

Implications for the residential aged care industry

Caring for Older Australians – Productivity Commission Report

September 2011



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The reform agenda

In August 2011, the Government publically released the Productivity Commission's final report entitled *Caring for Older Australians*.

This research represents the most comprehensive review of the aged care industry since the Review of Pricing Arrangements in Residential Aged Care 2004 (The Hogan Review). The Productivity Commission has consulted extensively and made use of over 900 submissions to the public inquiry and draft report to produce a well balanced report proposing a major overhaul of Australia's aged care system.

The report has been released at a time when Australia's rapidly ageing population faces a [dramatic slow down in investment in the aged care industry](#).

The Productivity Commission has addressed most of the issues raised by Grant Thornton Australia in our response submitted to the Inquiry. The majority of [our recommendations made in relation to the draft report](#) have been adopted.

The Australian Prime Minister formally released the report on 8 August 2011 and the media response to the review has been generally positive. Strong support from the industry and the Council of the Ageing (COTA)

reflects the success of the report in addressing consumer and provider concerns for the future of aged care.

What has been proposed?

Fundamentally, the Productivity Commission has recommended a comprehensive overhaul of the aged care system to facilitate greater levels of choice, innovation and responsiveness, whilst ensuring there will be equity of access to care. Importantly, the report recognises the need to establish sustainable funding models to achieve a balance between service quality, commercial viability for providers, and sustainability for the taxpayer.

The key initiatives/changes proposed in relation to residential aged care are to:

1. Establish an Australian Seniors Gateway Agency to provide information, needs assessment, care coordination and referral services
2. Introduce an entitlement based assessment and funding system in which consumers have choice in relation to the services they receive and the environment in which they receive them
3. Remove the distinction between high care, low care and extra

services, allowing all residential aged care facilities to charge accommodation bonds

4. Uncap the restrictions on accommodation charges, enabling residents more control over their services environment and delivering more appropriate returns to providers who meet that demand. Consumers would have choice in relation to payment options for accommodation via bonds or periodic charges
5. Introduce the Australian Home Credit Scheme to allow consumers of aged care services to draw down on the value of their principal place of residence without having to sell the family home. For those who do sell, an Aged Pensioners Savings Account scheme would allow them to deposit surplus proceeds while preserving their pension entitlements
6. Establish a schedule of prices for care services based on comprehensive benchmarking research; and
7. Gradually remove supply constraints on both residential aged care and community care, whilst increasing allocations during the transition.



Under the proposed reforms, responsibility for aged care regulation and pricing would be transferred to an Australian Aged Care Commission (AACC) and aged care policy responsibilities would remain with the Department of Health and Ageing.

The timelines for the most critical initiatives are summarised below.

Implementation Plan – Critical Initiatives		
Stage 1 – within 2 years	Stage 2 – within 2-5 years	Stage 3-5 years and beyond
1. Establish Gateway Agency, new Australian Aged Care Commission (AACC) and Pensioner Savings Account scheme	1. Introduce entitlement based assessment and funding system	1. Remove supply regulations for both residential and community care
2. Remove distinction between high care, low care and extra services (allow bonds for all)	2. Introduce Home Credit scheme	2. Conduct a public review of reform initiatives and improve as required
3. Uncap accommodation charges	3. Set care prices based on comprehensive cost assessment by AACC	
4. Increase community care places by 20% above Aged Care Approvals Round (ACAR) baseline		
5. Increase supported resident supplement		
6. Conduct benchmarking of aged care costs		

Although the proposed reforms have been referred to by some as radical, Grant Thornton considers that the measures represent a fundamental necessity if the industry is to grow and adapt to support the growing number of older Australians that will require aged care services.

In this context, we believe that the relaxation of regulatory constraints is inevitable regardless of the Government’s response to the Productivity Commission’s recommendations. The principal uncertainty is around the timing of the changes and the means through which the price and supply deregulation process is managed.

The Government is conducting stakeholder consultation on the recommendations and a formal response can be expected ahead of the 2012 Federal Budget, although the industry and broader stakeholders would hope for an early outcome. Many operators are already planning for the changes and are considering their role in the next stage of the industry’s evolution.

What does it mean for the industry?

The most substantial changes impacting upon operators in the residential aged care industry would result from the establishment of entitlement models and the relaxation of regulatory restrictions over supply (approved places) and price (resident capital and recurrent contributions).

The Productivity Commission's report correctly concludes that the creation of a responsive and competitive market will require providers to change their business models and will test the management skills of some. The extent to which these changes represent a threat to existing operators will depend largely on their capacity to adapt and capitalise on their existing strengths.

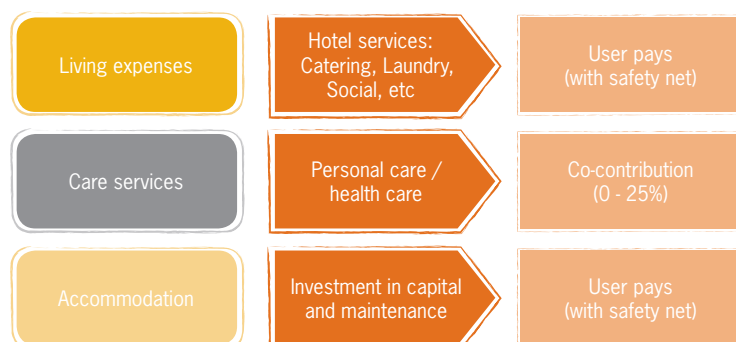
From the provider's perspective, the challenge and opportunity is to address the three critical factors that will be paramount in this new environment:

1. Resident co-contributions and pricing
2. Increased competition; and
3. Capital funding.

1. Co-contribution and pricing

The Productivity Commission has recommended that the users of aged care services should make a greater contribution to the cost of their care, which is similar to the approach proposed in the [UK Dilnot Report Commission on Funding of Care and Support - July 2011](#). The Productivity Commission proposed that prices would be established through a combination of market forces and the provision of subsidies reflecting the real cost of delivering care and related services.

The diagram below summarises the funding streams:



Our predictions relating to the major market changes are based on [our experiences in Australia and in less regulated operating environments](#) overseas. Assuming that an appropriate implementation strategy is adopted for future resident/subsidy contributions, the following critical changes can be expected in Australia:

1. Substantial growth in investment in high quality aged care services and infrastructure underpinned by commercially viable business models
2. Greater levels of competition between providers, driving service innovation, consumer choice and efficiency. Strong service integration driven by entitlement models
3. Accelerated redundancy of older residential aged care facilities and the rationalisation of existing services
4. Downward pressure on very high individual accommodation bonds (super-bonds) and competitive pressure on some extra service facilities; and
5. New foreign and domestic entrants into the market and consolidation among existing providers.



These initiatives open the door to a more viable industry in which consumers are able to exercise choice in relation to accommodation and services. The burden for doing so will drive higher expectations for value and quality.

The current over-regulated system limits choice and the capacity for consumers to influence service standards. Prices for accommodation charges and hotel services (catering, laundry, entertainment, etc) are capped in the majority of cases and this inhibits service innovation.

Under the proposed reforms, consumers will be expected to contribute to the full cost of these services, where they can afford to pay, as well as a limited proportion of personal and health care costs. Prices would be subject to negotiation with those receiving services.

Grant Thornton research confirms the Productivity Commission's conclusion that the provision of aged care services in modern facilities is not financially viable. This is largely because of the over regulation of pricing under the Aged Care Act 1997. In the absence of such restrictions, providers would be able to charge a commercial price for their services and can expect Government subsidies that are adequate to cover care costs.

Establishing appropriate pricing will require more than just an assessment of current operating costs. In a competitive environment, price will be determined

more directly by the value perceived by residents and their families than provider resource inputs.

Providers will have to capitalise on their knowledge of resident priorities and preferences to design innovative services that are both valued and affordable. Their capacity to let go of redundant aspects of their current service models and adapt to increased competition will be paramount in a less regulated pricing environment.

2. Increased competition

Grant Thornton anticipates that the proposed reforms would result in increased levels of investment and greater levels of service innovation. However, the level of competition for business in a more commercial and dynamic market will be a new paradigm for most operators.

We are already observing new investment in the Australian aged care sector from foreign interests, drawn to our relatively affluent and rapidly ageing population. Some of these investors are currently operating in countries more accustomed to competing in less regulated conditions.

The proposed relaxation of supply constraints will remove the protection afforded to current facilities under our existing managed bed policy. **Our experience in New Zealand** indicates that heightened consumer expectations, particularly in affluent areas, can result in aggressive competitive behaviour. Operators with strong, flexible service

models and access to capital are able to establish themselves in the catchment areas of existing operators who do not meet market demand. The resulting impact on occupancy levels and the workforce can result in service closure.

While many operators have voiced their concerns at this threat, the Productivity Commission's priority has been for the sustainable improvement of service levels for consumers and not the protection of established operators.

To prevail in this new world, providers must leverage their superior knowledge of the communities in which they operate, their established care service models, workforce and reputation.

Based on their understanding of their community, providers can determine whether current service models are likely to remain competitive in a more dynamic environment and develop strategies for their adaptation and the upgrade or redevelopment of their building stock.

3. Capital funding

The Productivity Commission has recommended the removal of restrictions on the payment of accommodation bonds in standard high care which would dramatically increase the proportion of consumers who could pay refundable entry contributions in residential aged care.

At the same time, providers would be required to offer periodic accommodation charges as an alternative

(and set at a commensurate value) to accommodation bonds.

The move has raised concerns about the potential decrease in bond receipts across all forms of residential care if residents prefer to pay periodic accommodation charges. Although future preferences are difficult to predict, we do not share the same level of concern. There are several reasons why the number of accommodation bonds might actually increase over the short to medium term.

3.1 Investment stimulus requirement

Although we anticipate the entrance of new market participants in the future, it will be established Australian operators that will drive the initial development and the redevelopment of the country's aged care building stock. Grant Thornton estimates that an investment of approximately \$21 billion will be required in the short and medium term.

Few existing providers have the cash reserves to undertake new developments or redevelopments at a cost of over \$180,000 per bed (excluding the cost of land) without resident capital contributions. Lending horizons for Australian financial institutions are relatively short and the use of accommodation bonds is a well established mechanism for the repayment of bridging finance.

The success of the Productivity Commission's vision for a rejuvenated industry is dependent upon new investment by providers. Future reform implementation strategies will need to facilitate access to resident capital contributions. In the longer term, operators and their financiers will develop alternative capital financing models on the back of the more profitable operating models. This will help reduce dependence on accommodation bonds for new developments.

3.2 Resident preferences

Residents currently paying accommodation bonds have been assessed as requiring low care services (or extra service high care). The average length of stay for low care residents is

approximately 36 months compared to high care entrants of 15 months (Department of Health & Ageing 2011).

The introduction of accommodation bonds for standard high care may not appear attractive given the likely duration of stay. However, many high care extra service facility operators have been successfully operating under this model for many years.

Feedback from the Productivity Commission indicates that the proposed Australian Aged Care Home Credit Scheme can be used to draw down accommodation bonds against the value of the resident's home. This means that the resident can retain their home, and often their pension, while incurring a servicing cost to the Government limited to the Consumer Price Index.

Alternatively, the Aged Pensioners Savings Account scheme can be used to deposit the surplus from the sale of the home after paying an accommodation bond and the pension would be preserved.

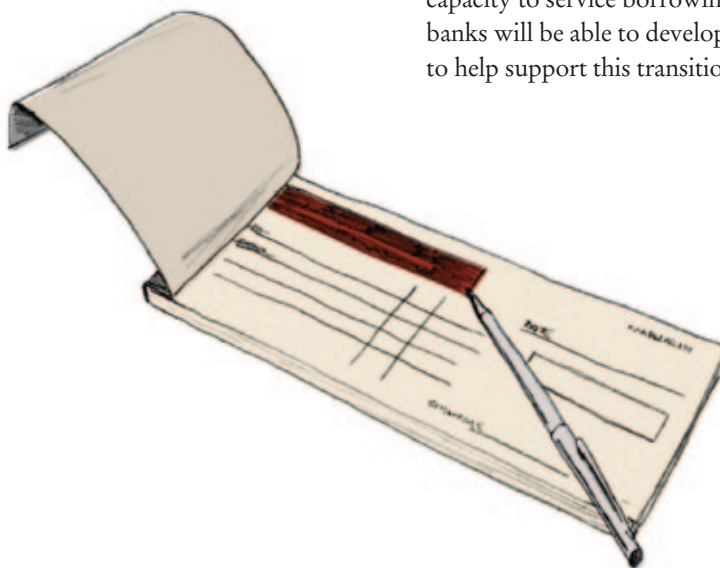
Conversely, a resident paying periodic accommodation charge instead of a bond must meet the providers' cost of capital. This would be substantially greater than CPI charges from the Home Credit Scheme (or no charges from funds from the sale of the home) and represents a disincentive for consumers to pay accommodation charges in lieu of a bond.

3.3 Alternative capital contribution models

With the establishment of entitlement models, the resident's capacity to influence the setting in which they receive care will drive the creation of a broader spectrum of service environments and innovative building designs. International experience demonstrates that seniors' housing models adapt to consumer expectations where entitlement models are effective. This is reflected in their options for accommodation payments.

In the future environment proposed by the Productivity Commission, recipients of residential aged care services will be able to receive care services in apartments or units and should be able to make contributions based on their personal circumstances and preferences, including strata purchases, loan licenses and rental alternatives currently provided at retirement villages. In a less regulated pricing environment, providers will develop alternative capital funding models that meet consumer demand and support the development of accommodation that their clients value.

In the longer term, we believe that the emergence of entrepreneurial financing alternatives and consumer preferences are likely to reduce the industry's dependence on accommodation bonds in their current form. However, if the reforms are successful in creating a more viable industry, providers will have greater capacity to service borrowings and banks will be able to develop products to help support this transition.



Opportunities and challenges

Below we consider some alternative approaches to planning for change in a more dynamic and responsive market. The following are examples of opportunities and challenges for consideration during the strategic planning process.

i) Service integration

The proposed entitlement models will afford consumers greater choice in the setting in which they receive care. [Our overseas experience](#) demonstrates that such models can open the door for greater levels of service integration between retirement living, residential aged care and community care services.

Residential aged care facilities can operate as an effective and efficient service hub for the community. This provides valuable and affordable benefits to consumers while generating revenue and referral opportunities.

In a village context, the potential for serviced apartments, rehabilitation and transitional care and home care services would be greatly enhanced.

Conversely, operators of retirement villages without care services may find it difficult to meet the needs of residents that have received an entitlement for care. This will create opportunities for service expansion within villages or partnerships with established care providers.

ii) Redevelopment/renovations

Improved access to capital funding and more commercial accommodation charges will prompt many operators to

upgrade their facilities.

Developing viable operating models (and securing bank finance) in a dynamic market will require careful planning and consultation. Operators must think beyond current services to adapt to future priorities, preferences and competitor activity.

Input from the care team members closest to residents and families will be

expansion opportunities.

While caution is always wise when making investment decisions, we believe that the relaxation of aged care price and supply constraints in Australia is inevitable. With a rapidly ageing population and growing demand for service innovation, strategically minded organisations will plan to leverage their strengths to adapt now rather than

“It’s not the strongest of the species that survives... it’s the one that is the most adaptable to change.” Charles Darwin

instrumental in this regard. The ability to leverage established experience and resources is a major competitive advantage not available to new entrants to the market.

Considerations for development planning are provided in the [Grant Thornton Aged Care Review – Second Report](#).

iii) Service expansion

Many operators may wait until the reform recommendations are formally adopted (or even implemented) by the Government before actively seeking

waiting for them to become liabilities in a changing market.

Residential aged care activities share synergies with retirement living, community care and other seniors’ care and accommodation services that will be enhanced under formal, entitlement based aged care systems. Providers should not limit their expansion possibilities to residential aged care, but consider how they might benefit from the development of a broader service offering to better meet customer needs and preferences, which may include a range of accommodation types and standards.

Outstanding issues in the Productivity Commission Report

Grant Thornton made a series of recommendations for reconsideration after the release of [The Productivity Commission's draft report in January 2011](#). Most of our proposed changes were adopted in the final report. However, two important matters need to be addressed in the implementation process:

i) Support for the financially disadvantaged

The Productivity Commission's draft report proposed that a residential aged care provider should be subsidised for the care of "supported residents" based on the cost of accommodating two residents per room. As illustrated in our response to the draft report, modern Australian aged care facilities have been built almost entirely as single room facilities and it is unlikely that these standards will change in the future.

The final report proposes a compromised position, suggesting that the accommodation supplements would be based on Building Certification Standards 1999, in which an average of 1.5 residents per room was required as a minimum. It is proposed that those that do not meet the 1999 standards would be provided a lower supplement. Providers would be able to reduce their minimum supported resident ratios (quotas) through negotiation with other providers in their region who could accept higher numbers of financially disadvantaged residents.

Because most modern facilities

(and future facilities) will be built predominately with single rooms, providers that meet the benchmark standards would not be appropriately compensated for providing this level of accommodation for the financially disadvantaged. For those older facilities that don't qualify, penalty rates would favour those with higher levels of density (multiple bed wards) which are more efficient to operate (and were cheaper to build). In both instances, there would be little financial incentive to support disadvantaged residents with quality accommodation.

In addition, the proposed scheme for "trading" supported resident ratio

obligations would require brokering mechanisms that would be very difficult to manage and likely to result in unintended consequences that may marginalise the financially disadvantaged. Furthermore, the system would have to rely on planning mechanisms similar to the existing regional quotas that do not accurately determine support levels required in local communities.

While recognising there is a need for fiscally sustainable reform, it should be possible to retain and improve accommodation standards for all Australians regardless of their financial means. Rather than establishing benchmarks based on the number of



shared rooms, capital subsidies for supported residents should be based on a cost per room which is sufficient to accommodate residents in single rooms. This is likely to be set at a more modest capital cost than levels set for residents with financial means.

If the capital subsidies are adequate, providers will build new facilities within the constraints set while delivering privacy and dignity to all residents. Most importantly, operators of older facilities will be incentivised to redevelop their facilities and competitive pressures will remove the incentive to maintain older multi-bed wards.

In the short term, higher capital supplements will be attractive to established operators and therefore there would be no requirement to mandate supported resident ratios. The ratios should be monitored and where there is not adequate support for the financially disadvantaged in specific areas or regions, prices could be adjusted accordingly.

ii) Retirement living legislation

The Terms of Reference for the Productivity Commission's Inquiry asked them to examine whether the regulation of retirement specific living options should be aligned more closely with the rest of the aged care industry.

The report correctly identified the potentially detrimental impact of increasing the regulatory burden on villages. However, the Commission's deliberations on this topic were based largely on how the two sectors operate today, rather than giving more in-depth consideration to the impact of the major reforms presented elsewhere in the report. Our [recent review of the New Zealand aged care industry](#) revealed that in a less regulated supply and pricing environment, the line between residential care, community care and retirement living becomes increasingly blurred. In modern integrated villages, residents can move around care settings based on their service needs

and preferences, with their subsidy entitlement moving with them.

The [Grant Thornton/RVA Retirement Living Survey](#) revealed a desire amongst Australian operators to replicate this model, and the implementation of the Commission's recommendations would make this possible.

Unlike New Zealand, Australia has a three tiered government system. Facilitating choice between service settings will necessarily mean navigating between Commonwealth and State/Territory regulations. This will also have important implications for the Commission's (AACC) regulation of care services and accommodation bond prudential monitoring.

We believe that further planning and analysis should be undertaken to ensure that consumer choice and AACC powers are not diminished because of regulatory misalignment.



Planning for change

The Productivity Commission report has generally been met with a positive response. Given the long list of previous aged care reviews that have failed to effect reform, some are understandably cynical about the likelihood of meaningful change.

However, this review comes at a critical time for the country. As the population ages, investment in modern infrastructure is at its lowest levels and consumers are becoming strong advocates for change.

In our view, the key initiatives proposed by the Productivity Commission are not radical or ambitious – they are inevitable if we are to meet the needs of the largest generation of consumers in our history.

The future of aged care will be shaped by the expectations of these consumers and now is a good time to start thinking about what built environments and service options they will want.

Grant Thornton is working with aged care providers around the country to plan for the changes ahead. The diagram to the right summarises our approach.



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