The Treasury

Budget 2017 Information Release

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[40]	Not in scope	

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Treasury Report: ACC at Budget 2017

Date:	7 March 2017	Report No:	T2017/444
		File Number:	CM-1-3-1-2-3

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Steven Joyce)	Read prior to your meeting with Hon Woodhouse on 9 March.	9 March 2017
Associate Minister of Finance (Hon Simon Bridges)	None. For information.	Not applicable
Associate Minister of Finance (Hon Amy Adams)	None. For information.	Not applicable

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Helen Anderson	Senior Analyst	[39]	N/A (mob)	✓
Ben McBride	Manager, Health	[39]	[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: Yes (attached).

Treasury Report: ACC at Budget 2017

Executive Summary

You are meeting the Minister for ACC on Thursday 9 March 2017 to discuss funding for ACC non-earners' claims at Budget 2017. Post-2001 non-earners' claims are funded on a fully-funded basis, though the amount funded in any given year is discretionary. Any additional funding would flow through to core Crown net debt unless counted against the operating allowance, but would not affect OBEGAL. The 2017/18 baseline for these claims is $1.3b.

We do not support a baseline increase for ACC at Budget 2017, although we think elements of the Budget initiative have value. In our view, cost increases can be readily absorbed within baselines because:

- solvency for non-earners' claims has increased since the snapshot date of 30 June 2016,
- the proposed new funding policy, and the expected benefits of ACC management strategies, such as injury prevention, have created additional headroom within baselines over the forecast period, and
- high levels of cost growth in the ACC scheme suggest there is scope to manage costs through efficiencies.

As part of the Budget process, Ministers could signal an expectation that ACC's existing cost pressures for non-earners' claims be absorbed within existing baselines, and not added to future funding requests. Since ACC can continue operating within current baselines in the short to medium term, Ministers could consider delaying any funding increase (to the extent it is needed) until ACC has improved its understanding of underlying cost drivers, and / or has achieved specific performance improvements.

Recommended Action

We recommend that you:

a **note** Treasury does not support an increase in ACC baselines at Budget 2017, and

b **consider** raising the following points in your discussion with Minister Woodhouse:

  - Why can't additional costs for ACC non-earners' claims be met within existing baselines, given negative pressures and the likely scope for efficiencies?
  - As improvements in solvency have occurred since this request was estimated, why is a large funding increase needed for treatment injury claims?
  - What specific measures are in place or planned to improve understanding of ACC cost drivers and improve performance? How will progress be monitored?

- How might performance incentives for ACC be improved? How will Ministers' expectations of ACC's performance and management of cost growth be built into ACC's performance and budget management processes?

Ben McBride
Manager, Health

Steven Joyce
Minister of Finance

Treasury Report: ACC at Budget 2017

Purpose of Report

1. This report provides our analysis of the Budget initiative for ACC non-earners' claims. It aims to support your meeting with Minister Woodhouse on 9 March.

ACC Non-Earners' Claims

2. ACC is funded from general taxation for the claims it receives for injured people not in paid employment ('non-earners') including children, older people and visitors to New Zealand. Most claims are relatively straightforward and short-term. A small proportion of claims are for people who require long-term care for serious injury; for example, in the case of injury to an infant at birth. Funding is demand-driven, rather than capped.

3. The funding basis for non-earners' ACC claims changed from pay-as-you-go to fully funded in 2000/01. Post-2001 non-earners' claims are funded on a fully-funded basis. Essentially, this means that:

   - ACC estimates how much funding it will need to cover the forward liability for the coming year's claims (lifetime cost, discounted to present value);
   - ACC adjusts its estimated funding requirements to reflect the ratio of assets to liabilities (solvency) for non-earners' claims. Funding estimates are adjusted downwards if solvency is too high, or upwards if solvency is too low;[1]
   - if ACC's estimated funding requirements (adjusted for solvency) are higher than its existing baseline, additional funding is requested; if they are lower, excess funding is returned to the Crown.

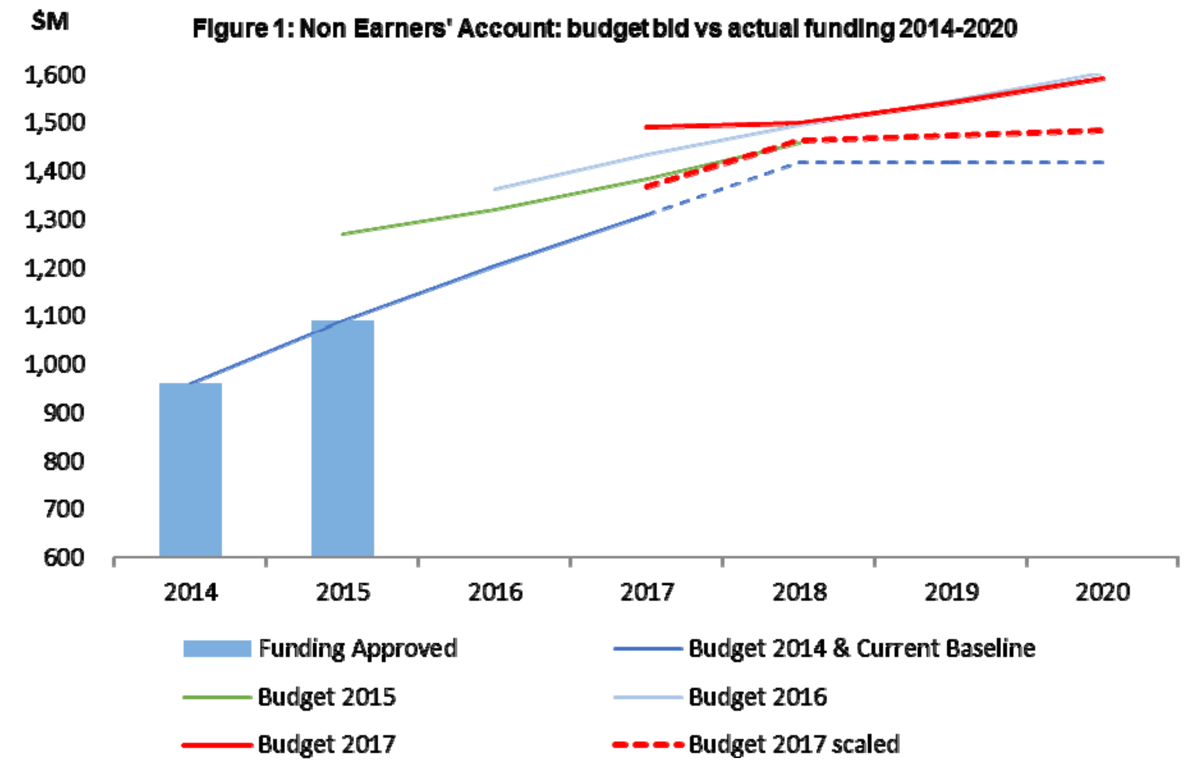
4. Pre-2001 non-earners' claims – some of which are still being paid out – continue to be funded on a pay-as-you-go basis. For these claims, ACC is funded enough to cover each year's cash costs.

5. Table 1 and Figure 1 show how ACC non-earners' funding has played out at the last three Budgets. Essentially, funding has stayed on the track set at Budget 2014.

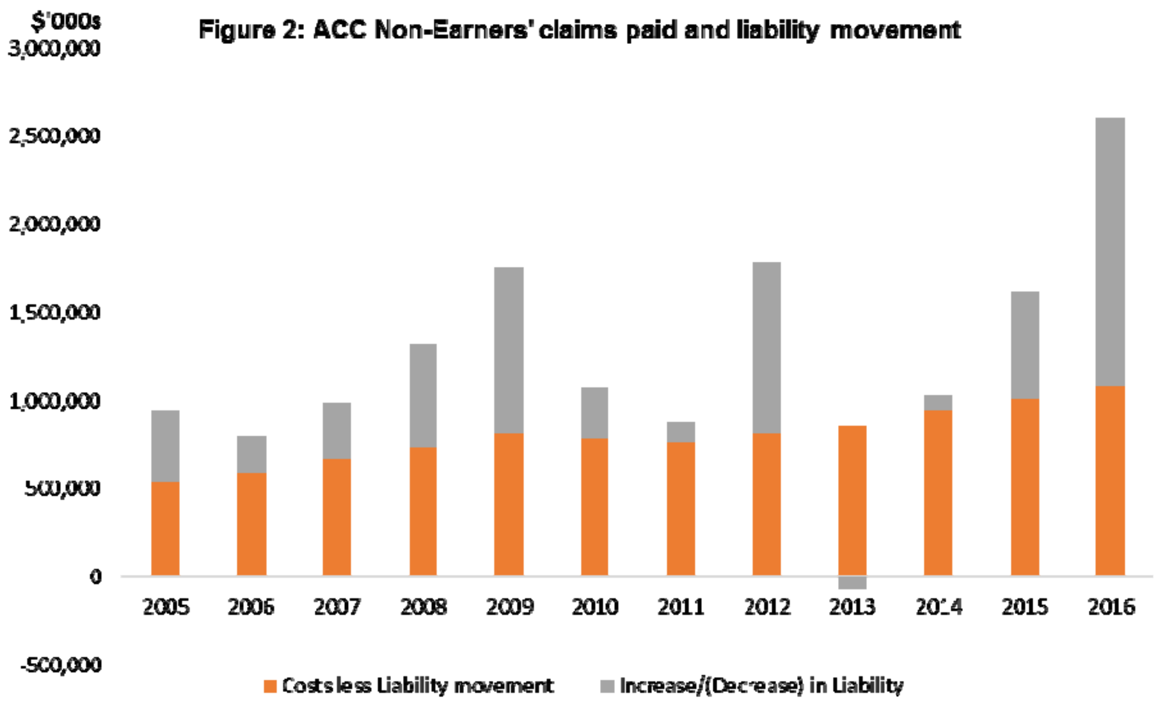
Table 1: ACC estimates and Budget decisions for ACC non-earners' claims, 2014-2016 ($m)

	Budget 2014 (for 2014/15)	Budget 2015 (for 2015/16)	Budget 2016 (for 2016/17)
Estimated lifetime cost of next year's claims	1,119	1,238	1,349
Pay As You Go	115	117	125
Funding adjustment – for solvency position	(273)	(84)	(110)
Total	**961**	**1,271**	**1,363**
Current year baseline	1,134	1,091	1,205
Funding request	**(174)**	**180**	**158**
Budget decision	**(174)**	**0**	**26**

1 Based on a funding target equalling the expected cost of claims to 50 per cent probability of sufficiency (i.e., excluding a risk margin). Given that reported solvency includes a risk margin, this equates to 88 per cent of reported solvency.



6. Funding requests for ACC non-earners' claims have tended to be volatile, reflecting large movements in the claims liability (see Figure 2). Everything else being equal, a fall in discount rates reduces solvency and increases the amount of funding needed today to meet expected future claims costs. Daily movements in discount rates can have a very big impact on the valuation of ACC's claims liability because of the large, long-term nature of the associated future cash flows – ACC claims may be paid out over 80+ years. In our view, it is important not to overreact to this volatility.



There is significant volatility in the claims liability. The liability movement includes expected increases to costs due to unwinding the discount rate each year, but the volatility in yearly results is primarily related to interest rate and inflation movements.

Integrating ACC into the Budget Process

7. Last year, the Minister of Finance and the Minister for ACC agreed to better integrate ACC into the Budget process from 2017 onwards [T2016/1196 refers]. Previously, funding requests for ACC non-earners' claims were submitted later than other Budget initiatives and sat somewhat outside the standard Budget process. Better integrating ACC into Budget creates an opportunity to:

   - better compare funding requests for ACC with other Budget initiatives. This is important given ACC's impact on fiscal targets; any funding increase for ACC non-earners' claims flows through to net core Crown debt, unless it is counted against the operating allowance. It also supports more consistent assessment and prioritisation of Budget initiatives;

   - increase visibility of ACC's claims performance, and explore how funding decisions can signal Ministers' expectations of efficient scheme performance and management of cost growth. Budget decisions have typically been a weak signal to ACC because of ACC's unique policy settings:

     - Underlying costs and performance are typically swamped by the 'noise' of economic changes and solvency adjustments in ACC's funding requests;

     - Incentives for ACC to make efficiencies are limited. As a statutory monopoly, it has a guaranteed customer base. It can meet its short and medium-term costs even when its claims liability is under-funded;

     - ACC's budget is agreed by the ACC Board, within the framework of the Minister for ACC's Letter of Expectations but without Cabinet oversight;

     - There are two separate funding decision processes (the Budget process for non-earners' costs, and levy-setting for other accounts).

8. ACC has worked hard to engage in Budget 2017 and related processes to date. It has provided comprehensive information on its cost pressures, and committed to strategic responses to reduce those pressures. Given the settings in which ACC is used to operating, some aspects of integration into Budget may take time to bed in fully.

ACC at Budget 2017

9. Treasury previously advised you of an ACC Budget initiative costing $182m in 2017/18 and $565m over four years – see Appendix 2. [33]

10. The $565m initiative incorporated the effect of proposed changes to the government funding policy for ACC non-earners' claims, which would align it with the policy for ACC's levy-funded accounts. These policies set some key assumptions about how funding is calculated, but do not determine underlying claims costs or funding levels. The proposed changes to the non-earners' policy do not affect the level of funding required in the long run, but make a big difference to how funding requirements are distributed over time. The changes involve:

   - discounting lifetime costs for the upcoming year's claims using ACC's expected investment returns, instead of risk-free rates. This reduces funding requirements in the short to medium term (these are made up over the long term), and

   - making up over-funding or under-funding over a period of ten years, rather than three years. This smooths volatility in funding requirements.

11. Without these changes, the funding request would have been much larger. In November 2016, you indicated support in principle for proposed funding policy changes to mitigate appropriation increases [T2016/2142 refers].

12. The Minister for ACC is now putting forward a scaled initiative for Budget 2017 (shown in Table 2) which is a subset of the original bid. We understand the initiative was scaled in order to:

- reflect recent improvements in non-earners' solvency, which make a smaller request more appropriate;
- acknowledge specific cost pressures that have arisen for non-earners' claims.

13. In this case, scaling means a reduction in funding, not a reduction in services or expenditure directed to ACC non-earners. Except for the ambulance initiative noted below (which is linked to Health funding), the default position is likely to be that existing levels of services and spending continue regardless of Ministers' funding decisions, with any funding shortfall being requested in future years. If Ministers are seeking a different outcome from this, it will be important to signal this in Budget discussions.

Table 2: ACC – support for non-earners Budget 2017 initiative (scaled) ($m)

	2016/17	2017/18	2018/19	2019/20	2020/21
Current baseline	1,231	1,310	1,417	1,417	1,417
ACC – support for non-earners initiative	**0**	**58**	**48**	**58**	**69**
Requested baseline	1,231	1,368	1,465	1,475	1,486

14. As shown in Table 3, the scaled initiative seeks additional funding for:

- treatment injury cost pressures ($142m over four years) – to support non-earners who have incurred an injury in the course of medical treatment. The cost of treatment injury claims has been rising at a relatively rapid rate (from a low base), driven by volume growth. Given this experience, we understand the Minister for ACC is seeking to boost the solvency of treatment injury claims to safeguard against future cost growth;
- emergency road ambulance services ($55m over four years) – to eliminate single crewing and meet demand growth in road ambulance services. This is a joint initiative with Health;
- free GP visits for under-13s ($36m over four years) – to meet the costs of making injury-related GP visits to children under 13 free of charge, which are funded by ACC. ACC has reflected these costs in its funding requests at previous Budgets but has not been specifically funded for them.

Table 3: Breakdown of scaled non-earners Budget 2017 initiative ($m)

	2016/17	2017/18	2018/19	2019/20	2020/21
Treatment injury	0	43	27	32	39
Free GP visits for under-13s	0	9	9	9	9
Emergency road ambulance services	0	6	12	16	21
Total	**0**	**58**	**48**	**58**	**69**

Treatment injury ($142m over four years)

15. The treatment injury request comprises a funding adjustment ($217m over four years) to increase ACC's reserves for future treatment injury costs, which is partly offset by ~$75m over four years in negative cost pressures (see Table 4). In particular:

- as a result of the proposed new funding policy, the funding requested for treatment injury claims costs is lower than currently allowed for in baselines;

- ACC management strategies – especially injury prevention – reduce the need for funding now and into the future. The costs of these strategies have already been incurred, but the expected benefits had not previously been accounted for in ACC funding requests.

16. The requested funding is for services rather than for ACC's overheads. Operating costs have virtually no effect on the request.

Table 4: Breakdown of cost pressures for non-earners' treatment injuries ($m)

	2016/17	2017/18	2018/19	2019/20	2020/21
Claims costs	0	(13.3)	(12.9)	(12.7)	(12.7)
Operating costs	0	0.5	0	(0.2)	(0.2)
Pay as you go	0	(0.2)	(0.3)	(0.4)	(0.5)
Management response	0	(4)	(6.1)	(6.1)	(6.1)
Total excluding funding adjustment	**0**	**(17)**	**(19.3)**	**(19.4)**	**(19.5)**
Funding adjustment – to increase solvency	0	60.3	46.5	51.7	58.2
Total requested	**0**	**43.3**	**27.2**	**32.3**	**38.7**

17. The main advantage of funding this part of the request is that it would top up the solvency of treatment injury claims, which is currently below target (about 84 per cent of reported solvency as at December 2016, against a target of 88 per cent). It would also help offset pressures likely to arise in future, including for a Terranova settlement and – in the longer term – demographic change.

18. However, we do not consider a baseline increase is needed for treatment injury costs. This is because:

- <u>solvency has increased</u> – the funding adjustment was calculated using June 2016 data, when discount rates (influenced by Brexit) were particularly low compared to recent history and non-earners' solvency sat at around 80 per cent. Discount rates have since increased and can be expected to be on an upward trajectory in the medium term as interest rates are expected to rise, which would mitigate the need for this adjustment;

- <u>the request is negative without the funding adjustment</u> – so maintaining current baselines already implicitly allows for a solvency adjustment in the order of ~$20m per annum;

- <u>the original $565m ACC initiative identified other negative pressures</u>, including an additional ~$45m-~$80m per annum reduction in funding requirements from ACC management strategies (see Appendix 2). It is unclear why these negative pressures should not still be factored in when considering the scaled initiative. If they are, additional treatment injury funding would seem to be warranted only if Ministers assume an even larger adjustment is needed.

19. In principle, there may be a case for a baseline increase to reflect the overall reduction in discount rates in recent years, which – all else being equal – would have increased the level of funding required for non-earners' claims. However, we have no good basis for inferring that an additional solvency adjustment (over and above what is already allowed for in baselines) would be needed. As was the case for the original non-earners' Budget initiative as a whole, the request for treatment injury funding therefore relies on a need for solvency adjustments that has not been demonstrated. Nor do we support additional funding for treatment injury pressures that have not yet materialised.

GP visits for under-13s and ambulance services (totalling $91m over four years)

20. In principle, we think these parts of the request have value:

- Free GP visits for under-13s is an existing Government policy initiative that has resulted in additional costs to ACC, and has not been formally recognised in non-earners' appropriations;

- We expect the ambulance services initiative would deliver good value. A scaled version of the Health part of this initiative was part of the minimum social sector package, and the full Health portion was in the 'minimum plus $100m' package.

21. Even if these components were funded in full, however, we have no good grounds for concluding that a net increase to ACC baselines is needed. Given the negative pressures across the non-earners' appropriations, it should be possible to meet these costs from within existing baselines. If current non-earners' baselines are held, you may wish to signal to the Minister for ACC that the funding requested for these services has been approved and should not be included again in future Budget requests.

The scope for efficiencies

22. In addition, we think there is scope for tighter management of ACC performance and costs overall. In the four years to 2016, claims costs have grown 40 per cent as against 12 per cent volume growth. Deteriorating claims performance has increased ACC's claims liability by $2b above expectations over the past three years [T2017/301 refers].

23. Specifically in relation to non-earners' claims:

- most of the increase in ACC's claims liability for sensitive claims (~$126m in the year to June 2016) arises in respect of non-earners. Sensitive claims costs are much higher than anticipated, and we do not yet have good information about the outcomes this funding is delivering;

- it is unclear why the use of certain services (physiotherapy, radiology, other medical services) has risen by ~20-35 per cent over 10 years. Independent actuaries have recommended investigating this further;

- entitlement claim frequencies are back to pre-2009 levels in the Non-Earners' Account (and all other accounts except Motor Vehicle) and are now roughly the same proportion of total claims as they were in that period. Cost growth in the scheme over that period was not seen as sustainable, and prompted a tightening of the scheme from 2009-2012;

- increased cost pressure on social rehabilitation, including an increase in average care hours for existing serious-injury claims, has resulted in significant liability growth since June 2016.

24. The scale of these increases suggests ACC can reasonably be expected to absorb some of its non-earners' funding requirements through efficiencies. We suggest you discuss this with the Minister for ACC.

Terranova costs

25. This initiative excludes the costs to ACC of implementing a Terranova settlement. These have been allowed for in preliminary forecasts, calculated according to the current funding policy for non-earners' claims. Funding requirements would differ (and should be lower in the short to medium term) under the proposed funding policy.

26. Additional funding is likely to be sought alongside approval for a final settlement. We will provide advice on any funding request in due course. Since ACC can absorb cost increases in year, funding for ACC's Terranova costs could be delayed until Budget 2018, although we would not expect ACC to favour this approach.

Next steps

27. We recommend that you:

    - discuss the ACC Budget 2017 initiative with the Minister for ACC, using the suggested speaking points in the recommendations, and
    - as part of the Budget process, consider signalling:
        - which elements of the initiative Ministers fully, partially or do not support, even if it does not make a difference to ACC baselines overall, and
        - an expectation that ACC's existing cost pressures for non-earners' claims be absorbed within baselines and not added to future funding requests.

28. Since ACC can continue operating within current baselines in the short to medium term, Ministers could consider delaying any funding increase (to the extent it is needed) until ACC has improved its understanding of underlying cost drivers, and / or has achieved specific performance improvements.

[40]

Appendix 1: Initiative summary spreadsheet (attached)

Appendix 2: Further information on the $565m initiative

The following tables summarise the original Budget initiative for ACC non-earners' claims, which has been referenced in our social sector Budget advice.

The table on the following page, which is extracted from an ACC report, breaks down the contents of Table A2 further to show funding requirements by cost category. For most of the cost categories, the funding request is lower than the 2017/18 approved level. This arises from the application of the proposed funding policy, which uses a higher expected rate of return on investment – see also paragraph 10 in the body of the report.

Table A1: ACC – support for non-earners Budget 2017 initiative ($m)

	2016/17	2017/18	2018/19	2019/20	2020/21
Current baseline	1,231	1,310	1,417	1,417	1,417
ACC – support for non-earners	**0**	**182**	**83**	**124**	**176**
Requested baseline	1,231	1,492	1,500	1,541	1,593

Table A2: Breakdown of ACC Budget initiative ($m)

	2016/17	2017/18	2018/19	2019/20	2020/21
Requested increase excluding funding adjustment	0	72	63	72	83
Management response	0	(50)	(74)	(81)	(88)
Other negative pressures	0	(47)	(48)	(52)	(57)
Difference	**0**	**(25)**	**(59)**	**(62)**	**(62)**
Funding adjustment – to increase solvency	0	207	142	186	238
Total requested	**0**	**182**	**83**	**124**	**176**

Funding Request - Total Cost Pressures by Cost Category

Proposed Funding Policy
2017/18 Approved Baseline

Cost Category	2017/18 $'000	2018/19 $'000	2019/20 $'000	2020/21 $'000
	Cost Pressures by Year			
Dynamic Risk Models				
General Practitioner	4,923	4,679	3,906	3,064
Physiotherapy	(4,729)	(5,418)	(5,668)	(5,946)
Radiology	(2,589)	(2,828)	(3,081)	(3,372)
Other Medical	(292)	(295)	(492)	(842)
Elective Surgery	(8,077)	(8,372)	(8,791)	(9,316)
SI Social Rehab (non capital)	(10,064)	(8,490)	(7,374)	(6,544)
Public Health Acute Services	(11,161)	(14,134)	(17,285)	(20,619)
	(31,990)	(34,858)	(38,785)	(43,574)
Other Models				
Other Social Rehabilitation	(5,864)	(6,238)	(6,598)	(6,258)
Weekly Compensation	(1,762)	(1,648)	(1,556)	(1,486)
Fatal Benefit	(109)	(114)	(120)	(127)
Vocational rehabilitation	(33)	(31)	(30)	(30)
IA & Lump Sum	(955)	(850)	(769)	(702)
	(8,723)	(8,881)	(9,073)	(8,603)
Operating Costs				
Administration Expenses	3,742	4,428	5,454	6,540
Claims Handling	9,664	8,285	7,748	8,069
Injury Prevention	(941)	94	(555)	(1,119)
	12,465	12,807	12,647	13,490
Funding Adjustments				
Funding Adjustment	206,901	142,381	186,117	237,530
Pay As You Go	852	350	80	(297)
	207,753	142,732	186,196	237,233
Treatment Injury Account				
Treatment Injury Account	47,300	33,387	38,515	44,731
Ambulance	6,000	12,000	16,000	21,000
Management Response	(50,430)	(74,091)	(81,340)	(88,421)
Total Cost Pressure	182,375	83,096	124,159	175,856

Vote Labour Market - ACC portfolio

No.	Agency/Sector	Initiative name	Agency initiative (net) 2016/17	2017/18	2018/19	2019/20	2020/21	Avg.	ROI	Value-for-Money Rating	Strategic Alignment	Comments from the Social Investment and Capital Investment Panel *(if relevant)*	Treasury Analysis and Comments
Cost Pressure Initiatives													
9642	Vote Labour Market - ACC portfolio	ACC - support for non-earners	-	58.000	48.000	58.000	69.000	**58.250**	N/A	1*	3*	Not applicable	Post-2001 non-earners' claims are funded on a fully-funded basis, although the amount funded in a given year is discretionary. Given discount rate changes and negative cost pressures (arising from proposed funding changes and ACC initiatives), and the likely scope for efficiencies, existing baselines should be sufficient to cover cost increases. There is no risk to ACC services in the short or medium term if baselines are not increased.
New Initiatives													
		Total Funding	-	**58.000**	**48.000**	**58.000**	**69.000**	**58.250**					

* Note these assessments reflect the original ACC initiative ($565m over four years), though the scaled initiative has similar benefits and drawbacks. Treasury granted this initiative an exemption from CBAx.