Date: 20 October 2009 CM-1-3-1-2

To: Minister of Finance

AIDE MEMOIRE - WORK ACCOUNT CONTESTABILITY

This note responds to the Prime Minister's request for urgent Treasury input to the issue of contestability in ACC's work account.

Objectives

A number of general objectives apply to any option. In particular, ACC's objectives in the Woodhouse Report are enduring. They are, in summary:

- No fault, uniform assessment regardless of cause, community responsibility
- Encourage prompt and complete rehabilitation
- Protect workers from the burden of injury risk via income-related compensation while incapacitated, and recognition of permanent impairment
- Administrative efficiency.

There are also wider economic objectives to consider:

- Maximising labour market participation by rehabilitating injured workers
- Socially efficient personal insurance offers a comparative advantage
- It is efficient for institutions to evolve as community expectations change.

Contestability has advantages …

- Potential economic gains through innovation and meeting actual needs (but limited by the need for legislation to specify minimum entitlements)
- contestability obliges providers to share gains with purchasers
- politicians have no comparative advantage in determining levies
- mechanisms to control ACC's performance are inconsistent and unsuccessful
- success could enable similar gains in other accounts and/or other industries.

… but features of the ACC scheme may mean the gains are limited

- ACC already offers some variable cover levels and workplace safety discounts
- Not clear that levies are excessive – competition in 1998 did reduce levies but could have been firms loss-leading to establish market share
- Foregoing the right to sue implies the Government should prescribe minimum entitlements, which limits opportunities to innovate
- Competition duplicates some costs; underwriters earn an explicit capital return
- Weak competitive pressure if providers delay entry because of NZ's small market, risk of future policy reversal and capital constraints (post credit-crunch)
- Regulation and monitoring costs increase.
- The Crown would retain some residual risks, such as meeting entitlements for those whose employers have fail to arrange cover or if an underwriter fails.
- Ensuring high-risks are covered and that all firms do get cover involves either a risk for the Crown or risk-sharing which undermines the gains from competition

High-level options for designing a contestable work account

- ***Status quo:*** ACC is sole underwriter, investment manager and claim manager. Ministers set levies.

- ***Contestable claim management:*** ACC retains the underwriter and investment functions. Employers appoint a claim manager from a list approved by ACC as underwriter. Ministers would set levies.

- ***Full contestability:*** Contestable underwriting, investment and claim management: employers would select an underwriter. The underwriter would manage in-house or appoint an investment manager and claims manager. The underwriter would set levies.

Under all the options the Crown would need to set minimum entitlements and retain an element of risk (the risk that a provider would have insufficient funds in future to pay claims incurred today). The following table compares the options.

Service	**Status quo**	**Contestable claim management, ACC underwriter**		**Full contestability**	
	Who provides	**Who provides**	**Tsy view of net gains**	**Who provides**	**Tsy view of net gains**
Injury prevention initiatives	Departments, ACC and others	Departments, ACC and others	Neutral	Departments, ACC others and Underwriter	**Positive**
Determine minimum entitlement	Statute	Statute	Neutral	Statute	Neutral
Optional top-up	Employer	Employer	Neutral	Employer/ Underwriter	**Positive**
Underwriting risk	ACC	ACC	Neutral	Underwriter	Neutral
Risk of underwriter failure	Crown	Crown	Neutral	Crown	Neutral
Levy setting	Govt	Govt	Neutral	Underwriter	**Positive**
Premium collection	IRD	IRD	Neutral	Underwriter	Negative
Investment strategy	ACC	ACC	Neutral	Underwriter	Positive
Investment management	Mandated managers	Mandated managers	Neutral	Mandated managers	Neutral
Emergency treatment	Public hospitals	Public hospitals	Neutral	Public hospitals	Neutral
Claim acceptance	ACC/doctors	Claim manager	**Positive**	Claim manager	**Positive**
Claim admin	ACC	Claim manager	**Positive**	Claim manager	**Positive**
Dispute resolution	Justice system	Justice system	Neutral	Justice system	Neutral
Rehabilitation provision	Providers	Providers	Neutral	Providers	Neutral

Treasury comment

The economic gains from contestability of the work account may to relatively modest in the short term because ACC's problems are predominantly in the earners and non-earners accounts rather than the work account. Work account contestability would have little effect on ACC's cost pressures which are predominantly arising in its other accounts. However, over time it may help to improve injury prevention and rehabilitation.

An important question is whether contestability would be enduring so that it would offer a worthwhile exemplar of how private provision can enhance services currently delivered under a statutory monopoly administered via a Crown entity.

Of the options described above, we consider there would be net gains from increasing the contestability in services such as claims management. It is not clear whether contestable underwriting (which would put the greatest competitive pressure on levies but would increase costs) would have net gains.

Implementation issues

Implementing contestability in the work account would include the following:

- Policy choices (issues include which areas are contestable, regulatory regime, monitoring regime)
- Legislative amendment. The scheme is significantly different from 1998 so legislation used for contestability may be unsuitable in some respects
- Role of ACC (e.g. closed fund, dominant market participant, or provider of last resort)
- Determining limits on firms' self-insuring their risk
- Resourcing a regulatory and monitoring regime
- Managing the timetable for contestability

Likely public debate

Perceptions that are emerging in the media include:

- Possible threat to comprehensive cover – claimants might be treated differently depending on the venue of their injury
- Slower rehabilitation if underwriters become more likely to dispute claims
- An explicit return on the underwriter's capital may increase prices
- Rates might rise or become volatile
- 'Cherry-picking' (e.g. discounts for firms with good claims history) may increase costs for average or poor-performing firms

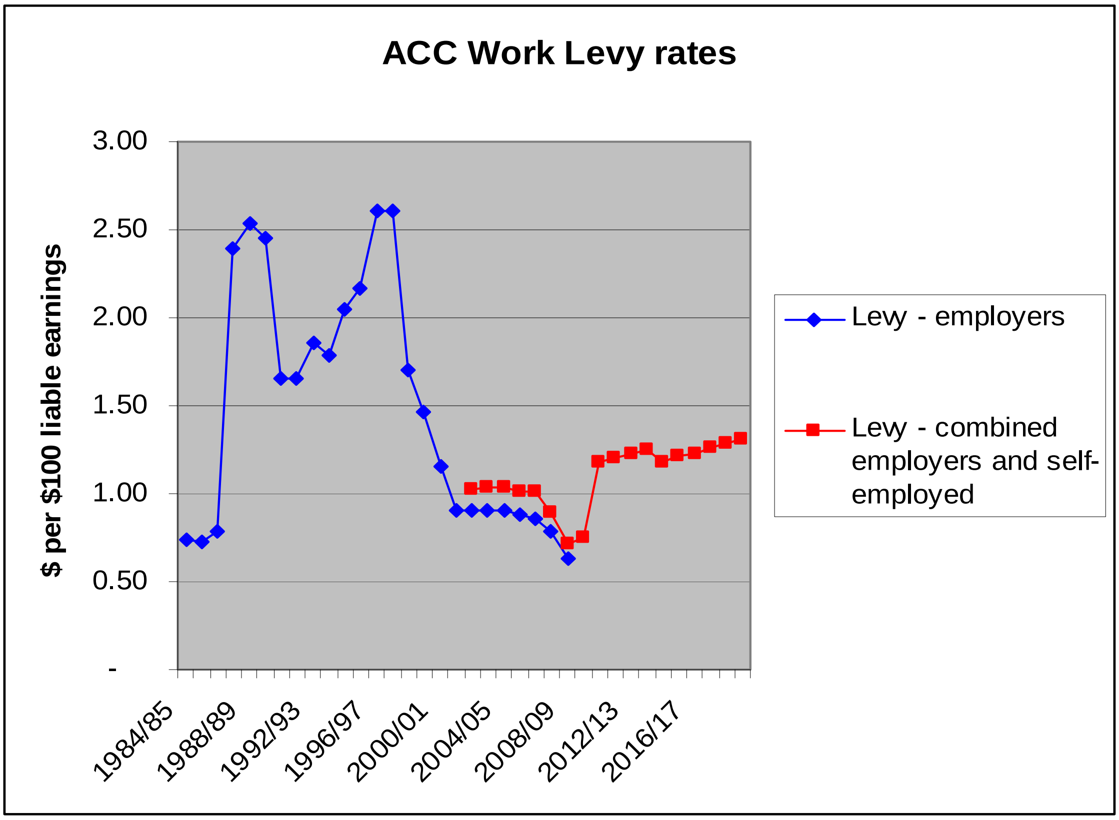
Making transparent the cost of capital and the injury performance of firms tends to encourage economic efficiency but would affect the incidence of costs between firms.

Background on ACC's work account

Work account 2008/09 financial results

	$m	$m
Levy income		539
Less		
Cash claims	443	
Increase in future liability	567	
Other operating costs and income	23	(1,033)
Deficit from underwriting activities		(494)
Surplus brought forward		495
Closing reserves		1

The above summarised statements show that reserves in ACC's work account are at break-even (unlike ACC's other accounts which have large deficits). While the work account generated an underwriting loss, a large component was due to a one-off change to liability valuation assumptions.



Source: Department of Labour. Excludes pre-1999 claims (the residual account)