

5. The Court of Justice of the EU defines economic activity as any activity consisting in offering goods and services on a market. However the European Treaties that govern the EU rules on State aid do not provide a definition of economic activity. As such the EU communication cited in Box 3 draws from case-law where Article 107 of the Treaty has not been applied to State aids acting in their capacity as public authorities.

6. Governments' possible reasons for departing from competitive neutrality are reproduced without regards to whether these should be considered as "good" or "bad" reasons.

Part B

Aspects of Competitive Neutrality

Chapter 1

Streamlining the Operational Form of Government Business

An important question when addressing competitive neutrality is the degree of corporatisation of government business activities and the extent to which commercial and non-commercial activities are structurally separated. Separation makes it easier for commercial activities to operate in a market-consistent way, but may not always be either feasible or economically efficient. Incorporating public entities having a commercial activity and operating in competitive, open markets, as separate legal entities – preferably subject to ordinary company law –enhances transparency, but may only be economically efficient when a significant amount of commercial transactions are involved.

1.1. The challenge and reality in OECD economies

In terms of operational forms of government business, most OECD countries have witnessed contrasting trends over the last decades. On the one hand, there has been a definite tendency to a more complete corporatisation of commercial activities (and some non-commercial activities as well). A number of public institutions have moved along the continuum ranging from government departments, statutory corporations, joint stock companies, to stock-market listing which has served to enhance transparency and accountability. Considered in isolation, this has almost certainly contributed to competitive neutrality. On the other hand, market liberalisation in the utilities sectors and network industries (e.g. telecommunications, transport and postal services) have exposed to the competitive economy a number of activities that were previously considered as natural monopolies.

Where, following liberalisations, SOEs remain market incumbents the scope for commercial disputes increases. Commercial disputes regularly arise in regulated markets with natural monopoly characteristics, where economies of scope and scale have left SOEs or former SOE incumbents with significant market share and where the performance of public policy functions (e.g. meeting universal service obligations) are the norm. SOEs or former SOE incumbents are often criticised by rivals or potential rivals claiming that they have preferential status and maintain control over the terms and conditions at which rival firms compete. In some cases they may also benefit from other advantages that are at the root of their competitive position, ranging from regulatory or debt advantages afforded by their (former) public sector status or more tacit advantages (e.g. brand entrenchment) due to a long-standing presence in the market.

Most governments have structurally separated (former) SOEs in these sectors into competitive and non-competitive parts and have encouraged competition in the market segments occupied by the competitive parts. This has usually gone hand-in-hand with bolstering the role of sector regulators and competition authorities. The process of structural separation generally leads to competitive neutrality. However, in some cases structural separation may not be an option for policy makers. The benefits of structural separation do not always outweigh the costs. Governments have found that structural separation is not suited to some types of economic activity where separation is not feasible (e.g. intertwined production processes or dependence on the same physical or human capital), or where certain levels of public services must be maintained to correct market failures or to fulfil public policy functions. In these cases, preserving the economies of scale reaped from joint provision of commercial and non-commercial activity might be justified according to efficiency grounds.

One of the more challenging competitive neutrality issues is how to level the playing field where the operational form of government business is not determined on efficiency grounds or with the purpose of correcting market failures, but rather motivated by other objectives. For instance, as mentioned earlier in some countries the continued use of SOEs and public institutions for the purpose of generating employment and/or political patronage makes it hard to change the organisational form of these entities. There have also been cases where a corporatisation of public services, entirely justified on efficiency and competitive neutrality grounds, was opposed by insider groups purely because it was perceived as a prequel to privatisation.

1.2. OECD sources

This section summarises OECD sources (i.e. OECD instruments, guidelines and best practices) which deal with aspects or elements of the competitive neutrality challenges cited above. The OECD sources presented below are intended for government authorities (especially SOE ownership bodies, regulatory and competition authorities) as guidance on how to best structure/regulate the government's participation in the economy. In particular, the *SOE Guidelines* (OECD, 2005a) are applicable to

commercial SOEs, including those which have not undergone a process of corporatisation or commercialisation. The remainder of the instruments and good practices refer in particular to the utility networks, where structural separation has been a focus of reform and where (former) state-owned incumbents remain important market players. OECD sources do not address more widely the commercial activities of general government:

- *Corporatise government business activity according to the SOE Guidelines*. The *SOE Guidelines* (OECD, 2005a) recommend corporatising commercial SOEs to the greatest extent possible, among other reasons, to maximise transparency and accountability. This will also be instrumental to counter ad-hoc political interventions that might impede competitive neutrality. The *SOE Guidelines* recommend that a corporatised SOE has an independent and well-resourced board and operates under the oversight of a state ownership function that abstains from day-to-day intervention, communicates clear and verifiable objectives to the board of directors and undertakes regular performance monitoring. The *SOE Guidelines* (OECD, 2005a) can be said to provide a blueprint for a successful corporatisation and commercialisation of state-controlled activities which operate on commercial basis and in competitive, open markets. If properly implemented, it can significantly curtail the use of SOEs for undisclosed purposes.

- *Evaluate the costs and benefits of structural separation.* OECD guidelines recommend consideration of structural measures (separating competitive and non-competitive activities), to the extent that benefits outweigh costs. These recommendations are applicable to SOEs as well as other incumbents with significant market power which may justify facilitating new competitive entry in the market. Separation can also be in the form of behavioural remedies which foresee the grating of access to key infrastructure, networks, key technology, including patents, know-how or other intellectual property rights, and essential inputs, in addition to other measures including accounting separation. (*Council Recommendation on Structural Separation* (OECD, 2001a) *Recommendation on Competition Policy and Exempted or Regulated Sectors* (OECD, 1979) and *Report on Regulatory Reform* (OECD, 1997a).)

- *Re-evaluate government ownership objectives.* It is also a useful exercise for government to re-evaluate its objectives in maintaining public ownership. If public ownership is a preferred option, then a combination of measures both regulatory and non-regulatory must be put into place to ensure that continued public stake in a business operation does not put it at an advantage to the private sector- this means that public business should be subject to the same laws and regulations as their private sector counterparts (where relevant). Without high standards of transparency and disclosure disciplines, neutrality can hardly be implemented. (*OECD Guiding Principles on Regulatory Quality and Performance* (OECD, 2005d), *SOE Guidelines* (OECD, 2005a).)

1.3. Options for remedial action

For a government committed to competitive neutrality, a consideration should first be given to the operational form of government entities having a commercial activity and operating in competitive, open markets. The approaches for pursuing neutrality are the following: (i) a structural separation of competitive from non-competitive operations where feasible and efficient; (ii) deciding on an optimal form for government business activities; (iii) setting out clear objectives to increase transparency and accountability; and (iv) regular/periodic review of continued government stake in business activities. Some concrete examples in implementing these practices are described below.

Structural separation of competitive from non-competitive operations where feasible and efficient. Structural separation implies the division of a formerly integrated entity into competitive and non-competitive parts. There are different degrees of separation ranging from accounting, functional or corporate separation, to ownership separation, club ownership and a separation of ownership from control. The type of separation may depend on the nature of the company and sector/industry.[1] However, most countries have reported that depending on technologies, capital equipment, human capital, etc. this is not always practically feasible, and sometimes where this is feasible it is not economically efficient.

Deciding on an operational form for government business activities. As mentioned, government businesses operate across a broad continuum, ranging from predominantly governmental to primarily commercial functions in terms of their operational form. This has implications for the level of corporatisation. The 'optimal' form will depend, in part, on the commercial activity's level of integration with the public institution to which it is linked. But it also relies on careful consideration of what constitutes commercial and non-commercial activity (concepts which are likely to differ among countries), a clear demarcation of the boundaries of the role of the State (i.e. sovereign rights) and where the government and market can benefit from efficiency gains.

In some economies, the role of the State in the market place may be more prominent than others without prejudice to competitive neutrality. This tends to be the case among Scandinavian economies where public and private businesses co-exist in a number of sectors in which the government continues to maintain a public policy interest. In Sweden and Finland where the state remains present in these areas, the corporatisation of business activity has been the trend at both the national and sub-national levels with the aim of operating on more competitively neutral terms. An example is provided from Finland concerning a former state enterprise which was fully corporatised in order to neutralise the preferential treatment (tax and regulatory) previously afforded due its organisational form (Box 4).

Box 4. Example: Finnish Road Enterprise

The former Finnish Road Enterprise (FRE) was a state enterprise entrusted, among other things, with maintenance of the Finnish road infrastructure. Private operators in the same field of business alleged, that bankruptcy protection and exceptional tax treatment of the state enterprise amounted to state aid, which is prohibited by the EU State aid rules.

A complaint was placed to the European Commission (by The Confederation of Finnish Construction Industries and Suomen Maanrakentajien Keskusliitto ry). The Commission held that:

- The bankruptcy protection and exceptional tax treatment of the state enterprise was a State aid (inapplicability of bankruptcy legislation and common Community taxation).
- Approved the arrangements relating to the setting up of the Road Enterprise.
- The *de facto* opening up to competition of the Finnish road service market was in the common interest.
- The Commission did not approve the allegation that FRE had charged predatory pricing.

The FRE aid measures which were deemed to be prohibited were ultimately overturned, and from January 2008 the company was incorporated as a wholly state-owned limited company (Destia Ltd).

Source: Submission from the Finnish authorities.

In other cases an SOE may require a distinct legal form (e.g. statutory corporation) from other companies. According to the *SOE Guidelines* (OECD, 2005a), this is not desirable for SOEs that exercise purely commercial activity and operate in competitive, open markets. However, a different legal form may be required to protect SOEs with a distinct public service role (e.g. protection from insolvency or bankruptcy where they provide public services; where employee remuneration is fixed by regulation; and where specific pension rights and protections are concerned). In these cases the legal form of the SOE should include a strict definition of the activity of the SOE concerned, and limits should be placed on the ability of the SOE to diversify or extend activities to new sectors/overseas to prevent misuse of public funds and aggressive growth strategies. The legal form should not be a barrier to ensuring transparency and accountability, especially where public budgets and public policy functions are involved and when reconcilable with confidentiality clauses.

Setting out clear objectives to increase transparency and accountability. Setting up a clear ownership policy supplemented by individual company objectives goes a long way in dispelling doubts regarding the role and extent of government businesses in the economy. The ownership policy provides transparency surrounding the justification/rationale for state ownership and the organisational form of a government enterprise.

An OECD country usually considered as a top performer in this respect is Norway. The Norwegian government's ownership policy makes extensive use of categorisation of SOEs and their role in the economy in pursuing either commercial and/or non-commercial objectives. All SOEs are officially designated as being either sector policy oriented (i.e. having primary objectives other than profitability) or commercial. The latter category is sub-divided into three categories, namely (i) fully commercial; (ii) commercial but with an obligation to maintain headquarters in Norway; and (iii) commercial but required to pursue certain additional objectives. The categorisation is a government policy, subject to parliamentary approval. It would appear that, perhaps reflecting the high degree of transparency around these procedures, political considerations sometimes play a direct role in the categorisation of SOEs (OECD, 2011a).

A competing example from a country with a strong commitment to competitive neutrality is provided by Australia. Australia has a number of different arrangements for governance structures of government activities depending on factors such as whether the body will, among other things (i) exercise regulatory powers, (ii) have a commercial focus and/or (iii) require a governing board (Commonwealth of Australia, 2005). Particular governance arrangements apply to government business enterprises (GBEs) regarding their corporate plans and investment powers and are outlined in *Governance and Oversight Guidelines* (Commonwealth of Australia, 2011). Although it does not set out specific government-wide objectives for government enterprises, it offers a clear picture of the role of GBEs and the key principles by which they should operate. In addition, each government business enterprise is expected to publish its objectives, articulated in *Statements of Corporate Intent*, which are considered on an annual basis by government ownership entities and Parliament.

Regular/periodic review of continued government stake in business activities. In addition to requiring annual or biennial reporting of company performance, some governments also require additional review of their continued stake in publicly-owned or controlled enterprises. OECD good practice suggests that reviews take place on a regular basis to evaluate the continued relevance of public enterprises' commercial objectives, the existing government stake in ownership and to evaluate any public interest objectives that the SOE may be fulfilling. Reviews are recommended to be commissioned at a high level, independently and aim to inform decision-making of ownership entities/oversight bodies/sector ministries to which SOEs report.

Other governments require an extensive review of government ownership objectives by parliament, a relevant ministry, or specialised committees. For example, in Australia, Germany and the United Kingdom, periodic review of continued government ownership activities are encouraged. Periodic review provides an opportunity for government authorities to reconsider the operational form for government business, which in some cases has led to the privatisation of government businesses. In Australia, the reviews take into consideration the reasons for retaining government ownership and specific business circumstances, in addition to national priorities. In Germany, this evaluation is bi-annually performed by the Federal Ministry of Finance for an internal government report which is at the same time part of the government's programme for privatisation. The authorities need to justify not only a change in ownership shares, but also public interest in continued ownership of each individual enterprise. In the United Kingdom, an *Operational Efficiency Review* of government businesses took place recently with the intention of examining government assets and the future strategy for each of such assets. On a regular basis, a Cabinet sub-Committee meets to examine the government's involvement with each SOE that holds financial or political significance. The Shareholder Executive also monitors the progress of each SOE through annual investment reviews to ensure that each business is fulfilling its stated objectives.

Note

1. For example, operational separation is most common in the electricity industry. Club ownership is most common in the airport sector (it is common for airlines to jointly own the slot co-ordination function). Vertical ownership separation is relatively more common in the electricity and gas sectors. Access regulation is found in all of these industries and is especially common in telecommunications and post. Separation into reciprocal parts is rarer, but is found in railways and telecommunications

Chapter 2

Identifying the Costs of Any Given Function

Identifying the costs of any given function of commercial government activity is essential if competitive neutrality is to be credibly enforced. The activity's ability to achieve this depends on the level of incorporation of the business. For incorporated SOEs, the major issue is accounting for costs associated with fulfilling public service obligations (if applicable). If public service obligations are subsidised by the public purse, costs should be identified in a transparent manner to ensure neither over compensation nor under compensation. For unincorporated units of general government which share costs between commercial and non-commercial activities the concern is that the attribution of costs often may not be feasible.

2.1. The challenge and reality in OECD economies

Commercial activities of public entities which remain integrated with other parts of the government sector typically share costs and/or assets and liabilities.[1] Where commercial and non-commercial activities' costs remain integrated, shared costs may result in advantages or disadvantages for government businesses. On the one hand, advantages may arise out of shared-cost structures that artificially lower costs effectively enhancing a public entity's ability to price more aggressively than competitors. On the other, disadvantages may also be of concern to public sector businesses, especially where public sector liabilities (e.g. guaranteeing employees pension liabilities) are concerned.

In most OECD economies, SOEs are subject to similar or even more stringent monitoring and oversight compared to private companies. In general, government-owned businesses (depending on the legal form) involve a complex system of oversight and monitoring above and beyond their day-to-day corporate governance structures. In addition to competition authorities and sector regulators, line/sector ministries, parliaments and state audit institutions have a stake in ensuring effective oversight and monitoring of SOEs. Nevertheless, some exceptions exist which may risk undermining competitive neutrality. This reality underlines the importance attached to and challenge associated with identifying costs among non-commercial and commercially-oriented activities, especially where public interest and taxpayer money is at stake.

To facilitate transparency and disclosure, governments generally require their businesses to separate the accounts of commercial and non-commercial activities. The effectiveness of transparency and disclosure depends on the consistency in which it is applied, especially where small or unincorporated government businesses are concerned. A minority of countries do not require their SOEs to separate accounts; this lack of transparency surrounding the cost structure can make it difficult to determine the extent to which competitive neutrality is ensured. This is further aggravated if companies do not specify the attribution of liabilities between commercial and non-commercial activities. Most countries report that their government businesses report liabilities similarly to their private sector counterparts. However, where public sector pension liabilities are concerned, the accumulation of such liabilities is rarely identified as a separate cost, especially where pensions are associated with the national pension plan for public employees.

2.2. OECD sources

This section summarises OECD sources (i.e. OECD instruments, guidelines and best practices) which deal with aspects or elements of the competitive neutrality challenges cited above. OECD sources presented below are applicable beyond the scope of "traditional" SOEs, including the activities of general government and are intended for SOE ownership entities, competition and public management authorities. The first point provides guidance specifically for budget authorities and addresses the application of budget principles to the activities of general government (defined according to the System of National Account threshold cited in Box 2):

- *Fully disclose and take into account direct and indirect shared costs and assets.* OECD sources suggest disclosing the proportion of shared costs and assets that are attributed to commercial activities, where both commercial and non-commercial activities are integrated. A public service provider may not fully reflect its costs if it is not taking into account a number of factors which could put it at a disadvantage or advantage vis-à-vis the private sector. Costs should include any shared financial (over head costs) and non-financial costs (depreciation cost of capital, tax and regulatory treatment). Costs should also include staffing

liabilities, salaries, benefits, and pensions. (*Best Practices in Budget Transparency* (OECD, 2001b).)

- *Increase transparency surrounding costs where public funds are being disbursed.* Where public funds are provided for services of general economic interest, the source and use of such funds should be made transparent. This is relevant for incorporated SOEs. For general government as a whole, budget transfers and/or off budget spending used to finance operations of government bodies with both commercial and non-commercial functions should be made transparent. (*SOE Guidelines* (OECD, 2005a), *Accountability and Transparency Guide* and *Guidelines for User Charging for Government Services* (OECD, 2010a).)

- *Remove any cost advantages or disadvantages as a sole result of public ownership.* Identifying costs are an important for determining rate of return targets, in addition to costing for public service obligations (if any). Any cost (dis-) advantages which may exist solely due to public ownership should be removed especially with regards to commercial activities of general government. (*Regulating Market Activities by the Public Sector* (OECD, 2005c), and *Guidelines for Contracting Out Government Services* (OECD, 1997b).)

2.3. Options for remedial action

As mentioned, the ability to identify the cost structure of entities providing commercial and non-commercial services in parallel is essential – not to the principle of competitive neutrality *per se*, but to enable authorities to enforce it credibly. The approaches are of particular importance for undertakings which receive compensation to fulfil public service obligations. The main building blocks are: (i) transparency and disclosure concerning the cost structure; (ii) separation of costs and assets between commercial and non-commercial accounts; (iii) clear attribution of liabilities; and, (iv) oversight, monitoring and cost neutrality adjustments. Some concrete examples in implementing some of these practices are described below.

Transparency and disclosure concerning the cost structure. High standards of transparency and disclosure should be maintained among SOEs (or other entities entrusted with public service obligations) as recommended by the *SOE Guidelines* (OECD, 2005a). Among other things, this is necessary to ensure that compensation for public service obligations do not provide a conduit for cross-subsidising competitive activities. In addition, the need for transparency around the operators' cost structure is further accentuated where compensation is provided through the public purse or where costs are shared with general government. The cost structure of publicly funded entities involved in commercial activities should be fully disclosed to the relevant regulatory authorities and to the largest extent possible (given concerns such as commercial confidentiality) be open to scrutiny by the general public.

A national example comes from Israel, whose ownership agency, the Government Companies Authority (GCA), has issued specific transparency and disclosure directives for government-owned companies. Companies, depending on their legal form, report according to internationally accepted accounting standards and are subject to the same transparency and disclosure practices as private sector companies. Some government companies may be required to provide further information concerning the company's performance in meeting its targets and objectives. Furthermore, SOE management is held accountable for any deviations from approved budgets where activities are required by law. The requirements set out by the GCA on financial reports are described in Box 5.

Separation of costs and assets between accounts corresponding to commercial and non-commercial activities. For government entities that perform both commercial and non-commercial activities, separate accounting serves to identify which costs and assets are attributed to non-commercial activities and to disclose which proportion are attributed to commercial activities. If financial assistance is received from the State, in addition to increasing transparency on the use of public funds, maintaining separate accounts avoids possible cross-subsidisation across various functions and activities of government businesses (this may already be achieved if commercial and public functions are operationally or structurally separated as described in section 1).

Box 5. Toolkit: Directives issued by the Israeli GCA to government companies on financial reports

The Israeli Government Companies Authority (GCA) issues directives to government companies on all matters concerning reports, audit procedures and transparency standards. In some cases, in addition to meeting the same reporting requirements as private sector companies, government businesses may be subject to an expanded and more precise reporting standard on specific matters which government companies must carry out in accordance with the law.

Under the GCA's circular on financial reports, government companies are required to disclose, *inter alia:*

- internal and external reports regarding the implementation of the targets and objectives which were set for the companies;
- the supervision of their implementation, including difficulties in the implementation of the targets and objectives;
- the company's policy for dealing with the difficulties and limitations that arose in the achievement of the goals;
- the objectives and explanations regarding the implementation of the relevant laws wherever these concern privatisation matters; and,
- structural changes required to protect the State's interests as prescribed for the company.

In addition, government companies are required to submit a budget performance report. This report details the actual performance of the budget in comparison with the original budget and the updated budget, including explanations and analysis of material deviations between the principles of the approved budget and the actual performance and the reasons for such deviations.

Source: Submission by the Israeli authorities.

The EU *Transparency Directive* provides for specific transparency requirements concerning the financial relations between public authorities and public undertakings in EU (inc. EEA) member States. The Directive also requires undertakings which enjoy exclusive or special rights, as well as undertakings which receive public service compensation for the provision of a service of general economic interest while having activities outside the service of general economic interest, to maintain separate accounts between their different activities. The objective is to prevent those undertakings from cross-subsidising other activities with funds raised through activities reserved for them or from compensation to provide public service obligations. Public undertakings excluded from the Directive are those which do not affect trade between EU (inc. EEA) member States and those whose turnover does not exceed a specific threshold. (Box 6)

In Australia, financial statements of government business entities may separate accounts to detail purely commercial activities from public interest activities.[2] Separate accounts may be held to evaluate the costs attributed to meeting public service obligations. In addition, cost attribution is intended to

serve as a method by which to ensure that pricing of goods and services fully reflect costs – thereby avoiding the possibility for a State provider of goods or services to price more aggressively than what the market would dictate. This link is made further in section 3 concerning commercial rates of return.

Box 6. Toolkit: The EU Transparency Directive

In EU (inc. EEA) member States, compliance with the Transparency Directive is obligatory. The EU Treaty requires the Commission to ensure that EU (inc. EEA) Member States do not grant undertakings, public or private, aids incompatible with the internal market. However, the complexity of the financial relations between national public authorities and public undertakings tends to hinder the performance of this duty. A fair and effective application of the EU aid rules to both public and private undertakings is possible only if these financial relations are made transparent.

The Transparency Directive has two objectives:

1. Ensuring transparency of financial flows between public authorities and public undertakings.

- Some examples of financial flows existing between public authorities and public undertakings that have to be made transparent are:
  - the setting-off of operating losses;
  - the provision of capital;
  - non-refundable grants, or loans on privileged terms;
  - the granting of financial advantages by forgoing profits or the recovery of sums due;
  - the forgoing of a normal return on public funds used; and
  - compensation for financial burdens imposed by the public authorities.

2. Ensuring that public and private undertakings enjoying special or exclusive rights or receiving public service compensation for the provision of a service of general economic interest maintain separate accounts between their different activities.

- Such separate accounts should be available in relation to, on the one hand, products and services in respect of which the Member State has granted a special or exclusive right or entrusted the undertaking with the operation of a service of general economic interest, as well as, on the other hand, for each other product or service in respect of which the undertaking is active.
- The objective is to prevent those undertakings from cross-subsidising other activities with funds raised through activities reserved for them or from compensation to provide public service obligations which would exceed the actual costs incurred in providing those obligations plus a reasonable profit.
- For an undertaking to maintain separate accounts the Transparency Directive requires that:
  - The internal accounts corresponding to different activities are separate;
  - All costs and revenues are correctly assigned or allocated on the basis of consistently applied and objectively justifiable cost accounting principles; and,
  - The cost accounting principles according to which separate accounts are maintained are clearly established.
  - The obligation of separation of accounts does not apply to undertakings whose activities are limited to the provision of services of general economic interest.
- Certain undertakings are excluded from the application of the Transparency Directive by virtue of the size of their turnover, in particular those public undertakings whose business is not conducted on such a scale as to justify the administrative burden of ensuring transparency.

Source: Submission from EU authorities.

Clear attribution of liabilities. The attribution of liabilities is an important aspect in ensuring that government businesses' costs are fully identified and accounted for. Government businesses that are involved in both public service and other activities may be exposed to different forms of liability than what may "normally" be found in the private sector; for example, where public sector pension liabilities are concerned.

Citing again the Australian example, government business enterprises report liabilities according to Australian Accounting Standards, however no distinction is made between those attributed to public interest objectives versus other activities of the businesses. For other types of government businesses, superannuation (pension) liabilities for government employees are not reflected in the balance sheets of the business activity (they are instead reflected in the Australian government's balance sheet).

In Ireland, pension liabilities are generally reflected in SOE balance sheets. One practical example of actuarial calculations as defined by the Irish gas and network supplier *Bord Gàis* is described in Box 7.

Box 7. Toolkit: Actuarial calculations for Bord Gáis in Ireland

***Bord Gáis* (gas networks and supplier) has defined pension benefit and contribution arrangements as follows:**

- Each of the defined benefit pension scheme assets are measured using fair values.
- Pension scheme liabilities are measured using the projected unit method and discounted at the rate of return of a high quality corporate bond of a comparable duration to the benefit flows.
- Pension schemes' surpluses, to the extent that they are considered recoverable, or deficits are recognised in full and presented on the face of the balance sheet net of related deferred tax.
- The current service cost and gains and losses on settlements and curtailments are charged to operating profit or provisions as appropriate. The interest cost and the expected return on assets are included as other finance income/expenses. Actuarial gains and losses are recognised in the consolidated statement of total recognised gains and losses in the period in which they occur.

The contributions payable by *Bord Gáis* under the defined contribution schemes are charged to the profit and loss account in the period in which they become payable.

Source: Submission by the Irish authorities.

Oversight, monitoring and cost neutrality adjustments. In addition to market regulation, oversight by government bodies charged with the ownership of SOEs obviously plays a key role in monitoring how costs and remuneration for public service obligations are calculated. Depending on the national context these include ownership agencies and/or economic and sector ministries, and are subject to accountability *vis-à-vis* the council of ministers, parliament and supreme audit institutions. The level of accountability can be assured through a number of supervisory controls. For example, in Spain the use of public funds by public enterprises or private companies granted with special or exclusive rights, or operating services of general economic interest are subject to a four to five step supervisory process beginning with internal controls and ending with Parliament, as described in Box 8.

Box 8. Toolkit: Supervising the use of public funds in Spain

In Spain the following supervisory controls are in place to ensure proper use of public funds in entities carrying out commercial activities. Act 4/2007 imposes specific disclosure requirements to public enterprises and private companies granted with special or exclusive rights, or operating services of general economic interest:

- First, the undertaking is subject to internal supervision which is carried out by its governing body. In larger companies, there is normally an internal audit department to ensure internal control and compliance.
- Second, either the General State Comptroller or the Regional Comptrollers audit public undertakings given that they also considered part of the public administration (at the national, regional or local level).
- Public undertakings submit Action, Investing and Financing Programmes (the so called PAIF) together with their Annual Accounts, in order to justify the use of the public funds that they receive.
- Third, according to commercial law, undertakings' accountability implies financial statements in compliance with the principles set forth in the General Accounting Plan (mandatory in Spain) subject to financial auditing.
- Fourth, the external supervision is exercised by permanent advisory bodies such as the *Tribunal de Cuentas* (the supreme supervisory body) and the regional external supervisory agencies.

Finally, the Parliaments, as legal recipients of audit reports and of external audit services, exercise supervision through plenary sessions and commissions. Notably, public undertakings excluded from the Act are those which do not affect trade between EU (inc. EEA) member States and those whose turnover does not exceed a specific threshold (in line with the EU Transparency Directive).

Source: Submission by the Spanish authorities.

Where cost imbalances may exist (e.g. benefits arising from shared assets or (contingent) liabilities), oversight/regulatory entities in some countries are committed to addressing these imbalances. Depending on the nature of the cost imbalance, different methods may be suitable to ensure a cost adjustment in line with competitive neutrality principles. Ideally, any cost advantages should be removed. However, in some cases, especially where shared costs may be relevant, direct compensation to the State budget may be best suited to remove benefits arising from the amounts invested in these entities (for example from shared costs). In other cases, a cost neutrality adjustment can be factored into prices. To calculate a cost neutrality adjustment that is factored into prices the South Australian authorities have developed a *Guide to the Implementation of Competitive Neutrality Policy* (South Australian Department of Treasury and Finance, 2010) which proposes options as to how to factor in competitive neutrality in to costing for government commercial activities. (Box 9)

A practical example of the controversy which may arise due to shared cost structure is demonstrated by a case concerning the Lithuanian Police Department (Box 10) and security services provided on a commercial basis by selected security departments of the police force. (Also see Box 14 for an example from Australia.)

Box 9. Toolkit: Calculating full costs and factoring in competitive neutrality adjustments

The cost base for each activity: includes all of the direct (labour, materials, service), indirect (HR and IT services, administration, finance costs) and depreciation costs of the activity and accounts for all of the real resources used to produce the service. In order to assess these costs, agencies need to have in place adequate financial management structures that allow costs, including indirect costs to be allocated to particular activities. Accrual accounting, output based costing and asset valuation systems, for example, would generate the information needed to calculate the cost base of a government business activity.

The competitively neutral cost benchmark: includes the cost base plus an adjustment for any advantages or disadvantages the activity receives because of government ownership (adjustments for private sector rate of return, taxes, regulation and legislation). It needs to be demonstrated that the constraints are externally imposed, exceed those facing the private sector and subsequently impose a cost on the government agency. In many cases it would be preferable to remove the cost disadvantage rather than trying to adjust prices.

The competitively neutral market price: If the cost advantage cannot be removed, then prices must be adjusted to factor in what the market will bear (which may change over time); the level of competition between service providers; any technological advantage available to other suppliers of goods and other service providers; and market strategic price behaviours, such as the introduction of loss leaders or cross product subsidisation. Pricing needs to cover the cost benchmark in the medium to long run.

Source: OECD (2005c), *Regulating Market Activities by the Public Sector*, p.34-35. Also see South Australian Department of Treasury and Finance (2010), A Guide to the Implementation of Competitive Neutrality policy, p.11.

Notes

1. Shared costs include financial and non-financial assets (e.g. property and equipment costs), liabilities (e.g. legal claims), employee pension obligations (e.g. contributions made towards those benefits and actuarial assumptions) and/or contingent liabilities (e.g. government loan guarantees and insurance).
2. Australia defines public interest activities as follows: A community service obligation exists only where a government business is specifically directed to conduct an activity that the organisation would not elect to do on a commercial basis, or that it would only do commercially at higher prices; and the government does not, or would not require other organisations in the public or private sectors to undertake or fund.

Chapter 3

Achieving a Commercial Rate of Return

Achieving a commercial rate of return is an important aspect in ensuring that government business activities are indeed operating like comparable businesses. If SOEs operating in a commercial and competitive environment do not have to earn returns at market consistent rates over a reasonable period of time, private sector competitors can be, other things equal, undercut. The problem may be aggravated if government businesses pursue aggressive pricing policies. Furthermore, setting appropriate rates of return for each separate line of commercial activity is an important factor to safeguard against distorting cross-subsidisation practices.

3.1. The challenge and reality in OECD economies

A challenge for policy-makers is to establish performance criteria ensuring that public sector business activities are earning market-consistent rates of return over a reasonable period of time in their commercial activities. The main problem lies in a number of factors related to an operator charged with providing public service objectives. For example, public service obligations may oblige certain state-owned enterprises or other operators to price at below costs for these services.[1]

Box 10. Example: Lithuanian Police Department

In 2005, the Lithuanian Commissioner General issued an order applicable to selected security departments of the police. The order allowed these police departments to provide services on a commercial basis; however it did not distinguish specific provisions that apply when fulfilling public functions versus commercial activity. As such, the police were not prohibited from using the same equipment, including police cars and the possibility to use car lights, no matter which activity was carried out by them. Private sector competition operating in the area of personal and property security (and regulated under a different law than the police services), complained that given that public commercial security services are regulated under a different framework, certain advantages are afforded through their public ownership which are not afforded to private sector competition (rights and powers of police are regulated under the law on police activity). The claimants argued that private security firms could not compete at the same level with the police due to the fact that they operate under different legal conditions.

The Competition Council was asked to examine whether certain provisions of the order were in compliance with Competition Law. The Competition Council found that :

- The problem was the legal regulation itself but not in the fact that the police pursued this commercial activity in general.
- The Competition Council could not apply the exemption placed in article 4 of the Law on Competition because the right to carry out such commercial activities was not regulated by any existing laws, but in the order issued by the Commissioner General.
- Because the police are regulated under different provisions, the same license obligations required of private actors in the pursuit of security commercial services was not required (the licenses are provided by the police departments themselves).
- The Competition Council stated that it is unclear how the police commercial activities are financed, and from what financial sources. Therefore, the possibility that commercial activities of the police were financed from Police Department's general budget was high.

In 2006 the Competition Council passed a resolution recognising that the provisions of the order of the Commissioner General contradicted the Law on Competition. The decision was affirmed by the Supreme Administrative Court. Consequently, the Commissioner General amended the order to ensure that it does not afford any rights to the police departments providing commercial services beyond those provided to the private sector. The Police Department has decided not to provide commercial services from January 2012.

Source: Submission by the Lithuanian authorities.

As mentioned earlier, some national authorities actually depart from competitive neutrality in an attempt to compensate SOEs for public service obligations, as such a commercial rate of return may not be guaranteed on the allocation of capital to activities at any given moment. Instead, the main objective for SOEs with both a commercial and non-commercial focus will be to earn a rate of return (on commercial activities) sufficient to justify a long-term retention of assets in the business. The challenge for SOE owners is to determine what is "adequate" in terms of targets, how this is adjusted to the level of risk for that particular business and benchmarked across industry standards, and to

determine a sufficient period of time over which it can expect a commercial rate of return on its assets. For some government activities, a further challenge will be related to whether accounting information concerning the business' operations (which is required to set appropriate rate of return targets) is available – this may be the case for smaller business units.

Most countries require their fully incorporated SOEs – whether or not they fulfil public service obligations – to earn market-consistent rates of return. A minority of countries have developed guidelines on how to calculate return requirements for their SOEs. It is rare to find SOEs which are not expected to earn market-consistent ROR. In the case of commercial activities operated by general government the application of ROR requirements seem to be the exception rather than the rule. Where applied, the usefulness of such requirements depends crucially on the attribution of assets and liabilities discussed in the previous section.

Regardless of national practice, objective setting and performance monitoring are at the heart of good ownership practices. ROR requirements on public business involved in non-profit maximising activities make sense only if the nature and extent of these additional obligations has been clarified. This underlines the importance for the ownership function to establish a methodology which clearly identifies the costs of inputs and the expected ROR.

3.2. OECD sources

This section summarises OECD sources (i.e. OECD instruments, guidelines and best practices) which deal with aspects or elements of the competitive neutrality challenges cited above. OECD sources presented below are intended primarily for SOE "owners" and competition authorities in setting rate of return targets and assessing performance. It is applicable to "traditional" SOEs, recently privatised SOEs (where predatory pricing is concerned), and (former) state-owned incumbents where commercial activities comprise of a significant portion of the entity's activities but where public service objectives are still of importance. The guidance is less likely to apply to the activities of general government except where such activities are primarily commercial in nature:

- *Where commercial objectives are concerned, commercial ROR targets should be set.* According to OECD guidance, incorporated SOEs should earn rates of return equivalent to that of private sector businesses; and performance should be benchmarked with similar business activities in the same industry. Without having to earn returns at commercial rates, private sector competition can be undercut, especially if the SOE pursues aggressive pricing policies. Furthermore, it ensures that the SOE is not engaged in cross-subsidisation from non-commercial to commercial activities. (*Regulating Market Activities by the Public Sector* (OECD, 2005c), *Accountability and Transparency Guide* (OECD, 2010a).)
- *Making commercial and non-commercial objectives transparent.* SOEs and other types of government businesses may be required to pursue objectives other than profit maximisation. The OECD guidelines hold that such objectives should be made transparent and should not be used to undercut actual or potential competition. (*SOE Guidelines* (OECD, 2005a))
- *Where public service obligations are concerned, ROR targets alone are not enough.* While good practice acknowledges the role of traditional competition-law based approaches to anti-competitive practices (e.g. cost predation tests), other approaches may be more adequate if SOEs do not maximise profits or are allowed to earn lower rates of return (e.g. appropriate cost accounting mechanisms and comparing performance across industries). Specific adjustments should be made to SOEs' commercial strategies in order to account for public service obligations other adjustments may be necessary in case it benefits from implicit or explicit guarantees, preferential/below-market rates for debt financing and/or if it benefits

from tax advantages. (*Predatory Pricing Reports* (OECD, 2004a, 1989), *Accountability and Transparency Guide* (OECD, 2005a).)

Box 11. Toolkit: Different methods used to calculate RORs and estimate performance of SOEs based on cost of capital

Methods used to calculate ROR targets

Weighted average cost of capital (WACC) method:

- Requires estimation of variables such as the required rate of return on debt and equity and the market values of assets, debt and equity
- Uses the cost of capital as the hurdle rate the business must achieve and is based on the presumption that a financially viable business must earn a return that is above its cost of capital
- Most appropriate for large government business activities, particularly if there are well-established private sector competitors so that benchmark data on the cost of equity is available

Example : Calculating the ROR target according to the WACC

The ROR target can be calculated according to the WACC. The *Australian Competitive Neutrality Guidelines* (2004) proposes a methodology, provided that accounting systems can provide the information required to set an appropriate ROR target. The methodology is reproduced below:

ROR Target = WACC = $R_e(E/V) + R_d(D/V)$ where:

- R_e is the required rate of return on equity (including risk premiums);
- R_d is the required rate or return on debt (including any debt neutrality charges);
- V is the market value of total assets (i.e. debt plus equity);
- E is the market value of equity; and,
- D is the market value of debt.

Risk broad-banding approach:

- Risk broad-branding is based on typical WACCs for businesses with high, medium and low levels of market risk
- Requires estimation of a premium for each level of market risk and cost of capital (at long term bond rate)
- Has advantages over uniform rate of return (below) as it recognises that different business activities imply different risk profiles

Uniform rate of return:

- Requires government businesses to generate a set level of return across all their assets
- Uses the typical WACC calculation for agencies with *average* market risk
- Simplest method of establishing a rate of return target and does not take into account that investors would expect higher returns from risky businesses and lower returns from less risky businesses

Source: OECD (2004) Regulating Market Activities by the Public Sector; OECD, 2010, Accountability and Transparency: A Guide for State Ownership; and *Australian Competitive Neutrality Guidelines* (2004).

3.3. Options for remedial action

For a government committed to competitive neutrality, setting market-consistent rates of return over a reasonable period of time for its businesses would ensure that they are indeed operating as "businesses" with specific profit/revenue objectives. The approaches for pursuing neutrality are the following: (i) Setting guidelines to ensure market-consistent ROR targets; and, (ii) ROR targets should be set to ensure cost-recovery over a reasonable period of time. Some concrete examples in implementing these practices are described below.

Setting guidelines to ensure market-consistent ROR targets. A ROR objective, benchmarked with firms in the same industry operating similar business activities is the most common method used by OECD economies to ensure that government-owned businesses are earning at market-consistent rates on their commercial activities (assuming that similar businesses are indeed operating on a competitive basis). The ROR is considered to be a useful proxy as it focuses on the cost of capital and hence ensures market-consistency of the SOEs' business operations. Some countries report that specific guidelines have been defined, outlining a methodology on how to calculate ROR targets for SOEs. Each method can be used to calculate returns, but their complexity and level of precision vary and each has its own merits depending on the availability of accounting information for the company in question.

Box 12. Toolkit: ROR calculations in Hungary

ROR Requirements for Hungarian SOEs

- In line with private equity standards, sophisticated planning guideline is prepared by HSHC. It specifies the principles and basic requirements for next year's business planning practice.
- The planning guideline has a macro outlook part that defines the premises and the owner's requirements for the upcoming year's business planning. All majority-owned HSHC portfolio companies are to use the planning guidelines.
- The main features of the guidelines are the following:
  - Gives an overview about external macro premises
  - Draws expectations for capital efficiency and dividend yield policies
  - Demonstrates the owner's resource allocation possibilities
  - Defines the formal minimum standards of business plans
  - Defines salary increase ceilings
- One of the main goals of SOE asset management is efficiency and increasing the rate of return. Therefore, capital effectiveness is monitored thoroughly. Minimum expected yield is defined individually for major SOEs. As for homogenous portfolios and other state-owned enterprises, yield requirement (HSHC uses return on equity) is defined for the group as a whole.
- As a general principle, the minimum target is positive earnings before tax and earnings cannot be lower than the previous years' one.

HSHC benchmarks yield requirements to average yields of the Hungarian Treasury bonds with 5 years maturity auctioned in 2010.

Source: Submission by the Hungarian authorities.

In general, the rule of thumb is that the ROR target should reflect the long term government bond rate (risk free) plus an appropriate margin for risk. The key question is obviously what methodology is applied to the calculation of this margin. These methods include the weighted average cost of capital (WACC) method; the broad branding approach; and a uniform ROR. Other methods place emphasis on evaluating value creation, they include: economic value added (EVA) performance measurement and the economic profit methodology (Boxes 11 and 15). The "reasonable profit" methodology is another method and is mainly used in the EU (Box 13).

Methods vary both with regards to ROR requirements and in which form they are communicated to SOEs. For example, in New Zealand rates of return are not specified by law but SOEs are expected to be market-consistent. These ROR targets take into account the cost of capital and details as to how capital was derived. Other more specific standards may be set out by respective line ministries in "Letters of Expectations" which may for example set out targets for shareholder returns. These expectations may set a return target to exceed the cost of capital over a five year period. Alternatively, the Hungarian State Holding Company (HSHC) has issued specific guidelines, in line with private equity standards, on ROR requirements for its SOEs. The HSHC approach is outlined in Box 12.

In the European Union recent changes to the SGEI package also place emphasis on the ROR on capital. Pursuant to the EU rules, compensation for the provision of a service of general economic interest cannot exceed the net cost of providing the plus a reasonable profit. Reasonable profit is taken to mean the rate of return on capital that would be required by a typical company considering whether or not to provide the service of general economic interest for the duration of the entrustment act, taking into account the level of risk. This methodology is intended to calculate what constitutes "reasonable" profit for an entity entrusted with public service obligations (e.g. services of general economic interest). Specific incentives must also be introduced under the framework to ensure quality of service and gains in productive efficiency.

Box 13. Toolkit: Determining "reasonable profit" for the provision of SGEI under the EU rules

The EU has defined "reasonable profit" as the rate of return on capital that would be required by a typical undertaking considering whether or not to provide the service of general economic interest for the whole period of entrustment, taking into account the level of risk. In duly justified cases Member States may rely on profit level indicators other than the rate of return on capital to determine what the reasonable profit should be, such as the average return on equity, return on capital employed, return on assets or return on sales.

A rate of return on capital that does not exceed the relevant swap rate plus a premium of 100 basis points shall be regarded as reasonable in any event. The relevant swap rate shall be the swap rate the maturity and currency of which correspond to the duration and currency of the entrustment act. Where the provision of the service of general economic interest is not connected with a substantial commercial or contractual risk, in particular when the net cost incurred in providing the service of general economic interest is essentially compensated ex post in full, the reasonable profit may not exceed the relevant swap rate plus a premium of 100 basis points.

In determining what constitutes a reasonable profit, Member States may (under the SGEI decision) or must (under the SGEI framework) introduce incentive criteria relating, in particular, to the quality of service provided and gains in productive efficiency. The introduction of efficiency incentives allows the provider to increase its profit in case efficiency gains are higher than expected. *A contrario*, the profit of the provider will be reduced if efficiency gains are lower than expected.

Source: Submission by EU Authorities.

ROR targets can be set to ensure cost-recovery over a reasonable period of time. Once a ROR target has been set, performance must be assessed. The fact that requirements are imposed does not imply that state-owned businesses must earn a commercial ROR in every calendar year or accounting

period. An important aspect of ensuring cost recovery is to set as a general rule that business should earn a commercial ROR "over reasonable period of time." In New Zealand and Australia this is considered to be a five year period.

In Australia, all government businesses are required to earn a commercial ROR on the goods and services offered over a five year period, taking into account the full costs of resources employed, including the cost of capital (calculated according to credit risk of the Australian government). Government businesses are expected to manage their performance objectives to recover costs, as such prices should reflect this principle (taking into account economic "forces" and pricing conditions which may be imposed). The *Australian Competitive Neutrality Guidelines* (Commonwealth of Australia, 2004) sets out standards in this regard, which are the basis for resolving any controversy which may arise (Box 14 illustrates an example from Australia where rate of return requirements, among other issues, were the subject of a competitive neutrality complaint and investigation).

Determining costs and setting appropriate prices for goods and services are related but different exercises; as such identifying costs is covered separately in Section 2. Prices will depend on a number of factors including: what the market will bear (which may change over time); and, the level of competition between goods/service providers. Determining appropriate price settings depends on the competitive neutrality cost benchmark (Box 9), which in turn should be factored into prices.

Box 14. Example: The Australian Valuation Office

In November 2003, the AGCNCO received a complaint from Herron Todd White Pty Ltd concerning the activities of the Australian Valuation Office (AVO), an Australian Government business unit operated by the Australian Taxation Office (ATO).

The AVO provides a range of valuation services, on a fee for service basis, to government departments and agencies and the private sector. These services include: appraisals of property and other assets for government housing and welfare agencies (examples include large scale valuations for State and Territory housing authorities and the valuation of the assets of applicants for social security benefits); special purpose valuations of property for capital or rental value, connected to acquisitions, disposals, leases or financial statements; plant and equipment valuations; and corporate valuations for consolidation and taxation purposes.

Herron Todd White Pty Ltd is one of Australia's largest Independent Property Advisory groups. The complainant alleged that the AVO was not complying with competitive neutrality and that the pricing regime used by the AVO in tendering situations systematically fails to adequately reflect the full costs of service provision. The complainant claimed that the AVO's pricing failed to adjust for a number of key cost advantages which accrue from its position within the ATO, including: access to resources such as IT and telecommunications at reduced rates; reduced commercial rents, accommodation search costs and fit-out costs as a result of being co-located with the ATO; and diminished search and compliance costs in relation to professional indemnity insurance, given AVO's 'government' status. The complainant further alleged that the pricing regime employed by the AVO fails to include a tax equivalence component, and that the AVO cannot be earning a rate of return which accords with normal commercial standards.

The issue was addressed through a complaint made to the Commonwealth Government complaints office, AGCNCO, who undertook an investigation of the issues and provided a report, along with recommendations, to the relevant Australian Government Ministers and the Treasurer. The AGCNCO found that the AVO:

- operated as a standalone business and did not receive a competitive advantage through access to ATO resources at non-commercial rates;
- appeared to gain no material advantages in the areas of taxation, regulation or debt financing, as a result of it being government owned;
- met competitive neutrality obligations in relation to payments for insurance costs in the areas of public liability, property loss and fraud, fidelity, workers' compensation and third party motor vehicle coverage; and

Box 14. Example: The Australian Valuation Office *(continued)*

- generated a rate of return in the last five years, based on current levels of expenditure that is consistent with competitive neutrality principles.

However, in the area of professional indemnity insurance, the AGCNCO found that an increase was required, on competitive neutrality grounds, in the professional indemnity insurance premium paid by the AVO. The AGCNCO recommended that the Department of Treasury and the Department of Finance and Administration institute a process, drawing as appropriate on information obtained from the AVO and other key stakeholders, to determine the extent of the increase in professional indemnity insurance premiums required.

Source: Submission by the Australian authorities. For an example where the AGCNCO has found an *ex ante* breach of competitive neutrality policy concerning ROR projections refer to the most current AGCNCO report concerning PETNET. See: www.pc.gov.au/agcnco/publications/investigation/petnet.

In order to assess whether government businesses are indeed meeting return targets over a reasonable period of time, profits need to be measured against assets. A number of methodologies can be used to assess performance. They are outlined in Box 15.

Box 15. Toolkit: Measuring Returns and Assessing Performance

Methods used to estimate performance of SOEs on the basis of cost of capital

Economic Value Added:

- Measures performance by tracking changes in a company's economic value from a shareholder perspective
- Calculates net operating profit minus an appropriate charge for the opportunity cost of all capital invested in an enterprise
- Encourages a mindset in which managers recognise that all capital has a cost and therefore they should allocate capital to its most effective use
- Applicable to a wide range of industries consistently

Economic Profit Methodology:

- Measures value creation as the after-tax operating profit less the cost of capital charge for the operating assets.
- Excludes the gains and losses arising from non-operating assets, the financing flows and tax impacts of the debt/equity capital structure
- Applicable to all business in different sectors across the portfolio

Source: OECD (2005c) Regulating Market Activities by the Public Sector; OECD (2010), Accountability and Transparency: A Guide for State Ownership.

Note

1. A fundamental difference between public and private sector production is the basis on which production is undertaken. For government, the production of goods and services is often determined by public policy objectives, while the private sector is motivated by profit maximisation. Private companies may pursue similar aggressive pricing policies as part of their corporate strategies, however these issues fall outside the scope of this paper.

Chapter 4

Accounting for Public Service Obligations

Competitive neutrality concerns almost invariably arise when public policy priorities are imposed on public entities which also operate in the market place. It is important to ensure that concerned entities be adequately compensated for any non-commercial requirements on the basis of the additional cost that these requirements impose. The most precise and transparent mode of compensation is direct payments provided directly from public sector budgets. If other modes of compensation are undertaken, concerns about their impact on the competitive landscape may arise.

4.1. The challenge and reality in OECD economies

Almost all countries provide some form of compensation to undertakings (public or private) which deliver public service obligations alongside their commercial activities. Compensation methods vary depending on the country, the type of public service and the entity delivering such services. The main competitive neutrality challenge is to accurately calibrate compensation to minimise any distortionary effects. On the one hand, inadequate calculation of compensation may put service operators at a disadvantage *vis-à-vis* their competitors, and may also have an impact on the quality of public services for end users. On the other hand, if service providers are over-compensated concerns arise over value for money in service provision. Furthermore, a risk is that compensation provided for the fulfilment of public service obligations (and often related subsidies) is used as a conduit for unintended cross-subsidisation of commercial activities by the same entity.

In practice, it may be complicated to decide whether or not certain activities qualify as public service obligations. For example, sector regulation (if entrusted to regulatory entities that are from the government ownership function) would not normally be considered as public service obligations, but where the regulated entity has a monopoly position it can be used to a similar effect. In some cases public planners see it as easier to continue providing public services through fully controlled entities. Compensation may be provided by the public purse (methods range from direct transfers, capital grants, reimbursements and budget appropriations, to state aids/subsidies) or they can be funded entirely through user charges or a combination of both user charges and compensation.

Further to the last point, as mentioned earlier a common practice is to allow incumbents to maintain monopoly rents in some of their activities and use these to compensate for their public service obligations (as is often the case in specific sectors with targeted regulation giving monopoly rights to a single operator). This type of compensation is usually provided through derogations to regulations (e.g. competition laws) in order to permit cross-subsidisation from profit-making to loss-making activities. Operators are to incorporate any public service obligations into tariffs/prices, effectively implying a form of cross-subsidisation – not among activity areas but among customer segments.

A commonly heard complaint by potential or actual competitors is that public service providers (especially SOEs or incumbents) are over-compensated for carrying out public service delivery. On numerous occasions, the first opening of segments of any given network industry to market competition has given rise to accusations of unfair advantages for the incumbent. The latter may be charging excessive revenues in certain "lucrative" areas, notionally in order to fund public service obligations elsewhere but in actual practice subsidising its competitive activities. In addition to effects on the competitive landscape, such practices may also fall short of commonly agreed standards of transparency.

4.2. OECD sources

This section summarises OECD sources (i.e. OECD instruments, guidelines and best practices) which deal with aspects or elements of the competitive neutrality challenges cited above. OECD sources presented below are intended for SOE ownership bodies and competition, regulatory and budget authorities, including at the sub-national level. The guidance is applicable to all types of government entities (ranging from "traditional" SOEs, (former) state-owned incumbents, to general government) and other market actors (public or private or third sector (e.g. non-profit) operators benefiting from special or exclusive rights) involved in the provision of public services:

- *Ensure a sufficient degree of transparency and accountability around SOEs' use of public budgets to fulfil public service objectives*. OECD guidance recommends a sufficient degree of transparency and disclosure surrounding the use of public budgets provided as compensation for fulfilling public service obligations. The use of public resources should be subject to budget oversight and monitoring. Public funds should be provided following procedures that are truly representative of the public interest. (*SOE Guidelines* (OECD, 2005a), *Principles for Managing Ethics in the Public Service* (OECD, 1998c), *Accountability and Transparency Guide* (OECD, 2010a), *Market Mechanisms in Public Service Provision* (Blöchlinger, 2008), *Promoting Performance* (Mizell, 2008))
- *Ensure that adequate compensation is provided for in the discharge of public service obligations entrusted to SOEs*. In the context of compensation for public service obligations, OECD guidance recommends that SOEs should receive adequate compensation for the discharge of public policy priorities they are entrusted with. (*SOE Guidelines* (OECD, 2005a).)
- *Compensation for public service obligations should be disbursed and spent in a manner which can be accounted for separately.* In the context of accounting for non-commercial priorities, an important challenge for policy makers is to ensure that compensation is disbursed and spent in a manner which can be accounted for separately. These recommendations are applicable to incorporated and, in most cases, unincorporated units of government that have non-commercial priorities but nevertheless operate in the market place on a competitive basis. (*SOE Guidelines* (OECD, 2005a), *Accountability and Transparency Guide* (OECD, 2010a), *Best Practices for Budget Transparency* (OECD, 2010a), *Best Practice Guidelines on Off-Budget and Tax Expenditures* (OECD, 2004b).)
- *Public service providers should neither be put at a competitive disadvantage, nor have their competitive activities effectively subsidised by the State.* OECD guidance recommends establishing reliable cost calculation methodologies that avoid, to the extent possible, cross-subsidisation practices. In a competitive neutrality context, this is relevant in cases where SOEs or incumbents are expected to provide essential public goods alongside commercial activities. (*SOE Guidelines* (OECD, 2005a), *Accountability and Transparency Guide* (OECD, 2010a), *Report on Universal Service Obligations* (OECD, 2010c).)

4.3. Options for remedial action

As mentioned above, OECD sources suggest that a government committed to competitive neutrality should consider accounting for public service obligations an important challenge. The approaches for pursuing accounting neutrality are the following: (i) determining adequate compensation in fulfilling public service obligations; (ii) ensuring that compensation does not amount to undue subsidies; and, (iii) determining a neutral compensation method. Some concrete examples in the implementation of these practices are described below.

Determining adequate compensation. Specifically, adequate compensation should ensure that there is neither over nor under compensation. Determining adequate compensation assumes that public authorities have clearly identified the public service obligation, the price at which it should be offered and have laid out clear expectations for quality of a given product or service. It further assumes that key performance indicators can be built around these expectations to ensure that service/product delivery targets have been met. The price of a particular product or service may not necessarily cover the costs involved (costs should be clearly identifiable as outlined in section 2). As such some countries have developed specific thresholds for acceptable margins above which costs can be eligible for compensation.

For example, in Turkey companies which provide public services are compensated according to duty-loss (according to Decree law no. 233) which allows the Treasury to compensate any duty losses up to 110% of losses incurred. In Austria, most government business providing public services set prices to meet universal service obligations according to sector regulators' requirements (e.g. postal and gas sectors); sector regulators are also responsible for determining compensation amounts. For the Austrian Post, compensation is provided on the basis on an equalisation fund, financed on a pro-rata basis corresponding to the market share held by the incumbent and other licensed postal operators. A threshold has been set: if net costs of universal service obligations exceed 2% of the annual costs, such costs will be refunded.

Box 16. Toolkit: Determining adequate compensation for public service obligations in EU (inc. EEA) member States according to the "Altmark Criteria"

A compensation for the discharge of public service obligations may or may not entail State aid. The Court of Justice of the EU explained in its judgement Altmark[1] when a compensation does not amount to State aid:

- First, the recipient undertaking must actually have public service obligations to discharge and the obligations must be clearly defined.
- Second, the parameters on the basis of which the compensation will be calculated must be established in advance in an objective and transparent manner.
- Third, the compensation cannot exceed what is necessary to cover all or part of the costs incurred in the discharge of public service obligations, taking into account the relevant receipts and a reasonable profit for discharging those obligations.
- Fourth, where the undertaking which is to discharge public service obligations is not chosen pursuant to a public procurement procedure which would allow for the selection of the supplier capable of providing those services at the least cost to the community, the level of compensation needed must be determined on the basis of an analysis of the costs which a typical undertaking, well run and adequately equipped, would have incurred in discharging those obligations, taking into account the relevant receipts and a reasonable profit for discharging the obligations.

Further clarification as to the applicability of rules on State Aid to compensation for the discharge of public service obligations are reflected in the adoption of the new SGEI package in December 2011. The new packages favours the net avoided cost methodology to better estimate the costs associated with the discharge of public service obligations:

New SGEI Framework

The new framework for the assessment of the compatibility of **large** commercial SGEIs uses the net avoided cost methodology as the default rule. Under the net avoided cost methodology, the cost of the public service obligation is calculated as the difference between the net cost for a company of operating an SGEI and the net cost for the same company operating without a public service obligation.

The old framework of 2005, in contrast, was based on a cost allocation methodology, under which costs that are common to the SGEI and other activities of the same provider are allocated based on allocation keys.

The primary reason for introducing a new methodology is to better estimate the economic cost of the public service obligation and to fix the amount of compensation at a level which ensures the best allocation of resources. The new Framework also allows alternative methodologies when the net avoided cost methodology is not feasible or appropriate.

New SGEI decision

The new decision applies to public service compensation for **smaller** services and to **social** SGEIs, where no prior notification to the Commission is required. Under the decision, the cost allocation methodology remains the default rule, but public authorities are also free to use the net avoided cost methodology.

Source: Submission by the European Commission authorities. Also see: http://ec.europa.eu/competition/state_aid/legislation/sgei.html.

Ensuring that compensation does not amount to undue subsidies. Compensation should be based on a clear identification of costs and separate accounts as demonstrated section 2 on identifying costs. Among EU (inc. EEA) member States services of general economic interest must be compatible with EU rules on State aid. The Court of Justice of the EU jurisprudence (in "Altmark") defines four criteria that need to be fulfilled in order for a compensation not to qualify as State aid. However, if these criteria are not met, compensation is not necessarily prohibited. Compensation is allowed as compatible State aid if it complies with the conditions of the exemption Decision. If it cannot be exempted, it can be notified to the Commission and authorised under the Framework. The compatibility rules for compensation constituting State aid were provided under the *2005 SGEI package* (consisting of the Decision and the Framework) and basically required compliance with the first three Altmark criteria to ensure that services of general economic interest were not overcompensated (entrustment with a clearly defined service of general economic interest; objective and transparent pre-defined parameters for calculating the compensation; no overcompensation). On 20 December 2011 the Commission adopted a revised package of SGEI rules. The *Transparency Directive* sets out clear rules as to how undertakings must transparently disclose their cost structure (see Identifying costs above for more details). The new SGEI package favours the net avoided cost methodology to calculate adequate compensation. (Box 16)

A practical application of how compensation can be determined is the example on land transport services in Poland (Box 17).

Box 17. Toolkit: The public transport sector in Poland

In the Polish land transport sector, compensation for public service obligations is regulated by the Act of 16 December 2010 on Public Transport.[2] Under that Act, compensation for the provision of public transport services covers revenues lost by the operator (carrier) in respect to the use of concessionary fares (imposed by statutory act or established within the jurisdiction of authority responsible for the organization of public transport) and incurred costs related to the provision of public services. As a rule, the operator is entitled to a so-called reasonable profit. The method of calculating compensation is in each case specifically regulated in the contract for the provision of public services (pursuant to Polish regulations it is called services agreement for public transport). The operator is entitled to compensation if it proves, by presenting relevant documents, that the lost revenue resulting from the use of concessionary fares and the costs incurred in connection thereof, are grounds for incurred losses related to the provision of public transport services. The authority commissioning the provision of services is required to verify documents submitted by the operator. If the operator conducts other business activity in addition to providing services in the field of public transport, it is obliged to keep separate accounts for both areas of activity.

In 2010, the Office of Competition and Consumer Protection conducted a survey among entities supplying the land transport services at central, regional and local levels. The results indicate that the amount of compensation is adequate covering only the costs of providing public services without taking reasonable profit into account.

Source: Submission by the Polish authorities.

Determining a neutral compensation method. A neutral compensation method would include rules on compensation, practices and calculation methods. These rules should be determined in accordance with service delivery objectives and relevant competition rules and regulations. In general, cross-subsidisation may be a less transparent means of compensation and could in some cases require derogation from laws and regulations which could be a source of non-neutrality (as discussed in Section 6 on Regulatory Neutrality, also see Box 23). Cross-subsidisation from the compensation provided for the discharge of public service obligations towards other activities is for the most part not allowed in the majority of OECD economies and is not considered to be competitively neutral. The

EU rules on State Aid specifically ensure that there is no cross-subsidisation of commercial activities with funds granted to cover service of general economic interest. Where cross-subsidisation is allowed among EU (inc. EEA) member States, it can only be from profit-making activities to finance public service activities ensuring that overcompensation is not provided. This not only safeguards the competitive situation in the market but also aims to use public funds more efficiently.

In other cases, government businesses may incorporate costs of public service obligations in their tariff structures and user fees (postal service, water, electricity) – this may or may not imply cross-subsidisation depending on whether user fees actually cover the costs for public service delivery. Other funding options include the avoidable cost method, "accepting lower rates of return," levies on users, cash transfers, voucher systems, etc. but they are less favoured by the *SOE Guidelines* (OECD, 2005a) and accompanying *Accountability and Transparency Guide* (OECD, 2010a) compared with direct funding (Box 18).

Box 18. Toolkit: Methods for measuring the cost of public service obligations

There are four main methods to evaluate costs of "special obligations":

Marginal costs: Includes costs that increase as a result of increased production or service. In principle, short-run marginal costs should be used, as they do reflect the real opportunity cost of supplying the additional product or service. But there are a series of practical difficulties in estimating marginal costs, related for example to the treatment of common and joint costs, especially when the same enterprise produces a variety of goods or services, or to the determination of the appropriate marginal unit of production. The distinction between short-run and long-term marginal costs might also be difficult concerning depreciation, for example, or in cases where capacity is not in a long-run equilibrium. In addition, these marginal costs might vary significantly according to the demand level, not even mentioning issues related to congestion in some industries. These difficulties can make the estimation of marginal costs extremely costly and complex.

Fully distributed costs: The idea is to include average variable cost plus a mark-up to cover fixed costs. A practical way to achieve this is to distribute fully the total costs of the enterprise by allocating them to all its different products or services. There again a number of allocation methods could be used. Fully distributed costs are considered as "fair" but tend to overestimate costs. This method ignores the discrepancies that often exist between average and marginal costs in the case of infrastructure industries. It is appropriate when the cost functions approach constant returns to scale.

Avoidable costs: Includes all costs associated with an additional block of output, including variable and capital costs whenever additional capacity is required. Actual costs should be considered, even if they might differ from best practice. The evaluation also takes into consideration capacity utilization, with avoidable costs calculated at peak-load capacity to include capital costs incurred by the "additional" production or services deriving from the "special obligations". Avoidable costs increase with the size of the incremental level of output to be considered, as more capital costs might thus be considered as "avoidable". A distinction has thus to be made between short-run and long-run avoidable costs, the latter allowing incorporating additional capital costs. A related question arises with the estimation of capital costs and the appropriate rate of return to use for measuring the opportunity cost of capital. In some cases, a mark-up might also be added to avoidable costs to reflect a contribution to common costs.

Stand-alone costs: Costs incurred for producing an output in isolation. They by definition ignore economies of scale and scope. They result in significant over-estimation of the real cost of "special obligations".

Source: Quoted directly from OECD (2010), *Accountability and Transparency: a Guide for State Ownership*, Box 1.10, p. 28. [Original source: Australian Industry Commission (1994), "Community Service Obligations: Some definitional, costing and funding issues".]

The Hungarian government has established a State Aid Monitoring Office which examines the compatibility of aid with the EU rules on State aid. A clear set of procedures are in place at the national level aim to ensure that operators receiving aid are compensated adequately and in compliance with EU rules (Box 19).

A system to control subsidies/State aid, as demonstrated by EU member States, has proven effective in ensuring adequate and neutral compensation for the discharge of public services. The mechanisms that are built into examining compensation ensure that it does not amount to undue subsidies nor provide undue competitive advantages to public versus private competitors. If designed appropriately, a system of subsidy/State aid control can be an effective means to ensure the provision of public service obligations but also increase the efficiency of public spending.

Box 19. Toolkit: Determining neutral compensation for public service obligations in Hungary

The procedural rules oblige all aid grantors to notify their aid plans a priori to State Aid Monitoring Office (SAMO), which is responsible for assessing the compatibility of each aid proposal with relevant EU laws and regulations. SAMO gives guidance and assistance to the aid grantor bodies when they prepare the rules of their aid plan and the notification.

SAMO also has to keep the aid grantor informed about the recovery or suspension of any aid scheme or individual aid assessed by Commission. Furthermore, SAMO also monitors whether all necessary steps have been taken to execute the decision on recovery or suspension. SAMO regularly publishes discussions of State aid issues, in the State Aid Law Journal which provides information on Community State aid legislation and related changes, on Commission and Court of Justice of the EU decisions and on the assessment of national practices.

SAMO represents a privileged link with the European Commission and aid grantors, and helps in locating the proper tools for realizing/helps to realize the national objectives, in a way which is compatible with current EU State aid laws and regulations.

If the state/municipality intends to compensate a public service provider to fulfil a public service obligation, it should notify their aid plans a priori to SAMO (According to Government Decree 37/2011. (III. 22.) and SAMO will decide on a preliminary opinion. According to the regulation, the aid grantor should ensure the avoidance of overcompensation.

In order to avoid overcompensation the aid grantors will have supervisory powers stipulated in the aid contracts. Public service providers should cooperate and facilitate the controlling procedures. Furthermore, they have to prepare a report periodically.

The public service provider, who was compensated for the public service, must account the aid separately. After having fulfilled the public service tasks, the service provider (beneficiary) will have the right for the amount of aid that was de facto needed. (Planned budget must be in line with de facto spending.) The difference between planned and de facto expenditures must be paid back or it will not be paid out. In the past internal supervisors and auditors helped the aid grantors to examine expenditures.

In certain cases beneficiaries must submit a report on the fulfilment of the goals defined in the contract and a detailed financial report that should be approved by an external auditor. The auditor issues a declaration for the aid grantor.

There are sector specific rules for agricultural, fishery, forestry and rural development cases.

Source: Submission by the Hungarian authorities.

Notes

1. Case C-280/00, Altmark Trans, 2003, ECR I-7747.
2. Journal of Laws of 2011 No. 5, item 13.

Chapter 5

Tax Neutrality

An equal or equivalent treatment of public and private business activities is essential for tax neutrality. Where government businesses are incorporated according to ordinary company law, tax treatment is usually similar or equal to private businesses. However, unincorporated businesses are in a different category. An important additional consideration is whether public business undertakings are provided perverse incentives in the market place motivated by a desire to avoid taxes. One example would be governments purchasing goods and services from themselves purely to avoid taxation.

5.1. The challenge and reality in OECD economies

Public, private and third sector operators may face different tax treatment as a result of their ownership structure or legal form. This applies to a range of direct or indirect tax regimes including corporate/income taxes, value-added taxes (VAT), property taxes, registration and other special taxes. The challenge for competitive neutrality is to determine the extent to which the (un-) favourable tax treatment of public undertakings' commercial activities distorts the playing field.[1]

In practice, a majority of SOEs operating in OECD economies are subject to the same or similar tax treatment as private enterprises, especially where they constitute legally incorporated businesses operating at arm's length from the government. Some exceptions apply to specific categories of SOEs, including statutory corporations which may perform public policy functions. According to the balance between duties and benefits, such exemptions may or may not be considered as neutral.

Where tax exemptions are afforded, policy-makers should understand to what extent these play a role in influencing the commercial and investment decisions of public undertakings. For example, where income tax exemptions exist, the actual discrepancy compared to a taxable entity can be expressed in prices (depending on how state enterprises' ROR targets are set). Exemptions which are enjoyed by some public bodies have also led some public authorities to favour in-house provision of goods and services in order to avoid the cost of VAT on their purchases (which would have been levied if the provision had been outsourced).

Other forms of tax discrimination relate to special taxes (used to limit access to areas of importance for public service obligations). Special taxes can be used to over-compensate for the disadvantages associated with providing public services in unprofitable areas, further bolster the position of the SOE incumbent, and often result in stifling competition altogether.

Tax disadvantages for government business activities should also be considered. Such is the case in a number of OECD economies where public authorities report higher tax rates on their commercial activities. Also, VAT exemptions may actually provide a competitive disadvantage to certain market activities by public entities reliant on large purchases of goods and services, since these entities, unlike their private competitors, cannot deduct paid VAT. Other disadvantages are also reported, including not benefitting from tax write-offs or refunds as would otherwise apply to private companies.

5.2. OECD sources

This section summarises OECD sources (i.e. OECD instruments, guidelines and best practices) which deal with aspects or elements of the competitive neutrality challenges cited above. OECD sources presented below are primarily intended for consumption tax authorities with a particular focus on cross-border transactions. The last point below addresses the tax treatment of "traditional" SOEs exempt through regulatory provision; it is equally applicable to the commercial activities of general government if significant in nature:

- *In cross-border trade, businesses in similar situations carrying out similar transactions should be subject to similar levels of value added taxation.* (*OECD International VAT/GST Guidelines – International Guidelines on Neutrality* (OECD, 2011b).)
- *In cross-border trade where specific administrative requirements of foreign businesses are deemed necessary, value added tax should be administered in a way which does not create disproportionate or inappropriate compliance costs for business.* (*OECD International VAT/GST Guidelines – International Guidelines on Neutrality,* (OECD, 2011b).)

- *Ensure transparency surrounding tax exemptions and rectify possible advantages associated with them.* In cases where tax rules cannot be evenly applied, OECD good practice recommends transparency concerning tax treatment and rectification, if possible, any advantages associated with uneven tax treatment. Where dictated through regulatory provision, reform of regulatory treatment of SOE and other publicly owned entities may be necessary. (*Marketisation of Government Services* (OECD, 2003).)

5.3. Options for remedial action

For a government committed to competitive neutrality, tax neutrality is an important aspect to ensuring that public businesses are subject to similar treatment as their private sector counterparts. The approaches for pursuing tax neutrality are the following: (i) Application of direct and indirect taxes in lieu of compensation; and, (ii) implementing tax neutrality adjustments and other forms of compensation. Some concrete examples on the implementation of these practices are described below.

Application of direct and indirect taxes in lieu of compensation. A first consideration is to evaluate what direct and indirect taxes may or may not be applicable to public undertakings as compared with similar private businesses. In particular, public authorities should consider income tax treatment and VAT treatment of public authorities' transactions. Further considerations may be made in a cross-border context but do not fall within the scope of this paper. Where differences in tax treatment may exist, public authorities should consider to what extend tax treatment may influence the playing field among public and private operators.

Box 20. Toolkit: EC VAT Directive - Article 13.1 (Application of VAT on transactions of public authorities)

Article 13

1. States, regional and local government authorities and other bodies governed by public law shall not be regarded as taxable persons in respect of the activities or transactions in which they engage as public authorities, even where they collect dues, fees, contributions or payments in connection with those activities or transactions. However, when they engage in such activities or transactions, they shall be regarded as taxable persons in respect of those activities or transactions where their treatment as non-taxable persons would lead to significant distortions of competition. In any event, bodies governed by public law shall be regarded as taxable persons in respect of the activities listed in Annex I, provided that those activities are not carried out on such a small scale as to be negligible.

Source: EC VAT Directive, http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/index_en.htm

Where undue advantages or disadvantages are faced by public undertakings a number of options exist. For example, in Finland income tax exempt statutory corporations and municipal enterprises are still liable to a municipal and church tax (see below) depending on the type of commercial activity (e.g. if the activity falls outside a given municipality). If it is not possible to apply taxes due to the public sector status of an undertaking (e.g. general unit of government), voluntary application of the applicable tax provisions can be considered (as also recommended by the *SOE Guidelines* (OECD, 2005a). Finally, where certain tax rules may favour public undertakings, authorities may consider extending the same treatment to similar private sector businesses to ensure similar tax treatment. In some cases, general government activities are also provided on a non-profit basis – in these cases due to the non-profit nature of the activities a differentiated tax treatment may be justifiable.

The EU approach, as outlined in the *VAT Directive* (Article 13), is to make VAT applicable to the activities of public undertakings "where their treatment as non-taxable persons would lead to significant distortions of competition." (Box 20) An illustration of implementation was provided by Ireland where since 2009, based on case law of the Court of Justice of the EU, public bodies in Ireland are subject to charge VAT for all services which are provided in competition with private operators (e.g. in the provision of street parking, waste collection and recycling, recreation and amenities).

Implementing tax neutrality adjustments and other forms of compensation. Where behavioural methods are not possible, another option is to put in place a system of tax neutrality adjustments in order to compensate for differences in tax treatment. In the United Kingdom, where certain public businesses are not liable for tax due to their government department status (e.g. Trading Funds), their operating conditions are adjusted to reflect this exempt status, among other factors, in rates of return targets.[2] This approach is further elaborated in Box 21.

Box 21. Toolkit: Before and after tax rate of return targets

A partial exemption from income tax has the potential to be non-neutral in competition between state and private enterprises. It is a *potential* distortion because the effect on prices charged by state enterprises, vis-à-vis those charted by private competitors will depend on how rates of return targets are expressed:

- If a state enterprise faces and achieves a rate of return target that is expressed as an after tax rate of return on assets employed, which is comparable to its private competitors, then that state enterprise will have a significant competitive advantage if its business is mainly directed at sales to state agencies (where sales to state agencies is income tax exempt). Assuming its costs were comparable to private sector competitors the state enterprise could charge lower prices and still achieve the after tax rate of return targets since it would not pay tax. The after tax nature of the rate of return target makes taxation payments a cost of doing business so far as calculating the rate of return target is concerned.
- Alternatively, if the same state enterprise were to set a before tax rate of return target comparable to its private sector competitors, then the tax exemption should not flow through to lower prices. In this event, tax is not a cost of doing business so far as calculating the rate of return target is concerned – tax is then simply one mechanism by which a return is made to the state.

Source: OECD (2003), Finland, p.16.

Similarly, in Australia, according to the *Australian Competitive Neutrality Guidelines* (Commonwealth of Australia, 2004) tax neutrality is to be maintained between government businesses and (potential) competitors. In order to ensure tax neutrality there are three tax neutralising systems that may apply to government business activity (Box 22). In Norway, although it was not possible to extend the validity of VAT on transactions concerning in-house provision of services among public bodies, one way to encourage neutrality among in-house service providers and to give equal consideration of outsourced provision of services (normally subject to VAT) is to enact a system of VAT compensation for all municipal purchases.[3]

Among EU member States, the system of State aid control provides the means to ensure tax neutrality, whereby any tax advantage may be scrutinised to determine if it amounts to State aid and can be removed or compensated if found incompatible with the internal market.

Box 22. Toolkit: The tax neutrality system in Australia

According to the Australian Competitive Neutrality Guidelines (2004), there are three taxation neutralising systems that may apply to government business activities:

- **Actual tax**: most government businesses that are structured as separate legal entities will already be subject to, and paying, Commonwealth and state taxes by virtue of the overarching governing framework that sits above any enabling legislation for the government business.
- **Taxation equivalent regime**: requires the business to calculate tax liability in a comparable manner to competitors and to make an equivalent payment to the Official Public Account. This regime may be appropriate for business units, other significant activities of Financial Management and Accountability Act agencies, significant commercial activities in non-commercial Commonwealth Authorities and Companies (CAC) Act entities, and CAC Act entities with tax exemptions.
- **Taxation neutrality adjustment**: requires the business to calculate tax liability in a comparable manner to competitors, but no actual payment need be transacted. The adjustments are notional to be incorporated into the cost base of a business activity and are taken into account when determining a pricing strategy.

Source: Submission by the Australian authorities.

In general, it is inherently difficult to determine whether tax neutrality requirements are met. In many countries private firms may be subject to different treatment (tax or regulatory) depending upon organisational form. Furthermore, within particular markets tax-exempt entities may also be prominent. In such cases, determining whether the covered entities are accorded a tax-based advantage or disadvantage is generally possible only where there is a well defined reference group of actual or potential competitors. This is particularly true at the sub-central level, if there is a general lack of central government control over sub-central government tax policy. This is recognised in the *OECD International VAT/GST Guidelines* (OECD, 2011b), which exclude sub-national taxes from its scope. Finally, many countries have multiple tax rates, as such not all goods and services bear the same tax rate. Differences in VAT tax or regulatory treatment mean that within a country the VAT system may not be applied evenly, demonstrating further the challenges in determining tax neutrality, and the need to approach the issue with caution.

Notes

1. It should be noted that tax neutrality is equally applicable to the activities of private sector companies. However it falls outside the scope of this paper.

2. Where SOEs are performing an economic activity in a market, State aid rules apply which generally means that preferential tax treatment is not permitted.

3. OECD (2003), Norway, p. 27. At the time this report was published (2003), the authors describe the status of the proposed remedy as follows, "The VAT treatment of municipal services has been studied by a preparatory committee, which handed over its report to the Ministry of Finance on 10 December 2002. The committee proposes VAT compensation for all municipal purchases (which implies an extension of the present VAT system with VAT compensation of only specified services). The Government will follow up on the committee recommendations with proposal to the Parliament in the 2004 budget."

Chapter 6

Regulatory Neutrality

To ensure competitive neutrality government businesses should operate, to the largest extent feasible, in the same regulatory environment as private enterprises. Where this is not feasible, appropriate adjustments should be made to neutralise the remaining advantages/disadvantages. The word "regulatory" is interpreted broadly as referring both the legal and regulatory frameworks in which businesses operate (e.g. the general business environment dealing with business laws, licensing and regulations) as well as the enforcement of sector and market regulations. Regulation should be non-discriminatory in the sense that there are no differences in coverage, applicability, transparency or implementation, neither between public and private businesses nor between different legal classes of businesses. Government functions charged with oversight and regulation of SOEs should be separated and should not be involved in the day-to-day management of these enterprises' commercial activities.

6.1. The challenge and reality in OECD economies

Claims of uneven regulatory treatment of public and private businesses are often heard. For example, government-controlled utilities or financial sector activities are sometimes identified as areas where state-owned businesses may be subject to a lighter regulatory approach than similar enterprises undertaking the same type of activities. Further problems arise when unincorporated government entities (or entities incorporated according to a tailored legal framework) are involved, since such entities often enjoy regulatory and other advantages due to their integration with the executive powers.

Frequently cited regulatory advantages include the under enforcement or the over enforcement of restrictive business practice laws (e.g. for under enforcement the use of merger regulations to defend SOEs and prevent the entry of private competitors has been cited as an example). Other examples of regulatory advantages conferred to SOEs may include preferential treatment with regard to disclosure or conforming with other requirements (i.e. newly introduced environmental regulations); sovereign immunity laws; bankruptcy laws; compliance with start-up administrative requirements (e.g. obtaining building permits or complying with zoning regulations); and preferential access to land. Often, municipally-owned businesses are cited as benefiting from some of theses advantages.

Governments have also been accused of erecting regulatory barriers unfounded in genuine public-interest objectives with the purpose of protecting their own enterprises (i.e. to protect national champions). This can create significant cost asymmetries between incumbents and entrants with considerable harm to competition. Proximity of SOEs to policy-makers puts them at an unfair advantage than private sector counterparts to exert influence on the policy-making process in favour of their business operations.

An overview of OECD country practices (OECD, 2012b) suggests that, in the case of SOEs (incorporated according to the ordinary company law) the regulatory differences between public and private business activities are mostly small or non-existent. Where differences persist, governments mostly justify them citing one of two arguments: (1) the concerned SOE operates in an area involving a natural monopoly; and (2) regulatory preference is needed to compensate SOEs for public sector obligations. Reflecting this, the benefits conferred on the SOEs concerned are primarily exemptions from competition laws; and secondarily related to the setting of tariffs in the network industries. In some cases, the use of regulatory remedies may be warranted (e.g. where true natural monopolies are involved certain general competition rules do not apply), but caution is needed. Exemptions from competition rules may hamper economic efficiency in sectors where competition may currently not be feasible but where new entrants could materialise in the longer run.[1]

The use of sector regulation in regulated markets as a remedy for public service obligations can be particularly onerous. In some countries, network operators (e.g. water companies) are compensated for universal service obligations through regulatory permissions to raise end-user tariffs above shadow prices for the entire community. This is very difficult to reconcile with competitive neutrality, because if tariffs are differentiated between an incumbent provider and new entrants there may be a case of unlawful discrimination, but if they are not then the entrant may enjoy net benefits due to the combination of high tariff and an absence of public service obligations.

Non-trivial concerns relate to the regulatory treatment of unincorporated or weakly incorporated public entities that compete in the market place. For example, municipal enterprises (often in the form of statutory corporations) are reported to enjoy significant regulatory advantages in areas such as planning and registration processes, access to land use as well as protection from new entrants due to their proximity to the local policy makers. Also, unincorporated business activities undertaken by units of the general government sector are often self-regulated which, in addition to the issue of regulatory neutrality, gives rise to concerns about transparency.

6.2. OECD sources

This section summarises OECD sources (i.e. OECD instruments, guidelines and best practices) which deal with aspects or elements of the competitive neutrality challenges cited above. OECD sources presented below deal with general business environment issues (i.e. business laws and regulations), it is also concerned with market regulations (i.e. sector specific). Concerning the general business environment, OECD sources address the treatment of incorporated SOEs where different from private businesses. The recommendations are also applicable to SOEs established according to corporate charter or statutory authorisation, or where commercial activities remain integrated with general units of government, and where regulatory exemptions may be afforded by law which may not be consistent with competitive neutrality. OECD guidance covers the following issues concerning regulatory neutrality:

- *Ensure equal regulatory treatment between public and private businesses.* The use of regulatory exemptions to compensate for performance of public policy functions is not supported by the SOE Guidelines, which recommend the use of budgetary outlays for this kind of compensation. Where regulatory exemptions apply due to the legal form, OECD Guidance recommends incorporating SOEs according to company law making it subject to the same regulatory treatment as private businesses. Where this is not possible, the validity of regulations could be extended or applied on a voluntary basis. (*SOE Guideline* (OECD, 2005a), *Recommendation of Council on Regulatory Policy and Governance* (OECD, 2012c).)

- *Government participation in regulated markets should be evaluated on a periodic basis.* This recommendation is particularly relevant for regulated markets where SOEs or incumbents retain certain monopoly rights. (*Recommendation on Competition Policy and Exempted or Regulated Sectors* (OECD, 1979), *Recommendation on Improving Quality of Government Regulation* (OECD, 2005d), *Report and Recommendations on Regulatory Reform* (OECD, 1997a), *Guiding Principles on Regulatory Quality and Performance* (OECD, 2005d), *Recommendation on Competition Assessment* (OECD, 2009e).)

- *Financial regulation should be consistent and neutral irrespective of ownership, institution, sector, and markets.* This applies equally to government-controlled or owned financial institutions. (*Policy Framework for Effective and Efficient Financial Regulation* OECD, 2010b).)

- *Regulatory measures, alone, are not enough; a multi-disciplinary approach is needed to level the playing field.* A combination of regulatory and non-regulatory measures may be necessary to neutralise any advantages or disadvantages that may accrue due to ownership. Competition, trade and investment authorities are all identified as having a role in enforcing competitive neutrality. (*APEC-OECD Integrated Checklist on Regulatory Reform* (OECD, 2005b), *OECD Guiding Principles on Regulatory Quality* (OECD, 2005d, 1995), *Report and Recommendations on Regulatory Reform* (OECD, 1997a).)

6.3. Options for remedial action

For a government committed to competitive neutrality, the approaches for pursuing neutrality in the regulatory area are the following: (i) a structural separation of those operations where regulatory discrimination is warranted; (ii) an ongoing evaluation of public sector obligations and assessments of the competition and regulatory approach; and (iii) compensatory payments where regulatory advantages apply. The first option was already described in detail in the first section of Part B. Some concrete examples in implementing the two other options are described below.

Evaluation of public service obligations and assessment of competition and regulatory approach. Among the EU (inc. EEA) member States as well as certain other countries such as Turkey, specific guidelines apply to undertakings (public and private) performing public policy functions (e.g. in EU terminology SGEI). These guidelines determine the conditions under which exemptions from competition law may be permitted for the purpose of ensuring the provision of public service obligations. In the specific case of the EU (inc. EEA), derogation from competition law may be accorded if the application of EU rules would obstruct the performance of the task of providing SGEI (Article 106 (2) TFEU). Rules have been developed to assess the necessity of restricting competition for the purpose of performing SGEI. Although budgetary outlays are the most transparent means of compensation, they are not the only means of compensation used among EU member States. Regulatory exemptions to compensate for public service obligations can be acceptable if they are narrowly established and compliance is monitored, the rationale and conditions for derogations are described in Box 23.

Box 23. Toolkit: Restricting competition for the purpose of ensuring the provision of services of general economic interest

EU rules concerning the conditions under which derogation from the competition law is allowed for the purpose of ensuring the provision of Services of General Economic Interest (SGEI)

- Article 106 (2) TFEU provides a general derogation from the application of the Treaty provisions, and in particular from the competition rules. The derogation applies equally to public and private undertakings provided that the following conditions are met: (i) the undertaking in question must have been entrusted with the operation of a service of general economic interest; (ii) the application of the rules of the Treaty (including those on competition) would obstruct the performance (in law or in fact) of the tasks assigned to this undertaking and (iii) the development of trade is not affected to such an extent as would be contrary to the interests of the Union. As any exception, the derogation of Article 106 (2) is interpreted restrictively.

- The rationale for the derogation is that SGEI are services in the public interest but, for economic reasons, notably their non-lucrative nature, they might not be provided if reliance was placed exclusively on the market forces for their provision. By entrusting the task of performing SGEI to a particular undertaking (or group of undertakings), the State not only assigns responsibility to that undertaking for the provision of the SGEI but also grants it certain economic advantages in order to motivate it to undertake the non-lucrative service. The Court of Justice of the European Union has made it clear that undertakings providing SGEI should be given economically acceptable conditions so that they can perform their tasks in conditions of economic equilibrium.[2] This could justify restrictions of competition from individual undertakings in the economically profitable sectors. If competitors are allowed to cherry-pick the most profitable parts of the system, the provider of the SGEI would not be able to operate in economically acceptable conditions.[3] However, this does not justify the exclusion of competition as regards specific services dissociable from the SGEI, if these could be offered by other undertakings without compromising the economic viability of the SGEI.[4]

- In determining the necessity of the restriction of competition for the purpose of the performance of the SGEI in economic equilibrium, one needs to take into account the economic conditions in which the undertaking operates, in particular the costs which it has to bear and the legislation to which it is subject.[5]

Source: Submission from EC authorities.

Where some consideration should be given to assessing the role of direct government participation in markets, the OECD Competition Assessment Toolkit (CAT) is an approach that is used by the authorities in a number of OECD and non-OECD economies. The CAT asks strategic questions in order to assess whether the same policy objectives could be achieved in a fashion that is less detrimental to competition in the markets affected. A similar sort of assessment could be used as a starting point in promoting competitive neutrality. An assessment of the market involvement by a government body would first be assessed under this competition lens to determine whether there is an alternative approach which would have less of an impact on competition but would still achieve the desired policy objectives.

Compensatory payments. Where regulatory (dis-) advantages cannot be removed or conferred equally among market participants, compensatory payments can serve to neutralise any benefits (disadvantages) associated with uneven regulatory treatment. Financial compensation for (dis-) advantages is not a common practice in OECD countries. Only one country is known to have systematically implemented such practices, namely Australia in the context of its competitive neutrality framework. The Australian practices are described in Box 24. A special case relates to the practices of some Swiss cantons, which demand that publicly owned enterprises enjoying a monopoly-like position (or privileged access to natural resources) make compensatory payment to local authorities for public policy purposes. Conversely, at the federal level the Swiss competition authority (as is the case in many or most other OECD countries) is generally limited to making recommendations regarding changes to the practices of relevant entities. The latter may or may not decide to follow the recommended action (Box 25).

Box 24. Toolkit: Regulatory Neutrality Adjustments

According to the Australian Competitive Neutrality Guidelines (2004), there are three regulatory neutralising adjustments that may apply to government business activities:

- Making the actual regulatory payment or fulfilling the actual regulatory obligation;
- Making an equivalent payment to the Official Public Account; or
- Notionally including regulatory payments in the business activity's' cost base, and therefore prices, by an amount equivalent to any advantage they accrue by not being subject to similar regulatory arrangements or obligations as their competitors.

Source: Submission from Australian authorities.

Box 25. Example: Swiss Post

The Swiss Post, a state-owned provider of postal services, was investigated by the Competition Commission to evaluate the effects of special provisions in the company's regulatory framework which allowed the public operator to enjoy preferential access to roads not provided to private logistics service providers. The specific provision allowed the Swiss Post to use heavy weight trucks (> 3.5 t) at night and on Sundays for the transportation of postal goods related to its public service obligation. In addition, the Swiss Post was allowed to fill up to a quarter of its trucks with other goods it was transporting on a commercial basis. According to regulation, private competitors could only use smaller trucks (< 3.5 t) at night and on Sundays; however, they were free to conclude arrangements with the Swiss Post to transport parcels and mail at night.

The Competition Commission came to the conclusion that:

- the provisions afforded by the regulation clearly affected competition between the Swiss Post and its competitors;
- private competitors, especially those offering postal services, were at a competitive disadvantage compared to the Swiss Post and that possible arrangements with the Swiss Post did not seem to be practical and attractive for those competitors; and,
- competitors may not have been able to offer similar services (e. g. the A-Mail >50g) at a comparable price due to higher transportation costs.

The Commission issued a recommendation to the Federal Council to change the problematic provision, by abandoning special privileges of the Swiss Post or to allow competitors to operate under the same conditions. The issue has been addressed by the Federal Council within the context of the revision of Postal Law.

Source: Submission by the Swiss authorities.

Notes

1. This is one of the reasons why OECD guidance advocates regular reviews of regulation in a context of changing economic conditions.
2. C-320/09 Corbeau [1993] ECR I- 2568 -2569, para 15-18.
3. Ibid.
4. Ibid, para 19
5. Case C-393/92 Almelo, para 49.

Chapter 7

Debt Neutrality and Outright Subsidies

The need to avoid concessionary financing of SOEs is commonly accepted since most policy makers recognise the importance of subjecting state-owned businesses to financial market disciplines. Competition and other regulatory authorities in the EU (inc. EEA) member States and in some other jurisdictions enforce competition law to rein in outright subsidies and State aids, and subject SOEs to market conditions in accessing finance. Despite such advances, debt neutrality remains an important area to tackle if the playing field is to be levelled. As identified, many government businesses continue to benefit from preferential access to finance in the market due to their explicit or perceived government-backing.

7.1. The challenge and reality in OECD economies

Although in most countries SOEs and other government businesses are expected to borrow on non-discriminatory terms and prices as compared to businesses in the private sector, it is often the case that they benefit from preferential access to financing. Where the majority of SOEs in OECD economies obtain financing through the market or according to market terms, it does not necessarily follow that they do not obtain unintended advantages due to their ownership. Preferential treatment stems from the fact that government-owned or controlled companies are often attributed lower risk rating by lenders due to explicit or perceived of government backing.[1] Government backing can be in the form of explicit, implicit or perceived guarantees, or in more exceptional cases outright subsidies/State aid or subsidised financing.

Most OECD economies do not allow outright subsidies/State aid or other forms of financial assistance to the *commercial* activities of SOEs. They subject their SOEs to the same regulatory framework (e.g. no exemptions from bankruptcy laws) and lending conditions as private sector companies.[2] However, a few exceptions apply to sustain loss-making SOEs or other government-controlled companies which are too big to fail (e.g. for economic reasons or social reasons such as maintaining jobs) or in order to sustain their commercial operations. Favourable tax or regulatory regimes, exemptions or in-kind benefits can also be seen in this light, which can distort the competitive landscape by making it possible to price more efficiently compared to private competitors in like circumstance given that they lower the SOEs cost base.

The competitive neutrality challenge is to ensure that State aids and subsidies do not distort firms' behaviour by subjecting them to softer budget constraints. For SOEs or other incumbent firms in financial difficulty, subsidies/State aids may be deemed politically necessary to ensure the survival of the company and help the firm to restructure in order to become viable again. However, such measures can also have distortive effects by allowing the receiving firm to improve its cash flow, enhance its balance sheets and build assets in a way that allows the firm to raise additional debt financing or equity capital. It also adds to a perceived lower default risk, which in turn may result in cheaper finance in the market place than would be available to non-subsidised operators.

A further challenge is that where loans are provided at below market interest rates or against collateral or securitisation that would not be acceptable under purely commercial terms these too can have distortive outcomes. SOEs may have access to favourable credit rates or enjoy government-provided credit guarantees which reduce their cost of borrowing and enhance their competitiveness *vis-à-vis* their privately-owned rivals. In addition, government enterprises often benefit from implicit or perceived government guarantees that may also contribute to lower costs of borrowing or may otherwise give it a competitive advantage *vis-à-vis* non-government backed competitors. Preferential access to credit for SOEs commercial activities can result in crowding out private sector borrowers.

7.2. OECD sources

This section summarises OECD sources (i.e. OECD instruments, guidelines and best practices) which deal with aspects or elements of the competitive neutrality challenges cited above. OECD sources presented below are intended for SOE oversight bodies and financial institutions (including state-owned banks as receivers and providers of credit).The guidance is concerned with the activities of "traditional" SOEs and other types of government commercial activity benefitting from preferential financial treatment:

- *Avoid preferential financial treatment of SOEs.* OECD guidance recommends that public enterprises access credit on the same terms as the private sector. This guidance is generally applicable to state-owned entities and state-owned banks as receivers of credit, but also to state-owned banks also as providers of credit. (*SOE Guidelines* (OECD, 2005a), *Regulating Market Activities by the Public Sector* (OECD, 2005c), *Competition and Financial Markets* (OECD, 2009f).)

- *Put into practice debt neutrality adjustments.* Drawing upon a number experiences, such as those of Australia and among EU (inc. EEA) member States, good practice suggests adjusting for any advantages which may arise out of government ownership or perceived State-backing. (*Regulating Market Activities by the Public Sector* (OECD, 2005c), *Roundtable on Competition, State Aids and Subsidies* (OECD, 2010d).)

7.3. Options for remedial action

For a government committed to competitive neutrality, some options to consider in approaching debt neutrality are the following: (i) access debt on neutral terms; and (ii) implementing debt neutrality adjustments. Some concrete examples in implementing these options are described below.

Access debt on neutral terms. As mentioned previously, most SOEs access financing according to market terms, regardless of the source of financing. "Market terms" assumes that interest rates reflect the credit risk of that type of business activity, regardless of ownership. Where financing is obtained from the market, the main reported advantage arising from government ownership or control is perceived backing by the State (e.g. general government taking on debt obligations of an SOE). In New Zealand, in order to dispel any doubts about indirect benefits which may arise, loan documentation for the borrowings of SOEs is required to have an explicit disclaimer making clear that the Crown does not guarantee the repayment of debts of its subsidiaries. In the EU, the European Commission, in charge of State aid control, also verifies whether the special status of certain public bodies confers them undue advantages to access debt with respect to their competitors.[3]

Where financing is acquired from the State itself, for example, where state-owned banks lend to state-owned enterprises, special care should be taken to ensure that lending is according to market terms. Where financing is acquired from public budgets (for commercial activities) this should also be provided at market rates. An example of this can be seen in the United Kingdom where SOEs are generally not allowed to borrow from the open market (to prevent them from benefiting from an implicit government guarantee) and must instead obtain financing from the National Loans Fund (NLF). The NLF must generally ensure that loans are extended on commercial terms; this usually involves the borrower proving that the terms of the loan are indeed commercial by benchmarking it against market rates.

Implementing debt neutrality adjustments. Where debt cannot be accessed on neutral terms, a number of governments have put into place a system of debt neutrality adjustments. One way debt neutrality can be addressed – as pioneered by the Australian authorities – is by relying on debt rating agencies to provide a credit evaluation of government businesses under a counterfactual assumption of private ownership. The difference between what individual entities actually pay and what they would pay if they were privately owned can then be subtracted from their revenue streams through "debt neutrality charges" (Commonwealth of Australia, 2004). Government business must adjust its cost base, and therefore prices, if borrowing at preferential rates (e.g. rates which reflects the credit risk of the Australian government as opposed to rates that reflect the credit risk of that type of business activity). If government businesses borrow funds from the market, any cost advantages associated with public ownership can be adjusted through a debt neutrality payment to the Office of Public Accounts.

Government sector agencies borrowing from public budgets, receive funding with the appropriate debt neutrality adjustments already incorporated into the cost of debt. (Box 26)

Box 26. Toolkit: Debt Neutrality Competitive Neutrality Guidelines in Australia (2004)

Significant government businesses in Australia are liable to factor in debt neutrality adjustments to their borrowing if they benefit from debt advantages due to their public ownership. Businesses are required to pay a debt-neutrality charge on all borrowings. The charge should reflect the difference in the cost of borrowing with an implicit government guarantee and the cost of borrowing as a stand alone entity. Businesses may instead of a payment, make a notional adjustment (and include in its cost base) to neutralise debt.

Credit Ratings

Government businesses should obtain independent annual credit ratings. If the rating establishes that the business borrows at chapter rates (due to public ownership) it is free to borrow at cheaper rates but must pay a debt neutrality charge to a consolidated revenue fund on the basis of the difference. Small businesses activities (with liability less than A$10million for more than 90 days) may conduct their own rating but must demonstrate the underlying assumptions and methodology. Businesses with less than A$1 million in liabilities (for more than 90 days) are not concerned by debt neutrality charges.

Debt Charges

Where a debt neutrality charge is in order, the calculation/margin of charges is based on the "stand alone" credit rating associated to the government business. A system of points is attributed to the size of benefits associated with implicit guarantees (as assumed by lending institutions). Debt charges should be set according to the size of the benefits corresponding to the number of points. The charges apply to all forms of liability (including liabilities such as finance leases and derivatives).

Source: Submission by Australian authorities *Australian Competitive Neutrality Guidelines* (Commonwealth of Australia, 2004).

Similar practices in Spain require ex-post adjustment of debt advantages associated with public ownership. This approach is established by a law (*Royal Decree 1373/2009*) which stipulates that preferential access to financing should be estimated and compensated to the Treasury by the public undertaking, taking into account the costs of such advantages.

Notes

1. Perceived guarantees occur for example where a State has no intention of supporting an enterprise, but markets assume that it is so systemically or macro-economically important that it cannot be allowed to fail.

2. Non-commercial activities are in some cases subsidised, but would not constitute a competitive neutrality challenge if conducted according to the practices highlighted in sections 2 and 4.

3. For example, in January 2010, the European Commission adopted a decision concluding that the French Post Office (La Poste) enjoyed an implicit State guarantee because of its special status as a public body ("Etablissement d'Intérêt Economique et Commercial"). This guarantee conferred an economic advantage over its competitors, which had to operate without such a guarantee, and therefore distorted competition on the postal markets. The Commission concluded that the conversion of La Poste into a public limited company, which took place on 1 March 2010, would remove de facto the unlimited guarantee that it enjoyed.

Chapter 8

Public Procurement

To support competitive neutrality, procurement policies and procedures should be competitive, non-discriminatory and safeguarded by appropriate standards of transparency. Some additional issues may arise. Where long-existing SOEs or in-house providers are involved, their incumbency advantages may be such that the entry of competitors is effectively impeded. To the extent that these advantages reflect economies of scale this is in principle not a competitive neutrality problem, but it may nevertheless frustrate governments' attempts to introduce competition in the market.

8.1. The challenge and reality in OECD economies

The public sector increasingly relies on market mechanisms (e.g. outsourcing, tendering, concessions and other forms of public-private partnerships – PPPs) to purchase goods and particularly services in areas previously controlled by government. Where former public sector monopolies once dominated goods and service delivery, markets have been opened to competition between private and public enterprises. In order to ensure a level playing field among market participants, most governments have developed and implemented national public procurement policies.

Where commercial disputes have arisen, claims often refer to undue advantages that incumbents (whether public or private entities) or in-house providers may have in the bidding process. These advantages include: a stronger position to pre-qualify or bid for contracts where a given SOE has already established a track record; information advantages concerning service levels and costs; and lower start-up and transition costs compared with potential entrants – especially where contracts are of limited duration. Any of these barriers may not necessarily reflect onerous practices at the level of general government – merely an accumulated competitive or informational advantage allowing SOEs to tailor their offers more closely to government requirements. Some barriers are in place to ensure social and environmental concerns (e.g. procurement which includes social clauses to protect workers or environmental standards). There are also cases where the general government may also face disadvantages competing alongside the private or third sectors (e.g. more stringent reporting requirements).

Other more worrisome claims have sometimes been made. These include illicit practices such as corruption, bid rigging, abusive related party transactions and other unethical behaviour by sellers in public procurement. Preferential treatment to national champions (often state-owned or former state-owned incumbents) has also been asserted by actual or potential competition.

Where in-house procurement is concerned – i.e. where a public authority may purchase products or services directly from the organisation it owns or where it procures from itself – competitive tendering may not be required in many jurisdictions. Competitive neutrality challenges can arise where there is ambiguity surrounding acceptable derogations from national public procurement policies for the purposes of in-house procurement. Other jurisdictions have very specific guidance establishing the situations in which in-house procurement is permitted and when such practices may be exempt from competitive tendering.

8.2. OECD sources

This section summarises OECD sources (i.e. OECD instruments, guidelines and best practices) which deal with aspects or elements of the competitive neutrality challenges cited above. OECD sources presented below address all aspects of procurement, including procurement processes involving (former) state-owned incumbents and in-house providers. The guidance addresses SOEs as both potential bidders or as contracting authorities themselves. All the points are of concern to SOEs and general government management functions where public procurement is of relevance; in particular the second and fourth points address competition and anti-corruption authorities:

- *Public procurement should be a competitive process.* The *SOE Guidelines* (OECD, 2005a) promote the use of general procurement rules for SOEs just as they would apply to other companies (Guideline 1.A.); a level playing field is encouraged where consistent application of rules apply to both public and private companies. Furthermore, the *SOE Guidelines*

(OECD, 2005a) call for the removal of legal and non-legal barriers to fair procurement and promoting ethics in the procurement process.

- *Ensure transparency and equitable treatment in procurement policies and procedures*. Procurement policies and procedures should ensure clear selection criteria in advance; and fair and equitable treatment in the selection of suppliers. Any unfair barriers are recommended to be removed to ensure fair and un-discriminatory selection processes. Where discriminatory preferences exist, OECD recommends that these should be made transparent and shared with potential bidders in advance. This guidance applies to SOEs as purchasers. (*SOE Guidelines* (OECD, 2005a), *OECD Recommendation for Enhancing Integrity in Public Procurement* (OECD, 2009g), *Guidelines for Contracting Out Government Services* (OECD, 1997b), *Principles for Managing Ethics in the Public Sector* (OECD, 1998c).)

- *All public entities, including in-house bidders, participating in a bidding process should operate according to standards of competitive neutrality.* In-house bids should be treated the same as outside bids, and neutrality should be safeguarded between private and public providers. (*Best Practice Guidelines for Contracting Out Government Services* (OECD, 1997b).)

- *Integrity and ethics are essential in the procurement process.* This applies to SOEs as public purchasers and organisers of tenders. The Recommendation on Hard Core Cartels also applies to State undertakings participating as suppliers themselves. (*SOE Guidelines* (OECD, 2005a), *OECD Recommendation for Enhancing Integrity in Public Procurement* (OECD, 2009g), *Principles for Managing Ethics in the Public Sector* (OECD, 1998c), *Effective Action Against Hard Core Cartels* (OECD, 1998b), *Guidelines for Fighting Bid Rigging in Public Procurement* (OECD, 2009h).)

8.3. Options for remedial action

For a government committed to competitive neutrality, the following considerations are made with regard to public procurement: (i) ensure public procurers compare bids on a like-for-like basis; (ii) reflect and take into account differences between bidders; and (iii) establish complaints mechanisms and reconciliation measures. Some concrete examples in implementing these options are described below.

Ensure public procurers compare bids on a like-for-like basis. In general, economic operators are subject to the following principles in public procurement procedures: equal treatment, non-discrimination, transparency, proportionality and mutual recognition which are all consistent with competitive neutrality. These principles are reflected in most national policies which are also embedded in WTO rules. In order to fulfil these criteria, in some economies, the State sector is outright discouraged from participation in public procurement processes to avoid risk of indirect preferences and other neutrality issues which may arise out of their participation in managed competitions. In other cases, jurisdictions have issued specific rules on the terms that govern public participation in managed competitions and how specifically the issue of in-house procurement should be treated.

In Australia, there is a primary obligation on Commonwealth government businesses to comply with the *Commonwealth Procurement Rules (CPRs)*. There is a secondary obligation on government businesses to self-declare their tenders compliant with competitive neutrality principles. This is to ensure that all potential suppliers (public or private) have the same opportunities to compete for government contracts. (Box 27)

Box 27. Toolkit: Ensuring Competitive Neutrality in Managed Competitions - Australia

The *Commonwealth Procurement Rules* (CPRs) articulate the policy framework and rules which govern agencies procurement activities. Potential suppliers must be treated equitably based on legal, commercial, technical and financial abilities in respect to their ability to provide the product or service. The CPRs do not allow for discrimination on the basis of origin or government ownership. This ensures that all organisations are not disadvantaged on the basis of their organisational structure when agencies are procuring goods and/or services. According to the *Australian Competitive Neutrality Guidelines* (2004), all agencies conducting a tendering process must include a requirement for public sector bidders to declare that their tenders are compliant with competitive neutrality principles. Should a public sector bid be successful, the business activity would need to assess the application of competitive neutrality in accordance with the Guidelines.

Source: Submission by Australian authorities.

Among EU (inc. EEA) member States, applicable EU public procurement rules underline that the award of public contracts should not distort competition. This competition-based approach is effective where a public body is eligible to participate in a public tender. As pointed out, a remaining challenge is with regard to in-house provision if public undertakings are exempt from public procurement procedures as otherwise required. The EU has addressed this "gap" through its "Teckal" judgement which essentially limits the conditions under which procurement of goods and services can be conducted in-house without a competitive tender. The criteria establish a "positive list" of conditions which make in-house procurement permissible. Anything that falls outside the scope of these criteria is intended for managed competition along the lines of public procurement procedures as set-out in national laws and in accordance with EU rules on public procurement (Box 28).

Box 28. Toolkit: EU Rules on Public Procurement

EC Directive on Contracts for Public Works, Public Supply and Public Service - Recital 4:"Member States should ensure that the participation of a body governed by public law as a tenderer in a procedure for the award of a public contract does not cause any distortion of competition in relation to private tenderers."

Exceptions to in-house procurement in EU (inc. EEA) member States – "Teckal" Judgement: An exception is provided only for the procurement granted to public sector enterprise by public authority exercising functions of the founding body for the enterprise. In this case, there is no obligation to use public procurement procedures. This exemption, however, has very limited application and can only take place if the following three conditions are met:

a) An essential part of the public sector enterprise activity concerns the exercise of public duties in favour of that public authority;

b) A public authority exercises control over public sector enterprise equal to the control exercised over its own unincorporated entities, particularly involving the impact on strategic and individual decisions regarding the management of enterprise's matters; and,

c) The object of the procurement belongs to the core scope of business of public sector.

d) A further criterion, stemming from jurisprudence, necessitates the lack of private participation in the enterprise providing in-house services.

Source: Submission by the European Commission and ECJ judgements (Cases C-26/03, C-410/04).

Reflect and take into account differences between bidders. Practically speaking procurers must be equipped with the right tools to ensure competitive neutrality among bidders in managed competitions. One way is to ensure that bidding processes are fair and that bids (from public, private or third sector) reflect and take into account differences between bidders prior to the awarding of public contracts. This approach was followed by the UK Ministry of Justice which developed a set of *Principles of Competition* designed to remove any advantages that apply to bidders as a result of their ownership in the provision of custodial services to prisons. The Principles focus on the following six factors considered to address competitive neutrality concerns in the procurement process: process; costing; grant funding; pensions; risk; and, tax. Each of the factors is covered in detail in Box 29.

Ex-post complaints mechanisms and correcting measures. In most countries, specific mechanisms have been set-up to receive complaints in cases of non-neutrality after a public procurement process has been initiated. For EU (inc. EEA) member States, specific review procedures set out in EC *Directive 2007/66/EC* are aimed at improving the effectiveness of review procedures concerning the award of public contracts. EU rules require that a sufficient amount of time is factored into the procurement process before signature of the contract, to ensure the possibility for a review process and for tenderers or candidates to make an effective review of the decision to award a contract. This so-called "standstill" period provides an opportunity for tenderers or candidates (who may not have been awarded the contract in question) to request adequate information, to review the decision, and to bring forward review proceedings if necessary. Where procedure or awarding of the contract constitutes an infringement, correcting measures can be taken by eligible authorities.

Box 29. Toolkit: Six Principles of competition in the UK

Process: Separate regulatory, commissions, procurement and bidding functions into different departments to avoid any conflicts of interests that arise when assessing bids (public, private and third sector). Provide all relevant information in a timely manner and reduce any incumbency advantages.

Costing: A formula is given and applied to all public sector bids to reflect the allocation of indirect costs.

Grant funding: All bidders must declare grant funding, including any received by subcontractors. Bidders must attest that grant funding will not be used to subsidise their bid, including indirect costs.

Pensions: Address pensions transfer or treatment of public sector pensions. Provide guidance on the broader issue of the treatment of staff who are transferred from the public sector. All public sector bids from incumbents must apply any uplift of three per cent per annum to all payroll costs.

Risk: A list of risks which are considered insurable is given and the principles require that each bid includes a limit of liability for each of the list risks irrespective of the bidder. Any public sector bidder is required to obtain a quote for commercial insurance coverage. Bidders must evaluate all other risks and clearly attribute their commercial value.

Tax: Although the evaluation of bids excludes VAT and corporate taxes, bidders are required to provide information on the expected liabilities for both.

Source : Competition in mixed markets: ensuring competitive neutrality (Office of Fair Trading, 2010)

Ex-post complaints mechanisms and correcting measures. In most countries, specific mechanisms have been set-up to receive complaints in cases of non-neutrality after a public procurement process has been initiated. For EU (inc. EEA) member States, specific review procedures set out in EC Directive 2007/66/EC are aimed at improving the effectiveness of review procedures concerning the award of public contracts. EU rules require that a sufficient amount of time is factored into the procurement process before signature of the contract, to ensure the possibility for a review process and for tenderers or candidates to make an effective review of the decision to award a contract. This so-called "standstill" period provides an opportunity for tenderers or candidates (who may not have been awarded the contract in question) to request adequate information, to review the decision, and to bring forward review proceedings if necessary. Where procedure or awarding of the contract constitutes an infringement, correcting measures can be taken by eligible authorities.

The United Kingdom as been considering how to improve competition in the public service markets and has underlined the role of competition and consumer tools to remedy any distortions that may arise in managed competitions (Office of Fair Trading, 2004, 2011). This approach has been taken in Sweden as well (Box 30).

Box 30. Example: Dala-Mitt rescue services in Sweden

The local federation Räddningstjänsten Dala-Mitt (Dala-Mitt Rescue Services) is jointly owned by the Borlänge, Falun, Säter and Gagnef municipality. Its main activity is to provide emergency response services to the Swedish Civil Contingencies Agency, a government agency. According to the procurement criteria as set out in the competitive tendering process, access to specialised training facilities is necessary in order to run the training courses. Specialised facilities for such use are in public ownership, usually at the municipally-owned training grounds outside Borlänge.

In three consecutive tendering processes, a private competitor (Niscayah AB) was refused access to the specialised training facilities outside of Borlänge. A complaint was submitted to the Swedish competition authority. In this case, the competition authorities consider that:

- refusal of access is a breach of the Competition Act as it distorts and impedes, by object or effect, the occurrence and development of effective competition in tendering for emergency response operation training for part-time firefighters in the area of mid-Sweden.
- given that all specialised training facilities are in public ownership, refusing a private company access to key infrastructure makes it very difficult for other companies to compete in the market.

The competition authority has petitioned that Dala-Mitt Rescue Services may be prohibited through an injunction from refusing Niscayah AB access to training facilities at Bysjön training area for the purpose of providing emergency response operation training activities. The case is pending with the Stockholm City Court.

Source: Submission by the Swedish authorities.

Part C

Options for Implementation Based on National Practices

Approaches to Competitive Neutrality

The purpose of this section is to draw attention to national practices in OECD member States where competitive neutrality has been enshrined in national policies. It serves as a catalogue of practices without prejudice as to whether they should be implemented. It first outlines national approaches to competitive neutrality and is followed by examples of redress and remedial action currently implemented by relevant authorities.

Governments that are committed to competitive neutrality, including by implementing the elements presented in Part B of this report, need to decide how to coin this commitment into concrete rules and regulations, and how to implement it throughout the public administration and business sector. A crucial trade-off concerns whether to enshrine the commitment in a specific policy framework, or to reflect it in numerous specific pieces of legislation (e.g. competition, public administration and public procurement laws). Another important consideration is the ways in which non-neutral practices, where detected, are remedied by the competent authorities (e.g. remedial action or compensatory payments). Finally, governments need to consider whether to provide private (or public) competitors who consider themselves "wronged" with specific complaints mechanisms, or let them rely on ordinary administrative procedures and/or litigation.

Encompassing and autonomous frameworks

The most effective way of obtaining competitive neutrality is arguably to establish an overall policy framework addressing all relevant issues, including suitable enforcement and implementation mechanisms and in consistency with international commitments. However, very few countries have done this. In principle a competitive neutrality framework would include the following elements:

- A stated commitment to ensuring competitive neutrality at the highest level of government (plus, in the case of federal states, at the sub-national level). Parliamentary approval of such a commitment may be advisable since certain remedies of non-neutrality can require legal changes.
- Identifying the placement of responsibilities for enforcement and implementation. The responsibilities may be collected in one public body or split between, for instance, entities responsible for oversight and implementation. The latter would be the case where an oversight body (typically, in this case, the competition authorities) are charged with detecting non-neutral regulation or discriminatory public procurement practices, whereas remedying these practices are the responsibility of government ministries.
- A guidance detailing what is meant by competitive neutrality and how it is to be implemented (including its application to each of the eight "building blocks" listed in Part B). Such a guidance, where it exists, needs to be disclosed to market participants and the general public.
- Mechanisms of redress to ensure that departures from competitive neutrality are remedied without delay and, where relevant, adequate and prompt compensation paid to economic agents that have suffered losses due to non-neutral practices.
- A complaints mechanism allowing market participants to bring their concerns about competitive neutrality to the attention of the relevant authorities.

The most complete competitive neutrality framework implemented today is the one found in Australia. As described in other OECD documents this framework is backed by separate implementation and complaints handling mechanisms. In the words of the Australian National

Competition Council "a major strength is [the] reliance on the 'spirit' of reforms and the flexibility afforded to governments in meeting their commitments" (Commonwealth of Australia, 2004b). As further posited by a study commissioned by OECD "the Council has no doubt that rigid highly prescribed agreements set down in black letter law would have been an inferior model" (Rennie and Lindsay, 2011) – hence implicitly refuting the model of implementing competitive neutrality through numerous separate legislative initiatives that has been seen in certain other OECD countries.

Another approach that comes close to a full-blown competitive neutrality framework is found at the pan-European level in the body of EU law dealing with State aid and transparency. Unlike the Australian example it does not allocate specific responsibility for competitive neutrality *per se*. In one sense it goes beyond competitive neutrality by addressing departures from a level playing field not related to the ownership of the competing entities. Conversely, it is more limited than the Australian approach in that it does not generally address non-neutralities that arise for reasons other than preferential treatment (e.g. favourable commercial terms to companies perceived by the market as enjoying government support). It is nonetheless a unique system in that it ensures effective control of subsidies/State aid received by SOEs, including recovery.

It does not follow that all countries committed to competitive neutrality ought to necessarily follow the Australian or EU approach. Operating an autonomous framework goes a long way toward ensuring competitive neutrality, but it can also be costly and resource intensive. Governments will need to consider whether the scale and frequency of their competitive neutrality related concerns are such that they can justify the resource commitment. These these two jurisdictions, which have gone furthest in implementing overarching competitive neutrality frameworks, have done so as part of a wider effort not aimed solely at regulating the competitive position of public sector businesses. In the Australian case, competitive neutrality moved to the fore in the context of a general overhaul of the country's competition and productivity related policies; in the EU it is linked with the European Commission's efforts to safeguard the integrity of the European Internal Market.

Competitive neutrality as part of other commitments

A number of OECD and non-OECD governments are committed to all aspects of competitive neutrality as defined in Part B, but have not gone as far as to develop formal competitive neutrality frameworks. In practice they have usually augmented existing legislation to address the competitive landscape in which publicly controlled businesses operate and rely on the enforcement mechanisms already in place. One exception from this approach is Spain, which has established a commitment to competitive neutrality through special decree and empowered the Ministry of Economy to establish implementation mechanisms (as touched upon in Box 32 below).

Examples of a wide ranging commitment to competitive neutrality implemented largely through competition law are found in the Scandinavian countries (Box 31). Recent legislative change in Denmark, Finland and Sweden (as well as longer-standing practices in Norway) aim to prevent market participants from receiving any kinds of public support that could distort competition. These countries do not necessarily go beyond what is established by EU legislation, but they enshrine the commitment in national law backed by more immediately applicable enforcement mechanisms. Several of the legal changes in Scandinavian countries deal explicitly with business activities by municipalities and other sub-national levels of government. Conversely, the competition-law based approaches in Scandinavia generally do not include unincorporated public businesses. One initiative (in Finland) aims at including an obligation to incorporate certain activities to fill this enforcement gap. Moreover, in all those countries incorporation is among the remedial actions that the competition authorities have recommend in the case where public service providers are found to compete unfairly.

Box 31. Toolkit: Competition-based provisions in Scandinavia countries

- **Denmark**: One of the stated purposes of the *Danish Competition Act* is to achieve competitive neutrality. It applies to any form of commercial activity as well as aid from public funds granted to incorporated commercial activities (public or private). Government controlled businesses and public authorities exercising commercial activity are subject to the prohibitions laid down by the Act.
- **Finland**: Competitive neutrality is high on the government agenda. It is regarded as important to ensure equal preconditions for private and public production by means of competition law and other laws and policies. The *Finnish Competition Act* is applicable to all businesses and commercial activities controlled by government. In addition, the *State Enterprises Act* and the *Local Government Act* apply as respective "companies' acts" stipulating the legal personality, organisation and basic functions of government enterprises. The former was recently amended (January 2011) to incorporate (to the extent possible) companies operating under this act; an amendment to the latter is currently being considered with a view to introduce a corporatisation obligation for municipally-owned economic operators engaged in competition with private operators on a market.
- **Sweden:** Since January 2010, the *Swedish Competition Act* includes a new rule which aims to overcome difficulties faced by anti-trust regulators where previous antitrust rules fell outside the scope of Competition Act and the EC Treaty on the Functioning of the EU. The rule encompasses all types of government commercial activities and prohibits public undertakings from operating (national and sub-national level) if it distorts or impedes competition. The aim is to avoid market distortions where government-owned businesses are present.

A selective commitment to competitive neutrality

In some cases it may be rational for governments (at least in a short- to medium-term perspective) to abstain from overarching commitments to competitive neutrality. A slavish adherence to the eight points enumerated in Part B may in practice be appropriate only where public businesses either operate on a fully commercial basis, or where their non-commercial obligations are balanced by prompt and adequate compensation by government.

Where governments compensate SOEs for the performance of public policy functions through other advantages (these may, as mentioned in the first part of this report, include regulatory derogations, cheap finance, tax advantages, etc.) using the individual "building blocks" as presented in Part B as a blueprint for competitive neutrality could be counterproductive. In a nutshell, the risk would be that some publicly owned businesses – faced with non-commercial obligations and stripped of any compensatory advantages – would operate in the market place at a competitive disadvantage.

As also mentioned earlier, this should not be taken to indicate that any compensation for non-commercial obligations can be as good as the next. Prompt and transparent payments that appear on public sector accounts are generally (as stressed by the *SOE Guidelines* (OECD, 2005a)) the superior mechanism. Where this is not feasible, other forms of compensation should be considered which either directly remedy the competitive disadvantage of the non-commercial obligations or whose pecuniary value to the recipient can be calculated accurately. The use of remedies whose value is either hard to calculate or depends on other business parameters than the ones linked with the obligations is highly problematic from a competitive neutrality perspective.

Moreover, where public businesses operate in multiple jurisdictions additional challenges may arise, *inter alia* reflecting the fact that the private businesses competing with SOEs in sectors where compensations for non-commercial objectives are necessary may not be the same as those that compete with the same enterprises in fully competitive segments of the markets. Ideally, the two sets

of activities should be fully separated at the level of the SOE, but this may in practice not always be the case.

A number of countries have combined a commitment in principle to competitive neutrality with the existence of SOEs with public policy functions in the following fashion. First, competitive neutrality has been established as a standard that shall apply to any public sector business not operated largely or partly in the public interest. Secondly, advantages accorded to certain businesses in compensation for non-commercial obligations have been clearly identified and calibrated as carefully as possible. Thirdly, it has been applied to the businesses in question with respect to all aspects of competitive neutrality (as per the "building blocks" proposed in Part B of this report) that are not intended as part of the compensation.

Redress and Remedial Action

Where governments are committed to competitive neutrality, the framework (legislative or not) chosen to enshrine this commitment as well as its placement within the public administration has implications for what remedial options are available. Where an overall competitive neutrality framework is established the enforcement will be placed with one body and oversight possibly in another – e.g. in the case of Australia, the Treasury has responsibility for competitive neutrality policy, while the Department of Finance and Deregulation assists responsible Ministers in implementing competitive neutrality arrangements for their SOEs and the Productivity Commission administers a complaints mechanism.

Where competitive neutrality relies mainly on competition law, the responsibility between, on the one hand, detection and assessment of non-neutral practices and, on the other, remedial action may in practice be split. The first of these roles typically lies with the national competition authorities whereas the latter – for example in the case where the remedies include changes to the functional form of government businesses – would be the responsibility of the executive powers (acting, as the case may be, on the recommendation of the competition authorities) if the practice has its origin in government regulation.[1] It must, however, be recognised that only a minority of OECD countries have comprehensive competition-law based approaches to competitive neutrality. In most countries, competition authorities have limited, if any, powers of redress.[2]

Reflecting this, national practices differ and may involve concerned public bodies beyond competition authorities. Based on country experiences options available to public authorities that detect departures from competitive neutrality seem to include the following:

- *Prohibition of anticompetitive practices and structural or behavioural remedies.* In the context of opening the network industries, competition authorities have taken pre-emptive recourse to structural separation of purely commercial from other activities. Similar action has been taken to ring-fence commercial activities by general government – which have sometimes also been corporatised in the process – often in response to pressures from competition authorities and other regulators charged with overseeing competitive neutrality. Much remedial action at the level of municipal business activities has been of this nature: the regulators have found that such businesses enjoyed unfair advantages by virtue of being placed within the municipal administration and instructed the municipalities to create separate entities for commercial purposes and operate these at arm's length. Another solution has been to rely on competition rules and prohibit practices that amount to an abuse of a dominant position held by the SOE and imposing appropriate structural or behavioural remedies. For example, in the case of opening railway passenger services to competition some governments have concluded that the state-owned rail operators enjoyed such hard-to-quantify incumbent advantages that abusing their dominant position was inevitable. The only possible remedy was to prohibit the operators from bidding in public procurement and concession tenders. Prohibition as a more extreme measure must be carefully weighed by the relevant authorities.

- *Punishing or redressing past transgressions*. Partly related with the previous point, few, if any, regulators have the powers to fine public sector businesses or their owners for departures from competitive neutrality. However, competition authorities do possess remedies to address certain abuse situations that may arise. Competition authorities have the powers to address competitive neutrality cases under the rules on abuse of dominant position, if the competitive advantages enjoyed by the SOEs have been used to distort competition. Also, the competition laws in many countries empower the regulators to demand full disclosure by public sector entities that undertake commercial and public

interest activities in a "bundled" fashion (i.e. absent structural separation). Failure to comply leads to fining. Finally, where a commitment to competitive neutrality is established by law competitors of public entities may potentially seek legal redress. This route has not been taken often, *inter alia* because private businesses are wary of pulling representatives of the state powers in court. However past court cases, including some involving national postal services, demonstrate that it remains an option (Capobianco and Christiansen, 2011).

- *Compensatory payments.* At the heart of any comprehensive framework for competitive neutrality is the imposition of payments to or from public businesses reflecting the estimated value of their (dis-) advantages. The public agencies usually empowered to oversee such compensatory payments are mostly the national competition authorities, but can also be a government line ministry (Spain and Australia). In Spain this role is entrusted to the Ministry of Economy and Finance (in coordination with the Competition Authority). However, unlike the Australian model, in Spain this remedy is enforced *ex-post* in cases of "non-compliance." (Box 32)

Box 32. Toolkit: Remedying non-compliance in Spain through compensatory payments

Beyond competition authorities the Ministry of Economy and Finance is entrusted to apply a number of neutrality adjustments in cases of non-compliance. It may exercise the following functions in order to enforce competitive neutrality:

- To determine the additional cost involved in the obligations and responsibilities associated to the public services that such entities are required to undertake.
- To estimate the extra cost of debt, bank guarantees, and safeguards, associated with being a public undertaking, as well as the impact of applying a specific regulatory framework to them.
- To estimate the income that the Treasury Department should receive as compensation for the capital invested in the public undertaking, as well as the corresponding dividends, taking into account the added financial responsibilities for ensuring public services, and the advantages that such undertakings enjoyed in terms of access to finance and of the regulatory framework applicable to them.

The Competition Authority is informed by the Ministry prior to the exercise of these functions.

Source: Submission by the Spanish authorities.

One important enforcement issue arises out of the growing reliance on competition legislation to safeguard competitive neutrality. As mentioned above, most of the options for remedial action relate to structural change that may sometimes be undertaken by government ministries (or equivalent authorities at the sub-national levels) that own or undertake the relevant business activities. Competition authorities may advise these ministries but their recommendations may not be binding on the recipient, especially if the uncompetitive situation is attributable to government regulation and not to the behaviour of the undertaking. In some cases, the role of competition authorities in the sphere of competitive neutrality may be limited due to the fact that ensuring the level playing field requires a number of different policies outside the scope of competition law. Nevertheless, competition authorities can contribute to the attainment of competitive neutrality within the scope of their powers by working together with regulatory authorities to develop non-discrimination policy or regulatory reform (an approached favoured by the Japanese authorities). And, even where the national executive is convinced of a need to take action, further constraints might arise from the legislative powers if legislative change is required (an example was provided in Box 25). Among EU member States the European Commission has powers to ensure compliance with EU law in view of protecting the internal market.[3]

A competitive neutrality commitment is stronger when parties that consider themselves "wronged" have access to a proper complaints handling mechanism. Obviously, in all countries where public bodies are entrusted with pursuing competitive neutrality (or aspects of competitive neutrality) the general public has the option of addressing its complaints to these bodies. However, as discussed above, the powers of such agencies to enforce remedial action differ sharply. In some cases they may intervene at the company level and force immediate change, levy neutrality charges or impose fines. In others, their role is mostly advisory *vis-à-vis* the national executive powers.

The most wide-ranging example of complaints handling mechanism is in Australia, where the Productivity Commission is responsible for receiving and investigating complaints about the implementation of competitive neutrality arrangements in relation to Commonwealth Government businesses through a dedicated body, the Australian Government Competitive Neutrality Complaints Office (AGCNCO) (each State and Territory has an equivalent office). Complaints generally fall into one of three groups, namely that (i) an Australian Government business is not complying with the competitive neutrality arrangements that apply to it; or (ii) those arrangements are ineffective in removing competitive advantages arising from government ownership; or (iii) any Australian Government business not subject to competitive neutrality arrangements should be.[4] Any individual or organisation (including a government body) may lodge a complaint with the AGCNCO. The AGCNCO is entitled to investigate complaints and to require information where pertinent to an inquiry. Generally, the competitive neutrality complaints offices are given flexibility in carrying out their investigation and acquiring relevant information – for example, by way of public hearings, data gathering, retention of consultants and so forth. When possible the AGCNCO tries to find a suitable resolution to a complaint through an advisory role to avoid having to go through a formal inquiry process.

If a formal inquiry process is indeed initiated, the AGCNCO is not entitled to take remedial actions. The complaint's office publicly reports on the outcomes of its investigation to the government and makes recommendations for future action to be made (Box 33). Under Australia's current arrangements, the responsible Minister for the particular government business in question is to respond with any proposed action to put in place competitive neutrality arrangements (to the extent that the benefits outweigh the costs). The Treasurer has a high-level oversight role over the process.

Box 33. Toolkit: Australia: Competitive neutrality complaints handling and redress

The Australian Government Competitive Neutrality Complaints Office (AGCNCO) of the Australian Productivity Commission follows a structured process to handle complaints, investigate complaints and redress. The process involves a five-step process, essentially involving:

1. Clarification of the nature of the complaint and specification of the particular principles of competitive neutrality which are allegedly distorted;
2. Confirmation that the complaints office is the appropriate venue to handle the complaint (in particular, that the complaint relates to an SOE owned by the relevant Government) and that the complaint:
   - is about a substantive and non-trivial issue, and not frivolous or vexatious;
   - relates to a competitive neutrality issue; and
   - is not in relation to a competitive neutrality issue that is currently being reviewed by the Government.

Box 33. Toolkit: Australia: Competitive neutrality complaints handling and redress *(continued)*

3. Confirmation that the SOE carries on a significant business activity, where "business" is summarised as an operation:
   - which charges users for goods and services;
   - in an environment where there is an actual or potential competitor (whether public or private); and
   - where the managers have a degree of independence in producing or supplying the good or services and the price of supply.
4. Confirmation that the complaint relates to the presence of a competitive advantage as a result of its public ownership (i.e. competitive neutrality), and not as a result of other factors, specifically:
   - a failure on the part of the SOE to implement the competitive neutrality principles;
   - the SOE incorrectly applying the competitive neutrality principles and the application is not effective to remove the relevant competitive advantages; or
   - that the relevant Government activities have not been exposed to competitive neutrality principles and should be.
5. Systematic analysis of whether there is a particular breach of any aspect of the competitive neutrality principles (and whether the benefits of implementing competitive neutrality principles outweigh the relevant costs). Analysis is guided by a number of guidance documents on specific issues developed by the AGCNCO (e.g. on calculating rates of return, cost allocation and pricing).
6. On the basis of its investigation and if necessary, the AGCNCO provides advice to the Government on the application of competitive neutrality to the Australian Government businesses in question.

Source: Submission by Australian authorities and Matthew Rennie & Fiona Lindsay (2011), "Competitive neutrality and State Owned Enterprises: Australian practices and their relevance for other countries", *OECD Corporate Governance Working Papers, No.4,* www.oecd.org/daf/corporateaffairs/wp

Notes

1. Among EU member States, if the practice is imputable to an undertaking (e.g. abuse of dominant position), the competition authorities can impose remedies – including changes in the structure of the undertaking – to restore competition (see bullet on "punishing of redressing past transgressions" below).

2. For further reading see Capobianco and Christiansen, 2011.

3. In the EU a member State adopting legislative or regulatory measures in breach of the competition rules enshrined in the TFEU can be subject to an infringement procedure by the European Commission. The Commission has powers of its own (action for non-compliance) to try to bring an infringement to an end and, where necessary, may refer the case to the Court of Justice of the EU.

4. For a complainant or potential complainant, the first stage is to liaise directly with the specific SOE to resolve the issue. If this liaison is not successful, the complainant can then approach the relevant competitive neutrality complaints office.

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