



**Australian Government
Aged Care Financing Authority**

**Update on funding and financing issues
in the residential aged care industry**

September 2018

Foreword

I am pleased to present the Aged Care Financing Authority's (ACFA) Update on financial developments in the aged care residential industry. This update is based on ACFA consultations with a cross section of aged care providers along with financial institutions and analysts undertaken in August and September 2018. The objective of the Update is to identify the key funding and financing issues currently impacting on residential aged care providers.

A handwritten signature in black ink that reads "M. Callaghan". The signature is written in a cursive style with a period at the end.

Mike Callaghan AM PSM
Chairman
Aged Care Financing Authority
September 2018

Contents

Introduction	ii
Structure of the Update.....	iii
Executive Summary.....	iv
PART A.....	1
Residential Aged Care: Financial Performance in recent years	1
Residential aged care financial performance – survey results for 2017-18	4
Factors influencing the financial performance of residential care providers.....	4
PART B.....	10
Feedback from consultations.....	10
Overview of financial performance in 2017-18	10
Level of concern over financial developments in 2017-18	11
Implications of changes to ACFI	11
Efforts to curtail costs	13
Additional services	14
Accommodation supplements.....	15
Quality considerations	16
Future investment plans	16
Viability of aged care providers.	18
The challenge of providing aged care to the homeless	19
Conclusions	21
Attachment A.....	23

Introduction

The Aged Care Financing Authority (ACFA) sixth Annual Report on the Funding and Financing of the Aged Care Sector was published on 28 August 2018. The Report was based on data supplied by aged care providers in their 2016-17 Aged Care Financial Reports. This was the most comprehensive data available. The majority of the industry who report on the financial year ended 30 June submit the data required by ACFA by 31 October of the same year. Providers who report on an end December basis, submit their required data by 30 April the following year. Consequently ACFA's Annual Reports are based on data which, in the majority of cases, is over a year old at the time of publication.

It was noted in the 2018 Report that a number of policy changes, particularly those involving changes to the Aged Care Funding Instrument (ACFI), that took effect in 2016 and 2017 will only be partially impacting on the 2016-17 financial results of providers. The Report observed, however, that the Aged Care Financial Performance Survey published by StewartBrown indicated a sizeable decline in the financial performance of residential aged care facilities in the nine months to March 2018. ACFA has also received representations from providers and the peak groups who represent the sector, expressing concern over the financial pressures impacting on providers.

Since finalising the 2018 ACFA Annual Report, StewartBrown has completed its survey results for the twelve months to June 2018 which indicates that the overall financial performance of the residential aged care facilities participating in the survey has declined further compared with the nine months to March 2018. While the StewartBrown survey results are not directly comparable with the comprehensive data underlying ACFA's Annual Reports on funding and financing issues, they are likely to broadly reflect developments in the residential aged care sector.

Given these developments, ACFA undertook to provide the Minister for Aged Care with an update of its assessment of the funding and financing issues currently impacting on the residential aged care sector. ACFA acknowledges and thanks StewartBrown who facilitated an examination of the results of its survey for the 12 months to June 2018. However, in the absence of comprehensive data at the provider level for 2017-18, this update is largely qualitative. It is mainly based on feedback from consultations with a cross section of providers, financial institutions and analysts, along with reflections by ACFA on the factors that may be influencing the current financial position and the implications of these developments. The providers consulted include: profit and not-for-profit; metropolitan, regional and remote; and those operating one or a few facilities along with those operating a very large number of facilities.

The issues discussed with providers included: trends and influences on revenue performance, including ACFI payments, other revenue sources and any steps taken to increase revenue; trends and influences on expenses along with any measures to reduce costs and increase efficiency; the impact of revenue and expenditure developments on care

quality; assumptions underlying projections for future financial performance; and the potential impact of recent developments on investment intentions. The providers consulted were targeted with the objective of gaining a representative overview of developments in the industry, however care is required in drawing broad conclusions from a limited sample base. Nevertheless ACFA believes the consultations have provided a useful insight on developments. On the basis of feedback from these consultations, ACFA provides some observations on implications for the outlook for the industry.

Structure of the Update

The Update is in two parts.

Part A

Part A covers background on:

- The financial performance of the aged care residential industry in recent years
- A summary of survey results of the performance of the industry in 2017-18
- A breakdown of residential provider revenue and main expenses
- Changes to ACFI.

Part B

Part B provides a summary of the feedback from ACFA consultations with providers and financial institutions and covers:

- Overview of financial performance in 2017-18
- Level of concern over financial developments
- Impact of changes to ACFI
- Efforts to curtail costs
- Accommodation supplement
- Quality considerations
- Future investment plans
- Viability of aged care residential providers
- Aged care to the homeless.

Executive Summary

- The measures taken in 2016 and 2017 to address Government concerns that ACFI claiming practices were leading to higher than expected claims growth have slowed the growth in ACFI payments which has had a sizeable impact on the financial performance of residential aged care providers in 2017-18. This should have been expected given that ACFI payments account for nearly 61 per cent of providers' revenue.
- The impact of the slower rate of revenue growth came at a time when the rate of growth of wages, which accounts for the bulk of expenses, is increasing.
- Some providers also considered increased activity of the Aged Care Quality Agency was adding to cost pressures.
- While all providers are concerned about financial developments, the intensity of the 'level' of concern varies depending on the providers' ownership structure and degree of exposure to residential aged care.
- Problems with the ACFI funding tool was raised throughout the consultations and the need for a more stable, more contemporary, more efficient and more effective funding tool is pressing.
- Many providers are seeking to increase revenue through the provision of additional services, although there remains uncertainty over what services can be offered.
- All providers were seeking to constrain the growth in costs, particularly staff costs, in response to the pressure on revenue.
- Many providers are putting investment plans on hold, the result of financial pressures and uncertainty over future policy settings.
- A major issue when considering the overall financial outlook for aged care residential providers is whether and to what extent the average ACFI claim per resident per day increases in the short to medium term. If after the return of indexation in 2018-19 the rate of growth in average ACFI claims remains significantly below the rate of growth in costs, providers will be facing growing financial pressures. In addition to the need to introduce a more effective and efficient funding tool, it will be important to ensure that the rate of indexation and forecast growth in acuity underlying the Budget projections are appropriate.
- While there would appear to be no immediate concern over the viability of the bulk of the residential aged care sector, the continuation of the combination of slower growth in ACFI funding, rising staff costs and greater focus on quality will put increasing pressure on providers and the viability of some will come into question.
- Of immediate concern is the number of smaller facilities, particularly in remote and regional areas, that are experiencing significant financial difficulties and are likely to be forced to sell or merge with a larger facility. It will be important for the Department of Health to proactively monitor the financial position of providers and consideration should be given to formalising the range of measures available to a provider in financial difficulties, including facilitating the sale or transfer to another provider.

PART A

Residential Aged Care: Financial Performance in recent years

The current financial performance of the residential aged care industry should be considered in the context of the performance of the industry in previous years along with factors that may have been impacting on that performance.

ACFA's 2018 Annual Report noted that the financial performance of residential aged care providers in aggregate in 2016-17 was broadly stable though with somewhat mixed results in performance measures with Earnings Before Interest, Tax, Depreciation and Amortisation (EBITDA) up, but Net Profit Before Tax (NPBT) down (Table 1)

**Table 1: Overview of financial position of residential care providers
2015-16 and 2016-17**

	2015-16	2016-17	Change (\$m)	Change (%)
Revenue	\$17,172m	\$17,756m	\$584m	3.4%
Expenditure	\$16,109m	\$16,751m	\$642m	4.0%
Total EBITDA	\$1,985m	\$2,072m	\$87m	4.4%
Total NPBT	\$1,063m	\$1,006m	-\$57m	-5.4%
EBITDA p.r.p.d	\$11,134	\$11,481	\$347	3.1%
NPBT p.r.p.d	\$5,962	\$5,572	-\$390	-6.5%

In 2016-17:

- 68 per cent of residential providers achieved a net profit compared with 69 per cent in 2015-16 and 68 per cent in 2014-15;
- Average EBITDA per resident per annum increased from \$11,134 to \$11,481, an increase of 3.1 per cent; and
- Total profit for the sector was \$1,006 million, a 5.4 per cent decrease compared with 2015-16.

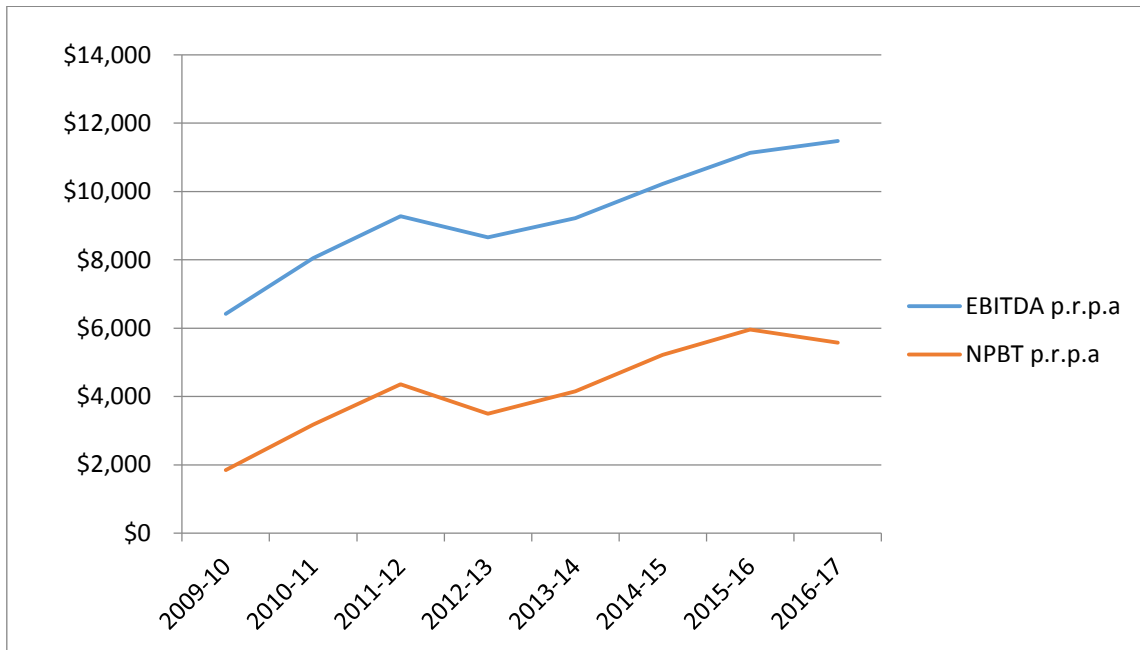
Over a longer period, there has been a trend improvement in the financial performance of the residential aged care sector, although it has varied with an improved performance in some years followed by a lower performance in others (Chart 1).

As noted in ACFA's 2018 Report, the downturn in the industry's financial performance in 2012-13 followed a pause in ACFI indexation and adjustments to the ACFI tool. The financial performance of the industry recovered after the 2012-13 indexation pause was lifted, helped by a significant increase in ACFI claim per resident per day made by providers and an increase in the accommodation supplement for new and refurbished facilities. In addition in 2013 the Government folded the \$1.2 billion Aged Care Workforce Supplement into ACFI

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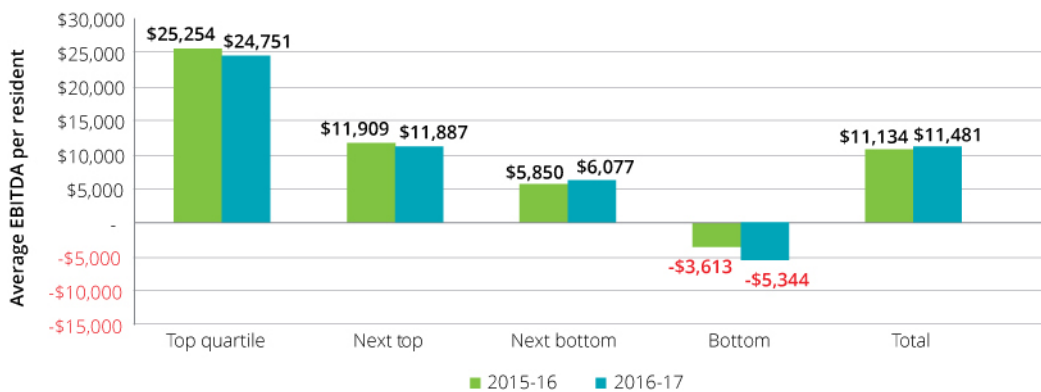
with a one-off 2.4 per cent increase in the basic subsidy, which largely offset the impact of the indexation pause.

Chart 1. EBITDA and NPBT per resident per annum, residential care providers, 2009-10 to 2016-17



While overall there has been a trend increase in the financial performance of the residential aged care providers in the period to 2016-17, there remained significant and long standing variance in performance across providers (Chart 2). For example, while the average EBITDA per resident per annum in 2016-17 was \$11,481, it was \$24,751 for the top quartile of providers while the bottom quartile had on average a negative \$5,344 EBITDA per resident per annum.

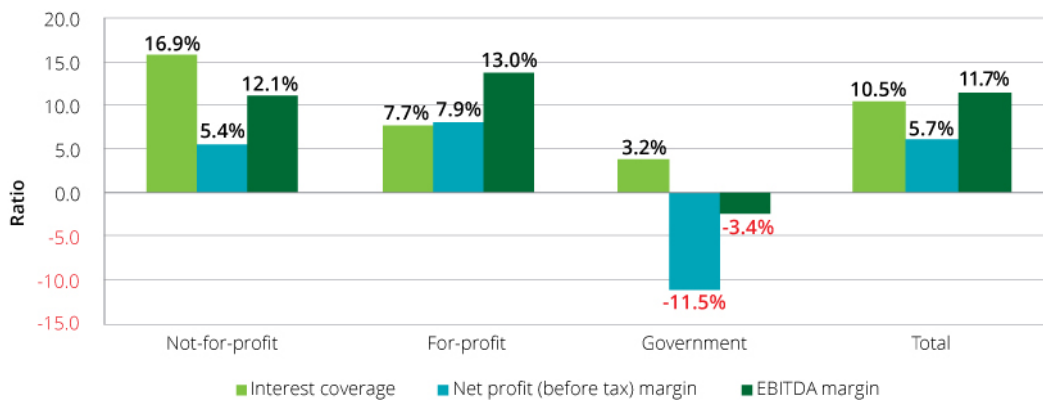
Chart 2: Comparative EBITDA per resident per annum, 2015-16 and 2016-17



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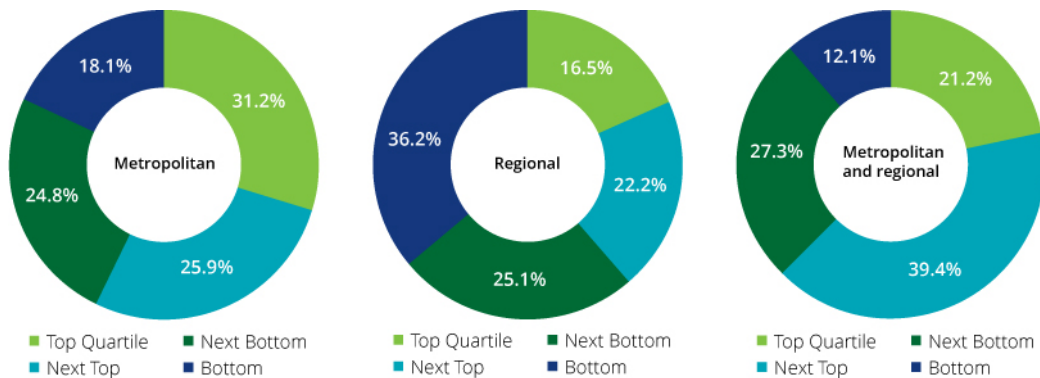
Overall, for-profit providers have outperformed the not-for-profit and government providers in terms of EBITDA margin and Net Profit margin (Chart 3). However as regularly noted in ACFA reports, care has to be taken in making such comparisons because the not-for-profit and government sectors often have different business motives, business models, funding sources and objectives including the delivery of community and social benefits to those in need and many operate in rural and remote areas.

Chart 3: Residential care provider interest coverage, Net profit margin and EBITDA margin by ownership type



A higher proportion of providers operating in metropolitan areas were in the top quartile of providers ranked by EBITDA per resident in 2016-17 (31 per cent), compared with those operating in regional areas (17 per cent). Conversely, a higher proportion of providers operating in regional areas were represented in the bottom quartile (Chart 4). However, there were regional providers in the top quartile of providers with an EBITDA per resident that was almost double that of metropolitan providers in the top quartile.

Chart 4: Residential care provider average EBITDA per resident per annum 2016-17 by quartile and location



Residential aged care financial performance – survey results for 2017-18

The quarterly Aged Care Financial Surveys published by StewartBrown have indicated that over 2017-18 there has been a progressive overall deterioration in the financial performance of the residential aged care facilities surveyed.

It is not possible to directly compare the results of the StewartBrown survey with those in ACFA's annual reports because collection methods and coverage vary considerably. The survey is largely focused on not-for-profit facilities. Nevertheless, the survey covers 38 per cent of aged care facilities and is likely to broadly reflect developments in the sector as a whole.

The StewartBrown results for the 12 months to June 2018 indicated 45 per cent of facilities reported a negative EBT (Earnings Before Tax), up from 34 per cent as at June 2017, and 21 per cent of facilities had a negative EBITDA in the June 2018 survey, up from 14 per cent as at June 2017.

There were significant declines in average facility EBT and EBITDA reported in the June 2018 survey, with average EBT of \$810 per bed per annum (pbpa) in June 2018 compared with \$3,236 in June 2017 and average EBITDA of \$6,745 in June 2018 compared with \$8,821 in June 2017. While the largest proportion of facilities recording losses were in outer regional and remote and very remote areas, significant declines occurred in inner regional and metropolitan areas.

Based on the survey results for the twelve months to June 2018 compared with the 12 months to June 2017, among the main factors influencing the overall financial performance of facilities included:

- Average ACFI per bed per day was largely unchanged (\$172.57 pbpd in June 2018 compared with \$172.08 pbpd in June 2017).
- Direct care costs increased by 4.6 per cent in June 2018 survey compared with June 2017.
- Care labour costs as a percentage of ACFI were 80.7 per cent in June 2018 compared with 77.5 per cent in June 2017.
- Direct care hours per resident per day were 3.06 in June 2018 compared with 2.91 in June 2017.
- The accommodation result of \$11.18 pbpd in June 2018 compared with \$9.95 pbpd in June 2017.

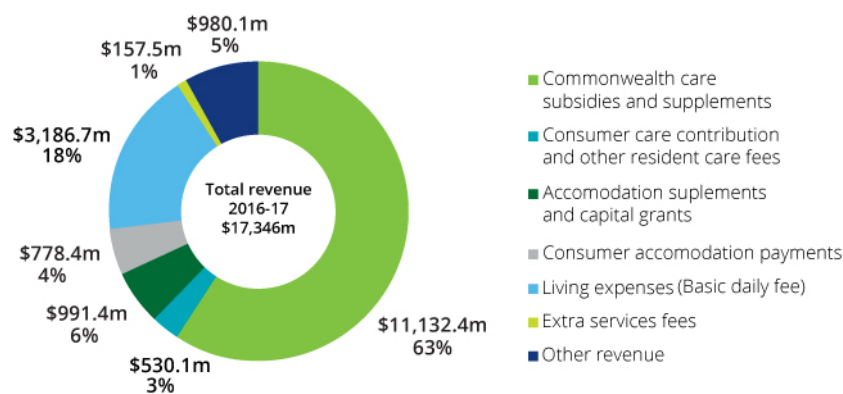
Factors influencing the financial performance of residential care providers

StewartBrown has observed that the significant overall deterioration in the financial performance of residential aged care facilities in 2017-18 evident in the results of their survey in large part reflects the changes to ACFI in 2016 and 2017 and the pause in ACFI indexation in 2017-18, along with rising staff costs.

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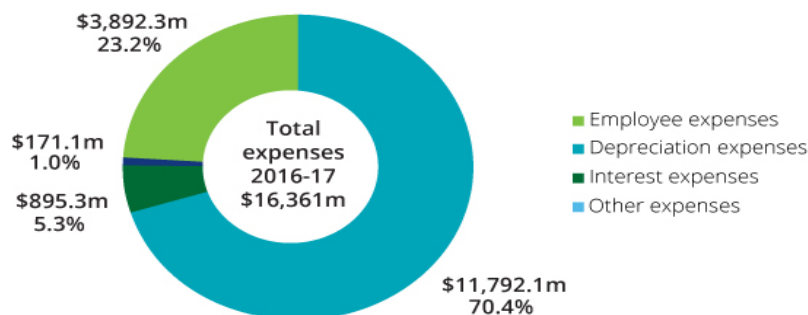
Care related funding under ACFI is the main revenue source of aged care providers, accounting for 60.5 per cent of revenue in 2016-17. The next main source is the basic daily fee paid by residents for living expenses (18 per cent), followed by the Government accommodation supplement for supported residents (5 per cent) and daily accommodation payments from residents (4 per cent). The Government fixes the basic daily fee and the accommodation supplement. Other revenue sources, including investment income from accommodation deposits, are relatively minor. In 2016-17, the Government provided approximately 68 per cent of the revenue of providers, consumers 26 per cent (excluding refundable accommodation deposits) and other income the remainder (Chart 5).

Chart 5: Breakdown of residential provider revenue, 2016-17



In 2016-17, the main expense item for residential providers was employee expenses, which accounted for 70.4 per cent of total expenses, with wages accounting for 67.5 per cent of total expenses. The other expense categories were: accommodation (rent, repairs and maintenance, rates, utilities) at 7.6 per cent; hotel expenses (such as catering, cleaning, laundry) at 6.9 per cent; depreciation at 5.3 per cent; administration at 3.6 per cent; care expenses at 3.2 per cent; management fees 2.9 per cent; and, other expenses at 2 per cent (Chart 6).

Chart 6: Proportion of total expenses, residential care providers, 2016-17



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With ACFI payments representing nearly 61 per cent of the revenue of aged care providers, any move by the Government to curb the growth in ACFI outlays will impact on the financial performance of providers. The changes to the ACFI scoring system and the pause in ACFI indexation also occurred when there was continuing growth in wages in the aged care sector, with many workers impacted by the decisions by the Fair Work Commission to grant a 3.3 per cent increase in the minimum wage in June 2017 and a 3.5 per cent increase in June 2018. This compares with wage cost indexation of subsidies of 0 per cent in 2017-18 and 1.2 per cent in 2018-19. With wages accounting for 67.5 per cent of provider's expenses, continued growth in the largest expense item of providers when income is being constrained will put pressure on the financial performance of the sector. The downturn in the sector's financial results in 2017-18 mirrors that which occurred in 2012-13 when on both occasions the Government made changes to ACFI and paused indexation in order to curb the growth in ACFI payments.

Conversely, the improvement in the overall financial performance of the industry in the years (as evident in chart 1) immediately prior to 2012-13 and 2017-18 corresponds with growth in ACFI payments, and in turn the income of providers, over this period (see table 2). In the four years prior to the pause in indexation in 2012-13, growth in ACFI payment per resident averaged 8.6 per cent and ACFI growth per resident above indexation averaged 6.7 per cent. In the four years prior to the pause in indexation in 2017-18, growth in ACFI payment per resident averaged 6.3 per cent and growth in ACFI per resident above indexation averaged 3.9 per cent.

The Government said its decision to change ACFI arrangements and pause indexation in 2017-18 was because real growth in ACFI expenditure per resident per day was higher than what had been budgeted for by the Government and higher than frailty growth (with sudden sharp increases in claims in particular areas of the funding tool suggesting changes in claiming behaviour). For example during 2015-16, real growth of expenditure per resident per day through ACFI was 5.5 per cent, compared with Government budgeted growth of 3.2 per cent. The result was an increase to the Government's forecast expenditure. The changes to ACFI that took effect in 2016 and 2017 were implemented in order to reduce the growth in ACFI expenditure. It was for similar reasons that the Government adjusted the ACFI tool and paused indexation in 2012-13.

Table 2: Annual change in selected indexes, wages, and payment rates, 2008-09 to 2017-18

	CPI (change between March quarters)	WPI (Health Care and Social Assistance)	Age Care Award 20101	ACFI subsidy rates	Average ACFI payment per resident	ACFI growth per resident above indexation
2008-09	2.4%	4.1%	-	1.7%	7.4%	5.6%
2009-10	2.9%	3.8%	-	1.7%	7.7%	5.9%
2010-11	3.3%	3.3%	3.4%	1.8%	10.0%	8.1%
2011-12	1.6%	3.0%	2.9%	1.9%	9.3%	7.3%
2012-13	2.5%	3.3%	2.6%	0.0%	3.7%	3.7%
2013-14	2.9%	2.9%	3.0%	1.7%	4.6%	2.8%
2014-15	1.3%	2.6%	2.5%	4.3%	9.8%	5.2%
2015-16	1.3%	2.6%	2.4%	1.3%	6.9%	5.5%
2016-17	2.1%	2.3%	3.3%	1.5%	3.7%	2.1%
2017-18	1.9%	2.7%	3.5%	0.0%	N/A	N/A
<i>Average annual change</i>	2.2%	3.1%	3.0%	1.6%	7.0%	5.1%
<i>Cumulative change</i>	24.7%	35.2%	-	17.1%	83.4%	56.7%

Notes:

1. The Aged Care Award was not in effect in 2008-09 so growth can only be calculated over the period 2009-10 to 2017-18
2. ACFI subsidy rates have been adjusted to account for the Conditional Adjustment Payment that was rolled into ACFI subsidy rates in 2014-15
3. Average ACFI payment per resident includes all basic subsidy payments
4. The change to subsidies in 2016-17 did not apply across all domains of the ACFI – the CHC domain only received half indexation
5. Average ACFI payments per resident for 2017-18 are not available at the time of publication. The latest ACFI monitoring report is for April 2018 and shows growth for the period 1 July 2017 to April 2018 of negative 0.1%, compared with growth from 1 July 2016 to March 2017. Chart 9.1 in Chapter 9 provides more detailed tracking of ACFI growth rates.
6. The average annual and cumulative change in ACFI payments are calculated to the end of 2016-17.

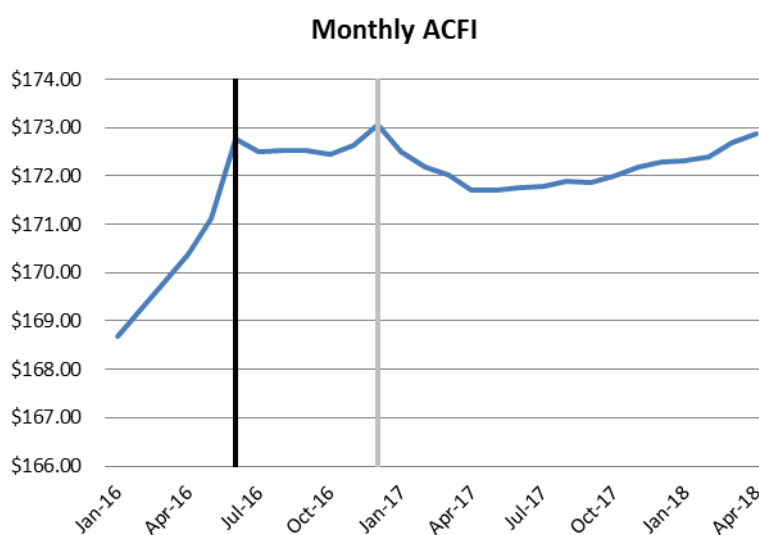
Providers and the Government have differing views about the reasons for the increases in ACFI claims. This is a significant issue that has an important bearing on the outlook for the residential aged care industry and is discussed further in the section outlining feedback from the consultations with providers. Whether the Government's or providers' view is closer to reality will determine whether the impact on the financial performance of providers as a result of the ACFI changes is imposing excessive pressure on providers and/or impacting on the level of care residents are receiving, or it has brought ACFI payments back to a level more in line with the growth in acuity level of aged care residents.

The changes to ACFI in 2016 and 2017 not only involved a pause in indexation but also changes in the complex health scoring matrix which meant that it would be less common for a resident to achieve a high rating, and in turn maximum ACFI payments. The change only applied to new residents or to existing residents when they were reassessed. The result for providers is that when a resident with a high ACFI score leaves there is the prospect that

they will be replaced with a resident with a lower ACFI score and all other things being equal, this will result in a decline in ACFI revenue for the provider (though if the new resident does have lower needs then there would also be a potential decline in cost for the provider. Providers advised that consultants who monitor ACFI payments report that on average, in 2017-18 the ACFI payment for a new aged care resident was below that of a departing resident. While this may not of itself be unusual if new residents normally have lower needs to start with than departing residents, the quantum of the difference may now be higher.

The monthly report the Department of Health publishes on ACFI payments indicates that there was a noticeable decline in ACFI claims following the changes of 1 January 2017, however since April 2017 they have increased each month to April 2018. The Chart also shows there was a significant increase in claims before the changes took effect which highlights the concerns around the subjectivity of the system. This 'bring forward' of higher claims also contributes to the subsequent temporary reduction.

Chart 7: Average ACFI claim per month



Growth in the cumulative daily average ACFI payment in the period July 2017 to April 2018 is 0.1 per cent below the same period in the previous year, and compares with the Government's projection of an increase in ACFI payments of 1.9 per cent (which presumably reflects the Government's assessment of frailty growth). As noted, the changes to ACFI introduced in 2016 and 2017 were in response to the Government's view that ACFI claims were growing faster than the growth in the frailty of residents entering aged care. However with ACFI claims now below the Government's projected growth in ACFI payments, this may suggest that the actual growth in ACFI payments in this period has been below the growth in the frailty of aged care residents

The unknown, however, is whether the Government's allowance for frailty growth in its Budget estimates and projections is an accurate reflection of the actual increase in frailty in

the population entering residential age care. If, as maintained by the Government, the rise in ACFI claims significantly above Budget projections reflected the 'claiming behaviour' by providers rather than the growth in the acuity levels of residents, the implication is that overall a sizeable proportion of providers have been classifying residents as being in a high domain under ACFI, and claiming commensurate payments, when the actual care needs of the residents are lower. If this is the case, changing the scoring system under ACFI such that it is more difficult to classify residents in a category above their care needs would curtail the revenue of providers without adversely impacting on the resident's level of care.

In contrast, providers claim that growth in ACFI payments per resident per day above indexation, which they point out are subject to an audit program, has reflected a continuing increase in the frailty of residents. If this is the case, then measures to reduce the growth in ACFI claims will adversely impact on the financial position of providers, which in turn may cause challenges to the level of care residents receive. This issue was pursued in the consultations with providers

As noted previously, there has always been significant variability in the financial performance of residential aged care providers. Similarly, the impact of the squeeze in providers' margins as a result of the changes to ACFI will not have been uniform across the sector. In the StewartBrown survey results, the decline in facility EBITDA of the top quartile was less than the decline in EBITDA for all facilities surveyed. In addition, providers that have had sound financial results for several years are likely to be in a position to better absorb a downturn in financial performance compared with a provider that has been in a loss situation for an extended period.

PART B

Feedback from consultations

Following is a summary of the issues raised in consultations conducted by ACFA in August and September 2018 with a cross section of residential aged care providers, financial institutions and analysts. At [Attachment A](#) is an overview of the range of providers and institutions consulted. The objective of the consultations was to gain feedback on recent financial developments in the residential aged care sector. Also provided are some comments from ACFA on the issues raised, particularly in terms of the implications for the outlook for the sector.

The providers consulted were chosen with the aim of obtaining views from a representative cross section, although given that the coverage was limited, care is required in drawing broad conclusions.

Overview of financial performance in 2017-18

Feedback

All providers indicated that 2017-18 was a difficult year, a result of the changes to ACFI in 2016 and 2017, rising costs (especially wages), increased scrutiny by the Quality Agency and, for some, pressure on occupancy rates. Some providers also referred to RAD cash outflows and signs of a trend towards Daily Average Payments (DAPs). Many providers said their profit/surplus declined and some providers moved from a profit position to making a loss in 2017-18 while others said their losses had increased. A few providers said that while margins were squeezed because of the ACFI changes, their overall performance benefitted because of new/refurbished facilities coming on stream and receiving the higher accommodation supplement from the Government. All providers said they were seeking to reduce costs and many were either implementing or considering increasing revenue through offering additional services.

ACFA comment

With ACFI contributing approximately 61 percent of the revenue for aged care providers, it should have been expected that the changes to the ACFI tool in 2016 and 2017 and the pause in indexation, combined with ongoing growth in costs, would have resulted in a decline in the financial performance of providers. The feedback is consistent with the results of StewartBrown's survey of facilities for the 12 months to June 2018. When the comprehensive data for 2017-18 becomes available, it is highly likely that ACFA's 2019 Annual Report will record a sizeable decline in the financial performance of residential aged care providers overall.

In terms of the future outlook for the financial performance of the sector, a major unknown is whether, and to what extent, average ACFI payments per resident per day will increase in

real terms in the medium term (as they did in the past) or whether more modest growth rates become a long term feature. At the end of the first full year of ACFI in 2008-09, around 7 per cent of residents with ACFI classifications were in High-High-High classifications. This has grown to 31 per cent in 2017-18. This growth may not have reflected the underlying frailty growth in the population, but providers shifting their focus from low to high care residents and potential low care residents having lower demand to enter residential care as low care. If this was the case, some slowing in the rate of growth of ACFI compared to the past decade could be expected.

Level of concern over financial developments in 2017-18

Feedback

While all providers indicated that 2017-18 was a difficult year, the extent of concern expressed appeared to be influenced by the relative exposure of the organisation to the residential aged care sector and/or organisational and ownership structures. Listed providers were particularly sensitive to developments given their continuous exposure to market scrutiny and shareholder expectations. In addition, providers who were either exclusively or predominantly concentrated on residential aged care were very concerned about developments and the implications for the ongoing viability of their organisation. This was particularly the case for providers operating in remote and regional areas. Aged care providers that were part of an organisation with a diverse range of activities and income streams were concerned about the financial performance of their aged care facilities but were inclined to take a longer-term view of developments.

ACFA comment

It is to be expected that the level of concern expressed by providers over the decline in their financial performance in 2017-18 will be influenced by the extent of their exposure to the residential aged care sector. This issue is discussed further in the section dealing with providers' future investment plans.

Implications of changes to ACFI

Feedback

Some providers highlighted that the changes to ACFI not only involved a pause in indexation but (and as outlined previously) the changes to the scoring arrangements for complex health care involved a reduction in their ACFI payments. The changes to the scoring system applied to the reappraisal of existing residents and to new residents. The result was that when a resident left a facility, it was likely that the new resident would have a lower ACFI score and in turn the provider would receive a lower ACFI payment. With the average length of stay of a resident around three years, a number of providers estimated that they were about half way through the downward adjustment to their ACFI revenue as a result of new residents replacing grandfathered existing residents.

The rationale for the changes to ACFI in 2016 and 2017 remained a point of contention with providers. As noted earlier, the Government introduced measures to slow the overall growth in payments by adjusting the ACFI tool and pausing indexation because it believed the rate of growth of ACFI claims reflected claiming behaviour by providers rather than growth in the frailty/acuity of residents. Providers continue to argue that as a result of increased home care, residents are entering residential aged care with more complex health conditions and this is increasing and reflected in the rise of ACFI claims. Many providers stressed that they were following the ACFI claiming procedures, their claims are audited and they believed there had not been a significant increase in ACFI downgrades. They did note, however, that facilities having to refund any assessed 'over claiming' in ACFI payments from the date of entry of the resident can pose cash flow problems for the facility. Some providers said the changes to ACFI and the pause in indexation was a blunt measure by the Government if they had concerns with the claiming behaviour of a group of providers. However many providers believed the reason for the changes to ACFI were not related to better aligning Government subsidies with the growth in the acuity of residents but was simply a budget saving measure. Several providers said that as a result of the ACFI changes they were confronted with either providing and absorbing the cost of the level of care a resident required but for which they were not funded, or not delivering the full care that a resident needs. While many of the changes to the complex health care domain initially announced in 2016 were subsequently amended and replaced by the across-the-board pause in indexation, a number of providers said they had warned the Department of Health that the impact of the measures would be significantly larger than envisaged by the Government, but this advice was not accepted.

Some providers said their ACFI claims per bed were on the low side compared with industry averages but as a result of the changes to ACFI and the revenue pressure they were facing, they had no other option but to seek to maximise their ACFI revenue as far as possible. All providers commented on the high administrative costs associated with ACFI and that it took staff away from delivering care to residents. Another point raised was the subjective nature of the ACFI tool and that many aspects of the ACFI involve interpretation by assessors. It was also observed that ACFI was creating different classes of residents in terms of their attractiveness to providers. Specifically, providers were seeking residents with a high ACFI score across all domains at the expense of residents with a low ACFI score. As one provider noted, low care residents are becoming the new 'at risk' group as the funding reforms are making the provision of care for these residents almost unviable. This is a particular problem for some conditions which involve difficult behavioural issues but do not score highly in terms of the complex health care domain – younger onset dementia was cited as a specific example.

Most providers claimed that the rate of ACFI indexation in 2018-19 is insufficient given the growth in wages. Some providers highlighted that they would not be viable if ACFI indexation remained around 1.5 per cent while wages grew by between 2.5 to 3 per cent.

ACFA comment

The problems with the ACFI funding tool were raised throughout the consultations. In the 2018 Annual Report, ACFA observed that there is a need for a more stable, more contemporary, more efficient and more effective funding tool and a system that provides greater financial stability to both providers and the Government. As outlined further below, a major factor raised by providers that is hindering future investment in the residential aged care sector is uncertainty over the Government's policy settings. The fact that providers continue to dispute the reasons for the changes to ACFI in 2016 and 2017, suggests that they do not have confidence in the rationale for the Government's future policy measures. For example, some providers were not confident that the current review of alternative funding arrangements through the Resource Utilisation and Classification Study (RUCS) will achieve a more stable tool that better aligns funding with the cost of care, but instead will be focused on restraining future budget outlays. The Government has, however, indicated that the issue of overall funding is separate to reviewing the funding tool. As noted in the ACFA 2018 Annual Report, it is important to not only ensure the funding tool is stable, more contemporary and efficient, but that the indexation arrangements, after a realistic discount for provider efficiency gains, appropriately reflect cost increases. Confidence in the policy framework for the residential aged care industry needs to be restored.

Efforts to curtail costs

Feedback

All providers said that in response to the pressure on revenue they were seeking to constrain the growth in costs. With staff costs representing such a large proportion of expenditure, many providers had reviewed rosters in an effort to reduce staff hours. A few said they had initiated redundancies, although most said they were targeting ancillary and administrative staff rather than care staff. It was observed that adjusting staff hours can take time and prove difficult given the need for consultation with staff and the unions along with restrictions in some of the awards. As regards wages, most providers said their Enterprise Bargaining Agreements provided for wage increases of between two to three percent. It was pointed out that wage increases in the aged care sector have been higher than those elsewhere in the economy because aged care worker pay rates are close to the minimum wage and the increase in the minimum wage was 3.3 per cent in 2017 and 3.5 per cent in 2018. Providers contrasted this with the low level of ACFI indexation in 2018-19.

A number of providers said that they have cut back on staff training and development in order to reduce outlays. Other areas where there have been cost saving changes are in the provision of non-clinical services – spiritual, pastoral and life-style activities, such as outings. Some providers said they have out sourced the provision of services in an effort to achieve savings and have renegotiated procurement agreements. Others have found savings by bringing previously outsourced services in-house. A point raised many times was the importance of economies of scale in minimising costs, particularly with respect to administration and IT activities. Some providers noted that an important factor explaining

variations in financial performance across their facilities was the skill and experience of the facility manager.

ACFA comment

The squeeze in margins in 2017-18 has increased pressure on all providers to contain costs. This is relevant because the StewartBrown benchmarking of the financial performance of the sector highlights that an important driver of profitability in residential aged care is prudent cost management. The top quartile of providers in terms of EBITDA are the lowest cost providers. In addition, scale is becoming increasingly important in the residential aged care sector. While the industry has consolidated over recent years, the ongoing pressure to keep costs as low as possible and achieve economies of scale is likely to increase the pace of consolidation.

Additional services

Feedback

The provision of additional services for a fee, that is care and services in a non-extra service facility that are over and above those that providers are required to provide, currently varies across providers. Some facilities, particularly for-profit, offer packages of additional services for varying fees, and a consumer has to choose one of those packages to become a resident in that facility. Such facilities said they had little scope to offset constraints on ACFI funding through increasing additional services income. Many providers, both in the profit and not-for-profit sectors currently offer limited or no additional services. A number of the not-for-profit providers said offering additional services for a fee caused concerns with their mission values. Nevertheless, many said that given financial pressures they felt it necessary to introduce, or at least explore the feasibility, of introducing fees for additional services. Some said that they would provide the same additional services for all residents, but would only charge those who could afford to pay. Other providers said that they operated facilities in low socio-economic areas and there was little scope to increase their revenue through introducing additional services. The scope to increase a facility's revenue through offering additional services for a fee was considered to be negligible in most rural and remote areas.

Some providers said the main constraint they faced in introducing additional services was the imprecision around what was allowed, and they wanted to avoid any reputational damage that may flow from being accused of charging inappropriate additional service fees. Some providers said that they were currently providing services to residents at no charge while other providers were charging a fee for the provision of the same service. In response, some of these providers had introduced an additional service fee for all new residents. However the view was expressed that the practice of many providers making the acceptance of additional service fees as a condition of entry to a facility needed to be clarified.

ACFA comments

Confusion around what services can be included as an additional service needs to be removed. Clarity is also required as to whether paying for an additional services package can be a condition of entry into a facility. ACFA notes that the Department of Health has established a working group with providers to consider the application of additional service fees. Many providers observed that if the basic daily fee was uncapped, they would abandon charging for additional services and would continue to provide these services while increasing the basic daily fee for non-supported residents. The relationship between uncapping the basic daily fee and the application of additional service fees may need to be considered. In a competitive environment, competition between facilities should help ensure that the fees charged are reflected in the quantity and quality of the services provided, and regulation could be kept to a minimum

Thought should also be given to increasing transparency around additional service fees by requiring providers to publish their additional services and associated fees.

Accommodation supplements.

Feedback

A number of providers noted that their financial results in 2017-18 benefitted with new and refurbished facilities coming on line and accessing, where eligible, the higher accommodation supplement. A higher accommodation supplement paid by the Government on behalf of eligible residents was introduced from July 2014 for significantly refurbished and new facilities. The higher accommodation supplement is available to facilities that have been built or significantly refurbished since 20 April 2012. Some providers indicated that significant refurbishment is the 'single most significant revenue strategy' that they can implement. However some providers said that while access to the accommodation supplement was an important consideration when considering a refurbishment, in the current uncertain environment the main consideration was whether the refurbishment will improve the accommodation value of the facility through increased RADs and DAPs. They noted that this meant that refurbishments would be concentrated in the metropolitan locations rather than in regional and remote areas.

ACFA comment

There remains a large stock of older, multi - room facilities that need to be refurbished. The feedback that some providers see refurbishment as an important revenue strategy in the current environment is significant, although as outlined further subsequently, there are a number of factors constraining investment in the residential aged care sector. The prospect that refurbishment will be concentrated on facilities in metropolitan areas further highlights the challenges facing facilities in rural and remote areas, although it is noted that rural and remote facilities can apply to the Government for capital grants (which have recently been increased) and may be eligible for the viability supplement. The adequacy of these grants needs to be monitored.

Quality considerations

Feedback

All providers said that the increased activity of the Aged Care Quality Agency was adding to their costs and impacting on staff morale. Providers reported that a stricter approach by the Quality Agency resulted in them having to devote additional resources to deal with quality audits as well as the approach of the Agency putting pressure on them to increase staff numbers and skills at a time when revenue constraint was forcing them to attempt to reduce staff numbers. Providers are apprehensive as to the additional pressure that will be placed on costs with the introduction of additional unannounced audit inspections.

ACFA comment

While ACFA considers that a focus on ensuring high care quality is appropriate, providers feel they are being squeezed between the pressure from the ACFI changes to reduce operating and staff costs and the pressure from increased quality audit activity to increase staff numbers and skills, and in turn staff costs. This divergence is adding to the uncertainty of providers regarding the direction of Government policy. The impact of current pressures, both financial and quality, on staff morale is significant in that it is reducing the attractiveness of the aged care sector as a place where people will want to work when providers say a major challenge they face is attracting and retaining the workforce necessary to manage their services and deal with the requirements of an aging population.

Future investment plans

Feedback

Many for-profit providers emphasised that the current return on capital employed in the residential aged care sector is below the cost of capital and in the absence of any change, providers will no longer invest in residential aged care. StewartBrown suggests that when assessing financial performance of aged care providers, an appropriate measure is the Return on Assets employed (RoA). In 2015-16, the RoA for the residential care sector participants in their survey (largely not-for-profits) was approximately 1.7 per cent, declined to 1.2 per cent in 2016-17 and is estimated to be 0.5 per cent in 2017-18. StewartBrown states that this is 'hardly a viable return for aged care provider organisations'.

Investment intentions will be fundamentally influenced by the prospect of future returns and the overall opportunities available in the aged care sector. In this respect, two different viewpoints were raised during the consultations. One approach was pessimistic and centred around the view that the continuation of current parameters and low rates of return will drive more providers into a loss situation and there will be no further significant investment in the sector. Some other providers had a more positive outlook, however, noting that they had been in the residential aged care business for a very long time, had experienced many cycles in terms of financial pressures, and expected there would be policy changes given the importance of aged care and the demographic pressures in Australia. Nevertheless, even those providers taking a more optimistic and long-term view as to the opportunities in the

Aged Care Financing Authority | Update on funding and financing issues in the residential aged care industry

Australian aged care sector said they were putting some projects on hold pending gaining greater policy certainty. Notwithstanding the concerns expressed over returns being below the cost of capital and policy uncertainty holding back investment plans, nearly every provider consulted said they were making an application for additional bed licences in the current Aged Care Approvals Round (ACAR).

Some providers noted that there appeared to be a shift from RADs to DAPs and RAD/DAP combinations. Factors that were believed to be influencing this trend included a decline in house prices in some areas, difficulties in selling houses, and a shorter length of stay for some residents. The extent to which this is an issue varied depending on the provider's business model with providers less reliant on RADs less concerned over a shift away from RADs to DAPs

A large number of providers, both profit and not-for-profit, said their immediate investment plans would be directed to retirement living rather than residential aged care. Factors influencing this decision included: the considerable policy and regulatory uncertainty currently in the aged care sector; the desirability of diversifying income streams given the volatility in residential aged care; and the advantages of establishing an integrated aged care operation that involved retirement living, home care and residential aged care.

The financial institutions consulted had a generally positive outlook for the residential aged care sector and were not seeking to reduce exposure to the sector, although were continually monitoring developments. It was evident that the institutions were confident that their clients in the sector were sound. Nevertheless, some said that they were rejecting more loan applications from providers, particularly from smaller providers. Both the financial institutions and investment advisers said there was a significant amount of institutional capital interested in investing in the Australian residential aged care sector but it was currently on the sidelines given the uncertainties around the regulatory environment and future direction of reforms.

ACFA comment

The widespread view from providers – both for-profit and not-for-profit – that they have curtailed or delayed investment plans in the residential aged care sector, citing depressed returns and policy and regulatory uncertainty along with the impact of increased home care packages, is a concern.

Chart 8: Proportion of providers planning to either upgrade or build

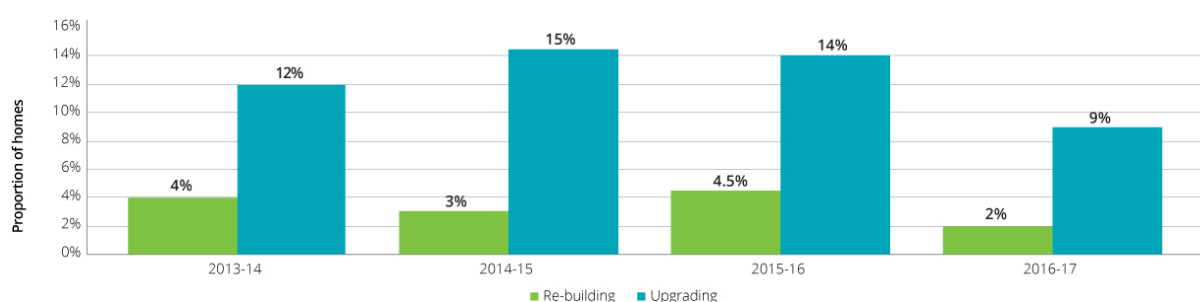


Chart 8 shows the proportion of providers planning to either build or upgrade facilities over the period 2013-14 to 2016-17. The proportion in 2016-17 is significantly lower than in previous years. Based on the feedback received during the consultations, it is likely that there will be a further significant decline in 2017-18 in the proportion of providers planning to either upgrade or build. This is a concern because of the lead times involved in bringing new aged care facilities onto the market and the expectation that there will be a significant increase in demand for residential services as the bulk of the baby boomer generation enters their 80s in about eight years, notwithstanding the increased availability of home care packages. An issue that requires further examination is the factors impacting on the capital investment challenge facing the sector, including the impact of a possible shift in consumer preferences from RADs to DAPs.

Viability of aged care providers.

Feedback

All providers consulted said that 2017-18 was a difficult year and the pressures had continued into 2018-19, with a number of them moving from a profit to a loss situation (noting that a proportion of providers have been making a loss for some time). Nevertheless none of the providers consulted suggested that there was an immediate likelihood of them ceasing operations, although some were concerned about their viability if current trends continued. Many providers from the not-for-profit sector reported they have substantial reserves to draw on if needed. In addition many are part of larger operations with diversified income streams. Nevertheless there appears to be a growing number of smaller providers, particularly in regional and remote areas, that are currently facing significant financial stress. Some of the providers consulted said they were receiving an increasing number of approaches from smaller providers who were facing difficulties and were seeking to sell their operations. In some cases they were offering to hand over their facilities for no monetary return. The providers receiving the approaches said that they had declined most of them because of the difficulties of turning around facilities that were facing not only financial but quality problems. Apart from the costs and reputational risks associated with absorbing a poorly performing facility, providers said that it channelled a significant amount of management time that needed to be deployed elsewhere given the range of challenges the sector was facing.

Analysts report that in the current environment there will be significant 'opportunistic acquisitions', although some providers said that in the current challenging environment they would only be interested in acquisitions if they got a 'bargain'.

The feedback from the consultations was that the providers facing financial and quality problems left it too late before seeking assistance. An example cited by a provider in a regional area was an offer to take over the back-office functions of another smaller provider that was widely known to be in financial difficulties. The offer was refused because the smaller provider wanted to maintain its autonomy and independence, notwithstanding that its financial position continued to deteriorate.

ACFA comment

While there will always be a role for smaller operators in the aged care residential market, the current tight operating conditions will likely be accelerating the trend towards greater consolidation. The less efficient providers are facing pressure on margins, rising consumer expectations and increased scrutiny over meeting quality standards. The result is that an increasing number of marginal providers will likely be forced to sell or merge with larger operations. Such a trend will lead to a more efficient and resilient residential aged care industry overall, however a concern is that the adjustment may be disorderly and those immediately impacted will be residents in facilities that are no longer viable. As such, increased attention should be directed towards monitoring providers that may be encountering serious financial difficulties. A possible early warning sign of a facility facing significant financial difficulties is when major quality shortcomings are identified after an audit by the Quality Agency and/or there are sizeable delays in paying a RAD when a resident leaves a facility.

Giving greater attention to monitoring aged care providers who may be experiencing financial difficulties is consistent with the Government's decision to improve the prudential standards for protecting RADs.

Currently when the Department of Health is aware that an operator may be in significant difficulties it will try and assist in identifying an operator who could take over and in doing so minimise the disruption to residents involved. However consideration should be given to establishing a more structured and pro-active mechanism to, in the first instance, provide advice and support to facilities facing financial problems and if necessary, facilitate the sale or transfer of the facilities of a provider in difficulties to another provider. This may require the Government contributing to meet the costs associated with a provider taking over an aged care facility in significant difficulties. The peak industry bodies should also play an increasingly active role in this area, particularly in helping to overcome the tendency for facilities in difficulties leaving it too late before seeking assistance.

The challenge of providing aged care to the homeless

Feedback

The aged care providers that provide accommodation to the homeless indicated that they face specific challenges. They have 100 per cent supported residents and no access to RADs or other forms of consumer contributions through additional services, although do have access to capital grants. In addition the vast majority of the homeless have no family connections or support and as such providers have to perform tasks that would normally be undertaken by a family member. This increases provider costs. Providers highlighted that the ACFI funding arrangement does not adequately recognise the needs of the homeless. They emphasised that they have been significantly impacted by the changes in the scoring arrangements for ACFI along with the freeze in indexation and that this was not sufficiently offset by the current homeless supplement.

ACFA comment

Consideration may need to be given to further assist providers focused on providing aged care accommodation to the homeless, noting that the Tune Review recommended further consideration of homeless funding. The work on the Resource Utilisation and Classification Study may also shed some useful light on homelessness funding and homeless issues should be considered in the context of any new funding tool.

Conclusions

It is not surprising that the measures taken in 2016 and 2017 to address Government concerns that ACFI claiming practices were leading to higher than expected claims growth have slowed the growth in ACFI payments which has had a sizeable impact on the financial performance of residential aged care providers in 2017-18 given that ACFI payments account for 61 per cent of the revenue of providers. Moreover the impact of the slower rate of revenue growth on revenue came at a time when the rate of growth in wages in the aged care sector, which accounts for the bulk of expenditure for providers, is increasing.

While 2017-18 has been a difficult year for aged care residential providers, the impact of the ACFI changes has varied across providers.

The level of concern expressed by providers over the decline in their financial results in 2017-18 is influenced by the extent of their exposure to the sector along with the structure of their ownership. In particular providers who were either exclusively or predominantly concentrated on residential aged care are particularly concerned about developments and the implications for the ongoing viability of their organisations.

A major issue when considering the overall financial outlook for aged care residential providers is whether and to what extent the average ACFI claim per resident per day increases in the short to medium term. If after the return of indexation in 2018-19 the rate of growth in average ACFI claims remains significantly below the rate of growth in wages, providers will be facing growing financial pressures.

Pressure from the changes to ACFI has motivated providers to seek to increase revenue through offering additional services for a fee. However there is confusion over what services can be offered. This should be clarified. Consideration should be given to the link between uncapping the basic daily fee and offering additional services.

A particular area of concern coming from the consultations is the feedback that providers are putting on hold future investment in the sector given current pressures and in particular, uncertainty over the future direction of Government policies. In order to set the framework for greater investment in the residential aged care sector, the Government needs to restore confidence in the rationale and direction of future Government policies. In addition to the need for a more effective and efficient funding tool, it will be important to ensure that the rate of indexation and forecast growth in acuity underlying the Budget projections are appropriate.

While there would appear to be no immediate concern over the viability of the bulk of the residential aged care sector, the combination of slower growth in ACFI funding, increasing staff cost pressures and greater external focus on monitoring/auditing/policing quality is putting pressure on providers. Should this continue, it will curtail investment in the residential aged care sector and bring into question the viability of a number of providers. Some facilities have been making losses for some time and have been cross-subsidised by

providers reflecting their mission values or to provide aged care to areas that would not otherwise be serviced. Where providers are largely in financial difficulties because of shortcomings in their management and operational expertise, their future in the industry should be limited. However the overall funding arrangements and regulatory framework needs to be consistent with ensuring the long-term viability and efficiency of the residential aged care sector and the delivery of quality care to residents.

Of immediate concern is the number of smaller facilities, particularly in remote and regional areas that are experiencing significant financial difficulties and are likely to be forced to sell or merge with a larger facility or organisation, where one exists. It will be important for the Department to monitor the financial position of providers and consideration should be given to formalising the range of measures available to a provider in financial difficulties. In particular, consideration should be given to establishing a more structured and pro-active mechanism to, in the first instance, provide advice and support to facilities facing financial problems and if necessary, facilitate the sale or transfer of the facilities of a provider in difficulties to another provider.

Providers operating in regional and remote areas, along with those providing aged care services to the homeless, are facing particular pressures. Recognising the significant constraints facing these providers, including high cost structures and the very limited ability they have to achieve a contribution from residents, consideration should be given to enhancing the support provided to these providers.

Attachment A

Overview of consultations

In the absence of comprehensive data for 2017-18, the Update on Financing Issues in the Residential Aged Care Industry was based on consultations by the ACFA chair with a cross section of providers along with financial institutions and analysts in August and September 2018. The providers consulted were chosen with the aim of obtaining views from a representative cross section.

The ACFA chair met with a range of for-profit and not-for-profit providers with a diversity of size, operating structures and locations. The providers consulted were in aggregate responsible for nearly 900 aged care facilities with representation across all states and territories, and across a wide range of metropolitan, inner and outer regional areas (over 170 in inner regional and 50 in outer regional and remote areas).

Approximately 40 per cent of providers consulted were for-profit and 60 per cent were not-for-profit. They included large and medium providers as well as those operating less than ten facilities.

The providers consulted have approximately 300 facilities in NSW/ACT, 240 facilities in Victoria, 140 in Queensland/NT, 90 in Western Australia, 80 in South Australia and 15 in Tasmania.

In addition, the ACFA chair met with the aged care sector peak bodies, financial institutions and financial analysts focused on the residential aged care sector.