The Treasury

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[40]	Not in scope	

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THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: ACC appropriations at Budget 2016

Date:	21 March 2016	**Report No:**	T2016/431
		File Number:	CM-1-3-1-2-3

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	**Note** that ACC is seeking a $158m funding increase in 2016/17, and **discuss** with the Minister for ACC what steps are being taken to understand ACC cost increases.	24 March 2016
Associate Minister of Finance (Hon Steven Joyce)	As above	24 March 2016
Associate Minister of Finance (Hon Paula Bennett)	As above	24 March 2016

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Helen Anderson	Senior Analyst	04 917 6307 (wk)	021 269 3359 (mob)	✓
Ben McBride	Manager, Health	04 917 6184 (wk)	021 869 450 (wk) [23]	

Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report

Enclosure: No

Treasury Report: ACC appropriations at Budget 2016

Executive Summary

ACC is seeking $158m of additional funding in 2016/17, and smaller increases in out years, to cover increases in the estimated costs of providing for injured non-earners since 2014. As an interim measure for Budget 2016, we recommend that a portion of this request ($26.4m) be funded to allow for expected growth in the non-earner population. Any increase to appropriations would flow through to net debt.

ACC's $158m funding request is based on application of a government funding policy (agreed in 2006) and assumptions that are actuarially reasonable. However, we do not recommend funding the requested amount in full due to:

- the limitations of the current funding policy for the ACC Non-Earners' Account, which tends to over-collect appropriations (and can generate large changes in estimated funding requirements from year to year). The 2016/17 funding request could be almost halved by using more realistic investment return assumptions, for example. A review of the funding policy will be complete for Budget 2017.

- lack of clarity about the underlying drivers of cost growth and how it is being managed. Excluding the impact of demographic and discount rate changes, the expected lifetime (present value) cost of 2016/17 injuries to non-earners has increased by an estimated $25m due to scheme performance. Non-earners' use of the scheme is at historic highs in some areas. While some cost growth is outside ACC's control, overall it does not seem to be well understood and there is a lack of urgency in responding to it. We noted similar issues at a scheme-wide level in our recent monitoring report to the Minister for ACC [T2016/249 refers].

We think there is value in testing the scope for efficiencies in the ACC scheme. For example, there may be pockets of over-servicing that are not improving rehabilitation outcomes. Ministers might consider a range of ways to encourage efficiency and make the impacts of performance improvement initiatives more visible, such as funding ACC to a level that allows for expected cost reductions from injury prevention initiatives. A suite of measures is likely to be needed: simply setting a lower funding track does not signal to ACC an expectation of managing within lower baselines, because it always has enough funds to meet its short-term costs. While there remains a significant risk that additional funding for non-earners' claims will be needed in future, the Non-Earners' Account is currently fully funded for the expected cost of claims after 2001. If the requested $158m is not funded, there will be no impact on ACC services to non-earners over the medium term.

[33]

ACC purchases services and allocates expenses at the scheme level, so identifying efficiencies in one area could improve scheme performance as a whole. A cross-scheme perspective will also be important for understanding the flow from ACC weekly compensation to benefits, which we think is less likely to come from the Non-Earners' Account than from other parts of the scheme. There may be value in exploring incentives on ACC to manage this flow.

We recommend you discuss this funding request and expectations for Budget 2017 with the Minister for ACC, including what steps ACC is taking to understand cost increases and how efficiency in the scheme can be encouraged.

Recommended Action

We recommend that you:

a **note** that ACC is seeking a $158m increase in 2016/17 for the cost of non-earners' claims, with smaller increases in out years,

b **note** in relation to the requested $158m increase that:

- an estimated $25m of the increase is driven by higher than expected claim costs due to scheme performance (excluding demographic pressures and discount rate changes), and that non-earners' use of the scheme is at historic highs in some areas,
- the underlying drivers of these cost increases, and the potential for efficiencies, are not yet well understood, and
- the current funding policy for the Non-Earners' Account (which generated the $158m requested increase) tends to over-estimate funding requirements, [33] [33]

c **agree** that funding for non-earners' claims be increased by $26.4m in 2016/17 to allow for an expected increase in the non-earner population, and

Agree/disagree	*Agree/disagree*	*Agree/disagree*
Hon Bill English	Hon Steven Joyce	Hon Paula Bennett

d **raise** the following points with the Minister of ACC:

- The growth in ACC's underlying claims costs and what steps are being taken to understand it,
- How incentives and other policy settings could encourage efficiencies in the scheme,
- [33]

Ben McBride
Manager, Health

Hon Bill English	Hon Steven Joyce	Hon Paula Bennett
Minister of Finance	**Associate Minister of Finance**	**Associate Minister of Finance**

Treasury Report: ACC appropriations at Budget 2016

Purpose of Report

1. This report provides our advice on ACC's request for $158m additional funding in 2016/17 to cover an increase in the estimated cost of non-earners' claims since 2014. We recommend that ACC appropriations for 2016/17 be increased by $26.4m to allow for an expected increase in the number of non-earners. This report also:

   - explains the key drivers of ACC's full funding request of $158m;
   - [33]
   - provides talking points for discussion with the Minister for ACC.

ACC seeks additional funding at Budget 2016

ACC seeks additional funding to cover treatment and support costs for injured people not in paid employment…

2. ACC receives government funding to pay treatment and support costs for injured people who are not in paid employment. These costs include acute treatment of non-earners injured in an accident (which ACC bulk-funds) and accident-related visits to GPs, physiotherapists, specialists and other medical practitioners. They also include the costs of providing (often lifelong) care and support for a relatively small number of non-earners with serious injuries, such as new-borns injured during delivery.[1]

3. A small proportion of government funding to ACC is paid into the Treatment Injury Account to cover non-earners' injuries that occur in the course of medical treatment.[2] The rest is appropriated to the Non-Earners' Account, which covers all other injuries to non-earners. Post-2001 non-earners' claims are funded on a fully-funded basis, while earlier claims are funded on a pay-as-you-go (PAYGO) basis.

4. ACC is seeking an additional $158m in 2016/17 for these non-earners' appropriations, with smaller increases in out years. This is shown in Table 1 below. Any increase in ACC appropriations would flow through to net debt (unless counted against the operating allowance) but would not impact OBEGAL.

Table 1: Funding sought by ACC at Budget 2016 for non-earners' claims

$ million	2016/17	2017/18	2018/19	2019/20	2020/21
Current baseline	1,205	1,310	1,417	1,417	N/A
ACC requested	1,363	1,433	1,495	1,545	1,604
Increase	158	124	79	128	N/A
Increase (%)	13	9	6	9	N/A

[1] Note support for non-earners can include ACC weekly compensation in limited circumstances – e.g. injured children may be eligible for loss of potential earnings from age 18.

[2] The current 2016/17 baseline comprises $1,065m for the Non-Earners' Account and $140m for the non-earners' portion of the Treatment Injury Account.

5. The requested $158m increase has been generated by applying a government funding policy agreed in 2006 [SDC Min (06) 6/2 refers]. Essentially, the funding policy is applied by calculating the amount of funding needed to meet 100 per cent of the expected lifetime cost of post-2001 non-earners' claims (discounted to present value) – this equates to a funding target of 88 per cent of reported solvency.[3] Estimated funding requirements are then adjusted to reflect the funding position of the Non-Earners' Account relative to the target, with a view to correcting any over or under-funding over three years.

6. The non-earners' appropriations last changed in 2014. At Budget 2015 ACC sought an additional $114m for 2016/17, which was not approved. The increases now requested are larger in each year of the forecast period than those requested in 2015.

Table 2: Funding sought by ACC at Budget 2015 (not approved)

$ million	2016/17	2017/18	2018/19	2019/20	2020/21
ACC requested at Budget 2015	1,319	1,384	1,459	1,519	N/A
2016 request less 2015 request	44	49	36	26	N/A

7. The $44m extra (compared to 2015) now sought for 2016/17 includes the impact of everything that has affected actual and expected costs of non-earners' claims and the funding position of the Non-Earners' Account, including demographic changes (an increase in the projected number of non-earners); changes in actual and projected claims costs; and the impact of discount rate changes and investment returns. For example, increased costs in some areas have been offset by reductions of around $46m for discount rate changes and $47m for better than projected investment returns.

…of which about $40m is driven by higher than expected claims costs

8. Of the $158m requested increase:

- $47m is a reduction to the down-side 'funding adjustment' described at paragraph 5 above, as the level of over-funding for fully-funded non-earners' claims is now lower than the position estimated in 2014.

- A further $2m is an increase in the estimated costs of pre-2001 (PAYGO) claims in 2016/17.

- The remaining $109m reflects an increase in the expected lifetime cost of non-earners' injuries occurring in 2016/17 ('new year costs'). Of this:

  - $68m stems from ACC's 2015 review of costs and is largely driven by reductions to discount rates, which makes the liability more expensive in today's money;

  - $41m stems from ACC's 2016 review of costs, and is largely driven by higher claim costs. Costs per non-earner have also increased in most areas, driven by lower discount rates and more claims per non-earner.

[3] Reported solvency includes a risk margin, which government has opted not to fund for non-earners' claims. The funding policy agreed by Cabinet was light on detail, so the policy as now applied is (understandably) a mix of Cabinet-agreed parameters and practice developed by ACC.

9. The $41m increase in projected 2016/17 new year costs includes (among other changes) the following increases and decreases compared to last year's forecast:

- an increase of $26.4m to cover growth (of around 2 per cent) in the projected number of non-earners in 2016/17, driven by a higher forecast unemployment rate and recent trends in immigration;

- an increase of $25.2m in medical costs, of which $6.9m is for scheme expansion in relation to sensitive claims, reflecting higher claims volumes and more counselling sessions than previously forecast;

- an increase of $10.5m in expenses, driven by more injury prevention investment;

- partly offset by decreases of $21.7m for public health acute services (driven by low inflation) and $10.8m for discount rate changes.

10. Excluding demographic (+$26m) and discount rate (-$11m) changes, non-earners' new year costs have increased by around $25m due to worsening scheme performance.

11. Non-earners' use of the scheme is now at historic highs in some areas. As shown in Table 3, the number of GP claims is forecast to be 11 per cent higher than five years ago, and about the same as 10 years ago; and the use of physiotherapy, radiology and 'other' medical services (which include specialist consultations, lab services, dental and counselling services for sensitive claims) has risen by around 20-40 per cent over 10 years. Although initiatives such as free doctors' visits for under-13s have contributed to increases in medical treatment claims over the past two years, these initiatives do not explain longer-term trends. Frequencies for this claim type have increased each year since 2009/10, and are now much higher than the previous peak of 2007/08.

Table 3: Forecast number of medical treatment claims per 1,000 Non-Earners

Payment type	Next year 2016/17 accident year	Current year 2015/16 accident year	5 years ago 2011/12 accident year	10 years ago 2006/07 accident year
General practitioners	**283**	278	255	283
Physiotherapy	**112**	106	84	81
Radiology	**108**	105	87	84
'Other' medical	**94**	91	79	77

12. While some cost growth is outside ACC's control, overall we are not confident that it is well understood, or that it is getting (or is necessary to get) better results for ACC claimants. External actuaries have noted a lack of urgency in responding to these cost increases. This is concerning given the potential we have seen over the past 10 years for ACC's claims performance to change rapidly. Higher levels of services do not always get better results for ACC claimants, so there may be scope to manage costs by addressing pockets of over-servicing. It is worth getting to the bottom of the drivers of cost growth now, in order to mitigate the risk of pressure to take more drastic action (such as cutting scheme benefits) if costs continue to rise.

13. We think there is scope to improve incentives for efficiency in the scheme. Currently, ACC's funding estimates tend to reflect actual and expected scheme experience, rather than an assessment of effective and efficient performance. Ministers might consider funding ACC to a level that allows for expected cost reductions, for example from injury prevention initiatives. A suite of measures is likely to be needed: simply setting a lower funding track does not signal to ACC an expectation of managing within lower

baselines, because it always has enough funds to meet its short-term costs. We recommend you discuss this with the Minister for ACC.

14. Beyond 2016/17, ACC projects that funding requirements will increase by 3-5 per cent per year. Current accident year costs increase by about 4 per cent per year, reflecting demographic change; standard and superimposed inflation; and some growth in the number of claims per non-earner. Projected increases in the use of the scheme are lower than recent experience, meaning that costs could turn out to be higher than expected if current increases are not managed. [38]

[33]

15. As noted above, the Non-Earners' Account funding policy aims to return funding levels to the funding target (100 per cent of the expected cost of claims, or 88 per cent of reported solvency) over three years. Funding for post-2001 non-earners' claims is around 92 per cent of reported solvency; the fully-funded portion of the Non-Earners' Account has a $227m surplus. Hence, ACC's estimate of 2016/17 funding requirements has been adjusted downwards to reduce funding levels in the Account.[4]

16. If the $158m funding increase is not provided, funding levels are projected to drop as shown in Table 4 below (all else being equal). Appropriations in 2017/18 and out years would also be larger than currently estimated. If no funding increase is provided this year, ACC currently projects it would require a total appropriation of $1,492m in 2017/18 (rather than the $1,433m projected if 2016/17 appropriations are increased).

Table 4: Estimated funding levels if no additional funding is provided at Budget 2016 (all else equal)

Account	June 2016	June 2017	June 2018	June 2019	June 2020
Non-Earners' Account	90.6%	87.4%	84.7%	82.9%	80.1%
Non-earners' portion of Treatment Injury Account	94.8%	94.0%	93.3%	93.1%	92.7%
Combined	92.2%	90.0%	88.0%	86.8%	84.9%

17. The assumptions underpinning the funding policy have a big impact on requested appropriations, however. The current policy uses forecast investment returns to project future asset values and the first year of claim costs, but discounts out years using risk-free discount rates, which is likely to over-estimate funding requirements. If forecast investment returns were used (as they are for ACC's levied accounts), the requested increase in 2016/17 would be $76m lower – see Table 5 overleaf:

4 ACC's current estimate of 2016/17 accident year costs is $1,349m for post-2001 claims, plus $125m for pre-2001 (PAYGO) claims. This total of $1,474m has been adjusted downwards by $110m, generating a total requested appropriation of $1,363m. Note this negative funding adjustment is $47m less than what was projected in 2014 (see paragraph 8).

Table 5: Impact of discounting using forecast investment returns

	$ millions				
Vote ACC	**2016/17**	**2017/18**	**2018/19**	**2019/20**	**2020/21**
Current baseline (A)	1,205	1,310	1,417	1,417	N/A
ACC requested (B)	1,363	1,433	1,495	1,545	1,604
Estimated using investment forecasts (C)	1,287	1,388	1,470	1,532	1,600
Difference from current baseline (C-A)	82	78	53	115	N/A
Difference from ACC requested (C-B)	(76)	(45)	(25)	(13)	N/A

18. Furthermore, the current funding policy tends to overshoot the funding target. The requested $158m increase is projected to keep funding levels at around 92 per cent of reported solvency throughout the forecast period. We understand this is due to the difference between the assumptions used to project asset growth and value liabilities, which creates an expected surplus each year.

19. [33]

20. If the requested $158m increase is not funded, and funding levels for non-earners' claims fall below the target, further funding increases will be needed in future (all else being equal). While this remains a significant risk, however, there will be no impact on ACC services over the medium term if the requested $158m is not funded. There is no substantial risk to the scheme in allowing solvency to fall while the scope for efficiency is tested, or if government chooses to trade off shorter-term and longer-term priorities (as in, for example, the decision to suspend contributions to the Super Fund).

As an interim measure for Budget 2016, we recommend a $26.4m increase for demographic pressures

21. Given our concerns about both the Non-Earners' Account funding policy and cost growth in non-earners' claims, we do not recommend funding the full $158m requested for 2016/17.

22. We think it would be reasonable to use the $26.4m requested for expected growth in the non-earner population as the basis for a funding increase for ACC at Budget 2016. [33]

23.

[33]

[33]

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24. Overall, we do not think the current policy settings and process for advising on ACC appropriations are working well:

- Ministers have limited visibility over changes in ACC's underlying costs because ACC's budget is not set under Cabinet oversight, and these changes are often swamped by economic factors. Opportunities to compare ACC cost pressures with those in other sectors are limited because the ACC appropriation-setting process is not fully integrated into the Budget process (and ACC levy decisions are made entirely outside it).

- Financial incentives for efficiency are limited because the scheme is fully funded with substantial cash reserves. Setting ACC baselines lower than requested does not on its own encourage efficiencies or trade-offs, but simply increases future funding requests (all else being equal).

- As noted above, current settings tend to over-collect for non-earners' claims. In our view, they also underestimate the discretion inherent in the definition of 'full funding' and in the level of servicing of ACC claims, and hence the extent to which ACC funding decisions are a matter of substantive judgement rather than technical process.

- Forecast funding requirements tend to be volatile due to the impact of discount rates, and the short (three-year) horizon for making up over and under-funding. This can result in frequent large changes to funding estimates that may have little to do with, and can be difficult to relate back to, underlying scheme performance.

- [33]

25. In December 2015, Cabinet directed officials to report back to you and the Minister for ACC with advice about how ACC can be better integrated into the overall process for Budget 2017, including ACC reporting on its cost pressures and Non-Earners' Account funding proposals being considered as part of the Budget process [CAB-15-MIN-0272 refers]. We will work with MBIE and ACC on this, and report to you in due course. In the first instance, this is likely to involve ACC providing information on its cost pressures for Budget 2017 at the same time as other agencies. We will also:

- work with MBIE and ACC on a review of the funding policy for non-earners' claims (for example, reviewing the funding horizon and assumptions about investment returns); and

- update you on ACC's budget (currently in the process of being set), which could provide useful insights about expected claims performance and cost implications.

26. It will be important to take a whole-of-ACC, cross-government perspective on this work:

- ACC purchases services and allocates expenses at the scheme level, rather than at the level of individual accounts. Looking into the Non-Earners' Account should therefore enable a better understanding of cost drivers, and identifying efficiencies in one area could influence scheme performance as a whole.

- While not part of the Budget process, ACC's levy-funded accounts (Work, Earners' and Motor Vehicle Accounts) are also an important part of government, and ACC's costs and claims performance affect levy rates just as they do ACC appropriations. They are also important for understanding the flow from ACC weekly compensation to benefits: many working-age people switching from weekly compensation to a benefit are likely to have been supported by the levy-funded accounts, as ACC non-earners may already be receiving a benefit. Currently, there is no real incentive on ACC to manage flows onto the benefit system. There may be value in exploring this further.

27. Over the coming year, we also plan to refresh our approach to monitoring ACC. We think there would be value in a chew session with you to discuss our emerging ideas on how the monitoring function could be improved, and what you are looking for from this function.

We recommend you discuss this funding request, and [33] [33] , e Minister for ACC

28. We recommend you raise the following points with the Minister for ACC:

- The growth in ACC's underlying claims costs and what steps are being taken to understand it;

- How incentives and other policy settings could encourage efficiencies in the scheme;

- [33]