Reference: 20150160

22 July 2015

Thank you for your Official Information Act request, received on 12 May 2015. You requested the following:

- *Briefings, reports and the like written by the department since January 2014 regarding potential changes to the levy setting framework for ACC*

On 11 June we responded to your request, advising you that 19 documents relevant to the request would be released publicly as part of the Treasury's Budget 2015 proactive release and a specific ACC release. On 9 July we advised you that the ACC release would not include Treasury documents and that we would provide you with a further response covering the remaining information you requested.

Information Being Released

Please find the enclosed the following documents:

Item	Date	Document Description	Decision
1.	6 March 2014	Setting a Government funding policy for ACC	Release in part
2.	6 March 2014	Aide Memoire: Government funding policy for ACC	Release in part
3.	11 March 2014	ACC funding policy for Fiscal Issues	Release in full
4.	4 April 2014	Further information about setting a Government funding policy for ACC	Release in part
5.	8 April 2014	Aide Memoire: Further information about setting a Government funding policy for ACC	Release in part
6.	27 May 2014	Aide Memoire: Transition to a new ACC funding target	Release in full

7.	3 July 2014	Aide Memoire: Options for moving to ACC's new funding target	Release in full
8.	25 July 2014	Aide Memoire: Transition to the funding policy for ACC's levied accounts	Release in part
9.	31 July 2014	Aide Memoire: Transition to ACC's funding policy – macroeconomic considerations	Release in full
10.	13 November 2014	Aide Memoire: ACC funding policy – issues for discussion	Release in part
11.	13 March 2015	EGI Briefing ACC funding and levies	Release in part

I have decided to release the documents listed above, subject to information being withheld under one or more of the following sections of the Official Information Act, as applicable:

- personal contact details of officials, under section 9(2)(a) – to protect the privacy of natural persons, including deceased people,
- advice still under consideration, section 9(2)(f)(iv) – to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials, and
- legal advice under section 9(2)(h) – to maintain legal professional privilege.

Information Publicly Available

The remaining documents detailed in our letter to you of 11 June are now publicly available on the Treasury website.

Please note that this letter (with your personal details removed) and enclosed documents may be published on the Treasury website.

This fully covers the information you requested. You have the right to ask the Ombudsman to investigate and review my decision.

Yours sincerely

Ben McBride
Manager, Health

Information Being Released
OIA 20150160

Doc 1	Page 1
Doc 2	Page 22
Doc 3	Page 26
Doc 4	Page 30
Doc 5	Page 54
Doc 6	Page 56
Doc 7	Page 59
Doc 8	Page 63
Doc 9	Page 65
Doc 10	Page 71
Doc 11	Page 74

RECEIVED
14 APR 2014
MINISTERIALS

JOINT ACC, TREASURY AND MBIE BRIEFING

Setting a Government funding policy for ACC

RELEASED UNDER THE OFFICIAL INFORMATION ACT

Date:	6 March 2014	**Priority:**	High
Security Classification:	In Confidence	**Tracking number:**	Treasury – T2014/375 MBIE – 1963 13-14 ACC – BP 14/006

ACTION SOUGHT		
	Action sought	**Deadline**
Hon Bill English **Minister of Finance** Hon Steven Joyce **Associate Minister of Finance** Hon Judith Collins **Minister for ACC** Hon Craig Foss **Associate Minister for ACC**	**Note** that a meeting has been scheduled for Joint Ministers to discuss the briefing at 8.30pm on Tuesday, 11 March 2014.	11 March 2014

CONTACT FOR TELEPHONE DISCUSSION (IF REQUIRED)			
Name	**Position**	**Telephone**	
Ben McBride	Manager, Health **The Treasury**	04 917 6184	*[Withheld under s9(2)(a)]*
Kirstie Hewlett	General Manager, Labour Environment **Ministry of Business, Innovation and Employment**	04 901 8603	
Herwig Raubal	General Manager, Actuarial and Risk **ACC**	04 816 6272	

14 APR 2014

JOINT REPORT FROM THE ACC, THE TREASURY, AND THE MINISTRY OF BUSINESS, INNOVATION AND EMPLOYMENT:

SETTING A GOVERNMENT FUNDING POLICY STATEMENT FOR ACC

Executive Summary

1. Over recent years there has been a disconnect between the levies that ACC has recommended and the levies agreed by Cabinet. On 10 October 2011 Cabinet therefore directed officials to undertake a 'review of the funding policy for the Accident Compensation Corporation (ACC) Accounts and the reasons for the fluctuations in the projections of the ACC's Accounts' [CAB Min (11) 37/19 refers].

2. Officials consider that these disconnects are a result of different weightings or considerations applied by Government and ACC to factors, such as acceptable levels of levy and funding volatility, appropriate funding targets and the public interest which is rightly only considered by the Government. There has also been a lack of transparency around how to go about setting levies, particularly related to what, and how, critical factors should be taken into account. These issues are compounded by the time constraints of annual levy rounds.

3. There is often public confusion around the current levy setting process with much of the public not understanding that ACC's levy consultation process is separate from the Cabinet decision making process, particularly when the Government sets levies at rates different to those consulted on and recommended by ACC.

Setting parameters for ACC's funding policy

4. This paper proposes that the Government provides more clarity around key issues like how levy and funding volatility should be treated in the calculation of levies and the Government's preferred funding target, making it more likely that ACC would consult on, and recommend, levy rates that are accepted by the Government.

5. Any funding policy would not remove the Government's prerogative to set different rates to those proposed by ACC if it was in the public's interest. The Government would also be able to amend its funding policy to reflect its preferences.

Improving transparency of the Government's public interest considerations

6. Further improvements to transparency and accountability could also be made by the Government stating:

   - the factors of public interest it intends to consider as part of its levy making decisions, recognising these would not be exhaustive; and

   - the rationale when the Government decides not to follow ACC's advice and how the Government's levy rates relate to its funding policy.

What: The proposed contents of the Government's funding policy

7. The core objectives of ACC funding are reasonably agreed. Achieving inter-generational equity, ensuring that each cohort faces the true cost of the accident cover

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it receives, keeping levies reasonably stable, providing correct incentives to avoid accidents and ensuring long-term solvency are all important. There are numerous trade-offs between these goals. The funding policy is a statement of how the Government expects these various risks and trade-offs to be managed.

8. The package proposed by officials involves the following:

- Setting a base levy that would cover the lifetime cost of injuries expected to be incurred in the coming levy year. This in effect represents the true underlying cost of providing accident cover, which should anchor levy rates.

- When the funding level deviates from the funding target, including a levy adjustment that would return the funding level to the target over a period of 10 years (a 10 year funding horizon). This balances the need to pursue a funding target without compromising the incentives and accountability for the effective management of the Scheme. This is a longer horizon than has previously been used. It should result in more stable levies and fewer surprises in levy recommendations.

- A cap on average levy increases for each levied Account from one year to the next of 15%. This would add further stability to levies.

9. While officials agree on the parameters for setting levies, we have differing perspectives on an appropriate funding target.

- **The ACC Board's** interpretation of its requirement to fully fund the Scheme involves setting a funding target that will usually result in a surplus on ACC's balance sheet. ACC proposes a funding target of 110% of the reported liabilities which is assessed to be consistent with a balance sheet surplus being reported 69% of the time. The ACC Board agrees that from time to time ACC's balance sheet can be in deficit as it can post-fund. However, it does not consider setting levies with the expectation that they will generate a balance sheet deficit to be consistent with its obligations to fully fund or its obligations as Board members. Rather the Board considers that levies should be set targeting a surplus, but noting that a deficit may arise from time to time. It is important to consider separately the risk margin, which is required to be reported as a liability in the financial accounts, and the buffer, which is designed to ensure that the Accounts are usually in surplus. The recommended funding target, therefore, contains a risk margin plus a 10% buffer.

- **The Treasury and the Ministry of Business, Innovation and Employment** (the Ministry) consider that it is more important that levies collect the minimum required to fully fund the Scheme. This involves setting the funding target at the expected cost of claims (which has a 50% probability that the estimate of liabilities is sufficient to cover claim payments). This is consistent with the Government's current funding policy for the Non-Earners' Account and the Treasury and the Ministry do not consider that extending this approach to the levied Accounts would pose any meaningful risk to the Scheme. Officials agree that a lower funding target would have no discernible impact on ACC's ability to provide entitlements in the future, since ACC is required to post-fund any shortfalls through its levies. The Treasury and the Ministry consider that the $4 billion difference between ACC's higher funding target and the expected cost of claims is better placed with levy payers. *[Withheld under s9(2)(h)]*
[Withheld under s9(2)(h)]
However, this option would mean that ACC would have a deficit on its balance sheet more of the time, as the expected cost of claims would be less than the

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reported liabilities (which includes a risk margin, as required by accounting standards[1]).

10. It is possible to investigate funding target options that include a combination of risk margin and buffer but such options would not meet the objectives that Options 1 and 2 are respectively designed to meet. For example, a funding target of 100% of reported liabilities (which would include the risk margin but no buffer) would not meet the ACC Board's interpretation of full funding, which requires more frequent balance sheet surpluses than deficits. Nor, from the Treasury or the Ministry's perspective, would funding the risk margin mitigate any risk in addition to Option 2.

11. ACC would continue to be responsible for the technical assumptions in calculating levies which would have to be consistent with the Government's funding policy and stated in the ACC Board's funding policy. The Ministry would continue to review these assumptions using external actuarial advice.

[Withheld under s9(2)(f)(iv)]

How: Ministerial Direction and subsequent legislation change

13. A Ministerial Direction under the Crown Entities Act 2004 could be issued requiring ACC to consult on, and recommend, levies consistent with the Government's funding policy.

14. Officials also recommend making it a legislative requirement for the Government to issue a funding policy statement. An amendment to the AC Act could also strengthen the transparency and accountability of the levy setting process by requiring the Government to state factors of public interest it considers to be important and to specify its reasons for not accepting ACC's recommendation, should that occur.

15. Cabinet decisions would be required to issue a Ministerial Direction and to initiate the drafting of legislative amendments for inclusion in a bill.

16. Officials would like to discuss with Ministers the Government's expectations for when decisions would be made and implemented, given the timing of this year's levy round and that a bid has been placed for a bill to amend the AC Act to be introduced at the end of 2014. The time constraints placed by the 2014 election mean that implementing a Government funding policy to inform the upcoming 2015/16 levy round would be challenging.

Not relevant to request

[1] NZ International Financial Reporting Standards (IFRS) require a risk margin to be reported but not funded, as discussed later in this paper. They do not specify the required level of the risk margin.

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Recommendations

The Accident Compensation Corporation (ACC), the Treasury, and the Ministry of Business, Innovation and Employment (the Ministry) recommend that you:

Setting parameters for ACC's funding policy

a **Agree** that a Ministerial Direction is issued under the Crown Entities Act 2004, outlining the Government's policy on how ACC's levied Accounts (Work, Earners' and Motor Vehicle Accounts, and the earners' portion of the Treatment Injury Account) are to be funded.

AGREE / DISAGREE

b **Agree** that the Government's funding policy includes the following parameters for setting levies:

- Setting a base levy that would cover the cost of injuries expected to be incurred in the coming levy year.
- When the funding level deviates from the funding target, include a levy adjustment that would return the funding level to the target over a period of 10 years (a 10 year funding horizon).
- A 15% cap on levy increases to average levies in each levied Account from one year to the next (adjusted for inflation in the Motor Vehicle Account).

AGREE / DISAGREE

c **Agree** that the Government's funding policy includes a funding target of:

EITHER:

- 110% of ACC's reported liabilities – ACC's recommendation.

AGREE / DISAGREE

OR:

- the expected cost of claims (50% probability of sufficiency) – The Treasury and the Ministry's recommendation.

AGREE / DISAGREE

d **Note** that ACC would continue to set the technical assumptions that go into the levy setting process within the parameters of the Government's funding policy.

e **Note** that the Government would also be able to amend its funding policy to reflect its preferences and the Government would continue to be able to set different levy rates to those proposed by ACC if it was in the public's interest.

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Improving transparency of the Government's public interest considerations

f **Agree** that the Government outlines:

- the issues of public interest that it expects to consider when setting levies, to allow levy payers to understand the types of considerations the Government will take into account; and
- the rationale when Government decides not to follow ACC's advice and how the Government's levy rates relate to its funding policy.

AGREE / DISAGREE

[Withheld under s9(2)(f)(iv)]

Not relevant to request

Setting these improvements to the levy setting process in legislation

j **Agree** that the funding policy be part of a Ministerial Direction until the high level framework for the levy setting process can be placed in legislation, subject to agreement on a timetable to progress these proposals.

AGREE / DISAGREE

Timing

k **Note** that time constraints placed by the 2014 election mean that implementing a Government funding policy to inform the upcoming 2015/16 levy round would be challenging.

l **Note** that a bid has been placed for a bill to amend the Accident Compensation Act 2001 to be introduced at the end of 2014 and decisions on the funding policy would have to be made in 2014 to be included in that bill.

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m **Agree** to meet officials to discuss a timetable for progressing these recommendations, which will require Cabinet agreement.

AGREE / DISAGREE

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Ben McBride
Manager, Health
The Treasury
___/___/___

Hon Bill English
Minister of Finance
___/___/___

Kirstie Hewlett
General Manager
Labour Environment
Ministry of Business, Innovation and Employment
___/___/___

Hon Steven Joyce
Associate Minister of Finance
___/___/___

Herwig Raubal
General Manager Actuarial and Risk
Accident Compensation Corporation
___/___/___

Hon Judith Collins
Minister for ACC
___/___/___

Hon Craig Foss
Associate Minister for ACC
___/___/___

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Purpose

1. On 10 October 2011 officials were directed to undertake a 'review of the funding policy for the Accident Compensation Corporation (ACC) Accounts and the reasons for the fluctuations in the projections of the ACC's Accounts' [CAB Min (11) 37/19 refers]. Interim reports have been provided to Ministers English, Joyce, Collins and Foss.

2. This paper proposes:

   - setting a Government funding policy to improve the ACC levy setting process, with a view to encouraging more transparency of the Government's funding preferences and improving the alignment of ACC's levy recommendations with the Government's expectations;

   - that the Government articulates the issues of public interest it intends to factor into its decisions, recognising these would not be exhaustive;

[Withheld under s9(2)(f)(iv)]

Not relevant to request

3. This paper was developed jointly between ACC, the Treasury and the Ministry of Business, Innovation and Employment (the Ministry) and its advice should be taken as joint advice. Agencies' individual views are identified where a unanimous recommendation could not be reached, due to the legitimate differences in perspectives given the remit of the respective agencies.

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PART ONE: IMPROVING THE ACC LEVY SETTING PROCESS

Problem definition

In recent years, the Government has more often than not rejected ACC's levy recommendations

4. ACC's recommendations, in recent years, have only had limited influence on the levy rates the Government has eventually set. The Government has only accepted ACC's recommendations for all three levied Accounts once in the last six years.

5. There are two reasons why the Government may not have accepted ACC's recommendations in recent years:

   - Differing views between the Government and ACC on funding policy, particularly in critical areas such as funding targets, and preferences around levy and funding volatility. There is no clear statement of the Government's objectives and preferences in the funding of ACC's levied Accounts for ACC to factor into its own funding policy and ACC itself has changed its funding approach a number of

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times over the last few years. There has been limited engagement between Ministers and the Board about ACC's funding policy.

- The Government considers a wider range of factors when setting levies, including issues of public interest, which are beyond ACC's responsibilities.

6. The main focus of this paper is the first bullet point above. Given that wider factors such as public interest are beyond the remit of the ACC Board, officials consider that they sit outside the scope of any funding policy. However, we have identified steps that Ministers could take to improve the clarity and transparency of the levy-setting process where they choose not to accept ACC's recommendations on the basis of public interest factors (the second bullet point above). These are discussed in paragraphs 17 to 20 below.

There is a downside to the disconnectedness in the levy setting process

7. The weightings given to the factors taken into account in the levy setting process and the lack of transparency has meant that Government decisions have not always benefited from the full extent of ACC's technical expertise and public submissions on all of the options it might want to consider.

8. This is compounded by the time and resource constraints resulting from annual levy rounds, when work has to begin on the coming year's levies as current year levies are being implemented.

A lack of transparency is a barrier to stakeholder understanding

9. Confusion can also result from the public not understanding that ACC's levy consultation process is separate from the Cabinet decision making process, particularly when the Government sets levies at rates different to those consulted on and recommended by ACC.

10. This can be aggravated by the fact that while the public has access to ACC's funding policy, the Government has no explicit funding policy that guides and explains its levy decisions. While ACC's consulted levy rates are accompanied by a comprehensive package of information about the Corporation's funding policy, detailed levy rates and future levy intentions, the rates set by the Government are often different to the ACC rates and are unaccompanied by supplementary information.

The ACC levy setting process could be improved if the Government stated its expectations

A Government funding policy would improve consistency between ACC's recommended rates and Government expectations

11. Officials consider that the issues described above can be significantly improved if the Government set out a funding policy for the ACC levied Accounts, that ACC was required to follow when it calculates levies it consults on and recommends to the Government.

12. Differences of perspective on appropriate funding targets, acceptable funding and levy volatility were behind the differing levy recommendations provided by ACC, the Treasury and the Ministry in recent years. Providing clarity on these issues will go some way to resolving key areas of difference and enable ACC to develop proposed levy rates knowing the Government's intentions in these areas.

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13. Setting a Government funding policy now would also mean that Ministers would not need to consider this aspect of ACC levies each time levy decisions were made.

14. Agencies consider an appropriate Government policy in this area would comprise:

    - parameters for calculating levies (including a funding horizon); and

    - a target level of funding for ACC's levied Accounts.

15. This solution is expected to achieve the best balance of providing alignment between ACC's recommendations and the Government's agreed rates. Further, it is also expected to bring more transparency to the process, without encroaching on ACC's statutory responsibilities and capabilities.

The Government could still change its funding policy from time to time

16. The Government would continue to shape its funding policy if its risk preferences changed. Theoretically this could be done any number of times but officials consider that each change to the Government's funding policy would need to be made public in order to maintain the transparency of the process.

Improving transparency of the Government's public interest considerations

17. While a Government funding policy statement would align ACC's levy recommendations with the Government's intentions around funding policy, there would remain the potential for the Government to set alternative levy rates where it was considered to be in the public interest to do so. This is because it is the Government's prerogative to make calls on aspects of broader public interest like affordability to levy payers and the impact on the Government's financial accounts.

18. This could however continue to cause confusion with the public, who may not understand the difference between ACC's recommendations and the Government's agreed levy rates.

19. It would therefore be helpful for the Government to provide some guidance upfront on the factors of public interest the Government intends to consider, in addition to the factors within its funding policy, recognising that any guidance will never be exhaustive around what is in the public interest. Making these public interest factors available to the public would act as a reminder that the Government's decisions could differ from ACC's recommendations.

20. Transparency and accountability would also be improved if Ministers publicly stated their reasons when they do not follow ACC's advice and how the Government's levy rates relate to their funding policy. This would ensure that any departure from the stated funding policy was clearly understood.

PART TWO: CONTENTS OF A GOVERNMENT FUNDING POLICY

Parameters for calculating ACC levies (including a funding horizon)

21. The first key element recommended for a funding policy is how ACC levies should be calculated. Officials consider the key objectives that need to be considered in this regard are:

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- To ensure intergenerational equity, so that in a given year those covered by the Scheme fund the expected lifetime cost of injuries that occur in that period.

- To set prices as close as possible to the underlying costs of providing cover. This helps ensure that those covered face the right incentives to promote safety and avoid accidents.

- To maintain reasonable stability in levy rates.

- To ensure long term solvency of the Scheme.

- To support accountability for effective management of the Scheme.

22. There are inevitable trade-offs to be made between these objectives. For example, where the Scheme has diverged from full funding there is an inherent trade-off between returning quickly to the funding target (which implies larger, more immediate changes in levies) and holding levies reasonably constant (which implies a longer transition back to target solvency). Likewise, where underlying costs change, and this is expected to be permanent, it is in principle desirable that levy rates change quickly to reflect this. Such conflicts and trade-offs are continuously present. The main purpose of a funding policy is to set in advance how these trade-offs will be managed.

23. The case for the Government to set a funding policy is independent of the level of funding ACC is required to target (discussed from paragraph 35 below).

The recommended base levy rate

24. Levies can be thought of as comprising two components:

- An amount to cover the expected lifetime cost of claims incurred in the coming levy year ("base rate"). If the Scheme was at target solvency, and costs were stable, then levies could remain constant at this level indefinitely.

- A funding adjustment (positive or negative) that brings ACC's funding position back towards the funding target.

25. In line with the basic full funding approach, levies collected in a year are set to cover the cost of injuries incurred in that year, regardless of when the entitlements are paid out. This is important for a long-tail Scheme like ACC because it means that levies are set to cover entitlements that are paid out up to 80 years in the future.

26. Setting levies in this full-funded fashion means that people contribute to the cost of their injuries, rather than leaving the burden to future levy payers. By aligning costs as directly as possible with those responsible, levy changes more accurately reflect increases or decreases to the incidence, or severity, of injury.

27. Officials therefore recommend that the base levy rate should continue to be set using the expected cost of claims for the upcoming year.

Adjusting the base levy to take the funding level towards the target

28. In reality, ACC's assets will rarely be at the selected target funding level (discussed further below). ACC's finances are subject to a continuous range of shocks, including economic conditions, claims experience, discount rates and investment returns. Collectively these can have significant effects on the funding position.

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29. Officials propose the following approach to adjust the funding level towards the target when deviations result from changing economic conditions and claims experience:

 - Adjustments to the base levy rate would seek to return the funding level to the target over a period of 10 years (a 10 year funding horizon).

 - As an additional safeguard, levy increases from one year to the next would be capped to 15%.

30. The 10 year funding horizon is longer than that typically used in recent years (3 to 5 years has been more the norm). This longer horizon allows more stable levy rates, since past unders and overs are amortised more slowly over future years. There is a trade-off in terms of deviations from target solvency levels, which will tend to be greater than if rebalancing took place more rapidly.

31. Officials' judgement is that a 10 year horizon would allow a reasonable level of levy stability, without removing incentives and accountability for the effective management of the scheme that a longer time period would start to cause. A 10 year horizon would keep levies more stable than the current 5 year horizon.

Limiting average levy rate changes within each Account

32. As an additional safeguard, officials recommend that a limit be placed on overall year to year levy increases for each Account. This constraint is likely to be largely redundant; given the 10 year rebalancing horizon it would be relatively rare that this cap was brought into operation. Its main purpose is to reassure Government that the proposed policy will not produce unanticipated large increases.

33. Officials therefore recommend a limit to levy increases, and for the limit to be set at 15%.

34. The 15% cap would be adjusted for the Motor Vehicle Account to allow levy changes to include increases due to inflation.

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Setting a funding target

The AC Act leaves open the questions of what the funding target should be

35. The second key element to setting a Government funding policy is the level of funding that these Accounts should be targeting. Setting the funding target amounts to providing the detail for what "fully fund" and "adequate" mean in the context of the AC Act, which requires the levied Accounts to fully fund the cost of all claims with an adequate level of assets.

36. No legal definition of "fully fund" or "adequate" can be definitively discerned from the AC Act, and *[Withheld under s9(2)(h)]*

37. Differences of perspective on the funding target was the cause of ACC, the Treasury and the Ministry presenting Ministers with alternative levy rates to choose from in recent years. This contrasts to the situation for the Non-Earners' Account, where the Government has articulated a funding policy.

38. Officials agree that an alignment of Government and ACC with respect to the funding target would be beneficial.

Two options based on different perspectives of what "fully fund" and "adequate" mean

39. Officials have set out two options for the funding target. These generally correspond to the funding targets underlying the levy recommendations presented to Ministers in recent years by ACC on the one hand, and the Ministry and the Treasury on the other, although ACC has included here for consideration a slightly amended funding target based on results from its recently developed dynamic risk model.

40. At the heart of the differences between the two options outlined below is that the **first option**, favoured by ACC, sets the funding target in the context of the Board's financial risk assessment. The ACC Board considers that full funding requires an expectation that the levied Accounts will not usually be in deficit. The ACC Board therefore recommends that the target level of funding be 110% of the reported liabilities. It is important to recognise that the reported liability includes a risk margin as required by accounting standards. The recommended funding target therefore includes this risk margin plus a 10% buffer to provide confidence that the levied Accounts will not usually be in deficit.

41. The **second option**, favoured by the Treasury and the Ministry, sees full funding to mean holding assets equal to the expected cost of claims: a 50% probability that the estimate of liabilities is sufficient to cover claim payments, in line with the funding target for the Non-Earners' Account, and in recognition of the fact that ACC has the power to levy.

42. The trade-offs and implications of these two options are discussed more fully below.

43. The following table shows the difference between the respective funding targets as at 30 June 2013[2].

Figure 1: Difference between funding at the lower funding level (expected cost of claims) and higher funding levels (with risk margins)

Option	Funding level
Option 1: 110% of reported liabilities (75% probability of sufficiency plus 10% buffer)	$20,911m
Option 2: expected cost of claims (50% probability of sufficiency)	$16,909m

Option 1 – 110% of reported liabilities, with a focus on the balance sheet

44. The first option sets the target funding level for the levied Accounts at 110% of the liabilities reported in ACC's financial accounts[3]. The reported liabilities on ACC's balance sheet include a risk margin as required by the relevant accounting standards. It is important to consider separately the risk margin, which is required to be reported as a liability in the financial accounts, and the buffer, which is designed to ensure that the Accounts are usually in surplus. The recommended funding target, therefore, contains a 10% buffer.

Not Relevant to Request

[3] This is a slightly lower funding target currently used by ACC, which has a midpoint of 115.5% or 117.5% depending on the Account.

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45. It is worth noting that standard commercial practice for an insurer would be to establish a buffer of 100% or more. The Board acknowledges that this is excessive given ACC's status. Nonetheless, it notes that the recommended buffer is far from excessive in commercial terms.

46. In arriving at the level of 110%, the Board undertook an assessment of a range of funding targets from 90% to 110% (i.e. a buffer of -10% to 10%), the former approximating to Option 2 below. The Board was provided with an assessment of the financial risk entailed based on internal modelling. The Board noted that:

- There is a 10% chance of the funding ratio falling 25 percentage points below the target. This represents $4.8b based on the liabilities at 30 June 2013.
- A target funding level of 110% of liabilities implies that the levied Accounts would report a balance sheet deficit 31% of the time.
- A target funding level of 90% of liabilities implies that the levied Accounts would report a balance sheet deficit 70% of the time.

47. The Board considers that reporting a deficit 70% of the time is not consistent with full funding. It also notes the reasonably high probability of a very large loss arising in any one year. Such a large loss is more readily sustained when starting from a surplus than a deficit.

48. The ACC Board agrees that from time to time ACC's balance sheet can be in deficit as it can post-fund. However, it does not consider setting levies with the expectation that they will generate a balance sheet deficit to be consistent with its obligations to fully fund or its obligations as Board members. Rather the Board considers that levies should be set targeting a balance sheet surplus, but noting that a deficit may arise from time to time. The Board considers that the target of 110% of liabilities provides an appropriate buffer on the balance sheet to ensure that the levied Accounts will usually report a surplus, and occasionally a small deficit, which is consistent with the obligation to fully fund the Accounts, without being so conservative as to raise an unreasonable amount of capital on the balance sheet. Noting that even at this level the levied Accounts will be in deficit 31% of the time, the Board considers 110% of the reported liabilities to be the minimum acceptable funding target.

49. The Board is concerned to ensure that the ACC Scheme is run in a stable manner over time. Balance sheet deficits are not, in the Board's view, consistent with stability in the Scheme. The Board is concerned that targeting a balance sheet deficit, as would be the case with option 2 below, generates significant risk of instability in the Scheme's management.

50. To refer to a recent example, in the year to 30 June 2012 ACC reported a loss due to interest rate movements of approximately $5 billion. Whilst this is not likely to be repeated in the near term given the current level of Government Bond rates, it is certainly a possibility in the future. Should it be the case that the levied Accounts target a $2 billion balance sheet deficit, which is implied by Option 2, a similar interest rate movement will mean that ACC will report a $7 billion deficit on its balance sheet in respect of the levied Accounts alone. The Board considers that this will necessarily require a firmer response than under Option 1, whereby the levied Accounts will have started from a $2 billion balance sheet surplus and so report a $3 billion balance sheet deficit under the scenario.

51. The Board is also concerned that Option 2 will impact the public's confidence in ACC's financial management. ACC's financial results are widely reported in the media and a large balance sheet deficit will likely attract attention. The Board considers it important that New Zealanders have confidence that the Scheme's finances are being

appropriately managed. It does not consider that generally reporting balance sheet deficits, and occasionally very large deficits, is conducive to this.

52. Finally, ACC has spent many years building the levied Accounts to a sound financial position. The Board is concerned that immediately weakening this and exposing the Scheme to risks of large balance sheet deficits, as discussed above, will undermine its wider programme to run the Scheme in a stable manner. The Board acknowledges that the current balance sheet position is ahead of its recommended target and that this will need to be addressed over the coming years, but it does not consider that this should extend to taking the levied Accounts into a deficit position.

Option 2 – expected cost of claims, because ACC is a statutory monopoly with the power to levy

53. The second option would set the target at the expected cost of claims, which is the amount that ACC expects to pay out on all the claims that have incurred to date. This interpretation of full funding is currently used to fund the Non-Earners' Account.

54. This interpretation of full funding is based on collecting, on average, the best estimate of the lifetime costs of injuries incurred to date, rather than focusing on the reported liabilities as a measure of adequacy[4]. The Treasury and the Ministry support this interpretation because it better reflects ACC's status as a statutory monopoly with the ongoing power to levy. From this perspective, funding the best estimate of costs would be sufficient, and the collection of any additional margins or buffers would be unnecessary. In this way, Option 2 is consistent with the general principle of taxation that taxes should only raise adequate money to fund necessary costs.

55. The choice of a funding target does not impact on how sure claimants can be that ACC has sufficient funds to meet entitlement costs as they fall due because the Government has the ongoing ability to raise levies. Margins above the expected cost of claims would not be used to cover any increase in claim costs: a rise in costs would simply require a proportionately larger margin.

56. Should Ministers choose Option 2:

- officials recommend that the funding policy statement clarify the Government's view on solvency and financial risk in relation to the ACC Scheme, so that the ACC Board is in no doubt about Government's expectations for how it manages such risk. This would also assure the Board that recording balance sheet persistent deficits against a 75% probability of sufficiency as a result of applying Government's funding policy would not be equated with poor performance; and

- officials would provide further advice on options for transitioning to the new funding target (unwinding the risk margin and buffer) over time. Options would consider the Government's fiscal strategy as well as the funding position and expected levy pathway within each of ACC's levied Accounts.

Financial and policy implications of the two options

57. These options have different implications in a number of areas that the Government may be concerned about, as summarised in the following table.

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[4] NZ International Financial Reporting Standards are set by the External Reporting Board, an independent government entity. These standards are based on accounting, rather than policy, principles, and were not designed primarily for statutory monopolies such as ACC.

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58. The funding target does not impact on levy stability; the issue of levy stability is addressed by setting an appropriate funding horizon.

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Figure 2: Funding target options compared

Area of interest	**Option 1 – 110% of reported liabilities** *ACC preference*	**Option 2 – expected cost of claims** *Treasury and Ministry preference*
The amount held by ACC in reserves as opposed to remaining with levy payers.	Option 1 would see ACC target to hold a $2 billion buffer on its balance sheet. This amount is not lost to the New Zealand economy because ACC holds significant investments domestically[5].	Option 2 is consistent with the general principle of taxation that taxes should only raise adequate money to fund necessary costs, leaving the $4 billion difference between the two options with levy payers.
ACC's reported balance sheet position.	Internal modelling shows that whilst Option 1 will usually result in a balance sheet surplus, a deficit will still be reported approximately 31% of the time. The ACC Board does not consider it to be consistent with its obligations to fully fund or as Board members to set levies with the expectation that they will generate a deficit on the balance sheet. Rather it considers that levies should be set targeting a balance sheet surplus, but noting that a deficit may arise from time to time. The Board considers that Option 1 allows the Scheme to be run in a stable manner whilst not being so conservative as to raise an unreasonable level of assets on the balance sheet. It is noted that the recommended target level of funding is not as large as would apply for a commercial insurer noting ACC's ability to post-fund. (Commercial insurers often target at least 99.5% probability of sufficiency by holding considerably more capital. In the ACC context, 99.5% sufficiency would equate to more than 200% of liabilities.) The Board is also concerned that public confidence in ACC's financial position not be impacted by regular, and occasionally large, reported balance sheet deficits.	Option 2 would likely result in consistent deficits on ACC's balance sheet when measured against a 75% probability of sufficiency, but not against expected costs. On average, it is estimated that Option 2 would show a $2.1 billion balance sheet deficit[6], though this could be significantly larger. However, the Treasury and the Ministry do not regard balance sheet deficits against a 75% probability of sufficiency as an appropriate measure of ACC's underlying performance or risk to the Scheme, or (on its own) as an indication that government intervention would needed to improve performance. Our view reflects that: • ***[Withheld under s9(2)(h)]*** • ACC is a statutory monopoly with the effective power to tax. Unlike a commercial insurer, it can address downside risk by post-funding deficits. • Deficits can be caused by economic factors, such as changes in interest rates, which are unrelated to underlying Scheme performance and are not within the control of the ACC Board. A risk margin and buffer would not make a difference to managing these movements. • Experience from 2008/09 shows that ACC's solvency can recover much more quickly than expected. Should Ministers choose Option 2, officials recommend that the funding policy statement clarify the Government's view on solvency and financial risk in the context of the ACC Scheme, so that the Board is in no doubt about Government's expectations for how it manages financial risk. This would assure the Board that recording persistent balance sheet deficits against a 75% probability of sufficiency as a result of applying Government's funding policy would not be equated with poor performance.

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[5] At 30 June 2013, ACC held approximately $24.6 billion in assets, including $2.7 billion in New Zealand equities and $12.2 billion in bonds.
[6] This estimate is appropriately conservative. The funding level for post-2001 claims in the Non-Earners' Account is currently at 110% of the expected cost of claims even though the target funding level does not include a risk margin or buffer.

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Area of interest	**Option 1 – 110% of reported liabilities** *ACC preference*	**Option 2 – expected cost of claims** *Treasury and Ministry preference*
Impact on the Crown accounts.	Option 1 results in ACC's levied Accounts having a positive impact on the Crown's reported solvency approximately 69% of the time.	Option 2 would consistently bring down the Government's net worth when judged against a 75% probability of sufficiency. However, this is consistent with the funding policy for the Non-Earners' Account, where the Government has decided not to fund a risk margin and a deficit is therefore recorded.
Financial risk assessment.	The Board notes that: • There is a 10% chance of the funding ratio falling to approximately 25% below the target. To put this in context, the 25% represents $4.8 billion based on the liabilities at 30 June 2013. • A target funding level of 110% of liabilities implies that the levied Accounts would report a balance sheet deficit 31% of the time. • A target funding level of 90% of liabilities implies that the levied Accounts would report a balance sheet deficit 70% of the time. The Board considers that reporting a balance sheet deficit 70% of the time is not consistent with full funding. It also notes the reasonably high probability of a very large loss arising in any one year. Such a large loss is more readily sustained when starting from a balance sheet surplus than a deficit. Noting that a target of 110% of the reported liability produces a balance sheet deficit 31% of the time, the Board considers this to be a minimum acceptable level for the funding target.	ACC's financial position (surplus or deficit) is reported against a 75% probability of sufficiency. Given that ACC can post-fund any shortfalls through levies, the Treasury and the Ministry do not consider that this benchmark provides an accurate assessment of financial risk in the ACC Scheme, or that the risk margin and buffer serve (or have served historically) a purpose in mitigating such risk. On this view, funding additional margins is an inappropriately conservative approach for a statutory monopoly. The financial risk associated with the ACC Scheme ultimately sits with government on behalf of levy payers. A funding policy statement would provide assurances for the Board around financial risk management by clarifying Government's views on solvency in the ACC context.

59. ACC would continue to be responsible for the technical assumptions in calculating levies. These assumptions would be consistent with the Government's funding policy and stated in the ACC Board's funding policy. These technical assumptions would include how the base rate of levies and the funding target are calculated, including the use of discount rates, and how the funding horizon is applied. This would be reviewed by the Ministry and its actuaries.

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PART THREE: HOW THIS COULD BE IMPLEMENTED

The Government could implement a funding policy for ACC through a Ministerial Direction…

60. Without legislative change, the Government could provide clarity around its funding policy through a Ministerial direction under the Crown Entities Act 2004[7].

61. The Direction would set out Ministers' expectations on what ACC would focus on so that levies are based on a funding target and parameters that reflect appropriate weightings on levy and funding volatility. The Government's objectives would be clearly communicated to ACC so that it could use these when developing levy rates to be consulted on, and recommended to Ministers.

…and a change to the AC Act could be used to strengthen transparency and mandate its continued use

62. There is no statutory requirement that binds future governments to produce a funding policy statement or requires the Government to explain why it set alternative rates.

63. Legislative change would therefore be required if the Government wishes for a Government funding policy statement to be a permanent feature of the ACC levy setting process. Such an amendment to the AC Act would embed the benefits that a Government funding policy statement brings to transparency and improve the alignment of ACC's recommendations with the Government's expectations.

64. Further improvements to transparency and accountability could also be enshrined in law, by making it a requirement that the Government states:

- the factors of public interest it intends to consider as part of its levy making decisions; and

- the rationale when the Government does not follow ACC's advice and how the Government's levy rates relate to its funding policy.

Timing

65. Cabinet decisions would be required to issue a Ministerial Direction and to progress legislative amendments.

66. The constraints placed by the 2014 election on the timing of levy consultation and decisions means that it would be challenging to implement any Government funding policy in time to inform the upcoming 2015/16 levy round. ACC has already commenced its levy setting process in order for consultation and Government decisions to be made in advance of the three-month period of restraint preceding the election.

67. A bid has been placed for a bill to amend to the AC Act, to be introduced at the end of 2014. For inclusion in this bill however Cabinet decisions on the funding policy would have to be made by mid-2014. Timing of decisions needs to be considered alongside

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[7] Under section 103 of the Crown Entities Act 2004 the Minister for ACC may direct ACC to give effect to a government policy that relates to ACC's functions and objectives.

this year's levy round, on which ACC has already started work. In this context, we propose a meeting with you to discuss your expectations for the timing of decisions on a funding policy and its implementation.

[Withheld under s9(2)(f)(iv)]

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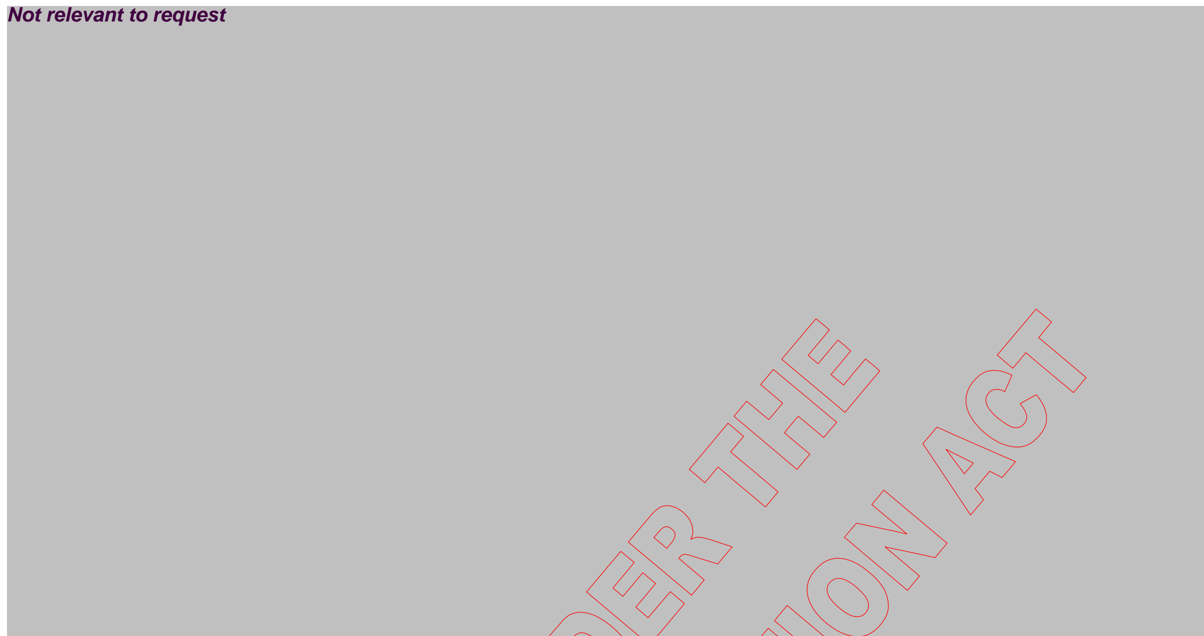
Not relevant to request



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Reference: T2014/353 CM-1-3-1-2-3

Date: 6 March 2014

To: Minister of Finance (Hon Bill English)
Associate Minister of Finance (Hon Steven Joyce)

Deadline: 10 March 2014

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Aide Memoire: Government funding policy for ACC

This aide-memoire summarises our advice on a Government funding policy for ACC. It accompanies a joint report on funding policy, which you are discussing with Ministers Collins and Foss on 11 March. We will discuss this paper with you at the pre-Cabinet meeting on 10 March.

Purpose of a Government funding policy

Treasury, the Ministry of Business, Innovation and Employment (MBIE) and ACC agree that a Government funding policy for ACC would improve the levy-setting process. We also agree on most of the key parameters of the policy, as outlined in our joint report.

ACC's funding target is the only point of difference between the agencies

Agencies have different views on the level of funding that ACC should target:

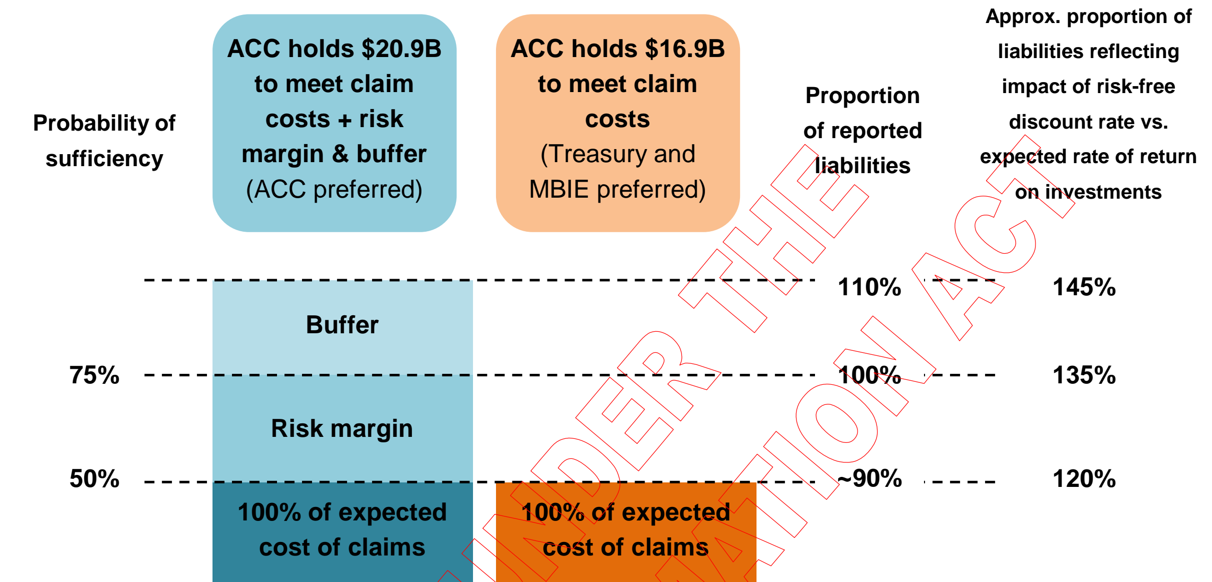
- **ACC prefers a higher funding target (option 1),** which would require ACC to hold about $4B more than the expected cost of claims. This is slightly lower than ACC's current funding target.
- **The Treasury and MBIE prefer a lower funding target (option 2),** which would require ACC to hold assets equal to the expected cost of claims. This is the approach that Government has agreed for ACC's Non-Earners' Account.

The two options are summarised in Figure 1 below. A key point is that option 1 includes two margins over and above the expected cost of claims:

- a risk margin, which is included in reported liabilities.[1] Funding the risk margin means there is a 75 per cent probability that the estimate of the liability will be enough to cover claim payments; and
- an additional buffer of 10 per cent of the expected cost of claims.

[1] As accounting standards require ACC to report (though not to fund) a risk margin, a funding target that includes this margin can be described as 100 per cent of reported liabilities.

Figure 1: Options for ACC's funding target



Both options target at least the expected cost of claims. Option 2 targets a deficit only against reported liabilities – that is, where the benchmark includes a risk margin. Under this option, there is a 50 per cent probability that the estimate of the liability will be enough to cover claim payments. Any shortfall in either option is addressed through the funding adjustment.

These margins serve no purpose in mitigating financial risk

ACC is a statutory monopoly with effective power to tax. If claim costs are higher than expected, levy rates can go up. In this sense, analogies with commercial insurers – which cannot post-fund deficits – are irrelevant. Effectively, there is no such risk to be mitigated in this context.

Over the last five or so years ACC has faced a combination of financial shocks that could be considered at the more extreme end of what could be expected to arise. These include:

- the Christchurch earthquake (a major earthquake in a large city in the middle of the day was considered by ACC to be as severe a catastrophic injury event as they could expect to face)
- the most significant financial crisis since the great depression, and
- late recognition by ACC's actuaries of its own performance deterioration.

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Yet since 2009 solvency has improved much more quickly than expected and, in hindsight, levies were increased more than they needed to be. The levied accounts are now at or near full funding (including additional margins), well ahead of the 2019 target: at 31 December 2013, solvency in the Work Account was 140 per cent, the Earners' Account was 136 per cent, and the Motor Vehicle Account was 97 per cent. Scheme solvency overall was 100 per cent.

Essentially, a risk margin and buffer are not needed because:

- ACC is already 'buffered' by other policy settings, including its status as a statutory monopoly with the power to levy; a conservative investment strategy; and the use of risk-free rates to calculate the liability (as Figure 1 shows, when assessed using an expected rate of return ACC's proposed funding target is around 145 per cent of the expected cost of claims). Given these settings, ACC is well-placed to respond to shocks and actual solvency levels may well exceed expectations, as they have for post-2001 claims in the Non-Earners' Account.
- such margins do not help ACC to manage these risks. A risk margin and buffer ultimately do not help ACC cover any increase in claim costs, as they must be held in addition to what ACC expects to pay out. Holding these margins can actually exacerbate volatility, since they increase ACC's funding requirements over and above the expected cost of claims if performance deteriorates.

Our view is that ACC's case for these margins is not based on an assessment of actual financial risk facing the scheme. Rather, our understanding is that it reflects concerns that large reported deficits will lead to negative perceptions of the ACC Board's performance, which in turn could drive over-correction by the Board and undermine public confidence in ACC. We do not consider these concerns to be an adequate basis for retaining $4B in additional margins. We think they can be mitigated by ensuring the funding policy clearly sets out Government's view on solvency in the ACC context.

Other issues

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The role of Ministers in determining levy rates

While it has not been explicitly considered as part of this work, Treasury recommends that Ministers (rather than the ACC Board) continue to determine levy rates. Delegating levy decisions to the ACC Board would raise a number of issues.
[Withheld under s9(2)(h)]

Next steps

We will brief you on the funding policy on 10 March. Should Ministers agree the proposals, we will discuss with you the timing for implementing the policy.

Helen Anderson, Senior Analyst, Health, 04 917 6307
Ben McBride, Manager, Health, 04 917 6184

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[Withheld under s9(2)(h)]

BUDGET-SENSITIVE

ACC levy reductions agreed in Budget 2013

At Budget 2013, indicative ACC levy reductions of $300m in 2014/15 and $1b in 2015/16 were signalled, with an OBEGAL impact of $425m and $1.45b respectively.

In November 2013, the Cabinet agreed levy reductions of $426m in the 2014/15 fiscal year ($387m in the levy year).

Impact on fiscal headroom

A change to funding policy for the earners', work and motor vehicle accounts will not have any significant impact on the primary net debt measure (core Crown net debt), as ACC sits outside of the core Crown and the Crown does not directly contribute to these account.

While reductions in ACC levies above what is included in the forecasts will not impact the Government's debt track, there will be an impact on the total Crown OBEGAL above the current forecast assumption. A levy holiday or rebate is likely to present challenges to maintaining growing surpluses over the next few years.

Impact on the macro economy

The table below outlines the range or possible options and their OCR impact. These options are in addition to the reductions already included in the fiscal forecasts.

		In addition to any change to the operating allowance...	
Scenario	**Estimate of levy reductions**	**OCR impact**	**Exchange rate impact (initial appreciation)**
Current funding policy	n/a	n/a	n/a
Implementation of new funding policy in 2015/16 – ACC option	$325m additional to existing reductions (midpoint estimate)	0-10 basis points, possibly at peak of cycle	0-0.5%
Implementation of new funding policy in 2016/17 – ACC option	$450m above current reductions (midpoint estimate)	5-10 basis points, persists over four years	0-0.5%
Tsy/MBIE option: no risk margin or buffer, with a longer unwind	$500m pa over 10 years	5-10 basis points, persists over four years	0-0.5%
Levy holiday or rebate	A one-off $4b rebate over one year	30-40 basis points in first year	0-1.0%
	Two $2b levy rebates over 2 years	20-40 basis points for two years	0-1.0%
	A $3b levy holiday for one year	20-30 basis points in first year	0-0.75%

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Impact on managing the cycle

The above considerations have not so far taken account of the macroeconomic policy mix. The phasing and timing of levy reductions can help to mitigate pressure on monetary policy. The current levy changes were not counted against operating allowances (and do not impact net debt). However, reducing levies can impact the fiscal impulse and have implications for managing the cycle.

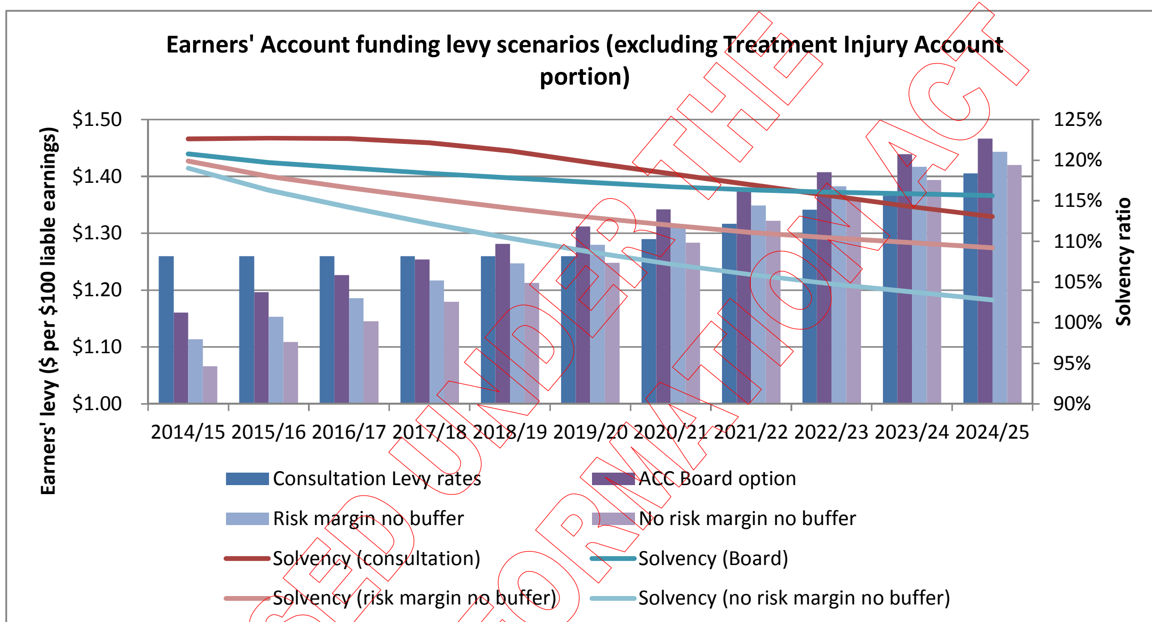
Beyond maintaining operating surpluses over the medium term, the OBEGAL impact is less relevant than the level of the levy reductions reflected above. There is no impact on core Crown net debt from further levy reductions, and the main contributor to additional positive fiscal impulse is from the reductions received by levy payers.

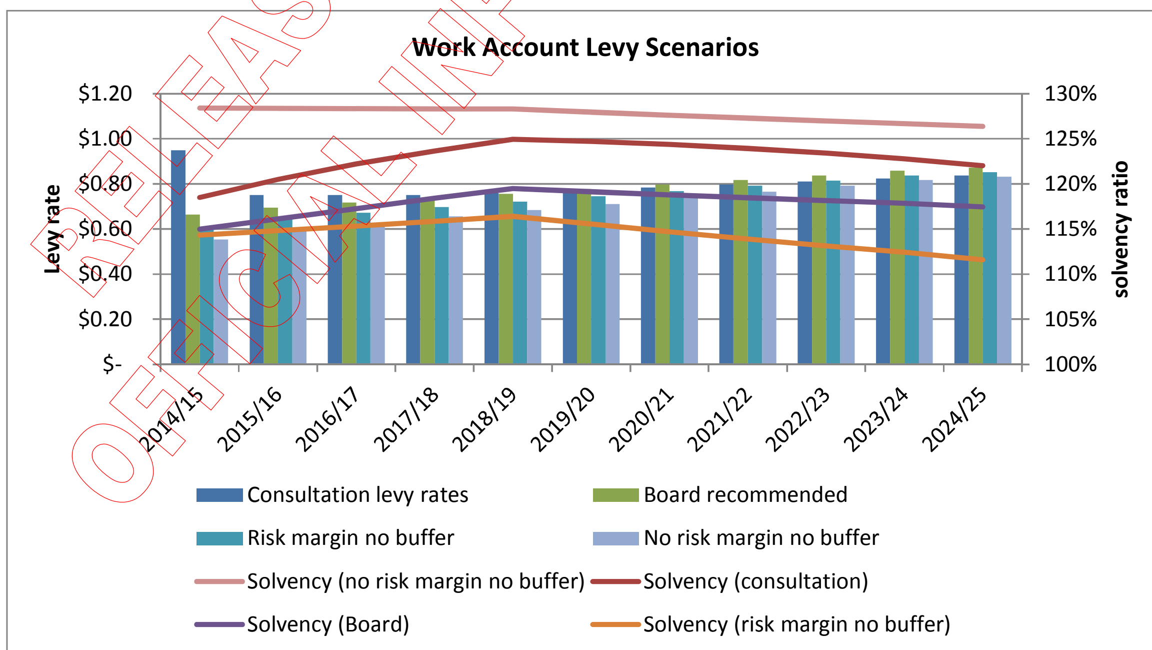
You have indicated that the operating allowance will be lifted to $1.5 billion per annum from Budget 2015. Levy reductions on top of the higher allowances would add to pressure on monetary policy that has been discussed to date. A one-off levy rebate in the order of $4 billion may put pressure on the OCR of around 30-40 basis points for 1 or 2 years. A levy reduction of $500 million per annum for 10 years may add around 5-10 basis points to the OCR, but would be more persistent. Smaller, phased increments could also be considered and tailored to the prevailing macroeconomic conditions in future years.

Managing any levy reductions within the operating allowances is one way to avoid putting additional pressure on monetary policy. Modest levy reductions could be considered alongside other Budget initiatives in future Budgets. There may be limited room for levy reductions within operating allowances over Budgets 2015-2017 given spending initiatives and possible tax cuts. Alternatively, ACC levy decisions could be deferred to Budgets 2018-2020, when there may be some room to reduce levies within operating allowances of $1.5 billion per annum by keeping new spending to around $1-1.2 billion per annum and using the remainder for levy reduction.

BUDGET-SENSITIVE

ANNEX: Levy scenarios





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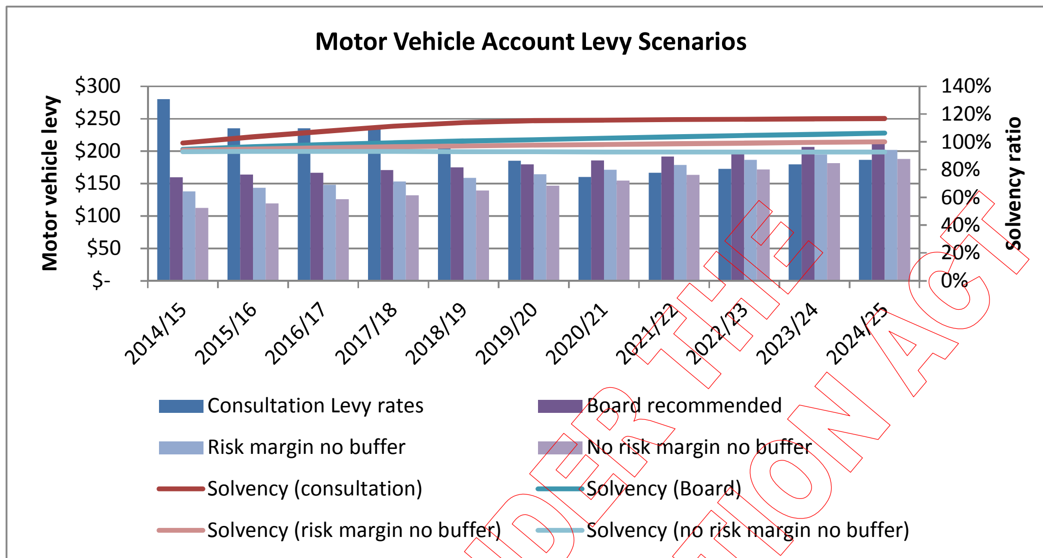
BUDGET-SENSITIVE



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JOINT MBIE, TREASURY AND ACC BRIEFING

Further information about setting a Government funding policy for ACC

Date:	4 April 2014	**Priority:**	Urgent
Security Classification:	In Confidence	**Tracker number:**	2505 13-14 T2014/601 BP 14/012

ACTION SOUGHT		
	Action sought	**Deadline**
Hon Bill English Minister of Finance **Hon Steven Joyce** Associate Minister of Finance **Hon Judith Collins** Minister for ACC **Hon Craig Foss** Associate Minister for ACC	**Note** the attached information **Discuss** with Joint Ministers at 5.30pm on Thursday, 10 April 2014.	10 April 2014

CONTACT FOR TELEPHONE DISCUSSION (IF REQUIRED)			
Name	**Position**	**Telephone**	
Ben McBride	Manager, Health **The Treasury**	04 917 6184	*[Withheld under s9(2)(a)]*
Kirstie Hewlett	General Manager, Labour Environment **Ministry of Business, Innovation and Employment**	04 901 8603	
Herwig Raubal	General Manager, Actuarial and Risk **ACC**	04 816 6272	

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BRIEFING

Further information on a Government funding policy for ACC

Date:	4 April 2014	Priority:	Urgent
Security Classification:	In Confidence	Tracker number:	2505 13-14 T2014/601 BP 14/012

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Purpose

To provide:

- information about smoothing the transition to the new funding policy
- information about funding horizons shorter than the 10 year horizon previously proposed by officials
- a draft Ministerial direction to implement the funding policy and a summary of what could be placed in legislation at the next opportunity.

Executive summary

Joint Ministers met on 11 March 2014 to discuss a proposal to set a Government funding policy for ACC's levied Accounts [briefing T2014/375; 1963 13-14; BP 14/006]. The proposed funding policy involved basing levies on new year injury costs and spreading the impact of changing claims experience and economic conditions over a 10 year funding horizon. At that meeting Ministers sought additional information about ways to transition to the new funding policy.

Transitional measures are available to avoid gradual levy increases after an initial levy reduction that would result from the proposed funding policy but these transitional measures would delay the implementation of a principles-based approach to setting levies. We therefore recommend that any transitional period be kept to a minimum to allow the benefits of the proposed new funding policy to manifest.

Further work is required on how the transitional measures could be implemented, particularly if Ministers choose to freeze levies for a period to avoid the gradual increase in levies forecast to cover increasing new year injury costs. While a Ministerial direction (attached) has been developed to implement a principles-based funding policy, freezing levies may prescribe too great a level of specificity to implement through a Ministerial direction.

We await further direction from Joint Ministers on how you wish to proceed. No decisions have so far been made on: whether to set a Government funding policy for ACC; what the target funding should be; or whether and how to transition to the new funding policy. A further meeting of Joint Ministers has been scheduled for Thursday, 10 April 2014. Officials will be available to support your discussion.

Recommended action

The Accident Compensation Corporation (ACC), the Treasury, and the Ministry of Business, Innovation and Employment recommend that you:

a **Note** that no decisions have so far been made on the proposal to set a Government funding policy for ACC, what the target funding should be, or the other proposals to clarify the Government's expectations and improve transparency around levies and funding [briefing T2014/375; 1963 13-14; BP 14/006].

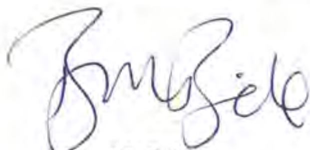
Noted

b **Note** that transitional measures are available to smooth the transition to a new funding policy but these would delay the implementation of a principles-based approach to setting levies.

Noted

c **Note** that a meeting has been scheduled for Joint Ministers to further discuss setting a Government funding policy for ACC.

Noted



Ben McBride
Manager, Health
[Withheld under s9(2)(a)]
The Treasury

..... / ...... / ......

Kirstie Hewlett
General Manager, Labour Environment
[Withheld under s9(2)(a)]
Ministry of Business, Innovation & Employment

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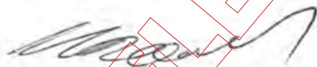

Herwig Raubal
General Manager, Actuarial and Risk
[Withheld under s9(2)(a)]
ACC

4 / 4 / 14

Hon Bill English
Minister of Finance

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Hon Steven Joyce
Associate Minister of Finance

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Hon Judith Collins
Minister for ACC

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Hon Craig Foss
Associate Minister for ACC

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Background

1. This briefing complements the following advice provided to Joint Ministers:
    - *Setting a Government funding policy for ACC* [briefing T2014/375; 1963 13-14; BP 14/006] and
    - *Additional information on a Government funding policy for ACC* [aide memoire 2174 13-14].

2. The funding policy proposed by officials in March [briefing T2014/375; 1963 13-14; BP 14/006] was based on the following principles, to:
    - ensure intergenerational equity, so that in a given year those covered by the Scheme fund the expected lifetime costs of injuries that occur in that period
    - set prices as close as possible to the underlying costs of providing cover. This helps ensure that those covered face the right incentives to promote safety and avoid accidents
    - maintain reasonable stability in levy rates
    - ensure long-term solvency of the Scheme
    - support accountability for effective management of the Scheme.

3. There are inevitable trade-offs to be made between these objectives.

4. The scenarios presented here include the 2015/16 levies that were signalled in last year's budget. The Government signalled in 2013 that levy reductions in 2015/16 would add to the 2014/15 levy reductions, to total $1 billion. The 2015/16 rates used in the scenarios are: $1.26 in the Earners' Account (no change from 2014/15 rates); 75 cents in the Work Account (a reduction from 95 cents in 2014/15); and $195 in the Motor Vehicle Account (down from $330.68 in 2014/15). These rates are indicative and subject to further work (including how the reductions are distributed across Accounts and further valuations), public consultation and Cabinet decisions.

5. Consistent with previous modelling, the scenarios in this aide memoire show the impact of moving to a 10 year funding horizon, with three possible funding targets[1]:
    - 110% of reported liabilities (ACC's preference)
    - 100% of reported liabilities (as requested by Ministers)
    - Expected cost of claims (88 to 90% of reported liabilities, depending on the Account; Treasury and the Ministry's preference).

6. Only selected scenarios are provided in the figures in this aide memoire. The full set of scenarios, together with accompanying movements in funding positions and impacts on levy revenue, is attached as Appendix 1.

[1] These are targets only. For example, targeting 100% of reported liabilities would see, on average, ACC's balance sheet in surplus 50% of the time, and in deficit 50% of the time. Targeting 110% of reported liabilities is expected to result in balance sheet surpluses 69% of the time. Targeting the expected cost of claims would see ACC's balance sheet usually in deficit.

The 'baseline' levy path

7. The proposed funding policy would, all else equal, result in initial levy reductions in each of the levied Accounts before levies gradually increase again (a 'v-shaped' levy path). This is because:

   - **Levy reductions are required in each of the levied Accounts to implement the proposed policy.** This is the case for all three funding targets, though particularly so for the two lower targets. Levies need to be reduced in the Work and Earners' Accounts because their funding positions are significantly above the proposed targets, so levies would have to be below the new year injury costs for some period to return this excess funding. In the Motor Vehicle Account, current levy rates are significantly greater than new year injury costs, so levies need to reduce towards new year injury costs to stabilise the funding position at the target level.

   - **New year injury costs, which are the basis for levy setting under the new funding policy, are expected to rise gradually into the future.** It is important for current year levy payers to collectively pay for the expected lifetime costs of injuries that occur in that year. A strength of the funding policy proposed by officials is that it takes the new year's levy costs as a basis for levy setting, which puts a focus on new year injury costs as an indicator of how well ACC is managing the scheme. All else equal, these new year costs are expected to increase over time, driven mainly by health sector inflation, which is generally higher than CPI or salary inflation. In addition, regular price inflation is also a component in the levy increases in the Motor Vehicle Account because levies in that Account are calculated on a per vehicle basis.

8. It is important to note that levies would only track in line with new year injury costs if the funding position was at the target, there were no shocks to the underlying liabilities, and new year injury forecasts proved accurate. The difference between forecast and actual levy rates is discussed further below.

Smoothing the transition to the new funding policy

9. Ministers have sought further information about smoothing levy paths. Officials have modelled two potential approaches:

   - **Capping the rate at which levies reduce**. This would mitigate how quickly levies fall initially and thereby smooth the baseline levy path, though not avoid the 'v-shape' (i.e., a levy increase immediately after a period of levy reductions).
   - **Freezing levies for a fixed period**. This would delay the eventual levy increases, to when the levy freeze is over.

10. The pros and cons of each of these approaches are discussed further below.

11. We note that any arrangements to smooth the transition to the new funding policy would require a delay to implementing a principles-based approach to levies and funding, and the benefits that the funding policy would engender. A shorter

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transitional period would enable the benefits of the policy to be realised more quickly, and avoid the build-up of further margins (which would ultimately require levies to remain below new year costs for a longer period, as more money needs to be returned to levy payers). A very long transitional period could ultimately undermine a principles-based funding policy. The transition path would need to be considered in the context of Government's fiscal strategy, particularly if transitioning to the lowest funding target (the expected cost of claims).

An example: Possible levy paths in the Motor Vehicle Account

12. The figure below illustrates indicative levy paths for the Motor Vehicle Account, targeting the expected cost of claims (the lowest funding target, preferred by MBIE and Treasury). The equivalent scenarios for the other levied Accounts and for the other targets are included in Appendix 1. They show a similar pattern to what is illustrated in Figure 1.

13. **These levy paths are indicative only, and would be reassessed each levy round.** While these scenarios show relatively smooth levy paths after the initial levy drops, in reality, levies will deviate from this path. Funding levels and costs rarely match forecasts because changes in claims experience and economic conditions are very difficult to predict for long-tail schemes like ACC. Levy paths are reassessed each levy round to reflect changes in new year injury costs and the adjustment required to return the funding position to the target. So in practice, levy rates are likely to vary around the levy paths illustrated in this paper.

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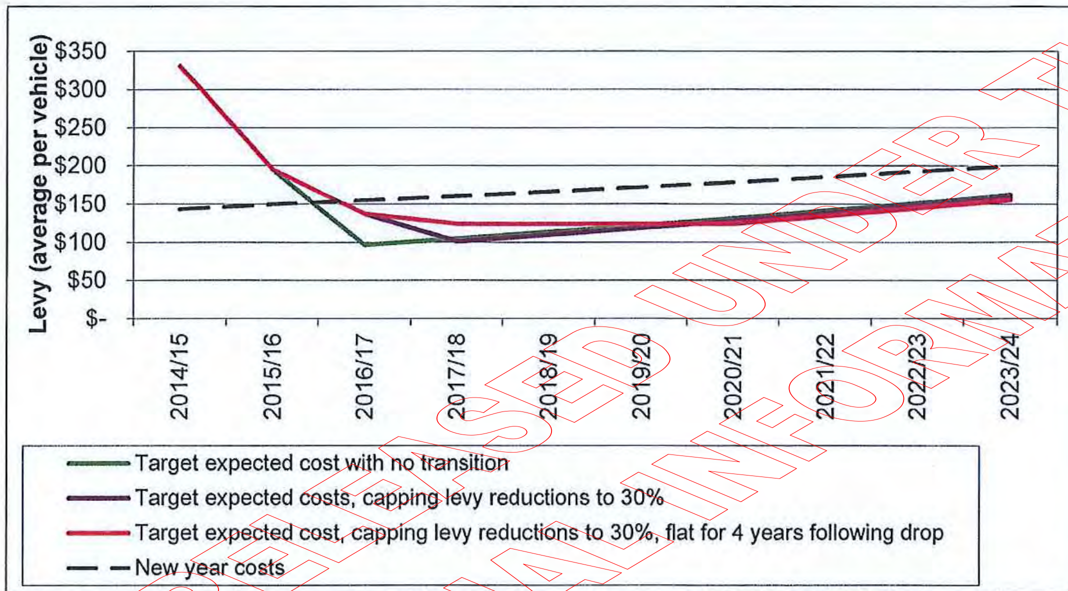
Figure 1: Levy paths for Motor Vehicle Account, targeting expected cost of claims (88% of reported liabilities. Compares path with no transition (green), reductions capped at 30% (purple), reductions capped at 30% and then frozen for four years (red).



Scenario		2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24
Target expected cost with no transition	Levy rates ($)	330.68	195.00	96.57	104.81	113.28	122.07	131.30	141.30	151.29	161.62
	Solvency	101%	104%	103%	102%	101%	101%	100%	99%	99%	98%
	Levy ($m)	1,055	629	314	345	378	412	449	489	530	573
Target expected costs, capping levy reductions to 30%	Levy rates ($)	330.68	195.00	137.25	101.01	109.69	118.67	128.09	138.25	148.40	158.88
	Solvency	101%	104%	105%	104%	103%	102%	101%	100%	100%	99%
	Levy ($m)	1,055	629	447	332	366	401	438	478	520	564
Target expected cost, capping levy reductions to 30%, flat for 4 years following drop	Levy rates ($)	330.68	195.00	137.25	123.79	123.79	123.79	123.79	134.17	144.54	155.23
	Solvency	101%	104%	105%	104%	104%	103%	102%	101%	101%	100%
	Levy ($m)	1,055	629	447	408	413	418	423	464	506	551
New year costs		143.19	149.53	154.76	160.13	165.81	171.83	178.27	185.53	192.56	199.89

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Capping the initial levy reductions

14. The initial levy reductions (shown by the **green line**) could be constrained by applying a simple cap to the reductions until the levies generated by the funding policy stabilise. The **purple line** in Figure 1 shows the impact of a 30% cap in the Motor Vehicle Account, if Ministers choose to target funding at the expected cost of claims. A consequence of this more gradual reduction of levies is that progress towards the levies that would be produced by the funding policy is delayed by about two years (as shown in the table below the graph).

15. The rates that are feasible for capping the initial levy reductions are constrained by the subsequent impact on future levies and the funding position.

16. Caps need only be implemented if the funding target is set at the expected cost of claims, and then only for the Motor Vehicle Account (a 30% cap) and the Work Account (a 10% cap). Capping levy decreases has little to no effect for other funding targets. For the Earners' Account, capping has no meaningful impact at any level of target funding. This is shown in the figures in Appendix 1 where the differences between the green and purple lines are negligible or non-existent.

Freezing levies

17. Ministers also expressed concern about the gradual increase in levies after the initial reduction. The **red line** in Figure 1 indicates how this could work. In Figure 1, levies are frozen for four years after the initial drop. Shorter or longer levy freezes are also possible. As shown in Figure 1, a four year levy freeze would delay progress towards the funding target by about three years.

18. The pattern is the same but less pronounced for the other Accounts and other funding targets, as shown in the figures in Appendix 1. This is because the transition to the expected cost of claims in the Motor Vehicle Account involves the greatest levy reductions.

19. The freeze would begin at different times across the Accounts and be set at different rates, depending on the funding target and transitional measures selected.

20. Freezing levies, particularly for a prolonged period, could raise significant issues:

- Freezing levies does not build into the system any mechanism for responding to fluctuations in the funding position or new year injury costs through levy adjustments. While the modelled scenarios make it look like levies can be set in advance whilst progressing towards the funding target, these scenarios would only eventuate if forecasts turned out to be accurate. In practice, freezing levy rates would result in significant fluctuations in the funding position. It is for this reason that officials are proposing a funding policy that allows some flexibility in levy rates to account for movements in the funding position.[2]

- It is important to consider such an approach in the context of the principles noted in paragraph 3. One of these is that levy payers should face the expected lifetime cost of injuries occurring in that period. Given the underlying pressures for costs to increase over time, even in real terms, a flat levy does not meet this principle. Further, the principle of levy stability should be considered relative to economic costs. Ultimately, stability is better achieved by linking levy setting to the costs of new year claims rather than a flat levy rate which does not reflect the economic reality of injury costs over time.

21. Should Ministers wish to pursue a levy freeze, a shorter freeze period would mitigate these issues.

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[2] On the other hand, the use of a 10 year funding horizon balances the need to return the funding position to the target without too much impact on levies. Importantly, the funding policy allows levies to respond to fluctuations in the funding position as they arise.

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22. In addition, a range of practical matters would need to be considered in relation to a levy freeze:

- It is unclear what the purpose would be of ACC consulting on levy rates while the price freeze was on, since the Government would already have selected a particular rate. While it might still be possible for the Government to choose a different rate depending on the situation, there would be no rationale for the consulted on rate except that it was the selected rate when the levy freeze was introduced. This could be mitigated through a shorter levy freeze period (e.g. 2 years).
- Officials would need to consider potential mechanisms for implementing a levy freeze because it appears that a levy freeze would be too specific an action to implement through a Ministerial direction. Any mechanism would have to comply with the levy setting provisions in the Accident Compensation Act 2001.

Alternative transitional approach: A one-off levy rebate to take the funding position straight to the target

23. An alternative approach to return to the funding target is to provide a one-off rebate to levy payers, totalling the equivalent value of the excess funding in each Account. Such a rebate or levy holiday could be used, for example, as a counter-cyclical measure after 2016/17. Depending on the funding target chosen, the rebate could be up to three times as large as on-going levies in the Work and Earners' Account. Once this excess has been paid out, levies could begin afresh at new year injury costs, and track along that line (the **dashed line** in Figure 1), unless there are any subsequent deviations from the forecast new year injury costs or funding position. These differences between the forecasts and the actual outcomes would be dealt with through levy adjustments determined by the 10 year funding horizon.

24. Little work has been done on the feasibility of implementing this option. Further investigation is required of the mechanism for paying out the rebate, and when the rebate would be paid out. As with the proposal to set a levy freeze, there is doubt that a one-off levy rebate could be implemented through a Ministerial direction because it seems to be directing a specific course of action rather than adherence to a general policy.

25. ACC has deep concerns regarding a rebate, which it considers sets a dangerous precedent whilst undermining the principles that should form the basis of levy setting. The proposed funding policy governs how levies are determined and describes a systematic process to return the Scheme to a selected funding target over an agreed horizon in accordance with an agreed set of principles. The ACC Board does not consider that ACC funds should be used for counter-cyclical purposes. The proposal also presents considerable operational, legislative and communication challenges. Should Ministers wish to pursue this option then the Board would appreciate the opportunity to discuss this further prior to a decision being made.

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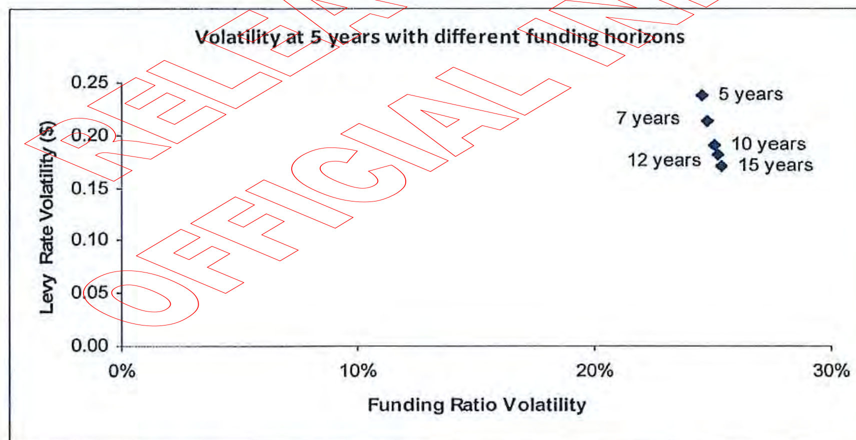
Shorter funding horizons

26. Ministers also sought further advice on the possibility of a shorter funding horizon.

27. As outlined in our briefing in March, the choice of funding horizon comes down to a trade-off between levy and balance sheet volatility. A shorter horizon results in a quicker return to the funding target (less balance sheet volatility), but at the expense of greater levy volatility. A key drawback of a shorter funding horizon is that levy adjustments in response to balance sheet shocks would be larger, in order to return the funding position towards the target sooner.

28. Figure 2 shows the results of ACC's modelling of the relationship between levy and funding volatility for different funding horizons. As the funding horizon is increased from 5 to 10 years, levy volatility is significantly reduced at the cost of marginal balance sheet volatility. Beyond 10 years the gains to levy stability are reduced.

Figure 2: Volatility at 5 years with different funding horizons



29. It is also important to consider accountability mechanisms. The longer the horizon, then arguably the less accountability on current management to return the Accounts to the target funding position. This issue is mitigated in the proposed funding policy by outlining a principles-based approach for ACC to calculate the levies it consults on at each levy around. The proposal would also support accountability by requiring the Government to explain the rationale for any deviation from levies generated by the funding policy. In addition, given that the funding horizon is effectively 're-set' each levy round, lengthening the horizon would not enable decisions about the management of the scheme (for example, a decision to increase levies) to be pushed out to the end of the period.

30. Weighing up these trade-offs, officials consider that a 10 year funding horizon sufficiently spreads the impact of these adjustments over a number of years, while keeping the impact on levies to an acceptable level, and maintaining a reasonable focus on returning the Scheme to the chosen funding target. It is acknowledged, however, that the choice of funding horizon is a judgement.

Draft Ministerial direction

31. The attached draft Ministerial direction (Appendix 2) would require ACC to implement the proposed funding policy. Provisions for the funding target and any transitional measures would have to be inserted once decisions have been made. Similarly, the wording of the direction would need to reflect any changes to the frequency of levy rounds.

32. In addition to the Ministerial direction, the Government could amend the Accident Compensation Act 2001 to implement the remaining recommendations presented to Ministers in March. This would require the Government to make public interest considerations known before and after levy decisions are made, and to require future governments to issue Ministerial directions. A bill amending the Accident Compensation Act 2001 is expected to be introduced late this year.

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Appendix 1: Scenarios

Introduction

33. These scenarios present the modelled impacts of various approaches to smoothing the transition to a new funding policy [briefing T2014/375; 1963 13-14; BP 14/006], by capping the extent of the initial reductions and/or by freezing levy rates once levies bottom out.

    - The original, unsmoothed levy paths are represented by the **green lines** in the charts and shaded green in the accompanying tables.
    - The **purple lines** show levy paths for capped reductions. A feasible capping rate has been selected for each Account. Where the capping has any impact, the return to the funding target is delayed.
    - The **red lines** show how, in addition to the capping of the initial reductions, what the levy path could look like if levies were frozen for four years once they bottom out. You will notice that the red lines bottom out at a higher rate than the purple line. This is to make up for the growth in underlying costs over the duration of the levy freeze. The levy freeze further delays the return to the funding target.
    - The forecast new year injury (economic) costs are marked in the levy scenarios as **black dashed lines**.

34. It is important to note that while these scenarios show relatively smooth levy paths after the initial levy drops, in reality, levies will deviate from this path. Funding levels and costs rarely match forecasts because changes in claims experience and economic conditions are very difficult to predict for long-tail schemes like ACC. This means that levy paths are reassessed each levy round to reflect changes to new year injury costs and the adjustment required to return the funding position to the target. So in practice, levy rates are likely to vary around the levy paths illustrated here.

35. The scenarios have been presented by Account (Motor Vehicle, Work, and Earners'). For each Account, the transitional measures have been modelled for three funding targets:

    - 110% of reported liabilities (ACC's preference)
    - 100% of reported liabilities (as requested by Ministers)
    - Expected cost of claims (88 to 90% of reported liabilities, depending on the Account; Treasury and the Ministry's preference).

36. The scenarios presented here include the 2015/16 levies that were signalled in last year's budget. The Government signalled in 2013 that levy reductions in 2015/16 would add to the 2014/15 levy reductions to total $1 billion. These rates are indicative and subject to further work (including how the reductions are distributed across Accounts, further valuations), public consultation and Cabinet decisions.

37. An additional set of scenarios was run to show the effect of a seven year funding horizon compared to the 10 year horizon used in the other scenarios (Figure A.4).

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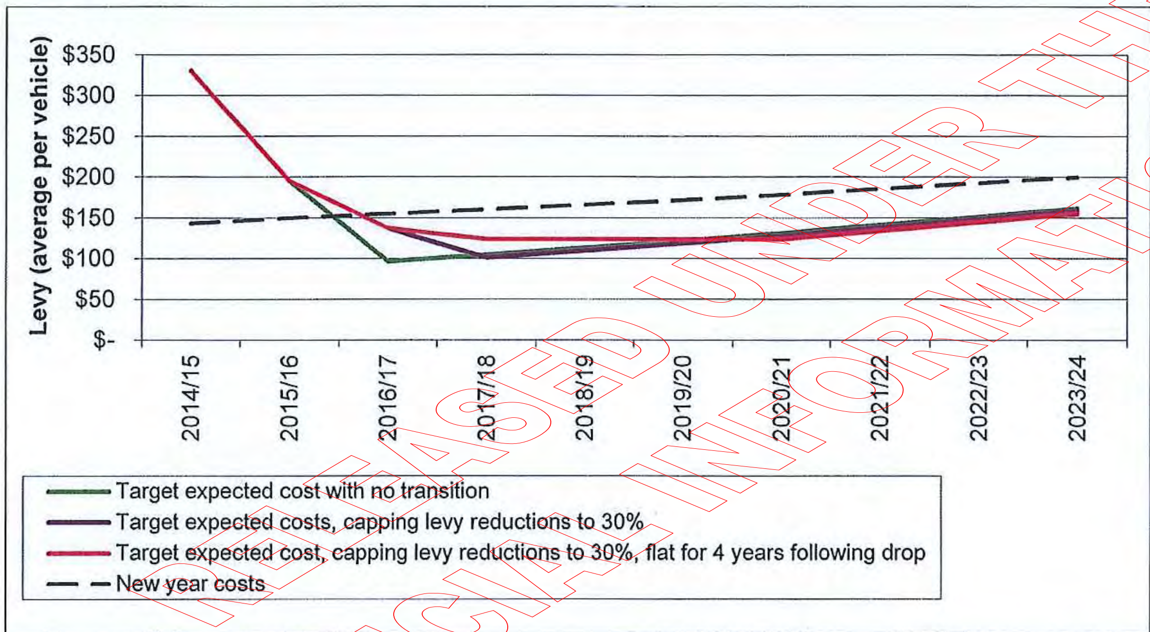
Motor Vehicle Account

Figure A.1 – Indicative levy paths for new funding policy for Motor Vehicle Account targeting expected cost of claims (88% of reported liabilities)



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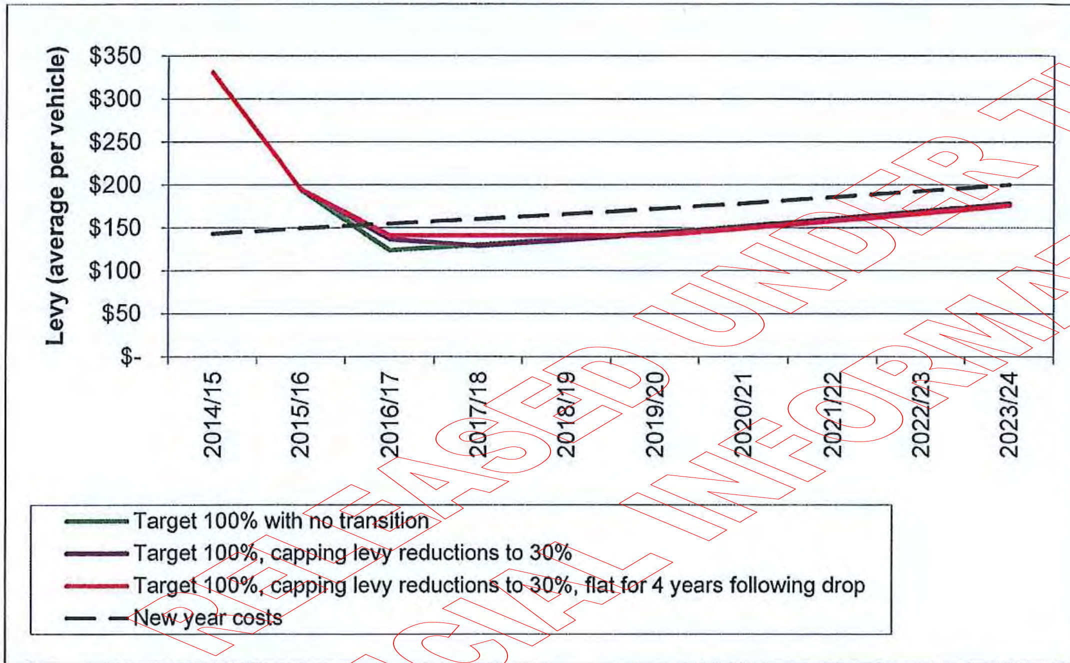
Scenario		2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24
Target expected cost with no transition	Levy rates ($)	330.68	195.00	96.57	104.81	113.28	122.07	131.30	141.30	151.29	161.62
	Solvency	101%	104%	103%	102%	101%	101%	100%	99%	99%	98%
	Levy ($m)	1,055	629	314	345	378	412	449	489	530	573
Target expected costs, capping levy reductions to 30%	Levy rates ($)	330.68	195.00	137.25	101.01	109.69	118.67	128.09	138.25	148.40	158.88
	Solvency	101%	104%	105%	104%	103%	102%	101%	100%	100%	99%
	Levy ($m)	1,055	629	447	332	366	401	438	478	520	564
Target expected cost, capping levy reductions to 30%, flat for 4 years following drop	Levy rates ($)	330.68	195.00	137.25	123.79	123.79	123.79	123.79	134.17	144.54	155.23
	Solvency	101%	104%	105%	104%	104%	103%	102%	101%	101%	100%
	Levy ($m)	1,055	629	447	408	413	418	423	464	506	551
New year costs		143.19	149.53	154.76	160.13	165.81	171.83	178.27	185.53	192.56	199.89

Notes:

- The 30% cap (**purple line**) would reduce how quickly levies initially reduced. While levies would follow a different path in the short term, there is little difference from 2020/21. It would, however, delay the application of the new funding policy and the progress towards the funding target.
- The **red line** would freeze levies for four years (from 2017/18) but further delay the application of the new funding policy and the progress towards the funding target.

Figure A.2 – Indicative levy paths for new funding policy for Motor Vehicle Account targeting 100% of reported liabilities



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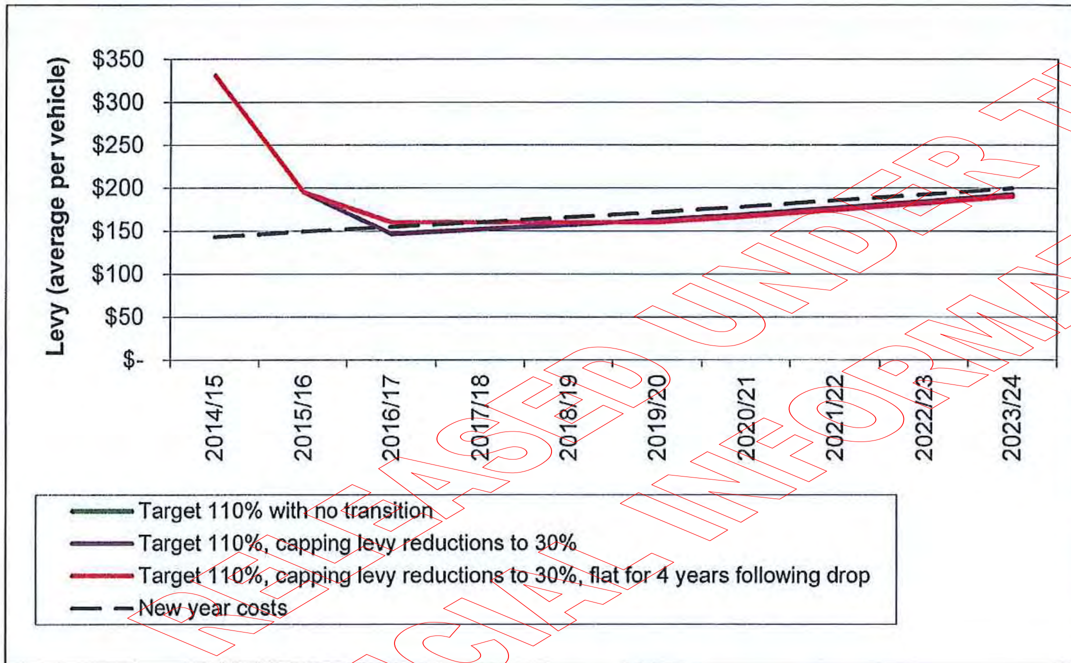
Scenario		2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24
Target 100% with no transition	Levy rates ($)	330.68	195.00	123.84	130.23	136.96	144.14	151.88	160.54	169.21	178.30
	Solvency	101%	104%	104%	104%	104%	104%	104%	104%	104%	104%
	Levy ($m)	1,055	629	403	429	457	487	520	556	593	633
Target 100%, capping levy reductions to 30%	Levy rates ($)	330.68	195.00	136.50	129.01	135.81	143.05	150.85	159.56	168.29	177.43
	Solvency	101%	104%	105%	105%	104%	104%	104%	104%	104%	104%
	Levy ($m)	1,055	629	445	425	453	483	516	553	590	630
Target 100%, capping levy reductions to 30%, flat for 4 years following drop	Levy rates ($)	330.68	195.00	141.00	141.00	141.00	141.00	148.91	157.71	166.53	175.77
	Solvency	101%	104%	105%	105%	105%	105%	105%	105%	105%	105%
	Levy ($m)	1,055	629	460	465	471	476	509	546	584	624
New year costs		143.19	149.53	154.76	160.13	165.81	171.83	178.27	185.53	192.56	199.89

Notes:

- The difference between the **green line** and the **purple line** is negligible, so it may not be necessary to use a cap under this scenario.

Figure A.3 – Indicative levy paths for new funding policy for Motor Vehicle Account targeting 110% of reported liabilities



Scenario		2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24
Target 110% with no transition	Levy rates ($)	330.68	195.00	146.92	151.74	157.12	162.83	169.28	176.80	184.36	192.41
	Solvency	101%	104%	105%	106%	106%	107%	107%	108%	109%	109%
	Levy ($m)	1,055	629	479	501	525	551	579	613	647	683
Target 110%, capping levy reductions to 30%	Levy rates ($)	330.68	195.00	146.96	152.03	157.10	162.77	169.38	176.89	184.44	192.48
	Solvency	101%	104%	105%	106%	106%	107%	108%	108%	109%	109%
	Levy ($m)	1,055	629	479	502	525	550	580	613	647	683
Target 110%, capping levy reductions to 30%, flat for 4 years following drop	Levy rates ($)	330.68	195.00	160.35	160.35	160.35	160.35	166.96	174.60	182.27	190.43
	Solvency	101%	104%	105%	106%	107%	108%	108%	109%	109%	110%
	Levy ($m)	1,055	629	523	529	536	542	571	605	639	676
New year costs		143.19	149.53	154.76	160.13	165.81	171.83	178.27	185.53	192.56	199.89

Notes:

- The **green line** and the **purple line** are identical, so it would not be necessary to use a cap under this scenario.
- All the modelled scenarios are very close to the dashed line (new year injury costs) because the current funding position is not too far off the target of 110% of reported liabilities.

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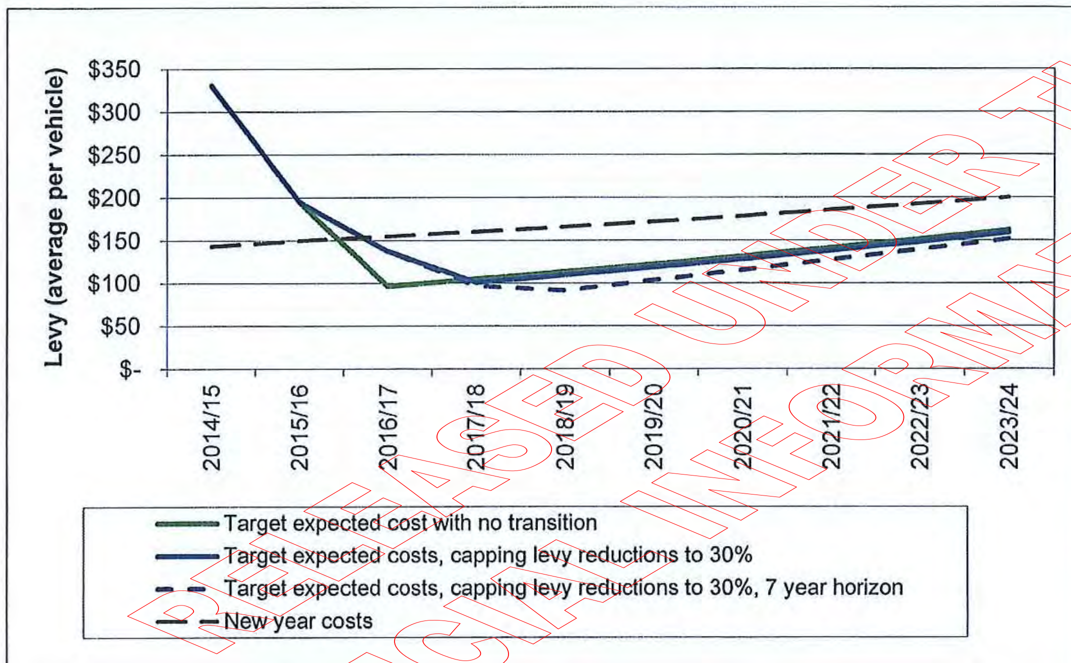
Figure A.4 - – Indicative levy paths for new funding policy for Work Account targeting expected cost of claims (90% of reported liabilities) comparing a 10 year funding horizon and a seven year funding horizon



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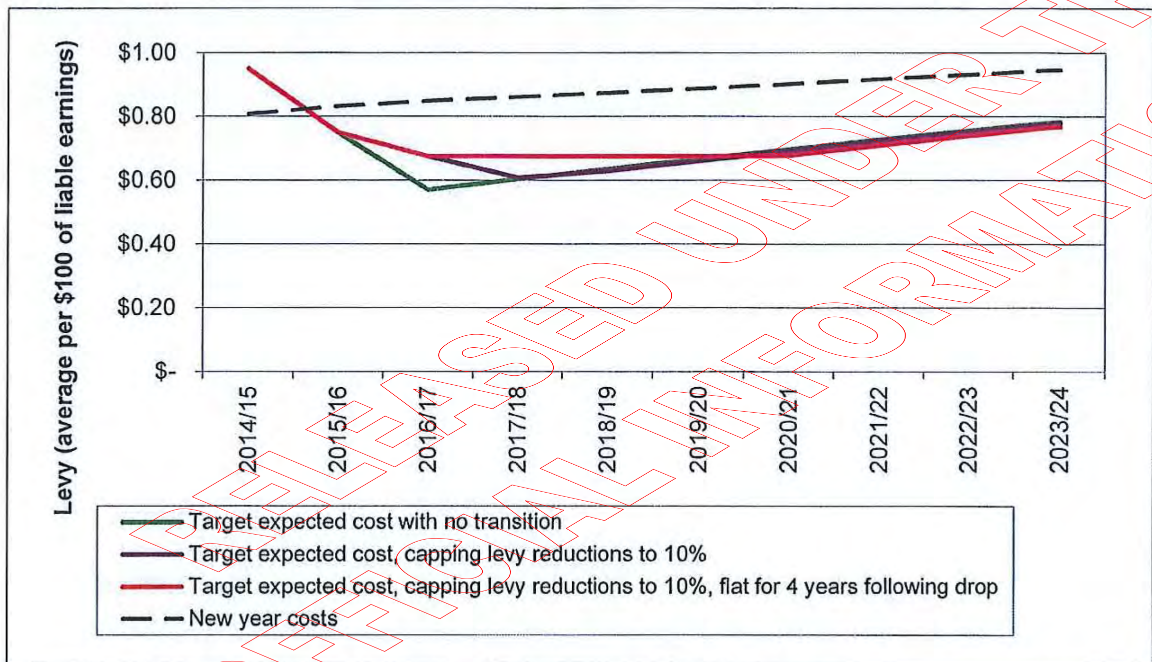
Scenario		2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24
Target expected cost with no transition	Levy rates ($)	330.68	195.00	96.57	104.81	113.28	122.07	131.30	141.30	151.29	161.62
	Solvency	101%	104%	103%	102%	101%	101%	100%	99%	99%	98%
	Levy ($m)	1,055	629	314	345	378	412	449	489	530	573
Target expected costs, capping levy reductions to 30%	Levy rates ($)	330.68	195.00	137.25	101.01	109.69	118.67	128.09	138.25	148.40	158.88
	Solvency	101%	104%	105%	104%	103%	102%	101%	100%	100%	99%
	Levy ($m)	1,055	629	447	332	366	401	438	478	520	564
Target expected costs, capping levy reductions to 30%, 7 year horizon	Levy rates ($)	330.68	195.00	137.25	96.83	91.57	103.48	115.37	127.58	139.57	151.7
	Solvency	101%	104%	105%	103%	102%	100%	99%	98%	97%	96%
	Levy ($m)	1,055	629	447	319	305	349	394	441	489	538
New year costs		143.19	149.53	154.76	160.13	165.81	171.83	178.27	185.53	192.56	199.89

Notes:

- Figure A.4 compares the proposed 10 year funding horizon (**purple line**) with a shorter funding horizon of seven years (the **dashed purple line**). The associated table shows how the seven year funding horizon would speed up progress towards the funding target. For example, in 2013/24, the forecast funding position would be 96% under a seven year horizon, compared to 99% under a 10 year horizon.
- Both lines are targeting 88% of reported liabilities. The seven year horizon takes the funding position towards the target sooner through larger adjustments from the new year injury costs. In this case, lower levies in the short term.

Work Account

Figure A.5 – Indicative levy paths for new funding policy for Work Account targeting expected cost of claims (90% of reported liabilities)



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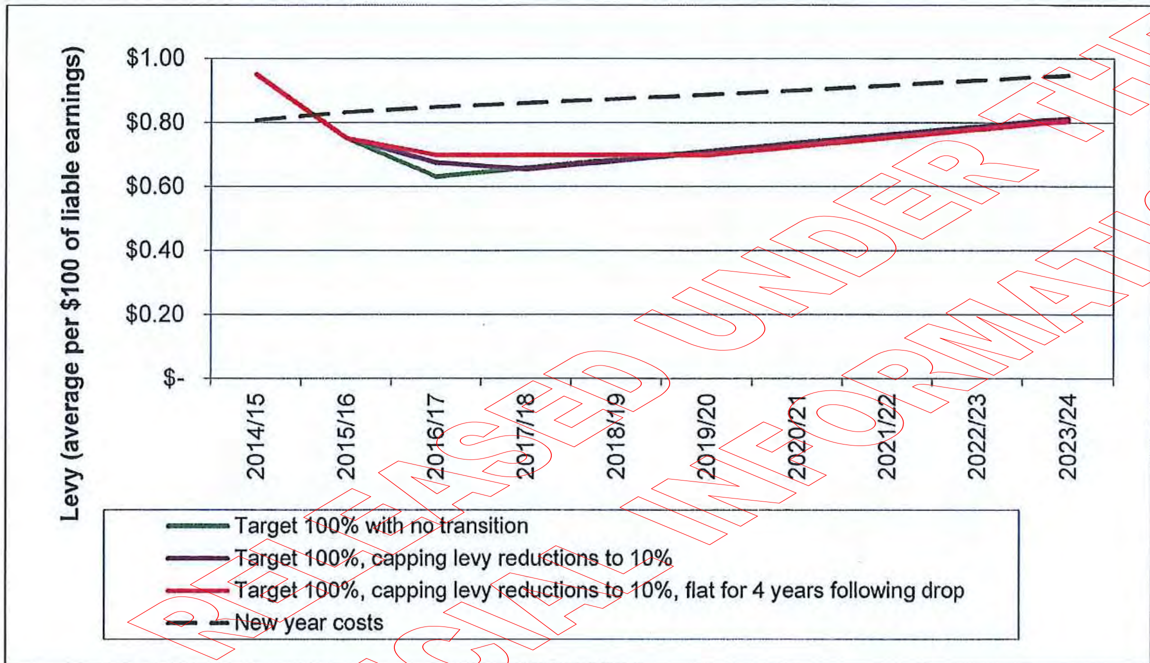
Scenario		2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24
Target expected cost with no transition	Levy rates	0.95	0.75	0.57	0.60	0.64	0.67	0.70	0.73	0.76	0.78
	Solvency	119%	120%	120%	119%	119%	117%	115%	114%	112%	111%
	Levy ($m)	729	598	473	516	560	591	635	682	729	777
Target expected cost, capping levy reductions to 10%	Levy rates	0.95	0.75	0.68	0.61	0.63	0.66	0.69	0.72	0.75	0.78
	Solvency	119%	120%	121%	121%	120%	118%	117%	115%	113%	112%
	Levy ($m)	729	598	557	519	554	585	630	676	724	772
Target expected cost, capping levy reductions to 10%, flat for 4 years following drop	Levy rates	0.95	0.75	0.68	0.68	0.68	0.68	0.68	0.71	0.74	0.77
	Solvency	119%	120%	121%	122%	122%	120%	118%	116%	115%	113%
	Levy ($m)	729	598	557	575	594	599	618	665	713	762
New year costs		0.81	0.83	0.85	0.86	0.87	0.89	0.90	0.92	0.93	0.95

Notes:

- Figures A.5 to A.7 show a similar pattern of trends to the equivalent figures for the Motor Vehicle Account. The key difference is that under the proposed funding policy, Work Account levies would remain further below new year injury costs for longer because there is more excess funding in the Work Account compared to the Motor Vehicle Account.

Figure A.6 – Indicative levy paths for new funding policy for Work Account targeting 100% of reported liabilities



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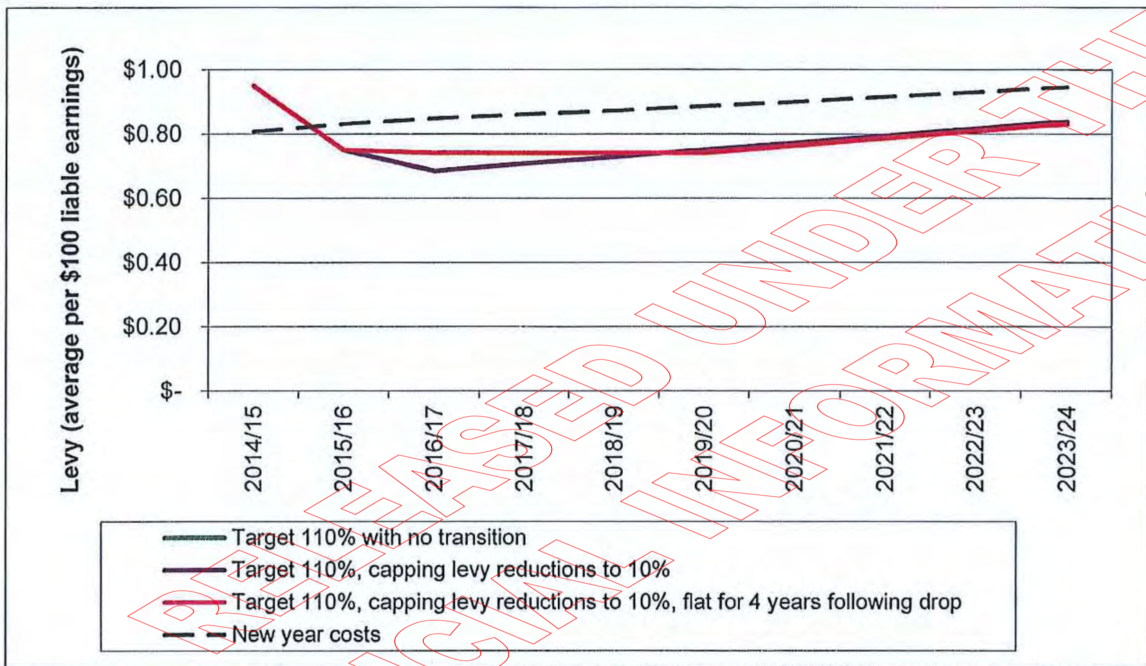
Scenario		2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24
Target 100% with no transition	Levy rates	0.95	0.75	0.63	0.66	0.68	0.71	0.74	0.76	0.79	0.81
	Solvency	119%	120%	121%	121%	121%	120%	119%	118%	117%	116%
	Levy ($m)	729	598	521	562	602	630	671	715	760	805
Target 100%, capping levy reductions to 10%	Levy rates	0.95	0.75	0.68	0.65	0.68	0.71	0.73	0.76	0.79	0.81
	Solvency	119%	120%	121%	121%	122%	120%	119%	118%	117%	116%
	Levy ($m)	729	598	557	558	599	627	668	712	757	803
Target 100%, capping levy reductions to 10%, flat for 4 years following drop	Levy rates	0.95	0.75	0.70	0.70	0.70	0.70	0.73	0.75	0.78	0.80
	Solvency	119%	120%	122%	122%	123%	121%	120%	119%	118%	117%
	Levy ($m)	729	598	577	595	614	619	661	705	750	796
New year costs		0.81	0.83	0.85	0.86	0.87	0.89	0.90	0.92	0.93	0.95

Figure A.7 – Indicative levy paths for new funding policy for Work Account targeting 110% of reported liabilities



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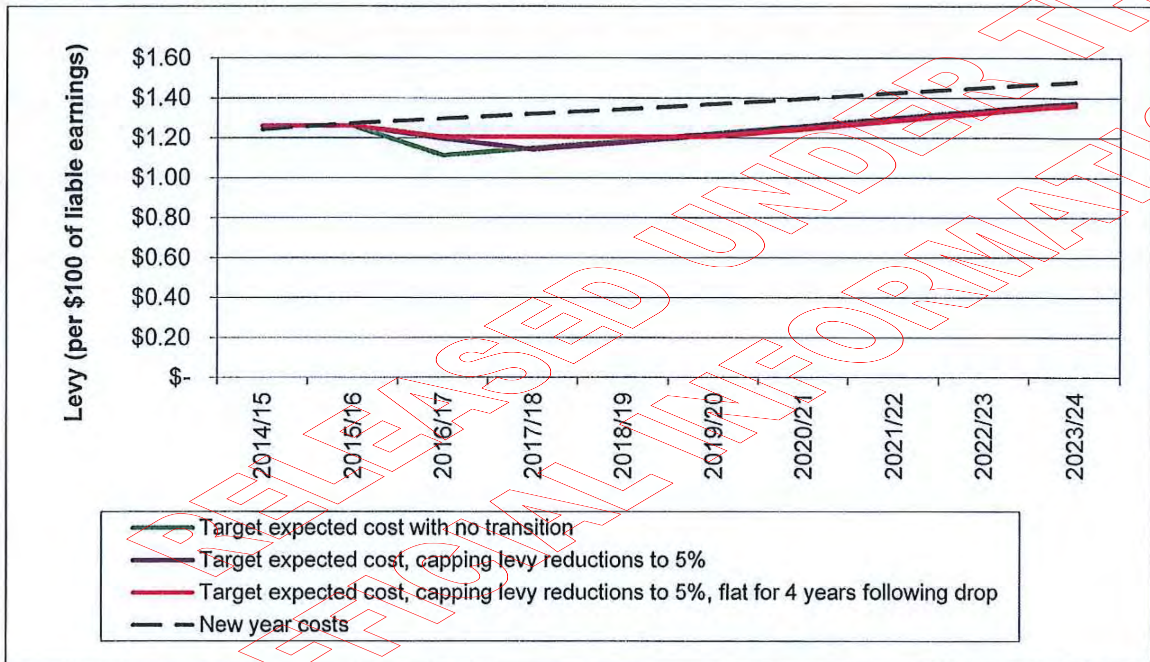
Scenario		2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24
Target 110% with no transition	Levy rates	0.95	0.75	0.68	0.71	0.73	0.75	0.77	0.80	0.82	0.84
	Solvency	119%	120%	121%	122%	123%	122%	122%	121%	121%	120%
	Levy ($m)	729	598	566	603	640	666	704	745	787	831
Target 110%, capping levy reductions to 10%	Levy rates	0.95	0.75	0.68	0.71	0.73	0.75	0.77	0.80	0.82	0.84
	Solvency	119%	120%	121%	122%	123%	122%	122%	121%	121%	120%
	Levy ($m)	729	598	566	603	640	666	704	745	787	831
Target 110%, capping levy reductions to 10%, flat for 4 years following drop	Levy rates	0.95	0.75	0.74	0.74	0.74	0.74	0.76	0.79	0.81	0.83
	Solvency	119%	120%	122%	123%	124%	124%	123%	122%	122%	121%
	Levy ($m)	729	598	611	630	650	657	696	737	780	823
New year costs		0.81	0.83	0.85	0.86	0.87	0.89	0.90	0.92	0.93	0.95

Earners' Account

Figure A.8 – Indicative levy paths for new funding policy for Earners' Account targeting expected cost of claims (90% of reported liabilities)



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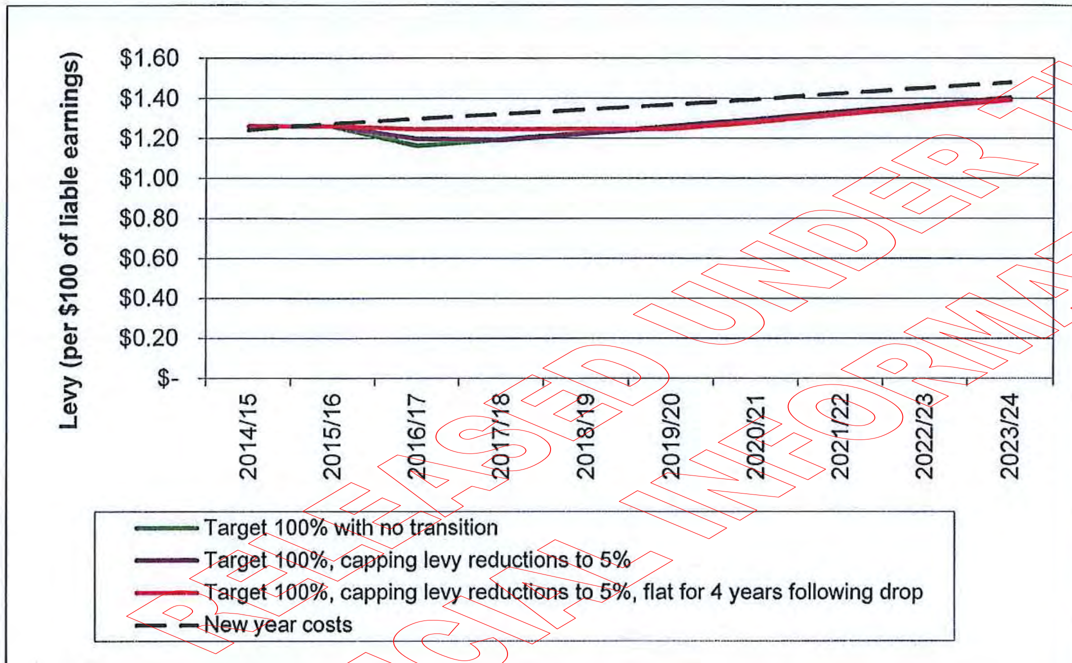
Scenario		2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24
Target expected cost with no transition	Levy rates ($)	1.26	1.26	1.11	1.15	1.18	1.22	1.26	1.30	1.34	1.37
	Solvency	123%	123%	120%	117%	115%	113%	111%	109%	108%	107%
	Levy ($m)	1,212	1,277	1,172	1,253	1,337	1,421	1,507	1,599	1,692	1,790
Target expected cost, capping levy reductions to 5%	Levy rates ($)	1.26	1.26	1.20	1.14	1.18	1.22	1.25	1.29	1.33	1.37
	Solvency	123%	123%	121%	119%	116%	114%	112%	110%	109%	108%
	Levy ($m)	1,212	1,277	1,269	1,244	1,328	1,412	1,498	1,591	1,685	1,783
Target expected cost, capping levy reductions to 5%, flat for 4 years following drop	Levy rates ($)	1.26	1.26	1.21	1.21	1.21	1.21	1.24	1.29	1.32	1.36
	Solvency	123%	123%	122%	120%	118%	116%	114%	112%	110%	109%
	Levy ($m)	1,212	1,277	1,279	1,320	1,362	1,400	1,486	1,580	1,674	1,771
New year costs ($)		1.24	1.27	1.30	1.32	1.34	1.37	1.39	1.42	1.45	1.48

Notes:

- Figures A.8 to A.10 show a similar pattern of trends to the equivalent figures for the Motor Vehicle and Work Accounts. The key difference is that under the proposed funding policy, less of an initial levy reduction is required in the Earners' Account because there is less of a difference between current levies relative to new year injury costs.

Figure A.9 – Indicative levy paths for new funding policy for Earners' Account targeting 100% of reported liabilities



Scenario		2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24
Target 100% with no transition	Levy rates ($)	1.26	1.26	1.16	1.19	1.23	1.26	1.30	1.33	1.37	1.40
	Solvency	123%	123%	121%	119%	118%	116%	115%	114%	113%	112%
	Levy ($m)	1,212	1,277	1,229	1,307	1,388	1,470	1,553	1,643	1,734	1,829
Target 100%, capping levy reductions to 5%	Levy rates ($)	1.26	1.26	1.20	1.19	1.22	1.26	1.29	1.33	1.37	1.40
	Solvency	123%	123%	121%	120%	118%	117%	115%	114%	113%	112%
	Levy ($m)	1,212	1,277	1,269	1,302	1,384	1,466	1,550	1,640	1,731	1,826
Target 100%, capping levy reductions to 5%, flat for 4 years following drop	Levy rates ($)	1.26	1.26	1.25	1.25	1.25	1.25	1.28	1.32	1.36	1.39
	Solvency	123%	123%	122%	122%	120%	119%	117%	116%	115%	114%
	Levy ($m)	1,212	1,277	1,325	1,368	1,412	1,450	1,535	1,626	1,717	1,813
New year costs ($)		1.24	1.27	1.30	1.32	1.34	1.37	1.39	1.42	1.45	1.48

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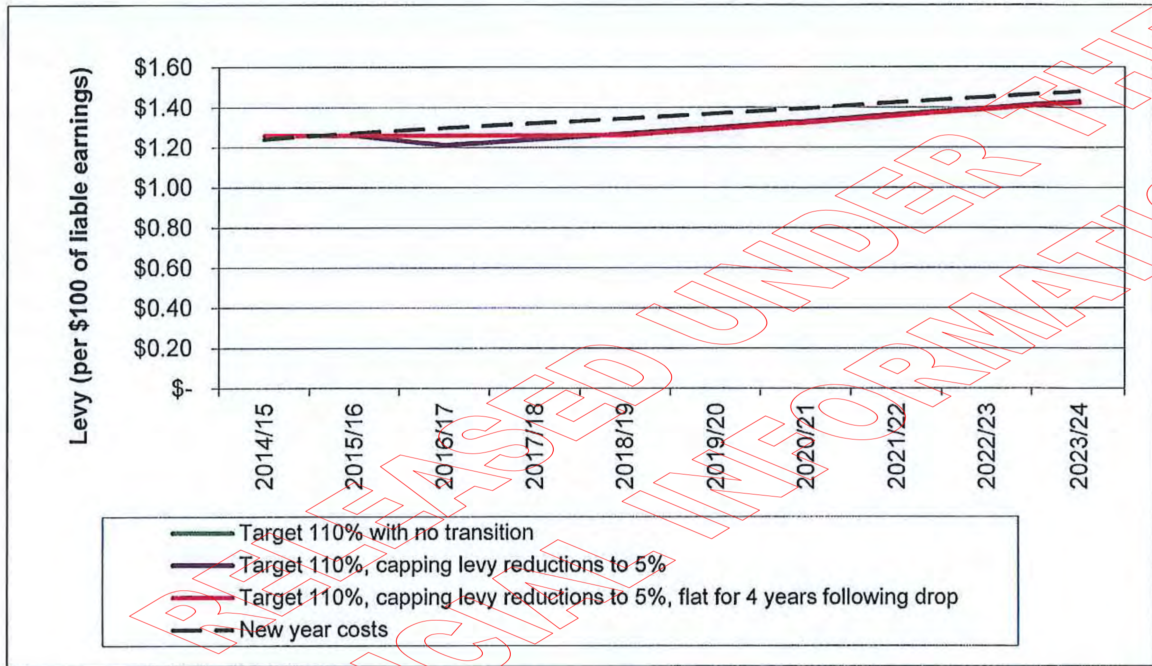
Figure A.10 – Indicative levy paths for new funding policy for Earners' Account targeting 110% of reported liabilities



Scenario		2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24
Target 110% with no transition	Levy rates ($)	1.26	1.26	1.21	1.24	1.27	1.30	1.33	1.37	1.40	1.43
	Solvency	123%	123%	122%	121%	120%	119%	119%	118%	118%	117%
	Levy ($m)	1,212	1,277	1,286	1,361	1,440	1,519	1,599	1,687	1,776	1,868
Target 110%, capping levy reductions to 5%	Levy rates ($)	1.26	1.26	1.21	1.24	1.27	1.30	1.33	1.37	1.40	1.43
	Solvency	123%	123%	122%	121%	120%	119%	119%	118%	118%	117%
	Levy ($m)	1,212	1,277	1,286	1,361	1,440	1,519	1,599	1,687	1,776	1,868
Target 110%, capping levy reductions to 5%, flat for 4 years following drop	Levy rates ($)	1.26	1.26	1.26	1.26	1.26	1.29	1.32	1.36	1.39	1.43
	Solvency	123%	123%	123%	122%	121%	120%	120%	119%	118%	118%
	Levy ($m)	1,212	1,277	1,342	1,385	1,432	1,511	1,592	1,680	1,769	1,862
New year costs ($)		1.24	1.27	1.30	1.32	1.34	1.37	1.39	1.42	1.45	1.48

Appendix 2: Draft Policy Direction to ACC in relation to the funding of levy funded Accounts

The Minister for ACC directs the Accident Compensation Corporation (ACC), under section 103 of the Crown Entities Act 2004, to give effect to the Government policy described below.

Purpose

The purpose of this Policy Direction is to set out the Government's policy with respect to the funding of ACC's levy funded Accounts. The levy funded Accounts ("levied Accounts") are currently:

- the Earners' Account (including any part of the Earners' Account required to fund the Treatment Injury Account in accordance with section 228 of the Accident Compensation Act 2001)
- the Work Account
- the Motor Vehicle Account.

Accident compensation is by nature a long term activity with liabilities that stretch over decades. However, levies are normally set on an annual basis. In setting levies it is necessary to consider the long term nature of the claims they will fund as well as the desire of all stakeholders for reasonable stability within the scheme. This Policy Direction informs ACC of the Government's expectations with regards these two factors. In particular the Policy Direction is intended to ensure that there is increased:

- transparency around annual funding decisions, by making it clear how today's funding decisions will impact the scheme over future periods;
- consistency and stability in decisions over time, by imparting a longer term focus.

This Policy Direction also sets out the Government's policy on the level of financial risk that ACC is expected to accept on behalf of levy payers.

Government Objectives

The Government's core objectives with respect to ACC levies are that:

1. Levies are to be kept as stable as possible from year to year, relative to underlying costs, so as to allow businesses and individuals to better plan their expenses
2. Levies are established so as to correctly price both the expected lifetime cost of claims in the year and any other costs of providing ACC's services. Levy payers in each period should, as close as possible, face the expected lifetime costs of claims from injuries occurring in that period.

Other important objectives include:

- Levies are kept as low as possible while ensuring ACC is able to effectively perform its functions under the Accident Compensation Act

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- Equity is maintained, both between different groups currently covered and across generations

- The long-term financial stability of the ACC scheme, to ensure that the public of New Zealand has confidence in the scheme.

It is acknowledged that in certain circumstances not all of these objectives will be achievable. In this instance ACC must, in making its final levy recommendations, explain how the recommendations have balanced the conflicting objectives.

Direction to ACC

Administration of levied Accounts

Consistent with the Government's objectives, ACC must administer the levied Accounts and recommend levies according to the following parameters for each levied Account:

- ACC must set a base levy rate that funds the expected lifetime costs of claims arising as a result of injuries occurring during the levy year.

- ACC must include an adjustment to the base levy rate that takes ACC's funding position towards the selected funding target of [insert funding target].

- Any adjustment to the base levy rate is calculated to return the funding position to the selected funding target over a 10 year horizon.

- Any annual increase to the average levy for each Account is capped at 15%, adjusted for inflation in the Motor Vehicle Account.

Levy consultation

When undertaking public consultation on levy rates, ACC must provide sufficient information at a level of detail that allows submitters to understand how ACC's proposals give effect to this Policy Direction, how proposals were derived, and what the implications are for future funding levels. This information must also be provided to Ministers with ACC's levy recommendations.

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BUDGET-SENSITIVE

Reference: T2014/634 CM-1-3-1-2-3

Date: 8 April 2014

To: Minister of Finance (Hon Bill English)
Associate Minister of Finance (Hon Steven Joyce)

Deadline: 10 April 2014

Aide Memoire: Further information about setting a Government funding policy for ACC

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This aide-memoire summarises our further advice on a Government funding policy for ACC. It accompanies a joint report, which provides the advice requested by Joint Ministers on 11 March. You are discussing this report with Ministers Collins and Foss on 10 April.

Key points

An important function of the funding policy is to ensure that judgements about ACC's funding target (and other key policy settings) sit with Ministers.

- Given the size of ACC's additional margins ($4B), any decisions about unwinding these margins would need to take a range of wider factors (beyond ACC) into account, including Government's fiscal strategy.

Moving to a lower funding target means that, all else being equal, levies have to drop significantly then rise again...

- Levy reductions are needed to mitigate over-funding, especially if Ministers opt for a much lower funding target. Levies are then forecast to increase gradually to meet the rising cost of claims (which in turn reflects health cost inflation).

...but in practice, future levies may deviate significantly from the 'baseline' path.

- Actual levies will not follow the baseline path, as adjustments will be needed to reflect differences in experience compared to forecasts. Historically, levies have fluctuated significantly.

We are comfortable with the use of a transition mechanism to get to a lower funding target...

- All else being equal, we favour earlier implementation of a new funding policy. This would enable the benefits of a principles-based approach – including greater

certainty and transparency around levy-setting – to be realised sooner, and prevent further build-up of unnecessary margins.

- But given the size of the margins involved, we are comfortable in principle with the use of a transition mechanism:
  - We think there is a risk of over-stating the impact of a short transition period (such as a short levy freeze), especially given the likelihood of levy rates deviating from their forecast path.
  - We do not think that a well-managed transition mechanism need critically undermine a principles-based funding policy.

- There may be scope to consider transition measures that align with other elements of a new funding policy. *[Withheld under s9(2)(f)(iv)]*

...and we can provide further advice on aligning the transition to a lower funding target with Government's fiscal strategy.

- For example, there may be opportunities to use a levy holiday or rebate as a counter-cyclical measure after 2016/17. We can provide further advice on this.

We are comfortable with a 10-year funding horizon, though we note that actuaries thought this was on the long side.

- We are comfortable that a 10-year funding horizon represents ACC's best advice following the modelling work they have undertaken.

- Agencies agree that the precise length of the funding horizon is a judgement. Independent actuaries who work with ACC considered that a 10-year horizon was on the long side when we discussed it with them. We think that a horizon longer than 10 years would take levy rates too far away from the underlying cost of claims.

- We think that the risks associated with a 10-year horizon are low. The horizon is effectively re-set on an annual basis, so that funding adjustments need to be spread across each rolling 10-year period. It is unlikely to create perverse incentives in relation to scheme management (e.g., to push out any difficult judgements, for example around levy increases, to the end of the period).

Helen Anderson, Senior Analyst, Health, 04 917 6307
Ben McBride, Manager, Health, 04 917 6184

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IN-CONFIDENCE

Reference: T2014/966 CM-1-3-1-2-3

Date: 27 May 2014

To: Minister of Finance (Hon Bill English)
Associate Minister of Finance (Hon Steven Joyce)

Deadline: Wednesday 28 May 10.30am

Aide Memoire: Transition to a new ACC funding target

This aide-memoire responds to your request for further advice on the transition to a lower funding target for ACC. The paper *Setting a Government Funding Policy for ACC's Levied Accounts* will be discussed at EGI on Wednesday morning.

On 15 April, Joint Ministers opted for a funding target for ACC of 100-110 per cent of reported liabilities. ACC modelling shows that, all else being equal, it would take around 20 years (applying the new funding policy from 2016/17 as described below) to reduce funding in the Earners' and Work Accounts to the top of this band, i.e. to 110 per cent.[1] We recommend further work on options for reaching the funding target over a shorter period (recommendation 5.2 in the paper).

Getting to a lower funding target – baseline paths

Figures 1 and 2 below, provided by ACC, show the indicative baseline paths for the Earners' and Work Accounts under the proposed funding policy (note that actual levy rates are likely to differ). Levy paths will be reassessed each levy round to reflect changes in new-year costs and correct over- or under-funding over the agreed horizon.

ACC's modelling incorporates the following assumptions:

- 2015/16 levy rates are the same as those used in Budget 2014 forecasts.
- Levies are kept flat at the lowest point for one year, to avoid sharp levy increases immediately after large levy reductions (as discussed at the meeting of 15 April). The trade-off between smooth levy paths and getting to the funding target within a reasonable timeframe was not made clear at this time.
- A 10-year funding horizon for levy changes – i.e., levies are set to correct over- or under-funding over the next 10 years – as agreed by Joint Ministers on 15 April.
- The funding policy reduces funding levels (the top line) gradually, by keeping levy rates below new-year injury costs. Levy rates (the bars) keep going up to reflect health cost inflation, but increase at a lower rate than expected costs.

[1] It would take about five years in the Motor Vehicle Account, which is at a lower level of funding.

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Figure 1: Baseline path for the Earners' Account levy

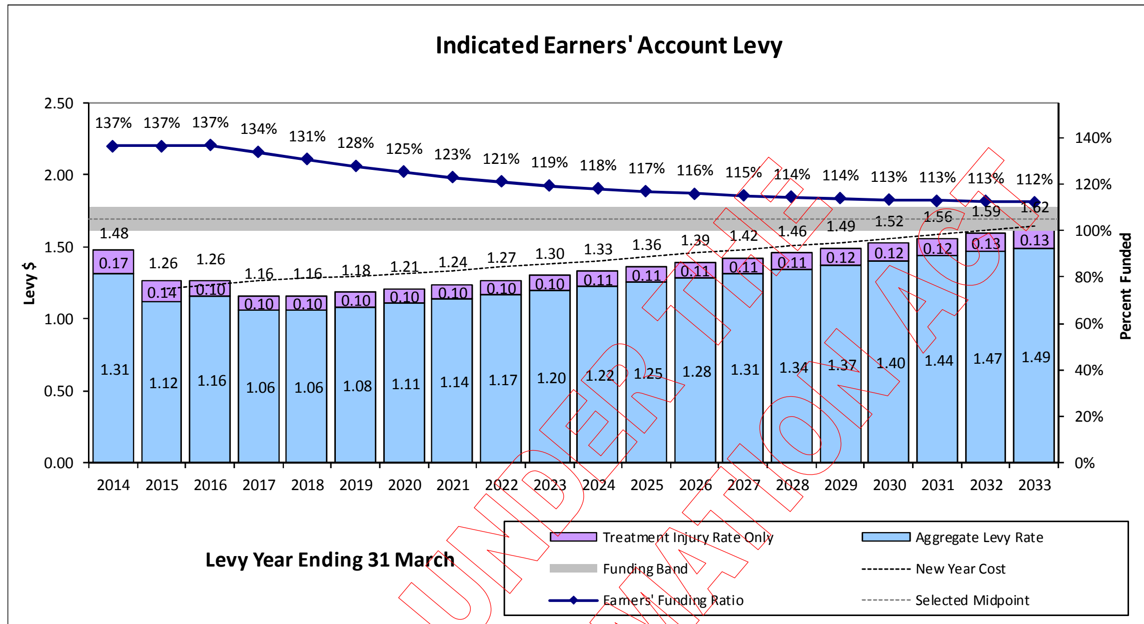
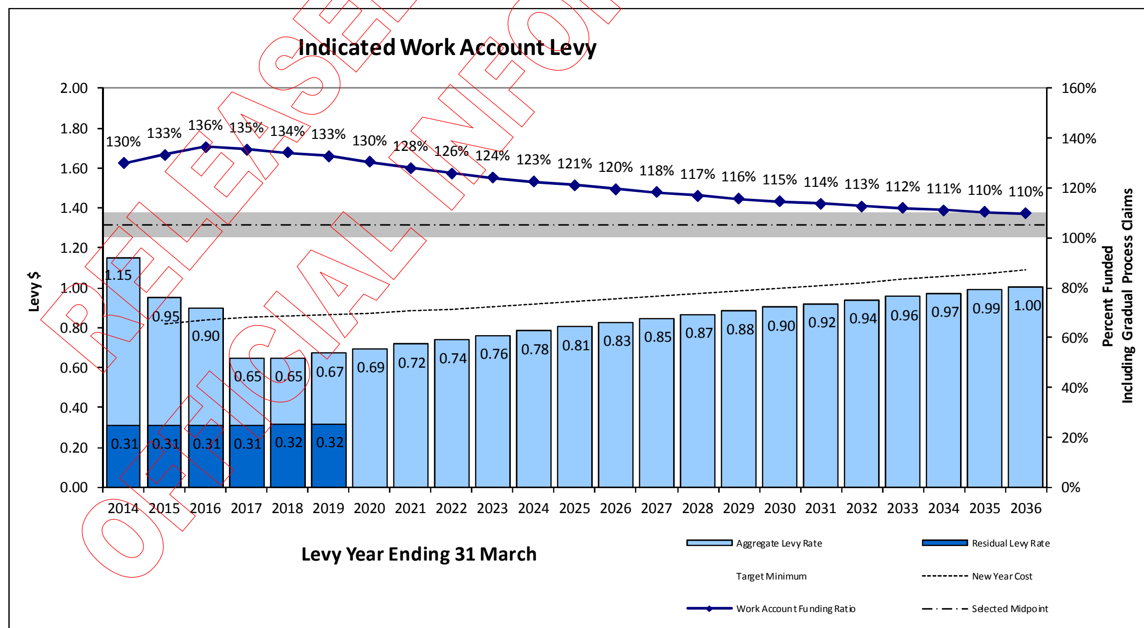


Figure 2: Baseline path for the Work Account levy



- The 10-year funding horizon doesn't mean that the funding target is actually reached in that timeframe. Each levy round, ACC would reassess the gap between actual and target funding, and reset levies to close the gap over the next 10 years. Since the gap keeps getting smaller (all else equal) but the adjustment is still spread over 10 years, progress towards the target flattens off over time.

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We recommend further work on a shorter transition to the funding target

- If the new funding policy is applied as above, all else being equal it will be years before Ministers' decision on ACC's funding target is implemented and surplus funding is fully returned to levy payers.
- As noted above, there is a trade-off between a shorter transition to the funding target and a smooth baseline levy path:
  - Getting to the target more quickly would mean larger levy reductions followed by larger increases (all else equal).
  - We recommend further work on transition options to make the trade-offs explicit, and inform Ministers' decisions on the preferred path.
- There could be scope to reduce funding levels more quickly through a levy holiday or rebate, potentially as a counter-cyclical measure after 2016/17 (depending on the fiscal strategy). We can advise on this option as part of further work [T2014/634 refers].
- Such an approach should not be seen to undermine a principles-based funding policy, but rather as part of the transition to that policy (of which the funding target is a key part). A more timely transition to the target would put this element of the policy in place more quickly.

Helen Anderson, Senior Analyst, Health, 04 917 6307
Ben McBride, Manager, Health, 04 917 6184

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Reference: T2014/1261 CM-1-3-1-2-3

Date: 3 July 2014

To: Minister of Finance (Hon Bill English)
Associate Minister of Finance (Hon Steven Joyce)

Deadline: 11 July 2014

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Aide Memoire: Options for moving to ACC's new funding target

This aide-memoire advises you on options for moving to ACC's new funding target in the levied accounts (the Earners', Work and Motor Vehicle Accounts). It accompanies the paper *Funding policy for ACC's levied Accounts – Transitions*, on which the Minister for ACC is seeking your feedback. The expectation is that Ministers will give a signal on the funding policy when 2015/16 levy decisions are announced in late July.

The paper responds to EGI's request for further consideration of options to reduce funding levels to the new target – 100-110 per cent of reported liabilities – over a shorter period [EGI Min (14) 11/9 refers]. All else being equal, applying the funding policy from 2016/17 means it would take about 20 years for the Earners' and Work Accounts (by then projected to be funded at about 137 and 136 per cent respectively) to fall to 110 per cent funding.

Flat levy rates could be set to achieve the funding target in 5-10 years – but there would still be significant levy increases at the end of the period

MBIE and ACC recommend getting to the new funding target by setting lower, flat levies for about 5 years in the Earners' Account, and 10 years in the Work Account (both starting in March 2016).[1] Under this option:

- Earners' and Work levies would be set at a flat rate projected to reduce funding to 105 per cent (the middle of the target band) within 5/10 years respectively
- levy rates would remain at that level until the target was reached (so the transition could be shorter or longer, depending on ACC's actual funding position)
- all else being equal, once the target was reached, levies would then rise again to reflect new-year costs. This might be done gradually at the end of the transition period, rather than in a single step.

[1] The funding policy would first be applied to levy rates from March/June 2016 onwards. Decisions on levy rates beginning March/June 2015 (the 2015/16 levy year) will be sought at the end of next month. As these decisions have not yet been made, the paper assumes 2015/16 levy rates as built into Budget 2014 forecasts (Earners' $1.26, Work $0.90, and Motor Vehicle $195.00).

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MBIE and ACC do not recommend:

- a 5-year transition in the Work Account. Since this would require Work levies to be set very low, it would undermine employer incentives to participate in ACC's discount programmes. Steep levy increases would be needed (the current projection is for a rise from $0.37 to $0.90) once the target was reached
- any special measures in the Motor Vehicle Account, since applying the funding policy is expected to get funding levels within the target band in 5 years anyway.

Table 1 summarises MBIE's and ACC's preferred option. Levy paths are indicative only. Actual levy rates would be calculated closer to the time.

Table 1: MBIE and ACC-recommended transition (Earners' and Work Accounts)

	Earners' Account	Work Account
Transition period	About 5 years – projected to reach 105% in 2020/21	About 10 years – projected to reach 105% in 2025/26
Assumed 2015/16 levy (as per Budget 2014 forecasts)	$1.26	$0.90
Projected levy during transition period	$1.00 (for 5 years)	$0.63 (for 10 years)
Projected levy in first year after target reached	$1.36 (in 2021/22)	$0.95 (in 2026/27)

Although this option would implement the funding target more quickly, we don't think it is compelling enough to rule out other approaches at this point. In particular:

- a long transition period could well set expectations of ongoing (unsustainably) low levies, which would pose significant communications challenges. Increases at the end of the period (currently projected at 36 per cent for Earners' and 51 per cent for Work levies) would be hard to explain
- there may be risks in relying on a period of lower levies to return funds. This option is projected to require large levy reductions in 2016/17 (see Table 2 below)
- it means a persistent, significant distortion to the baseline levy path. While we recognise that in practice levy rates will always deviate from this path, this approach would effectively divorce levy rates from new-year costs for 5/10 years.

We think a levy rebate is an opportunity worth exploring further

We think the potential benefits of the alternative option, a levy rebate, make it worth further consideration. Under this approach, 2016/17 levy rates could be set at the funding target (new-year costs at 105 per cent of reported liabilities) with a view to returning surplus funds via a rebate in one or more later years. This would:

- set levy rates at new-year injury costs from the outset

- decouple the process of returning these surplus funds from underlying levy rates. All else being equal, this would allow levy rates to match new-year costs more closely, and should mitigate expectations of ongoing low levies
- enable funds to be returned to levy-payers in a more visible and meaningful form, compared to a period of lower levy rates
- offer potential fiscal management advantages. For example, funds could be returned as a counter-cyclical measure in a downturn (e.g. in 2018 or later). Payments could be made over 2-3 years to help manage fiscal impacts.

This type of approach has a precedent in demutualisation and insurance company payouts – Southern Cross, for example, returns surplus funds to policy holders on a similar basis from time to time. As noted in the paper, private sector experiences of these processes could be used to guide the design of a levy rebate (see further below).

The following table summarises estimated 2016/17 levy rates and reductions under 3 scenarios: no transition; a 5-year Earners' and 10-year Work transition (MBIE- and ACC-preferred); and a levy rebate after 2016/17 that set 2016/17 levy rates at or around new-year costs.[2]

Table 2: Estimated 2016/17 levy rates and reductions under transition scenarios

Account		2014/15 (current rates)	2015/16 (as per BEFU 14 forecasts)	2016/17		
				Funding policy (no transition)	5-year Earners', 10-year Work	Levy rebate after 2016/17
Earners'	Levy rate	$1.26	$1.26	$1.16	$1.00	$1.26
	Est. levy reduction	-	-	$0.12b	$0.30b	-
Work	Levy rate	$0.95	$0.90	$0.65	$0.63	$0.85
	Est. levy reduction	-	$0.04b	$0.25b	$0.27b	$0.08b
Motor Vehicle	Levy rate	$330.68	$195.00	$125.00	$125.00	$145.05
	Est. levy reduction	-	$0.44b	$0.68b	$0.68b	$0.61b
Total levy reduction from 2014/15 rates		**-**	**$0.48b**	**$1.05b**	**$1.25b**	**$0.69b**
Total levy reduction from assumed 2015/16 rates				**$0.57b**	**$0.77b**	**$0.21b**

[2] New-year costs are projected to be $1.27 in the Earners' Account in 2016/17. Rather than increasing the levy by $0.01 (assuming a 2015/16 levy rate of $1.26), a flat Earners' levy rate has been assumed.

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We recommend further work on a rebate and fit with the fiscal strategy

MBIE and ACC do not recommend a levy rebate for a range of reasons, including the legal and operational issues it would raise and the need for decisions on timing and distribution. The paper notes that a rebate of surplus funds – estimated at about $5B across all 3 accounts by the end of the 2017/18 levy year – would have a large fiscal impact, and departs significantly from funding policy principles.

Should Ministers wish to consider a rebate option, there would be a range of areas for further work. We consider that:

- the potential advantages of a rebate in terms of managing the cycle are worth exploring further. Fit with the fiscal strategy, including Government's goals for managing net debt and avoiding adverse impacts on interest rates in the economic upswing (and whether levy reductions would be inside or outside the operating allowance), would be a key area for further work
- decisions about the transition to the funding target should take wider factors (such as the fiscal strategy) into account, and need not be bound by the funding policy principles. Given current funding levels, there are in any case trade-offs between different elements of the policy: a 10-year funding horizon can be implemented only at the expense of a timely transition to the funding target
- compared to a flat-levy option, a rebate option would have the advantage of quickly aligning levy rates with new-year costs (in line with the funding policy intent) and avoiding ongoing large impacts on levy rates
- the need to work through legal, policy and implementation issues should not rule out a rebate at this stage:
  - Though a rebate would make distribution decisions more obvious (and raise different legal and policy questions) every transition option implicitly requires such decisions.
  - The costs of paying out a rebate would likely be minimal compared to the amount of funds being returned.
  - Drawing on the experiences of insurers could help mitigate risk. Principles could be developed to underpin and explain the distribution of a rebate, and to help communicate its exceptional status – we understand from Finity (actuaries who work closely with ACC) that these are typically used in a demutualisation. Public consultation could be undertaken on aspects of a rebate, such as how funds should be distributed.
- compared to longer-term changes to levy rates, a rebate could be more easily communicated as a one-off transition measure – though we would not rule out recommending special measures in future if any of the levied accounts were persistently well over (or under) Ministers' chosen funding target.

Helen Anderson, Senior Analyst, Health, 04 917 6307
Ben McBride, Manager, Health, 04 917 6184

IN-CONFIDENCE

Reference: T2014/1363 CM-1-3-1-2-3

Date: 25 July 2014

To: Minister of Finance (Hon Bill English)
Associate Minister of Finance (Hon Steven Joyce)

Deadline: For meeting Monday 28 July, 5.30pm

Aide Memoire: Transition to the funding policy for ACC's levied accounts

The attached A3 summarises the options and next steps on the transition to the new funding policy for ACC's levied accounts. It aims to support your discussion with the Minister for ACC and officials on Monday 28 July.

The options in the attached A3 include:

- the original option of applying the funding policy from 2016/17 (**Option A**). This is the approach that generates an expected 20-year transition in the Earners' and Work accounts, and which prompted Ministers' interest in further work on a shorter transition period [EGI Min (14) 11/9 refers]
- an option of setting flat levy rates to get to the new funding target in an estimated 5 years in the Earners' Account, and 10 years in the Work Account (**Option B**). This was the alternative option recommended in MBIE's paper *Funding policy for ACC's levied Accounts - Transitions*
- an additional option, not previously provided, which was referred to in the ACC Board's response to the above report (**Option C**). ACC has modelled this option in response to the Board's interest in a transition that sticks more closely to underlying injury costs. It includes a shorter period of constant levies (3 years) and results in smoother levies at the end of the transition period (though note in practice it would also be possible to smooth increases under Option B).
- a levy rebate option (**Option D**).

We have consulted MBIE and ACC in preparing this A3.

Helen Anderson, Senior Analyst, Health, 04 917 6307
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Transition to the funding policy for ACC's levied accounts

1 Projected funding levels exceed the new funding target

Ministers have set a funding target of 100-110% of reported liabilities for ACC's levied accounts, as part of the funding policy. This target will apply from the 2016/17 levy year. ACC currently holds about $2.93b above the target midpoint (105%). Assuming 2015/16 levy rates as per 2014 Budget forecasts, this is projected to be $4.49b by the end of the 2015/16 levy year.

*Includes Treatment Injury

2 Getting to the new funding target

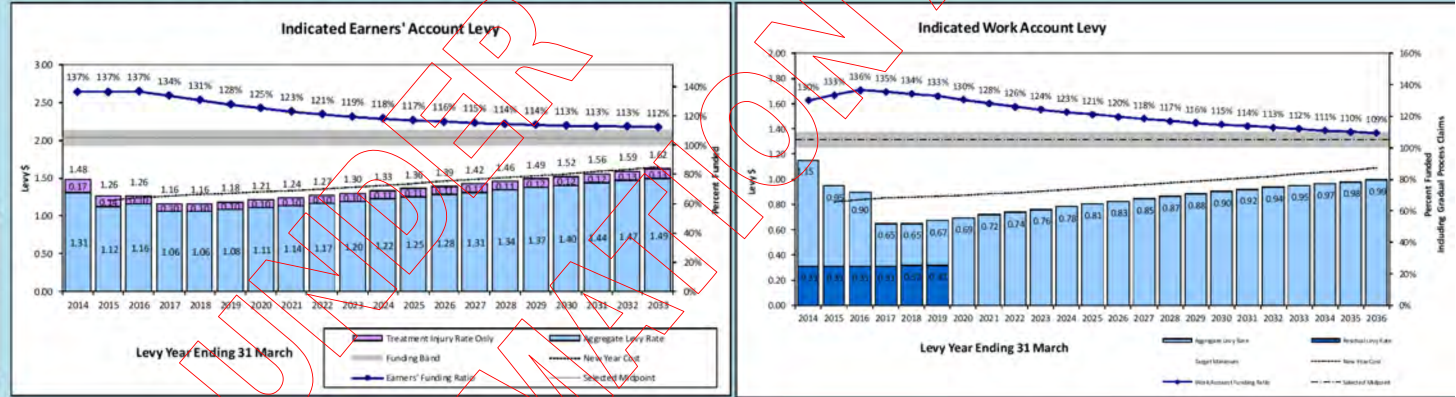
- Levies need to fall below new-year injury costs in order to return surplus funds – but ultimately will need to increase again to reflect new-year costs.
- A smoother (more stable) levy path means a slower transition to the funding target. A quicker transition means a steeper v-shaped (or u-shaped) levy path, i.e. larger reductions followed by larger increases.
- Levy reductions need to be considered in the context of the fiscal and budget strategy, and the impacts on monetary policy. Reductions above the $1.5b operating allowance could put pressure on the OCR. All options present macroeconomic challenges, unless managed within allowances or (for example) offset in other ways.
- Future levy paths are indicative, and will be reassessed in line with scheme performance and the impact of economic factors such as interest rates. All options assume 2015/16 levies as in Budget 2014 forecasts.

Options: Which set of rules should the ACC Board use to develop its levy recommendations?

Option A: Apply the funding policy from 2016/17

- Adjusts levies s9(2)(f)(iv) to aim for the target (105%) in 10 years' time
- Reduces funding levels very slowly, but with a smoother levy path – favours alignment with principles over a timely transition to the target
- Levies are linked to underlying costs during the transition

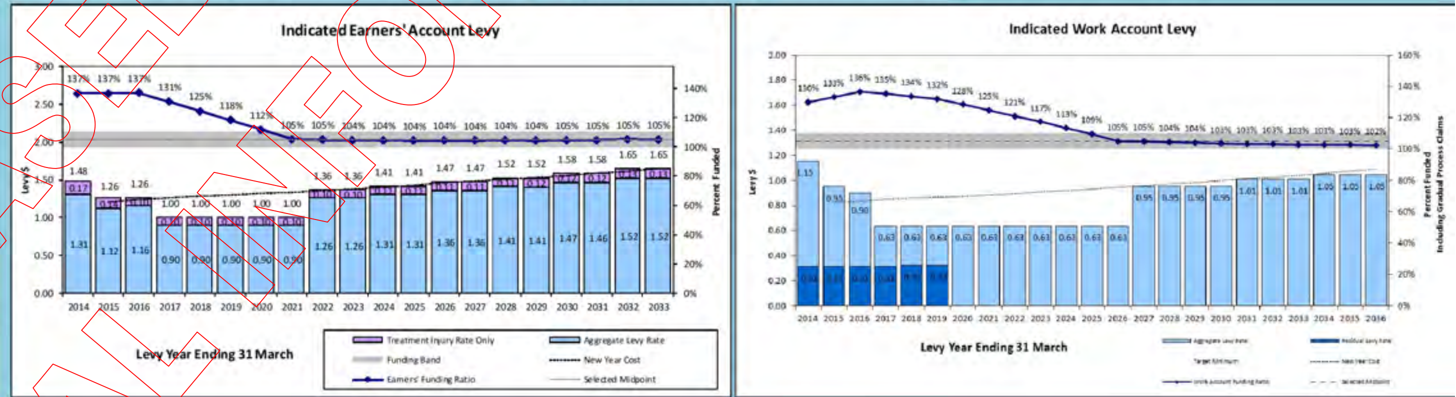
Estimated transition	Earners' and Work: About 20 years Motor Vehicle: About 5 years
Estimated 2016/17 levy year reductions	$570m from forecast 2015/16 rates



Option B: Set flat levy rates to get to the funding target (as previously consulted on)

- Sets levies at a low flat rate to get to the target in 5 years (Earners' Account) / 10 years (Work Account)
- Quicker transition to the target, but then a steeper levy increase – potential to do this in increments, rather than a single step
- Levies are not linked to underlying costs during the transition (favours flat levies over link to costs)

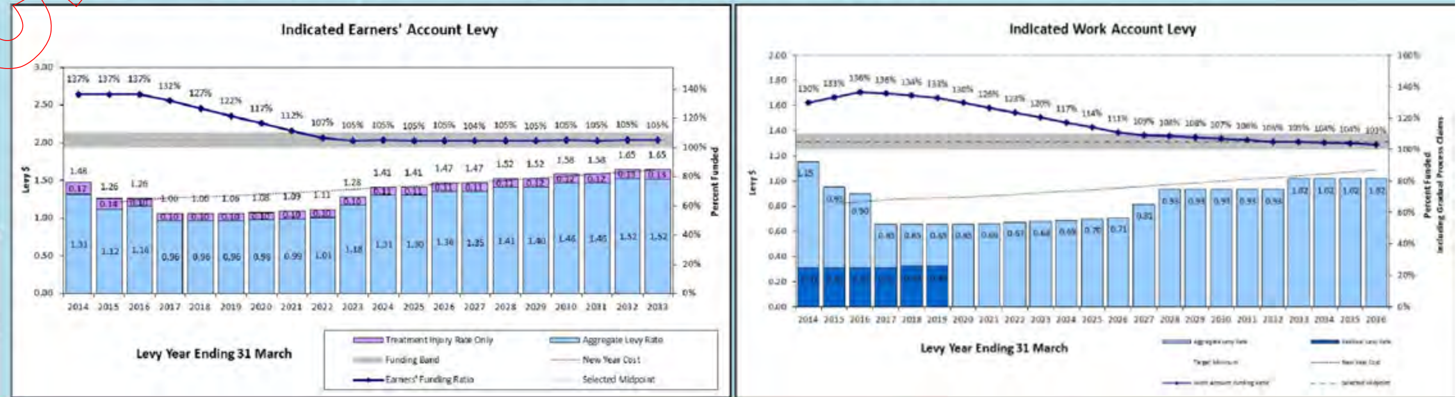
Estimated transition	Earners': 5 years, Work: 10 years Motor Vehicle: As per Option A
Estimated 2016/17 levy year reductions	$770m from forecast 2015/16 rates



Option C: 3 years' flat levies, with levy rates linked to costs (ACC Board option)

- Sets levies at a flat rate linked to costs for 3 years, then a fixed proportion of costs (resulting in gradual levy rises) until the top of the target band (110%) is reached
- Shorter period of flat levies to stay closer to expected costs; targets the band rather than the 105% midpoint
- Expected transition to 105% is between Options A and B

Estimated transition	Earners': 7 years to 105%, Work: 11 years to 110%, 16 years to 105% Motor Vehicle: As per Option A
Estimated 2016/17 levy year reductions	$746m from forecast 15/16 rates



Option D: Return funds via a levy rebate – could include Motor Vehicle Account

- Sets levies at the target from 2016/17, and pays out surplus funds via a levy rebate – enabling a quick transition without a large levy increase, and enabling underlying levy rates to better track new-year costs in line with the funding policy intent
- Has a precedent in demutualisation and insurance company payouts – e.g. Southern Cross
- May be possible to return the funds in a way that helps manage the cycle – e.g. by using a rebate as a fiscal stimulus in a downturn
- ACC Board has strong objections (e.g. consistency with funding policy principles; logistics), outlined in its response to the Transitions paper
- Potential for more complexity and risk: dependent on economy; requires legislative change, explicit allocation decisions; further work needed to identify system implications, etc.

Estimated transition	1-3 years from 2016 to 2021, depending on economic conditions / fiscal strategy
Estimated 2016/17 levy year reductions	$210m from forecast 2015/16 rates – needed to set levy rates at new-year costs (mostly Motor Vehicle)

Should Ministers wish to pursue this option, officials would do further work to:

- explore a range of design choices: e.g. who receives a rebate – principles could be developed to guide this; how a rebate is paid out – this may not have to be done by ACC
- engage other agencies (e.g. IRD)
- engage actuaries to guide options for the design / allocation of a rebate

3 Next steps

- Discuss with colleagues on Monday 28 July whether there is a preference for Options A-C, **OR** further work and report-back on a levy rebate option
- Consider at Cabinet on 4 August as part of Budget strategy discussion – any further work on a rebate would also require Cabinet consideration
- Confirm and issue Ministerial direction to ACC prior to the 2016/17 levy round (levy consultation in 2015 for the 2016/17 and 2017/18 levy years)
- Consider communication of funding policy and transition decisions

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IN-CONFIDENCE

Reference: T2014/1389 CM-1-3-1-2-3

Date: 31 July 2014

To: Minister of Finance
(Hon Bill English)

Associate Minister of Finance
(Hon Steven Joyce)

Deadline: Monday 4 August
(if any)

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Aide Memoire: Transition to ACC's funding policy - macroeconomic considerations

In May 2014, Cabinet agreed to a Government funding policy for ACC's levied accounts to take effect from the 2015 levy round (the 2016/17 levy year). Cabinet also requested further consideration of options to reduce funding levels to the new funding target – 100-110 per cent of reported liabilities – over a shorter period of time [EGI Min 11/9 refers].

A Cabinet paper will be considered on Monday 4 August that seeks agreement to a transition to the new funding policy.

Ministers have indicated a preference for setting ACC levies at a flat rate to reach the funding target band over a specified period (5 years in the Earners' Account, 9 years in the Work Account), subject to further information on the macroeconomic considerations.

There are material fiscal and macroeconomic implications to consider. In particular, there are implications for the fiscal strategy objective of avoiding adverse pressure on interest rates. Managing ACC levy reductions from within operating allowances may be challenging given your other fiscal priorities. Cabinet decisions would also create significant implications for the *Pre-election Economic and Fiscal Update*.

The Treasury recommends that this decision should be deferred by Cabinet until early next year to ensure decisions align with the fiscal strategy. This would allow time for Ministers to consider whether ACC levy reductions should count against operating allowances and consider the trade-offs with respect to other tax and spending settings.

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Fiscal implications

The proposed Cabinet paper would seek agreement to setting out a pathway for getting to the funding target rather than signalling a specified amount of levy reductions. MBIE's costings of the option under consideration indicate annual levy reductions of around $850 million per annum from 2016/17 (there would be an impact on the fiscal year 2015/16 for the accounts that have levy year starting 1 April).[1] However, the estimates are only indicative.

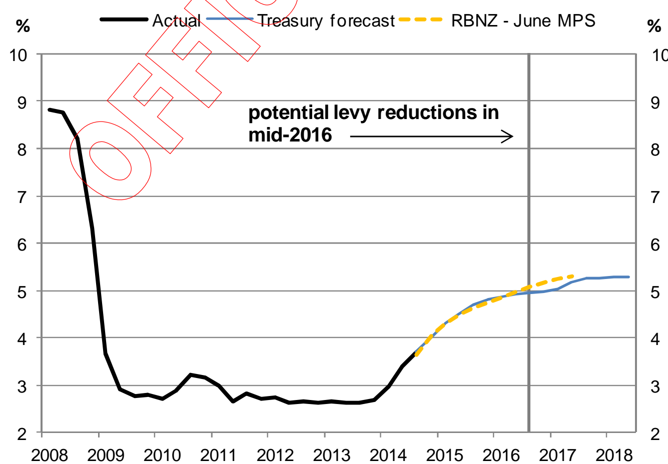
Levy reductions from 2016/17 would be additional to current Treasury forecasts for ACC levy rates. Current Treasury forecasts assume that 2015/16 levy rates are maintained into future years. The additional levy reductions to get to the funding target would commence on 1 April and 1 July 2016 (depending on the account).

There would be impacts on OBEGAL. Impacts on net debt would be minor as changes relate to levy-funded accounts. These have not been quantified.

Macroeconomic implications

In macroeconomic terms, levy reductions are broadly similar to tax reductions. In the absence of offsetting tax and spending adjustment (ie, if ACC levy reductions were not managed within operating allowances), this would have implications for the fiscal impulse. The forecast fiscal impulse in the *Budget Update* indicated fiscal tightening that averages 0.6% of GDP per year over 2015/16 to 2017/18. An additional levy reduction of around $850 million per annum would add to the fiscal impulse by 0.3% of GDP in the year that levy reductions are introduced (2016/17). On current forecasts, the fiscal impulse would still be negative in each forecast year (although less negative than otherwise), but this would also depend on the timing of tax and spending initiatives in future Budgets. The forecast fiscal impulse assumes the $1.5 billion operating allowances from Budget 2015 are allocated smoothly across the forecast horizon.

Figure 1 - Interest rate forecasts (90-day bank bill rate)



[1] This cost has changed from the figure in earlier advice due to the removal of the residual from 2016/17.

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There are material macroeconomic implications to consider. Further ACC levy reductions occurring in 2016 would come at a time when the economy is expected to be operating at, or above, potential. Although uncertain, the OCR is currently expected to increase by a further 150 basis points over the next two years (from 3.5 to 5%). Under this scenario, floating mortgage interest rates are likely to be near 8 percent.

ACC levy reductions would provide a boost to household consumption that would add to inflationary pressures. This would be taken into account by the Reserve Bank in setting the OCR, implying slightly higher interest and exchange rates than otherwise for a period. The interest rate impacts of ACC levy changes alone are likely to be modest - less than one OCR increase (ie, less than 25 basis points). Nevertheless, in combination with higher operating allowances already planned, this would mean that fiscal policy is placing more pressure on monetary policy than was factored into the forecasts last year.

Options for managing levy reductions

The Fiscal Strategy includes the goal of ensuring any changes in fiscal policy settings do not have a material adverse impact on interest rates.

In principle, there are a number of potential ways to manage ACC levy reductions without adding to pressure on interest rates:

- manage ACC levy reductions from within future operating allowances;
- manage the composition of tax and spending initiatives to limit the overall amount of fiscal impulse; or
- manage the timing of levy reductions for when macroeconomic conditions permit.

Manage ACC levy reductions from within future operating allowances

ACC levy changes have not always been included within the allowance framework in the past (which would make sense if the only fiscal target was net debt). However, since the Fiscal Strategy includes the objective of avoiding pressure on interest rates, there is a case for managing ACC levy changes from within allowances.

Managing ACC levy reductions from within the operating allowances would mean that levy reductions do not add additional pressure to interest rates than was factored into the *Budget Update*. However, this may be challenging from a fiscal management perspective given your other fiscal priorities. Levy reductions of $850 million per annum would be equal to over half of one Budget's $1.5 billion per annum allowance. The Fiscal Strategy states that operating allowances will be $1.5 billion *on average*. This flexibility may help to accommodate ACC levy reductions within allowances (or through smoothing the impact over both Budget 2015 and 2016 allowances), but it would still require trading off levy reductions with other potential tax and spending initiatives.

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Manage the composition of tax and spending initiatives to limit the overall amount of fiscal impulse

Even if ACC levy reductions were outside operating allowances, decisions could be made to manage the overall fiscal impulse taking into account the overall composition of revenue and spending initiatives in future Budgets.

One option would be to use some of the operating allowance to fund initiatives that do not add directly to macroeconomic stimulus, thus offsetting some of the fiscal impulse from ACC levy reductions. One such initiative is Kiwisaver one-off enrolment. Kiwisaver subsidies are excluded from the Treasury's fiscal impulse indicator since the first-round impact is a switch from government saving to household saving (although there may be second-round effects). However, it will be practically challenging to find other initiatives of this type that could offset the size of ACC levy reductions. The indicative cost for Kiwisaver one-off enrolment is around $100-300 million over four years, much less than the cost of ACC levy reductions that are being considered.

Minister Joyce has also raised the issue of different impacts of tax and spending on interest rates. Treasury's previous advice on Budget allowances stated that we consider tax reductions to have somewhat less stimulatory effects than direct government spending.[2] Current practice is to use the operating allowances to manage both revenue and expense initiatives. The Fiscal Strategy Report states that any future tax reductions will come from within the $1.5 billion per annum operating allowances. Nevertheless, a different approach could be taken with respect to ACC levies, although it risks making fiscal management overly complicated, pushes the analysis beyond the limits of its precision and would be difficult to communicate. For example, if it was assumed that levy impacts have interest-rate impacts equivalent to two-thirds of increased spending, then it is implied that the $850 million per annum in ACC levy reductions should be offset by $550 million per annum in spending changes.

Manage the timing

Another option would be to defer the timing of levy changes until macroeconomic conditions permit (eg, wait until an economic downturn). For example, this could be done through a levy rebate that would be paid out in an economic downturn. A levy rebate would also have the advantage of enabling levy rates to be stable and for pricing to reflect cost. However, this would require some foresight about the timing of the economic cycle and would create uncertainty for households and businesses. Deferring also has the downside that the amount of surplus cash would become larger over time.

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[2] Our modelling suggests personal tax cuts would have approximately two-thirds the impact on interest rates of direct government purchases, although this is highly uncertain and would depend on the nature of the specific initiatives.

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Implications for the *Pre-election Economic and Fiscal Update*

Decisions at Cabinet on Monday 4 August would create implications for the fiscal forecasts in the *Pre-election Update*.

The criteria for inclusion of items in the fiscal forecasts are:

- the matter can be quantified for particular years with reasonable certainty; and
- a decision has been taken, or a decision has not yet been taken but it is reasonably probable (ie, more likely than not) the matter will be approved, or it is reasonably probable the situation will occur.

At present ACC have their own funding policy while the Government has the final decision making rights around levy rates. Decisions in the past have demonstrated that ACC's recommendations (based on their own funding policy) will not automatically be accepted.

Under this current situation, applying the criteria above:

- future levy changes could be modelled based on ACC's funding policies;
- however, there is sufficient uncertainty about the final levy decisions so we cannot be reasonably probable of the outcome.

Therefore, under current conditions we do not forecast the Government's future levy decisions.

Under the new funding policy the Government still retains the final decision making rights, however the decision indicates an expected levy path over time. We believe that the probability that the Government will then agree a future levy recommendation based on the funding path has increased so that now it is reasonably probable that the matter would be approved.

On that basis, if Cabinet decides a funding path for ACC on Monday, it will need to be included in the *Pre-election Update* fiscal forecasts. We would also include a discussion in the Fiscal Outlook chapter about the change, and amend Specific Fiscal Risks accordingly.

There will not be an opportunity to include the macroeconomic impacts in the economic forecasts.

If decisions on levies are made now with a decision to charge the cost against future operating allowances, then that implies a pre-commitment of future operating allowances that will need to be made transparent in the *Pre-election Update*.

Next steps

We would recommend deferring the Cabinet decision on the transition to the new funding policy. A decision in early 2015 would allow ACC to take this into account in its work on the 2016/17 levy round. This would allow further time for Ministers to consider how to align decisions with the fiscal strategy.

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Helen Anderson, Senior Analyst, Health, 04 917 6307
Tim Ng, Director, Macroeconomic & Fiscal Policy, 04 917 6124

IN-CONFIDENCE

Reference: T2014/1922 CM-1-3-1-2-3

Date: 13 November 2014

To: Minister of Finance (Hon Bill English)
Associate Minister of Finance (Hon Steven Joyce)

Deadline: For meeting Monday 17 November, 5.00pm

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Aide Memoire: ACC funding policy - issues for discussion

This aide-memoire updates you on ACC funding policy. It accompanies the joint MBIE and ACC briefing, *ACC funding policy – Issues for discussion*, and supports your meeting with the Minister for ACC on 17 November.

As you are aware, funding levels in ACC's Earners' and Work Accounts exceed the target of 100-110 per cent of reported liabilities set by Ministers earlier this year. With the recent fall in funding levels due to discount rates and policy change, ACC projects that the funding target could now be reached more quickly than officials previously envisaged. Forecast levy tracks are still only indicative, however. ACC's funding position is very responsive to economic factors, and could well change again before decisions on the future levy path are made.

Decisions about the general direction of levies beyond 2015/16 could be taken early next year, in the context of Budget decisions and your fiscal strategy. Final decisions on levy rates for 2016/17 and 2017/18 would be made late next year, following public consultation and recommendations by ACC. 2015/16 levies are unaffected.

While ACC's funding position has fallen, it remains too high – and the key issues and trade-offs involved in reducing funding levels have not changed

Officials have previously discussed with you a range of ways of reducing ACC funding levels. In July 2014, noting that applying the agreed funding policy from 2016/17 would mean a projected 20-year transition to the funding target,[1] Ministers directed further work on getting to the target over a shorter timeframe [EGI Min (14) 11/9 refers]. Ministers subsequently:

- considered and rejected returning excess levies as a rebate or using them to reduce debt or some other capital recycling measure

[1] This occurs because of the rolling 10-year funding horizon, which is designed to reduce levy volatility. Effectively, it means that levies would be set s9(2)(f)(iv) to reach the target funding level within the next 10-year period. Since the gap between actual and target funding keeps getting smaller (all else equal) but the adjustment is still spread over 10 years, progress towards the target flattens off over time.

- indicated a preference for reducing funding via a period of low, flat levies, but deferred decisions to align with Budget discussions
- indicated an intention to review the residual levy
- signalled levy reductions of $700-$900m from 2016.

In recent months, ACC's funding position has declined:

- Funding in the Earners' Account has fallen from 137 per cent to 132 per cent, mainly due to the change in discount rates.
- Funding in the Work Account has fallen from 130 to 117 per cent due to the change in discount rates (5 percentage points) and expansion of ACC hearing loss cover (8 percentage points). Expansion of hearing loss cover was agreed by Ministers in February 2014 [CAB Min (14) 6/15 refers].

The decline in funding position does not reflect deterioration in claims performance. This may appear in future forecasts, however, as trends show a rise in ACC claim numbers and entitlement claims and a decline in rehabilitation performance.

The lower funding position means that, all else being equal, the funding target can be reached more quickly. Table 1 below summarises the potential impact on the transition to the funding target in the Work Account (see Annex A of the briefing).

Table 1: Transitions to the funding target band (110%) in the Work Account

	Projected transition (indicative only)	
	July 2014	**November 2014**
Scenario A: Apply funding policy from 2016/17	Length: Approx 20 years	Length: 12 years
Scenario B: Set flat levy rates to get to the funding target	Length: 7 years (9 years to 105%) Projected levy during transition period: $0.63 Projected levy in first year after transition period: $0.98	Length: 4 years (much longer to 105%) Projected levy during transition period: $0.64 Projected levy in first year after transition period: $0.86

Alternatively, the lower funding position means that funding could fall over a longer period, with higher, smoother levies. But smaller levy reductions would mean that:

- reductions would fall below the signalled $700-$900m[2]

[2] The MBIE/ACC briefing does not provide figures for total levy reductions or OBEGAL impacts under the re-forecasted scenarios. These are under development and will be provided once available.

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- if the residual levy were to be abolished while Work levies remained above $0.64, some businesses (those whose injury risks have increased since the residual levy was set) would see a levy rise.

We don't consider that these re-forecast scenarios fundamentally change the key issues or trade-offs involved in getting to the funding target. This is because:

- funding levels remain above the target, particularly in the Earners' Account
- there is still a trade-off between the speed of levy reductions and the smoothness of the projected levy path. Scenario A still involves a long projected transition, while Scenario B still involves a significant rise in levy rates at the end of the transition period
- most importantly, the funding position is volatile and could well change again before decisions are made about the future levy path. By comparison, in December 2013, funding levels stood at 140 per cent in the Work Account and 136 per cent in the Earners' Account.

Taking only ACC into account, we continue to favour a shorter transition – though levy reductions need to be considered in light of the fiscal strategy

Taking only ACC into account, we prefer an approach that would reduce funding levels more quickly. This is because:

- high funding levels diminish incentives to maintain ACC performance. They create the risk that cost increases (for example, due to expanding ACC coverage or performance deterioration) are not fully visible, or that their trade-offs are not fully explored. Returning funds to levy-payers sooner would mitigate this risk
- given the inherent volatility of ACC's funding position, longer-term levy tracks are more unpredictable.

We recommend that levy reductions are considered in the light of Government's fiscal strategy. Decisions on the overall levy path early next year would ensure consistency between ACC levy reductions, Budget decisions and the fiscal strategy, including consideration of the fit between levy reductions and operating allowances.

Helen Anderson, Senior Analyst, Health, 04 917 6307
Ben McBride, Manager, Health, 04 917 6184

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ACC Funding and Levies: Strengthening Financial Responsibility and Transparency

Responsible Person: Ben McBride, 917 6184

First Contact Person: Helen Anderson, 917 6307

Purpose

1. This paper seeks Ministers' agreement to:

    - improve the transparency of the ACC levy-setting process, by setting out in legislation key principles for levy-setting; a requirement to set a funding policy; and related requirements
    - enable the Minister for ACC to discontinue residual ACC levies when they are no longer needed.

Not Relevant to Request

Comment

3. Treasury has been consulted on this paper, and supports its recommendations. The paper reflects previous Ministerial discussions, *Not Relevant to Request* *Not Relevant to Request* (funding policy to be progressed now, *Not Relevant to Request*

Levy-setting

4. We support the inclusion of principles for levy-setting – such as full funding, levy stability and long-term solvency – in legislation, and the requirement to set a funding policy for ACC's accounts, as a way of increasing transparency and promoting stability in the levy-setting process.

5. As the paper notes, these proposals will not necessarily change the outcome of levy decisions. In our view, Ministers' decisions not to accept ACC's levy recommendations over the last couple of years have been driven mainly by the different objectives and perspectives of Ministers and ACC. To the extent that this continues, the legislative principles and associated funding policy will improve transparency but otherwise have limited impact.

6. The ACC funding policy agreed by Ministers in 2014 has not yet been implemented. Ministers may wish to consider how the proposed changes fit with the implementation of the funding policy. While the proposals only provide a framework for the funding policy (rather than legislating for the funding policy itself), there may be risks in introducing a bill that would create a funding policy framework if ACC levy decisions later this year are unlikely to be based on a funding policy.

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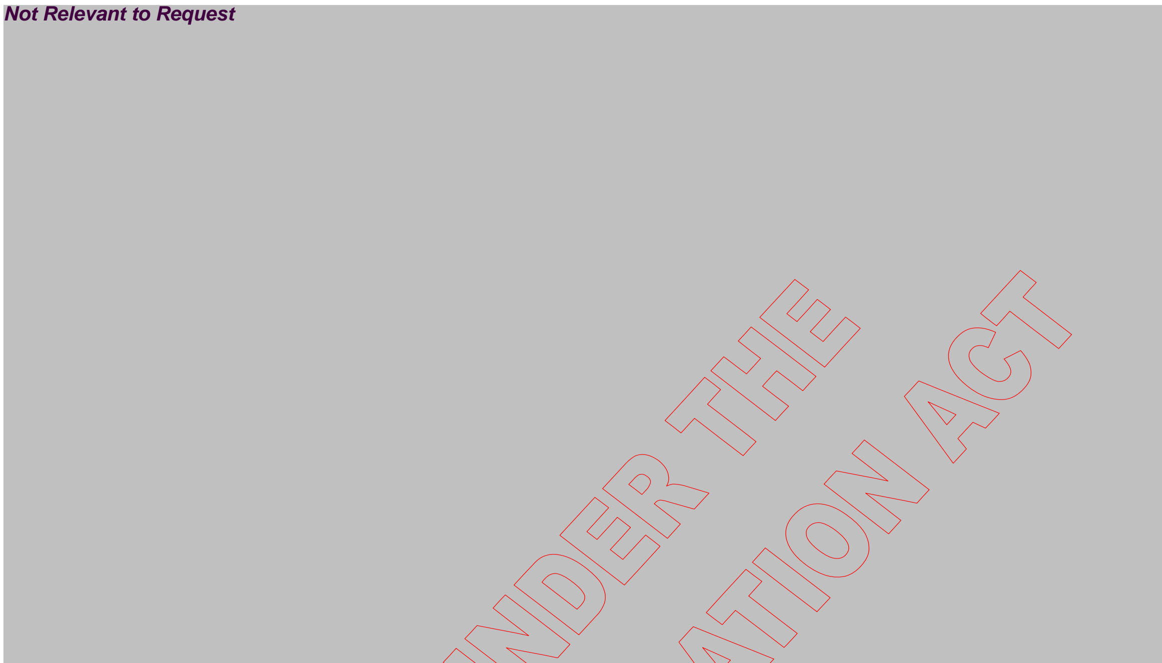
Not Relevant to Request



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Treasury Recommendation

10. We recommend that you **support** the recommendations in this paper.

Title	Pg	Recommend	Fiscal Implications ($m GST excl.)					Treasury Comment
			14/15	15/16	16/17	18/19	Out years	
ACC Funding and Levies: Strengthening Financial Responsibility and Transparency		**Support**	*Operating*					Ministers may wish to consider fit with the implementation of the funding policy, ***Not Relevant to Request***
			-	-	-	-	-	
			Capital					
			-	-	-	-	-	