Dear Minister

ACCOMMODATION PAYMENTS – Equivalence Methodology to convert Daily Accommodation Payments (DAPs) to Refundable Accommodation Payments (RADs)

At the Aged Care Financing Authority’s (the Authority) meeting of 5 March 2013 you asked the Authority to provide additional advice on the issue of the methodology for ensuring equivalence between a daily accommodation payment (DAP) and refundable accommodation deposit (RAD) in the context of industry concerns over the potential impact of the announced methodology on funding flows.

The Authority has considered this issue at both its March and April meetings this year and I am pleased to provide you with the Authority’s advice.

Overview of concerns

Industry’s concerns represent a complex number of interrelated issues. For the most part, these reflect the lack of certainty as to the impact of the proposed framework for accommodation payments on the pool of bonds that currently represent 44% ($12B) of the aggregated industry’s total assets of $27B, and the corresponding disquiet as to the funding impact of a potential contraction of this pool.

The specific issue articulated surrounds the use of the Maximum Permissible Interest Rate (MPIR) to convert Daily Accommodation Payments (DAPs) to Refundable Accommodation Deposits (RADs). However, this reflects two separate issues:

1. Anchoring the accommodation payment in the DAPs rather than the current focus on bonds/RADs;
2. Application of MPIR as the “conversion factor”.

Summary of the Authority’s consideration and position

The Authority notes that the announced accommodation pricing framework represents a significant change from current industry practice of setting an accommodation bond price based
on business needs and the resident’s circumstances, and then determining an equivalent daily payment if and when required.

The Authority considered a range of factors in assessing these issues. These are outlined in detail in Attachment A.

Further to these considerations, the Authority notes:

- the current dependence of the aged care sector on lump sum payments for capital formation to fund service expansion;

- the level of uncertainty in parts of the aged care sector and financing institutions about the future level of lump sum deposits in view of the changes to the accommodation payments framework and changes to means testing arrangements, and the perceived risk this poses for capital formation and service expansion at least in the short to medium term; and

- that the perceived risk could be mitigated by anchoring the equivalence formula in the RAD instead of the DAP without significant detriment to pricing transparency and consumer choice of payment mode or residential facility.

In the light of these considerations, the Authority recommends that:

1. for a transition period until 1 July 2017, and subject to the outcome of the review described in recommendation 3, the equation using the MPIR as “conversion factor” be anchored in the RAD so that providers can determine a RAD price and then convert that to a DAP price based on the MPIR. The DAP price would then adjust each quarter with movements in the MPIR with the RAD price remaining constant. From 1 July 2017 the anchor point would change to the DAP with the RAD adjusting with movements in the MPIR, subject to the findings of the review. As already announced both RAD and DAP prices and combination options would need to be published by the provider;

2. consideration be given in the context of finalising the Accommodation Pricing Guidelines as to how anchoring in the RAD will affect the Level 3 pricing approval process;

3. that Section 4(2)(e) of the Living Longer Living Better (LLLB) Bill concerning a review of the LLLB package be modified to include a review of the appropriateness of continuing to anchor the equivalence formula in the RAD, taking into account the impact on consumers, providers and investment in the sector.

4. that the consumers’ rights and total discretion as to selection of facility, choice of payment mode and the 28 day (after entry to a facility) choice of payment period based on the published pricing (both DAP and RAD) are explicitly and comprehensively communicated.

Next Steps

Consistent with paragraph 16 of the Authority’s Interim Operating Framework, I have asked the Department to publish this advice within 28 days after the date of this letter.
All members of the Authority are available to discuss these issues with you further if needed, and we look forward to receiving your feedback.

Yours sincerely

AUTHORISED FOR ELECTRONIC TRANSMISSION

Lynda O’Grady
Chair

17 May 2013
ATTACHMENT A

CONSIDERATION OF CONCERNS
Equivalence Methodology to convert Daily Accommodation Payments (DAPs) to Refundable Accommodation Payments (RADs)

Background
Under the LLLB reforms, the regulation of accommodation payments for residential aged care aims to address several policy objectives including:

1. For the consumer:
   • Transparency of prices and underlying pricing principles;
   • Equity (between residents); and
   • Choice of method of payment and time to make such a choice so as not to impact on entry to the desired facility.

2. For the provider:
   • Certainty of pricing and funding options;
   • Standardisation of accommodation pricing between low and high care ie: removal of the current differentiation; and
   • Financial equivalence for providers between alternate methods of payments available to residents.

Proposed Framework
The proposed framework to be effective 1 July 2014 provides for:

1. Harmonisation of price regulations across low care and high care, including in relation to:
   • transparency and pricing principles; and
   • consumer choice of method of payments (i.e. DAPs, RADs or combination);

2. Three tiers of DAPs (and equivalent RADs) reflecting the value of the accommodation offered, requiring approximately 15% of the current bonds (those currently above $85 DAP) to be approved by the Pricing Commissioner prior to publication;

3. Equivalency conversion of DAPs to RADs by application of a “conversion factor”

4. Adoption of the MPIR as released each quarter, as the “conversion factor”; and

5. Choice of payment mode within 28 days of entry, not before entry.

Overview of concerns
Industry’s concerns extend to general concern about the policy objectives and the proposed framework, because it introduces a period of uncertainty about the likely mix of DAPs and RADs and the implication for funding of their operations.

For the 2010/11 financial year, almost 97% of the industry, submitted audited F10/11 General Purpose Financial Reports in compliance with obligations under the Conditional Adjustment Payment.
Based on these reports, $12B (44.4%) of total industry assets of $27B was provided by bonds, with the percentage being higher in the for-profit sector.

Clearly, the aged care industry has evolved its current business models and borrowing practices around a model where the Low Care and Extra Services providers can negotiate a RAD with a prospective new resident and expect to receive this as a lump sum in most cases. Lending institutions are also operating on this model.

There is greater certainty over replacement bond values in the current system as bond values are largely dependent on an individual’s wealth and the negotiation process for each resident. The negotiation process is aided by the current rationed supply of services.

Given that only residents entering Low Care or Extra Services facilities are currently eligible to pay for their accommodation as a bond, there is prospectively a substantial pool of RAD funding that may become available after 1 April 2014 from residents entering current high care places.

The dependency of the industry on funding by bonds (RADs) is causing alarm amongst sections of the industry and financiers as to the consequence of a potential net drop in the level of such funding. Although DAPs and RADs are by calculation financially equivalent, providers are not indifferent to the consumers’ choice. This is because DAPs impact revenue and profitability, whilst RADs provide cornerstone balance sheet funding and access to interest receipts thereon and for bonds received prior to 30 June 2014, retention income for up to five years.

ACFA commissioned KPMG to undertake scenario modelling to provide estimates of the possible impacts from each of the pricing and method of payment changes in the currently different low and high care sectors. At an aggregate industry level, a net fall in RAD funding appears unlikely. However at a facility or provider level, short and medium term changes may cause transitional funding contractions that may not be easily replaced by incremental third party debt or equity contributions.

ACFA will examine further the impact of current financial arrangements on capital formation and investor confidence, including superannuation funds, in future annual reports.

**The issues regarding proposed equivalence methodology**

The general concern about consumers’ likely decision between DAPs and RADs is exacerbated by two interrelated issues:

1. The anchoring of pricing in the DAP rather than RAD; and
2. Application of quarterly MPIR as the “conversion factor”

**Issue 1: The anchoring of pricing in the DAP rather than RAD**

In summary, using a variable interest rate to calculate the RAD from the DAP results in the RAD adjusting quarterly with MPIR movements.

In particular, this would see:

- RAD values (for a given DAP amount) fall when interest rates rise;
- higher RADs (for a given DAP) when interest rates are falling; and
- a balancing out in these movements over the longer term.
Regular movements in RAD values would provide less certainty to providers and financiers over future flows of RADs. The issue may be more a concern in the implementation phase as once the new system is bedded in it is likely that trends in payments will become more clear, aiding certainty.

The graph at Attachment 1 shows the history of movements in the MPIR since 1997.

The impact on consumers and providers of variations in RADs

- Regular recalculations of RADs may add some complexity for providers, but this would be limited, as the recalculation itself is simple and consumers would only be offered one price at any given time.
- Once a price was agreed for a particular resident, the price is then fixed for their time in care, that is, the quarterly movement in interest rates does not affect already agreed prices for residents in care.
- Regular recalculations would be required irrespective of whether the equivalence formula was anchored in the RAD or the DAP.
- However, as interest rates rise the cost of providing accommodation will increase, since the weighted average cost of capital (debt/equity costs) will increase. The provider may adjust future DAPs (and associated RADs) upward to compensate for this increased cost.
- If higher interest rates did not result in a reduction in the RAD then this may influence consumers towards paying a DAP instead.
- The Productivity Commission’s Caring for Older Australians report noted that expressing accommodation payments in terms of a daily payment rather than a lump sum may improve pricing transparency.

The flexibility that already exists in the announced model

There is flexibility within the announced model which allows providers to consider options which would mitigate concerns.

In particular, the announced methodology does not restrict providers from adjusting DAPs in response to interest rate movements and a provider can choose to adjust the DAP either up or down in a particular quarter to reflect changes in costs in such a way as to maintain the RAD value or limit movements, provided the DAP value still appropriately takes into account the factors specified in the accommodation pricing guidelines.

The announced methodology does not restrict providers from adjusting DAP prices where appropriate such as to adjust for higher costs from interest rate rises, allowing RAD values to be maintained or variations limited and managed.
Example

1 July 2014 - a provider published a DAP of $50 with an equivalent RAD of $238,845 (based on the December 2012 MPIR of 7.62%)

1 October 2014 - the MPIR rises to say 8%

Under the proposed methodology, the provider may choose to:
1. Keep their DAP at $50 - the equivalent RAD becomes $227,500
2. Retain their RAD at $238,845 by adjusting their DAP to $52.49

<table>
<thead>
<tr>
<th>Model</th>
<th>1 July 2014 - Baseline</th>
<th>1 Oct 2014 - Option 1</th>
<th>1 Oct 2014 - Option 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>DAP</td>
<td>$50</td>
<td>$50</td>
<td>$52.49</td>
</tr>
<tr>
<td>MPIR</td>
<td>7.62%</td>
<td>8.0%</td>
<td>8.0%</td>
</tr>
<tr>
<td>RAD</td>
<td>$238,845</td>
<td>$227,500</td>
<td>$238,845</td>
</tr>
</tbody>
</table>

This optional adjustment gives the same result as if the RAD had been the price reference point. There is anecdotal evidence that many in the industry are not currently aware of this flexibility.

A clear communication should be programmed if the announced approach is retained.

Issue 2: Application of quarterly MPIR as the “conversion factor”

Alternate “Conversion Factor” options

After considering reports from consultants Allens Consulting and PwC, as well as submissions made through the public consultation on accommodation payments, it was concluded that other prospective “Conversion Factors” namely a Weighted Average Cost of Capital (WACC) was inferior to the MPIR because:

- There is a wide divergence in WACC rates between providers, due to differences in operational efficiency (e.g. number and size of facilities), cost of debt, profit vs not-for-profit status, risk profile and relevance of WACC to actual investment decisions; and
- The use of the differing rates between facilities in accommodation payment conversion may hamper pricing transparency. It is also likely to cause confusion for consumers and make it difficult to compare the relative value of each accommodation option. The MPIR has been used in aged care since 1997 and is specified in legislation as the ‘conversion factor’ to be applied when providers calculate an equivalent daily accommodation payment from an agreed bond amount. The MPIR is set three percentage points below the Australian Taxation Office’s General Insurance Charge – a penalty rate applied by the ATO on outstanding debts - as it intends to keep parity with borrowing costs rather than exceed them.

Smoothing or less than quarterly revisions

ACFA has considered smoothing/averaging MPIR’s over multiple quarterly periods or allowing re-pricing on a less frequent basis.
Given the optional adjustment of RADs in response to changes in quarterly MPIRs, it is not considered necessary or advisable, as it would make prices less responsive and less flexible to changes in market prices and market signals.

**Issue 3: Level 2/3 threshold issue**

For a number of providers who are within range of the Level 2/Level 3 threshold of DAP of $85/day, changes in MPIR may move them from Level 2 to Level 3 where prices would need to be approved by the Aged Care Pricing Commissioner (the Pricing Commissioner). Similarly, MPIR changes may trigger the need for Level 3 providers to have to re-apply to the Pricing Commissioner.

It is recommended that providers be allowed to retain their pricing category for 12 months from the time of adjustments caused only by MPIR changes.

**Overview**

This is a time of significant change across many facets of the aged care industry. It is to be expected that there will be concerns and some degree of hesitation from both industry and their financiers when the full impact of the reform package will not be seen until implementation has progressed.

As a result, there is a risk that too much uncertainty or investor and lending institution hesitation may hinder future investment in aged care.

In many respects, the MPIR issue represents part of a broader concern amongst some sectors of the industry and lending bodies regarding the move to allow consumer choice over lump sum or periodic payments.

In attempting to model consumers’ likely decisions as to choice of DAP or RAD, it was noted that many factors are likely to influence a resident’s choice of payment method, not all of which would be financial or objectively measurable, and therefore not able to be reflected in the scenario modelling.

These issues and impacts also need to be considered not just individually, but also holistically in the context of the broader package of reforms. In particular, the potential pool of lump sum payments will increase with the removal of the restriction on lump sum payments in high care. Hence, while lump sum payments may vary under the MPIR and choice of payment framework, there is also the potential for this to be offset by more lump sum payments being paid by future residents with high care needs.

A number of industry members have suggested starting with a RAD and calculating an equivalent DAP as a way of giving greater certainty to providers and financiers regarding refundable accommodation deposit holdings. This may overcome misperception or uncertainty about the options illustrated above.

The Authority considers that whilst the flexibility within the announced model to adjust DAPs should be sufficient with respect to interest rate movements to maintain a desired RAD, the degree of uncertainty and the risks to capital formation for future investment
warrants serious consideration of the adoption of RAD as the anchor point for the new framework as a means of mitigating the perceived risk during a period of transition.

The Authority is also mindful that the greater focus on consumer choice and transparency from 1 July 2014 means that regardless of how the accommodation payment equivalence is anchored, providers will no longer be able to control whether accommodation is paid by a lump sum or daily payment. Even if the lump sum price is set first, the consumer will have total discretion to choose to pay a DAP rather than to pay a lump sum RAD provided announced measures to ensure consumer discretion are properly implemented.

**Conclusion**

**ACFA notes:**

- the current dependence of the aged care sector on lump sum payments for capital formation to fund service expansion;

- the level of uncertainty in parts of the aged care sector and lending institutions about the future level of lump sum deposits in view of the extent of the changes to the regulation of accommodation prices and changes to means testing arrangements, and the perceived risk this poses for capital formation and service expansion at least in the short to medium term;

- that the perceived risk could be mitigated during a transition period by anchoring the equivalence formula in the RAD instead of the DAP without significant detriment to pricing transparency and consumer choice of payment mode or of aged care home; and

**ACFA recommends that:**

1. for the transition period until 1 July 2017, and subject to the outcome of the review described in recommendation 3, the equation using the MPIR as “conversion factor” be anchored in the RAD so that providers can determine a RAD price and then convert that to a DAP price based on the MPIR. The DAP price would then adjust each quarter with movements in the MPIR with the RAD price remaining constant. From 1 July 2017 the anchor point would change to the DAP with the RAD adjusting with movements in the MPIR, subject to the findings of the review. From 1 July 2017 the anchor point would change to the DAP subject to the findings of the review. As already announced both RAD and DAP prices and combination options would need to be published by the provider;

2. consideration be given in the context of finalising the Accommodation Pricing Guidelines as to how anchoring in the RAD will affect the Level 3 pricing approval process;

3. section 4(2)(e) of the Living Longer Living Better (LLLB) Bill concerning a review of the LLLB package be modified to include a review of the appropriateness of continuing to anchor the equivalence formula in the RAD, taking into account the impact on consumers, providers and investment in the sector;

4. consumers’ rights and total discretion as to selection of facility, choice of payment mode and the 28 day (after entry to a facility) choice of payment period based on the published pricing (both DAP and RAD) are explicitly and comprehensively communicated.
Historical Maximum Permissible Interest Rates (MPIR) - 1997 to present

- Jul-00, 9.95%
- Aug-07, beginning of GFC
- Jul-08, 11.75%
- Jan-11, 9.02%
- Jul-09, 7.13%
- Jan-13, 7.24%

(Actual data was monthly from 1997 to 1999, quarterly from 1999 to 2013)