

By email: [accompricingreview@health.gov.au](mailto:accompricingreview@health.gov.au)

## Submission to Residential Aged Care Accommodation Pricing Review

Pride Aged Living is an industry specific consulting firm, our primary areas of focus are consumer-based revenue streams, (HELF and Accommodation payments (RAD/DAP)). Our clients cover providers all over Australia and across the sector in both ownership and scale. As such we have extensive practical experience in working with and advising providers in the area of accommodation and the related area of investment rationale.

We are making this submission because in our experience the current accommodation regime has the following key deficiencies:

1. Current setting for the accommodation supplement means providers have to charge self-funded residents higher fees, in effect self-funded residents are subsidising supported residents because the current subsidy level is insufficient to support investment in new stock.
2. The setting that allows residents rather than providers to determine their payment preference has the effect that providers cannot manage their balance sheets, which is a fundamental requirement for the efficient allocation of capital and has a negative impact on Return on Equity, which is the driver of long-term investment in the sector.
3. Because RAD increases over time, even if the aggregate level of RAD held by a provider at one point in time was optimised over time, the RAD pool grows and becomes excessive and therefore capital inefficient.
4. To the extent, the current system has resulted in excess RAD being held by providers, this unnecessarily increases the Government exposure under the Bond Guarantee Scheme.
5. While we support the Permitted Use, the restriction on the use of RAD has the practical effect of eroding accommodation financial outcome because it is virtually impossible for a provider to generate risk weighted returns equivalent to the DAP forgone on RAD that is invested under the Permitted Use regime.
6. While RAD is often cited as an interest free loan, the economic cost of a RAD is almost universally higher than the cost of debt.
7. Excess RAD within the system results in providers using less equity and this in turn increases the risk of provider failure.
8. The use of RAD by residents combined with the Permitted Use restrictions impedes the growth of corporate models where the Operator (Opco) and asset owning entities (Propco) are separate economic entities. The separation of Opco and Propco is a common feature within the economy and would unleash significant amounts of capital, especially from superannuation funds to support the expansion of operational places. These are desperately needed and are ultimately the true source of innovation, value to consumers, and provide the mechanism to unwind the sectors reliance on RAD and the Government exposure under the Bond Guarantee Scheme.

## Matters for this Review

With respect to the key areas for review, we make the following submissions.

### Equity of contribution and outcomes regardless of how a particular individual's aged care accommodation costs.

If equity is considered from the residents' perspective, then it could be argued that each resident, irrespective of means, should pay the same accommodation charge for the same room. Under the current system self-funded residents generally pay more than the accommodation supplement. This is not equitable.

If equity is considered from the providers perspective, the existence of the 40% reduction factor is inequitable. The investment in the physical facility is unaltered by whether the resident profile is 41% supported residents or 39% supported residents. This system is not equitable.

From the perspective of Government, not all facilities are comparable and so it is inequitable to ask Government to pay the highest price in respect of all residents.

Based on the above we do not see the current system as equitable.

### Ensuring that low means residents have access to high quality accommodation.

In the current environment demand exceeds supply, while ever the accommodation supplement is materially below the market-based room price, which it currently is, it has the potential to cause those of low means to have less access to high quality accommodation. Providers can rightly say "*we don't have any supported rooms available*".

While there is a disincentive for a provider to be close to or below the 40% threshold, as the supported ratio moves towards 0% the disincentive is compensated by the higher charges (accommodation and HELF) from self-funded residents. Without adjustment to the Supported Supplement rate, we anticipate that supported residents will be disenfranchised.

### Supporting the capacity of providers to invest in and deliver places in high quality residential aged care homes.

The statistics on new places coming online is evidence that the economics for building new places does not add up. While RAD provides a ready source of funding for new developments, it generally does not provide all the capital required.

Investment is ultimately driven by Return on Equity (ROE). This is driven by;

- a. the cost of development;
- b. the mix of equity and debt (RAD or other forms); and
- c. the rent (Accommodation supplement DAP) the facility generates.

In this regard the universal cap on RAD and the lack of a focus on investment return in the assessment criteria for applications for higher RAD's is unhelpful to new developments.

### Fostering a sector able to innovate and attract investment.

As noted above, under the present system it is difficult for investors to become Propco participants in the sector. This starves the sector of capital and innovation. Creating an environment which allows similar ownership structures to that which exist in; hotel accommodation, retail shopping malls and commercial tenancies, which all exist in an Opco Propco environment, is the most efficient pathway for attracting capital which will in turn generate more innovative residential models.

### The adequacy of accommodation revenue, including the supplement.

Pride Aged Living has particular expertise in this area; we have been involved in major projects that have examined and fostered the development of Opco/Propco models. While the evidence we have is too extensive to include in this submission we can demonstrate the following:

1. There is a base return on investment that will attract investment capital in the form of Propco operators to the sector.

2. Having a commercial accommodation supplement is critical in achieving the returns necessary to attract investment capital.
3. Optimising the level of RAD held at the individual provider level is foundational to having adequate accommodation revenue.

The above can be achieved through:

1. Including in the assessment criteria for Higher RADs consideration of the return on investment.
2. The relativity of accommodation charges to local real-estate values (rents and property prices).
3. Setting the accommodation supplement with reference to a benchmark capital value/cost and a base capital return/MPIR.

## Responses to Consultation Questions

### 1. Outline how you think the accommodation supplement could be reformed to ensure quality accommodation for residents of low means.

- a. Removal of the 40% adjustment to the subsidy - this has no economic basis when the subsidy is considered purely as a return on the investment in the capital stock.
- b. Setting the subsidy based on cost of capital and a base price/value per place - this ensures a relationship between the supplement and the value of the accommodation and removes the incentive for providers to favour self-funded residents.
- c. A system similar to the higher supplement for significant refurbishment would be helpful, appropriately rewarding providers for investment/reinvestment in facilities<sup>1</sup>.
- d. Consider replacing the 40% supplement differential with a differential based on the regional supported ratio - this would align the incentive to provide supported places with the true demand for low means places.

### 2. Should the value of the accommodation supplement be universal or tiered such as by location or proportion of residents or other basis?

- i. See 1(b) and (1c) above.

### 3. Should the Higher Accommodation Supplement be staggered over time, so that as the accommodation facilities age, the supplement is reduced (with the full value payable again after a new renovation)?

- a. As noted in 1(b).

### 4. How suitable is the current incentive structure to encourage providers to accept low means residents (a discount on the Accommodation Supplement based on a single threshold of 40% supported residents)? How could those incentives be preserved or enhanced?

- a. It is not, at the current levels providers simply cannot afford to take in low means residents as in addition to unsustainable income from the supplement, providers cannot attract necessary HELF fees from low means residents.
- b. See 1(b) above.

### 5. How can the Accommodation Supplement be reformed to support an uplift in the quality of accommodation?

- a. As noted above, a tiered system based on differential rates for new or refurbished facilities would match return with investment.
- b. A weighted regional scale should be introduced to account for variations in affordability, land values, and construction costs across locations. This would ensure that providers in lower-income or high-cost regions are able to achieve equivalent quality outcomes and remain viable under a nationally consistent framework.

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<sup>1</sup> Note the current investment requirement it's too low. And required a once only reinvestment. A system that required continual reinvestment of meaningful scale is recommended.

- 6. Outline how the Accommodation Supplement pricing impacts on incentives for capital investment in residential aged care.**
- The current supplement level is a disincentive.
  - The gap between the current supplement and that required, together with caps on the Higher RAD, are undermining providers ability to make projects viable.
  - When working with providers on the economics of proposed new developments we are finding that the number of supported residents targeted directly impacts viability with lower supported ratios being associated with more sustainable projects.
  - Our analysis of clients' financial positions often shows that reducing the proportion of supported residents is the only way to maintain a sustainable economic position within the current regulatory framework. This outcome is at odds with policy intentions to promote equitable access for supported residents and highlights the need to realign supplement settings with actual capital and operating costs.
- 7. In what ways could the Accommodation Supplement be reformed to better incentivise capital investment in residential aged care?**
- See comments above.
- 8. To what extent are the current rates of the Accommodation Supplement sufficient to cover providers' capital and operational costs relating to accommodation?**
- Totally inadequate. Supported by the Stuart Brown survey data on accommodation. At a macro level the accommodation return required to support investment are 7.5%. With construction costs circa \$500,000 this equates to a supplement materially higher than the current levels, circa \$102pd.
- 9. How does the costs of providing accommodation vary across different operating environments, such as differences in location?**
- We do not have sufficient data to comment specifically on this. However, it is reasonable to expect that factors such as land values, construction costs, and labour availability would contribute to material variations across regions. Further sector-wide analysis and transparent cost benchmarking would be valuable to quantify these differences and ensure that funding models reflect actual cost structures.
- 10. What factors should be considered in setting an equivalence mechanism and rationale for each?**
- Investment in real estate requires long term stable yields. The MPIR is fundamentally a short-term variable rate. Basing the MPIR on the cost of capital or on a longer-term average rate would provide appropriate equivalence from an investment perspective and would also remove the price differential between residents who enter under different prevailing MPIR rates.
- 11. What is an appropriate rate of return on lump sum for providers? Is this an appropriate level for setting an MPIR?**
- The most authoritative document we have seen on this is the report by Frontier Economics to the Royal commission <https://www.frontier-economics.com.au/aged-care-royal-commission-the-required-return-for-aged-care-service-providers/>. They concluded that the rate was 7.63%. This is consistent with our research finding that the required initial rental yield is between 7.0% and 8.5%.
- 12. How does this change with economic conditions? Does the MPIR link to the General Interest Charge represent an appropriate way of adjusting equivalence in line with economic conditions?**
- Refer to the Frontier Economics report.

**13. Would a Weighted Average Cost of Capital be an appropriate equivalence mechanism? If so, how should this be derived?**

- a. Refer to questions 11 and 12.
- b. Weighting is difficult in the sector as the NFP and FP segments have different approaches to the use of debt and access to equity.
- c. If you adopt a weighting of debt, then this must include RAD and if it does, then control of the extent of RAD taken should be vested in the provider.
- d. Using a weighted approach also removes the shifting preference by residents for RAD and DAP which provides greater economic certainty to providers.

**14. Is there a case for an equivalence range rather than a single point of equivalence defined by the MPIR and why? How might this work?**

- a. If you adopt a ROE model, this question is resolved.
- b. There is an argument that regional areas would require a higher rate of return as there is less capital growth,

**15. Should the Government introduce a mandated minimum accommodation payment that prevents providers receiving less revenue from non-supported residents than they do from supported residents?**

- a. We do not support mandating a minimum payment as this continues a policy that disenfranchise providers from managing their debt and equity mix.
- b. A provider with no growth ambitions requires very little RAD, whereas a provider with growth ambitions or is looking to undertake a refurbishment, will be more inclined to accept RAD.
- c. For the above reasons we support a model where providers can set their preference for payment.
- d. While the RAD retention had removed some of the disincentive from a provider's perspective of holding excess RAD, from an investment perspective the fact that the RAD is fixed for the period of occupancy works against sustainability. Within the Real Estate Investment Trust market (REIT) the drivers of long-term sustainability are:
  - i. Initial investment return >7.5%
  - ii. Indexation of rents from existing tenants (residents)
  - iii. Ongoing increase in the base rate of rent.

Lifting the RAD limit to \$750,000 and indexing this partially addresses point (i).

The indexation of DAP addresses point (ii), however as the RAD is not indexed this is only partially effective.

Increasing the base price is an area where providers have to demonstrate more economic sophistication.

**16. What are the advantages and disadvantages of moving the MPIR-related fluctuations in pricing from the DAP to the RAD?**

- a. As noted above, investment is long-term while the MPIR is a short-term rate. To attract capital the investment yield needs to be stable. To counteract this, providers currently adjust the RAD upwards as the MPIR rate falls. In general, they do not then adjust the RAD down as rates rise. This disadvantages consumers.
- b. In tighter economic conditions, or when the MPIR has risen providers may discount RADs to achieve the same economic outcome or to maintain occupancy. However, once lower RADs are established, it is difficult to re-apply for renewal or approval at higher RADs, even when necessary to achieve viable returns or reflect updated replacement costs or lower MPIRs, effectively locking in unsustainable pricing.

**17. Would setting DAPs as the default make accommodation pricing easier to understand for prospective residents and their families?**

- a. Fundamentally, residents are renting their room, this is consistent with the relatively short-term nature of their tenure. In this context the concept of “buying” the room on a guaranteed repurchase price (the economic impact of paying a RAD) is curious. Given that the Permitted Use restrictions also have a negative impact on the potential investment yield on excess RAD relative to the DAP, it also negatively impacts the EBITDA of providers,
- b. In our experience once a provider says “Our RAD is” in response to the question of “how much does it cost to come here”, this embeds in the mind of the enquirer that they have to pay a lump sum. Given the stress associated with moving into care and the many negative impacts of the resident finding the lump sum funds, changing to a system where the default is a DAP would in our experience be beneficial for all stakeholders.
- c. We are advocates of combination payments with a draw down. This requires less up-front funds from the resident and allows them to tailor an ongoing payment structure that suits their individual position. The sector has not embraced the consumer benefits of the combination payment. We welcome the opportunity to provide more detail on these benefits from both the consumer and provider perspectives.

**18. Are there other relevant factors to consider in relation to setting the DAP as the default payment type?**

- a. Clearly providers will have to work through refinancing their operations as RADs decline. This is another reason why we support giving providers the decision on their preference for RAD or DAP.
- b. The availability of RAD has some advantages over traditional debt, namely in aggregate it does not have to be repaid while most traditional debt does require repayment over time. If the provider has the decision on its payment preference, noting that if their preference does not accord with the resident, then residents will go to another provider, this allows the provider to take in RAD if and when this is appropriate in terms of their refurbishment cycle, new builds and to cover initial losses.
- c. The new Default Minimum Liquidity amount is a significant issue if the DAP becomes the default mechanism, as this imposes a very significant inefficiency in capital management.
- d. There is often much discussion of the inability for the sector to attract debt. We consider this to be an inappropriate discussion. Debt and equity flow to where there are appropriate returns. Creating more flexibility and equity in the accommodation payment structure will facilitate the exchange of RAD for debt and equity.

**19. Do you think the DAP should be set as the default payment type? Why**

- a. No, as stated herein we support a system where providers are able to manager their balance sheets. In this context we support the current regime of Permitted Use and the Evaluated Minimum Liquidity Amount (EMLA), which provides appropriate governance over the use of any RAD taken in by a provider.
- b. We advocate for providers to have the decision on the mode of payment they receive.
- c. We also support a model where there is a requirement to offer a minimum number (%) of self-funded places under a RAD.

The Directors of Pride Aged Living are highly respected in the sector and have developed a number of innovative models and approaches to accommodation including:

1. Excess RAD evaluation model;
2. Single Payment Plan;
3. RAD pricing methodology;
4. EMLA assessment methodology;
5. Capital project evaluation model;
6. Conducted extensive detailed research into rental yields under Opco /Propco arrangements; and
7. Facilitated Opco Propco arrangements.

Given our experience we welcome the opportunity to assist the Independent Panel in its deliberations on these important matters.

Regards,





Director