Full Cost Pricing

A QUICK REFERENCE GUIDE FOR ELECTED OFFICIALS AND STAFF

AUDAX AT FIDELIS

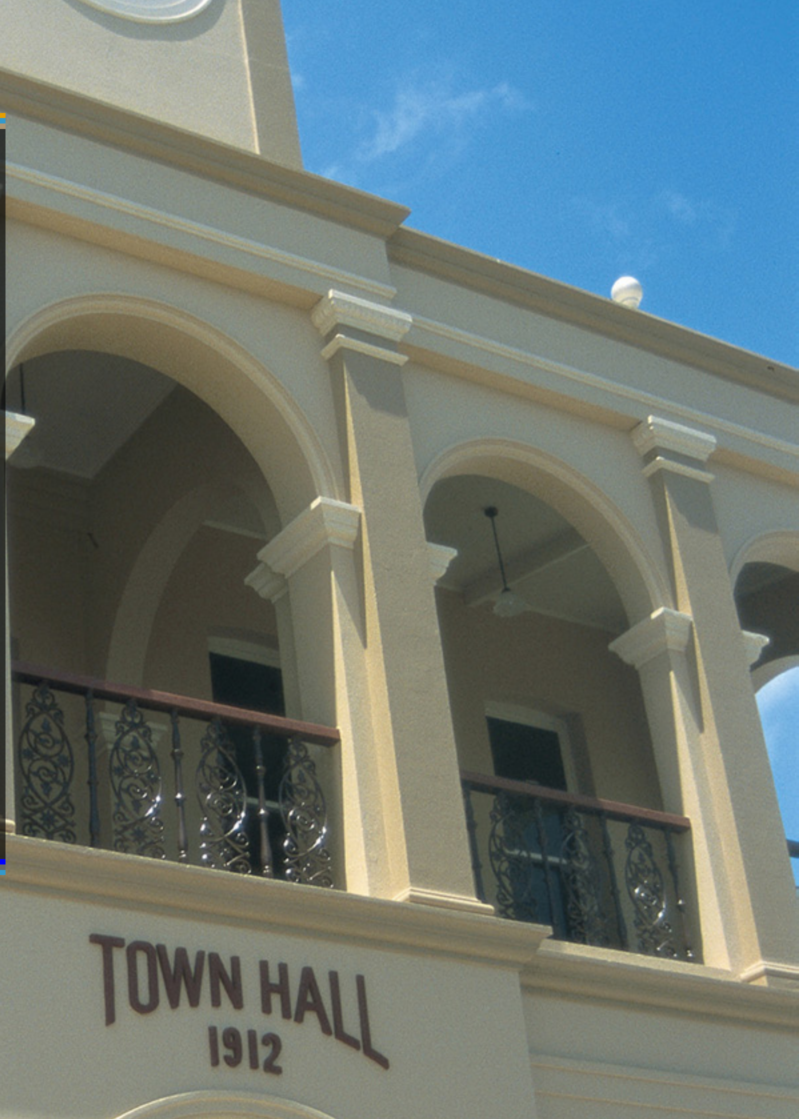
QUEENSLAND TREASURY CORPORATION

This booklet is a quick reference guide to help you to:

- understand what full cost pricing is
- understand the importance of full cost recovery to local governments
- consider the implications on your council's ability to deliver services sustainably if costs are under-recovered, and
- understand the many considerations when adopting a full cost recovery approach.

Local governments, as custodians of community assets, manage portfolios of social and commercial activities. The spectrum of activity may extend to airports, childcare centres, art galleries, waste collection, water and sewerage services, property development and social housing.

This booklet focuses on commercial businesses. It will explore the concept of full cost pricing in a local government context, and the importance of understanding the full cost of service delivery.



Service delivery and your local government

Local governments are responsible for providing a range of services to the community, some of which are, in other states or countries, successfully provided by the private sector. For example, water and sewerage, waste collection and airports are utilities that are often run as profitable commercial operations.

These services bear similar characteristics: they are capital-intensive, have a significant fixed cost component and incur variable costs determined by usage of the service.

Despite the importance of providing services sustainably, local government has often been reluctant to pass on the full cost of services that are considered critical to the community.

As a result, local governments often limit price increases to the Consumer Price Index (CPI) even though input costs, such as electricity, materials and staffing, may have increased at a much greater rate.

The difference between the full cost of providing a service and the revenue raised is often subsidised by other council revenue such as rates. Over time, under-recovery by these businesses can result in an erosion of community equity through recurring operating deficits.

To support financial sustainability, a local government is encouraged to understand the full cost of its services so it can:

- engage in an informed dialogue with its community about the cost versus quality of service delivery
- provide services at a cost the community is willing and able to bear
- consider the pricing of utility charges in the context of promoting regional growth, and
- make decisions in the best interest of the community.

CONSIDER

A local government is facing a $50 million outlay to build new water network capacity due to growth in the region. If the council understands the full cost of delivering water, it will be able to more effectively discuss the issues and options with its ratepayers—for example, whether to build new infrastructure (higher cost, maintaining level of service), or consume less water thereby deferring development for several years (lower cost, lower level of service).

Role of full cost pricing in local government

In April 1995, the Commonwealth, State and Territory Governments agreed to implement nation-wide reform with the National Competition Policy (NCP). The NCP included the Competition Principles Agreement (CPA), a series of measures to promote more effective competition across the economy.

A component of the CPA is competitive neutrality, which aims to promote effective competition between government and private sector service providers operating in the same market. Full cost pricing is expected to apply to all government monopoly services. Where council services aren't operating in competitive markets, it is necessary to approximate a competitive price. The intention of this process is to:

- avoid price gouging by monopoly providers
- encourage full cost recovery, in turn promoting financial sustainability, and
- send price signals to the market of the true cost of delivering services, which is expected to result in economically efficient outcomes.

The ***Queensland Competition Authority (QCA) Act 1997*** placed the QCA in charge of implementing and monitoring the NCP in Queensland. For the vast majority of local governments, QCA's role is limited to providing leadership and guidance with respect to full cost pricing principles.

In 2000, the Department of Local Government and Planning (DLGP) issued ***Full Cost Pricing in Queensland Local Government - A Practical Guide*** to assist local governments with the practical application of full cost pricing.

In more recent years, the Local Government Act (2009) has set out how local governments can identify business activities that should consider adopting full cost pricing.

Understanding how full cost pricing works

Full cost pricing requires that revenue generated meets the full cost of providing the service, not just the day-to-day operating cost. This required revenue level is referred to as the maximum allowable revenue (MAR).

Recovering the MAR ensures the service can be delivered sustainably. Over time, the actual revenue collected should approximate the MAR. It is also important that revenue should not significantly exceed the MAR, as over-recovering from users could be construed as price-gouging behaviour.

The key components which contribute to MAR are:

- return on assets
- depreciation
- operating expenses, and
- tax equivalents.

Return on assets

Local governments should ensure that their assets earn a return that justifies the community's investment.

The return reflects both the debt (borrowing) and equity costs of building and maintaining the asset. The equity costs reflect the risk borne by the community in owning and operating a commercial business.

Depreciation

The reduction in the value of an asset over time, particularly due to wear and tear, is captured through depreciation. The recovery of depreciation expense through revenue generated is important to ensure that the local government maintains its future financial sustainability.

Operating expenses

Local governments should seek to recover all reasonable costs associated with providing the service. These can include materials, contract services and employee costs—any expenses that can be considered prudent and efficient in providing the service *[see definitions on page 6]*.

Tax equivalents

Under the NCP, local government businesses are expected to operate on a competitively neutral basis. This means that council is considered to be a tax-paying entity, and therefore will need to ensure revenues are sufficient to meet a tax liability in the same manner a private enterprise would.

Miscellaneous revenues

To avoid double-counting, miscellaneous revenues such as interest earned on cash holdings should be deducted from the revenues council recovers from users.

Pricing considerations for council services

The full cost of providing a service may be allocated among users of the service based on a range of considerations. Exactly how this is done is a decision for the local government. It is not uncommon for a different methodology to be used for each business.

Pricing considerations for a water business

The QCA recommends water businesses adopt a two-part tariff structure: a fixed connection charge and a variable usage charge. There are no set rules governing the proportion of each part. However, a common starting point for setting prices is to analyse fixed and variable cost elements of the business, and recover fixed costs through the connection charge and variable costs through the usage charge.

Another consideration is whether different users are being provided with different levels of service. For example, the size of the connection is a common method for pricing differentially among the user base; a user with a 100mm connection benefits more from access to the network than one with a 25mm connection.

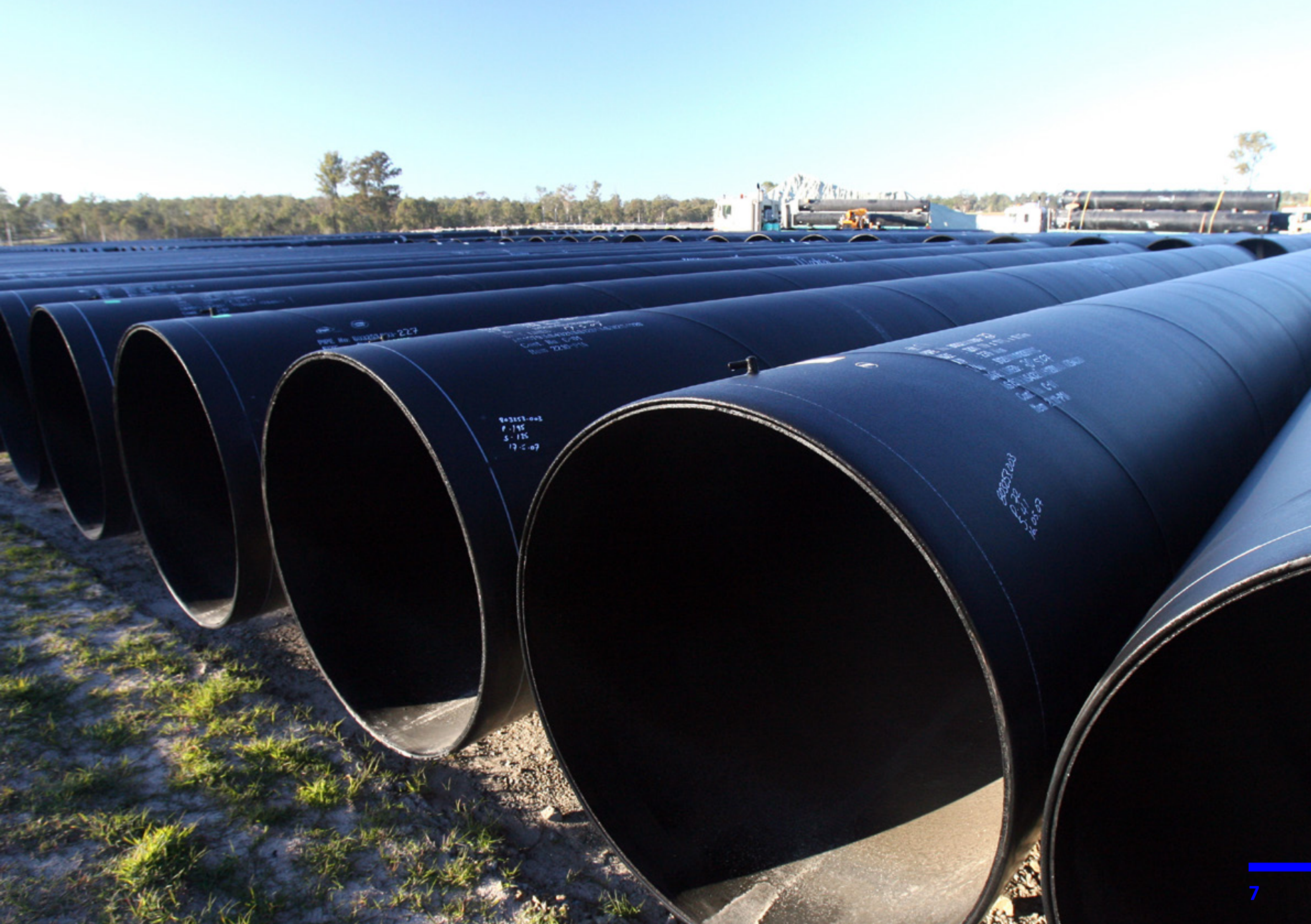
Likewise, particular regions in a local government area may have stand-alone networks with differences in cost. Local governments can maintain separate pricing structures reflecting the different costs of providing the service for each region, or develop uniform pricing across their entire local government area.

Pricing considerations for a waste business

Waste businesses can be operationally complex, making pricing decisions correspondingly complicated.

Firstly, a waste business will generally provide a larger number of services than a water business, and each service lends itself to a different way of apportioning costs. For example, landfill usage may best be gauged by volume of waste processed, while for a materials recovery facility the number of transactions may be a more accurate measure. This complexity makes apportioning costs difficult.

Secondly, prices are often used to influence behaviours that will have a long-term benefit to the community. An example is a local government with two landfills, one nearing the end of its useful life, and that has no alternative sites available. Differential pricing between the two landfills could extend the useful life of the older site.



Ensuring prices are fair

The QCA's Statement of Regulatory Pricing Principles (August 2013) discusses at length how pricing practices should consider fairness. The paper also acknowledges that, despite the importance of the concept, an objective definition of fairness is still lacking.

Some local governments approach pricing on the principle of 'last year plus three per cent', even when the rationale for the original price is no longer relevant. This method can be difficult to justify to ratepayers as being fair, and does not consider the needs of the business.

The following considerations may help local governments assess whether their approach to setting prices could be considered fair.

Users pay for what they use

A local government may decide that users should pay for what they use, so that one group of users does not subsidise another. For example, if commercial businesses are using 30 per cent of the water network, then they can expect to pay 30 per cent of the network's running costs.

Council understands the implications of subsidising a service

The whole community subsidises a service whenever total revenue collected from users does not meet the cost of providing the service. This shortfall has to be made up through general rates, fees and charges or by reducing community equity. There are reasons why local governments may set prices below full cost recovery. However, this decision should be made with an understanding of what the full cost is and the impact subsidisation will have on council, the community and financial sustainability.

While there are valid reasons a local government may choose to subsidise the cost of a service, subsidisation does dilute users' appreciation of the cost of the service. This could encourage inefficient use of the service.

Similar services are offered at the same price

While different users expect to pay the same price if they are receiving the same service, there may be exceptions. For example, the cost of providing a given service may differ from region to region within the same local government area, or in some cases, socio-economic or 'ability to pay' considerations may outweigh other factors.

Price setting is understood by the community

The methodology underpinning prices should be transparent, auditable and replicable.

Costs should be prudent and efficient

Annotated QCA definitions of prudent and efficient costs appear below.

- Capital expenditure is prudent if "it is required as a result of a legal obligation, growth in demand, renewal of existing infrastructure."
- Operating expenditure is prudent if "it is required to meet … the forecast required supply or … its nominated standard of service"
- Capital expenditure is efficient if "the scope is the best means of achieving the desired outcomes after having regard to the options available…"
- Operating expenditure is efficient if "it is undertaken in a least-cost manner over the life of the relevant assets…"

Major challenges for councils

Robust forecasting

Determining appropriate pricing requires a detailed understanding of all the costs of delivering a service, now and into the future. This involves having the data and processes in place to forecast operating costs, asset values and capital expenditure, as well as demand and available supply. Missing or incomplete data can undermine the accuracy of these forecasts. Forecasts should be updated regularly as better information becomes available.

Consistency with asset management plans

A key element of a robust financial forecast is to ensure its consistency with council's asset management plans. If asset management and renewal is not fully understood, this could result in large unexpected costs that are not catered for in the pricing.

Historical under-recovery

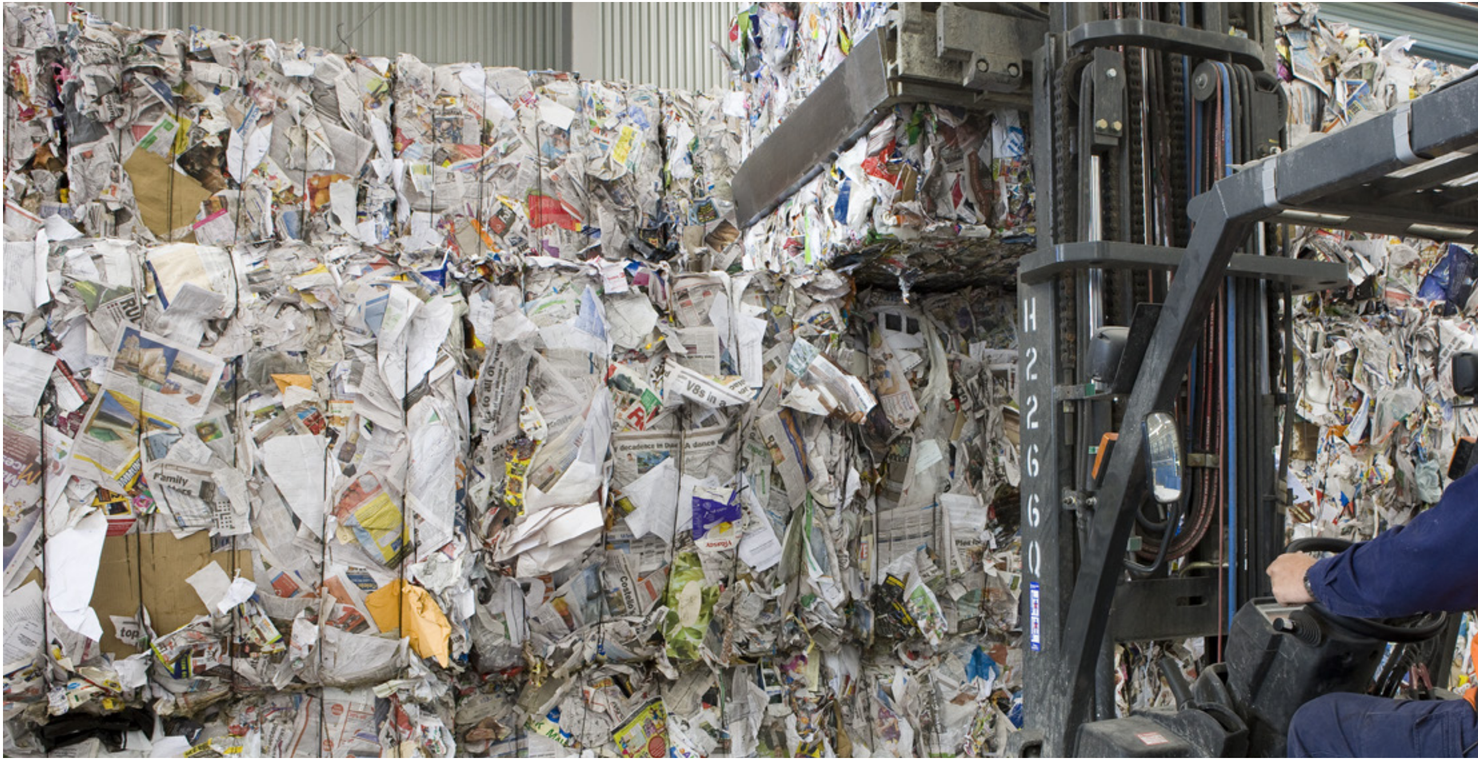
For local governments that have historically under-recovered their costs, an immediate move to full cost pricing may be too great an impost for the community. This may require council to develop a longer, more gradual increase to achieve full cost price levels. This is referred to as 'price pathing'.

Equitable price-setting for the community

It is in a local government's best interests to inform the community of the cost of providing services and how the costs will be recouped. This should be undertaken in a transparent manner. An example is where a local government provides the same service (eg, water) to different regions and incurs different costs. Regardless of whether a council decides it is more equitable to charge one price across the entire local government area or recover costs individually for each region, both the council and the community should understand the financial implications.

Service level changes

A local government may choose to inform the community of the costs of providing a service of differing levels of quality. This would empower the community to make an informed decision about the level of service it is willing to pay for.



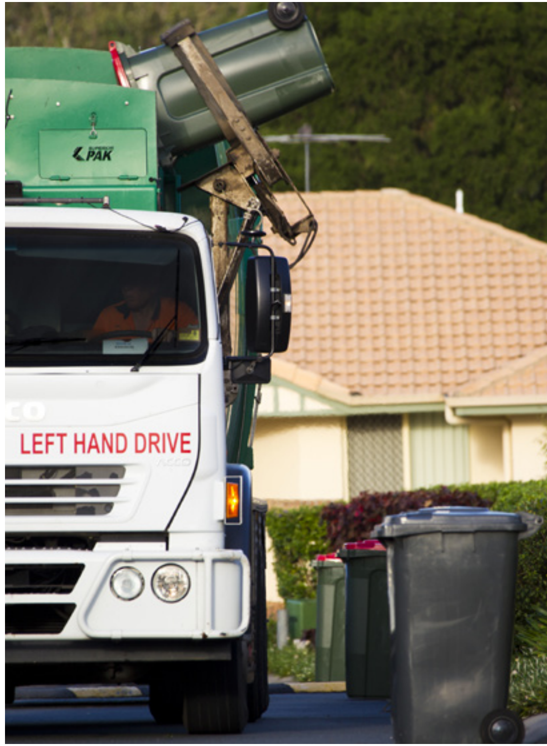
Local government's discretion in pricing

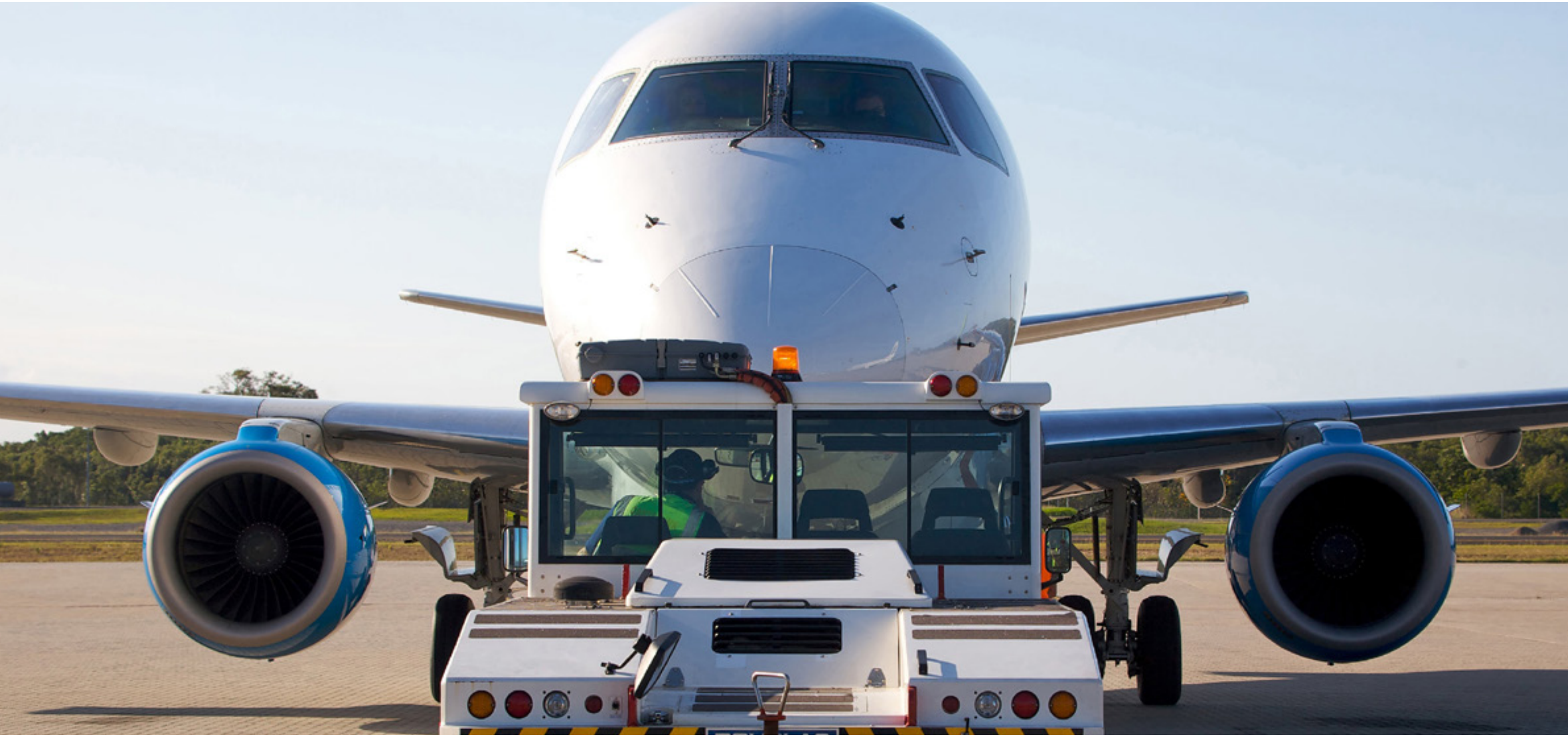
At the end of the day, local governments have significant discretion over pricing. This flexibility is important, as recovering the full cost of providing a service may not always be possible. For example, there may be a need to phase in full cost pricing over a period of time. The important issue is that a local government understands the full cost of providing a service so as to be able to make informed decisions about how costs are to be recouped.

Price can also be an effective tool to influence behaviours that are in the best interests of the community. For example, if water conservation is a priority, the connection charge can be lowered and the usage charge increased to discourage heavy users of the network. Or the life of a landfill site could be prolonged by increasing the price of general refuse loads while decreasing the price of green waste loads.

Regardless of the circumstances, it is vital that local governments understand the full cost of service delivery so that they can make a fully informed pricing decision that considers:

- the impact on the community's capacity to pay
- the impact on the council's finances and long-term sustainability
- whether prices are fair and equitable to users, and
- whether prices are consistent with the level of service expected by the community.





A way forward

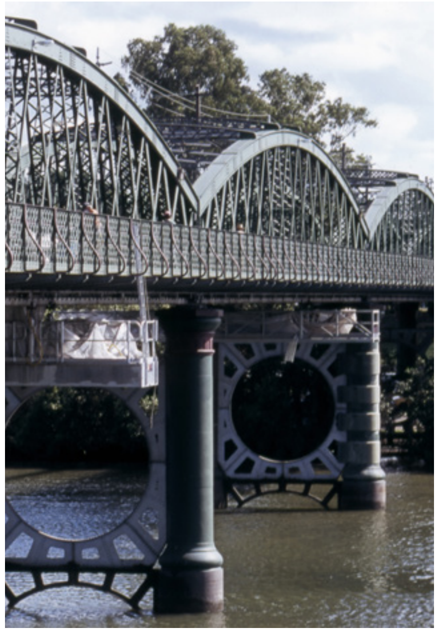
For many local governments, full cost pricing for services may represent a significant deviation from current policy. It may require a shift in thinking about service delivery and how the costs of maintaining long-life infrastructure assets are shared fairly and equitably among the community.

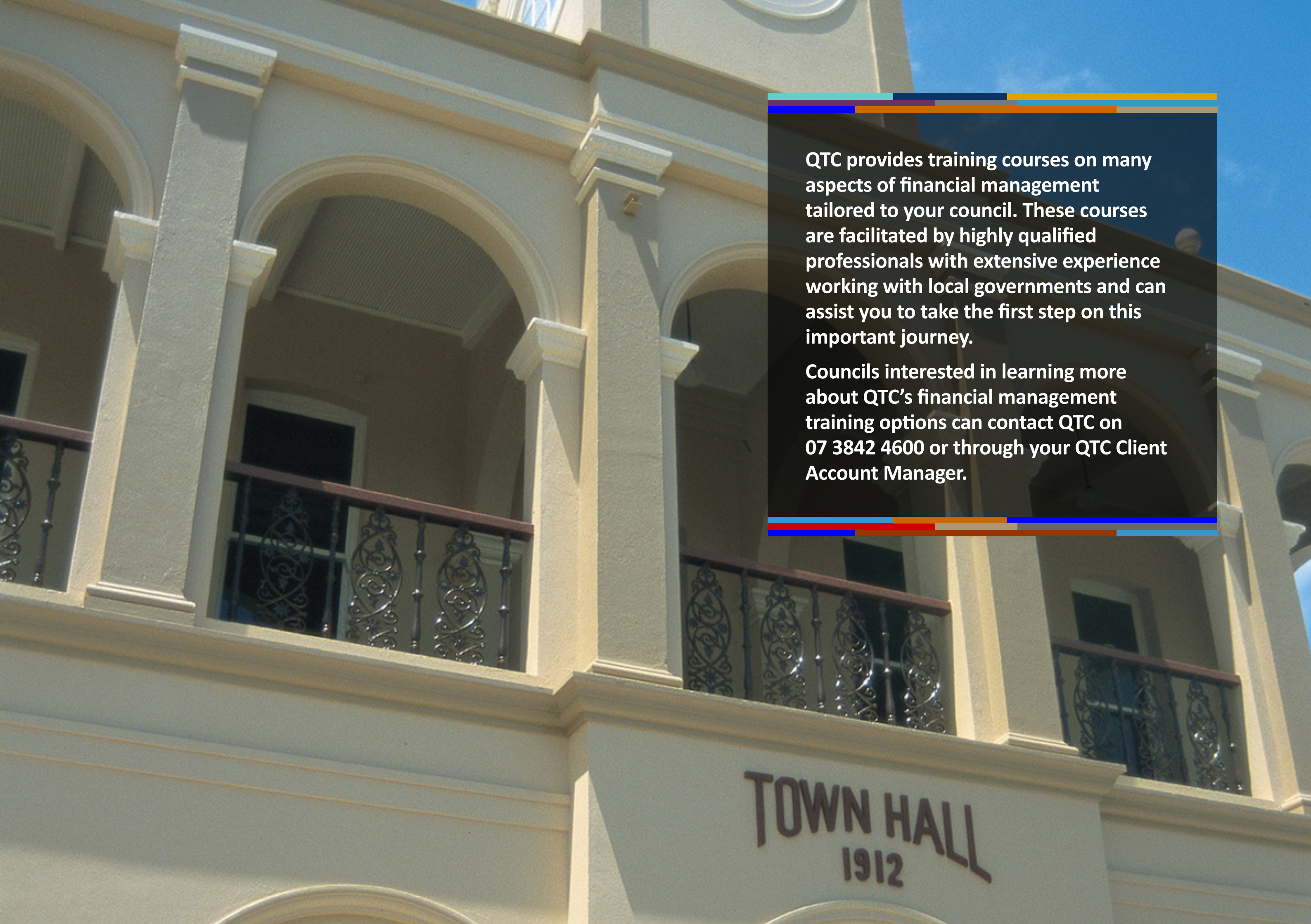
Given the capital-intensive, and in some cases operating cost-intensive, nature of many local government services, understanding full cost pricing is vital to ensure services are financially sustainable.

QTC recommends that local governments develop a roadmap to facilitate the process of understanding the full cost of the services they deliver and implementing full cost pricing where it is considered appropriate.

Following such a road map would:

- ensure asset management and finance staff work together to harmonise forecasts relating to asset maintenance and capital expenditure
- develop a view of the full cost of delivering services, supported by robust financial forecasting tools and processes
- assess options for how costs can be equitably apportioned across user groups
- formally adopt a plan to transition to full cost prices over a defined period, and
- periodically test service levels and prices with the community to ensure alignment with expectations.





QTC provides training courses on many aspects of financial management tailored to your council. These courses are facilitated by highly qualified professionals with extensive experience working with local governments and can assist you to take the first step on this important journey.

Councils interested in learning more about QTC's financial management training options can contact QTC on 07 3842 4600 or through your QTC Client Account Manager.

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