

Economic advice on cost allocation and pricing practices of the national broadcasters

September 2018

Final report

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Mike Makin  
Assistant Secretary  
National Broadcasters Review Taskforce  
Department of Communications and the Arts  
2 Phillip Law Street, Canberra ACT 2601

24 September 2018

## Economic advice on cost allocation and pricing practices of the national broadcasters

Dear Mike

We are pleased to submit this Report on the cost allocation and pricing practices of the national broadcasters, the Australian Broadcasting Corporation (ABC) and the Special Broadcasting Service Corporation (SBS). This Report is provided pursuant to our proposal dated 7 June 2018 and Agreement dated 21 June 2018.

### Restrictions on Report Use

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### Basis of Our Work

We have not independently verified, or accept any responsibility or liability for independently verifying, any information provided to us by the Department or information obtained in the public domain for the purpose of this project, nor do we make any representation as to the accuracy or completeness of the information.

If you would like to discuss any aspects of this letter or the Report in further detail, please do not hesitate to contact me on (02) 9248 5196.

Yours sincerely

Signature redacted

Craig Mickle  
Partner, Economics, Regulation and Policy

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# 1. Executive summary

EY was engaged by the Department of Communications and the Arts to undertake a review of the cost allocation and pricing practices of the ABC and SBS's commercial activities to assist the Australian Government's Inquiry into the competitive neutrality of the national broadcasters.

EY was instructed to adopt a targeted approach which considered the overarching strategies and policies and focused on particular commercial activities of interest (e.g. most material, related to growth areas) rather than undertake a comprehensive review.

Our review of ABC Commercial's activities suggest that:

- ▶ The ABC does not have a formal competitive neutrality policy and it is not clear how it or ABC Commercial considers competitive neutrality in its decision making. There may be benefit in the ABC developing an internal document which outlines how it interprets its obligations in relation to the Commonwealth's competitive neutrality policy and how this is reflected in ABC Commercial's business practices;
- ▶ There does not appear to be any evidence that the ABC's approach to cost allocation and pricing has breached the principles of competitive neutrality. This is supported by the fact that there has only ever been one competitive neutrality complaint made in relation to the ABC to the Productivity Commission, with no adverse findings made;
- ▶ The ABC has a separate division through which all the activities it deems to be commercial (i.e. directed at raising revenues) are undertaken. The segment accounts for ABC Commercial are not reported publicly and were not made available to EY as part of this review;
- ▶ The ABC does not appear to have in place a formal cost allocation methodology document, despite having separate business segments. While the ABC indicated that there are internal procedures applied and internal reviews of the appropriateness of the allocators that are conducted on a regular basis, there may be benefit in developing a formal overarching document which provide the principles to guide the allocation of shared costs between ABC Commercial and the broader ABC (i.e. which operates to fulfil the ABC's Charter obligations);
- ▶ ABC Commercial also has limited ability to influence the price of its content and services, which suggests it is unlikely that its approach is materially inconsistent with competitive neutrality principles; and
- ▶ While the ABC indicated to EY that it undertakes reviews of its compliance with competitive neutrality on a regular basis (e.g. every few years), EY did not see any evidence to support this.<sup>1</sup> The methodology adopted by the ABC to assess its compliance with competitive neutrality could also be improved to more clearly demonstrate its compliance with the requirements and intent of the Guidelines.

Our review of SBS's commercial activities suggest that:

- ▶ SBS does not have a formal competitive neutrality policy but there is evidence that SBS considers competitive neutrality in its decision making. There may be benefit in SBS developing an internal document which outlines how it interprets its obligations in relation to the Commonwealth's competitive neutrality policy and how this is reflected in its business practices;
- ▶ There does not appear to be any evidence that SBS's approach to cost allocation and pricing has breached the principles of competitive neutrality. This is supported by the fact that there has never been any competitive neutrality complaint made in relation to SBS to the Productivity Commission;

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<sup>1</sup> For example, previous reviews were not made available to EY. The ABC also did not mention that it regularly reviews ABC Commercial's compliance with competitive neutrality every few years in its submission.

- ▶ SBS has in place a well-established cost allocation methodology, which appears to be implemented across all business activities, including at the business case stage to underpin decision-making, and also on an ex post basis in the reporting and tracking of activities;
- ▶ SBS maintains that all its activities are driven by meeting the Charter. However within this constraint, SBS appears to engage in a number of more “commercially focussed” activities (i.e. activities that further meeting the Charter but are also commercially attractive to SBS);
- ▶ SBS’s hybrid funding model creates a strong incentive for these activities to at least recover the avoidable costs of undertaking them. If it does not, it will merely will reduce the funding available for other activities over the funding cycle. This would support a view that it is not breaching competitive neutrality in competing in parts of the market; and
- ▶ SBS appears to have limited capacity to influence the market price of advertising or content, which suggests that its approach is unlikely to be inconsistent with competitive neutrality principles. It may however, form a view that it can afford to purchase some appropriate content (i.e. Charter consistent) at prices that fully commercial operators are unable to justify.

## 2. Introduction

### 2.1 Context of the inquiry

In March 2018, the Australian Government appointed a Panel to conduct an inquiry into the competitive neutrality of the national broadcasters, the Australian Broadcasting Corporation (ABC) and Special Broadcasting Service Corporation (SBS). The Department of Communications and the Arts (the Department) is assisting the panel with the Inquiry.

The objective of the Inquiry is to assess whether the national broadcasters operate in a manner consistent with the general principles of competitive neutrality.<sup>2</sup> The Panel has defined competitive neutrality in its *Issues Paper on the Inquiry into the competitive neutrality of the national broadcasters* (Issues Paper) as follows:

*“Competitive neutrality as it relates to government entities means that they should not gain undue competitive advantage as a result of their government ownership when competing with private sector entities.”<sup>3</sup>*

The national broadcasters provide important ‘public service’ functions for the Australian community in terms of the content they provide across various formats, including television, radio and digital media services. They are required to act in accordance with their Charters and functions which are set out by legislation<sup>4</sup>, with their activities largely or almost exclusively funded by the Australian Government as part of its budget each year. However, the national broadcasters also undertake a range of other commercial or business activities in addition to their public service functions.

The Commonwealth Government’s *1996 Competitive Neutrality Policy Statement*<sup>5</sup> (the *Competitive Neutrality Policy Statement*) defines these activities as “business activities”, where there is:

- ▶ User-charging for the good or service;
- ▶ An actual or potential competitor, and
- ▶ A degree of independence in relation to the supply and price of the product.

In providing these activities, the national broadcasters may compete in commercial markets against private media providers. The national broadcasters typically aim to earn an appropriate (i.e. commercial) rate of return on these commercial activities, which should reflect the risks that they face in operating in these markets. This is particularly important because the challenges and risks of operating in the media landscape have accelerated in recent years.<sup>6</sup>

A key aspect of the Inquiry relates to how the national broadcasters set prices for their commercial activities and whether they reflect the full costs of providing the activities, including an appropriate allocation of shared costs and a commercial rate of return specific to each particular product and market.

### 2.2 EY’s scope

In June 2018, EY was engaged to assist the Panel undertaking the inquiry by providing the following services:

- ▶ Providing a cost breakdown of the main commercial activities of the ABC and SBS;

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<sup>2</sup> Australian Government, 2018, *Inquiry into the Competitive Neutrality of the National Broadcasters – Issues Paper*, p. 4

<sup>3</sup> Ibid, p. 10

<sup>4</sup> The Charters and functions are outlined in the *Australian Broadcasting Corporation Act 1983* and the *Special Broadcasting Service Act 1991*

<sup>5</sup> *Commonwealth Competitive Neutrality Policy Statement 1996*, p.7

<sup>6</sup> Australian Government, 2018, *Inquiry into the Competitive Neutrality of the National Broadcasters – Issues Paper*, pp. 5-6

- ▶ Identifying how each broadcaster goes about pricing their commercial activities and services to reflect their allocated costs;
- ▶ Preparing case studies that demonstrate the cost allocation methods of the ABC and SBS – for example, particular commercial activities of the broadcasters, what methods they use to calculate cost allocation and how this aligns with the general principles of competitive neutrality (as defined in the Issues Paper) and the Commonwealth's Competitive Neutrality Policy; and
- ▶ Providing separate comparisons of the ABC and SBS cost allocation methods to a 'model' commercial media participant operating in comparable markets to the ABC and SBS.

EY was not asked to undertake a comprehensive review of the cost allocation and pricing practices of all of the national broadcasters' commercial activities. As a result, EY was instructed to adopt a more targeted approach which considered the overarching strategies and policies and focused on particular commercial activities of interest (e.g. most material, related to growth areas).

### Terminology used in this report

In this report, unless otherwise stated, the term:

- ▶ 'General principles of competitive neutrality' refers to the requirement that government entities should not gain undue competitive advantage as a result of their government ownership when competing with private sector entities, as defined in the Issues Paper. EY has adopted this interpretation for the definition of competitive neutrality for the purposes of this report.
- ▶ 'Competitive Neutrality Policy Statement' refers to the *1996 Competitive Neutrality Policy Statement*, a policy statement made by the Commonwealth Government in 1996 to give effect to the general principles of competitive neutrality and focus on implementing competitive neutrality arrangements for government businesses.
- ▶ 'Commercial activities' refers to all business activities as defined in the Competitive Neutrality Policy Statement plus all other activities where there is a degree of competition in respect of services provided by other operators in the market.
- ▶ 'Best endeavours' refers to the requirement for government businesses to act honestly, reasonably and make a positive effort to perform their Competitive Neutrality obligations. Refer to Section 3.1 of this report for further discussion on the 'best endeavours approach'.

## 2.3 EY's approach

To undertake this analysis, we:

- ▶ Reviewed the ABC and SBS's submission made to the Inquiry;
- ▶ Met with the ABC and SBS to discuss its submission, sought information and made further enquiries to understand the cost allocation and pricing practices of the commercial activities;
- ▶ Reviewed Board papers, internal strategy documents and other additional information that the ABC and SBS provided to EY as part of this review;
- ▶ Assessed the cost allocation and pricing practices for consistency with the Commonwealth Government's Competitive Neutrality Policy Statement, competitive neutrality principles and good industry practice;
- ▶ Summarised our findings in this report; and
- ▶ Provided versions of the draft report to the ABC and SBS for their review.



A full list of information reviewed and stakeholders from the ABC and SBS that EY consulted with is contained in Appendix B.

## 2.4 Acknowledgments

We would like to acknowledge the support and assistance provided by the national broadcasters in meeting with EY, responding to queries and providing information and access to staff members. We appreciate the cooperation of both the ABC and SBS in allowing us to undertake our review.

## 3. Competitive neutrality

### 3.1 Policy objective

The concept of competitive neutrality is broad but widely accepted to mean that government entities should not gain undue competitive advantage as a result of their government ownership (referred to in this report as the ‘general principles of competitive neutrality’).<sup>7</sup>

In Australia, the Commonwealth Government in the 1995 Competition Principles Agreement first stated the general principles of competitive neutrality. Since then, although competitive neutrality is not legislated, these principles have been prescribed in various documents and milestones (see Table 1).

Table 1: Competitive neutrality in Australia

Key document / milestone	Description
1995 Competition Principles Agreement (CPA)	In Australia, the objective of competitive neutrality was first stated in the <i>1995 Competition Principles Agreement (CPA)</i> : to eliminate “resource allocation distortions arising out of public ownership of entities engaged in significant business activities” and that “government businesses should not enjoy any net competitive advantage simply as a result of their public sector ownership.” <sup>8</sup>
1996 Competitive Neutrality Policy Statement	The <i>1996 Competitive Neutrality Policy Statement</i> formalised the CPA at a Commonwealth level and focussed on implementing competitive neutrality arrangements for government businesses <sup>9</sup> . This included establishing a task force responsible for helping government businesses incorporate competitive neutrality policy into BAU activities. The growing number of government businesses coupled with the political climate at the time, which tended towards neoliberalism and commercialisation, catalysed the push towards competitive neutrality reform. This document also stated that the requirements of competitive neutrality should only apply where the benefits of the arrangements outweigh the administrative costs.
2000 Council of Australian Governments (COAG) meeting	A 2000 COAG meeting concluded that monitoring competitive neutrality was difficult for governments <sup>10</sup> but was still important in addressing advantages inherent in government businesses. As a means to contemplate both issues, COAG recommended that certain entities which are not subject to Executive control, including the ABC and SBS, should adopt a “best endeavours” approach towards competitive neutrality. This involved “at a minimum, the provision of government competitive neutrality policies to these entities (government businesses)”. <sup>11</sup>

<sup>7</sup> Department of Communications 2018, *Inquiry into the Competitive Neutrality of the National Broadcasters – Issues Paper*, p. 10

<sup>8</sup> Productivity Commission 1995, *Competition Policy Agreements*, p. 17  
<https://www.pc.gov.au/inquiries/completed/access/files/ncpagreement.pdf>

<sup>9</sup> Commonwealth Treasury 1996, *Commonwealth Competitive Neutrality Policy Statement*, p. 4  
<http://archive.treasury.gov.au/documents/275/PDF/cnps.pdf>

<sup>10</sup> National Competition Council 2002, *Competitive Neutrality: Scope for Enhancement – Staff Discussion Paper*, p. 46  
<http://ncp.ncc.gov.au/docs/PIReCn-001.pdf>

<sup>11</sup> Ibid, p. 4

2004 Competitive Neutrality Guidelines for Managers	<p>The <i>2004 Competitive Neutrality Guidelines for Managers</i> primarily focussed on assisting managers within government businesses apply and interpret competitive neutrality policy. The document reinforced the 1996 policy statement and provided a more actionable approach to implementing and adhering to competitive neutrality policy. Importantly, the document formally stated that competitive neutrality policy only applies to activities that meet three criteria:</p> <ul style="list-style-type: none"> <li>▶ “Contains charging for goods and services”;</li> <li>▶ “Has an actual or potential competitor”; and</li> <li>▶ “Managers possess a degree of independence in relation to the production or supply of the good and service and the price at which it is provided.”<sup>12</sup></li> </ul> <p>The Guidelines reinforced the requirement that competitive neutrality should only apply where the benefits of applying competitive neutrality outweigh the costs.</p>
2015 Competition Policy Review	<p>The <i>2015 Competition Policy Review (Harper Review)</i> critically examined and made recommendations to core aspects of competitive neutrality policy<sup>13</sup>, which include:</p> <ul style="list-style-type: none"> <li>▶ The Government updating its competitive neutrality policies and guidance, a requirement for portfolio ministers to publicly responding to findings of future complaint investigations, and the review of the policies to be overseen by an independent body;</li> <li>▶ Increasing the transparency and effectiveness of the governments’ competitive neutrality complaints handling processes; and</li> <li>▶ Requiring government businesses to include a statement on compliance with competitive neutrality principles in their annual reports.<sup>14</sup></li> </ul>
2017 Review of the Commonwealth Government’s Competitive Neutrality Policy	<p>The Commonwealth Government commenced a review of Competitive Neutrality Policy to assess whether the underlying aims of competitive neutrality are still being achieved by the <i>1996 Competitive Neutrality Policy Statement</i>.</p> <p>In the Government’s response to the Competition Policy Review, it supported the recommendations to review the Commonwealth’s competitive neutrality and strengthen the complaints process and endorsed the principles of accountability and transparency of its competitive neutrality policy.<sup>15</sup></p> <p>The outcomes of that review are pending.</p>

There are some key observations from Table 1:

- ▶ There is no single consolidated instrument that contains the Government’s overarching position on competitive neutrality and how it applies to government entities, including the national broadcasters;

<sup>12</sup> Commonwealth Treasury 2004, *Australian Government Competitive Neutrality Guidelines for Managers*, p. 9  
[https://consult.treasury.gov.au/market-and-competition-policy-division/competitive-neutrality-review/supporting\\_documents/2004%20Competitive%20Neutrality%20Guidelines%20for%20Managers%20AGCN\\_guide\\_v4.pdf](https://consult.treasury.gov.au/market-and-competition-policy-division/competitive-neutrality-review/supporting_documents/2004%20Competitive%20Neutrality%20Guidelines%20for%20Managers%20AGCN_guide_v4.pdf)

<sup>13</sup> Harper et. al 2015, *Competition Policy Review – Final Report*, pp. 58-59

<sup>14</sup> Ibid, pp. 267-268

<sup>15</sup> Australian Government 2017, *Review of the Commonwealth Government’s Competitive Neutrality Policy*, pp. 4, 24

- ▶ The Commonwealth Government's current formal position on competitive neutrality is contained within its *1996 Competitive Neutrality Policy Statement* and the *2004 Guidelines for Managers*;
- ▶ However, the 2000 COAG meeting allowed certain government businesses to adopt a "best endeavours" approach to competitive neutrality, although neither COAG nor any other party have provided prescriptive guidance on what a 'best endeavours' approach would specifically entail. More broadly, the term "best endeavours", as used in contracts and case law, refers to the requirement for a *"party to act honestly, reasonably and make a positive effort to perform the relevant obligations* (competitive neutrality obligations in the context of this report). *These actions must also be balanced against countervailing considerations such as existing duties and obligations, commercial and financial interests of the party obliged to use the best endeavours and timing;*"<sup>16</sup>
- ▶ Competitive neutrality is also not legislated so there does not appear to be any enforcement against failure to comply with competitive neutrality principles, policy or best practice; and
- ▶ All of this may be subject to change, pending the outcomes of the ongoing review of the Commonwealth Government's Competitive Neutrality Policy. This may strengthen the focus on competitive neutrality given the Government's acceptance of the key recommendations of the Harper Review.

As such, rather than attempt to adopt a set criteria from one of the policies or guidelines outlined above, our report uses the general principles of competitive neutrality as the basis for assessing the cost allocation and pricing practices of the ABC and SBS's activities as described in Sections 2.1 of this report.

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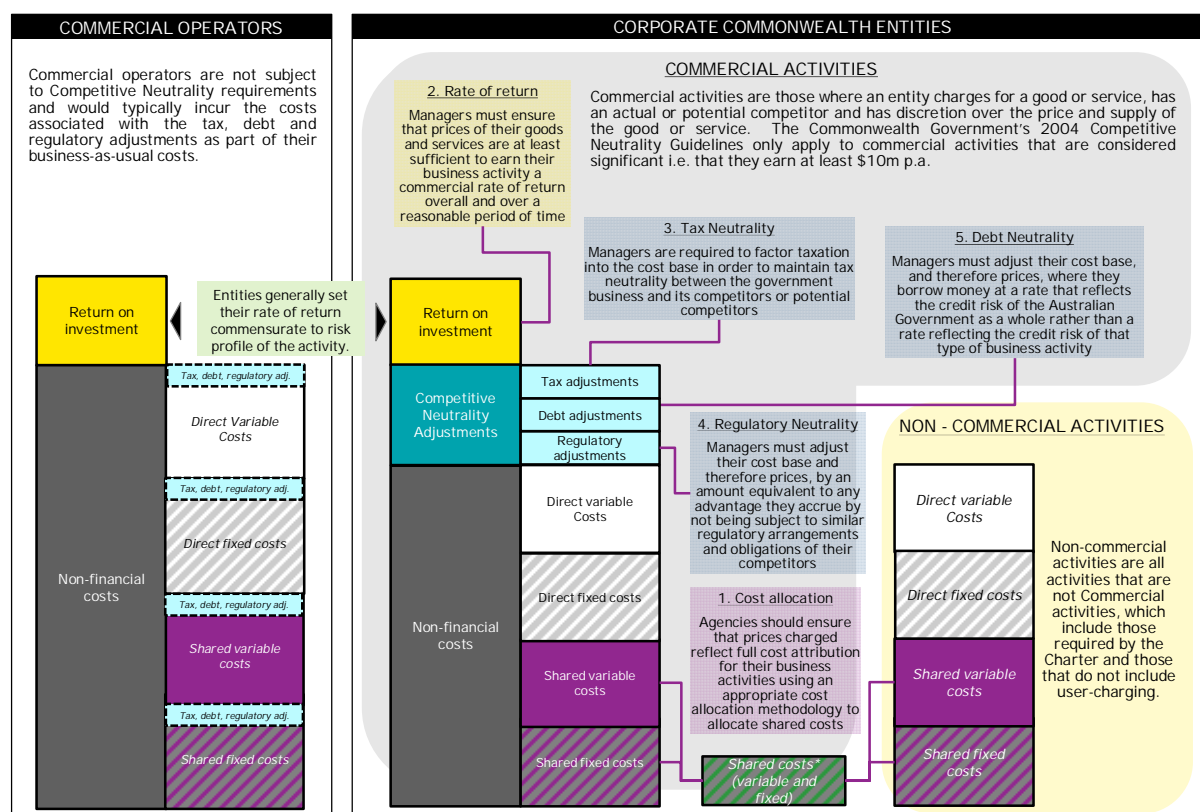
<sup>16</sup> Hartmann & Alex 2007, 'Best Endeavours' and 'Reasonable Endeavours' Explained - When You Agree to Use Your 'Best' or 'Reasonable Endeavours' What Does it Actually Mean?', *Australian Construction Law Newsletter* 46, p. 1  
<http://www.austlii.edu.au/au/journals/AUConstrLawNlr/2007/69.pdf>

## 3.2 Implications for pricing of commercial activities

In relation to competitive neutrality, the main implications for prices are that they should reflect the full cost of providing the activities where the benefits of doing so outweigh the administrative costs.

Figure 1 shows the breakdown of the costs and rate of return components that should underpin the prices that a government entity charges for its commercial services. It also shows how this compares to the prices of a private sector operator and the 'cost stack' of the government entity's non-commercial or public service activities.

Figure 1: Breakdown of cost and rate of return components



Definitions for Cost Allocation, Rate of Return, Tax Neutrality, Debt Neutrality and Regulatory Neutrality are from "Australian Government Competitive Neutrality Guidelines for Managers, 2004"

Source: EY analysis, based on *Australian Government Competitive Neutrality Guidelines for Managers (2004)*

### 3.2.1 Estimate of costs

Government businesses conducting commercial activities should ensure that their prices reflect the full cost of providing the activities. This should include:

- ▶ Direct costs (completely attributable to a business unit), which can be fixed or variable;
- ▶ Shared costs (attributable to two or more business units), which can be fixed or variable;
- ▶ Adjustments for competitive neutrality (i.e. the *2004 Guidelines for Managers* identifies taxation, debt and regulatory adjustments); and
- ▶ A commercial rate of return.

The "best endeavours" approach was recommended by COAG for certain entities which are not subject to Executive control, including the ABC and SBS. This approach foregoes the requirement for prescriptive competitive neutrality arrangements, as government businesses are diverse in size and structure.



However, these broader principles still recognise the need for full cost attribution.<sup>17</sup> Under the ‘best endeavours’ approach, government businesses are encouraged to “*satisfy the full cost attribution approach to pricing specified in the CPA*”, which broadly alludes to the tax, regulatory and debt adjustments required to neutralise government advantages.<sup>18</sup> This interpretation of a “best endeavours” approach aligns with EY’s definition, as set out in Section 2.2.

The *Guideline for Implementing Full Cost Attribution* defines full cost attribution as:

*“A system under which all costs, including indirect and overhead costs, are allocated to a function, activity, good or service on a reliable and consistent basis.”<sup>19</sup>*

Although there is no mandated method for full cost attribution, the government business must justify the reasoning behind their chosen approach. Other common methods are:

- ▶ Avoidable cost method: The business unit only incurs costs that could be avoided if the business unit ceased operation<sup>20</sup>; and
- ▶ Standalone cost method: The business unit incurs the costs required if it were to hypothetically commence operations as a standalone business.

### 3.2.2 Cost allocation method used to attribute shared costs

According to the *1998 Cost Allocation and Pricing, Competitive Neutrality Research Paper*, government businesses should use an appropriate cost driver to allocate shared costs.<sup>21</sup>

This is consistent with the approach used in industries subject to economic regulation, where cost allocation methodologies are required to be developed, are applied in considerable detail and are subject to scrutiny from a range of stakeholders.

There are no formal cost allocation guidelines that apply to the ABC or SBS. However the Australian Energy Regulator’s cost allocation guidelines for electricity distribution network service providers<sup>22</sup> is useful in outlining some key principles about the use of appropriate cost drivers or allocators, which include:

- ▶ The following costs may be allocated to a particular category of services
  - ▶ Costs which are directly attributable to the provision of those services;
  - ▶ Costs which are not directly attributable to the provision of those services but which are incurred in providing those services, in which case such costs must be allocated to the provision of those services using an appropriate allocator which should;
    - ▶ Except to the extent the cost is immaterial or a causal based method of allocation cannot be established without undue cost and effort, be causation based; and

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<sup>17</sup> National Competition Council 2002, *Competitive Neutrality: Scope for Enhancement – Staff Discussion Paper*, p. 27  
<http://ncp.ncc.gov.au/docs/PIReCn-001.pdf>

<sup>18</sup> Ibid, p. 6

<sup>19</sup> Local Government Association - South Australia 2001, *A Guideline to Implementing Full Cost Attribution*, p. 7  
[https://www.lga.sa.gov.au/webdata/resources/project/Finance\\_Full\\_Cost\\_Attribution\\_A\\_Guideline\\_to\\_Implementation\\_LGA\\_2001.pdf](https://www.lga.sa.gov.au/webdata/resources/project/Finance_Full_Cost_Attribution_A_Guideline_to_Implementation_LGA_2001.pdf)

<sup>20</sup> Commonwealth Treasury 2004, *Australian Government Competitive Neutrality Guidelines for Managers*, p. 37  
[https://consult.treasury.gov.au/market-and-competition-policy-division/competitive-neutrality-review/supporting\\_documents/2004%20Competitive%20Neutrality%20Guidelines%20for%20Managers%20AGcompetitive\\_neutrality\\_guide\\_v4.pdf](https://consult.treasury.gov.au/market-and-competition-policy-division/competitive-neutrality-review/supporting_documents/2004%20Competitive%20Neutrality%20Guidelines%20for%20Managers%20AGcompetitive_neutrality_guide_v4.pdf)

<sup>21</sup> Productivity Commission 1998, *Cost Allocation and Pricing, CCNCO Research Paper*, p. 4  
<https://www.pc.gov.au/research/supporting/cost-allocation-pricing/costallo.pdf>

<sup>22</sup> AER, June 2008, *Cost Allocation Guidelines for Electricity Distribution Network Service Providers*

- ▶ To the extent the cost is immaterial or a causal based method of allocation cannot be established without undue cost and effort, be an allocator that accords with a well accepted cost allocation method.
- ▶ The same cost must not be allocated more than once.<sup>23</sup>

### 3.2.3 Competitive neutrality adjustments

Government businesses should neutralise any government advantages they possess by making adjustments to their cost build up. According to the *2004 Competitive Neutrality Guidelines for Managers*, adjustments are required for the following categories:

- ▶ **Tax Neutrality:** Factoring taxation into the cost base in order to maintain tax neutrality between the government business and its competitors or potential competitors
- ▶ **Debt Neutrality:** Adjusting their cost base, and therefore prices, where they borrow money at a rate that reflects the credit risk of the Australian Government as a whole, rather than a rate reflecting the credit risk of that type of business activity
- ▶ **Regulatory Neutrality:** Adjusting their cost base and therefore prices, by an amount equivalent to any advantage they accrue by not being subject to similar regulatory arrangements and obligations of their competitors.

### 3.2.4 Rate of return

Government businesses should set prices to seek to earn a commercial rate of return, which should:

- ▶ Be specific to the business unit, product or investment  
Reporting separate rates of return reduces the opportunity to cross-subsidise between business units e.g. If business unit A earns a low RoR and business unit B earns a high RoR, a blended RoR will disguise the performance of business unit A;
- ▶ Be aligned to competitors in the market  
An acceptance of relative low RoRs by the government business may indicate that they are operating in a commercially unfeasible manner. Indicators of this behaviour include underpricing in the market;
- ▶ Reflect the risk profile of the investment; and
- ▶ Reflect other factors justifiable by the business unit e.g. strategic direction.

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<sup>23</sup> Cost Allocation Principles, s.6.15.2 of National Electricity Rules

## 4. Australian Broadcasting Corporation

### 4.1 Overview of the ABC

The Australian Broadcasting Corporation (ABC) is a government-funded statutory corporation operating under a Charter outlined in Section 6 of the *Australian Broadcasting Act 1983*. The ABC is classified as a Corporate Commonwealth entity, which means it is a body corporate and operates independently with an independent Board with the specific duties outlined in Section 8 of the *Australian Broadcasting Act 1983*.

The ABC is accountable to the Parliament as a whole, with the overall responsibility for the ABC lying with the Minister for Communications. This entails regular appearances at Senate estimate hearings, questions on notice, preparation of an annual report, regular reporting to the Department of Finance<sup>24</sup>, preparing Corporate Plans in accordance with the *Public Governance, Performance and Accountability Act 2013* and providing it to the Minister.

The ABC Board also has a duty to keep the Minister for Communications and Finance Minister informed of its activities and significant decisions and issues that may affect the entity or any of its subsidiaries.<sup>25</sup>

The ABC Board is independent and the Minister for Communications has no strategic control and oversight. The *ABC Act 1983* "expressly provides for both the editorial and administrative independence of the Corporation...and in acknowledgement of that independence...accepts the obligation to meet the highest standards of public accountability."<sup>26</sup>

The ABC currently receives funding from the Federal Government in three-year periods to fulfil its Charter responsibilities. The ABC has clear performance objectives and metrics with respect to its Charter activities, which are stated in its Annual Reports, Corporate Plans, Annual Performance Statements and Portfolio Budget Statements.

The ABC also undertakes commercial activities beyond its Charter responsibilities. The ABC's Annual Reports state the revenues of ABC Commercial, compare them against the ABC Commercial budgets and specify the proportion of gross revenue by activity. However, there is no clear break down of expenditure and return and no clear performance objectives and metrics of ABC Commercial, which are not specified in its Annual Reports, Corporate Plans and Annual Performance Statements.

ABC Commercial has been in operation in various forms for more than forty years and has the primary purpose of generating revenues for the ABC that can be applied to its Charter activities.

This relationship is shown in the following diagram (see Figure 2).

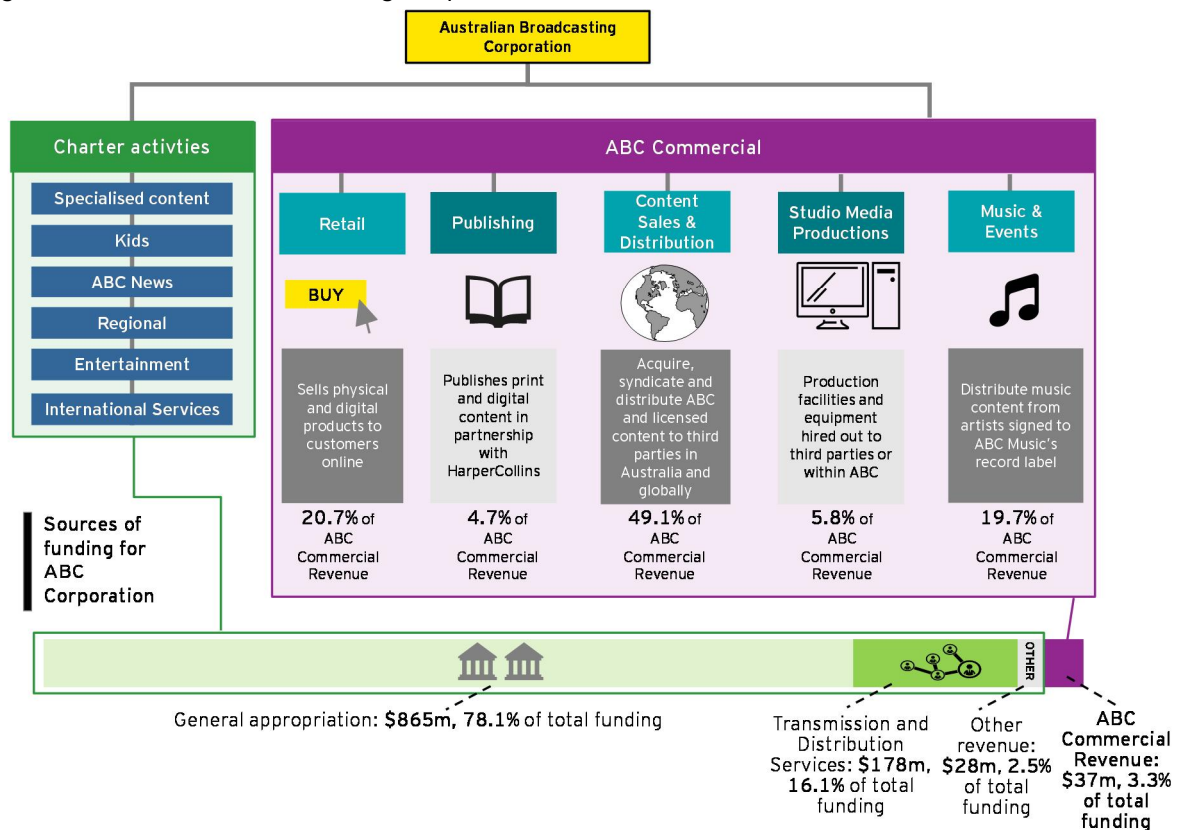
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<sup>24</sup> ABC 2018, *Overview of regulatory obligations*, p. 2

<sup>25</sup> *Public Governance, Performance and Accountability Act 2013*, s19

<sup>26</sup> ABC 2017, *Annual Report 2016/2017*, p. 54

Figure 2: Australian Broadcasting Corporation Structure (2017-18 Financial Year)



\*diagram is for indicative purposes only and not to scale  
Source: ABC Annual Report (2017/18)

## 4.2 Overview of ABC Commercial

ABC Commercial is the commercial arm of the ABC that manages a range of media businesses which create, market and license products, content and services related to the programming and Charter activities of the ABC. The team extends the reach of high-quality Australian content, identifies and develops new revenue streams, and has a particular focus on the expansion of revenue opportunities in the digital sector.<sup>27</sup>

In relation to ABC Commercial:

- ▶ The General Manager of ABC Commercial reports to the ABC Chief Financial and Strategy Officer, who reports to the Managing Director of the ABC;
- ▶ There is a separate ABC Commercial Board, chaired by the Managing Director and attended by the Chief Financial and Strategy Officer, GM Commercial, Content Directors, Director Editorial Policies, General Counsel and GM Finance and Operations that provides governance, assesses performance;
- ▶ ABC Commercial has accounting separation from the ABC and according to the ABC, uses separate management accounts:
  - ▶ To inform business cases underpinning new activities; and
  - ▶ To report the net profit for ABC Commercial and for each business unit, on a monthly basis;<sup>28</sup>

<sup>27</sup> Ibid, p. 80

<sup>28</sup> This information was not reported in the ABC's Annual Reports nor made available to EY as part of this work

- Its five key business units are:

Table 2: ABC Commercial business units

Business unit	Description
Content sales and distribution	The content sales and distribution business unit offers content sales and syndication to third parties (broadcasters, digital platforms etc.) in Australia and across the world. Content includes ABC and ABC co-produced programming.
Music	ABC Music is Australia's largest independent record label, representing Australian musicians across a range of genres (kids, classics, country etc.). ABC Music offers digital and physical music content to global service providers. The business unit is also involved in staging live music, tours and events.
Publishing	The publishing business unit is involved in a variety of activities including: <ul style="list-style-type: none"> <li>► Publishing books in partnership with HarperCollins Australia</li> <li>► ABC Magazines: notable titles include <i>"Gardening Australia"</i> and <i>"Organic Gardener"</i>.</li> <li>► Other activities include licensing and publishing books related to ABC programming and journalism.</li> </ul>
Retail	ABC retail offers physical products through the ABC Shop Online (although ABC Commercial has recently decided to exit this). These include DVDs, books and other merchandise related to ABC's programming.
Studio Media Productions (SMP)	SMP hires out ABC's surplus production facilities and labour to third parties including commercial television networks, film and television companies.

Source: EY, based on information provided by ABC Commercial.

## 4.3 ABC Commercial's cost allocation and pricing arrangements

### 4.3.1 Overview

The key aspects of ABC Commercial's cost allocation and pricing arrangements are:

- ABC Commercial operates as a separate business division to the broader ABC and has accounting separation from the ABC. This means that ABC Commercial is separated by governance, undertakes its activities at arm's length and reports profit and loss independently of the broader ABC;
- There does not appear to be any overarching policy document that guides the costing and pricing aspects of ABC Commercial's business nor any formal documentation to guide cost allocation between ABC Commercial and the charter organisation or across ABC Commercial's different business units. However, there are internal procedures applied to allocate shared costs that are adopted;
- In respect of competitive neutrality, the ABC does not have an overarching competitive neutrality policy (e.g. that explains what it considers to be "best endeavours" compliance with the principles of competitive neutrality). However, the ABC's submission noted that:
  - It supports the principles underpinning the development of Commonwealth's competitive neutrality policy, which only applies to the business activities of the ABC Commercial division<sup>29</sup>;

<sup>29</sup> ABC 2018, *Application of Competitive Neutrality to ABC's Commercial Activities*, pp. 4-5



- ▶ It adheres to the application of the existing complaints handling mechanism overseen by the Productivity Commission. The ABC has only been subject to one complaint in 1999-2000, but no adverse findings were made<sup>30</sup>;
- ▶ It gives appropriate regard to the impact of its activities on the commercial and community sectors in its broader content activities and does not use its government funding to compete unfairly for content or audiences. This is consistent with the requirements in the ABC Charter that the ABC 'take account' of the broadcasting services provided by the commercial and community sectors<sup>31</sup>; and
- ▶ ABC's cost allocation documentation has not been externally reviewed.

ABC Commercial is charged shared overhead costs by the ABC for legal, shared services, IT, rent, news content, marketing and labour related to archives, research and production using a pro-rata drivers (see Table 3).

Table 3: Drivers to allocate shared costs to ABC Commercial

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- ▶ The internal charging between ABC Commercial and the broader ABC are based on Service Level Agreements (SLAs), which are based on discussions between business unit leaders and ABC Commercial at the beginning of the year. These discussions involve both:
  - ▶ The basis of allocation; and
  - ▶ The quantum of costs allocated to ABC Commercial. Key events that have ABC Commercial's cost allocation and pricing principles have been the downsizing of business

<sup>30</sup> Ibid p. 5

<sup>31</sup> ABC 2018, *ABC Submission: Inquiry into the Competitive Neutrality of the National Broadcasters*, p. 6

activities e.g. the closure of ABC shops and the changing nature of ABC Commercial's services in the market.

- ▶ This is part of the development of ABC Commercial's budgets and is reviewed monthly; and
- ▶ A number of the rates used in calculating the total cost are benchmarked against the market (such as cost of rent). SLAs are developed based on negotiations between ABC Commercial and the broader ABC. The ABC did not provide any evidence of how reasonable the SLAs are compared to market or commercial benchmark rates.

#### 4.3.2 Pricing

According to the ABC, ABC Commercial sets prices for services at market rates.

- ▶ According to ABC Commercial, it does not offer products at less than the market price on its ABC Shop Online;
- ▶ Where appropriate, ABC Commercial sets prices in consideration of its own costs and targeted rate of return. If ABC Commercial is unable to negotiate a price that would recoup its costs, it will not proceed with the deal. However, the ABC has not explained how the "market price" is sourced and updated;
- ▶ ABC Commercial charges for content distribution in accordance with market rates set through contracts held with industry participants<sup>32</sup>. Revenue from these contracts is based on content quality and is driven by the customers and their purchasing requirements;
- ▶ Studio Media Production's (SMP) policy is to set labour costs in accordance with known industry/market rates. SMP's pricing is allocated a share of overheads on a pro- rata basis;
- ▶ Specifically in respect of SMP:
  - ▶ The method of costing of labour and facilities used by SMP exceeds the minimum cost benchmark consistent with competitive neutrality principles;
  - ▶ Content distribution costs are based on contracts with industry leaders. The revenue from these contracts is based on content quality and is driven by the purchasing requirements of these customers. There is no opportunity to undercut the market for content distribution; and
  - ▶ The ABC only undertakes commercial studio and labour hire, subject to its own operational requirements and if there is an acceptable net profit to the ABC after taking all these costs into account.
- ▶ As ABC Commercial sets prices with reference market rates, it does not explicitly make any adjustments for debt, taxation or regulatory neutrality.<sup>33</sup>

#### 4.3.3 Performance assessment

ABC Commercial focuses on performance assessment in both its *ex-ante* and *ex-post* decision-making process.

Ex ante (business case stage)

When considering new activities, business cases are generated before activities proceed to implementation. Business cases are used to understand the viability and profitability of new products prior to decisions being made to pursue the development, production and/or sale of such products. Business cases are reviewed by ABC Commercial business unit managers and are submitted to the General Manager, ABC Commercial, ABC Chief Financial & Strategy Officer, ABC Managing Director or the ABC Board as required by the ABC's Delegations Policy for final sign off.

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<sup>32</sup> Including Netflix, Stan, Apple etc.

<sup>33</sup> ABC 2018, *Application of Competitive Neutrality to ABC's Commercial Activities*, pp. 6-10

ABC Commercial business units have a standard business case template that is used for these business cases. These business case templates include product specific deal considerations. For example, for music deals, the business case contains line items for production costs (including recording, design and art and mastering), royalties, promotion costs, etc.

Table 4: Standard Business Case Structure

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Ex post (operational phase)

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**4.3.4 Self-assessment of consistency with competitive neutrality**

According to the ABC, it undertakes a review of ABC Commercial's compliance with competitive neutrality "every few years". The ABC included the latest review of its compliance against the *2004 Guidelines for Managers* in its submission.<sup>34</sup> The ABC's methodology for each competitive neutrality adjustment is broadly as follows:

<sup>34</sup> ABC Finance 2018, *Application of Competitive Neutrality to ABC's Commercial Activities*, p. 3

- ▶ Identifying the relevant 2004 guideline requirement;
- ▶ Identifying ABC Commercial's position on the requirement; and
- ▶ Assessing if the guideline requirement has been met

The ABC did not identify any instances where a competitive advantage was present within the operations of ABC Commercial and therefore concluded that the ABC Commercial operations currently adhere to the principles of competitive neutrality. In particular, the submission notes:

- ▶ Between 2008 and 2018, ABC Commercial earned a blended rate of return that was higher than the 10-year government bond rate as at 30 April 2018<sup>35</sup>; and
- ▶ In May 2018, the ABC reviewed the pricing for products sold through ABC Shop Online to industry rates and found that the pricing of such ABC products was not lower than market prices.

ABC Commercial indicated that it seeks to achieve an appropriate rate of return in its price setting process. However, the ABC's submission did not provide any explanation of whether ABC Commercial's rate of return was consistent with the risk profile of the investment.

## 4.4 Case study on Studio and Media Productions

Studio and Media Productions (SMP) is a business unit within ABC Commercial, which resells spare capacity in ABC production facilities, equipment and labour. SMP reinvests its revenue in content across the whole of the ABC. Services include the hire of television studios, rehearsal rooms and recording suites, production staff and outside broadcasting vans.

Cost allocation considerations

ABC Commercial and SMP consider the following cost allocation guidance:

- ▶ SMP maintains an annually reviewed "master rate schedule" for its services. These document(s) includes rates for labour and equipment and is consistent with rate cards published by competitors online and market labour rates for contractors. Due to differences in labour and equipment costs, there are separate "master rate schedules" for services charged to third party broadcasters and ABC content producers, Table 5 sets out SMP's master rate schedule(s) at a high level.

Table 5 SMP master rate schedule

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- ▶ SMP will only approve engaging a client in a project if:
  - ▶ The needs of ABC content producers are met; and
  - ▶ The project's net return meets or exceeds the minimum internal margins set by ABC Commercial.

<sup>35</sup> After excluding costs in 2015-16 related to the closure of ABC shops

## 5. Review of ABC Commercial's cost allocation and pricing practices

### 5.1 Context

The timeframes of this project have influenced the ability to collect and analyse information. Our approach has therefore relied on a more targeted approach which considered the overarching strategies and policies and focused on particular commercial activities of interest (as described in Section 2).

Given the reasons articulated above, the subsequent key findings provide commentary on ABC's approach to pricing and cost allocation, particularly as they relate to best practice approaches applied by other organisations. It is noted that there is no formal requirements or obligations on the ABC to utilise best practice approaches and therefore there is no explicit "pass or fail" criteria.

### 5.2 Key findings

#### 5.2.1 The ABC does not have a formal competitive neutrality policy and it is not clear how the ABC considers competitive neutrality in decision-making

The ABC does not have an overarching, documented competitive neutrality policy which describes the organisation's approach and commitment to the principles of competitive neutrality.

The evidence that the ABC included in its submission to the inquiry and provided to EY to demonstrate its compliance with competitive neutrality was based on an *ex post* assessment of its prior activities and outcomes. For example, in the work undertaken by the ABC's Finance team on the application of competitive neutrality principles to ABC Commercial:

- ▶ The ABC suggested that ABC Commercial complied with competitive neutrality because it earned a blended rate of return higher than the 10-year government bond rate between 2008 and 2018<sup>36</sup>. The ABC did not provide any evidence to show that a particular rate of return was targeted in setting ABC Commercial's prices. Notwithstanding that the ABC is only required to comply with a best endeavours approach, this would generally be expected for commercial organisations and is a requirement in the *2004 Guidelines*<sup>37</sup>; and
- ▶ ABC Commercial undertakes business cases for any new investments and projects, which require information on costs, average prices and forecast units sold. However, based on the business case template provided to EY, there is no consideration of whether the prices, attribution of costs and rates of return are consistent with competitive neutrality.

As a result, because the evidence provided by the ABC relied on *ex post* assessments, we have only been able to assess what has happened historically. The ABC has not provided any evidence of its *ex ante* processes and practices to demonstrate its compliance with competitive neutrality, which means that an *ex post* assessment in the future may not produce the same findings.

There may be benefit in the ABC undertaking further work to gain a more informed understanding of the application of competitive neutrality to ABC Commercial. This may include working with the Australian Government to seek guidance on the development of an internal document which outlines how it interprets its obligations in relation to the Commonwealth's competitive neutrality policy and how this is reflected in its business practices.

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<sup>36</sup> As at 30 April 2018 and after excluding costs in 2015/16 related to the closure of ABC shops

<sup>37</sup> ABC 2018, *Application of Competitive Neutrality Principles to the ABC's Commercial Activities*, p. 11



### 5.2.2 There does not appear to be any evidence that the ABC's approach to cost allocation and pricing has breached the principles of competitive neutrality

The application of competitive neutrality as defined in Section 2.1 only applies to ABC Commercial's activities. Based on the evidence presented to EY, there does not appear to be any evidence that ABC Commercial:

- ▶ Adopts an approach to cost allocation and pricing that breaches the principles of competitive neutrality; and
- ▶ Does not adhere to the "best endeavours" approach to cost allocation and pricing, as recommended by COAG for ABC's commercial activities in 2000. Whilst the *2004 Guidelines for Managers* provided some guidance, it is not clear what a 'best endeavours' approach would require in this regard. However, there is no evidence that the ABC is operating inconsistent with this.

This is supported by the fact that there has only ever been one competitive neutrality complaint made in relation to the ABC to the Productivity Commission, in which no adverse findings were made.

### 5.2.3 ABC Commercial does not appear to be operating at best practice in relation to cost allocation

The assessment undertaken has identified a number of areas where ABC could improve its approach to cost allocation and pricing to enhance transparency and give greater confidence that its costing and pricing practices are aligned with competitive neutrality principles. In particular:

- ▶ The ABC does not appear to have a formal cost allocation methodology document to guide the allocation of shared costs despite having separate business segments. According to the ABC, there are internal procedures whereby cost allocators (refer to Table 3 of this document) are agreed by the Finance team with business unit leaders during the annual planning process; and
- ▶ Whilst the ABC indicated that there are internal reviews of the appropriateness of the allocators that are conducted on a regular basis, there is no evidence that these allocators have been externally reviewed.

### 5.2.4 ABC Commercial has limited ability to influence the price of its content and services

ABC Commercial has assessed that it is charging appropriate prices, on the basis that:

- ▶ Its prices are in line with the market; and
- ▶ It has limited ability to influence the prevailing market price.

The ABC did not however provide evidence or examples of how it assesses the market price and considers whether it earns a rate of return commensurate with the level of risk that ABC Commercial faces.

While ABC Commercial considers it has limited ability to influence the market price, it does not mean that it is unable to compete for certain appropriate content based on the returns it can achieve.

However given these dynamics and the absence of any competitive neutrality complaints, it is unlikely that ABC Commercial's approach to pricing is materially inconsistent with competitive neutrality principles.

### 5.2.5 The ABC's assessment of how competitive neutrality applies to ABC Commercial is a useful exercise but can be improved

The ABC submission includes a self-assessment of how ABC Commercial's historical practices have complied with the principles of competitive neutrality. The ABC indicated to EY that it undertakes

reviews of its compliance with competitive neutrality on a regular basis (e.g. every few years). This would be consistent with good industry practice.

However EY did not see any evidence to support this.<sup>38</sup>

Further, the methodology adopted by the ABC in Attachment E of its submission appears to have misinterpreted the application of a number of elements of competitive neutrality policy. For example:

- ▶ Tax neutrality – the intent of Section 4.1 of the 2004 Guidelines for Managers is to ensure that publicly-owned businesses that operate commercial / business activities (e.g. ABC Commercial) do not receive an advantage over private-sector competitors as a result of any taxation exemptions
  - ▶ The ABC (and by definition, ABC Commercial) is exempt from some corporate and state income taxes under s.71(1) of the *ABC Act*, which is a benefit that is not available to ABC Commercial's private sector competitors;
  - ▶ The Guidelines require ABC Commercial to neutralise its tax exemption through one of three systems to ensure that the cost base of, and price charged by, ABC Commercial includes a notional adjustment for tax (notwithstanding that ABC Commercial does not actually pay this amount);
  - ▶ However the ABC appears to have interpreted the requirement of the 2004 Guidelines as adjusting ABC Commercial's prices based on actual tax paid, rather than notionally adjusting prices to ensure there is no distortion to the market; and
  - ▶ As a result, based on Attachment E of its submission and the additional information provided, ABC has not demonstrated its compliance with the tax neutrality requirements of the 2004 Guidelines.
- ▶ Rate of return analysis - the intent of Section 4.4 of the 2004 Guidelines for Managers is to ensure that publicly-owned businesses that operate commercial / business activities (e.g. ABC Commercial) do not receive an advantage over private-sector competitors by charging prices that do not recover a commercial rate of return overall over a reasonable period of time. Specifically, page 30 of the 2004 Guidelines requires that government businesses "should earn a rate of return equal to the Commonwealth long-term bond rate, plus a margin for risk"
  - ▶ According to Attachment E of its submission, states that ABC Commercial earned a rate of return that "was higher than the 10-year government bond rate as at 30 April 2018" over the period of 2008-2018 (after excluding costs in 2015/16 related to the closure of ABC Shops).<sup>39</sup> ABC Commercial did not disclose the rate of return it had achieved to EY due to its commercial sensitive nature, however it confirmed that it "also exceeded the average government bond rate between 1 July 2008 and 30 April 2018"<sup>40</sup>; and
  - ▶ However ABC Commercial's analysis of its rate of return does not specifically include a margin for risk and has not demonstrated whether the rate of return reflects the changing nature and risks over time. This is particularly important because the challenges and risks of operating in the media landscape have accelerated in recent years.

As described in Section 5.2.2, while there does not appear to be any evidence that ABC Commercial's approach to cost allocation and pricing is inconsistent with the principles of competitive neutrality, the methodology used by ABC Commercial to assess its compliance with the 2004 Guidelines could be improved to more clearly demonstrate its compliance with the requirements and intent of the Guidelines.

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<sup>38</sup> For example, previous reviews were not made available to EY. The ABC also did not mention that it regularly reviews ABC Commercial's compliance with competitive neutrality every few years in its submission.

<sup>39</sup> ABC Finance 2018, ABC: Submission: Inquiry into the Competitive neutrality of the National Broadcasters, Attachment E: Application of Competitive Neutrality Principles to the ABC's Commercial Activities, page 11

<sup>40</sup> ABC, 20 August 2018, ABC response to EY follow up questions

## 6. Special Broadcasting Service Corporation

### 6.1 Overview of SBS

#### 6.1.1 Background

SBS is a government-funded statutory corporation operating under a Charter outlined in Section 6 of the *Special Broadcasting Services Act 1991*. SBS is classified as a Corporate Commonwealth entity with an independent Board who must act in accordance with the specific duties outlined in Section 10 of the *SBS Act 1991*.

SBS is accountable to the Parliament, with broad oversight lying with the Minister for Communications. The SBS Board has a duty to keep the Minister for Communications and Finance Minister informed of its activities and explain significant decisions and issues that may affect the entity or any of its subsidiaries<sup>41</sup> in relation to its expenditure and activity<sup>42</sup>. However the SBS Board is independent and the Minister for Communications has no strategic control.

Some of SBS's key accountabilities include:

- ▶ Preparation of an annual report and regular reporting to the Department of Finance;
- ▶ Preparation of Corporate Plans in accordance with the *Public Governance, Performance and Accountability Act 2013* and providing it to the Minister; and
- ▶ Regular appearances at Senate estimate hearings, questions on notice.

#### 6.1.2 Funding and operating model

SBS is a hybrid-funded broadcaster and receives funding from the Federal Government via a government appropriation determined in three-year funding cycles. In 2017-18, SBS was provided with \$280 million by the Federal Government, including transmission costs.

SBS also obtains funding from advertising and commercial revenue, with SBS allowed to advertise up to five minutes per hour under the *SBS Act 1991*. Advertising revenues contributed 30 per cent of SBS's funding in 2017-18 (around \$107m).

According to SBS:

- ▶ Whilst as a hybrid funded organisation SBS has teams responsible for activities such as the sale of advertising, it does not have a dedicated separate commercial or business function or activity, in contrast to the ABC;
- ▶ All programs and content is undertaken to fulfil its Charter obligations, which is the touchstone for all organisational activity in pursuit of public interest objectives inherent within it;
- ▶ It considers all functions and activities across the organisation as aiding delivery of the Charter to service the Australian community with a diverse media offering; and
- ▶ SBS places the Charter at the centre of its decisions on investment of new activities. SBS then considers the capacity for that activity to deliver a distinctive service in a market where there is demand. If SBS then proceeds with the investment, it will assess the whether there is a capacity to make a commercial return (i.e. determine if it at least recovers the avoidable costs of undertaking the activities).<sup>43</sup>

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<sup>41</sup> PGPA Act – Section 19

<sup>42</sup> Deloitte Report – SBS Act

<sup>43</sup> For example, we understand that the financial performance of Food Network to date has exceeded the targeted rate of return (or discount rate) of 8% (on a real pre-tax basis) assumed in its business case in 2015. Refer to Section 4.4 for more detail.

### 6.1.3 SBS's submission

On 22 June 2018, SBS provided a submission to the Panel's issues paper. The key points of SBS's submission from the perspective of this report are that:

- ▶ The principal function of SBS is to meet its Charter and all of its activities are undertaken to meet its Charter obligations;
- ▶ SBS is alert to the competitive neutrality principles and has robust strategies, policies and procedures in place to deliver on the broader requirements of its Charter and the *SBS Act* in respect of competitive neutrality;
- ▶ SBS operates with some competitive limitations in the market. Its submission outlines a ten-point summary of these limitations<sup>44</sup>;
- ▶ SBS further notes that:
  - ▶ The principles that the Inquiry panel intends to use in guiding its analysis "appear reasonable and provide an appropriate basis for guiding the review"<sup>45</sup>;
  - ▶ The Inquiry panel should consider the following points when assessing competitive neutrality principles:
    - ▶ A clearer definition of "public interest" in the context of SBS's services, in line with the *Competition Principles Agreement in 1995*; and
    - ▶ Recognise that "independencies between content, platforms and audience pathways" are required to fulfil charter obligations."<sup>46</sup>
  - ▶ The net benefit to SBS as a result of its regulatory obligations and exemptions are not clear. However, Deloitte Access Economics on behalf of SBS concludes that the "trajectory of regulatory changes in recent years have favoured commercial FTA broadcasters relative to the national broadcasters"<sup>47</sup>; and
  - ▶ Distributors largely control the acquisition process for television content. SBS have pursued cost effective options for pursuing appropriate content by buying based on script alone or in the "second window"<sup>48</sup>.

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<sup>44</sup> SBS 22 June 2018, *SBS Submission to the Inquiry into the Competitive Neutrality of the National Broadcasters*, p. 4

<sup>45</sup> Deloitte Access Economics 22 June 2018, *SBS – Report on aspects of Competitive Neutrality*, p. 26

<sup>46</sup> *Ibid.*, p. 26-27

<sup>47</sup> *Ibid.* p. 40

<sup>48</sup> *Ibid.* p. 34

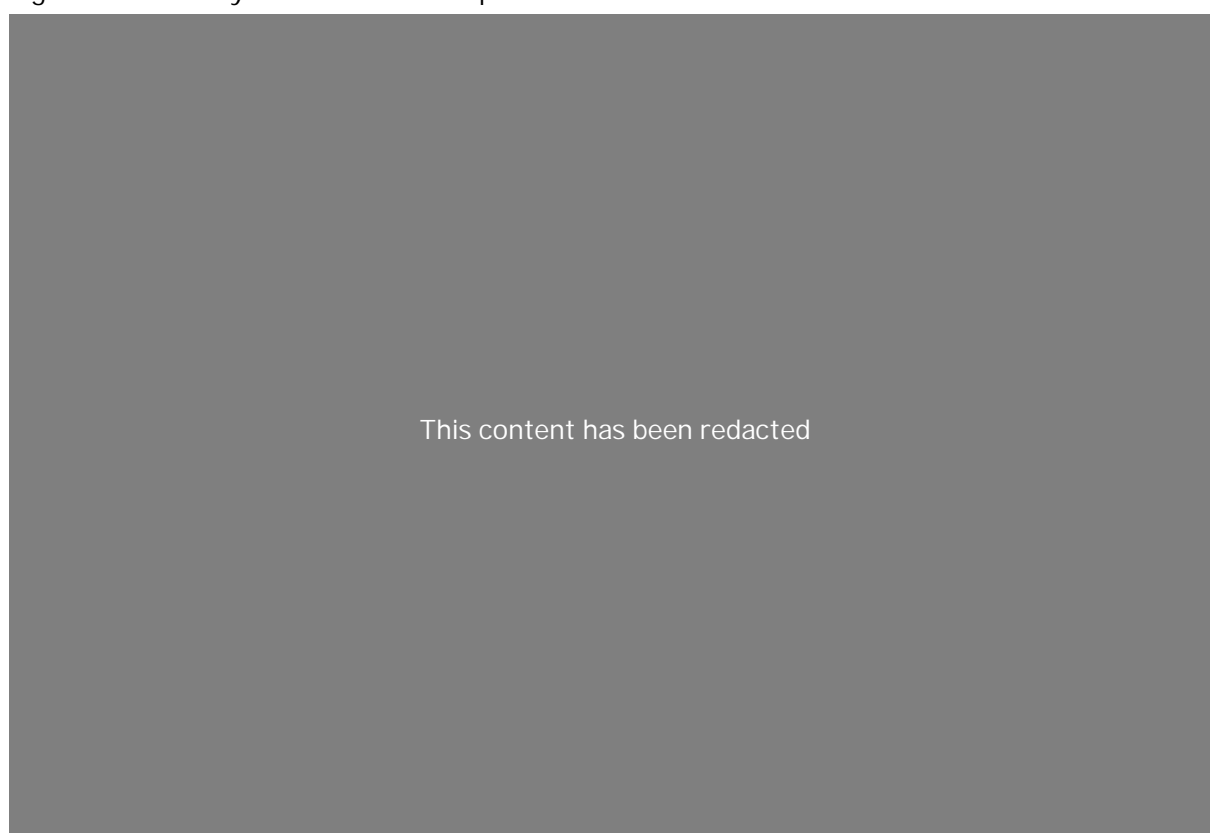
## 6.2 SBS's business processes for new activities

Figure 3 shows the process that SBS undertakes for new activities. SBS will only undertake a new activity if it meets its Charter obligations. It then gives consideration to (noting these are not listed in order of priority):

- ▶ Whether it engages audiences with SBS's network suite of services;
- ▶ Whether it enhances delivery of public interest outcomes; and
- ▶ Commercial and financial value.

According to SBS, all new significant new activities adhere to the below process, with a more streamlined process adopted for the evolution of ongoing business activities with an established risk profile.

Figure 3: Summary of SBS's business processes for new activities



## 6.3 Summary of cost allocation arrangements

SBS has in place an Internal Cost Allocation Methodology which has the following characteristics:

- ▶ The current iteration of SBS's cost allocation methodology has been in place since 2006/07. However, SBS have utilised a cost allocation methodology to account for costs since the mid to late 1990s (prior to the establishment of the World Movies channel with Foxtel);
- ▶ Its actual costs are reviewed and updated annually;
- ▶ It is implemented to attribute shared costs by activity, content or platform throughout the lifecycle of new initiatives (i.e. before and after implementation); and
- ▶ It is based on reasonable cost allocators that are likely to be consistent with good industry practice, as shown in Table 3.



Table 6: Drivers to allocate shared costs within SBS

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## 6.4 Case study on Food Network

### Background

The Food Network focuses on providing global food programming, exploring cultures through different cuisines across the world.<sup>49</sup> The channel began broadcasting on 17 November 2015 and broadcasts 24 hours a day. Notable current programs include *Bizarre Foods with Andrew Zimmern*, *Adam Liaw's series* and *Anthony Bourdain: No Reservations*.

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<sup>49</sup> SBS, 22 June 2018, SBS Submission to the Inquiry into the Competitive Neutrality of the National Broadcasters, p. 28

Table 7: Timeline of key events

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#### SBS's considerations

SBS's decision to introduce the Food Network channel was based on the following criteria:

- ▶ Contribution to SBS's Charter;
  - ▶ The "Food Network allows Australians to explore cultures through different cuisines from around the world and speaks to the inclusive ability of food to bring diverse communities closer together;"<sup>50</sup>
  - ▶ Unmet market need for global food programming in the free-to-air TV space;
  - ▶ Further, SBS is able to retain editorial control to protect its independence and Charter obligations;
- ▶ Audience scale - How many people watch listen or engage;
  - ▶ Strong existing evidence of audiences watching food programs on SBS's main channel;
  - ▶ Evidence supporting the attraction of new audiences;
- ▶ Return on investment - Net cost of content against the audience criteria;
  - ▶ Arrangement allows for a self-funded model to earn more revenues to support local content investment;
  - ▶ Programming uses unutilised spectrum capacity - SBS can use previously purchased programming to show on the Food Network; and
  - ▶ Shared costs were attributed to Food Network by implementing its internal cost allocation methodology - set out in the table below.

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<sup>50</sup> Ibid, p. 28

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## Outcomes

- ▶ In January 2017, Food Network reached 5.3 million unique viewers, the highest number since launch<sup>51</sup>;
- ▶ As at March 2018, there is a 30 per cent overlap in Food Network and SBS main channel audiences as a result of cross-promotion<sup>52</sup>; and
- ▶ Excluding the Food Network's first year in operation, the Food Network has generated a financial return to SBS.<sup>53</sup> The Food Network has exceeded SBS's discount rate (or target rate of return) of 8% on a real pre-tax basis as at 2015, which is likely to exceed the guidance on the rate of return in the 2004 Guidelines for Managers.<sup>54</sup>

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<sup>51</sup> SBS, 2017, SBS Annual Report 2017, p. 49

[http://media.sbs.com.au/home/upload\\_media/site\\_20\\_rand\\_224099426\\_sbs\\_annual\\_report\\_2017.pdf](http://media.sbs.com.au/home/upload_media/site_20_rand_224099426_sbs_annual_report_2017.pdf)

<sup>52</sup> SBS, 22 June 2018, SBS Submission to the Inquiry into the Competitive Neutrality of the National Broadcasters, p. 28

<sup>53</sup> SBS, 22 June 2018, SBS Submission to the Inquiry into the Competitive Neutrality of the National Broadcasters – Appendix 1.1, p. 36

<sup>54</sup> The 2004 Competitive Neutrality Guidelines for Managers stated that “the rate of return should, over time, be at least equal to the long term (10-year) Commonwealth bond rate, as this is the Commonwealth's base level cost of capital, plus a margin for risk (p. 31).” The average 10-year Commonwealth Government bond rate from Jan-Jun 2015 was 2.65%. The Guidelines do not specify what the appropriate margin for risk should be, however it is likely that SBS's real pre-tax rate of return of 8% exceeds the target rate of return implied by the Guidelines at the time.

## 7. Review of SBS's cost allocation and pricing practices

### 7.1 Context

The timeframes of this project have influenced the ability to collect and analyse information. Our approach has therefore relied on a more targeted approach which considered the overarching strategies and policies and focused on particular commercial activities of interest (as described in Section 2).

Given the reasons articulated above, the subsequent key findings provide commentary on SBS's approach to pricing and cost allocation, particularly as they relate to best practice approaches applied by other organisations. It is noted that there are no formal requirements or obligations on SBS to utilise best practice approaches and therefore there is no explicit "pass or fail" criteria.

### 7.2 Key findings

#### 7.2.1 SBS does not have a formal competitive neutrality policy, but there is evidence that it applies competitive neutrality principles in its decision making

SBS does not currently have an overarching, documented competitive neutrality policy which describes the organisation's approach, understanding and commitment to the principles of competitive neutrality.

However, there is evidence that it implicitly considers the principles of competitive neutrality in its decision-making and analysis at the Board and Executive level. For example, for all new activities, the Board considers the activity in respect of a range of factors including its competitive context, Charter alignment and commercial attractiveness.

SBS is only required to adopt a 'best endeavors' approach to competitive neutrality. Whilst the 2004 Guidelines for Managers provided some guidance, it is not clear what a 'best endeavors' approach would require in entirety. There may be benefit in the Australian Government clarifying these requirements and SBS undertaking further work to gain a more informed understanding of the application of competitive neutrality to SBS. This may include working with the Australian Government to seek guidance on the development of an internal document, which outlines how it interprets its obligations in relation to the Commonwealth's competitive neutrality policy and how this is reflected in its business practices.

#### 7.2.2 There does not appear to be any evidence that SBS's approach to cost allocation and pricing has breached the principles of competitive neutrality

Based on the evidence presented to EY, there does not appear to be any evidence that SBS:

- ▶ Adopts an approach to cost allocation and pricing that breaches the principles of competitive neutrality; and
- ▶ Does not adhere to the "best endeavours" approach to cost allocation and pricing, as recommended by COAG for SBS's commercial activities in 2000. Whilst the 2004 Guidelines for Managers provided some guidance, it is not clear what a 'best endeavours' approach would require in this regard. However, our review has found no evidence that SBS is operating inconsistent with this.

This is supported by the fact that there has never been any competitive neutrality complaint made in relation to SBS to the Productivity Commission.

#### 7.2.3 SBS has in place a well-established cost allocation methodology

SBS has in place a documented cost allocation methodology to guide the attribution of SBS's costs by activity, content and program.

The current version of cost allocation methodology has been in place since 2006-07 (but previous versions have been utilised since the 1990s) and is reviewed internally on a regular basis. The cost allocation methodology is implemented across all business activities, including at the business case stage to underpin decision-making, and also on an ex post basis in the reporting and tracking of activities.

While, as has been noted, SBS has in place a well-established cost allocation methodology, there may be some merit in having the cost allocation methodology externally reviewed periodically.

#### **7.2.4 SBS has limited ability to influence the price of advertising or content**

The only purely commercial activity that SBS undertakes is the receipt of advertising revenues off the back of the content it provides and the size and nature of the audience it can attract. SBS has limited ability to influence the price of advertising (and thus content) because it is generally a price taker. According to SBS:

- ▶ Advertisers generally find the commercial networks as more financially attractive propositions;
- ▶ Advertisers have options to show its ads on other avenues as an alternative to SBS; and
- ▶ SBS has limited other options to generate revenue.

That does not mean however that SBS is not able to compete for certain appropriate (i.e. Charter consistent) content based on the returns it can achieve.

Given these market dynamics, it is unlikely that SBS's approach to advertising is materially inconsistent with competitive neutrality principles.

#### **7.2.5 The approach that SBS takes to fulfilling its Charter and its funding model have important implications for its operating model**

The approach that SBS takes to fulfilling its Charter and its funding model have important implications for its operating model, which are distinct to the ABC, and how the pricing of these activities should be considered:

- ▶ SBS maintains that all activities are undertaken to fulfil its Charter. However within this constraint, SBS appears to engage in a number of more "commercially focussed" activities (i.e. activities that deliver on the Charter but are also commercially attractive to SBS); and
- ▶ SBS's hybrid funding model creates a strong incentive for these activities to at least recover the avoidable costs of undertaking them. If it does not, it will merely will reduce the funding available for other activities over the funding cycle. This would support a view that it is not breaching competitive neutrality in competing in parts of the market.

## 8. Appendices

### 8.1 Appendix A - References

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## 8.2 Appendix B – Information provided by the ABC

- ▶ On Friday 25 June 2018, the Department contacted the ABC by email to notify that it had engaged EY to assist the Panel by reviewing the cost allocation and pricing practices of the commercial activities of the national broadcasters
- ▶ On Wednesday 4 July 2018, EY contacted ABC to request information for its review and organised a meeting to talk through ABC's materials and discuss EY's request.
- ▶ On Tuesday 17 July 2018, EY met with the ABC. The following items were discussed and requested by EY, with agreement from ABC's representatives at the meeting:
  - ▶ Template business case and management account pro-formas;
  - ▶ Information on Service Level Agreements (SLA);
  - ▶ Brief description of cost allocation principles;
  - ▶ Methodology used by ABC Commercial to review Competitive Neutrality obligations, as outlined in *ABC Submission – Attachment E – Application of competitive neutrality to ABC's Commercial Activities*;
  - ▶ Description and example of monthly analysis of performance undertaken by ABC Commercial;
  - ▶ Paragraph on ABC's May 2018 work being undertaken comparing price of ABC Commercial's products with market; and
  - ▶ Information on *ABC Kids Listen App*, *4 Corners Don Dale*, *Deal with oOh! Media* and *SMP* to inform EY's case studies
- ▶ EY met with the following representatives from the ABC:
  - ▶ Annalisse Morrow – Lawyer, Technology and Commercial, Legal;
  - ▶ Carl Toohey – Senior Strategist;
  - ▶ Cheryl Scroope – Chief Financial Officer, ABC Commercial;
  - ▶ Jessica Ellis, Head of Content Sales and Distribution, ABC Commercial; and
  - ▶ Andrew Lambert, General Manager, ABC Commercial
  - ▶ Jennifer Jesurajah, Business Analysis, Audit
- ▶ On 18 July 2018, EY requested additional information supplementary to the information discussed at the meeting on 17 July. This information request broadly covered:
  - ▶ Work undertaken by ABC Commercial to assess internal charges between ABC Commercial and ABC;
  - ▶ ABC Commercial price setting process, with reference to market rates;
  - ▶ ABC Commercial's position as a price-taker;
  - ▶ Reducing costs as an option to increase Rate of Return; and
  - ▶ How ABC Commercial assess the Rate of Return
- ▶ On Friday 27 July 2018 and Thursday 2 August 2018, the ABC provided written responses to EY's information requests and questions. The ABC did not provide actual original documents used for business purposes for EY to review or access. The ABC did however provide copies of its business case templates and line items from its management account pro formas;
- ▶ On Monday 6 August 2018, EY requested clarification and further information on the ABC's previous responses; and
- ▶ On Friday 17 August 2018 and Monday 20 August 2018, the ABC provided a detailed response to EY's second information request. Many of the ABC's executives responsible for providing

clarifications were indisposed during the period between the date of EY's second information request and the ABC's response.

## 8.3 Appendix C - Information provided by SBS

- ▶ On 25 June 2018, the Department contacted SBS by email to notify that it had engaged EY to assist the Panel by reviewing the cost allocation and pricing practices of the commercial activities of the national broadcasters.
- ▶ On Monday 2 July, EY contacted SBS to request information for its review and organised a meeting to talk through SBS's materials and discuss EY's request. Due to an exceptionally busy period for SBS (e.g. during the 2018 FIFA World Cup), EY and SBS agreed for a meeting in four weeks' time.
- ▶ On Friday 3 August, EY met with SBS, where it allowed EY to review the following information in hard copy at SBS's premises (due to the commercially sensitivity of the materials):
  - ▶ SBS – Scripps Networks Interactives Agreement, dated 27 August 2015;
  - ▶ SBS VICELAND Circular Resolution, dated 20 June 2016;
  - ▶ National Indigenous Television (NITV) Launch Strategy, dated 5 June 2012;
  - ▶ FY18 Strategy and Risk Report, 2017-18;
  - ▶ Finance Report March YTD, 2017-18;
  - ▶ Internal cost allocation methodology document, 2006-07
  - ▶ Food Network P&L and assumptions;
  - ▶ SBS VICELAND P&L and assumptions;
  - ▶ SBS on-demand P&L and assumptions; and
  - ▶ NITV service charges.
- ▶ On Tuesday 7 August, EY had a follow-up meeting with SBS and conducted an additional review of the information above.
- ▶ On Thursday 9 August, upon EY's request, SBS provided by email:

This content has been redacted

- ▶ A report by Standard Media Index (SMI) on SBS's advertising market; and
- ▶ Responses to EY's additional questions on SBS's operating model, internal business processes for new activities and advertising.
- ▶ SBS reviewed two versions of EY's draft report:
  - ▶ Draft report sent on Friday 10 August; and
  - ▶ Draft report sent on Monday 13 August.

SBS provided written comments on both versions of the draft, which EY considered in developing this report.

- ▶ All documents were provided to EY as commercially sensitive material
- ▶ EY met with the following stakeholders from SBS stakeholders:
  - ▶ James Taylor, Chief Financial Officer;
  - ▶ Clare O'Neil, Director of Corporate Affairs;
  - ▶ Jessica Harris, Head of Engagement and Corporate Social Responsibility; and
  - ▶ Nitsa Niarchos, Head of Financial Planning and Analysis.