Aged Care Financing Authority

Submission to Royal Commission into Aged Care Quality and Safety

April 2019

Executive summary

Role of ACFA

The Aged Care Financing Authority (ACFA) is a statutory committee established to provide the Australian Government with independent and transparent advice on the impact of funding and financing arrangements on the viability and sustainability of the aged care sector, the ability of consumers to access quality aged care and the aged care workforce. ACFA also considers other matters referred to it by the Minister. A key aspect of ACFA's activities is the monitoring and analysis of the overall state of financial developments in the sector and the financial performance of aged care providers. In providing advice on the sustainability of the aged care sector, a key aspect is whether the funding and financing arrangements are such as to support the level of investment needed to meet existing and prospective demand for quality aged care services.

Performance of aged care providers in 2017-18

2017-18 was a difficult year for both home care and residential care providers. For home care providers, average Earnings Before Interest, Tax, Depreciation Amortisation (EBITDA) per consumer dropped to $1,217 from around $3,000 for the previous three years. For residential care providers, after improving for five years, the average EBITDA per resident fell by 24 per cent to $8,746 in 2017-18 compared with $11,481 in 2016-17. Fifty-six per cent of residential providers reported a net profit in 2017-18 compared with 68 per cent in 2016-17.

Policy changes impacting on financial performance of providers

The overall deterioration in the financial performance of residential aged care providers in 2017-18 in large part reflects the changes to the Aged Care Funding Instrument (ACFI) in 2016 and 2017 and the pause in ACFI indexation in 2017-18, along with rising staff costs.

The Government said its decision to change ACFI arrangements and pause indexation was because real growth in ACFI expenditure per resident per day was considered to be higher than the frailty growth in the population, and was higher than what had been budgeted. The Government said this was the result of providers seeking to maximise claims, particularly since there was sharp growth in certain areas of ACFI rather than growth being spread across all ACFI areas which would be expected if claims were increasing in line with the growth in frailty. The Government said this behaviour was widespread and was not concentrated in a small group of providers. Providers say their ACFI claims, which are subject to an audit program, reflected the care needs of residents and the frailty of residents was increasing. Providers also argue that if the Government was concerned about the claiming behaviour of some providers, those providers should have been targeted rather than changing ACFI such that most providers were negatively impacted.

The major recent reform initiative in the home care sector that impacted on the financial performance of providers was the introduction of consumer directed care and home care packages following consumers rather than being allocated to providers. This reform allows consumers to direct their care package to the provider of their choice as well as to change providers. This has resulted in a substantial increase in the number of approved home care providers and in turn greater competition between providers which has resulted in a decline in profit margins. The increase in provider numbers comprised both for-profit and not-for-profit providers, although the proportion of for-profit providers has increased from a low base.

Issues surrounding the outlook for the financial performance of providers

For residential care providers, there is the prospect that growth in ACFI will not return to levels seen in the past. If this is the case, it will have implications for the financial performance of providers. Some providers have indicated that they are concerned that they would not be viable if over future years ACFI payments increased by around 1.5 per cent (1.4 per cent was the rate of Wage Cost Index for 2017-18 which is the rate used for ACFI) and wages continued to increase by 2.5 to 3 per cent.

The deterioration in financial performance and uncertainty over future developments in the industry is holding back investment in residential aged care. Such a situation is not consistent with establishing the environment necessary for facilitating the level of investment needed to meet the demand for residential care services from an ageing population. A number of providers have advised they are investing in retirement living rather than residential aged care in order to diversify revenue sources. Some providers say they are concerned that while the decline in margins is resulting in pressure to reduce staff costs, the enhanced activity of the Quality and Safety Commission is increasing cost pressures and impacting on staff morale. Feedback from consultations suggest there is an increasing number of mainly small providers facing financial and quality problems who are seeking to leave the industry.

Home care providers are likely to continue to experience a challenging business environment as they adjust to the introduction of home care packages following consumers. The home care sector is in a period of transition. Providers have to change their operations and processes to respond to consumer preferences and provide consumers with the information they require to make informed decisions. The initial impact of the reform has increased costs for providers while the increased competition sparked by the large increase in approved home care providers has put downward pressure on prices. The increase in the number of packages will increase potential consumers for all providers, although given the extent of the increase in the number of providers, it is likely that there will be a shake-out and a number of providers will leave the market. Established providers are concerned that new entrants are compromising quality in their efforts to undercut more established providers.

Characteristics of a viable and sustainable aged care system

To provide the level and quality of aged care services that older Australians require now and into the future, it is essential that the aged care sector is financially viable, stable, efficient, effective, responsive and sustainable. It is evident from developments in the sector over recent years that it faces many hurdles in achieving this objective. From a funding perspective, some of the characteristics of a viable and sustainable aged care sector include:

Confidence and Trust: An essential overall ingredient for a sustainable aged care industry is confidence and trust in the Government's funding and regulatory arrangements. While the Government is the main source of funding for aged care, the services are provided largely by non-government providers. The extent to which these providers are prepared to make long-term investments in the sector will depend on their confidence in the direction and consistency of Government policies.

Stable Government funding arrangements: There needs to be a stable, efficient, effective and equitable residential care funding tool which provides financial stability for both the residential aged care sector and the Government. The tool needs to be administratively simple, involve assessments external to the provider, ensure the equitable allocation of funds based on the needs of residents, and be based on transparent studies to determine the cost of care. Similarly, there needs to be stable and efficient funding arrangements for home care that ensures targeted care is available for all consumers. The funding arrangements should also be based on transparent studies to determine the cost of care.

***Appropriate overall Government funding*:** Efficient arrangements for allocating Government funding to residential care providers and home care consumers are necessary, but it is important that the overall funding pool for the aged care system is adequate and sustainable. The funding has to be sufficient to meet the level and quality of aged care needs of consumers and meet community expectations, and in doing so provide the incentive for providers to invest in the industry. The level of funding provided by the Government has to support the delivery of quality aged care services, but it should not support inefficient or poorly managed providers or provide higher than necessary funding.

Funding that is flexible and adaptable to changing demographics and demands: The demographics of the Australian population are such that there will be increasing pressure on funding for aged care, both residential and home care. Demand and consumer preference for particular services will likely change and there will be innovations in the way services are delivered along with the interaction between home care and residential care and with other sectors, such as retirement living and hospitals. The funding arrangements have to be responsive to these changes and should not deter but rather encourage innovation.

***Equitable contribution to costs by consumers*:** Sustainable aged care funding arrangements will require that consumers who can afford to do so make a greater financial contribution towards their residential everyday living expenses and care costs, complemented by a greater choice of higher quality services and service types. This would involve stronger means testing arrangements for care fees and uncapping the basic daily fee in residential care, which may reduce the reliance on charging fees for additional services. Home care consumers should be required to pay the income tested care fee.

***Effective prudential oversight*:** Effective prudential oversight of the aged care sector is necessary given that the range of current and prospective reforms and developments are likely to be disruptive to a number of providers. An increasing number of marginal providers will likely need to sell or merge with other providers. Such a trend will lead to a more efficient and resilient aged care sector, however the adjustment should be orderly and any impact on consumers should be minimised. This will require more proactive prudential oversight of the sector and polices to minimise disruptive adjustments.

***Sound management and governance arrangements*:** A sustainable aged care system will require well managed aged care providers with sound governance arrangements. Providers need to look at their internal operations to ensure they are delivering care in the most efficient and effective way. There will need to be adequate sources of financing to support the level of investment required to meet current and future demand for aged care services. Under the current funding and financing arrangements there are very diverse financial outcomes, with the top quartile of providers in terms of profit continuing to achieve significantly better results than the lowest quartile. The very wide variation in financial performance across the sector suggests there is scope for many providers to pursue greater efficiencies and improve their results.

1. Introduction

This submission by the Aged Care Financing Authority (ACFA) to the Royal Commission into Aged Care Quality and Safety provides background on ACFA, its output and methodology, and comments on the contribution ACFA can make towards achieving a sustainable aged care system. The submission provides an overview of the financial performance of residential and home care providers and the policy changes that have impacted on this performance. It also comments on some of the issues surrounding the outlook for the financial performance of providers as well as the future demand for aged care services. It concludes by summarising the funding and financing challenges in the sector and against this background identifies some of the characteristics of a viable and sustainable aged care sector.

2. Background on ACFA

ACFA is a statutory committee established under the *Aged Care Act 1997*. Its role is to provide independent, transparent advice to the Australian Government on funding and financing issues in the aged care sector. ACFA does not have a regulatory or administrative role. It is an advisory committee that looks at issues from a whole of sector strategic perspective.

ACFA was established in 2012 with its responsibilities and operations guided by the *Committee Principles 2014* made under the *Aged Care Act 1997*. All ACFA reports to Government are required to be published within 28 days of being provided to Government and are available on the ACFA website at https://agedcare.health.gov.au/aged-care-reform/aged-care-financing-authority. A full list of all completed reports published by ACFA is at Appendix B.

As outlined in the *Committee Principles 2014*, the functions of ACFA are:

- at the request of the Minister, provide advice in relation to any specific issues relating to the funding and financing of aged care services;
- provide advice to the Minister by 30 June each year on the impact of funding and financing arrangements on: the viability and sustainability of the aged care sector, the ability of consumers to access quality aged care, and the aged care workforce; and
- to consider other matters referred to the Authority by the Minister.

ACFA is required to consult broadly on all of its reports and has in place a rolling program of meetings and discussions with key stakeholders in the sector, including provider and consumer groups. It holds roundtables after its annual reports are released and participates in industry conferences.

ACFA members are appointed by the Minister responsible for Aged Care. ACFA is led by an independent Chair and Deputy Chair, complemented by seven members with a mixture of aged care, consumer and finance sector expertise. The ACFA membership and structure are provided in Appendix A. There are also three ex-officio Australian Government representatives on ACFA.

3. ACFA's output and methodology

Annual reports

Each year ACFA provides the Minister responsible for aged care with a report on the funding and financing of the aged care sector in accordance with the requirements of the *Committee Principles 2014*. ACFA's 2019 annual report will be the seventh it has provided to the Minister, and published, since it was established.

ACFA's annual reports are based on data supplied by aged care providers to the Department of Health, primarily in their Aged Care Financial Reports. This is the most comprehensive financial data available on the aged care sector and provides a unique basis to analyse the overall financial position of aged care providers. ACFA only sees the aggregate data collected by the Department of Health and does not have access to data provided by individual providers, nor data at the facility level. Most providers report on the financial year ended 30 June and submit the required data by 31 October of the same year. However some providers who report on an end December basis submit their requested data by 30 April the following year. The result is that ACFA's annual reports are based on data which, in the majority of cases, is over a year old at the time of publication.

In ACFA's 2018 annual report, which was based on 2016-17 data, it was noted that a number of significant policy changes, particularly the changes to ACFI that took effect in 2016 and 2017, were only partially impacting on the 2016-17 financial results of providers. However, survey results by the accounting firm StewartBrown suggested a notable decline in the overall financial performance of the residential aged care sector in 2017-18. Given these developments, ACFA provided the Minister in September 2018 with an update of its assessment of developments in the residential aged care sector. This update was based on consultations with a cross section of providers. In order to have a more contemporaneous assessment of financial developments in the aged care sector, ACFA has undertaken an extensive program of consultations with providers in preparing its 2019 annual report.

Over time, each annual report builds upon the last, producing a substantial body of data on the funding and financing developments in the aged care sector. A particular focus of the annual report is on monitoring the financial performance of aged care providers. The main measure used to assess profitability is Earnings Before Interest, Taxes, Depreciation and Amortisation (EBITDA). By excluding factors that vary depending on organisations financing decisions and the size and age of facilities, EBITDA provides a measure of core profitability. The reports also refer to Net Profit Before Tax (NPBT).

Other ACFA reports

In addition to the annual report, ACFA reports to Government on specific issues that the Government has referred to ACFA. At Appendix B is a list of all the reports ACFA has provided to the Government since 2012. These are all available on ACFA's website at:
https://agedcare.health.gov.au/aged-care-reform/aged-care-financing-authority

At the request of the Government, ACFA has provided independent advice on specific design features of the funding of aged care, such as: reports on the definition of significant refurbishment; accommodation payments; methodology for ensuring equivalence between a Daily Accommodation Payment (DAP) and Refundable Accommodation Deposit (RAD); base interest rate; the Bond Guarantee Scheme; and access to care for supported residents. Between July 2014 and September 2016 ACFA provided the Government with regular reports on the impact of the 1 July 2014 financial reforms on the aged care sector. ACFA has also reported on factors influencing the financial performance of aged care providers along with a report on issues affecting the financial performance of rural and remote providers, both residential and home care. Other reports have covered the operation of the aged care sector – such as the use of respite care and how consumers plan and finance their aged care. ACFA's most comprehensive assessment of the funding and financing issues arising from the 2014 reforms was its report to inform the *Legislated Review of Aged Care Reforms 2017* (known as the Tune Review).

4. ACFA's contribution in providing independent advice

The nature of the funding and financing arrangements in the aged care sector is such that an independent and transparent adviser to the Government can play an important role. The Government is the main source of funding for aged care services as well as controlling the supply of subsidised residential aged care places and home care packages, along with determining the size of the Commonwealth Home Support Program. The Government also sets the limit that consumers are required to contribute towards the cost of their aged care as well as setting the quality standards providers have to meet.

While the Government is the main source of funding for aged care, non-government providers, both for-profit and not-for-profit, are the main source of delivery of aged care services. As such, Government policy settings have a major impact on the financial performance of aged care providers and, along with the management and business skills of providers, influence the financial viability of many providers. While individual aged care providers may not succeed and will leave the industry, a key requirement for a sustainable aged care sector is funding and financing arrangements that support the financial viability of efficient providers.

The Government's funding arrangements for the aged care sector should seek to avoid overly generous support for inefficient providers and providing a greater rate of return than necessary for providers to maintain their involvement in the industry. There is an element of tension between the objective of ensuring that subsidies for aged care are not 'excessive' nor support inefficiencies and/or excessive profit, and providers who have an incentive to see Government subsidies increase. The Productivity Commission's 2011 report *Caring for Older Australians* proposed addressing this tension by recommending that an independent Australian Aged Care Commission set the price for aged care services as well as recommending the level of consumer co-contribution.

The Government did not adopt this recommendation, but it did establish ACFA as an independent authority to advise on funding and financing issues in the aged care sector. In many respects, ACFA acts as an 'honest broker' between the Government and aged care providers. It canvasses the views of aged care providers, assesses the aggregate data provided to the Department of Health, and makes its own assessment of the overall state of financial developments in the sector and its main drivers. While the secretariat supporting ACFA comes from the Department of Health, along with the technical assistance for the analysis it undertakes, the views and recommendations submitted to the Minister are independent of the Department. For ACFA to be effective in providing this 'honest broker' role, it is important that all parties recognise and accept that it is independent.

ACFA does not advise on the appropriateness of the overall level of Government expenditure on aged care, which depends on the level and quality of aged care required by the Australian community. As noted previously, one of ACFA's main roles is to advise the Government on the impact of existing funding and financing arrangements on the financial performance of providers and the overall viability and sustainability of the sector. In addition, ACFA considers factors that may be impacting on the overall efficiency of aged care providers.

The ageing of the Australian population will see a marked increase in the number of Australians likely to need aged care. The structural ageing of the population over the next 20 years will see the size of the 70 years and over cohort increase by around 1 million people each decade. Within this cohort, older age groups will more than double. This rapid expansion in the oldest age groups will result in a marked increase in demand for aged care services. The proportion of each age group who use aged care services increases dramatically with age.

As noted further below, ACFA has canvassed projections for the future demand for residential aged care in its annual reports and while it is evident that over the coming decade the demand for aged care services will increase, there are a range of factors that will influence the composition of this demand, in particular the interaction between the growing preference for home care and the demand for residential care. In fulfilling its role in providing advice to the Government on the sustainability of the aged care sector and continuing access to aged care services, an aspect of ACFA's consideration is providing advice on whether the funding and financing conditions in the sector are such so as to support the level of non-government sector investment needed to meet the expected future demand for aged care. Such factors that will have a bearing include the overall financial position and outlook for providers, the stability of funding arrangements, the level of trust in the overall direction of policies, and the availability of financing.

5. Financial performance of aged care providers in 2017-18

Provider numbers

The number of home care providers was stable until 2015-16 but has since increased significantly, from 496 approved providers in 2015-16 to 873 providers in 2017-18 (Chart 1). The increase in home care providers was in response to the introduction of Increasing Choice in Home Care. In contrast, the number of residential care providers has been steadily declining from a peak of 1,121 in 2010-11. The number fell from 902 in 2016-17 to 886 in 2017-18 (Chart 2).

Chart 1: Number of home care providers, 2012 -13 to 2017-18

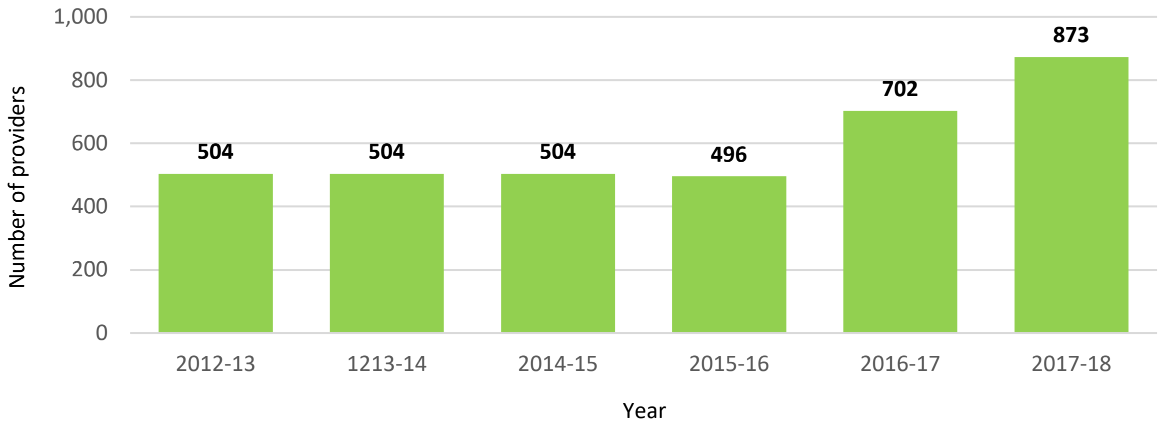
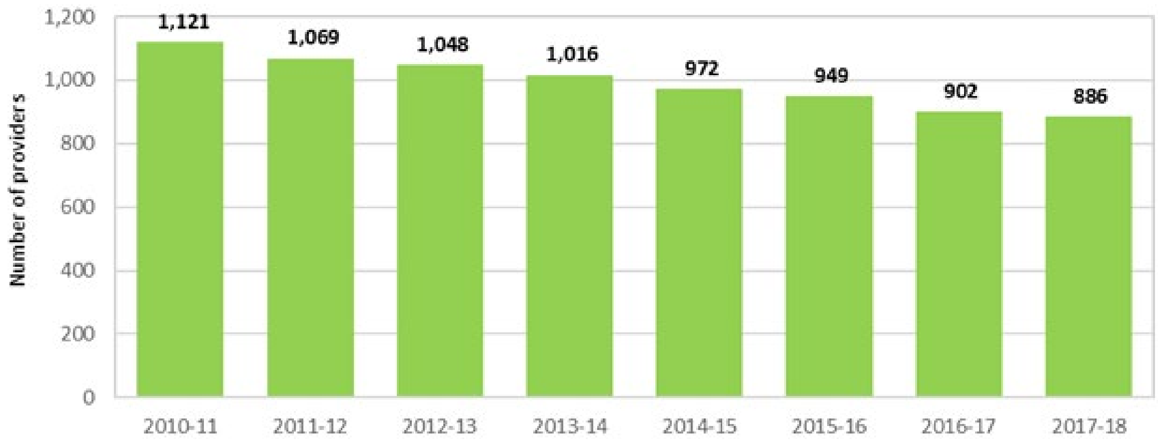


Chart 2: Number of residential care providers, 2010-11 to 2017-18



Access to aged care

The number of consumers of home care increased from 97,516 in 2016-17 to 116,843 in 2017-18. The number of consumers in residential care increased from 239,379 in 2016-17 to 241,723 in 2017-18. The average occupancy in residential care continued to fall, 90.3 per cent in 2017-18, down from 91.8 per cent in 2016-17 and 92.4 per cent in 2015-16 (Table 1), and a peak of 97.1 per cent in 2003-04.

Table 1: Occupancy rates in residential care, by ownership type, 2013-14 to 2017-18

Ownership Type	2013-14	2014-15	2015-16	2016-17	2017-18
Not-for-profit	94.6%	94.0%	94.0%	93.0%	92.1%
For-profit	91.0%	91.0%	91.0%	90.0%	87.9%
Government	90.0%	89.0%	90.0%	90.0%	90.3%
Australia	**93.0%**	**92.5%**	**92.4%**	**91.8%**	**90.3%**

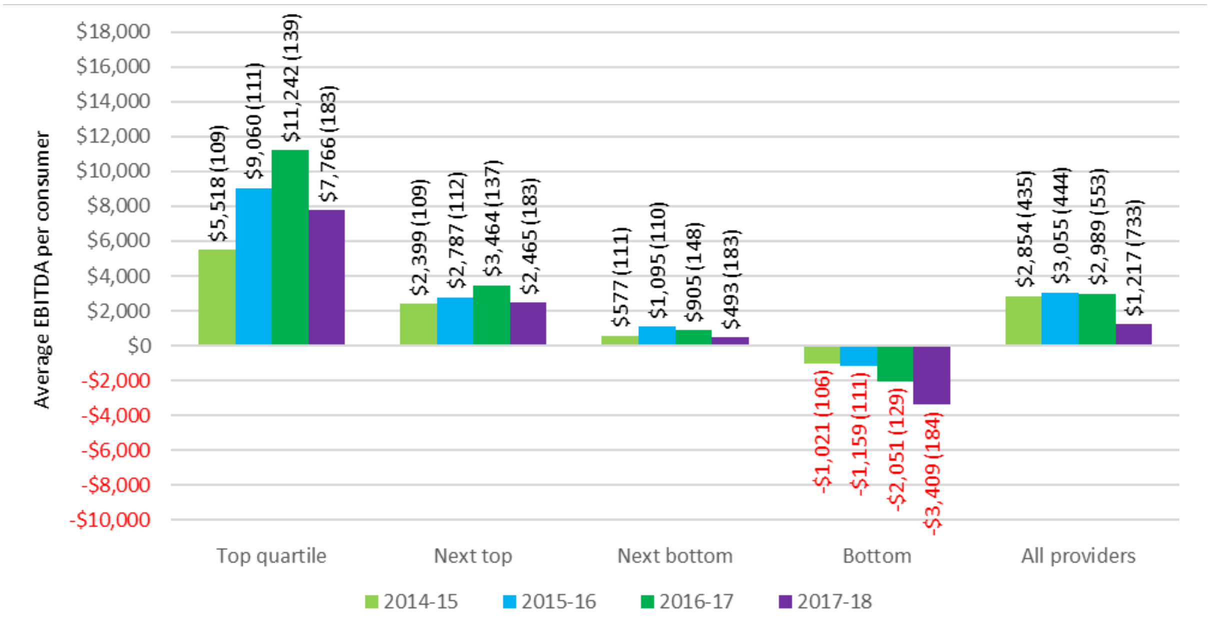
While occupancy has been falling in residential care, new data available since the creation of the National Prioritisation System for home care packages, following the assignment of packages to consumers rather than allocation to providers, has provided information for the first time about the level of unmet demand for home care packages. At 30 September 2018, there were 127,748 consumers registered on the National Prioritisation System as either waiting for a package or accessing a package whose funding level was below their assessed need.

Financial performance of providers

Home care

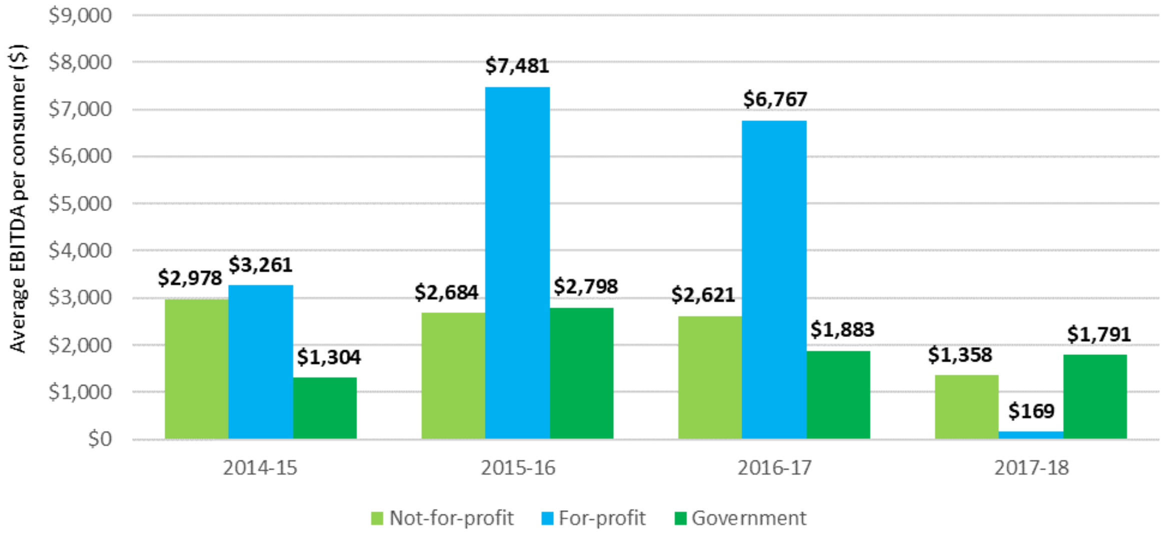
In terms of profit per consumer, both Earnings Before Interest Tax Depreciation and Amortization (EBITDA) and Net Profit Before Tax (NPBT) for home care providers fell significantly in 2017-18. Average EBITDA per consumer dropped to $1,217 from around $3,000 for the previous three years. Average NPBT per consumer declined to $947 in 2017-18 from $2,837 in 2016-17 (Chart 3).

Chart 3: Home care provider average EBITDA per consumer, 2017-18, by quartile (number of providers in parentheses)



After significantly outperforming the not-for-profit and government home care providers in the previous two years, the for-profit providers had by far the worst results in 2017-18. The for-profit home care providers recorded an average EBITDA per consumer of $169 compared with $6,767 in 2016-17 and $7,481 in 2015-16 (Chart 4).

Chart 4: Home care average EBITDA per consumer, by ownership type, 2014-15 to 2017-18



When performance in 2017-18 is considered by location, providers in regional and metropolitan areas reported relatively similar levels of EBITDA per consumer in 2017-18, in contrast to 2016-17 where metropolitan providers were the strongest performers.

The decline in the financial performance of home care providers in 2017-18 appears to be mainly the consequence of the February 2017 reforms which saw packages being allocated to consumers rather than providers.

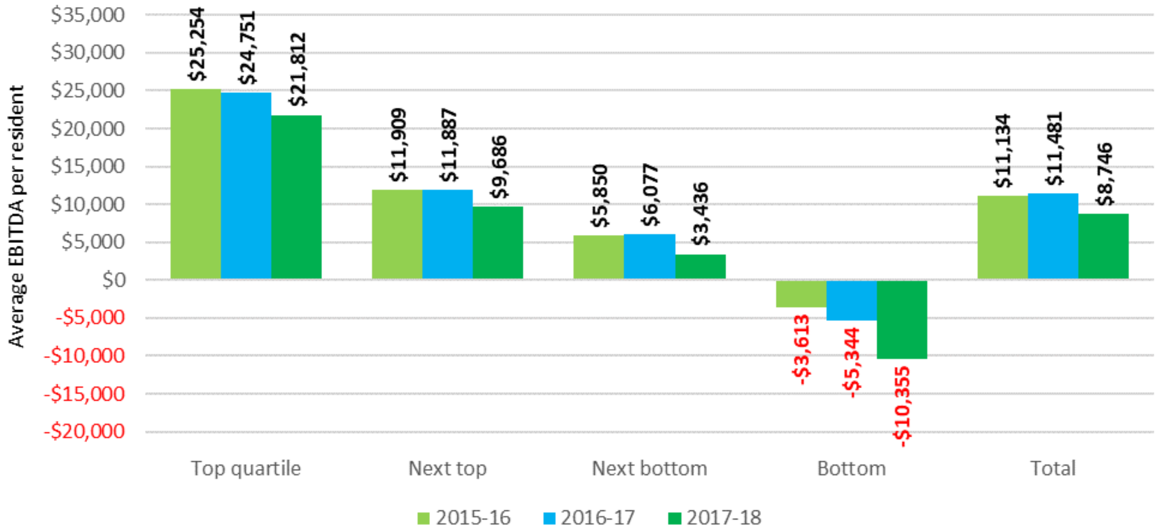
Unspent package funds per consumer continued to increase in 2017-18. As at 30 June 2018 the level of unspent funds was $539 million, up from $329 million as at 30 June 2017.

Residential care

There was a significant overall decline in the financial performance of residential care providers in 2017-18. After improving for five years, the average EBITDA per resident fell by 24 per cent to $8,746 in 2017-18 compared with $11,481 in 2016-17 (Chart 5). Fifty-six per cent of residential care providers achieved a net profit in 2017-18 compared with 68 per cent in 2017-18.

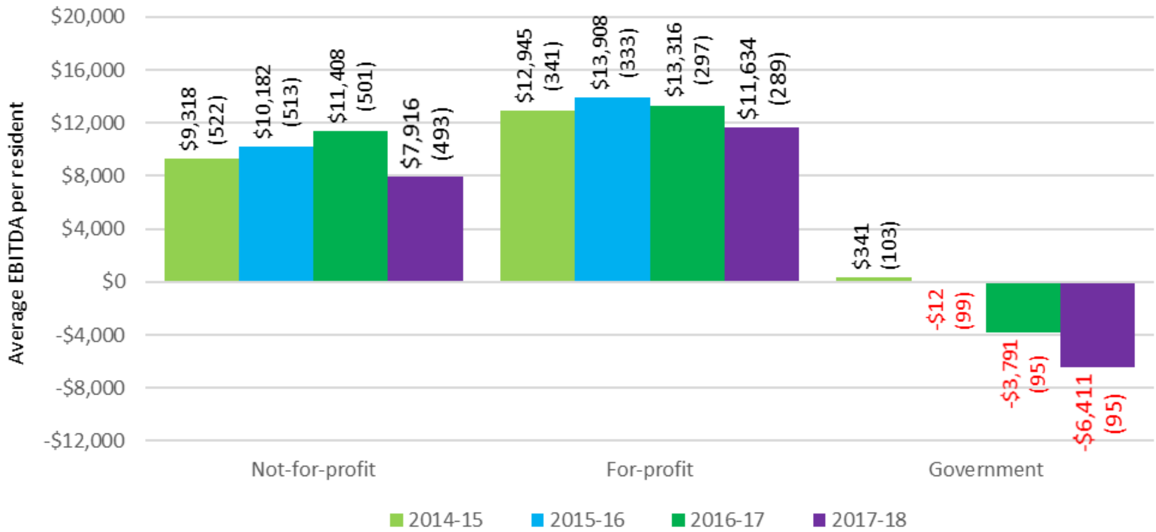
In 2017-18, growth in revenue for residential care providers was constrained by the Government's decision to change the scoring system for ACFI and pause indexation while their costs continued to grow, particularly wages.

Chart 5: Residential care providers average EBITDA per resident per annum, by quartile, 2015-16 to 2017-18



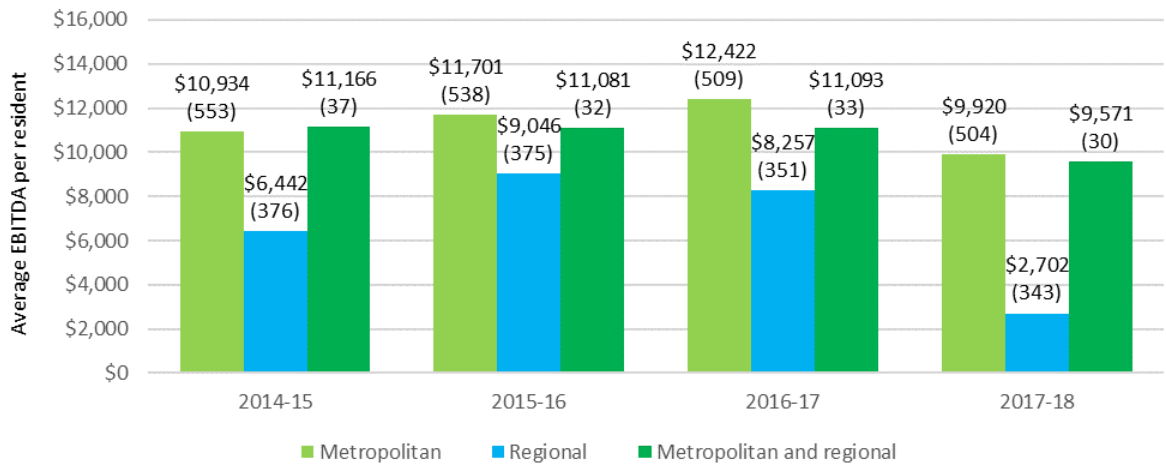
As in previous years, financial performance varied across ownership types, location and scale. The for-profit providers continued to outperform the not-for-profit providers and while the performance of both groups fell in 2017-18, the not-for-profit providers dropped significantly more than the for-profit providers (Chart 6).

Chart 6: Residential care providers average EBITDA per resident, by ownership type, 2014-15 to 2017-18



In terms of location, the EBITDA per resident per annum for metropolitan providers declined by 20 per cent to $9,920 in 2017-18. Regional providers recorded a very significant decline from $8,257 in 2017-16 to $2,702 in 2017-18 (Chart 7).

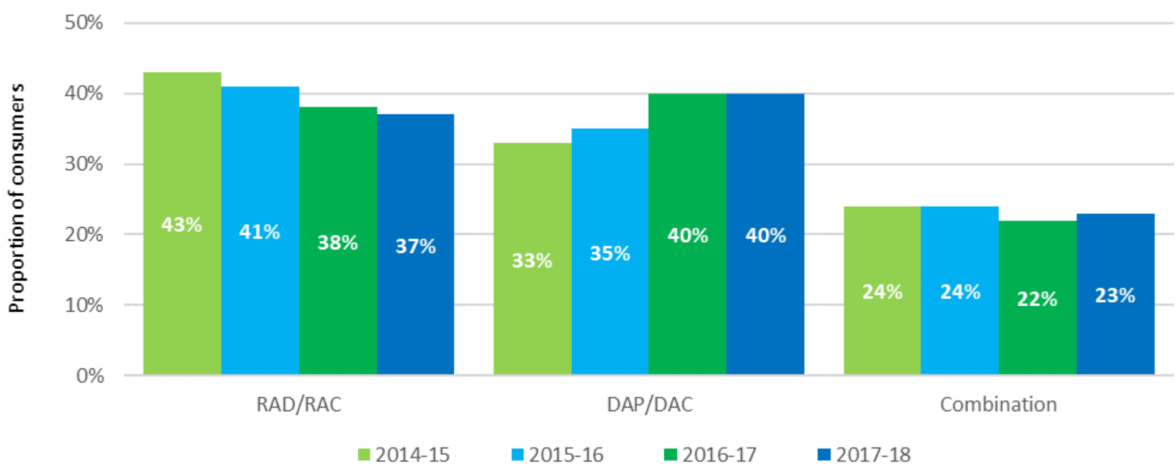
Chart 7: Residential care providers average EBITDA per resident, by provider location, 2014-15 to 2017-18



Residential care accommodation payments

In 2017-18, Daily Accommodation Payments (DAP) and Daily Accommodation Contributions (DAC) were slightly more popular than Refundable Accommodation Deposits (RAD) and Refundable Accommodation Contributions (RAC). The proportion of residents choosing RAD/RACs has dropped every year since 2014-15. The residents choosing DAP/DACs has gradually risen over the past few years (Chart 8).

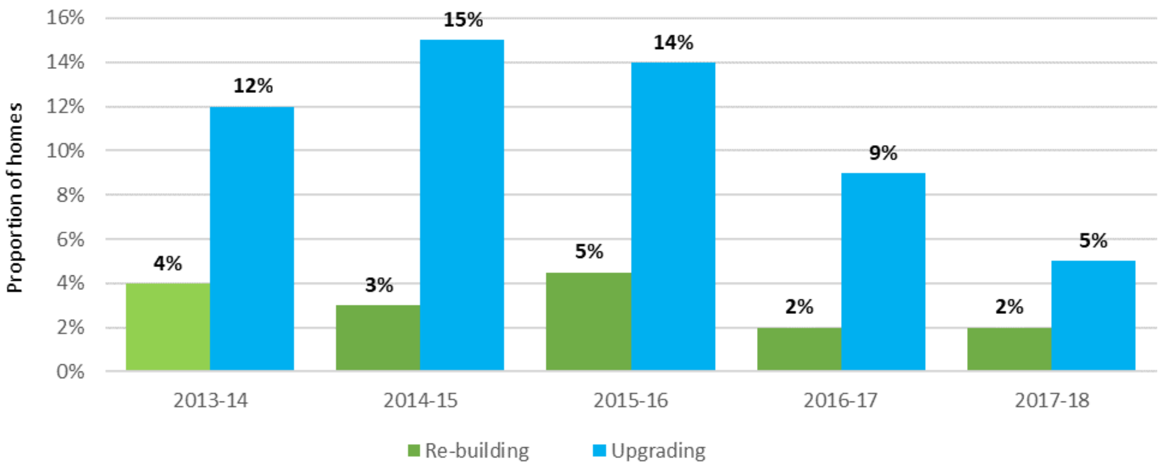
Chart 8: Resident method of accommodation payment, 2014-15 to 2017-18



Building and investment intentions

In 2017-18 there was a further decline in providers reporting they were planning to rebuild or upgrade their facilities (Chart 9). Providers cited depressed returns and policy and regulatory uncertainty, along with the potential impact of increased home care packages, as influencing decisions to defer capital investments.

Chart 9: Proportion of facilities planning to either upgrade or rebuild, 2013-14 to 2017-18

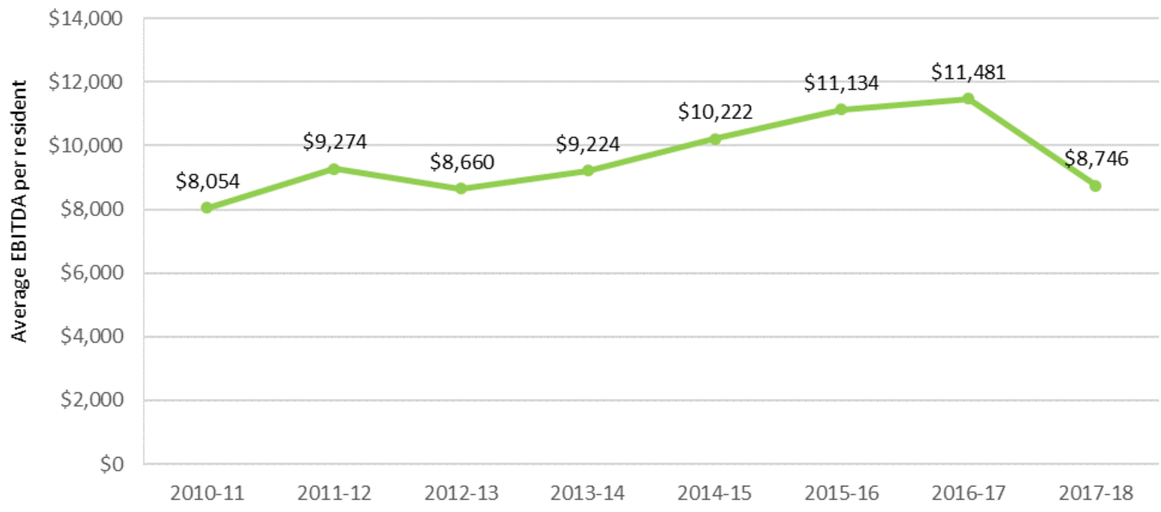


6. Financial performance of aged care providers in recent years

Residential care

The current financial performance of the aged care sector should be considered in the context of the industry over recent years. While 2017-18 was a difficult year for residential aged care providers with an overall decline in financial performance of the sector, and these difficulties have extended into 2018-19, over the period from 2009-10 to 2016-17, 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 10).

Chart 10: Residential care providers average EBITDA per resident per annum, 2010-11 to 2017-18



The financial performance of the residential aged care sector declined in 2012-13 (from EBITDA of $9,274 per resident per annum in 2011-12 to $8,660 in 2012-13) following a pause in ACFI indexation and adjustments to the ACFI funding tool. These were the same factors behind the decline in the overall financial performance of the residential care aged care sector in 2017-18. The performance of the residential sector 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 with a one-off 2.4 per cent increase in the base subsidy in 2014-15, which largely offset the impact of the indexation pause.

While up to 2016-17 there was a trend increase in the financial performance of residential aged care providers, there remained significant and long standing variance in performance across providers (Chart 5). This variance continued in 2017-18 when the overall financial performance of the sector declined. For example, while the average EBITDA per resident per annum in 2017-18 was $8,746, it was $21,812 for the top quartile of providers while the bottom quartile had a negative $10,355 per resident per annum

Overall, for-profit providers have outperformed the not-for-profit and government providers in terms of EBITDA margin and Net Profit margin (Chart 6). As regularly noted in ACFA reports, however, 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 regional and remote areas. Some providers have observed that the Government should welcome the fact that they are prepared to cross subsidise the provision of aged care services to segments of society who would otherwise be excluded. Other providers have indicated that they provide a level of care beyond that covered through Government subsidies and cover the loss from other operations.

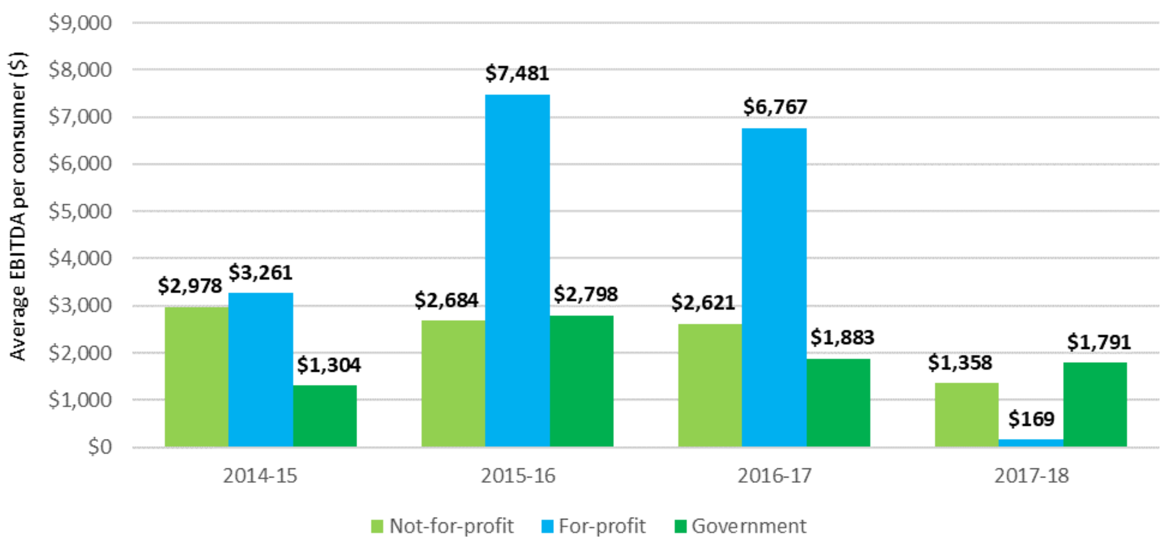
The overall financial performance of providers in regional locations is traditionally lower than for those in metropolitan areas. This was also the case in 2017-18. Previous analysis by ACFA suggests that when compared with metropolitan providers, those in rural and remote locations: receive less Government funding per resident per annum from ACFI (likely a combination of more low care residents and more limited access to health professionals to deliver higher level care); have significantly higher costs, particularly staff costs; receive lower average RADs; and have lower occupancy rates. Rural and remote providers receive a viability supplement and can access capital grants.

Home care

After years of broadly constant average returns, 2017-18 saw significant declines in both EBITDA (Chart 3) and NPBT per consumer for home care. There was also a significant variation in the performance of home care providers in 2017-18. The top quartile of providers had an average EBITDA per consumer of $7,766 in 2017-18 while the bottom quartile had an average loss of $3,409 per consumer.

After significantly outperforming the not-for-profit and government sectors in recent years, the for-profits reported the biggest decline in EBITDA per consumer in 2017-18 (Chart 11).

Chart 11: Home care EBITDA per consumer, by ownership type, 2014-15 to 2017-18



A notable feature in both 2016-17 and 2017-18 was the significant increase in the number of home care providers in response to the introduction in February 2017 of home care packages being assigned directly to consumers rather than to providers.

Another feature in recent years is the rise in unspent funds in home care packages. Prior to the changes to home care in February 2017, when consumers moved between home care providers or exited care, unspent package funds could be retained by the former home care provider. As part of the changes introduced in February 2017, unspent package funds now follow the consumer to their new home care provider or are returned to the Government and the consumer (based on their respective proportions) when the consumer leaves care. There are a number of possible reasons for the increase in unspent package funds, including consumers saving a proportion of their allocated funds for future possible events or the purchase of a specific item, the services a consumer is seeking not being available, or consumers not currently requiring all the funds they have been allocated. As at June 2018, providers were holding $539 million in unspent package funds, up from $329 million at June 2017. The level of unspent funds as at June 2018 equates to providers holding average unspent funds per consumer of $5,898.

7. Policy changes impacting on the financial performance of providers

As noted previously, 2017-18 was a difficult year for both residential care and home care providers.

Residential care

The overall deterioration in the financial performance of residential aged care facilities in 2017-18 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. Care related funding under ACFI is the main revenue source of aged care providers, accounting for 62 per cent of revenue in 2017-18 (Chart 12). **T**he main expense item for residential care providers in 2017-18 was employee expenses, which accounted for 70 per cent of total expenses (Chart 13).

Chart 12: Proportions of total residential care provider revenue, 2017-18

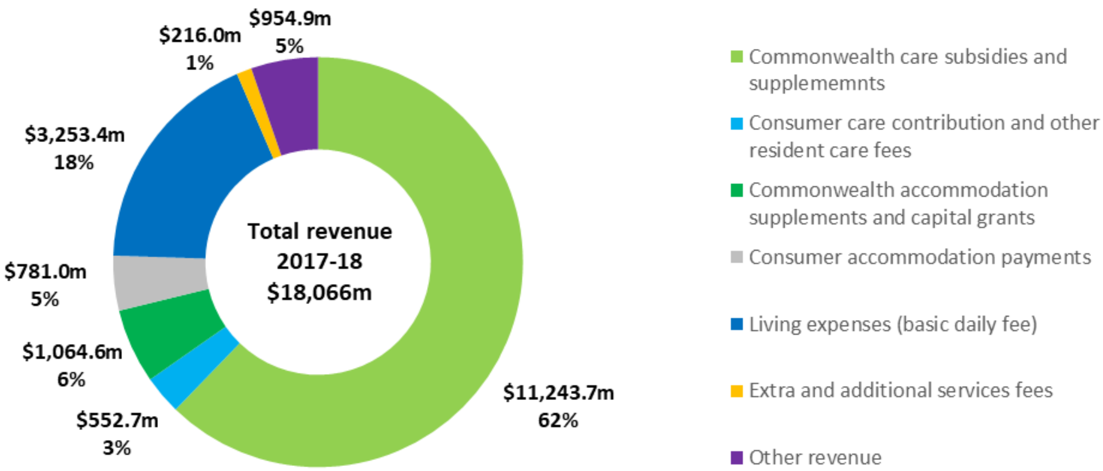
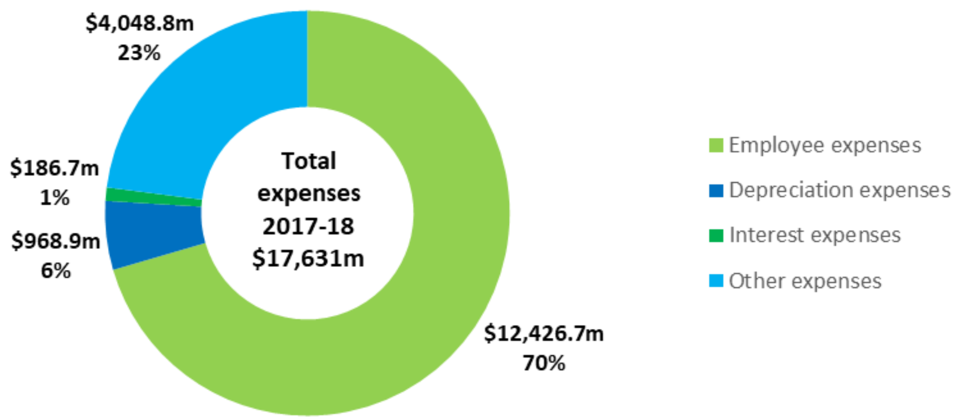


Chart 13: Proportions of total residential care provider expenses, 2017-18



With ACFI payments representing over 62 per cent of the revenue of residential care providers, it is not surprising that the steps by the Government to curb the growth in ACFI outlays had a significant 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 employee expenses accounting for 70 per cent of providers' expenses, continued growth in the largest expense item when income is being constrained clearly put pressure on the financial performance of the sector.

As noted previously, the downturn in the residential care 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 (Table 2). Conversely, the improvement in the overall financial performance of the industry in the years immediately prior to 2012-13 and 2017-18 corresponds with a rate of growth in ACFI payments, and in turn the income of providers, well above the growth in providers' expenses. 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 the ACFI 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 changes to ACFI that took effect in 2016 and 2017 were implemented in order to reduce the growth in ACFI expenditure so that it would be more in line with the budget projections. 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 ACFI subsidy rates, 2008-09 to 2017-18

	CPI (change between March quarters)	WPI (Health Care and Social Assistance)	Age Care Award 2010	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%	0.1%	0.1%
Average annual change	2.2%	3.1%	3.0%	1.6%	6.3%	4.6%
Cumulative change	24.7%	35.2%	_	17.1%	83.6%	56.8%

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.

Providers and the Government have differing views about the reason for the increase in ACFI claims prior to 2017-18. As noted previously, the Government's view is that 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 Government notes that the increase in ACFI claims was not limited to a few providers and was focused on areas of ACFI where there was more subjectivity in the tool. The implication of the Government's view is that a sizeable proportion of providers had been classifying residents as being in a high domain under ACFI, and claiming commensurate payments, when the actual care needs of the residents were 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, and an indexation pause would help recover some of the excess claiming.

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, reflected the care needs of residents and the frailty of residents were increasing. Providers say that changing the scoring for complex health care and freezing indexation for all providers was a blunt measure by the Government in response to concerns the Government may have had about the claiming behaviour of a few providers. Many providers noted that they took steps to lift their ACFI claims where they thought they were 'under claiming', but stress that their claims were in line with the care needs of the 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. Several providers have indicated 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 needed but for which they were not funded, or not delivering the full care that a resident needs.

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. Either way, the volatility in funding experienced under ACFI is not beneficial for either Government or providers.

Home Care

The major recent reform initiative in the home care sector was the introduction of packages following consumers which took effect from February 2017. This allows consumers to direct their care package to the provider of their choice as well as to change providers. As noted previously, this has resulted in a substantial increase in the number of home care providers and in turn competition between providers. The increase in provider numbers comprised both for-profit and not-for-profit providers, although the proportion of for-profit providers has increased.

With a significantly larger number of providers competing for home care packages, several providers have indicated that the competition has resulted in a decline in prices charged to consumers. (Since November 2018 home care providers have been encouraged to publish their current pricing information on the Service Finder on the My Aged Care website and, from 1 July 2019, providers will be required to publish their prices using a mandated template Pricing Comparability Schedule). While increased price competition is a benefit to consumers, it has negatively impacted on provider revenue. As noted previously, another important development since the introduction of home care packages following consumers is the significant increase in the amount of unspent package funds held by providers on behalf of consumers. From the providers' perspective, unspent package funds represent a missed opportunity to increase their revenue and financial returns.

While the increased competition resulting from the February 2017 changes to home care has put pressure on providers' revenue, the reforms also increased the costs for providers. Systems had to be changed so that each consumer had an itemised account of expenditure under their package, along with identifying the cost and price of each service. Providers also had increased costs associated with marketing services and targeting customers. Some providers indicated that as a result of the reform they had to attract new skill sets into their workforce. The home care sector is in a period of transition. Providers have to change their operations and processes to respond to consumer preferences and provide consumers with the information they require to make informed decisions.

8. Issues surrounding the outlook for the financial performance of aged care providers

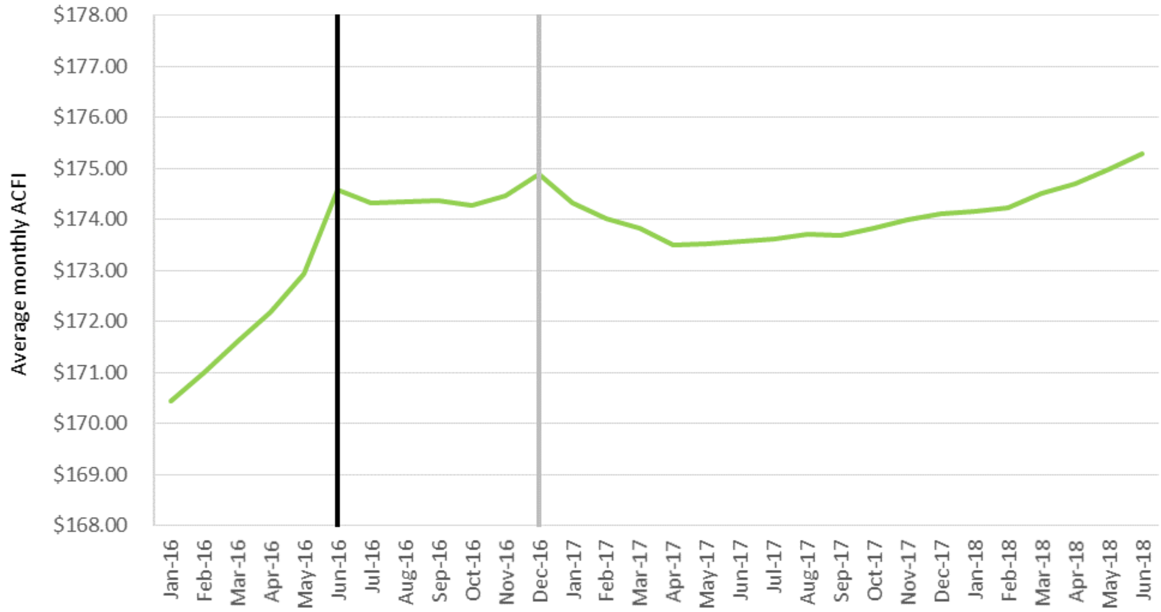
Future growth in ACFI

With ACFI contributing over 60 per cent of the revenue of aged care providers, it was to be expected that the changes to the ACFI tool in 2016 and 2017 and the pause in indexation, combined with ongoing growth in costs – particularly wages – would have a significant impact on the financial performance of providers. Many providers saw a decline in their profit/surplus in 2017-18. While traditionally around 30 per cent of residential care providers make a loss for a variety of reasons, such as not-for-profits pursuing their mission objectives, in 2017-18 the number of providers making a net profit was 56 per cent, down from 68 per cent in 2016-17. While all providers experienced margin pressure in 2017-18, some providers advised that the impact on their performance was cushioned as a result of new or refurbished facilities coming on stream which attracted a higher accommodation supplement.

In terms of the next few years (prior to a potential change to a new funding tool), much will depend on whether average ACFI payments per resident per day increase in real terms (as they did in the past), or whether more modest growth in ACFI remains.

The impact of both provider claiming behaviour and government policy change is evident in Chart 14. Prior to the June 2016 and January 2017 changes, provider claims increased noticeably. Following the changes to ACFI in 2017, there was a significant drop in overall ACFI claims, largely driven by lower average Complex Health Care claims and little growth in other ACFI domains due to providers not reappraising residents. From April 2017, the average ACFI claim has slowly grown.

Chart 14: Average monthly ACFI payments, January 2016 to June 2018



A number of providers expressed the concern that they would not be viable if over future years ACFI payments increased by around 1.5 per cent (1.2 per cent was the effective indexation rate for 2018-19 though the rate would have been 1.4 per cent but for a 50 per cent reduction in indexation in Complex Health Care for that year which is to be lifted in 2019-20) and wages continued to increase by 2.5 to 3 per cent. There is the prospect that growth in ACFI will not return to levels seen in the past. At the end of the first full year of ACFI in 2008-09, around 7 per cent of residents with ACFI classifications were 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 because of the expansion of home care packages.

Many providers indicated they reviewed their ACFI claiming procedures to ensure that they were not under claiming. Such adjustments may have resulted in sizeable growth in ACFI claims but it would not result in ongoing strong growth in ACFI revenue. If this is the case, the future growth in ACFI may be more in line with the underlying frailty growth in the population and this would represent a notable slowing in the rate of growth in ACFI compared with years prior to 2017-18. Such an outcome would have implications for the business model some providers have been pursuing.

Uncertainty around policy settings

The rationale for the changes to ACFI in 2016 and 2017 remains a point of contention with providers and is contributing to providers indicating that there is a degree of uncertainty over the direction of future policies

As outlined further below, a major factor raised by providers that is hindering future investment in the residential aged care sector is uncertainty over policy settings. The fact that providers continue to dispute the reasons for the changes to ACFI in 2016 and 2017 may mean they will have doubts over the rationale for future policy measures. For example, while there is wide recognition of the problems with ACFI and many providers support the current review of alternative funding models through the Resource Utilisation and Classification Study (RUCS), and in particular welcome a new model which will reduce their administrative costs, some remain sceptical, believing that the Government's focus will continue to be on restraining future budget outlays and any new funding model will not address the margin squeeze they are currently facing. The Government has indicated that the issue of overall funding is separate to reviewing the funding tool.

Incentive to diversify revenue streams

While all residential care providers indicated that 2017-18 was a difficult year given the changes to ACFI, the extent of concern appears to be influenced by the level of exposure to residential aged care. For example, listed providers are particularly sensitive to developments given their continuous exposure to market scrutiny and shareholder expectations. In addition, providers who were exclusively or predominantly concentrated on residential aged care were very concerned about developments and the ongoing viability of their organisations.

In contrast, residential care providers that are part of an organisation with a diverse range of activities and income streams are concerned about the financial performance of their residential aged care activities, but are inclined to take a longer-term view of developments, particularly in terms of future investment in the industry. As noted further below in the discussion on capital investment, a number of residential aged care providers have indicated they are seeking to diversify their revenue streams though increasing investment in other activities, such as independent retirement living. If policy changes are constraining the range of organisations prepared to expand aged care operations, particularly the participation of entities that specialise in aged care, this will constrain the overall efficiency of the industry and limit its capacity to meet the demands coming from the ageing of the Australian population.

Curtailing costs and quality considerations

The squeeze in margins as a result of changes in ACFI put pressure on residential care providers to constrain the growth in costs. With staff costs representing such a large proportion of expenditure, many providers have reviewed rosters in an effort to reduce staff hours. Some providers report that they have achieved savings, including redundancies, without impacting on care outcomes. Some note they have reduced ancillary workers and the provision of such services as life style activities, spiritual and pastoral care. Feedback from some providers suggests there was scope for significant efficiency gains and cost savings. The scale of operations is also becoming increasingly important, particularly with respect to administration and IT activities.

As regards wages, the Enterprise Bargaining Agreements (EBA) of many providers has seen wage increases of between 2 to 3 per cent. Wage increases in the aged care sector have been higher than elsewhere in the economy because many aged care workers' pay rates are at or 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 have emphasised that a significant increase in the minimum wage in the future will have a major impact on their financial position.

The ongoing pressure to keep costs as low as possible and achieve economies of scale is likely to increase the pace of consolidation in the residential age care sector (this is discussed further below).

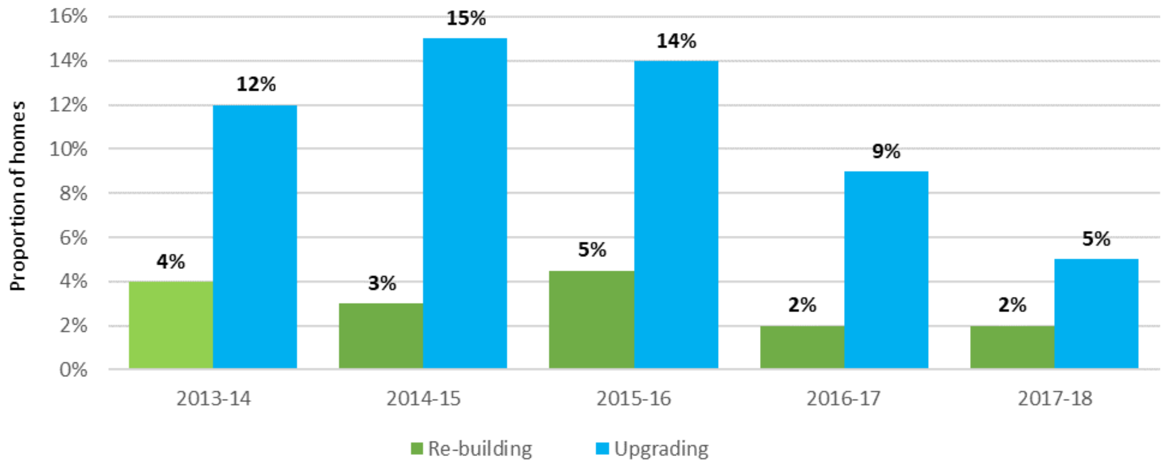
Providers have indicated that the increased activity of the Aged Care Quality Agency, now the Aged Care Quality and Safety Commission, has resulted in them having to devote additional resources to deal with quality audits. In the short-term, providers also note that they have borne additional costs as a result of the Royal Commission process. Feedback from many providers suggest that they feel they are being squeezed between pressure from increased quality audit activity – along with rising community expectations – to increase staff costs, and pressure to reduce costs in response to the constraints on the growth in their revenue. The impact of current pressures, both financial and quality, on staff morale appears to be significant and is reducing the attractiveness of the aged care sector as a place where people want to work when providers say a major challenge they face is attracting and retaining staff.

Investment plans

The financial results of some providers in 2017-18 and 2018-19 have benefited from new and significantly refurbished facilities coming on stream which are eligible for a higher rate of accommodation supplement from Government for lower means residents. The higher supplement was introduced from 1 July 2014 to encourage new investment and support access for lower means residents. This supplement, along with higher DAPs/RADs as a result of the refurbished or new facilities, has boosted provider revenue and helped offset the squeeze on margins as a result of the changes to ACFI. In addition, new and refurbished facilities are normally more efficient than older facilities. The accommodation supplement has helped reduce the large stock of older, multi-bed style room facilities. Another incentive for investment in rural and remote areas is the Government's capital grants program, which has recently been increased.

The investment decision for the new and refurbished facilities that have come on stream in 2017-18 and 2018-19 was taken several years ago. As evident in Chart 15, a large number of providers have curtailed or delayed future investment plans in the residential aged care sector. Providers cite compression in margins and uncertainty, including regulatory uncertainty, as factors influencing decisions to put investment plans on hold. Many for-profit providers say that the current return on capital employed in the residential sector is below the cost of capital and in the absence of any change, these providers will continue to reduce or hold-back investment in aged care.

Chart 15: Proportion of facilities planning to either upgrade or rebuild, 2013-14 to 2017-18



Some providers have expressed concern over the apparent shift from RADs to DAPs and RAD/DAP combinations (Chart 8). This is mainly noticeable in the for-profit sector and should the move away from RADs be maintained, this will impact on the capital funding model of affected providers and will require a restructuring of their business plans.

A further factor influencing investment plans is concern over occupancy rates. In 2017-18, the occupancy rate across all residential care providers was 90.3 per cent, down from 91.8 in 2016-17 and 92.4 per cent in 2015-16. This decline has occurred in the last two years following relative stability above 92 per cent for several years. But it is not the average occupancy rate which is relevant to an individual provider, but the occupancy rate they are experiencing. Some providers with occupancy rates in the high 90 per cent range indicated that a fall in their occupancy rate by a few percentage points would bring their viability into question. Similarly, they suggested that they would only contemplate new investment if there was the prospect of achieving a very high occupancy rate.

Given uncertainties in the outlook for residential aged care, along with the related desire of many providers to diversify their income streams and reduce their exposure to residential care, a number of providers have indicated that over the next few years they are planning to increase investment in other activities, particularly retirement living, rather than aged care. Supporting this trend is the concept of establishing integrated aged care operations involving retirement living, home care and residential aged care.

The implications of the curtailment of investment plans in terms of meeting the expected future demand for aged care services is discussed further in Section 9.

Viability of residential aged care providers

2017-18 was a difficult year for residential aged care providers given the changes to ACFI and rising costs. It is evident that 2018-19 is also a challenging year for, while indexation of ACFI has returned, providers note that the rate of indexation is well below the increase in their costs. As mentioned above, a number of providers are also concerned about lower occupancy rates and fear that adverse publicity over quality issues in the industry will further depress their occupancy rate.

In ACFA's consultations with providers, many welcomed the $320 million increase in general subsidies for residential care providers in 2018-19 announced by the Government on 10 February. Providers noted that this will assist their financial results in 2018-19 although many emphasised it was a one-off financial boost and did not deal with ongoing financial concerns.

Notwithstanding the financial pressures confronting providers in recent years, there is no indication that a large number are intending to reduce or cease operations. In particular, many of the not-for-profit providers have very large reserves which provide a significant buffer to fluctuations in their financial performance. Many of the for-profit providers are more exposed to volatility in their financial performance. A number of providers, both for-profit and not-for-profit, have registered that if the current compression of margins continues for an extended period, it will bring into question their long-term viability.

The feedback from consultations suggests, however, that a growing number of smaller providers, particularly in rural and remote areas (but not exclusively) are facing such pressures that they are considering or seeking to leave the industry. A number of providers, particularly in the not-for-profit category, said they have received an increasing number of approaches from smaller providers facing financial and quality concerns and who are seeking to sell their operations.

Many of the providers facing financial difficulties may be eligible for the viability supplement, which was recently increased, and they could take advantage of the announcement by the Government providing an advisory service for both residential and home care providers. The Government has said that this advisory service would be prioritised on rural and remote areas and smaller operators. However the feedback is that those providers facing financial difficulties leave it very late before seeking assistance or seek to sell their operation. Most of the providers receiving the approaches had declined taking over the provider in financial difficulties, mainly because the provider seeking takeover is not only experiencing financial pressures but also significant quality problems, with many facing sanctions. In the current environment, providers observe that it is a challenging task to turn around a significantly underperforming operation and it poses significant reputational risks.

Home care

Home care providers are likely to continue to experience a challenging business environment as they adjust to the introduction of home care packages following consumers. As noted previously, the initial impact of this reform has increased costs for providers while the increased competition sparked by the large increase in approved providers has put downward pressure on prices. The increase in the number of packages will increase potential consumers for all providers, although given the extent of the increase in the number of providers it is likely that there will be a shake-out and a number of providers will leave the market. Feedback from ACFA consultations suggest that some providers are already contemplating whether they will continue to offer home care packages.

Increased attention on ensuring quality may accelerate this move given that many established home care providers have questioned the quality of the services being provided by new entrants. Part of the additional funding for aged care announced by the Government on 10 February 2019 included additional money for auditing the quality and integrity of home care services.

9. Meeting future demand for aged care services

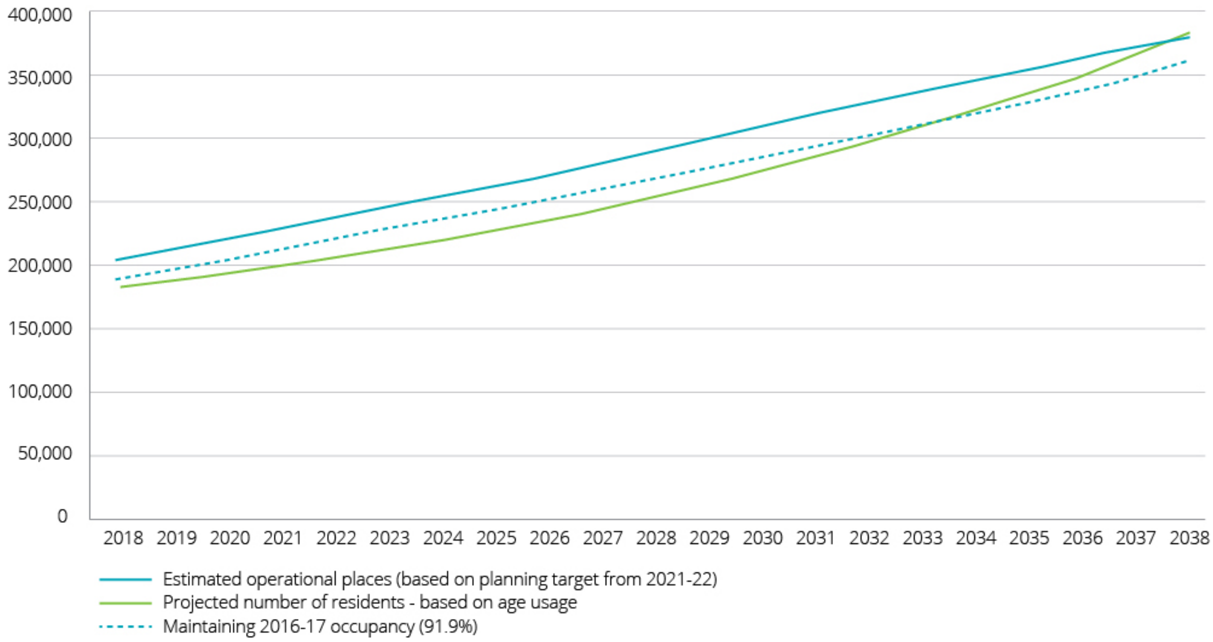
As noted previously, the ageing of the Australian population will see a marked increase in the number of Australians likely to need aged care. The rapid expansion of the number of older people, particularly in the oldest age groups, will result in a marked increase in demand for aged care services. By age 80, the proportion of people using either permanent residential care or a home care package is around 7 per cent. This doubles by age 85 and more than doubles again by age 90.

The profile of the ageing of the population and the proportionate growth in older age groups will not be smooth over the next decade. Because the baby boomers are such a large group compared with the pre-war generation, the proportion of the 70 and over population who are aged 85 and over will reduce over the next decade before subsequently increasing. As such, the challenge of ensuring there is sufficient aged care supply to meet demand arising from the baby boomer generation is more likely to be felt in 10 plus years' time than in the next decade. However the investment decisions to ensure that there is adequate supply to meet the expected growth in demand for aged care services, particularly residential aged care, 10 years from now will need to be taken over the coming decade.

One of the major uncertainties in considering the future demand of aged care services is the composition of that demand, particularly the interaction between home care and residential care and the impact of technology and innovation. As evident by the National Prioritisation System, the current demand for home care is not being met, whereas there appears to be evidence that demand for residential care is currently being met. Average occupancy rates for residential care have started to trend down towards 90 per cent. As the number of home care packages has increased, the proportion of people in each age group using residential care has decreased, suggesting some substitutability between home care and residential care. As such, the continued release of additional home care packages may reduce demand for residential care.

Chart 16 comes from ACFA's 2018 annual report and provides projections for the demand for residential aged care. The solid blue line is the expected number of operational places and grows at the same rate as the size of the population aged 70 years and older (the target provision ratio formula). The green line uses current age usage of residential care, both permanent and respite care, and projects this forward with population growth in each age group. The dashed blue line would be the usage of residential care if current occupancy levels were maintained. The gap between the green line and the blue line widens over the next decade because of the influence of the post war generation and eventually narrows as the baby boomers enter their 80s. The implication is that if residential care places are released in line with the existing target provision formula, this is likely to exceed the demand over the next decade, but demand will start to grow at a faster rate than the target provision ratio rate (based on the size of the population aged 70 years and older) towards the end of the decade. These projections do not take into account the potential impact on demand for residential care places coming from a significant increase in home care packages.

Chart 16: Projected demand for residential care, 2018 to 2038



In response to the changing demographics, the Tune review concluded that the current planning ratio will not be adequate to meet future demand and recommended changing the aged care planning ratio after 2022 to reflect numbers of consumers over age 75 rather than age 70, with this to be done in a way which would increase the number of places over time. As noted, however, demand for residential care places may shift in response to changing consumer preferences, the availability of additional home care places, particularly higher level packages, and the merging between retirement living and residential aged care.

The implication is that while the demand for aged care will clearly increase with the ageing of the population, it is unwise to make projections as to the specific supply response needed to meet this demand based on current usage rates. The supply response will have to be flexible and be responsive to changing consumer preferences, technological changes and developments in the aged care industry.

Nevertheless a significant capital investment will be required and this investment will largely come from the non-government sector, both for-profit and not-for-profit organisations. The challenge facing the Government is to ensure that the funding and regulatory arrangements in the aged care sector are such that it provides the ongoing environment that facilitates this needed investment. A key requirement in this regard is that the non-government sector has confidence in the direction and stability of Government aged care policies and those providers achieve a return such that it will attract the necessary capital and labour resources. The Government funding arrangements will also need to be flexible so that providers can respond and adapt to changes in consumers preferences for aged care services as well as innovate and embrace technological advances.

10. Funding and financing challenges in the aged care sector

To provide the level and quality of aged care services that older Australians require now and into the future, it is essential that the aged care sector is financially viable, stable, efficient, effective, responsive and sustainable. It is evident from developments in the sector over recent years that it faces many hurdles in achieving this objective. These include:

- ACFI has not provided a stable and effective care funding tool for both the Government and providers. The Government has been concerned that the growth in ACFI payments has exceeded the underlying growth in the acuity of the Australian population and subsequent changes it has made to ACFI arrangements have had a significant impact on the financial performance of aged care providers. A sizeable proportion of residential aged care providers are currently making a loss and a number of smaller providers are seeking to leave the industry while many are concerned about their ongoing viability if current financial trends are maintained. Overall, under the ACFI funding tool there have been cycles of high growth followed by low or no growth causing uncertainty for providers, investors and the Government. Moreover, the current ACFI arrangements cannot satisfactorily resolve the extent to which resident's care needs have been increasing over time compared with the extent to which providers have maximised the potential to use the ACFI tool to increase revenue growth (including in response to low indexation). ACFI is also administratively complex for both providers and the Government and has resulted in the sector diverting resources away from delivering care. In addition, ACFI has some perverse incentives that may encourage outdated modes and types of care and lead to inefficiencies with providers focusing on ACFI claiming rather than the needs of residents.

- Volatility, uncertainty and margin pressures have resulted in many residential care providers putting investment projects on hold while they assess the future direction of the market and reforms. In addition, a number of providers are investing in activities other than residential aged care in order to diversify their revenue sources and reduce their exposure to the volatility in the aged care sector.

- These developments are not consistent with establishing the environment necessary for facilitating the investment needed to meet the needs of an ageing population.

- The Government continues to fund the bulk of the cost of aged care notwithstanding the Living Longer Living Better reforms which introduced changes to means testing. As noted in the Tune Review*,* in the case of residential care the Government's share of the overall average cost per resident per year only reduced to 65.6 per cent under the post-reform means test compared with 68.3 if the pre-reform arrangements were applied. The Tune Review observed that, given the demand and costs of aged care will increase significantly in the future, it is likely to be unsustainable for the Government to continue to cover two-thirds of the cost of aged care and there is a strong case to increase the proportion of costs that are met by consumers.

- The contribution aged care residents make to the cost of their everyday living expenses (such as food, linen, utilities) is capped at 85 per cent of the single pension. StewartBrown estimates that this is nearly an average of $8 per bed per day below the cost of providing these services. One area where providers can boost their revenue, and the level of services available to residents, is through the provision of additional services for a fee. However there remains considerable uncertainty as to what additional service fees are permitted and this is precluding a number of providers charging additional service fees to residents who can afford to do so, even where the providers are already providing the additional services.

- There is a wide diversity in the financial performance of providers in both the residential and home care sectors. There are providers, irrespective of size, ownership type and location, who are achieving good returns (albeit somewhat lower than in the past) under current funding arrangements. While a range of factors would be affecting the individual performance of providers, including in particular the demands facing providers operating in rural and remote areas, the magnitude of the variance in financial results suggests there is scope for many providers to improve their operations and performance.

- The introduction of home care packages following consumers has increased competition in the home care market and compressed providers returns. Given the large increase in the number of approved providers, there is likely to be some rationalisation of providers in the future which could cause some disruption for consumers. A major development is the rise in unspent funds, which may mean that some consumers are not receiving all the care they require and is forgone business for providers. It may also indicate that some consumers could have been assessed as requiring more funding than they actually need. There are also prudential considerations in ensuring that the unspent funds being held by providers is available to be spent on consumers when required or returned to the Government if the consumer leaves home care. Providers also have to be more flexible in adjusting their procedures and processes so that they are more responsive to what consumers are seeking.

11. Some characteristics of a viable and sustainable aged care system

One of ACFA's functions is to provide advice on the impact of funding and financing arrangements on the viability and sustainability of the aged care system. In pursuing this task, and against the background of developments in the aged care sector in recent years, ACFA has identified from a funding perspective a number of characteristics of a viable and sustainable aged care system.

i. Confidence and Trust

The overriding challenge facing the Government is maintaining confidence and trust in the quality of aged care services and the funding and financing arrangements for the sector. Towards achieving trust, the regulatory and funding arrangements have to be stable, understood, and transparent. Trust is essential because, while the Government is the main source of funding for aged care, the services are primarily delivered by the non-government sector – for-profit and not-for- profit providers. These providers will not invest in the sector, nor will they be able to attract the required staff, unless they understand the basis of regulation, the Government's approach to the funding of the sector, and they have confidence in the adequacy and stability of Government policies. From the consumer perspective, there needs to be trust in the quality of care people will receive from the aged care system for this will influence the preparedness of consumers and their families to seek the support that they need.

ii. Stable, predictable, efficient, equitable and effective arrangements for allocating Government funding

There needs to be a stable, efficient and effective residential aged care funding tool which provides financial stability to both aged care providers and the Government. The Government also has the challenge of ensuring that the funding tool is consistent with achieving ongoing equity of access for all consumers and that it does not incentivise outmoded or inefficient care practices and use of resources. The current review of alternative residential care funding arrangements and the Resource Utilisation and Classification Study (RUCS) is an important exercise. Desirable features of a new funding tool include: administrative simplicity; funding assessments external to the provider; equitable allocation of funds based on the mix of residents and their needs; recognition that many care costs are shared between residents; transparent studies to determine the cost of care; and indexation arrangements that adequately reflect movement in costs. In introducing a new funding model, it will be important to ensure that providers have confidence in the new arrangements. The new system needs to be transparent, robust and evidence based to achieve this objective. Similarly, there needs to be stable and efficient funding arrangements for home care that ensure that targeted care is available for all consumers. The home care funding arrangements should also be based on transparent studies to determine the cost of care.

iii. Appropriate overall funding

Efficient arrangements for equitably allocating funding across residential care providers and home care consumers are necessary, but it is also important that the overall funding pool for the aged care system is adequate and sustainable. The funding has to be sufficient to meet the level and quality of aged care needs of current and prospective Australians and in doing so provide the incentive for providers to invest in the industry. The level of funding provided by the Government has to support the delivery of quality aged care services required by Australians but it should not support inefficient or poorly managed providers nor should it provide higher than necessary funding.

The Government needs to ensure that the Budget forecasts of aged care spending are as realistic as possible. Aged care is a sizeable and growing component of the Commonwealth's budget and its importance will grow in line with the ageing of the Australian population. An overshooting of aged care expenditure can cause problems for the management of the Government's accounts and bring into question its fiscal sustainability. It is not, however, a simple matter to determine the appropriate amount of funding for the aged care sector, although it is an issue that requires careful consideration. The sector is very diverse and the financial results of providers vary depending on business structures, financing arrangements, and motivations, including those who are mission based. In addition, the Government has to take into account the range of aged care services sought by the community along with the extent to which consumers will contribute to the cost of their aged care.

It is important to ensure that the Government's contribution to care costs reflects the growth in these costs over time, although the indexation methodology should also make allowance for achievable productivity improvements. While the indexation rate for ACFI has been markedly lower than the rate of growth in the costs of providers, particularly wages, if the new funding model reduces the capacity of providers to boost their revenue through claiming behaviour, it will be important that the new indexation arrangements adequately reflect the growth in costs (while providing an incentive for productivity gains). It may take around two years before a new aged care funding tool is introduced. In the meantime the Government will need to ensure that the indexation of ACFI rates is appropriate and address the financial pressure confronting the industry.

iv. Funding that is flexible and adaptable to changing demographics and demands

The demographics of the Australian population are such that there will be increasing pressure on funding for aged care, both residential and home care. Demand will change and there will be innovations in the way services are delivered and the interaction between aged care and other sectors, such as retirement living and hospitals. The funding arrangements have to be responsive to these changes and should not deter but rather encourage innovation.

Currently the provision of residential aged care places and home care packages is determined by the Aged Care Provision Ratio (the Ratio). The Tune Review concluded that while it would ultimately be desirable for the supply of aged care to be uncapped, significant work needed to done before the government could safely remove supply controls while ensuring the system was fiscally sustainable for the government and equitable for consumers. Specifically, before uncapping supply there needs to be: an accurate understanding of underlying demand; equitable and sufficient contributions by consumers to their cost of care; a robust system for assessing eligibility for subsidised services; and provisions for ensuring equitable and continuing supply of aged care services in places where there is limited choice and competition.

There has been progress on some of these requirements but, before they are all met, the Tune Review made a number of recommendations to improve the flexibility of current arrangements, including to change the population cohort on which the planning Ratio is based, from people aged 70 years and over to people aged 75 years and over, which would allow the overall supply of aged care to better match the key demand driver in aged care, namely the ageing of the population. All these measures are consistent with ensuring the sustainability of the aged care system.

v. Equitable contribution to costs by consumers

Sustainable aged care funding arrangements will require consumers who can afford to do so making a greater financial contribution towards their residential everyday living expenses and care costs, complemented by a greater choice of higher quality services. This would involve stronger means testing arrangements for care fees, in line with the recommendations of the Tune Review, which would reduce pressure on Government expenditure.

In addition, uncapping the basic daily fee for residential care for consumers who can afford to pay would boost the revenue of residential providers and for some may provide the opportunity of dispensing with charging fees for the provision of additional services. There is currently uncertainty over what are permissible additional services that aged care providers can offer residents for a fee. Another recommendation by the Tune review which should be pursued is requiring that providers charge the income-tested care fee in home care and that the value of the basic daily fee is proportionate to the value of the home care package. There is also a need to improve consumer understanding of the fees they may be asked to pay so that they can more effectively plan for their aged care.

vi. Effective prudential oversight

Effective prudential oversight of the aged care sector is necessary given that the range of current and prospective reforms and developments are likely to be disruptive to a number of providers. The current tight operating conditions will likely be accelerating the trend towards greater consolidation in the residential aged care market. There is also evidence that some providers are thinly capitalised (relatively higher proportion of liabilities to assets) and as a result are more exposed to financial and economic risk events. After a period of very strong growth in home care providers, it is likely that this will be followed by a reduction in the number of providers. In both residential and home care, there will always be a role for smaller operators, but the current tight conditions will likely put pressure on less efficient providers and those unable to achieve economies of scale.

An increasing number of marginal providers will likely need to sell or merge with other providers. Such a trend will lead to a more efficient and resilient aged care sector, however the adjustment should be orderly and any impact on consumers should be minimised. Towards the end, the Government should be proactive in identifying providers facing difficulties, providing advice and support to such providers, and if necessary facilitate the sale or transfer of facilities or operations to another provider. This may require the Government contributing to meet the costs associated with a provider taking over another facing significant financial and likely quality, difficulties.

vii. Sound management and governance arrangements

A sustainable aged care system will require well managed aged care providers with sound governance arrangements. It will also require adequate sources of financing to support the level of investment required to meet current and future demand for aged care services. Providers need to look at their internal operations to ensure they are delivering care in the most efficient and effective way. The changes taking place in the sector as it moves towards a more consumer driven and market based system will continue to challenge traditional business and workforce models. Providers have to take the lead in shaping the aged care workforce to take the industry into the future by implementing in full the recommendations of the Aged Care Work Force Strategy Taskforce. Providers will need to be increasingly responsive and flexible. For some providers this may include adjusting their business models to deal with an apparent shift from RADs to DAPs. Under the current funding system there are very diverse financial outcomes, with the top quartile of providers in terms of profit continuing to achieve significantly better results than the lowest quartile. The very wide variation in financial performance across the sector suggests there is scope for many providers to pursue greater efficiencies and improve their results. Towards this objective, all providers should seek to ensure that their governance arrangements and management capabilities are best practice.

Appendix A

ACFA membership and Structure

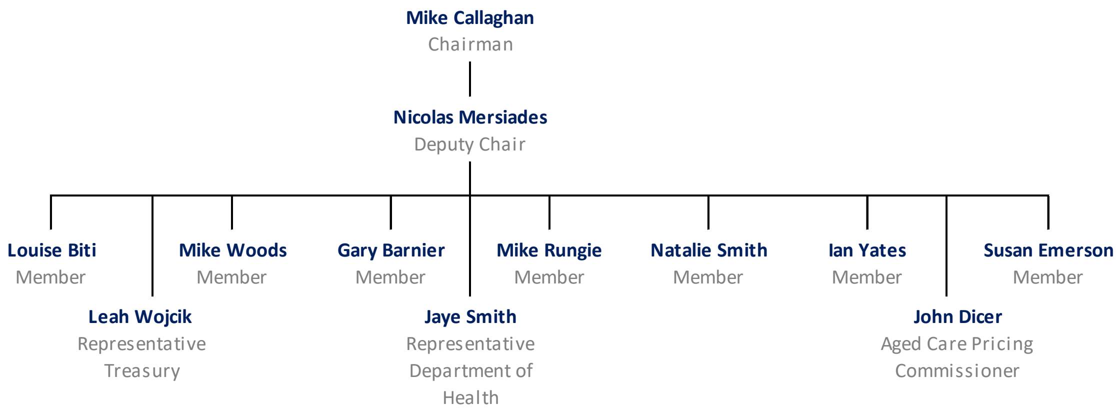
Members

ACFA position	Name	Organisation
Chairman	Mr Mike Callaghan	Economic consultant
Deputy chair	Mr Nicolas Mersiades	Director Aged Care, Catholic Health Australia
Member	Mr Ian Yates AM	Chief Executive, COTA Australia
Member	Mr Gary Barnier	Former aged care executive, independent advisor
Member	Mrs Natalie Smith	Head of Business Execution, Business and Private Bank, ANZ
Member	Prof Michael Woods	Professor, Centre for Health Economics Research and Evaluation, UTS Business School
Member	Dr Mike Rungie	Former CEO, Aged Care Housing Group
Member	Ms Susan Emerson	General Manager Equip for living and Leef Independent Living Solutions SA/NT
Member	Ms Louise Biti	Director, Aged Care Steps

Government representatives

ACFA position	Name	Organisation
Representative	Mr Jaye Smith	First Assistant Secretary, Ageing and Aged Care Group, Department of Health
Representative	Mr John Dicer	Aged Care Pricing Commissioner
Representative	Ms Leah Wojcik	Manager, Health and Disability Social Policy Division, Department of the Treasury

Structure



Appendix B

ACFA Reports to Government

Work	Date of publication
ACFA's report on understanding how consumers plan and finance aged care	Published 24 December 2018.
ACFA's report on respite for aged care recipients	Published 28 November 2018.
ACFA's Update on Funding and Financing issues in residential aged care industry	Published 5 November 2018.
2018 ACFA Annual Report on Funding and Financing of the Aged Care Sector	Published 28 August 2018.
2017 Annual Report on Funding and Financing of the Aged Care Sector	Published in August 2017.
Application of the Base Interest Rate	Published in June 2017.
Bond Guarantee Scheme	Published in May 2017.
Report to Inform the 2016-17 Review of Amendments to the *Aged Care Act 1997*	Published in June 2017.
Access to Residential Care by Supported residents	Published in February 2017.
2016 Annual Report on Funding and Financing of the Aged Care Sector	Published in August 2016.
Report on Issues Affecting the Financial Performance of Rural and Remote Providers, Residential and Home Care	Published in February 2016.
2015 Annual Report on Funding and Financing of the Aged Care Sector	Published in August 2016.
Report on Factors Influencing the Financial Performance of Residential Aged Care Providers	Published in June 2015.
Report on Improving the Collection of Financial Data from Aged Care Providers	Published in October 2014.
Reports on the Impact of Financial Reforms on the Aged Care Sector	Monthly reports - August 2014 to April 2015. Quarterly report s – September 2015 to June 2016.
2014 Annual Report on the Funding and Financing of the Aged Care Sector	Published in August 2014.
Supported Residents Data Book	Published in May 2014.
Interim advice to the Minister on Improving the Collection of Financial Data from Aged Care Providers	Published in August 2013.
First Annual Report (2013) on the Funding and Financing of the Aged Care Sector	Published in July 2013.
Estimation of the possible impacts on revenue and balance sheet funding from changes to accommodation payment arrangements	ACFA's advice and KPMG modelling published in May 2013.
The framework for setting accommodation payments in residential aged care	Final ACFA advice provided to Minister in November 2012. Government announced its position in December 2012. Further advice on the method for determining a RAD and a DAP using a MPIR provided to Minister on 17 May 2013. Government announced its position on 23 May 2013.