Australian Government
Aged Care Financing Authority

03 September 2020

Royal Commission into Aged Care Quality and Safety

Dear Ms Bailetti

Response to Reports provided to the Aged Care Financing Authority (ACFA) regarding the funding, financing and prudential regulation of the Australian aged care system

I refer to Reports commissioned by the Royal Commission concerning the funding, financing and prudential regulation of aged care (Attachment C), and your invitation for ACFA to review these Reports.

ACFA is an independent statutory body established by the Australian Government whose role is to:

- At the request of the Minister, provide independent advice to the Australian Government on aged care funding and financing issues, including viability and sustainability, access to care and workforce; and
- in giving advice, consult with consumers, the aged care sector and the finance sector about these issues.

In reviewing the Reports, ACFA has identified areas that it considers would be appropriate to bring to the Royal Commission's attention. These matters have been categorised into four areas:-

1. Material matters where ACFA aligns with the assertions in the Reports
2. Material matters where ACFA does not align with the assertions in the Reports
3. Matters where ACFA considers further investigation is warranted to prove a key hypothesis
4. Matters raised where transition arrangements will be key to successful implementation

These matters are addressed in Attachment A.

Members of ACFA would be pleased to expand on the matters raised in this response.

Yours sincerely

Nicolas Mersiades
Deputy Chair
Aged Care Financing Authority

Attachment A

1. ACFA concurs with the following material matters asserted within the Reports

a. Frontier Economics' recommended amendments to reporting, being:
   i. RADs to be reclassified as non-current liabilities.
   ii. Include imputed interest on RADs as an expense.
   iii. Include implied interest on RADs as revenue.

b. Capital employed is the correct denominator in working out returns, and that RADs should be deducted from current liabilities.

c. The starting point for setting the MPIR should be the economically equivalent rate between the lump sum RAD and the daily payment. We believe this rate should then be adjusted to achieve the strategic objectives desired by the Government.

d. The University of Queensland's 'Cost of Residential Care' paper's analysis of scale on the efficient cost of delivering good quality care.

e. The BDO report's observation that providers often use sophisticated structuring as a way of maximising returns including related party loans and the view that the ranking of RADs in the corporate structure needs review. Such structuring may cause the Government to support the repayment of RADs to residents through the Guarantee Scheme while having no recourse to the related parties to recover property or other assets.

f. The BDO report's assessment that sophisticated corporate structures are appropriate, as they are efficient, but that they require appropriate oversight and governance. Also the BDO's advice regarding caution on the unravelling of structures as this might cause unintended consequences.

2. Material matters where ACFA does not align with the assertions within the Reports

Frontier Economics suggests that EBIT is a better measure than EBITDA. Their report suggests that this is important because more private providers rent their premises whereas most not-for-profit providers own their facilities. ACFA has not observed this in its reporting on the sector and believe the difference in depreciation charges is more likely due to more conservative depreciation policies and increased assisted living and independent living apartment ownership by not-for-profit organisations. ACFA considers a more appropriate measure of financial performance is the net present value of cash returns over cash investment and therefore EBITDA is a better economic and comparative measure of performance.

3. Matters where ACFA considers further investigation is warranted to prove a key proposition

a. Frontier Economics asserts that investment in new buildings over recent years is proof of adequate returns in the aged care sector. Based on consultations with approved providers, ACFA would suggest additional investigation is required due to the significant time lag between investment decisions and delivery of new facilities.

b. The scope of the Frontier Economics report was to determine a fair WACC for accommodation of aged care and consider possible reform impacts. There is an implication,

though not specifically stated, that there will be an ability to separate the services provision from accommodation. While this approach can be taken, ACFA would recommend a review of the assumptions and comparators used in the report to enable a fair WACC, giving specific consideration to:

i. Basing the analysis on current aged care operators reflects the current risk profile, regulatory settings and operating conditions, including operating margins. As the current industry has not been able to separate accommodation from services this may limit the usefulness as a comparator firm in determining the cost of equity for accommodation.

ii. Should the scope of the request infer a genuine intent to separate accommodation from services, the appropriate WACC would also need to incorporate a view on the most appropriate operator market conditions and its ability to have sufficient margin to afford market rents on a sustainable basis. Sectors which have separated the provision of care services to facilities include the hospital sector, social infrastructure and child care. These do not form part of the comparator group and may add weight to the analysis.

iii. RADs are a unique feature of the Australian residential aged care system. We agree with Frontier Economics that they should be considered as debt. However, we also consider that the volatile nature of RADs (due to the potential of a whole RAD outflowing when a resident leaves and is not replaced) makes RADs either more costly than senior debt or requiring a special risk premium for the equity investor. This matter deserves additional analysis.

iv. The debt funding used for the WACC calculation by Frontier Economics is akin to investment grade infrastructure debt funding which is not equivalent to the terms provided by lenders to aged care providers.

c. The University of Queensland's report into the cost of residential care claims that government owned and small sized facilities are statistically more likely to deliver higher quality of care. This conclusion warrants further study and testing as it is partly skewed by the limited measures of quality used eg there is a strong focus on clinical care rather than quality of life. It is also unclear how the study controlled for differences in resident profiles, especially in relation to smaller services.

d. The University of Queensland's report into the cost of residential care also claims to have found statistical evidence that higher direct care costs equated to higher quality. This conclusion would benefit from further study based on agreed objective measures of quality and using multi variate analysis.

e. The University of Queensland's report also claims to have found that there is a statistical correlation between quality and cost, but that the correlation is not strong, suggesting that the Government subsidy constraint and other factors are at play. This deserves further exploration as it suggests that Government subsidised sectors do not respond well to market forces in the absence of or with limited competition, and therefore quality falls to a common lowest denominator. ACFA also notes this conclusion seems to be contradictory to the conclusion in (d) above.

f. BDO was asked to correlate financial and care outcomes (as measured by consumer experience reports, hospitalisations etc.). BDO found a weak correlation. This deserves additional investigation as there are examples of care failures (e.g. sanctions) being a predictor of financial failure, and financial failure as a predictor of poor care.

g. BDO conducted a viability analysis of approved providers based on a decision tree which commenced with identifying all providers that are EBITDA and operating cash flow negative. BDO then went on to determine which of these providers would be likely to be able to liquidate current assets over current liabilities quickly, raise new debt, sell noncurrent assets or raise new equity. Any that could not achieve this were identified as not viable. ACFA offers the following observations about this analysis:

   i. The decision tree is an effective tool.

   ii. This analysis is not predictive as it relies on historical financial information. A combination of post facto and predictive tools would be very valuable.

   iii. ACFA recommends further benchmarking on the RAD baseline given alternate views in sector analysis, such as Ansell Strategics' recent analysis (Attachment C).

h. Table 4.5 of BDO's report shows average profit margins and returns compared with other industries. This table has limited usefulness as it compares infrastructure assets with consumer staples, retail and with professional services sectors. Each of these sectors has different risks and therefore require different returns. In addition, the report shows returns on equity for aged care that are heavily impacted by the RAD impact on total assets (note the low return on assets for aged care). The analysis in this part of the report requires further development.

i. The Royal Commission asked BDO to identify approximately six approved providers that met one or more of the following conditions and met them all collectively viz. organisations with significant bond/RAD liabilities accompanied by:

   i. Membership of a group with complex related entity structures, significant related party transactions (including loans) and significant reductions over recent years in the working capital of the approved provider.

   ii. Significant reductions over recent years in the capital of the approved provider (whether as a result of working capital withdrawals, dividend payments or any other reason), accompanied by increased total revenues.

   iii. A low capital adequacy or liquidity ratio (taking into account liabilities in the nature of bonds and RADs).

   iv. A high proportion of intangible assets to net assets.

   v. Repeated significant financial losses.

   vi. Significant and high levels of unspent home care package funds.

   ACFA's observation of the above criteria is that they tend to identify large, complex organisations that may or may not be in financial or prudential difficulty. A better analysis would be to pursue the decision tree analysis that BDO recommended in their other report for the Royal Commission where a series of threshold questions are considered before determining whether a provider is at genuine risk. This analysis, combined with a predictive tool, would lead to a more accurate identification of providers requiring attention.

j) The Deloitte Access Economics paper presents the outputs of a comprehensive model, based on assumptions regarding inputs and constraints. ACFA identifies the following assumptions as requiring further consideration: -

   i. A shift towards home care and away from residential aged care in accordance with consumer preferences. While ACFA agrees with this general assumption, we recommend that further consideration is given to the realistic likelihood, rather than

preference, of switching between home care and residential care for Australians requiring 24-hour care.

ii. The ending of RADs on a grandfathered basis. ACFA considers that this assumption introduces substantial transition issues as RADs will need to be replaced with either debt or equity. This needs to be modelled carefully as the impacts are likely to be significant.

iii. The capital investment and asset investment assumptions need further consideration. Given the 30 year time horizon of the model, and the average economic life of an aged care asset is considered to be 40 years, it is fair to assume that notable capital investment would be required to improve, maintain or replace existing infrastructure of the sector.

iv. Overall, ACFA questions whether this modelling provides a sufficiently robust analysis of future demand to provide the level of certainty required of budgeting by Government.

4. <u>Matters raised where transition arrangements will be key to successful implementation</u>

ACFA considers that any policy changes leading to broad industry restructure for aged care requires careful consideration and analysis of transition arrangements including modelling and limiting disruption of services, supply and accessibility, and retaining investment in the sector. In particular we believe careful modelling and transitioning arrangements need to be built around the following:

a. Any changes or cessation of RADs. ACFA notes that in the Deloitte Access Economics report, all financing measures have been deemed low impact. ACFA's 2020 Report indicates that there is $52 billion of assets funded with $13 billion of equity and $30 billion of RADs. As such, a transition away from RADs that is in place by 1 July 2021 and is assessed as low risk is not supportable as a reasonable assumption. It requires a careful understanding of the implications of such changes to the provision of supply and ongoing investment in the sector.

b. Workforce Impact. The Deloitte Access Economics Report identifies a very significant increase in workforce across both nursing staff and personal carers. While the modelling takes into account churn of staff as well as new graduates into nursing, the ability to fill the required forecast with domestic graduates will be limited by not only the university system's ability to provide training and courses, but also for the health system to be able to provide sufficient practical and placement opportunities for on-the-job component of their qualifications. This has been an ongoing challenge within health and has seen it take a focused multi-year program to increase the number of doctors graduating.

c. Demand. The uncertainty about future demand and hence cost will also need to be factored into the phased implementation of reforms, with flexibility to make adjustments in the light of experience.

Attachment B – Reports reviewed

1. The Profitability of Aged Care, A Report for the Aged Care Royal Commission, Frontier Economics, 23 July 2020.
2. The Required Return for Aged Care Service Providers, Report Prepared for Aged Care Royal Commission, Frontier Economics, 4 August 2020.
3. The cost of residential aged care, University of Queensland, July 2020.
4. Report on the Profitability and Viability of the Australian Aged Care Industry, BDO, 21 July 2020.
5. Financial Analysis Relating to Aged Care Providers for Assessment of Prudential Risk, BDO, 21 July 2020.
6. Aged care reform: projecting future impacts, A report for the Royal Commission into Aged Care Quality and Safety, Deloitte Access Economics, July 2020.
7. Technical mapping between ACFI and AN-ACC, Centre for Health Service Development, University of Wollongong, April 2020.