COMPETITIVE NEUTRALITY COMPLAINT AGAINST THE FLEURIEU REGIONAL AQUATIC CENTRE AUTHORITY AS OWNER AND OPERATOR OF THE FLEURIEU REGIONAL AQUATIC CENTRE

under the Government Business Enterprises (Competition) Act 1996

REPORT SUMMARY

being a summary of the contents of the report on the outcomes of the Competition Commissioner's investigation

24 FEBRUARY 2020
COMPETITIVE NEUTRALITY COMPLAINT AGAINST THE FLEURIEU REGIONAL ACQUATIC CENTRE AUTHORITY IN RESPECT OF THE OPERATIONS OF THE FLEURIEU REIONAL ACQUATIC CENTRE

On 9 September 2019, pursuant to Section 12 of the Government Business Enterprises (Competition) Act 1996 (the GBE Act) the Premier requested that I, in my capacity as Competition Commissioner, carry out an investigation of the competitive neutrality complaint concerning services provided by the Fleurieu Regional Aquatic Centre Authority (FRACA) (Attachment 1). To assist in my investigation the Premier provided a report on the matter prepared by the Essential Services Commission of South Australia (ESCOSA) at the request of the Treasurer (Attachment 2). For the record, I declare that I excluded myself from all discussions concerning the review of the complaint by ESCOSA and the preparation of the report to the Treasurer.

This report sets out my determination as to whether the grounds of the complaint have been substantiated in accordance with and for the purposes of the GBE Act, and also provides my reasons for making that determination.

In reaching my determination and preparing my report, I have had regard to all of the materials provided to me by the Department of Premier and Cabinet, the Essential Services Commission, the complainants and the respondent (including but not limited to correspondence received from the respondent’s solicitors). In doing so, I have given consideration to and acknowledge all of the evidence, arguments and submissions relevant to this competitive neutrality complaint, and have given appropriate weight to those matters in the context of the principles and requirements set out in the GBE Act. While I have not adopted all positions or arguments put or raised in that material, and have not directly referenced in my report all of the material before me, the material has assisted me in considering each of the relevant issues under consideration and in understanding the competing viewpoints held.

Where appropriate, I have, either by direct quotation or by reference to themes or arguments, mentioned certain evidence, arguments and submissions to explain the positions that I have reached. However, the fact that certain evidence, argument or submission has not been referenced in this report does not mean that I have not taken that argument or submission into account in my deliberations.

Summary of the Complaint

The FRACA is a corporatised entity, jointly owned by the City of Victor Harbor and Alexandrina Council established under section 43 of the Local Government Act 1999, and is a local government agency for the purposes of the GBE Act. As a corporatised entity, it has its own Board and publishes an annual report and annual financial accounts. The FRACA is obliged by its Charter to undertake a competitive neutrality assessment of its significant business activities each year.

The sole purpose of the FRACA is to operate the Fleurieu Regional Acquatic Centre (FRAC). The FRAC opened in March 2017 and comprises three swimming pools, a fitness centre/gym, a café and a shop. It was built on a
Greenfield site, at a cost of $21 million, partly funded by grants from the Commonwealth and State Governments (totalling $8 million). YMCA SA are the operational managers of the FRAC.

The FRACA Board has conducted two competitive neutrality reviews of its activities: the first in July 2017 and the second in November 2018. The FRACA Board engaged Wallmans lawyers (Wallmans) to assist in carrying out these reviews.

The complaint relates to the provision of membership packages by the FRACA that bundle gym services with other services, particularly recreational pool access, allegedly at non-commercial terms. Specifically, it is alleged that such bundled memberships are being offered at prices below which private sector gym operators can provide gym-only facilities and, as a consequence, infringe the competitive neutrality principles as they apply to publicly owned and operated facilities.

Findings of the Review by ESCOSA

In summary, ESCOSA’s advice is that while the FRACA has sought to apply the relevant competitive neutrality principles and guidance, the FRACA has not applied the competitive neutrality principles and guidelines in a manner that ensures consistency with the economic intent of the competitive neutrality principles.

ESCOSA noted that the actual ‘list’ price of the bundled product provided by the FRACA is lower than its estimate of the private sector-equivalent cost reflective price. Additionally, for majority of customers, further substantial and persistent discounts are available. While the competitive neutrality principles (and supporting guidelines) acknowledge that a local government authority may, in the short term, adopt loss-leading pricing behavior the guidelines also acknowledge that this cannot be sustained and, over the medium term to longer term, pricing should be cost-reflective on a private sector-equivalent basis, unless the costs of applying cost-reflective pricing outweigh the benefits.

In this regard, ESCOSA further noted that the FRACA has adopted a loss-leading pricing strategy for over two years (supported by substantial financial contributions from the Councils), based upon the FRACA’s assessment that the costs of applying cost-reflective pricing outweigh the benefits. ESCOSA considered that the FRACA’s cost-benefit assessment is overly narrow focused primarily on the business interests of the FRACA and does not suitably address the socio-economic context, the impact on the private sector operators and the efficiency objectives underpinning the competitive neutrality principles.

ESCOSA concluded that it is arguable that the FRACA is infringing the competitive neutrality principles and the FRACA could undertake the following actions to prevent that infringement:

- Provide separate gym-only and bundled gym services/recreational pool access products.
- Develop and implement a cost reflective price that accurately reflects the private sector-equivalent cost of providing a gym-only service.
- Ensure the price charged for a bundled gym services/recreational pool reflects the costs associated with providing the recreational pool access service as part of a bundled product competing with private sector operators.
ESCOSA noted an alternative remedy would be for all members of gyms in the Victor Harbor region to have access to recreational swimming on the same terms as FRAC members, net of any transaction costs involved. (In 2017, the complainants sought equal access to the FRAC pool for all gyms in the area on this basis, an approach rejected by the FRACA at the time on the grounds the proposal was not considered attractive for the FRAC.)

Finally, ECSOSA was of the view that if remedial actions were considered appropriate they be given immediate effect.

Responses to the ESCOSA Report

I provided a copy of the full report prepared by ESCOSA to the parties for comment.

The complainants indicated that they agree entirely with the findings of the report. While they believe the recommendations go some way towards resolving this issue they do not believe allowing the FRACA Gym the exclusive right to bundle the Pool allows fair competition. The complainants also noted that the wages paid by the FRACA to fitness staff are not commercially viable and cannot be matched by local facilities. They further indicated that one of the options for resolution of the issue would be to close the gym and return the space to its original intended use as a community space. The complainants also believed that the behaviour of the FRACA and Councils in this instance warrant compensation and penalties. I note that the Act and associated competition neutrality principles and guidelines do not provide any basis for the Competition Commissioner to award compensation or apply penalties.

The Chairperson of the FRACA provided a comprehensive response (Attachment 3) setting out the manner in which the FRACA has complied with the competitive neutrality principles and pointing to what the FRACA believes are misunderstandings of fact and misapplication of the principles of competitive neutrality contained in the ESCOSA report. The FRACA rejected each of the remedial actions proposed in the ESCOSA report because the FRACA argues none of the proposed remedial actions are required to give effect to the principles of competitive neutrality.

The FRACA outlined further work that it has commissioned on detailed cost attribution and has recently confirmed that the FRACA Board have not specifically considered a future fees and charges schedule at the moment but will as part of its 2020-21 budget deliberations.

Competition Commissioner Findings

The FRACA accepts the gym services it provides constitute a Category 2 significant business activity. Consistent with its obligations under the competitive neutrality framework it has undertaken annual competitive neutrality reviews. The establishment of the FRAC as a separate corporatised entity was also consistent with the competition neutrality principles.

ESCOSA identified a number of areas where the cost allocation methodology used in the 2017 and 2018 reviews was inadequate. For example, the use of revenue proportions as a cost driver for indirect costs and the failure to apply a comprehensive private sector-equivalence framework (see section 4.3.2 of the ESCOSA report). The FRACA
has since commissioned the creation of a cost allocation model which utilises costs on a per activity basis and indicated that future competitive neutrality reviews will also apply a notional rate of return. The notional rate of return mentioned appears low (compared to private sector equivalents) and further adjustments will be required for the exemption from income tax, access to cheaper financing and access to capital funds which benefit the FRAC compared to private sector-equivalent operators. Even before adjusting for these methodological issues, Table 4.3 in the ESCOSA report highlights that prices for the bundled product offered by the FRAC have been below the costs that Wallmans estimate a private sector gym only operator would have faced - with the additional range of discounts available to the vast majority of members further exacerbating the situation.

The FRACA have noted that the competitive neutrality principles (and supporting guidelines) acknowledge that a local government authority may, in the short term, adopt such loss-leading pricing behaviour and, in the absence of specific guidance on timelines in the South Australian guidelines, refer to the Victorian guidelines which specify a period of three to five years. The FRAC is coming up to its third anniversary and I recommend that the move to pricing reflective of full private sector-equivalence cost should not be delayed any longer.

The FRACA has taken particular issue with ESCOSA recommendations that the FRACA:

- Provide separate gym services-only and bundled gym services/recreational pool access products.
- Ensure the price charged for a bundled service accurately reflects the costs associated with providing the recreational pool access service as part of a bundled product competing with private sector operators.

The ESCOSA recommendations are directed at ensuring that access to the recreational pool service is not used as an unfair competitive advantage to induce gym customers to join the FRAC compared to other gyms in the Victor Harbor region. Whether this is the case or not is in large part a matter of whether the bundled price is fully reflective of the cost providing the full range of services on offer.

The FRACA is correct in noting that certain services may be provided as a community service obligation and not priced to recover full private sector-equivalent costs. The two Councils and the broader community in the Victor Harbor region may continue to decide that access to recreational pool services should not be subject to full cost recovery.

The ESCOSA proposals would allow access to recreational pool services to continue to be priced to consumers at below full cost recovery levels without providing an unfair competitive advantage to FRAC in the gym services market in the Victor Harbor region.

The FRACA alluded to potentially prohibitive capital costs to construct physical barriers between the pool and gym areas to ensure enforcement of gym services-only or aquatic-only memberships. While no supporting material was provided to back the claim, the need for physical barriers would seem an excessive response compared random checks of members entitlements and the fact that many regular members would be known to staff who would be familiar with their membership status.
In response to my draft report (which, as required under section 19(4) of the GBE Act, set out recommendations for the implementation of policies or practices to avoid further infringement of competitive neutrality principles), Mr Matt Grant, Chairperson of the Fleurieu Regional Aquatic Centre Authority, argued that the recommendation to provide separate gym-only and pool-only products was not directed to correcting an infringement of the principles of competitive neutrality and therefore that the recommendation is outside the scope of an investigation under the GBE Act. Mr Grant also argued that it would be contrary to the competitive process to require businesses to only provide services on a like-for-like basis with other competitors in a market and that any type of understanding between competitors to limit service offerings on this basis is likely to contravene the *Competition and Consumer Act 2010 (Cth).*

My recommendation in relation to cost-reflective pricing does not in any way limit the range of goods or services offered by the FRACA and nor is it intended by require a like-for-like “matching” of the range, nature or scope of the goods or services offered by competitors in the market (including the FRACA). Rather, consistent with the purpose of the principles of competitive neutrality and my finding that the relevant goods and services offered by the Council are significant business activities, the recommendation is intended to neutralise any net competitive advantage that the FRACA would have, by virtue of its control by the Council (a local government body), over private business operating in the same market.

The FRACA and the respective Councils have taken many actions to address their obligations under the competitive neutrality framework but further changes are necessary to deliver a comprehensive response to addressing the competitive neutrality issues that have been identified by the complainants and examined in detail in the ESCOSA report.

For the purposes of section 19(4) of the GBE Act, I recommend that the Council implement policies or practices to avoid further infringement of the same kind including (without limitation):

- separate gym-only, recreational pool only and bundled gym services/recreational pool access products
- a cost reflective price that accurately reflects the private sector-equivalent cost of providing a gym-only service, and
- ensure the price charged for a bundled gym services/recreational pool access product accurately prices for the separate gym-only and recreational pool only products net of any transaction cost savings identified for bundled memberships.

If these recommendations are implemented, members of other gyms in the region and the broader community would be able to access recreational swimming facilities without having to incur the costs associated with the FRAC gym and the FRAC could not use the bundled gym services/recreational pool access product as an unfair inducement in the gym services market in the Victor Harbor region. I should stress that the recommendation that the FRACA develop a revised response is not directed at making the FRAC-activities uncompetitive with private sector offerings, but rather to ensure that the provision and pricing of non-gym services in bundled service
products is not used in a manner which has more than trivial or nominal impact on the operation of the gym market in the Victor Harbor region.

I recommend that the FRACA’s revised response be provided within three months of the public release of my final report by the Premier.

I also recommend generally that the guidance material contained in the ‘South Australian Government’s Competitive Neutrality Policy Statement’ and in the ‘Guide to the Implementation of Competitive Neutrality Policy’ be updated to provide further clarity on:

- the conduct of cost/benefit assessments,
- timeframes for the application of full cost reflective pricing and ceasing loss-leading pricing strategies, and
- acceptable pricing structures where bundled service products are being offered at less than full cost reflective prices.

Attachments

Attachment 1: Letter from the Premier to the Competition Commissioner requesting an investigation of a competitive neutrality complaint concerning services provided by the Fleurieu Regional Aquatic Centre Authority

Attachment 2: Competitive Neutrality Advice, Fleurieu Regional Aquatic Centre Authority, Final, June 2019, Essential Services Commission of South Australia

Attachment 3: Letter from the Chair of the Fleurieu Regional Aquatic Centre Authority, providing a response to the Competition Commissioner’s Draft Summary Report
Mr Brett Rowse  
Competition Commissioner  
c/o Essential Services Commission of South Australia  
GPO Box 2605  
ADELAIDE SA 5001

Dear Mr Rowse

Pursuant to Section 12 of the *Government Business Enterprises (Competition) Act 1996* (the Act) I am assigning you as Competition Commissioner to carry out an investigation of competitive neutrality complaints concerning services provided by the Fleurieu Regional Aquatic Centre Authority and the City of Port Lincoln.

To assist you in your investigation I enclose two very comprehensive reports prepared by the Essential Services Commission of South Australia at the request of the Treasurer. The reports contain confidential advice on the two complaints and should assist you with your investigation and subsequent reports:

- Competitive Neutrality Advice – Fleurieu Regional Aquatic Centre Authority (Attachment 1)
- Competitive Neutrality Advice – City of Port Lincoln (Attachment 2)

Pursuant to Section 13 of the Act, you are required initially to prepare a draft report for each of the complaints that sets out the key findings of your investigation, as well as the proposed pricing recommendation and the reasons underpinning that recommendation.

Once the entities under investigation and other interested parties have had a reasonable opportunity to comment on the draft reports, you are required to consider the comments received and make any amendments to the reports you consider appropriate. The final reports, as set in Section 14 of the Act, are subsequently issued to me in my capacity as the responsible Minister.

I look forward to receiving your reports by 30 October 2019.
Should you wish to discuss this assignment further, please contact Murray Arthur-Worsop in the Competitive Neutrality Secretariat on 8429 5104.

Yours sincerely,

Hon Steven Marshall MP
PREMIER OF SOUTH AUSTRALIA

☐ / ☐ / 2019

Attachments:
1. Competitive Neutrality Advice – Fleurieu Regional Aquatic Centre Authority
2. Competitive Neutrality Advice – City of Port Lincoln
Competitive Neutrality Advice – Fleurieu Regional Aquatic Centre Authority

FINAL

June 2019
Enquiries concerning this advice should be addressed to:

Essential Services Commission
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Adelaide  SA  5001

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Freecall:     1800 633 592 (SA and mobiles only)
E-mail:       escosa@escosa.sa.gov.au
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<td>Revised Clause 7 Statement on the Application of Competition Principles to Local Government under the Competition Principles Agreement (September 2002)</td>
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<td>FRACA</td>
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<td>Gym services</td>
<td>Health and fitness services via a gym product, provided either by the FRACA or private sector competitors as the context indicates</td>
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1 Overview

The Essential Services Commission (Commission) is a statutory authority established as an independent economic regulator and advisory body under the Essential Services Commission Act 2002 (ESC Act). The Department of the Premier and Cabinet (DPC) has referred to the Commission a competitive neutrality complaint concerning the Fleurieu Regional Aquatic Centre Authority (FRACA). Under the standing request for advice issued by the Treasurer (Appendix 1), the Commission has assessed that complaint and provides the following advice to the Treasurer for review and consideration.

The complainants allege that the FRACA’s membership packages, which bundle gym services with recreational pool access, are not cost-reflective because they are being offered at prices below which private sector gym operators can provide gym-only facilities. As a result, it is alleged the FRACA has infringed the competitive neutrality principles relating to publicly-owned and operated facilities.

The Commission accepts the FRACA’s assessment that its business activities in the gym services market in the Victor Harbor region represent a ‘significant business activity’ and are therefore subject to the application of competitive neutrality principles, and the associated guidelines that apply to local government authorities. This entails deriving a cost-reflective price for a ‘significant business activity’ that reflects private sector-equivalent costs, rather than the costs attributable under local government ownership. This is important as it aims to ensure efficient pricing (leading to an efficient allocation of the community’s resources), reflecting the overarching economic intent of competitive neutrality policy.

The FRACA has sought to apply the relevant competitive neutrality principles and guidance. The Commission’s advice is the FRACA has not applied the competitive neutrality principles and guidelines in a manner that ensures consistency with the economic intent of the competitive neutrality principles. This is for the following reasons:

- The products offered by the FRACA do not include a separate gym access only product. Only a bundled gym services/recreational pool access product is provided. As such, the product offering is not competing on a like-for-like basis with the main private sector providers of gym services in the local area, who do not have access to pool facilities.

- This provides the opportunity for the FRACA to leverage recreational pool access as an additional extra within the bundled product, unless the bundled product is priced on a private sector-equivalent basis.

- However, the FRACA has not done this, given the recreational pool access component of the bundled package, which is in direct competition with private sector gym-only service providers, is effectively priced at zero. This could not be sustained by private sector operators, as they would have to recoup the economic costs associated with providing pool access. As such, it conflicts with private sector equivalence principles operating under the competitive neutrality policy.

- Further, the actual ‘list’ price of the bundled product provided by the FRACA is lower than its estimate of the private sector-equivalent cost-reflective price, which already prices the recreational pool access component of the bundle at zero. Additionally, for the majority of customers purchasing the bundle, further substantial and persistent discounts are available.

The competitive neutrality principles (and supporting guidelines) acknowledge that a local government authority may, in the short term, adopt such loss-leading pricing behaviour. However, these guidelines also acknowledge that this cannot be sustained and, over the medium to long-term, pricing should be cost-reflective on a private sector-equivalent basis, unless the costs of applying cost-reflective pricing outweigh the benefits.
The FRACA can price below cost and absorb losses because its owners subsidise its day-to-day operations – it is able to utilise its other government resources in a way the private sector competitors cannot, thereby gaining a relative competitive advantage. The FRACA’s 2017-18 annual report indicates that $1.37 million or 45 percent of the FRACA’s income was provided by council contributions. The councils also obtained Commonwealth and State Government grants to assist in funding the construction of the FRAC. Of the $21 million cost, 38 percent was obtained via grants, with the remainder financed by the councils. The private sector gym operators in the Victor Harbor region are small-to-medium sized enterprises that do not have access to this level of upfront or ongoing financial support.

For the FRACA to continue with its existing pricing policy for the bundled product, the competitive neutrality legislation requires it to demonstrate this provides net benefits in the socio-economic context. This extends beyond the FRACA’s business aspirations for the FRAC, given the broad range of factors the legislation and guidelines consider relevant to the assessment.

The Commission notes that the FRACA has adopted a loss-leading pricing strategy for over two years (noting that it is getting substantial financial contributions from the Councils). This is based upon the FRACA’s assessment that the costs of adopting private sector-equivalent cost-reflective pricing outweigh the benefits. The Commission considers that the FRACA’s cost-benefit assessment in this regard is overly narrow relative to that anticipated by the economic intent of competitive neutrality principles and guidelines. This is because the FRACA’s focus is primarily on the business interests of the FRACA; it does not suitably address the socio-economic context, the impact on private sector operators and the efficiency objectives underpinning the competitive neutrality principles.

Based on the Commission’s consideration of the complaint, it has concluded that, to the extent outlined in this advice, it is arguable that the FRACA is infringing the competitive neutrality principles. Further, it advises that, on this basis, the FRACA could undertake the following actions to prevent that infringement:

- Provide separate gym-only and bundled gym services/recreational pool access products.
- Develop and implement a cost-reflective price that accurately reflects the private sector-equivalent cost of providing a gym-only service.
- Ensure the price charged for a bundled gym services/recreational pool access product accurately prices recreational pool access in accordance with private sector-equivalent costs.

An alternative remedy would be for all members of gyms in the Victor Harbor region to have access to recreational swimming on the same terms as FRAC members, net of any transaction costs involved. In 2017, the complainants sought equal access to the FRAC pool for all gyms in the area on this basis, an approach rejected by the FRACA at the time on the grounds the proposal was not considered attractive for the FRAC.

These proposed actions would each have the effect of achieving a consistent basis of competition across the two ownership sectors (local government and private sector), without interfering with those differences in size, assets, skills and organisational culture which are inherent in the competitive process. The Commission’s view is that this would be consistent with the requirements of the competitive neutrality policy and principles.

It is also the Commission’s view that, if such actions are considered appropriate, consideration should be given to applying them immediately. The FRACA has already in effect been operating with substantial loss-leaders for over two years and, in order to comply with competitive neutrality principles, it is reasonable to expect such activity to cease promptly.
2 Complaint

Summary

- In the complaint referred to the Commission for advice, the complainants allege:
  - The FRACA’s membership packages that bundle gym services with other services, particularly recreational pool access, are being offered at prices below which private sector gym operators can provide gym-only facilities.
  - The FRACA has infringed the principles of competitive neutrality applying to a publicly owned and operated facility.
- The Secretariat referred the complaint to the Commission for advice in February 2019, in accordance with the standing referral issued by the Treasurer under section 5(f) of the ESC Act.

In accordance with the standing referral from the Treasurer, the Commission’s role is to provide advice regarding those aspects of a complaint that specifically relate to an alleged infringement of the competitive neutrality principles. It is not to comment on any other allegations within a complaint or the process undertaken by DPC prior to the referral of the complaint to the Commission for advice.

In this context, this chapter outlines the nature of the complaint received and the referral of the complaint. The Commission’s advice in relation to the complaint is provided in chapter 4.

2.1 Summary of complaint

The complaint was originally made in February 2017. It relates to the provision of membership packages by the FRACA that bundle gym services with other services, particularly recreational pool access, allegedly at non-commercial terms. Specifically, it is alleged such (bundled) memberships are being offered at prices below which private sector gym operators can provide gym-only facilities and, as a result is, an infringement of the competitive neutrality principles as they apply to publicly owned and operated facilities.

The FRACA is a corporatised entity, jointly owned by the City of Victor Harbor and Alexandrina Council, established under section 43 of the Local Government Act 1999, and is a local government agency for the purposes of the GBE Act. As a corporatised entity, it has its own Board and publishes an annual report and annual financial accounts. The FRACA is obliged by its Charter to undertake a competitive neutrality assessment of its significant business activities each year.

The sole purpose of the FRACA is to operate the Fleurieu Regional Aquatic Centre (FRAC), which opened in March 2017. The FRAC is a new facility, comprising three swimming pools, a fitness centre/gym, a café and a shop. It was built on a greenfield site, at a cost of $21 million. The cost was partly funded by grants from the Commonwealth and State Governments (totalling $8.0 million), with the remainder funded equally by Alexandrina Council and the City of Victor Harbor. YMCA SA are the operational managers of the FRAC.

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4 FRACA, Annual Report 2017-18, p.3.
2.2 Request for the Commission’s advice

In accordance with the standing referral issued by the Treasurer under section 5(f) of ESC Act, the Secretariat has referred the complaint to the Commission for advice.

The Secretariat contacted the FRACA and the complainants (identified by the Secretariat as FIT Goolwa and Spa Clubs Fitness) on 8 February 2019, informing the parties that the Premier (as the Minister responsible for the GBE Act) was referring the complaint to the Commission for advice. The parties were also informed that the Commission would be in contact with parties regarding that process.

The Secretariat provided the Commission with a copy of the contents of its file regarding the complaint, as did the Small Business Commissioner, for the purposes of this advice. The substantive material with respect to the specifics of the competitive neutrality complaint is a redacted version of a report by Wallmans Lawyers entitled ‘Fleurieu Regional Aquatic Centre Authority – Competitive neutrality review – July 2017’. This was provided to the Secretariat on 11 September 2017.

2.3 The FRACA’s public response to the complaint

In its 2017-18 annual report, the FRACA states that it has determined ‘that it is not of net public benefit to apply cost-reflective prices for Fleurieu Aquatic Centre at this point in time’.

This response is based on the outcome of the FRACA’s Board’s competitive neutrality reviews. The FRACA Board engaged Wallmans Lawyers (Wallmans) to assist it carrying out annual competitive neutrality reviews of its significant business activities, as required by its Charter. Two reviews have been carried out to date, one in July 2017 and one in November 2018. The approach adopted for both reviews is consistent, with the July 2017 report forming the base of subsequent reviews. The FRACA has provided these documents to the Commission (either via the Secretariat or directly). The only redactions in the November 2018 review relate to the cost breakdown associated with the YMCA management contract.

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7 FRACA, Fleurieu Regional Aquatic Centre Authority Competitive Neutrality Review, Summary Overview, November 2018, p.1.
3  Context and Commission’s approach

Summary

- The legislative and policy context for the application of competitive neutrality principles by local government agencies is contained within the following documents:
  - Government Business Enterprises (Competition) Act 1996 (GBE Act)
  - Revised Clause 7 Statement on the Application of Competition Principles to Local Government under the Competition Principles Agreement (Clause 7 Statement)
  - South Australian Government’s Competitive Neutrality Policy Statement (Policy Statement), and

- The Commission does not have a procedural or substantive role in that legislative and policy context. Instead, it provides a separate advisory function, giving advice to the Treasurer (under section 5(f) of the ESC Act) in relation to competitive neutrality complaints received and then referred to the Commission by the Department of the Premier and Cabinet. This advisory function is undertaken within the parameters prescribed by the ESC Act and the standing referral of the Treasurer (refer Appendix 1).

- In advising on a competitive neutrality complaint, the Commission’s primary focus is whether or not a local government agency has applied the competitive neutrality principles in a manner that ensures consistency with the economic intent of the competitive neutrality policy – being to ensure the efficient allocation of resources within the relevant market and beyond, which is strongly related to efficient pricing. It does this through tracking how a local government authority has applied the Clause 7 Statement and the Implementation Guide and linking this back to the economic intent of the policy.

- The assessment of a local government agency’s approach to competitive neutrality relates not just to process, but also to the methodological approach adopted by the local government agency and the subsequent effects of the approach adopted. Accordingly, in preparing advice, the Commission does not simply adopt a procedural check list approach but instead looks closely at methodologies and outcomes (intended and actual).

3.1  Legislative and policy context

The South Australian Government is a signatory to the 1995 Competition Principles Agreement, which requires it to ensure that there is a competitive neutrality framework in place. The Government Business Enterprises (Competition) Act 1996 (GBE Act) provides for oversight of the prices charged by South Australian government business enterprises and for other purposes. Part 4 of the GBE Act deals with the principles of competitive neutrality.

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The principles of competitive neutrality are designed to neutralise any net competitive advantage that a government or local government agency\(^9\) engaged in significant business activities\(^10\) would otherwise have, by virtue of its control by the government or local government, over private business operating in the same market.\(^11\) The principles of competitive neutrality are identified in policies published by the Minister.\(^12\)

The principles of competitive neutrality that South Australian local government agencies must comply with are set out in the document: 'Revised Clause 7 Statement on the Application of Competition Principles to Local Government under the Competition Principles Agreement' September 2002 (\textit{Clause 7 Statement}).\(^13\)

Other important documents that provide guidance on the implementation of competitive neutrality principles include the:

- South Australian Government's Competitive Neutrality Policy Statement (\textit{Policy Statement}),\(^14\) and

The efficiency ground for competitive neutrality policy is that the existence of a net competitive advantage for a government business, purely as a result of its government ownership, may enable it to price below a more efficient private sector competitor, and potentially forcing a more efficient service provider out of the market. Such a distortion of resource allocation reduces the overall economic welfare of the community. Efficient pricing involves setting prices to reflect competitive market prices, or where a market is not competitive, the full costs of supply.\(^16\)

The Clause 7 Statement requires competitive neutrality principles to be applied to a significant business activity\(^17\) carried out by a local government agency, unless the costs of implementing the principles are greater than the benefits.\(^18\) This is a matter for the local government agency to determine, with the factors required to be taken into account in determining whether the activity is significant presented in section 3.5.1.\(^19\)

\(^9\) The GBE Act (section 3) and Clause 7 Statement (p.8) define a 'local government agency' to include a council, a body established by a council or councils under the Local Government Act 1999 and the Local Government Finance Authority of South Australia.

\(^10\) Defined in Appendix 2 and discussed in section 3.5.1.

\(^11\) Section 16(1) of the GBE Act.

\(^12\) Section 16(2) of the GBE Act. Pursuant to section 5 of the Administrative Arrangements Act 1994, the GBE Act is currently committed to the Premier (available at: https://www.parliament.sa.gov.au/AboutParliament/ParliamentHouse/Documents/Acts%20Committed%20to%20Ministers.pdf, viewed 8 May 2019).


\(^16\) Implementation Guide, p.7.

\(^17\) Clause 7 Statement, p.9 defines a 'business activity'. A 'significant business activity' is defined in Appendix 2 and discussed in section 3.5.1.

\(^18\) Clause 7 Statement, p.8.

\(^19\) Clause 7 Statement, p.9.
The three identified mechanisms for implementing competitive neutrality principles are: corporatisation, commercialisation and cost-reflective pricing (section 3.5.2). These require different levels of business and accounting separation. Which to adopt is a matter for the local government agency, having regard to a number of factors including: the costs and benefits of applying the principles; the organisational context of the activities exposed to competition; the level of resources used in the supply of the good or service; and any special requirements such as increased accountability or a greater emphasis on efficiency.

### 3.2 Competitive neutrality complaint

Pursuant to section 17 of the GBE Act, a person that competes, or seeks to compete, in a particular market may make a complaint to the Minister alleging an infringement of competitive neutrality principles by a local government agency operating in the same market. This must be in writing, contain the full details of the alleged infringement and any further information required under the regulations.

The Competitive Neutrality Complaints Secretariat (Secretariat) manages competitive neutrality complaints on behalf of the Department of the Premier and Cabinet (DPC). The Secretariat’s role includes referring the matter for investigation to the local government agency against which the complaint has been made. The Secretariat assesses whether or not a complaint falls within the GBE Act, in that it raises a genuine issue as to an infringement of the principles of competitive neutrality by a local government agency. The Secretariat (as a constituent part of DPC) also has a role in referring competitive neutrality complaints to the Commission (see section 3.4).

### 3.3 Competition Commissioner

Competition Commissioners can be appointed under Part 2 of the GBE Act.

The Minister can assign a Competition Commissioner to investigate complaints of infringements of the principles of competitive neutrality. However, the Minister must be satisfied that the matter has been referred to the relevant government or local government agency for investigation first and that there is no reasonable prospect of the matter being resolved by agreement between the parties. This provides the local government agency the opportunity to respond prior to an investigation being instigated.

The Minister can also refuse to assign a complaint if the Minister considers the complaint frivolous, vexatious, trivial, or subject to a previous investigation which found no infringement; and there has been no change that affects the relevance of that finding.

The Competition Commissioner’s role is to investigate the complaint (and relevant evidence) in order to determine whether or not the principles of competitive neutrality (as established by and under the GBE Act and the Clause 7 Statement) have been infringed. The Competition Commissioner must
prepare a report on the outcome of the investigation and provide this to the Minister, complainant and relevant local government agency. The report must set out/include:

- A determination as to whether the grounds of the complaint have been substantiated.
- The Competition Commissioner’s reasons for making the determination.
- If the competitive neutrality principles are found to have been infringed, the Competition Commissioner’s recommendations. These may include recommendations for the implementation of policies or practices to avoid further infringement of the same kind.

A summary of a Competition Commissioner’s decision on an investigation is published on the Secretariat’s website. This summary must not contain any confidential information and the Minister must ensure that the summary is publicly available.

3.4 Nature and scope of Commission advice

Based on the evidence available to it and, in accordance with requirements of the standing request issued by the Treasurer (see Appendix 1), the Commission advises on whether, in its view, a local government agency has properly applied the competitive neutrality principles having regard to the specifics of a complaint that is made. The Commission’s advice is non-binding but may be considered in the assessment of any competitive neutrality complaint.

3.5 Application of competitive neutrality principles and the local government agency decision-making process

In applying competitive neutrality principles, a local government agency has various decisions to make. To support those decisions, analysis has to be undertaken across a broad range of factors, as shown in Figure 2.1. Key requirements are discussed in subsequent sections.

At any stage in this decision-making process, a local government agency may make a decision that can infringe the principles of competitive neutrality. For example, a local government agency may:

- decide that a particular business activity is not a significant business activity when it is
- adopt an inappropriate approach to implementing competitive neutrality principles based on the scale of the significant business activity
- not appropriately scope its cost-benefit analysis
- use inappropriate methodologies to derive private sector-equivalent pricing, or
- adopt pricing strategies that infringe the Competition and Consumer Act 2010.

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31 Section 19(3) of the GBE Act.
32 Section 19(4) of the GBE Act. Such recommendations are not binding on the relevant local government agency.
34 Sections 19(7) and 19(6) respectively of the GBE Act.
35 This decision process is based on the requirements of the Clause 7 Statement and the Implementation Guide.
36 The Trade Practices Act 1974 referred to in the Clause 7 Statement was repealed in 2010 and largely replaced by the Competition and Consumer Act 2010.
Figure 2.1: Implementing competitive neutrality

- **Corporatisation:** Creates a separate legal entity and is the most costly to implement.
- **Commercialisation:** Implements structural reform but does not require legal separation, and is not as costly as corporatisation to implement.
- **Cost reflectice pricing:** A non-accounting approach that does not require any structural separation/reform and is the least costly to implement.

For further explanation of these terms, please see section 2.5.2.

The decision process in Figure 2.1 has been developed to generally illustrate how a local government agency decides whether and how competitive neutrality is implemented. In doing so, a local government agency must consider various questions and draw upon the guidance provided, with the following key threshold questions:

- Has it assessed whether the business activities it undertakes constitute significant business activities? If not, why not?
- If it concludes that business activities undertaken represent significant business activities but does not consider implementation of competitive neutrality principles should be applied, how has this position been reached and how does it satisfy the requirements of the Clause 7 Statement and Implementation Guide?
- If it concludes that business activities undertaken represent significant business activities and that the implementation of competitive neutrality principles is relevant, what approach is to be adopted and why? How does the practical implementation of the approach adopted satisfy the requirements of the Clause 7 Statement and Implementation Guide?

An important aspect of this decision process is that it is dynamic. Whether an activity is a significant business activity can change over time depending on how the market related to the activity evolves. In this context, a local government agency needs to assess the extent to which it has significant business activities on a regular basis.

### 3.5.1 What is a significant business activity?

In broad terms, significant business activities are those activities undertaken by a local government agency that are in competition with private sector operators in the relevant market.

The Clause 7 Statement requires that competitive neutrality principles should be applied, where appropriate, to a significant business activity carried out by a local government agency, unless the cost of implementing the principles are greater than the benefits to be realised from implementation. In assessing this, a local government agency has to consider the definition of a significant business activity in the local government agency context. This definition is provided in Appendix 2 and is taken from the Clause 7 Statement. Guidance is also provided by the significant government business activity checklist contained in the Policy Statement.

The first step is to assess whether the activity meets the definition of a ‘business activity’ (see Appendix 2), which requires the activity to:

- be primarily for sale in the market
- have a profit making focus
- have user charging, and
- not be primarily funded from rate or grant revenue.

Whether a business activity is significant will depend on its size and influence in the relevant market.

In deciding whether an activity is a significant business activity to which competitive neutrality principles should be applied, the local government agency must take into account (Appendix 2).
the intent of National Competition Policy\textsuperscript{42}

- whether the business activity possesses sufficient market power to create a competitive impact in the market that is more than nominal or trivial, and
- whether the size of the business activity relative to the size of the market as a whole is more than nominal or trivial.

An action (to use a neutral term) is not a business activity (and therefore cannot be a significant business activity) if the achievement of community benefits is the main priority of the activity, such as Community Service Obligations (CSOs) (see Appendix 2).

However, it is important to consider what constitutes a CSO, when the same activity can be used both in a commercial and CSO context, and can be bundled with services for commercial reason to compete with private sector operators. How to deal with such a situation is not contemplated within the competitive neutrality legislation and guidelines. The Commission’s approach is that, even if an activity is ostensibly established to meet a broad community benefit, if such an activity is (even in part) used directly to compete with private sector operators it should not be treated as if it were a CSO.

The alternative would be to permit the pricing of such services at zero within the bundled price, which would appear to conflict with the underlying economic intent of competitive neutrality. In practice it may depend on the specifics of the market in which the relevant activities are being provided. For example, whether it is feasible for private sector operators to provide a comparable bundled product.

By way of further explanation:

- An activity that is undertaken solely for the purposes of a CSO will not attract the operation of competitive neutrality principles.
- An activity that is undertaken for the purposes of a CSO but which also in part competes in a market with private sector operators will attract the operation of competitive neutrality principles. This is so regardless of the degree to which, from the local government agency’s perspective, the activity falls within the competitive market. For example, even though, from the local government agency’s perspective, the activity is 95 percent concerned with delivering a CSO, the residual five percent may have a market impact which is more than ‘nominal or trivial’.

What constitutes ‘nominal or trivial’ is not expressly defined in the legislative and policy documents that establish the competitive neutrality framework. The Commission considers that the terms should be ascribed their common meaning. As defined in the Macquarie Dictionary, ‘nominal’ means ‘slight’, ‘not real or substantial’ or ‘in name only’, and ‘trivial’ means ‘of little importance’, ‘trifling’ or ‘insignificant’. If the competitive impact of the business activity in the relevant market, and the size of the business activity relative to the size of the market as a whole is not nominal or trivial (as these terms are defined above) then the activity should be considered significant. This does not appear to require the significant business activity to have a dominant position within the relevant market, merely sufficient market presence to have more than a trivial or nominal impact on the operation of that market.

In undertaking this assessment, a local government agency has to consider the competitive impact of its business activity without access to the confidential commercial information of its competitors. This impact will need to be estimated through market intelligence, which may include competitor published price lists and gaining an understanding of the nature of the specific market, and estimating market size and market shares, to the extent practicable. This assessment will rely on both qualitative and quantitative approaches, the balance of which will depend on the circumstances.

Overall, when considering whether a particular activity is a significant business activity, a local government agency has to attempt to define the market from a product/service, geographic and

\textsuperscript{42} For more information on National Competition Policy, refer to the National Competition Policy website, available at http://ncp.ncc.gov.au/. A key principle of National Competition Policy is that competitive markets will generally best serve the interests of consumers and the wide community.
temporal perspective in order to assess whether a business activity constitutes a significant business activity.

If business activities do constitute significant business activities, the local government agency has to assess whether the benefits of implementing competitive neutrality principles outweigh the costs. In doing so, it has to consider the various potential ways in which competitive neutrality principles might be implemented in practice and the costs and benefits associated with each. This is reflected in Figure 2.1, with further discussion in section 3.5.2.2.

The Clause 7 Statement categorises significant business activities into either Category 1 (being a business activity with an annual revenue in excess of $2 million or employing assets in excess of $20 million), or Category 2 (all other). But this has no bearing on how a local government agency should set about developing and implementing a cost-reflective price.

### 3.5.2 Implementing competitive neutrality

Having determined that its business activities are significant business activities, a local government agency then needs to consider implementing one of three mechanisms: corporatisation, commercialisation, or cost-reflective pricing. A description of each is provided in Table 2.1.

<table>
<thead>
<tr>
<th>Mechanisms</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporatisation</td>
<td>Corporatisation is the preferred path to competitive neutrality under the Competition Principles Agreement. It represents the strongest form of private sector equivalence and is the most costly to implement.</td>
</tr>
<tr>
<td></td>
<td>Corporatisation creates a legally separate business entity that has many characteristics of a private sector operator. It will have a board, charter, business plan, and publish an annual report and accounts.</td>
</tr>
<tr>
<td></td>
<td>Corporatisation explicitly isolates public policy products/services provided by the created corporate, such as CSOs, from those products/service competing with the private sector.</td>
</tr>
<tr>
<td>Commercialisation</td>
<td>Commercialisation involves the structural reform of an entity, but does not require legal separation and is not as costly to implement as corporatisation. Commercialisation can take various forms that trend more towards corporatisation or cost-reflective pricing, depending on the degree of private sector equivalence adopted.</td>
</tr>
<tr>
<td></td>
<td>Similarly to corporatisation, commercialisation seeks to split out and account for the products/services competing directly with private sector operators and those with a public policy dimension, such as CSOs.</td>
</tr>
<tr>
<td>Cost-reflective pricing</td>
<td>Cost-reflective pricing is an accounting approach. It does not require any form of structural separation within the entity. It is considered the least costly to implement because of this.</td>
</tr>
<tr>
<td></td>
<td>It seeks to isolate the costs of supplying the significant business activities from the local government agency’s overall product/service portfolio. Thereafter, the approach makes adjustments to account for any net competitive advantage of public sector ownership, and then assesses what pricing policy to adopt based upon private sector-equivalent costs (costs adjusted to account for any net competitive advantage/disadvantage of public sector ownership).</td>
</tr>
<tr>
<td></td>
<td>Cost-reflective pricing can be introduced by ring-fencing the significant business activity from the other activities of the local government agency.</td>
</tr>
</tbody>
</table>


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43 See Appendix 2.
44 Sometimes also referred to as ‘measures’ or ‘models’ in the guidance papers.
45 Clause 7 Statement, p.6.
Each mechanism provides a differing degree of ‘private sector equivalence’.46 This relates to the measures undertaken to make the public sector provision of the significant business activity more equivalent to that when it is provided by the private sector. The most basic mechanism is cost-reflective pricing, with the most complex being corporatisation.

An objective of all three mechanisms is to ensure there is transparency in the pricing of significant business activities and that the costs of supplying these products/services is split from the costs associated with public policy objectives, particularly CSOs.47

Thereafter, actual pricing may differ from this private sector-equivalent cost-reflective price, provided the relevant local government agency assesses that the benefits outweigh the costs.48 This allows for the actual pricing for significant business activities to account for the market place and the level of competition, pricing strategies and technological advantages/disadvantages of competitors.49

However, over the medium to long term, the price for significant business activities should reflect competitively neutral private sector-equivalent costs.50 This means that pricing strategies can be loss-leading in the short term, but cannot be sustained for an undue period of time. What constitutes short, medium or long term is not defined in the competitive neutrality documents and, in the Commission's view, must be determined in the context of the market into which the significant business activities are being provided.

In effect, the implementation of the competitive neutrality principles requires a two-part process involving the assessment of the costs and benefits of: (i) the mechanism to adopt; and (ii) setting an appropriate price for the significant business activity. The latter is dependent on establishing private sector-equivalent costs.

### 3.5.2.1 Competitive neutrality mechanisms

The Clause 7 Statement and the Implementation Guide identify the following factors relating to the nature and circumstances of the significant business activity in question to assist the local government agency in selecting an appropriate mechanism (Table 2.2).

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48 Clause 7 Statement, p.8.
49 Clause 7 Statement, p.8
50 Implementation Guide, p.28.
Table 2.2: Characteristics of the significant business activity to account for

<table>
<thead>
<tr>
<th>Characteristics</th>
<th>Description</th>
</tr>
</thead>
</table>
| Organisational context of the activity               | **Corporatisation:** Where commercial activities are the principal activity and occupy most or all of the entity, corporatisation and the full range of additional private sector equivalence measures. This requires that commercial and non-commercial activities be separated and CSOs explicitly identified, separately costed and directly funded by the local government agency.  
**Commercialisation:** Where the significant business activity is only a part of the broader functions of the entity undertaking the activity, has several objectives to achieve and occupies only part of the entity. Separation of commercial and non-commercial will be required, at least as a separate business unit. In principle, the treatment of the CSO activities will require their identification, costing and separate funding as under corporatisation. |
| Size of resource employed                             | **Corporatisation:** 'Large' business activities can more easily offset the transaction costs associated with incorporation, new or amended legislation/regulations, administration of private sector equivalence practices and the expenses of a Board structure.  
**Commercialisation:** 'Medium' sized business activities are more suited to this less costly process. |
| Efficiency objectives                                 | **Corporatisation:** 'Large' business activities where there are particular concerns about the efficiency of a business activity and the need for greater private sector equivalence.  
**Commercialisation:** 'Medium' sized activities where there are particular concerns about the efficiency of a business activity and the need for greater private sector equivalence. |
| Accountability objectives                             | **Corporatisation:** Where there are particular concerns in relation to the performance of the activities in question and/or external confidence in the existence of competitive neutrality is needed. Provides enhanced transparency through the formalisation of reporting requirements regarding the Board and management.  
**Commercialisation:** Where the additional benefits of enhanced transparency through corporatisation do not outweigh the costs imposed. |

Source: Commission, drawing from Implementation Guide and Clause 7 Statement

3.5.2.2 Assessing the costs and benefits of implementing competitive neutrality

The principles of competitive neutrality only need to be applied where they are appropriate and only to the extent that the benefits from implementation exceed the costs. Table 2.3 summarises the guidance for local government agencies provided by the Clause 7 Statement and the Implementation Guide for making an assessment of the costs and benefits of implementing competitive neutrality.

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51 Clause 7 Statement, p.4.
Table 2.3: Cost-benefit factors a local government agency should account for

<table>
<thead>
<tr>
<th>Factors</th>
<th>Description</th>
</tr>
</thead>
</table>
| Policy considerations                  | - Government legislation and policy relating to:  
  - ecologically sustainable development  
  - occupational health and safety  
  - industrial relations  
  - access and equity  
  - Social welfare and equity considerations, including CSOs  
  - Economic and regional development, including employment and investment growth  
  - Interests of consumers generally or a class of consumers  
  - Competitiveness of Australian businesses  
  - Efficient allocation of resources  
  - Impact on actual/potential competitors of the relevant local government business activity  
  - Local policies relating to:  
    - economic and business development  
    - local employment  
    - quality of supply of goods and services, including timeliness of supply  
  - Impact on the local community  
  - Impact on the State and national economies, if any. |
| Possible benefits                       | - Increased market contestability:  
  - producing incentives for lowering costs  
  - increasing consumer choice for customers  
  - Improved assessment of the performance of a significant business activity:  
    - leading to operating efficiencies  
  - Clearer definitions of objectives and roles:  
    - both the business and non-business components of local government operations. |
| Possible costs                          | - Management and culture changes.  
  - Research and analysis to determine cost-reflective pricing arrangements.  
  - Administration of tax equivalent and debt guarantee frameworks.  
  - Compliance and the monitoring of compliance. |

Source: Clause 7 Statement, p.10

The factors that a local government agency has to consider as part of its cost-benefit assessment are broad from an economic, policy and social perspective. They extend beyond the specific business interests and objectives the local government agency may have for the significant business activities. However, while recognizing the difficulty of the task, the guidance available does not identify what weight a local government agency should give to any specific factor. 52

Notwithstanding this, the Commission considers that the outcome of any cost-benefit assessment should not conflict with the overall economic intent of the competitive neutrality policy and principles: the efficient allocation, or best use, of the community's resources. 53 Being that significant local government agency business activities should not enjoy any net competitive advantage over private sector businesses operating in the same market simply as a result of their public ownership because

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this can distort resource allocation within the relevant market and beyond,\textsuperscript{54} resulting in inefficiency.\textsuperscript{55} As noted previously, this relies on efficient pricing by local authority businesses (see section 3.1). This relates back to the importance of identifying private sector-equivalent cost-reflective prices for significant business activities noted in section 3.5.1.

### 3.5.2.3 Developing private sector-equivalent cost-reflective pricing

Developing private sector-equivalent cost-reflective pricing is not straightforward. Private sector-equivalent cost-reflective pricing for significant business activities will generally require costs to be allocated between significant business activities and other business activities undertaken by the local government authority. It might also require adjustments to the local government authority’s cost base to account for private sector equivalence. Further, the development of private sector-equivalent cost-reflective pricing can be complicated by the bundling of a CSO and a significant business activity or activities.

Regarding cost allocation, the costing methods that can be employed are fully attributed cost or avoidable cost. These can be used separately or in combination with each other.

(a) **Fully attributed costs**

Fully attributed costs requires the full attribution of all costs incurred in the production of a good or service output. For the purposes of calculating private sector-equivalent cost-reflective prices, the attribution of costs should take full account of all relevant costs, such as (non-exhaustive):\textsuperscript{56}

- all direct costs such as labour, materials and premises
- indirect costs (overheads) such as personnel, IT support and administration,\textsuperscript{57} and
- depreciation of physical assets utilised.

The approach is best illustrated by way of an example. If a local government authority provides both a CSO and a significant business activity using the same facility, the full costs of providing that facility would be allocated between the CSO and significant business activity. This requires the development of approaches to apportion costs. In turn, this requires an assessment of what is causing the cost to be incurred and the identification of ‘cost drivers’. Cost apportionment methodologies can then be developed based on the cost drivers identified.

So far, the costs allocated to the CSO and the significant business activity represent the local government authority cost base. The next stage is to apply private sector equivalence measures to the costs attributed to the significant business activity. This seeks to ensure the costs attributable to the significant business activity align with those that private sector operators might face. This requires the local government authority to identify any differences between it and a private sector provider supplying the significant business activity, and to make any relevant cost adjustments to reflect this. Examples might include (not exhaustive):

- Adding the cost of any identified advantages as a result of ownership, such as:\textsuperscript{58}
  - Commonwealth and State taxes
  - debt guarantee fees

\textsuperscript{54} Distortions ‘within the relevant market’ can come from a local government agency being able to price below a more efficient private sector competitor, purely as a result of its government ownership (see section 3.1). Distortions ‘beyond’ the relevant market can occur if the private sector operators respond by reducing their prices below efficient levels and therefore attract an ‘excess’ of resources from other markets into the relevant market.

\textsuperscript{55} Policy Statement, p.4.

\textsuperscript{56} Implementation Guide, p.24.

\textsuperscript{57} Choosing an appropriate cost driver for allocating overheads is important.

\textsuperscript{58} Implementation Guide, pp.24-27.
rate of return on capital employed

- Deducting the cost of any identified disadvantages as a result of ownership, such as:
  - additional cost of employment and HR functions
  - additional accountability, reporting requirements and less flexibility in managing operations.

Once private sector-equivalent costs have been calculated, a price based on these costs can also be calculated. Based upon the example used, the outcomes of this exercise would be a private sector-equivalent cost-reflective price for the significant business activity based on fully attributed costs. The costs of the CSO activity based on the local government agency’s cost base would also be identified on a fully attributed basis (for this example), but a price need not be identified. That is not to say that the local government authority does not price access to the CSO, but that the price need not be explicitly identified through this process.

(b) Avoidable cost

By contrast, avoidable cost is the sum of all the costs that could be avoided if the product or service were not provided. In this case if the same local government authority provided both a CSO and a significant business activity using the same facility, the avoidable costs of providing the CSO would be the costs avoided if the CSO was not provided. The remaining costs would be allocated to the significant business activity. This might result in a different cost allocation to the full attribution method.

Thereafter, the costs associated with the significant business activity would also be adjusted to reflect private sector equivalence. However, the precise nature and magnitude of the adjustments might differ from those if the fully attributed cost allocation approach has initially been used. This is because the starting point from which any relevant private sector-equivalent adjustments are made is likely to be different.

The outcomes of this exercise would be a private sector-equivalent cost-reflective price for the significant business activity based on avoidable costs. The costs of the CSO activity based on the local government’s cost base are also identified on an avoidable cost basis, but a price need not be identified. Again, this does not mean the local government authority does not price access to the CSO; rather, it means that price need not be explicitly identified through this process.

The above illustrates that any private sector-equivalent cost-reflective prices calculated is situation specific and methodologically dependent. This means that understanding the methodologies adopted are important to the assessment of a local government authority’s application of the competitively neutrality principles.

(c) Bundling CSO and significant business activities

A further point to note is that a local government authority might bundle both its CSO activity with a significant business activity and use this bundled product to compete with private sector operators in the market for the significant business activity. The critical aspect to account for in these circumstances is that a CSO is generally made available by a local government authority because the private sector is unable to provide the service profitably (implying that there is no competitive market for the services).

The implication of this is that the product mix that the local government authority is using to compete with private sector providers in the relevant market differs from what the private sector operators can provide. Further, a characteristic of the outcomes of using either the fully attributed or avoidable cost

\[59\] Implementation Guide, p.28.

\[60\] An agency seeking to incorporate such cost reductions into the derived private sector-equivalent costs would be required to calculate the costs associated with any additional HR functions, supported by evidence of the process that is not applicable to the private sector.
allocation approach to establishing private sector-equivalent cost-reflective prices for significant business activities in this context, it is that these prices need not necessarily directly account for any costs attributable to the CSO activity.

So, if the CSO is bundled with the significant business activity, how the methodological approach adopted by a local government authority accounts for this in calculating a private sector-equivalent cost-reflective price and how this translates into the actual pricing strategy adopted is relevant. This is because it may have implications with respect to the underlying economic intent of the competitive neutrality policy (see section 3.5.2.2).

### 3.6 Commission’s assessment approach

The Commission’s assessment approach considers both the economic intent of the competitive neutrality policy and principles and the decision-making process that a local government authority has undertaken with regard to its significant business activities.

As noted in section 3.1, the competitive neutrality policy is based on the principle that significant government business activities should not enjoy any net competitive advantage over private sector businesses operating in the same market simply as a result of their public ownership. 61 This seeks to achieve a consistent basis of competition across the two ownership sectors, without interfering with differences in size, assets, skills and organisational culture, which are inherent in the competitive process. This relies on efficient pricing by local authority businesses, which involves setting prices to reflect competitive market practices, or where a market is not competitive, the full costs of supply. A further efficiency ground for the policy rests on the notion that advantages accruing uniquely to government-owned businesses are ‘unfair’ to private sector firms competing in the same market. 62

The Commission’s assessment approach has regard to these factors, the requirements of the Treasurer’s standing referral (see Appendix 1) and the legislative and policy framework outlined in section 3.1. Of particular relevance are the Clause 7 Statement and the Implementation Guide. This is because these documents contain specific details with respect to the steps, processes and factors that a local government authority should follow when considering whether competitive neutrality applies to any of its business activities and, if so, what it should do.

These steps, processes and factors aim to ensure the economic intent of the competitive neutrality policy and principles is met. In instances where the Clause 7 Statement and Implementation Guide do not provide specific guidance, consideration is given to the overall economic intent of the policy and the requirements of the GBE Act and National Competition Policy.

The Commission’s methodological approach seeks to identify the actions taken by the local government agency and track these through a competitive neutrality decision making process. Through this, it is possible to identify any infringements of the competitive neutrality principles and potential remedial actions that the local government agency could adopt. In considering remedial actions, the Commission will, where practicable, consider the materiality of any particular infringement of the principles, given the context of the specific complaint and the economic efficiency objectives of the competitive neutrality principles.

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61 Policy Statement, p.4.
4 Commission’s advice

Summary

- The Commission understands the complaint concerns the FRACA’s approach to bundling what it considers to be a CSO (recreational pool access), with a significant business activity (gym services), and that the price being charged for this bundled service is below a reasonable private sector-equivalent and therefore fails to meet competition neutrality principles.

- There are grounds to consider that the FRACA has not applied the competitive neutrality principles and guidelines in a manner that ensures consistency with the economic intent of these principles.

- The FRACA considers its provision of gym services to be a significant business activity. The Commission has not found any evidence to contradict this finding.

- The FRACA does not provide a gym services-only membership product, it provides a bundled gym services/recreational pool access product. The 2018-19 list price of this bundle is below the FRACA’s own calculation of the 2018-19 private sector-equivalent cost-reflective price. Once discounts are factored in, the actual effective price is well below that price. This has been the case for over two years, with the bundled gym services/recreational pool access product in effect acting as a ‘loss-leader’.

- Further, the FRACA’s calculation of the private sector-equivalent cost-reflective price is likely to reflect a low estimate. This is because the price effectively includes recreational pool access at zero cost and price. Given this, the actual price charged is also likely to reflect a low estimate, as it is below the existing private sector-equivalent cost-reflective price.

- Overall, the FRACA’s private sector-equivalent cost-reflective estimated prices and the actual prices charged do not reflect the intent of private sector equivalence. It places gym services-only private sector operators at a competitive disadvantage solely as a result of the FRACA’s facilities being publicly owned and being capable of absorbing medium to long-term losses. This is likely to lead to inefficient prices, unless there are clear reasons why the benefits of the FRACA’s pricing strategy outweigh the costs.

- In this regard, the Commission considers that the FRACA’s cost-benefit assessment is too narrow and does not suitably address the socio-economic context. This is particularly the case given the FRACA’s future pricing strategy of maintaining significant discounts appears to be in direct conflict with the competitive neutrality guidance and therefore the overall economic intent of the competitive neutrality principles.

- The situation could be immediately improved by the FRACA:
  - Providing separate gym services-only and bundled gym services/recreational pool access products.
  - Developing and implementing a cost-reflective price that accurately reflects the private sector-equivalent cost of providing a gym-only service.
  - Ensuring the price charged for a bundled service accurately reflects the costs associated with providing the recreational pool access service as part of a bundled product competing with private sector operators.

- An alternative remedy would be for all members of gyms in the Victor Harbor region to have access to recreational swimming on the same terms as the members of the FRAC, net of any transaction costs involved. In 2017, the complainants sought equal access to the FRAC pool for all gyms in the area on this basis, an approach rejected by the FRACA at the time on the grounds the proposal was not considered attractive for the FRAC.

- These proposed actions would each achieve a consistent basis of competition across the two ownership sectors, without interfering with those differences in size, assets, skills and organisational culture which are inherent in the competitive process, consistent with the intent of the competitive neutrality principles.
4.1 Consultation undertaken by the Commission

The Commission has consulted with the complainants and the service provider in an effort to obtain as much evidence and information as possible, while seeking to provide advice in a timely manner - given the time since the original complaint was made. This involved Commission staff meeting with officers of the FRACA, the Alexandrina Council and the City of Victor Harbor. Meetings were also held with the complainants, being the operators of Spa Clubs Fitness (Mr. Graham Mowatt) and FIT Goolwa (Mr. Bruce Konings).

4.2 Understanding the complaint

The complaint as expressed by the complainants has been set out in section 2.1.

The FRACA provides the following goods and services through the FRAC:

- recreational swimming and water play (recreational pool access)
- swimming lessons
- health and fitness activities via a gym (gym services)
- children’s birthday parties
- food and drink through the café, and
- sale of merchandise through the shop.

The Commission understands that the essence of the complaint is that the FRACA has bundled what it considers to be a CSO (recreational pool access) with a significant business activity (gym services), with the price being charged for that bundled service below a reasonable private sector-equivalent - and on that basis there is a failure to meet competition neutrality principles.

The Commission notes that this complaint directly relates to efficient pricing and therefore to the underlying intent of the competitive neutrality policy and principles (see section 3.5.2.2).

4.3 Commission’s assessment

The Commission has analysed the complaint in accordance with the requirements of the Treasurer’s referral letter (Appendix 1), having regard to competitive neutrality policy and principles as they apply to the specifics of the complaint. In doing so, the Commission has adopted the assessment approach outlined in section 3.6. This approach has regard to the objectives of the GBE Act and the requirements of Part 4 and Part 5 of the GBE Act. The key documents relied on by the Commission in developing an assessment approach that meets these requirements and those of the ESC Act are the Clause 7 Statement and Implementation Guide (see section 3.6).

In summary, three central questions guide the Commission’s two-part analysis in the context of the specifics of this complaint:

Part 1

- Have significant business activities been identified? If not, should they have been? (section 4.3.1)

If significant business activities have been identified, move to Part 2.

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63 FRACA, Fleurieu Regional Aquatic Centre Authority Competitive Neutrality Review, Summary Overview, November 2018, pp.1-2.
Part 2

- Have appropriate private-sector equivalent cost-reflective prices for such activities been derived? (section 4.3.2)

- How do the private-sector equivalent cost-reflective prices relate to actual pricing strategies? (section 4.3.3)

In undertaking this assessment, the Commission may consider that a local government authority has failed Part 1 by concluding that an activity is not a significant business activity, when there are grounds for concluding that it is. In such cases, the Commission might elect to provide advice only in relation to Part 1, or it may suggest potential options that, if applied by the local government authority might lead to a positive outcome for Part 2.

Further, noting that the principles of competitive neutrality only need to be applied by a local government agency where they are appropriate and only to the extent that the benefits from implementation exceed the costs (see section 3.5.2.2), the Commission has also assessed the role of cost-benefit analysis in the FRACA’s own competitive neutrality assessment and decision making (section 4.3.4).

4.3.1 Have significant business activities been identified correctly?

The FRACA has identified, through competitive neutrality reviews undertaken by Wallmans on its behalf, the following as significant business activities:64

- swimming lessons
- gym services, and
- children’s birthday parties.

The FRACA has identified its gym services as significant business activities, because:

- it is not an activity engaged in for the main priority of achieving a community benefit, and
- these services will have more than a nominal or trivial effect on competition within the relevant market. 65

The FRACA identified the market for gym services as comprising:66

- services provided by means of personal trainers, gyms with trainer support services, 24-hour accessible gyms and fitness classes
- facilities which provide these services include dedicated gym facilities and community spaces (for example, parks and beaches), on the basis that while users may demonstrate a preference for a particular type of service, each service is broadly substitutable in terms of the service outputs, and
- the geographic area of the market taken as the council area of the constituent Councils (Alexandrina Council and the City of Victor Harbor).

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65 FRACA, Fleurieu Regional Aquatic Centre Authority Competitive Neutrality Review; Full Report (partially redacted), November 2018, p.16.
66 FRACA, Fleurieu Regional Aquatic Centre Authority Competitive Neutrality Review; Full Report (partially redacted), November 2018, pp.15-16.
The Commission understands that Wallmans’ assessment that gym services are a significant business activity was qualitative, rather than empirical. The Commission has not found any evidence to contradict this finding. The Commission has categorised this significant business activity as Category 2 (see section 3.5.1).

The FRACA’s competitive neutrality review identified recreational pool access as a core CSO activity. It concluded that these services were meeting a specific public policy objective in respect to community infrastructure, amenity and services, and not a commercial objective.

The Commission also acknowledges that the provision of the core pool infrastructure of the FRAC is not profitable from a commercial perspective. This is evidenced by the amount of government funding support required to establish the FRAC, as well as the local government authority support to cover ongoing costs. However, in the Commission’s view, this does not mean that recreational pool access is solely a CSO activity (see section 3.5.1 above). At issue here is the appropriate treatment of recreational pool access within the bundled gym services/recreational pool access product. It relates directly to what constitutes a CSO when the mechanism of delivery (in this case swimming pools) has more than one use, and the same activity can be used both in a commercial (competitive) and CSO context, and can be bundled with services for commercial reasons to compete with private sector operators.

As noted in section 3.5.1, the Commission’s approach is that even if an activity is ostensibly established to meet a broad community benefit, if such an activity is (in part) used directly to compete with private sector operators it should not be treated as if it were a CSO. Accordingly, it is the Commission’s view that an appropriate allocation of costs for the recreational pool access activity should be made and priced within the bundled offering to achieve a private sector-equivalent cost.

4.3.2 Have appropriate private sector-equivalent cost-reflective prices been derived?

Given the FRACA has concluded that its gym services are a significant business activity, it must choose how to implement the competitive neutrality principles. In particular, it must calculate private sector-equivalent cost-reflective prices for the significant business activities.

The Commission does not consider, based on the evidence available, that the FRACA has derived an appropriate private sector-equivalent cost-reflective price for the bundled gym services/recreational pool access product that meets the requirements of the Clause 7 Statement, as set out in section 3.5.2.3, for the following reasons:

1. There are some potential issues with the treatment of indirect costs, in terms of the cost allocation method employed and the activities/products to which such costs are allocated.
2. In deriving cost-reflective pricing for its significant business activities, the FRACA has not appropriately accounted for private sector equivalence.
3. The methodology adopted appears to result in recreational pool access being priced at zero within the bundled gym services/recreational pool access product, which is in direct competition with private sector providers of gym services.

This reasoning is expanded upon below.

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68 While the FRACA as a whole has annual revenue of around $3 million (FRACA Annual Report 2017-18, p.N8) and assets valued at around $21 million (FRACA Annual Report 2017-18, Financial Statements p.3), the Commission has assessed that the revenue and assets for the significant business activity fall below the Category 1 threshold. The FRACA Annual Report 2017-18 is available at https://www.fleurieuaquaticcentre.com.au/about/fleurieu-regional-aquatic-centre-authority.
4.3.2.1 Cost allocation

The FRACA’s competitive neutrality review seeks to calculate private sector-equivalent cost-reflective prices for various activities/products, including the bundled gym services/recreational pool access product. The review, however, does not seek to calculate such a price for recreational pool access, as it considers this to be a solely CSO activity. How the FRACA’s competitive neutrality review allocates costs when undertaking this exercise is described below. In assessing the approach adopted, the Commission has not sought to verify the accuracy of the particular calculations performed in the competitive neutrality review, but has focused on the methodological aspects.

In determining what part of the FRAC’s cost base should be allocated to what activities/products, the FRACA’s competitive neutrality review identifies three overarching cost categories. These comprise direct costs, indirect costs and depreciation. Each of these has various sub-categories. The actual costs used for each category are the budget figures for the FRAC. These costs are allocated across the significant business activities/products listed in Table 4.1 for the purposes of developing private sector-equivalent cost-reflective pricing.

### Table 4.1: Significant business activities/products

<table>
<thead>
<tr>
<th>Category</th>
<th>Activities/products</th>
</tr>
</thead>
</table>
| Swimming instruction | ‘Swim School’                         
|                   | ‘Vac Swim’                                                            |
| Fitness services   | ‘Gym facilities and services (Health Club casual use)’                         |
|                   | ‘Group fitness’                                                                 |
|                   | ‘Group fitness – older adults’                                                    |
|                   | ‘Bundled aquatic/gym memberships’ (gym service-recreational pool access)          |
| Children’s parties | ‘Children’s birthday party – non-catered’                                         |
|                   | ‘Children’s birthday party – catered’                                             |
|                   | ‘Children’s birthday party – inflatable’                                          |

Source: Wallmans November 2018 review

While Wallmans (for the FRACA) has not calculated a private sector-equivalent cost-reflective price for the recreational pool access activity/product, costs have been allocated to it on the following basis:

- **Step 1** - allocate direct costs: For each of the activities/products listed in the above table and recreational pool access, the direct costs associated with the activity are allocated to it.  

- **Step 2** - allocate a proportion of the indirect costs: Indirect costs account for 53 per cent of the total FRAC cost base. The FRACA has allocated all indirect cost categories to all activities/products based on the percentage of budgeted revenue in 2018-19 for the activity/product.

- **Step 3** - allocate depreciation expenses: For the FRAC’s depreciation charge, around two percent of depreciation expenses are allocated to the gym-based activities/products, with approximately 98 percent attributable to the CSO activity recreational pool access.

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72 Calculated as $1,709,432/$3,252,353.
73 FRACA, *Fleurieu Regional Aquatic Centre Authority Competitive Neutrality Review*, Full Report (partially redacted), November 2018, pp.43 and 64.
The overall outcome of this exercise is that around 57 percent of the FRAC cost base is allocated to the
CSO activity of recreational pool access.\(^\text{75}\) This effectively includes the entire depreciation charge
associated with the facilities. The remaining 43 percent of the FRAC cost base is allocated to the
activities/products in table 4.1. Slightly over half of this 43 percent is allocated to the bundled gym
services/recreational pool access product.

The Commission has some observations regarding this approach.

(a) Revenue proportions as a cost driver for indirect costs

The Commission does not consider the blanket use of revenue proportions as a cost driver for indirect
costs appropriate, and is of the view that, for a number of costs included in the indirect cost category,
there are readily available cost drivers that better reflect cost causality.

There is a circularity in using revenue to allocate indirect costs for the purposes of calculating cost-
reflective prices. Revenues are based on existing prices, and these are then being used as an input in
setting future prices. If the magnitude of indirect costs used in the FRACA competitive neutrality review
was a low proportion of the overall cost base this would not be a concern. However, this is not the case,
given over half of the FRAC’s cost base is considered to reflect indirect costs.

Given this, the Commission considers that cost drivers that reflect cost causality are more appropriate
to adopt, while the use of revenue is considered appropriate only if another more suitable cost driver
cannot be identified. In this context, cost drivers that account for both the size of the area used to
provide the service and the level of construction value associated with that area may be more suitable.
Also, some costs defined as indirect costs, such as electricity, gas, water, and preventative/reactive
maintenance, should, in large part, be allocated to CSO recreational pool access.\(^\text{76}\) This is because the
size, value and running expenses of the facility is largely dictated by the size and construction of the
pools.

(b) Cost allocation methodology and bundled gym services/recreational pool access product

The FRACA does not offer a gym-only service price.\(^\text{77}\) The FRACA’s core gym service product is a
bundled gym services/recreational pool access product. Given this, it is important that private sector
equivalency principles are applied to the bundled product in totality. This is because, in this instance,
recreational pool access is being used in direct competition with the private sector and, as such, it is a
commercial use (see sections 3.5.1 and 4.3.1).

The cost allocation approach adopted in the FRACA’s assessment does not appear to account for this.
The cost allocation methodology appears to price recreational pool access within the bundled product
at zero. This is because there is no ‘transfer’ of a proportion of the costs associated with the
recreational pool access activity to the bundled gym services/recreational pool access product. The
basis on which the Commission makes this statement is provided in Appendix 3.

This is problematic and conflicts with private sector equivalence, given that the bundled product is
competing directly in the gym services market, which is a commercial setting. This is because private
sector operators would seek to recoup at least a proportion of the costs associated with providing
recreational pool access within the price of the bundled product, if it were profitable to provide this
service. This effectively allows the FRAC to compete on an unequal footing with private sector gym

\(^{75}\) FRACA, *Fleurieu Regional Aquatic Centre Authority Competitive Neutrality Review*, Full Report (partially redacted), November 2018, pp. 36 and 55.

\(^{76}\) Such expenses are allocated to operational expenses. Source: FRACA, *Fleurieu Regional Aquatic Centre Authority Competitive Neutrality Review*, Full Report (partially redacted), November 2018, Attachment 3.

\(^{77}\) While the FRAC provides a Health club casual use rate, it is part of the ‘All Access’ casual admission which provides visitor access to the entire Centre, including recreational pool access. Source: FRACA, *Fleurieu Regional Aquatic Centre Authority Competitive Neutrality Review*, Full Report (partially redacted), November 2018, p.28. This is confirmed by examining the fee chart for the FRAC on its website (viewed 20 May 2019), where gym facilities are a component of the All Access Casual Admission rates.
operators in the region. In this regard, the FRACA does not price recreational pool access at zero price in relation to casual admittance (section 4.3.3.1). This only appears to occur in the bundled gym services/recreational pool access product.

Also, in order to be able to ‘transfer’ a proportion of the costs associated with recreational pool access to the bundled gym services/recreational pool access product on a private sector-equivalent basis, an understanding of the private sector-equivalent costs for recreational pool access is required, which has not been undertaken by the FRACA. This, in turn, benefits from a cost allocation that reflects cost causality appropriately (refer to previous section regarding the use of revenue as a cost driver – section 4.3.2.1(a)).

### 4.3.2.2 Private sector-equivalence

The FRACA’s competitive neutrality review identified the following two areas where it has a competitive advantage due to its government ownership, and an adjustment was made to achieve private sector-equivalent costs:78

- The FRACA is exempt from council rates (estimated at $48,775 for the 2018-19 year).
- The FRACA is exempt from state land tax (estimated at $5550 per annum).

These costs were allocated to significant business activities based on the percentage of total budgeted 2018-19 revenue applicable to that activity.79

The Commission has not sought to verify the magnitude of the derived costs, but agrees with their inclusion. Although, consistent with the discussion of cost allocation in section 4.3.2.1, allocating these costs on the basis of contribution to total revenue may not be appropriate.

Table 4.2 presents other advantages identified by Wallmans, along with the reasons that it provided for not making a cost adjustment.

<table>
<thead>
<tr>
<th>Advantage</th>
<th>Wallmans reasoning</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return on capital employed</td>
<td>As the FRAC is forecast to make a loss for the foreseeable future, it will not be possible for the FRACA to provide a return to its owners.</td>
</tr>
<tr>
<td>Exemption from income tax</td>
<td>As the FRAC is forecast to make a loss for the foreseeable future, then the FRACA is not enjoying an advantage as it will not be liable for income tax.</td>
</tr>
<tr>
<td>Access to cheaper financing – access to Local Government Finance Authority loan funding</td>
<td>The FRACA is funded by the constituent Councils and therefore any debt required is held by the Councils and not the FRACA.</td>
</tr>
<tr>
<td>Access to capital funds</td>
<td>Capital funding required by the FRACA is provided by the constituent Councils.</td>
</tr>
</tbody>
</table>

Source: Wallmans November 2018 review80

The reasons for not making an adjustment appear to relate to either the operational characteristics of local government authorities or the fact that the FRAC is being subsidised and is loss making. The Commission considers this logic to be inconsistent with the principles underlying private sector cost equivalence, which is to adjust costs to reflect costs that would be incurred by a private sector-equivalent. For example, the Implementation Guide requires a business to include in its costs ‘the rate

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78 FRACA, Fleurieu Regional Aquatic Centre Authority Competitive Neutrality Review; Full Report (partially redacted), November 2018, p.21.
79 FRACA, Fleurieu Regional Aquatic Centre Authority Competitive Neutrality Review; Full Report (partially redacted), November 2018, p.21.
80 FRACA, Fleurieu Regional Aquatic Centre Authority Competitive Neutrality Review; Full Report (partially redacted), November 2018, p.21.
of return necessary for the capital employed having regard to the cost of risk free capital and a margin to represent the business risk associated with the particular industry. 81

In addition, the FRACA’s competitive neutrality review also identified some disadvantages of local government ownership, but elected to make no adjustments to costs to account for these disadvantages. 82 These ‘disadvantages’ covered matters such as additional accountability, reporting, compliance, and political and decision making processes suggested to be faced by a local government agency. No reasoning was provided for not making a cost adjustment.

4.3.3 How do cost-reflective prices relate to actual pricing strategies?

The Commission is of the view that the FRACA’s actual pricing strategies do not meet the requirements of the Clause 7 Statement (as set out in section 3.5.2.3), for the following reasons:

1. The FRACA does not appropriately price the recreational pool access in its bundled gym services/recreational pool access product on a private sector-equivalent cost-reflective basis. This allows the FRACA to leverage its pool infrastructure assets that were not financed on a private sector-equivalent basis into the regional gym services market through the provision of a product mix that is not replicable on a commercial footing.

2. This is exacerbated by the FRACA persistently offering widespread significant discounts off an actual bundled list price that is already lower than its calculated private sector-equivalent cost-reflective price. Such ‘loss-leading’ behaviour has been occurring for over two years and is ongoing, despite the Implementation Guide only accepting that departures from full cost prices might be appropriate in the short term. 83

These matters are further discussed in turn below.

4.3.3.1 Pricing of recreational pool access

The Commission is of the view that the FRACA is, whether knowingly or otherwise, using the pool infrastructure to leverage an unfair competitive advantage within the regional gym services market. This is being achieved through the differential pricing of recreational pool access in differing circumstances in a manner that conflicts with the competitive neutrality principles.

The FRACA does not offer a gym-only service price and so private sector gym operators need to compete on the bundled service price. 84 The bundled service provides broad access to all of the FRAC facilities, including unlimited access to the recreational pool access service during public access times. 85

As noted previously, the price for recreational pool access is effectively set at zero within the bundled price given the approach adopted in the FRACA’s competitive neutrality review (see section 4.3.2.1(c)). Further, while the FRACA’s competitive neutrality review does not calculate a private sector-equivalent cost-reflective price for recreational pool access, the FRACA does charge for recreational pool access outside the bundled gym membership products.

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82 FRACA, Fleurieu Regional Aquatic Centre Authority Competitive Neutrality Review, Full Report (partially redacted), November 2018, p.22.
84 While the FRAC provides a Health club casual use rate, it is part of the “All Access” casual admission which provides visitor access to the entire Centre, including recreational pool access. Source: FRACA, Fleurieu Regional Aquatic Centre Authority Competitive Neutrality Review, Full Report (partially redacted), November 2018, p.28. This is confirmed by examining the fee chart for the FRAC on its website (viewed 20 May 2019), where gym facilities are a component of the All Access Casual Admission rates.
85 Membership details provided on the FRAC website, viewed 20 May 2019.
These charges are illustrative of the actual price the FRACA is charging for recreational pool access on a CSO basis (that is, when the pool infrastructure financed through grants and rates is not being used on a commercial footing). So, in circumstances where the pool infrastructure assets are being used to provide recreational pool access on a commercial footing (that is, in the competitive market), at a minimum, the pricing of recreational pool access would reasonably be expected to resemble the CSO-type price the FRACA charges for that service (given that the CSO price need not be set to recover full economic costs).

This pricing should apply to the bundled gym services/recreational pool access product competing in the regional gym services market – but it does not. The price for casual admittance to the recreational pool access service is currently $6.50 for a single adult admittance and effectively $5.85 per session for the 20 times admittance option. So if a customer swims more than three times per week, based on the Full members’ rate of $17.90 per week (see Table 4.3), they would be better off taking out gym membership even if they never use the gym.

Table 4.3: Wallmans’ derived bundled gym services/recreational pool access product price compared with the FRACA approved price, and current and 2019-20 budget prices

<table>
<thead>
<tr>
<th></th>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Full</td>
<td>$16.51 per week</td>
<td>$16.27 per week</td>
<td>$17.90 per week $16.27 ex. GST</td>
<td>$18.50 per week $16.82 ex. GST</td>
</tr>
<tr>
<td>Concession</td>
<td>$16.51 per week</td>
<td>$13.02 per week</td>
<td>$14.33 per week $13.02 ex. GST</td>
<td>$14.80 per week $13.45 ex. GST</td>
</tr>
<tr>
<td>Mates Rates</td>
<td>$16.51 per week</td>
<td>$13.26 per week</td>
<td>$14.33 per week $13.02 ex. GST</td>
<td>$15.35 per week $13.95 ex. GST</td>
</tr>
<tr>
<td>Active Adults 60Y+ &amp; Active Youth 13Y-15Y</td>
<td>$15.74 per week</td>
<td>$11.93 per week</td>
<td>$13.13 per week $11.93 ex. GST</td>
<td>$13.50 per week $12.27 ex. GST</td>
</tr>
<tr>
<td>Foundation</td>
<td>$16.51 per week</td>
<td>$11.82 per week</td>
<td>n.a.</td>
<td>$13.00 per week $11.82 ex. GST</td>
</tr>
</tbody>
</table>

Source: Wallmans’ November 2018 review, the FRAC website (May 2019) and FRACA website (February 2019)

Meanwhile, the FRACA’s 2018-19 list price, before discounts, for bundled gym services/recreational pool access product is lower than the private sector-equivalent cost-reflective price in the FRACA’s competitive neutrality review (see Table 4.3).

Further, as the cost-reflective price effectively prices recreational pool access at zero (section 4.3.2.1(b)), this means the actual pricing of the bundle does as well. This contrasts sharply with the actual price charged for recreational pool access. Logically, it might be expected that a similar price

86 The 20X casual Aquatic Access cost $117 when the FRAC website was viewed on 20 May 2019.
87 FRACA, Fleurieu Regional Aquatic Centre Authority Competitive Neutrality Review, Full Report (partially redacted), November 2018, pp.31-32.
88 FRACA, Fleurieu Regional Aquatic Centre Authority Competitive Neutrality Review, Full Report (partially redacted), November 2018, pp.31-32.
91 Based on advertised standard rate – FRACA website viewed 20 May 2019.
for recreational pool access would be charged within the bundle as on a standalone basis. If not, then the question is why not?

Overall, it is not clear what justification there is to provide what is, in effect, preferential recreational pool access to the FRAC’s gym services customers. The only purpose of the actual pricing of recreational pool access within the bundled product appears to be to provide the FRACA with a superior bundled product, which cannot be replicated by other private sector operators, to compete in the gym services market. This has the characteristics of unfair competition, where the use of the infrastructure financed through grants and rates might be seen to be effectively cross-subsidising the FRACA’s market presence within the market for a significant business activity.

4.3.3.2 Discount pricing

The situation described above is exacerbated by the FRACA’s persistent and deep discounting. Over 80 percent of gym members have access to discounts on the FRACA Full membership fee. Discounts range from 19.7 percent (Mates Rates) to 28.4 percent (Foundation). The estimated average membership price is $14.42 per week (including GST), compared with $17.90 per week for Full membership. Consequently, the actual prices being charged to most customers are at a significant discount to the headline prices of the FRACA. Also, as noted previously, these prices effectively include recreational pool access at a price of zero.

The FRACA’s strategy has been to use the Mates Rates membership to build overall membership numbers. The FRACA has determined to retain this membership type, but decrease the level of discount applied from 20 per cent to 15 per cent over the next three years. Consistent with this, the 2019-20 Mates Rates weekly fee is a 17 per cent discount on the equivalent Full membership fee (Table 4.3, column 4). But this means that, with over two years of operation and a further three years of planned discounts, the Mates Rates membership price will likely still be in effect operating as a loss-leader after five years of operation (unless there is a substantial rise in the underlying Mates Rates membership price to which these discounts are applied). This loss-leader approach may reflect FRACA’s concern that by pricing higher (to reflect full cost-reflective prices) it risks a significant decline in patronage, with flow-on effects to the required level of Councils’ CSO contribution.

However, within the Victor Harbor area the private sector gym operators are small to medium sized enterprises. It might reasonably be expected that they would find it extremely challenging to absorb the losses the FRACA is proposing over the period of time it is contemplating. Such loss-leading behaviour by the FRACA might be considered sustained and excessive.

Overall, the FRACA’s pricing strategy appears to conflict with the intent of the competitive neutrality policy and principles. While the competitive neutrality principles provide for pricing strategies that allow loss-leading behaviour in the short term, prices are required to achieve private sector equivalence in the medium to long term (see section 3.5.2). Given the context of the market in which the FRACA is competing, sustaining loss-leading behaviour for more than two years might be considered unreasonable. This point is addressed further in the next section, where the Commission considers the FRACA’s cost-benefit assessment (see section 4.3.4).

93 The average $14.42 per week price is a weighted average price, and is derived by multiplying current approved prices for 2018-19 (inclusive of GST) for each membership type by the estimated number of members for that type, then summing and dividing by total estimated number of members. FRACA, Fleurieu Regional Aquatic Centre Authority Competitive Neutrality Review, Full Report (partially redacted), November 2018, p.61.
94 FRACA, Fleurieu Regional Aquatic Centre Authority Competitive Neutrality Review, Full Report (partially redacted), November 2018, p.31.
95 FRACA, Fleurieu Regional Aquatic Centre Authority Competitive Neutrality Review, Summary Overview, November 2018, p.5.
4.3.4 Cost-benefit assessment

The FRACA considers there is no net public benefit to the community in applying private sector-equivalent cost-reflective pricing to full membership (that is, pricing before discounts).\(^{96}\) The specific reasons provided in its competitive neutrality review are:

- Approved prices for the full fee membership are in line with current competitor market pricing.
- The price set would be non-competitive in the market and membership numbers would significantly decrease. This would have a significant flow on effect in the delivering the CSO services, as those would require significantly higher subsidies.
- The costs allocated to the bundled gym services/recreational pool access product memberships may be overstated because a number of members might only be using the aquatic facilities and be part of the CSO. The costs associated with these members should be allocated to the CSO.
- The FRACA fitness product offering comprises a modest gym when compared to other gyms in the market. Further, the group fitness elements are focused on the needs of older adults.

The Commission has concerns with those statements for the following reasons:

- It is incorrect to characterise the FRACA’s pricing as in line with current market pricing. The FRACA does not offer a gym services-only product, which would be comparable with the general market offering. The FRACA offers only a bundled gym services/recreational pool access product.
- How the FRACA finances what it considers its CSO is not the primary concern of the competitive neutrality legislation and guidance. Competitive neutrality principles have been put in place to ensure efficient pricing and fair competition (see section 3.5.2.2). This is reflected in the fact that the guidance regarding the factors to consider in a cost-benefit analysis include a considerable array of factors related to efficient allocation of resources, consumer outcomes, impact on competitors within the relevant market and so forth (section 3.5.2.2).
- While the FRACA states that it is not able to accurately quantify the percentage of customers using the bundled service for recreational pool access only,\(^ {97}\) it should be in a position to determine a reasonable estimate in the near term, even if this required some surveying of use, and to rectify this situation over the medium to long term. It should also be noted that this is likely a problem of the FRACA’s own making because of its pricing structure. As it currently stands, it is likely to be more cost effective for a regular recreational swimmer to join the gym solely to gain access to the pools, given the pricing of the bundled gym services/recreational pool access product relative to the pricing structure of recreational pool access. This, in part, reflects the fact that the effective price of recreational pool access in the bundled product is zero.
- How modest the FRAC gym might be is not relevant when it is the bundled service that private sector gyms must compete with; also, that is ultimately a decision for consumers to make.

Further, having regard to the full range of cost-benefit factors that a local government agency needs to take into account, the Commission’s view is that the FRACA’s assessment is too narrow and does not suitably address the socio-economic context. Arguably, this results in the FRACA suggesting that what is best for its operating environment is necessarily also what is best for the socio-economic context of the region; however, it has not provided sufficient evidence to support that contention.

\(^{96}\) FRACA, Fleurieu Regional Aquatic Centre Authority Competitive Neutrality Review; Full Report (partially redacted), November 2018, pp.32-33.
\(^{97}\) FRACA, Fleurieu Regional Aquatic Centre Authority Competitive Neutrality Review; Full Report (partially redacted), November 2018, p.32.
Table 2.3 summarises the factors that a local government agency must take into account when making an assessment of the costs and benefits of implementing competitive neutrality principles.\textsuperscript{96} The Commission considers that the FRACA has not had appropriate regard to some key Clause 7 Statement cost-benefit factors, including:

- Impact on actual/potential competitors of the relevant local government business activity
- Local policies relating to:
  - economic and business development
  - local employment
  - quality of supply of goods and services, including timeliness of supply
- Impact on the local community
- Competitiveness of Australian businesses
- Increased market contestability
- Economic and regional development, including employment and investment growth, and
- Efficient allocation of resources.

A further observation is that account needs to be taken of the relative scale of private sector gym operators to that of the FRACA, which is supported and cross-subsidised by two local councils.

While, for the two local councils, the gym service may represent a small percentage of their operation, private sector gyms are generally small or medium sized businesses without the same level of financial support to fall back on. This is the case for the complainants, which were operating in the area well before the FRAC opened, and so did not have the benefit of prior opportunity to factor the FRACA’s pricing approach into their business models. The impact the FRACA pricing approach has had on the complainants is outlined in Appendix 4.

While the FRACA suggests that it does not consider that there are net benefits to it adopting private sector-equivalent cost-reflective pricing, an alternative interpretation of the FRACA’s pricing strategy is that it represents a net cost to the community over the medium to long term. It risks reducing community choice and might impact negatively on small to medium sized businesses in the region. The FRACA’s competitive neutrality review does not appear to address the potential for such an alternative, nor does it consider how the FRAC might be managed to allow it and local private sector gym operators to coexist.

Specifically, from the perspective of the development of the regional gym market, because of its ‘deep-pockets’ and product scope, the FRACA can act as a price leader, which appears to have the capacity to absorb heavy discounting for a number of years. This would not be sustainable for a private sector operator in the relevant market. If the market is left to evolve in this manner, it is possible that private sector competitors will exit the market at an opportune moment\textsuperscript{99} and new entry may be deterred.

In this context, studies have forecast the FRAC may require an operating subsidy from the Alexandrina Council and City of Victor Harbor over the useful life of the asset, which is approximately 50 years.\textsuperscript{100} The FRACA also notes that both councils have determined, as a matter of public policy, that the FRAC will not be financially viable absent ongoing council funding.\textsuperscript{101} If this is the case then, from an

\textsuperscript{96} Table 2.3 is based on Clause 7 Statement, p.10.
\textsuperscript{99} This is most likely to occur when property leases expire or owned premises can be put to an alternative use or sold.
\textsuperscript{101} FRACA, Fleurieu Regional Aquatic Centre Authority Competitive Neutrality Review, Full Report (partially redacted), November 2018, p.14.
overarching socio-economic context, there seems very little detriment in the FRACA ensuring appropriate private sector equivalency in the pricing of its bundled product, which will provide private sector gym operators the opportunity to compete on fair terms.

4.4 Summary of findings

Based on the evidence available to it, the Commission is of the view the complaint that the FRACA is providing a bundled gym services/recreational pool access product at a price below which gym-only services can be offered by private sector operators has merit. Further, the FRACA does not provide a gym-only membership product and so private sector operators have no choice but to compete against the bundled offering. Consequently, based on the Commission’s analysis, it is open to conclude that the competitive neutrality policy and principles are being infringed.

A further observation is that the FRACA, whether inadvertently or otherwise, is leveraging its position by bundling recreational pool access with the gym service offering. The leveraging is reflected in offering the bundled service in a competitive market for a period of over two years at a price that does not reflect the cost of the overall product offering. The fact the FRACA is planning to continue to do so simply exacerbates this.

4.5 Recommendations for possible remedies

If the FRACA’s failure to apply competitive neutrality principles is considered a concern, the Commission suggests that it may be resolvable through the following combined actions by the FRACA:

- Providing separate gym-only and bundled gym services/recreational pool access products.
- Developing and implementing a cost-reflective price that accurately reflects the private sector-equivalent cost of providing a gym-only product.
- Ensuring the price charged for a bundled service accurately reflects the costs associated with providing the CSO recreational pool access products.

An alternative remedy would be for all members of gyms in the Victor Harbor region to have access to recreational swimming on the same terms as the members of the FRAC, net of any transaction costs involved. In 2017, the complainants sought equal access to the FRAC pool for all gyms in the area on this basis, an approach rejected by the FRACA at the time on the grounds the proposal was not considered attractive for the FRAC.\(^{102}\)

These proposed remedies seek to achieve a consistent basis of competition across the two ownership sectors (local government and private sector), without interfering with those differences in size, assets, skills and organisational culture which are inherent in the competitive process. The Commission’s view is that this would align with the intent of the competitive neutrality principles.

It is also the Commission’s view that if such actions are considered appropriate, consideration should be given to applying them in the very near term. The FRACA has already been in effect operating with substantial loss-leaders for over two years so it would be reasonable to expect that, if an infringement is confirmed by the Competition Commissioner, such activity should cease immediately.

\(^{102}\) Email from Mr Graham Mowatt (Spa Clubs Fitness) to the South Australian Small Business Commissioner dated 30 November 2018, attaching a copy of a letter dated 20 February 2017 from the Chairperson and Executive Officer of the FRACA to the complainants.
Appendix 1 - Treasurer’s referral letter

The Hon Rob Lucas MLC

Mr Brett Rowse
Chairperson
Essential Services Commission of South Australia
GPO Box 2605
ADELAIDE SA 5001

Brett.Rowse@escosa.sa.gov.au

Dear Mr Rowse,

In my capacity as Treasurer I seek advice from the Essential Services Commission of South Australia (Commission) in accordance with section 5(f) of the Essential Services Commission Act 2002 (ESC Act), to assist in the investigation of competitive neutrality complaints under the Government Business Enterprises (Competition) Act 1996 (GBE Act).

Background

1. Principles of competitive neutrality are designed to neutralise any net competitive advantage that a government or local government agency engaged in significant business activities would otherwise have, by virtue of its control by the government or local government, over private business operating in the same market.

2. Under Part 4 of the GBE Act, an appointed Competition Commissioner may be assigned to investigate, and prepare a report on, complaints of infringements of the principles of competitive neutrality.

3. Cabinet approved your appointment as a Competition Commissioner under section 5 of the GBE Act on 17 December 2018.

4. Further to this appointment, I seek advice from the Commission in relation to competitive neutrality complaints submitted to the Department of the Premier and Cabinet.

Referral

Subject to the requirements set out in this request for advice, I, Rob Lucas, Treasurer, request the Commission to provide advice to me pursuant to section 5(f) of the ESC Act in relation to any competitive neutrality complaints made under Part 4 of the GBE Act and referred to it by the Department of the Premier and Cabinet.
Requirements for the advice

In providing its advice, the Commission must:

1. have regard to the objectives of the GBE Act, the requirements of Part 4 and Part 5 of the GBE Act and the principles of competitive neutrality issued under the GBE Act
2. work collaboratively with the Department of the Premier and Cabinet to obtain any relevant information or data required to inform the advice, and
3. consult with, and seek any information from, any other relevant parties as required.

I am advised that in order to provide the advice, arrangements will be made between the Commission and the Department of the Premier and Cabinet to provide funding to cover all staff time, resources and materials to ensure no cross subsidy occurs with other statutory functions or powers undertaken by the Commission.

If the Commission requires further information in relation to this request for advice, please contact Graham Cooper, Manager, Cabinet Office, Department of the Premier and Cabinet on 8429 5113.

Yours sincerely

Hon Rob Lucas MLC
Treasurer

January 2019
Appendix 2 - Definition of significant business activity

As outlined in the Clause 7 Statement, in the context of competitive neutrality, a business activity is defined as any activity undertaken:

(a) which falls within the Australian Bureau of Statistics classification of ‘Public Trading Enterprise’ and ‘Public Financial Enterprise’; or

(b) where:
   (i) the activity is primarily involved in producing goods and services for sale in the market; and
   (ii) the activity has a commercial or profit-making focus; and
   (iii) there is user charging for goods and/or services; and
   (iv) the activity is not primarily funded from rate or grant revenue; or

(c) where the local government agency submits a tender as part of a tendering process in competition with the private sector.

An activity will not be a business activity if:

(d) it provides goods or services to the local government agency and for reasons of policy or law there is no competition with alternative suppliers; or

(e) it is clear that the intention of the local government organisation is that the activity’s predominant role is regulatory or policy-making, or where the achievement of the community benefits is the main priority of the activity.

Whether an activity is a significant business activity to which competitive neutrality principles should be applied is a matter for each local government agency to determine. This determination should be made taking into account:

▶ The intent of National Competition Policy.
▶ Whether the business activity possess sufficient market power to create a competitive impact that is more than nominal or trivial.
▶ Whether the size of the business activity relative to the size of the market as a whole is more than nominal or trivial.

Significant business activities are categorised as follows:

▶ Category 1 being a business activity with an annual revenue in excess of $2 million or employing assets in excess of $20 million.
▶ Category 2 relates to all other significant business activities.

Source: Clause 7 Statement, page 9.
Appendix 3 – Recreational pool access charged at zero cost

The following presents the basis on which the Commission concludes that the Wallmans/FRACA methodology effectively prices recreational pool access at zero within the bundled gym services/recreational pool access product.

The FRACA has defined the base CSO as recreational swimming and water play, which the Commission has defined as ‘recreational pool access’.\textsuperscript{103}

The FRACA calculates cost-reflective pricing ‘… by dividing the competitively neutral costs for each output by the forecast number of consumers of that output’.\textsuperscript{104}

The FRACA has determined that the provision of recreational pool access is not a business activity for the purposes of the application of the principles of competitive neutrality.\textsuperscript{105}

The FRACA determined significant business activity of Fitness services includes ‘bundled aquatic/gym membership’, which the Commission has defined as the ‘bundled gym services/recreational pool access product’.\textsuperscript{106}

Wallmans’ cost allocation methodology resulted in the bundled gym services/recreational pool access product being allocated $778,649 costs for 2018-19.\textsuperscript{107} The Wallmans’ report provides a breakdown of this cost into the components of direct costs, indirect costs and depreciation.\textsuperscript{108} No note or assumption refers to any allocation from recreational pool access. The depreciation cost of $10,583 is stated by Wallmans to be based only on the depreciation expense for the purchased gym equipment.\textsuperscript{109}

Adding adjustments for estimated ‘net competitive advantage’ resulted in a total competitively neutral cost estimate of $798,966.\textsuperscript{110} To this figure, Wallmans added the following:\textsuperscript{111}

- Allocation of share of competitively neutral cost of Group Fitness Classes for member participants - $54,906.
- Allocation of share of competitively neutral cost of Group Fitness – Active Adults Classes for member participants - $19,904.

This results in Wallmans’ estimate of a total competitively neutral cost of $873,776, which it then allocated across the membership types, to derive a cost-reflective price of $16.51 per week for all memberships, other than the $15.74 it assigns to the membership of Active Adults 60Y+ & Active Youth 13Y-15Y.\textsuperscript{112} This matches precisely the Wallmans’ estimate of cost-reflective price (excluding GST) provided in Table 4.3, column 1, of this advice.

As a result, the Commission has concluded that recreational pool access has been effectively priced at zero in the bundled gym services/recreational pool access product price.

\textsuperscript{103} FRACA, Fleurieu Regional Aquatic Centre Authority Competitive Neutrality Review November 2018, Summary overview, p.2.
\textsuperscript{104} FRACA, November 2018 Summary overview, p.3.
\textsuperscript{105} FRACA, Fleurieu Regional Aquatic Centre Authority Competitive Neutrality Review November 2018, Full report, p.14.
\textsuperscript{106} FRACA, November 2018 Full report, p.19.
\textsuperscript{107} FRACA, November 2018 Full report, p.20.
\textsuperscript{108} FRACA, November 2018 Full report, p.51.
\textsuperscript{109} FRACA, November 2018 Full report, p.51.
\textsuperscript{110} FRACA, November 2018 Full report, p.22.
\textsuperscript{111} FRACA, November 2018 Full report, p.61.
\textsuperscript{112} FRACA, November 2018 Full report, p.61.
Appendix 4 – Development of the market for gym services in the Victor Harbor area

Summary
Prior to the FRAC, the gym services market in the Victor Harbor region was very competitive and profitability challenging. Despite this, the main market participants were competing on an even footing in terms of product offering and access to financing options. The FRAC altered this, particularly the introduction of the FRACA’s bundled gym services/recreational pool access product at a price not in line with private sector-equivalent cost-reflective pricing. This, coupled with the FRACA’s operations being underwritten by Alexandrina Council and the City of Victor Harbor, result in the FRACA having the capability to exert influence over the direction of the gym services market in the region. This extends to the future commercial viability of the private sector small-to-medium sized businesses operating in this sector.

Development of the market in the Victor Harbor region

In 2006, the complainants FIT Goolwa and Spa Clubs Fitness started providing gym services in the region. Spa Clubs Fitness was located in the centre of Victor Harbor, with FIT Goolwa located approximately 20 kilometres away in Goolwa. Anytime Fitness entered the market in May 2013 and changed the dynamics of the market place. Anytime Fitness was located in the centre of Victor Harbor, approximately a kilometre from Spa Clubs Fitness. Anytime Fitness provided basic level core gym services and entered the market at a price lower than that charged by FIT Goolwa and Spa Clubs Fitness.

In terms of the product offering, while the core gym services provided by Anytime Fitness were relatively standard, its presence introduced new services to the market. These included 24/7 access and reciprocal rights to other franchised Anytime Fitness facilities. These services were accompanied by lower staffing levels, thereby reducing costs. By contrast, FIT Goolwa and Spa Clubs Fitness did not provide 24/7 access. They had defined fully staffed opening hours. Also neither gym provided reciprocal rights. FIT Goolwa and Spa Clubs Fitness both lost members and their incomes declined.

However, given there was similarity across the product offerings of all three providers, FIT Goolwa and Spa Clubs Fitness were capable of responding. Both FIT Goolwa and Spa Clubs Fitness invested in and introduced 24/7 access. Pricing was reduced, as was staffing levels and staffing hours. Spa Clubs Fitness also provided reciprocal rights across its clubs. This option was not open to FIT Goolwa because it was a single club. Also, both FIT Goolwa and Spa Clubs Fitness sought to develop their product mix in order to differentiate themselves from Anytime Fitness. This included a greater focus on the provision of fitness classes. This took place over 2013-14 to the end of 2015-16.

The overall outcome of this was a gym services market that comprised three main providers, and some fringe providers, there was more choice and flexibility to customers at lower prices. However, this did impact the profitability of FIT Goolwa and Spa Clubs Fitness, with both clubs struggling. The data provided by FIT Goolwa and Spa Clubs Fitness for 2015-16 (last financial year prior to FRAC opening) suggested that the market might struggle to accommodate further competitors.

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113 The Commission’s assessment is based on confidential operational performance data provided by both FIT Goolwa and Spa Clubs Fitness for the purposes of this Commission competitive neutrality advice. This data includes: average membership numbers; membership income and costs; and depreciation/amortisation. This provided the Commission with standard accounting reporting measures of PBITDA (profit before interest, tax, depreciation and amortisation) and PBIT (profit before interest and tax). This data covers the period from 2013 (prior to the FRAC opening) to the present. The Commission has attempted to cross-check the data sufficiently to ensure its robustness and to achieve a level of accuracy sufficient to provide a good understanding of the broad impact of the FRAC on private gym operators.
As a result, the FRAC opened in March 2017 into what was an already challenging market place. The FRACA provides a bundled gym services/recreational pool access product. While the full fee membership price is competitive, significant discounts to the full fee also apply.

Uptake of the membership of the FRACA’s bundled gym services/recreational pool access product was fast. In the period up to the end June 2017, 770 people became members, increasing to 1,010 by end June 2018. The FRACA estimates that by the end of June 2019 it will have 1,116 memberships.

While, at face value, such a rise might be expected to have significant consequences for the membership levels of the private sector gym providers, it was not as pronounced as might be expected. The reasons for this are:

- The pricing structure of the FRACA’s bundled gym services/recreational pool access product (including discounts), mean that for recreational swimmers who use the pool regularly it can be cost effective to become a member simply to access the pool at a lower actual cost per session. Given this, the FRAC membership includes a proportion that have little interest in using the gym services but have an interest in swimming on a regular basis. The proportion of members in this category is not known.

- The FRACA may have opened up gym services to parts of the population and increased the overall market size. It provides gym services in a differing setting and environment that might appeal to differing socio-economic groups from those using the private sector operator’s facilities. Notably, 54 percent of FRAC members are aged 60 years and over.

- Each of Anytime Fitness, FIT Goolwa and Spa Clubs Fitness has responded to the introduction of the FRAC. In terms of Anytime Fitness, the Commission’s understanding is that the main partner sold out of the business around May 2017 and this led to various changes. In particular, Anytime Fitness became more focused on offering a basic, low-cost gym service for the younger, highly motivated, demographic. Spa Clubs Fitness reduced prices to maintain members, but consider it also benefitted from people moving back to it from Anytime Fitness. FIT Goolwa also reduced prices, but not to the same extent as Spa Clubs Fitness.

Overall, income levels and operating margins continued to be challenged, as did maintaining memberships. Further, the price of FRACA’s bundled gym services/recreational pool access product has acted as a benchmark within the market. This is despite the fact the price does not reflect private sector-equivalent costs (in terms of pool use) and the product is being provided by the FRACA in effect as a loss-leader.

From the perspective of private sector operators, these outcomes have arisen because pricing (by them) at levels above the FRACA bundled price risks losing memberships, as members could credibly threaten to switch to the FRAC. However, this leads to a vicious circle, as pricing below the FRACA bundled price simply intensifies an already competitive market - but from the basis of an artificially low price. The outcome is an operating environment for private sector operators which is challenging in a way that is not faced by the FRACA.

Further, from the perspective of existing private sector operators and potential market entrants, there is effectively no end point to this, based upon the FRACA’s pricing behaviour to date. This is because both Alexandrina Council and the City of Victor Harbor have signalled their intent to underwrite the FRACA through significant cash contributions to its operations. The FRACA’s 2017-18 annual report indicates that $1.37 million or 45 percent of the FRACA’s income was provided by council contributions. The councils also obtained Commonwealth and State Government grants to assist in funding the

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114 FRACA 2016-17 Annual Report, p.9
116 Email from Executive Officer FRACA dated 31 May 2019.
construction of the FRAC. Of the $21 million cost, 38 percent was obtained via grants, with the remainder financed by the councils.

The effect of this is two-fold. Firstly it potentially creates barriers to entry. This is because the FRACA’s pricing strategy has the potential to set the foundation for competition, but the strategy reflects the FRACA’s capability to absorb medium to long term losses, to an extent not possible by small to medium sized private sector businesses. Secondly, it has implications for the value of private sector businesses operating with the market. This is because the value of these businesses largely depends upon future profit generation potential, which is being influenced by the FRACA’s pricing structure and the underwriting by the relevant councils. One of the complainants has experienced the implications of the FRAC in this regard.
Dear Mr Rowse,

Thank you for your letter (dated 4 December 2019) which attached the draft summary report with respect to Competitive Neutrality Complaint against the Fleurieu Regional Aquatic Centre Authority As Owner And Operator Of The Fleurieu Regional Aquatic Centre (December 2019) (Summary Report).

The response of the Fleurieu Regional Aquatic Centre Authority (Authority) to the Summary Report is set out in this letter.

The Authority welcomes the recognition by the Commissioner that the Authority has taken steps to implement the principles of competitive neutrality. The Summary Report makes three recommendations as to further actions which the Commissioner considers the Authority should take in respect of implementing these principles. These recommendations are:

- the implementation of separate gym-only, recreational pool only and bundled gym services/recreational pool access products;
- the application of a cost reflective price that accurately reflects the private sector-equivalent cost of providing a gym-only service.; and
- ensuring that the price charged for a bundled gym services/recreational pool access product accurately prices for the separate gym-only and recreational pool only products net of any transaction cost savings identified for bundled memberships.

Each of these recommendations is premised on the Authority offering separate gym-only and pool-only membership products. Consequently, the Authority’s response is focused on the recommendation that separate gym-only and pool-only membership products be offered by the Authority. The Authority reserves its position in respect of other aspects of the Summary Report which are contrary to the submissions made by the Authority in response to the Competitive Neutrality Advice – Fleurieu Regional Aquatic Centre Authority: Final (June 2019) (Investigative Report).

Implementation of a gym-only product is not required by the principles of competitive neutrality.


As indicated in the Authority’s response to the Investigative Report, the principles of competitive neutrality are intended to remove distortions caused by public sector ownership of significant business activities by removing advantages and disadvantages arising from that ownership.
The principles of competitive neutrality do not compel or preclude the provision of particular types of goods or services by public sector business activities. The principles of competitive neutrality do not constrain the types of goods or services which may be offered by a public sector business. Goods and services do not need to be provided on a like-for-like basis with private sector competitors. To compel this outcome would lead to inefficient outcomes, decrease consumer choice and reduce competition.

It would be contrary to the competitive process to require businesses (whether in private or public sector ownership) to only provide services on a like-for-like basis with other competitors in a market. Any type of understanding between competitors to limit service offerings on this basis is likely to contravene the Competition and Consumer Act 2010 (Cth). An efficient use of resources will result from a business being able to innovate in the manner in which services are provided through use of its available resources. Through this innovation, businesses distinguish themselves from competitors and consumers are offered greater choice.

There is no constraint within the principles of competitive neutrality on a government-owned business offering services on a whole-of-facility basis (even where part of the facility is delivered as a community service obligation).

Section 17(1) of the Government Business Enterprises (Competition Act) 1996 (GBE Act) enables a person who competes, or seeks to compete, in a particular market to lodge a complaint with the Minister alleging an infringement of the principles of competitive neutrality by a government or local government agency. Under section 18(1) of the GBE Act, the Minister may appoint an investigator to investigate a complaint alleging an infringement of the principles of competitive neutrality.

As the principles of competitive neutrality are unconcerned with the type of products provided by a significant government business activity, a recommendation that a particular configuration of products be provided is not a recommendation directed to whether or not there has been an infringement of the principles of competitive neutrality.

Rather than being focused on a distortion related to public sector ownership of the Aquatic Centre, the recommendation is focused on the difference in product offering by the Aquatic Centre in comparison to other operators in the market. Each of the operators in the market provides differently configured products.

The recommendation to provide separate gym-only and pool-only products not directed to correcting an infringement of the principles of competitive neutrality. Consequently, the recommendation is outside of the scope of an investigation under the GBE Act (i.e. is ultra vires).

**Implementation of recommendation to offer a gym-only product**

The Policy Statement indicates that:

The principles of competitive neutrality are to be applied to significant government business activities where it is appropriate to do so, and where the benefits to be realised outweigh the costs associated with implementation.

This replicates the statement in clause 3(6) of the Competition Principles Agreement (dated 11 April 1995) that the principles need be implemented in regard to a significant business activity ‘to the extent that the benefits to be realised from implementation outweigh the costs’. The Competition Principles Agreement is the document from which the principles of competitive neutrality originate.
Operational segregation will incur cost without public benefit

The Authority’s response to the investigative report indicated that to implement a gym-only membership product would require capital works to be undertaken at significant cost. The implementation (even if required by the principles of competitive neutrality) and its associated cost has no perceived public benefit. The cost would need to be funded by the Constituent Councils through rates which would reduce funds for other community facilities. There is no public benefit achieved through the segregation of membership products which outweighs the costs of providing segregated products. The costs of operational segregation and physical segregation are discussed in more detail below.

The Summary Report states that:

The FRACA alluded to potentially prohibitive capital costs to construct physical barriers between the pool and gym areas to ensure enforcement of gym services-only or aquatic-only memberships. While no supporting material was provided to back the claim, the need for physical barriers would seem an excessive response compared to random checks of members entitlements and the fact that many regular members would be known to staff who would be familiar with their membership status.

The principles of competitive neutrality are focused on addressing pricing distortions and do not require either operational change or a particular physical configuration of facilities offered by a significant government business activity. Rephrasing an observation made in the inquiry which led to the Competition Principles Agreement, the Policy Statement recognises that:

Competition policy does not require that all firms compete on an equal footing: Differences in size, assets, skills, experience and culture underpin each firm’s unique set of competitive advantages and disadvantages. Differences of this kind are the hallmark of a competitive market economy and not a consequence of public as distinct from private sector ownership.

The application of the principles of competitive neutrality is unconcerned with operational delivery of goods or services by significant government business activities or the facilities used for this purpose. Consequently, a recommendation which requires operational change or capital works for its implementation is not a recommendation directed to whether or not there has been an infringement of the principles of competitive neutrality. The recommendation is, therefore, outside of the scope of an investigation under the GBE Act (i.e. ultra vires).

**Operational segregation will incur cost without public benefit**

The summary report suggests that random checks and recognition of members will provide an effective means of policing segregated membership products.

Operationally it will not be practicable to undertake random checks of members to effectively provide for a separate gym-only membership product. The Aquatic Centre has more than 1,200 members and has on average 20,000 visits per month. Many of these visits are by casual users. This is a considerable cohort of people to monitor in regard to segregated usage.

There is no current means of distinguishing between gym-only members, pool-only members and casual users of the Centre. Implementing random checks on members will require additional staff and a change in culture at the Aquatic Centre. Access currently is on a whole of facility basis with access being provided via a reception area at the front of the Centre without the need to ‘police’ member access to particular areas. Wristbands to distinguish between members when they access the Centre is considered to be an unwarranted imposition on members and would be an additional cost to be borne by the Centre.
The Authority envisages that additional staff will be required in order to implement an operational separation of members, as policing the segregation would not be added to the responsibilities of lifeguards currently employed at the Centre to ensure pool usage is safe.

The costs of implementing operational change to segregate gym-only membership form pool-only membership is unwarranted and provides no perceptible public benefit. The segregation of usage is contrary to the intended use of the Centre. The Authority envisages that the policing of segregated membership will diminish user’s experience at the facility and may ultimately discourage membership and casual use.

**Physical segregation will impose cost without public benefit**

The Summary Report states that the need for physical barriers is an excessive response. This view is not supported by an understanding of the layout and operation of the Aquatic Centre. The Aquatic Centre has not been designed or constructed to provide segregated gym-only and pool-only membership products. The Centre has been designed and constructed to provide whole-of-facility access to users.

A plan of the Aquatic Centre is provided for your consideration. Aside from showing the existing layout of the Aquatic Centre, the plan shows the works which would be required to physically separate the gym area from the pool area. Such a physical separation is contrary to the design of the Aquatic Centre and the provision of whole-of-centre access.

The costings on the plan do not fully reflect the costs of implementing a gym-only membership product as operational implications of the gym only package still require detailed costing for alterations to the changing rooms and point of sale / scanning access. Tradespeople have not been available from the lead up to the Christmas/ New Year period and though January 2020 to provide detailed quotes for works required.

At this stage the Authority estimates that building modifications would be a minimum of one additional access point (estimated cost: $6,000) and additional lockers (estimated cost: $10,000). This results in infrastructure costs totalling $16,000. The cost of providing separate change rooms for the gym-only members also needs to be taken into account. Currently, the Centre has a single set of change rooms servicing all users. The cost of the additional change rooms and associated modifications are estimated to range between $100,000 - $250,000. These additional change rooms are not warranted by existing user numbers.

The common hallway linking wet and dry area as noted on attached floorplan by asterisk (*) and highlighted in yellow text would require permanent closure in order to provide separate gym-only and pool-only membership. Although this can be achieved by locking the door separating the area it will be a large inconvenience for swim/gym combined members as they will be required to leave the respective area, traverse the entrance foyer to gain access to other area if using gym and then swimming or vice versa.

No public benefit arises through making these physical changes to the Aquatic Centre to outweigh the costs either in terms of financial costs or user inconvenience.

**Recommendations regarding the competitive neutrality framework are irrelevant to the complaint against the Authority**

The Summary Report includes recommendations which are unrelated to the complaint against the Authority. These are that that the guidance material contained in the ‘South Australian Government’s Competitive Neutrality Policy Statement’ and in the ‘Guide to the Implementation of Competitive Neutrality Policy’ be updated to provide further clarity on:
• the conduct of cost/benefit assessments;
• timeframes for the application of full cost reflective pricing and ceasing loss-leading pricing strategies; and
• acceptable pricing structures where bundled service products are being offered at less than full cost reflective prices.

The Authority’s obligation in respect of implementing the principle of competitive neutrality can only relate to the implementation of the principles of competitive neutrality as currently stated in the Policy Statement and Clause 7 Statement.

The Authority suggests that any recommendations relating the competitive neutrality framework should be pursued by means other than the Summary Report.

**Commitment of the Authority to implement the principles of competitive neutrality**

The Authority has demonstrated its commitment to implementing the principles of competitive neutrality as set out in the Policy Statement and Clause 7 Statement. The Authority will continue to fulfil its obligation to annually review the application of these principles to the outputs of its significant business activities.

In its 2020-21 review of products and prices the Authority will reconsider the implementation of a separate gym-only membership product. However, the adoption of such a product cannot be committed to without a more detailed understanding of the costs involved and the business case (in terms of anticipated user numbers) for the additional costs. A decision of this nature requires authorisation by the Board of the Authority and the commitment of the Constituent Councils. If a new gym-only product is adopted by the Authority then this will be priced in accordance with the principles of competitive neutrality.

The Authority would be pleased to meet with you to discuss any aspects of its response. A tour of the Aquatic Centre can also be arranged if this would be of assistance to you.

Yours sincerely

Matt Grant

Chairperson

Fleurieu Regional Aquatic Centre Authority