

# COMMUNITY SERVICE OBLIGATION (CSO) POLICY FRAMEWORK FOR THE SOLOMON ISLANDS

## INTRODUCTION

The Solomon Islands Government (SIG) is undertaking a reform program to improve the performance of its State-Owned Enterprises (SOEs). This reform program, known as the SOE Governance Strengthening Program, is being supported by the Regional Assistance Mission for the Solomon Islands (RAMSI) and the Asian Development Bank (ADB), and builds on previous work which has led to the passage of the SOE Act and related measures.

One of the reforms in the SOE Governance Strengthening Program is the development of a policy framework to provide Community Service Obligations (CSOs). This document describes SIG's approach to providing CSOs (i.e. describes the policy framework).

The focus of the document is the provision of CSOs through SOEs, however, the key principles underlying this policy will also be relevant where the Government pays other public sector entities (eg. local Government entities), privately-owned business entities, or church groups to deliver non-commercial products and services as CSOs.

N.B. This is a guidance document to help SOEs, Ministries, Ministers, etc to implement the relevant provisions of the SOE Act and especially Part 6 of the SOE Regulations 2010. It is **not** a legal opinion. The Act and Regulations must be consulted on any legal matters, and the Office of the Attorney General should be asked to help with any issues about interpreting these laws.

The CSO policy document is organised as follows:

1. Key objectives
2. Definition
3. Costing
4. Funding
5. Contracting
6. Establishing New CSO's
7. Annual Review of Existing CSO's
8. Monitoring and Reporting
9. Concluding remarks

## KEY OBJECTIVES

The key objectives of the CSO policy framework are to ensure that:

- the Government understands the true costs and benefits of providing a CSO and so can make better decisions about using SOEs to achieve policy objectives;
- the delivery of CSOs does not negatively impact the performance incentives of SOEs or their commercial results;
- CSOs are efficiently provided (i.e. CSO outputs are delivered at least cost whilst also meeting the appropriate product/service standards); and
- CSOs are effective (measured through outcomes) in achieving their identified social goals.

These objectives support SIG's requirement that SOEs must operate as sound profit-making entities. They are also consistent with other SIG reform efforts to improve public financial management and enhance service delivery because SIG's SOE decisions will become more like other budget decisions.

## DEFINITION

To qualify as a CSO, the activity must satisfy the following criteria:

*1. Non-commercial product or service*

A CSO must relate to the provision of a non-commercial product(s) or service(s). That is, products or services that a commercial entity would not elect to do on a commercial basis, or which it would only do commercially at higher prices (based on the entity earning normal commercial profit levels and the products or services being delivered on a cost-effective basis).

*2. Explicitly purchased by the Government on behalf of the community*

ACSO product or service must be clearly purchased by the Government (through an appropriate Government Ministry, for delivery to the community on its behalf. The purchase must be the result of a specific government policy or directive and must be provided for some identifiable community or social benefit.

This means that SOE's or any other commercial business entities cannot simply argue that the non-commercial products or services that they provide to the community as a result of their activities automatically qualify as CSOs. The provision of such services must accord with the Government's priorities and outcomes to meet the needs of the Solomon Islands community and as such must be the result of a clear and explicit decision taken by the Government as part of normal budgeting processes. Only the Government can approve CSOs – no-one else can.

Although the SOE Act definition of a CSO intentionally includes SOE actions that benefit individuals rather than sections of the community, as a matter of policy SIG will not use its CSO powers for this purpose. Therefore any such action by any person – whether they are a Cabinet Minister, SOE Chairman or junior staff member – or by any SOE or any other organisation other than the government itself, will be illegal in terms of that Act, and subject to the punishments in that Act (refer provisions 8(4) and 8(5)).

A community may be defined as a group of people with readily identifiable characteristics who share the same need for help from the government<sup>1</sup>.

In cases where more than one Ministry could appropriately act as purchaser for a particular CSO, each of those Ministries should contribute to the preparation of the required Budget submission but, for administrative convenience and efficiency, only one Ministry will act as purchaser. The selection of that Ministry will be made by the Government.

## COSTING

The Long Run Avoidable Cost approach is the preferred method of measuring the cost of providing CSO's. Avoidable Cost is restricted to costs – mainly operating costs (including overheads), capital costs, and a provision for normal profit<sup>2</sup>—that would be avoided if the CSO was not carried out by the SOE. Those fixed costs which would be incurred in the absence of the CSO are not classed as avoidable and are not included in the cost of providing the CSO.

There are situations where the Avoidable Cost approach may not be the most appropriate method for costing the CSO. Examples of such situations are:

- The CSO output is large in relation to total SOE output;
- There are practical difficulties with accurately identifying which costs are avoidable (e.g. accounting records are not sufficiently detailed to allow accurate allocation of costs to each output type or to a particular customer group); and
- There is inadequate information about actual demand, which is important for estimating price concession CSOs<sup>3</sup>.

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<sup>1</sup>This definition was used in guidance on “community companies” under the Companies Act 2009.

<sup>2</sup>Normal profit refers to the returns that could have been achieved if resources had been used commercially. Calculation of normal profit is discussed further in the CSO Costing Guidelines, [provide weblink].

<sup>3</sup>Price concessions are defined as the reduction in price charged to certain consumers of a core service provided by a SOE. Subsidised operations are particular activities which SOEs are directed by governments to perform, which they would not otherwise undertake as a commercial decision.

If an alternative methodology to avoidable cost is to be used, the reasons for this must be clearly stated in the CSO submission (discussed in ESTABLISHING NEW CSO's) and agreed to by the SOE Monitoring Unit.

The Solomon Islands CSO Costing Guidelines provides further information on costing methodologies and how to apply them. This document can be found at <http://www.mof.gov.sb/ReportsNew/CSOs.aspx>.

## **FUNDING**

The preferred method of funding CSOs is direct funding from the Budget. This strengthens and standardises Government's decision-making, and also enhances transparency and accountability by making clear the cost to the community of providing social and community programs.

For the 2011, 2012 and 2013 budget years, CSO funding will be allocated to the Ministry of Finance and Treasury who will purchase the community service from the SOE or business entity (the provider) on behalf of the Government. This is a transitional arrangement only and is intended to facilitate the implementation of the SI CSO framework.

After 2013, CSO funding will be allocated to the Government Ministry that is most directly responsible for the SOE or for the social outcomes associated with the CSO. The relevant Ministry will then be responsible for purchasing the community service from the SOE or business entity and for all aspects of contract management, including monitoring performance and ensuring compliance with contract terms – especially requirements to be fulfilled before payments are made.

To aid transparency, the purchasing Ministry generally will be required to identify CSOs paid to different SOEs as separate activities.

To encourage efficiency in the provision of CSOs, wherever possible, funding is based on an agreed unit price for each CSO. The price is agreed between the purchaser and provider and represents the difference between the avoidable cost of providing the service and the revenue received, expressed on a per unit basis.

The budget for each CSO is determined using the agreed unit price and the estimated quantity to be provided, with actual funding dependent on the actual quantity provided (i.e. performance-based funding). By basing funding on a unit price, SOEs have an incentive to achieve efficiencies in the delivery of CSOs. Any efficiencies achieved improve a SOEs financial performance. Conversely, any inefficiencies impact adversely on financial performance.

Where CSOs are funded by other means, such as by cross subsidies from other SOE customers or lower SOE rates of return, the long-term objective is to move directly to direct Budget funding. In the meantime, the cost of providing the CSO is to be identified and made transparent.

## CONTRACTING

All CSO activities are to be formalised through a contract between the purchasing Ministry and the SOE or other entity providing the CSO. This helps to specify the exact requirements of the CSO activity which in turn should enhance the accountability of the provider and make it easier to identify whether the Government's social objectives are being met. Contracts can also help to manage risk by specifying which party is responsible for any unexpected changes in costs, and provide the SOE with a high degree of commercial certainty through access to a well-developed body of law if the Government does dispute or want to amend the terms of the CSO.

Fundamentally, CSO contracts should be structured using the same principles that would apply to contractual arrangements in the private sector. An important distinction for CSO contracts however is that the service or activity is provided to a third party - the community. This feature will need to be taken into account in structuring the contract, particularly in terms of the responsibilities for receiving and handling complaints.

CSO contracts must detail:

- the good(s) or service(s) to be provided;
- the financial arrangements, including contract price, frequency of payment, and agreed provision for variations;
- the quality, frequency, and quantity of the goods or services to be provided;
- performance measures against which the SOE shall be held to account and the mechanism(s) for reporting on these performance measures;
- the consequences of any breaches of contract terms, especially any penalties if the supplier does not meet contractual performance requirements; and
- any other matter that the parties consider should be specified in the contract.

Any part of the cost of delivering the CSO that will be recovered through User Fees or from any third party, including local or regional government, donors or any other source, shall be deducted from the amount payable by the Government to the SOE.

The Solomon Islands CSO Contracting Guidelines provides further information on what elements should be included in CSO contracts as well as key principles to consider when negotiating the contract. This document can be found at <http://www.mof.gov.sb/ReportsNew/CSOs.aspx>.

CSO contracting with SOEs must be dealt with as part of the Statement of Corporate Objective (SCO) process. CSO contracts must also comply with the SIG rules for contracting and procurement as set out in the *Financial Instructions 2010*. All contracts will be subject to review by the Minister for Finance and Treasury.

## **ESTABLISHING NEW CSOs**

If a Ministry considers there is a need for a CSO (either as part of a new policy/strategy under its portfolio or as part of established Government priorities), it should firstly consult with the Ministry of Finance and Treasury and the other Accountable Minister (if it is not that Ministry). Both Accountable Ministers (i.e. the Ministry of Finance and Treasury and the Responsible Minister) must agree with the CSO proposal for it to be progressed. If an SOE wants to obtain a CSO contract, it must start the process by getting agreement from its Accountable Ministers under the SOE Act.

If there is agreement, the lead Ministry should then initiate a tender process. Competitive tendering procedures are set out in the *Financial Instructions 2010*. Tenders must specify that budget funding has not yet been allocated for the proposed CSO project. It should also include pro-forma templates for CSO contracts.

Where there is no clear benefit in a tender (for example, the CSO relates to existing natural monopoly infrastructure owned and operated by a SOE), the process is for a letter to be sent to the SOE, co-signed by both Accountable Ministers, outlining the nature and scope of the proposed CSO and directing the relevant SOE to provide costings<sup>4</sup>. The SOE must provide initial costing estimates to the Ministry within 10 days of the receiving the direction.

The lead Ministry must then provide a written submission/application, approved by its Minister and the Accountable Ministers to Budget Cabinet. The Ministry of Finance and Treasury (SOE Monitoring Unit) and the other Accountable Ministry (if this is different to the lead Ministry) will assist with the preparation of this submission, though the intention is for the responsible Ministry to lead this work.

As a transitional measure, the Ministry of Finance and Treasury (SOE Monitoring Unit) will lead the preparation of all new CSO submissions/applications for 2011, 2012 and 2013 Budget years. The SOE Monitoring Unit will do this in collaboration with the Government Ministry that is most directly

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<sup>4</sup> Note, this direction could include costings of various CSO options.

responsible for the SOE or for the social outcomes associated with the CSO and the other Accountable Ministry (if this is different).

The submission/application must clearly detail:

1. the nature and scope of the CSO
2. the reason(s) why the CSO activity would not be provided as part of the SOE's normal commercial operations and should be classified as a CSO;
3. the social problem (or need) that the CSO is seeking to address, and evidence that this problem is substantial;
4. the government policy/strategy/plan under which the function is to be performed;
5. how the proposed CSO outputs (i.e. product or service) will address the identified social problem (or need);
6. whether other policy options to address the identified social problem (or need) are available and have been examined;
7. if available, evidence from other jurisdictions' experience about the effectiveness of the proposed CSO activity in addressing the identified social problem;
8. a cost benefit analysis of the CSO
  - a. benefits generated from the proposed CSO outputs should be identified and described in quantitative physical terms and, if feasible, valued in monetary terms
  - b. costs of the CSO outputs should be described in per unit and aggregate terms, and information provided on how these estimates were calculated/derived;
9. whether other delivery options are available and have been examined;
10. how performance of the CSO will be assessed and reported;
11. the Activity/Program, the funding required (based on a unit price and estimated quantity to be purchased), whether capital or recurrent, and for what period of time; and
12. the proposed payment terms, especially any conditions that must be fulfilled before payments are made.

The budget application/submission should be developed within the timeframe of the SOE Statement of Corporate Objectives (SCO) process, and should be informed by the other information provided in the SCO.

Final acceptance of a product or service as a CSO is dependent on Cabinet approval. Cabinet also determines the appropriate purchasing Ministry and allocation of funds. The process is summarised at Appendix A. Examples of CSO submissions will be made available at the online CSO registry,

<http://www.mof.gov.sb/ReportsNew/CSOs.aspx>. It is desirable that these submissions also include a draft CSO contract. This will provide a cross-check that all relevant factors have been dealt with, and should speed and simplify implementation.

## **ANNUAL REVIEW OF EXISTING CSOs**

For existing CSOs, the designated purchasing Ministry is responsible for reviewing performance annually and for negotiating, if required, with the CSO supplier. It must include the results of that review and any negotiations in its annual budget submission, if its Minister wishes to fund continued provision of the CSO.

The purchasing Ministry, with approval from its own Minister and the Minister for Finance and Treasury, applies for continued funding of the CSO as part of the annual Budget process (see Appendix A). The funding submission should be supported by information on the performance of the CSO, including both output-based and, where feasible, outcome-based measures. Economic valuation of outcomes (i.e. monetary value of benefits) should also be provided wherever possible.

In the case of CSOs contracted for a period of years and with some years remaining, the budget submission should include an estimate of the cost to the government of compensating the SOE if SIG wished to break the contract.

Purchasing Ministries and SOEs must report on the performance of CSO functions in their annual reports. The Ministry of Finance and Treasury will prepare summary reports on overall CSO performance for inclusion in the Budget.

## **MONITORING AND REPORTING OF CSOs**

Clear reporting on the nature, scope, outputs, and cost of CSOs helps to ensure that adequate attention is focused on the efficient and effective delivery of nominated CSOs.

SOEs must provide the following information in their annual reports:

- identify and describe each CSO product or service delivered;
- the quantity (i.e. number of units) of CSO products or services delivered;
- the revenue received for undertaking each CSO;
- the actual cost of carrying out the CSO(s), in per unit and aggregate terms; and
- statistical information on, and assessment of, all other performance criteria/measures agreed to in CSO contract;

As outlined in the CONTRACTING section, SOEs must also incorporate all details of the CSO contract agreed between the purchasing Ministry and the SOE in its Statement of Corporate Objectives (SCO) document.

In addition, the SOE Monitoring Unit will establish and maintain a registry of CSOs. The registry will list all CSOs and include a copy of original CSO submission/application, Government direction, contract, and annual funding review submissions for each CSO.

The registry will be available to the public to view online and the public may obtain copies of the documentation held on the registry. However, the SOE Monitoring Unit may charge any reasonable out of pocket expenses incurred in responding to a request for information and/or hard copies of documentation.

## **CONCLUDING REMARKS**

CSOs are an important mechanism to achieve social goals.

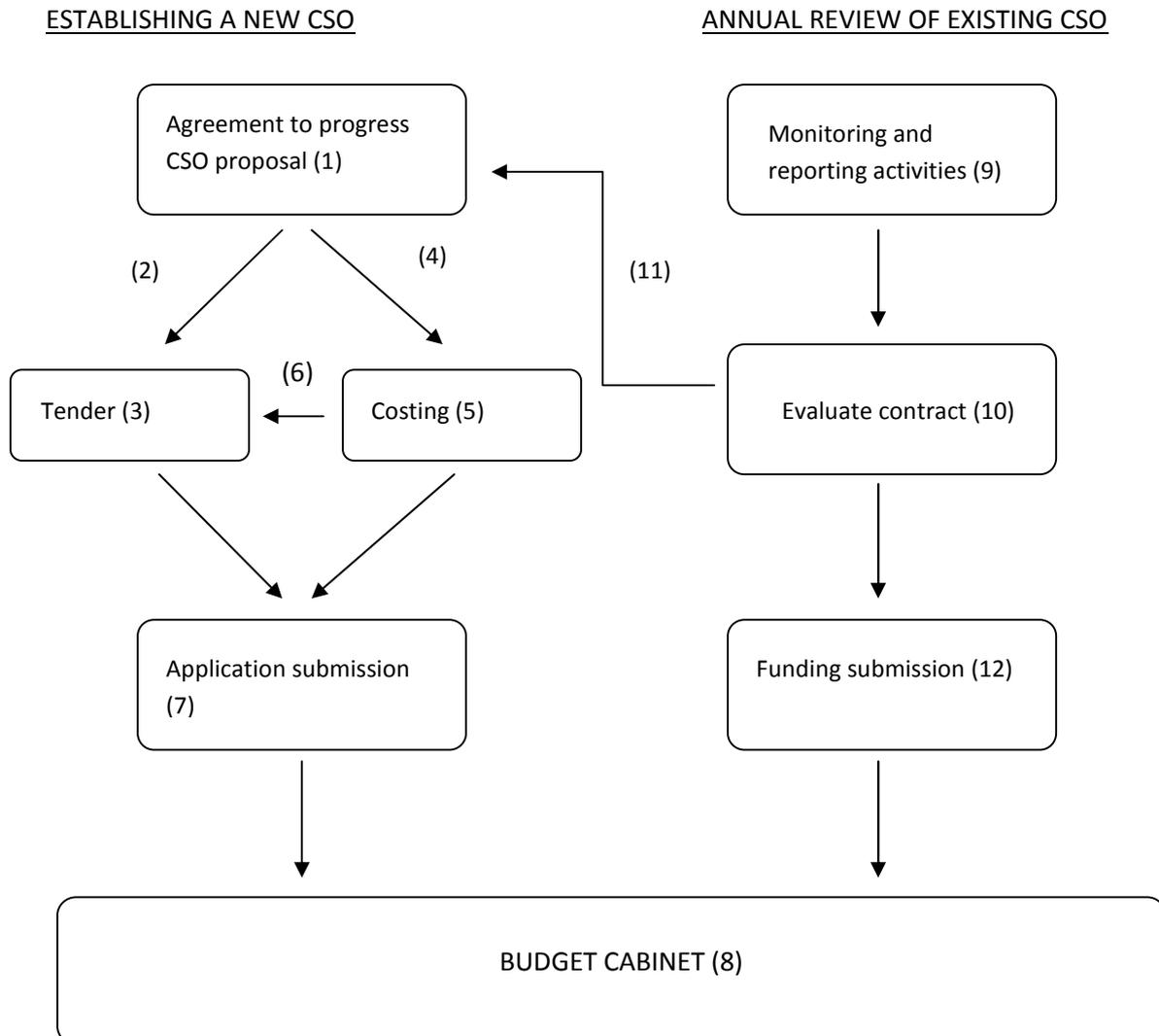
The above policy document describes SIGs approach to delivering CSOs. This approach is based on international best-practice and aims to deliver CSOs in a way that:

- does not negatively impact the performance incentives of SOEs or their commercial results;
- minimises cost (i.e. CSO outputs are delivered efficiently);
- ensures the CSO activity is effective (measured through outcomes) in achieving its identified social goal; and
- imposes the same decision-making disciplines on SOEs' CSOs as for SIG's decisions on Ministries' and Departments' spending and use of their existing resources.

Guideline documents have been prepared to assist with costing and contracting of CSO's. These guidelines can be found at <http://www.mof.gov.sb/ReportsNew/CSOs.aspx>. The CSO registry-which contains copies of all new CSO submissions/applications, annual review submissions, and contracts - is also a useful reference.

If you have any further questions about the CSO process or how to undertake any aspect of the CSO process, please feel free to contact the SOE Monitoring Unit.

## Appendix A: Flow chart of CSO process



- (1) If a Ministry or SOE considers there is a need for a CSO (either as part of a new policy/strategy under its portfolio or as part of established Government priorities), it should firstly consult with the Ministry of Finance and Treasury and the other Accountable Minister. Both Accountable Ministers (i.e. the Ministry of Finance and Treasury and the Responsible Minister) must agree with the CSO proposal for it to be progressed. Ministers will need to instruct their officials to make this happen.
- (2) If there is agreement, the lead Ministry should then initiate a tender process. Competitive tendering procedures are set out in the *Financial Instructions 2010*.
- (3) Tenders must specify that budget funding has not yet been allocated for the proposed CSO project. It should also include pro-forma templates for CSO contracts.

- (4) Where there is no clear benefit in a tender process (for example, the CSO relates to existing natural monopoly infrastructure owned and operated by a SOE), the process is for a letter to be sent to the SOE, co-signed by both Accountable Ministers, outlining the nature and scope of the proposed CSO and directing the relevant SOE to provide costings<sup>5</sup>.
- (5) The SOE must provide initial costing estimates to the Ministry within 10 days of the receiving the direction.
- (6) The preferred approach to procuring CSOs is to go to tender wherever possible. There may be certain circumstances however where it is preferable for SOEs to provide their costings ahead of this process (e.g. where Accountable Ministers are unsure of the merits of a possible CSO and want to get an indication of costs before deciding to undertake a full tender process). This step provides for this situation.
- (7) The lead Ministry must prepare a written application submission, approved by its Minister and the Accountable Ministers. The Ministry of Finance and Treasury (SOE Monitoring Unit) and the other Accountable Ministry (if this is different to the lead Ministry) will assist with the preparation of this submission, though the intention is for the responsible Ministry to lead this work. As a transitional measure, the Ministry of Finance and Treasury (SOE Monitoring Unit) will lead the preparation of all new CSO submissions/applications for 2011, 2012 and 2013 Budget years.
- (8) Acceptance of a product or service as a CSO is dependent on Cabinet approval. Only Cabinet can approve CSOs – no-one else can. Cabinet also determines the appropriate purchasing Ministry and allocation of funds.
- (9) The purchasing Ministry is responsible for managing the CSO contract with the CSO provider (SOE or other organisation). This includes monitoring and collecting information on performance.
- (10) Using the performance information collected as part of the CSO contract, the purchasing Ministry, in co-operation with the Accountable Ministries, should evaluate whether the CSO is being efficiently delivered and whether it is achieving the identified social objective.
- (11) If the evaluation indicates that the CSO is not being delivered efficiently and/or is not achieving the identified social goals, then the CSO output or delivery (and thus the CSO contract) will need to be changed. To do this, the CSO should undergo a thorough review following the same steps and procedures as for a new CSO proposal.
- (12) The funding submission should include key information on the performance of the CSO. In all cases where there is an existing contract, the budget submission should include an estimate

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<sup>5</sup> Note, this direction could include costings of various CSO options.

of the cost to the Government of compensating the SOE if the Government decides to break the contract. More details may be required if the submission actually proposes to terminate an existing contract early.