Government of Pakistan
Finance Division
Central Monitoring Unit
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Subject: **DISTRIBUTION OF PUBLIC SERVICE OBLIGATIONS (PSO) COSTING GUIDELINES FOR STATE-OWNED ENTERPRISES**

In accordance with the requirements of the State-Owned Enterprises (Governance and Operations) Act, 2023 and the SOE Ownership and Management Policy, 2023, CMU has prepared "Public Service Obligations (PSO) Costing Guidelines". The document provides an in-depth costing methodology designed to assist SOEs in estimating and managing the financial requirements of fulfilling PSOs, with particular emphasis on activity-based, standard, and marginal costing approaches.

2. These guidelines will apply to all PSO activities that fall in non-tariff regulated sectors. State-Owned Enterprises are requested to follow the guidelines in preparation of their PSO claims.

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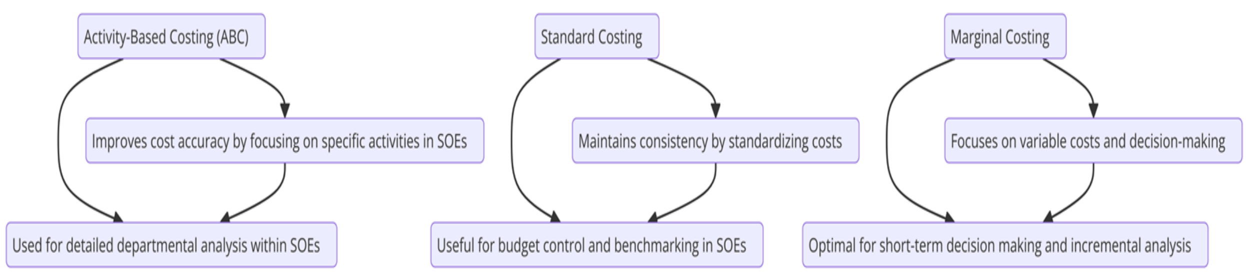
Public Service Obligation (PSO) Guidance and Implementation of framework for State-Owned Enterprises (SOEs)

(Schedule II of Act and Annexure 5 of Policy)

COSTING GUIDELINES

The PSO Costing Guidelines are essential for SOEs as they provide a standardized framework to address the unique financial challenges associated with public sector obligations. PSOs often involve delivering services that are critical to public welfare but may not be commercially viable. Without clear costing guidelines, SOEs may face difficulties in accurately estimating and justifying the financial resources needed for these obligations, which can lead to underfunding, operational inefficiencies, and misaligned budget allocations. By implementing these guidelines, SOEs can achieve a more transparent and consistent approach to costing, which is crucial for securing adequate funding and ensuring accountability in their operations.

Furthermore, these guidelines help bridge the gap between the financial goals of SOEs and the broader socioeconomic objectives of the government. PSOs typically have a significant impact on public services and economic stability, making it crucial for SOEs to manage these obligations efficiently. With a well-defined costing framework, SOEs can better align their financial planning with government policies and regulatory standards. This alignment not only enhances transparency for stakeholders but also strengthens the government's oversight and support for SOEs, enabling a more sustainable and balanced approach to public sector management.



1. ACTIVITY BASED COSTING

Step	Details	Example Values	Benefits
1. Identify Activities	Key activities identified: Track Maintenance, Train Operations, Station Services, Passenger Services.	Activities like track maintenance, train operations, station services, and passenger services are identified as crucial.	Clear activity breakdown helps identify cost centers.
2. Assign Costs to Activities	Direct and indirect costs assigned to each activity: labor, fuel, maintenance, station upkeep, etc.	For Track Maintenance: PKR 5,000/km/year; Train Operations: PKR 1,000/trip; Station Services: PKR 20,000/station/year; Passenger Services: PKR 10/passenger.	Accurate cost assignment improves budget accuracy.
3. Determine Cost Drivers	Specific cost drivers for each activity: track length, number of trips, number of stations, number of passengers.	Track Maintenance based on length of track; Train Operations on number of trips; Station Services on number of stations; Passenger Services on number of passengers.	Identifies high-cost drivers to target for cost reduction.
4. Calculate Cost per Activity	Calculate cost using drivers: Track Maintenance - PKR 500,000; Train Operations - PKR 200,000; Station Services - PKR 100,000; Passenger Services - PKR 100,000.	For a 100 km railway line: Total cost - PKR 900,000.	Provides transparent cost per activity for budget justification.
5. Allocate Costs to the PSO	Allocate total costs to activities in proportion to resource use: Track Maintenance - PKR 450,000; Train Operations - PKR 180,000; Station Services - PKR 135,000; Passenger Services - PKR 135,000.	Total allocation example: Track Maintenance - 50%, Train Operations - 20%, Station Services - 15%, Passenger Services - 15%.	Justifies social value by showing detailed costs for PSO delivery.

EXPLANATION:

Under Activity based costing PSO framework for SOEs begins by identifying **key activities** essential for operations, such as track maintenance, train operations, station services, and passenger services. Breaking down these activities enables SOEs **to pinpoint cost centers accurately,** allowing for more effective allocation of resources. Each activity's relevance is determined based on its direct impact on service delivery and operational performance, providing a structured approach to understand the cost dynamics within SOEs. Once activities are identified, costs are assigned based on various direct and indirect inputs, including labor, fuel, and maintenance costs. This step is further refined by determining specific cost drivers, such as track length or the number of passengers, which influence the cost distribution for each activity. By focusing on these drivers, SOEs can enhance cost accuracy, helping to identify areas where efficiency improvements can be made, or resources can be optimized. In the final stages, costs are calculated for each activity, yielding a total cost for PSO operations. This total is then allocated across activities based on resource consumption, ensuring that each segment accurately reflects its share of the overall budget. This structured allocation justifies the budget requirements for each activity, enhancing transparency and enabling better financial planning within SOEs.

2. STANDARD COSTING

Step	Details	Example Values	Benefits
1. Setting Standard Costs	Predetermined cost rates for routine activities like track maintenance, fuel, and labor, based on historical data or industry benchmarks.	- **Track Maintenance:** PKR 500/km; 100 km/month → PKR 50,000 monthly	Simplifies cost estimation and provides a baseline for budgeting.
		- **Fuel Costs:** 150 liters per trip at PKR 1/liter; 200 trips → PKR 30,000	
		- **Labor:** PKR 25/hour; 3 hours/trip; 200 trips → PKR 15,000	
2. Budgeting and Control	Use standard costs to develop a monthly budget for routine PSO activities.	- **Track Maintenance:** PKR 50,000	Enables efficient resource allocation and quick budget preparation.
		- **Fuel Costs:** PKR 30,000	
		- **Onboard Staff Labor:** PKR 15,000	
		- **Total Monthly Budget:** PKR 95,000	
3. Variance Analysis	Compare actual costs to standard costs to identify variances and understand causes, enabling better cost control.	- **Fuel Costs:** Actual PKR 32,000; Variance of PKR 2,000 unfavorable due to fuel price increase	Informs operational adjustments and highlights areas for efficiency.
		- **Labor Costs:** Actual PKR 14,500; Variance of PKR 500 favorable due to reduced overtime	
4. Advantages for PSO	Simplifies the costing process, supports budgeting accuracy, and provides insights for efficient decision-making and financial control.	- **Improves Budgeting:** Establishes predictable costs for planning	Enhances operational consistency and ensures financial discipline.
		- **Cost Control:** Quicker identification of cost variances for corrective actions	

EXPLANATION:

Standard costing is a costing technique that involves setting predetermined cost rates for routine activities, such as maintenance, fuel usage, and labor. These rates are typically based on historical data or industry benchmarks, which serve as a baseline for measuring expected expenses. By establishing standardized costs, organizations can streamline cost estimation processes and create reliable budgets for Public Service Obligations (PSOs). For example, a fixed rate per kilometer for track maintenance or a set hourly wage for labor can simplify budgeting and improve accuracy in financial forecasting. Once standard costs are defined, they are used to prepare monthly budgets, providing a clear and consistent framework for resource allocation. This budgeting process enables SOEs to allocate funds efficiently across various PSO activities, reducing the likelihood of unexpected expenses. Standard costs allow for a structured approach to budgeting, as managers can quickly estimate monthly expenses for routine operations. The resulting budgets help in planning and controlling costs effectively, ensuring resources are directed towards priority activities without excessive spending. Variance analysis is a critical component of standard costing, where actual costs are compared with the standard costs to identify any discrepancies. These variances can highlight areas where operational adjustments may be needed, such as cost savings or addressing inefficiencies. For example, if actual fuel costs are lower than the standard cost, it indicates favorable performance, while higher costs may signal inefficiencies. This approach to cost control not only informs financial decision-making but also encourages continuous improvement within SOEs by providing insight into cost trends and fostering a culture of accountability.

3. MARGINAL COSTING

Step	Details	Example Costs	Benefits
1. Identify Variable Costs	Determine costs that change with the level of service, such as labor, materials, fuel, and maintenance. Fixed costs like rent are excluded.	- **Labor:** PKR 40,000 for construction and new operators - **Fuel:** PKR 20,000 annually - **Materials:** PKR 50,000	Focuses on costs directly associated with expansion.
2. Calculate Incremental Costs	Calculate the additional expenses directly related to the expanded service or new region coverage.	- **Labor Costs:** PKR 40,000 - **Fuel Costs:** PKR 20,000 - **Maintenance & Materials:** PKR 50,000	Allows the SOE to assess the specific costs of scaling up PSO services.
3. Assess Total Marginal Cost	Sum the variable costs for the expanded service, reflecting the direct financial impact of extending the PSO.	- **Total Marginal Cost:** PKR 110,000	Provides a clear estimate of the incremental cost for
4. Decision-Making	Use the marginal cost to evaluate whether the service extension is viable within revenue capabilities or requires government subsidies.	- **Total Marginal Cost:** PKR 110,000 - **Comparison:** Benefits of access vs. cost	Supports informed decisions on whether to proceed with PSO expansions.
5. Pricing & Budgeting	Determine a minimum fare or subsidy required to cover incremental costs based on estimated usage, if applicable for PSO services.	- **Fare Calculation:** Minimum fare of PKR 11 per passenger if 10,000 passengers expected annually	balances cost recovery with social service objectives.
6. Reassessment	Adjust the marginal cost estimate based on changes in demand or additional government mandates for service expansion.	- **New Routes/Service Frequency:** Costs updated if service level changes	Enables ongoing adaptability to align with evolving PSO mandates.
6. Advantages of Marginal Costing	Provides a targeted analysis of expansion costs, better resource allocation, and alignment with policy goals by focusing on additional costs only.	- **Targeted Cost Analysis:** Focus on variable costs only - **Resource Allocation:** Clear separation of fixed vs. variable costs	Facilitates policy-driven service expansion with a focus on cost-effectiveness.

EXPLANATION:

Marginal costing is a method that focuses on identifying variable and incremental costs associated with specific services, enabling SOEs to determine the feasibility and sustainability of expanding or maintaining Public Service Obligations (PSOs). Initially, this approach involves identifying variable costs such as labor, materials, fuel, and other expenses that fluctuate with the level of service. By isolating these costs, SOEs can concentrate on expenses directly linked to PSO services, providing a clear understanding of the cost structure and allowing for more informed financial decision-making. The next step in marginal costing involves calculating incremental costs, which are the additional expenses required to maintain or expand services. By summing these variable and incremental costs, SOEs derive the total marginal cost, which serves as a benchmark for evaluating the affordability and sustainability of their PSOs. This total marginal cost calculation is especially useful for assessing whether a service expansion is feasible within the budget constraints and capabilities of the SOE, supporting informed decision-making based on realistic financial assessments. Furthermore, marginal costing aids in financial planning by facilitating cost adjustments based on changes in service demand or government directives. SOEs can use this approach to evaluate whether existing services need restructuring or whether new services should be introduced, aligning operational objectives with financial constraints. This method also enhances budgeting accuracy by focusing on the costs most susceptible to change, enabling SOEs to manage their PSOs more effectively and to justify additional funding requirements when necessary.

While reviewing the PSO proposals the Finance Division shall also keep the following aspects in view:

In reviewing PSO proposals, the Finance Division will evaluate the balance of fixed and variable costs to ensure efficient cost management and assess the capital structure, focusing on debt-to-equity ratios and funding sources to maintain financial stability. Additionally, it will analyze financial and operating leverage, identifying the extent to which fixed costs impact profitability and cash flow under varying revenue scenarios, as well as the degree to which debt amplifies returns and risks. This holistic approach will help assess financial resilience and operational efficiency in PSO's proposals.

The above costing framework shall not apply to cases where a PSO is undertaken by SOE under a regulated tariff structure.