

Commercialisation of Government Business Activities in Queensland

Policy Framework

Queensland Treasury 2010

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Table of acronyms

CBU	Commercialised business unit
CSO	Community service obligation
DJAG	Department of Justice and Attorney-General
FA Act	<i>Financial Accountability Act 2009</i>
FPMS	<i>Financial and Performance Management Standard 2009</i>
FCP	Full cost pricing
GOC	Government owned corporation
QCA	Queensland Competition Authority
QTC	Queensland Treasury Corporation
SBA	Significant business activity



Introduction – commercialisation in context

Commercialisation is a governance framework used by Queensland Government departments to deliver commercial activities of Government by adopting to various degrees, features of a commercial environment including a commercial pricing framework.

Commercialisation aims to achieve value for money in the consumption and delivery of Government services by applying commercial principles. It provides a framework for ensuring resources are used in the most productive manner when providing Queensland Government services.

This paper focuses at a strategic level on the general principles of commercialisation. The commercialisation framework allows Queensland Government agencies to adopt commercialisation principles in a manner suitable to their individual agency requirements. This ensures agencies maximise the performance of their service delivery.

The *Financial Accountability Act 2009* (FA Act) and the *Financial and Performance Management Standard 2009* (FPMS) provides the overarching legislative framework for commercialisation reforms. The purpose of the FPMS is to provide a framework for an accountable officer of a department or statutory body to develop and implement systems, practices and controls for the efficient and effective financial and performance management of the department or statutory body.



Overview: key elements of commercialisation reform

General

- The primary objective of commercialisation is the efficient use of resources in both service consumption and service delivery.
- The commercialisation policy is built around four key principles:
 1. competitive neutrality (competition with alternative providers on equal terms)
 2. clear and non-conflicting objectives
 3. management responsibility, authority and autonomy
 4. accountability for performance.
- Commercialisation is appropriate where services can be provided by Government to internal or external clients, and where the benefits of commercialisation outweigh the costs of implementation.
- Commercialisation requires agencies to adopt a commercial culture which includes introducing new incentives within their service delivery unit. To ensure cultural changes are embraced, it is important the implications of commercialisation are communicated effectively both to internal and external stakeholders throughout the reform process.

Commercial operating framework

- Commercialised activities will be established as separate business units within Government.
- Policy and regulatory roles must be clearly separated from commercial activities within the portfolio department.
- Commercial disciplines will be applied including commercial pricing arrangements, performance monitoring, taxation, capital structure and dividend policy, and community service obligations (CSOs) where appropriate.
- Commercialisation arrangements will achieve at least a budget neutral outcome.

Untying of clients

- When commercialised agencies have been placed on an appropriate commercial footing they may be required to compete for public sector business.
- Clients will determine the mix, level and, once 'untied', the source of services which best suits their needs and provides the best value for money.



Implementation issues

- Commercialisation will be driven by the portfolio department in close consultation with Queensland Treasury. If any reform impacts on industrial relations matters, the Department of Justice and Attorney-General (DJAG) will also be involved in the implementation arrangements.
- Implementation will be on a case-by-case basis to ensure that detailed arrangements suit the particular circumstances and do not impose an overall cost on the budget.

Management autonomy and accountability for performance

- The portfolio Minister will set strategic policy directions for the commercialised business unit (CBU), but will not be involved in day-to-day operations.
- The portfolio Minister is responsible for the monitoring of performance.
- An annual performance contract will specify the objectives, nature and scope of the unit's main activities, investment strategies, target performance indicators, agreed CSO activities, target dividends, budget and other financial requirements.
- CBU management will be responsible for commercial operations subject to Government policy.
- Continued management autonomy will depend on sound performance. Otherwise, stricter external controls will be imposed.

Human resource management and industrial relations

- The enterprise bargaining process will be used by CBUs as the basis for negotiating with unions to achieve conditions of employment and work practices consistent with Queensland Government policies. This will involve complying with Queensland Government policies regarding employment conditions.
- Large CBUs may be established as separate bargaining units within the public sector, subject to approved monitoring and review by DJAG and relevant central agencies. CBUs are subject to the *Public Service Act 2008* and must ensure fair and reasonable employment conditions and standards.

Performance monitoring

- The portfolio department will monitor performance, provide regular performance reports to Queensland Treasury, and continually implement measures to improve performance.
- Monitoring will encompass reporting on financial indicators, including statement of financial performance and statement of financial positions, as well as non-financial indicators.
- Normal budget monitoring processes will continue to apply to CBUs.



Pricing policies

- Where an external market exists, prices should be governed by competitive market forces.
- Treasury's *Full Cost Pricing Policy* should be used as a guide for setting prices. Where possible, prices should be set to recover all costs incurred in producing and delivering the services. Such costs could include for example:
 - operating costs, including salaries/wages and raw materials and equipment
 - capital costs for asset consumption
 - taxes and tax equivalents
 - any other competitive neutrality adjustments as appropriate.
- Invoicing and recovery of unpaid accounts will be the responsibility of the CBU.

Capital structure

- The mix of debt (through the Queensland Treasury Corporation (QTC)) and equity will be determined with reference to comparable private sector benchmarks and stability of cash flows.
- Debt/equity swaps and, in some cases, transfer of assets from/to the portfolio department may be required to adjust the current capital structure.
- The funding mix for major new capital investment will depend on the ability of cash flows to service debt and on the decision to provide equity funding through the State Budget.

Dividend policy

- Dividends will be negotiated annually. The starting point will be the target return on assets, less interest and tax equivalents. Other factors taken into account will include the level of profits generated, the need to retain earnings for reinvestment in the business and the level of dividends paid in comparable private sector entities.

Assets

- Assets required by the business will generally be vested in the CBU on commercialisation at current value.
- At the time of commercialisation, a strategy for disposal of surplus assets should be implemented. The distribution of funds will need to be negotiated with Treasury.
- Detailed asset registers must be maintained.

Taxation

- To ensure competitive neutrality, CBUs are required to pay tax equivalents. The *Manual for the National Tax Equivalents Regime* provides a guide to imposing the tax equivalents for State Government commercialised and corporatised entities.



Community service obligations (CSOs)

- CSOs are non-commercial activities which the Government has directed the CBU to undertake, as set out in the Treasury policy document *Community Service Obligations – A Policy Framework*.
- CSOs must be specified in explicit arrangements and included in the annual performance contract.
- CSOs specifically exclude:
 - conditions applicable across the broad public service
 - compliance with regulations
 - activities which, although in isolation are commercially non-viable, enhance business performance
 - activities which if undertaken more efficiently, would be commercially viable.
- Funding of a CSO will be considered within the context of the State Budget process.



1. What is commercialisation?

1.1 Aims of commercialisation

Commercialisation aims to achieve value for money in the consumption and delivery of Government services by applying commercial principles. It provides a framework for ensuring resources are used in the most productive manner when providing Queensland Government services.

Commercialisation helps free up funding for other purposes by reducing costs and increasing productivity in the delivery of Government services. Commercialisation also improves customer focus and the quality and timeliness of service delivery. The adoption of commercial management practices by agencies is consistent with the outcome-focused resource management practices of service delivery.

1.2 Commercialisation defined

The Financial and Performance Management Standard 2009 (FPMS) defines commercialisation as:

“the process by which a department or a commercialised operation of a department, charges for the goods or services it provides and adopts, in varying degrees, other features of the commercial environment, including the principles of competitive neutrality, clear and non-conflicting objectives, an appropriate level of management responsibility, authority and autonomy and accountability for performance.”

The essential element is the establishment of commercial behaviour between buyers and suppliers of services.

Under full commercialisation, CBUs trade with clients in a competitive environment. Full commercialisation generally implies considerably more change to traditional servicing than simply full cost pricing/user charging.

Full commercialisation reflects the simulation of market conditions in the provision of Government services. Full commercialisation involves:

- untying clients
- pricing at efficient market rates
- setting performance targets in terms of acceptable rates of return
- the payment of dividends and tax equivalents
- recognising CSOs
- giving management more autonomy and at the same time making them more accountable for performance.

The degree to which CBUs compete for private sector work will be determined at the implementation of commercialisation and reviewed regularly depending on the CBU including the type of market in which it is operating.



1.3 Commercialisation principles

Improving value for money in the delivery and consumption of services through commercialisation reform involves four key principles:

1. competitive neutrality
2. clear and non-conflicting objectives
3. management responsibility, authority and autonomy
4. accountability for performance.

An overarching requirement for CBUs is that arrangements put in place must at least achieve a budget neutral outcome in the medium term. Commercialisation must have as its primary goal, the efficient utilisation of resources across the Queensland Government sector.

1.3.1 Competitive neutrality

Market distortion arises where a CBU is not subject to the same commercial imposts as its private sector counterparts. For example, a CBU could have the capacity to underprice its services on the basis of its Government ownership. This could potentially price private competitors out of the market.

The Queensland Government has a number of potential competitive advantages when compared to the private sector. Disparities may exist if a Government business:

- is exempt from all or some taxation
- is exempt from a requirement to pay dividends to the owner of the business (the State)
- is exempt from various regulatory requirements
- has access to cheaper sources of finance (where the State has a higher credit rating and hence lower interest rate for borrowings).

Competitive neutrality refers to the process of identifying and, where appropriate, removing competitive advantages so that Government businesses are competing on equal terms with their competitors. Generally, this means that Government businesses are required to:

- pay tax equivalents
- earn a commercial return and pay a dividend to its owners
- pay a debt neutrality fee to remove the advantages of Government access to lower cost funds.

By making Government businesses operate in a similar environment to the private sector there is incentive for Government businesses to adopt competitive practices.

Administrative arrangements for ensuring competitive neutrality should be as simple as practical so the costs of compliance are minimised and productive effort is not diverted from the actual performance of the service.

Competitors of Government businesses are able to complain if they believe Government businesses are not adhering to the principle of competitive neutrality. The *Queensland Competition Authority Act 1997* provides an independent mechanism for competitors of certain Government businesses to lodge a complaint with the Queensland Competition Authority (QCA) where they believe the business enjoys a competitive advantage by virtue of its Government ownership. This complaints mechanism applies to business activities declared by the Ministers (the Premier and the Treasurer) by gazette notice to be a 'significant business activity'.



When the QCA receives a competitor complaint about one of the Government's significant business activities, it investigates the complaint and reports to the Ministers on whether or not the complaint is substantiated.

If a business activity is not declared a significant business activity, competitive neutrality complaints are investigated by Queensland Treasury.

1.3.2 Clear and non-conflicting objectives

Commercialisation requires Government business units to have clear commercial objectives to:

- clarify management responsibilities
- assist in measuring commercial performance and identifying factors contributing to poor performance
- assist in monitoring of social programs (including CSOs) to ensure efficient and cost effective delivery of these services.

Potential conflicts of interest could arise if a CBU was responsible for setting the policy or standards for a regulatory function that impact on the services it provides.

Wherever possible, there should be appropriate separation of roles between the portfolio department and the CBU to minimise conflicting objectives. Responsibility for policy, regulation and social objectives should be functionally separated from the delivery of commercial services within an agency.

For the purposes of transparency, arms length trading arrangements between a supplier and a customer should be implemented.

1.3.3 Management autonomy

Through the portfolio Minister, the Government will be responsible for setting the strategic policy directions for a CBU, but will not be involved in day-to-day management or setting the detailed operational policy.

Organisational arrangements for CBUs must be structured to establish clear roles and to permit adequate autonomy and authority in the management of operations.

CBU management will have the flexibility to exercise judgement on operational matters, within the parameters laid down by the portfolio department and Queensland Treasury.

Management autonomy in day-to-day operations will, subject to overarching control mechanisms outlined in later sections, extend to such issues as:

- efficient market pricing
- quantity and quality of service output
- staff resources and delegations
- asset management.



1.3.4 Accountability for performance

Given the operational flexibility of CBUs, strict performance accountability mechanisms must be established. Performance will be assessed against negotiated targets which will be set down in the annual performance contract. Comparative performance assessment with the private sector must take account of advantages and disadvantages of public sector operations.

CBUs are generally subject to the basic management framework of the Queensland public sector and will comply with the requirements of the FA Act and the FPMS. Additional financial and operational performance reporting requirements will be set down in the CBU's annual performance contract.

CBU management will be responsible to the portfolio Minister and Treasurer as representatives of the Queensland public, the ultimate owners of the capital invested in the business.

CBUs will be required to earn revenue from clients to meet the full costs of business.

2. Implementing commercialisation

2.1 Assessing the case for commercialisation

Government agencies considering the implementation of commercialisation should consider the extent to which a CBU is the most suitable organisational structure for achieving Government objectives.

Commercialisation is just one means of improving the quality and performance of public sector management for some Government activities. Commercialisation can create strong incentives for managing costs and improving the quality of services provided to customers.

However, alternative models of service delivery may provide better outcomes than a commercialisation arrangement. Alternative approaches that may improve the effectiveness and efficiency of Government service delivery could include:

- corporatisation
- greater utilisation of the private or community sector as a supplier or provider
- franchises or alliances.

Commercialisation should be considered for a State Budget funded agency or particular functions within a State Budget funded agency where:

- services are being provided by the agency to clearly identifiable clients or to itself
- reform will promote rational economic choice in the allocation and use of resources, and efficiency in providing services
- the user has discretion to accept or not accept the services or has considerable discretion as to the quantum which may be accepted
- the services are applied for the benefit of a specified user or user group having the capacity to pay
- the scale of operations is such that the expected financial and economic benefits from implementing the reform measures outweigh the expected costs.

Commercialisation policy does not directly apply to the provision of public goods that is, services for which there is no market or access is restricted and the Government has determined on public interest or equity grounds the service should be provided.



The appropriateness of providing services to Government under a commercial structure will be assessed on a case-by-case basis by the portfolio department in consultation with Queensland Treasury and other interested parties.

Commercialisation should be implemented progressively over an appropriate period to ensure a successful transition of systems, procedures and cultures within both service and consumer agencies and to enable the Government to adjust the specific arrangements where necessary.

2.2 Stages of commercialisation

Commercialisation can be a significant reform process and its implementation must be tailored to the needs of agencies. Departments can implement a more commercial approach in a series of stages.

The first stage involves establishing a general business environment between clients and services providers. This would include the agency/business unit:

- identifying the services
- identifying client needs or outcomes
- matching services to client needs or service outcomes
- establishing indicative costs and prices of services
- establishing standards for performance
- consulting with client groups
- regrouping activities to form organisational units which are client oriented and have clear accountability for performance, including separation of policy and service delivery functions
- assessing the extent to which competitive practices are employed by the business unit.

At this stage business units may continue to receive State Budget funding. Activities remaining would typically be in the nature of policy or regulation and would continue to receive funding under the normal State Budget process.

The next stage (partial commercialisation) involves establishing formal commercial relationships between clients and service providers and a more commercial approach to the planning and management of the business unit and the agency. At this stage, the following steps should be implemented:

- separate roles not consistent with commercialisation to promote clear focus on business objectives and reduce potential conflicts of interest and lack of objectivity
- negotiate service contracts between clients and service providers that specify requirements and standards
- where relevant, transfer budgets to clients and require efficient and effective use of products and services by both clients and service providers
- establish prices on a negotiated basis – this may be a fair market equivalent or full cost pricing
- ensure the CBU is separately identified within the accounts of the department
- ensure service providers are accountable for use of resources and identify the full costs of the business
- review work practices and skill requirements



- compare internal suppliers with benchmarks where alternative suppliers are not available
- ensure CBUs are accountable for performance and performance is assessed against negotiated targets with appropriate use of rewards and sanctions
- ensure the unit operates with the appropriate level of authority and autonomy.

Partial commercialisation is particularly appropriate where the market is developing and the Government is providing the service to meet market shortcomings, intra-departmental activities or to satisfy particular Government policy objectives. In these situations, market and market prices may not be as readily identifiable for the consumer and choices may be restricted. The agency would typically invoke user-pays principles (in accordance with the FPMS) from partial to full cost pricing.

The final stage of full commercialisation involves the move to a competitive environment where clients have freedom to choose the source of supply. Movement to this level needs to be assessed on a case-by-case basis. In this assessment, the following factors are relevant:

- a competitive market for the service should ideally exist
- policy and service roles to be separated to the maximum practical extent with major trading units separately identified
- Government service providers compete on a fair and equitable basis, including making tax equivalent payments (competitive neutrality)
- efficient market prices should be adopted
- supply to external customers should be consistent with the core business of the CBU and only within management approvals
- working arrangements and skills should be reviewed in light of the more competitive operating environment
- delegations must be arranged to give CBU managers appropriate autonomy and control over commercial decisions for which they are accountable
- assets to be managed by CBUs within broader departmental or Government policies
- commercial performance targets to be established
- CBUs are required to earn a profit and make dividend payments
- CBU performance assessment must take account of advantages and disadvantages of public sector operations.

Full commercialisation is appropriate where maturity exists in a market as characterised by a discernible level of competition for the services.



Agency responsibilities according to business type

Government Policy/regulatory focus	Business Service/client focus	
<i>Policy/Regulatory Functions</i>	<i>Partial Commercialisation</i>	<i>Full Commercialisation</i>
<ul style="list-style-type: none"> Establish a general business environment between clients and service providers Units are budget funded Charges often of a tax or regulatory nature Some element of user charging and revenue retention arrangements 	<ul style="list-style-type: none"> Focus on service to clients Define the business (for example, products and clients) Transfer budget to clients to enable them to pay for services Identify full costs of business and implement partial or full cost pricing where possible 	<ul style="list-style-type: none"> Separate policy and service roles within the CBU to the maximum extent possible Compete for clients Pay tax equivalents and other competitive neutrality payments Earn surplus and pay dividends Responsible for all relevant assets and liability of the business Performance targets

2.3 Implementation process

Portfolio departments will have primary responsibility for detailed implementation of commercialisation in close consultation with Queensland Treasury.

Departmental responsibilities include structural reform of CBUs. This requires the development of implementation plans and strategies, and circulation of these plans within the organisation.

Queensland Treasury will have the lead role in developing the detailed financial arrangements consistent with the overall commercialisation policy and with the mandate of budget neutrality. Queensland Treasury will also ensure the policy framework is properly implemented and the detailed arrangements for the CBU operate effectively.

Queensland Treasury also has a role in considering whether a CBU should be declared a significant business activity under the competitive neutrality provisions of the *Queensland Competition Authority Act 1997*, Section 1.3.1.

2.3.1 Consultation

Consultation with union, industry and other relevant groups should occur prior to and during the implementation of commercialisation arrangements for a Government activity.

Consultation may involve union and private sector representation on implementation working groups, and negotiation with unions on appropriate industrial arrangements in particular, enterprise agreements.

The level and scope of consultation would need to be considered by agencies in developing commercialisation proposals.



3. Management issues in adopting commercial practices

3.1 Management autonomy and accountability

3.1.1 Portfolio Minister

The portfolio Minister will establish the strategic policy directions for CBUs within their area of responsibility. The objectives, nature and scope of the main activities of the CBU (commercial and non-commercial activities) will be specified in an annual performance contract.

To ensure management is held fully accountable for the CBU's performance, the portfolio Minister will not become involved in the day-to-day management or detailed operational policy of the CBU.

3.1.2 The Treasurer

The Treasurer will have a key policy role in matters affecting the financial and economic performance of CBUs.

3.1.3 The Chief Executive

The Chief Executive Officer (CEO) of a department is the accountable officer under the FA Act and is ultimately responsible for the effective operation of their department as a whole. By virtue of their position, the CEO may face situations where there are competing interests between the social and commercial areas within their department. For example, where commercial outcomes would be materially influenced by a particular decision in the policy or regulatory area, the CEO might be persuaded to moderate that decision to the commercial advantage of the CBU. Delegation of authority for commercial operations to CBU management reduces the likelihood of such situations.

Any non-commercial directives which are given to the CBU would need to be clearly documented and CSO funding agreed by the Cabinet Budget Review Committee.



3.1.4 CBU management

A high level of management authority and autonomy will provide appropriate incentives for management to maximise the efficiency of their operations and enhance economic returns.

The level of autonomy given to CBU management will generally be at the discretion of the CEO, but there will still be a need to operate within the public sector environment. For example, CBU management need to work within the public sector employment framework while utilising enterprise bargaining to achieve best practice.

Nevertheless, appropriate operating flexibility will be given to a CBU once it is fully commercialised, subject to prevailing Government policies. The greater autonomy afforded to management after commercialisation reform will allow them to:

- determine the most appropriate resource mix for the delivery of their services – this would involve decisions on necessary skill and staffing levels, discipline profiles and sources of labour, including decisions relating to the contracting out of specific tasks
- determine financial and personnel delegations within their business – each position within the organisation will need to have clearly defined roles and formal delegation of authority sufficient to effectively perform those roles
- have appropriate regard to the competitive market environment in which the unit operates, set the price for their services and control the quality and level of output
- be responsible for financial management of the business
- subject to requirements of this commercialisation policy (including compliance with the Government's *Cost-Benefit Analysis Guidelines*), purchase and dispose of assets.

3.1.5 Performance contract

Before each financial year, the expectations and requirements of the Government will be clearly defined in a formal annual performance contract.

The details of the contract will be agreed between all contracting parties that is, the CBU management, the CEO of the portfolio department, the portfolio Minister and the Treasurer. The contract will be reviewed and renegotiated annually.

The annual performance contract will include such matters as:

- the objectives, nature and scope of the main activities of the CBU, including commercial and non-commercial activities
- short and medium term target rates of return and the nature of other financial and non-financial measures which will be used by Government to assess performance
- the dividend target
- forecast taxation obligations
- full details of any agreed CSO activities, including description, arrangements for measuring the effectiveness of their delivery, agreed funding levels, costing and payment arrangements
- a risk assessment



- broad financial requirements, such as:
 - general budget sector financial policies and strategies
 - maximum debt-to-equity ratios
 - borrowing and investment requirements
- details of any planned major investments, including expected returns and proposed financing arrangements
- detailed reporting requirements, including frequency, form and content of reports.

3.1.6 Rewards and sanctions

For commercialisation to succeed, the process must be driven from within the CBU. Implementing an appropriate system of rewards and sanctions will help ensure this impetus persists within management.

Market competition provides an automatic system of incentives and disciplines that are reflected in the commercialisation framework, for example:

- the prospect of retaining a share of profits for reinvestment in the business and in the skills of its workforce
- operational flexibility and autonomy given through devolution of authority allows management to influence outcomes resulting in the quality of these outcomes being attributed to management expertise
- accountability mechanisms ensure tighter external controls can be imposed in the event management is making decisions which, for example, are:
 - inconsistent with financial policies and strategies applicable to the budget sector generally and/or with any other material requirements specified in the annual performance contract
 - adversely impacting on economic performance.



3.2 Human resource management in a commercialised environment

Generally, human resource management in a commercialised environment involves the adoption of best practice commercial standards. Human resource management needs to occur within the context of Government's principles and standards to ensure the best practice standards of equity, merit and impartiality are also adhered to.

CBUs will be required to comply with the *Public Sector Ethics Act 1994*. This may require business units to adopt the relevant department's code of conduct or to develop its own code of conduct in terms relevant to its industry.

The enterprise bargaining process will be adopted by CBUs as the basis for negotiating with unions to achieve conditions of employment and defining work practices. This will involve complying with either federal or state industrial relations laws and being aware of Queensland Government policies regarding employment conditions and industrial relations practices. For this purpose, large CBUs may be established as separate bargaining units within the public sector subject to approved monitoring and review by DJAG and relevant central agencies.

The transition from a traditional public service environment to a CBU structure will place new demands and requirements on both management and staff. Accordingly, careful workplace planning must be instituted from the time the intention to commercialise is identified. This may require a process of job redesign to ensure an appropriate alignment between work responsibilities and remuneration levels. The mix of skills and employment levels may need to be adjusted to reflect the requirements of a competitive environment. Management will need to formally consult staff and unions about any major changes that may impact on employment conditions and practices.

3.3 Performance monitoring

3.3.1 Performance monitoring in CBUs

Significant autonomy in the pursuit of commercial objectives provides CBU management with incentives to seek out efficiency gains. However there needs to be corresponding accountability for the effective operation of the CBU. An appropriate performance monitoring regime ensures this accountability is achieved.

Performance monitoring is concerned with the CBU's progress towards achieving specified targets consistent with the objectives set for the unit.

Performance monitoring is a supplement to, not a replacement for, existing budget monitoring processes. It will augment the public reporting regime established under the FPMS and the audit reports of the Auditor General.

Objective monitoring by an authority external to the business unit of economic, financial and non-financial performance will be a key factor in improving the efficiency and effectiveness of service delivery.



3.3.2 Outputs, outcomes and strategic direction

The focus will be on monitoring the economic results and financial health of the CBU to ensure the Government is achieving the best value for money and the investment is viable in the long term.

The targets will form a complete business profile and canvass the important aspects of the CBU. In particular, targets will cover economic, financial and non-financial criteria.

Specific indicators may need to be established for each CBU. Performance indicators will be accompanied by a statement of financial performance, statement of financial position and cash flow statement for the following four years.

In contrast with budget monitoring where the focus is on the role of the CBU as a part of the overall State Budget, performance monitoring examines the strategic direction of the CBU in the context of the industry in which it operates. Performance monitoring will evaluate the costs, benefits and risks of alternative business strategies.

Primary responsibility for monitoring the performance and ongoing viability of CBUs will rest with the portfolio department. Monitoring will normally be undertaken on a monthly basis.

Queensland Treasury will maintain the regular budget review process and will have an oversight role in the performance evaluation process. Queensland Treasury will be concerned with ensuring performance targets are being met and the overall monitoring process is being undertaken in an effective manner.



4. Financial framework for commercial practices

4.1 Pricing policies

Efficient market pricing of services is essential to promoting rational economic choice in the allocation and use of resources.

Inefficiencies are generally minimised in a competitive market so prices should reflect the ‘efficient price’ for providing a good or service. To the extent possible, operating to a market pricing regime is critical to the success of commercialisation reform.

CBUs should consult the Queensland Treasury *Full Cost Pricing Policy* (FCP Policy) for guidance in developing pricing benchmarks. The FCP Policy seeks to ensure that the pricing structure of CBUs is competitively neutral, similar to the pricing structure faced by private sector competitors. In setting prices under FCP, the CBU must meet all fixed and variable costs (including competitive neutrality fees such as debt guarantee fees and tax equivalents), as well as provide an appropriate rate of return on equity.

Accordingly, CBUs will be expected to charge market prices for services they produce. Normal commercial principles should apply to the invoicing and recovery of charges for services rendered, including the imposition of penalties (for example, interest) on overdue accounts and/or providing discounts for early payments.

During the transitional period leading up to commercialisation, Queensland Treasury and the portfolio department will closely monitor the prices of services produced by CBUs to ensure prices are generally being maintained at market levels.

Detailed pricing policies would be the responsibility of the CBU’s management. There may be some cases where longer term external monitoring is warranted to ensure prices are being set to provide an appropriate return on capital and cover the full efficient cost of producing the good or service. This may need to be imputed or benchmarked if there is no readily available market price for the CBU’s product. This might happen if:

- there was no established market or
- the unit’s product is materially different from those of its competitors.

Once competition is introduced there would be strong incentive for the CBU not to overcharge relative to the market. Implementation of appropriate arrangements in relation to taxes, dividends, debt service charges and full cost allocations (including corporate overheads) will help to ensure the unit has limited opportunity to distort the market.



4.2 Capital structure

4.2.1 Implementation of appropriate capital structure

The assets of the business have been funded over time by a mixture of borrowings and Consolidated Fund injections. The relative contributions from these sources in the past would reflect the non-commercial environment in which the agencies have operated. Consequently, current debt/equity levels may not be appropriate for a CBU operating under a commercial charter.

Hence, the existing capital structure may need to be adjusted prior to commercialisation. The desired levels of debt and equity will be determined by applying the agreed debt-to-equity ratio to the current value of the asset base. A comprehensive asset valuation exercise and detailed review of the asset base will first need to be undertaken. In some cases, some assets may not be appropriate for a commercial environment and may need to be retained by the portfolio department.

Existing capital amounts will be adjusted through appropriate debt/equity conversions on commercial terms.

Operating under full commercial constraints will require substantial adjustments by the CBU and it might be necessary to consider this when implementing the desired capital structure. In some situations debt capital could be phased-in until cash flows have stabilised sufficiently to ensure appropriate, long-term debt levels can be serviced. Conversely, surplus assets may be retained until it is clear they are not required for operational purposes.

4.2.2 Capital investment

It is not necessary for major new capital investment opportunities which may arise to be funded in the same debt and equity proportions as the business' capital structure. There may be compelling reasons to utilise debt finance only or to have the investment fully funded through Government equity contribution (which may be a direct contribution or retained earnings). However, any significant adjustments made to overall capital structure as a result of short-term funding constraints would need to be wound back in the longer term.

The funding mix used for any new capital investment will depend on a number of factors including:

- the capacity of cash flows to service additional debt (depends on the level of debt outstanding and variability in cash flows)
- the Government's capacity to provide capital injections given State Budget priorities
- whether there is any need to adjust the debt-to-equity ratio to bring it into line with market norms.

Major new capital investments, including the financial assessment of projects, will need to be included as part of the annual performance contract.

4.2.3 Borrowings

Short-term overdraft or long-term borrowing facilities will be made available to CBUs at commercial rates through QTC, subject to normal Treasurer approval processes. CBUs will not be able to seek debt finance from sources other than QTC.

Loan funding will be subject to the terms and conditions applicable to QTC finance at that time. Such terms and conditions will generally accord with market practice. QTC will make case-by-case assessments as to the capacity of the CBU to service the debt being sought.



4.3 Dividend policy

Ownership of the net worth of public enterprises is vested in the Government on behalf of the Queensland public. Net worth is measured as the difference between the current aggregate value of the assets and the liabilities. Net worth reflects the State's equity in the business.

The payment of a dividend to the Consolidated Fund recognises the State's equity has an opportunity cost, that is, the financial return the State would have earned on its funds if they were invested in an alternative use of equivalent risk.

The adoption of an explicit dividend policy will help to dispel any misconception that the cost of equity finance is zero and facilitates comparison with private and public sector benchmarks.

Once the capital structure and required rate of return on assets have been set, dividends would effectively be determined as a residual matter as the return on debt is fixed and debt has priority over equity in the distribution of revenues.

Dividend payments will need to be negotiated on a case-by-case basis, taking into account the fact that:

- dividends must be paid out of profits actually generated, that is, they must be based on actual results, not on target returns
- unrealised capital gains (which form part of the required return on assets) are not available for distribution as dividends
- the business may need to retain equity to finance growth
- the quantum of dividends sought on an on-going basis must not be such that payment would prejudice the financial health of the business
- the need to allow management to retain earnings is an incentive to maximise profits
- the principle of competitive neutrality suggests that dividend payments should be broadly consistent with those of the private sector competitors.

4.4 Ownership and valuation of assets

The asset base being employed by each CBU (including plant and equipment, land and buildings) must be reviewed prior to the implementation of full commercialisation arrangements. Assets that are clearly surplus to requirements will be disposed of in a manner appropriate to the particular circumstance. Any compensation will be determined by Queensland Treasury in consultation with the portfolio department having regard to the specific circumstances, including the manner in which the asset was originally acquired. Compensation will not be provided in cases where the asset was funded from the Consolidated Fund or through revenues generated from within the public sector.

The remaining assets which are required by the CBU in the conduct of its normal business activities (including CSOs) will generally be vested in the CBU on behalf of the Queensland public. Assets will be deemed to be transferred to the CBU as at the agency's effective date of commercialisation.

Ownership of assets by CBUs may not always be appropriate and control of certain assets might need to be transferred to non-commercial sections within the portfolio department. For example, building management (commercially operated) is separate to the Government ownership of the buildings.



4.5 Taxation arrangements

4.5.1 Rationale for tax equivalent payments

Taxation is one component of a package of commercial charges and disciplines imposed on CBUs to ensure they operate in a competitively neutral environment.

In the absence of an appropriate taxation regime for the agency, the CBUs performance is overstated relative to private sector benchmarks. This serves to mask any inefficiencies. Tax exemptions also tend to distort decision making (for example, if a stamp duty exemption is provided on the purchase of a particular good, the agency may purchase more of that good than would otherwise be economically justified).

4.5.2 Payments of tax equivalents

Entities subject to the National Tax Equivalents Regime are exempt from the payment of Commonwealth taxes to the Australian Government. However, these entities will be required to make tax equivalent payments to the Consolidated Fund in lieu of payments to the Commonwealth for income tax as set out in the *Manual for the National Tax Equivalent Regime*.

CBUs will also be required to make payments to the State in lieu of duties, land tax and local government rates.

4.6 Community service obligations

4.6.1 Definition

A Community Service Obligation (CSO) is broadly defined as any specific Government directive to a CBU to provide a service not in line with their commercial decisions. The Treasury policy document *Community Service Obligations – A Policy Framework* outlines guidelines that apply in situations where the Government requires a CBU to deliver a CSO.

A CSO activity is intended to satisfy a specific objective of the Government and, as such, would generally not be undertaken in a normal commercial business.

The term also covers activities that provide a direct benefit to specific sections of the community for example, if prices are held below market levels. Given CBUs generally do not directly service the public, activities falling into this category will be uncommon.

CSOs can also capture a range of activities that do not provide tangible benefits to a defined group but the Government still considers to be desirable from a broad community perspective.

4.6.2 Identification of CSOs

While CSOs need to be assessed on a case-by-case basis, there are a number of important conditions which need to be satisfied before an activity would be considered for CSO funding. These are outlined in the following sections.



4.6.3 Material and binding Government directive

There must be an explicit Government directive for the performance of a clearly specified activity. Further, the scope and scale of the activity must be such that it would justify the effort involved in separately measuring and funding it as a CSO. The CSO activity should be clearly identified in the annual performance contract.

A distinction needs to be drawn between CSOs and directions or mandates of a regulatory nature. The latter responsibilities relate to compliance with a range of legal and regulatory requirements which are not specific to the CBU for example, environmental controls. These requirements are generally applicable to any entity undertaking similar activities and so are not considered to be CSOs.

4.6.4 Non-commerciality

The activity must be one that would not ordinarily be undertaken by an entity operating with a commercial objective. The activity should not be capable of being performed in a manner which would provide an acceptable rate of return.

An activity which would be commercially viable in the absence of inefficient practices would not be eligible for CSO funding unless such inefficiencies are being imposed upon the CBU by way of an explicit Government directive.

CSOs also need to be differentiated from non-commercial activities which are typically a cost of being in business or activities that a commercial firm might ordinarily undertake to promote good business. These types of activities would need to be funded from operating revenues.

4.6.5 Clear policy objective

The activity must be performed to satisfy a clearly defined policy objective. This ensures only activities which the Government sees as a priority would be undertaken.

Ideally, the policy objective would be defined in a manner which allows for flexibility in the method by which the service is delivered so the most effective outcome is achieved at the most efficient cost.

4.6.6 Review of CSOs

Once formally established, CSOs should be comprehensively reviewed by the portfolio department at least every three years to ensure they continue to meet the Government's objectives and are delivered effectively.



4.7 Broad public sector costs

The financial performance of CBUs will be influenced by a number of operating conditions unique to the public sector for example, public service employment and industrial relations conditions. However, these are broad conditions applying across Government as a whole. They do not represent specific non-commercial directives imposed on CBUs and hence, do not fall within the CSO category. Nevertheless, such costs may warrant special attention outside of any CSO arrangements.

Viewed in isolation these factors might be seen as constraints on performance. However, at the same time, Government ownership of CBUs brings certain advantages which would prove in practice difficult to fully remove for example, the shield of the Crown.

Accordingly, any public sector constraints would need to be considered in the context of any inherent advantages enjoyed by the CBU. The obvious difficulty involved with accurately measuring these effects suggests the best way to account for them is through agreed adjustments to target rates of return. It is anticipated that such adjustments would be the exception rather than the rule and any resulting concessional arrangements would be phased out over time.



Attachment 1: Financial performance measures

Some of the more common financial statement ratios are suggested below. Other targets specific to business units and reflecting the nature of their business are to be agreed between business units and the portfolio Minister.

Performance indicator	Calculation
EBIT (earnings before interest and taxation)	Net profit before tax + interest expense – interest income
NPAT (net profit after tax)	Net profit – tax
Net assets	Current assets – current liabilities – future income tax benefits + non current assets (excludes interest bearing working capital items (e.g. cash) and funding items (e.g. dividends and tax payable))
Return on net assets	EBIT / (average of opening and closing net assets) <i>expressed as a %</i>
Sales growth	(Budget year sales – last year sales) / last year sales <i>expressed as a %</i>
Net profit before tax per dollar of sales revenue	Net profit before tax / sales <i>expressed as a %</i>
Gross profit as a % of sales	Gross profit / sales <i>expressed as a %</i>
Gearing level	Net debt / (net debt + net equity) <i>expressed as a %</i>
Current ratio	Current assets / current liabilities <i>expressed as a ratio of 1</i>
Debtor days outstanding	(Closing trade debtors * 365 days) / total sales
Return on assets	EBIT / total assets
Return on equity	Net profit after tax / equity
Debt: equity	Interest bearing liabilities / equity
Interest coverage	EBIT / net interest expense



Glossary

Capital structure – the mix of debt and equity used to finance a business.

Commercialisation – the process by which a department charges for the goods or services it produces, and adopts other features of the commercial environment including adopting the principles of competitive neutrality, clear and non-conflicting objectives, an appropriate degree of management responsibility, authority and autonomy, and accountability for performance.

Commercialised business unit (CBU) – a business unit operating within a departmental framework that applies the concept of commercialisation to the provision of its services by ensuring competitive neutrality, clear and non-conflicting objectives, management responsibility, authority and autonomy, and accountability for performance.

Community service obligations are non-commercial activities which CBUs are directed by the Government to undertake to meet a clear policy objective. They are activities which would not be undertaken for commercial purposes.

Competitive neutrality – the process of identifying and, where appropriate, removing competitive advantages so that Government businesses are competing on equal terms with their competitors.

Competitive neutrality adjustments – amounts paid by a CBU to the Government to offset an advantage the CBU has over the private sector by virtue of its Government ownership. Competitive neutrality adjustments are included in the cost benchmark under full cost pricing.

Corporatisation – changes the conditions and the structure under which the Government owned business activities are carried out so they are acquired and carried out by separate legal entities and, as far as practicable, on a commercial basis and in a competitive environment. Corporatisation is a similar but more extensive process of reform than commercialisation.

Consolidated Fund – the whole-of-Government operating fund into which administered funds are paid, and from which the cost of the activities of Government are paid as appropriated by Parliament.

Dividends – the amount of an entity's profit to be distributed to the owners of the entity.

Debt/equity swaps – refinancing deals in which a debt holder agrees to cancel an amount of debt in exchange for an amount of equity.

Debt to equity ratio – measure of an entity's financial leverage (the extent to which an entity is financed by borrowed money). It is calculated by dividing an entity's total liabilities by stockholders' equity.

Debt guarantee fees – amounts equivalent to the benefit which accrues to a CBU (as compared to a private sector firm) due to the lower cost of borrowing that a CBU may access by virtue of its Government ownership.

Enterprise bargaining – the process of employers and employees negotiating the terms and conditions for their workplace which results in an enterprise agreement.

Fixed cost – cost that does not vary with production or level of sales for example, rent, property tax, insurance or interest expenses.



Full cost pricing – the cost benchmark set out in the Treasury document Full Cost Pricing Policy. The cost benchmark includes operating costs, non-current assets used, tax and tax equivalents, costs of debt financing and competitive neutrality adjustments.

National Tax Equivalents Regime (NTER) – an administrative arrangement between the Commonwealth and the states under which Commonwealth income tax laws are applied to certain government bodies, namely Government owned corporations and commercialised business units. The NTER is administered by the Australian Taxation Office which charges the Queensland Government on a fee-for-service basis. The primary objective of the NTER is to promote competitive neutrality, through a uniform application of income tax laws, between NTER entities and their privately held counterparts.

Outsourcing – a contracting arrangement where the Government contracts with an external service provider for the provision of services (that might otherwise be performed by Government employees) specified and paid for by the Government.

Performance measures – quantifiable units of measurement used to determine and assess the delivery of outputs. They establish how performance will be judged for each output by translating it into a measured value of quantity, quality, cost, timeliness and, where appropriate, location.

Rate of Return – a measure of the profitability of an enterprise relative to the assets used in earning that profit.

Revenue retention – an arrangement between a department and Treasury where the department retains all or part of the revenue it receives from the delivery of a service

Tax equivalent payments – payments made by the CBU to the Consolidated Fund as the value of benefits derived by the CBU because it is not liable to pay Commonwealth, State or local government tax that would be payable by it if it were not a Government entity.

User charging - the charge applied to goods or services supplied by a department. The **Financial and Performance Management Standard 2009** sets out user charging requirements for departments.

Variable cost - a cost that changes according to the volume of production for example, costs of labour, material or overheads.

