Community Service Obligations

Introduction – The Conventional Economic Wisdom

Government business enterprises (GBEs) and service providers within government departments generally behave in different ways from commercial firms. We expect (or at least hope) that a publicly owned electricity authority, for example, will have a different approach to matters like pricing, caring for the environment, serving isolated or poor customers, providing special services, and supporting community activities, to that which would be taken by a commercial organization. These different, non-commercial approaches are generally called *community service obligations* (CSOs).

Consumers should not take CSOs for granted, however. The political trend is for governments to take a tougher line on CSOs than they have in the past. The economic fashion, supported by government treasury and finance departments, and by organizations such as the Industry Commission, is that governments should identify CSOs specifically, measure their costs, and that governments should fund them through specific budgetary allocations.

Each stage of the process – defining CSOs, costing CSOs and paying for CSOs – is problematic, and there is a risk that, rather than being seen as a core function of government and its agencies, CSOs will come to be seen as a nuisance, an impediment on the track that leads from government provision, through commercialization and corporatization, to complete and unregulated privatization.

Defining CSOs

General Definition

A Commonwealth study in 1994 found sixteen different definitions of CSOs, and, for good measure, added a seventeenth.[1] Definitions tend to fall to two categories:

(1) Defining CSOs as providing services, to some customers at least, at a price less than the cost of production.

(2) Defining CSOS as doing things, for reasons of government policy, which commercial enterprises operating in a competitive environment and subject to normal government regulations, would not do.

That same study proposed a definition falling into the second category:

> *A community service obligation arises when a government specifically requires a public enterprise to carry out activities relating to outputs or inputs which it would not elect to do so on a commercial basis, and which the government does not require other businesses in the public or private sectors to generally undertake (sic), or which it would only do commercially (sic) at higher prices.*

The ACA's concern is mainly with outputs. Input based CSOs relate to matters such as conditions of employment, conditions of contracting etc. These are important issues in their own right, for they concern matters such as Australian purchasing preferences which can add to costs, but they are not the immediate concern of this paper.

The definition seems innocuous, but it leaves many gray areas of policy.

First, it is far from clear what a government requirement is. Governments do not always spell out just what CSOs are. The wording may be vague. What, for example, does the Commonwealth mean when it says that Australia Post will ensure the letter service is "reasonably accessible"?[2] Sometimes communities look at historical practices and assume that these are part of an organization's CSOs. For example, many Australians believe that Australia Post has a Commonwealth imposed requirement to maintain heritage buildings.

Second, the notion of what firms would and would not do on a commercial basis is unclear. Many GBEs operate as monopolies; in fact the existence of natural monopoly is often the very reason for public provision of goods and services. Does this mean that when a GBE sets a price at a lower level than a profit-seeking monopolist would, that it is carrying out a CSO? Also, what is a commercial basis for pricing? Even in commercially competitive industries we see examples of price discounting and cross-subsidies in pricing. Firms may engage in national or "base point" pricing for commercial reasons. For example, a soft drink firm may, for reasons of long term corporate strategy, ensure its drinks are available throughout the country, and subsidise its distributors in remote locations. Firms engage in price discrimination not out of any sense of "community service" but for the good commercial reason that different consumers differ in their willingness to pay. Airlines and cinemas recognize this when they offer student discounts, for example. More on these matters when we look at costing CSOs further on.

Third, the definition does not cover situations where goods and services are provided free because of reasons of non-excludability (also known as *public goods*). For example, roads, hospitals, police services and schools are provided to all; non-payers are not excluded. Cost/benefit analysis may dictate an optimum distribution of these services, based on considerations of scale economies. But, in order to guarantee fair access to publicly provided goods and services, governments usually provide such services at higher costs to remote communities than they do in the cities. The cost per unit of service provided by these small schools, hospitals, police stations etc, to the extent that they are higher than costs in optimum sized facilities, are the costs of the

CSO of making government services available to remote communities. Sometimes governments insist on certain standards as a matter of prestige; for example in the Parliamentary areas of Canberra there is a very high standard of public amenities, such as underground power lines. These special conditions are sometimes known as *Parliamentary Service Obligations.*

Fourth, many GBEs are statute-limited in their operations. A public transport authority is not permitted to enter the interstate coach business. An electricity authority is not permitted to expand into other energy markets. These are constraints not imposed on commercial entities. To the extent that these limitations lock GBEs into certain markets, possibly with little growth prospects, are they CSOs? In some cases utilities, especially energy and water utilities, are expected to try to limit their markets for conservation purposes. Such limitations would seem to fit within most definitions of CSOs, for they deprive the businesses of potential growth or profit. But they are notoriously hard to cost.

Specific Definitions

Within agencies the definitional problem gets to be more acute. Governments seek specific identification of CSOs; the more specific and concise the better from a government point of view. The fashion in public sector management is devolution with well-defined statements of objectives, resources and expected outputs. (This may seem self-evident to those who have come to take such a management philosophy for granted, but it contrasts strongly with other public sector management approaches, such as micromanagement from on top, or management through developing a strong bureaucratic élite, embodying a culture of public interest.)

When governments devolve responsibility to program managers, or to the boards of publicly owned corporations, they therefore aim at precise and concise definitions of what those managers may and not do. Such specificity and brevity flows over to definition of CSOs.

Many of these statements are very short. Australia Post's statement of its CSOs is barely more than 100 words long, and basically specifies a single national rate for its letter service. At an operational level, of course, there are more detailed instructions on CSOs, but they are constrained by this higher level definition.

Consequently there is no real incentive or specific requirement for those providing public goods and services to step outside the narrowly defined CSO. A manager in an electricity utility, for example, may believe it would be reasonable to keep the accounts office open longer to cater for the needs of people who want to pay accounts after work. If this activity results in a higher net cost, however, and is not specified as a CSO, there is no incentive to do it.

As part of this simplification of the task of public administration, governments have tried to direct managers to a few simple statements of objectives, and to make managers more conscious of the budgetary costs of their decisions and recommendations. While

management always needs a clear focus, the imperative of financial performance has become something of an obsession in certain GBEs. Also, GBEs, by design, are cut off from the political and policy making process, and it is very easy for managers to forget their wider public responsibilities, even if they are spelled out. This may be what has happened in the Civil Aviation Authority, which, many claim, has let its community responsibility for air safety be compromised by its responsibility to provide services for the aviation industry.

A further problem is that many government agencies, Commonwealth and State, are partially or wholly exempt from certain environmental or planning legislation. In NSW, for example, the State Rail Authority has ignored local government restrictions on billboard advertising, and has fouled the landscape with advertising hoardings.

To an extent government agencies, especially GBEs, have a more free rein than their private counterparts. There is specific exemption from regulation, mentioned above. There is also the fact that as monopolies they know they have power. Managers of enterprises in commercial markets may have some reason to be good corporate citizens. Threats of consumer boycotts and adverse publicity, and the rewards of being seen to be good corporate citizens, can, in cases, result in behavior which is responsive to the community's needs. Governments often have the full weight of bureaucratic inertia and the resources of Attorney General departments to protect them against public criticism. This is not a New Right argument for privatization; powerful monopolies are insensitive to community needs wherever they reside. It is, however, an argument against assuming that public ownership, in itself, will ensure good corporate citizenship.

Changing Definitions

Many CSO definitions are based on a historical minimum service. For example, Telecom's CSOs are defined in terms of standard, voice, telephony services.[3] In accordance with International Telecommunications Union Regulations and Conventions Australia Post operates a high cost lettergram service.[4]

Consumer organizations often put disproportionate effort into defending historical CSOs, while paying insufficient attention to what may be reasonable CSOs to negotiate in emerging markets. Should all households in Australia be provided with broadband telecommunications through fiber optic cable or satellite? Should access to a public electronic mail system be a basic CSO, similar to the present CSO relating to voice telephony? These notions may sound outlandish, but, then fifty years ago, universal access to telephone services would have seemed outlandish. To date, there has been very little debate about CSOs in relation to the "information superhighway" or pay television.

Costing CSOs

> *The pursuit of precision in the costing of CSOs is likely to prove fruitless and yet be very costly.*
>
> Steering Committee on National Performance Monitoring of Government Trading Enterprises.

Costing definitions

Once a CSO is defined, how much does it cost to provide? The Industry Commission (and others) use three basic definitions of cost: *avoidable cost* (also known as *long run marginal cost*), *fully distributed cost* (also known as *absorbed* or *allocated cost*), and *stand-alone cost*. These progress from low cost through to high cost estimates.

> **Avoidable costs** are those costs the agency would save if, over the long run, it did not provide the service. This is a simple enough definition; it corresponds to the economists' notion of long run marginal cost.[5] If, for example, Telecom were to get rid of all its public phone boxes there would be some saving, as these operate at a loss. These savings would be the installation, repair, lighting, coin collection etc, offset by the loss of revenue from public phones.
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> **Fully distributed** costs come closer to accountants' notion of costs, for they include avoidable costs plus some share of overheads. (Overhead allocation is a very imprecise activity in itself.) In the case of Telecom's public phone boxes, this would include some proportion of the operating costs of the local exchange, the major trunk exchanges, central administration, R&D etc.
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> **Stand-alone costs** are the costs which would be incurred if the CSO were to be provided through an entirely separate agency, without any of the economies of being linked in to an existing agency. In the public phone case this would be the cost of a telephone network which comprised nothing except public phones – conceptually absurd, maybe, but an illustration of how high stand-alone costs may be if anyone attempted to measure them. The notion may have some legitimacy in an agency which provided a service which was quite unconnected with its original mission. For example, a railway authority might find itself, for historical reasons, supplying a town water supply. (Many small town water supplies were originally developed for steam engines.) In such a case stand-alone cost and avoidable cost may correspond.

These definitional distinctions are not just minor academic distinctions. In a 1989 study, for example, the Bureau of Transport and Communication Economics, using avoidable costs, estimated Telecom's CSOs to cost $148 million annually. Telecom, using fully distributed costs, estimated the same CSOs to cost $800 million annually.[6]

Economists and financiers tend to favor using avoidable costs when costing CSOs. They give the lowest estimates, and they embody the notion that CSOs are marginal to an enterprise's activities. But even once narrowed down to this definition, they are far from easily measured. There are still many conceptual ambiguities, discussed below.

Capital Costs

One basic problem in measuring avoidable or long run marginal cost is that it should include some measure of capital cost. This is problematic, for it involves three steps, all of which involve rough accounting assumptions:

(1) A valuation of existing assets, or of proposed replacement assets.

(2) An estimate of the life of those assets, and how they wear with use (i.e. depreciation).

(3) An estimate of the opportunity cost of capital, or discount rate.

All three are subject to a wide latitude for interpretation. Asset valuation is always difficult, particularly for unique and long-life assets owned in the public sector. What is a reasonable valuation for the 110 year old Sydney-Melbourne railroad? If it were to be replaced today, would it follow the same alignment, or would a lower cost alignment be used? How long will it last? Accountants can get reasonable depreciation estimates on short life assets, but for infrastructure assets they are notoriously hard to estimate. And what is a reasonable discount rate? Is it the return on capital which a public utility can use through exploiting its monopoly position, or is it the much lower long term government bond rate, which reflects the marginal cost of long term capital to the government? These can be a long way apart, and can have a high impact on cost estimates.

Even once all these three elements of capital cost are defined, there are measurement problems. Costing is expensive, and businesses often resort to simple accounting measures, such as measuring depreciation plus nominal interest, which gives much higher cost estimates than estimates based on more rigorous models, such as life cycle costing using real discount rates.[7]

When not to Include Capital Costs – Off-Peak Pricing

Many industries have high fixed costs and demand which fluctuates over a 24 hour period. A public transport system, for example, generally works to capacity during morning and evening peak periods, but has plenty of spare capacity at other times. A telephone utility has ample spare capacity outside normal business hours.

If fixed capital facilities are provided for peak demand, then it is reasonable to charge all or most capital costs to peak use, and to regard capital costs as very low or zero at other times. The cost of occupying a seat in a half empty train is next to nothing. The cost of using a telephone at midnight is simply the tiny amount of electricity required to activate the circuit.

Therefore provisions such as pensioner discounts for off-peak travel, which may look like CSOs, may actually be very profitable for the entity. Commercial airlines and

hotels use off-peak pricing extensively. Some CSOs, such as school bus services, involve a mixture of peak and off-peak use.

Price Discrimination

Peak load pricing is separate from *price discrimination*, which is the practice of setting different charges for different customers for the same service. It can make commercial sense, if prices are set in accordance with willingness to pay (price elasticity). Airlines and cinemas offer discounts for children, for example. As long as customers can make some contribution to fixed costs, and are not displacing customers who would have paid more, it is commercially sensible to provide the service to them at reduced price.[8] Such commercial price discrimination is very hard to disentangle from non-commercially motivated discounts to needy groups, for it is often the more needy who have less capacity to pay.

Other Commercial Practices

It is tempting to see every loss-making operation as a CSO. Telecom has proposed that each exchange operating at a loss is providing a CSO to the extent of that loss. It is tempting to see geographic uniform pricing as a CSO.

But, as pointed out, commercial firms engage in such practices. Corporations may have a business objective of having a national presence. There may be economies in national price advertising. Many commercial establishments accept that there is high and uncontrollable variability in the cost of service delivery, and accept that losses in some areas will be offset by high profits in other areas. The cost of having differential prices, reflecting different delivery costs, may be too great.

In any event, a loss does not, in itself, indicate a consumer benefit. Losses can result from inefficiency. or from cost structures imposed by input-based CSOs. If, for example, a GBE has to abide by public sector provisions of employment, and if these impose costs beyond those which would be incurred by a similar commercial enterprise, then these costs should be attributed to that obligation, and not to any associated output-based CSO. If GBEs are operating inefficiently it may be quite reasonable to cost CSOs on the basis of costs which would be incurred under conditions of best practice. or some other normative standard.

Monopoly Power

One commercial practice which most firms will use, if they can get away with it, is to use market power to exploit monopoly pricing. To increase profits, prices are set well above the cost of production.

Monopoly pricing has adverse effects in terms both of social justice (consumer transfers) and economic (or allocative) efficiency. In other words, consumers are ripped

off and there is inefficiency as monopolies restrict output in order to maintain high prices, with the result that services are under-provided. To take a case in point, holders of copyright may hold the price of music recordings much higher than the cost of production. As a result those who do buy recordings pay more than they would in a competitive situation, and many potential consumers miss out altogether, as they cannot afford the over-priced recordings. To the extent that they would have been willing to have paid at least the cost of production, this missing out on the market is known as *deadweight loss***.**

Generally, enterprises with monopoly power should be directed, through price control or other instruments of trade practices policy, to reduce prices to those which would prevail in competitive markets. Governments tend not to define such control as a CSO, on the reasonable basis that competition policy should prevail throughout the economy.[9] Such logic, however, overlooks the fact that many government entities are not subject to effective price control. Profits from electricity utilities, for example, are major revenue sources for state governments.

To the extent that GBEs engage in monopoly pricing, with its attendant costs, they are really failing in their basic implicit community service obligation of not exploiting their monopoly power. These costs, being consumer transfers and deadweight loss, can be measured and should be counted as *community service shortfalls* (CSSs). The notion of CSSs may be novel to managers in GBEs, but there is a precedent for such measures in the Industry Commission's practice of measuring and reporting on the costs of tariff and related assistance. There are numerous cases ranging from minor exploitations (parking charges at airports) through to major imposts on consumers (electricity charges). As with straight abuses of monopoly power, so too does the community suffer when monopoly GBEs operate inefficiently, and pass the cost of inefficient operations on to customers.

Cost/benefit Measures

Sometimes governments or GBEs, having measured the cost of CSOs, will identify the number of beneficiaries, and will come up with figures such as "each isolated farmhouse costs $X to connect to the telephone system". Such measures are often simplistic, because they confuse the notions of immediate *recipients* of CSOs and *beneficiaries* of CSOs.

In terms of defining beneficiaries, CSOs fall into three categories:

(1) Those pertaining to the whole community, such as preservation of heritage assets.

(2) Those which implicitly involve non-economic provision to high cost consumers, such as uniform pricing for city and country customers.

(3) Those which are targeted to specific groups, such as pensioners.

For the second and third categories, there is the risk that crude cost/benefit measures will yield high figures on the cost per beneficiary, and will expose the beneficiaries as highly privileged at the expense of the rest of the community.

This may sometimes be the case, but it is often fallacious to equate the immediate recipient of a benefit with the ultimate beneficiary of a service. For example, the rural population has fallen from 21 to 14 percent of Australia's population over the last thirty years.[10] This means that certain CSOs, such as Commonwealth CSOs relating to post and telecommunications, and state CSOs relating to electricity provision, sub-economic sized schools and police stations, etc, are seen to be accruing to a smaller and smaller proportion of the population. But these CSOs arise not only from a sense of city/rural social justice, but also from a sense that those living away from our cities are custodians of national resources, and that they need some support for this function. The beneficiaries are the whole community. If we did not provide small rural schools and police services, for example, the social costs on the whole community may be much higher than the cost of these CSOs.

Sometimes providing low cost services to particular groups may be an easy way to ensure those groups purchase services with *positive consumption externalities*. For example, connection of a house to a proper sewerage system has benefits not just for that household, but also for the whole community. Governments, in recognition of this benefit, tend to make sewerage connection mandatory when it is available. The costs for some households to connect to sewerage will be higher than for others, but we may accept a uniform charge as the cost of ensuring sewerage is affordable to all.

Paying for CSOs

The conventional wisdom is that CSOs should be identified, costed, and funding should be explicit, either by way of budget allocation, or, perhaps, by way of including the value of the CSO as part of the dividend to be paid by the GBE to the government. Economists tend to have a hierarchy of preferences:

(1) Specific budgetary allocation (which works on the cost side of budgets).

(2) Measured and identified dividend relief (which works on the revenue side of budgets).

(3) Cross-subsidy.

The argument for making CSOs a charge against the budget has two aspects – economic efficiency and accountability.

In terms of economic efficiency, making a CSO a specific budgetary allocation is likely to result in a more fair and efficient allocation of costs than would be the case if it were funded through cross-subsidy. The fairness comes from the fact that cross-subsidies are, in effect, a sales tax on one class of users to provide a benefit to other users. This may

be inequitable, especially for basic services such as electricity. Also, it may result in inefficient resource allocation, as any arbitrary impost or subsidy does. Those whose charges are higher as a result of the CSO will tend to under-consume, while those whose charges are lower will tend to over-consume. Pensioner discounts on electricity, for example, may result in wasteful consumption and consumer failure to implement more efficient measures, such as insulation. An impost on commercial electricity users, to fund CSOs, may result in a lowering of the competitive position of those firms, and may encourage them to over-use alternative sources of energy (e.g. gas). The taxation system, in theory at least, is designed with regard to equity and allocative efficiency. It is better to finance CSOs, therefore, through the taxation system than by imposing *ad hoc* sales taxes on certain services and commodities. (This argument holds only for GBEs which operate on a "user pays" basis. It does not hold for general public goods which are provided free, such as policing and education.)

In terms of accountability, budgets are subject to annual review and justification. If CSOs are provided for welfare purposes, for example, then they should be funded from the welfare budget, assessed against other welfare programs, and subject to the same discipline of Cabinet justification. Perhaps it would be better to give a general increase in pensions rather than a specific subsidy for electricity consumption. Similarly with CSOs relating to environmental protection, rural competitiveness etc

Given the considerable problems in costing CSOs, however, there are problems in trying to apply too much economic rationality to the process. GBEs generally (but not always) will have an incentive to use costing methods which overstate the cost of CSOs. The government will generally have an incentive to minimize the budgetary impact of CSOs by adopting costing methodologies which minimize the costs of CSOs. (Exceptions to these rules can occur; a government wanting to kill off a particular service may overstate its cost and the agency wishing to defend a CSO may understate its cost).

There are practical problems with the notion that CSOs should be funded from budgets. Although economic theory suggests that cross-subsidies should be replaced with taxes and explicit subsidies, the budget process does not support such rationality. Governments tend to consider revenue and expenditure decisions separately. There is little concept of linking tax increases to increased expenditure, even if economy-wide savings would result. The ongoing saga of Medicare shows that the Commonwealth has a single minded obsession with reducing budgetary outlays, even though there are good allocative reasons for raising Medicare outlays and taxes to take over the role of private insurance funds. If CSOs were all subject to the budgetary process they would be vulnerable to this expenditure reduction mentality (rather than to the more rational notion of seeing the exercise as a re-allocation of the tax burden).

CSOs are not always social welfare measures. They do often distribute resources from high income earners to low income earners, but welfare is usually not their purpose. There is a tendency, however, for government agencies not to want to "own" CSOs when they have to be funded from budgets, and they finish up in a residual "welfare" category.

Also, cross-subsidies are often low cost to administer. Costing is an expensive exercise. Uniform prices, for example, are often easy to administer. That is why they are so common in commercial establishments.

It would be irresponsible to argue that CSOS should be left too vague or woolly, but specific identification of CSOs carries its own risks. GBEs and government departments may come to see the stated CSOs as the limit of their community responsibility. Statements of CSO obligations should support a culture of public service; they are there to protect that culture, not to substitute for it. The notion of a culture of community service may not sit well with the prevailing fashion of managerialism, which tries to reduce public administration to a few "bottom line" considerations, but it does align with more enduring notions of public service.

Notes

1. Steering Committee on National Performance Monitoring of Government Trading Enterprises *Community Service Obligations: Some Definitional, Costing and Pricing Issues.* Steering Committee on National Performance Monitoring of Government Trading Enterprises April 1994.

2. Industry Commission *Mail, Courier and Postal Services Report #28* AGPS October 1992.

3. Bureau of Transport and Communications Economics Report # 64 The Cost of Telecom's Community Service Obligations AGPS 1989.

4. Industry Commission Op Cit.

5. An economist may refine the definition so that *marginal cost* relates to only one unit of output, while *avoidable cost* relates to output of a total service. Conceptually *marginal cost* may relate to one phone call made from an outback phone box; *avoidable cost* may relate to all calls from outback phone boxes.

6. BTCE Op Cit.

7. The convention of adding interest and depreciation, while honored by accounting conventions, always gives an over-estimate of costs.

8. The ultimate theoretical refinement of such a practice is known as *Ramsay Pricing*, which results in fixed costs being distributed among different customers exactly in accordance with each consumer's potential consumer surplus.

9. This is the general line of argument by the Steering Committee on National Performance Monitoring of Government Trading Enterprises. (Op Cit).

10. ABS, 1954 to 1986.