

The viability of residential aged care providers and the potential impact from Productivity Commission recommendations on changes to the aged care system

Prepared by Deloitte Access Economics for ACAA and ACSA

Summary of findings

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The report examines the financial viability of aged care services under recommendations made in the Productivity Commission's draft report *Caring for Older Australians*.

The findings are based on several data sources including publicly available information, a survey of aged care providers, interview with aged care providers and financial institutions, and internal data and modelling.

A model was developed to assess required funding changes, including supported and non-supported accommodation payments to ensure future financial sustainability.

The required rate of return residential aged care providers must generate to attract capital was estimated using the "weighted average cost of capital" (WACC). A different WACC was calculated for high and low care beds and for for-profit and not-for profits providers allowing for different tax treatments for both groups.

The financial viability of residential aged care providers was determined by comparing the WACC with the average internal rate of return. The model incorporated bonds and periodic payments, occupancy rates, CPI, building life-span, the cost of accommodation and expected returns on investments. The report also examines some alternative scenarios taking the PC recommendations into account. Sensitivity analysis was conducted using a higher WACC, a higher cost of building and excluding the cost of land.

PC recommendations including removing caps, high and low care distinctions; supported places and prudential regulation have also been considered alongside recommendations concerning bonds and periodic payments.

The potential impact of proposed new rules governing accommodation bonds and periodic payments is addressed. Risks associated with the consequent need to raise commercial debt and equity investments are also canvassed.

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These findings have been provided to the PC to assist in its preparation of the final *Caring for Older Australians* report. ACSA/ACAA will also use the data in ongoing advocacy and negotiations.

The report reached the following conclusions and makes eight recommendations.

The Productivity Commission's recommendations could make high care facilities viable again, by increasing Government subsidies for supported places to reflect the cost of supply, and by removing price caps so that the market can competitively determine the price of unsupported places. However, clarity is required in relation to the Productivity Commission recommendation and, in addition; there is the need to specify a definition of the cost of supply. Moreover, basing the cost of supply on a two-bed room does not reflect the facility mix currently or going forward.

- **Recommendation 1:** Clarity should be provided in Draft Recommendation 6.4 of the Productivity Commission draft report to enunciate that it is only the subsidised element of the accommodation payments and charges that should reflect the cost of supply, while abolition of the caps is designed to enable demand side factors to operate in determining prices above the cost of supply, with the difference being resident copayments.
- **Recommendation 2:** The definition of the cost of supply should include the cost to finance commercial debt and equity (i.e. the WACC) and the cost of land. Cost of supply should not be based on a two-bed room but, rather, on a 'typical' new construction.

A number of factors influence the market value of any individual bond or periodic payment – including geography, income and wealth, 'quality' of facility/room (age, beds/room, fitout, view etc), and resident preferences.

- **Recommendation 3:** Reflecting factors such as geography, income and wealth, 'quality' of facilities and rooms, and resident preferences, there could be a range of (market) bed and bond rates published by a facility which reflect the interaction of the cost of supply with the different demand elements. Additionally, providers could schedule a decrease in the real value of the daily accommodation charge over time as the facility ages.

There is uncertainty about the equivalence of periodic payments and accommodation bonds since it is not known the proportion of people who will elect bonds relative to periodic payments, and this reduces the WACC at which the two are converted.

- **Recommendation 4:** A formulaic approach to determine equivalence between accommodation bond amounts and periodic payments should be avoided. Residents will have alternative appetites for periodic payments versus accommodation bonds, and these should be reflected in alternative market prices.

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Given the cost of care may no longer be cross subsidised by income earned from accommodation bonds, the price for care for some people is expected to rise. For example, residents who are not supported but cannot afford the average accommodation bond amount (e.g. people with assets above the minimum assets limit of \$39,000 currently but below the average accommodation bond) may find it difficult to access residential aged care under the recommendations. This may lead to a 'middle class' gap in access to appropriate residential aged care services.

- **Recommendation 5:** The contribution of the Australian government to the cost of care for supported residents should cover the full costs of care and provision for the potential need to step in and help support the cost of aged care accommodation for these low-middle income residents. Given there are additional challenges in the delivery of care to special needs groups such as the homeless and people with poor mental health, these should be more specifically recognised in contributions made by the government to the cost of care for these people.

What happens to the overall amount and value of bonds is unknown, but will depend in part on the income and entitlement impacts of the Pensioner Bond Scheme, the attractiveness of the Aged Care Equity Release scheme, the average value of bonds, and the scope to differentially price them. The equivalent bond under the recommendations is higher than the average bond currently, suggesting that the stock of bonds may fall, and providers (particularly) may have to adjust to a more expensive cash flow model. This may generate substantial risk for some exposed providers – notably low care, small scale and not-for-profit providers.

Competition from non-traditional players may also increase as barriers to entry are removed. While providers can mitigate against this risk to some extent, by changing their business models or diversifying, there is a need for more discussion in the Productivity Commission draft report in relation to these impacts and transition arrangements to ensure the sector is not overly disrupted.

- **Recommendation 6:** The Productivity Commission needs to address transition arrangements flowing from its recommendations – such as gradual phasing in, grandfathering, or support mechanisms to providers to assist with restructuring or with diversifying into community care, respite care or transitional care. To minimise structural change costs, transition should be implemented progressively and in partnership with the industry to avoid unintended incentives and consequences.

Establishment of an Australian Pensioners Bond fund may have a negative impact on the supply of accommodation bonds to providers, and will therefore increase the possibility of bond dilution under Productivity Commission recommendations. Given the negative impact bond dilution would have on investment (through an increase in the cost of capital), any competitive advantage in attracting lump sum payments for the Australian Pensioners

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Bond fund should be avoided. However, the potential impact on the supply of lump sum payments to providers will crucially depend on the treatment of income derived from the Australian Pensioners Bond fund as it relates to pension entitlements and the income test for the daily care fee and income tested fee. Currently this is unclear within the Productivity Commission draft report.

- **Recommendation 7:** The Productivity Commission should ensure recommendations avoid providing any competitive advantage in attracting lump sum payments for the Australian Pensioners Bond fund. It should also clearly outline the treatment of income derived from the proposed Australian Pensioners Bond as it relates to pension entitlements and the income test for the daily care fee and income tested fee.

Given the possibility of a dilution in the bond market arising from a move towards daily accommodation payments, this major issue should be recognised as part of proposed changes to the aged care industry. Access to bond lump sum income streams have been a key part of the growth of aged care infrastructure in Australia, as they offer benefits to residential aged care providers and residents. A move away from a strong lump sum stream could compress a facilities valuation, and may reduce a loan to valuation ratio below an acceptable threshold, putting some providers in breach of their debt contract.

- **Recommendation 8:** Any aged care reform process should recognise and build upon the positive features of the lump sum bond income stream.

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