The Treasury

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STATE SERVICES COMMISSION
Te Komihana O Ngā Tari Kāwanatanga

THE TREASURY
Kaitohutohu Kaupapa Rawa

Reference: T2016/1438 SH-1-6-3

Date: 4 August 2016

To: Minister of Finance (Hon Bill English)
Associate Minister of Finance (Hon Steven Joyce)
Minister of State Services (Hon Paula Bennett)

Deadline: For your meeting on Monday, 8 August.

Aide Memoire: Terranova costings

The estimated cost of a negotiated settlement for the care and support workforce has increased from around $300 million per annum at the time negotiations were entered into, to around [38] million now (full out-year cost). This mainly reflects the inclusion of employment conditions to match those of DHB employees, which the unions insist on. As a result, Ministers have been asked to increase the negotiating mandate.

We have now had an opportunity review the model that underpins the new costings. Overall, the approach taken seem reasonable. We draw out some detailed points below. Where we offer alternative figures or sensitivity analysis, these are rough in-house Treasury estimates and should be treated with caution. The intention is to quickly identify areas of potential concern rather than provide definitive numbers. We understand that the Ministry has also taken steps to have the model reviewed externally by a consultant at MartinJenkin.

The latest cost estimates

The latest costing, according to the Ministry's model, is summarised in table 1. This is based on increasing wages for 24,000 home care workers and 30,000 residential care workers, who are employed by private sector providers and deliver 61 million hours of care per year. The costing assumes that their wages are gradually levelled up to match current wage rates for approximately 1,000 mental health assistants employed by DHBs (covered by the mental health and public health nursing MECAs).[1]

Table 1: Latest costing / proposed new mandate (excludes ACC costs)

	Year 1	Year 2	Year 3	Year 4	Year 5	Totals
Wage rate increase Entitlements*	[38]					

* Night, weekend, overtime and shift rates; additional sick and annual leave; long service leave; public holidays.

1 These MECAs cover 3,100 staff in total, of which at least 602 are mental health assistants.

Based on our rough calculations, the modelling used to generate the numbers in table 2 implies an increase in the overall cost of wages, wage-related costs and other entitlements in the order of [38] . Alternatively, total expenditure on disability support and aged care is currently about $2.6 billion per annum ($1.4 billion by DHBs, $1.2 billion by the Ministry): the full out-year cost of the settlement ([38] million) equates to an increase of about [38] on this amount.

The costing has been described as a "worst case scenario", with the implication that a negotiated settlement may be achieved for less than this amount. However, if Ministers do agree to an increased mandate, it is likely that this number will quickly crystallise into the minimum fiscal cost to the Crown.

- It is clear that the negotiating team has not worked up alternative, lower-cost options – and also that they do not consider such options worth pursuing.

- Although the modelling seems (generally) to use conservative assumptions and will therefore tend to overstate the cost, once funds are appropriated there is little prospect of an underspend being returned to the centre. In the event that actual costs do turn out to be lower than estimated, there is not really any mechanism to identify this and claw back funding. The mostly likely outcome is that services will expand and/or margins for providers will increase. At best, money might be reprioritised to meet shortfalls in other parts of Vote Health.

The proposed "matrix approach"

The costing, and the proposed counter offer to the unions, is based on a "matrix approach" (see table 2). This just means that new wage rates will be phased in over time across four levels of employment. The proposed wage rates are based on, but not the same as, the current wage rates for mental health assistants (see right hand column of table 2). The structure is based on maintaining a [38] difference between each wage band, and increasing the top (level 4) rate to match the mental health assistant (MHA) rate by year 5.

Table 2: Matrix used for costing ($/hour)

	New wage rates assumed in the costing					Current
	Year 1	Year 2	Year 3	Year 4	Year 5	MHA rates
Level 1 (starting rate)	[38]					17.00
Level 2 (one year's employment)						18.67
Level 3 (two years)						20.25
Level 4 (three years)					21.89	21.89

Two points are worth noting in relation to table 2.

- It is not clear how the proposal will deal with wage increases for mental health assistants during the five-year phase in period (these have been 2% per annum over the last couple of years). The final level 1 rate [38]) assumes [38] annual increases over the current rate for mental health assistants ($17.00); but

the final level 5 rate ($21.89) assumes zero annual increases over the current rate (already $21.89).[2] This is not plausible since it would not achieve pay equity. So we think there will certainly be some additional costs for incremental wage increases over and above those assumed in the baseline costing. Applying [38] annual increases across all wage rates in the proposed matrix (and not netting out the increases already built in) would increase costs to around [38] million per annum by year 5.

- In 2016 prices, the final (year 5) rate structure is <u>not</u> the same as MHA wage rates: it is more generous at all levels except level 4. We do not understand the reason for this: it is not necessary to achieve pay equity. It was explained to us in terms of the need to "do a deal" with the unions. We were also told that [38]

Assumptions and risks

As noted above, the costing methodology seems broadly reasonable. However, there are some assumptions and risks that warrant further attention.

<u>Staff turnover</u>. The costings assume workforce attrition rates of 5% per annum. This is a conservative assumption that will tend to overstate the actual cost. The costing is moderately sensitive to changes to this assumption, which affects the number of staff at each level in the pay matrix. A 5% attrition rate would mean that 86% of staff were in the top pay band by year 5. A 10% attrition rate reduces the estimated cost to [38] million per annum by year 5 (with 73% of staff in the top pay band). A 20% attrition rate reduces the cost to [38] million per annum (with just over half of all staff in the top pay band).

<u>Existing terms and conditions</u>. The costing assumes that all existing care and support staff working for private providers are currently on the minimum wage, with no extra payments for working nights or weekend, and none of the other entitlements available to mental health workers. In reality, some staff will already have higher rates of pay and better conditions than this. So, again, it is a conservative assumption that will overstate the <u>gross</u> cost of a settlement. However, the <u>fiscal</u> cost will only be reduced to the extent that providers can be persuaded to absorb some of the gross costs themselves. This is not straightforward because the Ministry pays standard prices while the impact of new wage rates on individual provider margins will depend on the existing employment terms of their staff.

[2] The level 2 and 3 rates assume [38] and [38] annual increases respectively.

The Ministry has assured us that they do anticipate being able to recover some of the gross cost of the settlement from providers, [38]

Aged residential care: flow-on issues. Around one-third of aged residential care costs are currently borne by residents themselves. About 30,000 people are in residential care at any time. Around 5,000 of these pay the full cost of their care. A further 4,000 have assets over the threshold and pay the maximum contribution but receive higher-level care which is subsidised. The rest qualify for the residential care subsidy, although they still pay almost all of their income, including NZ Superannuation, towards the cost of their care. Three points are worth drawing out here.

- An increase in wages of the order proposed will significantly increase costs for people paying all or part of the costs of their own residential care.

- The baseline costing assumes that the ratio of public to private payments will remain unchanged. Even under existing policy settings, this probably ignores certain flow-costs to the Crown. For those eligible for the residential care subsidy, NZ Superannuation will cover proportionally less of the costs of care. Reducing the proportion of residential care costs borne privately by 5 percentage points would increase the cost by around [38] million in year 5.

- A significant increase in the private costs of residential care is likely to be controversial. It may generate pressure to increase the asset threshold for the residential care subsidy. Raising the threshold would further increase fiscal costs. If the threshold is left unchanged, it is possible that people above the asset threshold will de-cumulate their assets more quickly and thus qualify for a subsidy sooner than would have otherwise been the case.

Note that additional fiscal costs related to aged care will not necessarily be offset by the fact that the costings are otherwise generally conservative. If providers manage to increase their margins, or the scope of services expands to absorb additional funding, then the appropriation will not be underspent. It is thus likely that a new bid would be made for additional funding to address any flow-on effects.

Related costs for ACC. These were previously estimated (roughly) at $55 million per annum. Those costs are not included in table 1. The cost estimate has not been updated to reflect the proposed increase in the negotiating mandate, but we would expect it to increase materially. The costs will flow through to future bids for the non-earners' account and levy calculations.

Recommended next steps

A decision to endorse a pay equity settlement for the care and support workforce based on an MHA comparator is a significant one that will not ultimately turn on

detailed points raised in this note. The methodology used to generate the costings seems reasonable. The numbers themselves are generally conservative, although they are subject to material risks or uncertainties in some areas (wage inflation and residential care).

Before Ministers agree to increase the negotiating mandate, we recommend that the Ministry of Health is asked to re-cost its proposed counter-offer using:

- wage rates that are the same as those for mental health assistants
- clear and realistic assumptions about annual wage increases for mental health assistants over the next five years, and details of how these will affect the cost of a settlement
- a more realistic assumption about workforce attrition rates
- estimated savings (if any) that will be made by sharing costs with providers. We think this needs to be supported by reasonably detailed advice about how the settlement will be operationalised, how funding for individual providers will be matched to their cost structure (for example, in relation to things like weekend and night rates). We think these issues should be looked at now, while all parties are still at the table and before the Crown is committed to a particular settlement based on a gross fiscal envelope
- a revised assumption for the public-private split of aged residential care costs, reflecting the impact of higher prices.

We also recommend that Ministers ask for advice about the impact on people paying their own costs of residential care (number of losers, maximum amount lost), and for indicative costings for an "offsetting" increase in the asset threshold for the residential care subsidy.

In view of the various moving parts and substantial fiscal costs, we suggest that Finance Ministers approve the details of any counter-offer to the unions before it is made. This will facilitate cross-agency engagement, including by officials from Treasury and SSC.

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